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Statement on the Final Financial Sector Monitoring Mission to Spain

A staff team from the International Monetary Fund (IMF) visited Madrid December 2-16 for the fifth independent monitoring mission in the context of the European financial assistance for bank recapitalization, as agreed with the Spanish authorities and the European Commission (EC) on July 20, 2012. This was the final such mission, as the bank recapitalization arrangement expires in late January 2014. The team met with official and private-sector representatives and discussed its preliminary findings with the Spanish authorities and European partners at the end of the visit. Staff will convey a final report to the authorities and the EC by early February 2014.

Program achievements

Implementation of the financial sector program by the Spanish authorities has been steadfast, and all of the program's specific measures are now complete. These include:

- identifying undercapitalized banks via a comprehensive asset quality review and independent stress test;
- taking actions to address these shortfalls, supported by funding from the European Stability Mechanism;
- segregating certain types of real estate-related assets of state-aided banks into a specialized asset management company (SAREB);
- adopting plans to restructure or resolve state-aided banks within a few years, with implementation now well underway;
- adopting reforms to Spain's frameworks for bank resolution, regulation, and supervision that should enhance financial stability and better protect the taxpayer; and

- developing a major reform of the legal framework for former savings banks, which is now in the final stages in parliament and expected to be adopted by end-2013.

Efforts under the program have made the banking system stronger, safer, and leaner, as has important policy progress at the European level. These developments have in turn supported financial stability and investor confidence—key prerequisites for solid and sustainable growth.

Remaining challenges and policy agenda

Notwithstanding this substantial progress and the recent stabilization of output, important challenges for the financial sector remain, as the economy continues to undergo a process of private-sector deleveraging and fiscal consolidation that can restrain the pace of recovery, with concomitant challenges for bank profitability. Other uncertainties for the sector arise from unknowns regarding the methodology of the forthcoming European bank asset quality review and stress test, as well as the unwinding of the state's ownership interest in intervened banks over the next few years.

It will thus be crucial to maintain the reform momentum. Sustained efforts will help safeguard and build upon the program's gains, while further enhancing banks' ability to lend and support the nascent recovery:

- At the ***Spanish level***, priorities include continued pro-active monitoring and supervision, including continued efforts to ensure adequate provisioning and to help prepare banks for the forthcoming European tests. Efforts to ensure adequate provisioning will also foster asset disposal over time, helping to free space on banks' balance sheets for new lending. Supervisors should also continue to encourage banks to build nominal capital—including by taking advantage of buoyant equity markets to boost share issuance, restraining cash dividends, and supporting profits through further efficiency gains—rather than relying on credit contraction to support capital ratios.
- At the ***euro-wide level***, priorities include further progress on banking union and continued monetary policy support to help reduce financial fragmentation, ease credit conditions, and assist the recovery.

Strong efforts along these lines could help generate a self-reinforcing and virtuous cycle of falling funding costs, higher profitability and capital, easier credit conditions for households and businesses, and more job creation.