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Also in this issue

- What Makes a Chief Risk Officer Great?
- Making Enterprise Risk Management a Reality
- The Spanish Banking Sector – Where to Now?
- Islamic Finance – An Introduction
- Bank Internal Audit – New Standards from the BIS

The Spanish Banking Sector: Where to Now?

In this article, Dennis Cox, CEO, Risk Reward Ltd together with Alexander Brown discuss the continuing crisis in Spanish banking. They review both the economic and political background and identify a series of options which should have been considered to resolve the situation.

The Current Scenario

The collapse of Bankia in May of this year and the subsequent uncertainty in the Spanish banking sector has left both Spain and its fellow Eurozone members reeling as Mariano Rajoy's government is left scrambling for a solution to attempt to save its financial sector.

Following the request by BFA, Bankia's parent group, for a public bailout of €19 billion on top of a previous government cash injection of €4.5 billion, it quickly became clear to the global markets that Spain did not have the liquidity to finance such a move and would have to turn to foreign aid.

Now, with over €97 billion worth of savings and investment having left the country in the first quarter of 2012 and another estimated €180 billion worth of toxic loans derived from a stagnant property industry tied up on the balance sheets of Spain's national banks, obvious parallels can be drawn between the Spanish crisis and that seen in Ireland in 2009. Clear and decisive action is necessary on the part of the Spanish government to help try to restore international confidence in the banking sector.

As the situation currently stands Rajoy's Partido Popular has three possible options before them:

1.. **Recapitalising or nationalising parts of the Spanish banking system,**

2. **Allowing ailing banks to fail and letting insolvency regulation take its course (with a deposit protection scheme securing the first €100,000 held by an individual in a savings institution), or**

3. **Creating a Spanish version of Ireland's NAMA, the so called "bad bank".**

Any option will require some funding from Brussels either through the EFSF or the ESM. However there are difficulties in obtaining the necessary consensus leading to an effective capital saving. Spain is a much larger economy than Greece or even Ireland, which received a €78 billion bailout, and the size of funding requirements may prove prohibitive.

The recently announced €100bn Euro bail out will not in our opinion be sufficient to provide anything other than short term relief for the Spanish banking sector. Further, there are doubts regarding its funding. Lastly, that the German government retains the view that providing additional capital would only encourage profligacy inhibits unify action. Generally Berlin opposes further moves for bailouts by Eurozone members without submitting a combined EU and IMF austerity programme which would potentially further cripple the economy and be politically humiliating for Spain's new government. Austerity without growth prospects and hope inevitably leads to depression and civil unrest.

The Economic and Banking Reality

Fundamental to any support from Brussels, however, are the results on the Spanish banking sector due to be released over the coming months. The IMF is due to publish a complete report on the Spanish Banking sector next week. On top of this Spain has hired the 'Big Four' accountancy firms to audit the entire Spanish banking sector, with results expected some time in August. The Spanish Ministry of Economy and Finance have hired two consultancy firms, Roland Berger and Oliver Wyman to run stress-tests based upon the methodology of those run last year by the European Banking Authority with results due in the next two months. This is all likely to result in a continual barrage of bad news facing the Spanish Banks and banking market further reducing the likelihood of any economic action taken. It will also require additional bail outs to be provided the size of which will probably have been increased by the recent funding requests.

With the interest costs on Spain's 10 year bonds having risen above 7% last week, indecisiveness or floundering would only lead to further loss of international confidence in Spain leaving it frozen out of the credit markets.

However on June 7th Spain successfully sold 2 billion worth of 2yr, 4yr and 10yr bonds at a yield of 6.40%

The Spanish Banking Sector: Where to Now?

in the primary debt market and cover of over 3.5 times the debt sold. Are they frozen out the debt market, is

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confidence in Spanish government bonds rising or were sales driven by speculation? Without clear and decisive action, Spain faces further collapse in the economy as its banking sector crumbles and investors flee the country towards its safer and more stable northern neighbours.

