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Spain: Financial Sector Reform—Fourth Progress Report

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SPAIN

FINANCIAL SECTOR REFORM: FOURTH PROGRESS REPORT

November 2013

Prepared by Staff of the

INTERNATIONAL MONETARY FUND*

PREFACE

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

- better capitalize Spain's banking system and reduce uncertainty regarding the strength of its balance sheets, with a view toward improving its access to funding markets; this in turn should help ease domestic credit conditions and thereby support economic recovery; the capitalization drive also aims to protect taxpayers by requiring weak banks to undertake private capital-raising efforts now before undercapitalization problems expand; and

- reform the frameworks for financial sector regulation, supervision, and resolution to enhance the sector's resilience and avoid a re-accumulation of risks in the future.

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

This report provides information and analysis on the status of Spain's financial sector reform program. The Ministry of Economy and Competitiveness, the Bank of Spain (BdE), and the European Commission (EC) requested that IMF staff provide such monitoring via quarterly reports, of which this report is the fourth. The fifth and final report will be produced in early 2014, as the program ends on January 23, 2014. This monitoring by IMF staff is conducted as a form of technical assistance under Article V, Section 2(b), of the IMF's Articles of Agreement. Views expressed in the report are those of IMF staff and do not necessarily represent those of the IMF's Executive Board. Further information on the objective and scope of these reports is in the Terms of Reference (TOR). IMF staff is not a party to the MoU, nor responsible for the conditionality or implementation thereof.

The report is organized into two main sections:

- *Macro-financial context*. Macroeconomic and financial conditions in Spain will affect the reform program's prospects for success, and vice-versa. Thus, as per the TOR for these reports, this section provides an update of recent macro-financial developments and key implications for the reform program.

- *Progress on financial sector reforms*. This section discusses progress on key measures under the reform program, as well as risks going forward and recommended actions to mitigate them. Further background on recent developments in the financial sector (e.g., trends in profitability and capital buffers) are provided in Annex 1.

EXECUTIVE SUMMARY

Implementation of Spain's financial sector program remains on track. Essentially all measures specified in the program have now been implemented, as envisaged under its front-loaded timetable. Of note, capital-augmentation measures arising from last year's stress test are now complete, SAREB has almost concluded its organizational development and is now accelerating the liquidation of its assets, and key reforms of Spain's financial sector framework have been adopted or put in train.

Macro-financial developments since the last progress report have been broadly positive. Output and unemployment have stabilized, with strong export growth. The clean-up of banks' balance sheets under the financial sector program has significantly bolstered the system's capital and liquidity, with all banks now having a core tier 1 capital ratio in excess of 9 percent, except for one relatively small bank that is in the process of being taken over by a stronger bank. Profits in the first half of 2013 also exceeded assumptions in the stress test's base case. On the other hand, profitability was boosted at least in part by temporary factors, and nonperforming loans, which tend to lag changes in economic growth, are still increasing. Against this background of mixed but broadly positive developments, Spain's financial markets rose briskly in recent months.

Despite recent improvements, important risks remain, including those associated with the ongoing macroeconomic adjustment. The correction of Spain's large external, fiscal, and financial imbalances is well underway, with policy actions at both the European and Spanish levels helping to ease market pressures over the last year. Nonetheless, significant further adjustment remains. Deleveraging by households and businesses, as well as planned fiscal adjustment over the next several years, will continue to weigh on domestic demand, such that the pace of recovery is likely to be restrained, with concomitant challenges for bank profitability that could in turn slow the recovery of credit conditions, reinforcing headwinds to growth and downside risks. There is also upside potential, especially in the medium term, in a scenario of strong policies and reforms by both Spain and Europe.

This calls for continued efforts at both the European and Spanish levels to help safeguard and build upon the program's gains. Priorities in this regard in the financial sector include measures to further enhance banks' ability to lend and support recovery, as outlined below and elaborated upon in the report.

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

- ***Enhanced monitoring and supervision***. To ensure that banks maintain strong and transparent balance sheets, it will be essential to continue pro-active monitoring of financial sector health, with a view to identifying risks at an early stage and addressing them with prompt supervisory action when needed. One priority in this regard is to ensure that Spanish banks are well-prepared for the forthcoming SSM/EBA balance sheet review and stress test. Such monitoring capabilities should be enhanced by the ongoing work at the BdE to develop and use forward-looking scenario exercises on bank resilience (FLESB) as a regular tool for informing its supervision. Recent progress on reforms to enhance supervisory procedures is also welcome and should be completed further, including to strengthen measures to avoid conflicts of interest.

- ***Boosting nominal capital to facilitate lending***. To avoid exacerbating already-tight credit conditions, supervisory actions to strengthen solvency should continue to prioritize measures that increase nominal capital (e.g., limiting cash dividends) over ones that reduce lending. In this regard, the Bank of Spain's recent guidelines recommending that banks limit cash dividends to no more than 25 percent of profits are welcome and should be extended to 2014. Banks should also be encouraged to take advantage of buoyant equity markets to increase share issuance.

- ***Deferred tax assets***. Improving the quality of bank capital by converting deferred tax assets (the value of which depends on future profits) arising from timing differences in provisioning rules into tax claims (the values of which are independent of future profits and hence are fully loss-absorbing) could further buttress capital positions. However, it will be important to ensure that (i) any such measure is accompanied by further actions by banks to strengthen their balance sheets and ability to lend and (ii) the net fiscal implications are minor.

- ***Facilitating asset disposal***. Accelerated asset disposal could also free capital space on banks' balance sheets for new lending to the growing parts of the economy and foster corporate debt restructuring where appropriate. This goal could be facilitated by continued efforts to ensure adequate provisioning and by considering reforms to reduce tax impediments to asset disposal.

- ***SAREB***. SAREB has nearly completed the due diligence on its assets, strengthened the servicing strategy, and hedged most of the interest-rate risk on its senior debt. Importantly, the liquidation process has gained momentum. However, property price declines and the deterioration of loans' credit quality remain key challenges for SAREB's cash flow and profitability.

- ***Savings bank reform***. The government submitted a draft law to reform the savings bank system to parliament in June. The priority now is to ensure timely adoption of the draft law—which aims to enhance savings banks' governance and reduce risks to financial stability—without significant dilution of key objectives, followed by full and timely implementation.

- ***Europe's contribution to recovery***. Measures at the European level are also key to supporting growth and financial stability. This includes swift progress toward fuller banking union in order to reduce financial fragmentation within the euro area, continued monetary policy support, and keeping state-aided banks' EC-approved restructuring plans under careful review to ensure they are sufficiently flexible to changing circumstances and avoid any unnecessary constraints on the supply of credit.

Summary of Recommendations[1]

Safeguarding and building upon the program's gains

- Continue close monitoring of financial sector health, including by using the FLESB to help guide supervisory decisions (¶17-19).

- Focus supervisory actions to bolster solvency and reduce risks on measures that, while boosting banks' capital, do not exacerbate already-tight credit conditions. This includes extending recently adopted limits on cash dividends to 2014 and encouraging banks to take advantage of buoyant equity markets to issue shares (¶20).

- Consider boosting the quality of bank capital by converting DTAs arising from timing differences in provisioning rules into transferable tax claims that would not be deductible from Common Equity Tier 1 (CET1) capital as defined under the EU's implementation of the Basel III framework. Ensure that (i) any such measure is accompanied by additional actions by banks to strengthen their balance sheets and ability to lend and (ii) the net fiscal implications are minor (¶20).

- Facilitate asset disposal by continued efforts to ensure adequate provisioning and by considering reforms to reduce tax impediments to asset disposal (¶20).

Savings bank reform

- Ensure timely adoption and vigorous implementation of the draft law submitted to parliament without significantly diluting its key provisions (¶13).

SAREB

- Continue efforts to devise and implement effective liquidation strategies (¶11).

Europe's contribution to recovery

- Ease funding costs for banks, households, and businesses by making swift progress toward fuller banking union and by continued monetary support (¶20).

- Keep restructuring plans under state aid rules under review to provide sufficient flexibility to changing circumstances and to avoid any unnecessary constraints on credit provision (¶20).

[1] Paragraph numbers in which these recommendations are discussed appear in parentheses.

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THE MACRO-FINANCIAL CONTEXT

Macro-financial developments since the last progress report have been broadly positive, with output and unemployment stabilizing. Spain's financial markets have also risen briskly in recent months. Nonetheless, the pace of recovery is likely to be restrained as the economy continues to undergo a difficult process of correcting pre-crisis imbalances.

1. **Spain's economy is showing signs of stabilization**. Of note:

- GDP growth turned positive in the third quarter, with output rising 0.1 percent (q-o-q).

- The seasonally adjusted unemployment rate, which has risen during the crisis to a very high 26½ percent (Eurostat estimate), also stabilized in September. The unadjusted rate (INE data) has fallen by 1.2 percentage points since its peak in the first quarter.

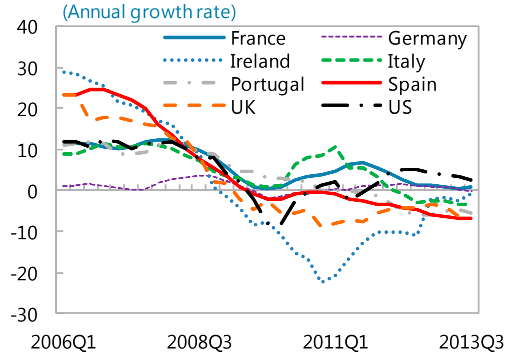
- The current account is on course to register a surplus in 2013—the first in over 20 years—with exports growing by about 6 percent.

- The clean-up of banks' balance sheets under the financial sector program has significantly bolstered the system's capital and liquidity. All banks covered by the stress test now have capital levels exceeding the minimum regulatory requirement (9 percent core tier 1, EBA definition), except for one relatively small bank that is in the process of being taken over by a stronger bank. System-wide profits are also up both before and after provisions, though this at least partly reflects temporary factors (see Annex 1 for further discussion of recent trends in banks' financial indicators).

2. **These positive developments have helped propel Spain's financial markets in recent months**. Between end-June and end-October, the risk premium on Spain's 10-year sovereign bond eased about 65 basis points, as did the yield (Figure 1). Bank wholesale borrowing costs fell even faster, with 5-year CDS spreads for many banks dropping more than 100 basis points. Rates on new deposits—banks' main source of funding—also continued to decline (Annex 1). Equity markets have been similarly bullish, with the IBEX rising 23 percent.

3. **Nonetheless, credit conditions remain tighter than in the euro area core**. Bank lending to the nonfinancial private sector fell by 6¾ percent (y-o-y) at end-September, one of the most rapid contractions among major advanced economies. Nonbank financing has picked up a portion of the slack, such that total credit to the nonfinancial private sector contracted at a slightly slower pace of 5½ percent (y-o-y). Lending to businesses has contracted more rapidly than lending to

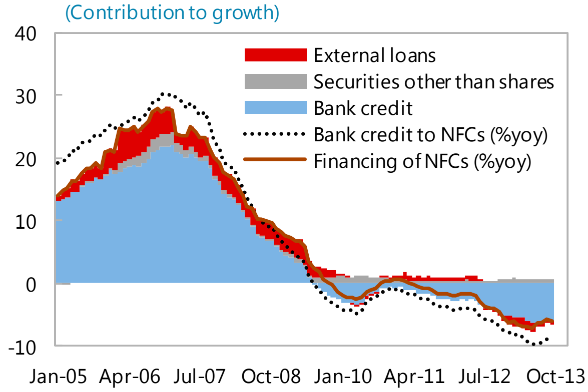
Bank Credit to the Private Sector 1/
(Annual growth rate)



Sources: Haver, BdE
1/ Numbers for Spain are adusted to remove the effect of the transfer of loans to SAREB.

