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Spain: Financial Sector Reform—Final Progress Report

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SPAIN

FINANCIAL SECTOR REFORM: FINAL PROGRESS REPORT

February 2014

Prepared by Staff of the

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

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

PREFACE

Spain undertook a major program of financial sector reform during the last 18 months 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 Eurogroup approved this support, with Spain's commitments under the 18-month 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 ESM, without this assistance gaining seniority status. The program concluded as scheduled in January 2014.

This report provides information and analysis on Spain's financial sector reform program. At the program's outset, 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. This is the fifth and final such report, the publication of which marks the end of this type of monitoring, which IMF staff has 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.

EXECUTIVE SUMMARY

Spain's ESM-supported program of financial sector reform aimed to assist economic recovery by promoting financial stability. The program was adopted in mid-2012. At the time, Spain's real-estate bust and the euro-area debt crisis had combined to fuel a vicious cycle of failing banks, unsustainable fiscal deficits, rising borrowing costs, contracting output, rapid job loss, and severe financial market turmoil. The program aimed to stem the financial sector's contribution to these forces by requiring weak banks to more decisively clean their balance sheets and by reforming the sector's policy framework. These efforts aimed in turn to support economic recovery by improving banks' access to market funding and by avoiding a disruptive and disorderly unwinding of a significant part of the sector. The program's strategy built on reforms that the authorities had already undertaken during the crisis (e.g., stronger provisioning requirements) and was developed in consultation with Spain's European partners, was supported by ESM financing, and was consistent with the main recommendations from IMF staff's June 2012 *Financial Stability Assessment Program* (FSAP) and Article IV consultation.

The Spanish authorities' implementation of the program has been steadfast. All of the program's specific measures are now complete. These have included the following key actions:

- identifying undercapitalized banks via a comprehensive asset quality review and independent stress test;
- requiring banks to address their capital shortfalls, including if necessary through bail-ins of junior debt and injections of public capital;
- reducing uncertainty regarding the strength of banks' balance sheets and boosting liquidity by segregating state-aided banks' most illiquid and difficult-to-value assets into a separate, newly created asset management company (SAREB);
- adopting plans to restructure or resolve state-aided banks within a few years, with implementation now well underway; and
- reforming Spain's frameworks for bank resolution, regulation, and supervision to facilitate a more orderly clean-up and better promote financial stability and protect the taxpayer.

These efforts have substantially reduced threats emanating from banks to the rest of the economy, as has important policy progress at the European level.

- Actions under the program have significantly strengthened the system's capital, liquidity, and loan-loss provisioning. The capitalization drive has also helped to contain losses to taxpayers and bank creditors by addressing undercapitalization problems before they expanded further, as inaction would likely have produced a deepening cycle of losses on deposits, accelerating deposit outflows, and more bank failures.
- Financial market conditions have improved dramatically during the program, with risk premia on external borrowing by Spain's banks and sovereign down more than 75 percent and equity prices up more than 50 percent during the program period. These improvements and similar trends in other stressed euro-area financial markets reflect, among other factors, the package of key crisis-fighting measures adopted in Europe during the last 18 months (e.g., OMT) and to which Spain's financial-sector program was a contributing element. Spain's real economy is now also starting to recover, with output now growing and the unemployment rate falling.

Notwithstanding this substantial progress, important challenges for the financial sector remain. Although system-wide profits through the first three of quarters of 2013 have moved back into the black, this partly reflects one-off factors. Core pre-provision profits continue to decline, and the NPL ratio is still rising (though at a declining pace). Private-sector deleveraging and fiscal consolidation will also continue to pose headwinds for growth for some time. This may keep the pace of recovery restrained, adding to challenges to bank profitability. This in turn could slow the recovery of credit conditions—which are still tight—reinforcing headwinds to growth and downside risks. Additional uncertainties for the banking sector arise from unknowns regarding the methodology of the Single Supervisory Mechanism's (SSM) forthcoming comprehensive assessment, as well as the unwinding of the state's ownership interest in intervened banks over the next few years. Outcomes could also surprise on the upside (as in recent months), especially in a scenario of strong policies and reforms by both Spain and Europe.

It is thus crucial to maintain the reform momentum. Major structural reform efforts in a variety of areas (including labor and fiscal policies) will need to continue to achieve sufficiently rapid growth to bring unemployment down to reasonable levels over the medium term. Reform priorities in the financial sector include measures to further enhance banks' ability to lend and support recovery, as outlined below and discussed in the report. Strong efforts along these lines could help nudge the economy toward the upside scenario of a virtuous cycle of falling funding costs, higher profitability and capital, easier credit conditions for households and firms, and more job creation.

- ***Enhanced monitoring and supervision***. It will be essential to continue pro-active monitoring and supervision, including continued efforts to ensure adequate provisioning and to prepare banks for the SSM's forthcoming comprehensive assessment.
- ***Boosting core capital to facilitate lending***. Another top priority is for supervisors to continue encouraging banks to build core capital in absolute levels—including by taking advantage of buoyant equity markets to boost share issuance, extending the dividend limit to 2014, and supporting profits through further efficiency gains. This will help avoid excessive reliance on credit contraction to support capital ratios, which would worsen already-tight credit conditions.
- ***Avoiding impediments to asset disposal***. Another benefit of efforts to ensure adequate provisioning is that it should foster asset disposal over time (helping to free space on banks' balance sheets for new lending) and corporate debt restructuring (thereby reducing debt overhang), including increased conversion of corporate debt into equity. Tax reforms could further reduce impediments to asset disposal.
- ***Deferred tax assets (DTAs)***. The recently adopted DTA conversion mechanism has provided an important boost to banks' capital ratios as measured on a fully-loaded Basel III basis. The priority now is to ensure that this measure is accompanied by further actions by banks to strengthen their balance sheets and ability to lend. The fiscal effects of the mechanism should also be closely monitored to ensure that they are minimal as expected.
- ***SAREB***. SAREB made major progress in 2013 in developing its organization and accelerating asset liquidation. However, property price declines and the deterioration of loans' credit quality remain key challenges for SAREB's cash flow and profitability. Implementation of effective liquidation strategies will be critical going forward.
- ***Savings bank reform***. A major reform to enhance savings banks' governance and reduce their risks to financial stability was passed in late 2013. Strong implementation is now key.
- ***Europe's contribution to recovery***. At the euro level, priorities include more monetary easing to raise the prospects of achieving the ECB's inflation objective, making swift progress toward more complete banking union to help reduce euro-area financial fragmentation, and ensuring that state-aided banks' EC-approved restructuring plans remain sufficiently flexible to changing circumstances and maximize the return on the taxpayer's investment in state-aided banks.

Summary of Recommendations[1]

Safeguarding and building upon the program's gains

- Continue close monitoring of financial sector health, including via new tools developed during the program (¶32-36).
- 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 (¶37-38).
- Promote vigorous action in these areas so as to ensure that the recently adopted DTA conversion mechanism is complemented by, and does not substitute for, actions by banks to strengthen their balance sheets (¶37-38, Annex 1).
- Facilitate distressed asset disposal and voluntary debt workouts by continued efforts to ensure adequate provisioning, by reducing tax impediments to asset disposal, and by exploring further measures to facilitate corporate debt restructuring and debt-for-equity swaps (¶39).
- In the context of rising NPLs, ensure that banks maintain adequate reserve coverage by swiftly provisioning for new credit risk (¶39).

Savings bank reform

- Ensure vigorous implementation of the recently adopted savings bank reform (¶20).

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 more complete banking union and by more monetary easing (¶40).
- Ensure that the upcoming comprehensive assessment is rigorous and credible (¶40).
- Keep restructuring plans under state-aid rules under review to ensure that they remain sufficiently flexibility to changing circumstances, maximize the return on the taxpayer's investment in state-aided banks, and avoid any unnecessary constraints on credit provision (¶40).

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

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CONTENTS

PROGRESS ON FINANCIAL SECTOR REFORM

Spain's financial sector program has aimed to support economic recovery by restoring financial stability. Its strategy for achieving this goal has been to identify weak banks via a stress test, force them to address their capital shortfalls, restructure or resolve them if necessary, segregate their most illiquid assets into an asset management company, and strengthen the frameworks for financial sector regulation, supervision, and resolution. Implementation of this program has been steadfast, with all program measures now complete. Actions under the program have provided a major boost to the system's capital and liquidity and enhanced the framework for financial sector policies going forward. But the need for post-crisis repair is ongoing, requiring continued action and strong financial sector polices to safeguard the program's gains and better support recovery.

A. The Big Picture: Program Goals and Strategy

1. **Spain's financial sector program was adopted in July 2012 amidst a deep recession and severe financial market turmoil**. Spain's real estate bust and the broader sovereign debt crisis had combined to fuel a vicious cycle of sharply rising NPLs, falling bank capital, soaring borrowing costs for banks and the sovereign, tighter credit conditions for households and firms, shrinking economic activity, and rising unemployment. These forces left a significant portion of the banking system undercapitalized, which in turn further undermined confidence and the already very difficult outlook.

2. **The program aimed to help reverse these dynamics by more decisively addressing the legacy costs of the real estate boom-bust**. The Spanish authorities had taken several key reforms in this direction even before the onset of the ESM-supported program. Such measures included raising minimum capital requirements, restructuring the savings bank sector, and significantly increasing provisioning requirements for real estate development loans (REDs) and foreclosed assets. Nonetheless, the scale of the problem was such that further action was required to more decisively address it. The ESM-supported program was thus adopted, with "the main objective [being] to increase the long-term resilience of the banking sector as a whole, thus restoring its market access."

3. **The strategy for achieving this objective consisted of three main pillars**:

i) Strengthening the system's capital by (a) identifying undercapitalized banks via an independent asset quality review and stress test and (b) requiring banks to address their shortfalls, including if necessary through bail-ins of junior debt, injections of public capital, and the restructuring and/or resolution of their operations.

ii) Reducing uncertainty regarding the strength of banks' balance sheets and boosting liquidity by segregating state-aided banks' most illiquid and difficult-to-value assets (REDs and foreclosed assets) into a separate, newly-created asset management company (SAREB).

iii) Reforming the frameworks for financial sector regulation, supervision, and resolution to facilitate the immediate bank clean-up and better promote financial stability going forward.

This strategy was consistent with the main recommendations of IMF staff's *Financial Stability Assessment Program* (FSAP), which was completed in June 2012 shortly before the program was adopted, as well as recommendations from IMF staff's regular Article IV reports.

4. The Spanish authorities have steadfastly implemented this program (Annex 3). These actions, together with important reforms also at the European level, have reduced systemic threats emanating from the banking system to the rest of the economy, as discussed in more detail in the next main section. Nonetheless, important risks to financial stability remain, as headwinds from the adjustment of Spain's macroeconomic imbalances are likely to continue for some time. The following subsections provide further detail on program implementation in each of the three main areas.

B. Bank Recapitalization, Restructuring, and Resolution

5. A key element of the program was the establishment of a rigorous process to identify and address undercapitalized banks. This process has proceeded as follows:

- In September 2012, an independent stress test of banks' balance sheets—based on revised data from an asset quality review conducted by four major international accounting firms—identified ten banks that were projected to face capital shortfalls relative to a benchmark of a 6 percent CT1 capital ratio by end-2014 under an adverse scenario.

- These banks were divided into three groups: Group 1 (banks that could not fill their capital needs on their own and were already controlled by the state); Group 2 (other banks that could not fill their capital shortfall on their own); and Group 3 (banks that could fill their capital shortfall through their own means).

- For each bank in the first two groups, an EC-approved restructuring plan (if the bank was deemed viable) or resolution plan (if the bank was deemed non-viable) was then adopted in line with EU state-aid rules. These multi-year plans are still ongoing and entail measures such as management overhauls, lending restrictions, and cost-cutting. Divestment of the government's ownership in these banks is envisaged by no later than end-2017.

- The stress test identified capital shortfalls totaling €56 billion (5½ percent of GDP). Measures to fill these shortfalls were completed in the subsequent months, mostly in the first quarter of 2013. About 70 percent of the shortfall was filled by public capital injections, 23 percent by bailing-in junior debt, and 6 percent by private capital injections (see table below).

Measures to Meet Spanish Banks' Capital Shortfall

(Millions of euros)

	Bank name	Oliver Wyman capital shortfall	Measures Taken to Meet Capital Shortfall 1/						
			Injection of public capital 2/	Issuance of new private equity	Capital augmentation through SLEs 3/	Reduction in capital need from transfer of assets to SAREB 4/	Reduction in capital need from sale of assets 4/	Reduction in capital need from revaluation of assets 4/	Other 4/ 5/
Group 1	BFA-Bankia	24,743	17,959	0	6,669	191	0	0	0
	Catalunya Banc	10,825	9,084	0	1,676	188	0	0	0
	Nova Caixa Galicia	7,176	5,425	0	1,959	-276	0	0	0
	Banco de Valencia 6/	3,462	4,500	0	416	208	0	0	0
Group 2	Banco Mare Nostrum 7/	2,208	730	0	425	382	851	0	63
	Liberbank	1,197	124	0	850	145	215	0	0
	CEISS	2,062	604	0	1,433	263	0	0	0
	Caja3	779	407	0	44	228	0	108	0
Group 3	Banco Popular	3,223	0	2,500	0	0	328	85	332
	Ibercaja	225	0	0	0	0	150	0	93
	Total	55,900	38,833	2,500	13,472	1,329	1,544	193	488

Sources: Bank of Spain; FROB.

1/ Figures are only estimates, as final numbers from some operations, such as the transfer of assets to SAREB, are not yet final. For various technical reasons, the sum of measures do not exactly match the capital shortfall.

2/ State aid (injections of capital and cocos by the FROB). Does not include FROB support provided before the conclusion of the Oliver Wyman stress tests or during the sales of banks.

3/ In the burden-sharing process (SLEs) at the execution date, the capital augmentation was €745 millon more than expected. However, final results are pending the resolution of some legal claims.

4/ Estimates in restructuring/resolution plans.

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

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

7/ Reduction in capital need from sale of assets: €770 million from the sale of the Caixa Penedés branch, and €81 million of securities sales. The capital increase by SLEs is estimated at €382 million, but the measures take into account only €182 million because €200 million had been taken into consideration in the stress test exercise, reducing the capital shortfall (a conversion of preference shares into CoCos was planned, but finally it was not carried out).

- As a result of this process and previous injections of public capital, the state (via the FROB) became the controlling owner of a significant part of the banking sector (holding an estimated 18 percent of system loans). The FROB is now working to gradually divest of this ownership interest. Toward this end, it sold NCG to the Banesco group—a Venezuelan banking group that already owns Banco Etcheverría, a small Spanish bank—in December 2013 for €1 billion, with payments spread over several years.

C. SAREB

6. A second key element of the program was the segregation of state-aided banks REDs and foreclosed assets into SAREB. All state-aided banks were required to transfer their REDs and foreclosed assets over a minimum size to SAREB in exchange for government-guaranteed senior bonds issued by SAREB. In total, nearly 200,000 real estate-related assets were transferred to SAREB at a total transfer price of €51 billion, or 47 percent of these assets' gross book value.

