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Financial Assistance Programme for the
Recapitalisation of Financial Institutions in Spain:
Update on Spain's compliance with the Programme -
Winter 2013



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Directorate-General for Economic and Financial Affairs

Financial Assistance Programme for the Recapitalisation of Financial Institutions in Spain:

Update on Spain's compliance with the Programme - Winter 2013

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ABBREVIATIONS

AMC	Asset Management Company
BdE	Banco de España (Bank of Spain)
CDS	Credit Default Swaps
CoCos	Contingent Convertible Securities
CRR	Capital Requirements Regulation
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
ESM	European Stability Mechanism
EUR	Euro
FGD	Fondo de Garantía de Depósitos de Entidades de Crédito (Deposit Guarantee Fund)
FROB	Fondo de Reestructuración Ordenada Bancaria
GDP	Gross Domestic Product
INE	Instituto Nacional de Estadística (Spanish National Statistics Institute)
MFI	Monetary Financial Institution
MoU	Memorandum of Understanding
q-o-q	quarter on quarter
RDL	Real Decreto Ley (Royal Decree Law)
RED	Real Estate Development
RWA	Risk Weighted Assets
Sareb	Sociedad de gestión de activos procedentes de la reestructuración bancaria
SIP	Sistema Institucional de Protección (Institutional Protection Scheme)
SLEs	Subordinated Liability Exercises
SMEs	Small and Medium Enterprises
VAT	Value Added Tax
y-o-y	year on year

EXECUTIVE SUMMARY

1. Since mid-November, Spain has maintained access to financial markets and investor confidence showed tentative signs of stabilisation, albeit at a low level. The recent decision by the European Council to advance towards a banking union by introducing a Single Supervisory Mechanism and the release of the European Commission's (EC) blueprint on how to complete the Economic and Monetary Union contributed to restoring investor confidence. In Spain, net borrowing from the Eurosystem declined and the outflow of non-resident deposits came down. However, the supply of credit remains constrained by the banks' more prudent credit policies, limited access to market financing and declining profitability due to asset impairments. At the same time, financial-sector deleveraging and the economic recession continue to reinforce each other as the structural adjustment of the real economy advances towards a sustainable resumption of economic growth. Risks to Spain's financial sector remain significant and several challenges still lie ahead, despite the overall good performance.

2. Against this background, the recapitalisation of Group 2 banks and progress in rendering Sareb, the Asset Management Company (AMC), operational and transferring the impaired assets from the banks are supporting a healthy rebalancing in the financial sector. The cleaning up of bank balance sheets of bad debts accelerates deleveraging of exposures to the non-viable parts of the economy, on the one hand, and reinforces capital ratios and provides liquid securities that can be used to extend new lending to the sustainable part of the economy, on the other. In this respect, the timely set-up of the AMC, making it operational in its basic functions and the transfer of assets of Group 1 banks represent an important achievement of the programme that was reached within ambitious deadlines. Further progress with the horizontal conditionality was achieved as Spain presented law proposals to strengthen the governance of savings banks and clarify their role as shareholders of credit institutions while the bank regulatory and supervisory framework has been further strengthened. At the same time, the Spanish authorities have prepared a roadmap for the listing of banks included in the stress test, which have received State aid as part of their restructuring process. However, given the complexity of this very specific issue, it is currently further discussed with Spain's international partners, with a view for further enhancement. Overall, the banking sector reforms have advanced as planned, but they could be further strengthened in some areas.

3. Based on the adoption of the restructuring plans of Group 2 banks, the EC in liaison with European Central Bank (ECB) recommends to the European Stability Mechanism (ESM) the release of the second loan tranche of EUR 1.865 billion. The approved restructuring plans put the banks on track to re-establish their viability over time and limit the amount of funds required from the taxpayer. The EC came to the conclusion that the capital injection needed to cover the capital shortfall for Group 2 banks estimated at about EUR 6.3 billion in the bottom-up stress test would amount to only EUR 1.865 billion after burden sharing measures and other adjustments.

1 INTRODUCTION

4. This report provides an update on Spain's compliance with the conditionality of the Financial Assistance Programme since the submission of the First Review report in mid-November 2012. The Programme, which was agreed by the Eurogroup on 9 July 2012 and covers a period of 18 months¹, entails an external financing by the euro area of up to EUR 100 billion. On 3 December 2012, the Eurogroup reviewed the progress on the Programme² and welcomed the decision by the European Stability Mechanism (ESM) to authorise the disbursement of the first tranche of up to EUR 39.5 billion. Spain has used close to EUR 37 billion for the recapitalisation of Group 1 banks, for which the EC had adopted restructuring plans on 28 November 2012, and is using up to EUR 2.5 billion for capitalising Sareb.

5. The update on Spain's compliance with the Programme conditionality is needed for the release of funds necessary for the recapitalisation of Group 2 banks prior to the next formal second review. The report of the second review will be released after a joint EC/ECB³ mission that will take place in Madrid in late January 2013.

6. Since the First Review, progress with the implementation of both the bank-specific and the horizontal conditionality of the programme continues to be broadly on track. The EC adopted the restructuring plans for Group 2 banks (Banco Mare Nostrum, Banco Caja 3, Liberbank and Banco CEISS) on 20 December 2012, the AMC has become operational in its basic functions with the appointment of its Board of Directors, the approval of the by-laws of the company and the transfer of assets of Group 1 banks, and steps were taken for the further improvement of the bank regulatory and supervisory framework. At the same time, the draft roadmap for the listing of the banks included in the stress test, which have benefitted from State aid as part of their restructuring process, could be further enhanced. The biggest challenge in recent months has been to render Sareb operational in due time, which was achieved, but the AMC still faces additional operational defies going forward. In a similar way, the operationalization of eliminating the savings banks' controlling stakes in commercial banks remains a challenging goal.