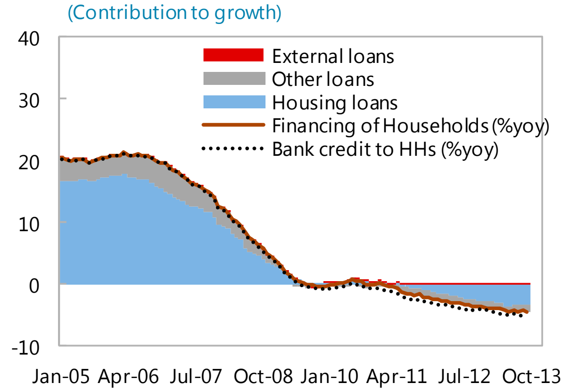
households. Similarly, the divergence between lending rates in Spain and those in the euro-area core has been larger for businesses than for households (Figure 2). These developments in credit quantities and lending rates reflect a combination of demand and supply factors, including weak demand and elevated default risk amidst recession (the NPL ratio continues to rise, including due to the reclassification of refinanced loans—see Annex 1 for further details), balance sheet pressures on households, businesses, and banks to delever, and incomplete banking union (see the last progress report and the Fall 2013 *Global Financial Stability Report* for more detailed analysis of these issues).

Spain: Financing of NFCs 1/
(Contribution to growth)



Source: BdE.
1/ Adjusted to remove effects of asset transfers to SAREB.

Spain: Financing of Households
(Contribution to growth)

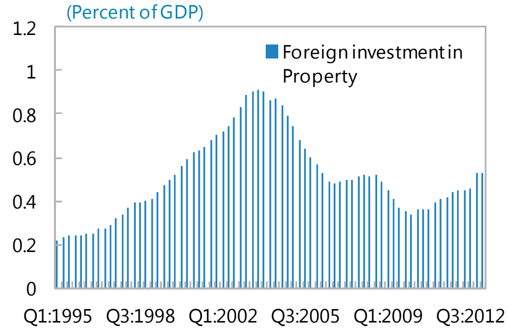


Source: BdE.

4. **Spain's macroeconomic imbalances continue to correct, but further adjustment remains.**[1] In particular:

- ***Fiscal***: Spain's fiscal effort has been one of the largest in Europe during 2012-13. Nonetheless, further substantial structural adjustment will likely be necessary to stabilize the debt-to-GDP ratio over the medium term.

Spain - Foreign Demands for Real Estate
(Percent of GDP)



- ***Housing***: At end-June, house prices were down 9-12 percent from a year earlier and 30-40 percent from their peak, depending on the index used. The very limited amount of new housing starts and completions—now about 15,000 units per quarter, a record low and fraction of the 170,000 units per quarter during the 2004-2007 boom—suggests that a significant overhang of supply remains, which may keep downward pressure on prices in the near term. Similarly, house price-to-rent and price-to-income ratios are still somewhat above their historical valuations. On the other hand, low levels of new

[1] See the staff report for the 2013 Article IV consultation with Spain for further discussion of these imbalances.

construction should accelerate the eventual stabilization of house prices. Foreign investor interest in Spanish real estate has also increased noticeably in recent months.

- ***Private-sector deleveraging***: Household debt ratios have declined only moderately from their peaks, as contracting credit has been partly offset by falling income (Figure 3). In contrast, the pace of adjustment for debt ratios of nonfinancial corporates has picked up considerably over the last year (Figure 4). However, both ratios are still well above pre-boom levels.

5. **These ongoing adjustments are expected to keep the pace of recovery restrained**. Growth is expected to continue receiving major impetus from expanding net exports. However, ongoing private-sector deleveraging, fiscal consolidation, and house price adjustment will weigh on domestic demand, the main component of output. On balance, IMF staff project a moderate pace of recovery over the medium term (Table 1). In this scenario, cumulative growth over 2012-14 will be between that assumed in the base and adverse cases of the September 2012 stress test (but closer to the base case). Similarly, some of the other key variables are close to the base case, while others are near the adverse case. On balance, staff's central scenario suggests an overall outcome (in terms of the effect on bank's capital) somewhere between the two cases. However, uncertainty around staff's central scenario is large, given the significant potential for both vicious and virtuous cycles to take hold.

Key Macro Variables
(annual rates, percent)

	Assumptions in Stress Tests								Actual	Latest IMF Staff Forecasts or Actual Observation 1/			Comments on latest actual observation or forecast
	Base case				Adverse case								
	2012	2013	2014	Average 2012-14	2012	2013	2014	Average 2012-14	2012	2013	2014	Average 2012-14	
Real GDP growth	-1.7	-0.3	0.3	-0.6	-4.1	-2.1	-0.3	-2.2	-1.6	-1.3	0.2	-0.9	Between base and adverse
Nominal GDP growth	-0.7	0.7	1.2	0.4	-4.1	-2.8	-0.2	-2.4	-1.6	-0.7	1.1	-0.4	Between base and adverse
Unemployment rate	23.8	23.5	23.4	23.6	25.0	26.8	27.2	26.3	25.0	26.9	26.7	26.2	Near adverse case
Harmonized CPI growth	1.8	1.6	1.4	1.6	1.1	0.0	0.3	0.5	2.4	1.8	1.5	1.9	Near base case
GDP deflator growth	1.0	1.0	0.9	1.0	0.0	-0.7	0.1	-0.2	0.0	0.6	0.9	0.5	Between base and adverse
House price growth	-5.6	-2.8	-1.5	-3.3	-19.9	-4.5	-2.0	-8.8	-9.0	*-9.4*	...	...	Heading near the adverse
Land price growth	-25.0	-12.5	5.0	-10.8	-50.0	-16.0	-6.0	-24.0	-6.4	*-17.4*	...	...	Near base case
Spain sovereign yield, 10-year	6.4	6.7	6.7	6.6	7.4	7.7	7.7	7.6	5.9	*4.1*	...	...	Better than both cases
Credit to households 2/	-3.8	-3.1	-2.7	-3.2	-6.8	-6.8	-4.0	-5.9	-3.6	*-4.2*	...	...	Between base and adverse
Credit to nonfinancial firms 2/	-5.3	-4.3	-2.7	-4.1	-6.4	-5.3	-4.0	-5.2	-7.8	*-9.4*	...	...	Worse than adverse

Sources: Haver; Oliver Wyman; IMF staff estimates.
1/ Projections based on the September 2013 *World Economic Outlook* update. Latest actual observations for 2013 are in italics.
2/ From the flow-of-funds data. Includes loans from resident credit institutions, off-balance-sheet securitized loans, and loans transferred to SAREB.

PROGRESS ON FINANCIAL SECTOR REFORM

Essentially all measures in the MoU have now been implemented, as envisaged under its frontloaded timetable (Annex 2). These actions have provided a major boost to the system's capital and liquidity. Nonetheless, risks to the financial sector arising from the difficult economic environment still loom large, requiring continued action to safeguard the program's gains and better support economic recovery.

A. Bank-Specific Measures

6. **All capital-augmentation measures required as a result of the program's September 2012 stress test are now complete**. Measures have included injections of public-sector capital, burden-sharing exercises, asset sales, private equity issuance, and the requirement that all intervened banks transfer their foreclosed assets and real estate development loans (over a minimum size) to an asset management company (SAREB) in exchange for government-guaranteed SAREB bonds that can be used as collateral for ECB financing.

7. **Restructuring of intervened banks and divestment of the state's ownership of them is ongoing and expected to be fully completed by 2017**. Following the process of recapitalization and restructuring, the government (through the FROB) is now the majority owner of a significant part of the banking sector (holding an estimated 18 percent of system loans). All of these banks are under EC-approved restructuring or resolution plans. These plans entail measures such as management overhauls, downsizing, and cost-cutting, as well as divestment of the government's ownership by no later than end-2017. The FROB is currently discussing the possible sale of two of these banks. It will be important to evaluate the costs and benefits from such sales from a fiscal viewpoint and compared to alternatives, while also taking into account that both banks are in resolution and can therefore only operate within a limited lifespan.

8. **Authority to undertake burden-sharing exercises under the resolution law should be extended until the forthcoming EU directive on bank recovery and resolution is in place**. The government's authority to undertake burden-sharing exercises under the resolution law through haircuts of subordinated debt and preference shares or their conversion into equity expires at end-2013. Extension of these powers to be effective until Spain harmonizes its framework to the upcoming EU directive on bank recovery and resolution would ensure full maintenance of a broad toolkit of resolution tools during the interim.

B. SAREB

9. **SAREB continues to make significant progress on its organizational development, including in the following key areas**:

- ***Servicing strategy***. Banks that transferred assets to SAREB are still servicing (e.g., collecting payments on loans and selling assets) many of these assets, based on servicing contracts signed with SAREB (though some of these banks have since sold their real estate management units, which continue their servicing of SAREB's assets, to international investors). To improve the quality of this service, SAREB has hired staff to create servicing teams inside these banks and has created weekly budgets and benchmarks for each bank. For the medium term, SAREB has designed a new servicing strategy based on servicers specialized by asset and competing among themselves.

- ***Staff***. SAREB now has the bulk of its core staffing in place. Final staffing levels and the pace of growth will depend heavily on the degree to which asset servicing is outsourced.

- ***Due diligence***. SAREB expects to complete due diligence on 80 percent of its assets by end- 2013 and on the whole exercise in early 2014. This timing is a few months later than initially planned due mainly to the unforeseen need to retrieve missing data from some loan files.

- ***Business plan***. In February 2014, SAREB is required by law to revise its business plan of March 2013, including to reflect information acquired from the due diligence exercise, the experience with asset liquidation in 2013, and the new commercial strategies.

10. **SAREB's key financial developments so far this year include the following**:

- ***Property sales are accelerating***. Units sold via the retail channel were six times higher in July than in March. According to SAREB, the current pace is satisfactory and in line with the business plan. Wholesale sales have also started with the creation of the first FAB (Fondo de Activos Bancarios, a special low-tax vehicle). This FAB will acquire nearly 1,000 real estate units from SAREB, and its financing includes equity participation from the investor (51 percent) and SAREB (49 percent). FABs are flexible structures, which enable SAREB to meet wholesale investors' preferences and thus ease the liquidation process. However, SAREB remains partially exposed to the FAB's assets, which calls for the close monitoring of the financial impact of these transactions to ensure that the gains outweigh the costs. More FABs (which may have different structures) are planned for launching by end-2013.

- ***Sales of real estate development loans (REDs) have started via four approaches***: (i) sale of large syndicated loans in the secondary OTC market; (ii) sale of individual bilateral loans to the debtor or third parties; (iii) sale of the loan collateral and use of the proceeds to repay the outstanding loans with possible acquittance; and (iv) sale of loan portfolios in the wholesale market to institutional investors. SAREB also launched several initiatives aimed at generating cash flows from the nonperforming REDs (e.g., a plan that supports the borrowers in liquidating loan collateral, altering payment structures, etc).

- ***SAREB has hedged much of the interest-rate risk on its debt***. SAREB's 1, 2, and 3-year senior bonds pay quarterly floating rate coupons linked to 3-month EURIBOR and to the spread at issuance between Spain's sovereign yield and 6-month EURIBOR. SAREB has hedged the EURIBOR-related interest rate risk on about 85 percent of its foreseen debt via a chain of swap agreements that enter into force on December 31, 2013.

- ***Cash inflows have matched outflows***. Through end-September 2013, SAREB's cash inflows matched costs, debt service, and credit line drawdowns. More than three-quarters of gross cash collections derive from REDs' redemptions, amortization, and interest payments. The rest is from rental income and sales of properties and REDs.

- ***Profit margins have been positive but declining***. SAREB indicates that profit margins on property sales have on average been positive and have exceeded projections in the business plan. However, sales margins on properties have been narrowing due to (i) the ongoing drop in real estate prices and (ii) the introduction of wholesale deals, which are necessary to liquidate SAREB's assets at a sufficiently rapid pace, but normally also have narrower profit margins than retail transactions.

