EXECUTIVE SUMMARY

This document presents an ex-post evaluation of the Financial Assistance Programme for the Recapitalisation of Financial Institutions in Spain implemented from July 2012 to January 2014.

The purpose of the evaluation is to assess the intervention in terms of relevance, effectiveness, efficiency, coherence and EU added value in order to draw lessons for future decision-making. This contributes to transparency and accountability of EU policies and may identify areas of improvement for similar ongoing or future interventions. An ex-post evaluation of the design, implementation and outcome of the programme is required by European Commission rules and in line with international best practice[1].

Acting upon a request from the Spanish authorities, which faced a banking crisis with increasing feedback loops to the sovereign debt market, the Eurogroup approved on 20 July 2012 an envelope of financial assistance of up to EUR 100 billion for the recapitalisation of financial institutions.

The envelope, which corresponded to about 10% of Spain's GDP, was approved along with programme conditionality as set out in the Memorandum of Understanding on Financial Sector Policy Conditionality (MoU). The programme entailed financing by the European Financial Stability Facility (EFSF) to be channelled through the Spanish government's Fund for the Orderly Restructuring of the Banking Sector (FROB) to financial institutions in need of public support. The Spanish government remained fully liable for the repayment of the loan. In November 2012, responsibility for providing financial assistance was transferred to the European Stability Mechanism (ESM).

The programme was designed with the main objective of increasing the long-term resilience of the Spanish banking sector, thus restoring its market access.

To achieve this, the 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. The broader objective of safeguarding financial stability in the euro area as a whole was embedded in the euro area Summit statement of 29 June 2012 and the Eurogroup statement of 20 July 2012. The programme design was novel in several respects vis-à-vis the former approach to financial assistance programmes for euro area Member States (e.g. it financed the restructuring and recapitalisation of the financial sector, bank recapitalisation was based on independent asset quality review (AQR) and stress tests and mandatory subordinated liability exercises (SLEs) for junior debt were requested).

The evaluators found that focusing the programme on financial sector conditionality while explicitly linking it with Spain's commitments to consolidate public finances and address macroeconomic imbalances under EU economic governance was appropriate.

A broad-based tightening in financing conditions in Spain was rooted in the banking sector but had spilled over to the real economy. In addition to measures directed at the financial sector, Spain needed a broader strategy to tackle macroeconomic sustainability issues given the country's large macroeconomic imbalances at the outset of the programme (see Chapter 2). The MoU contained explicit financial sector conditionality and required Spain to fully comply with its commitments under the Excessive Deficit Procedure (EDP) and European Semester recommendations, of which the Macroeconomic Imbalance Procedure (MIP) was of particular relevance. Contrary to standard economic adjustment programmes, the programme did not contain new specific conditions in the areas of fiscal policy and structural reforms, but compliance with those procedures was part of the conditionality and was fully assessed during the programme's review missions. This design contributed to a strong ownership of the programme by the authorities, while investors were reassured that the programme was part of a broader strategy taking into account the need to preserve debt sustainability and correct macroeconomic imbalances. The size of the financial envelope, while overshooting (ex-post) the final needs of the banking system, increased confidence in times of severe financial turmoil in Spain and growing financial market fragmentation across the euro area. Overall, the strategies chosen to deal with impaired assets and to recapitalise banks responded to

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[1] Communication to the Commission (COM), 'Responding to Strategic Needs: Reinforcing the use of evaluation' (SEC(2007)213), http://ec.europa.eu/smart-regulation/evaluation/docs/eval_comm_sec_2007_213_en.pdf

international best practice and significantly reduced uncertainty about the health of banks' balance sheets. They also allowed for a necessary recognition of losses by the banking system. The banks' recapitalisation plans benefited from the assessment of capital needs by independent experts, which provided more precise estimations in times of high uncertainty. Nevertheless, the evaluators found that several important decisions regarding the programme design could have been better communicated through programmerelated documents or public statements by the European and Spanish Institutions, notably the ones behind the choice of an asset management company (AMC) and the implementation of burden sharing measures from hybrid capital and subordinated debt holders in banks receiving public capital (see Chapter 3).

Implementation of the programme's financial sector conditionality was overall fast and forceful, with most major measures frontloaded to 2012.

