

# The impact of the crisis on the financial system<sup>\*</sup>

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The international financial crisis that started in August 2007 has had devastating effects on the financial systems of many countries in our geographical area. However, it seems to be clear that its first impact on Catalan and Spanish banks has not been as destructive as elsewhere. The most significant fact is that so far, Spanish authorities only had to intervene to prevent one bank to go bankrupt, while the rest of the branch has survived without massive direct public aid a considerable amount of banks in other countries needed. This opinion is shared by international organisations. The OECD 2008 report on the Spanish economy, for instance, states the strength of the finance sector as one strong point to possibly find a way out of the economic crisis.

<sup>\*</sup> I would like to thank the director of the magazine, Enric Llarch, for his comments on this article's first version.



## Introduction

It cannot be said that the Spanish banking sector has remained completely immune to the financial troubles that have appeared in recent months. In fact, some observers state that the worse for banks is still to come. Strong dependence of the Catalan and Spanish economy on building and the exhaustion of the growth model that prevailed over the last fifteen years leads to think that it is almost inevitable that the next months are characterised by more traumatic events, such as severe problems coming up in some banks, which could lead to consolidation processes in the sector or even to more direct intervention by authorities.

### **The exhaustion of the growth model that prevailed over the last fifteen years leads to think that it is almost inevitable that the next months are characterised by more traumatic events.**

This article intends to do a short analysis of the reasons for which Spanish banks have so far proved to be quite resistant to international financial turmoil and why this may change in coming months. The last part of the article will include some considerations on the possible development of the branch in the medium term given the changes that will occur in the international financial landscape due to the crisis and necessary business reorientation within the new setting that will require self-assertion of the Catalan economy.

Before getting in detail, two previous considerations on the scope of the article are to be made. First, the financial system is made up of three groups of organisations acting in different markets, although they are becoming increasingly integrated: banks, insurance companies and retirement funds and finally stock markets. Given the importance of banks in Catalonia's

financial structure, this paper will relate basically to that group.

As to the scope of analysis, it is difficult to define what the constituting element of the Catalan banking system is. On the one hand, there is a set of organisations having their headquarters in Catalonia and operating all over Spain and the world, whereas on the other, there are all banks operating in Catalonia, no matter where they are based. This paper will refer especially to the latter, which is basically made of Spanish-based banks.<sup>1</sup> Within them is the group of banks and savings banks having their headquarters in Catalonia, to which some specific reference will be made.

## Starting point

The starting point for the finance sector, in which the financial crisis beginning in summer 2007 was triggered, can be described out of a set of structural features that will be the foundations to explain the current state of affairs and future perspectives of the branch. These features can be summarised as follows:

- First: High economic growth in Catalonia and Spain has been followed by unprecedented credit growth in the private industry. Ever since the **European Monetary Union (EMU)** has been in force, Spain has been the EU-15 country with the highest growth in total capitalisation value as of GDP, a frequent indicator for financial development.<sup>2</sup>

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In this respect, there are several things to be said. First, the relevance of financing by banks as of the total, which is comparatively higher than the EU-15 average, shows the relative importance of the banking sector in Spain's financial structure. Second, there is no doubt

that growth in the building sector has acted as the main driver for this growth in financial brokerage.<sup>3</sup> Concentration of credit risk in this sector is, as we will see further on, one of the main threats for bank soundness. And last, growth in the banking sector has been higher than that of deposits in recent years, thus triggering the need for Spanish banks to increase their financing from wholesale markets, especially by issuing mortgage bonds. In this respect, it is very important to point out that the integration of the Spanish economy into the European Monetary Union has allowed to seize most of this financing from foreign investors, especially from fellow EMU countries. In fact, some studies on the process of European financial integration (cf. MAUDOS, 2008 and the references it contains) point out that Spain is one of the countries benefiting most in terms of GDP growth from progress in building the single finance market following the creation of the European single currency.