- ***Overall profits are likely to be negative in 2013, as expected***. Despite positive sale margins and the pick-up in sales from June, SAREB expects to book a loss in 2013, as anticipated in the business plan. The loss partly reflects the slow pace of property sales in the first half of 2013, which kept total profits from sales below expenses.

11. **Looking forward, SAREB expects to improve its performance in 2014**. Factors supporting this objective include the recent acceleration of asset liquidation, plans to fully deploy commercial strategies developed in 2013, and lower debt-servicing costs as SAREB starts to repay its bonds and takes advantage of the improvement in Spain's sovereign spreads during the last year. The primary risk factor relates to uncertainty regarding the future path of real estate prices, which will become more important over time as REDs increasingly become nonperforming and as profitability and cash flows thus increasingly become less dependent on performing loan redemptions and interest payments and more dependent on the sale of collateral, either by the borrower with the support of SAREB or by SAREB itself after repossession. This highlights the importance of SAREB continuing its efforts to devise and implement effective liquidation strategies geared toward supporting its cash flow and profitability.

C. Structural Reforms to Enhance Resilience Going Forward

12. **Completing structural reforms initiated under the program will further promote financial stability going forward**:

13. ***Savings banks reform***. The draft law to reform the framework for former savings banks (Annex 2, measure 20) was submitted to parliament on June 21, 2013, and final adoption is expected by end-year. The law is a welcome advance, as discussed in detail in the 2nd progress report, and it will be important to ensure that any final amendments do not significantly dilute the law's key provisions. Strong implementation of the law by the BdE in its capacity as supervisor will also be key to its success.

14. ***Enhancing supervisory procedures***. In October 2012, the BdE completed a comprehensive review of its supervisory procedures (Annex 2, measure 14). The BdE has since made notable progress in implementing recommendations included in the report or suggested by international partners in follow-up discussions, though some are still to-be-completed. Specifically:

- In the first half of 2013, a number of reforms were adopted, including the extension of on-site continuous monitoring to all significant Spanish banks and the reorganization of the Directorate General of Banking Supervision.

- In recent months, further progress has included the adoption of new by-laws and an internal circular to formalize new procedures for supervisory planning, on-site inspections, on-site continuous monitoring, and off-site monitoring.

- Still-to-be-completed reforms include improving the annual procedure for inspector rotation (though the above-mentioned reorganization of supervision entails the rotation of executive coordinators and heads of supervisory divisions), appropriately revising cooling-off periods (though the BdE announced on November 15 that its Executive Commission has asked its Secretary General to develop a proposal to adapt cooling-off periods applicable to directors general following their departure from office, taking into account also general rules that apply to the state sector), revising procedures for supervision of banks' corporate governance, and establishing a procedure to link macroprudential and microprudential supervision.

- Many of these to-be-completed reforms are awaiting the development of the Single Supervisory Mechanism (SSM) and are expected to be adopted as part of this process. More generally, implementation of the October 2012 report will likely need to be adapted to SSM procedures to ensure a smooth transition to this mechanism.

15. ***Promoting nonbank financing***. The authorities prepared a report in November 2012 that made a variety of recommendations to strengthen nonbank financial intermediation (Annex 2, measure 17). Significant progress has been made in implementing these recommendations. For example, the authorities have approved all regulatory changes needed for the creation of an Alternative Fixed Income Securities Market that aims to broaden SMEs' access to capital markets, measures have been taken to increase private equity investment, and an inter-agency working group on financial disintermediation has been created and is working on a regular basis.

D. Safeguarding and Building Upon the Program's Gains

16. **A set of mutually-reinforcing actions in the financial sector can help safeguard financial stability and promote faster economic recovery**. Actions taken by the authorities under the ESM-supported program have helped tackle the legacy risk from the real estate boom-bust, but macroeconomic risks continue to loom large. The challenge now is to ensure that financial sector policies safeguard the program's gains and facilitate economic recovery. Measures that would help achieve these ends include (i) further enhancing monitoring and supervision to identify and address risks at an early stage; (ii) taking steps to bolster capital in ways that do not exacerbate already-tight credit conditions (e.g., limiting dividend payouts); and (iii) further reducing funding costs (via banking union and continued monetary support). Such a strategy could help push the economy and financial system into the virtuous circle—in which lower funding costs and stronger capital mutually reinforce each other while also facilitating easier credit and more balance sheet transparency, which in turn pushes up growth and confidence, yielding yet lower funding costs and stronger balance sheets—and away from the vicious circle in which these dynamics operate in reverse. Elements of this strategy are further fleshed out below.

Enhanced monitoring

17. **To ensure that banks maintain strong and transparent balance sheets, it will be essential to continue pro-active monitoring of financial sector health**. The objective should be to identify new risks at an early stage and address them with prompt supervisory action when needed. In this regard, two useful tools have been developed during the program that should be used to enhance monitoring and supervision going forward:

18. ***Funding and Capital Plans (FCPs)***.

- As envisaged under the MoU (Annex 2, measure 21), all banks covered by the September 2012 stress test have begun to submit 3-year ahead quarterly projections of their balance sheets to the BdE. Banks make updated submissions each quarter—the first was this Spring and the second was this Summer—which the BdE compile and have shared with international partners.
- In aggregate, banks' projections for credit contraction are broadly in line with those of the BdE and IMF staff. However, the actual pace of credit contraction to the private sector (excluding RED loans) has been somewhat faster than banks projected in their FCPs. The undershoot in terms of the level of credit has occurred mainly at non-intervened banks, as intervened banks have kept the provision of credit close to the ceilings in their restructuring plans.
- Although data from just two quarters can be quite noisy and hence should be interpreted with caution, they nonetheless point to risks that non-intervened banks may not be able to fully pick up the slack in the provision of credit arising from the rapid deleveraging of

intervened banks required by their restructuring plans. These plans should thus be kept under review to ensure that they do not place any unnecessary constraints on lending, conditional on maintaining the essential goal of returning banks to viability.

19. ***Forward-Looking Exercise on Spanish Banks (FLESB)***. Another welcome addition to the BdE's supervisory toolkit is the FLESB, which aims to regularly assess the solvency position of Spanish banks. Differently from the stress tests done in the past, which were one-off exercises based on a pass-fail methodology, the FLESB is intended as a permanent framework to help the BdE regularly monitor banks' health and to guide its supervisory decisions. For example, FLESB findings may help the BdE engage in discussions with specific banks on plans to maintain adequate capital going forward. Intended as an internal tool, its characteristics will be flexibility to incorporate different macroeconomic scenarios; a granular top-down approach that includes some bottom-up elements and a bank-by-bank view; and a multi-year timeframe. It will also be just one of several factors and sources of information feeding into supervisory decisions. In this regard, the tool could usefully be employed to help ensure that Spanish banks are well-prepared for the forthcoming SSM/EBA balance sheet review and stress test. The BdE discusses the methodology and aggregate results from the first run of the tool in its November 2013 Financial Stability Report.

Maintaining sufficient capital

20. **Strategies that could help ensure that banks remain sufficiently capitalized to support recovery include the following**:

- ***Boosting nominal capital to facilitate lending***. To avoid exacerbating already-tight credit conditions, supervisory actions to strengthen solvency and reduce risks should prioritize measures that boost banks' nominal capital (the numerator of banks' capital ratios) over ones that reduce lending. Such actions include encouraging banks to take advantage of buoyant equity markets to increase share issuance, as well as continued efforts to encourage cost-cutting measures that bolster profitability and to restrain cash remuneration and cash dividends. On the latter, the BdE issued a letter to banks in June 2013 recommending that they limit dividend distributions and that, in any event, cash dividends in 2013 not exceed 25 percent of attributable consolidated profits. This recommendation is welcome and could usefully be extended to 2014; in this respect, strengthening the BdE's powers to limit (rather than simply making recommend) dividend distribution, on a microprudential or macroprudential basis, could be considered.

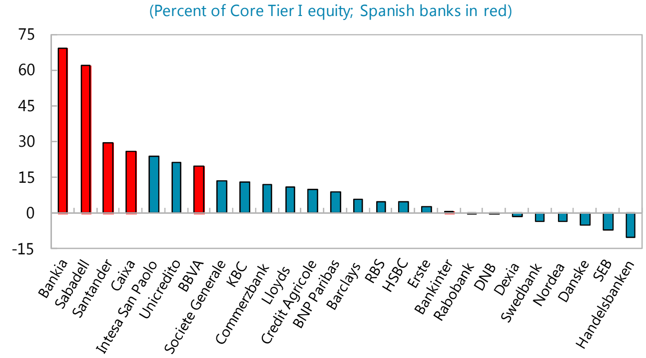
- ***Conversion of deferred tax assets***. The authorities are considering boosting the quality of bank capital by converting a portion of banks' deferred tax assets (DTAs) into claims on the government that would not be deducted from CET1 capital under Basel III, as was done recently in Italy. Such a reform could be helpful. However, it will be important to ensure that (i) it is accompanied by further actions by banks to strengthen their balance sheets and (ii) the net fiscal implications are minor (Box 1).

Box 1. DTA Conversion

DTAs are a low-quality asset that will increasingly be deducted from Basel III measures of capital. DTAs are generally only of value if a bank can generate future profits (and thus tax obligations) against which it can deduct DTAs. For this reason, DTAs will be increasingly deducted from CT1 capital as Basel III rules are gradually phased in.

Spanish banks have a large amount of DTAs. At end-June, Spanish banks' DTAs totaled €71 billion (7 percent of GDP), or more than 40 percent of CET1 capital. Of these, €59 billion were generated in Spain. A large portion of these DTAs arise from (i) significant losses in 2012 and (ii) timing difference associated with stepped-up provisioning on real estate-related assets. As a result of these DTAs, some Spanish banks' capital positions do not appear so strong when compared to their peers on a fully-loaded Basel III basis, a solvency measure on which markets increasingly focus.

Major European Banks: Net DTAs, end-2012 1/
(Percent of Core Tier I equity; Spanish banks in red)



The authorities are considering a proposal to convert some DTAs into higher-quality assets, as Italy did recently. To reduce uncertainty regarding the degree to which Spanish banks will be able to make use of their DTAs and thereby improve the quality of their capital, the authorities are considering adopting legislation that would convert DTAs arising from timing differences into transferable claims on the government in the event that banks do not have profits against which to claim a DTA when the associated timing difference is resolved. In this way, the value of the DTA would become certain and hence no longer deductible from capital under Basel III. The reform would affect €18-31 billion of DTAs currently held by banks, depending on which types of DTAs are made eligible (timing differences can arise for several reasons). To comply with EU competition rules, the reform would be permanent and apply to both financial and nonfinancial institutions. However, the authorities expect its application outside the banking sector to be negligible if it is applied only to timing differences related to provisioning rules.

Converting DTAs arising from timing differences in provisioning rules could be helpful, as it would boost the quality of capital, but it should not be provided as a windfall. Rather, it should be accompanied by actions by banks, such as those mentioned in the first bullet of paragraph 20, to further strengthen their balance sheets, as such actions have positive externalities in the current environment. For example, DTA legislation could be combined with legislation requiring banks to either issue more equity or refrain from cash dividends for given period (e.g., 3 years).

It will also be important to ensure that the net fiscal implications are minor. If DTA conversion is limited to timing differences associated with provisioning rules, the net cost may be modest, as some of the banks with the largest amount of DTAs are government-owned. Moreover, conversion will have high costs mainly in cases in which banks become insolvent before they are able to make use of DTAs. In these cases, the government loses on the conversion because it provides a claim against the government that is worth its full face value in exchange for a DTA that would never have been used otherwise. In such cases, however, the government might well be bearing the marginal cost of bank resolution anyway, such that whatever the government loses on DTA conversion, it gains in a higher residual value of the resolved bank, of which the government may have become the owner. Nonetheless, it will be essential to carefully analyze the fiscal implications of any measure. If these appear significant, the measure may need to be reconsidered absent offsetting measures that keep the net costs minor.