7. Based on this assessment, the report includes the recommendation of the EC in liaison with the ECB to the European Stability Mechanism (ESM) to release a second loan tranche of EUR 1.865 billion. The EC came to the conclusion that the capital injection needed to cover the capital shortfall for Group 2 banks estimated at about EUR 6.3 billion in the bottom-up stress test would amount to only EUR 1.865 billion after burden sharing measures and other adjustments.

¹ However, the restructuring of the banks receiving public support under the State aid rules is expected to take up to five years.

² See Spain's first compliance report with the programme conditionality at:
http://ec.europa.eu/economy_finance/publications/occasional_paper/2012/op121_en.htm

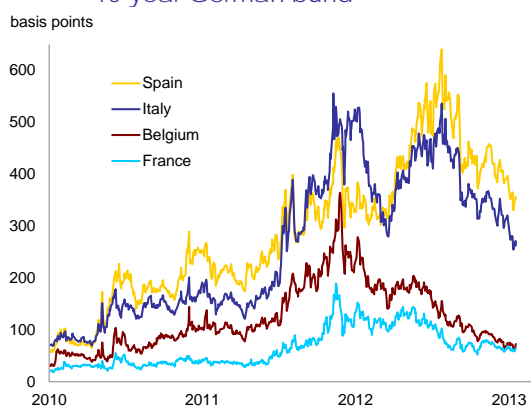
³ The mission will also involve expert teams from the European Stability Mechanism and the European Banking Authority. The International Monetary Fund will participate in the meetings as part of its independent monitoring.

2 RECENT FINANCIAL, MACROECONOMIC AND FISCAL DEVELOPMENTS

2.1 FINANCIAL SECTOR DEVELOPMENTS

8. Since mid-November, Spain has maintained access to financial markets and investor confidence showed tentative signs of stabilisation, albeit at a low level. The recent decision by the European Council to proceed towards a banking union by introducing a Single Supervisory Mechanism and the release of the EC's blueprint on how to complete the Economic and Monetary Union contributed to restoring investor confidence as of December. The risk perception about Spain and the sovereign yield spreads continued to normalize (see Graph 1 and Graph 2), whereas the stock market remained at a peak after the recovery from the summer lows. The issuance of secured, unsecured and covered bonds by private borrowers continued, but not as strongly as in September. In October, Standard & Poor's lowered its sovereign credit ratings on Spain and kept a negative outlook on the long-term rating. The downgrade reflected Standard & Poor's view of the mounting risks to Spain's public finances, due to rising economic and political uncertainty. This action triggered further downgrades and reviews of the Spanish banks' ratings. The restructuring of the banking sector advances with mergers and acquisition of weak banks and the implementation of the restructuring plans (recently approved by the EC) of banks which have received State aid.

Graph 1: Euro area sovereign spreads to the 10-year German bund



Source: Reuters EcoWin and own calculations

Graph 2: Spain's CDS 5 year spreads

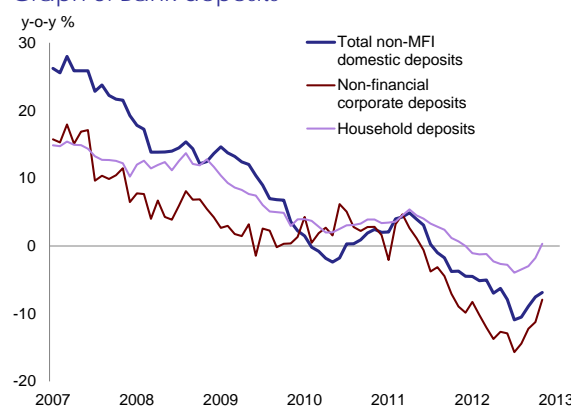


Source: Reuters EcoWin and own calculations

9. Financing conditions for the banking sector have remained tight despite recent improvements. The fall in domestic retail and corporate deposits has continued but decelerated to around 4% y-o-y in October 2012 from 6.5% in July (see Graph 3). However, the significant outflow of non-resident deposits of EUR 80 billion (or 18.5% of total) during May-August 2012 came to an end in September and October. Together with a better access to financial markets, this stabilisation of deposits reduced the reliance on net borrowing from the Eurosystem for a fourth month to EUR 313 billion in December 2012 from a record EUR 389 billion in August. Risks to Spain's financial sector nonetheless remain high and several challenges still lie ahead.

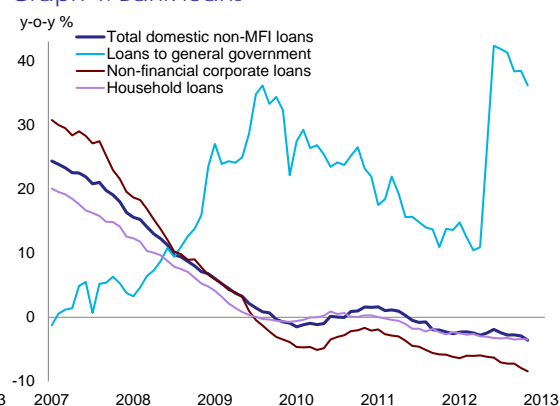
10. The decline in lending has continued on account of both supply and demand factors against the backdrop of deleveraging in the real estate and construction sectors. Credit growth remains in negative territory as the supply is constrained by banks' tight financing, efforts to rebuild capital ratios and more prudent lending policies on the back of weaker demand in a recessionary environment. As of October 2012, total non-MFI domestic credit shrunk by about 3% year-on-year being driven by the decline in the stock of credit to the private sector of almost 5% year-on-year. Domestic lending to non-financial corporations and households fell by around 8% and 3.5% year-on-year, respectively (see Graph 4). As regards financing of productive activity, the pace of decline is the fastest in the construction and real estate activities, which overexpanded in the boom. At the same time there was a strong increase in credit to the government – including both loans and government securities - by around 42% year-on-year.

