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Recapitalisation of Financial Institutions in Spain  
Fifth Review – Winter 2014



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European Commission

Directorate-General for Economic and Financial Affairs

# **Financial Assistance Programme for the Recapitalisation of Financial Institutions in Spain**

Fifth Review – Winter 2014

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## ABBREVIATIONS

AIRF	Autoridad Independiente de Responsabilidad Fiscal (Independent authority for fiscal responsibility)
BdE	Banco de España
BP	Business Plan
CET1	Common Equity Tier 1
CoCos	Contingent Convertible Securities
CRR	Capital Requirements Regulation
DBPs	Draft Budgetary Plans
DTAs	Deferred Tax Assets
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
EDP	Excessive Deficit Procedure
EPPs	Economic Partnership Programmes
ESM	European Stability Mechanism
FAB	Fondos de Activos Bancarios (Bank Asset Fund)
FCPs	Funding and Capital Plans
FGD	Fondo de Garantía de Depósitos de Entidades de Crédito (Deposit Guarantee Fund)
FLESB	Forward-Looking Exercise on Spanish Banks
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
INE	Instituto Nacional de Estadística (Spanish National Statistics Institute)
LTD	Loans-to-Deposits
MARF	Mercado Alternativo de Renta Fija (Alternative Fixed-Income Market)
MoU	Memorandum of Understanding
NCG	NCG Banco, S.A.
PDV	Plan de Dinamización de Ventas (plan to promote sales)
PIVE	Programa de Incentivos al Vehículo Eficiente (Programme of incentives for efficient vehicles)
QNA	Quarterly National Accounts
RDL	Real Decreto-ley (Royal Decree Law)
RED	Real Estate Development
REO	Real Estate Owned, i.e. foreclosed assets
RWA	Risk Weighted Assets
SGP	Stability and Growth Pact
SLEs	Subordinated Liability Exercises
SMEs	Small and Medium Enterprises

## EXECUTIVE SUMMARY

*This Fifth 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<sup>1</sup> (ECB) mission to Madrid during 2-13 December 2013. The mission considers that the positive assessment of steadfast programme implementation that formed the basis of the Eurogroup statement of 14 November has been maintained through the final review. Spain has pulled back from severe problems in some parts of its banking sector, thanks to its reform and policy actions, with the support of the euro area and broader European initiatives. Nevertheless, the reform agenda of the financial sector needs to continue beyond the finalisation of the programme.*

**1. The stabilisation of Spanish financial markets continued, also bolstered by positive economic news.** The drop in sovereign bond yields reached new lows and the rise in share prices reflects the positive sentiment surrounding signs of economic recovery. Against this background, the financing conditions for large parts of the economy, including banks, have improved, even if financing conditions for SMEs remain onerous. But expectations are slightly improving in this sector as well while the volume of ICO's on-lending programme for SMEs via commercial banks has increased significantly in the course of 2013. The liquidity situation and the financing structure of the Spanish banking sector have further strengthened, as balance-sheet deleveraging continues along with a recovery in other sources of finance, such as deposits and access to the repo market. The liquidity generated by the drop in the loan-to-deposit ratio is being used by banks to reduce their reliance on the Eurosystem and on the wholesale market.

**2. The solvency position of banks has remained broadly comfortable after the recapitalisation of parts of the banking sector, the transfer of assets to Sareb<sup>2</sup> and overall positive earnings results over 2013 so far.** The recent legislative measures on deferred tax assets should support the solvency of the banking sector under the new EU rules on capital requirements. Spain needs to continue monitoring closely the operation and stability of the banking sector. Continued in-depth diagnostics of the shock resilience and solvency of the Spanish banking sector remain vital. This is also important in order to ensure a proper preparation of the pending assessment of banks' balance sheets by the ECB and the EBA's stress test in the run up to the start of the Single Supervisory Mechanism. Moreover, the banks and the Spanish authorities need to stand ready to deal with any capital shortfalls that the ECB's comprehensive assessment may reveal.

**3. The process of restructuring of banks having received State aid continues with the double objective of reaching a balanced and viable asset/liability structure and providing credit to the real economy.** Unicaja launched an offer to acquire Banco CEISS and the return of NCG Banco, S.A. (NCG) to private ownership will soon be effective, reinforcing the stability of the Spanish banking sector. The monitoring of restructuring plans as adopted by the European Commission will continue in the coming years, including possible adaptations to significant market changes in duly justified situations. Banks' efforts to implement the agreed measures need to advance as envisaged. Policy makers and supervisors will in particular have to keep devoting close attention to the banks currently

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<sup>1</sup> 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.

<sup>2</sup> *Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria* S.A., the Spanish asset management company.

owned by the FROB<sup>3</sup>, in order to ensure proper governance and business models for these banks going forward. Furthermore, Sareb will have to continue its efforts to meet the challenge of divesting its significant asset portfolio with the view of maximising its financial results while minimizing distortions to the proper functioning of real estate markets in Spain at large.

**4. The broader economic environment has continued to weigh on the banking sector, even if that impact has recently been receding.** The private sector needs to continue reducing its still high level of debt going forward, as part of the overall structural adjustment towards more sustainable growth patterns. Recent evidence suggests a deceleration in the significant contraction of domestic private credit, and a bottoming-out is in sight. Nevertheless, the profitability of the banking sector over the coming years will be affected by the lower volumes of intermediation and continued pressure on asset quality. Despite green sprouts of economic recovery, high levels of unemployment and the still weak real estate market remain strong headwinds to banks' profitability and recapitalisation efforts by internal means.

**5. Compliance with the horizontal policy requirements in the Memorandum of Understanding (MoU) is complete.** This contributed to a thorough overhaul of the governance, regulatory and supervisory framework of the Spanish banking sector. Continuing on this path of pro-active supervision in order to ensure adequate provisioning and comfortable capital levels, advancing reform in the broader governance of the banking sector and fostering non-bank financial intermediation will help secure these achievements and contribute to a more resilient financial sector in Spain.

**6. The reform agenda of the financial sector needs to continue in order to consolidate the progress in stabilisation.** Remaining key issues will include:

- finalising the measures initiated as horizontal conditions under the MoU;
- close monitoring of financial sector stability and bank balance sheet repair;
- monitoring banks' efforts to maintain and further reinforce capital ratios, also in light of the forthcoming ECB comprehensive assessment with its Asset Quality Review and Stress Test;
- ensuring a smooth integration into the Single Supervisory Mechanism (SSM);
- the timely implementation of macroprudential supervision;
- monitoring of Sareb activity in order to ensure a timely asset disposal while minimizing the cost to the taxpayer;
- monitoring the implementation of the Law on evictions with a view to support financial stability;
- continuing efforts to identify and improve the process for the sale to retail clients of any instruments not covered by the deposit guarantee fund;
- preserving the unity of the single market for financial services in Spain, in order to avoid legal uncertainty and maintain financial stability;
- reviewing legislation on personal insolvency and consumer protection with due concern for balanced creditor/borrower rights, the stability of the financial sector and overall economic efficiency;
- completing the restructuring of state-owned savings banks in order to accelerate their full recovery.

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<sup>3</sup> *Fondo de Reestructuración Ordenada Bancaria*, Fund for Orderly Bank Restructuring <http://www.frob.es>

**7. The recent encouraging macroeconomic news bear witness of the advancing rebalancing of the Spanish economy and corroborate the expectation of a gradual recovery in activity and of an approaching end to employment destruction.** GDP growth returned positive in the third quarter of 2013, and economic indicators for the fourth quarter have generally been favourable. The economic recovery however remains fragile as imbalances continue to be worked out, and subject to external risks such as a reversal of the current benign global financial environment and a slowdown in emerging markets, especially in Latin America, to which Spanish companies are particularly exposed.

**8. Fiscal consolidation and structural reforms need to advance further.** Respecting fully the agreed fiscal consolidation targets and completing the reform agenda remain imperative to return the economy on a sustainable growth path and consolidate the recovery in confidence. The high budget deficit needs to be brought down so as to halt and reverse the ongoing rise in general government debt. This will require unwavering determination in the coming years. On the structural reforms side, following progress during 2013, the policy momentum needs to be maintained to finalise ongoing and planned measures - amongst which are the delayed law on professional services and associations, ongoing reforms of public administration, the forthcoming review of the tax system, further strengthening of labour market policies - and to ensure effective implementation of all reforms.

**9. With the Programme coming to an end in January 2014, the EC, in liaison with the ECB, where indicated, will continue monitoring Spain's financial sector and the broader economy.** This monitoring will be performed under all relevant EU surveillance processes. As regards the financial sector, this monitoring should allow the review of further progress with the stabilisation of all parts of the banking sector and the further effects of the horizontal policy measures taken under the terms of the MoU of the financial-sector programme. This should give indication and comfort that the stabilisation and reform of the banking sector is sustained and that the risk of re-emergence of a systemic banking sector crisis is well-contained.

## 1 INTRODUCTION

**10. This report assesses Spain's compliance with the conditionality of the Financial Assistance Programme.** A delegation from the European Commission (EC), in liaison with the European Central Bank (ECB), completed the fifth and last review of this programme for Spain from 2 to 13 December 2013. The European Stability Mechanism (ESM) and the European Banking Authority (EBA) also participated in the mission, as well as the International Monetary Fund (IMF), fulfilling its role as an independent monitor.

**11. The Programme, as agreed by the Eurogroup on 9 July 2012, covers a period of 18 months<sup>4</sup> and 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 of the Programme<sup>5</sup> 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 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 around 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<sup>6</sup> 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. Thereby, the total amount of funds disbursed under the Programme reached EUR 41.3 billion.