> Without clear and decisive action, Spain faces further collapse

Confidence in the international market is dependent upon political and economic stability; investors must feel that that the political system and regime are stable, with a foreign policy that is positive to foreign investment and an economy that is growing sustainably to encourage long term investment. The bursting of a large property bubble in 2008, an industry which contributed to 12% of GDP and employed 20% of the Spanish workforce, led to a collapse in economic growth, raising government debt without an alternative industry to drive the growth necessary to rehabilitate the Spanish economy. Moreover Spain suffers from a new and inexperienced government which won a landslide victory on the back of resentment towards the Partido Socialista Obrero (PSOE) previously in power. (It can be said that this result was far more a rejection of the left-wing Partido Socialista (PSOE) than a huge support of Rajoy's conservative Partido Popular.) As such this is a ministry that has yet to cut its teeth on any political crisis, , which has shown in its scattered early approach to the banking crisis so far and its initial failure to achieve any real resolution with Brussels. The recent €100 billion bailout proposals do appear to show recognition of the seriousness of the situation. The real question however is how the Spanish electorate will react to this problem; will the government manage to keep its electoral pledges and will we see outbreaks of civil unrest and disobedience in the autumn of this year?

A Nation of Nations

The political system in Spain is predominantly bi-partisan with the two main parties being el Partido Socialista Obero de España (the Socialist Worker's Party of Spain), which was voted out of power in November 2011 having been in power from March 2004 following the political fallout in wake of the Madrid bombings, and el Partido Popular whose leader, Mariano Rajoy, is the current Prime Minister. Beyond these two parties exist a number of smaller, minority parties representing some autonomous regions of Spain, in particular Cataluña, Galicia and El País Vasco. The Executive, (the Spanish government), is bi-cameral with a Congress of Deputies and a Senate, both elected which have control over federal policy.

The Judiciary consists of a Supreme Court exercising jurisdiction over national and provincial courts and a Constitutional Court which concerns itself with matters of constitution and human rights issues. Spain is, to quote American author Walt Whitman, 'not merely a nation but a teeming nation of nations', composed of 17 autonomous communities and 2 autonomous cities with 6 official dialects and 3 other large unofficial ones.

Unified in 1469, the country was previously made up of smaller kingdoms before an alliance between Aragón and Castilla formed Hispania, encompassing a large proportion of what is now considered modern day Spain. Following the transition to democracy in 1979 the boundaries of the autonomous states were redrawn and provisions were made within the constitution for the devolution of power to these individual states, each with their own executive and judiciary powers and far more importantly fiscal independence. Each autonomous region has the right to set its own budget and spending which causes a major problem for Rajoy's government. The autonomous communities seek the best of both worlds, fiscal independence coupled with security from the central government in bailing them out should things go horribly wrong. Another problem facing Spain's federal government is nationalism and sovereignty. There exists a strong basis for the argument of Spain as a multinational State and demands for sovereignty are particularly strong in the communities of Cataluña, Galicia and el País Vasco. Most notorious in the fight for sovereignty is the Basque separatist terrorist organisation ETA who since 1968 killed 829 individuals

The Spanish Banking Sector: Where to Now?

and injured many others, although never actively targeting civilians directly. Hindered by the toughening anti-terror laws and international co-operation in the wake of 9/11, ETA nevertheless is still a threat to political stability. Although under ceasefire as of September 2010, this may be merely a convenience for them and on previous occasions they have broken the cease-fire when it was to their advantage.

Whilst no terrorist activities have been claimed by ETA since June 2009 members of the Spanish gendarmerie 'La Guardia Civil' were injured following a spate of terrorist activity throughout that year. The government must balance on a knife-edge here, reining in the spending of autonomous regions to comply with the Maastricht Treaty without engendering any strong anti-government pro-sovereignty feeling which would weaken the current government and would risk a breaking by ETA of the ceasefire on the back of these anti-federation feelings. This would cause political turmoil the like of which would frighten off potential investors.

Worth considering is the growing feeling of 'Euroscepticism' within Spain. Spain is only 1 of seven countries in the European Union to not have an outright Eurosceptical party. However at this time there is a growing sense that the European Union is somewhat of a lost cause. Renowned Spanish economist José Luis Sampedro argues that Europe is not and will never be united since unification would take widespread agreement and also that the centralised control it would necessitate would weaken the existing tired capitalist system in Europe as competition and entrepreneurship is hindered by bureaucratic red tape.

It was Spain's membership of the Euro which allowed the opportunity for the creation of a property bubble and without a separate peseta to allow for devaluation against other European currencies and J-curve analysis to hold true, its unit labour costs have soured over 40% and left its exports uncompetitive. There is certainly evidence to suggest that Spain's non-participation in the Eurozone is being considered within the Congress of Deputies. Although at this juncture it seems unlikely that Spain will leave the Euro in the short term its impact on the long term success of the Spanish economy will continue to result in increasing pressure to withdraw with the forthcoming Greek election it is likely that either a radical Greek government might come into power or no government will be able to be formed. Either option will cause increasing chaos within the Eurozone and will cause increasing problems for Spain as a consequence.

