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Financial Assistance Programme for the Recapitalisation of Financial Institutions in Spain. Second Review of the Programme - Spring 2013

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Financial Assistance Programme for the Recapitalisation of Financial Institutions in Spain

Second Review of the Programme - Spring 2013

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ABBREVIATIONS

AMC	Asset Management Company
BdE	Banco de España (Bank of Spain)
BMN	Banco Mare Nostrum
CDS	Credit Default Swaps
CNMV	Comisión Nacional del Mercado de Valores (National Securities Market Commission)
CoCos	Contingent Convertible Securities
CPI	Consumer Price Index
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
EC	European Commission
ECB	European Central Bank
EDP	Excessive Deficit Procedure
ESM	European Stability Mechanism
Euribor	Euro Interbank Offered Rate
FGD	Fondo de Garantía de Depósitos de Entidades de Crédito (Deposit Guarantee Fund)
FROB	Fondo de Reestructuración Ordenada Bancaria (Fund for Orderly Bank Restructuring)
GDP	Gross Domestic Product
HICP	Harmonized Index of Consumer Prices
IMF	International Monetary Fund
LTRO	Long-Term Refinancing Operation
LTV	Loan-to-Value
MFI	Monetary Financial Institution
MoU	Memorandum of Understanding
NFC	Non-Financial Corporation
NPL	Non-Performing Loan
OW	Oliver Wyman
pps.	percentage points
RDL	Real Decreto-ley (Royal Decree Law)
RED	Real-Estate Developers
RWA	Risk Weighted Assets
Sareb	Sociedad de gestión de activos procedentes de la reestructuración bancaria
SLEs	Subordinated Liability Exercises
VAT	Value Added Tax
y-o-y	year on year

EXECUTIVE SUMMARY

This Second Review report provides an assessment of the progress made by Spain with respect to its Financial Assistance Programme for the Recapitalisation of Financial Institutions, based on the findings of a joint European Commission (EC)/European Central Bank[1] (ECB) mission to Madrid during 28 January – 1 February 2013. The mission found that the programme, and more widely the reform of the financial sector, is on track. The policy conditionality of the programme has so far been met despite ambitious deadlines. It will be important to maintain the momentum as persistent efforts are needed to compound the progress achieved to date and to overcome the still significant challenges, so that a successful conclusion to the programme may be assured.

1. **Since the last review, Spain's access to financial markets has further improved thanks to increased investor confidence**. Favourable developments in global capital markets and effective initiatives at European level have improved the climate for foreign investors to return to Spanish markets. This has resulted in better market access by the Spanish sovereign and private borrowers. Government bond yields declined by more than 2 percentage points in the second half of 2012 and issuance of bank debt resumed in January 2013, although still at high financing costs. Due to their improved liquidity positions, Spanish banks contributed with significant amounts to the early repayment of the long-term refinancing operations (LTRO) and reliance on the Eurosystem diminished by about 25% since the peak reached in August 2012. Despite the significant progress, a degree of uncertainty exists on whether these improvements would consolidate, as banks' profitability remains under pressure. On the domestic front, the satisfactory compliance with the conditions imposed in the Memorandum of Understanding has also contributed to the stabilisation of the banking sector and to the return of investor confidence. Overall, the reform momentum needs to be preserved as risks to the economy and the financial sector remain high.

2. **Significant progress in separating impaired assets from banks has been achieved since the last review, with the start of operations by Sareb[2].** Against the background of a necessarily demanding timeline, the Spanish authorities have succeeded in designing, implementing and operationalizing this entity with the first, and largest, transfer of assets from banks to Sareb occurring on time. Much work remains ahead in this regard, however, and the coming months will be devoted to making Sareb fully operational. A sound business plan will be the foundation upon which the success of Sareb will rest, so it is of the utmost importance that this plan should be both robust and credible.

3. **The implementation of the horizontal financial-sector conditionality has been further advanced and is close to completion in most areas.** The reform of the governance of the savings banks, a review of supervisory procedures at Banco de España (BdE), reforms of the regulatory frameworks governing banks' credit concentration and provisioning, and the enhancement of the credit register are still on-going. In all these areas, the Spanish authorities have achieved or are very close to achieving compliance with the Memorandum of Understanding (MoU) and have made very tangible progress towards major and lasting reforms in these areas. These reforms must be speedily implemented in order to allow them to enhance the viability of the Spanish banking sector.

[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] The Spanish asset management company.

4. **The macroeconomic situation remains challenging, with very high and rising unemployment, GDP contraction and a need to reduce large stocks of internal and external debt.** The rebalancing of the economy is on-going, as robust export growth and very weak domestic demand contribute to a narrowing of the current account deficit. Notwithstanding the significant policy progress already made, further determined advances remain necessary in the consolidation of public finances - including reinforcing the institutional framework - and in the swift completion and implementation of the structural reform agenda, along the lines specified in last year's country–specific recommendations.

5. **While credit contraction has been gaining speed, as the economy slipped again into recession and the rebalancing process accelerated, this seems mostly due to the necessary deleveraging of exposures toward the construction and real estate developer sectors and to falling credit demand.** Although it is difficult to draw clear-cut conclusions on the forces driving the decline in lending activity, it appears that the flow of credit to the more dynamic sectors of the economy is less constrained than the shrinking stock of total credit would suggest. In particular, the significant increase in impairment allowances and the technical balance-sheet effect of the transfer of assets to the Sareb play an important role in the declining banking sector balances whereas deleveraging reflects the necessary rebalancing of the Spanish economy towards more productive sectors. Since the onset of the crisis, the pace of deleveraging in the private sector does not appear excessive given the significant adjustment challenge and was moreover cushioned by an increase in leverage in the public sector.

6. **There is at present no reason to foresee further programme disbursements.** Two disbursements were made so far in a total amount of about EUR 41.4 billion for the recapitalisation of State Aided banks and the capital injection into Sareb. The rest of the Spanish banks either were not diagnosed with a capital shortfall in the stress test or were able to cover it by private means.

1 INTRODUCTION

7. This report assesses Spain's compliance with the conditionality of the Financial Assistance Programme. A delegation from the European Commission, in liaison with the European Central Bank, the European Stability Mechanism and the European Banking Authority, completed the second review of the financial sector assistance programme for Spain from 28 January to 1 February 2013. The International Monetary Fund also participated in the review, fulfilling its role as an independent monitor.

8. The Programme, which was agreed by the Eurogroup on 9 July 2012 and covers a period of 18 months[3], entails an external financing by the euro area Member States of up to EUR 100 billion. On 3 December 2012, the Eurogroup made the first review on the progress on the Programme[4] and welcomed the decision by the European Stability Mechanism (ESM) to authorise the disbursement of the first tranche of up to EUR 39.5 billion. Spain has used close to EUR 37 billion for the recapitalisation of Group 1 banks, for which the EC had adopted restructuring and resolution plans on 28 November 2012, and up to EUR 2.5 billion for capitalising Sareb. On 21 January 2013, the Eurogroup endorsed and on 28 January 2013 the ESM approved the second disbursement under the programme[5] of about EUR 1.9 billion for the recapitalisation of Group 2 banks, for which the EC had adopted restructuring plans on 20 December 2012.

9. The Memorandum of Understanding provides for bank-specific conditionality, in line with State aid rules, as well as horizontal conditionality. Since the last review, important progress with the two parts of conditionality has been made and the programme continues to be on track. The review report assesses conditions with a deadline prior to end-January 2013, including those which were met or those toward which there was substantial progress ahead of their deadline. The cut-off date for the information included in the report is 15 February 2013.

10. The bank-specific conditionality has advanced in all its 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 was performed. The assumptions under which the robust and independent bank stress test was conducted remain in general valid.
- Second, an external Asset Management Company (AMC) called Sareb was set up and became operational in its basic functions. The segregation of impaired assets from the balance sheet of banks receiving public support and their transfer to Sareb has started with the largest batch from Group 1 banks. Sareb will need to become fully operational based on a comprehensive business plan and complete the transfer of assets from Group 2 banks.
- Third, the restructuring and resolution plans of the banks with a capital shortfall identified in the stress test and unable to cover it fully by private means were adopted and the recapitalisation of viable banks is almost completed. The

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

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

[5] See the update on Spain's compliance with the programme conditionality at: http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/op126_en.htm

restructuring of the State-aided banks needs to be fully implemented now, including by conducting the burden sharing exercises.

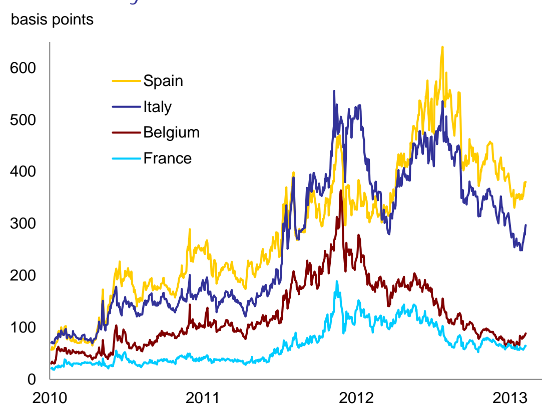
11. **The horizontal conditionality applies to the entire banking sector, unlike bank-specific conditions, and significant progress has been made since the inception of the programme, in particular as the MoU conditionality was frontloaded.** The horizontal programme includes measures aimed, inter alia, 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. Work remains on-going only in a limited number of areas, including the reform of the governance of the savings banks, a review of supervisory procedures at Banco de España, reforms of the regulatory frameworks governing banks' credit concentration and provisioning, and the enhancement of the credit register. However, in all these areas, the Spanish authorities have achieved or are close to achieving compliance with the MoU.

2 RECENT FINANCIAL, MACROECONOMIC AND FISCAL DEVELOPMENTS

2.1 FINANCIAL SECTOR DEVELOPMENTS

12. During the last quarter of 2012 and until the end of January 2013, Spain enjoyed improved access to financial markets and investor confidence consolidated. Spanish government bond yields have declined further and purchases by the private foreign sector have resumed. Liquidity constraints on the Spanish banking sector have also subsided. However, a certain degree of uncertainty exists on the permanent nature of the improvements observed. Government bond yields rose again recently, partly eroding a rally that brought down yields by more than 2 percentage points from the euro area record highs in July. New data confirming the negative momentum in the real economy together with some domestic political turbulence explain some deterioration observed from the end of January in the risk assigned to Spain by financial agents (see Graph 1 and Graph 2).

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



Source: Thomson Reuters EcoWin and own calculations

Graph 2: IBEX 35

Source: Thomson Reuters EcoWin and own calculations

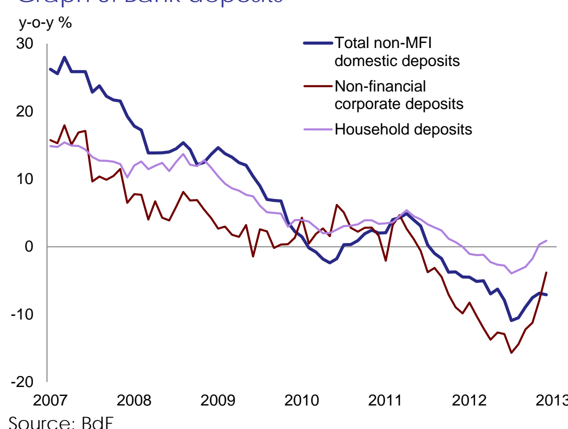
13. The improvement in the access of Spain to financial markets has been the consequence of a combination of both international and domestic factors. These enabling factors include: the consensus reached by the European Council on the basis for the establishment of a Single Supervisory Mechanism, the release of the EC's blueprint on how to complete the Economic and Monetary Union and, on the domestic side, the satisfactory compliance with the conditions imposed in the Memorandum of Understanding (MoU). The approval of restructuring and resolution plans of the Spanish banks which have received State aid, the capitalisation measures taken in the banks where capital needs were detected by the independent stress test, and the creation of the Sareb and the successful transfer of assets to it, have significantly contributed to cleaning up the Spanish banking system and restoring investor confidence. The capacity to generate sustainable profits in a recessionary environment is now the main challenge to be faced by the Spanish banks.