7. This segregation of assets aimed to support financial sector repair in several ways:

- ***Liquidity***. The transfer boosted the banking system's liquidity, as the transferred assets had little collateral value while SAREB's bonds can be used as collateral in the Eurosystem's repos and in the Spanish Treasury's liquidity management operations (the use of the bonds as repo collateral with private counterparties has been negligible). Similarly, the transfer avoided further large bank losses due to forced "fire sales" of these relatively illiquid REDs and foreclosed assets.

- ***Banks' valuation***. Transfer of these assets reduces uncertainty regarding the value of these banks' assets. This in turn should help lower their funding (and hence lending) rates and help the taxpayer by increasing the attractiveness of state-owned banks to potential buyers.

- ***Solvency***. Assets were generally transferred to SAREB at prices close to the valuations used to calculate banks' capital shortfalls under the adverse scenario in the stress tests run by Oliver Wyman. The transfer thus did not have material effects on banks' projected capital shortfalls. However, the exchange of these assets for safer SAREB bonds reduced banks' risk-weighted assets. This lowered the amount of capital needed to reach the target capital ratio (for most banks), though this effect was modest (see text table below).

- ***Focus***. The transfer of these distressed asset classes should enable the management of state-aided banks to better focus on the bank's core business.

- ***Real estate market***. Finally, the gradual liquidation of SAREB's assets may contribute to the reactivation and normalization of Spain's real estate market.

8. At the same time, the transfer increased the government's contingent liabilities due to the government guarantees on SAREB's bonds. The government also owns (via the FROB) 45 percent of SAREB's equity. Ensuring sound management of SAREB's assets will thus be key to ensuring that SAREB's net benefit to the public is positive.

9. In this regard, SAREB made substantial progress in developing its organization in 2013. It completed the transfer of assets, issuance of bonds, and injections of capital; adopted a business plan; hedged much of the interest-rate risk on its bonds; filled the bulk of its core staffing requirements; and completed due diligence on 80 percent of its assets. The latter found that the average market value of SAREB's assets was broadly similar to the average transfer price.

10. SAREB estimates that it registered a loss in 2013, an outcome that it had expected given the costs associated with its start-up phase. Audited accounts for 2013 are not yet available, but SAREB's broad financial developments in 2013 include the following (see Annex 2 for further details):

- The estimated loss partly reflects the slow pace of property sales in the first half of 2013 due to worse-than-expected liquidity and prices in the real estate market, the time required to develop commercial strategies and put them in place, and a difficult start for the servicing arrangements. This slow pace of sales in H1 kept total profits from sales below expenses, despite solid profit margins on sales. Sales accelerated during 2013, but profit margins also declined. The latter reflected a variety of factors, including falling real estate prices and 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.

- SAREB's expenses consisted mostly of debt service, as well as maintenance of foreclosed assets, capital expenditure, and asset management fees.

- A loss in 2013 was anticipated in SAREB's business plan and is not surprising in such an entity's first year of operation, when much energy is necessarily focused on establishing the company and running the due diligence.

- SAREB expects total cash inflows in 2013 to have exceeded operating expenses, debt service, and credit line drawdown, enabling it to redeem part of its senior debt and thus to only partially roll-over bonds maturing in late 2013-early 2014.

11. In 2014, SAREB expects to increase its sales volume, with profitability depending heavily on the evolution of house prices.

- Factors supporting profitability 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, and adjusting nimbly to changing macro and market conditions.

D. Structural Reforms to Enhance Resilience

12. Important reforms have been made to Spain's frameworks for bank resolution, regulation, and supervision. These reforms aim to reduce risks of similar crises in the future and better protect the taxpayer and economy from their consequences. Some reforms (e.g., on bank resolution) have also facilitated the clean-up of banks' balance sheets under the program. Reforms include the following (see Annex 3 for a complete list):

13. ***Capital requirements***. The minimum capital requirement during 2013-14 was increased to 9 percent CT1 (EBA definition).

Bank resolution

14. A new law governing state intervention in problem banks was adopted as part of a Royal Decree Law on August 31, 2012, with subsequent ratification by parliament. The law is a major achievement, as it strengthens the authorities' powers to (i) recapitalize, restructure, and resolve troubled banks in ways that minimize taxpayer costs and (ii) act swiftly to support financial stability while preserving fundamental property rights. Key elements include the following:

- ***Broader toolkit***. The authorities can now deploy a wider range of tools quickly and effectively when intervening in troubled banks and can better calibrate their actions to each bank's financial condition. For example, in line with emerging best international practices, special resolution techniques such as bridge banks and purchase and assumption transactions can now be implemented without shareholders or creditors' approval. The FROB can also promptly recapitalize ailing institutions, including through emergency procedures, and can require troubled banks to transfer problem assets to an asset management company.

- ***More burden-sharing***. When banks have to access public financing (e.g., government purchases of a bank's equity), the FROB can now impose losses on holders of hybrid capital and subordinated debt instruments. Mandatory burden-sharing can also be preceded by voluntary exercises whereby banks, under FROB steering, agree with holders of hybrid capital and subordinated debt instruments to restructure their claims. Such exercises would be carried out under the threat of mandatory burden-sharing if voluntary exercises are unsuccessful. Such burden-sharing powers are in line with emerging international best practice and with the transition to more uniform resolution rules across the EU, and appropriate use of these powers should reduce fiscal costs, improve market discipline, and support the going concern value of distressed banks. Though these powers were initially set to expire on June 30, 2012, they have since been extended indefinitely, consistent with recommendations in previous progress reports.

- ***Balance between financial stability and private property rights***. The law preserves a judicial review in favor of parties affected by the authorities' decisions while streamlining the process. The safeguard of the "no creditor worse off" principle is also introduced, so that creditors or shareholders of resolved banks are compensated if resolution results in a worse outcome than would have occurred under the bank's liquidation. The law also requires an independent valuation of banks' assets and liabilities whenever public money is injected in a bank in order to protect state resources and private property rights.

- ***Clearer delineation of institutional responsibilities***. The law designates the FROB—acting in coordination with the BdE—as the authority in charge of restructuring and resolving credit institutions. By doing so, this new institutional setup separates more clearly the supervisory and resolution competencies, which belong to the BdE and FROB, respectively. The law also makes reforms to the FROB's governance, including by making it fully state-owned so that the Deposit Guarantee Fund (and hence active bankers) no longer sit on its board.

Savings bank reform

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

16. Faced with the crisis, the authorities overhauled the savings bank system prior to the ESM-supported program. One key measure enacted over the last years was the spin-off of the vast majority savings banks' activity to newly formed commercial banks. Like any similar entity, these banks were put under the exclusive supervision of the BdE and were able to raise capital, thus ending two significant problems inherent in the savings bank model. Other important steps addressed flaws in the corporate governance of savings banks, as conflict-of-interest rules and fit proper requirements were strengthened, also to avoid political interference.

17. However, savings banks remained major shareholders of some commercial banks The above reforms were not accompanied by changes in the ownership chain (which perhaps made the reforms more politically feasible): savings banks, acting alone or in concert, became the holding companies of the commercial banks resulting from the spin-off. Such commercial banks still account for roughly one-sixth of the assets of banks included in the stress tests.

18. The persistence of savings banks as controllers or significant shareholders of commercial banks raised several issues, including the following:

- A first question was whether savings banks would have sufficient financial strength to provide capital to commercial banks, as an inability to do so would reduce financial stability. Also, as most savings banks derive their income mainly from their stakes in the commercial banks, in times of financial distress they would be unable to backstop banks.

- Second, the role of savings banks as controllers of commercial banks was still not addressed, particularly in light of the need to ensure an arms' length relationship with the latter entities, given their political connections.

19. To address these and other concerns, the government adopted a comprehensive reform of the savings bank system as part of the ESM-supported program. The reform was adopted by parliament in December 2013 and entailed a two-fold approach:

- First, the law strengthens the regulatory regime for the two small savings banks that still carry out banking activities directly. Such reforms include enhanced corporate governance rules, as well as limits on their size and a prohibition on such banks undertaking banking activity beyond their home region to help limit these banks' systemic importance and hence the risks that they could pose to financial stability.

- Second, and more importantly in the context of Spain's current system, the law provides that former savings banks that indirectly exercise banking activity (through ownership of a commercial bank) be transformed into "banking foundations." Certain activities of these foundations will be supervised by the BdE within the framework of its competences as the authority responsible for the supervision of commercial banks in which the concerned banking foundation might have possible influence. In this regard, foundations that have control over a commercial bank will be required to have (i) a management protocol describing their ownership policies; (ii) investments in a pool of diversified assets; and (iii) a reserve fund of liquid assets that can be used if necessary for the capital needs of commercial banks controlled by the foundation, unless they are implementing a BdE-approved plan to reduce their ownership below controlling levels within the next few years. Together, these requirements represent incentives that should ultimately lead banking foundations to lose control over commercial banks, an objective envisaged in the MoU. The requirements will be further developed through implementing regulations, with additional technical details specified by the BdE via circular.

20. Strong and timely implementation of the law will be key. This includes ensuring that the requirements discussed above are sufficiently stringent and that steady progress is made toward the MoU objective of reducing stakes to non-controlling levels. Care should also be taken in monitoring the concerted exercise of shareholding rights by different foundations, as well as lending to related parties by commercial banks in which foundations hold a significant stake, especially given that foundations will be required to have a diversified investment strategy.

BdE supervision

21. *Supervisory powers*

- The BdE's supervisory powers have been strengthened by the gradual transfer of sanctioning and licensing powers to it (though the Ministry of Economy remains the first forum for appeals against sanctions issued by the BdE, notwithstanding the possibility of going to court).

- Going forward and to further strengthen the BdE's operational independence, the authorities should consider transferring to the BdE the few remaining financial supervisory powers (distinct from regulatory, or rule-making, powers—see the second progress report for further discussion) that do not currently lie with it in a manner compatible with forthcoming SSM regulation and, where necessary, establish consultative processes to allow for appropriate checks and balances.

22. *Supervisory procedures*

- In October 2012, the BdE completed a comprehensive review of its supervisory procedures (Annex 3, measure 14).

- The BdE has since made notable progress in implementing recommendations included in the report or suggested by international partners. Adopted reforms include the extension of on-site continuous monitoring to all significant Spanish banks; the reorganization of the Directorate General of Banking Supervision; 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.

- Many of the 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.

Financial services reform

23. ***Consumer protection***. The law containing the reforms on bank resolution also includes provisions strengthening disclosure and suitability obligations of investment services providers, including by requiring that (i) additional information be given to investors in the case of placement of securities other than stocks by credit institutions and (ii) certain "documented actions" be taken when providing investment advice and other services to clients and that written evidence be maintained.

24. ***Strengthening nonbank financing***. The authorities prepared a report in November 2012 that made a variety of recommendations to strengthen nonbank financial intermediation (Annex 3, measure 17). The authorities have since made progress in implementing these recommendations. For example, the authorities made regulatory changes to allow an alternative bond market for SMEs, which is now operational following its first issuance in December 2013. Measures have also 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 to develop further measures.

Other initiatives

25. **Helpful financial sector reforms and initiatives have also been taken during the program period that were not explicit commitments under the MoU**. An important action in this regard was the BdE's recommendation that banks limit cash dividends in 2013 to no more than 25 percent of profits. Another example is the BdE's July 2013 publication of its Mortgage Loan Access Guide, which aims to help educate and protect mortgage borrowers. In November 2013, the BdE announced plans to review cooling-off periods for director generals.

MACRO-FINANCIAL DEVELOPMENTS AND OUTLOOK

Financial market conditions have improved dramatically during the program. The real economy is now also starting to recover, while risks posed to it by the banking sector have been substantially reduced under the program. Nonetheless, the pace of recovery is likely to be restrained as the economy continues to undergo a difficult process of correcting pre-crisis imbalances.

26. **Spain's economy is starting to recover**. Of note:

- Spain's financial markets continue to strengthen, with risk premia on sovereign and bank bonds now down by more than 75 percent since the program started and with sovereign yields touching record lows (Figure 1).

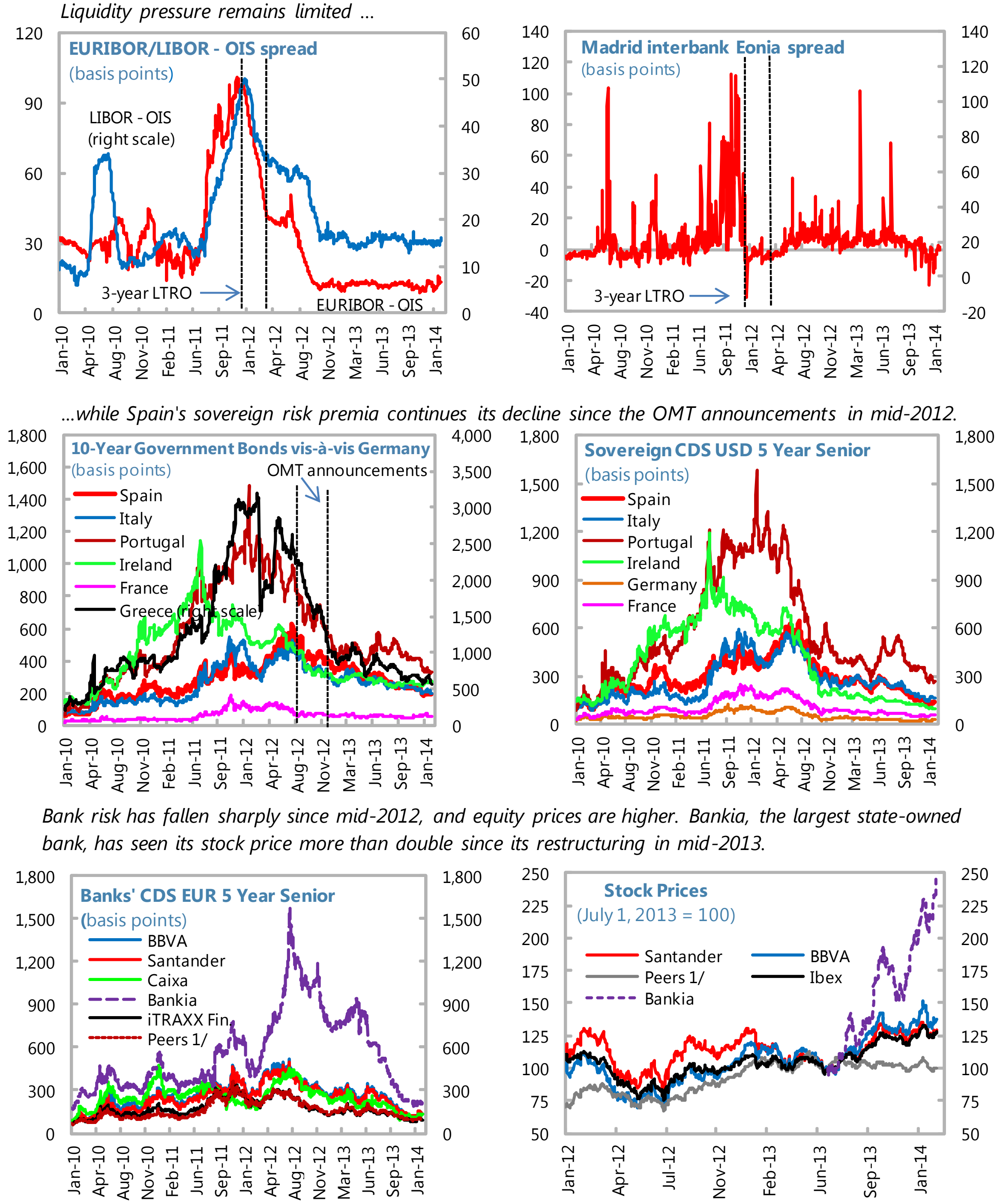
- The real economy has now also begun to expand. Output grew by 0.3 percent (q-o-q) in the fourth quarter of 2013—the second consecutive quarter of growth, ending two years of recession.

