Banking resolution: Spanish lesson

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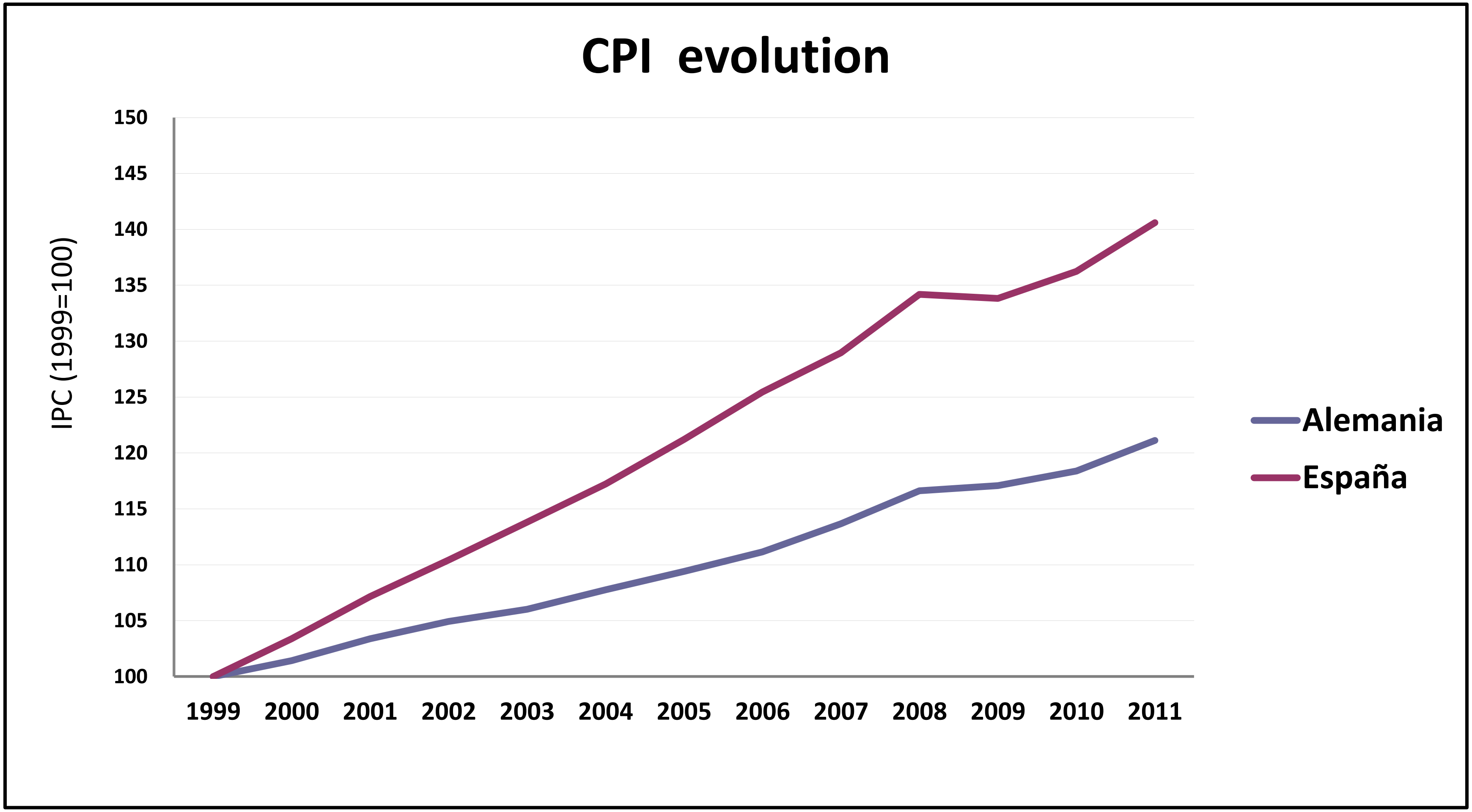
Characteristics of the Spanish economy before 2007