14. Financing conditions for the banking sector continued to improve leading to a gradual decline in Eurosystem refinancing and a pick-up of issuance of secured and unsecured debt. The reliance on net borrowing from the Eurosystem diminished to EUR 313 billion in December 2012 from a record EUR 389 billion in August. The fall in domestic retail and corporate deposits has decelerated significantly to around 0.2% y-o-y in November 2012 from 6.5% in July, as both items increased again in recent months (see

Graph 3). Furthermore, the significant non-resident outflows of about EUR 80 billion (or 18.5% of total) during May-August 2012 came to an end despite a temporary rebound in November. The relatively benign evolution in December seems to confirm the positive trend.

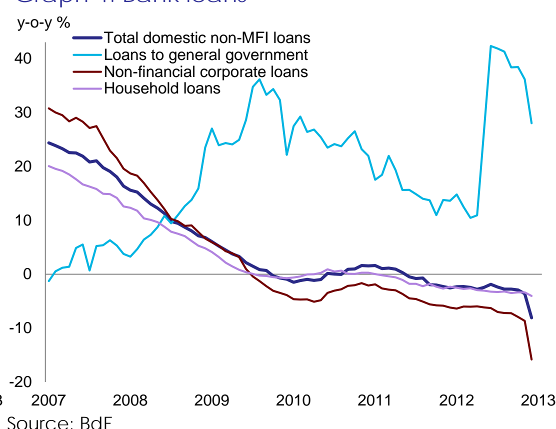
15. Issuance of bank debt resumed. The issuance of secured, unsecured and covered bonds by credit institutions continued in January 2013 and amounted to EUR 10.5 billion. That includes not only Group 0 banks' issuances but also two bonds issuances from former Group 3 Banco Popular (see Table 1). Non-financial corporates have also returned to the market and issued EUR 5.1 billion of bonds in January 2013. While it is encouraging that certain institutions have returned to the market, funding costs remain elevated relative to pre-crisis levels.

Graph 3: Bank deposits



Source: BdE

Graph 4: Bank loans[6]



Source: BdE

16. Due to their improved liquidity positions, Spanish banks were in a position to participate with a significant amount in the early repayment of the LTRO in late January. It represents another positive sign that the liquidity constraints in the banking sector have abated recently. At the same time, the underlying risk/return determinants behind such high participation of Spanish banks and the impact of early repayment on their profitability and liquidity conditions going forward merit further analysis.

Table 1: Issuances, January 2013

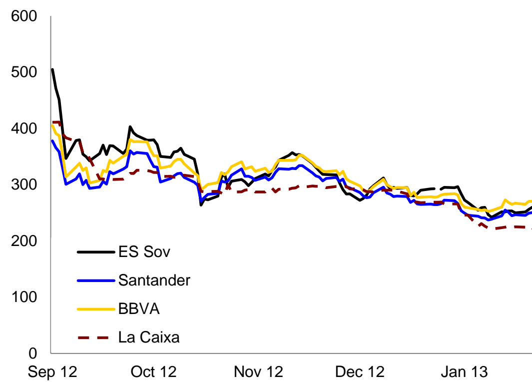
ISSUER	AMOUNT (million)	SPREAD	TYPE
BBVA	1,500	295	Unsecured
CaixaBank	1,000	285	Unsecured
BPE Financiaciones (Banco Popular)	750	364	Unsecured
Bankinter	500	220	Covered
Banco de Sabadell	1,000	250	Unsecured
Banco Popular	500	270	Covered
Santander Internacional	1,000	275	Notes
BBVA	1,000	215	Covered
Kutxabank	750	220	Covered
Santander	2,000	195	Covered
Bankinter	500	220	Covered
Total	**10,500**		

Source: BdE and ECFIN calculations

[6] The significant decline in loans in December partially reflects the accounting effect of the extraordinary transfer of assets from Group 1 banks to Sareb.

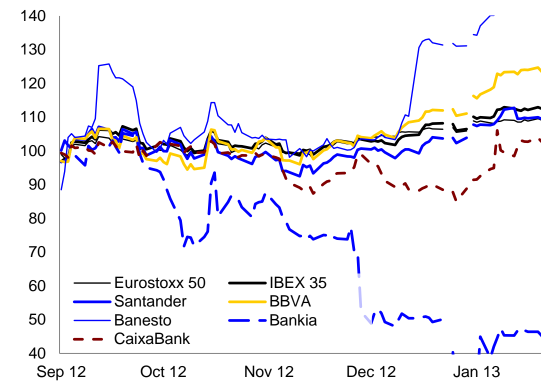
17. The better access to funding markets by Spanish banks was also reflected in rising share prices and lower risk premia. In line with sovereign exposures, CDS spreads for banks have declined over the last months showing a better perception from the markets on banks' risks. Moreover, stock prices have also improved for several banks (see Graph 5 and Graph 6).

Graph 5: CDS spreads (basis points)



Source: Bloomberg, own calculations

Graph 6: Share price indices



Source: Bloomberg, own calculations

18. The decline in lending has continued against the backdrop of deleveraging in the real estate and construction sectors. While bank loans continue to trend down, a significant portion of the decline seen in the data is related to the transfer of assets to Sareb in December 2012. Therefore, this data is not an accurate reflection of the reduction in the flow of credit to Spanish households and firms, due to the accounting effect of the transactions related to Sareb and the recapitalisation of the Group 1 institutions worth about EUR 56 billion. As of December 2012, total non-MFI domestic credit shrunk by about 8% year-on-year being driven by the decline in the stock of credit to the private sector of almost 10% year-on-year. Domestic lending to non-financial corporations and households fell by 15.8% and 4% year-on-year, respectively (see Graph 4: Bank loans). If the accounting effect of the transfer of assets to Sareb is left out, the annual reduction in the stock of credit was about 5.3% for the total non-MFI domestic sector and 9.3% for non-financial corporations. At the same time, the increase in credit to the government continued at around 27% year-on-year.

19. Credit supply is mainly constrained by the weaker solvent demand in a recessionary environment, but also by the banks' efforts to rebuild capital ratios and by more prudent lending policies. The acceleration in the decline of the stock of credit to the domestic private sector needs to be seen in the broader context of the economic rebalancing that affects the entire economy and in particular sectors such as construction and the real estate. As a matter of fact, a more granular analysis shows that the pace of decline in lending to domestic residents (non-MFI) as of the third quarter of 2012 was 3.5% y-o-y instead of 4.8% if construction and real estate activities loans are excluded. In a similar way, the pace of decline in net loans (-5.5% y-o-y) is much higher than the decline in the stock of gross loans (-1.2% y-o-y) at the end of November 2012 due to a significant increase in impairment allowances. Given the necessity to acknowledge and build impairment allowances for the bad debts on the balance sheet of the banks and in the economy in general, this shows that new credit flows to the viable part of the economy are not necessarily impaired by the decline in the stock of credit. This seems broadly in line with the main objective of the programme to restructure and clean-up the balance sheet of

banks from legacy assets, without unduly constraining the flow of lending to the viable part of the economy.

20. The main constraints to the provision of credit by the domestic banking sector related to their capitalisation and access to funding have started to ease in recent months. They should gradually translate into an improved credit market if the macro-economic conditions related to solvent credit demand allow for it. Furthermore, one needs to look at the total amount of credit in the economy and not only at the one provided by the domestic banking sector. For example, domestic credit to non-financial corporations(NFCs) was declining at 8% y-o-y as of December 2012, whereas external loans declined by only 0.5% y-o-y and corporate bonds issued increased by 12.5% y-o-y. Overall, the decline in total credit to non-financial corporates was thus 5.2% y-o-y instead of 8%.

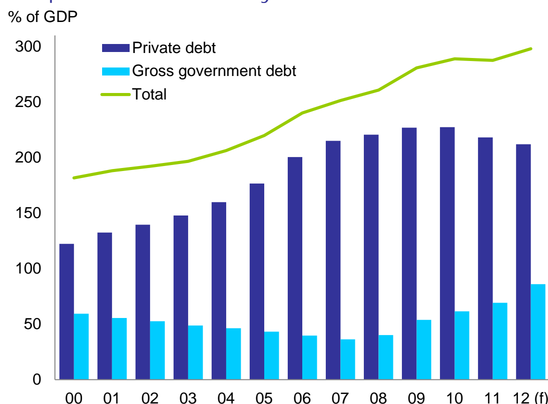
21. Deleveraging is necessary in the sectors that over expanded in the boom in order to allow the economy to adjust and grow again in a sustainable manner (please see Chapter 6.1 in Annex for a more detailed analysis)**.** As non-viable firms leave the market, factors of production are freed to allow the recovery in the viable part of the economy. Private sector deleveraging gained speed as of 2012 when the Spanish economy dived into its second recession in the last four years. The process started relatively late in the crisis[7] and was slow, leading to a decline in leverage of about 15% of GDP from its peak in 2010 to mid-2012, mostly due to a fall in non-financial corporation debt. In the meantime, public sector indebtedness grew constantly since 2008, reaching around 86% of GDP in 2012 according to the EC Autumn Forecast. This represents an increase of about 45% of GDP over the period, which means that leverage has actually increased in the total economy since the beginning of the crisis (see Graph 7).

22. The restructuring of the banking sector is visible in the downsizing of banks and an increase in their efficiency. The number of branches and employees has continued to decrease in the third quarter of 2012, so that they reached their pre-crisis levels. It represents a cumulative reduction of about 13% from December 2008 to September 2012 for both indicators and boosted bank efficiency by depressing operating costs. Operating expenses grew modestly by 0.2% y-o-y as of June 2012. If Spanish banks with a large presence abroad are left out, operating expenses dropped by 8.5%. In the savings banks sector, where the restructuring process has been deeper during 2011-2012 (see Chapter 3.2 for a more detailed analysis), the efficiency ratio improved significantly during the year preceding the third quarter of 2012 as it declined from 64% to 53%.

23. Banking sector results and the provision of credit to the real economy have continued to be affected by adverse developments in asset quality. The deterioration in asset quality continued in the second half of 2012, as non-performing loans reached 11.4% of total loans in November 2012 compared to 9.7% at the end of June 2012. Similar to the first half of 2012, the increase in impaired assets at system level was mainly driven by the on-going deterioration of the exposures to the real estate and construction sector, where non-performing loans surpassed 30% at the end of September 2012 . Non-performing loans in the household sector continued to remain far below the system level and went up to 4.5% at the end of September 2012 (see Graph 8). The relatively low level of impairment on the loans to households has been the result of the relatively good performance of the residential mortgage portfolio (see Box 1), as non-performing loans for mortgage loans stood at roughly 4% at the end of September 2012.

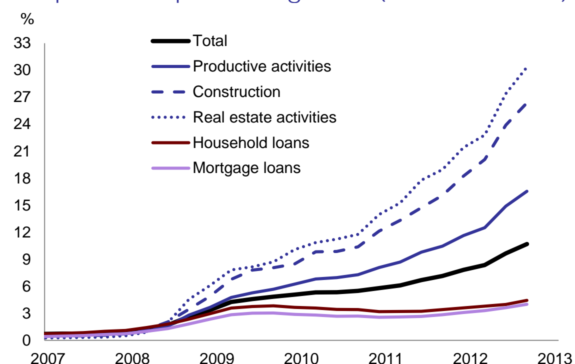
[7] During 2008 to 2010 private debt kept increasing by about 7% of GDP, also due to the decline in nominal GDP over the period.

Graph 7: Gross debt by sector as a % of GDP



Source: Eurostat, own calculations

Graph 8: Non-performing loans (% of total loans)



Source: BdE, own calculations

Box 1: Residential mortgages: where do we stand?

Despite significant strains in the banking sector, residential mortgage portfolios have remained relatively resilient during the crisis (see Graph 8 on non-performing loans). The delinquency ratio for residential mortgages is relatively low. It reached a peak in 2009 and, although it has been slightly increasing since September 2011, remains quite stable at around 3.5% as of September 2012. Furthermore, non-performing loans (NPLs) for primary dwellings seems to be even lower. Misclassifications of credits in the retail portfolio (including mortgages) detected by auditors during the bottom-up stress test were almost negligible (less than 0.1%) while they were higher in the SME portfolios.