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- ▶ Second: Spanish banks have remained loyal to the more traditional «buy to keep» (BK) banking model, as opposed to many international organisations that have been progressively inclined towards the alternative «originate to distribute» (OD) model. Both are radically different. The BK model is the one everybody knows: banks are financed through partly short-term deposits to grant long-term loans. As a consequence, they keep most of their credit risk in their balance sheet and keep incentives to assess it correctly. Contrarily, in the OD model the bank does not keep the credit risk in its balance sheet but conveys it to savers by means of issuing often highly complex financial instruments (securitisation) by which the risk is spread to the point that it is often hardly transparent. This makes incentives

for the bank to correctly assess risks much lower than in the other model. Bad alignment of incentives to ensure adequate risk selection and lack of transparency characterising this financial maze are at the origin of the present financial crisis. The model followed by Spanish banks has been characterised by being traditional retail banks based on capturing deposits and commercialising different financial products through a very extended network of branches allowing to maintain long-term relations with customers.

### **The model followed by Spanish banks has been characterised by being traditional retail banks.**

- ▶ Third: The regulation and monitoring policy by the Bank of Spain has contributed to bigger stability in the Spanish finance sector than in most neighbouring countries and has been highly appreciated by international organisations. The most prominent distinctive feature of the policy of the Bank of Spain are so-called «dynamic provisions», an instrument of preventive regulation to address the problem of pro-cyclicality of credit risk in banks: in the bullish phase of the cycle, credit grows above average and delinquency is reduced, while in the bearish phase the opposite occurs. Adopting dynamic provisions has forced Spanish banks to create major provisions in times of strong credit growth without the delinquency rate justifying it necessarily, but then it has allowed those banks to enter the troublesome phase of the economic cycle being better prepared to address the typical increase of delinquency.

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► Fourth: Current account debt has been one of the most typical features of the Spanish economy in the last years. Investment expenditure clearly above savings generated inside the country have created an increasing financing need. Most of this foreign financing has been canalised through the banking system, which allowed it to maintain the growth of credit to the private industry thanks to funds raised in international wholesale capital markets by issuing financial instruments (especially mortgage bonds). It is obvious that without integration of the Spanish economy in the EMU it would have been very difficult to attract this capital coming mainly from other EMU countries.

### **At the outbreak of the financial crisis, the Spanish and Catalan banking system was in a situation that can be considered solid.**

As a consequence of the above-mentioned items, the Spanish and Catalan banking system was in a situation at the outbreak of the financial crisis that can be considered solid. To underpin this assertion, two pieces of work shall be mentioned here. On the one hand, there are the surveys on indicators typically used to measure and assess the state of the financial system (liquidity, solvency, profitability, efficiency, etc.) and allowing to consider the situation of Spanish banks in relation with those from the rest of Europe as generally positive.<sup>4</sup> On the other, the International Monetary Fund (IMF) made a thorough examination of the Spanish financial system in 2005 as part of the programme to assess the financial system of the organisation's member states. Despite some recommendations for improvement, its concluding remarks clearly point out the strength of the Spanish finance sector (for details on this survey, cf. [IMF, 2006](#)).

The financial brokerage branch in Spain saw how labour productivity increased at an astonishing annual rate (7.62%) during the 1999-2005 period, far above its growth in 1995-1999 (MAUDOS, 2008). This rate contrasts with what occurred in the

Catalan and Spanish economy, where productivity growth proved to be anaemic during the same period, and also with the evolution in the same branch in the rest of EU countries. The key to explain this is the increase of total productivity of factors, defined as the part of labour productivity growth that is not attributable to improvement in its quality nor to the increase in capital use. We believe that the two decisive factors to explain this excellent performance in labour productivity have been high growth in bank activities allowed by recent economic development on the one side, and financial integration with European countries on the other, which provided the possibility of raising additional financing sources for the branch. The problem that is posed now is that slowdown in lending can soon translate in serious problems of excess capacity in the branch, especially when considering the business model of most banks, based on keeping a wide branch network throughout the country.

