ISSN 1725-3209

EUROPEAN ECONOMY

Occasional Papers 155 | July 2013

Financial assistance programme for the recapitalisation of financial institutions in Spain. Third review of the programme – Summer 2013

Economic and Financial Affairs

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KC-AH-13-155-EN-N
ISBN 978-92-79-29361-0
doi: 10.2765/48934

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European Commission
Directorate-General for Economic and Financial Affairs

Financial Assistance Programme for the Recapitalisation of Financial Institutions in Spain.

Third Review of the Programme – Summer 2013

EUROPEAN ECONOMY Occasional Papers 155

Acknowledgements

The report was prepared in the Directorate General for Economic and Financial Affairs under the direction of Servaas Deroose, Deputy Director General and Mission Chief to Spain.

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ABBREVIATIONS

ALMP	Active Labour Market Policies
AMC	Asset Management Company
BdE	Banco de España (Bank of Spain)
BMN	Banco Mare Nostrum
CDS	Credit Default Swap
CEO	Chief Executive Officer
CNMV	Comisión Nacional del Mercado de Valores (National Securities Market Commission)
CoCos	Contingent Convertible Securities
CRR	Capital Requirements Regulation
CSRs	Country-Specific Recommendations
DGS	Deposit Guarantee Scheme
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
EDP	Excessive Deficit Procedure
EMU	European Monetary Union
ESM	European Stability Mechanism
FCPs	Funding and Capital Plans
FGD	Fondo de Garantía de Depósitos de Entidades de Crédito (Deposit Guarantee Fund)
FROB	Fondo de Reestructuración Ordenada Bancaria (Fund for Orderly Bank Restructuring)
GDP	Gross Domestic Product
ICO	Instituto de Crédito Oficial
IMF	International Monetary Fund
LOMCE	Ley Orgánica para la Mejora de la Calidad Educativa (Law on quality of education)
LTRO	Long-Term Refinancing Operation
MFIs	Monetary Financial Institutions
MIP	Macroeconomic Imbalances Procedure
MoU	Memorandum of Understanding
NFC	Non-Financial Corporate
NRP	National Reform Program
OW	Oliver Wyman
pps	percentage points
RDL	Real Decreto-ley (Royal Decree Law)
RED	Real-Estate Developers
RWA	Risk Weighted Assets
Sareb	Sociedad de gestión de activos procedentes de la reestructuración bancaria
SLEs	Subordinated Liability Exercises
SME	Small and Medium Enterprise
ULC	Unit Labour Cost
VAT	Value Added Tax

EXECUTIVE SUMMARY

This Third Review report provides an assessment of the progress made by Spain with respect to its Financial Assistance Programme for the Recapitalisation of Financial Institutions, based on the findings of a joint European Commission (EC)/European Central Bank[1] (ECB) mission to Madrid during 21 – 31 May 2013. On the basis of this review it can be concluded that the programme remains on track, despite significant macroeconomic challenges, and the policy conditionality has been further advanced in both its dimensions - bank-specific and horizontal. At the same time, the positive trends in the stabilisation of the Spanish financial sector need to be maintained and the close monitoring thereof should continue. The completion of the burden sharing measures and the continuous monitoring of the evolution of asset quality and of the solvency situation of Spanish banks are particularly important at this stage of the programme.

1. **Spanish financial markets have further stabilised since the last review, with sovereign and corporate bond yields dropping amidst lower volatility, despite a very recent uptick.** In parallel, the liquidity situation of the Spanish banking sector has further improved and a steady reduction on Eurosystem financing has been observed. Stronger banks have improved access to capital markets, while state-aided banks managed to access interbank funding thanks to their holdings of ESM bonds. Bank deleveraging also contributed to this improvement as it resulted in a reduction of the liquidity needs for all banks.

2. **The solvency position of Spanish banks has been bolstered after the recapitalisation of parts of the banking sector and the transfer of assets to Sareb**[2], and solvency rates are now above the regulatory requirements[3], but do not always comply with the higher minimum requirements set in the MoU. The latter will be achieved by July, once the burden sharing measures are finalised. The process of bank restructuring is well underway for the banks having received State aid. The required burden-sharing exercises with banks´ shareholders and junior bond holders have made further progress. The decline in lending to the private sector accelerated in recent months largely on account of a lack of solvent demand and affects primarily real estate and construction sectors, but also non-financial corporates (NFCs). The decline is broad-based in terms of sector and company size. However, there is still a significant amount of new lending flowing into the economy targeting less indebted and more profitable companies, in line with the structural adjustment taking place in the real economy.

3. **Further important steps have been taken since the last review in separating impaired assets from banks**, as the foreseen transfers of assets to Sareb have now been completed and Sareb has commenced operations. After the successful start of operations, Sareb now faces the major challenge of implementing its business plan, i.e. successfully managing and eventually divesting the portfolio of assets against the backdrop of the still very difficult market conditions for the Spanish real estate.

4. **Ensuring bank profitability in a difficult economic environment represents a major challenge given the low interest rate environment and the increasing level of**

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[1] The mission also involved expert teams from the European Stability Mechanism and the European Banking Authority. The International Monetary Fund participated in the meetings as part of its independent monitoring.

[2] Sociedad de gestión de activos procedentes de la reestructuración bancaria, http://www.sareb.es

[3] of the Capital Requirements Directive (CRD) III.

non-performing loans. Banks have posted some profits in the first quarter of 2013 after a dismal performance in 2012, while a significant part was related to carry-trade, exceptional gains, commissions and assets sales. The resilience of the banks in the current adverse economic situation depends essentially on their capacity to generate pre-provisioning profits that can off-set a further deterioration in asset quality and deal with the effects of regulatory changes such as the recent welcomed requirement for better classification of restructured/refinanced loans. This is not easy as interest rate margins are squeezed by the low interest environment and the sharp competition for viable clients, in combination with a recent Supreme Court decision removing not clearly specified interest rate floors on retail mortgage contracts. A prolongation of the negative trends in unemployment, real incomes and solvency of companies beyond current expectations will heighten risks particularly for weaker banks. On the other hand, a return to improved profitability would consolidate solvency ratios to levels that allow banks to cover the risk of lending to the real economy, thus addressing potential weaknesses on the supply-side of the credit market. In this context, the on-going monitoring and diagnostics of the evolution of asset quality and the solvency situation of Spanish banks remain key elements in bolstering investor sentiment and the lending capacity of the banks.

5. Progress continued with respect to horizontal financial-sector conditionality. Thereby, compliance with the requirements in the Memorandum of Understanding (MoU) is nearly complete and achievements toward strengthening the governance, regulatory and supervisory framework of the Spanish banking sector have been made. Implementation efforts need to continue, including in the areas of the reform of the governance of the savings banks and changing supervisory procedures at Banco de España (BdE). Against the background of the on-going contraction in lending, progress with the implementation of measures to strengthen non-bank financial intermediation is welcome, including among other simplified access on capital markets for small and medium enterprises (SMEs), additional significant amounts of cheaper funds that the Instituto de Crédito Oficial (ICO)[4] could provide to banks for SME lending, increased venture capital by co-investment funds and business angels and the set-up of a national business incubator system.

6. Notwithstanding these positive trends, the stability of the Spanish financial sector may still be impaired by recent regional legal initiatives related to the housing market or uncertainty about the burden sharing and arbitration processes. The Spanish government has engaged in reconciling the legitimate concerns of mortgage debtors with imperative financial-stability concerns by providing temporary relief for some vulnerable households and pursuing the structural approach of improving the judicial process of evictions and creating better incentives for continued debt service. However, it has to be ensured that other initiatives, including those at regional level, equally preserve financial stability and the viability of the Spanish housing market, thereby honouring the commitments under the MoU. It is also essential that burden-sharing measures are completed and finalised as scheduled. In this context, the outcomes of the arbitration processes against the alleged mis-selling practices could represent an additional financial burden for the banks.

7. The economic and budgetary situation remains challenging. While the correction of external and internal imbalances proceeds, risks remain amid high unemployment, contracting activity, still large private domestic and external debt and fast rising public debt. In its proposals for the 2013 country-specific recommendations and for a revised path for the correction of the excessive budget deficit, the Commission emphasised the need for

[4] http://www.ico.es

further, albeit more gradual consolidation of public finances in the years ahead and accelerating the completion of structural reforms of, *inter alia*, product and labour markets, taxation, public administration and the energy sector.

8. There is at present no reason to foresee further programme disbursements. Two disbursements were made so far in a total amount of about EUR 41.3 billion for the recapitalisation of State aided banks and the capital injection into Sareb. The rest of the Spanish banks either were not diagnosed with a capital shortfall in the stress test or were able to cover it by private means.

1 INTRODUCTION

9. This report assesses Spain's compliance with the conditionality of the Financial Assistance Programme. A delegation from the European Commission (EC), in liaison with the European Central Bank (ECB), the European Stability Mechanism (ESM) and the European Banking Authority (EBA), completed the third review of the financial sector assistance programme for Spain from 21 to 31 May 2013. The International Monetary Fund (IMF) also participated in the review, fulfilling its role as an independent monitor.

10. The Programme, which was agreed by the Eurogroup on 9 July 2012 and covers a period of 18 months[5], entails an external financing by the euro area Member States of up to EUR 100 billion. On 3 December 2012, the Eurogroup made the first review on the progress of the Programme[6] and welcomed the decision by the European Stability Mechanism (ESM) to authorise the disbursement of the first tranche of up to EUR 39.5 billion. Spain has used close to EUR 37 billion for the recapitalisation of Group 1 banks, for which the EC had adopted restructuring and resolution plans on 28 November 2012, and around EUR 2.5 billion for capitalising Sareb. On 21 January 2013, the Eurogroup endorsed and on 28 January 2013 the ESM approved the second disbursement under the programme[7] of about EUR 1.9 billion for the recapitalisation of Group 2 banks, for which the EC had adopted restructuring plans on 20 December 2012. The total amount of funds disbursed under the Programme reached about EUR 41.3 billion.

11. The Memorandum of Understanding provides for bank-specific conditionality, in line with State aid rules, as well as horizontal conditionality. Since the last review, further progress has been made and the vast majority of the conditionality has been implemented. Thus, the programme continues to be on track. The review report assesses conditions with a deadline prior to end-May 2013, including those which were met or those toward which there was substantial progress ahead of their deadline.

12. Bank-specific conditionality has been implemented. The remaining challenges relate to the implementation of Sareb's business plan in terms of meeting its asset divestiture and profitability targets, the implementation of the banks' restructuring plans and the finalisation of their on-going SLE exercises:

- First, a comprehensive, independent diagnostic as regards the capital needs of individual banks, based on a robust asset quality review and valuation process, and bank-by-bank stress tests was performed. The assumptions under which the bank stress test was conducted remain in general valid, as revealed also by the recent back-testing performed by the BdE.
- Second, an external Asset Management Company (AMC) called Sareb was set up and became operational. The segregation of impaired assets from the balance sheet of banks receiving public support and their transfer to Sareb was achieved from both Group 1 (end-December 2012) and Group 2 (February 2013) banks. The business plan of Sareb has been approved by its Board and thus became fully operational. The main focus of the business plan is to divest the assets transferred by the state-aided banks within a period

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

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

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

of 15 years, ensure sufficient liquidity and enhance the recovery value of Sareb's assets over time so that profitability targets are met.

- Third, the restructuring and resolution plans of the banks with a capital shortfall identified in the stress test and unable to cover it fully by private means were adopted. The recapitalisation of viable banks is completed with the approval by the EC of the modified restructuring plan for Banco CEISS . The restructuring of the State-aided banks needs to be fully implemented now, including by finalizing the subordinated liability exercises in order to minimize the taxpayer's burden. Close monitoring by the BdE of the effectiveness of recent mergers and acquisitions will also be important to ensure that the full benefits of these actions are realised.

13. The horizontal conditionality applies to the entire banking sector, unlike bank-specific conditions, and the vast majority of it was already implemented, in particular as the horizontal conditionality was frontloaded. The horizontal programme includes measures aimed, inter alia, at strengthening the regulatory, supervisory and bank resolution frameworks, enhancing the governance structure of savings banks and of commercial banks controlled by them, improving consumer protection legislation as regards the sale by banks of hybrid capital and subordinated debt instruments.

14. In a limited number of areas, the proposals presented by the authorities, although in compliance with the MoU, still need to be further discussed with the international partners and the recommendations need to be fully implemented. These areas include the reform of the governance of the savings banks that provides incentives for former savings banks to gradually divest their controlling stakes in commercial banks, a review and reform of supervisory procedures at the BdE (taking into consideration also the nascent Single Supervisory Mechanism), reforms of the regulatory frameworks governing banks' credit concentration and provisioning, the measures to strengthen non-bank financial intermediation and the preparation and implementation of the banks' strategies to deal with impaired assets.

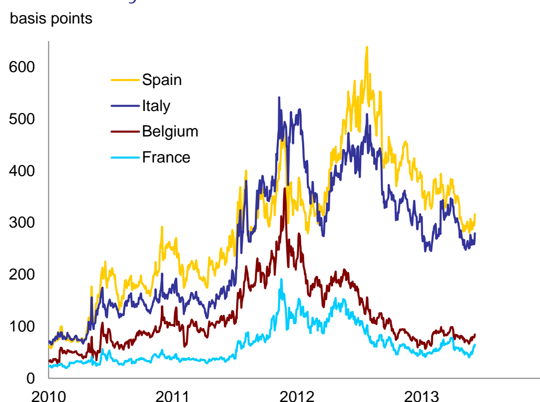
2 RECENT FINANCIAL, MACROECONOMIC AND FISCAL DEVELOPMENTS

2.1 FINANCIAL SECTOR DEVELOPMENTS

15. Since the last review, wholesale market funding conditions have further improved despite some volatility, in particular around the Cyprus crisis and the Italian elections. The positive evolution of Spanish sovereign yields and capital markets occurred against a general recovery of investor confidence in European financial markets. Risk premia have decreased significantly, allowing a decline in Spanish government bond yields as purchases by the private foreign sector have consolidated. 10-year government bond spreads declined below 300 points for a while, but broke again above this threshold recently. Liquidity constraints on the banking sector have also subsided in parallel with the satisfactory implementation of the recapitalisation and restructuring plans. The stock exchange indices also reflected the improved financing conditions and investor sentiment (see Graphs 1 and 2).