Graph 3: Bank deposits



Source: BdE and own calculations

Graph 4: Bank loans



Source: BdE and own calculations

11. The ongoing deterioration of asset quality has continued to weigh on the performance of the banking sector and its lending capacity. Non-performing loans increased to 11.2% of total loans in October compared to 9.7% at the end of June 2012. Similar to previous months, the main driver for the deterioration in asset quality has been the increase in impaired assets in the real estate and construction sector. Non-performing loans to households reached 4% at the end of June 2012, remaining therefore significantly below the system average. Notwithstanding the positive developments in net interest income, the increase in impairment charges due to the higher provisioning requirements resulting from the Royal Decree Law (RDL) 2/2012 and RDL 18/2012 have significantly impacted profitability at system level. Furthermore, banking sector profitability has been negatively affected mainly by the losses recorded by the banks controlled by the Fondo de Reestructuración Ordenada Bancaria (FROB)⁴. On the back of these developments, the return on equity at system level stood at -3% and the Core Tier 1 solvency ratio declined to 9.6% at the end of June 2012.

2.2 MACROECONOMIC AND FISCAL DEVELOPMENTS

12. Economic growth continues to face several headwinds, including deleveraging, very high unemployment, tight financing conditions and fiscal consolidation. These

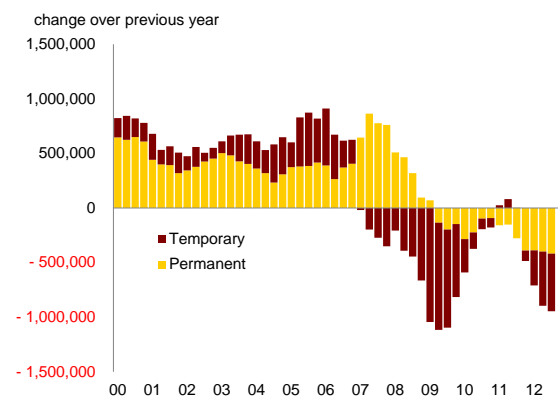
⁴ Fund for Orderly Bank Restructuring

factors are still negatively affecting domestic demand, which fell by more than 1% (q-o-q) in the third quarter of 2012, as a result of contracting consumption and investment. Net exports continue to support the Spanish economy and contributed around ¾ percentage points to quarterly growth in the third quarter. In aggregate terms, Spanish real GDP continued to contract by 0.3% in the third quarter, slightly less than in previous quarters thanks to less negative consumption growth due to the anticipation of the VAT rate hike in September. However, these advance purchases will negatively affect consumption in the last quarter of 2012 and together with the impact of fiscal measures concentrated at the end of the year may dampen considerably economic activity in the fourth quarter of 2012.

13. The recession will continue into 2013, but positive growth will return in the second half of 2013, according to the EC's 2012 Autumn Forecast. Thus, in 2013, real GDP it is expected to contract by 1.4%, with a similar composition of growth as in 2012. In 2014, real GDP should grow by 0.8%, under no-policy change assumption.

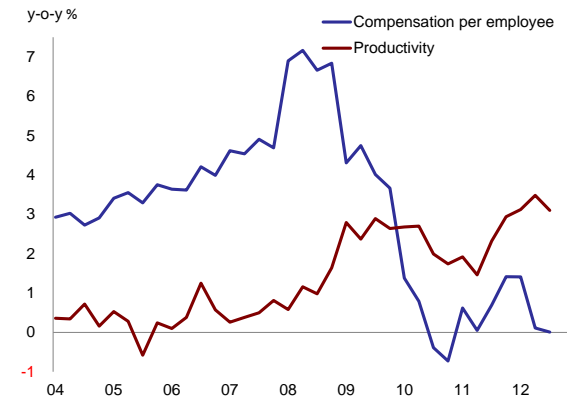
14. Employment continues falling at a significant pace, while wages stagnate (Graph 5 and Graph 6). The decline in employment continues unabated, at a rate of over 4½% (y-o-y) in the second and third quarter, and has apparently accelerated in the fourth quarter. The unemployment rate reached 25% in the third quarter of 2012 and is expected to increase further in the last quarter of the year. Compensation per employee stagnated in the third quarter of 2012 (y-o-y), driven by the fall of public sector wages (-0.6%) and reduced growth of wages in the rest of the economy (+0.1%). This moderation of wages together with the persistence of relatively high productivity growth has led to a further significant reduction of unit labour costs (-3%, y-o-y).

Graph 5: Employment and contract duration



Source: Thomson Reuters EcoWin.

Graph 6: Productivity and wages



Source: BdE, INE.

15. Inflation remains elevated, despite the ongoing deleveraging in the private sector, essentially due to fiscal measures, but also reflecting insufficient competition in product markets. Inflation came in at 3.0% in November, 0.4 percentage points less than in October, mainly due to a fall in energy prices. Core inflation fell by 0.1 percentage points to 2.4%. Inflationary pressures thus remain high especially in relation to the sustained contraction of economic activity. Hikes in indirect taxes and increases of administered prices are the main factors behind this high level of inflation, as inflation at constant taxes merely posted a growth of 1%.

16. Macroeconomic imbalances keep adjusting. The external deficit declined further to 1.8% of GDP in the third quarter of 2012 (moving four-quarter average), compared to 2.7% of GDP in the previous quarter. This improvement came from a strong performance of exports, which overcompensated the increase of imports. The adjustment of house prices advanced in the third quarter of 2012, falling by over 15% (y-o-y), compared to over 14% in the previous quarter. The cumulated adjustment since the peak reached -30.7% in nominal terms.