- ***Facilitating asset disposal***. Accelerated asset disposal could also free capital space on banks' balance sheets for new lending to the growing parts of the economy. It will therefore be important to avoid any artificial hindrances to this process. This includes continued efforts by supervisors to ensure that banks adequately provision for loan losses so that banks do not delay asset disposal simply to avoid recognizing losses. In this regard, strong implementation of the ongoing efforts to ensure accurate classification of refinanced and restructured loans (Annex 1) will be key, as will supportive tax policies on loss recognition. Scope for tax reforms to further facilitate asset disposal while improving tax efficiency should also be explored (e.g., by replacing real estate transaction taxes with higher taxes on property values or other revenue measures that are more efficient than transaction taxes).

Europe's contribution to recovery

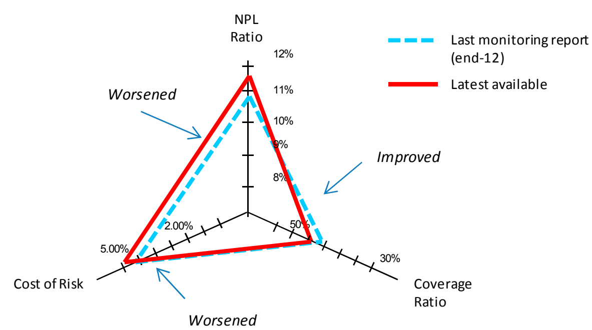
21. **Actions at the European level are also essential to facilitate faster and less costly adjustment**. Priorities in this regard include continued monetary support by the ECB and making swift progress toward fuller banking union so as to allow Spanish firms to compete for funds on their own merits, independent of their country of residence within the euro area (for more detail on IMF staff views on banking union, see the recent staff discussion note on banking union and the staff report for the 2013 Article IV consultation with the euro area). Both continued monetary support and fuller banking union would facilitate adjustment of imbalances in Spain and elsewhere in the euro area by easing borrowing and debt-servicing costs for households, businesses, and banks and by boosting both domestic demand and net exports. EC-approved restructuring plans for intervened banks should also be kept under review to ensure that they optimize the risk-adjusted return on the taxpayer's investment in these banks and avoid any unnecessary constraints on credit provision. Flexibility in restructuring plans will also be important to allow banks to adjust to changing circumstances as appropriate.

Annex 1: Banking Sector Developments

Banking trends during the first half of 2013 highlight higher profits (though driven by non-core items), better funding and liquidity conditions, and continued deterioration of asset quality. While Spain's banking system is stronger and safer than before, vulnerabilities remain. The priority is to maintain adequate capitalization and to swiftly provision for new credit risk, in the context of weak macrofinancial conditions.

Asset quality

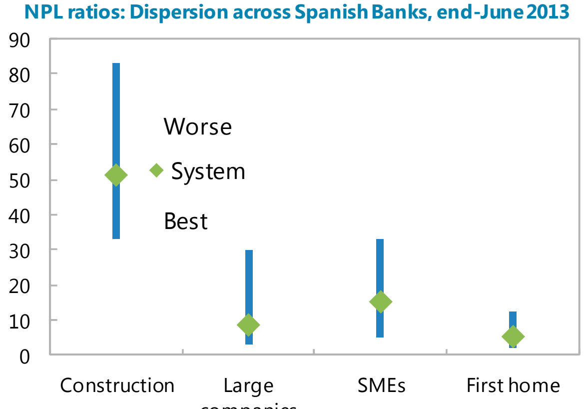
Asset Quality Deterioration in Spain, Since Last Monitoring Report



Credit quality continues to deteriorate. The stock of nonperforming loans (NPLs, or doubtful loans) continues to rise, reaching 12.1 percent of total loans as of end-August 2013, or an increase of 0.9 percentage points in just one quarter. Roughly three-quarters of the increase in the NPL ratio since end-February (after all loan transfers to SAREB were completed) reflects an increase in the numerator while roughly one-third reflects a falling stock of loans as banks delever. The coverage ratio (credit reserves to NPLs) has nonetheless improved in 2013 thanks to banks' efforts to step up provisions.

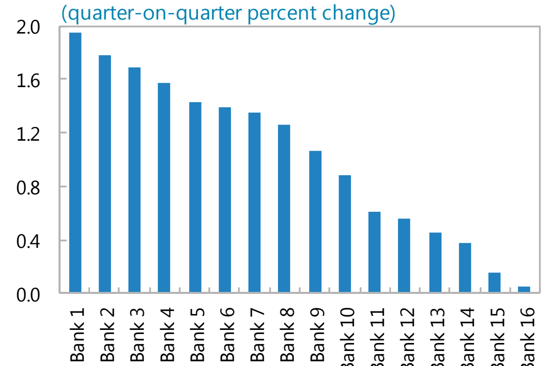
System-wide data mask wide important differences in NPL ratios across types of loans and banks. For example, NPL ratios for real estate development loans are much higher than for mortgages. Reflecting the heterogeneity of risk profiles across Spanish banks, the dispersion of NPL ratios across them is also high. Notwithstanding these important differences, NPL ratios have increased at all banks.

NPL ratios: Dispersion across Spanish Banks, end-June 2013



Source: BdE.

NPL Ratio, 2013Q2
(quarter-on-quarter percent change)



Source: BdE.

As noted in previous reports, substandard loans and repossessed assets add a further layer of non-normal assets to nonperforming loans. The system's high rate of non-normal assets suggests that a relatively high percentage of borrowers (especially businesses) are having problems servicing loans on time, as one would expect given the difficult economic environment.

Reclassifications of refinanced loans are likely to further push up NPLs and provisioning needs in the near term. As part of the MoU, banks are now requested to disclose data on refinanced (or restructured) loans. Spain is one of the first countries in Europe to take this important step toward improving transparency. The end-2012 data reveal a non-negligible amount of refinanced loans that are classified as performing, even though the resort to refinancing may indicate a higher credit risk that would justify a classification as substandard or NPL. The BdE has asked banks to review their classification of such loans, taking into account the BdE's further clarification of the criteria for such classification in May 2013, and to provision accordingly. Based on preliminary data submitted by banks by end-September 2013, the BdE estimates that the reclassification exercise will increase NPLs by €20.6 billion, substandard loans by €3.7 billion, and provisions by around €5 billion. However, final numbers will not be available before end-2013, following further review of these data by the BdE.

Refinanced/restructured loans: stock before and after reclassification

	Normal	Substandard	NPL
Strarting stock, March 2013	73,557	37,218	71,660
Stock after reclassifications, September 2013	48,193	40,888	92,224

Source: BdE.

Impairment rates (impairments as a percent of assets) are slightly under those in the stress test's base-case scenario. According to staff's estimates based on data covering about 90 percent of Spain's banking system, impairment rates for most asset categories at end-June, 2013, were generally slightly below the impairment rates expected in the stress test's base-case scenario.[2] The exception was real estate developer (RED) loans, which are already provisioned at above the adverse scenario if generic provisions on performing RED loans are included (according to RDL 18/2012). Repossessed assets, on the contrary, show the highest gap between what was impaired as of June, 2013 and what the stress test estimated for end-2014.

Spanish banks' credit losses: materialized 1H 2013, vs projected 2014

Asset class	Losses materialized, current (percent) 1/	Projected losses, 2014 (percent) 2/	
		Base case	Adverse case
Repossessed assets	36.6	55.5	63.4
Real estate developers 3/	45.4	28.6	42.8
Retail mortgages	1.5	1.8	4.1
Large Corporates	5.0	5.8	10.0
SMEs	7.2	10.6	16.7

Sources: BdE; IMF staff calculations.
1/ As of 1H 2013. Measured as stock of credit impairments, as percent of total gross stock of assets.
2/ Source: Oliver Wyman stress test exercise.
3/ Includes generic provisions on performing real estate developer loans from RDL 18/2012.

However, much uncertainty remains regarding the eventual extent of credit quality deterioration, which is likely to continue for some time. IMF staff's baseline projection as of

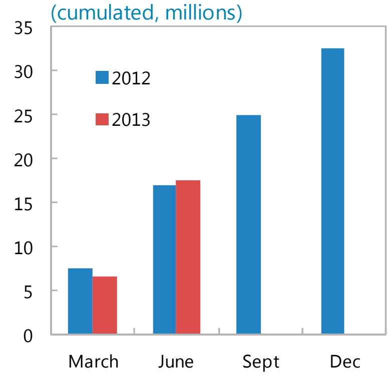
[2] The expected impairment rate in the stress test is defined here as projected losses by end-2014 on assets as of end-2011 and as a percent of these assets.

the Fall 2013 WEO is that growth will remain weak into 2014 (Table 1). The time lag between macroeconomic developments and their effect on credit quality implies that provisioning needs will likely remain high for some time across all asset classes, and indeed the table above suggests that provisioning rates for some loan categories may rise further between now and 2014. Supervisors should therefore ensure that any further weakening of asset quality is matched by increased provisions (in the case of loans) or impairments (in the case of repossessed assets).

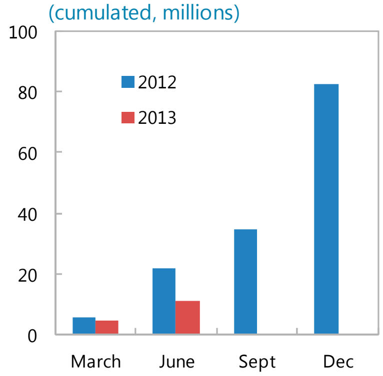
Profitability

System-wide profits were up in the first half of 2013. Banks' domestic pre-tax profits in H1 rose to €2.8 billion, up from a loss of €-15.2 billion one year earlier. The main driver of higher profits was a reduction in the flow of new loan-loss provisioning from €21.6 billion in H1 2012 to €11.2 billion in H1 2013, thanks to the absence of exceptional generic provisions that were imposed last year by law (mainly provisions linked to RDL 2/2012, on reaching minimum levels of specific provisions for problematic assets in the construction and development portfolios). Pre-provisioning profits, at €17.5 billion in H1 2013, also increased 2 percent from a year earlier and were already at the level assumed for the full-year 2013 (€17 billion) in the base case of the September 2012 stress test.

Spain: Pre-provision profits
(cumulated, millions)



Spain: Provisions on loans
(cumulated, millions)



Source: Banco de Espana.

Spanish Banks: Domestic Pre-Provisioning Profits

		Jan-Jun 2013	Jan-Jun 2012	Change (percent)
A	Total Revenues	30,918,382	30,872,445	0
	Net Interest Income	13,923,239	16,869,978	-17
	Net Income from Fees and Shares	10,417,248	12,834,593	-19
	Other Gains 1/	6,577,896	1,167,874	463
B	Total Expenses	13,455,160	13,801,269	-3
C=A-B	Pre-Provisioning Profits	17,463,222	17,071,176	2

Source: BdE. Spain business only. Data in Eur million.

1/ Includes non-recurring gains arising from hybrid instrument management exercises.

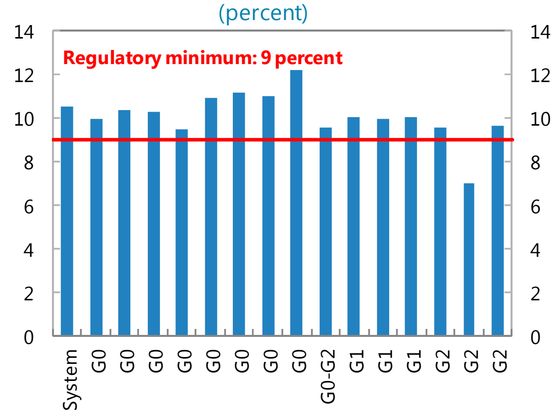
However, the ability to generate income from core banking activity remains impaired. Revenues in H1 were boosted by gains on financial assets and liabilities, which is partly explained by the existence of a non-recurring gain arising from hybrid instrument management exercises and other non-recurring activities. In contrast, net interest income fell as lower interest income—mainly due to less interest on loans linked to EURIBOR (which was down 1 percentage point from a year earlier), as well as lower loan volumes and higher non-interest bearing assets (NPLs and repossessed property)—was not fully matched by lower deposit rates, among other factors. Such effects more than offset higher interest income from government bonds, as these holdings increased to €313 billion in August 2013, up from €256 billion a year earlier.