Figure 1. Spain: Financial Market Indicators

Liquidity pressure remains limited …

…while Spain's sovereign risk premia continues its decline since the OMT announcements in mid-2012.

Bank risk has fallen sharply since mid-2012, and equity prices are higher. Bankia, the largest state-owned bank, has seen its stock price more than double since its restructuring in mid-2013.



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.

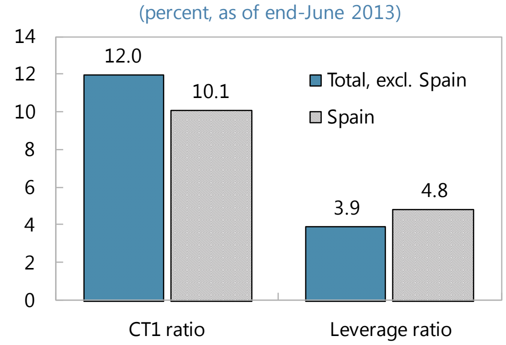
- The seasonally-adjusted unemployment rate also began to decline during 2013, though it remains very high at 26 percent at end-2013.

- Growth has been led by exports, which are estimated to have risen by 5½ percent in 2013 and to have shifted the current account into surplus for the first time in two decades (Table 1).

27. Efforts under the program have substantially lessened risks emanating from banks to the rest of the economy, as has important policy progress at the European level. Actions under the program have significantly bolstered the system's capital and liquidity, and market funding costs have dropped sharply (Box 1 and Annex 1). The latter development has occurred across stressed euro-area economies, with the ECB's OMT-related announcements being a key factor. Isolating the effect of Spain's program on the drop in funding costs is difficult, especially relative to the counterfactual, as an absence of action would have likely entailed a disorderly and disruptive unwinding of a significant portion of Spain's banking system, entailing potentially heavy costs for bank depositors that would have prompted further deposit outflows and an even sharper tightening of credit conditions for households and firms. That said, the strong reduction in risk premia across stressed euro-area economies since mid-2012 suggests an important positive impact from the package of crisis measures adopted during this period (e.g., OMT, SSM) and to which Spain's financial sector program was a contributing element.

28. At the same time, important areas of concern remain (Box 1). Credit to the private sector continues to contract rapidly (though the contraction is almost certainly less rapid than it would have been absent the actions under the program and partially reflects unavoidable deleveraging pressures). Notwithstanding the progress during the program, Spain's banks also continue to face notable risks, including from still-rising NPLs and weak core profitability (pre-provision profits from lending and fees are down 21 percent in the first three quarters of 2013 compared to the same period of 2012), while buffers as measured by CT1 ratios are still below-average for advanced Europe, though Spanish banks perform more favorably in terms of leverage ratios.

Europe: Core Tier 1 and Leverage Ratios 1/
(percent, as of end-June 2013)



Source: EBA and SNL.
1/ Based on the EBA list of 63 major banks, of which 4 are Spanish. CT1 ratio = core tier 1 capital (CT1) as a percent of risk-weighted assets. Leverage ratio = CT1 as a percent of assets.

Box 1. The Program's Main Achievement: Preserving Financial Stability

During the 18 months of the program, much has been achieved in terms of preserving financial stability, in a context of severe macrofinancial stress. A look at the main financial, credit, and market indicators illustrates such trends, while highlighting the remaining areas of vulnerability (see Annex 1 for further detail):

- ***Bank capital*** has been bolstered since 2011, in terms of both CT1 and leverage ratios. This is due to both (i) a strengthening of the numerator following recapitalization measures under the program, increased profit retention, and recent equity issuances and (ii) shrinking denominators.

Spanish Banks: Evolution of Financial, Credit, and Market Indicators, During Program Period (2012=100)

		2011	2012	Latest	Progress
Asset Quality	Stock of NPLs	83	100	114	Negative
	Coverage ratio 1/	87	100	104	Positive
	Yearly provisions 2/	25	100	29	Positive
Profitability	Pre-provision profits 3/	88	100	94	Negative
	Cost-Income	110	100	103	Negative
	RoA	Zero	Negative	Positive	Positive
Funding	Loan-to-Deposit	109	100	91	Positive
	ECB refinancing 4/	37	100	74	Positive
	Customer deposits 5/	111	100	101	Positive
Capital	Core Tier 1 ratio	99	100	119	Positive
	Leverage ratio 6/	104	100	111	Positive
Credit	Household loans	105	100	96	Negative
	Corporate loans 7/	120	100	89	Negative
Stock price	Ibex 35	106	100	117	Positive
	Santander	87	100	115	Positive
	BBVA	85	100	125	Positive
	Caixabank	124	100	136	Positive
CDS Spreads 8/	Kingdom of Spain	134	100	52	Positive
	Santander	131	100	42	Positive
	BBVA	128	100	42	Positive
	Caixabank	79	100	43	Positive

Sources: BdE, Bloomberg.

1/ Specific credit reserves, as percent of nonperforming loans. 2/ Yearly provisions for loan losses, as percent of loans. 3/ Latest refers to September 2013, annualized. 4/ As percent of banks' assets. 5/ Includes promissory notes (pagarés). 6/ Core Tier 1 equity, as percent of assets. 7/ Excludes loans to construction sector. 8/ Basis points, euro senior 5-year.

- ***Asset quality***, as a lagging indicator, remains an area of concern, as the stock of NPLs continues to rise (though recently at a lower speed). The coverage ratio has nonetheless improved due to stepped-up provisioning.

- ***Banks' funding structure*** has also become more stable due to the halting of deposit outflows at the system level (although different trends have been registered bank-by-bank, with flight-to-quality effects, especially at the peak of the crisis). The stabilization of deposits despite ongoing credit contraction has allowed banks to reduce their reliance on more volatile wholesale funding. In 2013, banks also substantially reduced their reliance on Eurosystem financing, though it remains at a high level.

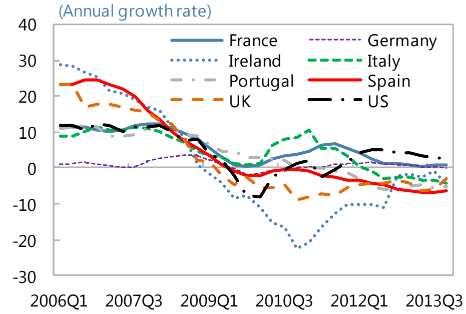
- ***Liquidity*** has been boosted by the capital injections in the form of ESM bonds and the transfer of illiquid assets to SAREB in exchange for SAREB bonds, as both types of bonds can be used as collateral for ECB or private-sector borrowing. Together with higher collateral values, significant net ECB repayments, and widened collateral eligibility rules, banks now have substantial collateral space that could be used for ECB borrowing, if necessary.

- ***Profitability*** has improved, with the sector back to a positive return on assets (RoA). Although pre-provision profits are on a downward trend, this is to be expected to a degree, given that bank assets are shrinking amidst deleveraging. That said, pre-provision profits in 2013 have been boosted by some non-recurring items (Annex 1), such as capital gains on bonds. The latter may continue to support profits in the near future given further recent declines in bond yields, but such profits will become more difficult to sustain once yields stabilize. More progress is also needed on cost reduction.

Box 1. The Program's Main Achievement: Preserving Financial Stability (concluded)

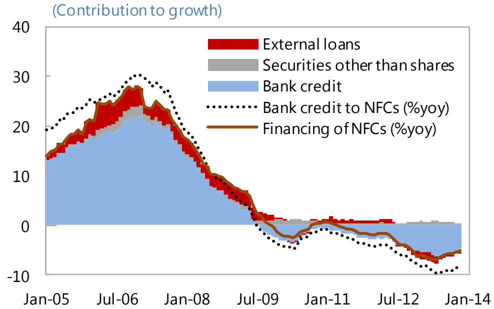
- ***Credit to the private sector*** has continued to contract rapidly, and lending conditions remain tight (Figure 2). This outcome reflects a variety of factors, including weak credit demand and elevated default risk amidst recession. It also partly reflects a necessary deleveraging of an over-leveraged private sector. That said, the pace of credit contraction is one of the fastest amongst advanced economies and is significant even in asset classes not related to the construction sector, where most of the boom-and-bust was concentrated. To the degree that credit contraction comes at the cost of less aggregate demand, the rapid pace of contraction may be faster than is optimal, given the wide output gap and high unemployment (Box 2). Tight credit conditions also partly reflect sub-optimal policies in terms of incomplete banking union contributing to euro-area financial fragmentation (see previous progress reports and the October 2013 *Global Financial Stability Report* for further discussion of the drivers of credit growth).

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



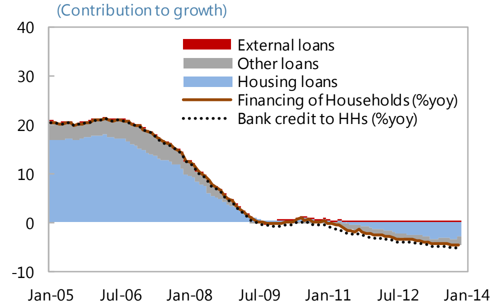
Sources: Haver, BdE
1/ Numbers for Spain are adusted to remove the effect of the transfer of loans to SAREB.

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



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

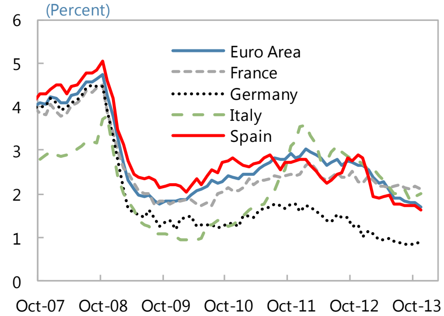
Spain: Financing of Households
(Contribution to growth)



Source: BdE.

- ***Market funding conditions*** have improved dramatically, with risk premia on unsecured bank debt down more than 75 percent, deposit rates down in line with euro-area trends, and equity prices up sharply (Figure 1). For example, state-owned Bankia's common stock price has more than doubled since the bank was restructured in May 2013, it now trades at a significant premium over book value, and in January 2014 it issued unsecured bank debt for the first time since before the program, at a 5-year maturity and yield of 3.6 percent. These strong funding conditions reflect confidence in a strengthened banking sector, as well as much improved conditions in Europe overall, with broadly similar reductions in risk premia in other stressed economies in the euro area.

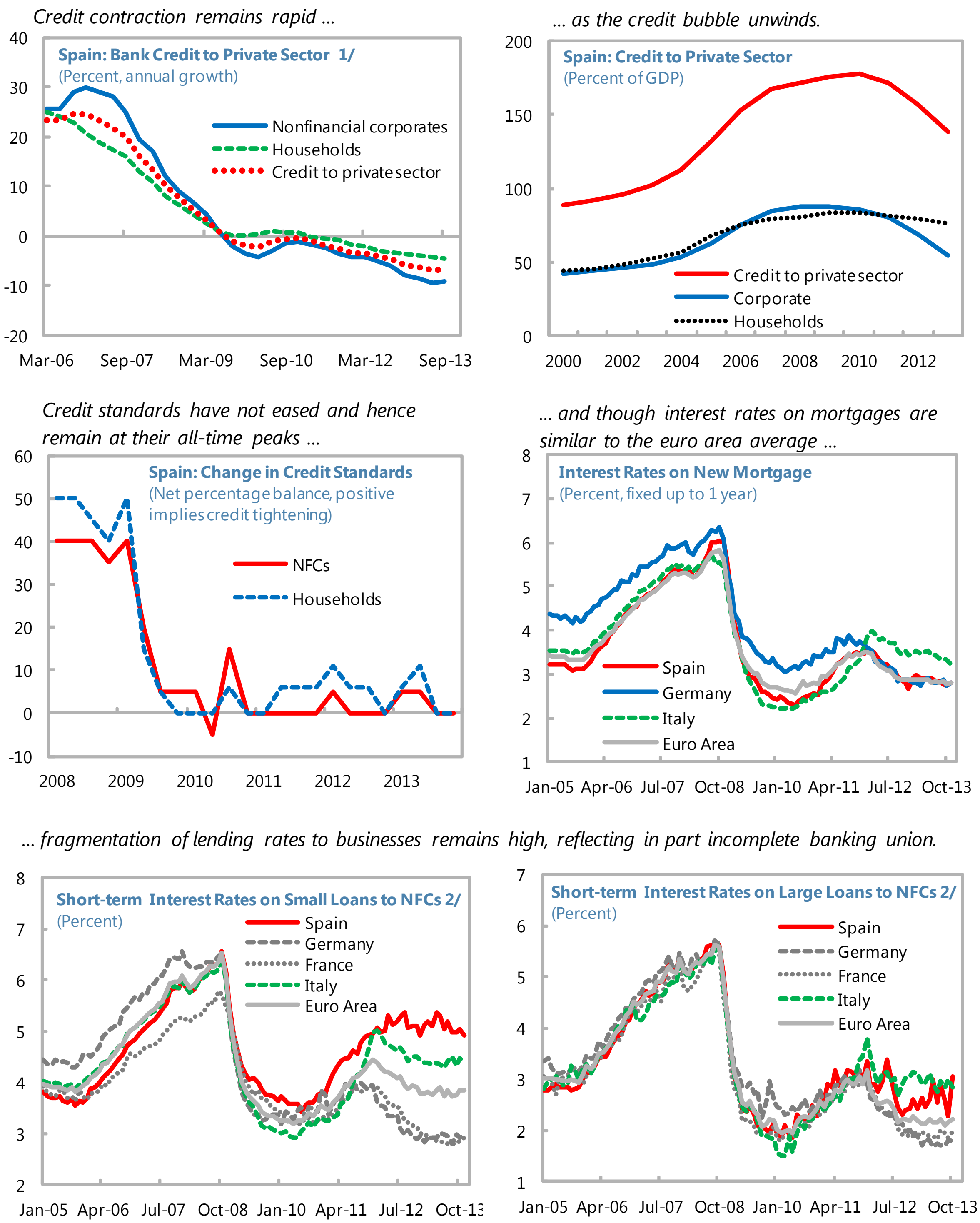
Deposit Rates 1/
(Percent)