17. Fiscal consolidation advanced in the third quarter, but the 2012 deficit target will likely be missed. The cumulated general government deficit for the first three quarters of 2012 reached EUR 65.3 billion (8.3% of cumulated quarterly GDP). However, the deficit increased due to bank recapitalisation measures of around EUR 10 billion (1% of GDP). Adjusting for advance transfers from the central government, the Autonomous Communities showed a deficit of slightly below EUR 12 billion for the first three quarters (1.1% of full-year GDP), which is a major improvement on the first half of the year, when the deficit already stood at 0.9% of the full-year GDP. The 2012 deficit target for the regions of 1.5% of GDP can therefore still be within reach for the regional level as a whole, but risks are substantial and a number of regions will most likely exceed their target. The recent decision not to adjust pensions for higher-than-expected inflation implies a saving of around 0.2% of GDP. Nevertheless, the social security system is still expected to post a deficit of above 1% of GDP, due to lower social contributions and higher transfers. Hence, even if the full effect of some of the consolidation measures kicks in only in the fourth quarter (VAT increase, corporate income tax hikes and the elimination of the Christmas bonus among public employees), meeting the full-year target of 6.3% (excluding bank recapitalisations) will be very difficult.

3 BANK RECAPITALISATION AND RESTRUCTURING

3.1 SEGREGATING THE BANKS' IMPAIRED ASSETS

18. The fulfilment of conditions laid out in the Memorandum of Understanding (MoU) with respect to the AMC is on track. The AMC has been successfully set up under the name of Sareb⁵ as a majority-private-owned company and became operational in its basic functions (see Box 1). The capital of the company will amount to 8% of its total assets, split between equity (25%) and subordinated debt (75%). Private investors have signed the shareholders agreements and disbursed the first tranche of capital related to the transfer of assets from Group 1 banks. All private shareholders have legally committed the total amount of capital contributions required to reach the 8% level. The amount disbursed so far is approximately EUR 3.8 billion, including equity and subordinated debt. The outstanding amount of capital will be disbursed before the asset transfer from Group 2 banks takes place. Despite progress in clarifying the governance of Sareb, the establishment of the Monitoring Commission is still pending. Sareb faces other operational challenges going forward, among which the adoption of a sound business plan and ensuring a good oversight of servicing agreements.

Box 1: Recent measures adopted by Sareb

The top management of Sareb and its Board of Directors have now been appointed. The main decisions adopted by the Board so far are the following:

- Issuance of senior bonds and creation of the senior bond syndicate;
- Approval of the by-laws of the company;
- Appointment of the auditor;
- Creation of the Remuneration Committee and the Auditing Committee;
- Adoption of the remuneration framework, which will allow the company to start the recruitment process for the remaining management levels. The business plan will not be approved until the full data on assets to be transferred by Group 2 banks has been received (expected by mid-January 2013).

19. The shareholders of Sareb are mostly Group 0 domestic banks, i.e. banks for which no capital shortfall was revealed by the bottom-up stress test. Insurance companies (both domestic and foreign) as well as two foreign banks (Barclays Bank and Deutsche Bank) have also acquired minority stakes in Sareb. In the first stage, a total of about EUR 40 billion RED loans and foreclosed assets of Group 1 banks have been transferred. In the second stage, the transfer of assets from Group 2 banks will take place in the first quarter of 2013. In between, additional investors are expected to contribute capital to Sareb. All in all, the total capital (equity and subordinated debt) is expected to amount to about EUR 5.1 billion.

⁵ Sociedad de gestión de activos procedentes de la reestructuración bancaria (Sareb)

20. The assets of Sareb will be managed by the transferring banks until Sareb has developed full operational capacity. Transferring banks have deep knowledge of these assets and are therefore best placed to manage those assets in a first stage. The servicing agreements have been negotiated with the banks in order to create the right incentive structure to ensure a proper management of the assets which maximises their value.

3.2 BANK RECAPITALISATION AND RESTRUCTURING

21. The MoU sets a strict timeline for the recapitalisation of the different groups of banks. Banks which were already state-owned at the time of the stress test (Group 1) had to be recapitalised by end-November 2012. Banks not able to cover their capital shortfall determined in the stress test on their own (Group 2) had to recapitalize by end-December 2012. The MoU requires that additional public capital would only be provided by the FROB once individual restructuring plans would have been approved by the EC. Furthermore, the MoU indicates that those restructuring plans would incorporate the results of the stress test exercise conducted by independent consultants. Finally, the restructuring plans were presented in time to allow the EC to approve them by the end of November and December 2012, respectively.

22. The EC adopted the restructuring plans for Group 1 banks on 28 November 2012. These banks already owned by the FROB are **BFA-Bankia, Catalunya Banc, NCG Banco and Banco de Valencia.** The EC approved the restructuring plans for all Group 1 banks and in the case of Banco de Valencia it approved the State aid required for the orderly resolution of the bank through its takeover by Caixabank. In the absence of the takeover, Banco de Valencia would have been wound down, as it was not possible to establish a viable business model for the bank on a stand-alone basis. The decisions under EU State aid rules were a precondition for the disbursement of the aid amounts.

23. On 20 December 2012, the EC approved the restructuring plans for Group 2 banks: Banco Mare Nostrum, Banco Caja 3, Liberbank and Banco CEISS. These banks failed the stress test and were not able to raise the necessary capital privately.

24. The restructuring plans of banks aim at addressing the reasons of the banks' distress and restore the entities' long term viability, while at the same time limiting the taxpayers' contribution to the minimum. The restructuring plans thus ensure a proper burden sharing and address distortions of competition created by the aid (see Box 2).