**12. The Programme continues to be on track and a successful completion according to its timeline is foreseen.** The Memorandum of Understanding provides for bank-specific conditionality, in line with State aid rules, as well as horizontal conditionality. The bank-specific conditionality has been finalised following three steps. First, an independent stress-test, finished at the end of September 2012, revealed a capital shortfall of about EUR 57 billion for the participating banks, which represent more than 90% of the Spanish banking sector. Second, troubled assets from the balance sheet of Group 1 (end-December 2012) and Group 2 (February 2013) banks receiving public support were transferred to an external Asset Management Company called Sareb. Third, viable banks with a capital shortfall identified in the stress test and unable to cover it fully by private means were recapitalised and restructuring and resolution plans were adopted for these banks. Horizontal conditionality has also been met.

**13. The reform of the financial sector needs to continue beyond the finalisation of the Programme.** The successful finalisation of the programme in terms of bank balance sheet repair, recapitalisation of weak banks and a strengthening of financial sector governance and regulatory and supervisory procedures should be further consolidated. In Section 5, the report puts forward some proposals for further financial sector policies with a view to increase the robustness of the financial sector going forward. Some of these proposals derive from the MoU conditionality, while others relate to challenges that became more evident during the implementation of the programme.

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<sup>4</sup> However, the restructuring of the banks receiving public support under the State aid rules is expected to take up to five years.

<sup>5</sup> See Spain's first compliance report with the programme conditionality at:  
[http://ec.europa.eu/economy\\_finance/publications/occasional\\_paper/2012/op121\\_en.htm](http://ec.europa.eu/economy_finance/publications/occasional_paper/2012/op121_en.htm)

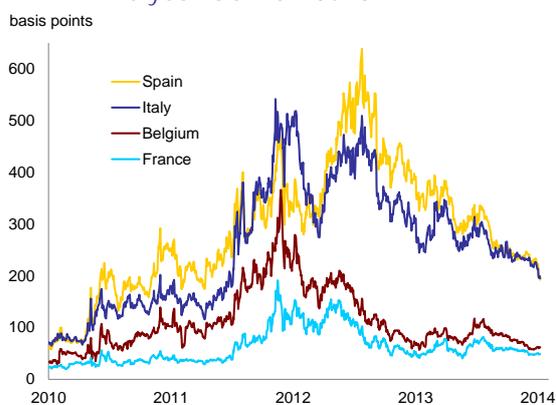
<sup>6</sup> See the update on Spain's compliance with the programme conditionality at:  
[http://ec.europa.eu/economy\\_finance/publications/occasional\\_paper/2013/op126\\_en.htm](http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/op126_en.htm)

## 2 RECENT FINANCIAL, MACROECONOMIC AND FISCAL DEVELOPMENTS

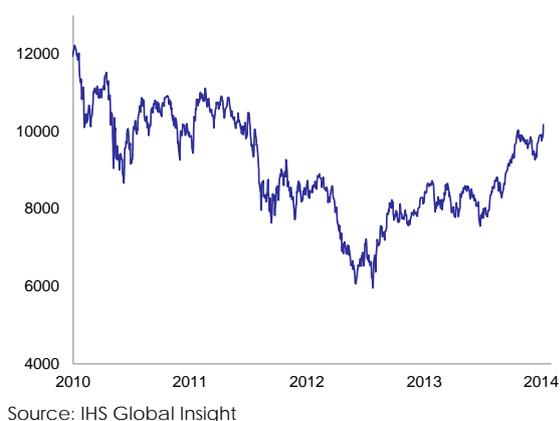
### 2.1 FINANCIAL SECTOR DEVELOPMENTS

**14. The situation on Spanish financial markets has continued to improve.** The 10-year government bond yield declined below 4%, compared to 6.4% at the beginning of July 2012 (see Graph 1). During the past couple of months, the 10-year spread over the German bund stabilised at about 220 basis points, and it has even gone below 200 recently. The continued improvement of the market sentiment is related to the cleaning-up of the Spanish banking sector, the ongoing adjustment of imbalances, signs of a nascent economic recovery as well as to the reduction of financial uncertainty in euro area financial markets in general. All these factors contributed to recent upgrades of the credit rating outlooks.

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



Graph 2: IBEX 35

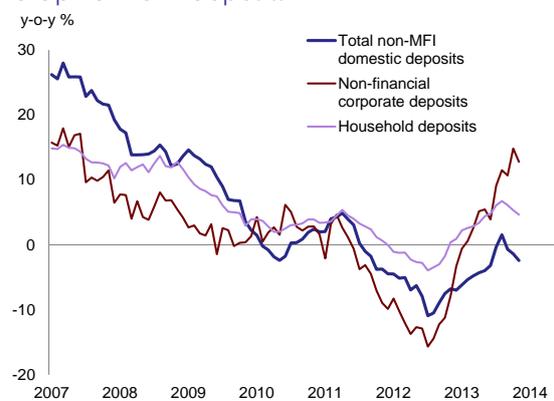


**15. The share prices of the Spanish banks followed the broader market** (see Graph 2). Despite some decrease recently, share prices showed a clear upward trend for several months, reflecting expectations of an emerging and gradually strengthening, economic recovery and prospects of improving, albeit still low, profits of Spanish banks. It remains to be seen whether this upward trend can be maintained going forward, also due to the still fragile recovery of the Spanish economy that is being reflected in low, but increasing banking profitability. Admittedly, the on-going deleveraging adds pressure on the degree of sustainability of banking profits. Furthermore, following the revision of the outlook for the sovereign by the four international rating agencies, Standard&Poor's upgraded also the outlook for five Spanish financial groups. Finally, the significant progress in solvency and the cleaning-up of bank balance-sheets contributed to the improved market sentiment.

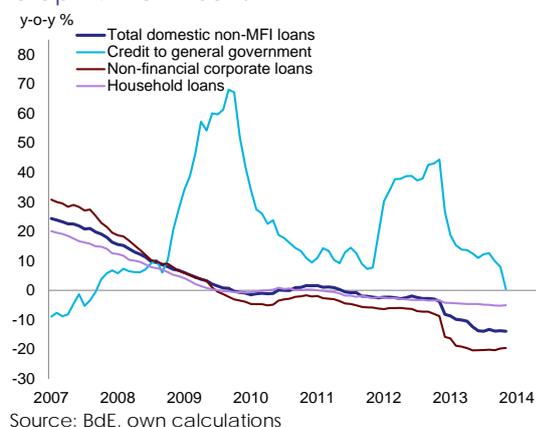
**16. Banks' access to financing further improved recently and its costs became more favourable. Inter-bank activity for secured operations continued its revival and the reliance on ECB financing shrank since the last review.** The annual growth rate of household and non-financial corporate deposits reached about 5% and 13%, respectively as of November 2013 (see Graph 3), although the substitution of commercial paper holdings have also exacerbated the firstly negative, and subsequently positive evolution of deposits. At the same time, the significant outflow of non-resident deposits of about EUR 156 billion during 2012 started to gradually revert in 2013. The issuance of debt securities by banks further improved and market access is now considered open to several Spanish banks. Nevertheless, despite the better access to wholesale funding, banks are reducing their

reliance on this source of financing in order to cut their interest costs. In parallel, net borrowing from the Eurosystem declined to around EUR 235 billion at the end of October 2013 and EUR 197 billion at the end of December 2013, from a record EUR 400 billion in mid-August 2012.

Graph 3: Bank deposits



Graph 4: Bank loans<sup>7</sup>



**17. Debt issuance by Spanish banks has been rather subdued over the past three months due to lower financing needs and also in line with euro area-wide trends.** In 2013, Spanish entities (banks and large corporates) issued EUR 24 billion of unsecured debt, 13% more than in the same period of 2012. Notwithstanding this overall improvement, there are still some lingering problems for the banking sector, as the correlation between sovereign and banking risk persists in the debt markets, which limits the banks' funding cost adjustment. Capital markets are fully open to Group 0 banks, while not yet to Groups 1 and 2. Entities in a restructuring process still have difficulties to place issuances of debt on markets, although some of them are planning the issuance of covered bonds for early 2014. The relatively low amount of debt issued by banks, in line with broader trends across the euro area, is due to lower financing needs as balance-sheet deleveraging continues along with a recovery in other sources of finance, such as deposits.

**18. Recent evidence shows a deceleration in the contraction of domestic bank private credit, and a bottoming-out is in sight.** The contraction in lending decelerated in recent months, as the economic recovery seems to take hold. Adjusted for the transfer of assets to Sareb, private domestic credit declined by around 8.5% y-o-y as of November 2013, slightly lower than the peak reached in May. Whereas the decline in domestic credit to households accelerated to about 5% y-o-y in November 2013, the annual contraction in bank credit to non-financial corporates decelerated to around 10% (see Graph 4).