Trickle- Up Change

In terms of civil unrest, the main civil political movement at this time is '15M', which started as a random outburst of smouldering public resentment with an unplanned sit-in at the star-shaped traffic intersection, la Puerta del Sol, in Madrid on May 15 2011 but has since taken the shape of a revolution of the intelligencia in Spain, with clear aims, pamphlets and supporting literature and a peaceful base now permanently maintained in the Puerta del Sol. The movement is driven by Utilitarian ideals that society should be driven by will to do the greatest good and cause the greatest happiness for the greatest number of people with harming the autonomy and rights of the individual.

A key pillar of this ideology is that the government, like the banking sector, have lost sight of their purpose which in a representative democracy would be that of protecting the interest of their voters. Instead the argument goes that the short-termism nature of politics means that politicians are driven by what will gain them funding for electoral success, and a widespread support base, and that break from short-termism is necessary for any real economic progress is to be made in Spain.

The current banking crisis has given rise to a new wave of negative feelings with slogans like 'Para la banca SI hay dinero, para sanidad y educacion NO' (Translation: There's money for the banks but not for Health and Education). Similarly it feels that the banking sector has lost sight of its true purpose which is to facilitate economic process. The earliest forms of banking, whilst no doubt profit driven, were engaged in agriculture and trade at a time when agriculture was seasonal and transportation took months, not hours or days. For example, banks would finance trade and farming, and merchant banks issued 90 day credit for travellers on the Silk Road, and ultimately held savings.

This is a view held by Joseph Stiglitz, the Nobel Prize- winning economist who in a speech to the Carnegie Council in September 2009 argued that the economic crisis was due to banks failing to serve their intended purpose 'which is allocate capital, manage risk, and do it at low transaction cost'. The claim is that the financial sector has gone from a sector which aids the economy to a huge industry in its own right driven towards profit-motivation rather than the quality of service provision. The extent of the effect which 15M will have upon the current system in Spain is difficult to predict. Whilst it will certainly be an influence it is doubtful they will achieve the full-scale revolution which they seek. Political upheaval is unlikely but change will definitely be forthcoming.

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Retail Banks and Cajas

The Spanish banking sector is divided into two main parts, large international retail banks such as Banco Santander and BBVA and smaller regional savings banks called 'cajas' ('caixa' in Catalan and Galician). It is these 'cajas' that are worst affected by the current financial crisis in Spain; the Spanish property bubble caused them to encumber themselves with large amounts of now 'toxic' assets made up of real estate loans or repossessed properties in a falling property market. Spain's premier anti-foreclosure organization, the Platform of People Affected by Mortgage (PAH) claims 150+ evictions occur daily, whilst statistics released by the INE (Instituto Nacional de Estadísticas) show that over 5.6 million houses, 20% of all homes in Spain, lie empty with Spanish property prices having fallen 30% thus far from peak to the present.

The cajas' small size means that they have little capital of their own, which was not a problem during the economic boom of the early part of the 2000s as credit was plentiful and free-flowing. With the economic crisis of 2008 they have had insufficient capital to be able to survive on their own and so have attempted to merge. The question is do these mergers result in a sustainable and feasible business model? It is questionable whether it would make sense to create larger financial institutions whose combined assets are still concentrated in toxic property. Does this risk creating institution which fall under the umbrella of those which are 'too big to fail' or is this an attempt to gain enough capital to allow for investment in a more diverse bank of assets? The more important question perhaps is whether these institutions will have the liquidity to allow them the time to diversify, minimise their exposure and start to lend again to stimulate interest and investment in the Spanish economy or will these crudely formed leviathans merely crumble?

Crucibles of Cajas

One complication is that these mergers have not been achieved through acquisition of one bank by a larger competitor but instead by forming a crucible; a curious amalgam of cajas of different sizes, taking different levels of controlling interests in the new trading company. Each caja predominantly serves a different province retaining its own histories and traditions. Whilst creating these banking groups, the cajas also maintain their own independent brands and working systems. The issue is that these banks are small regional banks predominantly serving different 'provincias' or small provinces based around a major city. Nothing is essentially achieved by such mergers other than increased complexity and confusion.