Box 2: Key features of the recapitalisation of Group 2 banks

The restructuring plans of Group 2 banks focus on the following measures:

- Banks will focus on their core banking activities both in terms of banking activities (retail and SMEs financing) and geographical scope (i.e. their historical regions), withdrawing from risky areas;
- They will restore their solvency, profitability and liquidity profile over the course of the five years restructuring period;
- They will lead to the emergence of smaller banks with an adjusted risk profile and improved corporate governance;

Last, but not least, these restructuring plans will address the moral hazard issues and potential distortions of competition with behavioural commitments on top of the structural commitments.

25. The overall capital needs for Group 2 banks have been reduced significantly as compared to initial estimates based on the stress test. Out of the EUR 6.248 billion of capital needs determined by the bottom-up stress test conducted by Oliver Wyman, the final capital needs for Group 2 banks amount to EUR 1.865 billion. Burden sharing measures have reduced the capital needs by approximately EUR 2 billion, whereas the transfer of problem loans to the AMC has diminished the capital needs by roughly EUR 1 billion. Other mitigating measures (e.g. divestments) have further reduced the capital needs by more than EUR 1 billion. Consequently, this overall reduction of the initial capital needs by roughly EUR 4.4 billion ensures that the contribution of taxpayers is limited to the minimum amount necessary.

26. Burden sharing is a central element of the restructuring plans. EU State aid rules require that all stakeholders significantly contribute to the restructuring cost in order to minimise the cost to taxpayers. In the context of the program the Spanish authorities require that existing equity holders will fully contribute to absorb losses, leading to the loss of their claims depending on the economic valuation of each bank. For holders of preference shares and perpetual subordinated debt, burden sharing will be implemented firstly by applying a haircut to the nominal amount of the instrument and subsequently through conversion of these securities into equity or equity equivalent instruments. As regards the holders of dated subordinated debt they would be given the choice between conversion into equity or into a senior debt instrument after taking an appropriate haircut.

27. As a result, there will be no cash outflow from banks to the holders of these securities, with the exception of the holders of dated subordinated debt instruments deciding to convert into new debt securities with a maturity matching that of the subordinated debt being exchanged. Spain has introduced legislation to ensure the effectiveness of the burden sharing measures, including when necessary by mandatory means. Spain has provided a legally binding commitment to ensure that the burden sharing under the agreed terms will take place.

28. In addition, each bank will carry out other divestments, generating capital to the extent possible. That means, for instance, that selling stakes below book value would not be helpful, as it would increase the loss for the bank and therefore the respective bank's capital need. In contrast, banks are concentrating on selling good parts of their business, such as their equity stakes in other companies.

29. The transfer of problem assets to AMC supports bank viability. All four Group 2 banks will transfer their problematic assets linked to real-estate development to the AMC, significantly diminishing the risk in their balance sheet. In total, Group 2 banks will transfer to the AMC roughly EUR 31 billion of assets in terms of gross book value with an average haircut of about 48%. This implies that the AMC will acquire assets with a face value of about EUR 16 billion. The transfer of problem assets to the AMC allows the bank to transfer the most risky portfolios off its balance sheet, thus avoiding the consequences (i.e. additional provisions, management of the assets, etc.) of potential future losses on those assets. This is laying the foundation to better lending to the productive part of the real economy going forward.

30. The EC will ensure that Spain implements the approved restructuring plans. Spain has provided the EC with a legal commitment to abide by the restructuring plans which the EC had approved, so to ensure that banks follow an ambitious but credible plan to restore viability. The EC has a monitoring system, including monitoring trustees, to ensure that the restructuring plans and commitments are duly implemented.

31. Group 3 banks have been able to cover their capital needs without public aid. Ibercaja and Banco Popular have managed to fully comply with the required capital needs without public support measures, *inter alia*, by repurchasing own subordinated debt and divesting assets. Banco Popular has been able to raise a significant amount of capital (i.e. EUR 2.5 billion) from the market covering most of its capital shortfall of EUR 3.2 billion.

32. Overall, the final capital needs of the Spanish banks are lower than those initially identified by the bottom-up stress test. Out of the original EUR 56 billion of capital needs identified by the stress test results published in September 2012 billion (pre-tax), less than EUR 39 billion are going to be finally disbursed. The initial amount has been reduced by almost EUR 13 billion through burden sharing measures. Furthermore, reductions of close to EUR 5 billion are generated by other mitigating measures, such as divestments and capital raises, whereas the estimated impact from the AMC transfer, resolution measures and other costs combined has been slightly negative.

4 ENHANCING BANK TRANSPARENCY, REGULATION AND SUPERVISION

33. Since mid-November, further progress in meeting horizontal conditionality was achieved in a number of areas, such as identifying possibilities to improve the regulatory and supervisory functions of Banco de España (BdE), preparing legislation strengthening the governance of savings banks and clarifying their role as shareholders of credit institutions, submitting a policy document on amending the provisioning framework and strengthening the credit institutions' funding, provisioning and capitalisation requirements. An overview on the status of implementation of all MoU conditionality is provided in Annex 6.2. At the same time, reforms in some areas, such as developing the roadmap for listing of banks could be further strengthened.

34. Pursuant to the MoU (conditions 13 and 14), the Spanish authorities identified several areas in which the powers of the BdE to issue guidelines and interpretations can be further enhanced. First, the powers of the BdE to issue binding guidelines *ad intra* will be reinforced and it will also be attributed the competence to issue binding replies to queries *ad intra*. The binding nature of these replies to queries will enhance legal certainty and consistency. At the same time, the possibility to issue binding guidelines also toward third parties could have been better explored. Second, authorities submitted at the end of October 2012, a report which includes the main findings of the internal review of the BdE and formulates proposals to enhance its supervisory procedures. The report includes *inter alia*, recommendations to further enhance on-site inspections and the off-site monitoring of credit institutions as well as improvements in the formalisation of supervisory actions.

