Summary for non-specialists
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Financial Assistance Programme for the Recapitalisation of Financial Institutions in Spain.

Third Review of the Programme – Summer 2013

The European Commission published the Third Review report of Spain's compliance with the Financial Assistance Programme for the Recapitalisation of Financial Institutions. The report is based on the findings of a joint European Commission (EC)/European Central Bank (ECB) mission to Madrid during 21 – 31 May 2013.

Overall, the mission found that the programme of financial assistance for bank recapitalisation remains on track and the policy conditionality has been almost fully implemented. Nevertheless, macroeconomic challenges are significant with a potential negative impact on the banking sector going forward.

Spanish financial markets have further stabilised since the previous review, notwithstanding a recent uptick in the government and corporate bond spreads. The liquidity situation of the Spanish banking sector has continued to improve due to better access to capital markets and interbank funding, with a steady reduction of Eurosystem financing.

Importantly also, solvency of Spanish banks has been bolstered by the recapitalisation of parts of the banking sector and the transfer of assets to Sareb . Solvency rates are now above the regulatory requirements. Once the burden sharing measures are finalised by end-July, all banks will comply with the higher minimum requirements set in the Memorandum of Understanding (MoU).

The transfers of assets (of about EUR 50 bn) to Sareb have now been completed. Sareb has commenced operations against the very tight preparation time foreseen in the MoU. It now faces the challenge of successfully managing and eventually divesting the portfolio of assets, against the backdrop of the still very difficult market conditions for the Spanish real estate.

The process of bank restructuring is well underway for the banks having received State aid. The required burden-sharing exercises with banks´ shareholders and junior bond holders are almost complete now. Still, the outcomes of the arbitration processes against the alleged mis-selling practices could represent an additional financial burden for the banks.

Finally, compliance with the horizontal conditionality in the MoU is nearly complete. Implementation efforts need to continue, in particular in the areas of the reform of the governance of the savings banks and changing supervisory procedures at Bank of Spain.

Despite these very encouraging trends and achievements, macro-financial stability in Spain is far from assured. The decline in lending to the private sector accelerated in recent months largely on account of a lack of solvent demand, but also due to tighter lending standards. It affects primarily real estate and construction sectors, but also non-financial corporates (NFCs). However, there is also new lending flowing into the economy targeting less indebted and more profitable companies.

The economic and budgetary situation remains challenging. While the correction of external and internal imbalances proceeds, risks remain amid high unemployment, contracting activity, still large private domestic and external debt and fast rising public debt. In the end of May recommendations, the Commission emphasised again the need for further, albeit more gradual consolidation of public finances in the years ahead and accelerating the completion of structural reforms.

Closely related to the macro-economic challenge is the need to maintain adequate capital levels and ensure bank profitability. Banks have posted some profits in the first quarter of 2013 after heavy losses in 2012 linked to a hefty build-up of provisions due to the clean-up of balance-sheets. Higher profitability and capital buffers would facilitate bank lending to the real economy and thereby address potential weaknesses on the supply-side of the credit market.

Therefore banks must be well prepared to deal with further deteriorations in asset quality and the effects of supervisory action, such as the recent welcome call by the Bank of Spain for better classification of restructured/refinanced loans. In addition, a recent Supreme Court decision removing not clearly specified interest rate floors on retail mortgage contracts could also threaten bank profitability going forward.

Restoring full stability of the Spanish banking sector may be hindered by recent regional legal initiatives related to the housing market. Spain needs to ensure that such initiatives, aiming to protect the socially weakest households, including those at regional level (for example in Andalucía), do not adversely affect financial stability and the viability of the Spanish housing market, thereby honouring the commitments under the MoU.

In sum, the programme remains on track and the resilience of the financial sector has increased, so that there is no reason to foresee further programme disbursements at this stage. Nevertheless, the assessment of the asset quality and of the solvency situation of Spanish banks should continue in order to provide reassurance that the programme is approaching its completion successfully.