16. The measures and political initiatives meant to restore market confidence in the irreversibility of the euro and deepen the European Monetary Union (EMU) helped stabilize the Spanish financial markets, but the overall fragmented European financial markets still pose a challenge. The easing of financial tensions around the euro was very much related to the ECB's enhancement of its unconventional measures to restore the monetary policy transmission mechanism and to the political impetus in moving towards a European Banking Union. The set-up of the European Stability Mechanism last year and the agreement on a Single Supervisory Mechanism are two important pillars in deepening the EMU and breaking the link between the financial sector and sovereign risk. Further steps towards the banking union are necessary to overcome the still fragmented European inter-bank and financial markets that hinder financial flows to some Member States.

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



Source: IHS Global Insight and own calculations

Graph 2: IBEX 35

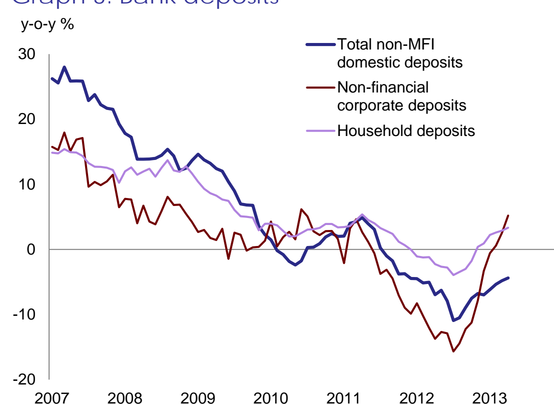
Source: IHS Global Insight

17. The Spanish financial sector and financial markets in general remain vulnerable also on account of domestic factors such as sector inherent weaknesses and the risk of a potential feedback loop from the real economy. As highlighted by the European Commission in the analysis carried out under the Macroeconomic Imbalances Procedure released in April, the levels of domestic and external debt are still high. The cleaning up of the banks' balance sheets has significantly advanced and the banks' exposure to the construction and real estate development (RED) sectors declined considerably with the

built-up of provisions, transfer of assets to Sareb and recapitalisation of Group 1 and 2 banks, but the restructuring process of the latter will still last for several years. Bank profitability is under pressure as the amount of NPLs continues to rise in the recessionary economic conditions which in turn feed into the on-going deleveraging and contraction in credit to the private sector. Therefore, uncertainty as regards both the evolution of the real economy – unemployment, real incomes and solvency of companies, and its potential impact on the financial sector remains high.

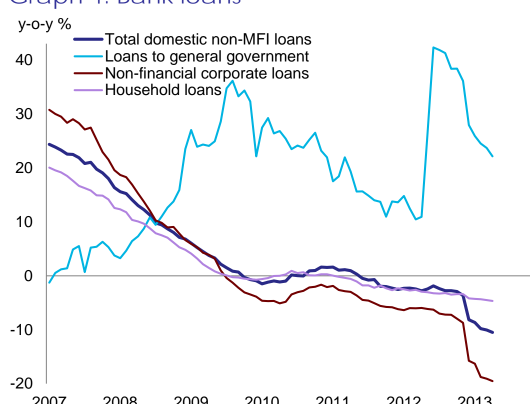
18. Financing conditions for the banking sector improved further in the first months of 2013, both in terms of deposits and debt securities issued. A certain recovery in the level of the inter-bank activity with other Monetary Financial Institutions (MFIs) from the Euro Area was also recorded, despite the continuing fragmentation of the market. The fall in resident retail and corporate deposits that peaked in mid-2012 was reversed and they rose by more than 3% and 5% y-o-y respectively as of April 2013 (see Graph 3). Furthermore, the significant outflow of non-resident deposits of about EUR 156 billion during 2012 turned into a hefty inflow of more than EUR 40 billion in the first four months of 2013. The inflow of non-resident deposits was driven by deposits from other Euro Area countries and in particular from other Euro Area MFIs, pointing to a certain recovery of the access to inter-bank funding. The issuance of debt securities by banks also improved (see next paragraph). As a result, the reliance on net borrowing from the Eurosystem further declined to EUR 255 billion in May 2013 from a record EUR 400 billion in mid-August 2012. The significant amount of about EUR 40 billion with which the two largest Spanish banks participated in the early repayment of the Long-Term Refinancing Operation (LTRO) in late January 2013 reinforced this trend.

Graph 3: Bank deposits



Source: BdE

Graph 4: Bank loans[8]



Source: BdE

19. The issuance of bank debt on wholesale markets advanced further in the first months of 2013, as Spanish banks took advantage of the stabilisation of financial market conditions. The issuance of unsecured and covered bonds by credit institutions continued not only for the larger banks with international presence, but also for those of Group 0 more focused on Spain. From January to April 2013, the Spanish financial institutions issued around EUR 15 billion[9] of debt, half of which was in the form of senior unsecured debt (see Table 1). Some non-financial corporates have also returned to the market and issued around EUR 4 billion of bonds during January - April 2013, sometimes at a lower price than the sovereign debt. The improvement in market access was manifest

[8] The significant decline in loans in December and February partially reflects the accounting effect of the extraordinary transfer of assets to Sareb from Group 1 banks and Group 2 banks, respectively.

[9] It does not include issuances by the ICO.

less in terms of issued volumes, but rather in terms of reduced rates of borrowing. Banks consolidated their presence on capital markets, but chose not to push up significantly the borrowed amounts as their financing needs are largely covered by the increase in deposits and access to cheaper funding from the ECB. In parallel, the contraction in lending is reducing the overall need for financing.

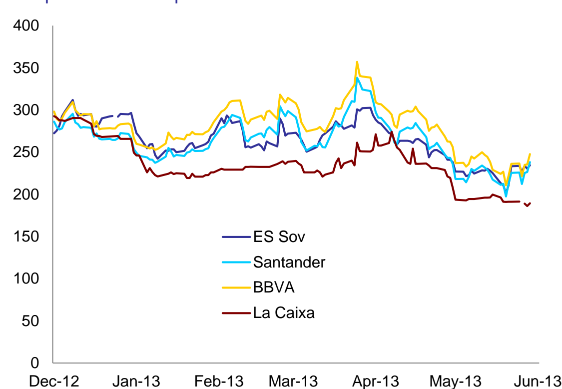
Table 1: Issuances, January - April 2013

ISSUER	AMOUNT (million)	SPREAD	TYPE
BBVA	1 500	295	Unsecured
Banco Popular	750	364	Unsecured
Caixabank	1 000	285	Unsecured
Bankinter	500	220	Covered
Banco Sabadell	1 000	250	Unsecured
Banco Popular	500	270	Covered
Santander	1 000	275	Notes
BBVA	1 000	215	Covered
Kutxabank	750	220	Covered
Santander	2 000	195	Covered
Bankinter	500	220	Covered
BBVA	1 500	273	Unsecured
Caixabank	1 000	210	Covered
Caixabank	250	nd	Unsecured
Bankinter	500	172	Covered
Banco Popular	100	270	Covered
Caixabank	1 000	245	Unsecured
Total	**14 850**		

Source: BdE and ECFIN calculations

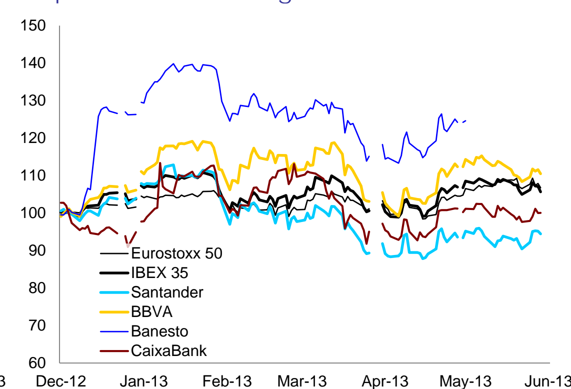
20. The share prices of the Spanish banks displayed an upward trend mainly in the first quarter of 2013 followed by some volatility afterwards, while their risk premia remained in a relatively low territory. In line with sovereign exposures, credit default swap (CDS) spreads for banks have declined over the last months showing a better market sentiment on banks' risks. Stock prices have also improved for several banks. The price-to-book values of some Group 0 Spanish banks have improved since the beginning of the banking programme and are now comparable to the values of their European peers, reflecting the positive investor sentiment (see Graphs 5 and 6).

Graph 5: CDS spreads



Source: Bloomberg, own calculations

Graph 6: Stock exchange indices



Source: Bloomberg, own calculations

21. Bank lending continues to trend downward despite improved access to liquidity and the cleaning up of bank balance sheets. The contraction in credit is broad-based and affects all economic sectors. As of April 2013, total non-MFI domestic credit shrunk by about 8% year-on-year being driven by the decline in the stock of credit to the private sector of almost 12% year-on-year. At the same time, the increase in total credit to the government decelerated to around 14% year-on-year, of which bank loans to the government were still rising at about 24% year-on-year. Domestic lending to non-financial corporations (NFCs) and households fell by 19.5% and 4.5% year-on-year, respectively (see Graph 4). A significant portion of the decline seen in the data is related to the transfer of assets to Sareb in December 2012 and February 2013[10]. If the accounting effect of the transfer of assets to Sareb is left out, the annual reduction in the stock of credit was much lower at about 8% for the total non-MFI private domestic sector and 10.5% for NFCs. As regards the corporate sector, the decline in financing is less severe if the better performance in terms of issuance of securities and access to external loans is taken into consideration. By including these two additional items in the analysis, total financing of NFCs was only about 8% lower than a year before as of March 2013. On one hand, based on some surveys[11], the SME sector seems to be more affected than larger companies by the contraction in lending. On the other hand, data provided by the BdE shows that the reduction in credit is quite dispersed among various sizes of firms[12], with some signals, but no clear pattern of a much more severe decline in lending for SMEs.

22. The acceleration in the decline of bank lending is related to both supply and demand factors which are difficult to disentangle in the current recessionary environment. The most recent Bank Lending Survey released by the BdE[13] shows that the net share of banks that have tightened credit standards for approving loans started to increase again in the last quarter of 2012 and first quarter of 2013, although by a modest margin. In addition, the terms and conditions for new loans have been tightened with a majority of banks reporting increasing loan margins. It seems therefore that despite the improved access to funding by Spanish banks, the provision of credit is still constrained by the banks' efforts to build prudent capital ratios and reinforce profitability by preserving interest rate margins. At the same time, a large and increasing majority of banks resident in Spain report a decline in the demand for loans, both from large enterprises and SMEs, largely driven by the decline in financing needs for fixed investment, working capital and mergers and acquisitions. Therefore, lending appears to be reflecting the rebalancing of the economy and the uncertainty surrounding the fragile economic environment, that hamper long term investments in physical capital and the need for working capital, thus reducing solvent demand for credit in the corporate sector.

23. The contraction in credit is also due to the adoption of more prudent lending policies in the recessionary environment, as the credit worthiness of borrowers is dented by the increasing share of NPLs. As reported by the BdE based on Central Credit Register data, the acceptance rate for credit applications from NFCs fell from about 45% in 2006 to levels of around 30% during the crisis. This decline occurred for all sectors of activity and affected more the Group 1 banks. The fall in the acceptance rates could reflect both a tightening of the supply of credit by financial institutions (suggested by the higher

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[10] Therefore, this data is not an accurate reflection of the reduction in the flow of credit to Spanish households and firms, due to the accounting effect of the transactions related to Sareb and the recapitalisation of the Group 1 and Group 2 institutions worth about EUR 76 billion.

[11] Such as the Survey on the Access to Finance of SMEs in the Euro Area by the ECB at http://www.ecb.int/stats/money/surveys/sme/html/index.en.html.

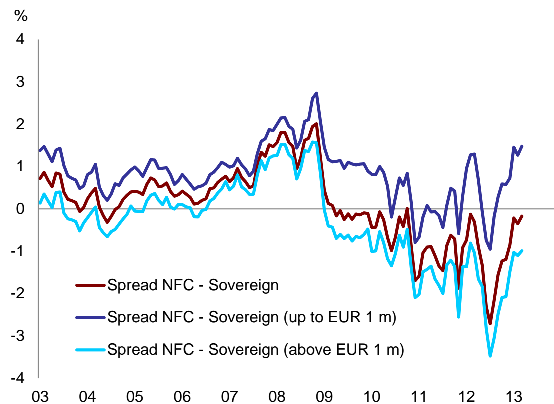
[12] The BdE approximates the firm size by the amount of debt recorded in the Central Credit Register; see the Financial Stability Report, May 2013 (page 27)

[13] See the report at http://www.bde.es/webbde/en/estadis/infoest/epb.html.

contribution of Group 1 banks) and a decline in the quality of the demand for credit. The latter is illustrated by the rising share of NPLs impacting particularly strong the corporate sector and especially the smaller firms, which are the least reliable debtors (see Paragraph 28). Thus, it is not surprising that banks are becoming more prudent when lending to the SME sector, which displays a higher credit risk on average.