35. Spanish authorities presented a proposal for a law aimed at: (i) clarifying the role of savings banks in their capacity as shareholders of credit institutions with a view to eventually reduce their stakes to non-controlling levels; and (ii) strengthening fit and proper rules for the governing bodies of savings banks and introducing incompatibility requirements regarding the governing bodies of the former savings banks and the commercial banks controlled by them. This corresponds to condition 20 of the MoU. Based on detailed comments made by the international partners, Spain has finalised a draft law on this matter. It will create a new legal framework for the functioning of Spanish savings banks (see Box 3). The operationalization of eliminating the savings banks' controlling stakes in commercial banks remains a challenging goal as the draft bill relies heavily on the exercise of regulatory powers by the BdE. A roadmap for the listing of banks which have received State aid was submitted by the Spanish authorities at the end of November, but plans regarding the listing of Group 2 banks were insufficiently developed. Therefore, the draft roadmap is in the process of being further discussed with international partners with the aim of further possible enhancements.

36. In order to improve the funding management and autonomy of credit institutions receiving state aid or for which capital shortfalls were revealed in the stress test, as well as monitoring credit supply by the whole banking system, the MoU (condition 21) requires them to provide standardised quarterly balance sheet forecasts. At present, the Spanish authorities are developing together with the ECB and in liaison with the other international partners a template for the submission of the required funding plans. Upon completion, banks should start providing their funding plans on a quarterly basis.

Box 3: Key features of the restructuring of Spanish savings banks

The Spanish savings banks have played an important role in the Spanish financial system as financial intermediaries mainly focused on the retail business segment. The legal framework, however, has made savings banks particularly sensitive to political interference and high concentration of risks, mainly linked to real estate activities, in many cases without a proper capital structure backing such risks. The crisis unveiled some important weaknesses accumulated over time in the sector which, in some cases, triggered the need for State aid. As a consequence, a relevant restructuring process had to take place. Within the framework of this restructuring, savings banks have been involved since 2009 in 12 integration processes (7 mergers or takeovers and 5 institutional protection schemes - SIPs), which reduced the total number of savings banks from 45 to 13. The number of banks will further fall to 11 when the two on-going merger projects (Ibercaja-Caja 3 and Unicaja-CEISS) will be closed. Out of 45 savings banks in early 2010, 43 participated or are participating in consolidation processes which in total assets represent an average of 99.9% of the sector. Inevitably, the consolidation process also increased risk in the financial sector by creating larger entities.

The Spanish authorities presented a draft law which complies with the requirements set in the MoU signed in July 2012. The proposal, to be discussed and approved by the Spanish Parliament in the first months of 2013 involves a complete new legal framework for the Spanish savings banks. The majority of savings banks will be converted into new legal entities without bank licence (*fundaciones bancarias*). Only a few savings banks (which have to comply with strict conditions that severely limit the volume and scope of their business) will be able to operate as credit institutions. The governance of both savings institutions and *fundaciones bancarias* are regulated in order to make their governing bodies more professional and independent. In the case of *fundaciones bancarias*, a set of incentives has been created to get a reduction over time of controlling level stakes at banks.

Special powers have been assigned to the BdE in order to monitor and supervise the relation between the *fundacion bancaria* and the banks where they hold stakes at controlling levels. *Fundaciones* holding stakes equal or greater than 30% need to subscribe a *management protocol* to be approved by the BdE where the relation with the bank where the stake is held is regulated and a *financial plan* to be also approved by the BdE. The BdE has to develop subordinated regulation in order to set up guidelines regarding the composition of investment portfolios of *fundaciones bancarias* and also for the creation of a Reserve Fund. The main goal of the latter will be to assure that the *fundacion bancaria* can provide capital support to the bank where they hold stakes. In this way, the proposal makes the holding of stakes at controlling levels significantly costly for *fundaciones bancarias*. In certain cases established in the draft bill (e.g. if the financial plan is not approved by the Banco de Espana) the banking foundation will be requested to implement a plan to reduce their participation in banks.

37. Spain developed a policy document regarding the permanent strengthening of the provisioning framework following the changes brought by Royal Decree Laws 2/2012 and 18/2012 (condition 22). The policy document starts from the current provisioning model and describes recent developments. Furthermore, it draws several conclusions from the financial crisis. Based on these, it proposes a series of principles that should be considered for the development of a future provisioning model. Spain's international partners have committed to provide comments on this document by mid-January 2013.

38. In line with the MoU requirements (condition 25), Spanish authorities proposed an approach aimed at requiring banks to review, prepare and implement strategies for dealing with impaired assets. The BdE sent to the credit institutions included in the bottom-up stress test a legally binding letter of requirements, issued on the basis of the Law 13/1994 on the Autonomy of the BdE. According to this letter, the internal audit departments of banks are requested to review the strategies, policies and procedures for managing impaired assets. The report summarizing the main findings of the internal audit

department, the supporting documentation as well as a plan including measures for addressing the identified shortcomings will be submitted to the BdE before 31 January 2013. Banks are expected to implement the measures aimed at improving their strategies and policies to deal with impaired assets in the first half of 2013. This approach will enable the BdE to identify the banks with poor arrears management systems and conduct on-site inspections in these banks.

39. In mid-November 2012, the Spanish government approved the Royal Decree-Law 27/2012 in order to reinforce the protection of some vulnerable mortgage debtors, following social discontent derived from certain cases of residential mortgage evictions. In turn, these legal changes raised concerns about a potential negative impact on the banks' mortgage portfolios and solvency. However, given the still low delinquency ratio of residential mortgages and the restrictive eligibility conditions of the new legislation, its impact on banks is expected to be rather limited (see Box 4).

Box 4: New legislation on evictions in case of mortgage default

Spain has passed new legislation in order to protect some vulnerable households from evictions in case of mortgage default. The Royal Decree-Law 27/2012 does not amend the current mortgage law or the civil procedure law, but establishes a moratorium on evictions for a period of two years running until 15 November 2014. This means that with regards to mortgage defaults (i) foreclosures will take place according to the ordinary execution process and (ii) banks will retain the ownership of the foreclosed properties.