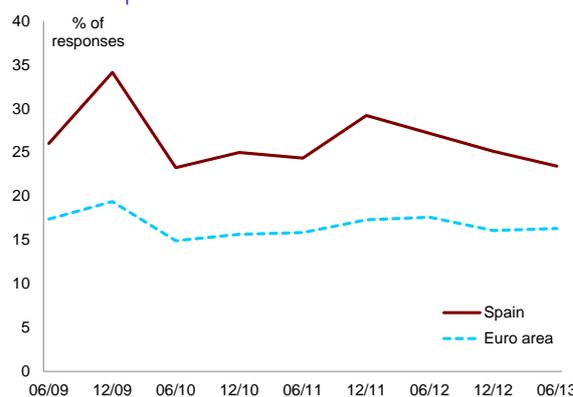
**19. The decline in lending to Spanish non-financial corporations decelerated in recent months, having been also alleviated by external borrowing and issuance of bonds.** In the quarter prior to November 2013, about EUR 11 billion of debt securities and external loans were issued on net basis by the non-financial corporate sector. Therefore, the rate of contraction in the total financing to non-financial corporates has decelerated to around 5.7% y-o-y as of November 2013. The biggest annual contraction in lending took place in the construction and real estate sectors, while lending to other economic sectors contracted at a slower pace. This shows that the reallocation of resources in the Spanish economy continues in order to put the real economy on a sustainable growth path. The

<sup>7</sup> The significant decline in loans in December 2012 and February 2013 partially reflects the accounting effect of the extraordinary transfer of assets from Group 1 and 2 banks, respectively, to Sareb.

increase in credit to government (including government securities) has slowed down, providing additional incentives for the expected recovery in private sector lending.

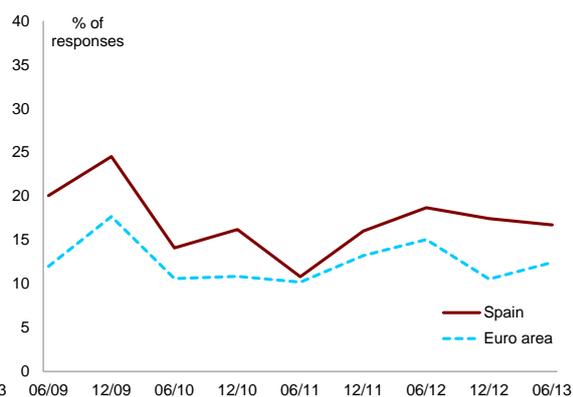
**20. Banks continue to consider weak solvent demand as the main contributor to the ongoing decline in lending to the private sector, although the situation is expected to improve. The tightening of standards for approving loans and of credit conditions has stopped recently.** The contraction in credit reflects the deleveraging needs of both the financial and non-financial sectors and the aversion for long-term investments while the economic adjustment is still unfolding. The most recent Bank Lending Survey, covering developments in the third quarter of 2013<sup>8</sup>, revealed that standards for approving credits have remained broadly unchanged in the second and third quarters of 2013. This suggests a bottoming-out of the tightening trend observed since the beginning of the crisis, in particular as banks expect some credit standards relaxation for SMEs in the fourth quarter. At the same time, fewer banks reported a decrease in the demand for loans (the ninth quarter in a row), with some stabilisation expected in the next quarter. The decline in demand continues to be driven by long-term loans and large enterprises. More banks than in the second quarter point to the decreasing financing needs for fixed investment as the main contributor to the decline in credit demand. On average, there has been no tightening of standards for approving credits to households, while lending conditions deteriorated marginally in terms of loan maturity, but improved slightly in terms of pricing.

Graph 5: Percentage of SMEs' considering access to finance their most pressing problem



Source: ECB

Graph 6: SMEs' rejected bank loan applications



Source: ECB

**21. On average, SMEs report a smaller deterioration in their access to finance over the past six months and their expectations about the next six months are positive for the first time since the beginning of the ECB survey<sup>9</sup> (see Box 1).** Nonetheless, accessing finance remains the SME's second most pressing problem after finding customers, although the numbers of such answers declined (see Graph 5). At the same time, the number of rejected applications remained flat at about 17% vs. 12% for the euro area on average (see Graph 6).

<sup>8</sup> See the report at <http://www.bde.es/webbde/en/estadis/infoest/epb.html>

<sup>9</sup> See the ECB's Survey on the access to finance of SMEs in the euro area – April to September 2013 (November 2013), at <http://www.ecb.europa.eu/stats/money/surveys/sme/html/index.en.html>

### Box 1: SME's access to finance

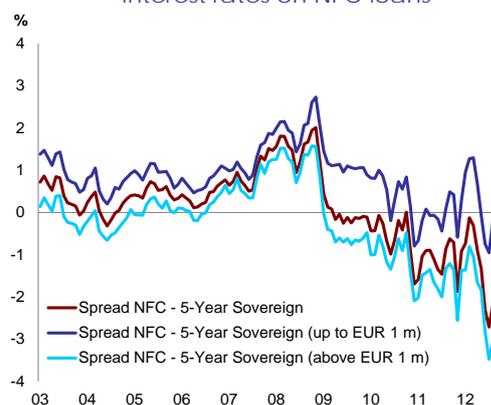
- In line with the overall decline in bank credit, Spanish SMEs' access to finance has been strongly reduced since the beginning of the crisis. Some larger companies managed to increasingly cover their financing needs by issuing corporate bonds, whereas SMEs were not in such a position.
- In the crisis, lending to SMEs became more risky, as illustrated by a relatively higher rate of NPLs than for other borrowers. It was further distorted by the loss of many established banking relationships, as the banking system underwent a severe restructuring. In particular the savings bank sector with a traditional emphasis on SME lending went through a major period of adjustment and consolidation. However, recent evidence suggests that the credit contraction for SMEs is decelerating and expectations on access to finance are turning positive. Government initiatives in this sector are also helpful.
- Analysis performed by the BdE, which approximates the size of non-financial corporates by the volume of bank debt reported to the credit registry<sup>10</sup>, shows a relatively broad-based decline for the different sizes of borrowers. For smaller corporates, the rate of decline in lending has not only been smaller than for larger ones, but has also stabilised over recent months.
- The ECB survey on the access to finance of SMEs shows a decline in the number of respondents considering access to finance as their most pressing problem. Relative improvements were also noticed as regards the percentage of respondents that applied for a bank loan (27% of the Spanish SME's, among the highest figures in the euro area) and the number of full successful applications that grew by 12% points.
- Spanish SMEs continue to note that the terms and conditions for bank financing, i.e. interest rate, other financing costs, the size and maturity of loans and collateral requirements, have become more onerous during the previous six months, although at a slower pace than before. At the same time, Spanish SMEs report a deterioration in their turnover and profitability, which might explain the stricter terms and conditions for bank borrowing.
- On a positive note, SME's expectations for the period October-March 2014 are positive for the first time since the beginning of the ECB survey. Also banks expected a relaxation of credit standards for SME's in the fourth quarter of 2013 and of the perceived decline in the demand for credit by SMEs. The Funding and Capital Plans submitted by banks signal banks' expectation of lending to SMEs and other non-financial companies turning positive in 2014, driven by the increased lending activity of G0 banks.
- The implementation of a wide array of measures to strengthen non-bank financial intermediation is targeting primarily the SME sector (see Section 4). Most notably, the ICO's funding of SMEs via commercial banks has recovered significantly in the second half of 2013 and its funding rates to banks dropped to very low levels.

**22. Despite the recent reduction in the banks' cost of funding, lending rates to non-financial corporates have not started to come down yet (see Graph 8). At the same time, a slight reduction in the lending rates to households was recorded.** The spread to the sovereign (see Graph 7) increased somewhat, signalling that the improvement in the risk perceptions regarding the sovereign was not transmitted fully to the Spanish corporate sector and that market fragmentation, albeit reduced, still continues. Moreover, nominal lending rates for loans above EUR 1 million increased in October 2013, while they remained fairly constant for loans below EUR 1 million. Despite improved funding

<sup>10</sup> See the BdE's Financial Stability Report issued in November 2013 at [http://www.bde.es/f/webbde/Secciones/Publicaciones/InformesBoletinesRevistas/InformesEstabilidadFinancera/13/IEF\\_Ing\\_Noviembre2013.pdf](http://www.bde.es/f/webbde/Secciones/Publicaciones/InformesBoletinesRevistas/InformesEstabilidadFinancera/13/IEF_Ing_Noviembre2013.pdf)

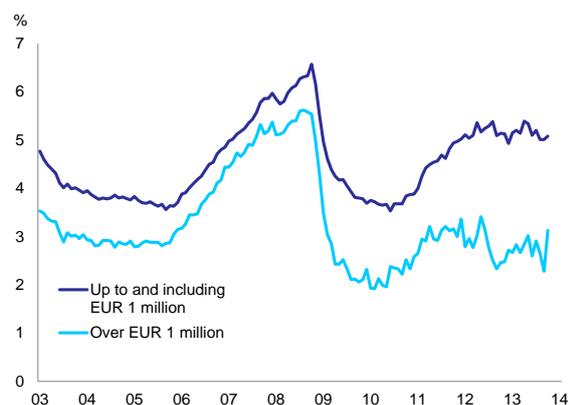
conditions for banks, lending rates for non-financial corporates have not adjusted in parallel, also due to the likely negative influence of past downgrades of sovereign risk on credit risk weights in the banks' internal rating based models. This may reduce the supply of lending for a given amount of capital and increases the lending rates. Moreover, SME lending is likely suffering from the loss of lender-client relationships triggered by the ongoing restructuring of the Spanish banking system. The cost of borrowing for households declined slightly in September and October, for both housing and consumer loans.

