

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

This paper was prepared by a staff team of the International Monetary Fund. The paper is based on the information available at the time it was completed in November 2012. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Spain or the Executive Board of the IMF.

The policy of publication of staff reports and other documents by the IMF allows for the deletion of market-sensitive information.

Copies of this report are available to the public from

International Monetary Fund • Publication Services  
700 19<sup>th</sup> Street, N.W. • Washington, D.C. 20431  
Telephone: (202) 623-7430 • Telefax: (202) 623-7201  
E-mail: [publications@imf.org](mailto:publications@imf.org) Internet: <http://www.imf.org>

**International Monetary Fund**  
**Washington, D.C.**



# SPAIN

## FINANCIAL SECTOR REFORM: FIRST PROGRESS REPORT

November 2012

Prepared by Staff of the

INTERNATIONAL MONETARY FUND\*

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

**PREFACE**

This report has been prepared by IMF staff at the request of Spain's Ministry of Economy and Competitiveness, the Bank of Spain, and the European Commission. The report aims to provide independent advice on Spain's efforts to recapitalize and restructure its financial sector with support from the European Stability Mechanism. Spain and its European partners specified their commitments to support these efforts in their Memorandum of Understanding on Financial Sector Policy Conditionality (MoU) of July 20, 2012. IMF staff is not a party to the MoU, nor responsible for the conditionality or implementation thereof.

This report is prepared 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. This report is produced under the Terms of Reference agreed between IMF staff, the Ministry of Economy and Competitiveness, the Bank of Spain, and the European Commission.

## EXECUTIVE SUMMARY

**The main finding of the report is that important progress has been made in reforming the financial sector.** In the view of IMF staff, the financial sector program is on track so far, with all deadlines met. However, the most challenging steps lie ahead, especially those related to implementing bank restructuring plans and making the asset management company effective. Recent developments and the outlook in key areas are as follows:

- **Macro-financial context:** Financial market conditions have improved since the announcement of the European Central Bank's Outright Monetary Transactions program, though they remain difficult. The economy faces further headwinds from private-sector deleveraging, tight credit, falling house prices, fiscal consolidation, and weak confidence amidst high uncertainty, as major pre-crisis imbalances correct. These forces have pushed the economy back into recession in 2012 and further contraction is expected next year, followed by slow recovery. Although this outlook remains broadly consistent with the baseline scenario used in the bank stress tests, risks around the baseline are large. The difficult outlook underscores the importance of Spain's ongoing efforts to rapidly repair its financial system to ensure sufficient credit flows to support the economy. With causality also going in the other direction—from growth to faster financial system repair—policies by both Spain and Europe to support growth while addressing imbalances and vulnerabilities will further enhance the reform program's prospects for success.
- **Banking sector developments:** As expected, Spanish banks' financial condition continued to deteriorate during the summer of 2012, as adverse macroeconomic conditions drove mounting credit risk that drained credit reserves and absorbed a large chunk of pre-provision profits. The system is increasingly polarized, with the largest and geographically diversified banking groups having a better risk profile than some of the more domestically oriented. While the recent improvement in market conditions has eased funding conditions for stronger banks, banks' liquidity remains a risk that is mitigated only by extensive Eurosystem support. Given the expectation of future loan losses, it is imperative to swiftly recapitalize and restructure or resolve the weakest banks in agreement with international partners, as envisaged under the financial sector reform program. Europe's support for this program via the European Stability Mechanism (ESM) is welcome and could be further enhanced if eventually provided in the form of direct recapitalization.
- **Bank restructuring and resolution:** An independent bottom-up stress test of banks' balance sheets—using data from a comprehensive asset quality review—was completed on time. The stress test was technically robust and provides a sound basis for identifying undercapitalized banks. The task now is to ensure that these banks rapidly address their capital shortfalls in ways that minimize fiscal costs and restore a well-capitalized system that can support economic recovery, as envisaged under the financial sector reform program. This means applying new burden-sharing powers to the full extent necessary to minimize taxpayers' losses, quickly winding down nonviable banks in an orderly manner and restructuring the weakest ones to ensure their return to viability, avoiding new mergers that do not clearly generate value, and ensuring that any downsizing of credit portfolios under restructuring plans is consistent with providing an adequate and sustainable supply of credit to the real economy.

- **Asset management company (AMC):** Banks receiving state aid will be required to transfer real-estate related assets to a centralized AMC to reduce uncertainty regarding the strength of their balance sheets, which should thereby enhance their access to market funding. The general framework for the AMC was put in place on schedule by end-August. However, the end-November deadline for it to be fully operational is ambitious, and strong efforts are needed to ensure that a number of challenges facing the AMC are met. It will be important to ensure the effective management of the transferred assets and to develop incentive structures that focus the AMC's management on maximizing its value.
- **Burden-sharing and resolution framework:** A recent Royal Decree Law (RDL)—now being ratified by parliament—providing the authorities with broad powers to swiftly and equitably resolve weak banks is a major achievement. It could be further enhanced by the inclusion of the principle of depositor preference. Consideration should also be given to establishing a governance model for nationalized banks that preserves the autonomy of these banks' management while ensuring accountability. Given its expanding and multiple roles, there may also be scope for further enhancing checks and balances in the Fund for Orderly Bank Restructuring's (FROB) internal arrangements.
- **Regulatory and supervisory framework:** Significant progress has been made in this area as well, including the adoption of new consumer protection and securities legislation and preparatory work on tougher regulatory requirements. However, work on reform of savings banks may need to accelerate to meet the associated deadlines.

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

### Bank restructuring and resolution

- Promptly address capital shortfalls so that all capital needs are met by end-December (¶25).
- Ensure that any aggregate downsizing of credit portfolios as part of banks' restructuring plans is consistent with an adequate supply of credit to the economy (¶30).
- Apply burden-sharing powers to minimize the overall costs for taxpayers (¶31, 44-46).
- Avoid new mergers that do not clearly generate value (¶31).
- Quickly wind down non-viable banks in an orderly manner (¶31, 45).
- Ensure no delay in the provision of ESM financing for recapitalization, with the ESM converting initial financing via ESM bonds into cash as quickly as feasible (¶34).

### AMC

- Avoid future expansions of the AMC's perimeter unless critical (¶37).
- Develop incentive structures that focus the AMC's management exclusively on maximizing the value out of the sale and restructuring of its assets (¶38).
- Ensure the transfer of assets does not affect their effective management (¶39).
- Pursue vendor financing agreements with banks (¶40).

### Legal and institutional framework for bank restructuring and resolution

- Formalize a cooperation agreement between the Bank of Spain and the FROB to clarify respective responsibilities (¶44).
- Enhance the FROB's checks and balances and internal controls to mitigate possible conflicts of interest (¶44).
- Formulate clear and easy-to-monitor governance arrangements and ownership policies for nationalized banks, as well as an exit strategy from such banks (¶44).
- Introduce depositor preference (¶46).
- Adopt regulations implementing the RDL to clarify the criteria for the departure from the *pari passu* treatment of creditors in resolution, subject to the "no creditors worse off rule" and based on sound public policy principles (¶49).

### Regulatory and supervisory framework

- Enhance the corporate governance regime for savings banks, and design a strategy for their loss of control over commercial banks (¶54).