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## **Direct impact of the international financial crisis**

When the financial crisis broke out, many international analysts singled out the Spanish banking system as one of those that could experience major problems. The reasons for this forecast were three: a high need of foreign financing, dependence on wholesale markets affected by acute lack of liquidity, and exposure of the branch to the real estate market. However, as has been previously mentioned, nothing of what may have occurred in the finance sector in Catalonia and Spain is moderately comparable to what has happened in the United States and a considerable number of European countries. What are the clues of this relatively

good performance of the Spanish financial system?

### **Lack of liquidity in international wholesale markets has eventually toughened the conditions by which Spanish banks can raise some sort of financing.**

First of all, direct and indirect exposure of Spanish banks to **subprime mortgages** was almost non-existent (less than 0.03% of total assets). The existence of growth opportunities in the domestic market partly explains the little interest of Spanish banks in this kind of products a good deal of European banks were actually featuring in their balance sheets. Secondly, on the passive side, Spanish banks have traditionally kept a solid deposit base. Thus the resort to international wholesale markets, which became increasingly important in recent years, has been tackled by means of securitisation of top-quality portfolios with long-term maturity dates and very different from those causing troubles in other countries. Securitisation of Spanish banks was conceived as a mechanism to raise financing rather than to transfer risks, so Spanish banks did not need to create complex and opaque structures leading a life of their own apart from balance sheets as if they were parallel banks. However, it is true that the great lack of liquidity that overcame international wholesale markets has eventually toughened substantially the conditions by which Spanish banks can now raise some sort of financing. This caused banks to increasingly turn to the European Central Bank in 2007 and 2008. As long as markets do not settle, this will be an obstacle to normal functioning of the banking system.

## **Domestic problems**

The current situation of the Catalan and Spanish economy is characterised by two clearly interrelated points feeding back each other. The one is the collapse of the building industry that had

been a main driver of economic activity for years; the other is the deep recession the economy is in, which will arguably go on for some months and is of unprecedented size in recent times. These two items are the biggest risk factors for credit institutes.

### **The current situation of the Catalan and Spanish economy is characterised by two interrelated points: the collapse of the building industry and deep economic recession.**

The building industry has reduced its activity considerably, and transactions in the real estate market have plummeted. As a consequence, real estate prices are adjusting to new economic circumstances, albeit gradually. This creates distress in many banks. Generally speaking, exposure of the banking sector to real estate loans in Spain is twice as high as the EMU average. The attached chart shows it, making a difference between credit to families and building or developing companies. It is true that some factors can alleviate the impact of this sort of troubles on financial brokers. For instance, mortgage lending to families has been kept within relatively cautious levels, with rates of credit on estimated real estate values hardly surpassing 80% (though the appraisal system to set real estate prices for lending is prone to abuse by banks).<sup>5</sup> This is shown by banks keeping in their balance sheet most of the credit risk they generate, thus being forced to manage it in an appropriate manner. Nevertheless, the main risk probably concentrates on credits given to developers, who are directly affected by the decline in transactions in the real estate market as well as price reductions. Some observers assert that these are the true «toxic assets» of Spanish credit institutions, most notably savings banks.

The change experienced on the Catalan and Spanish macroeconomic stage within few months has been considerable. Growth rates above 3% (2007) have been replaced by negative forecasts expecting even a 3% decrease for

2009 amidst an international landscape giving no hope for optimism. The evolution of employment, one of the big uncertainties about the direction the economy would take upon the outbreak of the crisis, has confirmed the worst expectations. The dramatic decline in demand as well as financing difficulties have increased the number of companies struggling with problems that may affect their very survival. All this, amidst a context of strong leveraging of the private industry, has caused a rapid increase of delinquency rates.