Graph 7: Spread over the sovereign for interest rates on NFC loans



Source: ECB, IHS Global Insight and own calculations

Graph 8: Cost of borrowing for NFCs

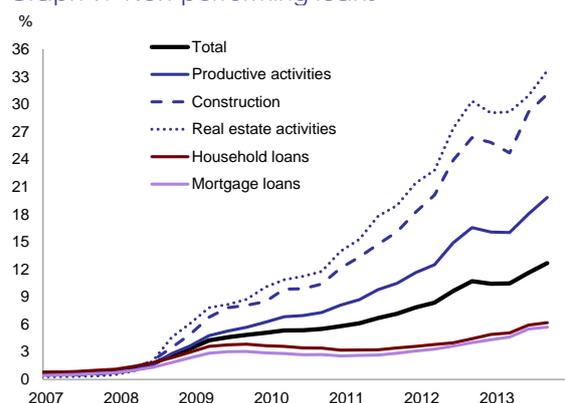


Source: ECB

**23. According to the banks' funding and capital plans, the contraction in lending to the private sector in 2013 has been somewhat higher than previously expected. Nonetheless, private sector lending is expected to bottom out in 2014.** The third set of funding and capital plans (FCPs) by the Spanish banks, which include actual data for the second quarter of 2013, reveals a higher decline in lending to the private sector in 2013 than initially foreseen, in particular for large non-financial corporations, but also for SMEs. At the same time, credit to households is expected to decline at a slower rate in 2013, due to an improved performance of the housing segment. This change in the structure of lending is expected to last until the end of the forecast horizon. The decline in lending to the household sector is likely to decelerate to about half of the rate of decline in 2013 and may turn positive for other non-financial corporates. As regards actual data vs. the forecast from the second set of FCPs, lending in the second quarter of 2013 was higher than forecasted for the public sector and households while it was lower than forecasted for companies.

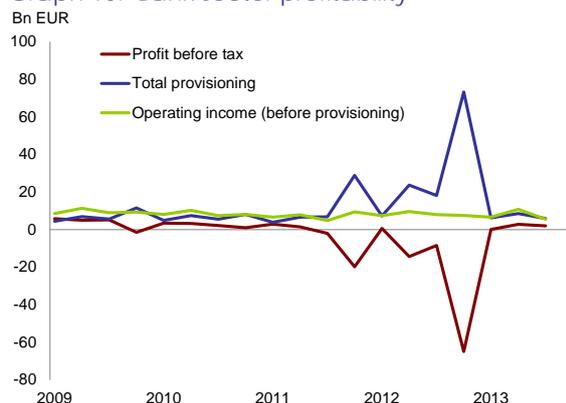
**24. The ratio of non-performing loans (NPLs) continued to increase in recent months, against the backdrop of the increase in the stock of impaired assets, the shrinking total loan portfolio and the reclassification of restructured loans.** The deterioration in asset quality has continued throughout the first three quarters of 2013, with NPLs increasing to 13% at the end of October 2013 compared to 11.9% at the end of June 2013 (see Graph 9). The stock of impaired assets went up by roughly EUR 14 billion between June 2013 and October 2013, whereas the reduction in the total loan portfolio amounted to roughly EUR 50 billion during the same period. Going forward, the NPLs ratio at system level is likely to increase more due to the further effect of the reclassification exercise of the restructured loans portfolio performed by banks in line with the guidance of BdE. According to preliminary data published by the BdE in November 2013, banks reported a total amount of EUR 181.3 billion of restructured loans (based on balance sheet data as of March 2013), with the bulk of these loans (roughly 73%) being classified as substandard and non-performing.

Graph 9: Non-performing loans



Source: BdE, own calculations

Graph 10: Bank sector profitability



Source: BdE, own calculations<sup>11</sup>

**25. The modest medium-term GDP growth outlook and the low interest rate environment are challenges for banks' profitability.** The third quarter of the year has confirmed the positive trend for bank profitability in 2013 (see Graph 10), which is on average above both the baseline and significantly above the adverse scenario of the 2012 Oliver Wyman stress test. For the vast majority of banks the net interest incomes have declined compared to the first three quarters of 2012 due to both the impact of low interest rates on assets with floating rates (i.e. mortgages) and the ongoing deleveraging process. This weakness should be carefully monitored by the supervisors in the future. In spite of it and of the significant contribution from non-recurring items in some cases, pre-provisioning profits demonstrate the banks' capacity to generate internal resources. Furthermore, the Spanish banking sector is becoming increasingly profitable due to the fact that, although provisioning requirements are still high (i.e. the BdE exercise on restructured loans) they are on a declining trend in comparison with the extraordinary provisions envisaged in the two RDLs from 2012. Operating costs have also been reduced at a rapid pace.

**26. The capital levels of the Spanish banks continued to increase during 2013 and some banks managed to tap the markets issuing fresh new capital.** On average CT1 stood at 10.5% while total own funds ratio was at 12% at the end of September 2013. Some banks have proven their ability to issue regulatory capital instruments (i.e. shares, contingent capital and subordinated debt) to private investors. Some policy actions will contribute to shore up banks' core capital in view of the new EU Regulation on capital requirements<sup>12</sup> and the comprehensive assessment to be carried out by the ECB along with the entry into force of the new single supervisor. First, the BdE issued a recommendation on a maximum 25% of paid-in-cash dividends for 2013. Second and more important, the tax legislation on DTAs was amended and it will allow banks to avoid the deduction of an amount which has been initially estimated at around EUR30 billion from the fully loaded common equity tier 1 (see Box 2).

<sup>11</sup> The figures in the chart includes the sum of the profit or loss of each deposit-taking institution taken individually. In the case of the savings banks that segregated their banking business to newly-created banks, those profit/losses may appear in both entities.

<sup>12</sup> Regulation no. 575/2013 on prudential requirements for credit institutions and investment firms and amending Regulation no.648/2012 (Official Journal of the European Union 27.06.2013)

## Box 2: New tax legislation on deferred tax assets (DTAs)

### Overview

- Under normal circumstances DTAs are accounted stemming from different sources and then compensated with future incomes if the bank is able to generate profits during a certain period. In the case of Spain, and according to its tax legislation, this period would be the following 18 years.
- As a matter of prudence, the new EU capital requirements framework (CRR) establishes that banks' DTAs relying on future profits should be deducted from own funds (i.e. CET1): 10% each year from 2014 on, regardless of the situation of the bank or whether it is probable that the bank will generate profits or not.
- During this phase-in period, the estimated impact of the new solvency regime would be substantial for some Spanish banks due to several factors, among which: (i) the huge amount of general provisions allocated during the last years that are not tax-deductible at the time they were registered in their balance sheets and (ii) the fact that losses cannot be refunded with taxes already paid as it happens in some countries.

### Legal amendments and scope

- Following other countries' experiences, the Spanish authorities approved in November the Royal-Decree Law 14/2013 that amends the Law on Corporate Income Tax (RDL 4/2004 of 5 March) allowing banks and other companies to transform a portion of DTAs into direct refundable tax credits from January 2014 for three specific cases.
- The amendment is applicable to all companies. The reference date for the application of the new rules is 1 January 2011.
- DTAs covered by this reform are those stemming from provisioning for (i) credit insolvencies, (ii) foreclosed assets<sup>13</sup> and (iii) pension funds for the company's employees.
- For the cases mentioned above, credit claims would only materialise in the following situations:
  - the company is **not able to generate enough profits** to offset remaining DTAs within the 18-year period. In this case, the unused amount of tax credits will become refundable in public debt.
  - **insolvency or liquidation procedure** of the company: in this case, the overall amount of remaining DTAs registered in the books of the company is automatically transformed into direct claims.
  - **accounting losses** at the end of a concrete year: in this case, DTAs will be transformed into refundable tax credits in the proportion of losses compared to the sum of capital and reserves of the company.

### Impact on the banks

- According to the CRR, DTAs that are transformed on a mandatory and automatic basis into a claim on the State would not be deducted from the regulatory capital. Hence, banks benefiting from the new tax regulation would not need to reduce their capital in the amount of these DTAs.
- Although the law has only recently been adopted and figures are preliminary, the total amount of non-deductible DTAs for the entire Spanish banking sector was tentatively estimated at no less than EUR 30 billion. The fiscal impact of the new regulation is limited to the three cases mentioned above and depends on the probability of occurrence of those events. As the new rules apply to all companies, the total fiscal impact will also depend on the possible effects materialising in the non-financial sector.

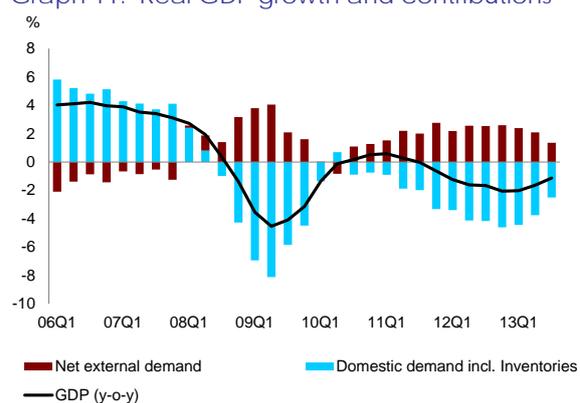
<sup>13</sup> The first two cases mainly apply to banks.

**27. The restructuring of the banking sector accelerated as the savings banks frontloaded the implementation of the restructuring plans.** The number of deposit-taking institutions has declined by about 40 or 12% of the total since 2010. The number of bank branches has also declined by around 12% of the total over the same period in parallel with the number of bank employees. Although banks and credit cooperatives sectors have also undergone changes in their structure, the consolidation process of the cajas' sector has been particularly rapid. The sector consisted of 45 institutions at the end of 2009 and is now integrated within 12 entities or groups of entities. The restructuring and deleveraging process is advancing at a fast pace in the savings banks sector, as the banks have implemented ahead of schedule their restructuring plans. The divestiture of bank assets continued as, for example, Bankia sold its participation in the insurance company Mapfre. Unicaja launched an offer to acquire Banco CEISS and the return of NovaCaixa Galicia to private ownership will soon be effective (see Section 3.2). Banesco, a Venezuelan bank which also controls another small Spanish bank, emerged as the winner in the bidding process.