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

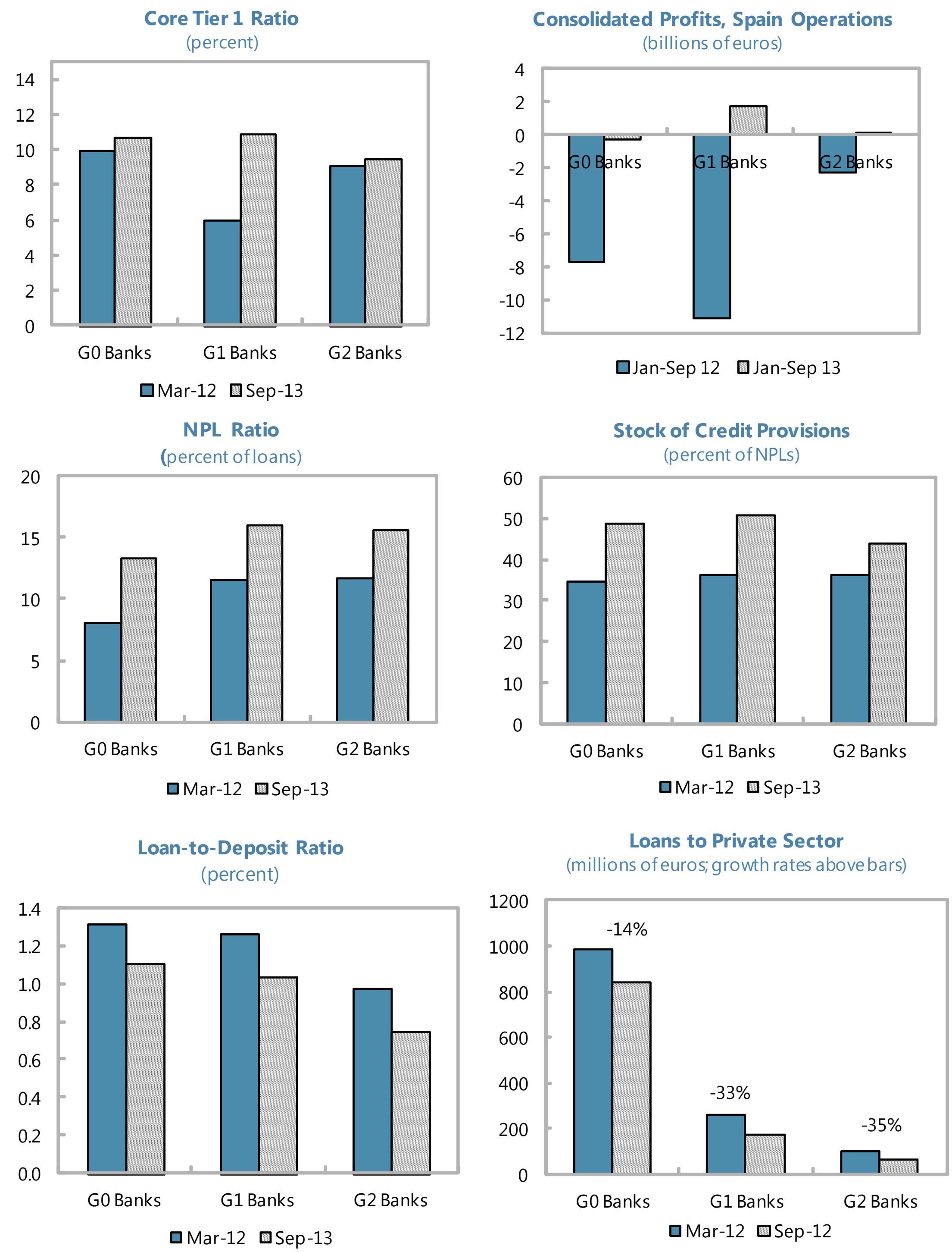
- ***Developments by bank type***. The balance sheet trends above have broadly held both for stated-aided banks (G1 and G2) and those not receiving state aid (G0 and G3) (Figure 3). However, G1 banks' capital ratios and profits have improved more than those of other banks, as expected given that restructuring has been most intense for these banks. Figure 3 also shows that much of the capital-raising was used to bolster provisions.

Figure 2. Spain: Credit Conditions



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: Bank Indicators by Group 1/



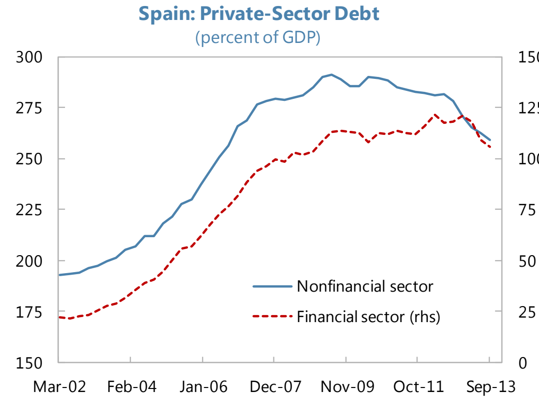
Sources: BdE; SNL; and IMF staff calculations.

1/ The two G3 banks are included in the G0 category for simplification. Separating G3 banks does not materially affect the results.

Box 2. Spain: Would Slower Private-sector Deleveraging be Good or Bad?

The main argument for slower private-sector deleveraging is that this could boost aggregate demand, which is much too low. Easier credit conditions and slower deleveraging would facilitate higher private-sector consumption and investment (Box 3) and thus faster closing of the very-wide output gap. Private-sector agents typically do not take this macroeconomic benefit to increased spending into account when making lending and borrowing decisions. This implies that slower deleveraging has a positive externality in the current context and that the current pace of deleveraging is faster-than-desirable, all else equal.

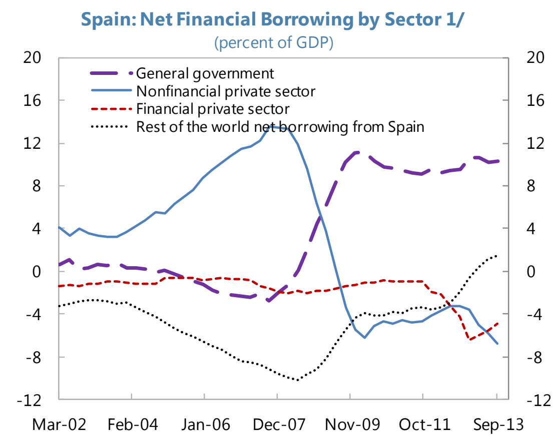
The main argument against slower deleveraging is that private-sector debt levels are still high. Private-sector debt-to-income ratios are falling, but the level of debt is still quite high relative to the pre-boom period and relative to other advanced economies (Figures 4 and 5). Debt ratios may thus have much further to fall before they reach a "normal" level that agents are comfortable maintaining indefinitely. This adjustment process would take longer to complete if deleveraging were to slow.



Source: Haver.

On balance, supporting growth and rebalancing its sources are the higher priorities at the moment.

- While the nonfinancial private sector has a high debt level, its flow of net financial borrowing is nearly *minus* 7 percent of GDP (i.e., the private sector is lending to other sectors)—well below the positive rates that were typical in the pre-boom period and below the rate needed to keep the private-sector debt-to-GDP ratio on a downward path (while keeping private-sector financial assets-to-GDP constant). Consequently, the private-sector debt ratio is now falling steadily, and private-sector deleveraging could be slowed while still keeping the private-sector debt ratio on a clear downward path.



Source: Haver.
1/ Change in financial debt minus change in financial assets.

- Slower deleveraging would boost aggregate demand and/or allow faster adjustment of the public-sector deficit, which—unlike private-sector net borrowing—is well above the sustainable rate. Such rebalancing of domestic demand would thus help to adjust net borrowing flows for both the private and public sectors toward their long-run equilibriums.

- Markets are likely to view this scenario of less rapid credit contraction and faster fiscal improvement as supportive of financial stability, such that Spain's risk premia and external borrowing costs could also fall, further assisting both demand and debt dynamics.

- Moreover, inducing higher private-sector demand may also not slow deleveraging that much if higher spending is matched nearly one-for-one by higher income due to the output gap (i.e., the paradox of thrift).

Box 2. Spain: Would Slower Private-sector Deleveraging be Good or Bad? (concluded)

- For example, suppose that monetary easing induces increased borrowing of 5 percentage points of GDP (pp), which is used to fund 3 pp of increased spending on domestically produced goods, 1 pp of higher tax payments, and 1 pp of imports. Using standard rules-of-thumb, output would rise by 3 percent, unemployment would fall by more than 2 percentage points, and the fiscal deficit would improve by 1 pp. Against these positive effects, the current account would fall by 1 pp (but still be near balance), and the nonfinancial private-sector's net financial saving would fall by 2 pp to 5 percent of GDP (still enough savings to keep the private-sector's net financial debt falling rapidly as a percent of GDP). On balance, this would seem to be a good tradeoff—even before further beneficial second-round effects from lower external borrowing costs arising from improved market confidence due to higher output and a lower fiscal deficit.

Policies can also help avoid, or at least reduce, the trade-off between deleveraging and aggregate demand. Such policies thus offer "win-win" opportunities to promote both deleveraging and higher output and should thus be top priorities. Policies along these lines that have been recommended by staff include the following (see staff's 2013 Article IV report for further discussion of specific policies):

- ***Encourage increased reliance on equity funding***. For example, in the financial sector, banks should be encouraged to build core capital in absolute terms (e.g., via dividend restraint and share issuance).

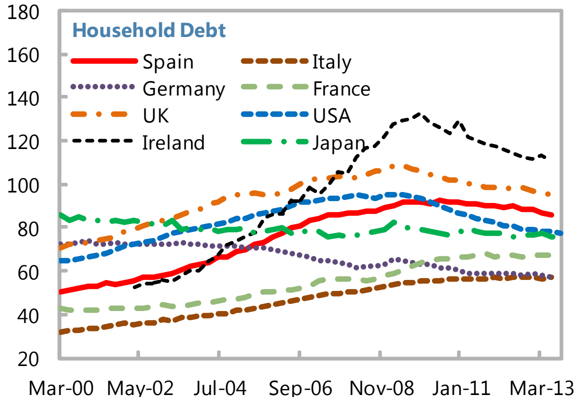
- ***Reduce real interest rates***. Measures to support lower real interest rates in Spain include more monetary easing by the ECB and further progress toward banking union. By slowing the pace at which debt compounds, lower real interest rates can accelerate deleveraging, holding constant the amount of new borrowing for spending/aggregate demand. Lower real interest rates are likely to be helpful in this context regardless of the credit demand response: if credit demand is unresponsive to lower lending rates, then the boost to aggregate demand may be modest, but deleveraging will be significantly accelerated; if instead credit demand is highly responsive to lower lending rates, then deleveraging will not accelerate much and would likely slow, but aggregate demand would be greatly boosted.

- ***Reform insolvency procedures***. More efficient resolution of debt distress can improve outcomes for both debtors and creditors, thereby boosting demand while accelerating deleveraging.

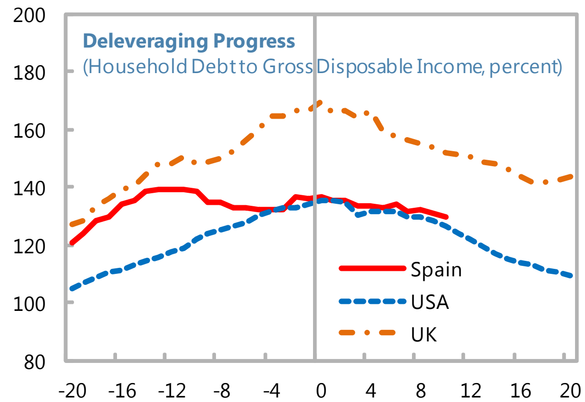
- ***Boosting net external demand***. Higher external demand can assist both growth and debt reduction. Measures to boost external demand include continued monetary support and labor market reforms.

Figure 4. Spain: Household's Financial Positions

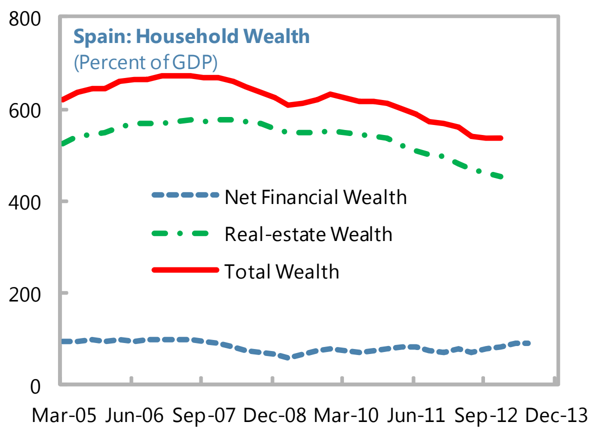
Despite contraction of nominal debt, Spain's household debt-to-GDP ratio is not yet falling rapidly ….



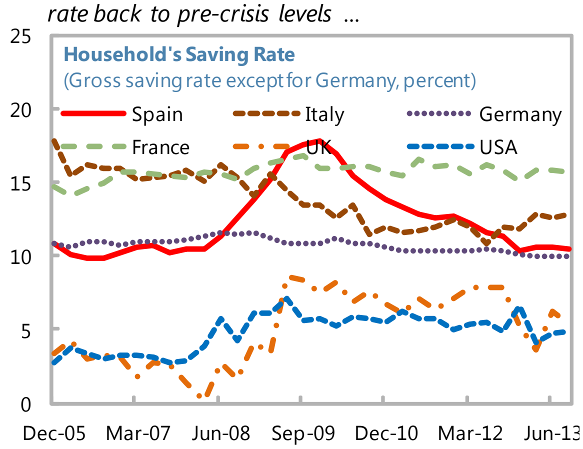
… due to falling nominal income. This partly reflects lower inflation than in other post-boom countries.



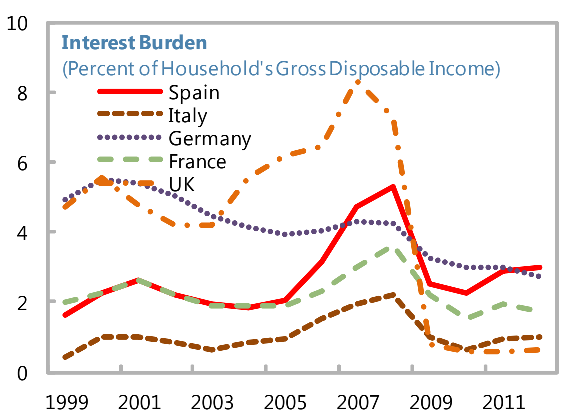
Household wealth has declined during the crisis.



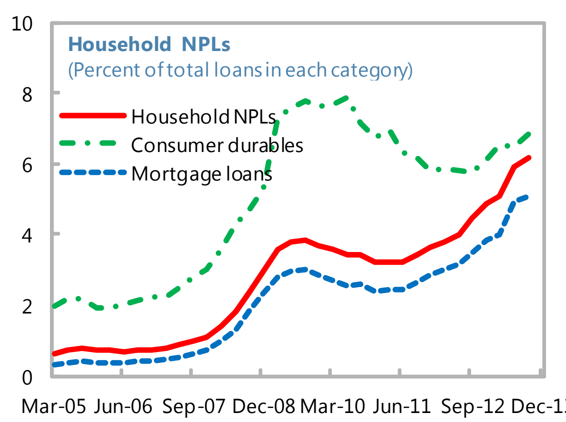
Falling disposable income has pushed the saving rate back to pre-crisis levels …



… while keeping the interest burden from falling …



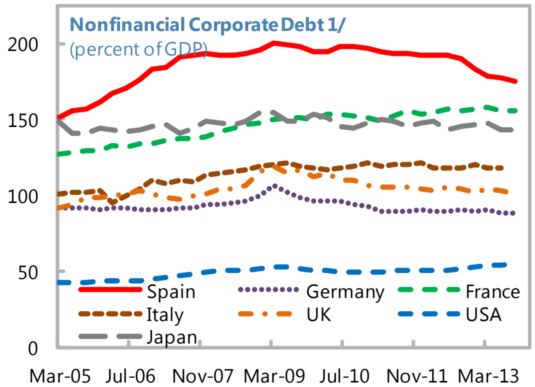
… and pushing up household NPLs.



