

**Spain: Financial Sector Reform—Second Progress Report**

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# SPAIN

## FINANCIAL SECTOR REFORM: SECOND PROGRESS REPORT

March 2013

Prepared by Staff of the

I N T E R N A T I O N A L M O N E T A R Y F U N D \*

\*Does not necessarily reflect the views of the IMF Executive Board.

## PREFACE

**Spain is undertaking a major program of financial sector reform with support from the European Stability Mechanism (ESM).** On June 25, 2012, Spain requested financial assistance from the European Financial Stability Facility (EFSF) to support the ongoing restructuring and recapitalization of its financial sector. The reform program aims to

- better capitalize Spain's banks and reduce uncertainty regarding the strength of their balance sheets, with a view toward improving banks' access to funding markets; this in turn should help ease domestic credit conditions and thereby promote economic recovery; the capitalization drive also aims to protect taxpayers by requiring weak banks to undertake private capital-raising efforts now before undercapitalization problems expand; and
- reform the frameworks for financial sector regulation, supervision, and resolution to enhance the sector's resilience and avoid a re-accumulation of risks in the future.

The Eurogroup approved this support for Spain, with Spain's commitments under the program outlined in the Memorandum of Understanding on Financial Sector Policy Conditionality (MoU) of July 20, 2012. In November 2012, responsibility for providing financial support for the program was transferred from the EFSF to Europe's new permanent rescue mechanism, the European Stability Mechanism (ESM), without this assistance gaining seniority status.

**This report provides information and analysis on the status of Spain's financial sector reform program.** The Ministry of Economy and Competitiveness, the Bank of Spain (BdE), and the European Commission (EC) requested that IMF staff provide such monitoring via quarterly reports, of which this report is the second. This monitoring is conducted as a form of technical assistance under Article V, Section 2(b), of the IMF's Articles of Agreement. Views expressed in the report are those of IMF staff and do not necessarily represent those of the IMF's Executive Board. Further information on the objective and scope of these reports is in the Terms of Reference (TOR). IMF staff is not a party to the MoU, nor responsible for the conditionality or implementation thereof. Information in this report is current as of February 28, 2013.

### **The report is organized into two main sections:**

- *Macro-financial context.* Macroeconomic and financial conditions in Spain will affect the reform program's prospects for success, and vice-versa. Thus, as per the TOR for these reports, this section provides an update of recent macro-financial developments and key implications for the reform program.
- *Progress on financial sector reforms.* This section discusses progress on key measures under the reform program, as well as risks going forward and recommended actions to mitigate them. Further background on recent developments in the financial sector (e.g., trends in profitability and capital buffers) are provided in Annex 1.

## EXECUTIVE SUMMARY

**The main finding of this report is that major progress has been made in implementing financial sector reforms.** The program remains on track: the clean-up of undercapitalized banks has reached an advanced stage, and key reforms of Spain's financial sector framework have been either adopted or designed. Indeed, the bulk of all of the measures for the entire program have now been completed.

**Going forward, it will be essential to maintain this reform momentum.** This includes completing program measures that remain in progress (Annex 2) and implementing reform plans that were drawn up as measures under the MoU (e.g., the BdE's recently completed report on measures to strengthen its supervisory procedures). Vigilant oversight will also be essential, as risks to the economy and hence to the financial sector remain elevated as Spain continues to undergo a difficult process of correcting pre-crisis imbalances. With further near-term headwinds from recession elsewhere in the euro area, Spain's economy is expected to contract for a second straight year in 2013, keeping the unemployment rate over 26 percent and likely prompting a further rise in the nonperforming loan ratio. However, banks are stepping up provisions to help cushion this outcome. More generally, the difficult macroeconomic outlook remains better than the adverse scenario that underpins estimates of banks' capital shortfalls under the program's stress test.

**The report's main findings and recommendations in key areas are as follows:**

- **Bank recapitalization and resolution:** Action is being taken to address banks' capital shortfalls: of note, restructuring plans have been approved for all banks receiving state aid, and a first round of capital has been injected (filling about two-thirds of the total capital shortfall), with the second round of public capital injections expected by early March. This progress toward cleaning up the weakest banks is a major achievement that should strengthen confidence in the system and improve its ability to support the real economy. Remaining elements of the recapitalization and burden-sharing exercise should be completed in a timely manner and in ways that minimize taxpayer costs. To help optimize the value of the state's investment in nationalized banks, the FROB's governance arrangements and ownership policies should continue to be strengthened.
- **SAREB:** Important progress has been made. Key achievements include the establishment of the company and the receipt of real estate-related assets from the weakest banks. Servicing agreements with participating banks to manage the transferred assets are also being finalized. Going forward, policy priorities to address remaining challenges include the completion of an updated and comprehensive long-term business plan and robust implementation of strong servicing agreements to safeguard the value of SAREB's assets. Addressing these and other near-term challenges should take precedence over a search for further equity participation, as the terms of such participation are likely to be more favorable to SAREB once it has established a solid track record of profitability.

- **Ensuring adequate aggregate credit supply:** Banks' wholesale funding costs have dropped in recent months, but so far there are only tentative signs of this translating into an easing of the tight credit conditions faced by most households and businesses. Against this background, the planned compilation of all major banks' Funding and Capital Plans (essentially banks' projections of their quarterly balance sheets) will provide a useful vehicle for assessing the likely near-term evolution of credit, the forces driving its rapid contraction, and the need for any remedial measures.
- **Monitoring and maintenance of financial stability:** To safeguard the program's gains, it will be important to continue closely monitoring the health of the financial system and refine the financial sector reform strategy if needed. Any risks that such monitoring may identify should be addressed at the earliest possible stage through strong supervisory action. Any further actions to strengthen solvency should focus mainly on measures—such as restrictions on cash dividends and bonuses and requirements to issue equity—that boost the numerator of capital ratios rather than cut the denominator (i.e., credit contraction) if possible, given the already tight credit conditions.
- **Regulatory and supervisory framework:** To support stronger financial sector oversight, the authorities have completed several benchmarks aimed at enhancing the BdE's regulatory (i.e., rule-making) and supervisory powers, including the transfer of licensing and sanctioning powers from the Ministry of Economy and Competitiveness to the BdE. To further strengthen the BdE's operational independence, the authorities should consider transferring all remaining supervisory powers to the BdE and, where necessary, establish consultative processes to allow for appropriate checks and balances. An action plan should also be drawn up to implement the BdE's recent proposals to strengthen its supervisory procedures, with specific timelines and taking into account the forthcoming Single Supervisory Mechanism (SSM).
- **Savings bank reform:** The draft law to reform the savings bank system is a welcome step aimed at enhancing these banks' governance and reducing risks to financial stability. It will be important to ensure that the draft law sets effective incentives for former savings banks to gradually divest their controlling stakes in commercial banks.
- **Addressing personal debt distress:** The authorities are designing new measures to extend the protection of socially vulnerable mortgage borrowers. Many proposals are steps in the right direction, though it will be important to ensure that measures are well-targeted so that assistance is focused on those most in need and to minimize moral hazard. Going forward, further study of ways to strengthen the insolvency framework to more efficiently address personal insolvency, while maintaining strong credit discipline and the payment culture in Spain, would be useful.

## Summary of Recommendations<sup>1</sup>

### ***Bank recapitalization and resolution***

- Complete the recapitalization and burden-sharing exercises in ways that minimize taxpayer costs and in a timely manner (§18-12).
- Further strengthen the FROB's governance arrangements and ownership policies to help optimize the value of the state's investment in nationalized banks (§118).

### ***SAREB***

- Meet SAREB's key near-term operational challenges: ensure full implementation of servicing agreements and completion of a sound, comprehensive, and updated long-term business plan (§122).
- Tightly enforce conflict-of-interest rules for SAREB's Board of Directors under Spain's general corporate regime and SAREB's establishing legislation. Adopt additional safeguards as appropriate, including rules that Board members should not participate in deliberations on asset portfolios that are similar to those that their bank intends to sell (§122).

### ***Ensuring adequate aggregate credit supply***

- Use banks' aggregated and consistent projections of their quarterly balance sheets to inform the likely future path of aggregate credit conditions and to identify any constraints; assess the need for and possible effectiveness of remedial measures on the basis of this analysis (§129-30).

### ***Monitoring and maintenance of financial stability***

- To safeguard the program's gains, ensure continued close monitoring of banks' solvency positions, with a view to detecting and correcting at an early stage any signs of renewed deterioration (§117).
- Encourage banks to prioritize capital building over distributions of cash dividends/bonuses (§117).

### ***Savings bank reform***

- In the draft bill to reform the system of savings banks, more clearly emphasize the strict character of the requirements that, in the interest of financial stability, banking foundations will have to comply with, such as risk diversification and holding of cash reserves (§131-35).

### ***Reform of the BdE's regulatory and supervisory powers and supervisory procedures***

- Clarify the areas of prudential regulation (i.e., rule-making) where the BdE has already been given powers and what kind of government involvement is envisaged in those cases. Based on this diagnostic, refine or expand the BdE's regulatory powers as appropriate (§137-39).
- Consider transferring to the BdE all financial supervisory powers that currently remain with the Ministry of Economy and Competitiveness (important such powers include the approval of mergers and significant transfer of ownership). Where necessary, establish consultative processes to allow for appropriate checks and balances (§137-39).
- Draw up an action plan to implement the BdE's recent proposals to strengthen its supervisory procedures, with specific timelines and taking into account the SSM (§140-41).

### ***Addressing personal debt distress***

- Study ways to strengthen the insolvency framework to more efficiently address personal insolvency while maintaining strong credit discipline and the payment culture in Spain (§142-46).

<sup>1</sup> Paragraph numbers in which these recommendations are discussed appear in parentheses.

## Approved By

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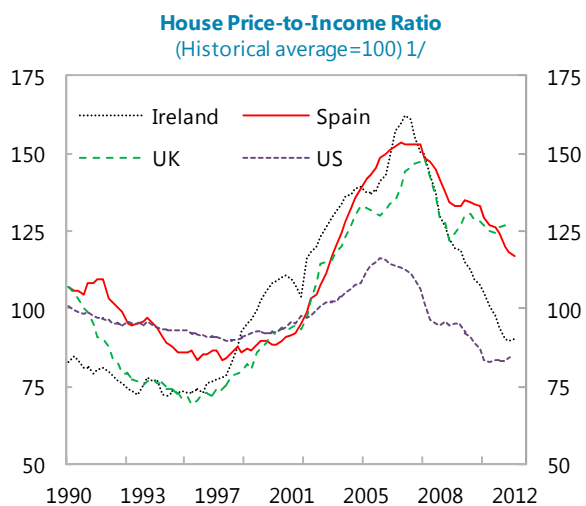
## THE MACRO-FINANCIAL CONTEXT

*The economy continues to contract as it undergoes a difficult process of correcting pre-crisis imbalances. The challenge of this adjustment has been exacerbated by weak economic conditions in many of Spain's main trading partners and by continued financial market fragmentation within the euro area. On the upside, the current account has improved significantly and is now in surplus, and the severity of financial market fragmentation has lessened since last summer in response to positive policy action at both the European and national levels. Nonetheless, Spain's external borrowing costs remain high even after this improvement, and credit conditions for most businesses and households are still tight. Going forward, economic recovery is expected to be slow and gradual, with high risks. This difficult outlook underscores the need to continue monitoring financial sector health closely and to complete initiated reforms at both the European and Spanish levels.*

### A. The Real Economy

#### 1. The economy continues to contract as it undergoes a difficult but necessary process of deleveraging and rebalancing toward external demand:

- GDP continued to fall in the fourth quarter of 2012, dropping 0.8 (quarter-on-quarter), bringing the full-year contraction to -1.4 percent.
- Weak growth has compressed imports (Table 1). Together with strong exports, this has pushed the current account into surplus in recent months. Further correction is expected, as both the public and private sectors seek to strengthen their weak financial positions, as indicated by Spain's still highly negative net International Investment Position (-90.5 percent).
- Real house prices continue to correct, falling another 2.4 percent in Q3 2012. The large overhang of houses for sale suggests that further declines are likely.



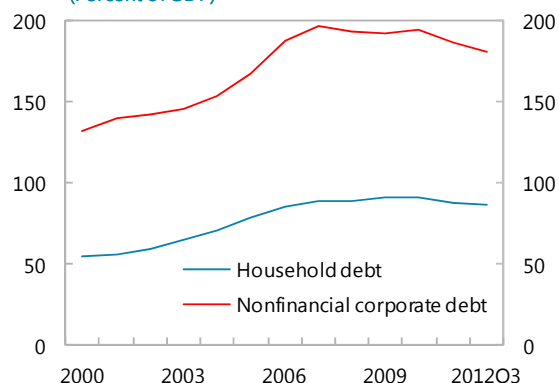
Source: OECD.

1/ Historical average calculated over 1980-present.



- Falling incomes and asset prices are taking a toll on household and corporate balance sheets (Figures 1 and 2), with NPL ratios on both household and corporate loans rising further (Annex 1). Declining disposable income has made it harder to save, with the household saving rate falling back below its pre-crisis level. Similarly, weak growth has left the ratios of household and nonfinancial corporate debt to GDP only moderately below their peaks, despite a significant contraction of nominal credit (Section C). However, the nonfinancial corporate debt ratio is now on a steeper downward trajectory.