## 2.2 MACROECONOMIC AND FISCAL DEVELOPMENTS

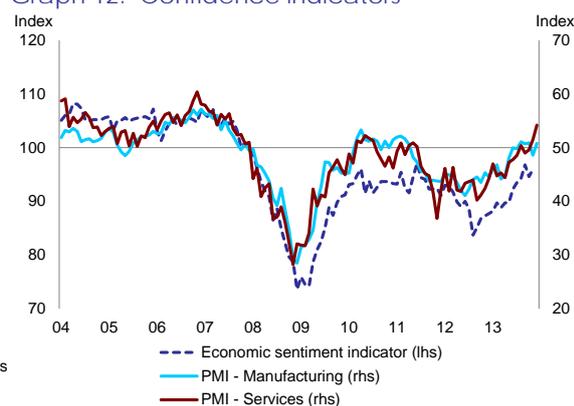
**28. Economic activity returns to modest growth amidst improved confidence.** After entering a double-dip recession in the second quarter of 2011, Spain, as expected, has returned to marginally positive GDP growth of 0.1% in the third quarter of 2013 according to the latest quarterly national account (QNA) data (see Graph 11). This positive growth has taken place amidst improved confidence shown by most available indicators (see Graph 12), a relaxation of financial conditions and less contractionary fiscal policy. The positive trends in confidence and in financial variables extended to the fourth quarter of 2013, pointing to GDP growth remaining in positive territory at the end of 2013. According to the Commission services' autumn forecast, GDP is expected to grow by 0.5% in 2014 after an estimated contraction of 1.3% in 2013. Going forward, the expansion of activity is expected to be moderate, as high unemployment, balance-sheet adjustment and still relatively tight bank credit conditions for smaller borrowers will continue to weigh on growth.

Graph 11: Real GDP growth and contributions



Source: INE

Graph 12: Confidence indicators



Source: European Commission and Ministry of Finance

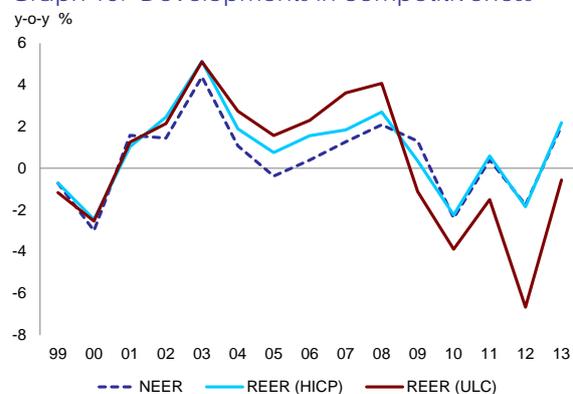
**29. The latest release shows a more balanced growth composition.** In Q3 2013, all domestic demand components except construction entered into positive growth territory, thereby leading domestic demand, after eleven quarters, to post a positive contribution to GDP growth of 0.3 p.p. Private consumption growth was to some extent a surprise and was

mainly explained by the effects of the PIVE<sup>14</sup> plan (phase I and II), the slow-down in the rate of job destruction, and the improved expectations. By contrast, net external demand registered a slightly negative contribution in the third quarter mainly as a result of decelerating exports, linked to a weakening demand from emerging economies. Despite this deceleration, exports remain robust backed by on-going improvements in price and cost-competitiveness (see Graph 13), which are expected to continue. While productivity growth is expected to decelerate, wage moderation will still allow for further improvements in nominal unit labour costs. In spite of the pick-up in domestic demand, imports slowed down in Q3 2013 relative to Q2, but mainly due to a base effect.

**30. The external adjustment progresses.** The more balanced growth composition is expected to continue over the coming quarters, with domestic demand gaining some momentum and net external demand still posting a positive though declining contribution. Nevertheless, the accumulated current account surplus (0.4% of GDP until the end of Q3 according to the QNA released by the INE) is projected to expand further in the coming quarters, supporting a gradual reduction of the large external liabilities.

**31. Inflation remains very contained.** HICP inflation dropped to a lower-than-expected 0.0% in October and rose to only 0.3% in November, as the effects of last year's rises in administered prices and VAT rates fall out from year-on-year growth rates. Inflation is expected to remain low due to still weak domestic demand and contained production costs as a result of wage moderation. This lower inflation is consistent with the process of internal devaluation and is enhancing competitiveness as it remains below the euro area average (see Graph 14). Profit margins nevertheless continue to remain high as tight credit conditions still prevail and firms tend to rely more heavily on own financing. This evidence for Spain appears in line with high profit margins characterising other euro area countries recovering from high indebtedness, high cost of financing or both.

Graph 13: Developments in competitiveness



Source: AMECO

Graph 14: HICP Inflation developments



Source: Eurostat and INE

**32. Employment destruction is bottoming out.** Unemployment fell from a peak of 27.2% in the first quarter of this year to 26% in the third quarter. The decline was largely due to seasonal factors and a contraction of the labour force, but also to a slower decline, better-than-expected, in employment levels in the third quarter. Latest available figures show an increase in affiliates in the social security records, underpinning the expectation that employment could start growing in 2014. Higher flexibility brought about by the labour market reform is likely to have contributed to these positive developments.

<sup>14</sup> Programa de Incentivos al Vehículo Eficiente, programme of incentives for efficient vehicles

**33. Budgetary developments in 2013 continue to present a mixed picture.** Up until end-September, the general government posted a deficit of 4.4% of annual GDP (excluding the impact of measures supporting the banking sector), slightly above the corresponding deficit last year. Tax revenues until November grew by 3.7% compared to the same period of last year (adjusted for differences in tax refund schedules). In the Commission's autumn 2013 forecast, the general government deficit was expected to narrow to 6.5% of GDP for the full year (net of measures to support the financial sector<sup>15</sup>), even though downside risks remained. To assure meeting the nominal deficit target, in late 2013 the government announced that it would not pay the EUR 2.2 billion previously made available to cover the electricity tariff deficit. Against a background of positive, albeit weak, real GDP growth, the general government deficit was expected to shrink to 5.9% of GDP in 2014. On 20 December 2013, the Spanish government adopted additional measures planned to yield savings of some EUR 3 billion (0.3% of GDP) in 2014.

**34. General government debt is high and still rising.** The debt-to-GDP ratio jumped from about 86% of GDP at the end of 2012 to around 93.4% at the end of the third quarter of 2013 and is projected to rise further in 2014-2015. The increase during the first part of 2013 was mostly due to the still high deficit and to some frontloading of issuance by the Treasury. The average cost of debt issuance has been falling (it was 2.45% on average in 2013), in line with trends in secondary market rates, and the average maturity of issuance was lengthened.

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<sup>15</sup> In the autumn forecast, such measures were estimated at 0.3% of GDP, resulting in an overall budget deficit of 6.8% of GDP. More recent information indicate that the amount of measures to support the financial sector is rather 0.5% of GDP.

## 3 BANK RECAPITALISATION AND RESTRUCTURING

### 3.1 SEGREGATING THE BANKS' LEGACY ASSETS

**35. Sareb has continued making significant progress in finalizing the due diligence of its portfolio and in setting up the various channels for the disinvestment of its assets.** Going forward, flexibility and adaptability on the part of Sareb to changing market conditions and evolving structure of its portfolio will be key to the overall success of the entity. Sareb's professional and experienced staff makes it well positioned to tackle the challenges ahead.

**36. The commercial activity of Sareb has picked up in recent months.** Following the introduction of a new sales plan in June 2013, sales of real estate assets (REO) through the retail channel have increased continuously starting from very low levels in May 2013. Based on preliminary data, November has been the strongest month in terms of REO sales to date (accounting for around 20% of the total number of units sold up to now) and this pace is expected to continue into the new year. Several sales agreed through the wholesale channel are still being finalized and could be included in the final figures for 2013. Regarding the portfolio of real estate development loans (RED), various strategies have been developed to optimize Sareb's income depending on the quality of the loan (i.e. performing or non-performing), type of loan (i.e. bilateral, syndicated), as well as the type of collateral. One channel, which has gained prominence in terms of income generation has been the so-called "Plan de Dinamización de Ventas" (PDV), in which Sareb assists the debtor, whose loan repayment may be at risk, in selling the collateral. Sareb considers this channel a faster and a more efficient way of liquidating the RED portfolio as compared to the payment in kind even though negotiating with individual debtors may also be time and resource consuming.

**37. Sareb is expected to post a loss in 2013, in line with its business plan.** While expenses have been largely in line with the expectations of the business plan (BP), sales of REOs were significantly lower than projected, more in line with the stressed scenario. At the same time, the income generated by the RED portfolio has been somewhat higher than projected in the BP. These deviations from the original BP should be seen in the context of limited information at the time of preparation of the BP at the beginning of this year (i.e. before the due diligence of its portfolio). In particular, the extrapolation of asset quality and liquidity of G1 banks assets to G2 banks assets led to an overestimation of the rental and interest income. Other factors include the loss recorded during the first three months of 2013 due to initial delays in starting the commercial activity of Sareb, the inability of servicers to meet their own projections, and a prolonged adjustment of the real estate market in Spain, resulting in a worse-than-expected absorption capacity. At the same time, income from financial assets have been better than expected thanks to the PDV activity and to the sale of loan portfolios, even though the interest income coming from performing loans was overestimated.