---

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

## Approved By

**Rodrigo Valdés and  
Ceyla Pazarbasioglu**

Prepared by a staff team comprising J. Daniel (head), K. Fletcher, P. Lopez-Murphy, P. Sodsriwiboon, J. Vacher (all EUR), R. Romeu (FAD), O. Frecaut, A. Buffa di Perrero (both MCM), A. Gullo (LEG), R. Espinoza (RES), and M. Chivakul (SPR). The report reflects discussions with the Spanish authorities, the European Commission, the European Central Bank, the European Stability Mechanism, the European Banking Authority, and the private sector held in Madrid during October 15-26, 2012.

## CONTENTS

<b>INTRODUCTION</b>	<b>7</b>
<b>THE MACRO-FINANCIAL CONTEXT</b>	<b>8</b>
A. Financial Markets and External Financing	8
B. Credit Conditions and Household and Corporate Balance Sheets	10
C. The Real Economy: Outlook and Risks	12
<b>PROGRESS ON FINANCIAL SECTOR REFORM</b>	<b>15</b>
A. Overview	15
B. Bank-specific Measures	15
C. Resolution and Burden-sharing Arrangements	24
D. Regulatory and Supervisory Framework	29
<b>TABLES</b>	
1. Main Economic Indicators, 2008-2017	31
2. Selected Financial Soundness Indicators, 2006-2012	32
3. Monetary Survey, 2008-2017	33
<b>FIGURES</b>	
1. Financial Market Indicators	34
2. Credit Conditions	35
3. Household's Financial Positions	36
4. Nonfinancial Corporate's Financial Positions	37
<b>BOXES</b>	
1. The Bottom-Up Stress Tests—Key Assumptions	19
A1. Sovereign Ratings and Collateral Eligibility: ECB Rules and Current Situation in Spain	43
<b>ANNEXES</b>	
I. Banking Sector Developments	38
II. IMF Staff Views on Status of MoU Conditionality	44

## INTRODUCTION

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

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

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

2. **This report provides information and analysis on the status of Spain's financial sector reform program.** The Ministry of Economy and Competitiveness, the Bank of Spain (BdE), and the European Commission (EC) requested that IMF staff provide such monitoring via quarterly reports, of which this report is the first.<sup>2</sup> The report is organized into two main sections:

- *Macro-financial context.* As noted above, successful reform and restructuring of Spain's financial sector will promote economic recovery. But, at the same time, financial and macroeconomic conditions in Spain will significantly affect the success of financial sector reform. Thus, as per the Terms of Reference (TOR) for these reports, this section provides an update of recent macro-financial developments and key implications for the reform program. Further background on recent developments in the financial sector (e.g., trends in profitability and capital buffers) are provided in Annex I.
- *Progress on financial sector reforms.* This section discusses progress on key measures under the reform program, as well as risks going forward and recommended actions to mitigate them.

---

<sup>2</sup> This monitoring is conducted as a form of technical assistance under Article V, Section 2(b), of the IMF's Articles of Agreement. IMF staff is not a party to the MoU, nor responsible for the conditionality or implementation thereof. Further information on the objective and scope of these reports is in the TOR of July 20, 2012. Information in this report is current as of November 9, 2012.



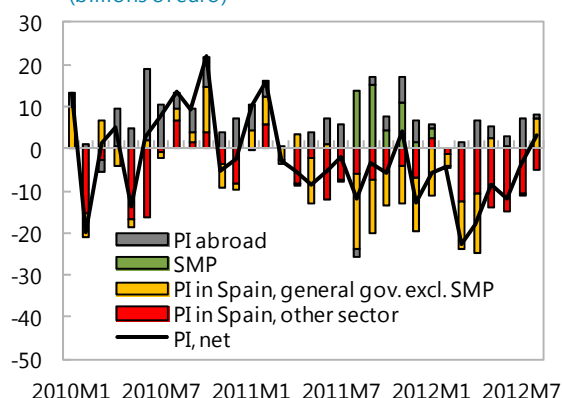
## THE MACRO-FINANCIAL CONTEXT

The success of Spain's financial sector reforms will depend crucially on both the public and private sector's ability to access financing at affordable rates and, relatedly, on an eventual return to sustainable growth. On the former, Spain's market access has improved considerably following the European Central Bank's (ECB) late-summer announcements related to its Outright Monetary Transactions (OMT) program. In contrast, real sector conditions remain difficult, with continued recession expected both this year and next. Risks around the outlook are high: on the downside, headwinds from fiscal consolidation, tight credit, falling house prices, and private-sector deleveraging could be more powerful than expected; on the upside, recent improvement in market sentiment could facilitate a faster-than-expected recovery, especially if further actions by Spain and Europe build on this momentum to solidify the monetary union and lessen frictions from Spain's adjustment.

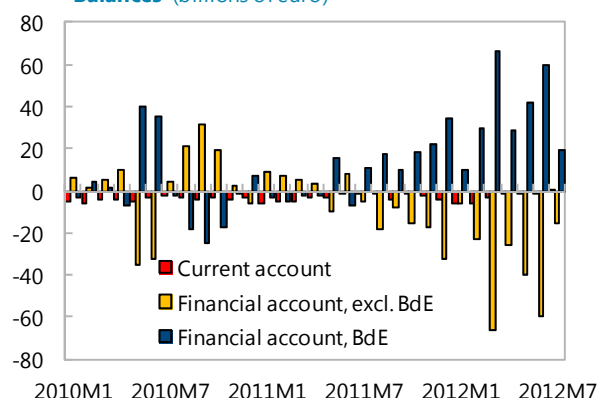
### A. Financial Markets and External Financing

3. **Pressure on Spanish markets intensified during the spring and summer of 2012 amidst large private capital outflows.** Outflows were led by the rapid withdrawal of portfolio investment by nonresidents, which became self-reinforcing as high price volatility dampened investor appetite and concerns rose that Spain's borrowing costs were reaching unaffordable levels, with the 10-year treasury yield peaking at 7.6 percent in late July. Other investment outflows also increased as Spanish banks used the liquidity from Long-Term Refinancing Operations (LTROs) to pay down obligations to foreign banks. With minimal offsetting repatriation by residents, outflows were increasingly financed by borrowing from the Eurosystem. The withdrawal of nonresidents left Spanish sovereign debt increasingly in the hands of domestic banks, intensifying sovereign-financial sector links and thereby raising tail risks of an adverse and self-reinforcing circle of sovereign-financial sector stress.

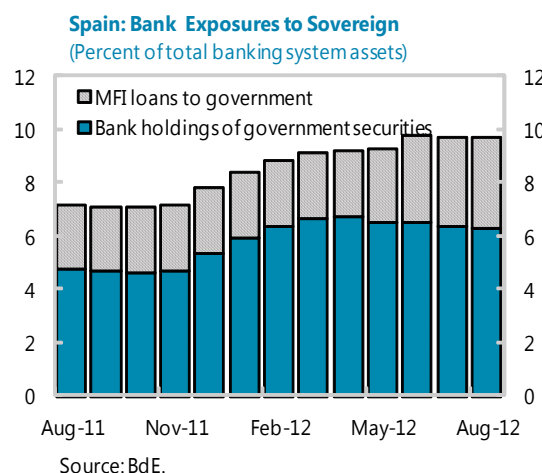
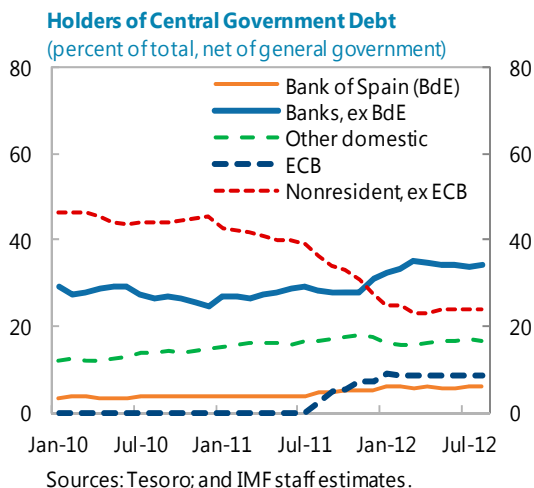
**Spain: Portfolio Investment (PI)**  
(billions of euro)