Spain: Private Sector Debt 1/  
(Percent of GDP)



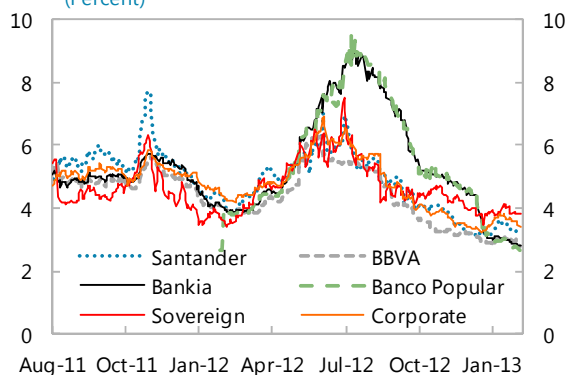
Sources: BdE, Eurostat.

1/ Debt liabilities include loans, securities other than shares, and other accounts payable, including trade credit.

## B. Financial Markets and External Financing

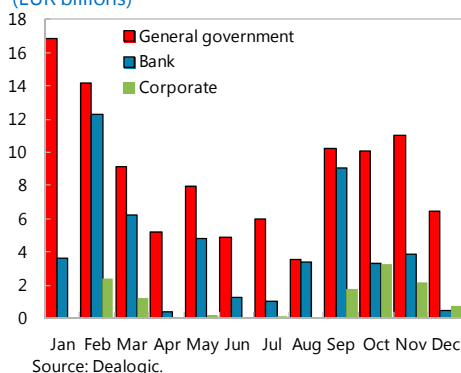
**2. Despite the ongoing economic deterioration, financial market conditions have improved significantly since the start of program last July** (Figure 3). Key developments, such as the ECB's creation of its OMT facility and the reduction of tail risks in Greece, have helped spur renewed capital inflows into Spain, which in turn have buoyed Spanish financial markets. For example, yields on 5-year Spanish sovereign bonds have fluctuated around 4.5 percent since the beginning of September, down from an average of 5.9 percent in the summer. Yields on the bonds of the largest nonfinancial corporations and banks have fallen even more dramatically. Taking advantage of these favorable conditions, large companies and banks continue to tap the market.

Spain: 5-year Bond Yield  
(Percent)



Source: Bloomberg.

Spain: Bond Issuance by Sector, 2012  
(EUR billions)

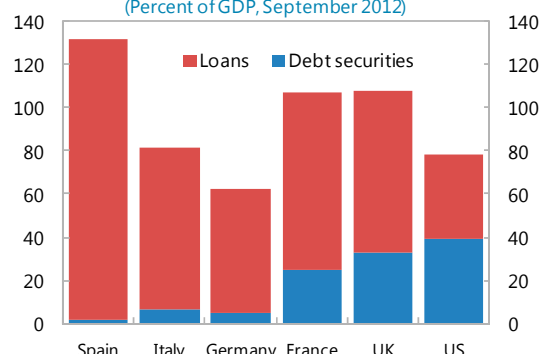


Source: Dealogic.

## C. Credit Conditions

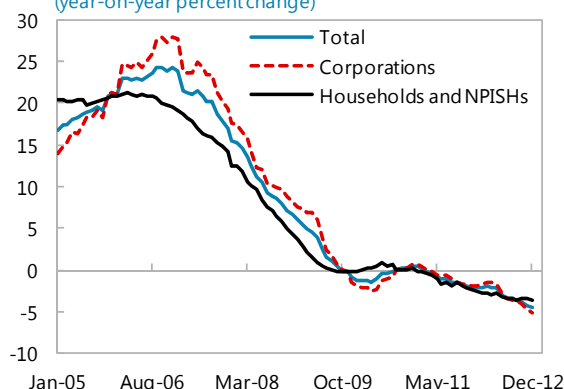
**3. However, better financial market conditions have not yet fed through to significantly easier credit conditions for most borrowers.** Bank financing remains the primary source of financing for the vast majority of Spanish households and firms, and this source of financing has continued to contract. Consequently, the growth rate of credit to the nonfinancial private sector (from both bank and market financing) fell further to over  $-4\frac{1}{2}$  percent at end-2012, a sharper drop than in other major European economies.<sup>1</sup>

**Nonfinancial Corporate Liabilities**  
(Percent of GDP, September 2012)



Sources: ECB; Eurostat; Federal Reserve.

**Spain: Financing of Nonfinancial Sector 1/**  
(year-on-year percent change)

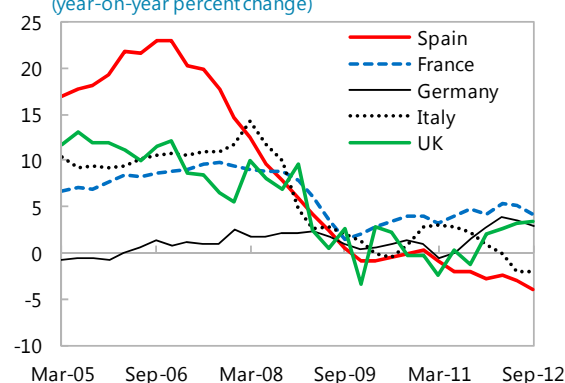


Sources: Bank of Spain; and National authorities.

1/ From flow of funds data; includes both bank credit and market financing (e.g., corporate bonds).

2/ Loans and securities other than shares.

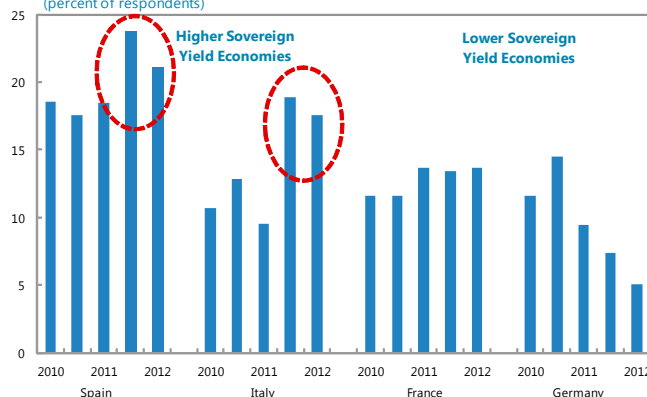
**Financing of Nonfinancial Sector 2/**  
(year-on-year percent change)



Although declining credit undoubtedly reflects in part weak credit demand amidst recession, there are also indications of ongoing tight credit supply. Specifically:

- Lending surveys indicate that credit availability tightened sharply at the onset of the crisis, with no sign yet of any reversal (Figure 4); and

**Unmet Demand for Bank Credit from SMEs 1/**  
(percent of respondents)



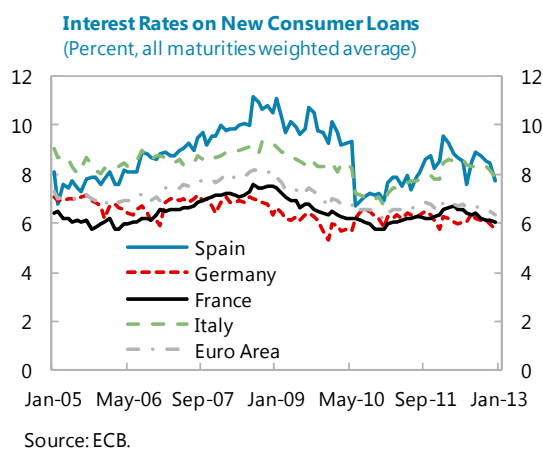
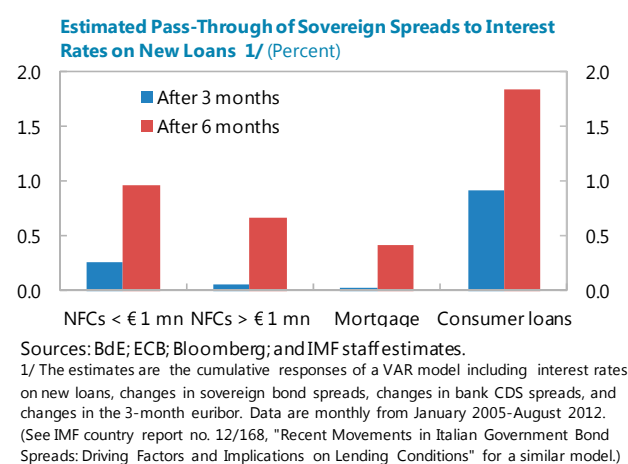
Source: SAFE survey (ECB).

1/ The chart shows the difference between credit requested and supplied. Credit requested is the percentage of firms that applied for a loan or who did not apply for a loan due to possible rejection. Credit supplied is the percentage of firms that applied for a bank loan and got all or most of it.

<sup>1</sup> Excludes the effects of the transfer of loans to SAREB (see next section for more details on this operation).

- Lending rates—the price of credit, which should fall in response to lower demand and rise in response to lower supply—remain well above euro area norms for small companies (Figure 4). In contrast, lending rates to large companies are much closer to euro-area averages. This divergent behavior across different types of lending could reflect the lower riskiness of large companies due to the larger international diversification of their operations. However, it could also partly reflect the ability of large companies to more easily access credit outside the Spanish banking system, thereby forcing Spanish banks to keep lending rates to them equivalent to those rates available from nonbanks and banks outside Spain, unlike SMEs, who are more captive to Spanish banking conditions.

**4. However, the effects of lower sovereign yields and financial sector reforms on lending rates are likely to show up with some lag.** Staff estimates suggest that sovereign spreads affect bank lending rates, with the most pronounced effects occurring after 6 months (see chart). In addition, data are not yet available to fully judge the effects on credit conditions of the significant boost to the banking system's capital and liquidity that occurred in December 2012–January 2013 as part of the financial sector reform program. Nonetheless, there are tentative signs that a delayed but significant effect may be taking hold, with interest rates on SME and consumer loans falling by 16 and 68 basis points, respectively, in December 2012.



## D. Outlook and Risks

**5. Economic and financial conditions are expected to remain difficult for some time.** Domestic demand is projected to stay contained over the medium term, reflecting continued deleveraging of the private sector amid tight financial conditions and ongoing fiscal consolidation. Although exports are expected to contribute increasingly to growth as the global economy recovers and competitiveness improves further, the ability of exports to fuel a rapid recovery is hindered by its moderate share of the economy. IMF staff thus project another year of -1½ percent growth for 2013, followed by slow and gradual recovery. In terms of the cumulative decline in real GDP during 2012–14, this difficult outlook is somewhat worse than the

assumptions underlying the base case used for the financial sector stress tests (table below; Table 1), but IMF staff's scenario remains significantly better than the adverse case used to assess banks' capital shortfalls.<sup>2</sup> Similarly, NPL ratios are still much lower than those implicit in the default probabilities used in the adverse case (though exact comparisons are complicated by the effects of foreclosures and write-offs; see Annex 1 for further discussion).

**Key Macro Variables**  
(annual rates, percent)

	Assumptions in Stress Tests						Latest IMF Staff Forecasts		
	Base case			Adverse case					
	2012	2013	2014	2012	2013	2014	2012	2013	2014
Real GDP growth	-1.7	-0.3	0.3	-4.1	-2.1	-0.3	-1.4	-1.5	0.8
Nominal GDP growth	-0.7	0.7	1.2	-4.1	-2.8	-0.2	-0.6	-0.1	1.9
Unemployment rate	23.8	23.5	23.4	25.0	26.8	27.2	25.1	27.0	26.0
Harmonized CPI growth	1.8	1.6	1.4	1.1	0.0	0.3	2.4	2.0	1.4
GDP deflator growth	1.0	1.0	0.9	0.0	-0.7	0.1	0.8	1.4	1.1
House price growth	-5.6	-2.8	-1.5	-19.9	-4.5	-2.0	-9.0	...	...
Land price growth	-25.0	-12.5	5.0	-50.0	-16.0	-6.0	...	...	...
Spain sovereign yield, 10-year	6.4	6.7	6.7	7.4	7.7	7.7	5.9	...	...
Credit to households 1/	-3.8	-3.1	-2.7	-6.8	-6.8	-4.0	-3.5	...	...
Credit to nonfinancial firms 1/	-5.3	-4.3	-2.7	-6.4	-5.3	-4.0	-8.0	...	...

Sources: Haver; Oliver Wyman; IMF staff estimates.

1/From the flow of funds data. Includes loans from resident credit institutions, off-balance-sheet securitized loans, and loans transferred to SAREB.

**6. Nonetheless, risks around the outlook are large.** Multiple feedback loops between critical macro variables—including confidence, growth, public and private balance sheets, and lending conditions—imply risks of vicious and virtuous circles, as indicated by the high volatility of Spanish markets in recent years. With the fiscal deficit still high (Table 1), significant medium-term adjustment is also required to put debt on a downward path. This adds further risk to the outlook, given uncertainty surrounding the exact magnitude of the resulting contractionary impulses. In general, downside risks dominate, including the risk that the rise in unemployment—which is already around the rates assumed in the adverse case—will continue to outpace expectations. Among other adverse consequences, this could raise losses on household lending substantially. That said, there are also important upside risks. Of note, recent productivity gains could spur further upside surprises on export growth, and the large amount of idle labor implies a potential for relatively rapid growth if such labor can be swiftly re-engaged in productive activity.

**7. The difficult outlook and high risks underscore the need for continued action by both Spain and Europe to promote a less costly adjustment.** Such actions include continued strong implementation of the financial sector reform program in Spain and timely progress on European reforms to solidify the monetary union. Risks to the outlook also suggest a need to maintain close monitoring of the financial system, as discussed in more detail in the following section.

<sup>2</sup> As discussed in the next section, the stress test was applied to banks' balance sheets as of end-2011. Capital shortfalls were assessed against a benchmark EBA core tier 1 ratio of 6 percent.