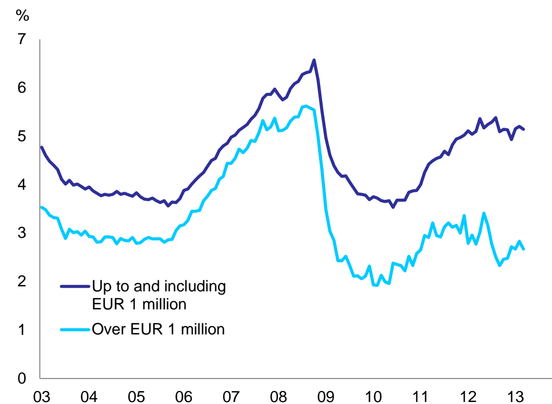
24. Notwithstanding the credit contraction, the increase in lending for companies with the same or increased bank debt in 2012 with respect to 2011 amounts to 6% of GDP[14], reflecting the reallocation of credit towards the viable part of the economy. The percentage of firms with growing or stable bank lending was found to be at around 35-40% for most economic sectors, and somewhat higher for large firms. Companies which were able to maintain or increase bank lending displayed higher profitability, lower indebtedness and a more dynamic turnover. The results of the analysis show that, overall, the redistribution of credit favours viable companies and reflects a healthy reallocation of factors of production in the economy.

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



Source: ECB, IHS Global Insight and own calculations

Graph 8: Cost of borrowing for NFCs



Source: ECB

25. Despite the fragmentation of financial markets, shrinking lending volumes and riskier conditions for doing business, the cost of new borrowing for the corporate sector is close to the historical lows recorded in the pre-crisis period. The spreads between bank lending rates to NFCs (both for loans below and up to EUR 1 million) and the yield for the Spanish sovereign bond with a similar maturity of five years are below their level from the boom years and clearly negative for large loans (see Graph 7). In nominal terms (see Graph 8) corporate lending rates have also come down a lot from the figures recorded during the boom period of 2006-2009 and are now at levels comparable to the historical lows of 2003-2005. The interest rate for loans up to EUR 1 million, which could be a proxi for SME loans has climbed in 2012 and early 2013 above the 2003-2005 average by about 100 bps, but this doesn't seem out of proportion with the higher risk premia reflected by the high NPL ratios in the SME sector. It is also true that the confidence crisis in the euro has also led to a serious fragmentation of financial markets in the euro area so that the low interest rates resulting from the accommodative monetary stance by the ECB has not been fully channelled to Spanish banks and further on to their clients. As a result, the spreads at which the Spanish companies borrow relative to their counterparts from the core Euro Area countries have increased in the crisis. Thus, current interest rates may

[14] According to the BdE analysis on debt developments using micro data based on the Central Credit Register. The study splits companies between those that kept or increased bank lending and the rest.

represent a competitive disadvantage for some Spanish companies, but do not appear to be the main driver of the current economic fragility, given their evolution.

26. Adequate access to credit for viable companies and solvent households is necessary so that the recovery takes hold. The acceleration in the contraction of domestic credit recorded in the first quarter of 2013 will reinforce the deleveraging process in the private sector (see section 2.2). At the same time, it may impact negatively the recovery of the real economy if the supply of credit to viable companies and solvent households is also constrained. Statistical data and anecdotal evidence point to weak demand for credit and the economic uncertainty being a main driving force behind the decline in bank lending. However, the on-going clean-up of bank balance sheets, rising NPLs and regulatory changes which may impact negatively capital levels and still difficult financing conditions for banks may contribute to an overshooting of the necessary curtailment of credit to those sectors that over expanded in the boom and may also affect solvent credit demand. This could create a vicious circle between the weak credit activity and the sluggish real economy which should be avoided. In this respect, the authorities have continued the implementation of measures to strengthen non-bank financial intermediation with a particular focus on the adequate access to finance of SMEs (see Section 4, MoU condition 17). The state credit agency (ICO) has started raising capital from the market to provide credit lines for project finance. Although non-bank financial intermediation is still small, this represents an important step toward the diversification of financing sources for companies.

27. Going forward, there are signs that the decline in credit to the private sector could start decelerating. The first set of funding and capital plans provided by the Spanish banks show that the decline in lending to the private sector is expected to continue, but should bottom out in 2014. Moreover, until the end of the projections (June 2015), lending to SMEs and other NFCs is expected to register positive growth, mainly driven by the Group 0 banks. If proven correct, this forecast by the banks shows that the pace of the credit contraction could soon decelerate, thus alleviating some of the current concerns (see Section 4, MoU condition 21). As fiscal consolidation takes hold (see also Section 2.2), credit to government is expected to decrease, thus removing disincentives for banks to lend to the more risky real economy. If, indeed, supply factors are acting as a constraint on lending, than the large jump in domestic bank credit to the government witnessed in recent years has provided banks with a profitable investment alternative relative to private sector lending.

28. The amount of impaired loans at system level has been positively influenced by the transfer of real estate and construction sector assets by the Group 1 and Group 2 banks to Sareb, but is still growing. The deterioration in asset quality has continued in the second half of 2012 and in the beginning of 2013. Notwithstanding this on-going increase in asset delinquency coupled with the reduction in the volume of credit, non-performing loans at system level declined from 11.7% at the end of November 2012 to 10.4% at the end of February 2013 due to the transfer of assets to Sareb. As of April 2013 NPLs continued their ascending trend and grew to 10.9% (see Graph 9). Against the backdrop of the transfer of assets to Sareb by the Group 1 and Group 2 banks, non-performing loans in the construction sector went down to 25.4% at the end of March 2013 compared to 26.4% at the end of September 2012. Non-performing loans in the household sector continued to remain significantly below the system level but edged up to just below 5% at the end of December 2012 and increased further to 5.1% at the as of March 2013. The performance of the residential mortgage portfolio continued to deteriorate, as non-performing loans for mortgage loans stood at roughly 4.6% at the end of March 2013 compared with 4.3% at the end of last year. A sustained increase in NPLs was recorded also in the corporate sector, which displays a relatively high and growing NPL ratio even outside of the construction and

RED sectors. Moreover, the non-performing loans ratios are higher for smaller than for large company sizes[15]. According to BdE, the ratio of non-performing loans (excluding construction and RED) for NFCs has reached about 15% of total for companies with a debt load of less than EUR 1 million and around 14% for firms with indebtedness between EUR 1 and 5 million as of December 2012.

29. Against the difficult macroeconomic setting projected for 2013, non-performing loans are expected to increase further both for households and corporates. However, their increase is expected to be significantly more moderate than in 2012, as the banks' net exposure to the real estate sector has been considerably reduced by around 50% via the asset transfers to Sareb and the compulsory built-up of provisions. At the same time, the new recommendations regarding the classification and provisioning of restructured/refinanced loans released by the BdE in April (see Section 4) are likely to further increase the amount of NPLs and the provisioning levels. As the assumptions of the Oliver Wyman stress test remain largely valid according to the recent back-testing exercise performed by the BdE (see Box 1) there are no expectations of a further surge in provisioning above of the OW scenarios or of additional capital shortfalls emerging from this process.

[15] The BdE approximates the firm size by the amount of debt recorded in the Central Credit Register; see the Financial Stability Report, May 2013 (page 33).

Box 1: Back testing of the Oliver Wyman (OW) stress test by the Banco de España

The results of the bottom-up stress test exercise carried out by OW for the Spanish banking system published in September 2012 have been re-assessed by the BdE[16] in the light of recent developments in the Spanish economy and in the banking sector and the most updated economic scenario carried out by this institution. The OW bottom-up stress test used the data available until December 2011 in the case of banks and took into consideration the macroeconomic scenarios defined in June 2012 in the top–down stress testing exercise.

More specifically, the BdE a) compared results of the OW exercise with developments effectively observed in 2012 (retrospective exercise) and b) updated the scenarios used by OW to estimate the probabilities of default of the portfolios considered (forward-looking exercise).

The BdE retrospective exercise concludes that:

- Actual defaults in 2012 were very significantly below the probabilities of default estimated by OW under the adverse scenario in all cases and even below the baseline scenario in most cases. Actual defaults were slightly above what was foreseen in the baseline scenario only in the portfolios corresponding to large corporates and public works. In this regard, the BdE concludes that the evidence shows that the OW exercise was conservative and demanding.
- Pre-provisioning profits in 2012 for domestic business stood slightly above EUR 20 billion for the banks included in the OW sample. This level is higher than the estimates of OW under both the baseline and the adverse scenarios (EUR 16 and 14 billion respectively).
- Regarding the economic scenarios used by OW, macroeconomic variables turned out better in 2012 than expected even when compared to the baseline scenario, except in the case of the unemployment rate and housing prices, which were close to the levels assumed in the adverse scenario (see Section 2.2 for more details).

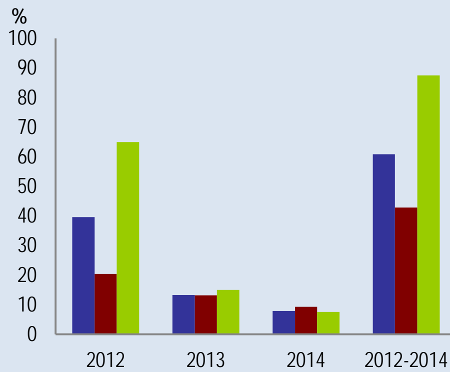
For this reason, the BdE carried out a forward looking exercise which takes into account the new macroeconomic variables expected by the BdE. The conclusions of this exercise are the following:

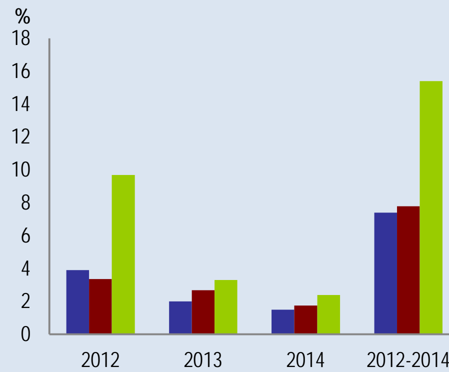
- When updating default probabilities using the most updated economic scenario by the BdE as explanatory variables in the models used by OW, the new probabilities of default increase above those estimated under the OW baseline scenario but far below those estimated under the adverse scenario. The charts provided in the BdE Financial Stability Report (Box 2.3) on the default probabilities of different portfolios estimated for the period 2012-2014 under the Oliver Wyman scenarios and the updated scenario built up by the BdE are quite illustrative of the results of the exercise carried out (see a reproduction of some of these charts at the bottom of this box).
- Regarding the core Tier 1 solvency ratios estimated for 2013, the BdE estimates that all the banks as well as all the groups considered in the MoU surpass the level of 9% set up in such Memorandum (Groups 0 and 3: 10.15%, Group 1: 11.25%, Group 2: 10.25%).
- Notwithstanding, the BdE warns about the uncertainty surrounding the results of these models.

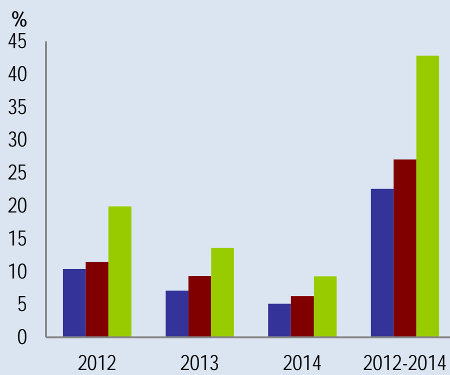
To sum up, in 2012, according to this exercise, banks' actual performance in terms of asset quality and profitability confirms that the results of the stress test exercise performed by OW are still valid as a sound basis for assessing the solvency of Spanish banks. The BdE will add stress testing exercises to the set of internal supervisory tools regularly used to assess financial prospects of each credit institution.

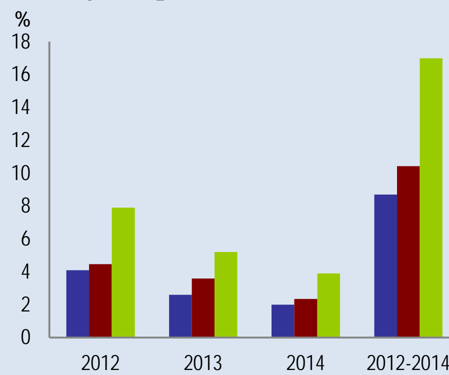
[16] See Banco de España, Financial Stability Report May 2013.