**Spain: Current Account and Financial Account Balances**  
(billions of euro)

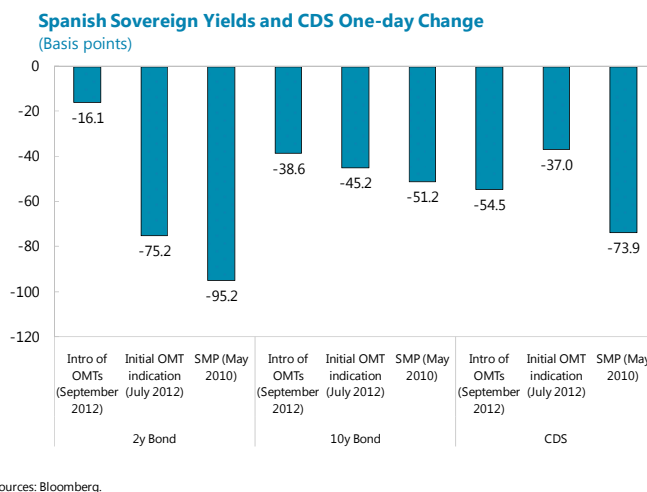


Sources: Bank of Spain; and IMF staff estimates.



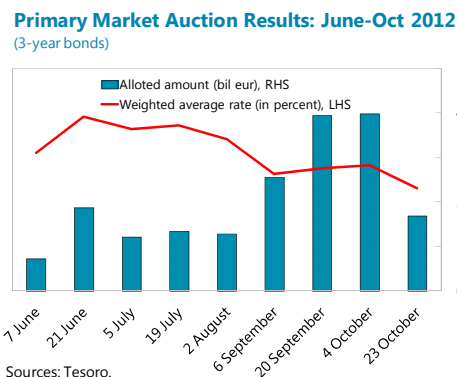
**4. Steps to strengthen the euro area, especially the ECB’s OMT-related announcements and ESM approval, have improved market sentiment since late July** (Figure 1).

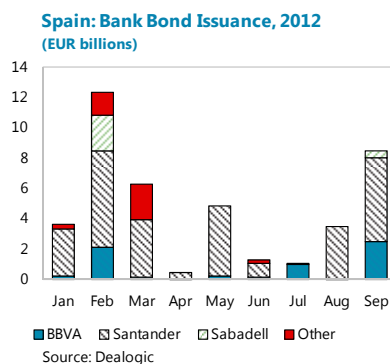
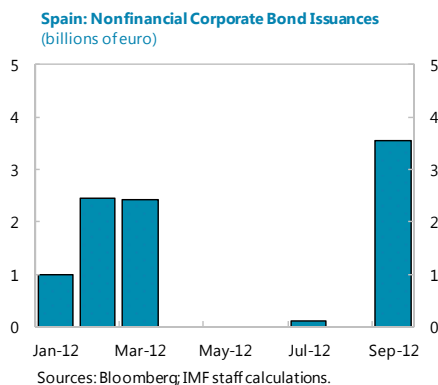
The 10-year yield has fallen to around 5½ percent amidst a significant return of capital by nonresidents (net portfolio investment turned positive in September), as introduction of the OMT greatly reduced the tail risk of an upward spiral in Spanish yields. Sovereign and bank CDS spreads have similarly fallen, while Spanish equities have rallied. Sovereign yields have a significant effect on banks’ funding costs and thus have a major role in determining the relevant context for the financial sector.



**5. Issuers of Spanish debt securities have taken advantage of these improved market conditions to access new financing:**

- The central government has accelerated its pace of primary market issuance, raising around €22 billion in August-October, with 95 percent of the year’s funding program already covered by end-October.
- Major banks and nonfinancial corporations also tapped bond markets in September. Issuances by the former helped banks reduce their borrowings from the ECB for the first time since July 2010.





6. **Like the LTRO earlier in the year, the recent ECB-induced market rally has also provided policymakers with breathing space to advance reforms to solidify the monetary union.** Issues of special relevance to Spain include the following:

- **OMT.** The announcement of OMT has been a very positive development. Its entrenchment in the euro area's crisis-fighting toolkit as a credible backstop will help further reduce sovereign risk premia.
- **Direct recap.** The June European Council meeting gave the possibility for the ESM to take direct stakes in banks once single supervision involving the ECB was effective. This was a helpful step, as direct recapitalization could make a substantial (but not critical) difference for Spain: gross government debt—which is projected to peak near 96 percent of GDP in 2016—could be reduced by some 4 percent of GDP;<sup>3</sup> sovereign-financial sector links would be reduced; the banks would gain from being backed by a strong owner, as this could reduce their funding costs; and concrete progress toward banking union would be made. Further efforts by Europe to complete this reform would be welcome.

## B. Credit Conditions and Household and Corporate Balance Sheets

7. **It is still too early to assess how much the improved financial market conditions will strengthen credit growth, which has been significantly negative.** Private-sector credit fell nearly 5 percent (year-on-year) through August 2012 (Figure 2). The sharpest drop was, appropriately, for the construction sector, from which credit reallocation is most required. Although the system has now delevered by 15 percent of GDP from its peak, the credit-to-GDP ratio remains significantly above pre-boom levels.

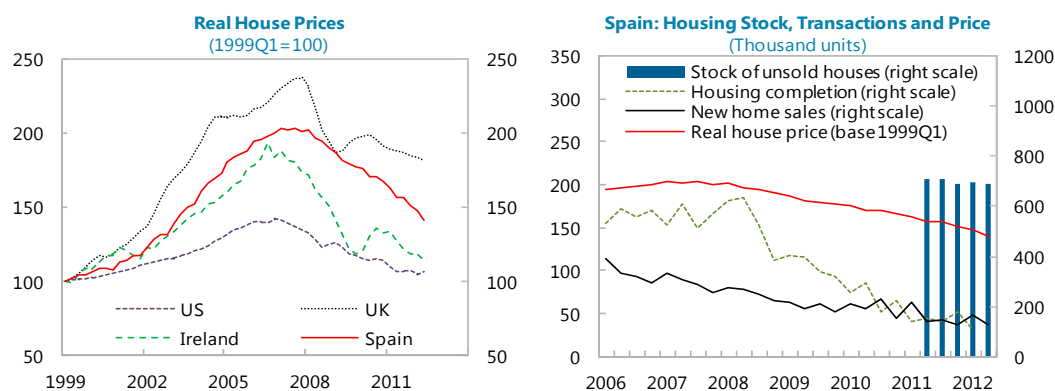
8. **The drivers of weak credit growth are difficult to disentangle:**

- On the demand side, economic contraction and weak private-sector balance sheets (see below) have undoubtedly sharply depressed credit demand.

<sup>3</sup> The debt peak of 96 percent of GDP is the October 2012 WEO projection adjusted to reduce the expected fiscal cost of bank recapitalization from €100 billion to €40 billion following the bottom-up stress tests results.

- On the supply side, surveys indicate that credit conditions remain much tighter than pre-crisis levels, though they have tightened only modestly over the last year (Figure 2). Some lending rates, especially for small and medium-size enterprises (SMEs), have also risen well above those in Germany or France, perhaps reflecting the spike in sovereign spreads earlier in the year and the related deterioration in macroeconomic conditions, which has raised risk premia.