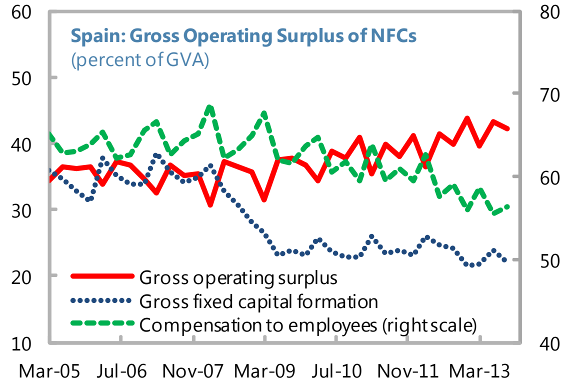
Sources: BdE; ECB; Haver; and IMF staff calculations.

Figure 5. Spain: Nonfinancial Corporate's Financial Positions

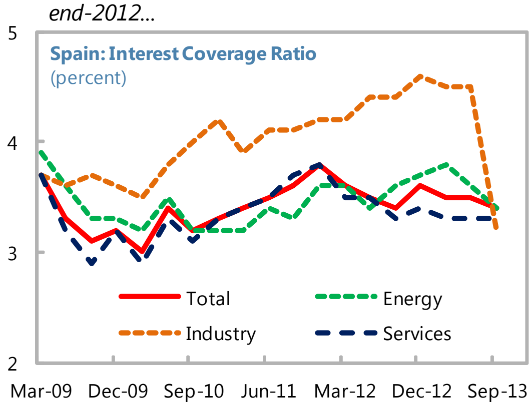
Corporate debt is high but declining.



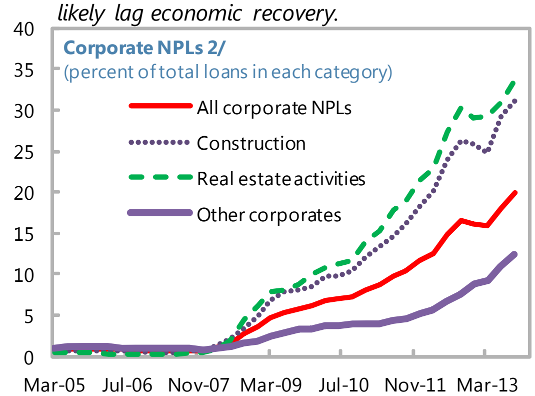
Corporate profitability is on an upward trend, as firms cut employment, investment, and operating costs.



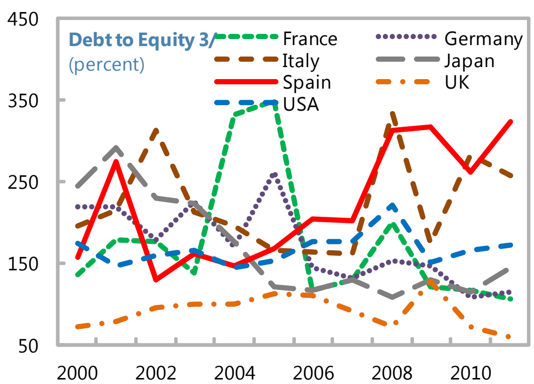
Debt servicing ability has improved slightly since end-2012…

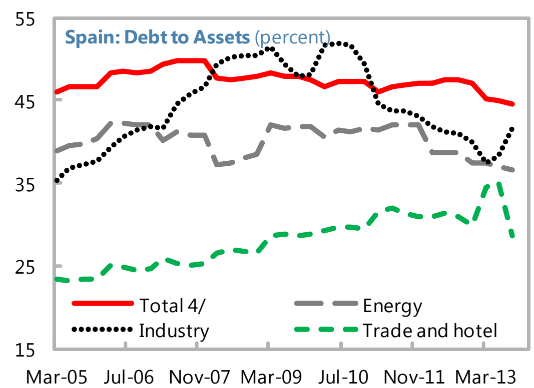


… but reversal of the upward trend in NPLs will likely lag economic recovery.



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.

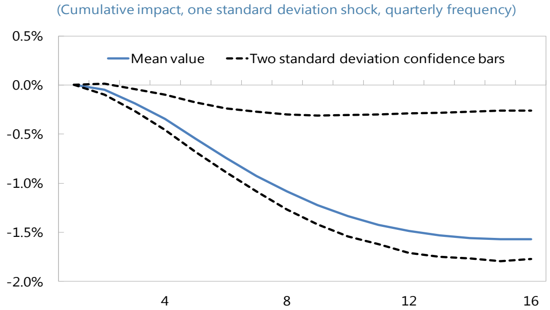
Box 3. Credit Supply Shocks and GDP Growth in Spain[2]

This box presents an empirical assessment of the importance of credit supply shocks in constraining economic growth in Spain since end-2007. The analysis is based on a parsimonious VAR at quarterly frequency that includes real GDP growth, expected GDP growth over the next quarter, and changes in bank lending standards on loans to enterprises. Regarding lending standards, it is important to consider that they cannot be treated as a pure measure of credit supply conditions. This is because banks can adjust lending standards not only in response to changes in their own risk attitudes, regulatory requirements, or balance sheet positions, but also because of variations in borrowers' creditworthiness. For example, banks would tighten lending standards when an ongoing or incipient recession undermines borrowers' repayment capacity. To address this identification problem, we impose in the VAR that a shock that moves within the same quarter lending standards as well as actual or expected GDP growth will not be interpreted as a credit supply shock. For example, news about an incipient recession that determines a downward revision of expected GDP growth and tighter lending standards will not be considered as a credit shock. We will instead identify as credit supply shocks only those shocks that determine an immediate change in lending standards without a contemporaneous impact on current or expected GDP growth.

Regarding possible limitations of the identification strategy, there are two main concerns. On the one hand, the identification restriction may be too strong. A credit supply shock, especially if realized at the beginning of the quarter, is likely to have already some effects on GDP within the same quarter, or at least on the expectations of next quarter GDP. This would introduce a downward bias in our estimates, thus providing a conservative assessment of credit supply shocks in affecting GDP growth. On the other hand, current and expected GDP growth may not fully capture banks' perceptions about borrowers' creditworthiness. In this case, the estimation framework would incur the risk of overestimating the role of credit supply shocks. Finally, the estimation results could be affected by omitted variable bias since the limited time-series of lending standards (available only from 2003 onwards) does not allow for a larger scale VAR.

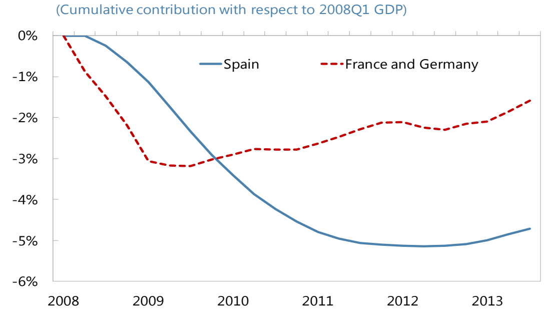
Figure 1 shows the substantial cumulative impact that a one standard deviation negative shock to credit supply has on real GDP while Figure 2 shows the total impact on GDP since end-2007. The effect of the shock is relatively muted in the first year, but grows over time leading to an overall reduction in GDP by more than 1.5 percent. The confidence bars show that this effect is statistically different from zero. By cumulating the effect of all credit supply shocks over time, Figure 2 shows the total impact on GDP with respect to the beginning of 2008. The impact for Spain is compared to the average effect for France and Germany. Consistent with the lower exposure of Spanish banks to US asset-backed securities, Spain suffered less from credit supply shocks than France and Germany during 2008. However, while credit conditions in France and Germany started to improve already in 2009, tighter credit supply contributed to a further large reduction in Spanish GDP in both 2009 and 2010 as pressures on sovereign debt markets intensified. The negative impact of credit supply on GDP began to moderate in the second half of 2012, but as of today GDP still remains about 5 percent below the level in the first quarter of 2008.

Figure 1 - Impact of a credit supply shock on GDP
(Cumulative impact, one standard deviation shock, quarterly frequency)



Sources: authors' estimates

Figure 2 - Total impact of credit supply shocks on GDP
(Cumulative contribution with respect to 2008Q1 GDP)



Sources: authors' estimates

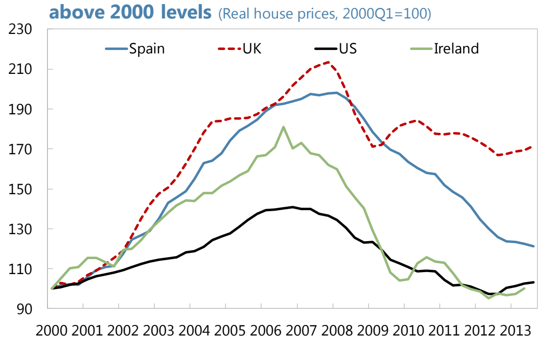
[2] Prepared by Andrea Pescatori and Damiano Sandri and based on preliminary findings from ongoing research. For additional details on the estimation procedure and results for other countries, see a forthcoming Box in the 2014 April WEO and a forthcoming IMF Working Paper by Pescatori and Sandri. For discussion of policies to stimulate credit supply, see Chapter 2 of the October 2013 *Global Financial Stability Report*.

29. Key macroeconomic imbalances also continue to correct, though further adjustment remains. In particular:

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

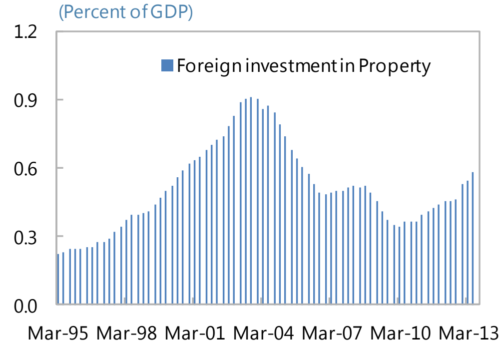
- ***Housing***: At end-September 2013, house prices were down 4-9 percent from a year earlier and 30-40 percent from their peak, depending on the index used. Although house prices have started to stabilize in the most recent data, further declines are possible as the supply overhang is still large (the stock of vacant new houses equals four years of sales, and the population is falling). On the upside, foreign investor interest in Spanish property has increased noticeably in recent months.

Spanish house prices continue to adjust, but remain above 2000 levels (Real house prices, 2000Q1=100)



Sources: Eurostat; FHFA; INSEE; and Ministerio Fomento.

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



- ***Private-sector deleveraging***: Debt ratios for households and nonfinancial corporates are declining, but are still well above pre-boom and/or average levels in other advanced economies (Figures 2, 4, and 5), suggesting significant further adjustment ahead.

30. These ongoing adjustments are expected to keep the pace of recovery restrained. Growth is expected to continue receiving impetus from expanding net exports. However, ongoing private-sector deleveraging, fiscal consolidation, and house price adjustment are likely to 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 similar to that assumed in the base case of the September 2012 stress test. However, some of the other key variables (e.g., unemployment) are running closer to the adverse case than to the base, while others (e.g., house prices) are running between the two scenarios. On balance, staff's central scenario suggests an overall outcome (in terms of the effect on bank's capital) somewhere between the baseline and adverse scenarios.

Key Macro Variables
(annual rates, percent)

	Assumptions in Stress Tests								Actual	Latest IMF Staff Forecasts or Actual Observation 1/			
	Base case				Adverse case								
	2012	2013	2014	Cumulative 2012-14	2012	2013	2014	Cumulative 2012-14	2012	2013	2014	Cumulative 2012-14	Comments on latest actual observation or forecast
Real GDP growth	-1.7	-0.3	0.3	-1.7	-4.1	-2.1	-0.3	-6.4	-1.6	-1.2	0.6	-2.3	Near base case
Nominal GDP growth	-0.7	0.7	1.2	1.2	-4.1	-2.8	-0.2	-7.0	-1.7	-0.5	1.0	-1.2	Between base and adverse
Unemployment rate 2/	23.8	23.5	23.4	23.6	25.0	26.8	27.2	26.3	25.0	26.0	25.8	25.6	Between base and adverse
Harmonized CPI growth	1.8	1.6	1.4	4.9	1.1	0.0	0.3	1.4	2.4	1.5	0.6	4.6	Near base case
GDP deflator growth	1.0	1.0	0.9	2.9	0.0	-0.7	0.1	-0.6	0.0	0.7	0.4	1.2	Between base and adverse
House price growth	-5.6	-2.8	-1.5	-9.6	-19.9	-4.5	-2.0	-25.0	-8.7	*-7.3*	...	...	Between base and adverse
Land price growth	-25.0	-12.5	5.0	-31.1	-50.0	-16.0	-6.0	-60.5	-6.4	*-12.4*	...	...	Near base case
Spain sovereign yield, 10-year 2/	6.4	6.7	6.7	6.6	7.4	7.7	7.7	7.6	5.9	*3.8*	...	...	Better than both cases
Credit to households, growth 3/	-3.8	-3.1	-2.7	-9.3	-6.8	-6.8	-4.0	-16.6	-3.6	*-4.2*	...	...	Near base case
Credit to nonfinancial firms, growth 3/	-5.3	-4.3	-2.7	-11.8	-6.4	-5.3	-4.0	-14.9	-7.8	*-9.4*	...	...	Worse than adverse

Sources: Haver; Oliver Wyman; IMF staff estimates.
1/ Projections based on the January 2014 *World Economic Outlook* update. Latest actual observations for 2013 are in italics.
2/ Amounts in the column for 2012-14 are the average over the period, not a cumulative amount.
3/ From the flow-of-funds data. Includes loans from resident credit institutions, off-balance-sheet securitized loans, and loans transferred to SAREB.

31. However, uncertainty around staff's central scenario is significant.

Downside risks

- Downside risks include that (i) recent improvements in market sentiment could reverse (e.g., in response to faster-than-expected withdrawal of monetary support in advanced economies or to policy slippages in Spain or Europe); (ii) headwinds from fiscal consolidation and deleveraging could be larger than expected, causing an even more extended period of weak growth and rising NPLs; and (iii) turmoil in emerging markets could accelerate, dampening profits from abroad for Spain's largest banks. Additional uncertainties for the banking sector arise from unknowns regarding the methodology of the SSM's forthcoming comprehensive assessment, as well as the unwinding of the state's ownership interest in intervened banks over the next few years.

- With moderate capital buffers, banks may respond to adverse shocks by relying on excessive credit contraction to maintain capital ratios, adding to headwinds and supporting a self-reinforcing cycle of stagnation. Moreover, even if downside risks do not materialize, the central scenario is still an adverse one in that unemployment would remain very high for an extended period.

Upside risks

- That said, the scope for virtuous cycles is also significant. Indeed, recent high-frequency indicators (e.g., PMI) suggest that near-term growth may continue to surprise to the upside. This could spur further reductions in borrowing costs for banks and sovereigns, especially if reform momentum also continues.