## PROGRESS ON FINANCIAL SECTOR REFORM

*The program remains on track: the clean-up of undercapitalized banks has reached an advanced stage, and key reforms of Spain's financial sector framework have been either adopted or designed. Indeed, the bulk of all of the measures for the entire program have now been completed (Annex 2). Going forward, it will be important to maintain this momentum with strong completion of initiated reforms and vigilant oversight. Further discussion of selected financial sector issues is below.*

### A. Bank Recapitalization and Resolution

#### ***What is being done?***

**8. The clean-up of undercapitalized banks has reached an advanced stage.** In September, an independent stress test of banks' balance sheets identified ten banks that were projected to face capital shortfalls—relative to a benchmark of a six percent Core Tier 1 capital ratio—by end-2014 under an adverse scenario. In October, these banks were divided into three groups, as described in the previous progress report: Group 1 (banks with large capital needs that were already controlled by FROB); Group 2 (banks that could not fill their capital shortfall on their own); and Group 3 (banks expected to fill their capital shortfall through their own means). For the first two groups, viability assessments were carried out, and restructuring or resolution plans were completed and approved by the EC on November 28 (for Group 1 banks) and December 20 (for Group 2 banks). Actual public capital injections in line with needs took place on December 26 for Group 1 banks, for a total amount of €37.0 billion (see table below). The single bank in that group deemed non-viable will cease to exist as a result of its sale that will be followed by a full incorporation of its business into that of the buyer. For Group 2 banks, public capital injections are expected during the first quarter of 2013 for a total amount of €1.8 billion. The two banks in Group 3 were able to raise the needed capital through their own means, most of it by end-2012, with completion well underway in early 2013. Hence, it is expected that once the burden-sharing exercises (see next paragraph) are completed in the next few months, all capital needs identified under the stress test will have been met.

## Expected Measures to Meet Spanish Banks' Capital Shortfall

(Millions of euros)

		Measures Expected to Be Taken to Meet Capital Shortfall 1/						
Bank name	Oliver Wyman capital shortfall	Injection of public capital 2/	Issuance of new private equity	Capital augmentation through SLEs	Reduction in capital need from transfer of assets to SAREB	Reduction in capital need from sale of assets	Reduction in capital need from revaluation of assets	Other 3/
Group 1	BFA-Bankia	24,743	17,959	0	6,593	191	0	0
	Catalunya Banc	10,824	9,084	0	1,553	188	0	0
	Nova Caixa Galicia	7,175	5,425	0	2,027	-276	0	0
	Banco de Valencia 4/	3,462	4,500	0	426	208	0	0
Group 2	Banco Mare Nostrum 6/	2,208	730	0	182	382	851	63
	Liberbank	1,197	124	0	714	145	215	0
	CEISS	2,062	604	0	1,196	263	0	0
	Caja3	779	407	0	36	228	0	108
Group 3	Banco Popular	3,223	0	2,500	0	328	85	332
	Ibercaja	225	0	0	0	150	0	93
Total		55,898	38,833	2,500	12,727	1,329	1,544	488

Sources: Bank of Spain; FROB.

1/ Figures are only estimates, as some operations, such as SLEs, are not ongoing and not yet final.

2/ State Aid (injections of capital and cocos by FROB). For BFA-Bankia, €4,500 million were already contributed by Frob in September, 2012.

3/ BMN: €63 million of lower tax liabilities. Banco Popular: €33 million of covered bonds buy-back, €125 million of net recoveries from previous write-offs, and €174 million of checked operating income. Ibercaja: €93 million of subordinated debt and securitizations repurchases.

4/ Does not include APS scheme covering up to 72.5 percent of loan losses on a €6,098 million loan portfolio, corresponding to an expected loss of about €600 million according to Bank of Spain estimates. As a result of the sales process of the bank, the final injection of capital has exceeded the initially estimated shortfall.

5/ €851 million in BMN: €770 million from the sale of the Caixa Penedés branch, and €81 million of securities sales.

6/ The capital increase by SLEs in BMN is estimated at €382 million, but the measures take into account only €182 million because €200 million had been taken into consideration in the stress test exercise, reducing the capital shortfall (a conversion of preference shares into CoCos was planned, but finally it was not carried out).

**9. Steps are being taken to contain public recapitalization costs.** As compared with the capital needs identified through the adverse scenario of the bottom-up stress tests in September, namely €55.9 billion, the final amount of public capital to be injected is expected to reach only €38.8 billion. Three factors are expected to contribute to this reduction, as illustrated by the table below:

- **Burden-sharing.** First and foremost, €12.7 billion of the capital needs of Group 1 and 2 banks is expected to be absorbed by subordinated liability exercises (SLEs)—i.e., the haircutting of subordinated debt and preference shares and/or their conversion into common equity. These exercises are currently ongoing
- **Transfer of assets to SAREB.** As discussed in more detail in Section B, banks receiving state aid are required to transfer certain assets—mainly relating to the troubled real estate development sector—to an asset management company (SAREB) in exchange for government-guaranteed SAREB bonds. These asset transfers are generally occurring at prices close to the valuations used to calculate banks' capital shortfalls under the adverse scenario. The transfer thus does not have a large effect on banks' projected nominal equity in the adverse scenario. However, the exchange of these assets for safe government-guaranteed bonds does reduce the denominator (risk-weighted assets) in banks' capital ratios and hence also lowers the amount of capital needed to reach the target ratio (for most banks).
- **Private-capital raising efforts.** Banks also filled part of their capital shortfall through their own means, including asset disposals, revaluations, and a private equity injection of €2.5 billion by one Group 3 bank.

### **Assessment**

**10. The clean-up process represents a major step toward rehabilitating Spain's financial system.** When complete, the clean-up will have significantly boosted the financial system's capital and liquidity. The latter effect results from both the injection of capital and from banks' transfer of illiquid assets to SAREB in exchange for bonds that can be used as collateral, especially for ECB financing. In addition, restructuring plans have been adopted to help return weak banks to profitability. Together, these measures are helping to improve confidence in the system, which should lower banks' funding costs. This in turn should support easier credit conditions for households and businesses than would otherwise have occurred, thereby supporting economic recovery. The financing provided by the ESM to support the clean-up is also long-term and low-cost. Financial sector stability could be further enhanced by reforms at the European level to move toward a more complete banking union, as these reduce the potential for adverse loops of sovereign-financial sector stress.

**11. The clean-up process is utilizing new powers provided by the well-designed restructuring and resolution law.** Notable powers include (i) the recapitalization of banks via the FROB's administrative powers rather than via ordinary commercial rules, as the latter would

have produced a lengthier process that in the meantime would have threatened financial stability, and (ii) the use of SLEs, which are expected to be applied to all Group 1 banks on a mandatory basis. For Group 2 banks, SLEs will be initially conducted through voluntary exchanges, though mandatory SLEs could still be exercised in certain cases.

**12. The SLE process is experiencing some delays, reflecting in part the complexity of the exercise and the importance of conducting it properly.** SLEs were programmed to be completed by the time of public capital injections at end-December 2012 (Annex 2, measure 10), but are still ongoing. These delays partly reflect a careful consideration of the technical and legal complexities of such exercises and are hence to a degree understandable. Nonetheless, the affected banks will remain below the EBA target capital ratio of 9 percent until SLEs are completed. The timely completion of SLEs will thus bring more certainty to the financial system and thereby allow a fuller realization of the program's benefits.

**13. Burden-sharing exercises are geared toward minimizing the required amount of public capital injections.** Plans for Spain's burden-sharing exercises—which are ongoing—envisage that holders of equity in banks with a negative estimated economic value will be near completely diluted (wiped out). All holders of undated subordinated debt and preference shares will receive equity or equity-like instruments in an amount that is a non-negligible fraction (between 40-80 percent on average) of the face value of their holdings. Holders of dated subordinated instruments—the stock of which is small relative to undated instruments—will be able to choose between receiving equity or cash/senior debt, with a more substantial haircut on the face value under the latter option.

**14. It is unclear whether burden-sharing exercises will also minimize the ultimate net cost to taxpayers.** An assessment of this issue requires the balancing of several considerations:

- Spain's burden-sharing exercises (i.e., SLEs) are planned to be among the most extensive in recent European history, as they are designed to cover around 25 percent of total capital needs (approximately €13 bn).<sup>4</sup> Burden-sharing with subordinated debt and preference shares has been near-complete in the sense of attempting to achieve a near-maximum contribution of these instruments to filling banks' capital shortfall.
- Larger haircuts—which may have been within the government's prerogative under the new bank resolution and restructuring law—on subordinated debt and preference shares would not have significantly affected the expected amount of public capital injections required, as undated subordinated debt and preference shares are in any case expected to be converted into equity. However, steeper haircuts would have given the state a

<sup>3</sup> Cases of near-complete conversion of subordinated debt into equity, as in Spain, have been limited in Europe during the crisis. One notable exception is a recent intervention in a bank in the Netherlands in which subordinated debt was completely wiped out (100 percent haircut).



larger ownership share in the affected banks and hence a larger share of future profits, reducing the net costs to the state, assuming the banks eventually return to profitability.

- On the other hand, the authorities have also factored other considerations into the burden-sharing process, including the potential effects of haircuts on (i) the number and outcome of legal challenges and (ii) deposits in state-aided banks held by owners of instruments subject to burden sharing. On the latter, one concern is that higher haircuts may prompt a larger withdrawal of such deposits in retaliation. This in turn might further hurt the profitability of state-aided banks and hence taxpayers' return on them.

On balance, it is unclear that the latter concerns are sufficiently strong to offset the more direct effect that higher haircuts would have on the share of future bank profits that go to taxpayers.

**15. Allegations of mis-selling have complicated the situation and should be addressed through an orderly, transparent, and efficient process.** Some holders of instruments subject to SLEs claim that they did not consent to the purchase of such instruments or that banks understated the risks of such instruments and that therefore such contracts are invalid. Such mis-selling allegations are a separate issue from the SLEs, which should be anchored on the overall evaluation of the bank's assets and liabilities and aimed at minimizing taxpayers' costs. At the same time, the mis-sell litigation involves a large amount of customers and potentially significant costs. Hence, it is important to develop an orderly, transparent, and efficient process to handle these claims. The authorities are fully aware of these issues and are developing a fast-track arbitration process, with claims filtered, for each bank, by an independent advisor. This filter should be based on a rigorous case-by-case legal assessment. According to the estimates of the Spanish authorities, the costs of mis-selling related allegations under arbitration would not push banks under regulatory capital requirements. Nonetheless, plans should be in place to ensure that banks will be fully capitalized under all plausible contingencies—including higher-than-expected costs from legal cases outside the arbitration process—even if somewhat remote.

**16. Going forward, the new resolution powers should facilitate more efficient restructuring and resolution, especially if powers are applied at an early stage.** Experience has demonstrated that delays in intervention can increase taxpayer costs, as bank losses and reliance on official financing rise in the meantime, reducing scope for burden sharing with the private sector. To facilitate more efficient resolution going forward, the authorities are encouraged to clarify (e.g., in the new resolution law's implementing regulations) that resolution decisions can depart from the *pari passu* treatment of creditors, in line with emerging international best practice (e.g., FSB Key Attributes). This possibility would facilitate the split of unviable institutions and the transfer of a certain portion of their business to healthier acquirers, thus avoiding financial disruption and optimizing private-sector contributions to resolution costs.<sup>5</sup>

<sup>4</sup> For further discussion of this issue, see paragraph 49 of the previous progress report.

**17. All banks' capital positions should continue to be monitored closely going forward.**

Although the ten recapitalized banks are now in a much stronger financial position, much uncertainty remains regarding both the duration of ongoing economic downturn in Spain and the effect it will have on banks' balance sheets. The widespread restructuring of the system—including a number of mergers—is also subject to implementation risks. Hence, it will be important for the Bank of Spain to continue monitoring all banks' capital positions, including that of the largest banks, as their core tier 1 capital ratios are below those of their peers (though Spain's largest banks have better-than-average leverage ratios, reflecting relatively high risk weights on their assets) and Basel III norms are expected to materially impact these banks over the next few years. The close monitoring conducted by the BdE, including plans to leverage its investment in the stress test framework (e.g., enhanced models, built as part of the September 2012 stress-testing exercise, for mapping macroeconomic assumptions into loan losses) to further enhance its own internal stress testing, which should occur regularly to help inform its supervision and allow for early detection of any possible deterioration of capital positions. Such monitoring should also facilitate early corrective action if needed, such as requirements to raise external equity and restrictions on dividends and bonuses for all banks (i.e., including those that are not receiving state aid).

**18. Further strengthening of FROB governance arrangements and ownership policies would contribute to optimizing the value of the state's investment in nationalized banks.**

Making a profitable investment in such banks depends on a series of factors, including sound management and an arms' length relationship between the state and the controlled entity. Toward these ends, the FROB is developing a framework for its ownership policies in banks. Likewise, with the FROB's responsibilities growing, it will be important to strengthen its internal governance arrangements to minimize conflicts of interest when FROB acts in multiple capacities (e.g., as a resolution authority and as a shareholder). Lastly, going forward and compatibly with forthcoming EU legislation, the authorities should elaborate a strategy for the interaction between FROB and the deposit guarantee scheme in ordinary times: this could possibly entail subsuming one entity into the other, with a view to preserving both (i) strong public control over such an entity and (ii) private-sector contributions to bank resolution.

## B. SAREB

### What is being done?

**19. Many of SAREB's key elements have been or are being put in place:**

- **Establishment:** In mid-December 2012, SAREB was incorporated, its Board of Directors was appointed, and key committees were established.
- **Staffing:** SAREB is quickly expanding its staff, with the top management team now nearly complete.