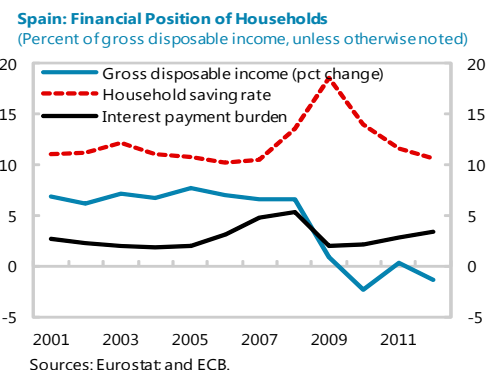
9. **The house price correction is ongoing.** Housing market activity has been subdued, owing to a large supply overhang, coupled with weak demand. House prices have fallen 30 percent from their peak. Further significant declines are possible, given a still large stock of unsold homes and weak growth of household disposable income amidst protracted recession and fiscal adjustment. The transfer of real estate development loans by banks receiving state aid to an asset management company (AMC)—as envisaged under the financial sector reform program (see next section)—could also affect house prices. Specifically, the pace at which the AMC disposes of repossessed assets (it will receive about €35 billion of such assets, out of a total of €88 billion) could have important effects on housing supply. The prices at which the AMC buys and sells assets could also become reference prices for the market, given low turnover in the housing market. Given these concerns, draft legislation on the AMC (next section) establishes the minimization of distortions in the housing market as one of the AMC's objectives. However, operationalizing this objective may not be straightforward.



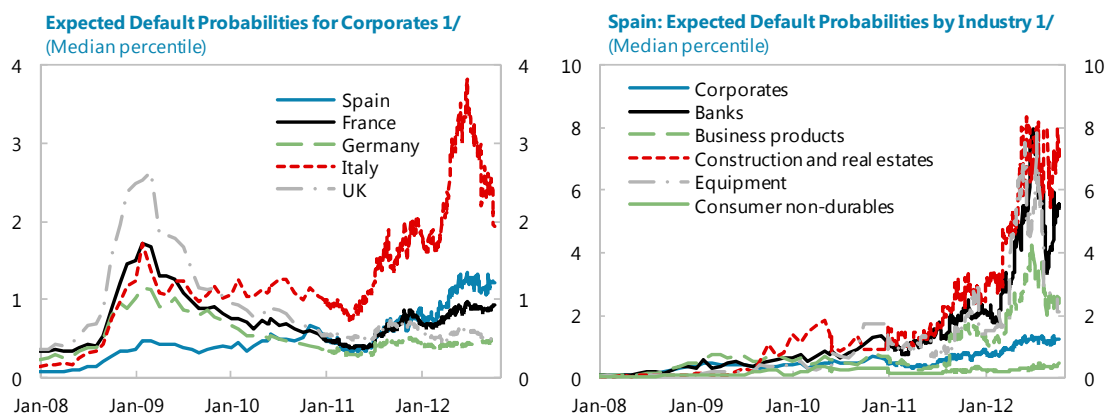
Sources: Banco de España; Ministerio de Vivienda; Instituto Nacional Estadística; US Federal Housing Finance Agency; UK National Building Society; Ireland's Department of the Environment, Community & Local Government and IMF staff calculations.

#### 10. Household finances remain under pressure.

Household indebtedness has gradually declined, but remains high by historical standards (Figure 3). Debt-servicing burdens have risen from the lows seen during the global financial crisis, as disposable income is falling, while the household saving rate has dropped back to its pre-crisis level. Income risks will likely remain elevated, as unemployment continues to rise and as more of the unemployed exhaust their eligibility for unemployment benefits.



11. **Corporate balance sheets remain stretched** (Figure 4). The corporate sector's leverage remains high, though adjusting. Earnings have been adversely affected by weak economic activity, with profits of large nonfinancial corporations falling sharply. Firms' debt-servicing ability has deteriorated while interest coverage ratios have fallen. The construction and real estate sectors are most vulnerable, with high and rising default rates.



Source: Moody's KMV.

1/ The expected default probability is a forward-looking measure of a firm's credit risk derived from the market values of related assets, including the firm's equity, bonds, and CDS spreads.

### C. The Real Economy: Outlook and Risks

12. **These difficult conditions have kept the real economy in recession.** Strong headwinds from a number of related factors—the deflating housing bubble, household and corporate deleveraging, tight credit conditions, ongoing fiscal consolidation, and high levels of uncertainty related to Spain's sovereign and banking crises—are expected to prompt an economic contraction of 1½ percent in 2012 and have pushed the unemployment rate to around 25 percent at mid-year. The contraction is driven by shrinking domestic demand, only partially compensated by net exports. Contracting imports and expanding exports (partly as result of improving relative unit labor costs, which is related to higher productivity on the back of labor shedding), have reduced the current account deficit, which has corrected by about 8 percentage points of GDP since 2007 and was in surplus in August.

13. **The outlook remains difficult.** Fiscal consolidation and private-sector deleveraging will continue to weigh heavily on domestic demand for the foreseeable future. Nonetheless, IMF staff project domestic demand to recover modestly going forward, assuming that (i) recent improvements in market sentiment persist, facilitating gradual improvement in credit conditions, and (ii) the labor market gradually adjusts, aided by the recent labor reform. Meanwhile, net exports are projected to gradually reaccelerate in line with global growth, with exports maintaining their world market share and the current account moving into surplus over the medium term. On balance, IMF staff projected in its October 2012 edition of the *World Economic*

*Outlook* that the Spanish economy would contract by a further 1.3 percent in 2013, with growth turning slightly positive the following year.

**Spain: Medium-Term Outlook 1/**  
(percent change, unless otherwise indicated)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Real GDP	3.5	0.9	-3.7	-0.3	0.4	-1.5	-1.3	1.0	1.6	1.7	1.7
Total domestic demand	4.1	-0.5	-6.2	-0.6	-1.9	-4.0	-3.3	0.1	0.9	1.2	1.4
Private consumption	3.5	-0.6	-3.8	0.7	-1.0	-2.2	-2.4	0.9	1.1	1.2	1.2
Public consumption	5.6	5.9	3.7	1.5	-0.5	-4.1	-5.4	-2.1	0.0	0.5	0.7
Fixed investment	4.5	-4.7	-18.0	-6.2	-5.3	-8.9	-4.1	-0.3	1.2	2.0	2.7
Net exports 2/	-0.9	1.5	2.9	0.2	2.4	2.4	1.9	0.9	0.7	0.5	0.4
Exports	6.7	-1.0	-10.0	11.3	7.6	2.4	3.5	4.5	4.6	4.8	4.8
Imports	8.0	-5.2	-17.2	9.2	-0.9	-5.7	-2.8	1.9	3.0	3.8	4.4
HICP (period average)	2.8	4.1	-0.2	2.0	3.1	2.5	2.4	1.5	1.5	1.4	1.4
GDP deflator	3.3	2.4	0.1	0.4	1.0	1.2	1.3	1.2	1.3	1.2	1.2
Unemployment rate (period average)	8.3	11.3	18.0	20.1	21.7	24.9	25.1	24.1	23.2	22.0	20.5
Current account balance (percent of GDP)	-10.0	-9.6	-4.8	-4.5	-3.5	-2.0	-0.1	0.7	1.3	1.8	2.2

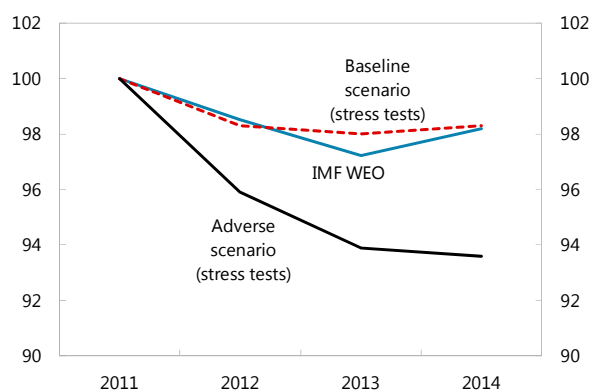
Sources: Eurostat; and IMF staff projections.

