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Financial Assistance Programme for the Recapitalisation of Financial Institutions in Spain. First review - Autumn 2012

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European Commission
Directorate-General for Economic and Financial Affairs
Publications
B-1049 Brussels
Belgium
E-mail: mailto:Ecfin-Info@ec.europa.eu

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First review - Autumn 2012

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Contributors:

Alvaro Benzo, Lucas Gonzalez Ojeda, Peter Grasmann, Oskar Grevesmuhl, Javier Jareno Morago, Bozhil Kostov, Mihai-Gheorghe Macovei, Maria-Cruz Manzano, Magdalena Morgese Borys, Corina Weidinger Sosdean, Jakub Wtorek, Norbert Wunner and the financial crisis task force of the Directorate General for Competition. Coordination and editing were ensured by Mihai-Gheorghe Macovei and technical assistance was provided by Michel Gerday.

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Comments on the occasional paper would be gratefully received and should be sent, by mail or e-mail to:

Peter GRASMANN
European Commission
Unit ECFIN.E1
B-1049 Brussels
Peter.Grasmann@ec.europa.eu

Or

Norbert WUNNER
European Commission
Unit ECFIN.F2
B-1049 Brussels
Norbert.Wunner@ec.europa.eu

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ABBREVIATIONS

ALMP	Active Labour Market Policies
AMC	Asset Management Company
BBVA	Banco Bilbao Vizcaya Argentaria
BdE	Banco de España (Bank of Spain)
BFA	Banco Financiero y Ahorro, S.A.
CDS	Credit Default Swaps
CET	Common Equity Tier
CIR	Central de Información de Riesgos (Central Credit Register)
CoCos	Contingent Convertible securities
CRR	Capital Requirements Regulation
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
ECC	Expert Coordination Committee
EDP	Excessive Deficit Procedure
EFSF	European Financial Stability Facility
ESM	European Stability Mechanism
FROB	Fondo de Reestructuración Ordenada Bancaria (Fund for Orderly Bank Restructuring)
FSAP	IMF's Financial Sector Assessment Program
GDP	Gross Domestic Product
IMF	International Monetary Fund
LTV	Loan-To-Value
MFIs	Monetary Financial Institutions
MoU	Memorandum of Understanding
NCC	National Commission for Competition
PDs	Probability of Defaults
RDL	Real Decreto Ley (Royal Decree Law)
RED	Real Estate Development
REER	Real Effective Exchange Rate
RLF	Regional Liquidity Fund
RWA	Risk Weighted Assets
Sareb	Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria
SCC	Strategic Coordination Committee
SLEs	Subordinated Liability Exercises
SMEs	Small and Medium Enterprises
ULC	Unit Labour Cost
VAT	Value Added Tax

1 EXECUTIVE SUMMARY

This report provides an assessment of the progress made by Spain with respect to its Financial Assistance Programme for the Recapitalisation of Financial Institutions in Spain, based on the findings of a joint European Commission (EC)/European Central Bank[1] (ECB) mission to Madrid during 15-26 October 2012. The mission found that the reform of the financial sector is on track. The ambitious policy conditionality of the programme has so far been met in a timely and high-quality manner. It will be important to maintain the momentum in the coming months as major challenges lie ahead, in particular the effective restructuring of banks and the set-up of the Asset Management Company (AMC).

Spanish financial markets have stabilized since the summer. Main factors behind this development have been the favourable impact of bold decisions at European level to enhance the financial architecture of the European and Monetary Union, the re-pricing of risk in the bond market following the ECB's announcements, and the implementation of the financial sector assistance programme. Access of Spanish issuers to funding markets has thereby improved, however external financing remains constrained.

The deleveraging process of the economy has continued, albeit at a moderate pace. The banking sector's efforts to increase capital levels, clean up its legacy assets and build up liquidity buffers in a context of rising non-performing loans further tightened the supply of credit. The interaction of weak credit supply and declining demand for credit reflects and drives this process and it has been recently reinforced as the economy further contracted in the second and third quarters. Domestic demand has been falling, the house price correction continues, unemployment has risen to new heights and private-sector balance sheets remain under pressure.

Regaining durable access to capital markets remains key. Against the backdrop of economic activity likely to remain subdued and economic adjustment further proceeding, market access at fundamentally-justified costs for the Spanish sovereign and private issuers is a precondition to provide the financial resources for the smooth reallocation of factors of production in the Spanish economy. Therefore, further confidence-building measures appear warranted in order to build on the recent stabilisation of financial market conditions.

The financial assistance programme is on track and key building blocks have been put in place.

- **Major progress was achieved through the conduct of a robust bottom-up stress test at the end of September.** The stress test yielded credible results in terms of identifying capital needs for the individual banks and revealing a capital shortfall of about EUR 59 billion for the entire banking sector. It also confirmed the diagnostic of the top-down stress test, i.e. the capital shortfalls are not widespread, but rather located in a specific group of banks.
- **The entering into force of Real Decreto Ley[2] (RDL) 24/2012 on 31 August, 2012 equipped both the Fondo de Reestructuración Ordenada Bancaria[3] (FROB) and the Banco de España (BdE) with the legal toolbox to restructure and resolve credit institutions, conduct mandatory burden sharing, improve the institutional framework and enhance capital requirements and bank transparency.** The Royal Decree Law provides the legal framework in which the European Commission is

[1] The mission also involved expert teams from the European Stability Mechanism and the European Banking Authority. The International Monetary Fund participated in the meetings as part of its independent monitoring.
[2] Royal Decree Law.
[3] Fund for Orderly Bank Restructuring (FROB), http://www.frob.es

assessing the restructuring plans submitted by the Spanish authorities for the banks that need public support in order to cover the capital shortfall identified in the stress-test. The European Commission adopted the restructuring plans for Group 1 banks on 28 November 2012.

- **A comprehensive blueprint for setting-up the Asset Management Company (AMC) was adopted on schedule by end-August.** Work on the secondary legislation regarding the structure and governance of the financial vehicle, the scope of assets, the transfer price and the provisional business plan is about to be finalised by mid-November. This provides the framework for the segregation of RED loans and foreclosed assets from the banks' balance sheets.

- **The capital needs of the banks will be reduced via burden sharing measures.** After allocating losses to equity holders, the Spanish authorities will require burden sharing measures from hybrid capital holders and subordinated debt holders in banks receiving public capital, including by implementing both voluntary and, where necessary, mandatory Subordinated Liability Exercises (SLEs). To that effect, the Spanish authorities have introduced legislation to ensure the effectiveness of the SLEs.

- **Other legislative measures foreseen by the MoU were adopted to further enhance bank transparency and the regulatory and supervisory framework.** The legal framework was upgraded in order to increase the quality and quantity of information provided by credit institutions to the general public, notably concerning real estate and construction sector exposures. The credit registry is in process of being enhanced and the consumer protection legislation as regards the sale by banks of hybrid capital and subordinated debt instruments was improved. The operational independence of the BdE was increased through the transfer of some key supervisory and regulatory powers from the Ministry of Economy.

- **Fiscal consolidation is set to accelerate in the remainder of 2012 and in 2013 with the adoption of new measures.** The general government deficit has narrowed only marginally in the first half of 2012 compared to the same period of 2011, in part because the recessionary environment delivers strong headwinds. Spain has adopted consolidation measures in July to underpin the revised deficit target for 2012, a multi-annual budget plan for 2013-14 in August and a draft 2013 budget in September. However, further consolidation measures still need to be set out in detail, especially for 2014.

- **Structural reforms aimed at correcting macroeconomic imbalances have advanced in several areas.** A range of measures have been launched in the areas of labour market policies, taxation, and the electricity tariff deficit. Spain has also announced a structural reform plan, which envisages further concrete measures to implement active labour market reform and employment policies, reduce the fragmentation of domestic product markets, liberalise professional services and improve the business environment.

As regards the achievement of the programme objectives, further rapid progress is expected with the finalisation and adoption of the bank restructuring plans for Group 2 banks, the recapitalisation of all banks needing State aid and rendering the AMC fully operational. Although the implementation of these measures is broadly on track, they represent important milestones of the programme and require well-thought decision making and effective implementation within ambitious deadlines, which is going to be challenging.

Successful completion of the First Review has paved the way for the release of the first loan instalment of around EUR 39.5 billion. The released tranche will be used for covering the capital shortfall of Group 1 banks estimated at EUR 37 billion and finance the FROB's stake in the capital of the Asset Management Company of about EUR 2.5 billion. The Commission services and the ECB consider that Spain has fulfilled the required conditionality and have recommended the first disbursement of funds from the ESM facility.

2 INTRODUCTION

1. This First Review report assesses compliance with the conditions of the Financial Assistance Programme for the Recapitalisation of Financial Institutions in Spain. The assessment is based on the findings of a joint European Commission (EC) / European Central Bank (ECB) / International Monetary Fund (IMF) / European Banking Authority (EBA) and European Stability Mechanism (ESM) staff mission to Madrid from 15 to 26 October 2012[4]. In accordance with the Memorandum of Understanding (MoU) on granting EU financial assistance to Spain[5], the mission assessed compliance with the conditionality and progress towards the key objectives of the Programme for restructuring and recapitalisation of the Spanish banking sector.

2. The Financial Assistance Programme was agreed by the Eurogroup on 9 July 2012. The Programme, which covers a period of 18 months[6], entails an external financing by the euro area of up to EUR 100 billion, to be channelled through the FROB, acting as agent of the Spanish government, to the financial institutions concerned. The financial package is provided under the terms of the Financial Assistance for the Recapitalisation of Financial Institutions by the European Financial Stability Fund (EFSF) and it will be taken over by the European Stability Mechanism (ESM), once this institution becomes fully operational.

3. The Memorandum of Understanding includes both bank-specific conditionality, in line with State aid rules, and horizontal conditionality. Conditions with a deadline prior to mid-November 2012 are assessed by this report, including those which were met or those toward which there was substantial progress ahead of their deadline.

4. The bank-specific conditionality has three main components:

- First, a comprehensive diagnostic as regards the capital needs of individual banks, based on a comprehensive asset quality review and valuation process, and bank-by-bank stress tests.
- Second, the segregation of impaired assets from the balance sheet of banks receiving public support and their transfer to an external Asset Management Company (AMC).
- Third, the submission of restructuring plans by the banks with a capital shortfall identified by the stress tests, recapitalisation and restructuring of viable banks and an orderly resolution of non-viable banks, with private sector burden-sharing as a prerequisite.

5. Horizontal conditionality applies to the entire banking sector, unlike bank-specific conditions, which only apply to banks unable to meet capital shortfalls identified by the bank-by-bank stress test without having recourse to State aid. The horizontal programme includes measures aimed, inter alia, at strengthening the regulatory, supervisory and bank resolution frameworks, enhancing the governance structure of savings banks and of commercial banks controlled by them, improving consumer protection legislation as regards the sale by banks of hybrid capital and subordinated debt instruments.

[4] The cut-off date for the information used for the assessment of compliance with the MoU conditionality is November 15.
[5] Signed between the European Commission and Spain on 23 July 2012.
[6] However, the restructuring of the banks receiving public support under the State aid rules is expected to take up to five years.

6. As regards the financing part of the Programme, so far there has been no disbursement from the contingency facility of EUR 30 billion set aside for unforeseen vulnerabilities of the Spanish banking sector that may threaten the entire financial sector in Spain and via contagion outside Spain. The main reason has been the relative calmness of the financial markets following the announcement of the Programme and the return of confidence over the summer. Under these circumstances, the FROB proceeded with a bridge recapitalisation of BFA-Bankia of EUR 4.5 billion in September, after the latter published its financial accounts for the first half of 2012, without having recourse to the contingency facility.

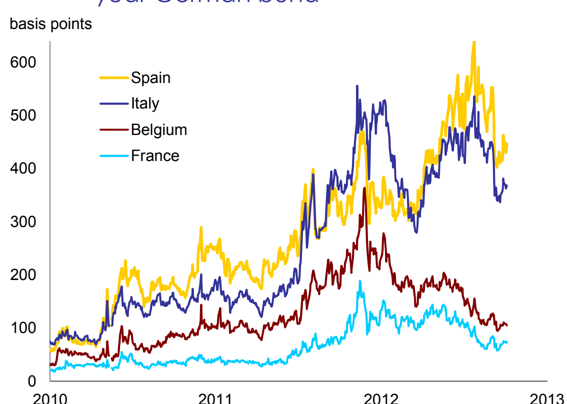
3 FINANCIAL, MACROECONOMIC AND FISCAL DEVELOPMENTS AND OUTLOOK

3.1 ACCESS TO FINANCIAL MARKETS IMPROVES, WHILE DELEVERAGING CONTINUES

7. **Market sentiment towards Spain improved in the third quarter of 2012 despite the fact that financial indicators in Europe, particularly those related to the most vulnerable euro area countries, continued to be dominated by tensions and upward revisions in sovereign risk premia**. The higher confidence in Spain's sovereign risk was reflected in the decline of the yields of the sovereign 10 year bonds after a pre-summer rally which drove bond spreads vs. the German Bund benchmark to record levels since the introduction of the euro. Spanish sovereign and bank credit default swaps (CDS) spreads as a measure of risk premia also improved because of the strong inter-linkage between sovereign risk and banking risk. However, the large volatility and still elevated levels of spreads and risk premia suggest that uncertainty going forward remains high.