- **Capital:** SAREB targets a capital base of 8 percent of its assets, with 2 percent as equity and 6 percent as subordinated debt (15-year callable and convertible bonds with an 8 percent coupon). In mid-December 2012, the FROB and 19 private investors—comprising most major domestic financial institutions and two foreign banks with operations in Spain—injected the capital needed to meet these targets, given the €36.7 billion asset transfer from Group 1 banks, which was successfully completed on December 31.<sup>6</sup> A second round of capital injections was completed by end-February to support the asset transfer from Group 2 banks (around €15 billion) occurring at the same time. SAREB's total capital has now reached about €5 billion, with the FROB owning 46 percent and 28 private investors owning the rest.
- **Bonds:** In exchange for their assets, banks receive floating-rate, government-guaranteed senior bonds issued by SAREB with maturities of 1-3 years. These bonds are issued and listed on the same dates as the corresponding asset transfers (e.g., December 31, 2012 for the asset transfer from Group 1 banks).
- **Cash protocol:** Government guarantees on SAREB's bonds pose non-negligible risks to the taxpayer. To ensure that SAREB prioritizes the extinguishment of this risk over payouts to SAREB's owners, SAREB has appropriately adopted a cash protocol that requires it to use 92 percent of its cash surplus to repay senior debt principal, with the remaining 8 percent retained by SAREB in an escrow account. Resources in the account can be used to call the subordinated bonds or distribute dividends only after five years and only if certain conditions are met. For example, SAREB's outstanding senior debt must be below 80 percent of the value of its assets, and SAREB's capital must remain above 9 percent after any early repayment of subordinated debt.
- **Business plan:** With the support of a new advisor hired in mid-January, SAREB's draft business plan is appropriately being updated based on new data and expanded to include a wider range of sale strategies and instruments. For example, SAREB plans to rent out some properties rather than sell them. Such properties and their associated rental incomes streams could be bundled into groups, which would then be sold as single vehicles. In this way, transaction costs could be reduced via economies of scale, while the creation of rental income streams could increase the attractiveness of SAREB's assets to investors (e.g., insurance companies) that value such streams highly.
- **Servicing agreements:** Banks that transfer assets to SAREB will continue to service these assets (e.g., collect payments on performing loans) for a fee. This arrangement poses risks

<sup>5</sup> The capital injected in mid-December exceeded the 8 percent target because the Group 1 banks transferred fewer assets (€7 billion less) than expected at the time of the capital injection. This was mostly caused by two factors: first, some assets originally included in the transfer perimeter turned out not to meet all of the criteria and were therefore not transferred; second, some loans were fully provisioned or written off since the first estimate of the transfer perimeter.

to the quality of SAREB's assets, as banks remain in charge of their day-to-day management but have no remaining stake in the results.<sup>7</sup> To mitigate this risk, SAREB and the participating banks are finalizing agreements that specify a system of key performance indicators, fees, and penalties aimed at ensuring that the assets are adequately serviced.

- **Vendor financing:** Vendor financing (i.e., financing provided to buyers of SAREB's assets) could facilitate the sale of SAREB's assets. As SAREB lacks the resources, infrastructure, and staff to provide such financing, participating banks are finalizing agreements to provide (for a fee) financing to buyers of SAREB's assets at the same conditions as they offer to buyers of their own assets.

### **Assessment**

**20. Important progress has been made, but challenges still lie ahead.** As illustrated above, much has been achieved in recent months. Continuation of this momentum will help lessen the risks ahead, which are both operational (SAREB's sheer size, with Group 1 banks alone transferring more than 145,000 assets, makes its asset management complex) and financial (the value of SAREB's assets will depend heavily on macroeconomic developments, though SAREB has some buffer in this regard, given that assets were transferred at conservative prices that were broadly similar to expected prices under the stress test's adverse scenario).

**21. Key next steps include completion of a long-term business plan, as well as staffing and organization.** The business plan should reflect the chosen asset valuation and cash-flow frameworks, as well as the degree of asset management outsourcing envisaged in the steady-state, which also affects internal organization and headcount needs.

**22. Another priority is to ensure proper incentive structures.** SAREB's main goal is to maximize the value out of the sale and restructuring of its assets. Aligning the incentives of SAREB's service providers and shareholders with this goal will promote its success. Specifically:

- **Servicing agreements:** These appear to be adequately detailed and robust to mitigate risks. The key now is to ensure their full implementation.
- **Conflict-of-interest rules:** SAREB's bank shareholders could be subject to perceived or real conflicts of interest, as these banks are also in the process of selling part of their real estate portfolios and may also be purchasers of SAREB's assets. Conflict-of-interest rules under Spain's general corporate regime and under SAREB's establishing legislation should thus be tightly enforced: this would entail, for instance, that Board members that are nominated by banks should not be involved in the management of their banks'

<sup>6</sup> Group 1 and 2 banks have transferred approximately €25 billion of performing real estate development loans (book value approximately €40 billion).

liquidation of real estate assets. SAREB's intention to develop further SAREB-specific rules is also welcome. Such additional safeguards should include that Board members do not participate in SAREB's deliberations on asset portfolios that are similar to those that their bank intends to sell.

**23. SAREB's decision to prioritize the meeting of these operational challenges over the search for further near-term contributions to SAREB's capital is appropriate.** Securing further capital contributions at this early stage of SAREB's development is likely to entail more costs than benefits, especially if it requires offering costly incentives (e.g., favorable bidding conditions for SAREB's assets) or if new capital contributions simply reduce the contributions of current investors rather than increase the total capital base. SAREB is more likely to attract capital on attractive terms once its operations and a profitable track record have been firmly established; achieving these objectives should be its overriding focus at the moment.

### C. Ensuring Adequate Aggregate Credit Supply

#### *What is being done?*

**24. As discussed in the first section of this report, credit conditions remain tight, hampering robust recovery.** To a degree, credit contraction in Spain is unavoidable, given the private sector's need to reduce its debt to more sustainable levels. However, the pace at which deleveraging occurs is important, as there may be asymmetries and nonlinearities in the impact over time that make a shorter and more rapid contraction more costly than a more gradual deleveraging. Such asymmetries could arise, for example, from confidence effects and tipping points, which Spain may be more susceptible to now than once it is on a steady recovery path with stronger fiscal numbers.

**25. Against this background, the authorities have developed proposals for strengthening nonbank financial intermediation (MoU measure #17).** The proposals include a range of measures to improve access to credit, especially through nonbank channels and/or to SMEs. Proposed measures include regulatory changes and tax incentives to promote the development of SME bond financing, increased funding for ENISA (the state innovation agency) so it can expand its lending to SMEs, increased funding for the state's guarantee scheme for loans to SMEs, etc.

**26. For bank credit, a system for gathering and compiling banks' balance sheet forecasts is also being developed (MoU measure #21) to help identify risks at an early stage.** A standardized reporting template has been agreed, and all banks that participated in the stress tests have made their first submissions to the BdE. These standardized submissions should help the BdE and European authorities anticipate future credit developments at an early stage, which in turn should facilitate pre-emptive action in the event banks' intentions in aggregate have undesirable macroeconomic implications.

**27. Credit limits in bank restructuring plans do not appear to be a significant constraint on system-wide credit at the moment.** Banks receiving state aid are subject to restructuring plans to promote their return to viable business models and to ensure that they do not use state aid to gain an unfair competitive advantage. These plans entail a significant downsizing of restructured banks' balance sheets. Much of the reduction in these banks' gross loan book will be accomplished through the transfer of most real estate development (RED) loans to SAREB and the writing down of many remaining RED loans. Excluding RED loans, restructuring plans target an average annual reduction in lending of around 5 percent over 2012-16.<sup>8</sup> Although this reduction is sizeable, the credit limits in restructuring plans—which are binding at end-2014 and end-2016—do not appear to be a significant constraint on system-wide credit at the moment, given that (i) credit for the system as a whole is expected to contract over 2012-16 (Table 3), as weak growth constrains loan demand and the drop in house prices reduces the stock of residential mortgages, and (ii) non-restructured banks, whose loan book is about 4½ times that of restructured banks, are projected to continue expanding their market share as they fill space vacated by restructured banks. However, credit limits in restructuring plans could become more constraining were growth prospects—and hence credit demand—to revive and/or if the ability of non-restructured banks to fill credit demand is more constrained than expected. If these or other key assumptions underpinning restructuring plans change significantly, the plans may need to be reviewed. That said, changes should not be made lightly, given the need for stability in banks' operations and planning.

### **Assessment**

**28. The authorities' action plan to support the financing of SMEs contains some useful initiatives, but they are unlikely to have large near-term effects.** Given Spanish businesses' high reliance on bank credit, the proposed measures may not have noticeable macroeconomic effects in the near term, as new alternative financing instruments take time to develop properly and given that investor demand for such instruments may be inadequate in the current recessionary environment. A number of measures also entail fiscal costs and hence may not be feasible, given very limited fiscal space.

**29. Given this, banks' balance sheet forecasts for all banks should become a key tool for assessing the outlook for credit conditions.** The plans of all major banks should be checked and adjusted for consistency and realism. For example, Spanish banks may all plan to cut lending, while assuming unchanged deposits. However, a reduction in lending by one bank will likely lead to lower deposits (possibly by a multiple of the original reduction in lending) in other banks via standard money-multiplier effects.<sup>9</sup> Some iteration of the plans will thus likely be necessary to ensure their mutual consistency.

<sup>7</sup> For Group 1 and Group 2 banks, based on estimates by the EC.

<sup>8</sup> This illustrates how one bank's lending decision can have externalities for other banks and for the economy as a whole, potentially resulting in decentralized outcomes that are inferior to more coordinated ones.

**30. If such plans indicate high risks of excessively tight credit going forward, they could be further used to assess the drivers of tight credit and possible remedies.** For example, if funding costs are a key constraint, this could be eased by banks' accessing regular ECB financing facilities. If restructuring plans become a constraint, these could be re-visited. If capital ratios are a constraint, macroprudential policies could be adopted to incentivize banks to take capital-raising measures, such as issuing more equity and cutting dividends and remuneration, while avoiding incentives to meet capital requirements through loan contraction and asset-shedding.

## D. Savings Bank Reform

### *What is being done?*

**31. The crisis revealed several weaknesses in Spain's framework for savings banks.**

Savings banks have no formal shareholders, as they are governed by a broad range of public and private stakeholders, and do not distribute profits. Consequently, savings banks' ability to raise external equity is quite limited. This contributed to inadequate capital buffers in the run-up to the crisis. Political interference from savings banks' public-sector shareholders also adversely affected financial stability, while a division of supervisory responsibilities between the BdE and regional governments complicated oversight of these banks.<sup>10</sup>

**32. Faced with the crisis, the authorities have fundamentally overhauled the savings banks system, but savings banks are still major shareholders of some commercial banks.**

One key measure enacted over the last years was the spin-off of the vast majority savings banks' activity to newly formed commercial banks. Like any similar entity, these banks were put under the exclusive supervision of the BdE and were able to raise capital, thus ending two significant problems inherent in the savings bank model. Other important steps addressed flaws in the corporate governance of savings banks, as conflict-of-interest rules and fit proper requirements were strengthened, also to avoid political interference. However, the above reforms were not accompanied by changes in the ownership chain—which perhaps made these reforms politically more feasible: savings banks, acting alone or in concert, became the holding companies of the commercial banks resulting from the spin-off. Such commercial banks still account for 17 percent of assets amongst banks included in the September stress tests.

**33. The persistence of savings banks as controllers or significant shareholders of commercial banks raises several issues.** First, the question is whether savings banks have sufficient financial strength to provide capital to commercial banks, as an inability to do so reduces financial sector stability. Also, as most savings banks derive their income mainly from their stakes in the commercial banks, in times of financial distress they will be unable to backstop banks. Second, the role of savings banks as controllers of commercial banks is still not fully

<sup>9</sup> For further background on savings banks and their role in the crisis, see *Spain: The Reform of Spanish Savings Banks* (IMF Technical Notes).



addressed, particularly in light of the need to ensure an arms' length relationship with the latter entities, given their political connections. Third, even if the remaining savings banks are sound, their lingering influence, whether actual or potential, does not achieve the thorough break from the past that is required to restore full confidence in the financial system. It is also typically in the best interest of charitable foundations to have a diversified investment portfolio so they can provide stable financing of their charitable activities.

**34. The Government has prepared a bill (*proyecto de ley*) to comprehensively reform the savings banks system.** The bill has a two-fold approach:

- First, it strengthens the regulatory regime for the few savings banks that are still carrying out directly a banking activity. Such reforms include enhanced corporate governance rules and a prohibition on such banks undertaking banking activity beyond their home region to help limit these banks' systemic importance and hence the risks that they could pose to financial stability.
- Second, and more importantly in the context of Spain's current system, the bill proposes that former savings banks that indirectly exercise banking activity (through ownership of a commercial bank) be transformed into "banking foundations." Certain activities of these foundations will be supervised by the BdE within the framework of its competences as the authority responsible for the supervision of commercial banks in which the concerned banking foundation might have possible influence. In this regard, foundations that have control over a commercial bank will be required to have (i) a management protocol describing their ownership policies; (ii) investments in a pool of diversified assets; and (iii) a reserve fund of liquid assets that can be used if necessary for the capital needs of commercial banks controlled by the foundation. Foundations holding 30 percent of a commercial bank would have to comply with softer requirements, such as the management protocol as per (i) above and a financial plan detailing their investment criteria and how they would backstop capital needs of the relevant bank. These requirements will be developed through implementing regulations, with further technical details specified by the BdE via circular.

**Assessment**

**35. The bill presented by the Government is a welcome step bringing clarity to the savings banks system and its positive elements should be preserved.** The strategy underlying the bill appropriately differentiates savings banks based on their systemic importance, with tougher requirements for those that hold significant stakes in commercial banks. The regime to transform such banks into banking foundations contains several positive elements, contributing to an arms' length relationship between the foundation and the commercial banks and setting some rules to ensure that the foundations have sufficient financial strength to support banks' equity if needed. Ultimately, these rules represent the incentives that should lead banking foundations to lose control over commercial banks, an objective envisaged in the MoU.