1/ IMF staff projection (October 2012 *World Economic Outlook*).

2/ Contribution to growth.

14. **This central projection is roughly aligned with the baseline scenario used for the financial sector stress tests** (see next section). Though staff's growth projection is more V-shaped, both scenarios have essentially the same endpoint for real GDP in 2014, broadly in line with the consensus forecast.

**Spain: GDP projections**  
(Real GDP levels, 2011=100)



Sources: BdE, IMF staff estimates.

15. **However, risks around the central scenario are large:**

- On the downside, the various headwinds noted above could prove stronger than envisaged, leading to a vicious circle of lower growth, fiscal overruns, damaged confidence, higher interest rates, and tighter credit. A notable risk relates to the fiscal targets, which staff expects to be exceeded during 2012-14 (Table 1). If instead the quantity of additional fiscal measures taken is large enough to hit the deficit targets, the contractionary effects of such consolidation could push the near-term growth path closer to the adverse scenario used for the financial sector stress test. Another key uncertainty is the path of unemployment, which has recently risen faster than expected.
- On the upside, further efforts at both the national and EU levels to bolster confidence could prompt the recent market rally to gain force, leading to a virtuous circle of lower interest rates, easier credit, stronger growth, and enhanced confidence. Structural reforms could also lead to a stronger medium-term outlook.

16. **The difficult macroeconomic outlook and large risks underscore the importance of timely efforts to promote the virtuous, rather than vicious, circle.** As discussed in Annex I, macroeconomic developments are a primary driver of financial sector health. Timely efforts by both Spain and Europe to reduce downside risks will thus improve prospects for successful financial sector reform. At the same time, strong implementation of financial sector reform will improve the economic outlook. For example, reforms to bolster Spanish banks' capitalization and make the value of their assets more certain should reduce these banks' funding costs, with much of the savings passed on to corporates and households in the form of lower borrowing rates. Lower rates should in turn help revive lending to the productive sector while facilitating deleveraging via lower debt-servicing costs, especially given the prevalence of variable-rate loans.

17. **It will be important to implement recapitalization and restructuring programs at a pace and manner that does not inadvertently undermine these broader macroeconomic objectives.** For example, plans for restructured banks (next section) may entail a rapid downsizing of credit portfolios, including to meet prudential requirements, strengthen business models, and/or ensure that nationalized banks do not obtain a competitiveness advantage under state aid rules. If other banks expand credit to offset this downsizing, it may simply entail a desirable re-allocation of activity from weaker to stronger banks amid a generalized, and appropriate, deleveraging. However, if strong banks' ability to expand credit is limited (e.g., due to Basel III requirements), credit constraints and borrowing rates could tighten. Given the already weak economy and potential for virtuous and vicious circles, financial sector reforms should be paced and designed so as to minimize risks of such contractionary effects.

## PROGRESS ON FINANCIAL SECTOR REFORM

*Credit conditions and economic recovery will benefit from ongoing efforts to ensure well-capitalized banks and reduce uncertainty regarding the strength of their balance sheets. Stronger frameworks for regulation, supervision, and resolution will assist this process and promote a more stable financial system going forward. Toward these ends, the authorities are undertaking a major program of financial sector reform, which so far is on track in the view of IMF staff. However, the most challenging tests lie ahead.*

### A. Overview

18. **In the MoU of July 20, 2012, Spain committed to deepen and accelerate its financial sector recapitalization, restructuring, and reform program.** Measures fall into three broad areas:

- *Bank-specific measures* to ensure adequate bank capitalization and reduce uncertainty regarding the strength of their balance sheets. This in turn should improve banks' access to funding markets so that they can provide sufficient credit to support economic recovery. Banks subject to restructuring will also take measures to reduce liquidity risks.
- *Resolution and burden-sharing legislation* to provide the legal framework for a swift and orderly process of financial sector restructuring, with a view to minimizing costs to taxpayers.
- *Reform of the financial sector regulatory and supervisory framework* to promote a sound operating environment and prevent a recurrence of imbalances.

19. **Implementation of the MoU is on track.** As envisaged in the MoU, progress on the bank-specific measures and the resolution and burden-sharing framework has been more rapid—as these actions are necessary to achieve the immediate clean-up of the sector—while reform of the regulatory and supervisory framework, while on schedule too, has been more gradual.

20. **However, this track record will need strong efforts to be sustained.** The forthcoming implementation stage of reforms is critically important and will likely prove more challenging than the design phase. To avoid slippages, the authorities and their European partners will need to demonstrate a continued strong determination to remain on track and, in some cases, accelerate the decision-making process. Further detail on specific measures and forthcoming challenges is below and in Annex II.

### B. Bank-specific Measures

21. **A key component of the program is a thorough clean-up of the banking sector.** The clean-up aims to ensure adequate capitalization by assessing the capital needs of individual banks via a rigorous asset review and under a demanding stress test, and then defining and implementing plans to address these needs and to close funding gaps. Banks requiring public

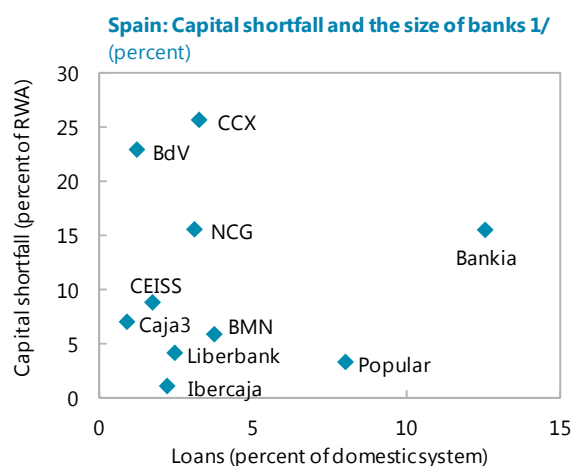


capital support will start from December to transfer their real estate foreclosed assets and all loans to real estate developers to a centralized AMC. This will reduce the riskiness of banks' assets (and thereby lower their funding costs) and allow them to focus on their core intermediation role of supporting the real economy.

## Identifying and addressing bank capital needs

### *What is being done?*

22. **The first step in the clean-up, the identification of banks' capital needs, was completed on schedule by end-September 2012.** This diagnostic work covered 17 banking groups representing around 90 percent of the system's domestic credit.<sup>4</sup> It has included the identification of individual bank capital needs through (i) a comprehensive asset quality review carried out by four major international audit firms (Deloitte, PwC, Ernst and Young, and KPMG) concluded in early August and (ii) a bank-by-bank bottom-up stress test (Box 1) conducted by an external consultant, Oliver Wyman, based on inputs provided by the asset quality reviews and completed in September. In line with benchmarks used in similar exercises internationally, banks' capital needs were assessed against Core Tier 1 ratios (European Banking Authority (EBA) definition) of 9 and 6 percent in a baseline and adverse macroeconomic scenario, respectively. Ten of the 17 banking groups, representing 35 percent of the sample's assets, were identified as needing additional capital under the adverse scenario, with a total capital need of €59 billion.<sup>5</sup>



Sources: Bank of Spain and Oliver Wyman.  
1/ Risk-weighted assets (RWA) and loans are as of end-June 2012.