Going forward, banks' earnings generation capacity will likely remain constrained until robust economic recovery is established. The net profit on domestic activities posted during the first six months of 2013 (€ 2.7 billion), however small, witnesses an important change of sign from a loss one year earlier (€ -12.7 billion). Yet, as noted above, this partially reflected non-recurring factors, and results were not uniform across banks. Going forward, the main challenges are further credit deterioration, the need to increase provisioning for refinanced loans in line with recent BdE guidance, and falling interest income on variable-rate mortgages, as these are reset at lower rates and as the removal of interest rates floors on some retail mortgage loans (in response to a court ruling) is implemented. Falling loan volumes due to deleveraging and a growing stock of non-productive assets (NPLs and repossessed assets) may also constrain future profit generation. Funding costs could also rise if LTROs expire and are not renewed. On the other hand, margin pressures could be mitigated by cheaper deposit and wholesale funding and further income from domestic government bonds. Outside of Spain, weaker prospects in emerging markets could affect banks exposed to these regions (emerging markets accounted for 23 percent and 32 percent of the loan book of Spain's largest and second-largest bank, respectively, at end-2012) though exposures elsewhere provide some diversification against this risk (the U.S. and U.K. together accounted for 39 percent and 10 percent of the loan book of Spain's largest and second-largest bank, respectively, at end-2012).

Capital buffers

Capital levels need to be maintained. At end-June 2013, all banks now exceeded the minimum Core Tier 1 ratio (EBA definition) level of 9 percent (except for one relatively small bank, CEISS, which is in the process of being sold to a stronger bank). However, buffers were not large. Together with the fragile economic environment, this underscores the need for Spanish banks to continue efforts to maintain recently achieved capital levels in ways that do not rely excessively on credit contraction, including by supporting profitability through gains in operational efficiency, issuing equity, and exercising restraint on cash dividends and remuneration. In this direction, one bank completed a capital raising issuance in September 2013, and the BdE recommended that banks limit cash dividends to no more than 25 percent of net income for the year 2013.

Core Tier1 ratio, end-June 2013
(percent)



Source: BdE.

Spanish banks have a relatively large amount of DTAs as a percent of equity (Box 1). This weakens the quality of their capital, as Basel III/CRD4 deducts most DTAs from Tier 1 capital, though this change will be phased in gradually. As discussed in Box 1 of the main text, the authorities are considering adoption of a mechanism to convert certain types of DTAs into higher quality assets.

Liquidity and funding

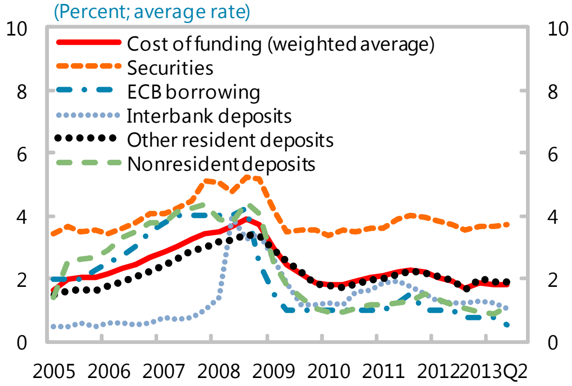
Banks' funding costs have continued to fall in recent months. Average interest rates on new deposits fell in line with euro-area trends in the third quarter, continuing a large drop since the start of 2013. Trends in the volume of household and corporate deposits have been heavily affected by the shift from deposits to bank promissory notes (a close substitute) during 2011 and the first half of 2012, as customers sought to avoid new hikes in deposit insurance premia. These hikes were subsequently reversed in mid-2012, prompting the reversal of these flows and a shift back into deposits as promissory notes mature. Total retail funding (domestic deposits plus retail promissory notes) has been broadly stable year-to-date through August. Government deposits and net non-resident deposits are up for the year, but have declined since end-March.

Spain: Change in Deposits, 2013
(change during period, billions of euro)

	Q1	Q2	Jul-Aug	Year-to-date
Total domestic deposits, retail promissory notes, and net non-resident deposits 1/	49	-1	-23	25
Household and corporate deposits and retail promissory notes	-2	4	-2	0
Bank promissory notes held by retail customers	-15	-10	-5	-31
Domestic household and corporate deposits	14	14	3	31
Household	9	13	1	23
Corporate	5	1	2	8
Government deposits	19	-5	-10	4
Net non-resident deposits 2/	31	0	-11	21
Net deposits with MFIs abroad 3/	21	2	-1	22

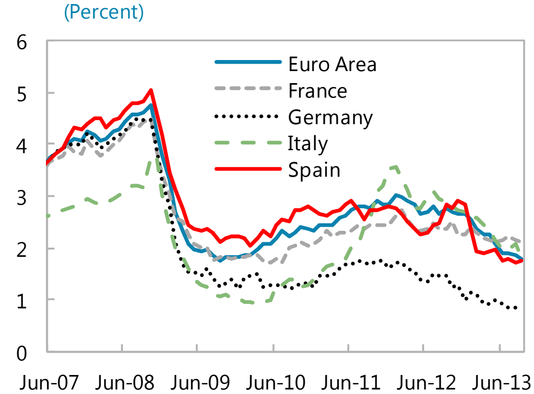
Source: BdE.
1/ Excludes deposits of domestic financial institutions.
2/ Non-resident deposits minus loans to non-residents.
3/ Deposits of foreign banks in Spanish banks minus loans from Spanish banks to foreign banks.

Spain: Cost of Bank Funding
(Percent; average rate)



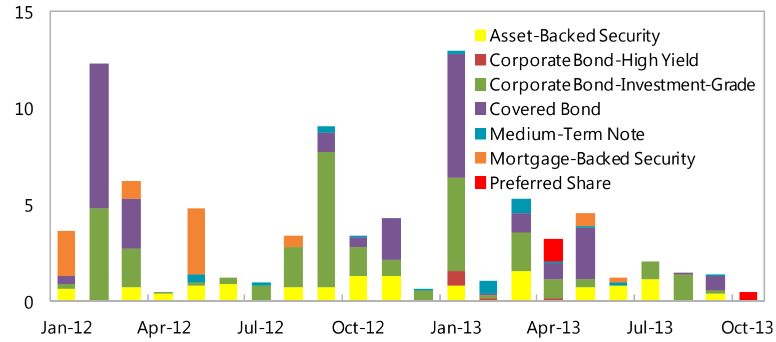
Sources: BdE; and IMF staff calculations.

Deposit Rates 1/
(Percent)



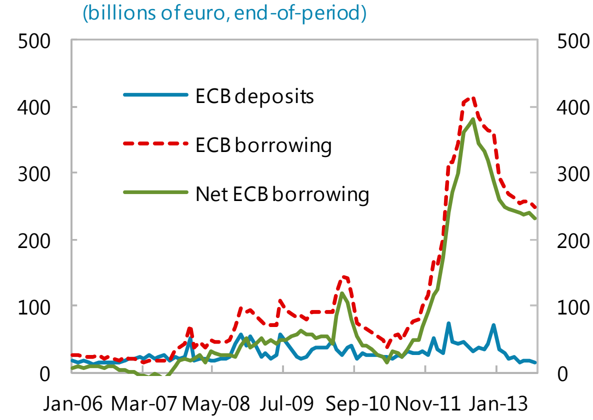
Source: ECB.
1/ All maturities, weighted average, for new deposits by households and NPISHs.

Banks continue to reduce their reliance on wholesale market funding. Bank wholesale borrowing rates fell along with the drop in sovereign yields during the third quarter (Figure 1), although the cost of issuances remains high compared to other sources of bank funding. Gross issuance of bank debt in the second and third quarters of 2013 was moderate, as bank funding needs also narrowed due to shrinking loan portfolios. Issuances remained limited to some stronger banks and were mostly covered-bonds that banks held on their own books, but used as collateral. The reduction of banks' reliance on wholesale funding has contributed to a significant improvement in the loan-to-deposit ratio, which has declined from a peak of 170 percent before the crisis to 126 percent in August 2013.



Source: Dealogic

Reliance on ECB borrowing has declined and collateral buffers have increased during the program. Improved funding conditions in retail and wholesale markets, declining needs for precautionary liquidity buffers, and negative credit growth allowed banks to reduce their recourse to ECB borrowing from a peak of nearly 40 percent of GDP in mid-2012 to about 24 percent of GDP by August 2013. The decline in ECB borrowing has slowed since April as stronger banks largely completed their plans to accelerate repayments. Higher collateral asset prices and the injections of ESM and SAREB bonds into intervened banks have created large collateral buffers, which could be used to expand borrowing from the ECB and in the repo market, if needed.



Source: BdE.

Annex 2: IMF Staff Views on the Status of MoU Conditionality

Measure		Deadline included in the July 20 MoU	Current status	Comments
1.	Provide data needed for monitoring the entire banking sector and of banks of specific interest due to their systemic nature or condition.	Regularly throughout the program, starting end-July 2012	Implemented	
2.	Prepare restructuring or resolution plans with the EC for Group 1 banks, to be finalized in light of the Stress Tests results in time to allow their approval by the EC in November.	July—mid-August 2012	Implemented	Plans adopted on November 28, 2012
3.	Finalize the proposal for enhancement and harmonization of disclosure requirements for all credit institutions on key areas of the portfolios, such as restructured and refinanced loans and sectoral concentration.	End-July 2012	Implemented	BdE Circular 6/2012
4.	Provide information required for the Stress Test to the consultant, including the results of the asset quality review.	Mid-August 2012	Implemented	
5.	Introduce legislation to introduce the effectiveness of SLEs, including to allow for mandatory SLEs.	End-August 2012	Implemented	RDL 24/2012 (Law 9/2012)
6.	Upgrade of the bank resolution framework, i.e. strengthen the resolution powers of the FROB and DGF.	End-August 2012	Implemented	RDL 24/2012

Measure		Deadline included in the July 20 MoU	Current status	Comments
7.	Prepare a comprehensive blueprint and legislative framework for the establishment and functioning of the AMC.	End-August 2012	Implemented	RDL 24/2012
8.	Complete bank-by-bank stress test (Stress Test).	Second half of September 2012	Implemented	
9.	Finalize a regulatory proposal on enhancing transparency of banks	End-September 2012	Implemented	BdE circular 6/2012
10.	Banks with significant capital shortfalls will conduct SLEs.	Before capital injections in Oct./Dec. 2012	Implemented	
11.	Banks to draw up recapitalization plans to indicate how capital shortfalls will be filled.	Early-October 2012	Implemented	
12.	Present restructuring or resolution plans to the EC for Group 2 banks.	October 2012	Implemented	
13.	Identify possibilities to further enhance the areas in which the BdE can issue binding guidelines or interpretations without regulatory empowerment.	End-October 2012	Implemented	A report has been submitted and the authorities have formally complied with the MOU. However, further clarity would be warranted, and BdE regulatory powers could be possibly expanded.