Several factors could explain this relatively high quality of retail mortgage portfolios, among which: (i) relatively lower loan-to-value (LTV) ratios [on average around 62%]; (ii) a relatively low level of unemployment amongst residential loan holders[8]; (iii) a low level of restructured operations and (iv) the low and recently fallen level of interest rates. The Euribor 12-months rate decreased by 70% during 2012. As a result, mortgage interest rates have significantly decreased. On average, Spanish households today pay around 40% less in a monthly mortgage payment as compared to the end of 2008. Housing affordability measured by the housing price index in relation to gross available income has decreased from 6.7 in 2010 to around 6 in 2012[9].

Nevertheless, this latter point explaining relatively stable mortgage portfolios also bears a potential risk for the future: the vast majority of mortgages loans in Spain provide for a floating rate normally linked to the Euribor. Therefore, mortgages portfolios are extremely sensible to any rate increase that could put more pressure on households' burden. In addition, the economic outlook will determine the evolution of residential mortgages delinquency ratios.

Mortgage portfolios have experienced some corrections recently which also point to increased resilience going forward. After an important decrease during the last years, average mortgage loans amount to around EUR 100 000, about 30% less than in 2008. Average maturity has also declined from almost 28 years in 2008 to 23.3 at the end of 2012[10]. In addition, the total outstanding amount of residential mortgages has significantly decreased from the end of 2009 and stands now at 2006 pre-crisis levels.

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[8] While unemployment in Spain has exceeded 26%, according to recent data only 7% to 9% of total outstanding mortgages were signed by people currently unemployed. Moreover, while unemployment is concentrated in certain groups, in particular affecting young people (the unemployment rate for people below 30 years is 40%), mortgages signed by them are around 4% of the total amount.

[9] Banco de España. Summary indicators. Housing market indicators.

[10] Asociación Española Hipotecaria: "Boletín Trimestral". February 2013.

24. The increase in loan-loss provisions has continued to weigh on banking sector profitability. Notwithstanding the challenging economic environment, interest income has remained resilient for the majority of banks. However, despite sustained efforts to increase efficiency and the positive effects for banks involved in carry trade on sovereign bonds, profitability at system level has continued to be markedly impacted by the increase in loan-loss provisions, in particular for real estate and construction sector exposures. Against the backdrop of these developments, the return on equity at system level stood at -8.7% at the end of September 2012.

25. Spanish banks are better capitalised to withstand a severe shock. The recapitalisation of Group 1 banks and the raising of capital of other banks, together with the transfer of assets to Sareb, will boost capital ratios above the current regulatory minimum capital levels. Consequently, Spanish banks have a stronger loss absorbing capacity. Furthermore, recent data shows that in general terms banks are over-performing the conservative estimates used in the most severe scenario of the stress test in terms of pre-provisioning profitability (see Box 2). As a result, on average, the loss-absorbing capacity observed so far, is higher than what was assumed in the stress test.

26. The front-loading of losses through a strict provisioning regime and the transfer of assets to Sareb have resulted in the early recognition of a significant proportion of the losses estimated in the bottom-up stress test. A very high volume of provisions were recorded in 2012 and transfers to Sareb were effected at a transfer price equivalent to the maximum losses estimated in the adverse scenario of the stress test. In addition, Spanish banks perform better than their international peers in terms of capital to total assets, which may suggest that Spanish banks' calculations of risk-weighted assets are more conservative. These factors explain why the average capital levels of Spanish banks have not increased to the same levels as banks in other programme countries that have undergone comprehensive stress tests.

27. Nevertheless, banks must ensure that adequate capital buffers continue to be maintained. In the near-term, the introduction of specific rules which raise the minimum core tier 1 capital level to 9% for Spanish banks will be an impetus in this direction. In the medium to long-term, banks should build additional capital buffers as a result of the gradual implementation of the forthcoming EU capital requirements legislation (CRD IV and CRR I) taking into account more stringent capital definitions which will reduce capital levels of some banks.

28. Consequently, Spanish banks should adopt prudent dividend policies by retaining a higher share of profits or paying dividends in shares in order to generate additional capital internally. In fact, some banks have begun to implement these kind of policies aiming at reducing pay-out levels through the so-called "scrip dividends". However, this has not been the case for all banks in 2012 since some of them have increased substantially their pay-out levels and even paid out, in cash, more than 50% of their annual profits.

Box 2: Results of the Oliver Wyman stress test: are they still a valid reference?

The bottom-up stress test exercise carried out by Oliver Wyman (OW) for the Spanish banking system published in September 2012, based on actual data until December 2011, provided a thorough assessment of the situation in the Spanish banking system, assessed the quality of banks' portfolios and identified capital shortfalls for certain credit institutions under two macroeconomic scenarios (a baseline and an adverse scenario).

In light of current developments in the Spanish banking sector and in the economy at large, the results of OW exercise remain conservative and a valid reference for assessing the forward-looking solvency of Spanish banks. In this regard the following considerations can be made:

- Comparing estimates from OW and actual figures, it seems that, at present, both the Spanish economy and the banking sector are far from reaching the projected adverse scenario, except in the case of unemployment and the evolution of interest rates where developments are more in line with the OW severe scenario.
- The GDP real growth baseline scenarios by OW for 2012, 2013 and 2014 is in total for that period broadly in line with current EC and IMF forecasts. However, under the adverse scenario, OW assumed declines in GDP growth significantly larger than those currently predicted by the EC and the IMF with available data. Therefore, it seems that the output growth scenarios used by OW can be considered as a prudent and conservative reference.
- Regarding unemployment, in the light of EC and IMF forecasts for 2012, 2013 and 2014, the OW baseline scenario seems slightly optimistic, while the adverse scenario for this variable is more in line with latest international forecasts.
- The comparison between observed house price developments and those assumed in the stress test is difficult because house prices are always subject to a high degree of heterogeneity. Notwithstanding this, under the adverse scenario, OW applied an average haircut of -64% on foreclosed assets, which can be considered as conservative given current developments in house prices.

Despite a slight deterioration of the macroeconomic framework in 2012, in relation to the baseline scenario of the OW exercise, the vast majority of Spanish banks have exceeded expectations in their capacity to generate profits. In terms of pre-provisioning profits, most credit institutions are significantly above OW estimates. Spanish banks have in fact increased their loss absorption capacity and solvency in the middle of a challenging year as a result of two measures (RDL 2/2012 [11] and RDL 18/2012 [12]) that impose stricter provisioning requirements.

2.2 MACROECONOMIC AND FISCAL DEVELOPMENTS

29. The economy continues to contract as domestic demand faces strong headwinds. Private sector deleveraging and fiscal consolidation are on-going, weighing on private and public consumption and investment. Very high unemployment is eroding disposable income. Financing conditions for households and firms remain tight despite improvements in financial markets.

30. Net exports are supporting GDP growth. According to the flash estimates, GDP fell by 0.7% (q-o-q) in the fourth quarter of 2012, compared to -0.3% in the third quarter. In

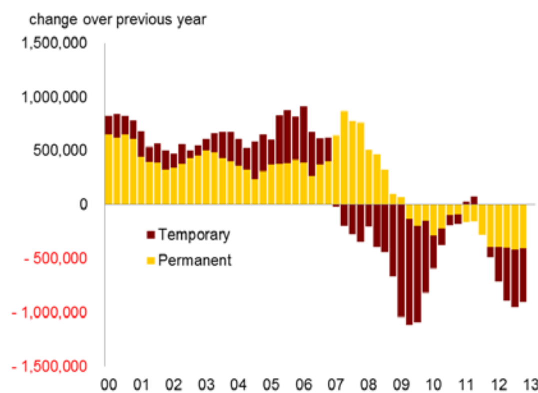
[11] http://noticias.juridicas.com/base_datos/Admin/rdl2-2012.html
[12] http://noticias.juridicas.com/base_datos/Derogadas/r1-rdl18-2012.html

annual terms, GDP fell by 1.4% in 2012, after growing by 0.4% in 2011. The short-term growth profile was affected by the advancement of purchases to the third quarter of 2012, due to the VAT rate hike in September, and by the fact that the impact of fiscal measures announced in July was concentrated at the end of the year. Exports have been resilient during the crisis and are expected to continue to support growth, thanks to increased geographical diversification. At the same time, weak imports reflect the fall in domestic demand. As a result, the current account deficit keeps adjusting, and is expected to reach a surplus of around 1% of GDP in 2013 according to the Commission services' 2013 Winter Forecast.

31. The recession is set to continue into 2013. GDP is expected to contract by a further 1.4% in 2013, still driven by a contraction of domestic demand and a positive contribution of net exports. Output is expected to stabilise and start recovering around the end of 2013 allowing for some positive growth of around 0.8% in 2014 (assuming no policy changes).

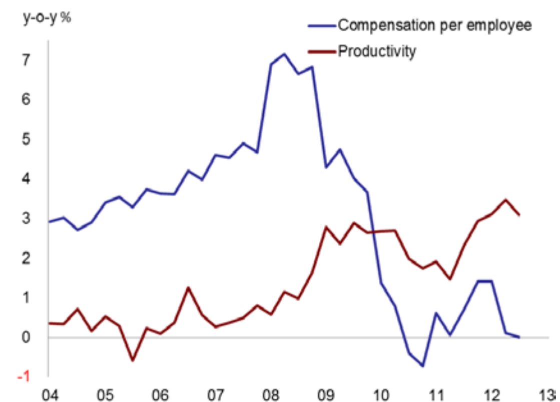
32. Employment is still declining fast, while the moderation in wages is not fully reflected in prices. Employment fell by 4.8% (y-o-y) in the fourth quarter of 2012, according to the Labour Force Survey (see Graph 9). Social security data for January show that the deterioration is continuing. The unemployment rate rose to 26% at the end of 2012, while wage growth is moderating. Combined with significant increases in measured productivity (partly due to labour shedding), this is resulting in falling unit labour costs and improving international cost competitiveness (see Graph 10). Further improvements in cost competitiveness are expected going forward. Inflation, measured by HICP, was slightly below 3% in January, mainly driven by hikes in indirect taxes and administered prices, although price rigidities are likely to be contributing to it. Inflation is expected to moderate in 2013 and fall below 2% by year end.

Graph 9: Employment and contract duration



Source: Thomson Reuters EcoWin.

Graph 10: Productivity and wages



Source: BdE, INE.

33. The 6.3% of GDP deficit target in 2012 was missed in spite of large consolidation efforts. The cumulated general government deficit for the first three quarters of 2012 was EUR 65.3 billion (8.3% of cumulated quarterly GDP), including bank recapitalisation measures of around EUR 10 billion (1% of GDP). The indicators available for the fourth quarter point to relatively strong tax receipts, reflecting the impact of measures in the areas of VAT and corporate income tax. These measures offset significant underlying revenue shortfalls as the economy shifts from tax-rich consumption-based growth to export-led growth. The Autonomous Communities showed a deficit of slightly below EUR 12 billion for the first three quarters (1.1% of full-year GDP, adjusted for advance transfers from the

central government). This is an improvement since the first half of the year, when the deficit already stood at 0.9% of the full-year GDP. While discretionary expenditure cuts in the area of education are likely to be concentrated in the fourth quarter, there are risks to the 2012 deficit target for the regions of 1.5% of GDP. The social security system is expected to post a deficit of above 1% of GDP, due to lower social contributions and higher transfers. The Commission services' 2013 Winter Forecast projects the deficit at 7% of GDP (excluding bank recapitalisation costs of 3.2% of GDP).[13] The Spanish government reported a 2012 deficit outcome of 6.7% of GDP at the end of February.

[13] The cut-off date for the Winter Forecast was 15 February.

3 BANK RECAPITALISATION AND RESTRUCTURING

3.1 SEGREGATING THE BANKS' LEGACY ASSETS

34. Despite the very challenging deadlines, Sareb, the Spanish asset management company, has made good progress towards becoming fully operational (see Box 3 on Sareb's main features). The first transfer of assets to Sareb took place on 31 of December. The Chairwoman and Managing Director of Sareb were designated on 14 November by the Board of FROB. Sareb has made significant progress in recruiting a management team and is intends to quickly hire additional staff.

35. Sareb's main objective is to manage and disinvest the portfolio of assets transferred by stated aided banks in an orderly manner, optimizing levels of recovery and value preservation, minimizing the cost for the taxpayer, within a maximum timeframe of 15 years. In its disinvestment strategy Sareb is going to use both the retail channel (via transferring banks) as well as wholesale channel targeting institutional investors.