23. **This process has been overseen by a Strategic Coordination Committee (SCC) involving the Spanish authorities and EC, ECB, EBA, ESM, and IMF staff.** An Expert Coordination Committee (ECC) with similar membership has also met more frequently and updated the SCC every two weeks. Both committees have played their roles appropriately, with substantial interaction among all participants, including IMF staff. There has also been ample provision of information.

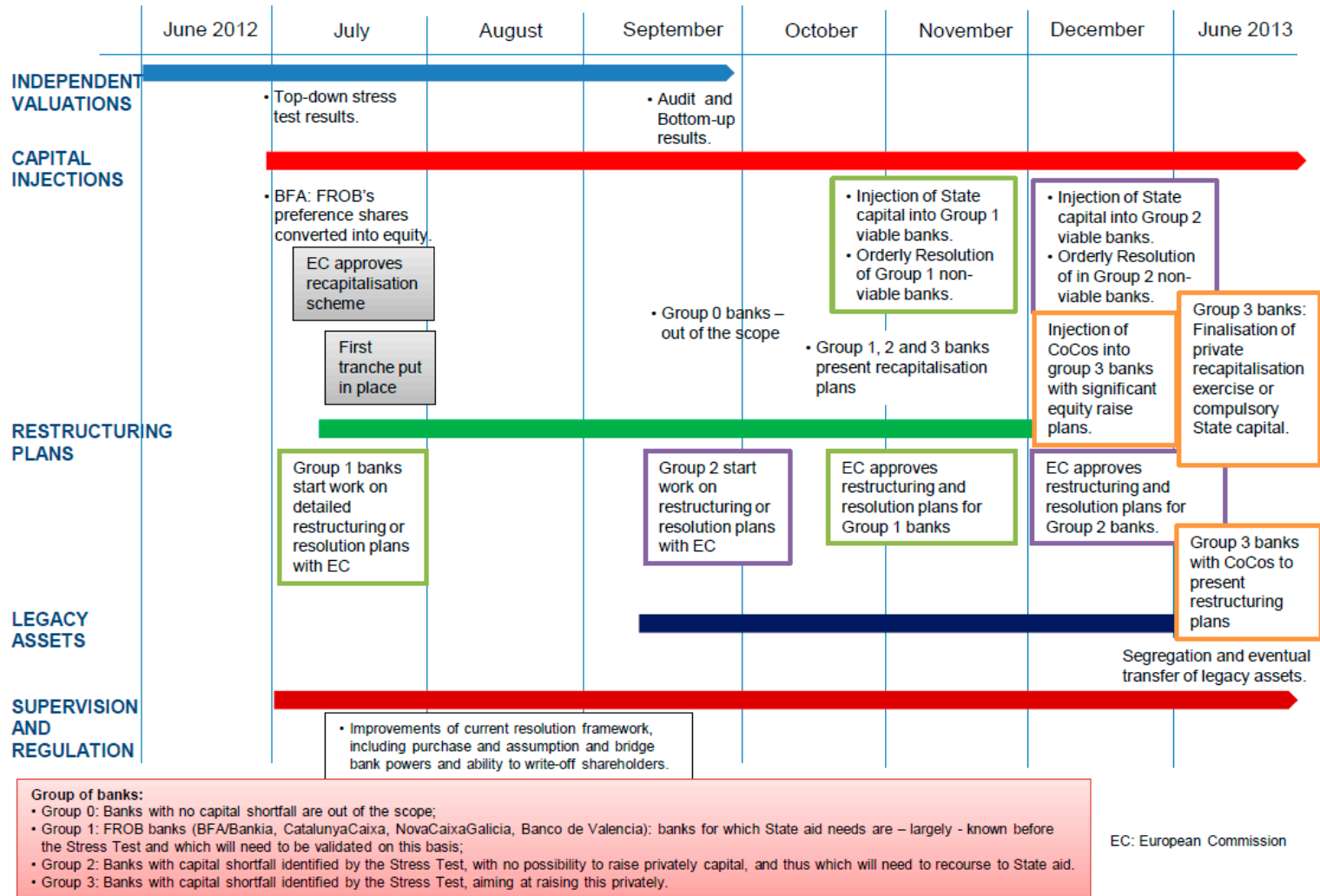
<sup>4</sup> The exercise started with 14 banking groups under consideration, but these were split into 17 parts in the course of the exercise to better assess the individual condition of some banks that were part of merger processes that had not been finalized yet.

<sup>5</sup> This amount is before tax effects and possible mergers underway. More detail on the results can be found on the BdE's website: [http://www.bde.es/webbde/en/secciones/prensa/info\\_interes/reestructuracion.html](http://www.bde.es/webbde/en/secciones/prensa/info_interes/reestructuracion.html)

24. **The second step in the clean-up, which was completed on schedule at end-October, is the triage of the 10 banks with capital shortfalls into 3 categories, as defined in paragraph 10 of the MoU:**

- *Group 1* was pre-defined by the MoU as the four banks already owned by the Fund for Orderly Bank Restructuring (FROB): BFA-Bankia Group, Catalunya Caixa, NCG Banco, and Banco de Valencia. These banks constitute 20 percent of the assets of all banks included in the stress test and 78 percent of the identified capital shortfall.
- *Group 2* are those banks that are not currently owned by FROB and that will need state aid to address their capital shortfalls. Four banks—BMN, Caja3, CEISS, and Libercaja, which constitute 7 percent of the assets of all banks included in the stress test and 16 percent of the identified capital shortfall—fall into this group.
- *Group 3* are those banks for whom their plans to meet their capital shortfall privately without recourse to state aid are deemed credible. Two banks—Ibercaja and Popular, which constitute 8 percent of the assets of all banks included in the stress test and 6 percent of the identified capital shortfall—have been placed in this category.

### Restructuring of the Spanish Banking Sector: Timeline



### Box 1: The Bottom-Up Stress Tests—Key Assumptions

The bottom-up stress tests assessed Spanish banks' ability to withstand deteriorating macro-financial conditions over three years (2012-2014) under a base case and adverse scenario. Key macroeconomic assumptions for the scenarios are below.