**36. However, further refinements may be advisable, and effective implementation will be needed to achieve the objectives outlined in the draft bill.** The draft bill could more clearly emphasize the strict character of the requirements that, in the interest of financial stability, banking foundations will have to comply with, such as risk diversification and holding of cash reserves. This will help ensure that the goal of removing banking foundations from controlling stakes of commercial banks is eventually and gradually achieved – effective enforcement by BdE will be also key in this respect. Also, a residual power to impose, under defined circumstances, such stricter requirements for foundations not falling within the various thresholds prescribed in the law would be advisable, as this would ensure the BdE is provided with sufficient powers to mitigate the risk of undue influence in all circumstances and thereby safeguard financial stability.<sup>11</sup> Lastly, care should be taken in monitoring the concerted exercise of shareholding rights by different foundations, as well as lending to related parties by commercial banks in which foundations hold a significant stake—this is especially important given that foundations will be required to have a diversified investment strategy.

## **E. Reform of the BdE's Regulatory and Supervisory Powers**

### ***What is being done?***

**37. A key set of MoU measures aim at strengthening the BdE's powers as the banking authority and reinforcing its operational independence.** This entails: (i) empowering the BdE to issue rules of general applicability (i.e., regulatory powers) without the need for government authorization and with binding effects towards all supervised entities; and (ii) enhancing the BdE's supervisory powers to autonomously enforce laws and regulations in its sphere of competence.

**38. The authorities have made concrete steps and introduced legal reforms in these directions, formally complying with the MoU.** In line with the MoU, an elaborate study has been prepared by the MoE, identifying possibilities to further empower the BdE to issue binding guidelines or interpretations. These are defined as legal instruments of a hierarchical nature, binding towards the entity issuing the guidelines or interpretations (i.e., BdE) rather than towards third parties. Moreover, sanctioning and licensing powers—previously conferred to the MoE—have been transferred to the BdE (see the previous progress report).

### ***Assessment***

**39. Nonetheless, the authorities are encouraged to further strengthen the BdE's regulatory and supervisory powers to further enhance the BdE's operational independence:**

<sup>10</sup> The BdE already has certain supervisory powers over all shareholding interests of 10 percent or more in commercial banks, whether or not these interest are banking foundations. However, these powers are more narrow than those that would provided for under the proposed residual powers.

- **Regulatory powers.** The authorities' study clarifies that under Spain's constitutional framework the primary legislator (i.e., parliament) may delegate to the BdE the exercise of certain normative powers. However, the study does not shed enough light on whether the BdE has sufficient powers to optimally perform its functions. Indeed, the proposal to strengthen the BdE's regulatory powers to introduce binding consultations and binding rules for its own internal procedures, as discussed above, is useful. However, the proposal does not address the more important issue of strengthening the BdE's ability to issue rules that are binding vis-à-vis supervised third parties. Toward this end, a review of the areas where the legislator has already given the BdE regulatory (i.e., rule-making) powers would be useful to clarify the current division of powers with the government. Based on this diagnostic, the opportunity to refine or expand these powers could be considered; this should still be done in a way that preserves the strict observation of democratic accountability principles, shaping the allocation of competences under the constitution. Indeed, any granting of regulatory powers by parliament to an administrative agency such as the BdE—rather than to the government itself—is justified solely on its technical expertise and should be on specific and well-defined matters.
- **Supervisory powers.** The BdE's supervisory powers have been notably strengthened, including by the transfer of sanctioning and licensing powers to the BdE, as noted above. However, some financial supervisory powers or remedial measures still do not lie with the BdE. For example, the MoE retains its competence to approve mergers and to take corrective action when the influence exercised by a significant shareholder may have a detrimental effect on the safe and sound management of a bank. As the MoU mentions only the transfer of sanctioning and licensing powers, there is no doubt that the authorities have fully complied with the MoU on this measure. Nonetheless, to further strengthen the BdE's operational independence, the authorities should consider transferring all remaining supervisory powers to the BdE—in a manner compatible with forthcoming SSM regulation—and, where necessary, establish consultative processes to allow for appropriate checks and balances. Proceeding in this direction would simplify the division of labor between the ECB and the competent domestic authorities, in view of the set up of the SSM, which will confer certain supervisory tasks to the ECB.

## F. Reform of the BdE's Supervisory Procedures

### *What is being done?*

**40. A review of BdE's supervisory procedures was completed in October.** In line with paragraph 24 of the July 2012 MoU, this formal internal review was meant to identify possible shortcomings and, in particular, to explore ways to ensure that findings of on-site inspections lead to effective and timely corrective actions. A substantive final report was prepared in late October and shared with the international partners. The recommendations included, among other measures, the adoption of a structured framework for Pillar 2 supervisory action, the

extension of on-site continuous monitoring to more banks, added formalization of supervisory actions, further development of macroprudential supervision, and enhanced relationships between supervisors and auditors.

### **Assessment**

**41. The proposed measures for further optimization of the BdE’s supervisory procedures deserve to be implemented fully.** The international partners provided feedback on the October report, pointing out to its comprehensiveness, clarity, and ambitious recommendations for improvement. They also suggested additional measures, including to further strengthen the formalization of supervisory actions and enhance the enforcement of provisions related to the rotation of supervisory staff. It is also recommended that the BdE develop an action plan with specific timelines for implementing the recommendations in the October report. As the SSM mechanism will condition the BdE supervisory framework, this plan should be fully consistent with the preparatory work for the creation of the SSM to ensure a smooth transition to this mechanism.

## **G. Addressing Personal Debt Distress**

### ***What is being done?***

**42. In Spain, individuals have little incentive to apply for bankruptcy, as debtors cannot obtain a “fresh start” following compliance with bankruptcy procedures and requirements.** Spain’s insolvency regime applies to all debtors, including both businesses and natural persons.<sup>12</sup> Under this regime, a natural person may resort to bankruptcy proceedings to address his/her financial difficulties. However, the current framework does not allow a “discharge,” or “fresh start,” for the financially responsible person declared bankrupt. On the contrary, creditors in Spain can legally pursue any unpaid claims against a bankrupt person with regard to any of the debtor’s future assets or income. Therefore, unless a debtor who is a natural person expects to reach a viable agreement with his/her creditors to re-structure his/her debts, there appears to be no strong incentive for an insolvent individual in Spain to apply for insolvency proceedings under the existing regime.

**43. This feature of the current bankruptcy regime may create economic disincentives.** Natural persons who are insolvent and have no reasonable hope of repaying their debts have little incentive to produce income in the formal sector, as their creditors can lay claim to all such income. This situation could prompt insolvent natural persons to move to the informal sector or to withdraw from the labor force entirely, with consequent adverse effects on potential output and fiscal balances. However, the magnitude of these potential effects is unclear, as reliable data on these issues are unavailable. It is important to note also that an insolvency regime that is overly lenient toward debtors could also create adverse incentives, including disincentives for

<sup>11</sup> The regime entails some differences in its treatment of businesses and natural persons.

loan payment, which in turn could adversely affect financial stability and credit availability, and for work in the formal sector (to understate income and thereby qualify for more lenient terms under such a regime).

**44. Against this background, the Minister of Economy recently announced a number of proposals.** Among others, these proposals include to (i) increase the beneficiaries of the good practices code; (ii) introduce a mechanism that allows debtors for whom the proceeds from the foreclosure of their home are insufficient to pay off their debt to write-off 35 or 20 percent of the balance if the debtor pays their remaining debt within 5 or 10 years, respectively; (iii) limit the maximum interest on late payments; (iv) avoid foreclosure after a single late mortgage payment; (v) adjust out-of-court foreclosure procedures; and (vi) enhance the independence of appraisal companies.

### **Assessment**

**45. It will be important to ensure that recent proposals to reform the framework for mortgages are well-targeted and maintain credit discipline.** A number of the proposals are steps in the right direction that respond to shortcomings in the current framework identified by Spanish legal experts and practitioners. However, it will be important to carefully quantify the likely effect of reforms to ensure that measures such as the increase in the beneficiaries of the good practices code are calibrated to achieve an appropriate balance between assisting those most in need while maintaining credit discipline and avoiding moral hazard. Targeting could also be enhanced by ensuring that any mechanisms for debt write-off apply only to those in economic distress by taking into account the debtor's broader financial position (income and net worth).

**46. Going forward, study of ways to strengthen the insolvency framework to more efficiently address personal insolvency in Spain, while firmly maintaining strong credit discipline, would be useful.** In this regard, consideration could be given to reforming Spain's insolvency framework to establish a special *personal* insolvency regime. The regime could include features, such as a "fresh start" for financially responsible debtors following a reasonable period of time after the closing of the liquidation phase, to efficiently tackle personal insolvency. More generally, consideration should be given to designing a more comprehensive approach to household debt restructuring where voluntary and out-of-court workouts are supported and promoted by the legal framework, including mechanisms to provide for assistance for the most vulnerable. However, it will be essential to design any such reform in a manner that does not create moral hazard and firmly maintains credit discipline and the payment culture in Spain.

Table 1. Spain: Main Economic Indicators, 2009-2018 1/

(Percent change unless otherwise indicated)

	2009	2010	2011	2012		2013	2014	2015	2016	2017	2018
				January WEO	Actual Outturn	Projections as of the January WEO					
Demand and supply in constant prices											
Gross domestic product	-3.7	-0.3	0.4	-1.4	-1.4	-1.5	0.8	1.4	1.6	1.6	1.7
Private consumption	-3.8	0.7	-1.0	-1.8	-2.2	-2.4	0.7	1.3	1.6	1.6	1.5
Public consumption	3.7	1.5	-0.5	-4.2	-3.7	-5.5	-1.4	-0.1	0.0	0.0	0.3
Gross fixed investment	-18.0	-6.2	-5.3	-8.8	-9.1	-5.8	-1.3	0.6	1.8	2.4	2.7
Construction investment	-16.6	-9.8	-9.0	-11.4	-11.5	-7.6	-1.2	-0.6	-0.1	0.5	0.8
Other	-24.5	3.0	2.4	-6.1	-6.7	-4.2	-1.8	3.1	5.8	6.0	6.1
Stockbuilding (contribution to growth)	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total domestic demand	-6.2	-0.6	-1.9	-3.8	-3.8	-3.7	-0.1	0.9	1.3	1.4	1.5
Net exports (contribution to growth)	2.9	0.2	2.4	2.4	2.4	2.1	0.9	0.5	0.3	0.3	0.3
Exports of goods and services	-10.0	11.3	7.6	3.5	3.1	3.9	4.1	4.3	4.3	4.4	4.5
Imports of goods and services	-17.2	9.2	-0.9	-4.4	-5.0	-3.1	1.6	3.2	3.9	4.2	4.2
Prices											
GDP deflator	0.1	0.4	1.0	0.8	0.3	1.4	1.1	1.2	1.3	1.3	1.4
HICP (average)	-0.3	1.8	3.2	2.4	2.4	2.0	1.4	1.5	1.4	1.5	1.5
HICP (end of period)	0.8	3.0	2.4	2.9	3.0	1.3	1.4	1.3	1.4	1.5	1.5
Employment and wages											
Unemployment rate (percent)	18.0	20.1	21.7	25.1	25.0	27.0	26.0	24.7	23.2	21.7	20.1
Unit labor cost in manufacturing	0.5	-7.2	-4.0	-1.8	...	-3.2	-1.7	-0.9	-0.7	-0.7	1.3
Labor cost in manufacturing	5.1	1.4	3.0	-3.0	...	2.3	0.4	0.8	1.0	1.0	0.8
Employment growth	-6.8	-2.3	-1.9	-4.6	-4.5	-2.4	1.6	1.9	2.1	2.1	2.1
Labor force growth 2/	0.8	0.2	0.1	-0.2	-0.2	0.1	0.2	0.1	0.1	0.1	0.1
Balance of payments (percent of GDP)											
Trade balance (goods)	-4.0	-4.6	-3.7	-2.5	-2.4	-0.7	0.0	0.7	1.8	3.3	4.9
Current account balance 3/	-4.8	-4.5	-3.5	-1.8	-0.8	0.4	1.0	1.7	2.2	2.3	2.6
Net international investment position	-93.7	-88.9	-91.7	-92.9	...	-92.1	-88.8	-83.9	-78.4	-72.8	-67.1
Public finance (percent of GDP)											
General government balance	-11.2	-9.7	-9.4	-8.0	-10.0	-6.4	-6.7	-6.4	-5.8	-5.4	-4.9
General government balance, excl. financial sector support	-11.2	-9.7	-9.0	-7.0	-6.7	-6.4	-6.7	-6.4	-5.8	-5.4	-4.9
Primary balance, excl. financial sector support	-9.4	-7.7	-6.5	-4.0	-3.7	-2.5	-2.4	-1.7	-0.8	-0.1	0.7
Structural balance	-9.3	-7.9	-7.7	-5.7	...	-4.4	-4.9	-5.1	-5.0	-4.9	-4.6
General government debt	53.9	61.3	69.1	86.2	...	93.2	98.7	102.6	105.6	107.9	109.6

Sources: IMF, World Economic Outlook (WEO); data provided by the authorities; and IMF staff estimates.

1/ Except for the actual outturn column, estimates and projections are from the WEO database as of the January 2013 WEO update.

2/ Based on the national definition (i.e., the labor force is defined as people older than 16 and younger than 65).

3/ Capital account not included.