36. The initial business plan of Sareb is now under revision. The business plan is being adjusted to incorporate new information on the evolution of the portfolio since end-2011 (which was the basis for the initial business plan) as well as to take advantage of greater granularity of the available information on the assets owned by Sareb. The main focus of the business plan is to manage the vehicle in a manner which ensures sufficient liquidity and enhances the recovery value of Sareb's assets over time.

37. Sareb is finalising servicing agreements with the transferring banks, which will continue to manage the assets. Such agreements include detailed procedures for managing the assets and aim to create the right incentives for the effective management of the assets. In addition, transferring banks will offer vendor financing for the potential buyers of Sareb's assets with the same funding conditions offered to their own clients.

38. Spanish banks will be competitors of Sareb. Spanish banks have adopted aggressive commercial practices to sell real estate properties rapidly in anticipation of the future competition with Sareb. Therefore, it is important that Sareb is able to offer its clients funding conditions that are in line with market conditions, so that it can compete on equal footing with the banks.

Box 3: Sareb – Main features of the Spanish AMC

Perimeter and size:

- After the first transfer of assets from Group 1 banks to Sareb, which took place on the 31st of December 2012, total real estate related assets amount to EUR 36.7 billion. The average haircut applied to these assets for their transfer is 54.5% relative to gross book value. More than 145,000 asset have been transferred thus far. Of the total amount, EUR 8.72 billion are foreclosed real estate assets, EUR 16.62 billion are performing real-estate developers (RED) loans and EUR 11.91 billion are non-performing loans.
- The value of assets to be transferred from group 2 banks to Sareb is expected to be around EUR 15 billion.
- According to preliminary information, approximately half of the assets owned by Sareb are either land or loans backed by land as collateral. Of the remaining assets, 35% correspond to finished properties.

Capital

- The capital required by Sareb for assets from group 1 banks has been fully disbursed both by private investors and the FROB. Furthermore, private investors have signed agreements in which they fully commit to provide the necessary capital once the remaining assets are transferred.
- To date, investors have provided EUR 3.82 billion capital to Sareb. 52.6% of this capital belongs to private shareholders, of which, over 95% are credit institutions. The remaining private shareholders are mainly insurance companies.
- After the transfer of the remaining assets to the AMC, total capital will be approximately 8% of total assets. 25% of this amount will be made up of equity while the remaining amount will consist of subordinated debt which is convertible into equity. A majority holding has been subscribed by private investors.

Corporate governance

- The Board of Directors will oversee the activities of the company, with 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.
- Sareb's by-laws are in line with standard practice for Spanish listed companies. In particular, based on a statutory provision included in the Royal decree establishing SAREB, they forbid direct involvement in the board of Sareb of a person working in the real estate at one of the shareholder banks.
- In mid-December 2012, Sareb's Audit and Remuneration Committees were established. The Executive and the Asset-Liability Committees will be created shortly.
- While the Banco de España will act as the administrative supervisory body of Sareb, there will additionally be a Monitoring Committee, outside the structure of Sareb, formed by four parties (Ministry of Economic Affairs and Competitiveness, Ministry of Financial Affairs and Public Administration, Banco de España and CNMV), to oversee compliance with the general objectives for which the company was formed. The Committee may agree to its meetings being attended by representatives of other public institutions or national or international bodies, as well as to admit permanent observers with full access to the information provided to it. The Committee was created at the end of January, and the Secretary General for Treasury and Financial Policy was appointed Chair of this Committee. The Ministry for Finance and Public Administration, the BdE and the National Securities Market Commission (CNMV) are about to appoint their representatives. In its first meeting, the Committee will adopt its rules and procedures and agree on invitating external observers. This Committee will meet in the future at least once per quarter, as foreseen by the legislation.

39. At this stage, the most immediate challenges for Sareb are the following:

- Adequately reviewing its business plan in order to define the most effective sales channels as well as alternative business strategies which may include leases.
- Ensuring the proper management of its assets by participating banks. Sareb will have to monitor closely the performance of those banks and take quick remedial actions if these arrangements do not allow the company to extract the maximum value from the company. Setting up adequate structures and procedures to carry out this monitoring properly and to engage with the banks effectively should be one of the top priorities of the company.
- Completing hiring of the staff and setting-up of the organization, including procedures and reporting requirements. In addition, getting a full picture of all the assets transferred to Sareb may take some time.

3.2 BANK RECAPITALISATION AND RESTRUCTURING

40. The stress test exercise which was finalised in September 2012 revealed capital shortfalls in 10 banks, which had to present recapitalisation plans. These allowed to check whether the banks would be able to fill the identified capital shortfall through their own means, or if they would need to resort to state aid which would include capital injections and the transfer of their real estate related foreclosed assets and their real estate development (RED) assets.

41. The EC adopted the restructuring plans for Group 1 banks on 28 November 2012, and for Group 2 banks on 20 December 2012. The EC approved the restructuring plans for all Group 1 banks, and in the case of Banco de Valencia it approved the State aid required for the orderly resolution of the bank through its takeover by CaixaBank. In the absence of the takeover, Banco de Valencia would have been wound down, as it was not possible to establish a viable business model for the bank on a stand-alone basis. The EC's decisions approving the restructuring plans of the group 1 and 2 banks will be published once confidentiality issues have been checked by the Spanish authorities and the banks.

42. Group 1 and Group 2 banks have a combined share of the credit in Spain of just above 20%.[14] This means that 80% of the system is not constrained by restructuring targets. These banks can contribute to picking up credit demand that will not be satisfied by the banks under restructuring.

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

44. In general, the restructuring plans of Group 1 and 2 banks plans secure the banks' solvency, and restore the profitability and liquidity profile over the course of the five-year restructuring period. In particular, the focus of the plans is to restore an adequate margin structure. This will over time also reinforce the banks' capital position. Another focus is on addressing the funding gap and thus reducing the banks' reliance on wholesale

[14] This figure excludes banks that will be absorbed by competitors (Banco de Valencia, Caja3 and Caja Penedes): for these the new non-aided buyers will be free to decide on the credit policy.

funding and allowing them to reduce significantly their reliance on central bank funding. This will enable banks to restore sustainable lending patterns towards real economy.

45. The restructuring plans foresee that banks refocus their business model on retail and SME lending in their historical core regions. They will exit from lending to real estate development and other overly risky activities and limit their presence in wholesale business. They will improve their cost base, by cutting both staff and branches. The plans furthermore concentrate banks' deleveraging in the most overleveraged sectors and areas. They will not provide new loans for real-estate development and reduce exposure to mortgage lending and public sector financing. In contrast, they have continued capability to finance SMEs and corporates. The plans will refocus the banks' activities in those regions and areas where the banks have a capacity to operate efficiently. The overall path of loan deleveraging is not accelerating due to the restructuring plans, if RED loans are excluded.

46. Furthermore, the restructuring plans address moral hazard, and potential distortion of competitions with behavioural commitments on top on the structural commitments such as acquisition bans, a ban on aggressive commercial behaviour and commitments as regards remuneration of employees. Overall capital needs have been reduced by close to EUR 5 billion as a result of capital generating divestitures by the affected banks (such as the divestiture by BMN of Caja Penedes).

47. The restructuring plans, in line with the MoU, ensure that State aid remains limited to the minimum amount necessary, so as to minimise the cost to the taxpayers. Consequently, not only will former owners of these banks contribute to the needed capital injection, but losses will also be allocated to holders of preference shares and subordinated debt holders of these banks by implementing both voluntary and, where necessary, mandatory subordinated liability exercises (SLEs). The initial estimated amount of capital needs has been reduced by almost EUR 13 billion through burden sharing measures.

48. Specifically, for holders of preference shares and perpetual subordinated debt, burden-sharing is being implemented firstly by applying a haircut to the nominal amount of the instrument and subsequently through conversion of those securities into equity or equity-equivalent instruments. Holders of dated subordinated debt will be given the choice between conversion into equity or into a senior debt instrument after taking an appropriate haircut. Consequently, as a result of the burden-sharing, there will be no cash outflow from banks to the holders of those securities, with the sole exception of the holders of dated subordinated debt instruments who decide to convert into new debt securities with the maturity matching that of the subordinated debt being exchanged. To that effect, the Spanish authorities have introduced legislation to ensure the effectiveness of the Subordinated Liability Exercises.

49. The State aid for those banks consists of capital injections and the transfer of problematic assets (see above). For assessing the asset transfer, the EC assessed the conditions of transfer of those assets with the help of external experts and concluded that they were in line with EU State aid rules. More specifically it verified that the transfer price based on the base case value of the stress test exercise, plus a variety of haircuts related to the specific conditions of the transfer to Sareb, was in line with the so-called real economic value, i.e. the long-term hold to maturity valuation.

50. The focus is now shifting to monitoring. The EC will actively monitor the implementation of the restructuring plans with the help of a monitoring trustee. In addition, there will be continuous contacts with the Spanish authorities as well as monitoring reports.

4 ENHANCING BANK TRANSPARENCY, REGULATION AND SUPERVISION

51. Since mid-November, implementation of the horizontal financial-sector conditionality has been further advanced and is close to completion in most areas. The reform of the governance of the savings banks, a review of supervisory procedures at Banco de España, reforms of the regulatory frameworks governing banks' credit concentration and provisioning, and the enhancement of the credit register are still on-going. In all these areas, the Spanish authorities have achieved or are very close to achieving compliance with the MoU and have made very tangible progress towards major and lasting reforms in these areas. An overview on the status of implementing the MoU conditionality is provided in Annex 7.2. The financial sector reforms must be speedily finalised in order to allow them to enhance the viability of the Spanish banking sector and ensure solid prospects for a sustainable economic recovery.

52. Further progress has been made in fulfilling the conditionality in the area of banking supervision and operational independence of BdE (MoU conditions 13 and 14). The main findings of the October 2012 report on the internal review of the supervisory processes of BdE, which includes inter *alia* recommendations to enhance on-site inspections and the off-site monitoring of credit institutions, were discussed with the international partners. Following these discussions, authorities will focus on further strengthening the formalisation of supervisory actions and enhance the enforcement of provisions related to the rotation of supervisory staff. As regards the strengthening of the operational independence of BdE, the agreed proposals to empower the BdE to issue binding guidelines *ad intra* as well as binding replies to queries will be implemented through amendments to the Law on the Autonomy of BdE and further changes to the solvency regulation. The amendments to the solvency regulation and the Law on the Autonomy of the BdE will be part of the legislative changes necessary for the transposition of CRD IV.

53. As regards the reform of the governance of savings banks, further progress was achieved since the last review. The Spanish authorities presented a proposal for a law aimed at: (i) clarifying the role of savings banks in their capacity as shareholders of credit institutions with a view to eventually reduce their stakes to non-controlling levels; and (ii) strengthening fit and proper rules for the governing bodies of savings banks and introducing incompatibility requirements regarding the governing bodies of the former savings banks and the commercial banks controlled by them. Based on detailed comments made by the international partners, Spanish authorities finalised a draft law on this matter which was under consultation until 7 February 2013. It is envisaged that the law is approved during the second part of the year. An updated roadmap for the listing of banks which have received State aid has been submitted by the Spanish authorities after the approval of restructuring plans for Groups 1 and 2.

54. As regards the obligation on quarterly balance sheet forecasts for banks, a reporting template for submitting has been developed. Despite a tight schedule, the first submission is foreseen for the second half of April (before the third review mission). The balance sheet forecasts will include both the asset and liability side of banks and will be extended (with a simplified reporting format) also to banks which did not need state aid support or showed a capital shortfall. The balance sheet forecasts done by banks will represent a powerful tool for the careful monitoring of the funding sources of banks and of the provision of lending to the economy.