Measure		Deadline included in the July 20 MoU	Current status	Comments
14.	Conduct an internal review of supervisory and decision-making processes. Propose changes in procedures in order to guarantee timely adoption of remedial actions for addressing problems detected at an early stage by on-site inspection teams. Ensure that macro-prudential supervision will properly feed into the micro supervision process and adequate policy responses.	End-October 2012	Implemented	The authorities have already implemented some recommendations in the report. Some remaining recommendations are expected to be implemented in the context of the SSM.
15.	Adopt legislation for the establishment and functioning of the AMC in order to make it fully operational by November 2012.	Autumn 2012	Implemented	
16.	Submit for consultation with stakeholders envisaged enhancements of the credit register.	End-October 2012	Implemented	
17.	Prepare proposals for the strengthening of non-bank financial intermediation including capital market funding and venture capital.	Mid-November 2012	Implemented	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	Draft legislation has been submitted. Prompt enactment and forceful implementation will be key.
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	

Measure		Deadline included in the July 20 MoU	Current status	Comments
20.	Prepare legislation clarifying the role of savings banks in their capacity as shareholders of credit institutions with a view to eventually reducing their stakes to non-controlling levels. Propose measures to strengthen fit and proper rules for the governing bodies of savings banks and introduce incompatibility requirements regarding the governing bodies of the former savings banks and the commercial banks controlled by them. Provide a roadmap for the eventual listing of banks included in the stress test, which have benefited from State aid as part of the restructuring process.	End-November 2012	Implemented	Draft legislation has been submitted. Prompt enactment and forceful implementation will be key to the success of the law.
21.	Banks to provide standardized quarterly balance sheet forecasts funding plans for credit institutions receiving state aid or for which capital shortfalls will be revealed in the bottom-up stress test.	As of 1 December 2012	Implemented	Second set of results were provided to international partners at end-August.
22.	Submit a policy document on the amendment of the provisioning framework if and once Royal Decree Laws 2/2012 and 18/2012 cease to apply.	Mid-December 2012	Implemented	
23.	Issues CoCos under the recapitalization scheme for Group 3 banks planning a significant (more than 2% of RWA) equity raise.	End-December 2012	Not relevant	Group 3 banks recapitalized without State aid.
24.	Transfer the sanctioning and licensing powers of the Ministry of Economy to the BdE.	End-December 2012	Implemented	RDL 24/2012 The possibility to further expand BdE supervisory powers should be considered.

Measure		Deadline included in the July 20 MoU	Current status	Comments
25.	Require credit institutions to review, and if necessary, prepare and implement strategies for dealing with asset impairments.	End-December 2012	Implemented	
26.	Require all Spanish credit institutions to meet a Common Equity Tier 1 ratio of at least 9 percent until at least end-2014. Require all Spanish credit institutions to apply the definition of capital established in the Capital Requirements Regulation (CRR), observing the gradual phase-in period foreseen in the future CRR, to calculate their minimum capital requirements established in the EU legislation.	1 January 2013	Implemented	RDL24/2012 Additional technical details implemented by BoE (Circular 7/2012)
27.	Review governance arrangements of the FROB and ensure that active bankers will not be members of the Governing Bodies of FROB.	1 January 2013	Implemented	RDL 24/23012
28.	Review the issues of credit concentration and related party transactions.	Mid-January 2013	Implemented	
29.	Propose specific legislation to limit the sale by banks of subordinate debt instruments to non-qualified retail clients and to substantially improve the process for the sale of any instruments not covered by the deposit guarantee fund to retail clients.	End-February 2013	Implemented	RDL 24/2012
30	Amend legislation for the enhancement of the credit register.	End-March 2013	Implemented	

Measure		Deadline included in the July 20 MoU	Current status	Comments
31.	Raise the required capital for banks planning a more limited (less than 2% of RWA) increase in equity.	End-June 2013	Not relevant	Group 3 banks recapitalized without State aid.
32	Group 3 banks with CoCos to present restructuring plans.	End-June 2013	Not relevant	Group 3 banks recapitalized without State aid.

Table 1. Spain: Main Economic Indicators, 2010-18
(Percent change unless otherwise indicated)

				Projections					
	2010	2011	2012	2013	2014	2015	2016	2017	2018
Demand and supply in constant prices									
Gross domestic product	-0.2	0.1	-1.6	-1.3	0.2	0.5	0.7	0.9	1.2
Private consumption	0.2	-1.2	-2.8	-2.8	-0.4	0.1	0.3	0.4	0.7
Public consumption	1.5	-0.5	-4.8	-2.0	-2.9	-3.8	-3.4	-2.5	-2.3
Gross fixed investment	-5.5	-5.4	-7.0	-7.3	-2.8	-0.7	0.6	1.3	1.9
Construction investment	-9.9	-10.9	-9.7	-11.6	-6.5	-3.0	-1.0	-0.2	0.4
Other	5.0	5.5	-3.9	-0.4	2.0	2.6	3.0	3.7	4.3
Total domestic demand	-0.6	-2.0	-4.1	-3.5	-1.3	-0.8	-0.4	0.0	0.4
Net exports (contribution to growth)	0.4	2.1	2.5	2.2	1.5	1.3	1.1	1.0	0.9
Exports of goods and services	11.7	7.6	2.1	5.7	5.8	5.6	5.2	5.2	5.2
Imports of goods and services	9.3	-0.1	-5.7	-1.0	1.8	2.4	2.8	3.4	3.8
Prices									
GDP deflator	0.1	0.0	0.0	0.6	0.9	1.0	1.2	1.2	1.2
HICP (average)	2.0	3.1	2.4	1.8	1.5	1.2	1.2	1.2	1.2
HICP (end of period)	2.9	2.4	3.0	1.3	1.0	1.2	1.2	1.3	1.2
Employment and wages									
Unemployment rate (percent)	20.1	21.7	25.0	26.9	26.7	26.5	26.2	25.6	24.9
Employment growth	-2.3	-1.9	-4.5	-3.9	-0.7	0.0	0.4	0.8	1.0
Labor force growth	0.2	0.1	-0.2	-1.5	-1.0	-0.2	0.0	0.0	0.0
Balance of payments (percent of GDP)									
Trade balance (goods) 1/	-4.6	-4.0	-2.5	-0.4	0.6	1.6	2.3	2.9	3.4
Current account balance 1/	-4.5	-3.8	-1.1	1.4	2.6	3.8	4.4	5.2	6.0
Net international investment position	-89	-92	-93	-92	-87	-82	-75	-68	-59
Public finance (percent of GDP)									
General government balance 2/	-9.7	-9.1	-7.1	-6.7	-5.8	-5.0	-4.0	-3.0	-2.0
Primary balance	-7.8	-7.1	-7.8	-3.2	-2.1	-1.1	-0.1	0.9	2.0
Structural balance	-8.3	-8.3	-6.5	-5.2	-4.5	-3.6	-2.9	-2.2	-1.5
General government debt	61.7	70.4	85.9	93.7	99.1	102.5	104.6	105.5	105.1

Sources: IMF, *World Economic Outlook* (Fall 2013); data provided by the authorites; and IMF staff estimates.
1/ Data from the BdE compiled in accordance with the IMF Balance of Payments Manual.
2/ The headline deficit for Spain excludes financial sector support measures equal to 0.5 percent of GDP for 2011 and 3½ percent of GDP for 2012.

Table 2. Spain: Selected Financial Soundness Indicators, 2006-2013

(Percent or otherwise indicated)

	2006	2007	2008	2009	2010	2011	2012	2013 (Latest available)
Solvency								
Regulatory capital to risk-weighted assets 1/	11.9	11.4	11.3	12.2	11.9	12.2	11.5	12.1
Tier 1 capital to risk-weighted assets 1/	7.5	7.9	8.2	9.4	9.7	10.3	9.9	10.9
Capital to total assets	6.0	6.3	5.5	6.1	5.8	5.7	5.5	6.1
Profitability								
Returns on average assets	1.0	1.1	0.7	0.5	0.5	0.0	-1.4	0.5
Returns on average equity	19.5	19.5	12.0	8.8	7.2	-0.5	-21.5	7.4
Interest margin to gross income	50.3	49.4	53.0	63.7	54.2	51.8	55.0	45.0
Operating expenses to gross income	47.5	43.1	44.5	43.5	46.5	49.8	45.3	43.5
Asset quality 2/								
Non performing loans (billions of euro)	10.9	16.3	63.1	93.3	107.2	139.8	167.5	180.7
Non-performing to total loans	0.7	0.9	3.4	5.1	5.8	7.8	10.4	12.1
Specific provisions to non-performing loans	43.6	39.2	29.9	37.7	39.6	37.1	44.7	43.4
Exposure to construction sector (billions of euro) 3/	378.4	457.0	469.9	453.4	430.3	396.9	300.2	262.6
of which : Non-performing	0.3	0.6	5.7	9.6	13.5	20.6	28.2	30.6
Households - House purchase (billions of euro)	523.6	595.9	626.6	624.8	632.4	626.6	605.1	593.9
of which : Non-performing	0.4	0.7	2.4	4.9	2.4	2.9	4.0	5.0
Households - Other spending (billions of euro)	203.4	221.2	226.3	220.9	226.3	211.9	200.3	194.4
of which : Non-performing	1.7	2.3	4.8	6.1	5.4	5.5	7.5	7.7
Liquidity								
Use of ECB refinancing (billions of euro) 4/	21.2	52.3	92.8	81.4	69.7	132.8	357.3	244.2
in percent of total ECB refin. operations	4.9	11.6	11.6	12.5	13.5	21.0	32.0	31.4
in percent of total assets of Spanish MFIs	0.8	1.7	2.7	2.4	2.0	3.7	10.0	7.4
Loan-to-deposit ratio 5/	165.0	168.2	158.0	151.5	149.2	150.0	137.4	125.2
Market indicators (end-period)								
Stock market (percent changes)								(ytd)
IBEX 35	31.8	7.3	-39.4	29.8	-17.4	-13.4	-6.4	16.8
Santander	26.8	4.6	-51.0	73.0	-30.5	-26.3	2.2	2.5
BBVA	21.0	-8.1	-48.3	49.4	-38.2	-12.1	2.4	19.1
Popular	33.3	-14.8	-48.0	-13.9	-24.1	-9.1	-69.9	25.0
CDS (spread in basis points) 6/								
Spain	2.7	12.7	90.8	103.8	284.3	466.3	294.8	185.0
Santander	8.7	45.4	103.5	81.7	252.8	393.1	270.0	171.2
BBVA	8.8	40.8	98.3	83.8	267.9	407.1	285.0	180.7

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

1/ Starting 2008, solvency ratios are calculated according to CBE 3/2008 transposing EU Directives 2006/48/EC and 2006/49/EC (based on Basel II). In particular, the Tier 1 ratio takes into account the deductions from Tier 1 and the part of the new general deductions from total own funds which are attributable to Tier 1.
2/ Refers to domestic operations.
3/ Including real estate developers.
4/ Sum of main and long-term refinancing operations and marginal facility.
5/ Ratio between loans to and deposits from other resident sectors.
6/ Senior 5 years in euro.