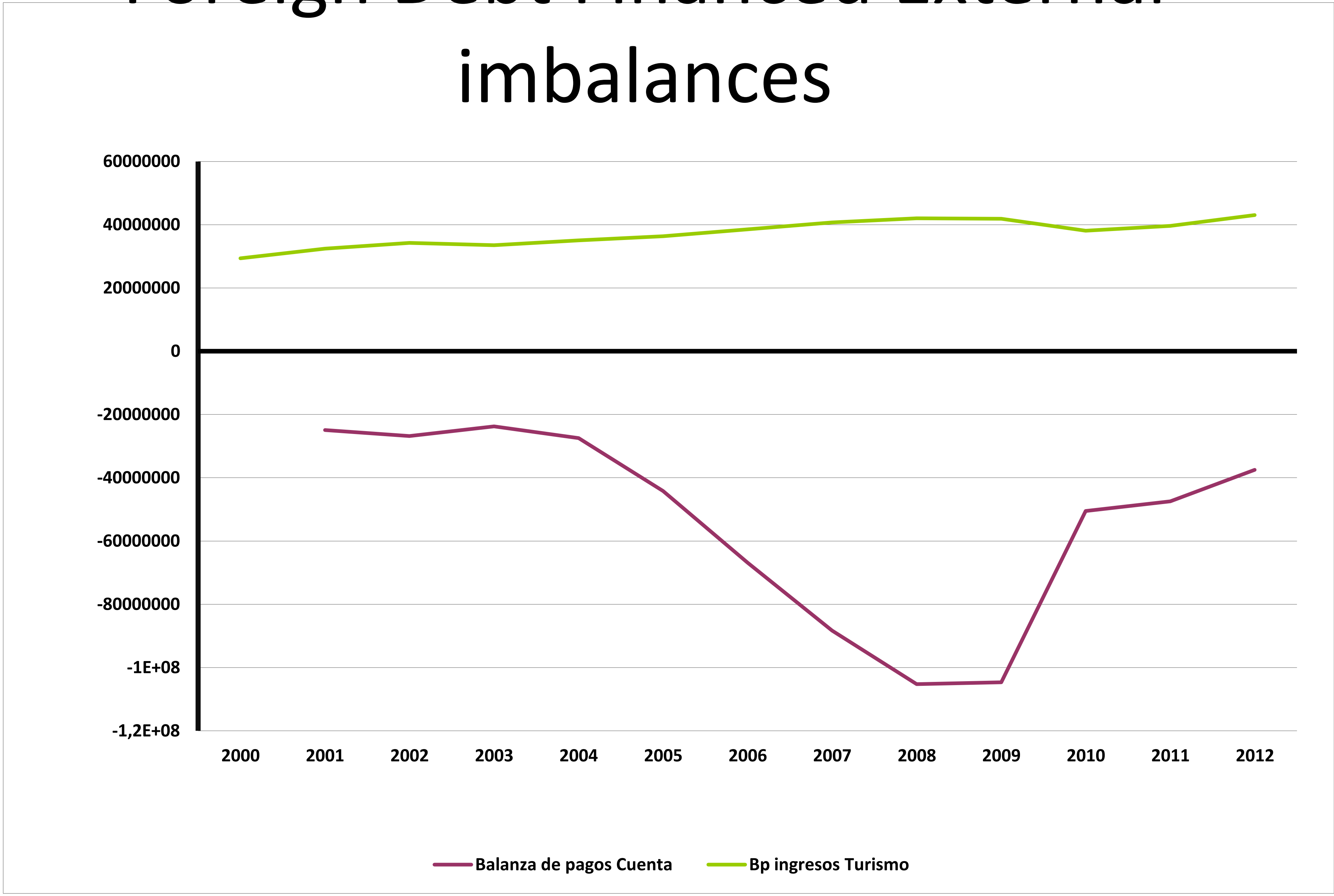
- High growth
- Low productivity
- Negative real interest rates
- External imbalances
- Low levels of government debt
- Potential real estate bubble
  - Ratio of real estate price to rent >4
  - Return on rents <3%