55. Pursuant to the MoU, the Spanish authorities submitted in mid-January a report on the regulatory framework for credit concentration and related party transactions. Given that the high lending concentration to the real estate and construction has been one of the main vulnerabilities of the banking sector, more forceful policy action to address and prevent excessive sectoral concentration appears warranted. The report provides a comprehensive analysis of the current regulatory framework for credit concentration and related party transactions in Spain and of the new tools to be included in the upcoming CRD/CRR IV. Since the outbreak of the crisis in 2008, further progress has been made to address the vulnerabilities associated with the high credit concentration on the real estate and construction sector, in particular through enhanced disclosure and transparency as well as the treatment of the concentration risk in the risk matrix. However, further progress could be achieved in this area, especially through the use of capital add-ons under Pillar II. The capital surcharges applied by credit institutions the basis of sectoral concentration indexes have not been revised as a result of the crisis. Going forward, without prejudice to current developments at EU level, more analytical work on the calibration of capital surcharges under Pillar II needs to be done in the coming months.

56. As a result of certain legal or operational constraints (legal ones in the case of savings banks) to increase their capital, some credit institutions were incentivised to sell regulatory capital instruments (i.e. preference shares) through retail branches to non-qualified investors. In light of the MoU requirements (condition 29), Law 9/2012, on bank restructuring and resolution established: (i) a set of rules limiting the sale of hybrids to retail customers: (ii) several amendments of Law 24/1998, on Securities Market in order to increase transparency of instruments different of deposits. Although the MoU condition was implemented, the necessary subordinated legislation still needs to be developed. In this regard, the Spanish authorities sent a draft Circular to the international partners which is under discussion.

57. The availability of adequate data on credit risk is critical both for micro prudential supervision and for an adequate macro prudential analysis (MoU condition 30). Moreover, the information on the credit history of individual borrowers is a key element for banks to assess the risk of borrowers. In this regard, the Spanish authorities presented in October a complete set of reforms on the credit register. After discussing with international partners, a new draft Circular was put in consultation by December. The Spanish authorities are currently working on an updated version of the draft Circular and the necessary legal amendments in this field. The new regulation is expected to be approved in the coming weeks.

5 SUSTAINABLE PUBLIC FINANCES AND GROWTH-ENHANCING REFORMS

5.1 STRENGHTHENING PUBLIC FINANCES

58. On 10 July 2012, the Council issued a revised excessive deficit procedure (EDP) recommendation to Spain, postponing the deadline for correcting the excessive deficit by one year to 2014 and fixing new intermediate headline targets of 6.3%, 4.5% and 2.8% of GDP for the years 2012-2014. The required structural efforts to achieve these targets were 2.7 pps., 2.5 pps. and 1.9 pps. of GDP, based on the macro-fiscal outlook at the time when the recommendation was issued. The revised EDP recommendation also set a deadline of three months for Spain to take effective action towards correcting the excessive deficit.

59. On 14 November 2012, the Commission concluded in a Communication that based on the 2012 Autumn Forecast Spain had taken effective action and that no further steps were required under the EDP procedure at that moment. Nominal budgetary targets set in the EDP recommendation were likely to be missed, with the 2012 general government deficit expected to reach around 7% of GDP (not including the costs of bank recapitalisation) compared with a 6.3% target. Nevertheless, an in-depth analysis showed that when correcting for changes in estimated potential output growth and for revenue shortfalls, the corrected improvement in the structural balance in 2012 and 2013 was in line with the EDP recommendation. From a bottom-up perspective, Spain has undertaken major discretionary consolidation measures, amounting to around 3½% of GDP (not including temporary and one-off measures) in 2012, also confirming the conclusion that Spain has taken effective action. While the 2012 deficit outcome of 6.7% of GDP reported by the government at the end of February beated most forecasts, meeting the EDP deadline of 2014 appears very challenging and a revision of the EDP deficit path cannot be excluded.

60. The fiscal framework should be strengthened further and the recurrent gap in the social security budget needs to be addressed. The implementation of the Budget Stability Law implied major progress in terms of more transparent and timely reporting on budgetary outcomes at sub-central government level in 2012. However, application of the provisions of the law as regards early warning and corrective mechanisms could be made more effective and more transparent. Plans for setting up an independent fiscal council appear to be still at a preparatory stage. They would need to be stepped up considerably if the council is to play an effective role already for the 2014 budgetary exercise, as originally announced in the September 2012 reform plan. The recurrent deficit in the social security system also needs to be reined in. Plans to introduce a sustainability factor in the pension system and to increase the effective retirement age would be an important step in this direction, but still need to be adopted.

5.2 BOOSTING ECONOMIC GROWTH AND JOB CREATION

61. Structural reforms that facilitate the correction of macroeconomic imbalances and boost growth potential support the objectives of the programme. Large accumulated private sector as well as external debt, fast rising public debt and very high unemployment are major vulnerabilities. The adjustment of the imbalances begun in 2008 but has proceeded unevenly and is likely to take time. The bank recapitalisation programme should be seen in the context of this on-going adjustment. While the programme stabilises

the banking sector (hence supporting its capacity to intermediate financial flows), fostering a more competitive economy remains imperative. Structural reforms in factor and product markets facilitate the reallocation of resources amongst sectors and increase the capacity of economy to undergo the necessary adjustment at a lower economic cost. Reforming domestic markets (e.g. for business or professional services) contributes to competitiveness by reducing the costs for companies that compete on world markets.

62. Wage growth is moderating more noticeably, finally responding to the sharp, accumulated deterioration in the labour market and to the 2012 reform. Moderating wage increase and advances in apparent productivity growth, on the back of labour shedding, resulted in a further fall of unit labour costs in 2012. This has helped Spain to regain some price competitiveness and hence contributing to the robust export performance. The 2012 labour market reform, which has brought about important changes to collective bargaining and to labour market regulation, has the potential of strengthening the link between wages, the economic cycle, and the firms' position. While it is early to draw definitive conclusions, some wage moderation observed lately and the increase in objective dismissals suggest that the reform might be starting to have an impact. Duality in the labour market remains, however, so far largely unchanged. The gravity of the labour market situation requires continuous monitoring and review of the impact of the reform. The Spanish authorities committed to prepare a first assessment of the reform by 2013-Q1. It should review the impact on wage dynamics, labour market segmentation and employability.

63. While the excessive reliance on employment subsidies has been partially addressed with the 2012 reform, the integration of passive and active labour market policies remains a challenge. These policies are necessary complement to the labour market reform. Spending on training, labour market integration and professional reorientation is still relatively low. The authorities are preparing an evaluation of active labour market policies (2013-Q1) which will serve as a basis to identify good practices and eventual budget reallocation. Public Employment Services need to be modernised to provide effective counselling and assistance to those looking for jobs. Furthermore, the coordination between national and regional public employment services needs to be enhanced. Skills mismatches and low labour market relevance of education and training contribute to the high youth unemployment rate. The labour market reform amended the training and apprenticeship contracts, and foundations were set to launch a dual vocational training system, which should, in the medium-term, facilitate work-based training and enable a better integration and matching of the changing needs of the labour market. The Law on the Quality of Education, currently under discussion, is due to be adopted in 2013-Q1. Its implementation will rely largely on the regions.

64. There has been progress in improving 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. As already discussed in the First Review report[15], some recent measures improve the efficiency of the tax system. These include an increase of VAT rates and a wider scope of application of the standard rate as well as measures aimed at ensuring less tax-induced bias towards indebtedness and home-ownership. However, there is scope to further limit the application of different reduced rates for VAT and to increase environmental taxes, most notably on fuel.

[15] DG ECFIN Occasional Paper No 121, November 2012.

65. Progress in delivering of some key product and services market reforms has been slow. The draft law on market unity was adopted by the Council of Ministers at the end of January (see below), whereas a series of fiscal incentives to foster entrepreneurship and to hire young unemployed workers were adopted at the end of February. However, a draft law on professional services has not yet been finalised. This important law aims to open up reserved activities in selected professions, lift registration obligations in professional bodies (with some exceptions) and simplify licensing requirements for the access to and the exercise of professional activities across regions.

66. The draft law on market unity was adopted at the end of January. The authorities estimate that this reform will add some 1.5 pps. to GDP over a ten year period following its adoption. These estimations are broadly aligned with the positive effects on GDP growth predicated from reforms reducing administrative burdens. The draft law has the potential to lift many hurdles to economic activity. The implementation of the law will hinge upon the elimination of inconsistencies with sector and regional specific legislation (within a six months' deadline) and enhanced administrative cooperation among the State, the regions and the local authorities. The reinforcement of the Spanish competition authority's watchdog role in market-unity related issues and the setting up of a response mechanism to individuals' complaints on hurdles to the single market will also be crucial. It is important that degree of ambition of the law is not reduced during the legislative process.

67. The "electricity tariff deficit" implies a considerable contingent liability for the budget as well as non-negligible macroeconomic risks. In 2012, the deficit (i.e. the gap between regulated 'access tariffs' paid by consumers and various regulated costs - including distribution costs and subsidies for renewable energy production) reached over EUR 5 billion (around 0.5% of GDP), exceeding the envisaged level of EUR 1.5 billion by a wide margin. The slippage was due to higher than expected premiums to renewable energy sources, drop in demand for electricity, and suspension of financing of the extra-peninsular compensation by the state budget. The cumulative total of the tariff deficit amounts to EUR 29 billion. Some new measures were recently adopted to contain the deficit in the future. New taxes on energy production introduced in December 2012 should generate EUR 3 billion in 2013. In addition, revising the annual adjustment of regulated costs (core inflation instead of CPI) and simplifying the system of support to renewable energy sources could generate another EUR 0.6 billion of savings a year. Despite these measures the electricity tariff deficit is still expected to be sizeable in 2013, leading the authorities to propose in February an extraordinary credit from the state budget of EUR 2.2 billion.

68. The measures promoting non-bank intermediation which were announced in November 2012 remain to be fully implemented. These measures, including enhanced capital market access for SMEs and venture capital financing, may contribute to improve the access of SMEs to financing in a context of overall bank deleveraging (see also the First Review report).

6 ANNEXES

6.1 DELEVERAGING IN THE SPANISH ECONOMY

6.1.1 Summary

69. Ensuring adequate access to funding represents a precondition for a viable banking sector that could provide the financial resources needed for the structural reallocation of production factors needed in the Spanish economy. Even though funding strains have eased and non-viable banks are being restructured, there have been both academic and policy discussions regarding the effects of financial sector deleveraging on economic growth.

70. Three main conclusions can be drawn from the analysis in this section. First, a one-size-fit-all quantitative analysis is insufficient to estimate the economic impact of bank deleveraging. Second, bank deleveraging supports structural adjustment and sustainable economic growth if confined to sectors and companies that grew untenably in the preceding boom. Third, judging by the recent and current pace of debt reduction in the economy, deleveraging does not appear excessive, given the formidable task ahead of Spain to correct a significant amount of private and public sector indebtedness. Nevertheless, the process needs to be carefully monitored in order to avoid a credit crunch for the viable companies that will support the economic recovery.

71. When assessing the economic impact of bank deleveraging in Spain, a number of considerations need to be taken into account:

- **There is a structural need to realign the economy away from construction and housing,** where overinvestment occurred during the boom, in order for the economy to return to growth and allow expansion in more dynamic economic sectors. A large part of the credit contraction is related to the downsizing of the construction and RED sectors and the building up of impairment allowances.
- **It is difficult to disentangle the contribution of supply and demand factors to the provision of new lending.** Most likely demand factors weigh most heavily at the current juncture, although supply conditions have yet to improve in line with the recent favourable developments in the banking sector.
- **Banks were induced to acknowledge bad debts and clean up their balance sheets,** as a prerequisite for restoring confidence in the financial sector and allow credit to flow to solvent clients. However, the recessionary environment weakens the credit demand and renders the selection of viable projects very difficult;
- **The restructuring plans for State-aided banks are likely to have limited adverse effects on the provision of credit,** as they focus on continued lending in the banks' core markets and especially to SMEs and households. The sectors targeted for reduction are precisely those that need to structurally shrink;
- **Adjustment and rebalancing in the real economy can be promoted via: structural reforms** that reduce price rigidities and the impact of negative nominal credit growth on the real economy; **improvement in the business environment** in order to encourage development of new viable businesses; and **fiscal consolidation**

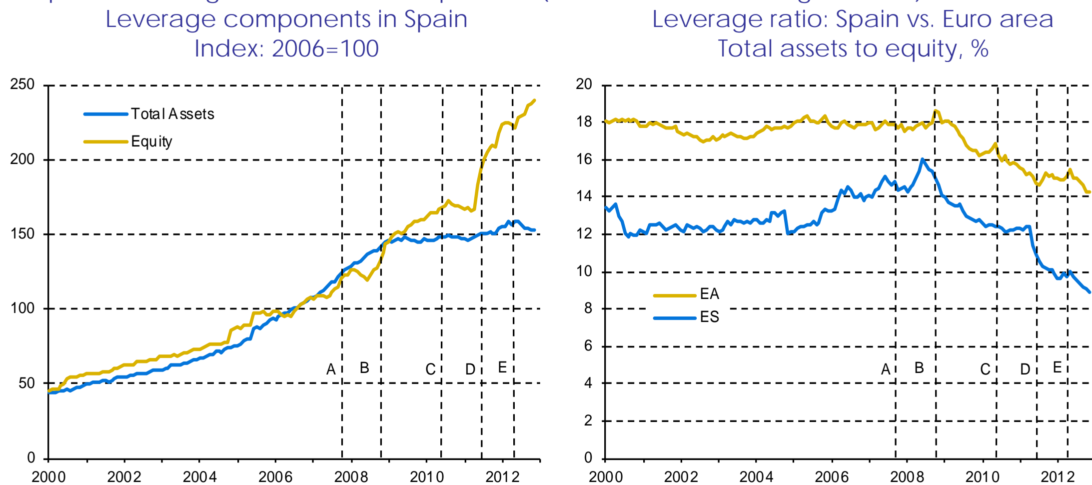
to restore investor confidence, speed up the liquidation of non-viable business and increase domestic savings.