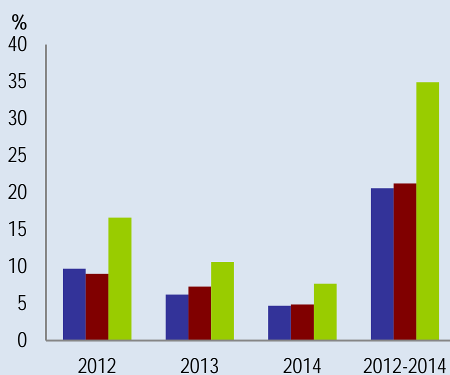
Estimated probabilities of default 2012-2014

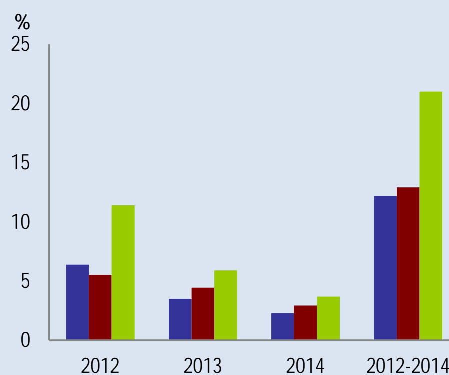












Baseline scenario external consultant
BdE estimation based on the external consultant's probabilities of default
Adverse scenario external consultant

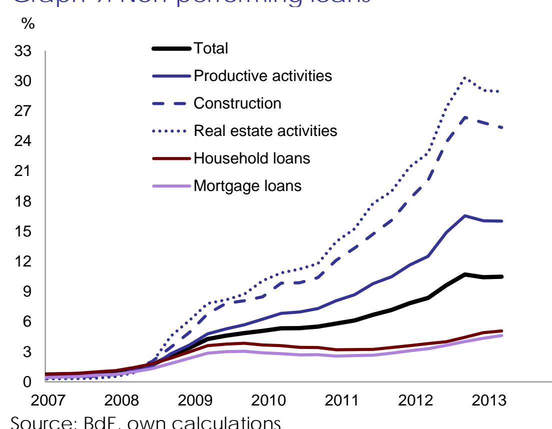
Source: BdE, Financial stability report, May 2013, p. 36

30. The increase in loan-loss provisions and the losses posted by the Group 1 and Group 2 banks impacted significantly banking sector profitability in 2012. The small profits registered by the Group 0 banks, especially by the internationally active credit institutions, as well as by other banks were not sufficient to offset the significant losses recorded by the Group 1 and Group 2 banks. The negative performance at system level was mainly the outcome of the sizeable increase in loan-loss provisions throughout 2012, in particular for the real estate and construction sectors (see Graph 10). In order to comply with the requirements of the Royal Decree 2/2012 and Royal Decree 18/2012, the majority

of banks recorded the bulk of loan-loss provisions in the last quarter of 2012. Against this backdrop, the return on equity at system level stood at -21% at the end of December 2012 compared with -8.7% at the end of September. In contrast to the pressure coming from the additional provisioning needs, net interest income performed favourably in 2012 including for both Group 1 and Group 2 banks. Furthermore, operating expenses declined in 2012 compared with the previous year reflecting *inter alia* the restructuring efforts and integration processes between different banks.

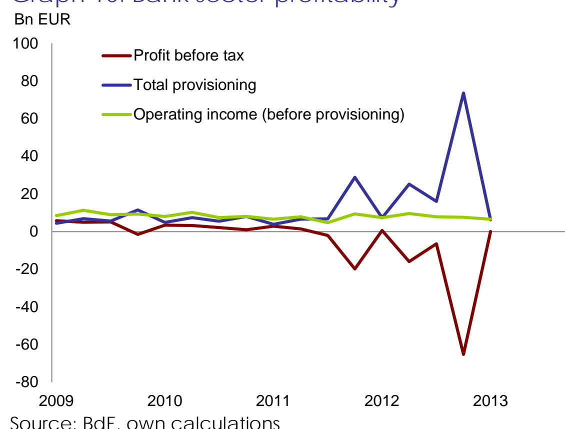
31. Going forward the main challenge for the banks is to remain profitable in the current difficult economic environment, in order to consolidate their solvency and lending capacity. Profitability in the first quarter of 2013 was on average above the expectations assumed in Oliver Wyman's stress test, reflecting the banks' capacity to generate capital internally, sizeable net interest income contributions from carry trades as well as the frontloading of provisions and restructuring costs to 2012. However, there are some outliers with results below what was foreseen in the baseline scenario, though still significantly above what was assumed in the adverse scenario. Moreover, a recent Supreme Court decision removed not clearly specified interest rate floors on retail mortgage contracts, with a potential negative impact on profitability. The Spanish authorities should continue monitoring closely the results of banks compared to the assumptions made in the bottom up stress test and ensure that profits are retained in a prudent manner.

Graph 9: Non-performing loans



Source: BdE, own calculations

Graph 10: Bank sector profitability



Source: BdE, own calculations

32. Certain regional initiatives regarding the protection of mortgage debtors are casting some legal and economic uncertainties upon Spanish banks with a possible negative impact on financial stability. In particular, the Decree-Law adopted by Andalucia may have potential negative implications for the stability of the financial system as a whole, envisaging direct effects such as financial sanctions for vacant houses owned by banks and even their partial expropriation. In addition, indirect effects may include a reduction of the investors' appetite for Spanish real estate assets, as well as a deterioration in the value of banks' portfolio of real estate assets and in the banks' ability to tap the markets with the so-called "cedulas hipotecarias"[17].

33. As regards the capitalisation of Spanish banks, in February 2013 the recapitalisation of those banks which registered a capital shortfall as a result of the stress test performed by Oliver-Wyman was completed. Of the total EUR 57 billion capital needs resulting from the bottom-up stress test, EUR 38.8 billion were injected in the banks by the Fondo de Reestructuración Ordenada Bancaria (FROB), close to

[17] Securities backed with mortgage loans whose underlying guarantee are the same houses subject to expropriation.

EUR 13 billion is assumed to be generated through the subordinated liability exercises and the rest was raised from private investors or through the sale of assets. Banks also obtained some capital relief from the transfer of assets to Sareb.

34. Subordinated Liability Exercises (SLE) advanced, but have not yet been completed (see Section 3.2). The arbitration processes put in place by banks to deal with mis-selling cases will reduce the amount of capital that was expected to be raised, but the full impact of these processes cannot be accurately estimated yet. Banks concerned by SLEs are experiencing a loss of market share as some dissatisfied clients decide to end their relationship with these banks.

35. Excluding those banks which have been recapitalised, the overall level of solvency of Spanish banks slightly decreased in 2012 to 12.1% in December, 33 basis points below 2011 levels. Nevertheless, the quality of capital has slightly increased since the core tier 1 ratio has increased (10.7%) and now represents a higher share of total capital. In addition, banks are now applying a new definition of capital which incorporates EBA standards.

36. Compared to their peers, Spanish banks are not amongst the banks with the highest capital ratios but rank favourably in terms of overall leverage. Any comparison of the solvency of the banks must also take into account the high level of risk-weighted assets to total assets, in Spanish banks which in turn is reflected in the comparatively favourable leverage ratio. In addition, anecdotal evidence shows that banks are under "market pressure" to maintain capitalisation levels above their regulatory requirements and are also prudent regarding potential capital needs arising from the changing regulatory framework or rising NPLs. This may reduce their risk appetite in lending to the real economy. Consequently, Spanish banks' should retain a high share of their earnings to build up the capital necessary to compensate for any possible constraints on the supply of credit resulting from capitalisation levels. In this regard, it is worth noting that, although some banks have maintained high dividend pay-outs, a large share of these dividends are scrip dividends which do not imply an outflow of resources from the bank.

37. As regards the quality of capital, an area of concern for a number of banks is the high volume of deferred tax assets in Spanish banks' balance sheets. These deferred tax assets have been accumulated as a result of the application of the dynamic provisions and the large domestic losses registered by some banks. However, the value associated with this type of asset only materializes if the banks earn taxable income.

38. The restructuring process in the banking sector has advanced further, as the numbers of institutions, branches and employees continued to decline. This trend was reinforced by the integration between credit institutions, such as the takeover of Banco de Valencia, of Caja 3, and of Banco Gallego. Thus, the number of deposit taking institutions has declined by about 17 or 6% of the total in 2012. The number of employees has declined by a similar amount of about 5.5% in 2012. The falls in the number of employees and offices were more marked in Group 1 and 2 banks, which are undergoing a thorough restructuring process steered by restructuring plans adopted by the EC (see also Section 3.2). As a result, the decrease in operating expenses was also relatively larger in Group 1 and 2 banks than in the rest of the banking sector, at 6% y-o-y in 2012. This should contribute to render the state-aided banks viable again by the end of the restructuring process.

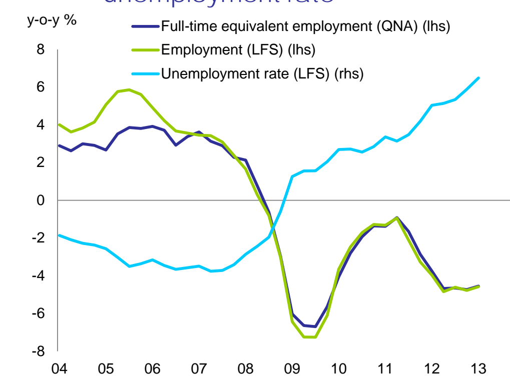
2.2 MACROECONOMIC AND FISCAL DEVELOPMENTS

39. The economy is still contracting as the domestic demand remains compressed. Falling gross disposable income (due to employment destruction and lower wage growth), rising unemployment, high debt levels, and tight financial conditions are restraining households' consumption and investment. In the case of firms, the need to repair balance-sheets, a weak economic outlook and tight financing conditions, especially for SMEs, are constraining investment. Finally, fiscal retrenchment to contain rising public debt levels also weighs on the short-term growth outlook. GDP is expected to contract by 1.5% in 2013 and the economy is expected to continue the process of rebalancing from domestic to external demand. The expected quarterly profile is characterised by a progressively lower contraction of output, which should stabilise at the end of 2013.

40. Net exports continue to support GDP growth. Real GDP fell by 0.5% (q-o-q) in the first quarter of 2013, compared to -0.8% in the fourth quarter of 2012. This relative easing of the contraction in the first months of 2013 partially reflects that major fiscal consolidation measures (a VAT rate hike, the abolition of the Christmas bonus, etc) had been kicking in in the last quarter of 2012. Exports are expected to remain resilient thanks to increased geographical and product diversification combined with improvements in cost competitiveness, while imports are falling on the back of subdued domestic demand. As a result, the current account deficit narrowed significantly from -3.7% of GDP in 2011 to -0.9% in 2012 and this trend has continued in the first quarter of 2013.

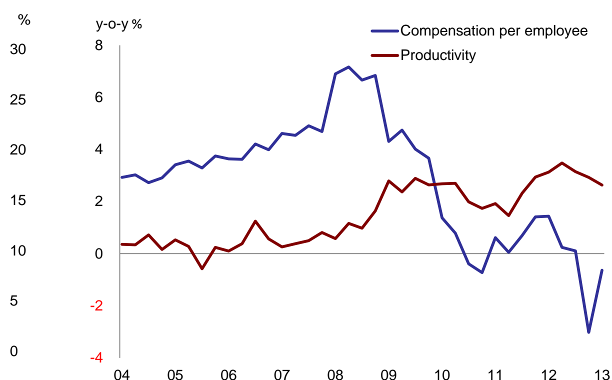
41. Employment destruction is still sizeable, while prices have moderated. Employment fell by 4.6% (y-o-y) in the first quarter of 2013, according to the Labour Force Survey (see Graph 11). The unemployment rate rose to 27.2% in the first three months of 2013, despite a fall in the labour force of 1% (y-o-y). Nonetheless, the available data during the second quarter of the year (mainly from Social Security) point to a possible moderation of employment destruction. In this regard, Social Security affiliates stabilized in May in seasonally adjusted terms.

Graph 11: Employment growth and unemployment rate



Source: INE.

Graph 12: Productivity and wages[18]



Source: BdE, INE.

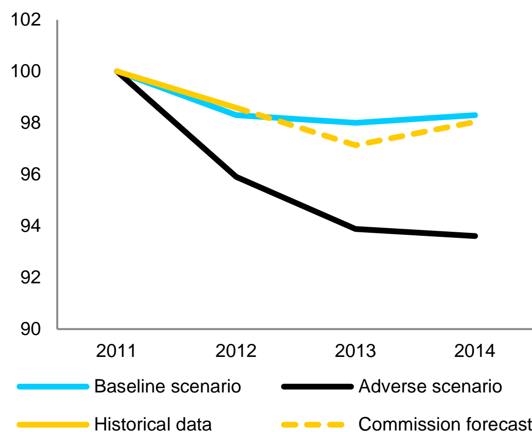
42. The wage moderation recorded in 2012 seems set to continue also in 2013, according to collective agreements data. In particular, the agreed wage increase of 0.6% (based on the agreements reached until April) is 1.5 percentage points lower than a year ago. Strong labour productivity growth together with continued wage moderation is

[18] The sharp drop in compensation per employee observed in Q4 2012 is due to the elimination of the Christmas bonus.

expected to further improve nominal Unit Labour Cost (ULC) in 2013 (see Graph 12). According to the latest data available, prices grew by 1.8% in May, compared to 1.5% in April.

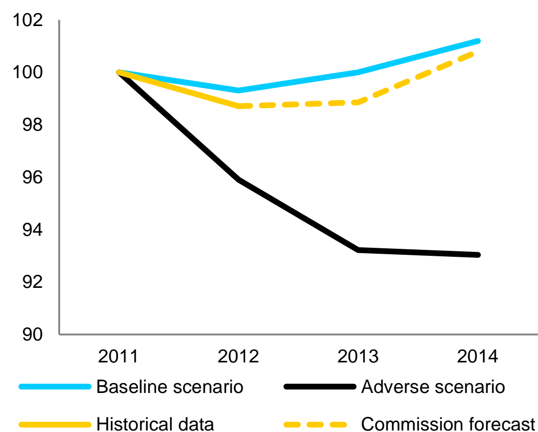
43. The contraction in output is more persistent than assumed in the base scenario included in the Oliver Wyman stress test, but output levels remain well above the adverse scenario (for more details on the OW stress test and the recent back-testing by the BdE see Box 1 in Section 2.1). In 2013, real GDP is expected to contract more than assumed in the base case (-1.5% compared with -0.3%). However, the actual decline of real GDP in 2012 turned out to be less severe than assumed in the base scenario (-1.4% compared with -1.7%). Hence, taking into consideration the expected cumulated impact on output, both real and nominal GDP remain close to the base scenario and well above the adverse scenario (see Graphs 13 and 14). However, the rise in unemployment has been more severe so far than assumed in the adverse case scenario (see Graph 15) while house prices have declined more in line with the adverse scenario (see Graph 16).