Low productivity growth

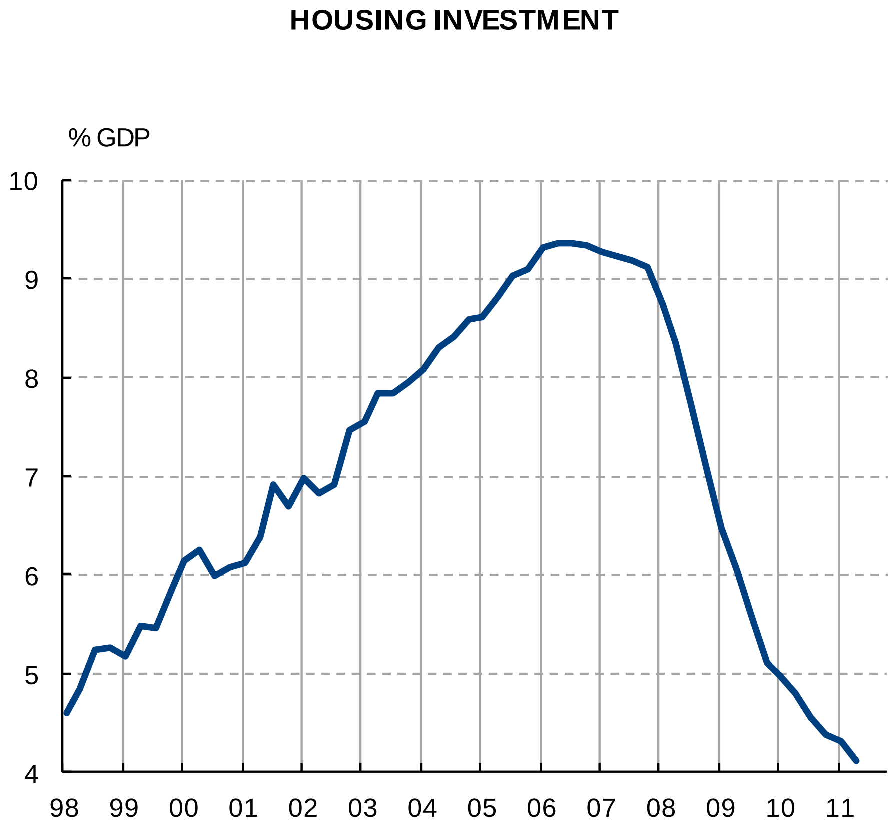
Loss of competitiveness

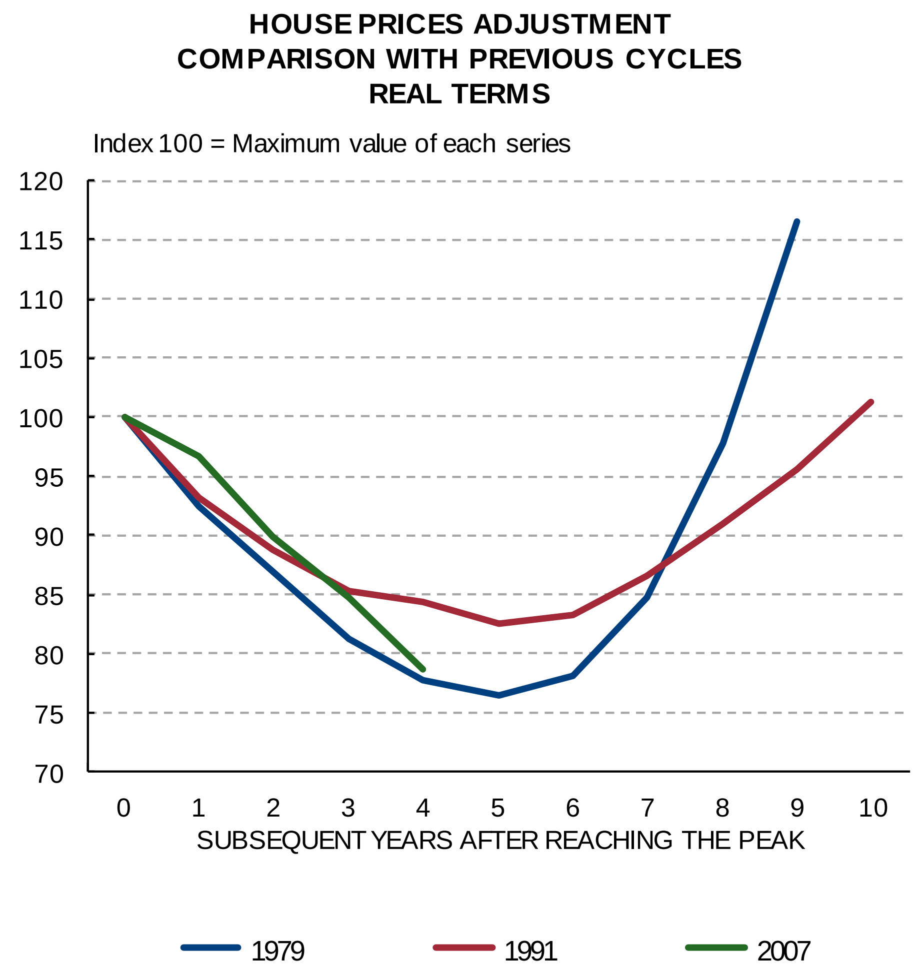


Foreign Debt Financed External imbalances