**Table 2. Spain: Selected Financial Soundness Indicators, 2006-2012**

(Percent or otherwise indicated)

	2006	2007	2008	2009	2010	2011	2012 (Latest available)
<b>Solvency</b>							
Regulatory capital to risk-weighted assets 1/	11.9	11.4	11.3	12.2	11.9	12.4	n.a.
Tier 1 capital to risk-weighted assets 1/	7.5	7.9	8.2	9.4	9.7	10.6	9.4
Capital to total assets	6.0	6.3	5.5	6.1	5.8	5.9	n.a.
Returns on average assets	1.0	1.1	0.7	0.5	0.5	0.2	-0.2
Returns on average equity	19.5	19.5	12.0	8.8	7.2	2.8	-3.0
<b>Profitability</b>							
Interest margin to gross income	50.3	49.4	53.0	63.7	54.2	51.8	53.9
Operating expenses to gross income	47.5	43.1	44.5	43.5	46.5	49.8	47.0
<b>Asset quality</b>							
Non performing loans (billions of euro)	10.9	16.3	63.1	93.3	107.2	135.8	169.3
Non-performing to total loans	0.7	0.9	3.4	5.1	5.8	7.6	9.6
Provisions to non-performing loans	272.2	214.6	70.8	58.6	66.9	58.3	60.0
Exposure to construction sector (billions of euro) 2/	378.4	457.0	469.9	453.4	430.3	396.8	378.7
<i>of which</i> : Non-performing	0.3	0.6	5.7	9.6	13.5	20.1	26.5
Households - House purchase (billions of euro)	523.6	595.9	626.6	624.8	632.4	626.6	614.7
<i>of which</i> : Non-performing	0.4	0.7	2.4	2.9	2.4	2.8	3.2
Households - Other spending (billions of euro)	213.4	221.2	226.3	220.9	226.4	212.2	216.6
<i>of which</i> : Non-performing	1.7	2.3	4.8	6.1	5.4	5.4	5.8
<b>Liquidity</b>							
Use of ECB refinancing (billions of euro) 3/	21.2	52.3	92.8	81.4	69.7	132.8	365.0
in percent of total ECB refin. operations	4.9	11.6	11.6	12.5	13.5	21.0	32.3
in percent of total assets of Spanish MFIs	0.8	1.7	2.7	2.4	2.0	3.7	9.8
Loan-to-deposit ratio 4/	165.0	168.2	158.0	151.5	149.2	150.0	151.3
<b>Market indicators (end-period)</b>							
Stock market (percent changes)							(ytd)
IBEX 35	31.8	7.3	-39.4	29.8	-17.4	-13.4	-8.1
Santander	26.8	4.6	-51.0	73.0	-30.5	-26.3	-1.2
BBVA	21.0	-8.1	-48.3	49.4	-38.2	-12.1	2.4
Popular	33.3	-14.8	-48.0	-13.9	-24.1	-9.1	-62.0
CDS (spread in basis points) 5/							
Spain	2.7	12.7	90.8	103.8	284.3	466.3	304.3
Santander	8.7	45.4	103.5	81.7	252.8	393.1	310.3
BBVA	8.8	40.8	98.3	83.8	267.9	407.1	332.9

Sources: Bank of Spain; ECB; WEO; Bloomberg; and IMF staff estimates.

1/ Starting 2008, solvency ratios are calculated according to CBE 3/2008 transposing EU Directives 2006/48/EC and 2006/49/EC (based on Basel II). In particular, the Tier 1 ratio takes into account the deductions from Tier 1 and the part of the new general deductions from total own funds which are attributable to Tier 1.

2/ Including real estate developers.

3/ Sum of main and long-term refinancing operations and marginal facility.

4/ Ratio between loans to and deposits from other resident sectors.

5/ Senior 5 years in euro.

**Table 3. Spain: Monetary Survey, 2010-2018**  
(Billions of euros, unless otherwise indicated; end of period)

	2010	2011	2012	Projections					
				2013	2014	2015	2016	2017	2018
<b>Aggregated Balance Sheet of Other Monetary Financial Institutions (OMFIs) 1/</b>									
Assets	3,471	3,621	3,573	3,443	3,389	3,390	3,369	3,389	3,424
Cash	8	7	7	8	8	8	8	8	8
Deposits at the ECB	27	51	72	30	28	18	16	13	10
Claims on other MFIs	211	203	209	204	198	193	189	192	194
Claims on non MFIs	1,936	1,887	1,734	1,632	1,593	1,610	1,638	1,675	1,720
General government	79	89	114	114	114	114	114	114	114
Private sector 2/	1,857	1,797	1,619	1,518	1,479	1,496	1,524	1,561	1,606
Corporates	896	840	707	655	634	644	661	683	706
Households and NPISH	876	857	823	782	766	773	783	797	817
Shares and other equity	103	163	169	158	150	148	141	140	134
Securities other than shares	520	544	565	573	570	567	563	567	565
General government	158	193	243	240	237	235	232	231	229
Claims on non-residents 3/	374	386	403	385	377	372	370	373	377
Other assets	293	381	414	452	466	473	444	420	416
Liabilities	3,471	3,621	3,573	3,443	3,389	3,390	3,369	3,389	3,424
Capital and reserves	283	367	412	396	389	390	387	391	394
Borrowing from the ECB	62	168	361	299	277	183	156	129	102
Liabilities to other MFIs	211	206	210	206	199	195	190	194	196
Deposits of non MFIs	1,728	1,650	1,533	1,522	1,525	1,540	1,563	1,609	1,664
General government	79	70	69	68	70	71	73	74	76
Private sector	1,648	1,581	1,464	1,454	1,455	1,469	1,490	1,534	1,589
Corporates	219	197	190	186	184	189	194	201	209
Households and NPISH	727	727	731	728	729	735	744	760	780
Debt securities issued	433	435	382	361	341	388	390	392	392
Deposits of non-residents 3/	512	493	343	347	353	386	374	364	360
Other liabilities	244	302	331	311	306	307	308	310	315
<b>Money and Credit 4/</b>									
Broad Money (M3)	1,140	1,121	1,109	1,103	1,119	1,143	1,170	1,200	1,232
Intermediate money (M2)	1,031	977	966	961	975	996	1,020	1,045	1,073
Narrow money (M1)	515	506	500	497	505	516	528	541	556
<b>(Percent of GDP)</b>									
Broad Money	108.7	105.4	105.0	104.5	104.0	103.5	103.1	102.6	102.2
Private sector credit	177.1	169.0	153.3	143.9	137.5	135.5	134.3	133.5	133.2
Corporates	85.4	79.0	67.0	62.1	58.9	58.3	58.3	58.4	58.6
Households and NPISH	83.6	80.6	77.9	74.1	71.3	70.0	69.0	68.2	67.7
Public sector credit	7.5	8.4	10.8	10.8	10.6	10.4	10.1	9.8	9.5
<b>(Percentage change)</b>									
Broad Money	-2.0	-1.6	-1.1	-0.6	1.5	2.1	2.4	2.5	2.7
Private sector credit 5/	0.8	-3.2	-9.9	-6.3	-2.6	1.1	1.9	2.4	2.9
Corporates 5/	-2.1	-6.2	-15.8	-7.4	-3.3	1.5	2.8	3.2	3.5
Households and NPISH	0.3	-2.2	-4.0	-4.9	-2.0	0.8	1.3	1.8	2.4
Public sector credit	21.9	13.6	28.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Memo items:</b>									
Loans to deposits (% other resident sector) 6/	149.2	150.0	135.6	128.2	124.9	124.9	125.3	125.4	125.2
Retail deposits (% change) 7/	2.9	-2.3	-0.3	-0.8	0.0	1.1	1.6	2.4	3.0
Wholesale market funding (% change)	-8.8	-1.4	-20.1	-2.9	-2.7	11.9	-1.0	-0.7	-0.3
Wholesale market funding (% assets)	22.6	21.3	17.3	17.4	17.2	19.2	19.2	18.9	18.7
Capital and reserves (% total assets)	8.1	10.1	11.5	11.5	11.5	11.5	11.5	11.5	11.5

Sources: Bank of Spain; and IMF staff estimates.

1/ Monetary financial institutions (MFIs) excluding Bank of Spain. Data are end-of-period.

2/ Loans to other resident sector, including nonmonetary financial institutions, insurance corporations and pension funds, nonfinancial corporations, NPISH, and households.

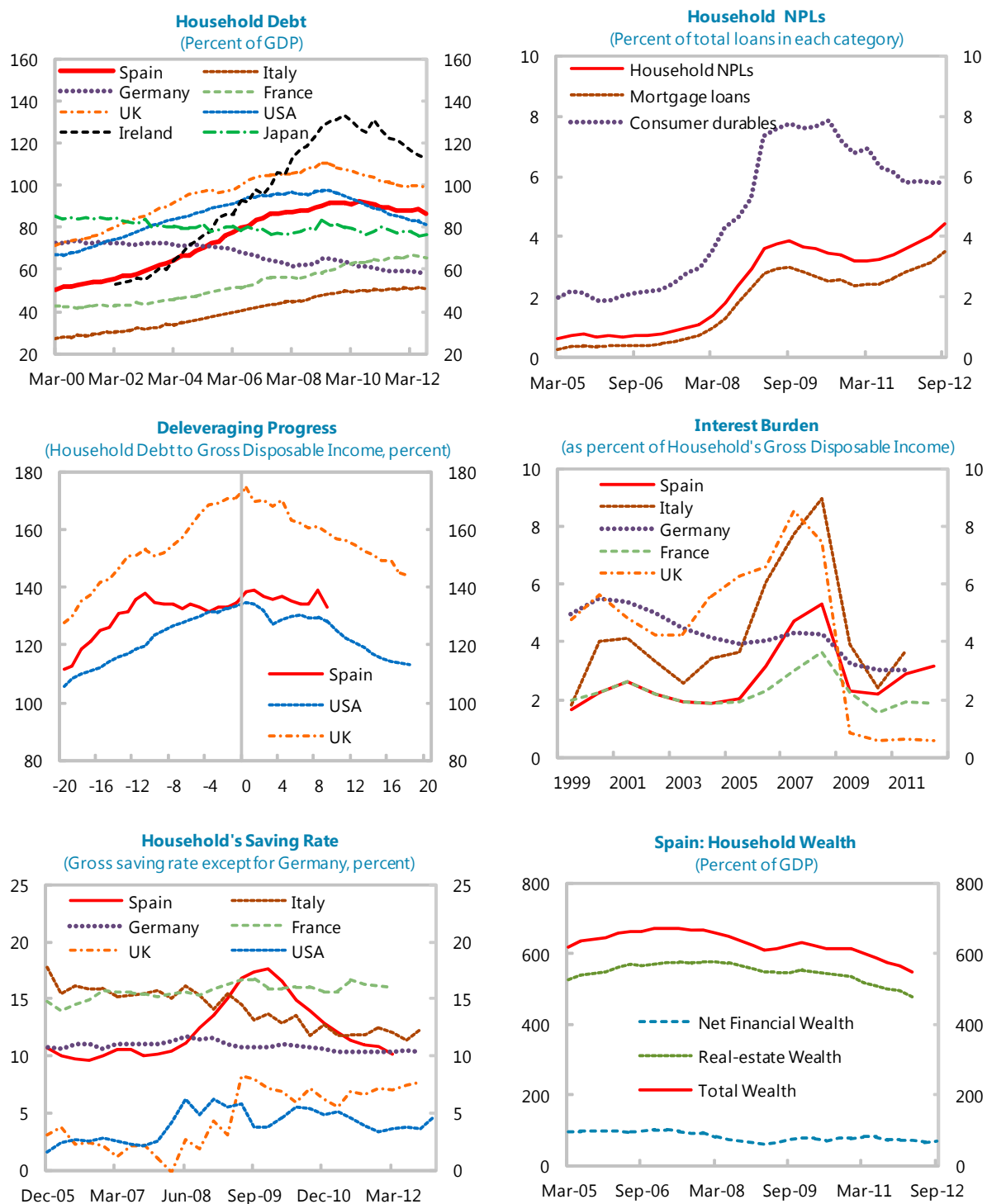
3/ Non-resident MFIs, general government and other resident sectors.

4/ Broad money (M3) comprises M2 plus repurchase agreements, money market fund shares and units as well as debt securities with a maturity of up to two years. Intermediate money (M2) comprises M1 plus deposits with an agreed maturity of up to two years and deposits redeemable at notice of up to three months. Narrow money (M1) includes currency in circulation and overnight deposits.

5/ A large decline of credit to private sector at end-2012 was partly resulted from assets transferred to AMC of about 54 billion euros in real estate developer loans.