Graph 13: Real GDP projections



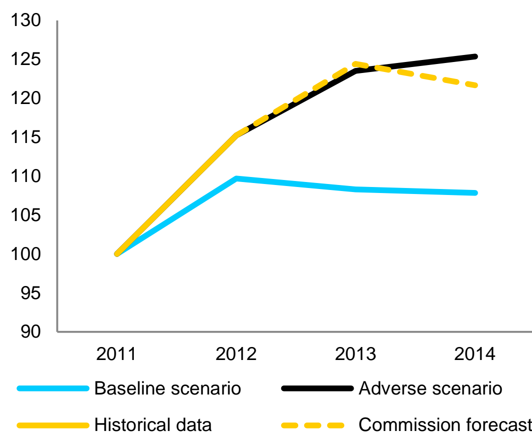
Source: IMF, Ameco, Commission forecasts spring 2013

Graph 14: Nominal GDP projections



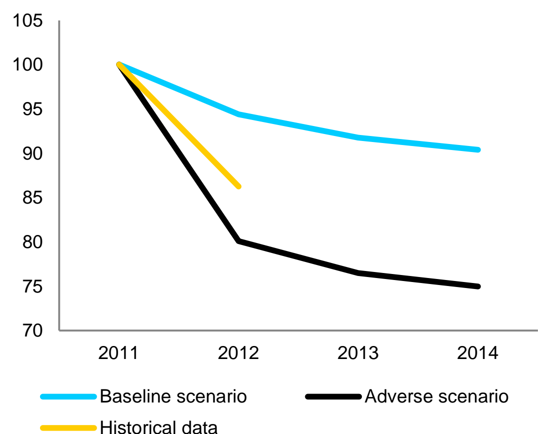
Source: IMF, Ameco, Commission forecasts spring 2013

Graph 15: Unemployment rate projections



Source: IMF, Ameco, Commission forecasts spring 2013

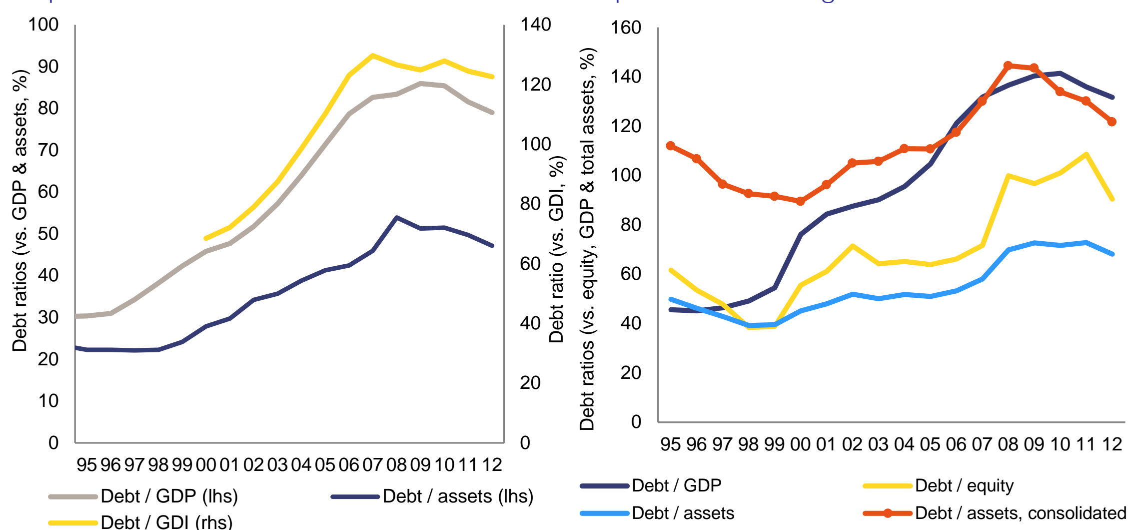
Graph 16: Housing price projections



Source: IMF, Eurostat

44. The necessary deleveraging of the private sector is expected to weigh on the economic growth over the medium term. Private sector deleveraging is progressing predominantly through the adjustment in net lending (see Graph 4 in Section 2.1). Despite an on-going negative adjustment in terms of bank credit flows, private sector debt remains elevated. Households and firms remain more indebted relative to other EU countries as well as by historical standards as measured with respect to their assets and their capacity to repay debt (see the 2013 In-depth Review under the Macroeconomic Imbalances Procedure (MIP)[19] for more details). Overall, the private sector has reduced its indebtedness by about 20 pps. of GDP from its peak, but leverage is still much above the pre-boom levels. Given the size of the imbalances as well as the historical and cross-country experience, the deleveraging is likely to take long and to continue to hold back domestic demand. By end-2012, the debt-to-GDP ratio had declined by around 8 pps. for households and 13 pps. for non-financial corporations compared to their respective peaks (see Graphs 17 and 18). In 2012, the deleveraging process in the private sector advanced at a higher pace only in the last quarter of the year.

Graph 17: Households indebtedness indicators[20] Graph 18: NFC leverage indicators



Source: BdE, INE

Source: BdE, own calculations

45. The non-financial private sector continues to be a net lender to the economy as it slowly deleverages. During 2012, the non-financial private sector was a net lender to the rest of the economy to the tune of about 4% of GDP. According to the Commission services' 2013 spring forecast, both households and non-financial corporations are expected to remain net lenders in terms of annual financial flows over the forecast horizon (2013-14). The impact of the net lending position of the non-financial private sector on the external deficit has been largely counteracted by a sizeable net borrowing position of the public sector since 2008. From a sectoral perspective, the move to a sustained current account surplus will therefore require further improvements in both private and public sector balances.

46. The general government deficit in 2012 reached 10.6% of GDP. Excluding bank recapitalisation measures, the deficit amounted to 7% of GDP, above the target of 6.3% of GDP, but down from 9% of GDP in 2011. The significant additional consolidation measures implemented in the latter part of the year, such as hikes in VAT and corporate

[19] Macroeconomic Imbalances - Spain 2013, European Economy. Occasional Papers. 134. March 2013. Brussels.

[20] Gross Domestic Income (GDI).

income tax, were not enough to offset a combination of underlying revenue shortfalls, as the economy continued to shift from tax-rich consumption-based growth to export-led growth, and some expenditure overruns. While some Autonomous Communities did not meet their deficit target of 1.5% of GDP, on the aggregate they still managed to achieve a significant budget consolidation compared to 2011. The social security system deficit increased by almost a percentage point to reach 1% of GDP, as rising unemployment led to lower social contributions and higher spending on unemployment and pension expenditures increased. While spending on interest payments and social benefits increased by 20% and 3% respectively, other spending (excluding bank support) was reduced by more than 10%. The Commission services' 2013 Spring Forecast projects the deficit to narrow to 6.5% of GDP in 2013 as the additional effects from discretionary consolidation measures more than compensate a further erosion of tax bases and higher expenditure on interest payments and social transfers.

47. General government debt rose to around 84% of GDP in 2012 from 69% in 2011. The increase in the debt ratio was due to the effect of the deficit, negative nominal GDP growth, costs of bank recapitalisation operations and the payment of regional and local administration arrears. According to the Commission services' 2013 Spring Forecast, the debt-to-GDP ratio is expected to exceed 95% in 2014, based on a no-policy-change scenario. In absolute terms, general government debt more than doubled in the period of 2008-12. Reducing the budget deficit to below 3% of GDP as recommended by the Commission on 29 May 2013 would put the debt on a downward trajectory as of 2016 (see Section 5.1).

3 BANK RECAPITALISATION AND RESTRUCTURING

3.1 SEGREGATING THE BANKS' LEGACY ASSETS

48. As envisioned in the MoU, the asset management company has been created under the name of Sareb in order to remove troubled assets from aided banks' balance sheets (see Box 2 for the overview of its main characteristics). Given the complexity of this undertaking and very tight deadlines for its set-up foreseen in the MoU, it is not surprising that Sareb is facing delays and operational challenges in implementing its business plan.

49. Having signed servicing agreements with the transferring banks and creating the essential infrastructures, Sareb is now fully operational, but still faces challenges related to the timely and accurate information flow from transferring banks, which has resulted in delays in starting its commercial activity. This area is currently under strategic review by an external consultant to propose solutions to fix the problems in the short-term while also reflecting on the strategic model for long-term.

50. In addition, Sareb is confronted with some legal uncertainties related to recent measures adopted by regional government in relation to mortgage debtors' protection. In particular, the Decree-Law adopted by Andalucia has potential negative implications for Sareb's activity – both direct (related to financial sanctions for vacant houses – estimated at up to EUR 200 million) and indirect (heightened uncertainty may discourage potential investors and cause deterioration in the value of Sareb's portfolio). Approximately 10% of Sareb's housing portfolio is located in Andalucia (6,000 homes) in addition to 17,000 homes that constitute loan collateral.

51. Sareb is in the process of conducting a due diligence on a significant part of its portfolio, which will provide management with important disaggregated information related to both the real estate assets and loans. The process was initially intended to be finished by end-June but is now foreseen to be completed by mid-August while the scope has been somewhat narrowed down to cover assets and loans amounting to 80% of transfer value. According to the management of Sareb, one of the challenges encountered during the process is related to the quality of collateral monitoring systems at the transferring banks, which in some cases are not detailed enough to provide the necessary management information and, thus, will have to be upgraded.

52. Preliminary results in the first quarter point to a slower-than-expected speed of sale of assets by the transferring banks (via the retail channel), since asset sales have started only late in the quarter as a result of the initial operational difficulties. Sareb will set up weekly targets for banks and enhance its monitoring of both sales and firm offers received. Also, an excessively rigid pricing policy from Sareb may have delayed sales.

53. Nevertheless, transferring banks have indicated that sales of Sareb assets have already improved and will continue to do so now that sales have effectively started and that Sareb is being more flexible on the pricing of sales. In addition, the work is on-going to kick-off sales via the wholesale channel, with the first sale of portfolio of assets expected to be finalized by end-July. The company expects this operation to create positive momentum amongst investors.

54. The revised business plan, taking into account more updated and more granular information as compared to the initial version, was adopted by the Board of Sareb in

March. While representing a good indication of foreseen commercial activity, it will have to be complemented and revised after completing the due-diligence process. Sareb management has performed some sensitivity analysis to take into account possible much more negative trends in terms of price development as well as delays of its sales of assets. The results obtained provide some comfort over the adequacy of Sareb's capital to withstand various adverse scenarios.

55. Sareb has made progress as regards the availability of vendor financing. The company has reached vendor financing agreements with the transferring banks and is now also negotiating similar agreements with Group 0 banks. Recently, Santander launched a EUR 1 billion programme to fund the acquisition of Sareb's assets by retail clients and wholesale investors. Vendor financing for retail customers is a key determinant of Sareb's ability to compete with other banks. These agreements ensure that Sareb's clients will have access to funding conditions that are equivalent to those offered for the acquisition of other real estate assets sold by the banks.

56. Looking forward, Sareb will be confronted with important challenges in the fulfilment of its tasks:

- Servicing agreements signed with the transferring banks must be monitored closely to ensure that the incentives are properly calibrated and assets are managed well.
- Competition with Spanish banks will be fierce since most banks are also deleveraging large real estate-related portfolios. Some banks are applying aggressive commercial strategies, with steep haircuts on the price of assets, to boost sales.
- It will be of key importance for the management of Sareb to get a clear understanding of the portfolio under its management. For that purpose, Sareb needs to finalize quickly the due diligence of all its assets and possible follow-up actions.
- Large uncertainties surrounding the Spanish economy continue to pose challenges. In particular, the weak macroeconomic outlook, the very high unemployment, the challenging fiscal outlook, and the on-going adjustment of the housing market imply that Sareb may face difficulties in selling its large portfolio of assets in the short- to medium-term.

Box 2: Sareb – Main features of the Spanish AMC

Key features:

- Sareb's main objective is to manage and disinvest the portfolio of assets transferred by stated aided banks in an orderly manner, servicing its debt, optimizing levels of recovery and value preservation, and minimizing the cost for the taxpayer and market distortions, within a maximum timeframe of 15 years.
- The business plan of Sareb has been approved by its Board. The main focus of the business plan is to manage the vehicle in a manner which ensures sufficient liquidity and enhances the recovery value of Sareb's assets over time. In its disinvestment strategy Sareb is going to use both the retail channel (via transferring banks) as well as wholesale channel targeting institutional investors.

Perimeter and size:

- After the two transfers of assets from Group 1 (end-December 2012) and Group 2 banks (February 2013) to Sareb, total real estate related assets amount to EUR 50.6 billion. Of the total amount, EUR 11.35 billion are foreclosed real estate assets, EUR 13.50 billion are performing real-estate developers (RED) loans and EUR 25.72 billion are non-performing loans.
- The average haircut applied to these assets for their transfer is 52.7% relative to gross book value.
- The total number of assets is around 198 000, of which foreclosed assets amount to around 107 000.

Capital:

- Sareb's capital amounts to EUR 4.8 billion. 25% of this amount is equity, while the remaining amount consists of subordinated debt which is convertible into equity.
- 55% of this capital belongs to private shareholders, of which, over 95% are credit institutions. The remaining private shareholders are mainly insurance companies.