8. **The improvement in investor confidence reflects important steps to strengthen the euro area financial architecture, including the provision of the EFSF/ESM financial backstop to clean up and restructure the Spanish banking secto**r. The approval of the financial aid to the Spanish banking system and the signature of the Memorandum of Understanding in late July, together with the fiscal measures taken by the Spanish authorities, and the the re-pricing of risk in the bond market following the ECB's announcements contributed to relieving tensions affecting the Spanish sovereign risk. This contributed to address severe distortions in government bond markets which had emanated to some degree from investor concern regarding the reversibility of the euro. The behaviour of Spanish sovereign yields and risk premia reflected to a large extent these positive developments (see Graph 1 and Graph 2).

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

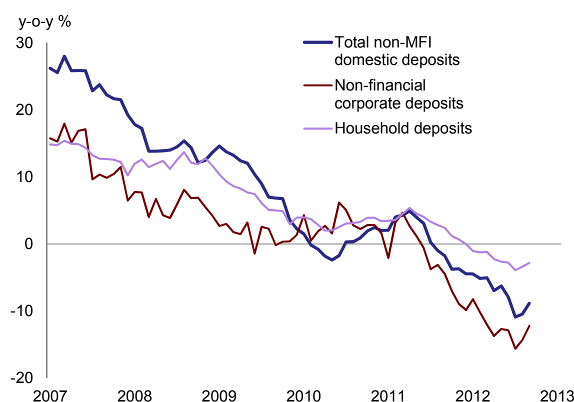
9. **As a result of the policy initiatives taken at both European and national levels, access to financial markets improved for Spanish issuers since August.** For banks, the overall issuance volume of secured, unsecured and covered bonds in September was the largest

monthly issuance since February 2012. Since mid-September, the improvement of funding conditions has continued although at a slower pace. In parallel, the stock exchange rallied, ensuring better access to capital for domestic blue chips (Graph 3). More importantly, some large and sound financial and non-financial, corporates such as Santander, BBVA, Sabadell, Banesto Telefonica, Iberdrola, Gas Natural have issued debt in the primary market after a period of inactivity by Spanish private issuers lasting since the first quarter of 2012. According to market sources, the demand of non-residents for Spanish private debt in the primary market increased in recent months. Nonetheless, at least for the banking institutions, the amount of unsecured debt issued was relatively small in size compared with previous issuances while costs were higher. Still, the issuance improved the institutions' cash position and was also an important contributing factor to the slight decrease in ECB borrowing in September and October after several months of uninterrupted strong growth.

Graph 3: Madrid Stock Exchange
(Spain Ibex 35 Index)

Source: Reuters EcoWin and own calculations

Graph 4: Bank deposits



Source: BdE, own calculations

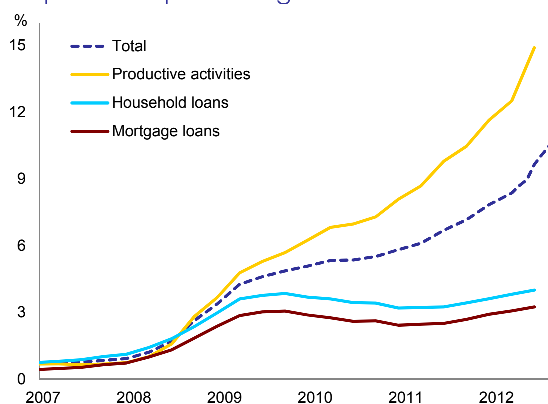
10. The sovereign also took advantage of the improved access to financing conditions. The Spanish Treasury increased the pace of government securities issuance and by the end of October it managed to cover about 95% of its bond issuance plan for 2012. If the favourable trend persists, the Treasury would start pre-financing its medium and long-term financing needs for 2013. Another positive development concerns the participation of foreign investors in government securities auctions, with international investors buying more than 50% of bonds at recent auctions.

11. Despite the recent improvement in investor confidence towards Spanish issuers, financing conditions for the overall banking sector remain tight. The trends witnessed in the first half of 2012 continued into the third quarter. The fall in domestic private deposits – household and corporate - accelerated to around 6.5% (y-o-y) in July, but receded to about 5% in September (see Graph 4). Correcting for the impact of substitutions to commercial paper due to higher deposit insurance premia, the real drop is actually much lower. At the same time, the outflow of non-resident deposits (including non-resident MFIs) increased by another EUR 45 billion or 11% from June to August, but recovered by about EUR 5 billion in September. In parallel, the reliance on net borrowing from the Eurosystem increased to a record EUR 389 billion (10.6% of total liabilities) in August 2012, but it declined subsequently to EUR 342 billion in October, helped by the issuance of unsecured senior debt on wholesale markets.

12. The deterioration in asset quality at system level has accelerated in the last couple of months. Non-performing loans reached 10.5% at the end of August 2012 compared to 9.0% at the end of May. The increase in impaired assets in the real estate and construction sector has been the main driver for the increase of non-performing loans at system level, as loan delinquencies in the construction sector stood at 23.9% at the end of June 2012. By contrast, the increase in impaired assets in the industry sector (non-construction) has continued but remained more subdued. Non-performing loans in the industry sector increased to 7% at the end of June 2012 compared to 6.1% at the end of March 2012 (see Graph 5). Non-performing loans in the household sector have continued to be considerably below the system average, due to the relatively low level of impairment on mortgage loans. The quality of mortgage loans deteriorated only slightly in recent months, as non-performing assets reached 3.2% at the end of June 2012 compared to 3.1% at the end of March 2012.

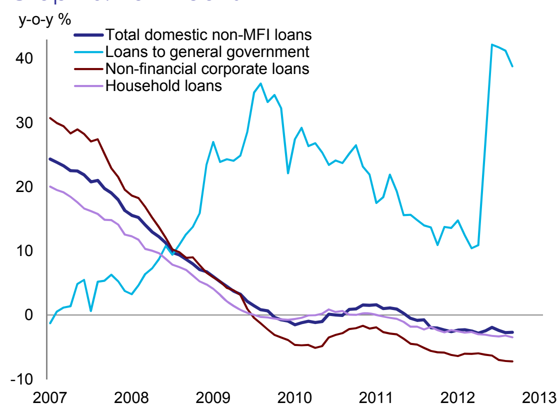
13. The increase in asset impairments has continued to put strain on banking sector profitability, which impacts negatively the banks' efforts to strengthen their capital ratios. Notwithstanding the difficult economic environment, the interest income of Spanish banks remained resilient in the first half of 2012. Interest income improved in the second quarter, increasing by 8% at the end of June compared to March 2012. However, the further increase in loan-loss provisions impacted significantly the profitability at system level at the end of June 2012, as banks need to comply with far more stringent provisioning requirements on real estate and construction sector assets required by the RDLs 2/2012 and 18/2012. Therefore, the banking system is expected to be loss-making in 2012.

Graph 5: Non-performing loans



Source: BdE and own calculations

Graph 6: Bank loans



Source: BdE, own calculations

14. The correction of the housing prices is expected to continue, impacting negatively on banks' profitability. On the supply side, the remaining large stock of unsold new homes implies further downward pressure on house prices (see Section 3.2 for further details). Demand for housing has been weak and is set to deteriorate further in line with its fundamentals, including falling household real disposable income, declining population, and remaining tight credit conditions.

15. Tight financing conditions, more prudent credit policies and the efforts to rebuild capital ratios to levels required by the EBA and Oliver-Wyman stress tests have restrained the banks' capacity to lend. Credit growth remains in negative territory as the constrained supply corroborated with weaker demand in a recessionary environment. More prudent lending policies due to the enhanced economic uncertainty have also played a role. The deleveraging

process, aimed at correcting the excessive credit growth of more than 20% year-on-year in the middle of the last decade, continues. As of September 2012, total domestic credit shrunk by about 3% year-on-year being driven by the decline in the stock of credit to the private sector which reached almost 5% year-on-year (see Graph 6). At the same time there was a strong increase in credit to the government by almost 40% year-on-year. The high increase in government credit reflects the gradual withdrawal of foreign investors from the domestic debt market which were replaced by the domestic banks and the financing of regional and local government arrears. Domestic lending to non-financial corporations and households, fell by around 7% and 3.5% year-on-year, respectively. Bank holdings of commercial bonds also went down significantly by about 20% year-on year. The total banking sector balance sheet was still growing modestly in August 2012 compared to a year before, but it shrunk by almost 3% since June 2012.

16. Non-financial corporations appear to bear the brunt of the deleveraging process, with construction and real estate companies being most affected, reflecting significant downsizing, following excessive growth in the boom years. According to the BCE/BdE Bank Lending Survey, banks have continued to tighten credit standards for loans for large enterprises in the first half of 2012, mainly because of their weakened ability to access market financing and higher risk expectations. Terms and conditions for loans have also become more stringent, both for large enterprises and small and medium enterprises (SMEs). This is consistent with the perception that access to finance of SMEs has been constrained lately. At the same time, banks are reporting a decrease in the demand for loans, both from large companies and SMEs, in particular for fixed investment. As regards households, the fall in credit has also been driven by both supply and demand factors. On the one hand, the terms and conditions for loans were tightened again, in terms of price and maturity, both for housing and consumer lending. On the other hand, the demand for loans continued to decrease as unemployment rose and households have reduced their indebtedness.

17. The deleveraging process by the non-financial corporate sector and Spanish households accelerated in recent months, but its pace remains moderate. This deleveraging is justified by the need to deal with the debt overhang accumulated during the boom years. Overall, the private sector has reduced its indebtedness by about 15% of GDP from its peak, but the leverage is still much above the pre-boom levels. The rate of decline in the bank gross financing of the non-financial corporations resident in Spain has picked up to above 4% in August 2012, but remains relatively modest as the total non-financial corporate debt is still large, at about 182% of GDP as of the first quarter of 2012. It has declined only gradually from a peak of about 194% of GDP in 2008. The gross financing of households was also declining at a broadly similar annual rate in August 2012, but slowing down from previous months. In this case the sector is a net lender to the economy. However the sector's liabilities remain relatively elevated at about 85% of GDP in the first quarter of 2012. At the same time, the households' net financial assets declined from around 82% of GDP in the first quarter of 2011 to about 73% of GDP the first quarter of 2012, reflecting a decline in disposable income and the saving rate.

18. Whilst some elements of the banking programme underpin the deleveraging process in the financial sector in the short run, also due to an accounting effect, the programme's overall impact on new lending should be positive. The segregation of RED loans and foreclosed assets of the banks recapitalised with public support to the AMC at transfer prices below their book value will reduce the balance sheet of these banks. At the same time, these banks will be recapitalised through the EFSF/ESM facility and will receive liquid AMC securities, thereby increasing their capacity to provide new lending to companies and households that are creating economic value in the adjustment process of the Spanish real economy. In a similar way, the downsizing of nationalised banks according to the restructuring

plans approved by the European Commission will take place only gradually, over a period of up to five years and should not increase significantly credit constraints for solvent clients.

19. **Viable clients should eventually be able to access credit from stronger and more efficient banks.** The authorities could facilitate this process by ensuring the transfer of the credit history of SMEs, for example, to their new credit institutions. Overall, a banking sector cleaned-up of legacy assets will be in a better position to access the debt and capital markets at favourable interest rates, and therefore satisfy the borrowing needs of enterprises and households with solvent demand. Moreover, a reallocation of credit needs to take place from the downsizing economic sectors, such as the real estate and construction, to businesses that can provide new sources of sustainable growth for the Spanish economy. Such a process is compatible with a moderate decline in the total nominal supply of credit. Nevertheless, going forward, the effects of the restructuring plans will have to be kept under review.

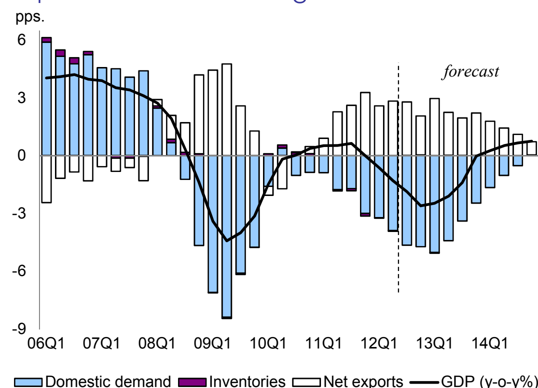
20. **Against the background of the on-going restructuring and deleveraging process taking place in the Spanish banking sector, the MoU condition 17 stipulates the preparation of proposals for the strengthening of the non-bank financial intermediation by the Spanish authorities.** As in many other European countries, the banking finance of non-financial corporations plays a predominant role in Spain and grew further during the boom years as a result of the buoyant demand and the easing of bank credit policies, as can be inferred from data provided by the Spanish "Central de Balances" and also from the survey on the access to finance of SMEs in the euro area jointly developed by the ECB and the European Commission. As far as the tightening of bank credit conditions can become binding for some viable and profitable companies, measures to make access to non-bank financing channels easier gains importance, in particular for SMEs.

21. **In this context, Spain finalised a plan of actions by mid-November 2012 that would improve the access of SMEs, mid-caps and larger non-financial corporations to finance.** It contains a broad range of measures aiming at inter alia creating an alternative bond market, supporting short-term financing for listed companies, strengthening the public and mutual guarantees for SMEs, developing a new line of equity loans for SMEs, supporting the development of SMEs via venture capital and business incubators and reforming the regulatory framework on venture capital investment. The implementation of the measures needs to be in line with State aid rules.