6.1.2 Bank leverage in Spain

72. This sub-section looks at bank leverage and its components by making use of two complementary indicators: i) the leverage ratio (assets/equity), and ii) the loan/deposit ratio, in order to also capture bank reliance on wholesale funding.

73. The leverage ratio for the Spanish banking system is currently lower than the euro area average. During the boom period it increased from 12 to 16, but has thereafter declined to about 9 (see Graph 11). During the boom both total assets and equity grew. Thereafter, a process of deleveraging started via a slowdown in the growth of assets at the same time that the growth of equity accelerated. In absolute terms, bank assets grew by a modest 10% from late 2008 to late 2012, while equity almost doubled during the same period. The new equity came from three main sources: i) capital raising, ii) retained earnings, and iii) public capital. Increases in equity, both private and public, have thus played a major role in the recent reduction of leverage in the Spanish banking sector.

Graph 11: Leverage ratio and its components (in terms of outstanding volumes)



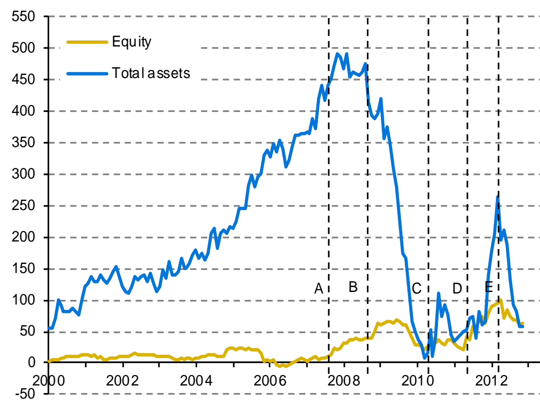
Note: Leverage ratio is computed as total assets to equity. A: Crisis outbreak; B: Lehman Brothers; C: First Greek programme; D: Sovereign crisis contagion; E: Greek PSI debt exchange. Last available data: November 2012.

Source: ECB and own calculations

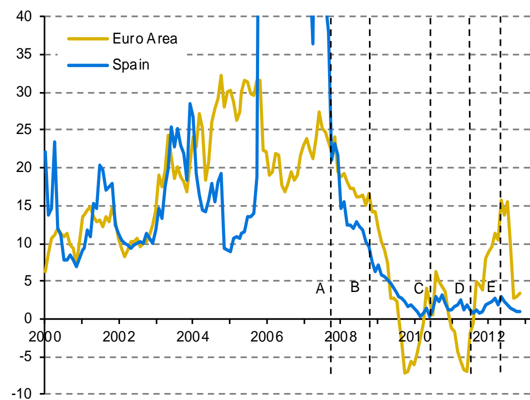
74. By nature, the annual change of the leverage ratio, i.e. the net change of assets and equity, is more volatile and also pro-cyclical. While the leverage ratio of Spanish banks was a modest 13 in 2006, the high growth rate of the leverage ratio implied a much higher marginal leverage (see Graph 12). Between 2006 and 2008, the implied leverage of new operations of Spanish banks skyrocketed as Spanish banks expanded their balance sheets rapidly (up to EUR 450 billion a year) with limited backing of new equity. To some extent the increase in both assets and equity could probably be explained by unrealised capital gains on trading and assets held available for sale.

Graph 12: Leverage ratio and its components (in terms of recent activity: annual flows)

Leverage components in Spain
Net annual flows (new transactions), EUR bn



Leverage ratio: Spain vs. Euro area
Flows of assets to flows of equity, %



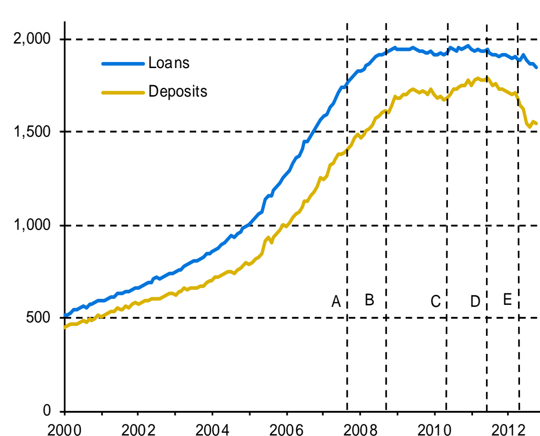
Note: The leverage ratio is computed as total assets to equity. Annual flows are computed as the sum of flows of twelve consecutive months. A: Crisis outbreak; B: Lehman Brothers; C: First Greek programme; D: Sovereign crisis contagion; E: Greek PSI debt exchange. Last available data: November 2012.

Source: ECB and own calculations

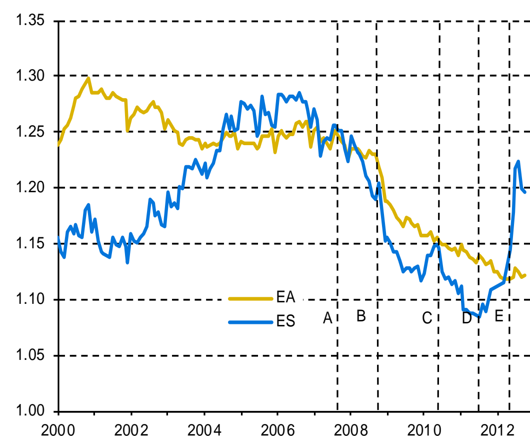
The loan-to-deposit (LTD) ratio indicates the proportion of loans financed by client deposits. In the mid-2000s, the ratio was around 1.25 (see Graph 13). This means that about a quarter of outstanding loans were financed by sources other than deposits. With the outbreak of the crisis, this ratio declined to around 1.1. Loans are of course not the only asset type a bank needs to fund. However, the LTD ratio is still a useful measure as loans tend to less liquid, i.e. harder to sell, than many other asset types. They should ideally then be backed by stable funding.

Graph 13: Loans and deposits (in terms of outstanding volumes)

Loans and deposits in Spain, bn EUR



Loan-to-deposits ratio: Spain vs. Euro area, %



Note: A: Crisis outbreak; B: Lehman Brothers; C: First Greek programme; D: Sovereign crisis contagion; E: Greek PSI debt exchange. Last available data: November 2012.

Source: ECB and own calculations

75. Between August 2011 and July 2012, deposits in Spanish banks declined by EUR 210 billion, or about 12%, which also led to a spike in the LTD ratio. This was to a great degree driven by a shift by depositors to other bank products (i.e. commercial papers for retail consumers) and did in fact not represent an outflow from the Spanish banking system. The trend has corrected itself after August 2012, but it does render the LTD ratio less valuable as a measure currently as it overstates the reliance on non-core funding. The sharp increase in the ratio during the height of the boom further indicates that, on the

margin, the expansion in lending was primarily funded by non-core funding (i.e. wholesale).

6.1.3 The Spanish crisis and economy wide deleveraging

Unbalanced growth during the boom

76. Excessive bank credit expansion following a period of low interest rates and lax financial sector regulations was probably the most important contributor to the economic and real estate boom in Spain. Following the introduction of the euro, the country's risk premium virtually disappeared and, Spanish interest rates fell sharply[16]. At the same time, capital inflows increased and as a result, the external financing constraint for the Spanish economy almost disappeared.

77. This sudden drop in interest rates falsified the interest rate signal in the economy that is formed on the basis of individual time preferences and misled businesses into believing that enough real savings existed in the economy (or could be imported) in order to lengthen the structure of production towards more capital intensive sectors. Indeed, part of the inflow of financial resources was used to increase the capital intensity of the Spanish economy, with investment in equipment increasing its weight in GDP by 1.4 %-points between 1995 and 2007, twice the euro area average. In addition, an important share of the external financial resources went to the non-tradable sector, and more specifically to construction and real estate activities, implying a large increase in the indebtedness of households and non-financial corporates. The significant increase of external financing was, unavoidably, accompanied by an increasing current account deficit.

78. Rapid credit growth to the private sector resulted in over-indebted households and firms, with debt at the peak of 86% and 140 % of GDP in 2010, respectively[17]. Private sector debt almost doubled between 2000 and 2008 and increased by ca. 100% of GDP. This was not compensated by the decline in public indebtedness of about 24% of GDP over the same period. In parallel, a house price bubble developed. During the 11 years preceding the relative house price peak in 2007Q3, nominal house prices grew at an average pace of 11.4% per year, amounting to a cumulated growth of 232%. In parallel, investment in the construction sector grew by 6% per year on average.

79. Eventually, the new structure of production skewed towards capital intensive activities and the non-tradable sectors was not sustainable. There was simply neither a genuine fall in time preferences, nor an increase in savings in Spain or in the euro area in general to allow for a successful completion of the projects undertaken and the repayment of the bank credit. The increase in interest rates following policy rate setting by central banks and incorporation of anticipated inflation likely triggered the unavoidable market correction.

The crisis and its deleveraging pressures

80. Since the beginning of 2008, the economy went through a rebalancing phase, cushioned by a significant fiscal relaxation during 2009-2011. First, a correction has taken place in the construction sector, which is already back at pre-boom levels after

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[16] Taking as reference, the one-year interbank interest rate was 10% in 1995 and 4% in 1998.

[17] For a more detailed analysis, please see the Commission Staff Working Document: In-depth review for Spain, In accordance with Article 5 of Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances.

plummeting in 2009 and 2010. Second, despite significant adjustment in house prices since their peak (of about -30%), their decline has recently accelerated to above 15% y-o-y in the third quarter of 2012 and further adjustment is to be expected. And third, private sector deleveraging started only in 2010 and has gained speed as of 2012 when the Spanish economy dived into its second recession in the last four years. Private sector deleveraging started relatively late in the crisis[18] and was slow at about 15% of GDP from its peak in 2010 to mid-2012, mostly due to a fall in non-financial corporation debt. In the meantime, public sector indebtedness grew constantly since 2008, reaching around 86% of GDP in 2012 according to the EC Autumn Forecast. This represents an increase of about 45% of GDP over the period, which means that leverage has actually increased in the total economy since the beginning of the crisis (see Graph 7 on the evolution of gross debt). A gradual decline in private debt is in line with historical experience showing that deleveraging processes take considerable time and imply large output losses, particularly when accompanied by banking and housing crises[19].

81. The necessary unwinding of the imbalances built-up during the boom is affecting economic activity and financial stability in the short-term. Credit to the private sector has contracted as the banking sector has been restructured and cleaned up of legacy assets. More importantly, credit demand has also been withheld due to the current economic uncertainty and the recessionary environment. Anecdotal evidence shows that recently the demand for credit by companies relates more to working capital rather than investment. Both firms and households are using their income and economic buffers to reduce debt. As the misallocation of resources in the boom is gradually unwound, a liquidation of bad investments also takes place. This implies an adjustment in both the real economy and the financial sector via a credit correction. The balance sheets of the non-financial private sector and of the financial one can be seen as two sides of one coin. As borrowers run into financial difficulties and some go bankrupt, the write-down of liabilities in the non-financial sector is accompanied by impairment of assets and shrinking balance sheets in the financial sector.