Corporate governance:

- The Board of Directors oversees the activities of the company. It has 15 members consisting of the president and the CEO, 8 representatives of Sareb shareholders, and 5 independent directors.
- Sareb's by-laws are in line with standard practice for Spanish listed companies. In particular, Sareb's governing rules forbid members of the Board to be involved on the decisions taken by the Board if the member has or could have a potential conflict of interest.
- The BdE acts as the administrative supervisory body of Sareb. In addition, there is a Monitoring Committee, outside the structure of Sareb, formed by four parties (Ministry of Economic Affairs and Competitiveness, Ministry of Financial Affairs and Public Administration, the BdE and the CNMV), to oversee compliance with the general objectives for which the company was formed. The Committee may agree to its meetings being attended by representatives of other national or international public institutions, as well as to admit permanent observers with full access to the information provided to it - in fact, the ECB was invited, and is a permanent observer. The Committee was created at the end of January, and the Secretary General for Treasury and Financial Policy was appointed Chair of this Committee. This Committee will meet at least once per quarter, as foreseen by the legislation.

3.2 BANK RECAPITALISATION AND RESTRUCTURING

57. The stress test exercise which was finalised in September 2012 revealed capital shortfalls in 10 banks, which had to present recapitalisation plans. The latter allowed to check whether the banks would be able to fill the identified capital shortfall through their own means, or if they needed to resort to State aid which would include capital injections and the transfer of the banks' real estate related foreclosed assets and real estate development (RED) assets to Sareb. The asset transfer had been completed in December 2012 for Group 1 banks and in February 2013 for Group 2 banks.

58. The EC adopted the restructuring plans for Group 1 banks on 28 November 2012, and for Group 2 banks on 20 December 2012. The EC approved the restructuring plans for all Group 1 banks and in the case of Banco de Valencia approved the State aid required for the orderly resolution of the bank through its takeover by CaixaBank. In the absence of the takeover, Banco de Valencia would have been wound down, as it was not possible to envisage a viable business model for the bank on a stand-alone basis.

59. On 13 May 2013, the Commission approved a modified restructuring plan for Banco CEISS opening the door for the acquisition of the bank by Unicaja Banco. The new plan is broadly similar to the plan approved in December 2012, with the main difference that Banco CEISS will be recapitalised with EUR 604 million in the form of convertible securities (CoCos) subscribed by the FROB rather than via an injection of ordinary shares to allow for a repayment of the CoCos during the restructuring period by the new entity. The sale of the bank had already been foreseen in the initial restructuring plan approved in December 2012.

60. In general, the restructuring plans of Group 1 and 2 banks secure the banks' solvency, and restore the profitability and liquidity profile over the course of the five-year restructuring period. In particular, the focus of the plans is to restore an adequate margin structure. Over time this will also reinforce the banks' capital position. Another focus is on addressing the funding gap and thus reducing the banks' reliance on wholesale funding and on central bank funding. This will enable banks to restore sustainable lending patterns towards real economy.

61. The restructuring plans foresee that banks refocus their business model on retail and SME lending in their historical core regions. Group 1 and 2 banks will gradually exit from lending to real estate development and other overly risky activities and limit their presence in wholesale business. They will also reduce their exposure to mortgage lending and public sector financing. The plans furthermore concentrate deleveraging of the banks in the most overleveraged sectors and areas. By contrast, there is a continued capability to finance SMEs and corporates. The overall path of loan deleveraging is not accelerating due to the restructuring plans, if RED loans are excluded. In order to boost their profitability and solvency, banks will improve their cost base, by cutting both staff and branches. The plans will refocus the banks' activities in those regions and areas where the banks have a capacity to operate efficiently.

62. Group 1 and Group 2 banks have a combined share of the credit in Spain of just above 20%.[21] This means that 80% of the loan market is not constrained by the targets

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

foreseen by the restructuring plans. The other Spanish banks can contribute to cover the credit demand that cannot be satisfied by the banks under restructuring.

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

64. **The State aid for Group 1 and 2 banks consists of capital injections and the transfer of problematic assets to Sareb** (see section 3.1)**.** Capital injections are the first instrument to be applied in order to re-establish financial market confidence into distressed banks and allowed them to comply with the regulatory solvency ratios.

65. **In order to assess the parameters of the asset transfer, the Commission took an active role.** The EC assessed the conditions of the transfer of assets to Sareb with the help of external experts and concluded that the former were in line with EU State aid rules. More specifically it verified that the transfer price based on the base case value of the stress test exercise, plus a variety of haircuts related to the specific conditions of the transfer to Sareb, was in line with the so-called real economic value, i.e. the long-term hold to maturity valuation.

66. **The restructuring plans, in line with the MoU, ensure that State aid remains limited to the minimum amount necessary**, so as to minimise the cost to the taxpayers. Consequently, not only will former owners of these banks contribute to the needed capital injection, but losses will also be allocated to holders of preference shares and subordinated debt holders of these banks by implementing both voluntary and, where necessary, mandatory subordinated liability exercises (SLEs). The initial estimated amount of capital needs has been reduced by almost EUR 13 billion through burden sharing measures (see Box 3).

67. **In the process of bank restructuring, focus has now shifted towards monitoring.** The EC is now actively monitoring the implementation of the restructuring plans with the help of a monitoring trustee for each bank. In addition, there will be continuous contacts with the Spanish authorities and monitoring reports will be drafted.

Box 3: The SLE exercise – objectives, progress and addressing mis-selling concerns

This box recalls the aims of the subordinated liability exercise (SLE), progress achieved so far and explains how mis-selling concerns are dealt with.

The overall aim of the SLE exercise is to limit State aid to the minimum necessary. For this purpose, capital and subordinated debt holders of individual banks are required to contribute to the capital needs and the restructuring costs of the banks in order to minimise the taxpayers' burden in line with the EU State aid rules. Spain has introduced legislation to ensure the effectiveness of the burden sharing measures, including, if necessary, by mandatory means.

In practice, the Spanish authorities, in line with the MoU, required that SLEs should be performed in the following way when state capital is injected: (i) holders of preference shares and perpetual subordinated debt would take a haircut on the nominal amount of the instrument and a conversion of these securities into equity or into convertible securities in some instances; (ii) holders of dated subordinated debt would typically get a choice between conversion into equity or into a senior debt instrument after taking a haircut.

The SLE outcomes as regards generated capital are in line with the approved restructuring plans. The SLEs of Liberbank and Bankia have already been completed, whereas the SLEs for Caixa Catalunya, Nova Caixa Galicia and Banco Mare Nostrum will be finalised by the end of June 2013. The SLE of Caja3 will be done in two steps, the voluntary exercise from 6 June to 19 June and the mandatory exercise from 24 June to 15 July 2013. The SLE of Banco CEISS was largely completed in May 2013, except for two issues of subordinated dated debt where there is a need to await the conditions of the Unicaja offer for the shares of Banco CEISS before this SLE can take place.

As Spanish banks sold many of the instruments affected by the SLEs to retail clients, where in some cases mis-selling could not be excluded, Caixa Catalunya, Nova Caixa Galicia and Bankia initiated arbitration processes. Hybrid holders can of course also take their case to the ordinary courts, in line with the Spanish legislation.

While the final capital impact of the arbitration processes and court proceedings are difficult to estimate, as a safeguard for the taxpayer, the MoU provides that capital needs in the banks stemming from compensation granted in the context of these arbitration procedures will not be covered by ESM funds. Accordingly, potential capital shortfalls as a result of potential compensations being granted will need to be covered in general by: a) profits generated by the bank, and b) other capital optimisation measures, or by the Spanish sovereign as a last resort, subject to State aid rules.

Furthermore, the Spanish authorities have recently approved a mechanism which aims to provide liquidity to the retail hybrid holders willing to sell the ordinary shares they will get through an SLE in banks which are not listed. Under the mechanism, the Spanish deposit guarantee fund offers to buy the shares in Caixa Catalunya and Nova Caixa Galicia – which are not traded on a stock exchange - obtained by individuals as result of the SLE. The offers from deposit guarantee fund are based on calculations by an independent expert, taking into account an illiquidity discount on the economic valuation of the shares.

4 ENHANCING BANK TRANSPARENCY, REGULATION AND SUPERVISION

68. As a follow-up on the recommendation to increase the transparency of banks (MoU condition 9), BdE has further clarified the provisions applicable to restructured/refinanced loans (following the amendments to Circular 4/20004 through Circular 6/2012, which entered into force in September 2012). Apart from the provisions aimed at increasing transparency requirements concerning the exposures to the real estate and construction sector, the Circular 6/2012 introduced new definitions on restructured, refinanced, roll over and renegotiated loans. The 2012 data on refinanced/restructured loans published by banks revealed differences among banks both as regards the percentage of restructured/refinanced loans in the total loan portfolio and the quality of these loans. These differences are a corollary of the different business models of banks, but reflect also different accounting practices. To address this situation, BdE sent two letters to banks at the end of April 2013 with the objective to provide further clarifications on the application of provisions on restructured/refinanced loans including the classification of these loans in normal, substandard and non-performing. Banks will perform a loan-by-loan analysis of their restructured/refinanced operations until September 2013 in order to identify possible loan reclassifications and additional provisioning needs following the clarifications made by BdE.

69. Authorities have started the implementation of the recommendations of the internal review of the supervisory processes of BdE (MoU condition 14). The main findings of the internal review are included in the October 2012 report on the internal review of the supervisory processes of BdE. Following the discussions with the international partners during the second review of the banking programme, authorities have committed to focus on further strengthening the formalisation of supervisory actions and enhancing the enforcement of provisions related to the rotation of supervisory staff. There will be semi-annual supervisory reports and subsequent letter of requirements for entities subject to on-site continuous monitoring. The first semi-annual reports will be produced on the basis of end-June 2013 data. On-site continuous monitoring was extended to all 17 major banking groups, which account for 90% of total banking sector assets. The re-organisation of the Directorate General Supervision in April led to the reinforcement of horizontal supervisory teams, including the setting up of an inspection team for Sareb and to the rotation of supervisory staff. After these recent improvements, the *de facto* rotation period for head of supervisory divisions and executive coordinators will decrease to roughly three to four years. Furthermore, BdE committed to analyse the current provisions on the cooling off periods for heads of departments and divisions. The update of supervisory procedures of BdE included in Circular 7/2011 is currently in the finalization phase. Before their approval by the Director General for Banking Supervision, these procedures have to be reviewed by the legal and internal audit departments of BdE.

70. Authorities have advanced the implementation of the Action Plan containing measures for strengthening non-bank financial intermediation (MoU condition 17). The measures promoting non-bank intermediation which were announced in November 2012 remain to be fully implemented, but good progress have been made in all areas of support covering the life cycle of a SME. Most of the measures have been initiated, including those related to enhancing capital market access for SMEs, creating a national business incubator system, providing capital seed for new businesses, promoting a network of "business angels" and creating a start-up co-investment fund, while the capital of the state counter-guarantee company has been increased. ICO is expected to borrow about EUR 18 billion from the markets at favourable interest rates in 2013 in order to lend this

amount to banks and further on to SMEs. There is a ceiling on the final pricing asked to SMEs, so that the favourable costs of financing are passed on (the bank margin has been recently increased in order to accommodate the higher credit risk). In addition, the launch of the new ICO Fond Global (managed by the AXIS Fund) was already approved and will leverage about EUR 1.2 billion into about EUR 4 billion of SME equity. The total outlays foreseen for ICO in 2013 at about EUR 23 billion are substantially higher than last year´s outlays of about EUR 11 billion. Speedy implementation of these initiatives will be critical to ensure their full impact.

71. As follow-up to conditions 18 and 20 of the MoU to strengthen the governance of savings banks and provide a roadmap for the eventual listing of the ones benefitting from State aid, the Spanish authorities have advanced the legislative process for the adoption of the draft law on savings banks. The draft law on savings banks was under public consultation, and, in its light, a few limited changes were made in agreement with the international partners. On 31 May 2013 the State Council issued its opinion on the draft law, making suggestions that did not alter its substance. The revised draft law was agreed with the international partners and on 7 June 2013 the Council of Ministers approved its submission to Parliament.

72. The approval of the draft law on savings banks will involve a profound restructuring of the legal framework under which savings banks operate. The law, in accordance with the MoU, will confine savings banks to their original social nature and vocation (small institutions with a limited geographical scope and retail activity) and it will strengthen the independence of their governing bodies in order to avoid political interference in their management. At the same time, the draft law introduces the concept of "*fundaciones bancarias*" (bank foundations) to accommodate the legal treatment of former savings banks which have significant stakes in commercial banks (equal or greater to 10%) or have a size greater than that considered appropriate by the law for a saving bank. Legal requirements and constraints are imposed on the bank foundations in order to assure and reinforce the independence of the governing bodies of the banks under their control. It is envisaged that the law will be approved by the end of 2013.

73. As regards the listing of banks which have received public aid, banks in Group 1 are either listed (Bankia), have been sold to listed companies (Banco de Valencia) or their sale is pending (Nova Caixa Galicia and Caixa Catalunya). One bank in Group 2 has been recently listed (Liberbank), others are in the process of merger with other institutions (Ceiss, Caja 3) or they currently do not have enough floating capital to be listed (Banco Mare Nostrum).