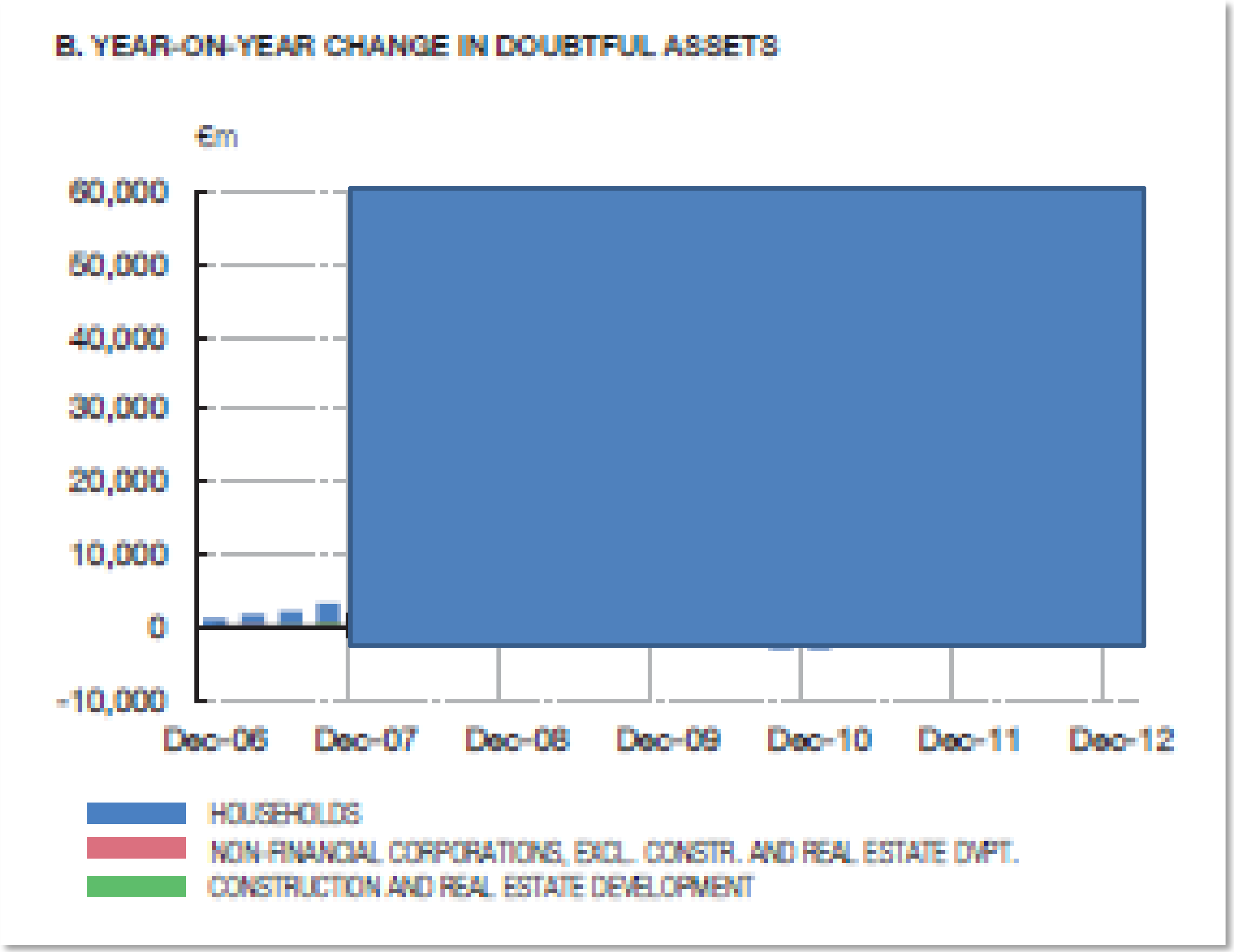


Real estate: quantities and prices





Doubtful assets



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