**38. Sareb's commercial channels developed this year will become fully operational in 2014,** thus allowing Sareb some acceleration in its asset sales, and somewhat lower debt-servicing cost as it repays some of its bonds. So far, profit margins on asset sales have been generally positive, although declining, in line with the ongoing falls in the real estate prices as well as greater reliance on the wholesale channel (which allows Sareb to dispose assets more quickly but usually generating lower margins). At present, a large majority of Sareb's gross margin is derived from the RED portfolio.

**39. The work on the revision of Sareb's business plan is ongoing.** Sareb is obliged to update its BP annually and the new plan is expected to be approved by the Board of Directors in February 2014. Sareb is now in the process of defining commercialisation strategies for the different segments of the portfolio (residential housing, commercial space and other assets, work in progress, land and loans) and the time-to-market of each one of the segments. Regarding loans, the strategies to liquidate the portfolio are complemented with the strategies to prevent portfolio deterioration. The macroeconomic scenario as well as projections for the evolution of real estate prices will have to be prudent enough in the context of a still significant uncertainty with respect to the future evolution of the real estate market in Spain. In addition, the evolution of the real estate market is likely to be very diverse across various regions and specific locations, so Sareb will need to increasingly rely on disaggregated information.

**40. Despite significant progress, Sareb will be faced with a number of challenges in the coming months, which need to be carefully monitored, including:**

- **The ongoing adjustment of the real estate market and weak macroeconomic outlook.** The evolution of the real estate prices as well as the re-activation of the real estate market remain among the main risk factors going forward and will continue to pose challenges to Sareb's commercial activity. In this respect, Sareb should rather err on the conservative side when preparing an update of its BP.
- **The changing landscape of the market for real estate assets and real estate loan servicing.** The increase in the REO portfolio of banks has been a catalyst for the emergence of a “new” market for the servicing of problematic assets, where the scale of Sareb portfolio amounts to around 20% of the market. This new market is likely to be more centralised around a few key players with a higher degree of expertise and specialisation. This evolution of the market is compatible with Sareb's medium-term strategy of having more specialized service providers but can also create operational challenges in the short term. It can also lead to some potential conflicts of interest, when the new servicers may also be the parties interested in purchasing some of the Sareb portfolio. The situation should be closely monitored and Sareb needs to be prepared to effectively deal with both short-term operational risk and a more strategic risk related to commercial relationship with the new servicers.
- **The changing nature of Sareb's portfolio.** As an increasing portion of the RED portfolio becomes non-performing, income generated through this channel may decline over time, although progress made with PDV activity is to some extent counterbalancing this effect. In order to ensure the stability of its profitability going forward, Sareb needs to continue to adapt its strategies to disinvest its portfolio, which will increasingly become majority REO, in the most efficient way in the context of a still weak real estate market.

## **3.2 BANK RECAPITALISATION AND RESTRUCTURING**

**41. The monitoring of the restructuring plans is proceeding for State-aided banks.** The effective implementation of the restructuring plans for all State-aided banks is well underway with burden-sharing exercises completed. In terms of capacity, the entities are working to reach their operational targets by re-sizing branches and the work force. Some banks accelerated the planned implementation in order to devote all efforts to the ordinary management of their banking business as soon as possible. As regards the required divestments of subsidiaries, banks are mostly on track although some specific sales are

delayed mainly due to the difficulty of selling real estate companies or to sell/liquidate not fully-owned subsidiaries.

**42. The banks are adjusting the balance sheet and credit portfolios at a good pace with the double objective of reaching a balanced asset/liability structure over the restructuring period and of continuing the provision of credit to the real economy.**

Liquidity and funding positions continue the positive trend shown in previous months, with lower loans-to-deposits (LTD) ratios and a decreasing recourse to ECB funding for most of the entities. In terms of solvency, the capital injected in the banks and the provisions taken in 2012 and 2013 provide a comfortable buffer, with the situation being continuously monitored to assess possible weaknesses in specific situations.

**43. The monitoring of restructuring plans will continue in the coming years,** including possible adaptations to significant market changes in duly justified situations.

This was the case, for example, in 2013 when the EC approved an amended plan in case of success of the then-planned acquisition of Banco CEISS by Unicaja. The acquisition of CEISS could be completed soon, and a modification of restructuring plans could occur again in relation to the sale process of NCG.

**44. The return of NovaCaixa Galicia to private ownership is underway.** In November 2013, the FROB launched the first phase of the sale of NCG in an open, transparent and non-discriminatory process. The offer was received with broad interest from domestic and non-domestic banks and other entities. The auction, completed on 18 December 2013, was successful in that Banesco won the auction in the first round as it offered the highest price. Given Banesco's offer difference to those of the other bidders, a second round was not needed, as envisaged in the terms for the auction.

## 4 ENHANCING BANK TRANSPARENCY, REGULATION AND SUPERVISION

**45. The horizontal conditionality in the MoU has been completed and contributed to a thorough overhaul of the governance, regulatory and supervisory framework of the Spanish banking sector.** It included 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 and measures to strengthen non-bank financial intermediation<sup>16</sup>. This section presents progress achieved since the last review with the implementation of follow-up measures that derive from the horizontal conditionality.

**46. The Spanish authorities have made further progress with the implementation of the November 2012 Action Plan on measures for strengthening non-bank financial intermediation (MoU condition 17).** The first six tenders for the allocation of investment commitments in the venture and development capital funds of ICO Fond Global (managed by the AXIS Fund<sup>17</sup>) took place with very strong interest from foreign investors. This has the potential to double the venture capital market in Spain. The EIF-AXIS business co-investment fund "Fondo Isabel la Católica" was registered in November 2013. The alternative bond market for SMEs (MARF)<sup>18</sup> has become operational and the first issuance on the market has already taken place in December 2013. The volume of ICO's on-lending programme for SMEs via commercial banks has increased significantly in the course of 2013, bringing it closer to the all-time record achieved in the second quarter of 2010. Important funding deals with KfW and the EIB contributed to the decline in ICO's funding rates to banks. In September 2013, the Entrepreneur Support Act was published and promotes alternative channels of financing. Among other measures, the regulation on covered bonds was streamlined and made more flexible, and a new instrument, *bonos de internacionalización* (internationalisation bonds) was created. A further legislative package of new measures to facilitate the financing of SMEs is being prepared.

**47. The Law on Savings Banks was adopted by Parliament in December (MoU conditions 18 and 20).** The Law defines a completely new framework for the banking activity of former savings banks which are converted into banking foundations without bank licence, having stakes in the banks where their banking activity has been transferred. The Law sets up the incentives to avoid undesired interferences in the management of the banks where the stakes of foundations are held (see also the previous review report<sup>19</sup>). In addition, the Law creates room for the functioning of traditional savings banks as small institutions of a social nature, limited in scope and with restricted local activity. In these cases, the Law sets clear and strong conditions to ensure the independence and professional competences of their governing bodies and reinforces the supervision power of the BdE. After the approval of the Law, the BdE will develop and publish subordinated legislation (Circulares) to implement the requirements to be complied with by the banking foundations.

**48. As of 1 January 2014, Spanish banks are subject to the new EU regulation on capital requirements<sup>20</sup> to be applied to all EU credit institutions.** In order to continue to

<sup>16</sup> In addition, the BdE has announced the review of its internal rules of procedure to adapt the cooling-off periods to the best domestic and international practices.

<sup>17</sup> <http://www.axispart.com/>

<sup>18</sup> Mercado Alternativo de Renta Fija (MARF), Alternative Fixed-Income Market

<sup>19</sup> At [http://ec.europa.eu/economy\\_finance/publications/occasional\\_paper/2013/op163\\_en.htm](http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/op163_en.htm)

<sup>20</sup> Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012

honour MoU requirements (condition 26), while complying with this new legal framework, which includes a different definition of capital, the Spanish authorities included a transitional provision in the recently approved Royal Decree-Law 14/2013. This provision empowers the BdE to forbid or restrict any bank capital release during 2014 if this would reduce the buffer over minimum capital requirements calculated according to the 'capital principal' definition on 31 December 2013.

## 5 AGENDA FOR FINANCIAL SECTOR REFORMS

**49. The reform of the financial sector needs to continue in order to consolidate the progress in stabilisation.** This section outlines the financial sector policies that appear needed in the period ahead to further increase the robustness of the financial sector while supporting its lending capacity to the real economy. Some of these proposals derive from the MoU conditionality, while others relate to challenges that became more evident during the implementation of the Programme.

**50. The post-programme agenda for financial-sector reforms should first and foremost ensure the finalisation of the measures initiated as horizontal conditions under the MoU.** In this context, the reform of the saving banks sector must be completed, as regards the adoption of secondary legislation without weakening its key provisions and the listing of these banks. A continuation of the upgrading of supervisory procedures at the BdE, taking into account also the new requirements of the Single Supervisory Mechanism, and the enhancement of the already implemented credit register appear warranted. The implementation and impact of the measures to improve non-bank financial intermediation will have to be monitored.

**51. Close monitoring of the financial sector health and the necessary bank balance sheet repair would further foster stability and confidence.** In addition to the standard and regular supervisory activities of the BdE, its new supervisory tool, the Forward-Looking Exercise on Spanish Banks (FLESB), should continue to be used to assess the soundness of banks. In this regard, the BdE could usefully continue its efforts to turn it into a full bottom-up exercise, in keeping with the Oliver Wyman recommendations. The close monitoring of the financial sector should guide the continuous efforts of banks to repair balance sheets and maintain an adequate level of provisions according to the accounting rules in place. This would avoid lending forbearance and strengthen the flow of new credit to the viable part of the economy.