- This underscores the importance of strong policies by both Spain and Europe, as outlined in the next section, to build on the recent encouraging signs and to help nudge the economy toward more robust recovery.

BUILDING ON THE PROGRAM'S GAINS

Going forward, it will be essential 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.

32. Strong financial sector policies at both the European and Spanish levels can reduce downside risks, safeguard financial stability, and promote faster recovery. Measures that would promote these ends include

- continued pro-active monitoring and supervision to identify and address risks at an early stage and to ensure adequate provisioning;
- encouraging banks to bolster capital in ways that do not exacerbate already-tight credit conditions;
- reducing impediments to asset disposal and corporate debt restructuring; and
- further reducing funding costs and easing credit conditions via swift progress toward more complete banking union and more monetary easing by the ECB.

Such a strategy could help push the economy and financial system into the virtuous cycle—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 cycle in which these dynamics operate in reverse. Elements of this strategy are further fleshed out below.

A. Enhanced Monitoring and Intrusive Supervision

33. 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. One key exercise in this regard is the SSM's forthcoming comprehensive assessment (Section C). In addition, the BdE has developed two new monitoring tools in conjunction with the program:

Forward-Looking Exercise on Spanish Banks (FLESB)

34. The FLESB is a welcome addition to the BdE's supervisory toolkit. A work in progress, the FLESB 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, with complementary assessments also of non-credit risks (such as market, funding, and sovereign risks) not covered by the FLESB. The BdE discusses the methodology and aggregate results from the first run of the FLESB in its November 2013 Financial Stability Report.

Funding and Capital Plans (FCPs)

35. Another monitoring tool developed under the program is the compilation of banks' FCPs. In line with the provisions of the MoU, a set of major Spanish banks are required to submit FCPs (i.e., balance sheet projections through 2015) and to update them on a quarterly basis. Banks have made three submissions so far, with the latest one based on actual data through Q2 2013.

36. Observations on the latest FCP include the following:

- Banks' projections for credit contraction are close to those of IMF staff (Table 3).
- One notable divergence from staff's projections is that banks envisage a rapid decline in their exposure to the sovereign and, relatedly, in ECB financing.
- However, a rapid decline in banks' holdings of public debt seems unlikely, as the stock of public debt will grow steadily during the next two years. Hence, if banks reduce their exposure to public debt, then either nonresidents or the nonfinancial resident sector will have to absorb a much larger share of it, which is inconsistent with the broad trends observed since Spain started to correct its external imbalances (Box 4). It seems more likely that banks will not reduce their exposure to the sovereign so fast.
- In fact, banks' exposure to the sovereign through the first nine months of 2013 was significantly underestimated compared to initial FCP forecasts. Domestic banks did reduce their holdings of public debt in the second half of 2013, but this may have reflected one-off effects as banks prepared for the SSM's comprehensive assessment, which will be based on end-2013 balance sheets and include some stressing of sovereign debt portfolios.

Box 4. How are Banks' Holdings of Domestic Sovereign Debt Likely to Evolve?

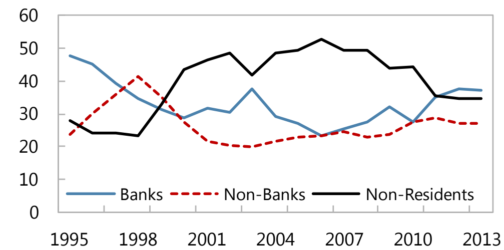
Spanish banks' holdings of domestic sovereign debt have risen substantially during the crisis, but are not unprecedented.

- These holdings fell to record lows during the boom, such that Spanish banks' share of all Spanish sovereign debt is still near 2003 levels, despite the run-up during the crisis. The share is also still well below levels that prevailed in the late 1990s (though the latter period may not be fully comparable because it was pre-euro). Changes in this share tend to be offset by changes in the share of debt held by non-residents, as the share held by nonbank domestics has remained broadly stable during the euro period.

- Similarly, Spanish sovereign debt as a share of banks' assets (9 percent as of end-October 2013) is still below pre-euro levels (e.g., 11 percent at end-1998), despite a doubling in this share since early 2011.

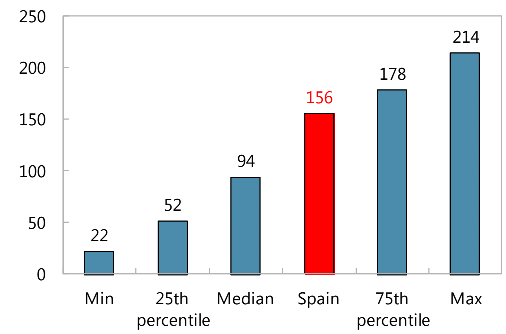
- From a cross-sectional perspective, Spanish banks' holdings of domestic sovereign debt as a share of capital are only moderately above the eurozone median, and higher levels are seen in some other advanced economies (e.g., Japan). The trend toward increased holdings of domestic sovereign debt has also been observed in most advanced economies during the crisis.

Holders of Spanish Sovereign Debt 1/
(percent of total)



Source: BdE.
1/ Term investments. Data for 2013 is for end- November.

Europe: Domestic Holdings of Sovereign Debt
(percent of Core Tier 1 capital)



Source: EBA. Data as of 1H2013; EBA data cover only the largest banks.

This trend across many advanced economies reflects various forces. These include (i) a rapid increase in the supply of public debt relative to private debt during the crisis; (ii) more demanding liquidity requirements from regulators and the market; (iii) the ability to easily use sovereign debt as collateral for central bank financing, combined with the increased need for, and availability of, such financing during the crisis; and (iv) increased home bias due to factors such as

- ringfencing by bank supervisors in some countries and the effects of bank regulation (e.g., having a higher risk weight on foreign sovereign debt than domestic sovereign debt in some cases, combined with increased concern about capital adequacy since the onset of the crisis); and

- increased sovereign default risk in some countries, which has a higher expected cost for foreign banks than for domestic banks, given that domestic banks have a higher probability of being insolvent in such an extreme scenario, even before losses on sovereign debt are applied, such that credit losses on sovereign debt pose little additional cost to domestic bank equity holders.

The future steady-state for bank holdings of sovereign debt is unclear. Some of the forces above may ease as the crisis recedes and as sovereign risk premia decline. This in turn may halt, and eventually reverse, the trend toward higher holdings of sovereign debt by banks. However, other forces, such as the higher supply of public debt relative to private debt, are likely to persist for some time, while others, such as liquidity requirements under Basel III, will intensify. Indeed, the trend toward Spanish banks' accumulation of domestic sovereign debt continued during the first half of 2013, despite a large drop in sovereign risk premia that should have caused several of the forces above to reverse. Domestic banks did reduce their holdings of Spanish sovereign debt in the second half of 2013, but it is unclear to what degree this represents a sharp reversal in the trend or instead one-off efforts to adjust holdings ahead of the SSM's comprehensive assessment, which will be based on end-2013 balance sheets and include stress-testing of sovereign portfolios.

- If, as staff project, banks reduce their holdings of sovereign debt less rapidly than envisaged in the FCPs, then banks will also likely need to reduce their ECB financing by less than envisaged in the FCPs to avoid an excessive contraction of credit. For example, if (i) banks buy more public debt than envisaged in the FCPs so as to keep their share of public debt constant and (ii) this is offset by lower credit to the private sector, the growth rate of the latter would be nearly 7 percent lower than envisaged in the FCPs in 2015, with adverse headwinds for the recovery. Unless this outcome is averted by a higher-than-expected inflow of external financing (to either banks or the sovereign), ECB repayments may need to be slower than projected in the FCPs. This in turn will require the continuation of supportive ECB policies and avoiding stigma from the use of ECB facilities (Section C).

B. Maintaining Sufficient Capital to Support Recovery

37. Strategies to help ensure that banks remain sufficiently capitalized to support recovery should include the following:

38. *Boosting capital to facilitate lending*. To avoid exacerbating already-tight credit conditions, it will be critical for supervisory actions to strengthen solvency ratios to continue prioritizing measures that boost banks' core capital in absolute terms (i.e., the numerator of banks' capital ratios) over ones that reduce lending (the denominator) or "optimize" risk weights. This includes ensuring that banks continue to (i) take advantage of buoyant equity markets to increase share issuance, (ii) bolster profitability through further gains in operational efficiency, and (iii) restrain cash dividends and cash remuneration. 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 should be extended to 2014 (Box 5). Strengthening the BdE's powers to limit dividend distribution (rather than to simply recommend limits) on a macroprudential basis would further support this objective.

39. *Facilitating distressed asset disposal and debt workouts*. Accelerated asset disposal could free capital space on banks' balance sheets for new lending to the growing parts of the economy. Increased voluntary workouts of distressed debt will also accelerate reduction of debt overhang. It will therefore be important to avoid any artificial hindrances to distressed asset disposal and debt workouts. 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. 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 with other revenue measures that are more efficient than transaction taxes). Additional reforms to improve the speed and efficiency of insolvency proceedings and to promote voluntary debt restructurings and debt-for-equity swaps could also be explored (see staff's 2013 paper on *Spain: Selected Issues* for further information on these issues), including via a broad review of related financial, commercial, and fiscal laws and regulations.

Box 5. Dividend Limits: Questions and Answers

The BdE recommended that banks limit cash dividends to no more than 25 percent of profits in 2013. This box elaborates on the rationale for such a limit, which could be usefully extended to 2014.

Why limit cash dividends? Higher levels of bank capital will either (i) increase a bank's capital ratio or (ii) allow the bank to slow its pace of credit contraction without reducing its capital ratio. Either outcome benefits the rest of society (i.e., has positive externalities): the first outcome reduces the risk of bank failures, which can disrupt financial stability and cost taxpayers; the second outcome boosts aggregate demand, which at the moment yields positive externalities given the wide output gap (Box 2). Measures that promote capital raising, but not credit contraction, are thus helpful in Spain's current situation. One such measure is a limit on cash dividends as a percent of profits, as it increases banks' capital due to higher profit retention. Importantly, it also does not create an incentive to accelerate credit contraction, as the limit is a function of a bank's profits and not its assets (unlike the minimum capital ratio). A dividend limit's effectiveness can be further enhanced by complementary measures to encourage additional capital-raising via share issuance and higher profits due to efforts to improve operational efficiency. Indeed, one variation on the dividend limit could be to set it as a percent of the absolute increase in a bank's regulatory capital. This would be essentially the same as setting it as a percent of profits, except that (i) it would effectively exclude from profits items that increase profits but not regulatory capital (e.g., more goodwill) and (ii) effectively add to profits capital raised from new share issuance, thereby encouraging such issuances.

Are dividend restrictions used elsewhere? Yes. For example, the U.S. Federal Reserve has announced that its expects "conservative common dividend payout ratios. In particular, requests that imply common dividend payout ratios above 30 percent of projected after-tax net income … will receive particularly close scrutiny."

Will dividend limits be evaded by share buybacks and other indirect methods of profit distribution? To be effective, restrictions on cash dividends should apply to all methods of distributing cash to shareholders, whether directly via cash dividends or indirectly via share buybacks, large bonus payments to senior bank employees who are also major shareholders, or other means. The term "dividend limit" is thus used throughout this report as shorthand for limits on all cash profit distributions, whether direct or indirect.

Aren't such dividend limits unfair, as they fail to differentiate between strong banks and weak banks? At least two key considerations are relevant to this question:

- ***First, the dividend limit does differ across banks in line with a bank's profits***. Granted, this yardstick differs from the standard capital-asset ratios on which most prudential requirements are based. However, the independence of the dividend limit from bank assets is a virtue in the current context, as it avoids creating an incentive to contract credit, as noted in the answer to the first question above. Moreover, capital ratios are an incomplete indicator of bank health—profitability is also key, just as fiscal deficits (a flow) can be a better indicator of fiscal health than debt levels (a stock). A prudential restriction based on profitability can thus be fully appropriate and complement capital requirements, just as fiscal rules can be based on debt or deficits.

- ***Second, applying the dividend limit to all banks avoids adverse, firm-specific signaling effects that would occur with a case-by-case application***. Banks and financial supervisors have more information than markets about a bank's health. This asymmetry may cause markets to react adversely to a dividend reduction not because markets place a high value on dividends themselves, but because investors see the reduction as a signal that non-public information about the bank's health is worse than previously estimated. This likely explains why dividends are much stickier than fundamentals. Indeed, surveys of managers suggest that signaling concerns are a main driver of dividends (Baker and Wurgler, 2012).

  This dynamic can create a "prisoners' dilemma" for banks during the bust phase of the cycle, in which all banks may want to lower their dividend in line with lower profits, but they all refrain from doing so unilaterally to avoid sending an adverse firm-specific (and potentially false) signal about the relative health of their bank. A publicly announced dividend limit for all banks (as a percent of profits) can resolve this coordination problem, making most, if not all, banks better off, especially if the limit is also successful in supporting economic recovery.

Could other measures reduce signaling problems in the future? Yes. Such problems could be reduced if Spanish banks specified their dividend policy not in terms of euros per share, but as a percentage of some relatively stable indicator of fundamentals, such as core profits or capital; a moving-average could be used if further smoothing is desired. With this approach, dividends would respond automatically to changing fundamentals without requiring discretionary action that markets could interpret as an adverse signal. Such a policy would also avoid an increase in dividends due simply to an increase in the number of shares (e.g., due to script dividends—dividends paid in shares rather than in cash). Indeed, some Spanish banks have already changed their dividend policy along these lines in light of these considerations.

Will a dividend limit make it harder for banks to raise equity by issuing shares?

- A successful dividend limit will increase bank equity. This could reduce the marginal return on bank equity, including because, higher equity reduces the chance of triggering implicit and explicit government guarantees on bank liabilities, which can be necessary to avoid self-fulfilling bank runs and to ensure financial stability. Higher equity thus reduces the effective subsidization from such guarantees, thereby reducing the return on bank equity (Admati and others, 2013) and increasing the cost of raising additional equity via share issuance.
- However, the fact that a dividend limit may increase bank equity is not a valid reason to oppose it, as this is the objective of the limit. The more relevant question is: for a *given amount of bank equity*, does the presence of a temporary dividend limit increase the cost of issuing shares?
- Standard economics says "no". To see this, suppose that a bank that has profits of 20 over the next year. Suppose also that it wants to raise its equity by 40. To achieve this, it can either (i) pay a dividend of 5 and raise 10 via share issuance each quarter or (ii) stop dividends this year and raise 5 via share issuance each quarter. The bank's path of capital and fundamentals are identical in both scenarios. Investors can also achieve an identical cash flow and share of ownership in either scenario by adjusting their purchases of new shares and/or sales of existing shares. Consequently, the pricing of equity issuances should be identical in both scenarios. In other words, the dividend limit has no effect of the value of any given level of bank equity.
- Miller and Modigliani (1961) famously proved this basic intuition in a more formal and general model. Indeed, their result is stronger, as they find that even shifting a bank's funding mix from debt to equity does not affect its value. However, this result does not consider government guarantees on bank debt, which provide banks with an incentive to keep equity lower than is socially optimal, as noted above.
- M&M's results also abstract from market imperfections such as taxes, transaction costs, inadequate aggregate demand, and asymmetric information. Such frictions imply that dividend limits may actually raise bank equity values because (i) raising equity via profit retention entails fewer transaction costs than share issuance; (ii) dividends are taxed at a higher effective rate than capital gains; (iii) equity values may rise if dividend limits are successful in improving macro outcomes (e.g., higher growth and lower risk premia); and (iv) dividend limits may reduce sub-optimal rigidities in dividend optimization arising from asymmetric information/signaling issues, as explained above.
- Alternatively, valuations could fall if these benefits are negligible and the limit is perceived as sending an adverse signal about the system as a whole. However, this potential effect exists with any publicly-announced prudential-strengthening measure—including a recommendation that banks issue more equity—and with any bank-specific announcement arising from supervisory action. Such effects are also likely offset by positive effects on system confidence arising from the signal sent by such measures that prudential oversight is vigilant and assertive.
- Experience with the 2013 limit suggests that it did not have any material adverse effect on banks' ability to issue equity: in the 3-day window surrounding the BdE's announcement of the limit on June 27, 2013, equity prices of Spain's largest private banks were essentially unchanged relative to their European peers. Since then, Spanish bank equities are up more than 40 percent and have outperformed peers by more than 30 percent.
- In sum, any effect on the ability issue equity seems unlikely to be highly negative, and could even be positive.