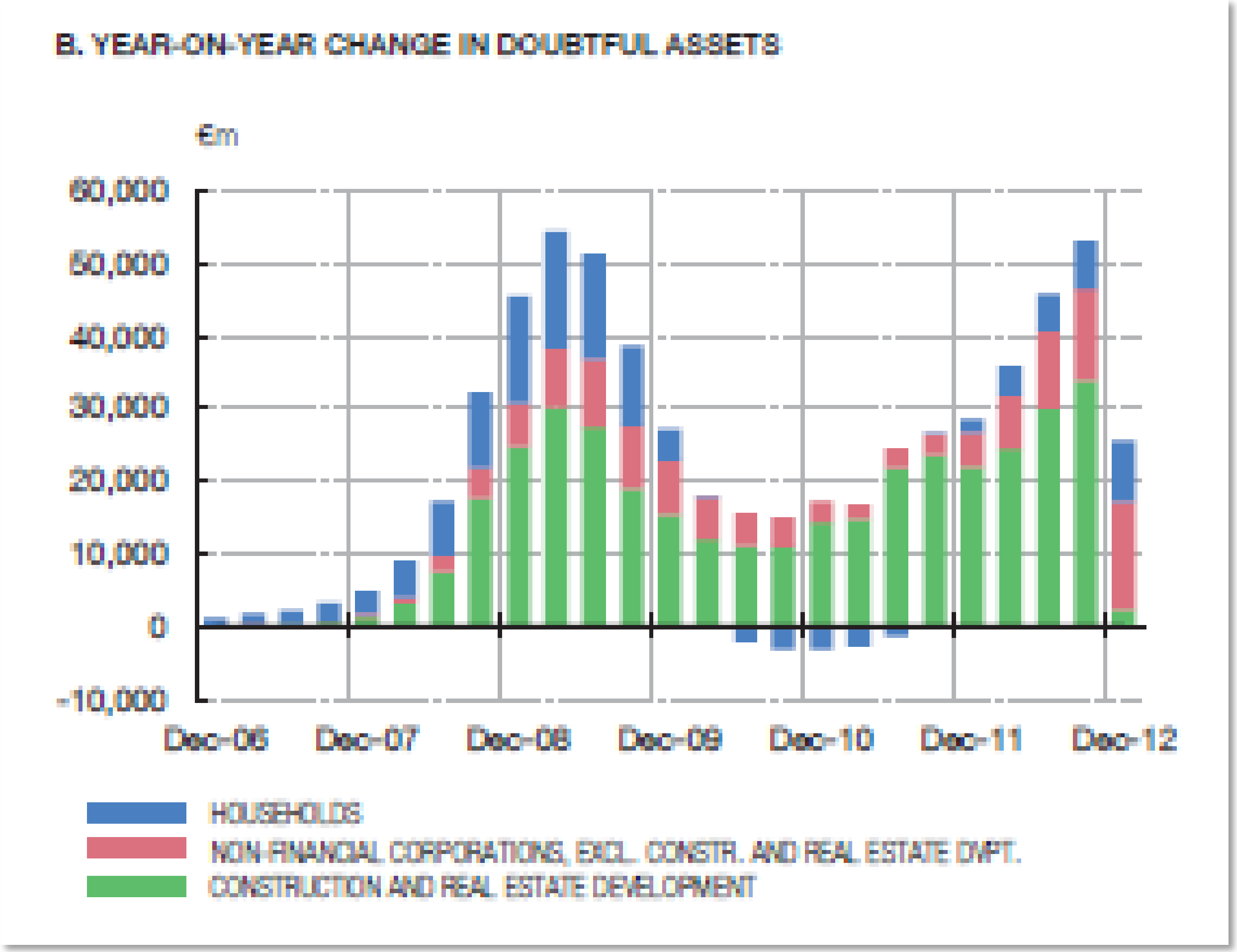
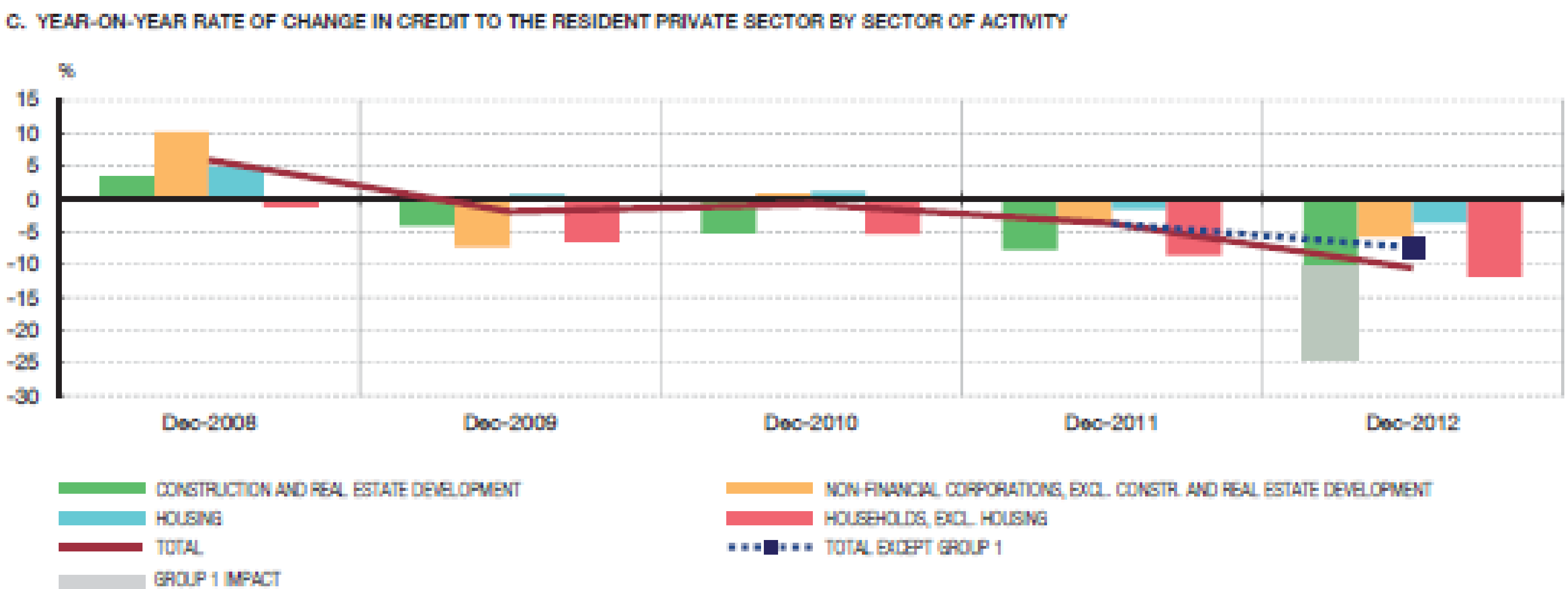


Macro projections

- End of year unemployment rate is improved to 26.6%. Forecast for 2014 is 25.9%. The reason for the improvement is the decrease in the labor supply, not any creation of employment.
- GDP rate of growth of -1.3% for 2013 and 0.7% in 2014.