82. Deleveraging is necessary in the sectors that over expanded in the boom in order to allow the economy to adjust and grow again in a sustainable manner. As non-viable firms leave the market, factors of production are freed to allow the recovery in the viable part of the economy. The increase in indebtedness of non-financial corporations was to a large extent driven by the real estate boom. During the years of the strongest credit growth to NFC, 2004-2008, credit to construction and real estate activities accounted for 54% of overall credit growth. If bank debt of construction and real estate sectors is excluded, the overall leverage ratio for NFC decreases by about half from 132% to 62% of GDP (Q2 2012)[20]. While deleveraging is needed in the non-viable part of the economy, it is critical to ensure credit provision to businesses that are catering to meet the new market demand structure. Therefore, in order to assess whether the speed of deleveraging in the economy is excessive, one also needs to look into the lending dynamics in the economy and access to

[18] During 2008 to 2010 private debt kept increasing by about 7% of GDP, also due to the decline in nominal GDP over the period.

[19] Countries with boom-bust credit cycles typically have deep recessions and sluggish recoveries, with GDP remaining 9-10% below the pre-crisis trend in the next 5-10 years (IMF WEO, Sept 2009). Deleveraging episodes accompanied by a housing crisis took 5½ years on average across high-income OECD economies and reduced private debt-to-GDP ratios by 20 pps. If they were accompanied by a banking crisis, they took 7 years, the reduction in debt to GDP was 30 pps on average and the recovery in GDP was considerably slower (see e.g. Aspachs-Bracons, et al., 2011). Evidence presented by IMF (2012a) indicates that housing crises, which are preceded by a build-up of household debt, result in a fall in real private consumption and GDP of 4%, on average, over a 5-year period. In the absence of a banking crisis the decline in private consumption is limited to 2%.

[20] For a more detailed analysis of private sector indebtedness, please see chapter 3 of the Commission Staff Working Document: In-depth review for Spain, In accordance with Article 5 of Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances.

credit by viable sectors. Such an analysis needs to be done in a more granular way and on a sectorial basis in order to be meaningful.

83. A recent study by the Bank of Spain[21] looks at the evolution of corporate indebtedness between 2007 and 2011 at firm level and by sector. The results show that companies and sectors that were highly indebted at the onset of the crisis have reduced debt faster than the average, while firms that started from a low level of debt have actually increased their leverage over the period. The pattern has been similar for large companies and SMEs.

What drives the contraction in credit?

84. The evolution of lending in Spain should be gauged against the need for deleveraging in certain parts of the economy and the need to write-off the legacy assets incurred during the boom. Therefore the underlying trends in the evolution of the stock of credit for the private resident sector needs to be corrected for certain developments:

85. First, the increases in impairment allowances due to increasing amounts of bad loans play a predominant role in the recent decline in the stock of credit to the private non-MFI borrowers. During the year prior to November 2012, about three-quarters of the decline (around EUR 77 billion) are explained by the impairment of bad debts on banks' balance sheets. Thus, the gross stock of credit to private non-MFI borrowers went down by 1.2% y-o-y as of November 2012 instead of a decline of 5.5% in the stock of net lending. This means that most of the contraction in credit does not necessarily affect new lending flows in the economy, but it is due to the writing off of bad debts, affecting the lending to non-viable borrowers.

86. Second, there is a difference in credit dynamics among various economic sectors in the economy. Total credit to domestic residents (non-MFI) was declining at 4.8% y-o-y in the third quarter of 2012[22]. At the same time, if one leaves out the construction and real estate sectors where the need for correction is the highest, credit to the rest of the economy was declining at a more moderate 3.5% y-o-y.

87. Third, one needs to look at the total amount of credit in the economy and not only at the one provided by the domestic banking sector, as the latter is under pressure to deleverage and has adopted more prudent credit standards. For example, domestic credit to NFC was declining at 8% y-o-y as of December 2012, whereas external loans declined by only 0.5% y-o-y and corporate bonds issued increased by 12.5% y-o-y. Overall, the decline in total credit to non-financial corporates was thus 5.2% y-o-y instead of 8%.

88. If one takes into account all these effects it is less obvious whether the speed of deleveraging is excessive or it just reflects the healthy process of economic adjustment away from unsustainable economic activities. It also seems that, so far, the decline in the stock of credit is not mainly driven by constrained new lending to solvent businesses. Disentangling the contribution of demand and supply factors as regards new lending is always very difficult. However, there are several developments (presented below) which point to the fact that at the current juncture, demand related factors outweigh the supply-side ones, despite the fact that supply conditions have not improved in line with banking sector fundamentals.

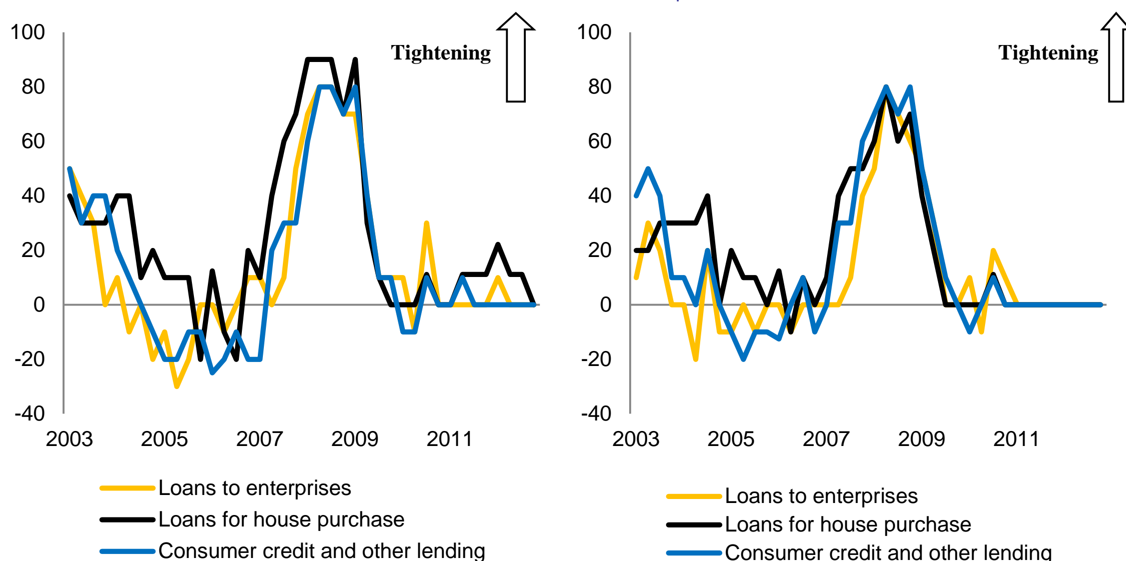
[21] see BdE Economic Bulletin, January 2013.

[22] Granular data is only available up to September 2012.

89. The main constraints to the provision of credit by the domestic banking sector related to their capitalisation and access to funding have started to ease in recent months. They should start translating into an improved credit market if the macro-economic conditions allow for it. In particular, the financing concerns of banks in the euro area were to large extent addressed by the Eurosystem's LTRO's and other liquidity providing measures. As of December, the reliance of Spanish banks on net borrowing from the Eurosystem declined to EUR 313 billion from a record EUR 389 billion in August. Together with other euro area banks, the Spanish MFIs also repaid early a significant amount of the LTRO's in January 2013. The recent recapitalisation of Spanish banks under the banking programme has increased overall capital levels in the system. Even though the profitability of banks is still under pressure due to the sustained provisioning effort and their capital buffers above the required levels are not that high, the risk-weighted assets of Spanish banks are much above the levels of their international peers, pointing to more comfortable capital levels in absolute terms.

90. According to the ECB Bank Lending Survey (BLS), Spanish banks have tightened their lending conditions during the crisis, but in the second half of 2012 no further tightening has been reported (see Graph 14). For several quarters in 2007, 2008 and 2009, more than 80% of Spanish banks tightened credit standards. Although banks maintain high credit standards they do not expect that they will resume a net tightening of credit standards in the coming quarter.

Graph 14: Changes in credit standards applied to the approval of loans and credit lines

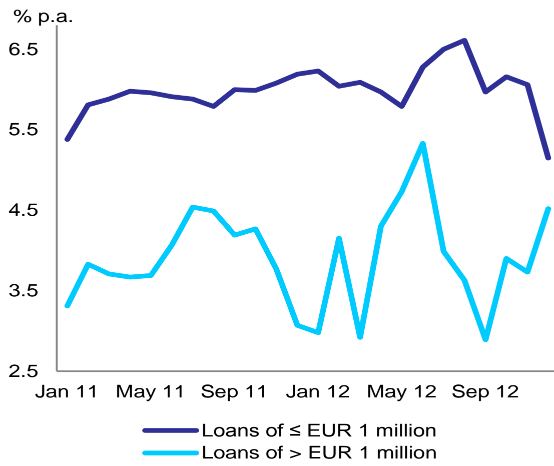


Source: ECB

Since the onset of the crisis, lending rates for Spanish non-financial corporates, and especially for SMEs, have on average been higher than the euro area average. Although it bears witness to a certain degree of fragmentation of euro area financial markets, it also reflects higher risk premia that investors perceive relative to individual economies. It is therefore encouraging that recent data from the ECB indicate a declining trend in interest rates on smaller loans, i.e. those most relevant to SMEs (see Graph 15). Average interest rates on new loans to non-financial corporates of smaller than EUR 1 million (maturity of 1-5 years) declined by 135bp between July and December 2012. One possible interpretation is that the lower funding costs experienced by Spanish banks have started to filter through to lending rates. For large Spanish companies, although

increasing, lending rates are closer to the euro area average, probably reflecting their ability to access credit also outside Spain or diversify their funding on capital markets.

Graph 15: Monthly average MFI lending rates to NFCs



'* New Loans (1-5 years) excl. overdrafts and revolving credits.

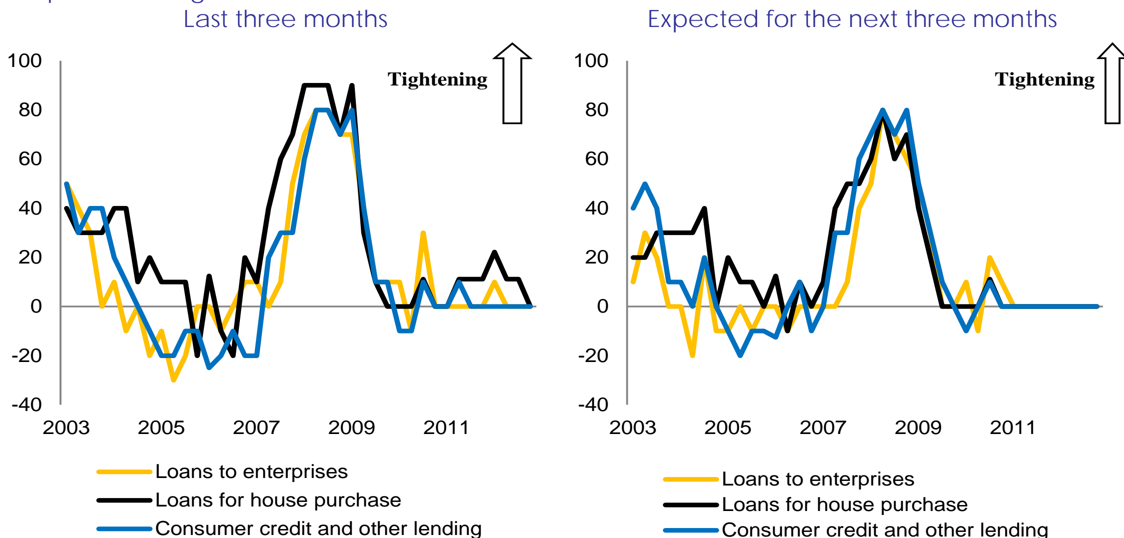
Source: Eurostat, own calculations

91. The supply of credit to finance a large increase in public deficits and debt since the beginning of the crisis have in part substituted new lending to the private viable sector. New lending worth about EUR 110 billion was granted by Spanish banks to the government from November 2011 to November 2012.