74. Banks have submitted their first set of Funding and Capital Plans (FCPs) as stipulated by condition 21 of the MoU and the BdE drafted a comprehensive report aggregating the results of the submission. Upon initiative and following guidance of the ECB, sixteen Spanish banks are required to present FCPs on a quarterly basis. The exercise was organised by BdE and the first round was completed by 6 May 2013. The plans presented by the Spanish banks were mutually consistent and made similar assumptions on key elements such as the evolution of loans and deposits and access to wholesale markets. In particular, the first round of FCPs revealed that Group 0 banks seem to have sufficient buffers to face potential risks and show conservative policies. In the case of Group 1 and Group 2 banks, the main risk is related to the evolution of deposits and the feasibility of implementing their very ambitious deleveraging plans. The first submission of the quarterly FCPs was satisfactory both in terms of the information and consistency of the data provided by the banks and the high quality overview report drafted by the BdE.

75. In terms of findings from the first set of FCPs submitted by banks, the macro-economic conditions projected by banks are fairly similar to the consensus forecast and the degree of dispersion among them was low. As expected, there are significant differences between the FCPs of Group 0 and Group 1 and 2 banks (in terms of projections on lending, asset quality, funding, etc.). The decline in lending is expected to bottom out during 2014, whereas the NPL ratios will continue to deteriorate in the short-run and improve again towards mid-2015. The funding structure of the banks is expected to improve further, with an overall reduction in wholesale funding and in net borrowing from the Eurosystem.

76. In light of the MoU requirements (condition 22), the Spanish authorities submitted in December 2012 a comprehensive document that analyses the current provisioning framework and some of the shortcomings identified in it. The international partners required additional analytical work on the calibration of the dynamic provisioning. Hence, the BdE sent an additional paper reflecting the work carried out in this regard in May 2013.

77. Authorities are implementing the proposed approach aimed at requiring banks to review, prepare and implement strategies for dealing with impaired assets. BdE sent in December 2012 to all banks included in the bottom-up stress test a legally binding letter of requirements, issued on the basis of the Law 13/1994 on the Autonomy of the BdE. In line with this letter, the internal audit departments of banks are requested to review the strategies, policies and procedures for managing impaired assets. Furthermore, these reports should provide an overview of the refinancing and restructuring policies in line with the requirements of Circular 4/2004 and Circular 6/2012. The reports summarizing the main findings of the internal audit departments, the supporting documentation as well as a plan including measures for addressing the identified shortcomings, were submitted to BdE at the end of March 2013. Based on a preliminary analysis of these reports by BdE, the weakest areas identified are the reporting systems, which reflect the complexity of arrears management, as well as the consistency of restructuring policies with the provisions of Circular 6/2012. Regarding the latter aspect, given the short period of time since the entry into force of Circular 6/2012, more time is needed for its effective implementation. Moreover, further IT improvements are necessary and some of these enhancements are still partly on-going. Banks are expected to implement the measures aimed at improving their strategies and policies to deal with impaired assets by September 2013, except for some IT improvements which have to be made only until December 2013.

78. Following the report submitted in mid-January 2013 in line with the MoU requirements (condition 28), the Spanish authorities started analytical work on credit concentration. The authorities collected information on the prudential measures adopted by other Member States as well as by non-EU countries (i.e. US and Canada) to tackle excessive sectoral concentration. To this end, BdE launched a query via the EBA requesting, *inter alia*, information on the supervisory methodology used by the EU banking supervisors to assess the sectoral concentration of a credit institution under the SREP (Supervisory Review Process). The countries which replied to the query have lower capital surcharges for sectoral risk concentration than Spain. Furthermore, BdE will assess possible modifications to the simplified option for the assessment of capital needs for sectoral credit concentration. The aim is to reduce the number of sectors involved in the calculation of the corresponding concentration indexes from 24 to 12 focusing on the sensitivity of these sectors to the economic cycle and recalibrate the capital surcharges under Pillar II. According to the results of a retrospective simulation performed by BdE on a sample of 30 banks, in the absence of prudent macroeconomic policies, there is no level of capital surcharges that could have stopped the level of sectoral concentration like the one on the

construction sector. The formalisation of the methodology for the calibration of capital surcharges under Pillar II is expected to take place in October 2013 with the view of applying the new methodology as of January 2014.

79. The enhancement of both micro prudential supervision and the macroprudential analysis will benefit from the enrichment of the data on credit risk available through the renewed credit register (MoU condition 30). The accuracy of the information on the credit history of individual borrowers is a key element for supervisors and banks to assess their risk as creditors. Moreover, this information allows supervisors to assess risk-taking from a more system-wide perspective. The BdE presented in October 2012 a complete set of reforms on the credit register and a new draft Circular was put in consultation by December. The Circular was discussed during the first months of 2013 and submitted for final public consultation in April, including some enhancements on the data provided by banks required by the international partners. The new Circular 1/2013 was approved by BdE on May 24.

80. The economic situation and rising societal concerns on residential foreclosures and evictions led to several legislative initiatives. A two-year suspension of evictions for vulnerable families has been included together with other initiatives in the recently approved Law 1/2013, of May 14, on measures to reinforce protection of mortgage debtors (see Box 4). This new legal framework aims at reaching a proper balance between consumer protection and financial stability. In principle, the measures that provide temporary relief for some vulnerable households are not likely to impair the incentives of debtors to service their mortgages and bring about serious consequences to the stability of the banks. Nevertheless, the outcome of the implementation of the new legislation needs to be closely monitored.

81. In order to replenish the Deposit Guarantee Fund[22] and extend the competences of the Deposit Guarantee Scheme (DGS), Royal Decree-Law 21/2012 was amended by Royal Decree-Law 6/2013 in March 2013. The scope of this exercise is two-fold: (i) increase the funding capacity of the DGS that could be used for further actions in the area of bank restructuring and resolution, and (ii) set-up a liquidity providing mechanism for the shares that were issued as a result of the SLE exercises (see Box 5).

[22] *Fondo de Garantía de Depósitos de entidades de crédito*, Deposit Guarantee Fund of Credit Institutions (FGD)

Box 4: New legislative actions on the protection of mortgage debtors

In May 2013, the Spanish parliament approved the Law 1/2013, to reinforce the protection of mortgage debtors. The law incorporates those provisions on the suspension on evictions already approved on 15 November 2012 via a new Royal Decree-Law 27/2012 (RDL), of urgent measures in order to reinforce protection of some vulnerable mortgage debtors.

Suspension of evictions for vulnerable families

The Law provides for a possible moratorium on evictions for a period of two years that applies only for evictions from primary dwellings for certain persons. People belonging to especially 'vulnerable' households will benefit from this measure. Some restrictive eligibility criteria have to be fulfilled (i.e. large families, unemployed debtors with no unemployment benefit). Households must also meet additional economic conditions (i.e. credit payments-to-income ratio must have multiplied by at least 1.5 times in the past four years; mortgages repayments must account for over 50% of the joint net income of all members in the family). The envisaged suspension does not affect the foreclosure procedure that can be executed.

Improvement of consumer protection

Some additional measures have been included in order to enhance the consumer protection framework as regards mortgage lending. Amongst other, the following amendments can be highlighted:

(i) the maturity of mortgages is limited to a maximum of 30 years to form part of the eligible portfolio for the issuance of mortgage bonds. This limit will only be applied to new operations.

(ii) the default interest rate applied by banks on mortgage loans is capped to three times the statutory interest rate only for mortgages.

(iii) debtor protection for the sale of mortgages loans is reinforced (i.e. handwritten certification on the risks embedded in floors and caps).

(iv) in case of default for the early termination of the contract at least three instalments of due payment of principal or interests are required.

Measures related to the European Court of Justice Aziz Ruling[23]

As a result of the aforementioned ruling, the Spanish authorities included some additional amendments in the law to comply with the ruling. These amendments include the introduction of new powers for consumers/borrowers and the judge to oppose foreclosures on the ground of unfair terms included in the contract. In addition, the law improves the non-judicial procedure for the repossession of mortgaged dwellings.

Other measures

- requirements to strengthen the independence of appraisal companies from credit institutions;
- debt relief after the foreclosure in case of early payments by the debtor upon the fulfilment of certain conditions;
- some further enhancements as regards auctions on foreclosures.

[23] The European Court of Justice ruling (March 14 2013), given as the result of a preliminary ruling proceeding raised by the *Juzgado de lo Mercantil nº 3 de Barcelona* –Commercial Court No 3, Barcelona, on the interpretation of the Council Directive 93/13/EEC, of 5 April 1993. Case C-415/11

Box 5: Additional financing and new functions for the Deposit Guarantee Scheme (DGS)

Two significant measures related to the DGS were adopted on (i) the funding of the DGS and on (ii) the new functions to be carried out by the DGS.

On funding, the RDL aims at replenishing funds available through additional contributions to be provided by banks. In this regard, an extraordinary contribution equal to 3‰ of deposits of each credit institution is envisaged. This exceptional levy is conceived as a one-off fee to be added to the ordinary annual contribution.

This levy will be paid by credit institutions in two tranches (i) the first one amounting to 40% of the contribution to be disbursed within the first twenty days of 2014. The managing committee of the DGS may decide to shift up to 50% from the first to the second tranche and (ii) the remaining 60% over a maximum of seven years as from January 2014.

In addition to this, the managing committee of the DGS may also decide to reduce the levy (limit: 90% of the amount to be paid): (i) up to a 50% for institutions having a deposit base lower than €5bn and (ii) up to 30% of institutions capital investments in Sareb disbursed before the end of 2013.

As regards the competences attributed to the DGS, the RDL set out that the DGS may decide to implement a liquidity mechanism for ordinary shares issued as a result of the SLEs carried out on the banks majority owned by the FROB and provided that they are not listed. This acquisitions would be done at market price determined by an independent expert.

5 SUSTAINABLE PUBLIC FINANCES AND GROWTH-ENHANCING REFORMS

5.1 STRENGTHENING PUBLIC FINANCES

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

83. On 29 May 2013, the Commission adopted a revised recommendation for a Council recommendation proposing an extension of the deadline for correcting the excessive deficit by two years to 2016. An assessment based on the data from the Commission services' 2013 Spring Forecast showed that Spain would not meet the nominal budgetary targets established in the Council Recommendation of 10 July 2012 in spite of having implemented a structural effort in 2012 and 2013 which, account taken of the unexpected adverse economic developments compared to when the Council recommendation was issued, was in line with the July 2012 EDP recommendation[24]. These unexpected adverse economic developments had entailed major unfavourable consequences for government finances. In particular, significant revenue shortfalls linked to the on-going rebalancing of the economy towards a less tax-rich growth structure and associated negative effects on revenue elasticities had led to a substantial deterioration in the budgetary position. Moreover, the economic recession had affected employment in a very negative way and unemployment had risen sharply. The key policy recommendations in the new EDP are summarised in Box 6.

[24] This conclusion confirms the one reached in the assessment of effective action of November 2012.

Box 6: Summary of the 2013 CSRs and EDP recommendation

This box summarises the main elements of the country-specific recommendations (CSRs) and new EDP recommendation addressed to Spain on 29 May in the context of the European Semester. Progress with these policy recommendations will be monitored in the context of the regular reviews under the financial sector assistance programme, as requested by the MoU. CSRs and EDP should be seen together as they aim to provide a comprehensive guidance on policies to boost growth and employment, increase competitiveness and bring public finances back on a sustainable path.

2013 CSRs:

- 2013 CSRs are based on a review of the economic and social performance in the previous year, also in response to 2012 CSRs, and EU-wide priorities for jobs and growth, as set out in the Commission's Annual Growth Survey. In addition, for Spain, they also take into account the analysis in the In-depth review published on 10 April 2013, with the conclusion that Spain is experiencing excessive macroeconomic imbalances. To a large extent the CSRs are based on commitments and deadlines set out in the National Reform Program (NRP) and Stability Program. Swift and effective delivery is paramount to start reaping the full benefits of the reform agenda, especially as the record on the 2012 CSRs has been uneven.
- The CSRs call for an acceleration of reforms in the areas of taxation, pensions, product and service markets, labour market, financial sector, public finances and public administration, while fiscal consolidation continues and social safety nets are preserved. In particular:
    - reforms in the area of taxation can support both fiscal consolidation and economic adjustment in Spain. More specifically, Spain has to conduct a systematic review of the tax system by March 2014, consider further limiting tax expenditure in direct taxation, and explore the scope to further limit the application of the reduced VAT rates and to take additional steps in environmental taxation;
    - the labour market situation remains critical. There is a need to speed up and further complement the on-going reforms of activation policies, as well as take stock of the effects of the labour market reform of 2012, with the objective of ensuring its full effectiveness. In addition, Spain should adopt the planned reforms in the area of education and training as weaknesses in these areas have contributed to the high youth unemployment rate;
    - barriers to doing business and lack of competition in product and service markets that are holding back growth and job creation and keep prices higher for consumers need to be addressed. In addition, Spain needs to urgently complete the reform of the energy sector and needs to step up reform efforts in transport;
    - the highly decentralised setting of Spain calls for enhanced coordination between the various public administrations, both to reduce costs and to limit the administrative burden on companies and households.

EDP:

- The headline deficit targets leading to the correction of the excessive deficit by 2016 are set at 6.5% of GDP for 2013, 5.8% of GDP for 2014, 4.2% of GDP for 2015, and 2.8% of GDP for 2016. Achieving these targets requires an estimated improvement in the structural budget balance of 1.1% of GDP in 2013, 0.8% of GDP in 2014, 0.8% of GDP in 2015, and 1.2% of GDP in 2016.
- In addition, the authorities should reinforce the medium-term budgetary strategy with well-specified structural measures for the years 2014-16 to underpin these targets. The fiscal framework should be strengthened further and the recurrent gap in the social security budget needs to be addressed. The planned regulation of the sustainability factor in the pension system is expected to contribute significantly to this objective.