Negative credit supply



Rigorous microprudential policy

- Strict definition of securitization (no liquidity lines)
- Dynamic provisioning
- No subprime credit
- A downturn was expected, but why a **banking** crisis?

Five lessons

1. Banks' bankruptcy procedures are important
2. Political economy considerations are important
3. Liquidity is important
4. Corporate governance is important
5. Macroprudential policy is important

1. Banks' bankruptcy procedures are important

- Small cajas faced difficulties related to property developers' problems
- Universal bankruptcy code
- Solution: protect all debt holders and merge all small cajas
- The merged cajas lack capital
- Solution: Government support combined with the issue of retail subordinated debt (lack of investor's protection)

European solution

- Theory: lex specialis for banks' bankruptcy is much more efficient
  - Limits the cost of shareholders bargaining power
  - Limits the externalities originated by banks' bankruptcies
- MOU forced Spain to draft new legislation (August 2012)

2. The political side - Chronology (I)

2008

- Start of the Keynesian fiscal policy. (Government budget deficit : 4,2% of GDP)

2009

- Creation of The *Fund* for Orderly *Bank Restructuring* (FROB) to protect investors (Budget deficit reaches 11%)

2010

- Budget deficit : 9,24%

Chronology (II)

2011

- July 15th European Stress test: 5 “cajas” saving banks fail the test
- November 29th. S&P downgrade for 37 Spanish banking institutions (Budget deficit: 8,51%).

2012

- February: new government
- Spanish sovereign risk premium at 547,9 basis points
- Acknowledgement of the real estate bubbles and new provisioning rules
- July 20th European MOU
- August Spanish resolution law for credit institutions

3. Liquidity matters

- The Spanish credit expansion was financed by German savings
- Spanish banks issued covered bonds in the wholesale market
- This lesson is characteristic of the 2007 crisis worldwide (US with originate and distribute, Northern Rock, etc…)
- Solution: Basel III Net Stable Funding Ratio (Liquidity Coverage Ratio may be more problematic)