3.2 DIFFICULT MACROECONOMIC OUTLOOK AS THE ECONOMY REBALANCES

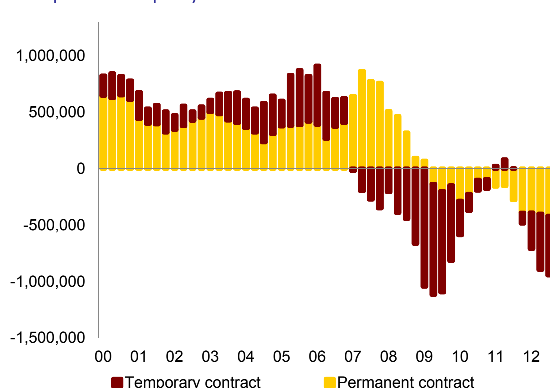
22. **The adjustment of large imbalances built up in the years prior to the crisis is holding back economic growth.** The necessary adjustment implies a profound shift in composition of GDP growth away from domestic demand (see Graph 7), which is being constrained by the private sector deleveraging, fiscal consolidation, further deterioration in the labour market, and tight credit conditions. In particular, private consumption is expected to remain very weak as the households' deleveraging coincides with high unemployment and the binding credit constraint. Investment, and especially investment in equipment, is set to decline given the unfavourable economic outlook, high corporate indebtedness, excess capacity and difficult access to credit. Public finances suffered a significant deterioration in the wake of the crisis and need to be brought back onto a sustainable path but ambitious fiscal adjustment is weighing on the short-term growth outlook. All in all, GDP growth is expected to contract by around 1½% in both 2012 and 2013, with the first signs of recovery only towards the end of 2013 (see Table 1).

Graph 7: Contributions to growth



Source: European Economic Forecast Autumn 2012

Graph 8: Employment and contract duration



Source: INE

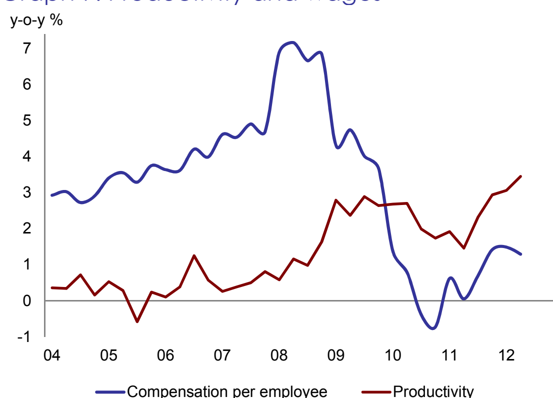
23. The unemployment rate remains stuck at very elevated levels and is set to increase further. It soared following the downsizing of the construction sector and the cyclical adjustment in the rest of economy and was further aggravated by rigidities of the Spanish labour market, which limited the sensitivity of wages to cyclical conditions. A comprehensive reform of the labour market eventually adopted in February 2012 is aimed at addressing these issues by reducing severance pay and allowing firms greater flexibility to adjust wages and employment (including working hours) to their specific economic situation. However, given the current weakness of the Spanish economy and a relatively short time span since its entry into force, it may take some time before the first positive effects become manifest. So far, the adjustment in employment continues to take place through the reduction in the number of workers rather than a reduction in working hours. In addition, permanent employment is now being affected as much as temporary employment (see Graph 8). Unemployment rate exceeded 25% in the third quarter of 2012 and it is expected to remain elevated over the medium term and even increase further in 2013.

24. The adjustment in the housing market is not yet finished. Demand for housing remains weak given high unemployment and tight credit conditions. This is illustrated by a continuing fall in sales of new houses. The number of sales declined by 14% between January and August 2012 compared to the same period last year. Given a weak demand for housing and the remaining large stock of unsold houses, estimated at around 700,000 of new dwellings, further adjustment in house prices is expected. The fall in house prices has accelerated in 2012, reaching a cumulated fall of 28% in nominal terms and 36% in real terms since the peak in 2007. In addition, the on-going restructuring of the Spanish banking sector and the creation of the AMC for state-aided banks will likely result in further downward pressure on house prices as the houses reposessed by banks enter into the market.

25. The external sector will provide some cushion for economic growth. Export growth is expected to remain robust, while imports are set to contract further on the back of very weak domestic demand, allowing a significant improvement in Spain's trade balance and current account deficit, which is on the way to reach a surplus in 2014. Export growth has been supported by declining unit labour costs (ULC) and improving product and regional diversification, which have allowed Spain to regain some of its lost competitiveness and maintain its export market share – a trend that is expected to continue in the near future. ULC have been falling since early 2010 driven by more moderate wage growth and stronger productivity increases (although mostly through employment adjustment) – see Graph 9. While

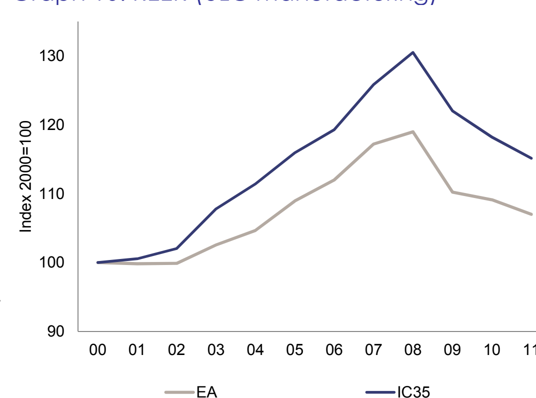
real effective exchange rate (REER) based on a ULC in manufacturing deflator appreciated by around 30% until 2008, it has since fallen by 13% - a recovery of almost one half of the lost competitiveness (see Graph 10).

Graph 9: Productivity and wages



Source: INE

Graph 10: REER (ULC manufacturing)



Source: Ministerio de Economía y Competitividad

Table 1: Main features of country forecast – Spain

		2011			Annual percentage change					
		bn EUR Curr. prices	% GDP	92-08	2009	2010	2011	2012	2013	2014
GDP		1063.4	100.0	3.0	-3.7	-0.3	0.4	-1.4	-1.4	0.8
Private consumption		620.0	58.3	2.8	-3.8	0.7	-1.0	-1.9	-2.1	0.0
Public consumption		222.7	20.9	3.9	3.7	1.5	-0.5	-4.9	-7.2	-1.4
Gross fixed capital formation		224.0	21.1	3.7	-18.0	-6.2	-5.3	-9.0	-5.6	-0.3
of which : equipment		63.0	5.9	4.2	-24.5	3.0	2.4	-6.6	-3.5	0.8
Exports (goods and services)		321.8	30.3	7.1	-10.0	11.3	7.6	2.1	4.2	5.7
Imports (goods and services)		330.3	31.1	7.5	-17.2	9.2	-0.9	-6.3	-3.2	2.4
GNI (GDP deflator)		1041.9	98.0	2.8	-3.0	0.3	-0.3	-2.0	-1.8	0.7
Contribution to GDP growth :	Domestic demand			3.3	-6.6	-0.8	-1.8	-4.0	-3.8	-0.3
	Inventories			0.0	0.0	0.1	-0.1	0.0	0.0	0.0
	Net exports			-0.3	2.9	0.3	2.3	2.6	2.3	1.2
Employment				2.1	-6.5	-2.3	-1.7	-4.5	-2.7	0.2
Unemployment rate (a)				13.9	18.0	20.1	21.7	25.1	26.6	26.1
Compensation of employees/f.t.e.				4.2	4.4	0.0	0.7	0.4	1.4	0.4
Unit labour costs whole economy				3.4	1.5	-2.0	-1.4	-2.7	0.1	-0.2
Real unit labour costs				-0.5	1.4	-2.4	-2.4	-2.9	-1.7	-1.6
Saving rate of households (b)				-	17.8	13.1	11.0	8.7	8.1	9.1
GDP deflator				3.8	0.1	0.4	1.0	0.2	1.9	1.4
Harmonised index of consumer prices				-	-0.2	2.0	3.1	2.5	2.1	1.3
Terms of trade of goods				0.2	4.5	-2.2	-3.3	-2.7	-0.2	-0.2
Merchandise trade balance (c)				-5.2	-4.0	-4.6	-3.8	-2.5	-0.8	0.0
Current-account balance (c)				-4.0	-4.8	-4.4	-3.7	-2.4	-0.5	0.4
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				-3.2	-4.3	-3.8	-3.2	-1.9	0.0	0.9
General government balance (c)				-2.3	-11.2	-9.7	-9.4	-8.0	-6.0	-6.4
Cyclically-adjusted budget balance (c)				-2.3	-9.4	-7.6	-7.6	-6.0	-4.0	-5.3
Structural budget balance (c)				-	-8.7	-7.6	-7.5	-6.3	-4.0	-5.3
General government gross debt (c)				53.4	53.9	61.5	69.3	86.1	92.7	97.1

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.

Source: European Commission, European Economic Forecast Autumn 2012

26. The banking sector programme is expected to have a positive impact on the stability of the financial sector in Spain. In the short-term, the necessary adjustment of credit growth following the boom and bust of the construction and real estate sector is expected to keep credit flows to the real economy constrained, contributing to the weakness of private consumption and investment. However, successful implementation of the planned financial sector reforms should largely reduce the funding costs of the Spanish banks contributing to easing of the lending conditions to the households and non-financial corporations. In particular, improved

capitalization of Spanish banks and reduced uncertainty related to the valuation of assets on the banks' balance sheets as well as restructuring of the weak segments of the banking sector should bolster market confidence.

27. **The Spanish economy is at a critical juncture, leaving no room for complacency with respect to the necessary structural reforms to boost growth and employment.** The capacity of the Spanish economy to undergo the necessary adjustment will depend on the smooth functioning of its factor and product markets, in particular the labour market. Increasing price and cost competitiveness of the Spanish economy through sustained wage moderation and higher labour productivity beyond the cyclical adjustment will be a necessary condition to ensure higher growth and employment creation in the future. It will be also key to ensure the external rebalancing of the economy. The large negative net international investment position (-92% of GDP in 2011) leaves Spain exposed to considerable external financing needs and liquidity risk. In order to attenuate the risk of financing difficulties, which could have serious repercussions on economic activity, Spain needs to significantly reduce its external liabilities, which will require a shift to persistent current account surpluses. All in all, the economic and financial situation in Spain remains challenging. As the correction of the large macroeconomic imbalances will take considerable time, Spain remains exposed to large financing needs and market pressure.

3.3 FISCAL CONSOLIDATION IN THE MIDST OF RECESSION

28. **The economic recession in Spain and the shift towards a less tax-rich growth composition have led to a considerable deterioration of public finances.** On 10 July 2012, the ECOFIN Council issued a revised excessive deficit procedure (EDP) recommendation to Spain setting new and ambitious consolidation targets and extending the deadline for correcting the excessive deficit by one year to 2014. In response, the Spanish authorities have undertaken comprehensive front-loaded fiscal consolidation measures which are largely expenditure-driven. However, the consolidation plan is partly based on temporary and one-off measures. Rebalancing revenues and expenditure in a structural way corresponding to the new economic growth structure, particularly at regional level, is a key challenge facing the Spanish economy.

29. **Major revenue shortfalls and rising interest payments are offsetting the impact of expenditure cuts and some tax hikes in 2012.** Deficit reduction hardly advanced in the first eight months of 2012, but is expected to accelerate in the final months of the year. Planned expenditure cuts seem to be largely on track, but broad-based revenue shortfalls, higher interest payments and rising social transfers almost offset these improvements. There should be significant fiscal tightening in the final months of the year, when the bulk of tax and spending measures should have their impact. For the year as a whole, the deficit is therefore expected to narrow from 9.4% in 2011 to about 8% of GDP, or about 7% of GDP excluding the effect of bank recapitalisations. This compares with the offical deficit target of 6.3% of GDP.

30. **The fiscal outlook remains challenging.** In 2013, the general government deficit is expected to narrow, thanks to further discretionary measures more than offsetting the impact of the continued recession and the shift to a less tax-rich growth model (for details see Box 6 in Section 5.2). Thus, the general government deficit is forecast to reach around 6% of GDP in 2013. In 2014, the expiry of some of the measures introduced in 2012, such as the income tax hike, is not yet compensated by additional, sufficiently specified consolidation measures. Moreover, the very tax-poor growth composition and a subdued recovery of the labour market contribute to a further widening of the general government deficit to 6.4% of GDP.

31. Successful fiscal consolidation is key to ensure that public finances are put back on a sustainable path. Outlining a comprehensive and realistic consolidation strategy is indispensable for re-establishing confidence in Spanish public finances. In this context, the budgetary targets especially for 2014 still need to be supported by convincing permanent measures on the revenue and expenditure side to ensure meeting the deficit targets and, most importantly, to stabilize the public debt to GDP ratio.

4 PROGRAMME IMPLEMENTATION

32. **This chapter describes the implementation of the Programme in keeping with the conditionality stipulated in the MoU**. The MoU includes both bank-specific conditionality, aiming at identifying individual bank capital needs and cleaning-up the legacy assets from the banks' balance sheets, and horizontal conditionality. Any aid to Spanish banks has to comply with the EU State aid conditionality. In addition, Spain has to fulfill its commitments under the Excessive Deficit Procedure and implement structural reforms within the framework of the European semester.

4.1 DEALING WITH IMPAIRED ASSETS AND RESTRUCTURING THE BANKING SECTOR

33. **The key objective of the financial assistance programme in Spain is to assess underlying losses in the banking system, identify the non-viable and weak banks and force their restructuring or resolution** in order to dispel any uncertainties regarding the health of the Spanish banking system.