Table 3. Spain: Monetary Survey, 2010-18

(Billions of euros, unless otherwise indicated; end of period)

	2010	2011	2012	Aug-13	2013	2014	2015	2016	2017	2018
					Projections					
Aggregated Balance Sheet of Other Monetary Financial Institutions (OMFIs) 1/										
Assets	3,471	3,621	3,581	3,293	3,251	3,131	2,985	2,952	2,935	2,935
Cash	8	7	7	6	6	6	6	6	6	6
Deposits at the ECB	27	51	72	15	12	12	12	11	9	8
Claims on other MFIs	211	203	209	190	177	171	167	162	166	168
Claims on non MFIs	1,936	1,887	1,733	1,594	1,537	1,482	1,472	1,480	1,499	1,523
General government	79	89	114	97	97	95	95	95	95	95
Private sector 2/	1,857	1,797	1,619	1,496	1,440	1,386	1,376	1,385	1,404	1,429
Corporates	896	840	708	630	624	606	611	621	634	651
Households and NPISH	876	857	821	796	741	706	690	688	692	698
Shares and other equity	103	163	167	176	180	174	168	164	161	157
Securities other than shares	520	544	566	591	608	603	557	554	553	552
General government	158	193	243	298	310	307	264	261	260	258
Claims on non-residents 3/	374	386	408	357	396	389	392	386	391	400
Other assets	293	381	419	353	336	294	211	188	149	120
Liabilities	3,471	3,621	3,581	3,293	3,251	3,131	2,985	2,952	2,935	2,935
Capital and reserves	283	367	403	425	425	410	392	386	382	384
Borrowing from the ECB	62	168	361	248	244	209	106	89	72	56
Liabilities to other MFIs	211	206	213	194	192	186	182	177	181	183
Deposits of non MFIs	1,728	1,650	1,535	1,512	1,507	1,472	1,474	1,482	1,496	1,513
General government	79	70	69	73	73	73	73	73	74	74
Private sector	1,648	1,581	1,466	1,439	1,434	1,399	1,401	1,409	1,422	1,439
Corporates	219	197	191	199	198	200	204	209	217	224
Households and NPISH	727	727	732	754	767	775	787	801	819	839
Others	702	656	543	486	469	424	411	398	387	376
Debt securities issued	433	435	394	320	329	307	300	293	285	285
Deposits of non-residents 3/	512	493	341	317	310	307	303	298	293	290
Other liabilities	244	302	334	277	245	241	229	226	225	225
Money and Credit 4/										
Broad Money (M3)	1,140	1,121	1,098	1,090	1,085	1,092	1,104	1,119	1,138	1,161
Intermediate money (M2)	1,031	977	956	949	946	952	962	975	992	1,011
Narrow money (M1)	515	506	495	492	490	493	498	505	513	524
(Percent of GDP)										
Broad Money	109.0	107.2	106.7	106.3	106.2	105.7	105.2	104.7	104.2	103.8
Private sector credit	177.6	171.8	157.3	146.0	140.8	134.1	131.2	129.6	128.6	127.7
Corporates	85.7	80.3	68.8	61.5	61.0	58.6	58.3	58.1	58.1	58.2
Households and NPISH	83.8	81.9	79.8	77.7	72.5	68.3	65.8	64.4	63.4	62.4
Public sector credit	7.5	8.5	11.1	9.5	9.5	9.2	9.1	8.9	8.7	8.5
(Percentage change)										
Broad Money	-2.0	-1.6	-2.1	2.6	-1.1	0.6	1.0	1.4	1.7	2.0
Private sector credit 5/	0.8	-3.2	-9.9	-12.7	-11.0	-3.7	-0.7	0.6	1.4	1.7
Private sector credit excl. SAREB	-0.4	-3.3	-5.8	-6.6	...	...	...	...	...	...
Corporates 5/	-2.1	-6.2	-15.8	-20.4	-11.8	-3.0	0.9	1.6	2.2	2.7
Households and NPISH	0.3	-2.2	-4.2	-4.4	-9.8	-4.7	-2.3	-0.3	0.6	0.8
Public sector credit	21.9	13.6	27.9	-20.2	-14.9	-1.8	-0.4	-0.2	-0.1	-0.1
Memo items:										
Loans to deposits (%, other resident sector) 6/	149.2	150.0	137.4	126.1	116.9	111.4	108.9	107.3	106.2	105.3
Retail deposits (% change) 7/	2.9	-2.3	-0.2	3.4	4.6	1.0	1.6	2.0	2.5	2.6
Wholesale market funding (% change)	-8.8	-1.4	-18.7	-18.3	-13.8	-4.4	-1.9	-2.0	-2.2	-0.5
Wholesale market funding (% assets)	22.6	21.3	17.5	16.9	16.6	16.5	17.0	16.8	16.6	16.5
Capital and reserves (% total assets)	8.1	10.1	11.2	12.9	13.1	13.1	13.1	13.1	13.0	13.1

Sources: Bank of Spain; and IMF staff estimates.

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

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

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

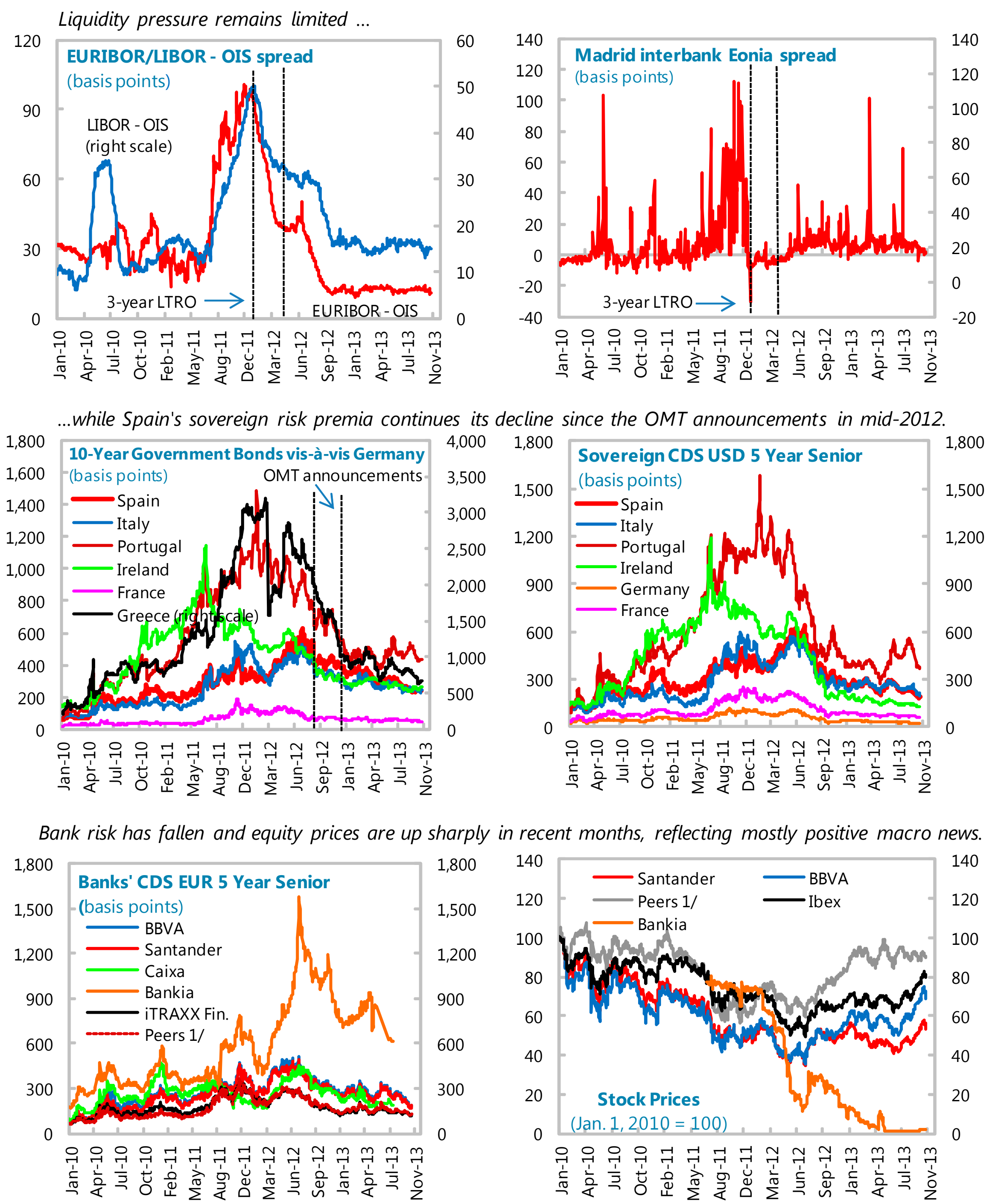
4/ Broad money (M3) comprises M2 plus repurchase agreements, money market fund shares and units as well as debt securities with a maturity of up to two years. Intermediate money (M2) comprises M1 plus deposits with an agreed maturity of up to two years and deposits redeemable at notice of up to three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

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

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

7/ Deposits from households and nonfinancial corporations.

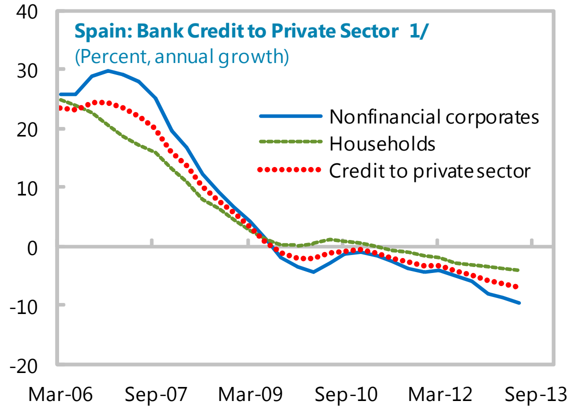
Figure 1. Spain: Financial Market Indicators



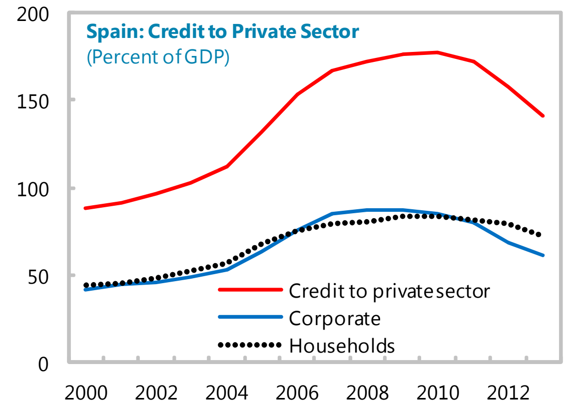
Sources: Bank of Spain; Bloomberg; and IMF staff estimates.
1/ Peers include Unicredit, Intesa-San Paolo, Commerzbank, Deutsche Bank, HSBC, Barclays, UBS, Credit Suisse, Societe Generale, BNP, and ING.

Figure 2. Spain: Credit Conditions

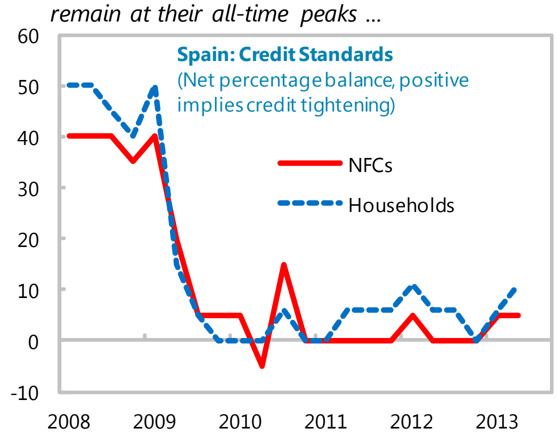
Credit contraction remains rapid ...



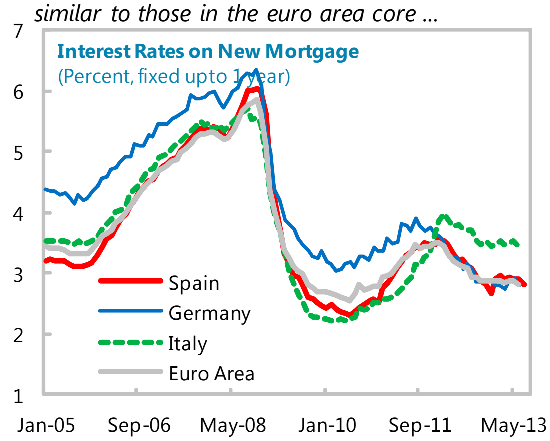
... as the credit bubble unwinds.