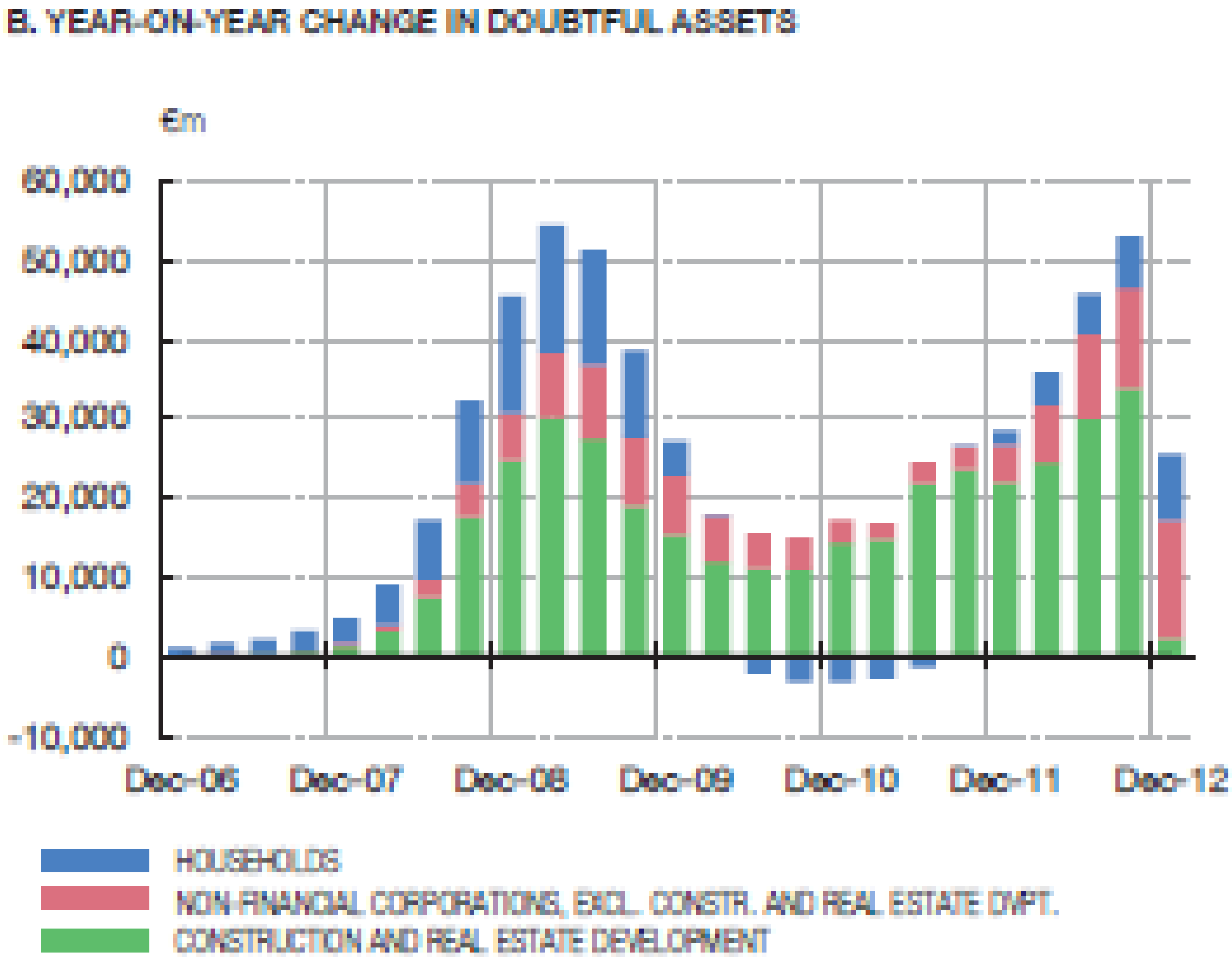
4. Corporate governance is important

- What do we know about banks’ corporate governance
  - High debt
  - Low market discipline
  - Executive compensation short term oriented promotes risk taking
  - Boards: Independence is not enough. Expertise and engagement are also critical
- Corporate governance of “cajas”,Cuñat y Garicano, 2010.

5. Macroprudential policy

- The real estate bubble (with Loan to Value ratios of up to 100% and value appraisals by related parties) was only acknowledged when it was too late.
- There was no bubble provided growth continued.
- A case of the « composition fallacy »
- New housing starts was 750.000 in 2007 (In the US at the peak new housing starts was twice that number)
- External imbalances: balance of payments and foreign investment to cover private and public debt

Contagion was underestimated



Good bank / bad bank

- A bad bank, SAREB, is created to dump toxic assets valued at market price. More than 50% is private capital.
- The bad bank is extracted out of the assets of the distressed bank.
- Problem: the good bank has to be recapitalized.
- Different from the Danish solution, where the good bank is extracted from the assets and insured deposits of the distressed bank.
- Corporate Governance.

Extrapolating

- Some of the lessons are already in Basel III: NSFR.
- Central banks actual independence?
- Is the countercyclical buffer enough? Excessive credit ends up in a crisis only once every three times. Modigliani Miller lead to capital injection, but under market imperfections it is a costly solution. Yet contagion could be minimized leading to an optimal mix: countercylclical buffers and contagion proof bankruptcy rules

Extrapolating (II)

- Corporate governance is an issue as board represent shareholders. Deposit insurance company should be represented (?) or, better, in case of a bank bankruptcy, depositors should get the good assets in the good bank bad bank separtation. Again: clear cut bank bankruptcy procedures (bail-in).
- Corollary: investors protection is essential

To conclude

- Spain had an excellent microprudential regulation but
  – Lack of credible bank bankruptcy mechanisms
  – Lack of macroprudential framework
  – Weak corporate governance
  – Political decisions to support economic activity

  were sufficient to lead to the current banking crisis.