34. **The identification of losses and capital needs has been done through a rigorous bank-by-bank stress test.** The stress test has been carried out by an independent expert, Oliver Wyman. To further strengthen the transparency and trustworthiness of the diagnostic, international audit firms and real estate experts were hired. Auditors conducted an independent review of accounts and operations used for sampling purposes while real estate appraisers reviewed about 1.7 million real estate appraisals and 8,000 complex real estate asset valuations to inform the asset valuation process.

35. **The restructuring of some of the banks will be achieved first by segregating all real estate development (RED) assets, above a certain threshold, to an asset management company, Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria (Sareb), which will manage these assets in order to maximise their value.** The main purpose is to eliminate any concerns regarding banks' solvency, stemming from their real estate exposures and to allow banks to refocus on their core lending activities. Additionally, troubled banks will be required to undertake the necessary steps to deleverage their non-core assets and improve their efficiency and profitability.

4.1.1 Identifying impaired assets and solving capital needs

36. **The due diligence process started with a top-down stress test in June 2012 and finished at the end of September with the publication of the results of a more granular bank-by-bank (bottom-up) stress test. The stress test revealed a capital shortfall of about EUR 59 billion for the entire banking sector (see Box 1).** The complete exercise was carried out by international consultants (Oliver Wyman[7]) and involved four auditors (PwC, Deloitte, Ernst &Young and KPMG) and several appraisal companies. This process was overseen by the Strategic Coordination Committee (SCC), involving the Spanish authorities, the European

[7] http://www.oliverwyman.com

Commission, the ECB, the EBA and the IMF. In addition, it was closely monitored by a technical Expert Coordination Committee (ECC), which provided the SCC with regular updates.

37. The following main conclusions can be drawn from the exercise:

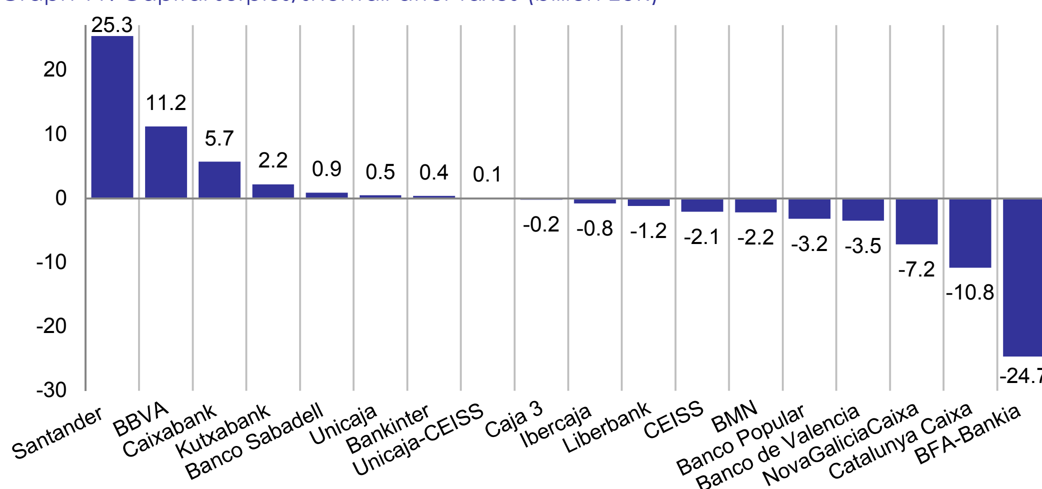
- **The weaknesses in the Spanish banking system, particularly the capital shortfalls, are not widespread, but rather located in a specific group of banks, mainly the banks having already received aid from the FROB.** The results of the stress test confirm the diagnostic from the IMF FSAP[8] as well as from the top-down stress test of Oliver Wyman.
- **Losses in the bottom-up exercise are consistent with those estimated by Oliver Wyman in the top-down exercise**. However, the bottom-up exercise has provided a much more accurate distribution of losses, increasing capital needs in those banks that had already been identified as being problematic in the top-down exercise.
- **The loss absorption capacity of the Spanish banking system is high but unevenly distributed amongst banks**. While banks like Bankia require as much as €25bn under the adverse scenario, other banks like Santander have an equally high excess capital buffer (€25bn) in the adverse scenario.

38. Based on the results of the bank-by-bank (bottom-up) stress test, the BdE and the European Commission, in consultation with the EBA and in liaison with the ECB, will establish the specific capital needs of each participating bank, and also determine the cases where there is no need for further capital. On the basis of the stress test results and the presented plans to address any identified capital shortfalls, the banks will be categorised in four groups (see Graph 11 and Table 2).

- ***Group 0*** comprises those banks for which no capital shortfall is identified and no further action from the public side is required: **Santander, BBVA, Caixabank, Sabadell-CAM, Bankinter, Kutxabank and Unicaja.**
- ***Group 1*** was pre-defined as banks already owned by the FROB: **BFA-Bankia, Catalunya Banc, NCG Banco[9] and Banco de Valencia.**
- ***Group 2*** consists of banks with capital shortfalls identified by the bottom-up stress test as unable to meet those capital shortfalls privately without having recourse to State aid: **Banco Mare Nostrum, CEISS, Liberbank and Caja 3.**
- ***Group 3*** includes banks with capital shortfall identified by the stress test with credible recapitalisation plans and able to meet capital shortfalls from private sources without recourse to State aid.
  BdE in liaison with the European Commission understands that **Banco Popular** and **Ibercaja** have presented credible plans, which are still being implemented, to reduce their capital shortfall to zero by the end of the year. Once implemented, it would include them in Group 0.

[8] IMF's Financial Sector Assessment Program.
[9] NCG Banco has its roots in Galicia and operates there under Novagalicia Banco.

Graph 11: Capital surplus/shortfall after taxes (billion EUR)



Source: BdE

Table 2: Expected losses in the base and adverse scenario, per portfolio segment

	2011 Balance EUR bn	Base scenario	Adverse scenario	Top-down adverse
Real estate developers	227	28.60%	42.80%	42-48%
Retail mortgages including foreclosed housing	622	3.00%	5.50%	5.90%
Large corporates	254	5.80%	10.00%	12-15%
SMEs	237	10.60%	16.70%	15-18%
Public works	41	12.50%	21.30%	21-23%
Other retail	74	11.80%	18.60%	15-20%
Total credit portfolio	1,436	9.00%	15.00%	15-17%
Foreclosed RED&Other	87	55%	64%	55-65%

Source: BdE

39. There are several options available to banks for making up for their capital shortfall. These include generating capital from internal measures, asset disposals, subordinated liability exercises (SLEs), raising equity or State aid. The Spanish authorities and the European Commission are assessing the viability of the banks on the basis of the results of the bottom-up stress test and the presented restructuring plans. Banks that are deemed to be non-viable will be resolved in an orderly manner.

Box 1: Overview of the bottom-up stress test

Scope

- The stress covers the business, in Spain, of 14 entities accounting for approximately 90% of the Spanish banking system.
- Three-year shock: 2012, 2013 and 2014.
- Core tier 1 target capital levels: 9% in the base scenario and 6% in the adverse scenario.
- Holdings of Spanish Sovereign debt have not been subject to shock.
- The stress test was done on the basis of a data validation exercise done by the large 4 independent audit firms. Auditors reviewed over 115,000 operations.
- The results of the validation exercise were combined with additional bank specific data, as requested by the consultant, from official sources and from banks and a rigorous appraisal of the value of collateral and foreclosed assets.
- Independent real estate appraisers (both national and international) reviewed 1.7 million real estate appraisals and 8,000 complex real estate asset valuations to inform the stress test exercise.

Key macroeconomic assumptions in the adverse scenario:

- Nominal GDP evolution: -7.1%
- Unemployment rate in 2014: 27.2%
- Cumulative house price declines: 26.4%
- Cumulative land price declines: 72%
- Credit to households: -17.6%
- Credit to non-financial firms: -15.7%
- Stock price evolution: -56.3%

Highlights:

- 7 entities failed the stress test with total capital shortfall of €59.3bn.
- Total losses estimated in the adverse scenario amount to €270bn, €90bn higher than in the base scenario.
- Average losses on the total credit portfolio amount to 14.6% (63.4% on real estate exposures).
- Banks total loss absorption capacity is €252bn in the adverse scenario. Although this may seem high, capital levels are very heterogeneous and some banks have as much as €19bn excess capital in the adverse scenario while others have an equally high capital shortfall.
- Pre-provisioning profits for the full 3-year period amount to €39bn, a conservative figure when compared to the pre provisioning figure registered in 2009 (€34bn) or in 2011 (€19bn) alone.
- Healthy banks passing the stress test with no capital shortfall hold over 60% of the total credit exposures to the Spanish economy.

Comparison with the top down exercise:

- Notwithstanding differences at individual portfolio level driven by more detailed data, the total projected losses in the bottom-up exercise under the adverse scenario (i.e. €265bn) are within the range and at the upper-end of the total projected losses (i.e. €250-270bn) in the top-down stress test; as regards the projected losses on different asset classes, these losses are somewhat lower for large corporates in the bottom-up exercise than in the top-down stress test due to the analysis of historical default rates; furthermore, since foreclosed assets are analysed based on gross book values adjusted for provisions and not on net book values, the projected losses are higher in the bottom-up exercise than in the top-down stress test.
- As regards the loss absorption capacity, the are some differences among the main categories of loss absorbing factors: (i) higher provisions in the bottom-up exercise: €110bn versus €98bn in the top-down stress test; (ii) the asset protection scheme increased to €8bn in the bottom-up compared to €6-7bn in the top-down stress test; (iii) the profit generation capacity under the adverse scenario amounted to €61bn in the bottom-up stress test, whereas it was at €60-70bn in the top-down exercise; (iv) due to more detailed supervisory information, the estimated capital buffer of the bottom-up exercise (€73bn) is within the upper range of the top-down stress test (€65-73bn).

4.1.2 Segregating the banks´ impaired assets

40. As envisioned in the MoU, the AMC is created in order to remove troubled assets from aided banks' balance sheets. This AMC will be called Sareb and will have a maximum life span of 15 years (see Box 2). The main objectives of Sareb, are to divest the portfolio of real estate loans and assets it acquires from banks receiving State aid, optimize levels of recovery and value preservation as well as minimize the cost for the taxpayer by returning capital to stakeholders as soon as feasible. Finally, it should aim at mitigating the negative impact on the Spanish economy, real estate market and the banking sector.

41. The fulfilment of conditions laid out in the MoU with respect to AMC is on track. A comprehensive AMC blueprint was prepared by the Spanish authorities by end-August. Primary legislation on AMC was included in the RDL 24/2012, which was adopted on 31 August. Secondary legislation, including key elements of the design of Sareb, is being developed and is due to be adopted on 16 November as a Royal Decree. Sareb is expected to be operational by end-November and can start accepting transfer of assets as early as 1 December 2012. Making this happen will continue to pose manifold administrative challenges.

42. Looking forward, the AMC will be confronted with important challenges in the fulfilment of its tasks.

- Given the long and complex process required for the design and of the main features of the AMC, the authorities will have to make strong efforts to set up the entity and all its different mechanisms in a short timeframe.
- The availability of funding with adequate terms and conditions for potential buyers of assets owned by the AMC will be a key condition for the successful sale of assets.
- Spanish banks will in all likelihood be strong competitors of the AMC since most banks are also deleveraging large real estate-related portfolios. Moreover, Spanish banks are currently offering advantageous funding conditions to potential buyers of their real estate related assets. Unless the AMC is able to offer similar funding conditions to its clients through vendor financing agreements with banks, it will have more difficulties to sell its assets.
- Until the AMC is able to develop fully independent operational capacity, the assets transferred to the AMC will be managed by the transferring banks through service level agreements. Hence, it is essential to establish the right incentives in those agreements in order to ensure that banks make strong efforts to extract the maximum value from assets that they no longer own.
- The management of a large AMC with a high number of assets can be very complex. In order to reduce the complexity the authorities have agreed to set minimum thresholds in order to avoid transferring too granular portfolios. Loans below EUR 250.000 represent only 2% of total real estate and development (RED) exposures but 30% of total RED loans in terms of number of loans. Likewise, foreclosed real estate assets below EUR 100.000 represent 14.5% of total but 56% in terms of number of assets. Thus, by establishing these thresholds, the complexity of managing the assets in the AMC is significantly reduced without retaining a material exposure to RED assets in the participating banks.

- The uncertainties surrounding the Spanish economy may influence the decisions of potential investors. Until there are signs of stabilisation, the fear of further deterioration of the economy could deter investors.

Box 2: Sareb – Main elements of the design of Spanish AMC

Main features:

- Sareb will be initially established as a for-profit company (Sociedad Anonima – SA).
- Majority private owned the FROB will have a minority stake.
- The overall size of Sareb will be capped at EUR 90 billion.
- Based on the provisional business plan, return on equity (ROE) will be 14-15%.
- Maximum life span of 15 years.

Scope and size:

- Real estate developer ("RED") exposures in the Participating banks: 1) foreclosed real estate assets (above EUR 100 000), 2) loans to real estate developers: normal, sub-standard and doubtful (above EUR 250 000), controlling stakes in real estate companies.
- Cut-off date for classification of assets: 30 June 2012, taking into account reclassifications carried afterwards in the context of the bottom-up stress test exercise.
- Participating banks: all banks in Group 1 and 2 as well any Group 3 bank that fails to raise the required capital from private sources. No other banks will be allowed to transfer assets to Sareb.
- Size: assets from Group 1 banks, with an estimated transfer value of around EUR 45 billion, will be transferred to AMC starting from 1 December 2012. The assets from Group 2 banks (and possibly Group 3 banks) will be transferred in the course of 2013.