Let us take Bankia as a case study. Bankia was a merger between 7 of these provincial saving houses, most notably the two largest of which were Caja Madrid and Bancaja. However whilst the assets were merged and a new trading name of 'Bankia' was established, the seven institutions maintained their individual brands foregoing most of the potential cost savings and meaning that the merger process was merely time-consuming and inefficient. The bank is believed to hold an estimated €32 billion worth of assets in toxic property loans, a figure worth considering when the bank's new Chairman, José Ignacio Goirigolzarri, formerly of BBVA, claims that €23 billion is needed for the bank's recapitalisation. Either of these figures raise the question of quite how deep the pit is into which the bailout would be sinking money to, and whether the hole in Bankia's books will continue to grow over time.

The other main merger in the last two years was Grupo Banca Civica, which combined four cajas: Caja de Burgos, Cajasol, Caja Canarias and Caja Navarra. This attempted merger has turned 'bad' as shares in Grupo Banca Civica have fallen since July 18, 2011 opening at from € 2.70 to an all time low of €1.22 on May 28 of this year as the Bankia story broke. This group is currently looking to be incorporated into the Catalonian bank 'la Caixa', with 1 Caixa share offered for 5 Grupo shares.

These two mergers seem to have backfired dramatically, but the Caixa merger seems set to go ahead as well as a new merger announced on May 29 between Liberbank, Ibercaja and Cajatres with combined assets of €120 billion with both Liberbank and Cajatres themselves products of earlier mergers. Past experience has shown that merging of cajas does not succeed because it is too slow and ineffective as a process and even once completed the merging cajas do not have the necessary strength or capital to survive the stress and strain that the current economic conditions places upon them. It is almost as if the Spanish banking sector does not want to learn from experience. The Spanish government and banking sector must find a new approach. Where can they go from here?

Option 1: Recapitalising the Sector

The first option available to the current Spanish government is to recapitalise the Spanish banking sector. This is the approach the Spanish government is trying to take, calling actively and explicitly for intervention and aid from European institutions to provide the necessary capital to finance such a move. This follows Spain's budget minister Cristóbal Montoro's statement that the rising interest on government debt means that Madrid 'does not have the door to the market open.' He also said on Spanish radio station Onda Cero that 'we have a problem in accessing markets, when we need to refinance our debt.' However this could be part of an attempt by the Spanish prime minster, Mariano Rajoy, to force Brussels' hand into accepting a banking union and backing Eurobonds (following opposition to the idea by Berlin with some positive interest for the idea in Paris.)

A major problem with this approach is the scale of the package necessary to recapitalise the Spanish banks. Montoro claims that 'we're not talking astronomical figures' with Banco Santander CEO Emilio Botin claiming that €40 billion are necessary to recapitalise the four nationalised banks: Bankia, Caixa Catalunya, Novagalicia and Banco de Valencia. However as previously stated over €97 billion have left the country in the first quarter of 2012, compared with an inflow of some €20 billion over the same period in 2011 and with an estimated €60 billion leaving in March alone. The speed at which savings are leaving the country is accelerating.

This is without the figures for the first two months of the second quarter which will show even worse results. As such it seems that the cost of recapitalisation may be greater, with our estimate lying somewhere in the region of €200 billion, much harder figure to raise. If recapitalisation of one bank requires in excess of €40 billion (probably €70 billion) then the sector probably requires €200 billion. It will also require liquidity of an excess of €150 billion once the trend of cash withdrawals will have significantly increased over time. Recapitalisation is possible but will be both expensive and as discussed politically difficult to achieve both locally and in an EU context. The alternative of nationalising the entire banking sector could actually fail by default. If the banks continue to fail then nationalisation may become the only viable alternative, solving nothing

The possibility of recapitalisation is at this time a distant one, with agreement needing to come from at least the Eurozone countries, which number 17 (or the entire European Union of 27) that are highly unlikely to agree. With the current situation appearing to be down to the wire, the result from such an approach is too distant for the floundering Spain to wait on. Hence this option for the time being is unlikely and should be ruled out.

Option 2: Allowing Banks to Fail

Deposit protection currently in Spain is up to €100,000 for credit institutions. A a possible option left open to the Partido Popular is to allow insolvency to take its course. In fact measures to speed up the insolvency process and facilitate pre-insolvency restructuring and refinancing were made by the PSOE in September 2011. This is by and large the most austere of the options available to the current ministry and would be difficult to reconcile politically with the Spanish people. Externally however, it is worth nothing that the only one Spanish financial institution on the SIPI list (the list of Structurally Important Financial Institutions, or banking institutions that are structurally important globally and cannot be allowed to fail) is Banco Santander. From a global perspective therefore there is little issue with allowing insolvent banks to merely fail. Allowing local cajas to fail will do nothing to foment the sense of nationalism which Rajoy's ministry needs to ease Spain's course through this economic storm. The second issue which arises is the cost of deposit protection which the government would have to bear. Even considering the vast amount of savings leaving the country over the previous months, Spain would need to seek outside aid to provide the capital necessary to finance this option.