		Base case				Adverse case		
		2011	2012	2013	2014	2012	2013	2014
GDP	Real GDP	0.7%	-1.7%	-0.3%	0.3%	-4.1%	-2.1%	-0.3%
	Nominal GDP	2.1%	-0.7%	0.7%	1.2%	-4.1%	-2.8%	-0.2%
Unemployment	Unemployment Rate	21.6%	23.8%	23.5%	23.4%	25.0%	26.8%	27.2%
Price evolution	Harmonised CPI	3.1%	1.8%	1.6%	1.4%	1.1%	0.0%	0.3%
	GDP deflator	1.4%	1.0%	1.0%	0.9%	0.0%	-0.7%	0.1%
Real estate prices	Housing Prices	-5.6%	-5.6%	-2.8%	-1.5%	-19.9%	-4.5%	-2.0%
	Land prices	-6.7%	-25.0%	-12.5%	5.0%	-50.0%	-16.0%	-6.0%
Interest rates	Euribor, 3 months	1.5%	0.9%	0.8%	0.8%	1.9%	1.8%	1.8%
	Euribor, 12 months	2.1%	1.6%	1.5%	1.5%	2.6%	2.5%	2.5%
	Spanish debt, 10 years	5.6%	6.4%	6.7%	6.7%	7.4%	7.7%	7.7%
FX rates	Ex. rate/ USD	1.35	1.34	1.33	1.30	1.34	1.33	1.30
Credit to other resident sectors	Households	-1.7%	-3.8%	-3.1%	-2.7%	-6.8%	-6.8%	-4.0%
	Non-Financial Firms	-4.1%	-5.3%	-4.3%	-2.7%	-6.4%	-5.3%	-4.0%
Stocks	Madrid Stock Exchange Index	-9.7%	-1.3%	-0.4%	0.0%	-51.3%	-5.0%	0.0%

**Banks were evaluated on a consolidated basis against a post-stress Core Tier 1 ratio (EBA definition) of 9 and 6 percent in the base and adverse scenarios, respectively.** The test stressed foreclosed assets and credit risk in the domestic loan book, but did not include a separate evaluation of market risk and liquidity risks. The tests were based on end-2011 data. To ensure the high quality of this data, the four major international audit firms carried out an asset quality review of each bank's loan portfolio to adjust for potential misclassification of loans, while five external appraisal companies assessed the value of foreclosed assets. Oliver Wyman developed bank- and asset-specific models to project future credit losses for both the credit portfolio and the foreclosed assets under both scenarios and compared them with a bank's loss absorption capacity (the sum of existing provisions, earnings generation capacity, eventual asset protection schemes, and the excess capital buffer with respect to the minima). The difference between the two corresponded to the capital shortfall.

**The test posed several constraints on banks' loss absorption capacity.** In modeling future profits, the test imposed limitations on deposit growth (negative), margins, commissions, and trading gains. Expected profits from outside of Spain and dividend income were cut by 30 percent. Deferred tax assets were excluded for intervened entities. Only executed management actions were considered. As a consequence, average yearly pre-provision profits were reduced from banks' expectations of €24 billion to €14 billion in the adverse scenario (pre-provision profits were €19 billion in 2011).

25. **The third step, which is still underway, is the finalization of restructuring or resolution plans for those requiring state aid.**

- For Group 1, the broad contours of the plans have been prepared by the authorities and discussed with the EC since August 2012.<sup>6</sup> The restructuring plans are now being finalized based on the stress test results. This includes an overall viability assessment to evaluate whether an entity is non-viable, even taking into account its restructuring plans. If such an entity is determined to be non-viable, it should be resolved rather than recapitalized. Restructuring plans will be presented in time to allow the EC to approve them by November 2012. On this basis, state aid will be granted, and plans can be implemented immediately, including the actual injections of public capital. The banks are scheduled to complete the transfer of their assets to the AMC by end-December.
- Restructuring plans for Group 2 banks have also been presented to the EC, fulfilling the end-October deadline, and are now being reviewed. These should be approved by the EC by end-December, with the implementation of these plans—including the transfer of assets to the AMC—occurring shortly thereafter.
- The two Group 3 banks are expected to meet all of their capital shortfall by end-December via private sources. If this does not occur, public capital would be immediately injected to fill any remaining gap, including if necessary via contingent convertible securities (CoCos) subscribed by the FROB, as described in the MoU. Any CoCos will subsequently be purchased back by June 2013 at the latest or else converted into ordinary shares. Any conversion to ordinary shares would require the affected bank to transfer certain assets to the AMC and adopt restructuring plans under state aid rules.

26. **Steps will be taken to minimize the cost to taxpayers of bank recapitalization.** After allocating losses to equity holders, the Spanish authorities will require burden-sharing measures from hybrid capital holders and subordinated debt holders in Group 1 and 2 banks receiving public capital. The concerned banks will carry-out both voluntary and, where necessary, mandatory Subordinated Liability Exercises (SLEs), through which existing hybrid capital instruments and subordinated debt will be converted into equity, bought-back at significant discounts, or transformed in other ways to fill capital shortfalls. The necessary legal adjustments have been incorporated in the Royal Decree Law (RDL) of August 31<sup>st</sup> described in Section C.

---

<sup>6</sup> The MoU specifies that bank plans submitted to the EC will be made available, once finalized, to ECB, EBA, and IMF staff.

## Assessment

### 27. **The bottom-up stress tests were thorough and technically robust.**

- Key macroeconomic assumptions underpinning the baseline and severe adverse scenarios (Box 1) support confidence in the estimates and provide some downside risk to the estimated capital needs.
- The bottom-up stress-test was also far more precise than the top-down exercise conducted in June. Although the macroeconomic scenarios were identical in both exercises, the bottom-up test took into account a number of bank-specific elements, including individual business plans that were vetted and adjusted for consistency and plausibility, and, most importantly, the results of the detailed asset quality review.
- On the bottom-up stress test, the ECC had in-depth discussions on the test's methodology for estimating credit impairment losses and the resulting impact on solvency under both the baseline and severe adverse scenario. Both the ECC and SCC concluded that the stress test was thorough and technically robust, providing a high level of comfort in this area.

28. **The stress test results reflect the assumptions selected in line with the specific purpose of the exercise.** No stress test can or should cover all contingencies. Hence the results do not represent an absolute worst case scenario, as is appropriate. Rather, the bottom-up exercise was well-designed for assessing the current challenges of the Spanish banking system and was carefully executed, under the close monitoring of the SCC and the ECC. The results are sufficiently robust and thorough to provide a sound basis for moving forward with bank-specific action plans to address identified capital needs under the prevailing circumstances. The BdE appropriately plans to leverage its investment in the stress test framework to further enhance its own internal stress testing, which should occur regularly to help inform its supervision.

29. **The triage of banks into the three categories has also yielded credible results.** The authorities and the EC reviewed the banks' plans to meet the capital needs identified by the stress test in an efficient and thorough manner, rejecting over-optimistic assumptions and engaging in detailed discussions with the banks' management teams.

30. **It will be essential to assess carefully whether restructuring plans have any systemic implications for credit supply, given that around 40 percent of GDP in credit to the private sector is involved.**<sup>7</sup> This assessment should include an analysis of the ability of stronger banks to compensate sufficiently for any downsizing of restructured banks' credit portfolios. If such analysis suggests a material risk that restructuring plans as a whole may significantly restrict the financial system's ability to meet solvent demand for credit, steps should be considered to

---

<sup>7</sup> This amount is roughly the total loan book of Group 1 and 2 banks before restructuring.

ensure adequate credit supply while maintaining banks' viability and capitalization. Given the already weak state of domestic demand—as indicated by a wide output gap and high unemployment—such assessments should err on the side of caution.

31. **More generally, the key challenge going forward will be to ensure strong and well-designed bank-specific action plans.** Firm application of new burden-sharing powers (Section C) will promote success in this regard by reducing the need to fill capital shortfalls through fiscal injections and/or asset shedding. Going forward, new mergers which do not clearly generate value should be avoided. Strong actions to address problems in weak banks should also not be delayed simply to avoid recognizing an unavoidable fiscal loss, as allowing problems to fester may increase the ultimate fiscal cost.

32. **An early recapitalization test occurred already in August with the partial recapitalization of a large banking group.** The MoU included the option of providing Spain with a first tranche of €30 billion from July 2012 if an emergency arises and based on a reasoned and quantified request from the BdE. In the view of IMF staff, such a need occurred when one large banking group found itself at risk after its end-August publication of large losses for the first half of 2012, bringing its solvency almost down to zero. However, the activation of this first tranche did not take place, and the authorities proceeded with an interim and partial recapitalization with domestic Spanish resources.