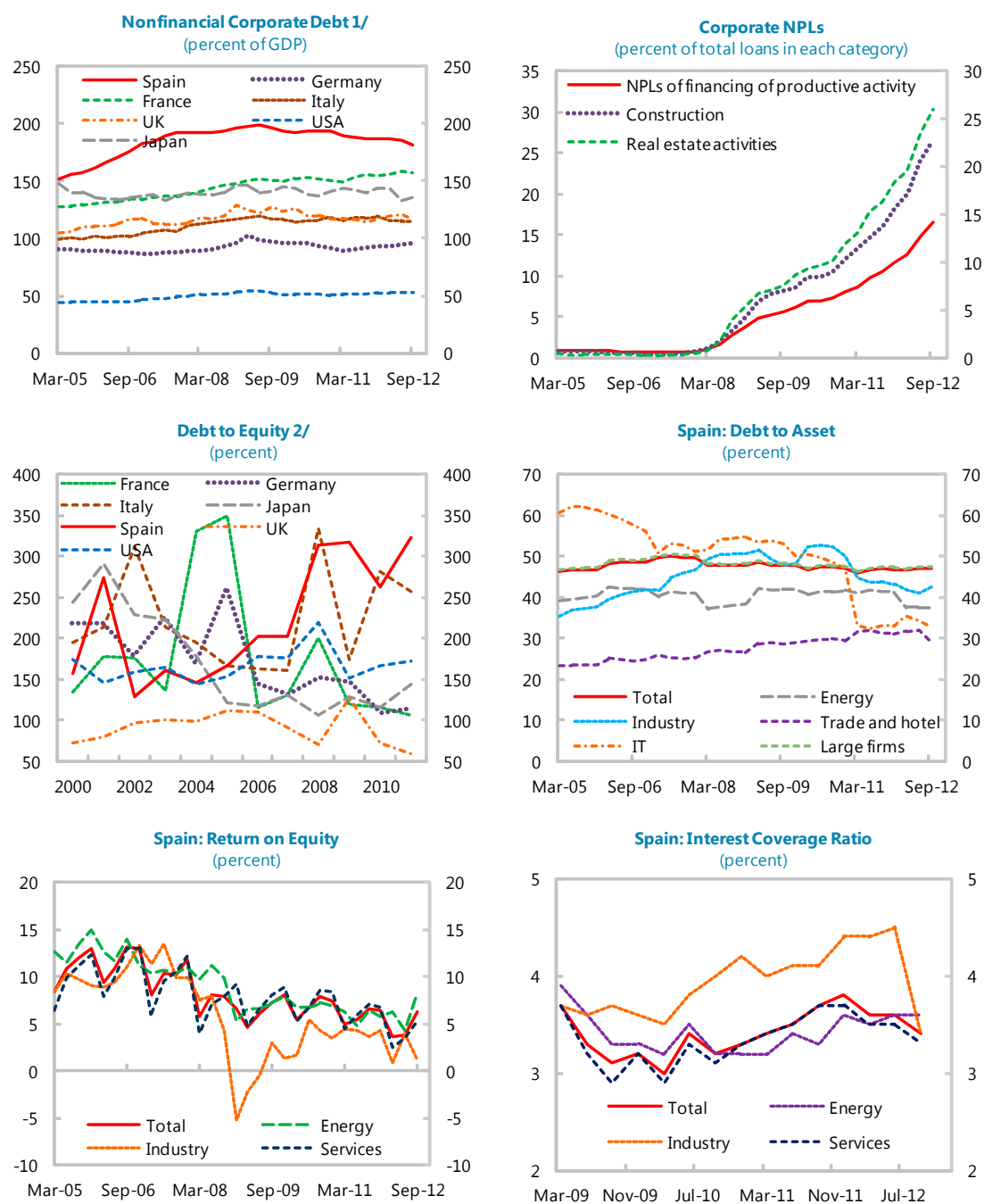
6/ Of which credit institutions, other resident sectors. Data are from supervisory returns. The ratio of lending to other resident sectors to overnight, saving, and agreed maturity deposits in both euro and foreign currency.

7/ Deposits from households and nonfinancial corporations.

**Figure 1. Spain: Household's Financial Positions**

Sources: BdE; ECB; Haver; and IMF staff calculations.



**Figure 2. Spain: Nonfinancial Corporate's Financial Positions**

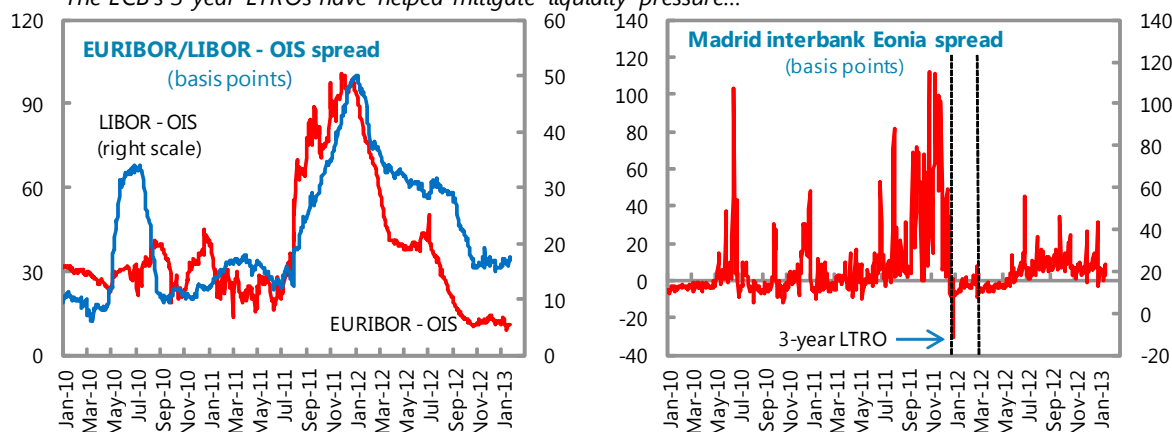
Sources: Bank of Spain; IMF's corporate vulnerability utility; and Haver.

1/ Includes trade credit.

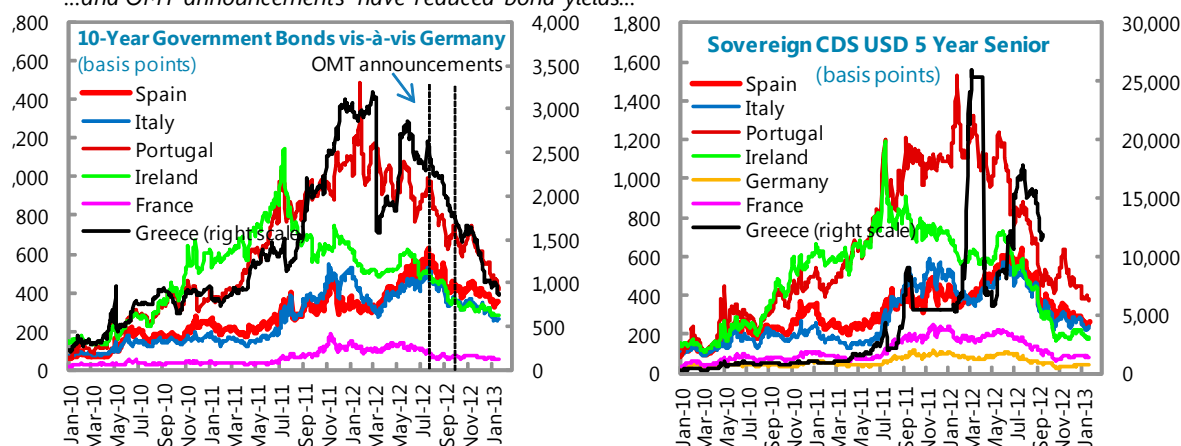
2/ Corporate debt-to-equity ratios are from IMF's corporate vulnerability utility, based on firms listed in Spain and market prices. The results may be affected by valuation changes.

**Figure 3. Spain: Financial Market Indicators**

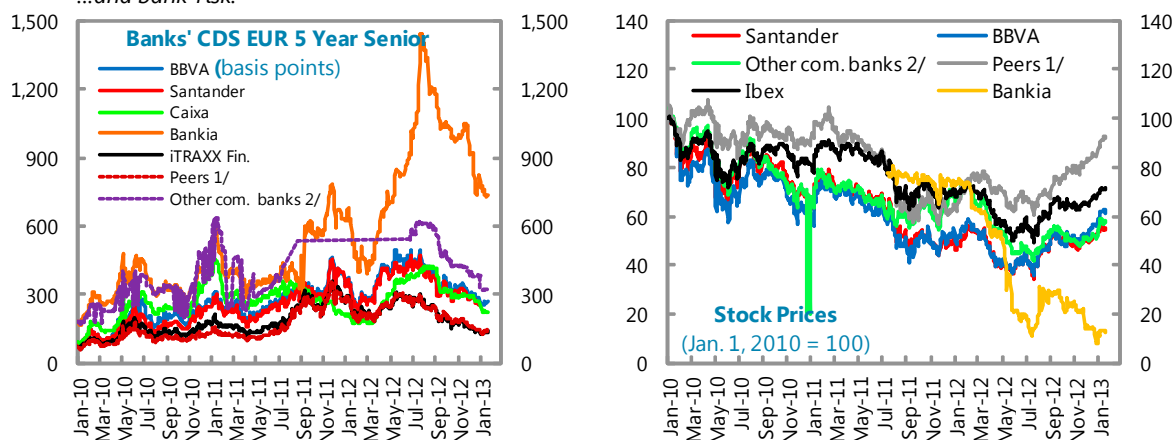
*The ECB's 3-year LTROs have helped mitigate liquidity pressure...*



*...and OMT announcements have reduced bond yields...*



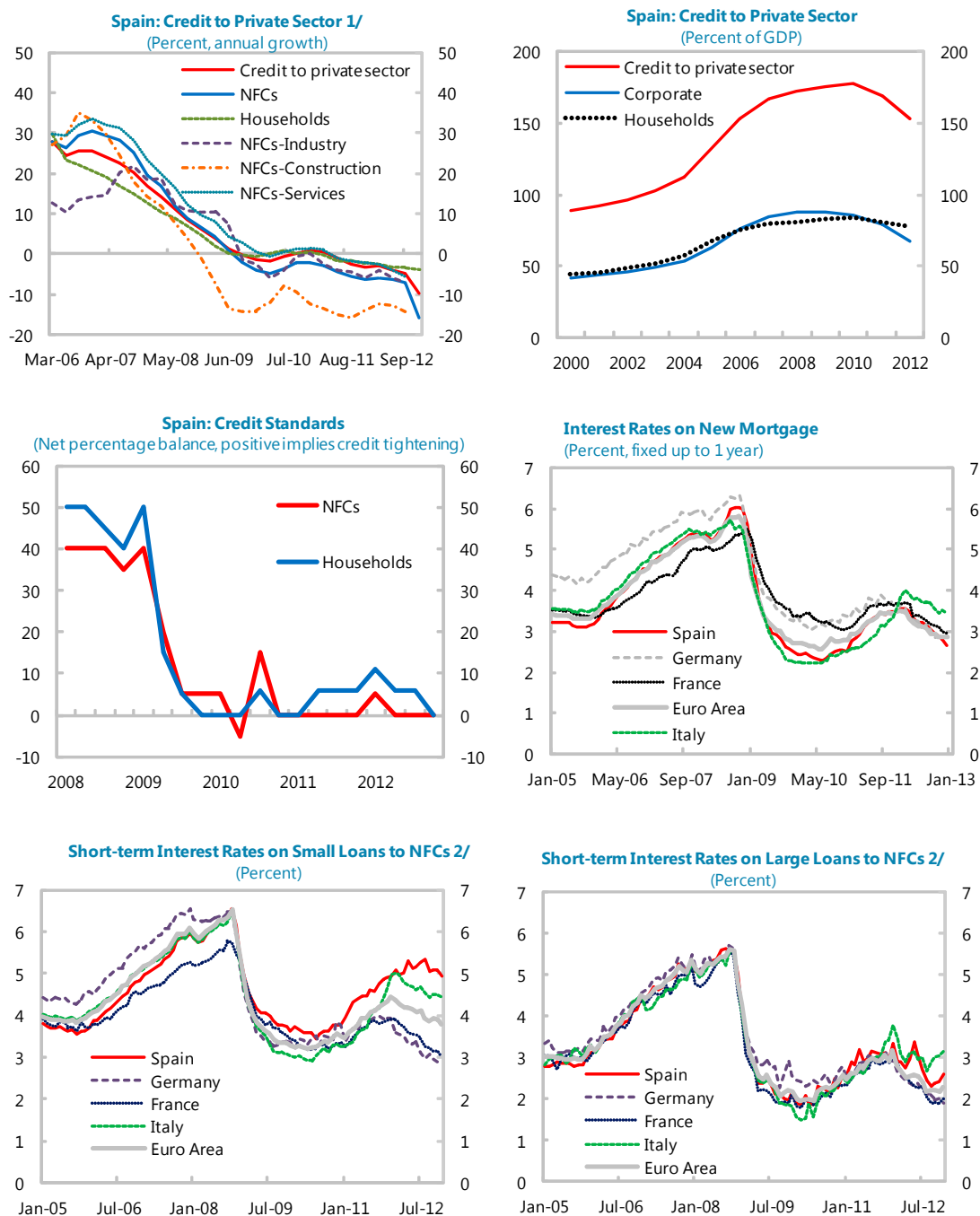
*...and bank risk.*



Sources: Bank of Spain; Bloomberg; and IMF staff estimates.

1/ Peers include Unicredit, Intesa-San Paolo, Commerzbank, Deutsche Bank, HSBC, Barclays, UBS, Credit Suisse, Societe Generale, BNP, and ING.

2/ Includes Banco Popular, Bankinter, Banco Sabadell, and Banco Pastor.

**Figure 4. Spain: Credit Conditions**

Sources: Bank of Spain; ECB; and IMF staff calculations.

1/ Banking system credit to the private sector. The sharp decline at end-2012 partly reflects the asset transfer to SAREB, which is not included as a bank.

2/ Interest rates on loans to new business up to 1-year maturity. Small loans are up to €1 million and large loans are above €1 million.

## ANNEX 1: BANKING SECTOR DEVELOPMENTS

The financial sector program is helping to stabilize Spain's banking system, with Group 1 and Group 2 banks now in the process of being cleaned and duly recapitalized. However, the weak economic environment continues to deteriorate banks' loan quality and domestic profitability. Access to funding has improved markedly, but liquidity is still reliant on Eurosystem support. In a context where such pressures are likely to continue well into 2013, it is of paramount importance for all banks to ensure adequate capital; swiftly provision for new credit risk; and further improve the efficiency of their operations.