92. As regards the demand for credit, uncertainties about the role of the euro in the periphery, about the overall public debt sustainability and about the unfinished economic adjustment that may lead to a wave of bankruptcies make businessmen cautious about investing until the liquidation process is over.

93. Accordingly, Spanish banks also report a continuous fall in the demand of loans by households and enterprises (see Graph 16). Moreover, the decline in demand is expected to continue in the next quarter with the exception for loans for house purchases.

Graph 16: Changes in the demand of loans and credit lines



Source: ECB

94. Several companies enjoyed good earnings in previous years and are cash rich, being adverse to investment in an uncertain environment and waiting for prices to fall further (while reducing their indebtedness). The financial assets of non-financial corporates (other than shares) declined only marginally by about EUR 36 billion from June 2011 to June 2012, but the decline in their financial liabilities was close to EUR 400 billion over the same period.

95. Hernando and Villanueva (2012)[23] use information of Spanish banks' balance sheets (1995-2009) to try to isolate credit supply factors by using the variation in capital growth associated to the bank-specific historical exposure to real estate. They find that the deterioration of banks' capital position has had only a limited negative impact on the supply of loans to non-construction firms. The authors conclude that the small magnitude of credit supply factor impact may be explained by the weakness of loan demand in a context of a deep recession.

6.1.4 Impact of the banking sector programme

96. The impact of the banking sector programme on the Spanish economy is predominantly positive, reinforcing two healthy trends. On one hand, the cleaning up of bank balance sheets of problematic real estate related assets accelerates deleveraging in the non-viable economy and, on the other hand, it offers in return to banks capital and liquid securities that can be used to extend new lending to the viable economy. In addition, the return in investor confidence facilitates the banking sector's access to external and domestic funding and allows it to place new equity issues to consolidate its capital base.

97. The amount of new capital injected in the banks by FROB (about EUR 39 billion) can be gradually used for new lending and represents a non-negligible 2.3% of the entire Spanish stock of credit that in turn can be gradually multiplied several times. At the same time, the ESM securities received by the banks are contributing to significantly easing the liquidity constraints for these banks and for the money market in general. Anecdotal evidence shows that Spanish banks are entering into repo operations by using the ESM bonds in transactions with foreign banks, thus improving the liquidity of money markets and reducing the transaction costs. Another liquidity relief comes from the Sareb securities received by the Group 1 banks (ca. EUR 37 billion) in return for the transfer of RED assets. The contraction in the overall stock of credit in the economy due to the transfer of the legacy RED assets to Sareb represents primarily an accounting effect without harming the flow of new credit in the economy.

Financial Program restructuring plans

98. The restructuring plans aim at ensuring the banks' return to viability and to sustainable lending. This means reducing risk by redesigning banks' business models around the activities and areas where their competitive strength resides: retail lending and core regions. Banks are expected to withdraw from lending to over-leveraged parts of the economy (e.g. real estate development) and focus on lending to productive parts of the economy (businesses). The essence of the downsizing will relate to areas linked to the real estate bubble such as RED loans where there will be no new production. Lending to the public sector and for house purchases will also decline. In contrast, loans to the business

[23] Hernando, Ignacio and Villanueva, Ernesto, The Recent Slowdown of Bank Lending in Spain: Are Supply-Side Factors Relevant? (24 January 2012). Banco de Espana Working Paper No. 1206.
Available at SSRN: http://ssrn.com/abstract=1991106 or http://dx.doi.org/10.2139/ssrn.1991106

sector, corporates and SMEs, will not be affected. This economic sector is expected to contribute most to restoring competitiveness of the Spanish economy in the coming years.

99. The situation for Spanish banks before the programme was one of investor mistrust towards the whole sector, given the uncertainty related to the size and location of expected losses. However, there was also a conviction among international partners that the major part of the system remained healthy but deeply affected by the problems of a few banks. Overall, state aided banks account for only 21% of the total Spanish banking system in terms of assets and 28% in terms of lending to customers (respectively 17% and 22% after the transfer of assets to Sareb). Group 1 banks account for only about 8% of lending to corporations and SMEs and 19% of lending to residential mortgages. Group 2 banks account for about 4% of lending to corporations and SMEs and 8% of lending to residential mortgages. Focusing on "stand-alone banks", i.e. not taken over by competitors, they account for about 22% in terms of loans to the non-financial sector.

100. The reduction of the banks' balance sheet according to the restructuring plans is in the range of 60% or more for Group 1[24] banks and about 30% for Group 2 banks over 2010 (the peak of the boom) and 2017. This seems like a very large drop, but if one takes as starting point the year 2012, then the reduction in the banks' balance sheets is less than 40% for Group 1 and about 20% for Group 2.

101. According to the approved restructuring plans, the bulk of the reduction in credit to private sector will be in the real estate and development portfolio where no new production will be done. As Spain is rebalancing following the burst of the housing and asset bubble, deleveraging and balance sheet repair in these sectors are unavoidable part of the adjustment. It also has to be kept in mind that much of the reduction in the RED sector is not imposed deleveraging, but a transfer of assets to the AMC. Exposure of Spanish banks to RED portfolio was one of the main reasons for the problems currently facing parts of the banking sector. Effectively dealing with remaining RED stock, especially when it is already problematic, is one of the objectives of the financial sector programme for Spain.

102. In the core regions, the restructuring plans foresee lending to corporates and SMEs without restrictions. For instance, Bankia (see Box 4) will keep all its SMEs network and plans to strengthen in this sector throughout its restructuring period.

103. Importantly, the restructuring plans approved by the EC changed the pattern of deleveraging: until 2012, loan reductions were largely focused on business loans (SMEs and large corporate), while RED loans even increased, partially as a result of the accounting effects of reclassification. However, from 2012 onwards, the reduction is focused on RED loans, whereas business loans remain stable. Thus, the foreseen reduction in total lending for Group 1 and Group 2 banks amounts to about 12% annually over 2012-2016, but it declines to only around 5% if RED loans are excluded. In a similar way, consumer loans are only expected to decline by about 3% annually on average.

104. By contrast, the stock of RED loans will be reduced almost to zero, which is economically sensible given its inadequate quality and the problems with the poor judgment in origination of such loans during the boom period. As regards loans for large corporates, they can be more easily substituted by the remaining 80% of the banking sector as these clients are able to switch borrowing if they are viable. However, if they are not viable and if

[24] Without Banco de Valencia which will be sold to and fully integrated into CaixaBank

banks reduce their exposure to them and stop supporting "zombie" companies, economic efficiency can only grow.

Box 4: Main features of the restructuring plans for BFA/Bankia

BFA/Bankia will be split into a core (steady bank) unit and legacy unit, within the same entity. The steady bank will include the existing Steady Bank Unit will form the basis of a sound and viable bank. It will include the existing retail, SME and public sector banking businesses of the BFA Group that are located in its so-called core areas, as well as those of a limited number of branches in selected main economic centres of other Spanish regions. The Legacy Unit will include the businesses, assets and liabilities that will be discontinued and will be sold, closed or held to maturity. The BFA Group will cease any new business in loans in a number of restricted activities such as REDs, loans outside the core regions and outside the branches in selected presence in other parts of the country and wholesale activities, refocusing on retail banking activities and SME business banking services. There will be additional branch and staff adjustments in its branch network and central services. Those measures involve a reduction between 2012 and 2017 of 39% in branches and 33% in staff.

The restructuring plans are much more lenient with the viable part of the bank, which means that some of the negative effects of the restructuring of the bank on the economy will be minimized. The Steady Bank will undergo a reduction of only 4% in loans and assets from 2012 and 2017. Residential mortgage lending is projected to decrease by around EUR 15 billion, compensated by credit to SMEs going up by the same amount. Basically the bank's exposure to the SME sector will increase significantly by about one third for the entire entity. The reduction of 24% in branches and 24% in staff between 2012 and 2017 in the Steady Bank will be much lower than for the entire group.

6.2 MAIN ECONOMIC AND FINANCIAL INDICATORS

	1995-1999	2000-2004	2005-2008	2009	2010	2011	2012 (e)	2013 (f)
Core indicators								
GDP grow th rate	3.7	3.6	3.0	- 3.7	- 0.3	0.4	- 1.4	- 1.4
Private consumption (annual % change)	3.5	3.7	2.8	- 3.8	0.7	- 1.0	- 1.9	- 2.7
Public consumption (annual % change)	2.7	5.0	5.4	3.7	1.5	- 0.5	- 4.1	- 5.4
HICP (annual % change)	2.8	3.2	3.5	- 0.2	2.0	3.1	2.4	1.7
Domestic demand incl. stocks	4.2	4.3	3.6	- 6.6	- 0.6	- 1.9	- 3.8	- 4.0
Unemployment rate (% of labour force)	17.2	11.2	9.3	18.0	20.1	21.7	25.0	26.9
Gross fixed capital formation (% of GDP)	22.5	26.7	29.8	23.6	22.3	21.1	19.3	17.9
Gross national saving (% of GDP)	22.0	22.6	21.1	19.2	18.4	17.8	17.9	19.4
General Government (% of GDP)								
Balance	- 4.2	- 0.4	0.3	- 11.2	- 9.7	- 9.4	- 10.2	- 6.7
Gross debt	64.7	52.5	39.8	53.9	61.5	69.3	88.4	95.8
Interest expenditure	4.6	2.7	1.7	1.8	1.9	2.5	3.0	3.5
Households								
Households saving rate	13.2	11.3	11.3	17.8	13.1	11.0	8.3	8.4
Rest of the world (% of GDP)								
Trade balance	- 0.1	- 2.8	- 6.0	- 1.9	- 2.2	- 0.8	0.8	3.6
Trade balance, goods	- 3.3	- 5.7	- 8.1	- 4.0	- 4.6	- 3.8	- 2.6	- 0.4
Trade balance, services	3.2	2.9	2.0	2.1	2.4	3.0	3.4	4.1
Current account balance	- 0.8	- 4.4	- 9.0	- 4.8	- 4.4	- 3.7	- 1.9	1.0
Net financial assets	- 27.0	- 39.7	- 70.1	- 91.9	- 86.4	- 89.3	- 89.7	n.a.
Net international investment position	- 26.9	- 41.3	- 69.7	- 93.7	- 88.9	- 91.8	- 90.5	n.a.
Competitiveness (index, 2005=100)								
Real effective exchange rate relative to the rest of the euro area	91.4	95.8	104.1	104.9	103.4	100.8	96.1	94.5
Real effective exchange rate relative to the rest of the European Union	93.7	95.3	103.8	107.7	105.2	102.5	96.8	95.6
Real effective exchange rate relative to the rest of 36 industrialised countries	92.4	92.7	104.6	109.0	104.6	102.3	95.6	95.7
Banking sector								
Assets (% of GDP)	173.7	194.9	274.5	328.9	330.9	340.5	341.6	n.a.
Private domestic credit (y-o-y %)	11.8	14.7	18.9	- 1.6	0.8	- 3.2	- 10.0	n.a.
Non-performing loans (NPLs), total	3.3	1.1	1.5	5.1	5.8	7.8	10.4	n.a.
NPLs, productive activities	n.a.	1.2	1.5	6.2	8.1	11.6	16.6	n.a.
" of w hich, construction, and	n.a.	1.0	1.7	8.5	12.1	18.2	26.4	n.a.
" real estate activities	n.a.	0.6	1.8	10.1	14.0	21.4	30.3	n.a.
NPLs, residential mortgages	n.a.	0.4	1.0	2.9	2.6	3.1	4.0	n.a.
Tier 1 ratio (%)	n.a.	n.a.	n.a.	9.3	9.6	10.5	9.6	n.a.
Interest rates								
10 year spread vis-à-vis the Bund	2.1	0.1	0.2	1.0	2.0	3.9	5.5	4.8
CDS 5 year	n.a.	n.a.	n.a.	92.9	203.4	318.1	427.2	262.0

(e) 2012 estimate or latest available data
(f) 2013: forecast or latest available data
Sources: Ameco, BdE, ECB, Eurostat, Thomson Reuters EcoWin.

6.3 TABLE ON THE STATUS OF MOU CONDITIONALITY

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

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

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

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