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Nevertheless, different factors such as lower interest rates or better credit risk management by banks have led to bad debt ratios at the beginning of the bearish phase of the economic cycle that were clearly under the levels featured

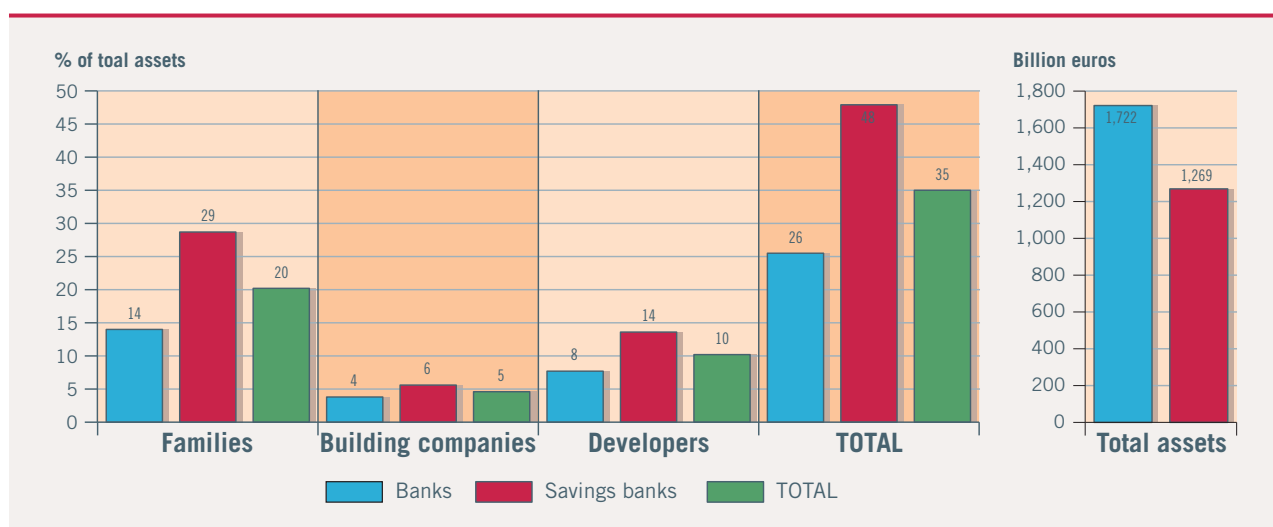
at the outbreak of the previous major crisis (1992-94),<sup>6</sup> though its spread over banks is today much higher. Given these data and the size of the current economic crisis, unprecedented in recent times, solvency troubles in the finance sector are to be expected, but they will not be of systemic character and concentrate on a relatively small number of banks.

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## Future perspectives

An analysis of what the future may bring can be done at two clearly separate levels. As to its immediate effects, the evolution of the finance sector will largely depend on how measures implemented by central banks and governments, among which the Spanish, will

**Graph 1. Bank credits related to real estate, 2008**



Source: Boletín Estadístico del Banco de España and own

▲ Exposure of the banking sector to real estate loans in Spain is twice as high as the EMU average.



work to counteract the worst effects of financial collapse. In the medium and long term, the effects of economic slowdown will also affect decisively the strategy of the different stakeholders involved in the branch for the following years.

Given the financial crisis, measures by economic authorities have been generally addressed to meet a set of goals. First, to halt generalisation of mistrust of the banking system. It can be said that this has been achieved by enlarging coverage of guarantee funds for deposits as it has been implemented throughout Europe in a more or less coordinated way and with the commitment of authorities not to allow potential bankruptcies to affect depositors. The second goal was to improve liquidity supply for banks, for which the European Central Bank introduced changes in its lending conditions for banks, and the Spanish government in its turn gave public guarantees for given bond emissions of banks, creating the **Financial Asset Acquisition Fund**. Although these actions have contributed to stabilising the situation of banks, it cannot be said that they have actually managed to prevent the inevitable decline of credit lending.

Finally, with the aim of securing medium-term solvency of banks, the government provides the possibility of recapitalising those having severe problems with public funds. This is a measure that has not been necessary to implement so far. The creation of a bank concentrating the most troublesome assets in the system («bad bank») or nationalisation of a bank are possibilities that have not been seriously envisaged in Spain yet. This is only likely to occur as a last resort if the situation goes on deteriorating. The analysis of all implications of such intervention is excessively complex to be considered in this article. However, as an example, I would like to point out two areas of economic policy that can be deeply affected. First, there is no doubt that some of these actions are more or less explicit subsidies to given banks, and it remains to be seen how competition is ensured in the banking market. Secondly, we

will have to see what the consequences of such measures will be regarding growth and sustainability of public debt.