The benefit of this option is that it removes the argument that financial bailout could not be justified to 'moral hazard', taking undue risk since there is no accountability. There is a great deal of public support within Spain for this approach, with strong backing from the aforementioned 15M movement who are lobbying for a protection of the depositors rather than the institution. In reaction to the existing Bankia crisis, 15M published a manifesto pushing for the accountability of banks for their actions rather than allowing 'moral hazard' to occur.

There is no logic in saving a bank unless the loss of the institution would cause significant economic stress. In terms of the savings banks, the failure could further depress an already struggling retail housing market in a specific region due to increased foreclosures. However there is not likely to be any long term fall out and depositors would be protected by the deposit protection scheme. Normal insolvency procedures would operate efficiently and depositors would receive the insured part of their deposits then migrating to higher quality names. This does appear a viable or relatively low risk alternative.

Option 3: The NAMA Solution

When considering the financial crisis in Spain it is worthwhile drawing comparisons between the crises that has arisen in 2008 in Ireland and now Spain. The Celtic Tiger economic growth over the last decade was driven by a property bubble, although a technological revolution also helped to drive the surge in Gross Domestic Product. Ireland's growth had been over +10% change in Gross Domestic Product for the ten years preceding the financial credit crisis. It too at first attempted the nationalisation of banks taking controlling interests in Anglo-Irish Bank with both Allied Irish Bank (AIB) and Bank of Ireland (BoI) each receiving a €3.5 billion recapitalisation bail-out package.

In the end Ireland created the National Assets Management Agency (NAMA) using a €77 billion budget to purchase 'bad' loans and assets from banks in the Republic of Ireland which it would then hold and manage for a projected 7 to 10 years. In the short term it recapitalised the Irish banks, and increased confidence in these institutions having less toxic assets on their balance sheets, and in the long term it allowed for the government to attempt to recover finances. The eventual deal involved creating a 'bad bank' which contained a mixture of healthy and impaired loans with a concentration on those involving undeveloped land and residential and commercial development. The

valuations of those loans were some €90 million and individual loans were required to be over €5 million, an idea supported by the rating firm Moody's, the purpose being to recapitalise whilst avoiding having to nationalise. The question today is whether such a similar business model could be applied to the Spanish banks. As previously stated Spain's banking sector is made up of large amounts of mid size savings accounts whereas NAMA took loans only from the 6 biggest lenders. This said, Bankia and the new merger between Liberbank, Cajatres and Ibercaja have created large enough financial institutions to allow for such a deal. The figures for Spanish 'bad' assets lie in the estimated region of €180 billion of which Bankia is believed to hold €32 billion and the new three-way merger holds a projected €11 billion.

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To enable the banks to thrive one option would be for the Government to create a 'bank' to take on the toxic assets as has been achieved in Ireland. The concern is that the banks might return to profligate ways, yet this is a different market with different and more conservative lenders. Accordingly the creation of such a vehicle relying on government guarantees rather than loans would appear attractive. There will still need to be a partial bank recapitalisation but this could be limited to perhaps €70 billion.

Is the Future Bright?

Looking forward, what does the future hold for Spain? Regardless of the direction this new Spanish government takes it must act swiftly if it wishes to stay in power and save a dwindling Spanish economy. The critical question remains how is such a revival possible? Key Spanish industries, e.g. tourism, property, automotive and even the wine industry are at best under pressure and are therefore unable to stimulate the growth necessary to rescue the economy. Austerity without vision is a disaster, so unless the current Spanish government can show there is a recovery light at the end of the of economy tunnel, they risk losing power and potential radical overhaul of the existing political and financial system.

With the impact of Germany creating a currency which is inappropriately strong there are few obvious long -term opportunities for Spain to grasp. The initial funding transference of perhaps €200bn will need to be followed by annual transfers of funding in the range of €100bn (indexed) in perpetuity. Will this be politically acceptable remains the question to be answered.

Risk Reward Expert Witness team members provided banking specialists to support the defence of a major commercial property firm against NAMA in Ireland.

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