Transfer price

- Starting point: base case scenario of the bottom-up analysis of the banks' portfolios conducted in the context of the stress test exercise concluded on 28 September 2012. Gross book value will be adjusted by provisions from RDL 02/2012 and 18/2012.
- Additional haircuts: 14% for loans and 7% for foreclosed assets, amounting to an average total haircut of 45.6% and 63%, respectively, from the gross book value for loans and foreclosed assets. These additional haircuts will cover the initial transfer costs and subsequent operational and managerial costs associated with the assets.

Capital and funding

- At the time of transfer, participating banks will receive bonds issued by Sareb and guaranteed by the Kingdom of Spain.
- In addition, Sareb will require two other sources of funding: 1) perpetual subordinated debt, and 2) common equity.
- Subordinated debt and common equity together will amount to 8% of total assets, and majority holding will be subscribed by private investors.
- Private investors: may include banks (excluding the Participating banks), insurance companies, investment funds, pension funds and other qualified investors.

Corporate governance

- Sareb will be managed by the Board of Directors. This board will have a minimum of 5 and a maximum of 15 members, consisting of the Sareb shareholders (in proportion to their stake in equity and subordinated debt) and a number of independent directors (no less than one-third of total).
- In addition, Sareb will be overseen by an external Monitoring Committee, composed of four members, appointed by the Ministry for Economic Affairs and Competitiveness, the Ministry for Finance and Public Administration, the BdE and the National Securities Market Commission.

4.1.3 Restoring the viability of the banking sector

43. While State aid for banks is granted for financial stability reasons during the crisis, the aid has to be in conformity with EU State aid rules. During the crisis, Member States have resorted to a number of State aid measures for banks to ensure financial stability and the maintenance of credit flows to the real economy. The role of the European Commission under EU State aid rules is to ensure that these aid measures do not generate unnecessary distortions of competition between financial institutions operating in the market or negative spill-over effects on other Member States. This has also the broader aim of avoiding harmful subsidiary races, limiting moral hazard and ensuring the competitiveness and efficiency of European banks within the EU and international markets. These principles will also be applied in the current Spanish banking programme (see Box 3).

Box 3: Principles of EU State aid rules

Under EU state rules, when a financial institution receives State aid, the Member State granting the aid has to submit a restructuring plan. When the Commission is assessing the restructuring plan, three key elements are crucial:

First, the restructuring plan has to demonstrate that the bank is able to restore its long-term viability over time. For restoring long-term viability, the bank needs to review its business models with the aim of regaining the ability to lend and compete after their restructuring period without State support, thus ensuring lending to the real economy on a solid basis. This review may require, depending on each individual case, a refocus on the banks' core business and the close-down of risky and/or loss-making activities.

Second, for avoiding that aided banks enjoy an undue advantage in the form of cheap or free capital, there is a need to re-pay the received State aid or remunerate it according to market rates as quickly as possible. For ensuring that State aid is kept to the minimum necessary, banks should first try to cover the restructuring cost through internal measures like divestments, and other burden sharing measures from its capital holders (such as equity holders, or junior creditors) with State aid only covering the remaining gap. This "minimum necessary" principle also helps to address moral hazard and thus incentivises bank capital holders to be vigilant towards "their" bank with the aim of not repeating the mistakes of the past.

Third, there is a need for temporary safeguard measures for dealing with competition distortions created by banks which have received large amounts of aid. In practical terms this will be addressed via divestments and other behavioural measures such as an acquisition ban.

44. Under the MoU, all banks are required to meet a certain minimum capital ratio[10]. Based on this condition there is a need for banks to demonstrate in a recapitalisation plan whether they can credibly achieve the required capital ratio on their own. The stress test results are the starting points for that analysis. However, the results of the stress tests are not equal to the final capital needs of the banks. This is because, first, real estate development (RED) assets of the banks receiving State aid will be transferred to the AMC, thus reducing the overall capital needs in two ways (i) namely by reducing the expected losses for the affected banks and (ii) by reducing the risk weighted assets (RWA) which are used to calculate the common equity tier (CET) 1 ratio. However, transferring RED assets to the AMC will in itself be considered as State aid.[11] In addition, there might be other divestments generating capital for banks.

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[10] As of 31 December 2012, banks are supposed to meet until at least end-2014 a Common Equity Tier (CET) 1 ratio of at least 9%.

[11] In line with the Impaired Asset Communication from 25 February 2009, state aid is the difference between the transfer value of the portfolio and its estimated market price. Footnote 2 in point 20 of the Communication (see link) http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2009:072:0001:0022:EN:PDF.

45. Capital needs will also be reduced via burden sharing measures. Burden sharing in line with the MoU foresees that steps will be taken to minimise the cost to taxpayers of bank restructuring. After allocating losses to equity holders, the Spanish authorities will require burden sharing measures from hybrid capital holders and subordinated debt holders in banks receiving public capital, including by implementing both voluntary and, where necessary, mandatory Subordinated Liability Exercises (SLEs). To that effect, the Spanish authorities have introduced legislation to ensure the effectiveness of the SLEs.

46. The Spanish Government in accordance with the scope and timeline established in the MoU approved on 31 August a new Royal Decree-Law on bank restructuring and resolution. The RDL provides the FROB and the Bank of Spain ample powers, among which the possibility to impose burden sharing on the holders of hybrid instrument and subordinated debt. The rationale behind burden sharing is that in the context of a public recapitalisation under the MoU not only equity holders should bear the losses before the new public capital get injected but also the holders of financial instruments which to some extent are loss-absorbing. Burden sharing may be implemented on a voluntary basis and failing this on a compulsory basis when the FROB has the control of the institution. Furthermore, the BdE is discouraging any bank which may need to resort to State aid from conducting SLEs at a premium of more than 10% of par above market prices until December 2012. The RDL sets a comprehensive and flexible framework for effective restructuring and resolution. It has taken into account the EU regulatory proposal on crisis management and bank resolution where applicable.

47. For the banks categorized into different groups, the Spanish authorities are to submit restructuring plans or resolution plans. For Group 1 banks, the restructuring plans were adopted by the European Commission on 28 November 2012. The banks in this group are BFA/Bankia (see Box 4), Catalunya Banc, Nova Caixa Galicia and Banco de Valencia The in-depth restructuring undergone by BFA/Bankia, NCG Banco, Catalunya Banc will allow them to become viable in the long term without continued state support. The banks and their stakeholders adequately contribute to the costs of restructuring. The plans foresee sufficient safeguards to limit the distortions of competition induced by the state support. Because its viability could not be restored on a standalone basis, Banco de Valencia will cease to exist as an independent entity and will be sold to and integrated into CaixaBank.

Box 4: The BFA/Bankia recapitalisation and restructuring process

Bankia is a subsidiary of Banco Financiero y Ahorro, S.A. (BFA). BFA itself had been created through a merger of seven savings Banks in 2010 and all of their banking business was subsequently transferred to BFA.

Later, in April 2011, BFA transferred 95% of the banking business to Bankia, its fully-owned subsidiary. Only 5% of the banking business was kept by BFA.

As a result of this transfer, Bankia is a large universal bank, with presence in all main business segments: mortgage and consumer lending, SMEs, large corporations as well as public and private institutions. On 31 December 2011, Bankia's total assets amounted to about EUR 300 billion and its credit portfolio amounted to about EUR 200 billion, of which roughly EUR 40 billion were in real estate related assets (mainly loans to real estate developers). In July 2011, Bankia went public, through an IPO although BFA keeps a slight majority stake.

BFA/Bankia had already received several capital injections. In June 2010, Spain injected about EUR 4.465 million of convertible preference shares into BFA. In June 2012, these shares were converted into ordinary shares. As a result of this conversion, the FROB became the sole shareholder in BFA, with the savings banks losing all their stakes.

In September 2012, BFA received a further capital injection amounting to EUR 4.5 billion subscribed by the FROB. BFA then granted a subordinated loan in the amount of also EUR 4.5 billion to Bankia to strengthen Bankia's solvency.

48. In the case of BFA/Bankia, NCG Banco and Catalunya Banc, the European Commission found that the proposed restructuring measures will ensure that the three banks return to long-term viability as sound credit institutions in Spain. By 2017, the balance sheet of each bank will be reduced by more than 60% compared to 2010. In particular, the banks will refocus their business model on retail and SME lending in their core regions. They will exit from lending to real-estate development and limit their presence in wholesale business. This will contribute to reinforcing their capital and liquidity positions and reduce their reliance on wholesale and central bank funding. The banks' transfer of assets to Sareb will further limit the impact of additional impairments on the riskier assets and help restore confidence. As regards NCG and Catalunya Banc, Spain committed to sell the banks before the end of the five-year restructuring period. Should a sale fail, Spanish authorities will present an orderly resolution plan.

49. Regarding Banco de Valencia, the Spanish authorities and the European Commission concurred that the bank's viability could not be restored on a stand-alone basis. Hence it will be resolved through a sale to another entity. The European Commission concluded that the total cost of the sale, including other requested support measures, is lower than the cost of winding down the bank. Through a competitive tender process, CaixaBank has been selected as buyer and, consequently, Banco de Valencia will be fully integrated into CaixaBank and will cease to exist as an independent bank.

50. For Group 2 banks, the Spanish authorities have also presented restructuring or resolution plans to the European Commission. The banks in this group include Ceiss, Banco Mare Nostrum, Caja 3 and Liberbank. All Group 2 banks must include in their restructuring or resolution plan the necessary steps to segregate their RED assets into an external AMC. Given that the transfer of problematic assets to the AMC will imply State aid, the presented plans have to take that into account. The Commission is currently in the process of assessing the received recapitalisation plans.

51. The MoU foresees that Group 3 banks will be split into those planning a significant equity raise of more than 2% of capital in relationship to their RWAs and those planning to raise less than 2% capital. Group 3 banks planning a significant equity raise corresponding of more than 2% of RWA between end-2012 and June 2013, will, as a precautionary measure, be required to issue contingent convertible securities (CoCos) under the Commission approved recapitalisation scheme by end December 2012 at the latest. CoCos will be subscribed for by the FROB using the Programme resources and can be redeemed until 30 June 2013 if the banks succeed in raising the necessary capital from private sources. Otherwise, the banks will be recapitalised through the total or partial conversion of the CoCos into ordinary shares.

52. Group 3 banks should be able to fulfil their capital needs by year end. The MoU allows Group 3 banks to raise equity still in the first half of 2013, but otherwise those banks should fill their capital needs until the end of the year 2012. The exception to that are subordinated liability exercises which should be only done once it becomes evident whether the bank will have to rely on state resources or not. This is because there will be stricter burden sharing rules applying when state resources are required.

4.2 ENHANCING BANK TRANSPARENCY, REGULATION AND SUPERVISION

53. Some weaknesses in banking regulation and supervision were identified. As a result, the MoU establishes some key areas in which banking regulation and supervision could be

improved. Therefore, additional efforts have been requested from the Spanish authorities to ensure an adequate regulatory and supervisory framework. The Spanish authorities have complied with the horizontal conditionality set out in the MoU as it is described in the following sections.

4.2.1 Enhancing bank transparency, supervisory information and consumer protection

54. As part of the efforts to enhance the regulatory framework for credit institutions, the Spanish authorities committed to enhance transparency, as key pre-requisite for fostering confidence in the Spanish banking system. Several important measures have already been taken to increase the quality and quantity of information provided by credit institutions to the general public, notably concerning real estate and construction sector exposures. In July 2012, the BdE released for public consultation a Draft Circular, which included, *inter alia*, provisions aimed at enhancing and harmonising disclosure requirements for all credit institutions on key areas of their portfolios such as restructured and refinanced loans, sectorial concentration.

55. In line with the MoU commitments, the final version of the Circular (i.e. Circular 8/2012) was approved by the BdE on 28 September 2012. As requested, this Circular provides, *inter alia*, for: *(i)* disclosure of risk exposures by business segments and geographical areas; *(ii)* disclosure of the probability of default (PDs) on restructured and refinanced loans by the credit institutions which were authorised to use internal models for the calculation of capital requirements; *(iii)* classification of all asset classes (including restructured and refinanced loans) according to loan-to-value intervals (i.e. Loan-To-Value (LTV) less or equal to 40%, between 40% and 60%, between 60% – 80%, over 80% but less than 100% and over 100%); *(iv)* disclosure of refinanced and restructured operations by differentiating among performing, substandard and non-performing loans; *(v)* disclosure by banks in their annual reports of a short summary of their restructuring and refinancing policies as well as of an explanation on the criteria used to assess the sustainability of the applied forbearance measures.

56. Regarding the information for supervisory purposes, data provided by institutions to the credit register of BdE is a key element not only from a micro prudential oversight perspective but also for financial stability purposes. Information on the credit history of individual borrowers (i) allows banks to properly assess the risk of borrowers and (ii) allows supervisors not only to reassess risk during on-site inspections and system-wide analysis but also to calibrate banks' internal models properly and also to adjust provisioning requirements. This is of utmost importance from the perspective of banks' risk management functions.