The potential effects of the Royal Decree-law 27/2012 on the banks are expected to be limited, mainly because of the following:

- banks are not giving up their rights to the foreclosed asset, but rather are forced to delay the evictions;
- the households which may benefit from this measure are subject to very restrictive eligibility criteria, which limits the potential beneficiaries to around 120,000 families (by comparison, between 2003 and 2012 more than 8.6 million residential mortgages were granted);
- The delinquency ratio for residential mortgages has increased in 2008-2009, but remained relatively stable afterwards at a relatively low level of around 3.2% of total loans;
- The measures will expire on 15 November 2014.

40. Ensuring an adequate solvency of the entire banking sector is essential and is one of the main purposes of this financial assistance programme. In this regard, the MoU (condition 26) aims at increasing the amount of capital of banks and aligning its definition with those internationally agreed. Spain will be subject to the forthcoming EU Capital Requirements Regulation. As it is envisaged in the MoU, the additional capital to reach the 9% ratio will be covered using the definition of capital approved by the European Banking Authority (EBA) for its 2011 EU-wide recapitalisation plan. For this purpose, Law 9/2012 adopted this capital definition to be required from the beginning of 2013. The BdE approved on 30 November a new Circular 7/2012 on some technical details on the minimum capital requirements.

5 ANNEXES

5.1 MAIN ECONOMIC AND FINANCIAL INDICATORS

	1995- 1999	2000- 2004	2005- 2008	2009	2010	2011	2012 (e)	2013 (f)
Core indicators								
GDP growth rate	3.7	3.6	3.0	-3.7	-0.3	0.4	-1.4	-1.4
Private consumption (annual % change)	3.5	3.7	2.8	-3.8	0.7	-1.0	-1.9	-2.1
Public consumption (annual % change)	2.7	5.0	5.4	3.7	1.5	-0.5	-4.9	-7.2
HICP (annual % change)	2.8	3.2	3.5	-0.2	2.0	3.1	2.5	2.1
Domestic demand incl. stocks	4.2	4.3	3.6	-6.6	-0.6	-1.9	-4.0	-3.8
Unemployment rate (% of labour force)	17.2	11.2	9.3	18.0	20.1	21.7	25.1	26.6
Gross fixed capital formation (% of GDP)	22.5	26.7	29.8	23.6	22.3	21.1	19.3	18.2
Gross national saving (% of GDP)	22.0	22.6	21.1	19.2	18.4	17.8	17.4	18.2
General Government (% of GDP)								
Balance	-4.2	-0.4	0.3	-11.2	-9.7	-9.4	-8.0	-6.1
Gross debt	64.7	52.5	39.8	53.9	61.5	69.3	86.1	92.7
Interest expenditure	4.6	2.7	1.7	1.8	1.9	2.5	3.0	3.9
Households								
Households saving rate	13.2	11.3	11.3	17.8	13.1	11.0	8.7	8.1
Rest of the world (% of GDP)								
Trade balance	-0.1	-2.8	-6.0	-1.9	-2.2	-0.8	1.0	3.3
Trade balance, goods	-3.3	-5.7	-8.1	-4.0	-4.6	-3.8	-2.5	-0.8
Trade balance, services	3.2	2.9	2.0	2.1	2.4	3.0	3.5	4.1
Current account balance	-0.8	-4.4	-9.0	-4.8	-4.4	-3.7	-2.4	-0.5
Net financial assets	-27.0	-39.7	-70.1	-91.9	-86.4	-89.3	n.a.	n.a.
Net international investment position	-26.9	-41.3	-69.7	-93.7	-88.9	-91.7	n.a.	n.a.
Competitiveness (index, 2005=100)								
Real effective exchange rate relative to the rest of the euro area	91.4	95.8	104.1	104.9	103.4	100.8	96.6	95.4
Real effective exchange rate relative to the rest of the European Union	93.7	95.3	103.8	107.7	105.2	102.5	97.3	96.0
Real effective exchange rate relative to the rest of 36 industrialised countries	92.5	92.7	104.6	109.0	104.6	102.2	96.0	95.1
Banking sector								
Assets (% of GDP)	173.7	194.9	274.5	328.9	330.9	340.5	342.2	n.a.
Private domestic credit (y-o-y %)	11.8	14.7	18.9	-1.6	0.8	-3.2	-5.5	n.a.
Non-performing loans (NPLs), total	n.a.	1.1	1.5	5.1	5.8	7.8	10.7	n.a.
NPLs, productive activities	n.a.	1.2	1.5	6.2	8.1	11.6	16.6	n.a.
" of which, construction, and	n.a.	1.0	1.7	8.5	12.1	18.2	26.4	n.a.
" real estate activities	n.a.	0.6	1.8	10.1	14.0	21.4	30.3	n.a.
NPLs, residential mortgages	n.a.	0.4	1.0	2.9	2.6	3.1	4.0	n.a.
Tier 1 ratio (%)	n.a.	n.a.	n.a.	9.3	9.6	10.5	9.6	n.a.
Interest rates								
10 year spread vis-à-vis the Bund	2.1	0.1	0.2	1.0	2.0	3.9	5.5	4.7
CDS 5 year	n.a.	n.a.	n.a.	92.9	203.4	318.1	427.2	257.2

(e) 2012 estimate or latest available data

(f) 2013: forecast or latest available data

Sources: Ameco, BdE, ECB, Eurostat, Thomson Reuters Ecowin.