**52. The forthcoming ECB comprehensive assessment with its Asset Quality Review and Stress Test is a challenge for all European credit institutions.** Most Spanish banks have significantly strengthened their solvency and the entire sector is much better capitalised. In the light of this exercise and amid remaining economic challenges, the supervisors should continue monitoring the banks' sustained efforts to maintain and further reinforce capital ratios, which are also instrumental to support their capacity to lend to viable borrowers. Despite the achieved good progress in stabilisation, banks and the Spanish authorities need to be ready to take remedial action if required, should the ECB's test reveal a shortage of capital in some banks.

**53. The BdE will need to ensure a smooth integration into the Single Supervisory Mechanism (SSM).** During the Programme, the BdE has improved its internal procedure ensuring adequate transmission of the information captured by the inspection teams and the continuous on-site supervision of the vast majority of the banking sector. The BdE should try to reinforce these improvements for the supervisory competencies retained, while fully engaging with the ECB for the integration of the supervision of systemically important banks into the SSM.

**54. The implementation of macroprudential supervision will be important in order to prevent the further build-up of macroeconomic imbalances.** The European Systemic Risk Board (ESRB) has recommended to the Member States to designate a national authority to conduct macroprudential policy. In the same vein, the new CRD IV framework setting out prudential requirements for credit institutions requests Member States to set up

an authority responsible for implementing a macroprudential oversight that monitors and prevents to the extent possible systemic risk. Against this background, Spain approved the general guidelines for setting-up a new macroprudential supervision framework in early 2013. The details of this framework and its implementation are still pending. Given the deadlines in the ESRB recommendation, the implementation process is behind schedule and steps need to be taken without delay.

**55. The monitoring of Sareb's activity should continue to ensure timely asset disposal while minimizing the cost to the taxpayer.** Notwithstanding significant success in terms of becoming operational and starting the disinvestment of its portfolio, Sareb faces significant challenges related to the ongoing adjustment of the real estate market in Spain, a weak macroeconomic outlook, a changing landscape of the market for real estate assets and real estate loan servicing as well as the changing nature of Sareb's own portfolio. Flexibility and adaptability on the part of Sareb to effectively respond to the changing environment will be key to sustained success of the entity. In addition, Sareb should continue to proactively manage potential conflicts of interests, also in the context of the transition to the new servicing strategy. In this respect, full ownership by Sareb of the information related to its assets and, thus, full control over its portfolio is of critical importance. As Sareb continues with the disinvestment of its assets through FAB structures (Fondo Activos Bancarios or Bank Asset Fund), in joint venture with other investors, it will be important to continue to closely monitor the impact of this activity on Sareb's cash flow and profitability.

**56. The implementation of the Law on evictions, and any further action in this field, continues to have an important impact on financial stability at national and regional level.** Different legal frameworks on housing across the national and regional levels and legal uncertainty about the rules to be applied could weigh on the value of the mortgage collateral and the stability of financial markets. Moreover, these effects could have subsequent repercussions on the balance sheets and provisioning needs of credit institutions and on the flow of credit to the economy and the functioning of Sareb. Therefore, Spanish authorities at all levels are encouraged to monitor the implementation of the Law on evictions with a view to support financial stability.

**57. Reputational risk for banks will also depend on the continued proper identification of any financial instrument ill-suited for individuals.** In line with the requirements of the Memorandum of Understanding, consumer protection and securities legislation as well as compliance monitoring by the authorities has been strengthened, to limit the sale by credit institutions of subordinate debt instruments to non-qualified retail clients. Going forward, continuous efforts are necessary to identify and improve the process for the sale to retail clients of any instruments not covered by the deposit guarantee fund. This also implies increased transparency on the characteristics of these instruments and consequent risks in order to guarantee full awareness of the retail clients and prevent unwarranted consequences.

**58. The unity of the single market for financial services in Spain is key to preserve efficiency and stability of the financial sector.** As demonstrated by some of the regional laws adopted earlier this year, which aimed at alleviating the social problems related to foreclosures and evictions, such initiatives often create additional legal uncertainty and are, at best, unhelpful in the re-activation of the real estate market and the entry of investors, especially the foreign ones. In the worst case, they may even endanger financial stability by creating different regulatory frameworks within the country, posing challenges to supervisors and regulatory authorities.

**59. Legislation on personal insolvency and consumer protection should be reviewed with due concern for balanced creditor/borrower rights, the stability of the financial sector and overall economic efficiency.** The effectiveness of the temporary measures put in place with respect to personal insolvency (including partial debt forgiveness) as well as measures to strengthen consumer protection (i.e. cap on the penalty interest rate) should be carefully assessed. This analysis should help define the medium- and long-term institutional and regulatory frameworks and set out appropriate incentives for private actors.

**60. The restructuring of state-owned savings banks should be completed with a view to return them to private ownership without undue delay.** As a result of the cleaning-up and recapitalisation of the saving banks sector, FROB became a majority shareholder in some institutions. While implementing the restructuring plans, the authorities should explore the possibility to return these banks to private ownership, striving for a process without additional public support, in order to accelerate their full recovery.

**61. A review of the legal framework of cooperative credit institutions could be considered.** Although cooperative credit institutions have a relative small share in financial intermediation in Spain, they play a significant role on rural areas. Given that their regime has not been reviewed for a long period of time, a review, in the light of the recent financial experience and regulatory developments, might be warranted.

## 6 SUSTAINABLE PUBLIC FINANCES AND GROWTH-ENHANCING REFORMS

### 6.1 STRENGTHENING PUBLIC FINANCES

**62. Reining in the fast-rising public debt demands further fiscal consolidation and strengthening of public finance management.** On 19 June 2013, the Council issued a revised recommendation under the Excessive Deficit Procedure (EDP) to Spain, extending the deadline for correcting the excessive deficit by two years to 2016. The headline deficit targets leading to the correction of the excessive deficit by 2016 are set at 6.5% of GDP for 2013, 5.8% of GDP for 2014, 4.2% of GDP for 2015, and 2.8% of GDP for 2016. Based on the Commission services' 2013 Spring Forecast extended to 2016, achieving these targets requires an estimated improvement in the structural balance of 1.1%, 0.8%, 0.8%, and 1.2% of GDP in the years 2013-2016, respectively.

**63. Progress with fiscal consolidation was analysed in detail in the autumn fiscal package under EU surveillance.** The EC issued its assessments under the Stability and Growth Pact (SGP) and the two-pack legislation (analysis of effective action under the EDP; assessments of Draft Budgetary Plans – DBPs<sup>21</sup> – and Economic Partnership Programmes – EPPs<sup>22</sup>) on 15 November. The EC concluded that in 2013 Spain appears to have taken effective action in line with the Council EDP recommendation, but also pointed to the risk that the Draft Budgetary Plan for 2014 may not fulfil the requirements in the EDP recommendation as the headline deficit target was subject to downside risks and the recommended structural effort may not be delivered. The Eurogroup of 22 November 2013 invited Spain and other Member States whose draft budgetary plans were considered at risk of non-compliance with the rules of the SGP to take measures to address the risks identified by the EC and to ensure full compliance of the 2014 budget with the SGP rules. On 20 December 2013, the Spanish government adopted a set of measures to reinforce the 2012 labour market reform (see below) that it expects to yield additional budgetary savings of about EUR 3 billion (0.3% of GDP) in 2014.

**64. Several reforms are underway to strengthen durably public finance management.** This is crucial to the success of fiscal consolidation and to give a greater emphasis to the growth friendliness of the consolidation, as recommended by the Council in June 2012. Significant steps have been taken to address shortfalls in the pension system (with changes to the rules for early retirement and the adoption on 13 December of the law revising indexation of pensions and introducing the sustainability factor) and implement measures to curb health care expenditures. Measures are being taken to monitor more closely and avoid the emergence of new arrears in public administration payments to providers. Legislation to reduce the reliance on indexation clauses in public sector fees and administered prices is expected to come into force in 2014. The ongoing reform of the public administration aims *inter alia* at curbing administrative burdens, reducing duplicated administrative structures, streamlining overheads while at the same time generating budget savings. The organic law<sup>23</sup> setting up an independent fiscal institution (AIRF) entered into force in November 2013. This leaves a relatively short period to make the new institution operational by early 2014, as it needs to contribute to next year's budgetary process. An expert group tasked to make proposals to simplify the tax system and make it more growth and employment friendly, while respecting Spain's fiscal consolidation commitments, is due to report by end of February 2014.

<sup>21</sup> [http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/budgetary\\_plans/index\\_en.htm](http://ec.europa.eu/economy_finance/economic_governance/sgp/budgetary_plans/index_en.htm)

<sup>22</sup> [http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/deficit/countries/spain\\_en.htm](http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/countries/spain_en.htm)

<sup>23</sup> Ley Orgánica 6/2013, de 14 de noviembre, de creación de la Autoridad Independiente de Responsabilidad Fiscal. (BOE, 15-noviembre-2013)

## 6.2 BOOSTING ECONOMIC GROWTH AND JOB CREATION

**65. Progress with structural reforms continues, although with some delays.** Overall, the reform agenda has been progressing broadly on track with the plans in the Spanish National Reform Programme and the Stability Programme, and with the 2013 country-specific recommendations. However, some important reforms such as on professional services keep cumulating delays against strong opposition from interest groups, and implementation of others is at an early stage.