C. Europe's Contribution to Recovery

40. Actions at the European level are also essential to facilitate faster and less costly adjustment. Priorities in this regard include the following:

- ***Monetary easing and more complete banking union***. Both (i) more monetary easing to raise the prospects of achieving the ECB's inflation objective and (ii) swift progress toward more complete 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.

- ***Comprehensive assessment***. The SSM's forthcoming comprehensive assessment provides an important opportunity to reduce uncertainty about the health of European banks, ensure adequate bank capital to support recovery, and promote confidence in the system. Toward these ends, it will be important for the exercise to be credible and rigorous, with lessons learnt from past country-specific asset quality reviews and EBA stress tests taken into account. The design of the exercises should also avoid creating incentives that may have undesirable and unintended consequences, such as prolonging the credit crunch in peripheral countries.

- ***Restructuring plans***. 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, avoid any unnecessary constraints on credit provision, and allow banks to adjust to changing circumstances as appropriate.

Annex 1. Banking Sector Developments

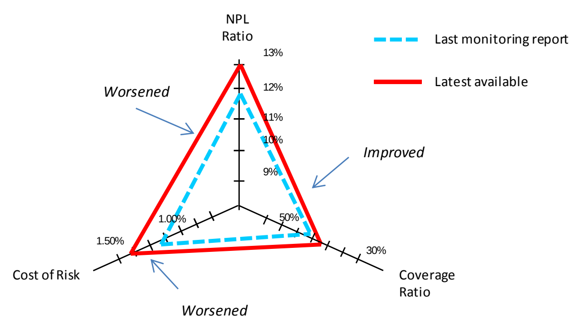
Banking trends during the first nine months of 2013 highlight a return to profit (though driven by a slower pace of provisioning for credit losses, while revenues remain under pressure), better funding and liquidity conditions, and a further rise in NPLs. Spain's banking system is stronger and safer than before, but vulnerabilities remain. The priority is to maintain adequate capitalization and to swiftly provision for new credit risk, in the context of difficult macrofinancial conditions.

Asset quality

Credit quality continues to deteriorate. The NPL ratio reached 13 percent at end-November 2013, up 1½ percentage points since end-June. The rising ratio was partly due to a falling stock of loans as banks delever, but a rising numerator still accounted for the majority (72 percent) of the increase. This in turn partly reflected the reclassification of refinanced loans undertaken by banks during the third quarter (see below).

Asset Quality Deterioration in Spain,

Since Last Monitoring Report



Source: IMF staff calculations on Banco de España data.

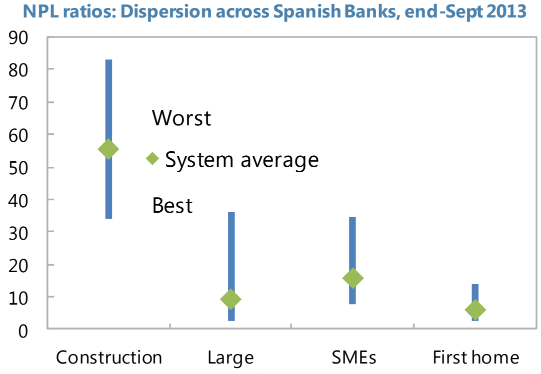
NPL Ratio: Nonperforming loans, as percent of loans.

Coverage Ratio: Specific credit reserves, as percent of nonperforming loans.

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

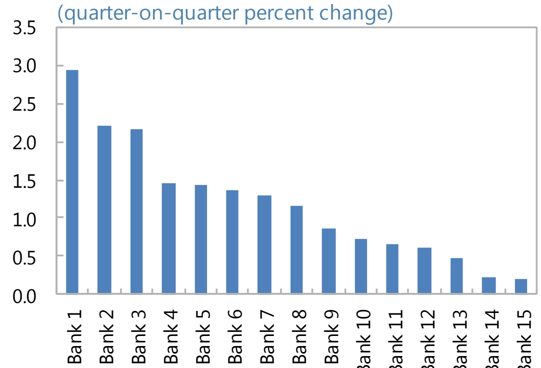
The rise in NPL ratios is broad-based across types of loans and banks (Figures 3 and 4), but the level varies markedly. For example, NPL ratios for real estate development loans are much higher than for mortgages. Reflecting the heterogeneity of risk profiles across Spanish banks, the dispersion of NPL ratios across them is also high.

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



Source: BdE.

NPL Ratio, Spain business, 2013Q3
(quarter-on-quarter percent change)



Source: BdE.

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

The coverage ratio (credit reserves to NPLs) has improved in 2013 despite the rise in NPLs. The flow of new loan-loss provisioning during Jan-Sept 2012 (€34.9 billion) was unusually rapid due to stepped up provisioning requirements (including exceptional generic provisions on RED loans) imposed by law. Although this pace of new provisioning slowed markedly to €16.3 billion during Jan-Sept 2013, this was still sufficiently rapid to outpace the rise in NPLs. Consequently, the coverage ratio (specific reserves) rose to 44 percent at end-September 2013, up from 38 percent a year earlier.

Reclassifications of refinanced loans are further pushing up NPLs and provisioning needs. 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 revealed 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 March 2014, following further review of these data by the BdE.

Refinanced/restructured loans: stock before and after reclassification (billions of euros)

	Normal	Substandard	NPL
Starting stock, March 2013	73.6	37.2	71.7
Stock after reclassifications, September 2013	48.2	40.9	92.2

Source: BdE.

Impairment rates (impairments as a percent of assets) are around 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-September 2013, were generally close to the impairment rates expected in the stress test's base-case scenario.[3] The exception was RED loans, which are already provisioned at close to 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 end-September, 2013 and what the stress test estimated for end-2014.

[3] 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.

Spanish banks' credit losses: materialized 3Q 2013, vs projected 2014

Asset class	Losses materialized, current (percent) 1/	Projected losses, 2014 (percent) 2/	
		Base case	Adverse case
Repossessed assets	35.7	55.5	63.4
Real estate developers 3/	40.1	28.6	42.8
Retail mortgages	1.7	1.8	4.1
Large Corporates	5.7	5.8	10.0
SMEs	7.5	10.6	16.7

Sources: BdE; IMF staff calculations.

1/ As of end-September, 2013. Measured as stock of credit impairments, as percent of total gross stock of assets.

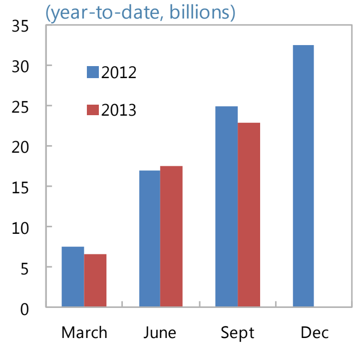
2/ Source: Oliver Wyman stress test exercise.

3/ Includes generic provisions on performing real estate developer loans from RDL 18/2012.

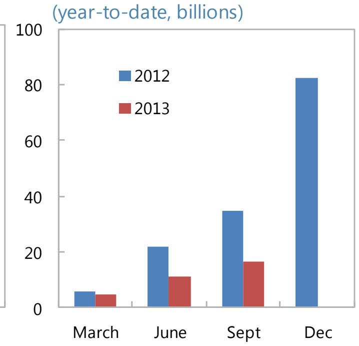
Much uncertainty remains regarding the eventual extent of credit quality deterioration, which is likely to continue for some time. IMF staff's baseline projection as of the January 2013 WEO is that the pace of recovery is likely to be restrained (Table 1). The time lag between macroeconomic developments 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

Spain: Pre-provision profits
(year-to-date, billions)



Spain: Provisions on loans
(year-to-date, billions)



Source: Banco de Espana.

System-wide profits were up in 2013 through September. Banks' domestic pre-tax profits during the first three quarters of 2013 rose to €4.7 billion, up from a loss of €-21.7 billion one year earlier. The main driver of higher profits was the reduced flow of new loan-loss provisioning discussed above. Pre-provisioning profits, at €23 billion through 3Q 2013, decreased 8 percent from a year earlier, but were already above the level assumed for the full-year 2013 (€17 billion) in the base case of the September 2012 stress test.

Spanish Banks: Domestic Pre-Provisioning Profits

		Jan-Sept 2013	Jan-Sept 2012	Change (percent)
A	Total Revenues	43,073,600	45,019,575	-4
	Net Interest Income	20,290,176	25,038,607	-19
	Net Income from Fees and Shares	15,161,181	19,644,189	-23
	Income from Shares	6,971,845	11,108,244	-37
	Net Fees	8,189,336	8,535,945	-4
	Other Gains 1/	7,622,244	336,779	2163
B	Total Expenses	20,085,915	20,090,750	0
C=A-B	Pre-Provisioning Profits	22,987,685	24,928,825	-8

Source: BdE. Spain business only. Data in thousands of euros.

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

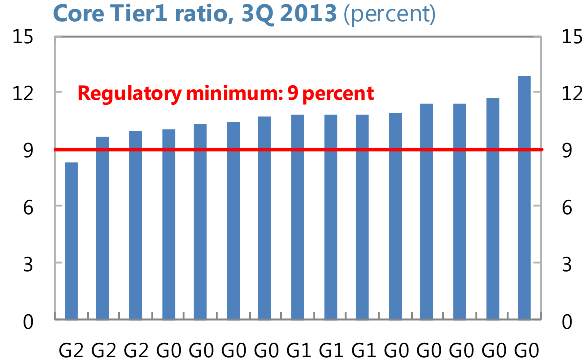
However, the ability to generate income from core banking activity continued to decline in 2013. Revenue in the Jan-Sept period were boosted by gains on financial assets and liabilities, which is partly explained by capital gains on bonds, the existence of a non-recurring gain arising from hybrid instrument management exercises, and other non-recurring activities. In contrast, net income from core banking activities—such as from lending, fees, and dividends from shares—was down 21 percent from a year earlier. Lower interest income reflected less interest income on loans linked to EURIBOR (which was down 1 percentage point from a year earlier), lower loan volumes, and higher NPLs, among other factors.

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 nine months of 2013 (€5.8 billion) witnesses an important change of sign from a loss one year earlier (€-15.2 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 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) will also constrain future profit generation. Funding costs could also rise if LTROs expire and are not renewed or replaced by other forms of ECB support. On the other hand, margin pressures are likely to be mitigated by cheaper deposit and wholesale funding (as term deposits and wholesale funding reset at lower rates) and possibly by further income from domestic government bonds.

Developments outside of Spain could also add pressure to consolidated profits. 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). For example, profits from the largest Latin American economies are experiencing some pressures. Exposures elsewhere, however, 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

Core Tier1 ratio, 3Q 2013 (percent)



Source: Banco de Espana.

Nearly all banks' capital ratios are now over the regulatory minimum, but most banks' buffers over this are not large. At end-September 2013, all banks 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 for many banks are not large, and Spanish banks compare unfavorably with respect to the average of Eurozone banks in terms of Core Tier 1 (though they compare favorably in terms of leverage ratios due to higher risk-weighting—see chart in main text). 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, a couple of banks completed a capital-raising issuance during the last quarter of 2013, and the BdE recommended that banks limit cash dividends to no more than 25 percent of net income for the year 2013.

The recent law converting DTAs into higher quality assets has a positive impact on banks' Basel III capital ratios. In December 2013, legislation was adopted that converts DTAs arising from certain types of temporary differences into transferable claims on the government in the event that banks (i) have accounting losses (in this case, the maximum percentage of DTAs that can be converted is equal to the accounting loss as a percent of capital); (ii) become insolvent; or (iii) are not able to use the DTAs before they reach their normal time limit of 18 years. In this way, the DTA becomes certain to be loss-absorbing and hence is no longer deductible from capital under Basel III. The reform affects about €30 billion of DTAs (out of a total €50 billion), related to timing differences generated by provisions on loans, foreclosed assets, and pension assets. This amount represents about 3 percent of the system's risk-weighted assets. As noted in the last progress report, authorities should ensure that (i) this 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.

Liquidity and funding

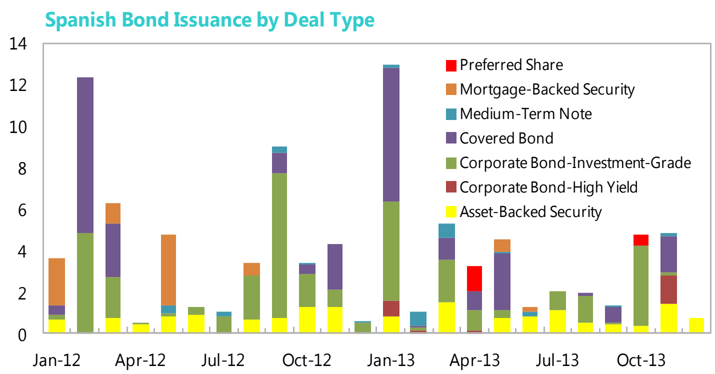
Deposits are still up in 2013 despite some recent declines since July. The increase in government deposits and non-resident deposits year-to-date has more than compensated for the decline in retail funding (domestic deposits plus retails promissory notes). Trends in domestic deposits are affected by the shift from deposits to bank promissory notes during 2011 and the first half of 2012 and the reversal of this effect starting in the second half of 2012.