5.2 TABLE ON THE STATUS OF MOU CONDITIONALITY

Measure	Date	Status
1. Provide data needed for monitoring the entire banking sector and of banks of specific interest due to their systemic nature or condition (Annex 1).	Regularly throughout the programme, starting end-July	Improvements ongoing
2. Prepare restructuring or resolution plans with the EC for Group 1 banks, to be finalised in light of the Stress Tests results in time to allow their approval by the Commission in November.	July 2012 - mid August	Implemented – plans adopted on 28 November 2012
3. Finalise the proposal for enhancement and harmonisation of disclosure requirements for all credit institutions on key areas of the portfolios such as restructured and refinanced loans and sectorial concentration.	End-July 2012	Implemented BdE Circular 6/2012
4. Provide information required for the Stress Test to the consultant, including the results of the asset quality review.	Mid-August 2012	Implemented
5. Introduce legislation to introduce the effectiveness of SLEs, including allowing for mandatory SLEs.	End-August 2012	Implemented RDL 24/2012
6. Upgrade of the bank resolution framework, i.e. strengthen the resolution powers of the FROB and FGD.	End-August 2012	Implemented RDL 24/2012
7. Prepare a comprehensive blueprint and legislative framework for the establishment and functioning of the AMC.	End-August 2012	Implemented RDL 24/2012
8. Complete bank-by-bank stress test (Stress Test).	Second half of September 2012	Implemented
9. Finalise a regulatory proposal on enhancing transparency of banks	End September 2012	Implemented BdE Circular 6/2012
10. Banks with significant capital shortfalls will conduct Subordinated Liability Exercises (SLEs).	before capital injections in Oct./Dec. 2012	Decisions stipulating SLEs adopted
11. Banks to draw up recapitalisation plans to indicate how capital shortfalls will be filled.	Early-October 2012	Implemented
12. Present restructuring or resolution plans to the EC for Group 2 banks.	October 2012	Implemented
13. Identify possibilities to further enhance the areas in which the BdE can issue binding guidelines or interpretations without regulatory empowerment.	End-October 2012	Implemented

Measure	Date	Status
14. Conduct an internal review of supervisory and decision-making processes. Propose changes in procedures in order to guarantee timely adoption of remedial actions for addressing problems detected at an early stage by on-site inspection teams. Ensure that macro-prudential supervision will properly feed into the micro supervision process and adequate policy responses.	End-October 2012	Implemented
15. Adopt legislation for the establishment and functioning of the AMC in order to make it fully operational by November 2012.	Autumn 2012	Implemented
16. Submit for consultation with stakeholders' envisaged enhancements of the credit register.	End-October 2012	Implemented
17. Prepare proposals for the strengthening of non-bank financial intermediation including capital market funding and venture capital.	Mid-November 2012	Implemented
18. Propose measures to strengthen fit and proper rules for the governing bodies of savings banks and introduce incompatibility requirements regarding governing bodies of former savings banks and commercial banks controlled by them.	End-November 2012	Implemented
19. Provide a roadmap (including justified exceptions) for the eventual listing of banks included in the stress test which have benefited from state aid as part of the restructuring process.	End-November 2012	A draft roadmap has been provided by Spain in November. It is still under discussion.
20. Prepare legislation clarifying the role of savings banks in their capacity as shareholders of credit institutions with a view to eventually reducing their stakes to non-controlling levels. Propose measures to strengthen fit and proper rules for the governing bodies of savings banks and introduce incompatibility requirements regarding the governing bodies of the former savings banks and the commercial banks controlled by them. Provide a roadmap for the eventual listing of banks included in the Stress Test, which have benefited from State aid as part of the restructuring process.	End-November 2012	Implemented (on the roadmap of the listing of banks, see condition 19)
21. Banks to provide standardised quarterly balance sheet forecasts funding plans for credit institutions receiving state aid or for which capital shortfalls will be revealed in the bottom-up stress test.	As of 1 December 2012	In progress – a reporting template is being developed

Measure	Date	Status
22. Submit a policy document on the amendment of the provisioning framework if and once Royal Decree Laws 2/2012 and 18/2012 cease to apply.	Mid-December 2012	Spain has submitted a document on which the international partners will provide feed-back
23. Issues CoCos under the recapitalisation scheme for Group 3 banks planning a significant (more than 2% of RWA) equity raise.	End-December 2012	Not relevant, Group 3 banks recapitalised without State aid
24. Transfer the sanctioning and licensing powers of the Ministry of Economy to the BdE.	End-December 2012	Implemented RDL 24/2012
25. Require credit institutions to review, and if necessary, prepare and implement strategies for dealing with asset impairments.	End-December 2012	Implemented
26. Require all Spanish credit institutions to meet a Common Equity Tier 1 ratio of at least 9% until at least end-2014. Require all Spanish credit institutions to apply the definition of capital established in the Capital Requirements Regulation (CRR), observing the gradual phase-in period foreseen in the future CRR, to calculate their minimum capital requirements established in the EU legislation.	1 January 2013	Implemented RDL24/2012 Additional technical details implemented by BoE (Circular 7/2012)
27. Review governance arrangements of the FROB and ensure that active bankers will not be members of the Governing Bodies of the FROB.	1 January 2013	Implemented RDL 24/2012
28. Review the issues of credit concentration and related party transactions.	Mid-January 2013	Not relevant for now
29. Propose specific legislation to limit the sale by banks of subordinate debt instruments to non-qualified retail clients and to substantially improve the process for the sale of any instruments not covered by the deposit guarantee fund to retail clients.	End-February 2013	Implemented RDL 24/2012
30. Amend legislation for the enhancement of the credit register.	End-March 2013	In progress (Draft Circular received and under discussion)
31. Raise the required capital for banks planning a more limited (less than 2% of RWA) increase in equity.	End-June 2013	Not relevant (Group 3 banks recapitalised without State aid)
32. Group 3 banks with CoCos to present restructuring plans.	End-June 2013	Not relevant (Group 3 banks recapitalised without State aid)