Overall, the adopted measures were effective in achieving the programme's objectives in a short period of time (see chapter 4). The use of the financial envelope, less than half of the available amount, achieved the programme's objective while meeting EU competition rules requiring to minimise the amount of granted State aid. Speed was important in the setup of the AMC (Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria – Sareb) to achieve its primary objective of removing doubts about the quality of banks' balance sheets and facilitating an orderly downsizing of bank exposures to the real estate sector. The transmission of ownership of impaired assets from banks to Sareb was fast and allowed for a rapid completion of the banks' recapitalisation process. However, the transfer of the asset management tasks to Sareb and the setup of the team were slower, resulting in some inefficiencies. Overall, bank recapitalisation was well implemented. The MoU's roadmap was followed and the banking system did not require additional State aid after the programme. The subordinated liability exercises were relevant as they responded to the need to minimise the public contribution to the costs of the programme, while they followed the direction of emerging EU legislation. Excluding senior debt from burden-sharing exercises was appropriate on the back of financial stability risks and potential contagion effects to other euro area Member States in mid-2012. Given the absence of a clear framework for bailing in senior debt at the time, doing so in such a context would have created legal uncertainty and its effectiveness would have been constrained by losses incurred by the government given the high levels of State-guaranteed debt held by the banks which were subject to burden sharing exercises. The decision followed the approach taken in 2010 with the economic adjustment programme for Ireland. The implemented reforms in the area of financial regulation and supervision increased the resilience of the banking system and reduced risks to financial stability, but the implementation of the December 2013 Law on Savings Banks, which was a key measure to strengthening the governance of savings banks, accumulated long delays. A faster implementation would have contributed to quickly remove any doubts about weaknesses in the governance of the savings banks.

The exact impact of the programme (effectiveness) is difficult to quantify in the absence of a counterfactual, but the implementation of the programme measures underpinned macro-financial stability.

Although important challenges remain (see below), the evaluators found that the programme's objectives were overall achieved and the programme avoided a disorderly deleveraging that would have had harmful consequences for the financial sector and overall macroeconomic stability. A number of financial indicators show an overall improvement in solvency, profitability and financing costs of the banking system, while the negative trend of credit contraction is showing signs of a gradual reversal (see Chapter 6). Banks carried out an orderly downsizing of exposures to the real estate sector, banks' reliance on central bank liquidity declined and risk identification and crisis management mechanisms were enhanced. This supported the MoU's broader objective of safeguarding financial stability in the euro area as a whole. To be sure, the success of the programme also needs to be seen in the context of a number of external actions at European Union/Euro Area level which were of paramount importance, in particular the announcement of the ECB's Outright Monetary Transactions (OMT) scheme and steps towards a Banking Union.

Spain's commitment to comply with the fiscal targets and structural reforms required under the EDP and European Semester/MIP over the programme period helped to foster a virtuous circle of positive news and credibility for the financial sector programme.

Positive feedback loops from the implemented reforms under the EDP and the European Semester contributed to the overall success of the programme, as they helped to restore investor confidence about the authorities' capacity to correct macroeconomic imbalances in parallel to the restructuring of the financial sector. Fiscal indicators improved although the original targets had to be revised during the programme due to adverse

macroeconomic developments. In parallel, the authorities implemented a range of structural reforms to improve labour and product markets and public administration. These measures facilitated the ongoing correction of macroeconomic imbalances. Recent developments of macroeconomic indicators allow for a preliminary positive assessment about the effectiveness of the programme in enabling a return to sustainable growth (see Chapter 5).

Despite significant adjustments in Spain's financial sector and wider economy during the programme period, several important challenges remain.

In particular, despite the improved economic outlook, a still declining stock of credit and high (though decreasing) levels of non-performing loans (NPLs) and foreclosed assets pose risks to banks' profitability. The maximisation of the recovery value with regard to the entities which are still under the control of the FROB remains challenging. In addition, Spain exited the programme with still large general government deficit and public debt levels. Despite significant adjustments in key economic flows over the past few years, further consolidation efforts would be needed to bring the general government debt on a downward path, while the persistently high level of unemployment and low productivity pose significant policy challenges for the period ahead. There are some pending key reforms, such as the reform of professional services and professional associations, which have been delayed, and if adopted, could have a positive impact on productivity growth.

The programme was consistent with EU rules and initiatives and benefitted from them.

The implementation of the programme was framed in an evolving environment in the EU with regard to bank supervision and restructuring/resolution structures. A common framework at supranational level for bank restructuring and resolution was being put in place during the programme period, but it had not yet entered into force. The measures implemented under the programme followed the direction of this new framework while they also complied with EU State aid rules (see Chapter 4).

There was value added in setting up a financial assistance programme for the recapitalisation of financial institutions.

With Spain's public finances under stress and rising financing costs in the run up to the programme, EFSF/ESM financing within the programme allowed the Spanish State to finance the recapitalisation of the banking system at much more favourable terms. Involving European institutions and bodies and the IMF in the programme design and its implementation reviews introduced a degree of certainty towards investors who at that time questioned the health of the banking system, the rigorousness of banks' supervision and the financing capacity of the State for restructuring the banking system in the absence of financial assistance. In the absence of a programme and other measures taken in parallel at euro area level (e.g. monetary policy measures and steps towards a banking union), macro-financial stability would have been much more difficult to achieve, and it would have been economically and socially more costly, given the favourable financing terms of the programme and the strong tightening of financing conditions in Spain and contagion fears across Member States at the onset of the programme.