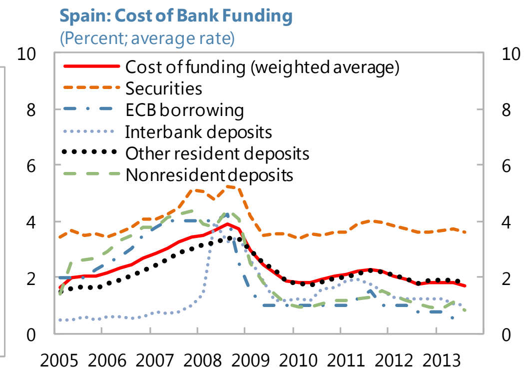
Spain: Change in Deposits, 2013
(change during period, billions of euro)

	Q1	Q2	Q3	Oct	Year-to-date
Total domestic deposits, retail promissory notes, and non-resident deposits 1/	49	0	-25	-6	17
Household and corporate deposits and retail promissory notes	-2	6	-8	-2	-7
Bank promissory notes held by retail customers	-15	-10	-7	-1	-34
Domestic household and corporate deposits	14	16	-1	-1	27
Household	8	14	-3	-2	18
Corporate	5	2	2	1	10
Government deposits	19	-5	-4	0	10
Net non-resident deposits 2/	31	0	-13	-4	14
Net deposits with MFIs abroad 3/	21	1	-5	-3	14

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

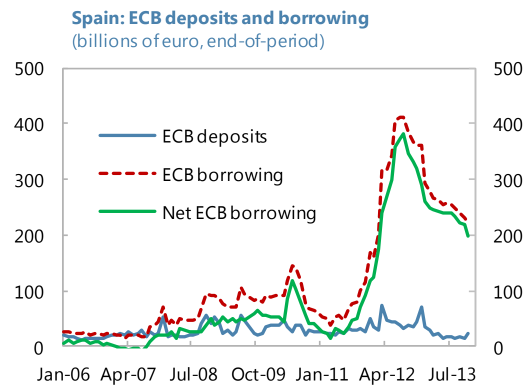
Banks' funding costs accelerated their decline in Q3. Average interest rates on new deposits continued falling in line with euro-area trends (Box 1). Borrowing rates in wholesale funding markets declined 150 bps in Q3, but they are still much higher than other sources of funding. Banks increased their reliance on wholesale market funding in Q4 compared to the previous two quarters, but cumulative gross issuances during 2013 are still well below 2012.





Sources: BdE; and IMF staff calculations.

Reliance on ECB borrowing continues to decline. Better funding conditions and shrinking credit have allowed banks to reduce their net borrowing from the Eurosystem by 38 percent during the twelve months through November 2013. The decline slowed down in Q2 but picked up again in Q3-Q4. These repayments, higher collateral asset prices, and the capital injections to intervened banks have created space to rely on ECB funding, if needed.



Source: BdE.

Annex 2. SAREB Developments

In its first year of operation, SAREB made substantial progress in developing its organization and is increasingly able to focus on its core mission of liquidating its assets in an orderly manner. As expected, it posted a loss in 2013 due to costs associated with its start-up phase. In 2014, SAREB expects to increase its volume of assets sold. Profitability will depend heavily on the future evolution of house prices.

Organizational development

In the first year of its existence, SAREB made substantial progress on its organizational development, including in the following key areas:

- ***Asset transfers***. Nearly 200,000 real estate-related assets were transferred to SAREB by Group 1 (€37 billion) and Group 2 (€14 billion) banks in December 2012 and February 2013, respectively and as scheduled. REDs represented 78 percent of SAREB's initial portfolio; the rest were foreclosed assets. On average, the transfer price was 47 percent of the gross book value.

- ***Capital injection***. SAREB's initial capital was €4.8 billion, of which €1.2 billion was equity and €3.6 billion was subordinated debt (15-year callable convertible bonds). This was slightly higher than the targeted 8 percent of the assets transferred. The FROB owns 45 percent of the equity and 46 percent of the subordinated debt; 27 private investors (half of which are Spanish banks that did not have identified capital needs) own the rest. This ownership structure avoided the formal consolidation of SAREB's debt into that of the government in Eurostat's statistics and brought private-sector expertise to SAREB's board. On the other hand, it also required the adoption of arrangements to reduce possible conflicts of interest (e.g., from Spanish bank owners who have their own real estate assets to manage), and strong implementation in this regard will continue to be important.

- ***Senior bonds issuance***. In exchange for their assets, banks received listed, government-guaranteed senior bonds issued by SAREB with maturities of 1-3 years, which pay quarterly floating rate coupons linked to 3-month EURIBOR and to the spread at issuance between Spain's sovereign yield and EURIBOR. SAREB hedged the EURIBOR-related interest-rate risk on about 85 percent of its foreseen debt via a chain of interest-rate swap agreements that entered into force on December 31, 2013.

- ***Due diligence***. SAREB completed due diligence on 80 percent of its assets in 2013. This timing is a few months later than initially planned due mainly to the unforeseen need to retrieve missing data from many loan files. Consultants and law firms supported SAREB's management in this thorough exercise, which included four work streams: (i) assessment of the legal documentation supporting the acquired assets; (ii) valuation of real estate assets and loan collateral; (iii) review of transfer prices based on asset classification; and (iv) establishment of data- and documentation-management tools. This thorough exercise (i) found that the average market value of assets was broadly similar to the average transfer price and (ii) enabled SAREB to better value its assets and design its liquidation strategies.

- ***Servicing strategy***. All banks that transferred assets to SAREB initially serviced (e.g., collected loan payments and sold assets) many of these assets, based on servicing contracts signed with SAREB. In the course of 2013, some of these banks 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 hired staff that are deployed inside these servicers and created weekly budgets and benchmarks for each servicer. For the medium term, SAREB might introduce 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.

- ***Business plan***. SAREB produced its first business plan in March 2013, based on still incomplete information on its assets and preliminary ideas on the liquidation strategies. The updated business plan, which SAREB is required by law to produce by February 2014, will reflect information acquired from the due diligence exercise, the experience with asset liquidation in 2013, and the new commercial strategies.

Key financial developments in 2013

SAREB estimates that it registered a loss in 2013, an outcome that it expected given the costs associated with the start-up phase. The estimated loss (audited accounts are not yet available) partly reflects the slow pace of property sales in the first half of 2013, which kept total profits from sales below expenses. The latter consisted mostly of debt service, but also maintenance of foreclosed assets, capital expenditure, and asset management fees. A loss in 2013 was anticipated in SAREB's business plan and is not surprising in such an entity's first year of operation, when much energy is necessarily focused on establishing the company and running the due diligence. More information on the main aspects of SAREB's finances in 2013 is below.

Sales of foreclosed assets have been below expectations, but accelerated in the second half of 2013. According to SAREB, the liquidation of foreclosed assets in 2013 has been below expectations due to worse-than-expected liquidity and prices in the real estate market, slow implementation of SAREB's commercial strategies, and a difficult start for the servicing arrangements. However, H2 2013 showed a strong improvement. The foreclosed assets sold via the retail channel were nearly seven times higher in November than in March (at this pace, all foreclosed assets would be sold via the retail channel in eight years). Wholesale sales of foreclosed assets started with the creation of the first FAB (Fondo de Activos Bancarios, a special low-tax vehicle that acquires SAREB's assets). The investors' and SAREB's roles in the funding and capitalization of the FABs can be tailor-made, which enables SAREB to meet wholesale investors' preferences and thus ease the liquidation process. However, this approach in principle implies that SAREB remains partially exposed to the assets transferred to the FAB, 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 in 2014.

The cash inflows from REDs have been above expectations thanks to higher-than-expected redemptions, amortizations, and sales of loans. RED sales have been conducted 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 expects total cash inflows in 2013 to exceed operating expenses, debt service, and credit line drawdown. Approximately 70 percent of gross cash collections derive from REDs' redemptions, amortization, and sales. The rest is from interest and rental income and sales of foreclosed assets. SAREB's cash balances are thus expected to have increased during 2013, thus enabling SAREB to partly amortize (and therefore only partially roll-over) the 1-year senior bonds maturing in December 2013 and February 2014 and to call some of the outstanding 2- and 3-year bonds. This will reduce the stock of outstanding debt by approximately €2 billion.

Profit margins have been positive but declining. SAREB indicates that profit margins on property sales have on average been positive. 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.

Outlook

In 2014, SAREB expects to increase its sales volume, with profitability depending heavily on the evolution of house prices.

- Factors supporting profitability 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 naturally become increasingly 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, and adjusting nimbly to changing macro and market conditions.

Annex 3. 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	Law 26/2013. 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	Law 26/2013. 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	Third set of results were provided to international partners at end-November.
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	2019
Demand and supply in constant prices										
Gross domestic product	-0.2	0.1	-1.6	-1.2	0.6	0.8	1.0	1.1	1.2	1.3
Private consumption	0.2	-1.2	-2.8	-2.5	0.4	0.5	0.6	0.9	1.0	1.1
Public consumption	1.5	-0.5	-4.8	-1.3	-2.0	-2.3	-2.4	-2.4	-2.4	-2.4
Gross fixed investment	-5.5	-5.4	-7.0	-6.0	-1.2	-0.1	1.1	1.7	1.9	2.1
Construction investment	-9.9	-10.9	-9.7	-10.3	-3.9	-1.9	-0.3	0.7	0.9	1.1
Mahinery and equipment	5.0	5.5	-3.9	0.7	2.8	2.9	3.2	3.5	3.6	3.7
Total domestic demand	-0.6	-2.0	-4.1	-2.9	-0.4	-0.2	0.1	0.4	0.5	0.6
Net exports (contribution to growth)	0.4	2.1	2.5	1.7	1.0	0.9	0.9	0.7	0.7	0.7
Exports of goods and services	11.7	7.6	2.1	5.4	5.9	5.6	5.2	5.1	5.1	5.1
Imports of goods and services	9.3	-0.1	-5.7	0.3	3.4	3.3	3.3	3.9	3.9	4.1
Prices										
GDP deflator	0.1	0.0	0.0	0.7	0.4	0.8	1.1	1.2	1.2	1.2
HICP (average)	2.0	3.1	2.4	1.5	0.6	0.9	1.0	1.1	1.1	1.1
HICP (end of period)	2.9	2.4	3.0	0.3	0.8	0.9	1.0	1.1	1.1	1.1
Employment and wages										
Unemployment rate (percent)	20.1	21.7	25.0	26.4	26.0	25.8	25.4	24.9	24.1	23.1
Employment growth	-2.3	-1.9	-4.5	-3.1	-0.2	0.1	0.4	0.6	0.9	1.2
Labor force growth	0.2	0.1	-0.2	-1.3	-0.7	-0.3	-0.1	-0.1	-0.1	-0.1
Balance of payments (percent of GDP)										
Trade balance (goods) 1/	-4.6	-4.0	-2.5	-0.9	-0.5	0.1	0.7	1.2	1.6	2.1
Current account balance 1/	-4.5	-3.8	-1.1	1.0	1.7	2.5	3.0	3.5	4.1	4.9
Net international investment position	-89	-90	-91	-91	-88	-83	-78	-72	-65	-58
Public finance (percent of GDP)										
General government balance 2/	-9.6	-9.1	-6.8	-6.7	-6.0	-5.0	-4.1	-3.2	-2.2	-1.2
Primary balance	-7.7	-7.0	-7.6	-3.7	-2.2	-1.1	-0.1	0.8	1.9	3.0
Structural balance	-8.6	-8.1	-5.9	-5.0	-4.4	-3.8	-3.1	-2.4	-1.6	-0.8
General government debt	62	70	86	96	101	104	106	107	107	105

Sources: IMF, World Economic Outlook; 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 2013, and 3.8 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	47.1
Operating expenses to gross income	47.5	43.1	44.5	43.5	46.5	49.8	45.3	46.6
Asset quality 2/								
Non performing loans (billions of euro)	10.9	16.3	63.1	93.3	107.2	139.8	167.5	191.0
Non-performing to total loans	0.7	0.9	3.4	5.1	5.8	7.8	10.4	13.0
Specific provisions to non-performing loans	43.6	39.2	29.9	37.7	39.6	37.1	44.7	44.3
Exposure to construction sector (billions of euro) 3/	378.4	457.0	469.9	453.4	430.3	396.9	300.4	258.0
of which : Non-performing	0.3	0.6	5.7	9.6	13.5	20.6	28.2	33.0
Households - House purchase (billions of euro)	523.6	595.9	626.6	624.8	632.4	626.6	605.3	586.3
of which : Non-performing	0.4	0.7	2.4	4.9	2.4	2.9	4.0	5.2
Households - Other spending (billions of euro)	203.4	221.2	226.3	220.9	226.3	211.9	200.3	181.5
of which : Non-performing	1.7	2.3	4.8	6.1	5.4	5.5	7.5	8.5
Liquidity								
Use of ECB refinancing (billions of euro) 4/	21.2	52.3	92.8	81.4	69.7	132.8	357.3	206.8
in percent of total ECB refin. operations	4.9	11.6	11.6	12.5	13.5	21.0	32.0	28.8
in percent of total assets of Spanish MFIs	0.8	1.7	2.7	2.4	2.0	3.7	10.0	6.4
Loan-to-deposit ratio 5/	165.0	168.2	158.0	151.5	149.2	150.0	137.3	124.9
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	21.4
Santander	26.8	4.6	-51.0	73.0	-30.5	-26.3	2.2	6.7
BBVA	21.0	-8.1	-48.3	49.4	-38.2	-12.1	2.4	28.6
Popular	33.3	-14.8	-48.0	-13.9	-24.1	-9.1	-69.9	49.7
CDS (spread in basis points) 6/								
Spain	2.7	12.7	90.8	103.8	284.3	466.3	294.8	157.5
Santander	8.7	45.4	103.5	81.7	252.8	393.1	270.0	120.0
BBVA	8.8	40.8	98.3	83.8	267.9	407.1	285.0	122.0

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, 2010-15

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

				Projections		
	2010	2011	2012	2013	2014	2015
Aggregated Balance Sheet of Other Monetary Financial Institutions (OMFIs) 1/						
Assets	3,471	3,621	3,581	3,171	3,064	3,017
Cash	8	7	7	7	7	7
Deposits at the ECB	27	51	72	35	35	35
Claims on other MFIs	211	203	209	173	167	163
Claims on non MFIs	1,936	1,887	1,733	1,495	1,442	1,438
General government	79	89	114	93	91	91
Private sector 2/	1,857	1,797	1,619	1,403	1,351	1,348
Shares and other equity	103	163	167	181	177	173
Securities other than shares	520	544	566	614	632	653
o.w. General government	158	193	243	303	335	356
Claims on non-residents 3/	374	386	408	375	370	343
Other assets	293	381	419	274	249	234
Liabilities	3,471	3,621	3,581	3,171	3,064	3,017
Capital and reserves	283	367	403	423	408	401
Borrowing from the ECB	62	168	361	227	193	174
Liabilities to other MFIs	211	206	213	181	175	171
Deposits of non MFIs	1,728	1,650	1,535	1,533	1,489	1,493
General government	79	70	69	79	79	79
Private sector	1,648	1,581	1,466	1,455	1,410	1,414
Debt securities issued	433	435	394	309	307	300
Deposits of non-residents 3/	512	493	341	221	220	219
Other liabilities	244	302	334	277	273	259
(Percent of GDP)						
Private sector credit	177.6	171.8	157.3	137.0	130.6	128.3
Public sector credit 4/	7.5	8.5	34.7	38.6	41.1	42.5
(Percentage change)						
Private sector credit 5/	0.8	-3.2	-9.9	-13.3	-3.7	-0.2
Private sector credit incl. SAREB	...	...	-5.8	-6.8	...	...
Public sector credit 4/	21.9	13.6	26.6	9.4	19.0	13.1
Memo items:						
Loans to deposits (%, other resident sector) 6/	149.2	150.0	137.4	111.2	107.1	104.9
Capital and reserves (% total assets)	8.1	10.1	11.2	13.3	13.3	13.3

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/ Public sector credit includes loans and securities.

5/ The decline in credit to the private sector in 2012 and 2013 is influenced by the transfer of loans to SAREB.

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