57. The Central Credit Register[12] (CIR) in Spain has proved to be a very useful risk management tool since 1962. According to BdE information at the end of 2008, more than 33.9 million direct and indirect credits (the latter for guarantees on direct credits) had been reported to the CIR worth a total of EUR 3.75 billion and distributed between 17.6 million borrowers, 94% of which were natural persons residing in Spain.

58. Nevertheless, the crisis has also shown areas where this credit register can be improved. For example, there is insufficient information on the type of collateral of each

[12] Central de Información de Riesgos (CIR).

exposure or on risk concentrations arising from indirect risk exposures and interlinkages between counterparties. In general terms, the granularity of the information could be enhanced.

- **The first step to enhance the credit register (required by the MoU-paragraph 26)** has been carried out by the Spanish authorities through the amendment of the Ministerial Order ECO/697/2004, of 11 of March.
- **By mid-October BdE submitted for consultation a draft report on the main features of the project to enhance the credit register carried out since 2011.** This would include a complete set of regulatory measures (accounting Circular, credit register Circular) and a new IT system to be fully implemented from December 2013 to 2015. In addition, in compliance with the MoU, the BdE sent for consultation by end-October a comprehensive package of draft legislation intended to be approved at the beginning of 2013.

59. As regards consumer protection, the MoU focuses on one of the most significant problems detected during last years. Given certain legal constraints to increase their capital (in the case of former saving banks) or operational difficulties (for the rest of the banks), credit institutions had a strong incentive to sell regulatory capital instruments through retail branches to non-qualified investors and this created some difficulties for banks to use hybrid and subordinated debt instruments for the purpose for which they were issued in terms of loss absorbency. The main problems have been arisen from preferential shares qualified as Tier 1 capital.

60. In light of this, Royal Decree-Law 24/2012 on bank restructuring and resolution established a set of rules enhancing the consumer protection framework by:

- **Limiting the sale of hybrids to retail customers**: i.e. setting out a minimum nominal amount for each investment. This will exclude *de facto* small retail clients and impose a minimum percentage of professional clients for any issuance.
- **Increasing transparency of instruments not covered by the deposit guarantee fund to retail clients.** Hence, several amendments of Law 24/1998, on Securities Market have been approved: i.e. improving the information in all prospectuses highlighting the difference of these products and the ordinary bank deposits to the investor in terms of risk and liquidity or requiring appropriate warning in advertisings elements. Some of these rules have to be specified through the necessary subordinated legislation.

61. The Spanish government has developed a complete framework limiting remunerations to be paid to directors and managers working for credit institutions having received state aid. Article 5 of Royal Decree-Law 2/2012 of 3 February on the restructuring of the banking sector established a general regime to be applied to remunerations paid by entities having received state aid from the FROB. As requested in this article 5 the Spanish government approved the Ministerial Order of 3 August on remunerations in entities receiving state aid for their recapitalisation or restructuring, including a complete set of rules on this matter. This Ministerial Order set up certain limitations for the total amount received as remuneration or compensation by managers or directors depending on if the FROB has a controlling stake in the credit institution or not.

4.2.2 Enhancing bank regulation and supervision

62. One of the objectives of the programme is to identify certain areas in which the regulatory and supervisory framework for credit institutions could be improved in the medium to long term. In this respect, the MoU foresees the enhancement of supervisory tools,

through the shifting of sanctioning and licencing powers from the Ministry of Economy to the banking supervisor (BdE) and the improvement of supervisory procedures of the BdE. In addition, the MoU requires banks to align their capital ratios to the EBA requirements.

63. For this purpose it is of utmost important to strengthen the operational independence of the supervisory authority from other stakeholders. In line with the MoU, some key powers, such as the authority to impose sanctions for very serious infractions and licensing powers should be transferred from the Ministry to the BdE. To this effect, the Royal Decree-Law 24/2012 amends Law 26/1988 in order to shift as of January 2013 the residual sanctioning powers from the Ministry of Economy to the BdE. In addition, an additional amendment has been included in order to transfer licensing powers to BdE.

64. On top of these improvements, a further strengthening of the supervisory competences appears warranted, considering that the capacity of the BdE to issue binding interpretations on supervisory practices and regulatory issues is currently limited. As committed in the MoU, the Spanish authorities submitted at the end of October 2012 a report which includes proposals for the further empowerment of the BdE to issue binding guidelines or interpretations.

65. In line with the MoU commitments, authorities submitted at the end of October 2012 a report on the main findings of the internal review and proposals to enhance the supervisory procedures of BdE. At the same time, authorities are expected to ensure that macro-prudential supervision will properly feed into the micro supervision process and adequate policy responses. This will allow authorities to effectively take into account imbalances and prevent, *inter alia*, the deterioration of bank portfolios.

66. In addition, one of the main purposes of this financial assistance programme is to ensure an adequate solvency of the entire banking sector. In this respect, high quality capital for banks had to be (i) shored up and (ii) aligned in its definition with those internationally agreed. Hence, the MoU (paragraph 23) foresees that the Spanish authorities require credit institutions to meet a Common Equity Tier 1 ratio of at least 9% from 31 December 2012 to at least end-2014**.** The definition of capital should be the one used for the EBA recapitalisation plan. From 1 January 2013, Spanish credit institutions will be required to comply with the forthcoming Capital Requirements Regulation (CRR), observing the gradual phase-in envisaged. The additional capital to reach the 9% ratio will be covered using the aforementioned EBA capital definition.

67. As a consequence, the Spanish government decided to amend Royal Decree-Law 2/2011, dated 18 February 2011, adopting extraordinary measures to strengthen the financial system in order to align the definition of "capital principal" to the EBA recapitalisation plan one. This amendment has been included as a Final Provision in the Royal Decree-Law 24/2012 of 31 August 2012, on bank restructuring and resolution. However, the definition of capital included in this Royal Decree-Law, had to be completed by some additional technical details to be materialized by the BdE through the relevant subordinated rules. A new draft Circular was submitted by BdE for consultation by mid-October and it is expected to be finally approved during the coming weeks. Therefore, the whole legislative process will be completed by the end of 2012.

5 REDUCING MACROECONOMIC AND FISCAL IMBALANCES

68. The adjustment of macroeconomic and fiscal imbalances is propelling the Spanish economy through a period of subdued economic growth combined with very high unemployment. In order to break the negative feedback loops between private and public sector deleveraging, compressed domestic demand, high levels of unemployment, further adjustment in the housing sector, financial sector stability and credit availability, well targeted structural reforms and a credible fiscal strategy are of utmost importance.

69. Deep structural reforms are critical to spur economic growth and employment creation in Spain. This is also a necessary condition for successful fiscal consolidation and easing market pressures. The Spanish government announced on 27 September a structural reform plan designed to improve market efficiency and boost potential growth, in line with the recommendations under the European Semester. Effective implementation of these structural measures will be critical and should be regularly monitored and assessed. It will hinge on full co-operation of regional and local governments.

70. Credible fiscal consolidation is a key condition to enhance the sustainability of public debt and to improve confidence in public finances. Spain will have to implement a considerable consolidation effort to correct the excessive deficit. To be as growth-friendly as possible, revenue-increasing measures should focus on improving the efficiency of the tax system, while expenditure cuts should improve the efficiency and quality of public spending.

5.1 PROGRESS WITH THE IMPLEMENTATION OF STRUCTURAL REFORMS

71. Structural reforms aimed at correcting macroeconomic imbalances have advanced in several areas. A range of measures have been launched in the areas of labour market policies, taxation, and the electricity tariff deficit. Moreover, Spain has announced a structural reform plan, which envisages further concrete measures to reform active labour market and employment policies, reduce the fragmentation of domestic product markets, liberalise professional services and improve the business environment (see Box 5).

72. The recent labour market reform took decisive steps to increase wage flexibility and reduce segmentation. Severe rigidities in the Spanish labour market have limited flexible adjustment of wages and led to market duality. The labour market reform adopted in February 2012 and passed by Law in July 2012 aims at increasing wage flexibility, bringing greater decentralisation of wage bargaining, and reducing labour market segmentation by substantially reducing the gap in employment protection between permanent and temporary contracts. There are some first indications that the reform increased internal flexibility and the ability of firms to adjust. However, evidence regarding wage moderation and duality appears to be more mixed. The Ministry of Employment and Social Security intends to establish a working group to monitor the implementation of the reform. A thorough assessment of the reform should critically review the impact on wage dynamics and labour market segmentation and identify concrete follow-up action.

73. Active labour market policies (ALMP) play a still insufficient role in promoting labour mobility and in reducing the occupational and skills mismatch. A large share of ALMP expenditure is devoted to encouraging the hiring and retaining of personnel by

subsidising social security contributions, while spending on training, labour market integration, and professional reorientation is relatively low. Some initial changes to the active and passive labour market policies have been adopted in July, but the integration of passive and active policies remains a challenge. A proposal for revision of vocational training and training for unemployed is under preparation. Reform plans on ALMP, including reform of the public employment service, still need to be made more concrete and effectively implemented.

74. To create new jobs, Spain needs to complement the labour market reform by wide-ranging ambitious structural reforms in the product and services markets. In particular, greater flexibility is needed both in terms of market entry and exit conditions as well as in terms of firm growth. The fragmentation of the domestic market is a major obstacle preventing businesses from taking advantage of economies of scale and scope. Business services (and in particular professional services) present a large development potential, but show relatively low productivity. The government intends to present proposals to reduce the fragmentation of the domestic market, to improve the business environment and to liberalise professional services (see Box 5). To properly tackle the problems, the proposals need to be ambitious in scope and depth and implementation closely monitored, also at sub-national level. Where firm structure is concerned, more than half of workers in Spain are employed in small companies (below 50 employees) compared to around 40% in Germany or France. This potentially undermines the productivity of the Spanish economy and limits its internationalization prospects. It would be important to identify and remove potential regulatory and administrative barriers with lock-in effects that prevent companies from growing.

75. Overall, recent measures improve the efficiency of the tax system. The tax-to-GDP ratio as well as VAT revenue and revenue from environmental taxes in Spain are among the lowest in the EU. Spain also has a high rate of home ownership, which has been encouraged by favourable tax treatment of owner-occupied housing. Some recent measures improve the efficiency of the tax system. In particular, an increase of VAT rates and a wider scope of application of the standard rate took effect from September 2012. The government has also adopted measures to ensure less tax-induced bias towards indebtedness and home-ownership. These include: introducing income ceilings for the tax deductibility of investments in owner-occupied housing as well as elimination of home mortgage tax deductions and investment deductions for house purchases from 2013. However, there is scope to further limit the application of different reduced rates for VAT and to increase environmental taxes, most notably on fuel.

76. Several measures have been adopted to address the electricity tariff deficit and to complete the electricity interconnections with neighbouring countries. The electricity tariffs in Spain are fixed by taking into account the electricity auction price, and grid access tariff which is supposed to cover distribution costs, support to renewables and other regulated costs. With the costs rising faster than the tariffs, a so-called tariff deficit has been generated in the system. The accumulated debt reached an amount of EUR 24 billion (more than 2% of GDP) in 2011. In 2012, several measures were adopted to reduce the electricity tariff deficit, including a temporary suspension of renewable energy premiums to newly-built plants, reduction of costs in the electricity sector, and raising end-user tariffs. In addition, the government approved a draft proposal on Energy Taxation for the Sustainability of the Energy System. It needs to be assessed whether the measures are sufficient to solve the issue of the electricity tariff deficit. To improve connectedness, new electricity interconnections with France and Portugal are being developed.

Box 5: The structural reform plan of September 2012

On 27 September 2012, Spain announced a structural reform plan. This plan responds to the country specific recommendations issued to Spain under the European semester and goes beyond them in some areas. The reforms to be adopted in 2012 and 2013 are clearly targeted at some of the most pressing policy challenges. Implementation will be crucial.

In the area of labour market and employment policies, the government intends to encourage development of **vocational secondary education** to improve skills of the young entering the labour market. In addition, there are further reforms in the field of **active labour market policies** aimed at creating incentives for private employment services' intermediation and encouraging public-private partnerships for intermediation. The planned assessment of active employment policies is supposed to determine future priorities and concentrate resources on measures with the greatest impact on employability.

A programme **on market unity, including a draft law,** aims at reducing the fragmentation of the domestic market. It intends to eliminate barriers to economic activity resulting from multiple and overlapping regulations by different layers of administration. Implementation of the law will require a comprehensive screening of the existing obstacles to the market unity and putting in place a new regulatory framework that should be fully implemented by regions and municipalities.

Regarding further liberalisation of professional services, the **draft law on professional services** will reinforce the freedom of access and exercise of profession and a unique authorisation system. The proposal aims at ensuring that reserves of activity and mandatory membership to professional bodies are justified and proportionate.

The Law on promotion of the **rental market** aims to introduce more flexibility and legal safety for the contracting parties, so that rental market becomes a viable alternative for house ownership and labour mobility is facilitated.

The plan presents a list of measures to **encourage entrepreneurship**, e.g. reducing administrative burden, improving business environment, revising education curricula, and enhancing access of companies to finance and to foreign markets.

A draft law on **electric energy sector** will aim at its further liberalization, addressing the existing inefficiencies and improving consumer protection.

Other measures announced in the plan include reforms of state administrations responsible for supporting scientific activity and enhancing internationalisation of the economy, initiatives to promote tourism, liberalisation of the telecom sector, liberalisation of railway transport, and support to the agricultural sector, enhancing environment protection, and improving functioning of judicial system.