The following lessons can be drawn from this ex-post evaluation of the Spanish financial sector assistance programme (see Chapter 7):

Scope of the overall programme strategy and financial assistance (relevance)

A short-in-time, frontloaded, financial-sector specific programme is a very useful instrument to keep in the toolbox of euro area financial-assistance interventions, but it is not suitable in all circumstances. To be successful, it requires inter alia that systemic risks stem predominantly from the financial sector, a strong technical and administrative capacity in the recipient country and the authorities' commitment and ownership with regard to the programme's measures.

Future programmes would benefit from specific considerations about the distributional and social impact of its measures. Financial-sector programmes could benefit from particular attention to financial consumer protection in order to limit negative spillovers of programme measures on consumers.

In the presence of high financial market volatility and uncertainties about banks' capital needs, the availability of an ample financial envelope provides a credible signal to markets that continued funding will be ensured in the event of unforeseen events. This reinforces the effectiveness of the programme.

Appropriateness of conditionality (efficiency)

Transparency is important when decisions involve re-distributional effects and may have a potentially significant impact on the taxpayer. Therefore, financial assistance programmes should benefit from clear public communication about measures involving burden sharing exercises and other measures which bear a significant social or redistributional impact. This would increase the ownership and credibility of the programme.
Contingency facilities to cover for possible early bank recapitalisations are a useful tool within a financial-sector programme, but the conditions under which those facilities could be drawn upon should be made clear upfront.
An AMC is an efficient tool to deal with impaired assets when there is a need to remove uncertainty from banks balance sheets, the problem is systemic, special powers and skills for asset resolution are needed, and the impaired assets are homogeneous enough to generate economies of scale. These conditions were met in the context of the Spanish programme, but different circumstances in future programmes might warrant different solutions. Thus, future financial sector programmes would benefit from a publicly available ex-ante analysis about the advantages and drawbacks of the strategy chosen to deal with impaired assets, including the implications of that choice for the taxpayer.

Appropriateness of programme implementation (efficiency)

Independent AQR and bottom-up stress tests are very useful tools to assure a financial-sector programme effectiveness and increase transparency and confidence about the estimations of capital needs of the banking system.
In the future, the setup of AMCs would benefit from a rapid transfer of both management and ownership of impaired assets. When the management of impaired assets transferred to the AMC remains temporarily within the banks, as was the case for Sareb, right incentives in servicing agreements with those banks should be established so that they make efforts to extract the maximum value from the transferred assets. It is important to ensure that capacity in terms of management and governance is built up quickly, that the management is independent, and that a realistic business plan is established.
When financial market uncertainty is very high and there is no functioning market for impaired assets to be transferred to an AMC, independent valuations based on the long-term economic value of those assets accompanied by an additional haircut can be an efficient tool to limit risks of potential losses for the AMC.
Clear communication is essential when implementing burden sharing exercises which might be different across programmes, so as to improve the public's perception of those decisions. Reasons leading to different approaches for burden sharing or other important sensitive decisions under different euro area programmes should be widely available and properly communicated by the institutions involved in those decisions. In this regard, the deep transformation in EU bank resolution and supervision frameworks which developed in parallel to the programme should facilitate a more homogeneous implementation and reduce legal uncertainty in future programmes.

Achievement of the programme's objectives (effectiveness)

Programme conditionality which is realistic and in line with a country's priorities facilitates the achievement of the programmes' objectives.
The achievement of the programme's objectives depends not only on domestic actions but also on the external environment. Possible measures at EU/EA level that could help achieving the programme's objectives are worth evaluating at the early stages of the programme design.
A financial sector specific programme with explicit requirement in the MoU for the country to comply with EDP and European Semester/MIP recommendations may create positive feedback loops and underpin the overall success of the programme, provided that sufficient implementation capacity and political commitment are in place. If those conditions are not in place, a fully-fledged programme with less frontloaded disbursements might be more suitable.
Consideration needs to be given to the aftermath of the programmes in terms of the path of fiscal consolidation and structural reforms. The risk of slowing down reforms after the programme can be reduced by ensuring an as-complete-as-possible implementation of the programme conditions within the programme period, for which frontloading the programme measures can be an efficient tool.

EU value added and coherence with other EU policies

Financial assistance from the EU/EA to a Member State adds high value where the Member State is unable to overcome negative sovereign-bank feedback effects on its own, by reducing financing costs for the State, supporting debt sustainability and thus macroeconomic stability, and by overcoming investors' concerns about the credibility of domestic bank regulators and supervisors.