5.2 BOOSTING ECONOMIC GROWTH AND JOB CREATION

84. Structural reforms that facilitate the correction of macroeconomic imbalances and boost potential growth support the objectives of the banking programme. While the programme stabilises the banking sector and supports its capacity to intermediate financial flows, a lasting rebalancing of the economy requires well-functioning and competitive labour, product and services markets. Labour market rigidities as well as weaknesses in active labour market policy and the education and the training system have contributed to fast-rising unemployment. Barriers to competition prevent more productive firms from growing and gaining market shares and hold back innovation. Weaknesses in the business environment (e.g. segmentation of Spain's domestic market, entry barriers in services' industries, lack of efficiency of the judicial system) also reduce market contestability and hold back job creation.

85. On 29 May 2013, the Commission issued a new set of country-specific recommendations (CSRs) to Spain in the context of the European Semester, which – together with the EDP recommendation – provide comprehensive guidance to address these reform challenges (see Box 6). These CSRs also take into consideration the analysis in the In-depth review published on 10 April 2013, with the conclusion that Spain is experiencing excessive macroeconomic imbalances. Spain's National Reform Programme (NRP) and Stability Programme, both submitted on 30 April 2013, set out a comprehensive policy response to address these imbalances. To a large extent the CSRs are based on the commitments and deadlines set out in the NRP and Stability Program. Progress with these policy recommendations will continue to be monitored in the context of the regular reviews under the financial sector assistance programme, as requested by the MoU.

86. Reforms of the public administration and systematic spending and tax reviews can improve the quality of public finances and thereby support both fiscal consolidation and growth. The government reform plans for the local administration, the work of the commission on administrative reform and systemic reforms such as the Market Unity law go in this direction. The tax system was somewhat rebalanced towards environmental and consumption taxes in 2012, and measures were taken to reduce the debt bias in the system and limit tax expenditure. There seems however to be scope for further improving the efficiency and transparency of the tax system, and a need to continue fighting the distortions from a large shadow economy sector.

87. Very high unemployment remains one of the most pressing policy challenges. Even as the active population has started to shrink, unemployment keeps rising and reached 27.2% at the beginning of 2013 (55.7% for young people) and long-term unemployment accounts for 44.5% of total unemployment. The fall in employment has especially affected labour-intensive sectors (such as construction and the public sector), thus supporting apparent labour productivity growth and the further fall in unit labour costs (-3.4% in 2012).

88. The 2012 labour market reform is apparently starting to impact the working of the labour market. The available data suggest that the reform has started to lead to higher internal flexibility, to some reduction of dismissal costs and to signs of increasing wage moderation. However, progress appears more mixed in particular as regards duality. Spain will present its first evaluation in July 2013, which should help refine the reform where necessary. Meanwhile, the reform of active labour market policies is taking time. Passive labour market policies and their links with active policies were revised in July 2012, aiming at increasing financial incentives to work. The on-going reform of Active Labour Market Policies (ALMP) should improve targeting and provision of training opportunities for

unemployed (including on-the-job training), reform the public employment service to improve job counselling services and better link unemployment benefits with job search activities and participation in training.

89. The high youth unemployment rate is fuelled by problems in the education and training systems. Early school leaving, although decreasing, continues to represent a major challenge, vocational training remains insufficiently used, and the insufficient tailoring of skills and capabilities to market needs have not been yet effectively addressed. The national Youth Employment and Entrepreneurship Strategy 2013-2016, presented in March 2013, aims to provide a response to some of the shortcomings regarding youth unemployment. The Strategy incorporates a range of short-term measures most of which had been approved on 22 February 2013 and announces longer-term measures intended to improve education and employment opportunities for young people. Measures to promote vocational training have been introduced with the labour market reform of 2012 (reform of training and apprenticeship contract) and there are plans to extend the pilot projects on the education tranche of the dual vocational training in the months to come. The draft Law on quality of education (LOMCE)[25] has been adopted by the Government in May, and its final adoption is still expected by the end of 2013.

90. It is taking longer than envisaged to address weaknesses in the business environment. Reforms are crucial to create the right framework conditions and incentives so that the reallocation of resources towards tradable sectors continues and spurs growth and employment creation. The Commission has recommended to address barriers to doing business, and to increase decisively competition in product and services markets, which, are holding back growth and job creation and keeping prices higher for consumer. To facilitate the reallocation of production factors, the Commission recommends reducing entry barriers (licensing procedures, establishment of retail premises), and tackling the inefficiencies in the rental market and in the insolvency framework. The 2013 NRP announces a number of product market and business environment reforms. The first draft of the law on market unity, which aims at addressing the fragmentation of the domestic market, was adopted by the Council of Ministers in January 2013. The parliamentary adoption of the law is foreseen by the end of 2013 under urgency procedure. The approval of the draft law on professional services is scheduled for the end of the first half of 2013. The law to support entrepreneurs and their internationalisation is expected to be approved by Parliament before the end of 2013. Timely adoption and implementation of these measures will be crucial to boost the growth potential.

91. The electricity tariff deficit, which represents a potentially sizeable contingent liability for the budget and a non-negligible macroeconomic risk, has not yet been tackled conclusively. In February and March 2013 the government simplified the system of support for renewable energy, revised the annual adjustment of regulated costs, and reviewed modalities of support to insular electricity generation systems. In addition, an extraordinary credit from the state budget of EUR 2.2 billion was made available. Eliminating the deficit will require a comprehensive approach. The 2013 CSRs recommend tackling the electricity tariff deficit by adopting and implementing a structural reform of the electricity sector by the end of 2013. The 2013 NRP announces a draft law further reforming the electricity sector and reviewing regulated costs by the end of June 2013.

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25 http://www.mecd.gob.es/servicios-al-ciudadano-mecd/participacion-publica/lomce.html

6 ANNEXES

6.1 MAIN ECONOMIC AND FINANCIAL INDICATORS

	1995-1999	2000-2004	2005-2008	2009	2010	2011	2012	2013 (e)	2014 (f)
Core indicators									
GDP growth rate	3.7	3.6	3.0	- 3.7	- 0.3	0.4	- 1.4	- 1.5	0.9
Private consumption (annual % change)	3.5	3.7	2.8	- 3.8	0.7	- 1.0	- 2.1	- 3.1	- 0.1
Public consumption (annual % change)	2.7	5.0	5.4	3.7	1.5	- 0.5	- 3.7	- 3.7	- 0.4
HICP (annual % change)	2.8	3.2	3.5	- 0.2	2.0	3.1	2.4	1.5	0.8
Domestic demand incl. stocks	4.2	4.3	3.6	- 6.6	- 0.6	- 1.9	- 3.9	- 4.0	- 0.4
Unemployment rate (% of labour force)	17.2	11.2	9.3	18.0	20.1	21.7	25.0	27.0	26.4
Gross fixed capital formation (% of GDP)	22.5	26.7	29.8	23.6	22.3	21.1	19.1	17.6	17.3
Gross national saving (% of GDP)	22.0	22.6	21.1	19.2	18.4	17.8	18.8	19.7	20.7
General Government (% of GDP)									
Balance	- 4.2	- 0.4	0.3	- 11.2	- 9.7	- 9.4	- 10.6	- 6.5	- 7.0
Gross debt	64.7	52.5	39.8	53.9	61.5	69.3	84.2	91.3	96.8
Interest expenditure	4.6	2.7	1.7	1.8	1.9	2.5	3.0	3.3	3.5
Households									
Households saving rate	13.2	11.3	11.3	17.8	13.1	11.0	8.2	8.0	8.9
Rest of the world (% of GDP)									
Trade balance	- 0.1	- 2.8	- 6.0	- 1.9	- 2.2	- 0.8	1.0	3.6	4.9
Trade balance, goods	- 3.3	- 5.7	- 8.1	- 4.0	- 4.6	- 3.8	- 2.4	- 0.4	0.6
Trade balance, services	3.2	2.9	2.0	2.1	2.4	3.0	3.4	4.0	4.3
Current account balance	- 0.8	- 4.4	- 9.0	- 4.8	- 4.4	- 3.7	- 0.9	1.6	2.9
Net financial assets	- 27.0	- 39.7	- 70.2	- 92.0	- 87.0	- 90.2	- 91.1	n.a.	n.a.
Net international investment position	- 26.9	- 41.3	- 69.7	- 93.7	- 88.9	- 91.8	- 91.1	n.a.	n.a.
Competitiveness (index, 2005=100)									
Real effective exchange rate relative to the rest of the euro area	91.4	95.8	104.1	104.9	103.4	100.9	95.8	93.7	92.1
Real effective exchange rate relative to the rest of the European Union	93.7	95.3	103.8	107.8	105.1	102.7	96.7	94.9	93.2
Real effective exchange rate relative to the rest of 36 industrialised countries	92.5	92.7	104.7	109.0	104.6	102.4	95.4	94.7	92.9
Banking sector									
Assets (% of GDP)	173.7	194.9	274.5	328.9	330.9	340.5	341.2	332.5	n.a.
Private domestic credit (y-o-y %)	11.8	14.7	18.9	- 1.6	0.8	- 3.2	- 9.9	- 12.2	n.a.
Non-performing loans (NPLs), total	3.3	1.1	1.5	5.1	5.8	7.8	10.4	10.9	n.a.
NPLs, productive activities	n.a.	1.2	1.5	6.2	8.1	11.6	16.1	16.0	n.a.
" of which, construction, and	n.a.	1.0	1.7	8.5	12.1	18.2	25.8	25.4	n.a.
" real estate activities	n.a.	0.6	1.8	10.1	14.0	21.4	29.1	28.9	n.a.
NPLs, residential mortgages	n.a.	0.4	1.0	2.9	2.6	3.1	4.3	4.6	n.a.
Tier 1 ratio (%)	n.a.	n.a.	n.a.	9.3	9.6	10.5	9.6	n.a.	n.a.
Interest rates									
10 year spread vis-à-vis the Bund	1.6	0.2	0.1	0.8	1.5	2.8	4.3	3.4	n.a.
CDS 5 year	n.a.	n.a.	n.a.	92.9	203.4	318.1	427.2	256.5	n.a.

(e) 2013 estimate or latest available data
(f) 2014: forecast or latest available data
Sources: Ameco, BdE, ECB, Eurostat, IHS Global Insight, Thomson Reuters EcoWin.

6.2 TABLE ON THE STATUS OF MOU CONDITIONALITY

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

Measure	Date	Status
14. Conduct an internal review of supervisory and decision-making processes. Propose changes in procedures in order to guarantee timely adoption of remedial actions for addressing problems detected at an early stage by on-site inspection teams. Ensure that macro-prudential supervision will properly feed into the micro supervision process and adequate policy responses.	End-October 2012	Implemented, follow-up on-going
15. Adopt legislation for the establishment and functioning of the AMC in order to make it fully operational by November 2012.	Autumn 2012	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	Proposals submitted, action plan under implementation
18. Propose measures to strengthen fit and proper rules for the governing bodies of savings banks and introduce incompatibility requirements regarding governing bodies of former savings banks and commercial banks controlled by them.	End-November 2012	Implemented, legal follow-up ongoing
19. Provide a roadmap (including justified exceptions) for the eventual listing of banks included in the stress test which have benefited from State aid as part of the restructuring process.	End-November 2012	Implemented
20. Prepare legislation clarifying the role of savings banks in their capacity as shareholders of credit institutions with a view to eventually reducing their stakes to non-controlling levels. Propose measures to strengthen fit and proper rules for the governing bodies of savings banks and introduce incompatibility requirements regarding the governing bodies of the former savings banks and the commercial banks controlled by them. Provide a roadmap for the eventual listing of banks included in the Stress Test, which have benefited from State aid as part of the restructuring process.	End-November 2012	Implemented, legal follow-up ongoing
21. Banks to provide standardised quarterly balance sheet forecasts funding plans for credit institutions receiving State aid or for which capital shortfalls will be revealed in the bottom-up stress test.	As of 1 December 2012	Implemented, the first quarterly submission took place
22. Submit a policy document on the amendment of the provisioning framework if and once Royal Decree Laws 2/2012 and 18/2012 cease to apply.	Mid-December 2012	A document has been submitted, discussions are on-going

Measure	Date	Status
23. Issues CoCos under the recapitalisation scheme for Group 3 banks planning a significant (more than 2% of RWA) equity raise.	End-December 2012	Not relevant, Group 3 banks recapitalised without State aid
24. Transfer the sanctioning and licensing powers of the Ministry of Economy to the BdE.	End-December 2012	Implemented RDL 24/2012
25. Require credit institutions to review, and if necessary, prepare and implement strategies for dealing with asset impairments.	End-December 2012	Implemented
26. Require all Spanish credit institutions to meet a Common Equity Tier 1 ratio of at least 9% until at least end-2014. Require all Spanish credit institutions to apply the definition of capital established in the Capital Requirements Regulation (CRR), observing the gradual phase-in period foreseen in the future CRR, to calculate their minimum capital requirements established in the EU legislation.	1 January 2013	Implemented, RDL24/2012 Additional technical details implemented by BdE (Circular 7/2012)
27. Review governance arrangements of the FROB and ensure that active bankers will not be members of the Governing Bodies of the FROB.	1 January 2013	Implemented, RDL 24/2012
28. Review the issues of credit concentration and related party transactions.	Mid-January 2013	On-going: analytical work in progress
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	Implemented, Circular 1/2013
31. Raise the required capital for banks planning a more limited (less than 2% of RWA) increase in equity.	End-June 2013	Not relevant, (Group 3 banks recapitalised without State aid)
32 Group 3 banks with CoCos to present restructuring plans.	End-June 2013	Not relevant,(Group 3 banks recapitalised without State aid)

KC-AH-13-155-EN-N