5.2 FISCAL REFORM IS ADVANCING

5.2.1 Budgetary consolidation

77. **On 10 July 2012, the Council issued a new EDP recommendation to Spain, extending the deadline for correction of the excessive deficit by one year to 2014.** New intermediate deficit targets of 6.3%, 4.5% and 2.8% of GDP were fixed for 2012, 2013 and 2014, respectively. Spain is required to achieve improvements of the structural balance of 2.7% of GDP in 2012, 2.5% of GDP in 2013 and 1.9% of GDP in 2014. Spain was given three months to take effective action. On 14 November, the Commission issued its assessment concluding that Spain had taken effective action and that no further steps in the excessive deficit procedure of Spain are needed at present[13].

78. **Regarding 2012, the assessment was based on the observation that Spain has adopted several discretionary consolidation packages during 2012 to underpin the revised**

[13] Communication COM(2012) 683 final and Staff Working Document SWD(2012) 390 final.

deficit target for 2012 (see Box 6). In total, measures of around 5¼% of GDP were adopted for 2012, including 1¾% of GDP on the revenue side and 3½% of GDP on the expenditure side. However, this sizeable consolidation effort has partly been counteracted by strong revenue shortfalls, linked to a less tax-rich growth composition and a stronger deterioration in the labour market, and higher social transfers, linked to the increase in pensions adopted in December 2011. Moreover, as in previous years, there are indications that a number of regions would again miss their budgetary targets. Therefore, the general government deficit is expected to reach 8.0% of GDP by the end of the year (see Table 3). Since an important part of the consolidation measures is due to materialise only in the last four months of the year, there are still implementation risks attached to these numbers. Nevertheless, correcting for revisions in potential output growth and for revenue shortfalls due to tax-poor growth, the estimated annual improvement of the structural balance is in line with the effort required by the Council for 2012.

Table 3: Composition of the budgetary adjustment

	2011		2012			2013		2014	
	outturn	SP April 2012	SP April 2012	COM SF 2012	COM AF 2012	COM SF 2012	COM AF 2012	COM SF 2012	COM AF 2012
	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Revenue	35,7	35,1	36,3	35,9	36,3	35,7	36,7	34,7	35,8
of which:									
- Taxes on production and imports	9,9	9,8	9,8	9,9	9,6	9,8	10,2	9,8	10,1
- Current taxes on imcome, wealth, etc.	9,6	9,5	10,3	10,2	10,2	10,1	10,2	9,6	9,7
- Social contributions	13,2	13,0	13,2	12,8	13,2	12,6	13,1	12,3	12,9
- Other (residual)	3,1	2,9	3,0	3,0	3,3	3,2	3,2	3,0	3,2
Expenditure	45,2	43,6	41,6	42,2	44,3	41,8	42,7	41,1	42,3
of which:									
- Primary expenditure	42,7	41,2	38,4	39,0	41,3	38,5	38,9	37,8	38,3
of which:									
- Compensation of employees	11,6	11,5	10,9	10,9	11,0	10,7	11,0	10,2	10,6
- Intermediate consumption	5,9	5,4	4,5	4,9	5,4	4,6	4,8	4,6	4,8
- Social payments	18,2	18,0	18,6	18,5	19,0	18,6	18,7	18,4	18,6
- Subsidies	1,1	1,1	0,9	0,9	1,0	0,9	1,0	0,9	1,0
- Gross fixed capital formation	2,9	2,8	1,7	1,9	1,8	1,8	1,5	1,8	1,5
- Other (resedual)	3,0	2,5	1,9	1,9	2,9	1,9	1,9	1,9	1,9
- Interest expenditure	2,5	2,4	3,2	3,2	3,0	3,3	3,9	3,3	4,0
General government balance (GGB)	-9,4	-8,5	-5,3	-6,3	-8,0	-6,1	-6,0	-6,4	-6,4
Primary balance	-7,0	-6,1	-2,2	-3,1	-5,0	-2,8	-2,2	-3,1	-2,5
One-off and other temporary measures	-0,2	0,4	1,0	0,2	0,3	0,0	0,1	0,0	0,0
Structural balance	-7,5	-7,3	-4,4	-4,3	-6,3	-4,1	-4,0	-5,1	-5,3
Change in structural balance	-	-	3,1	3,2	1,2	0,2	2,3	-1,0	-1,2
Corrected change in structural balance due to revision of potential output growth					1,2		2,4		-1,1
Real GDP growth	0,4	0,7	-1,8	-1,9	-1,4	-0,3	-1,4	1,1	0,8
GDP deflator	1,0	1,4	1,0	0,9	0,2	0,6	1,9	1,4	1,4
Nominal GDP	1,4	2,1	-0,8	-1,0	-1,2	0,3	0,4	2,5	2,3

Source: *SP April 2012 - Stability Programme April 2012; COM SF 2012 - Commission services' updated 2012 spring forecast; COM AF 2012 - Commission services' 2012 autumn forecast.*

79. **Regarding 2013, the assessment of effective action took additional consolidation measures of about 2¼% of GDP into account.** The general government deficit is expected to decline to 6.0% of GDP in 2013. In total, the budgetary impact of discretionary measures in 2013 is expected to be about 1¼% of GDP on the expenditure side and about 1% of GDP on the revenue side. The expected budget deviation from the target in 2013 is partly explained by the worse starting position. However, the 2013 budget bill is also based on optimistic macroeconomic and budgetary assumptions, especially as concerns social security. For the regions, the main consolidation measures in 2013 are the cuts in health and education included in the 2013-14 Budget Plan. There is only limited information currently available on the actual

implementation in regional budgets of these planned measures. However, correcting for revisions in potential output growth and for revenue shortfalls due to tax-poor growth, the estimated annual improvement of the structural balance is in line with the effort required by the Council for 2013.

80. The budgetary situation is expected to deteriorate in 2014. The general government deficit is set to widen to 6.4% of GDP in 2014 despite an expected improvement in the economic outlook with real GDP growth returning to positive territory. Apart from the base effect, the expected deviation from the budgetary target mainly reflects the expiry of temporary measures taken in previous years and the fact that planned consolidation measures for 2014 were not sufficiently specified in the multi-annual budget plan announced in August. Moreover, the composition of economic growth will continue to be tax-poor, with tax revenues not rising in full proportion to nominal GDP. Thus, for 2014, it appears that Spain has not taken sufficient measures and has yet to deliver the required structural effort.

Box 6: July, August and September fiscal measures

On **13 July 2012** Spain has approved a package of fiscal measures including, among others: (1) an increase in tax revenues, primarily from VAT, but also corporate income tax, personal income tax and excise duties, (2) a review of the unemployment benefit regime and of social security contributions, and (3) measures to increase the efficiency of the public sector and to reduce the public sector wage bill (e.g. elimination of the 2012 Christmas bonus for public sector employees).

On **3 August**, a multi-annual budget plan for the years 2013-14 was adopted to underpin the budgetary targets specified in the EDP recommendation. The budgetary plan, including July measures, entailed a substantial consolidation effort of around 1.2% of GDP in 2012, 2.5% of GDP in 2013 and 1% of GDP in 2014. However, the assumed macroeconomic scenario was optimistic, the expected budgetary impact of certain measures appeared to be on the high side and most expenditure cuts especially at sub-national level would need to be specified. Moreover, the plan did not fully take into account the expiry of a number of temporary and one-off measures in 2013 and 2014.

The draft 2013 budget announced on **27 September** specifies cuts in ministerial spending levels of around EUR 3.8 billion and tax measures of EUR 4.4 billion, some of which had already been announced in the 2013-14 budget plan. The draft 2013 budget contains hardly any new elements regarding 2014, where the planned expenditure cuts remain unspecified and a number of temporary tax increases will expire. Moreover, the budget remains based on an over-optimistic macroeconomic scenario, with real GDP contracting by only 0.5% in 2013. Meanwhile, consensus and Commission expect a much sharper contraction of around 1½% - 1¾% with a less tax-rich growth composition.

In addition, the reform plan, which accompanies the draft 2013 budget, foresees some structural fiscal measures. On **pension reform**, the authorities have announced that still in 2012 the Toledo Pact (special parliamentary commission) will discuss how to increase the effective retirement age, how to prolong working lives, and how to define the sustainability factor in the reformed pension system. To warrant sustainability of the system in the long-term, the reform should accelerate the increase in the statutory retirement age and bring forward the application of the sustainability factor. Moreover, an **independent fiscal agency** is to be established in the course of 2013. According to current plans, the agency would play an integral part in the implementation of the Budget Stability Law by providing analysis, reports and studies. Involvement of the agency in preparing macroeconomic and revenue forecasts remains to be assured, and the agency would need to be operational by mid-2013 to play a full role in the 2014 budget exercise.

5.2.2 Budgetary framework

81. The overhaul of the fiscal framework in 2011-2012 through the Budgetary Stability Law has strengthened the legal setting. In particular, it has introduced more stringent fiscal

rules (budget-balance, expenditure and debt rules) as well as a correction framework designed to be broadly in line with EU requirements and the intergovernmental fiscal compact. Progress has been made on reporting of fiscal data for regional governments, which represents a step forward in achieving higher fiscal transparency. However, given the challenge of introducing new reporting procedures across regional administrations, a sound track record regarding the quality and consistency of reporting remains to be achieved. Outstanding issues are related to the implementation of the Budgetary Stability Law. In particular, the implementation of the preventive and corrective arms of the Law needs to be stepped-up. There has been no official early warning mechanism or corrective action triggered so far to Autonomous Communities that are not on track to meet their fiscal targets, despite indications that a number of regions were exhibiting deviations from their targets in the first half of the year.

82. The Regional Liquidity Fund will be extended through 2013. By the end October 2012, eight of the 17 Autonomous Communities have applied for financial aid from the Regional Liquidity Fund (RLF) set up to provide affordable financing to regions that experience funding difficulties. The provision of liquidity is subject to strengthened fiscal conditionality and supervision through continuous monitoring of the adjustment plans of each beneficiary region in order to ensure meeting the general government budget deficit target. The government has recently announced that the RLF will be extended through 2013.

6 PROGRAMME FINANCING

83. So far there has been no disbursement from the contingency facility of EUR 30 billion set aside for unforeseen vulnerabilities of the Spanish banking sector. The main reason has been the relative calmness of the financial markets following the announcement of the Programme and the return of confidence over the summer. Under these conditions, the FROB proceeded with direct recapitalisation of BFA-Bankia in September.

6.1 FIRST DISBURSEMENT

84. The first disbursement of aid will take place after the European Commission's approval of the individual bank restructuring plans and of the SLEs for the Group 1 banks. For banks in Group 1 and Group 2, restructuring or resolution plans have been submitted to the European Commission. Group 1 bank plans were approved by the European Commission on 28 November 2012, paving the way for the first disbursement of funds under the Programme. The approval process for Group 2 banks is expected to run until end-December when these banks will be recapitalised or resolved in an orderly manner.

85. The capital injection in Group 1 banks financed under the Programme will amount to about EUR 37 billion. The starting point for determining the capital needs for the banks in Group 1 - Bankia/BFA, Catalunya Banc, NovaCaixaGalicia and Banco de Valencia - have been the capital shortfalls identified in the stress test conducted under the MoU in September 2012, of about EUR 46.2 billion. Two further elements impacted this figure: the transfer of RED loans and foreclosed assets to Sareb and the significant burden sharing measures. As regards the transfer of assets to Sareb, it has three main effects: (i) it crystallises the losses related to these assets (ii) it reduces future expected losses and (iii) it reduces the risk weighted assets (RWA) which are used to calculate the capital ratios. The burden sharing measures contribute directly to reducing the capital needs under the Programme, amounting to around EUR 10 billion for Group 1 banks.

86. Burden-sharing measures will be applied to equity holders and holders of preference shares and perpetual subordinated debt. In a first step, existing equity holders in Group 1 banks will take economic losses in the banks to the full extent. Then, 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 in the newly restructured banks. As regards the holders of dated subordinated debt, they will be given the choice between conversion into equity or into a senior debt instrument after taking an appropriate haircut. As a result, there will be no cash outflow from banks to the holders of these securities with the sole 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.

87. The necessary EFSF/ESM financial support to finance FROB's stake in the capital of Sareb would be of around EUR 2.5 billion. This would include both equity and subordinated debt in Sareb. Together with the EFSF/ESM support needed to finance the capital injection in Group 1 banks, it will result in a total amount of about EUR 39.5 billion for the first disbursement under the Programme (see Table 4).

Table 4: Estimated first disbursement

	EUR billion
Group 1 Banks (final)	**36.968**
of which Bankia	*17.959*
of which Catalunya Banc	*9.084*
of which Nova Caixa Galicia	*5.425*
of which Banco de Valencia	*4.500*
Equity in the AMC (not final)	**2.500**
TOTAL (not final)	**39.468**

88. For credit institutions belonging to Group 3[14], capital can be injected on the basis a recapitalisation Scheme until the end of the year 2012. Under a recapitalisation scheme approved by the Commission on 25 July 2012, Group 3 banks can receive recapitalisation measures and have to present a restructuring plan.

89. The scheme foresees that the capital will in principle be injected in the form of Convertible Securities (CoCos). The beneficiaries belonging to Group 3 will submit individual restructuring plans to the European Commission during the six-month period following the provision of the financial support provided by the FROB. No conversion of CoCos can in principle take place before the approval of the restructuring plan by the European Commission.

90. All Group 3 banks have to submit restructuring plans in case they need state aid. However, a repayment of the full amount of the aid until 30 June 2013 to remedy the capital shortfall in line with the presented recapitalisation plan will lead to lighter restructuring obligations.