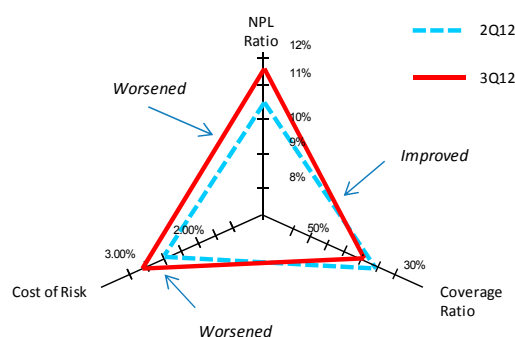
### Asset quality

**Credit quality continues to deteriorate.** The stock of nonperforming loans (NPLs) continued its relentless growth, reaching 11.4 percent of total loans in November, up from 10.5 percent in August.<sup>13</sup> The ratio of credit reserves to NPLs nonetheless improved due to exceptional provisioning, as banks moved to comply with two Royal Decree Laws requiring banks to undertake more conservative provisioning practices by end-2012. Different asset classes continue to show significantly different levels of stress (Box A1).

**A broader definition of distressed assets shows that a considerable portion of banks' assets are non-normal.** As of September 2012 (latest data), gross NPLs in the domestic loan portfolio ranged across banks from 4-24 percent of loans; substandard loans ranged from 0.3-13 percent. Together, these categories summed to 5-32 percent of banks' loans, indicating a wide dispersion of values between the strongest and weakest players, as well as a high average level of non-normal loans. On top of NPLs and substandard loans, repossessed assets added a further layer of 1-19 percent. These high levels of non-normal assets do not by themselves imply any hidden weakness in banks' balance sheets, as long as high levels of non-normal assets also entail high provisions. Non-normal asset rates for G1 and G2 banks will also fall significantly following the transfer of many of these assets to SAREB. Nonetheless, the system's high rate of non-normal assets suggests that households and businesses are experiencing widespread difficulties in servicing loans on time.

Asset Quality Deterioration in Spain:

3Q12 vs 2Q12



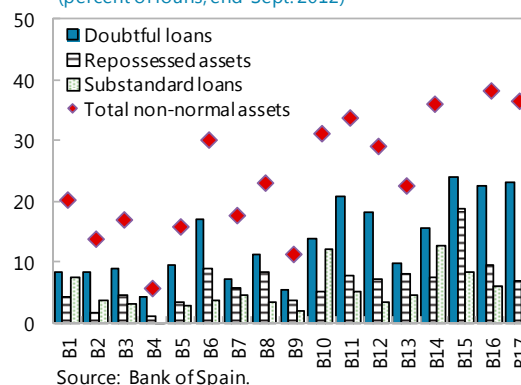
Source: IMF staff calculations on Banco de España data.

NPL Ratio: Nonperforming loans, as percent of loans.

Coverage Ratio: Credit reserves, as percent of nonperforming loans.

Cost of Risk: Provisions for loan losses, as percent of loans.

Spanish Banks: Non-normal Assets  
(percent of loans; end-Sept. 2012)



Source: Bank of Spain.

<sup>12</sup> A minority of the increase in the NPL ratio reflects recent reclassifications following the asset quality review undertaken under the financial sector reform program.

**Still, NPL ratios remain significantly below those assumed in the adverse scenario used in the September stress tests.** The 2014 NPL ratio implied in the default probabilities used in the adverse scenario is about 3.5 times today's ratio. For example, the NPL ratio on real estate development loans is 26 percent, compared with an 87 percent probability of default assumed in the adverse scenario. It is important to note, however, that the stress test's reported default probabilities do not include the repossession of foreclosed assets and write-offs.

#### **Box A1. What Accounts for Spain's Low NPL Ratio for Retail Mortgages?**

**The NPL ratio for retail mortgages in Spain remains low relative to the magnitude of house price declines and the scale of unemployment.** Indeed, at 3.7 percent at end-September, the NPL ratio for domestic residential mortgages is a mere one-third of the average NPL ratio for all loans.

**This resilience reflects a combination of several factors, including:**

- the full recourse nature of Spanish mortgages, which provides strong incentives for payment;
- relatively low loan-to-value ratios for mortgages in Spain;
- floating interest rates tied to European benchmarks, which have helped keep mortgage payments contained (Figure 1); and
- significant action to modify loans and foreclose on them (which, as long as loans are sufficiently provisioned for, do not per se indicate any hidden weakness in banks' balance sheets, but rather proactive asset quality management); for example, the stock of repossessed residential houses is now about three-fourths the size of the stock of mortgage NPLs; in addition, the stock of substandard mortgage loans—mostly loans whose debtors encounter payment difficulties and whose terms have therefore been modified—is substantial, although this stock varies significantly from bank to bank.

**Credit deterioration is likely to continue for some time.** The baseline projection that growth will remain weak through 2014 and the time lag between macroeconomic developments and their effect on credit quality imply that NPLs may continue rising for some time, with further adjustment of real estate prices being a key contributor. If macro variables remain negative, credit deterioration will spread towards other loan classes, including SMEs. NPL ratios for state-aided banks will, however, be rebased, reflecting their transfer of nonperforming assets to SAREB.



**Banks under restructuring will benefit from cost savings and the transfer of assets to SAREB.** The restructuring plans for Group 1-2 banks should improve the banking system's efficiency, which has suffered from chronic overbranching and whose operating structures have to adapt to lower business volumes (both for deleveraging and the transfer of assets to SAREB). In addition, the transfer to SAREB of a significant part of problematic assets will give more breathing space to future credit provisions, plus profitability will benefit from a high coupon on SAREB's government-guaranteed bonds received in exchange for the transferred assets.

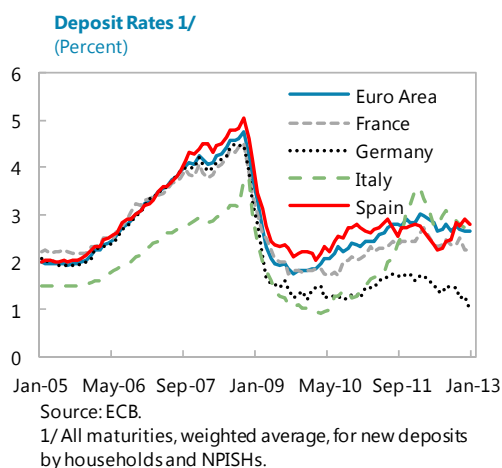
### ***Capital buffers***

**Capital is being significantly strengthened by equity injections into Group 1 and Group 2 banks.** Following the transfer of real-estate related assets and loans to SAREB, Group 1-2 banks will have received a total of €38.8 billion in capital in the form of government-guaranteed ESM bonds. Together with other capital-enhancing measures (text table on p. 13), this will significantly improve their capital positions.

**Banks should continue to maintain adequate capital buffers.** One bank successfully raised €2.5 billion from private investors (a good part of them retail), as one of the measures for closing its capital shortfall and thereby avoiding the issuance of cocos, and another one generated capital by listing a subsidiary abroad. Given prospective negative or very low profitability, earnings retention capacity will likely remain constrained for 2013, highlighting the need for Spanish banks to continue efforts to maintain adequate capital buffers, including by issuing equity and exercising restraint on dividends and remuneration, with supervisors encouraging (and, if necessary, requiring) actions in this direction, given continued heightened uncertainty.

### ***Liquidity and funding***

**Liquidity risk has improved markedly.** Taking advantage of lower market spreads, Spanish banks belonging to Group 0 issued a total of €7 billion in senior unsecured and covered bonds during the month of January 2013. Also, pressure on customer deposits eased in the last quarter of 2012. Spanish banks reported a positive inflow of deposits from domestic households and corporations, probably also reflecting improved customer confidence. However, despite credit contraction, the loan-to-deposit ratio remains high, indicating continuing liquidity risks for banks. Banks' domestic issuance of senior unsecured debt remains negligible.

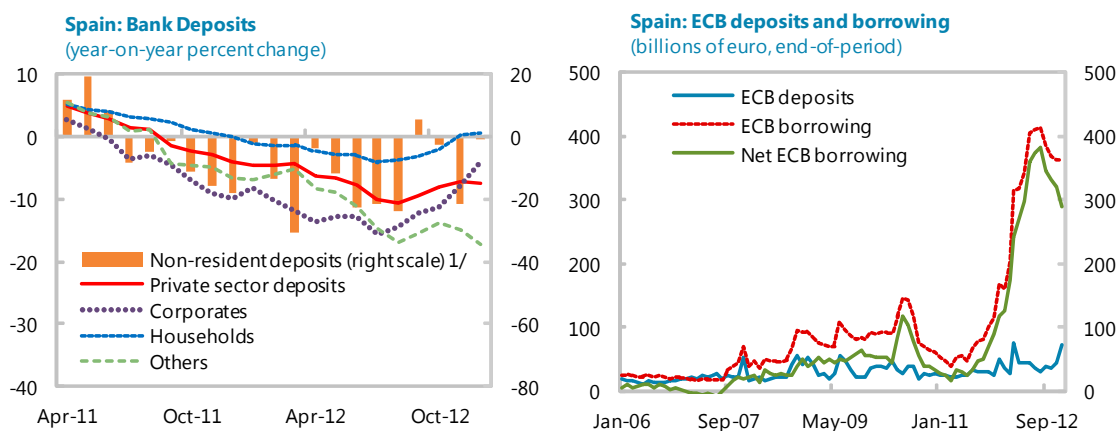


**Spain: Change in Spanish Deposits, 2012**  
(month-on-month change, billions of euro)

	Jul	Aug	Sep	Oct	Nov	Dec
Change in Spanish Deposits						
Domestic deposits from private sector	-66	-14	14	-2	10	7
Households	-10	-3	1	3	11	10
Corporate	-15	3	2	-6	6	9
Securitization companies and funds	-40	-15	11	1	-6	-12
Non-resident deposits	-22	-24	5	-3	-21	-1
Non-resident MFIs	-5	-20	3	3	-22	3

Source: Banco de Espana.

**Banks' reliance on ECB liquidity has fallen in recent months, but remains high.** Better market financing conditions allowed banks to reduce their reliance on ECB financing by €55 billion over the last four months. In addition, part of the LTRO funding has been reimbursed. Nonetheless, the stock of ECB financing remains large at €358 billion, or 10 percent of total banking sector assets, at end-November 2012. Unencumbered assets eligible as collateral for obtaining ECB financing are adequate for the system as a whole, and improved thanks to the eligibility of SAREB and ESM bonds that Group 1-2 banks received in the restructuring process. Collateral availability remains vulnerable to ratings downgrades and adverse price developments.



Source: Banco de Espana.

1/ Month-on-month change in billions of euro.



## ANNEX 2: IMF STAFF VIEWS ON THE STATUS OF MoU CONDITIONALITY

Measure		Deadline included in the July 20 MoU	Current status	Comments
1.	Provide data needed for monitoring the entire banking sector and of banks of specific interest due to their systemic nature or condition.	Regularly throughout the program, starting end-July 2012	Major improvements implemented in late January 2013 are in the process of being tested	With the recent improvements, the substance of the data provided now seems in line with MoU requirements, but the access process still needs improvement
2.	Prepare restructuring or resolution plans with the EC for Group 1 banks, to be finalized in light of the Stress Tests results in time to allow their approval by the EC in November.	July—mid-August 2012	Implemented	Plans adopted on November 28, 2012
3.	Finalize the proposal for enhancement and harmonization of disclosure requirements for all credit institutions on key areas of the portfolios, such as restructured and refinanced loans and sectoral 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 to allow for mandatory SLEs.	End-August 2012	Implemented	RDL 24/2012

Measure		Deadline included in the July 20 MoU	Current status	Comments
6.	Upgrade of the bank resolution framework, i.e. strengthen the resolution powers of the FROB and DGF.	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.	Finalize a regulatory proposal on enhancing transparency of banks	End-September 2012	Implemented	BdE circular 6/2012
10.	Banks with significant capital shortfalls will conduct SLEs.	before capital injections in Oct./Dec. 2012	In progress	
11.	Banks to draw up recapitalization 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	A report has been submitted and the authorities have formally complied with the MOU. However, further clarity would be warranted, and BdE regulatory powers could be possibly expanded.

Measure		Deadline included in the July 20 MoU	Current status	Comments
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	An implementation plan with specific timelines for adopting the recommendations in the report (consistent with preparatory work for the SSM) would be useful.
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	Draft legislation has been submitted; some enhancement to it would be advisable. Prompt enactment and forceful implementation will be key.

Measure		Deadline included in the July 20 MoU	Current status	Comments
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	Draft legislation has been submitted; some enhancement to it would be advisable (see discussion on savings bank reform in the main text). Prompt enactment and forceful implementation will be key to the success of the law.
21.	Banks to provide standardized 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	In progress	A reporting template is being 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	Implemented	A document has been submitted, discussions are ongoing

Measure		Deadline included in the July 20 MoU	Current status	Comments
23.	Issues CoCos under the recapitalization scheme for Group 3 banks planning a significant (more than 2% of RWA) equity raise.	End-December 2012	Not relevant	Group 3 banks recapitalized 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 The possibility to further expand BdE supervisory powers should be considered.
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 percent 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 FROB.	1 January 2013	Implemented	RDL 24/23012

Measure		Deadline included in the July 20 MoU	Current status	Comments
28.	Review the issues of credit concentration and related party transactions.	Mid-January 2013	In progress	Authorities submitted by mid-January 2013 a report on credit concentration and related party transactions in Spain
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 recapitalized without State aid
32	Group 3 banks with CoCos to present restructuring plans.	End-June 2013	Not relevant	Group 3 banks recapitalized without State aid