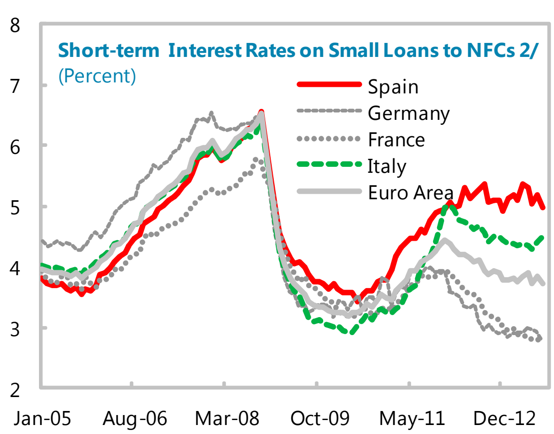
Credit standards have not eased and hence remain at their all-time peaks ...

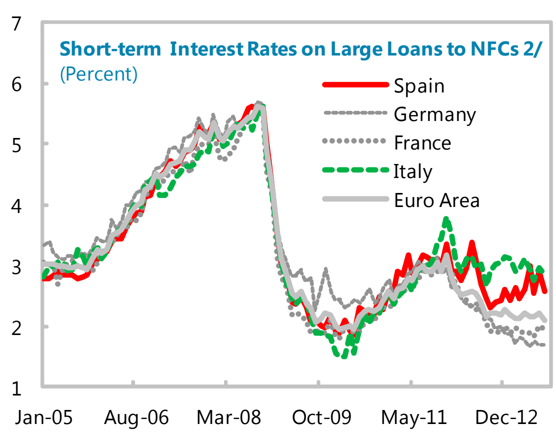


... and though interest rates on mortgages are similar to those in the euro area core ...



Frogmentation of lending rates to businesses remains high, reflecting in part incomplete banking union.

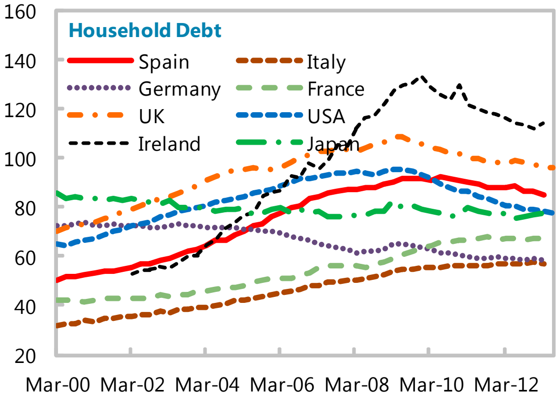




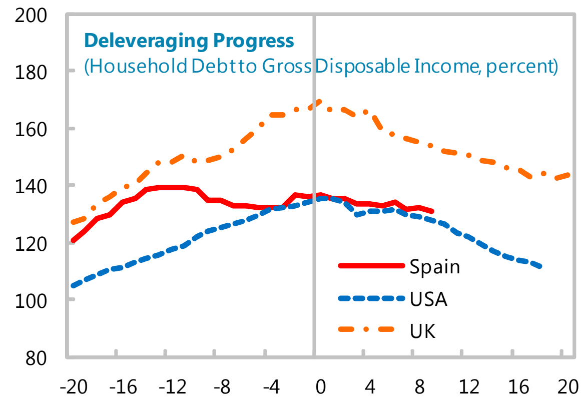
Sources: Bank of Spain; ECB; and IMF staff calculations.
1/ Excludes the effects of the transfer of loans to SAREB.
2/ Interest rates on loans to new business up to 1-year maturity. Small loans are up to €1 million and large loans are above €1 million.

Figure 3. Spain: Household's Financial Positions

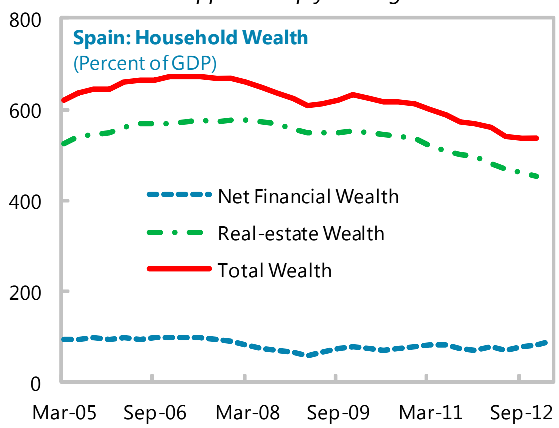
Despite contraction of nominal debt, Spain's household debt-to-GDP ratio is falling slowly ....



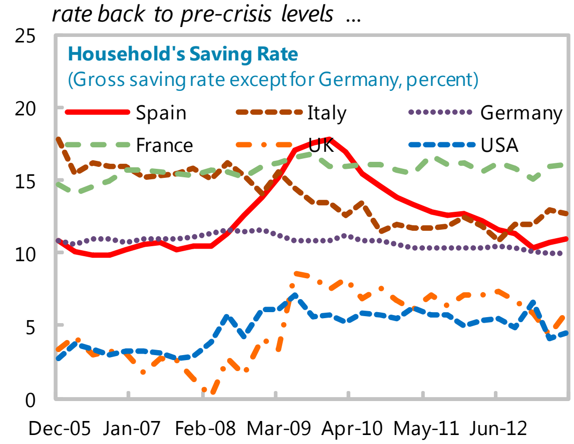
... due to falling nominal income. This partly reflects lower inflation than in other post-boom countries.



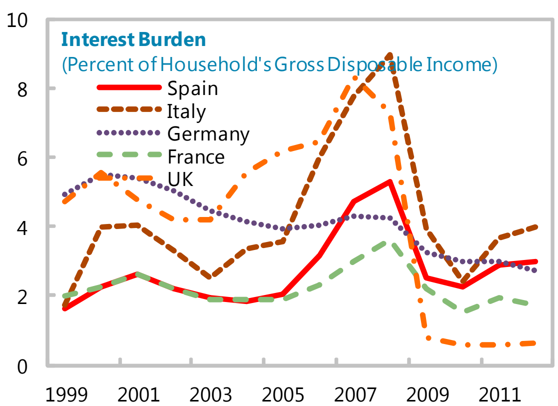
Wealth has dropped sharply during the crisis.



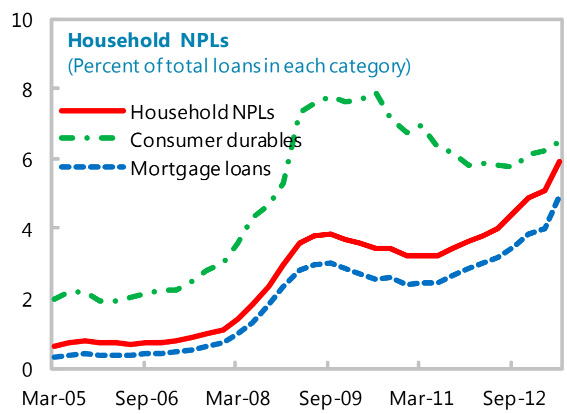
Falling disposable income has pushed the saving rate back to pre-crisis levels ...



... while pushing up the interest burden ...



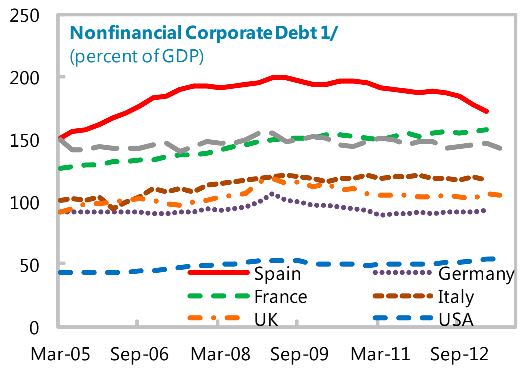
... and household NPLs.



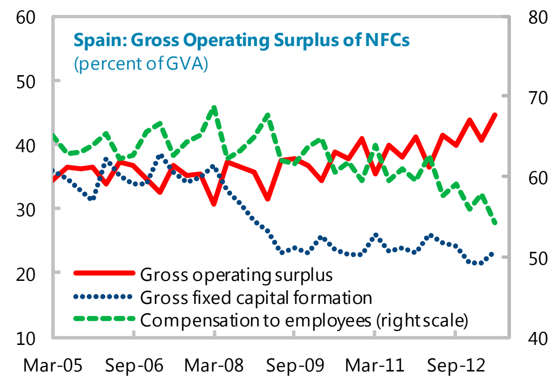
Sources: BdE; ECB; Haver; and IMF staff calculations.

Figure 4. Spain: Nonfinancial Corporate's Financial Positions

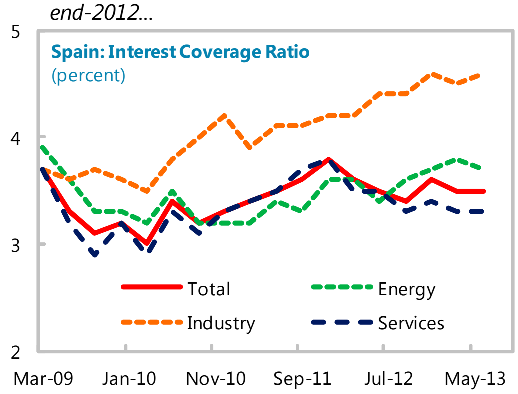
Corporate debt is high but declining.



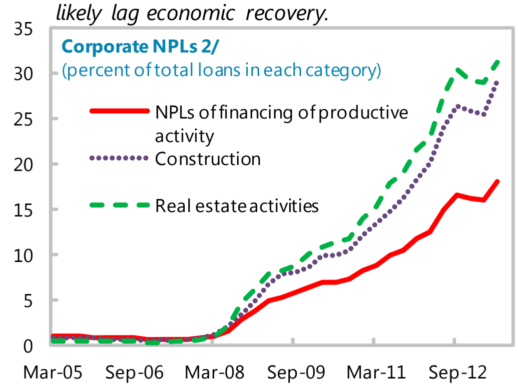
Corporate profitability is on an upward trend, as firms cut employment, investment, and operating costs.



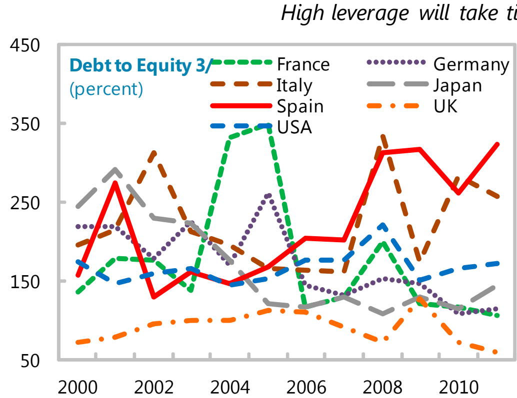
Debt servicing ability has improved slightly since end-2012…

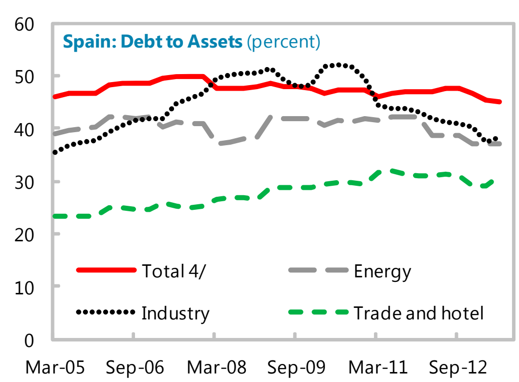


… but reversal of the upward trend in NPLs will likely lag economic recovery.



High leverage will take time to wind down.





Sources: Bank of Spain; IMF's corporate vulnerability utility; and Haver.
1/ Includes trade credit.
2/ A slight decline in NPL ratios of the corporate sector at end-2012 resulted from a transfer of loans to SAREB.
3/ Corporate debt-to-equity ratios are from the IMF's corporate vulnerability utility, based on firms listed in Spain and market prices. The results may be affected by valuation changes.
4/ Total includes some components that are not included in the other categories shown.