6.2 ASSESSMENT OF COMPLIANCE WITH THE EFSF/ESM CONDITIONS FOR DISBURSEMENT

91. According to Master Financial Assistance Facility Agreement between the EFSF/ESM and Spain, several conditions need to be fulfilled before a disbursement of funds can take place. These conditions try to establish whether (i) private sector and national level solutions have been sought in order to recapitalise the banks before the ESM facility is used; (ii) a recapitalisation by the EFSF/ESM is necessary in the light of the degree of distress of the financial institutions concerned; (iii) the funds available to the FROB have been fully utilized by the FROB by the time of the disbursement; (iv) the proposed recapitalisation complies with applicable national state aid rules, EU state aid rules and legal restrictions; and (v) the beneficiary financial institutions undertake in a legally binding manner to implement the recapitalisation plans. **The Commission services in liaison with the ECB consider that Spain has fulfilled all the required conditionality for the first disbursement of funds from the ESM facility.**

92. The stress-test conducted by an independent consultant has revealed a large capital shortfall for the Spanish banking sector of about EUR 59 billion (see Section 4.1), which cannot be covered exclusively by the private sector or by Spain. Spain has already followed the required hierarchy of actions to address this capital shortfall, trying to mitigate contagion and systemic risk. Both the Deposit Guarantee Fund and the FROB have contributed financially

[14] In case any institution will remain part of this group.

to the resolution of the crisis, including by supporting private mergers and acquisitions. However, for the banks which cannot access private capital in order to cover their capital shortfall and are not attractive partners for a merger and acquisition process, public support for an orderly resolution/restructuring remains the only option. This process is conditional on contributions to the cost of restructuring from the banks' shareholders and subordinated bondholders thus ensuring a proper burden sharing from the private sector. At the same time, the sovereign is confronted with a challenging fiscal position – an ambitious fiscal consolidation path during a recession and rapidly rising public debt levels - and relatively high costs in accessing bond markets. Therefore, it is not in a position to ensure the financing from the markets of the bank recapitalisation programme.

93. A recapitalisation partly financed by the EFSF/ESM appears necessary given the large capital gap identified by the stress-test and the need for an external financial backstop in implementing a thorough clean-up of the banking sector. Both the sovereign and the Spanish private issuers have been confronted with serious difficulties in accessing market funding over the summer and only the announcement of the financial assistance programme and the re-normalisation of the bond market conditions following the ECB's announcements in the summer have brought back some confidence. It points to the clear urgency in implementing the agreed programme and in providing the external finance necessary to recapitalise the ailing banks and set-up the AMC. Further uncertainty regarding the implementation of the programme could have serious implications for financial stability in Spain and the euro area as a whole.

94. The FROB has neither enough cash nor real issuance capacity to grant the financial support to undertake the recapitalization of the Spanish banking system. The FROB's current liquidity position amounts to EUR 4.6 billion, of which 2.6 billion are invested in Spanish public debt. However, the FROB is facing short-term financial commitments (during 2012 and 2013) of about EUR 3.1 billion and has to maintain a liquidity buffer for financial support granted outside the scope of the financial assistance programme, such as the integration process between various cajas. It also needs to be ready to grant immediate support if necessary to prevent the eventual disorderly collapse of any credit institution. Although the FROB still has a bond issuance capacity with the guarantee of the State amounting to about EUR 13 billion, it is not realistic to consider that the FROB would be able to raise a significant amount under the current market conditions. In conclusion, the FROB has some liquidity and bond issuance capacity, but it still needs to face short term liabilities and payments and also needs to preserve a liquidity buffer in order to meet other unexpected commitments.

95. The relevant restructuring or resolution plans have been approved for Group 1 banks and are about to be approved for Group 2 banks, according to the timetable as foreseen in the MoU. The recapitalisation needs have been established on the basis of bank stress tests for the financial institutions conducted by an independent consultant, overseen by Spain, the European Commission, EBA and the ECB with the IMF acting as an observer. The European Commission, in liaison with the ECB, is satisfied with the way the stress tests have been conducted.

96. Spain has confirmed that the proposed recapitalisation complies with applicable national state aid rules and legal restrictions. The Spanish National Commission for Competition (NCC) confirmed that the applicable State aid legislation in Spain derives from articles 107 and 109 of the Treaty of the Functioning of the European Union, which makes the European Commission the responsible authority to determine compliance with State aid legislation in the Treaty. From a national point of view, there is no national legislation on State

aid, without prejudice to some specific or sectorial regulations which do not apply to the issue at stake.

97. The European Commission is currently in discussion with Spain and the respective benefiting banks to ensure that the restructuring or resolution plans, which entails the proposed recapitalisation, comply with EU State aid rules. This approval will be done on the basis of a no objection decision on the basis of legally binding commitments provided by the Spain. This will ensure that each relevant financial institution benefiting from a recapitalisation will implement the plan in a legally binding manner.

7 CONCLUSIONS

98. Spain implemented important reforms in the banking sector within a relatively short period of time and in line with the conditionality agreed in the context of the Financial Assistance Programme. This progress together with an incipient normalisation in the pricing of sovereign risk in the bond markets improved Spain's access to financial markets considerably since the summer**.** Nonetheless, the macro-financial environment remains challenging due to Spain's relapse into recession, a significant adjustment taking place in the real economy, very high unemployment levels, the still constrained access to external financing and gradual financial deleveraging. Therefore, finalising the clean-up of the banking sector from legacy assets and the recapitalisation and restructuring of banks is key to regain market confidence and provide new lending to the economy.

99. As regards the bank-specific conditionality, the top-down stress test, the evaluation of the quality of banking sector exposures by audit firms and the bottom-up bank-by-bank stress test were performed in due time. The entire process was finalized by the end of September. The restructuring plans to address any capital shortfalls identified in the stress test have been approved by the European Commission for Group 1 banks and are being discussed between the Spanish authorities and the European Commission for Group 2 banks. The fulfilment of conditions laid out in the MoU with respect to AMC is on track. A comprehensive AMC blueprint was prepared by the Spanish authorities by end-August. Primary legislation on AMC was included in the RDL 24/2012, which was adopted on 31 August. The secondary legislation is about to be adopted by mid-November. Nonetheless, rendering the AMC fully operational by end-November is going to be challenging. In a similar way, rapid progress is also needed with the implementation of the subordinated liability exercises, the assessment of the banks' viability, the finalisation of effective restructuring plans and the transfer of assets to a commercially viable AMC.

100. The horizontal conditionality with a deadline prior to mid-November is also broadly on track. The most significant progress was achieved with the adoption of RDL 24/2012 at the end of August, which introduced the legal changes necessary for the restructuring and resolution procedures, burden sharing, setting the competences and funding of the FROB, the transfer of sanctioning and licensing powers from Ministry of the Economy to the BdE[15], regulating the sales of hybrid instruments to retail customers, introducing the new capital requirements and developing the primary legislation for the AMC. However, implementation of some conditions is still on-going, such as the one related to the preparation of proposals for the strengthening of non-bank financial intermediation.

101. Progress with structural and fiscal reforms aimed at correcting macroeconomic imbalances and stabilizing the public debt-to-GDP ratio has advanced in several areas. A range of measures have been launched in the areas of taxation, labour market policies and energy. Spain has announced a structural reform plan on 27 September, which envisages further concrete measures to reform active labour market and employment policies, reduce the fragmentation of the domestic market, liberalise professional services and improve the business environment. In the fiscal field, Spain has adopted additional consolidation measures in July to underpin the revised deficit target for 2012, a multi-annual budegt plan for 2013-14 in August and a draft 2013 budget in September. Therefore, fiscal consolidation is set to acelerate in the

[15] This condition was due for end December.

remainder of 2012 and in 2013, although the recessionary environment delivers strong headwinds and further consolidation measures still need to be set out in detail, especially for 2014.

102. Based on the progress achieved so far in the implementation of the Financial Assistance Programme and the challenges that Spain continues to face, the European Commission, in liaison with the ECB, has recommended disbursing a first tranche from the ESM facility, of about EUR 39.5 billion. The funds will be used for covering the capital shortfall of Group 1 banks estimated at EUR 37 billion and finance the FROB's stake in the capital of the Asset Management Company of around EUR 2.5 billion.

8 ANNEXES

8.1 MAIN ECONOMIC AND FINANCIAL INDICATORS

	1995-1999	2000-2004	2005-2008	2009	2010	2011	2012
Core indicators							
GDP growth rate	3.7	3.6	3.0	- 3.7	- 0.3	0.4	- 1.4
Private consumption (annual % change)	3.5	3.7	2.8	- 3.8	0.7	- 1.0	- 1.9
Public consumption (annual % change)	2.7	5.0	5.4	3.7	1.5	- 0.5	- 4.9
HICP (annual % change)	2.8	3.2	3.5	- 0.2	2.0	3.1	2.5
Domestic demand incl. stocks	4.2	4.3	3.6	- 6.6	- 0.6	- 1.9	- 4.0
Unemployment rate (% of labour force)	17.2	11.2	9.3	18.0	20.1	21.7	25.1
Gross fixed capital formation (% of GDP)	22.5	26.7	29.8	23.6	22.3	21.1	19.3
Gross national saving (% of GDP)	22.0	22.6	21.1	19.2	18.4	17.8	17.4
General Government (% of GDP)							
Balance	- 4.2	- 0.4	0.3	- 11.2	- 9.7	- 9.4	- 8.0
Gross debt	64.7	52.5	39.8	53.9	61.5	69.3	86.1
Interest expenditure	4.6	2.7	1.7	1.8	1.9	2.5	3.0
Households							
Households saving rate	13.2	11.3	11.3	17.8	13.1	11.0	8.7
Rest of the world (% of GDP)							
Trade balance	- 0.1	- 2.8	- 6.0	- 1.9	- 2.2	- 0.8	1.0
Trade balance, goods	- 3.3	- 5.7	- 8.1	- 4.0	- 4.6	- 3.8	- 2.5
Trade balance, services	3.2	2.9	2.0	2.1	2.4	3.0	3.5
Current account balance	- 0.8	- 4.4	- 9.0	- 4.8	- 4.4	- 3.7	- 2.4
Net financial assets	- 27.0	- 39.7	- 70.1	- 91.8	- 88.4	- 90.6	n.a.
Net international investment position	- 26.9	- 41.3	- 69.7	- 93.7	- 88.9	- 91.7	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	100.9	96.6
Real effective exchange rate relative to the rest of the European Union	93.7	95.3	103.8	107.8	105.1	102.5	97.3
Real effective exchange rate relative to the rest of 36 industrialised countries	92.4	92.7	104.7	109.0	104.6	102.2	96.0

8.2 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 on-going
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	Done – 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	Done BoE Circular 8/2012
4. Provide information required for the Stress Test to the consultant, including the results of the asset quality review.	Mid-August 2012	Done
5. Introduce legislation to introduce the effectiveness of SLEs, including allowing for mandatory SLEs.	End-August 2012	Done RDL 24/2012
6. Upgrade of the bank resolution framework, i.e. strengthen the resolution powers of the FROB and FGD.	End-August 2012	Done RDL 24/2012
7. Prepare a comprehensive blueprint and legislative framework for the establishment and functioning of the AMC.	End-August 2012	Done RDL 24/2012
8. Complete bank-by-bank stress test (Stress Test).	Second half of September 2012	Done
9. Finalise a regulatory proposal on enhancing transparency of banks	End September 2012	Done BoE Circular 8/2012
10. Banks with significant capital shortfalls will conduct SLEs.	before capital injections in Oct./Dec. 2012	In progress, being discussed with Spain
11. Banks to draw up recapitalisation plans to indicate how capital shortfalls will be filled.	Early-October 2012	Done
12. Present restructuring or resolution plans to the EC for Group 2 banks.	October 2012	Done – submitted plans are now being reviewed and finalised

Measure	Date	Status
13. Identify possibilities to further enhance the areas in which the BdE can issue binding guidelines or interpretations without regulatory empowerment.	End-October 2012	Proposals submitted, discussions on-going
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	Proposals submitted, discussions on-going
15. Adopt legislation for the establishment and functioning of the AMC in order to make it fully operational by November 2012.	Autumn 2012	In progress
16. Submit for consultation with stakeholders' envisaged enhancements of the credit register.	End-October 2012	Done
17. Prepare proposals for the strengthening of non-bank financial intermediation including capital market funding and venture capital.	Mid-November 2012	Done
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	A proposal is currently being drafted by the Spanish authorities to be finalised before the end of November
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	Not relevant for now
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	A proposal is currently being drafted by the Spanish authorities to be finalised before the end of November

Measure	Date	Status
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	Not relevant for now
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	Not relevant for now
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 for now
24. Transfer the sanctioning and licensing powers of the Ministry of Economy to the BdE.	End-December 2012	Done RDL 24/2012
25. Require credit institutions to review, and if necessary, prepare and implement strategies for dealing with asset impairments.	End-December 2012	Not relevant for now
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	In progress RDL24/2012 Additional technical details to be implemented by BoE
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	Done 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	Done RDL 24/2012
30. Amend legislation for the enhancement of the credit register.	End-March 2013	Not relevant for now
31. Raise the required capital for banks planning a more limited (less than 2% of RWA) increase in equity.	End-June 2013	Not relevant for now
32 Group 3 banks with CoCos to present restructuring plans.	End-June 2013	Not relevant for now

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