**66. Addressing the high unemployment levels and fostering a well-functioning labour market remains imperative.** There are some encouraging signs that unemployment is stabilising, but its levels remain very high (26% in 2013 Q3), particularly concerning youth, low-skilled and long-term unemployment. Following shortly the release of an OECD evaluation of the labour market reforms on 18 December 2013, the government adopted some new labour market measures, to: (i) reinforce incentives to work by adapting activation measures and their link to unemployment benefits; (ii) foster part-time jobs, as a tool against unemployment and duality; (iii) reduce red tape, among others, by simplifying and streamlining the current 42 contract templates into four (indefinite, temporary, training and apprenticeship and internship). Efforts to strengthen active labour market policies continue, amidst the complexity imposed by the division of competences between the central State and the regions. An expansion of the dual vocational training is foreseen, and Spain plans to finalise the national Youth Guarantee implementation strategy before the end of the year. However, implementation of most measures requires effective co-operation between the central government and the regions, and risks taking time before showing some positive impact.

**67. Product market reforms are key to the adjustment process.** By increasing competition and eliminating excess rents these reforms aim at ensuring that the adjustment burden does not fall primarily on consumers and employees. Key reforms recently adopted or in the pipeline include: the law on the guarantee of market unity, the reform of professional services, the dis-indexation law, and the reform of public administration.

**68. Several key reforms are progressing as planned.** The law on the guarantee of market unity, which aims to improve the functioning of the Spanish internal market, was adopted on 9 December 2013. The law aims at removing measures that may directly or indirectly obstruct the free movement and establishment of economic operators, goods and services throughout Spain, and at improving regulation. The complex implementation process is underway, including the revision and amendments to remove inconsistencies between the law and the sector specific legislation of some 2,700 legal texts, from different general government levels. Following some legal improvements introduced this year to the corporate insolvency framework, further measures are being considered to address remaining shortcomings, such as those related to the appointment and professional qualifications of insolvency administrators. The dis-indexation draft law, aiming at eliminating indexation in future public sector fees and administered prices was sent to the Parliament before end 2013. The reform of public administration is advancing, with the local administration reform having been adopted by the Parliament in the second half of December 2013. Its full implementation relies on the cooperation between the central Government and the regions.

**69. The reform of professional services is, on the other hand, still delayed and testing the government's determination.** The draft law aims at increasing the transparency and accountability of professional associations *vis-à-vis* its members and consumers of these services and at reviewing existing provisions on reserved activities in

selected professions. It also safeguards the principle of market unity in the access to and exercise of professional services and lists the professions requiring mandatory membership to a professional association. The degree of ambition of the first draft should be preserved, so as to meet the planned competition-enhancing goals of this reform.

**70. The electricity tariff deficit in 2013 was still large.** As the reform measures were taken in mid 2013, a state contribution would have been needed to avoid the electricity tariff deficit in 2013. However, to mitigate risks of not meeting the 2013 budget deficit target, the Parliament decided in December that the state will not cover part of the 2013 electricity tariff deficit. In particular, a special credit line of EUR 2.2 billion was cancelled and financing of extra-peninsular systems (EUR 0.9 billion) suspended for 2013. In addition, 58% of revenues from the tax on consumption of natural gas were exceptionally diverted to increase revenues of the autonomous communities. Thus, five energy companies will have to securitise the resulting estimated EUR 3.6 billion deficit, likely with a full state guarantee as was the case for the about EUR 26 billion of debt already outstanding. The government reiterated its commitment to eliminate the tariff deficit in 2014. This would require that the state budget finances EUR 0.9 billion of extra-peninsular compensation, and the tax on consumption of natural gas is entirely devoted to cover the tariff deficit. The electricity law was adopted by Parliament on 26 December 2013, and the Royal Decree on transmission and distribution was approved by the Government on 27 December 2013.

## 7 ANNEXES

### 7.1 MAIN ECONOMIC AND FINANCIAL INDICATORS

	1995- 1999	2000- 2004	2005- 2008	2009	2010	2011	2012	2013 (e)	2014 (f)
<b>Core indicators</b>									
GDP growth rate	3.7	3.6	3.0	-3.8	-0.2	0.1	-1.6	-1.3	0.5
Private consumption (annual % change)	3.5	3.7	2.8	-3.7	0.2	-1.2	-2.8	-2.6	0.1
Public consumption (annual % change)	2.7	5.0	5.4	3.7	1.5	-0.5	-4.8	-3.0	-2.1
HICP (annual % change)	2.8	3.2	3.5	-0.2	2.0	3.1	2.4	1.8	0.9
Domestic demand incl. stocks	4.2	4.3	3.6	-6.7	-0.6	-2.1	-4.1	-3.4	-0.8
Unemployment rate (% of labour force)	17.2	11.2	9.3	18.0	20.1	21.7	25.0	26.6	26.4
Gross fixed capital formation (% of GDP)	22.5	26.7	29.8	23.6	22.2	20.7	19.2	17.5	16.8
Gross national saving (% of GDP)	22.0	22.6	21.1	19.1	18.4	17.3	18.5	19.5	19.9
<b>General Government (% of GDP)</b>									
Balance	-4.2	-0.5	0.3	-11.1	-9.6	-9.6	-10.6	-6.8	-5.9
Gross debt	64.7	52.5	39.8	54.0	61.7	70.5	86.0	94.8	99.9
Interest expenditure	4.6	2.7	1.7	1.8	1.9	2.5	3.0	3.4	3.6
<b>Households</b>									
Households saving rate	13.2	11.3	11.3	17.8	13.9	12.7	10.4	10.5	10.5
<b>Rest of the world (% of GDP)</b>									
Trade balance	-0.1	-2.8	-6.0	-1.9	-2.2	-1.1	0.7	2.8	4.0
Trade balance, goods	-3.3	-5.7	-8.1	-4.0	-4.6	-4.2	-2.5	-0.8	0.2
Trade balance, services	3.2	2.9	2.0	2.1	2.4	3.1	3.3	3.6	3.9
Current account balance	-0.8	-4.4	-9.0	-4.8	-4.4	-4.0	-1.2	1.4	2.6
Net financial assets	-27.0	-39.7	-70.1	-91.8	-87.0	-89.6	-92.4	-90.2	n.a.
Net international investment position	-26.9	-41.3	-69.7	-93.8	-89.1	-90.3	-91.4	-93.4	n.a.
<b>Competitiveness (index, 2005=100)</b>									
Real effective exchange rate relative to the rest of the euro area	91.4	95.8	104.1	104.9	103.6	101.7	96.7	94.4	92.7
Real effective exchange rate relative to the rest of the European Union	93.8	95.3	103.8	107.7	105.2	103.4	97.5	95.7	94.0
Real effective exchange rate relative to the rest of 37 industrialised countries	92.2	92.6	104.6	109.1	104.8	103.3	96.4	95.8	94.6
<b>Banking sector</b>									
Assets (% of GDP)	173.7	194.9	274.5	329.2	332.0	346.1	348.0	316.4	n.a.
Private domestic credit (y-o-y %)	11.8	14.7	18.9	-1.6	0.8	-3.2	-9.9	-12.9	n.a.
Non-performing loans (NPLs), total	3.3	1.1	1.5	5.1	5.8	7.8	10.4	13.0	n.a.
NPLs, productive activities	n.a.	1.2	1.5	6.2	8.1	11.6	16.1	19.8	n.a.
" of which, construction, and	n.a.	1.0	1.7	8.5	12.1	18.2	25.8	31.1	n.a.
" real estate activities	n.a.	0.6	1.8	10.1	14.0	21.4	29.1	33.7	n.a.
NPLs, residential mortgages	n.a.	0.4	1.0	2.9	2.6	3.1	4.3	5.7	n.a.
Tier 1 ratio (%)	n.a.	n.a.	n.a.	9.3	9.6	10.2	9.7	10.7	n.a.
<b>Interest rates</b>									
10 year spread vis-à-vis the Bund	1.6	0.2	0.1	0.8	1.5	2.8	4.3	3.0	n.a.
CDS 5 year	n.a.	n.a.	14.6	92.0	204.0	319.6	431.9	238.4	n.a.

(e) 2013 estimate or latest available data

(f) 2014: forecast or latest available data

Sources: Ameco, BdE, ECB, Eurostat, IHS Global Insight

## 7.2 TABLE ON THE STATUS OF MOU CONDITIONALITY

Measure	Date	Status
1. Provide data needed for monitoring the entire banking sector and of banks of specific interest due to their systemic nature or condition (Annex 1).	Regularly throughout the programme, starting end-July	Implemented
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 (Law 9/2012)
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 (Law 9/2012)
7. Prepare a comprehensive blueprint and legislative framework for the establishment and functioning of the AMC.	End-August 2012	Implemented, RDL 24/2012 (Law 9/2012)
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	Implemented
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

<b>Measure</b>	<b>Date</b>	<b>Status</b>
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, proposals submitted, action plan under implementation
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, legal follow-up ongoing
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, legal follow-up ongoing
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	Implemented, the second quarterly submission took place
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	Implemented

<b>Measure</b>	<b>Date</b>	<b>Status</b>
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 (Law 9/2012)
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 (Law 9/2012) Additional technical details implemented by BdE (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 (Law 9/2012)
28. Review the issues of credit concentration and related party transactions.	Mid-January 2013	Implemented
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 (Law 9/2012)
30. Amend legislation for the enhancement of the credit register.	End-March 2013	Implemented, Circular 1/2013
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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