### **Measures by economic authorities have been aimed at meeting three of goals: to halt generalisation of mistrust of the banking system, to improve liquidity supply for banks and to secure their medium-term solvency.**

From a more structural point of view, it is obvious that the direct effects of the economic crisis are causing a reduction of activity in the finance sector and an increase in the delinquency rate, while the financial crisis has pushed financing costs for banks. This brings to the conclusion that bank benefits will be considerably lower for some years, so the need of companies in this branch to implement cost containment and rationalisation policies becomes apparent. In this respect, two points are noteworthy: first, the start of possible consolidation processes in the branch that may swallow up inefficient and unfeasible banks; and second, the need to rethink the current model of commercial distribution, based on a wide and costly branch network.

It also seems to be obvious that from the moment the economy starts recovering, banks will redo the structure of their balance sheets, reduce the relevance of real estate financing and increase that of non-financial companies from the rest of branches, especially small and medium-sized enterprises (SMEs).<sup>7</sup>

The main changes in the industry regarding both the business structure and regulation are likely to concentrate on savings banks. Their considerable importance in our country makes this issue an especially relevant one for the future of the Catalan economy. Generally speaking, the present situation of savings banks is more complicated than that of banks, as they are more exposed to the credit risk derived from problems in the building industry, their growth has been based on enlarging their

branch network, which may lead to large excess capacities under the new situation, and they are having more difficulties than banks in seizing resources and improving the quality of their capital. Savings banks have a peculiar legal structure, which is explained by the social mission going back to their origin and being their inherent characteristic, while also representing the origin of the two main problems that may threaten their survival as we know them today: insufficient own funds and risk of politicalisation of their governing bodies.<sup>8</sup> Nevertheless, we must not forget that if we look at what has occurred in the last thirty years, the savings bank model has been a considerable success (especially considering the present international landscape) regarding their growth their solvency and the drive of their social work. Losing this

heritage because of problems restricted to only some organisations and regions would not make much sense, especially from a Catalanian perspective. The problem of politicalisation can be solved with duly restrictive legislation as the case of Catalonia shows. The issue of seizing capital, a more important one from our point of view, is more difficult to solve as almost non existent use of share quota so far, the instrument provided for by legislation to facilitate capitalisation of savings banks, has proved. The current dilemma of savings banks is that if they move towards a shareholder structure (i.e. shares with some kind of political right), their very essence will be completely challenged, while holding to the current system dooms them to retain benefits as the only realistic way of seizing own resources.

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## Notes

1. The market share of foreign banks is relatively low, both in Catalonia and in the rest of Spain.
2. This rate grew at a 10.3% (annual average rate) in Spain during the 1999-2007 period, as opposed to 2.2% in the EU-15 (MAUDOS, 2008).
3. FERNÁNDEZ DE LIS and GARCÍA MORA (2008) point out that joint credit to families, developers and building companies in the real estate industry amounted to almost 75% of credit growth in the last years.
4. Two recent studies of this kind are MAUDOS (2008) and GUTIÉRREZ DE ROZAS RUIZ (2006).
5. Average loan to value is at around 65% and it is estimated that less than 10% of new mortgages given in the last years are above 80% (OECD, 2008 and ÁLVAREZ, 2008). It also remains to be seen if the changing demographic structure of creditors compared to other periods of credit expansion (e.g. the increasing number of mortgages given to migrants) will have a different impact on delinquency rates of banks.
6. Readers who are interested in the subject can refer to BANCO DE ESPAÑA (2008).
7. Credit penetration in SMEs and consumption is significantly lower in Spain than in the rest of European countries (FERNÁNDEZ DE LIS and GARCÍA MORA, 2008).
8. In fact, studies by international bodies assessing the Spanish financial system have always pointed out especially recommendations to reform the functioning and regulation of savings banks (cf. IMF, 2006 and OECD, 2008, among others). Some of these recommendations go along the lines of fostering the issuing of share quota (variable yield securities without political rights) to facilitate their capitalisation and reduce the number of representatives of public authorities at general assemblies.