The Spanish Financial Sector Assistance programme: 7 years later - speech by Rolf Strauch

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(*Please check against delivery*)

Good morning,

Our joint seminar today is an example of the ESM's outreach activities – we want to connect with our shareholders, the ESM Member States. We believe that engagement and collaboration will lead to a better mutual understanding and trust.

Looking back at the Spanish Financial Sector Reform Programme after seven years, I think you will all agree that it proved to be a success. The programme, supported by ESM loans to the Spanish government for bank recapitalisation, enabled Spain to emerge from a serious banking crisis and an economic recession. Today, Spain shows strong GDP

growth, an external surplus, and a much healthier financial sector.

I will now recall the developments that led to the crisis and subsequent reform programme.

Lead-up to the crisis

Prior to the economic and financial crisis, Spain experienced fifteen years of rapid growth, with strong employment and wage gains and rising public revenues. The economy grew at an average rate of 3.8% during 1999-2007, well above the euro area average.

However, this rapid growth was obscuring the build-up of sizeable internal and external imbalances. Bank lending, mostly financed from abroad, led to a large current account deficit, a surge in private sector indebtedness, as well as a swelling of bank exposure to the real estate and construction sector.

Spain's growth model exposed its weaknesses as financing conditions started to tighten. The economy entered into recession in mid-2008. GDP growth dropped sharply, the fiscal deficit widened, unemployment shot up to alarming levels. The government implemented a stimulus programme in 2009, which helped stabilise the economy in 2010. The banking sector as a whole coped relatively well during the early phase of the crisis, thanks to dynamic provisions and relatively high capital buffers at the time.

In mid-2011, the tightening of financial conditions in the euro area emerged as a major shock to countries with large external liabilities, including Spain. The economy fell back into recession, which was softer than the first one but lasted longer and was accompanied by fiscal consolidation measures. Vulnerable euro area countries were faced with significantly higher financing costs than countries with stronger macroeconomic fundamentals.

The economic downturn turned out deeper and longer than expected. The funding costs for Spain as well as Spanish banks significantly increased. These market conditions raised widespread concern that private and public resources would be insufficient to support the banking system with capital, despite some initial restructuring efforts in 2010. The strong job destruction after the burst of the housing bubble caused a rapid increase of the unemployment rate to 25% of active population, NPLs increased sharply,

particularly those related to real estate and construction, and capital outflows accelerated.

The financial sector programme

In June 2012, the Spanish government made an official request for financial assistance for its banking system to the Eurogroup for a loan of up to €100 billion. It was designed to cover a capital shortfall identified in a number of Spanish banks, with an additional safety margin.

In December 2012 and January 2013, the ESM disbursed a total of €41.3 billion, in the form of ESM notes, to the Fondo de Restructuración Ordenada Bancaria (FROB), the bank recapitalisation fund of the Spanish government. The remaining €58.7 billion in the programme envelope was not needed and remained unused.

The programme's main objective was increasing the long-term resilience of the Spanish banking sector. To achieve this, the Memorandum of Understanding (MoU) stated that it was essential to remove doubts about the quality of banks' balance sheets; to facilitate an orderly downsizing of bank exposures to the real estate sector, restore market-based funding and reduce bank's reliance on central bank liquidity; and to enhance risk identification and crisis management mechanisms so as to reduce the occurrence and severity of future financial crises.

Looking back, we can safely say today that the programme was well-prepared in terms of defining the scope of necessary measures to repair the banking sector. This included not only capital and funding needs, but also an improvement in bank governance, transparency and supervision. The creation of SAREB, an asset management company, recapitalised by public and private sources, was also a significant step. We should likewise note important reforms carried out by the Spanish government outside the ESM-supported programme, i.e. labour market, fiscal and pensions reform.

The programme design differed in several respects from earlier financial assistance programmes: it focused on the restructuring and recapitalisation of the financial sector; bank recapitalisation was based on an independent asset quality review (AQR) and stress tests; the bail-in of private subordinated creditors was carried out for the first time; the programme was relatively short (18 months); the IMF did not contribute loans (only the ESM).

In addition, there was a change in the overall approach to bank repair in financial assistance programmes. In contrast to earlier step-by-step, or piecemeal methods, the Spanish government and its European partners applied a more comprehensive approach. It is perhaps not a coincidence that this was the same period (June-July 2012) when Mario Draghi gave his famous “whatever it takes” speech, and the idea of banking union was launched by the Euro Summit. This was a time of broad and sweeping crisis management actions.

Programme results

The first positive results of the programme were soon visible: there was a quick stabilisation of market access in the banking sector and reduction of funding costs. The condition of the sector progressively improved thanks to bank consolidation. The number of *cajas*, or savings banks, was reduced from 45 to two. Furthermore, banks stabilised profitability and reduced their stock of NPLs and foreclosed assets, as well as their exposure to the real estate sector thanks to disposals and the transfer of bad assets to SAREB. Bank capital increased thanks to a reduction in risk-weighted assets and to capital injections.

Looking at the broader economy, Spain returned to economic growth in 2014 and continues to perform above the euro area average in that category. Strong job creation followed the economic expansion, and employment has recovered by more than 2.5 million. Structural reforms have been paying off: competitiveness gains have supported economic rebalancing towards tradable sectors, and exports of goods and services have stabilised at historical highs (above 30% of GDP). The large and persistent current account deficit, which had reached 9.6% of GDP in 2007, has turned into a surplus averaging 1.5% of GDP in 2014-18. This positive data is reflected in rating upgrades and record-low sovereign borrowing costs.

Challenges

Spain has continued to record strong economic growth and rapid job creation, but long-term challenges remain. The key vulnerabilities for the economy overall include high public and private debt, an unemployment rate considerably above the euro area average, relatively low productivity, and a large stock of net external liabilities.

Several legacy problems also remain in the banking sector. These include larger and more persistent-than-expected losses of SAREB, which pose a contingent liability to the state. Banks have adequate capital buffers, but should further strengthen them towards the euro area average to withstand any future risks. In addition, the privatisation of Bankia and the reform of *cajas* need to be completed. Finally, banks still face pressure on profitability due to the low interest rate environment, and potentially from a price correction in financial assets if the macro environment deteriorates.

Lessons learned

There are five lessons from the Spanish Financial Sector Assistance programme that I would like to mention here.

(1) Three legs of a successful programme: strong government ownership of the programme; the quality of programme; and large upfront external support.

(2) Burden sharing/bail-ins can and should be a key element of bank restructuring, with due attention to social impact (thresholds, compensation).

(3) Banking reforms were successful, but the overall reform package was somewhat incomplete regarding fiscal, labour and product markets. The reform impetus of crisis years could have been more fully used.

(4) Continuous, rigorous, independent monitoring is needed to detect and address emerging risks.

(5) SAREB worked well to carve out impaired assets from banks and build financial stability but some complexities, such as the eventual sale price of assets and funding strategy, were underestimated in its creation.

Conclusion

Spain is a European success story in overcoming the crisis, and I am confident that it will find a way to deal with the challenges it faces now and in the future. I am encouraged by the fact that there is a strong national consensus on fiscal and financial stability as key pillars of economic success.

The Spanish programme was the first one supported by the ESM, and it was a valuable lesson for my institution. The programme was a key milestone in the development of the EU bank resolution framework, and it also demonstrated that the newly created ESM was an effective firewall, protecting the euro area and its members.

Thank you very much.

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