33. **This first tranche of €30 billion should remain available to insure against risks in the context of high macroeconomic uncertainty and be made more easily accessible.** The tranche remains relevant, since its objective is to provide “a credible backstop” in case of the materialization of risks “until recapitalization of banks has been fully effected”. IMF staff is of the view that, in line both with the letter and the spirit of the MoU, there is merit in keeping this tranche available.

34. **The ESM should provide as much of the financial support under the program in cash as possible.** Currently, the ESM is only allowed to obtain financing for a disbursement once such a request is made. This constraint on pre-funding limits the availability of cash for the initial disbursement, but the ESM should ensure it replaces bonds with cash as fast as ESM market access allows. Recapitalization of banks with cash rather than ESM bonds would further enhance banks' balance sheets and reduce reliance on Eurosystem liquidity.

## Separation of banks' problematic assets

### *What is being done?*

35. **The clean-up process includes the transfer of certain assets from banks in Groups 1 and 2 to a centralized AMC.** A comprehensive blueprint for the establishment and functioning of the AMC was prepared by end-August, in line with the MoU deadline. The legislation enacted on August 31 established the AMC and empowers the FROB to instruct distressed banks to transfer problematic assets to it. It also envisages that the AMC may isolate its assets in different

trusts, with a view to facilitating their optimal management and investors' participation. Implementing regulations are in the final stage of adoption. The FROB will take a significant minority stake in the AMC, but the majority will be privately owned, one of the characteristics that would normally be expected to exclude the AMC from being classified as part of the general government according to Eurostat criteria. A sunset clause, defining the temporary nature of the AMC, has been set to 15 years from its inception.

36. **The design features of the AMC have now been defined.** The perimeter of assets to be acquired by the AMC will include loans related to real estate development and foreclosed assets of a value larger than a minimum amount, as well as majority participations in real estate companies. The gross book value of such assets held by Group 1 and 2 banks is about 8½ percent of system-wide loans and foreclosed assets.<sup>8</sup> Upon certain, strict criteria, other types of loans may be transferred. Transfer prices have been set based on the assets' long-term economic value and incorporating several other factors, such as maintenance and legal costs, which result in valuations close to those in the adverse stress test scenario. This pricing aims to value the assets at levels that are fair and to attract sufficient private equity investment in the AMC. In exchange for the assets sold to the AMC, the transferring banks will receive government-guaranteed bonds issued by the AMC. The bonds issued by the AMC will be structured in such a manner that they will meet the conditions set out by the ECB to be eligible as collateral in Eurosystem credit operations. The AMC's equity is expected to be about 8 percent of assets.

### **Assessment**

37. **While the general framework was put in place on schedule by end-August, it will be challenging for the AMC to be fully operational by the ambitious end-November deadline.** The MoU deadlines have been met, and the legislative package is expected to be completed soon. However, it would have helped the preparatory process had some key decisions been taken more promptly. The valuation of the transferred assets has been appropriately set at a relatively conservative level. The chosen coverage of the transferred assets aims to strike a balance between promoting a thorough and credible clean-up of banks' books and not overwhelming the AMC's management capacity with many loans of limited aggregate importance. In this regard, a higher minimum value for an asset to be eligible for transfer to the AMC (which has been set at €250,000 for loans and €100,000 for assets—on the low end by international comparison) could have achieved a somewhat better optimization in the view of IMF staff. Taking over some 168,000 items from the first 4 banks alone will represent a major logistical challenge for the AMC. To help meet this challenge, it will be important to avoid future expansions of the perimeter unless critical and ensure sufficient staffing.

38. **It is essential that the right incentive structure is in place to help meet the challenges of the operational phase.** The AMC faces a number of risks, including those that could arise from possible conflicts of interest among stakeholders, its leveraged structure, and

<sup>8</sup> This value refers to banks' pre-stress test valuation of these assets.



the challenging task of managing many files. Some steps to mitigate these risks have been taken, such as the establishment of suitability requirements for the AMC's directors and senior management. As further arrangements affecting the AMC's incentive structure are developed, the following guiding considerations could help further mitigate risks:

- As envisaged in the RDL, the AMC should be a commercially-driven entity whose aim is to maximize value out of the sale and restructuring of its assets, including on the right timing strategy to do so.
- This requires an active management focused exclusively on this goal. Corporate arrangements and the legal documentation should be carefully designed with this in mind. In particular, a coherent ownership policy to be followed by all parties should formulate clear objectives for management. A regular independent review of the AMC's operations might also be useful.

39. **Operationally, a top priority for the AMC in the near term is to ensure that the transfer of assets is made in such a way that their effective management is maintained.** As the transferring banks may not have the full incentives to manage assets they no longer own, adequate provisions should be set in the transfer and servicing agreements, and the AMC must handle the decision-making process. To meet this operational challenge, credit (or assets and liabilities) committee structures with the capacity to handle decisions could be quickly established. The quality and eligibility of the loans must be verified under transparent criteria, with a view to facilitating their subsequent transfer to private investors. Workout teams for the most important assets/loans from a policy and value perspective should operate as soon as possible. This could also enable a better view on the possible cash-flows over the medium term. To provide enough human resources for such tasks, it will be important for the AMC to quickly get up to adequate staffing levels.

40. **Vendor financing agreements with banks could also help make the AMC more effective.** Especially in the initial, difficult start-up period, vendor financing (i.e., financing made available to buyers of AMC assets) could facilitate the sale of assets. The AMC could have a credit line for a limited period, whereby banks would commit to make available vendor financing under certain commercial conditions.

41. **In sum, bank-specific actions have progressed in line with the MoU, with deadlines hit so far.** However, the most difficult phase, that of implementing the restructuring plans of individual banks and making the AMC effective, lies just ahead.

## C. Resolution and Burden-sharing Arrangements

### *What is being done?*

42. **Both the MoU and the IMF's Financial Sector Assessment Program (FSAP) call for upgrading the legal framework for bank resolution, redistributing responsibilities in this**

**field, and introducing burden-sharing mechanisms.** These measures are necessary to (i) provide the authorities with sufficient powers to recapitalize, restructure, and resolve troubled banks in a way that minimizes taxpayer costs and to act swiftly to support financial stability while preserving fundamental property rights and (ii) invest such powers in the agencies best placed to exercise them.

43. **Toward this end, an RDL entered into force on August 31, 2012, and is in the process of being ratified by the parliament.** The RDL's two broad reforms to the resolution framework are to

- designate 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.
- empower the FROB and BdE to take more wide-ranging actions towards a bank at the different stages of financial distress—early intervention, restructuring, and resolution—including by imposing losses on shareholders and creditors. Depending on such stages and based on a bank's viability, different kinds of temporary public support may be provided.

### **Assessment**

44. **The RDL is a major achievement.** Key improvements, many of which also incorporate emerging international best practices, include the following:

- **Triage and viability test.** The authorities can now calibrate their actions to each bank's financial condition, as the RDL draws a distinction between viable and non-viable institutions. This analysis will also affect the nature of public financial assistance. In particular, temporary public financing through recapitalizations would be targeted at banks that are considered still viable but, due to current market circumstances, are unable to raise their own funds. For non-viable institutions public financing would instead facilitate orderly resolution (unless this would have seriously harmful effects on the financial system's stability) to, for example, support the sale of certain parts of a failed bank's business to a healthier acquirer. In both cases, the requirement for an independent valuation of banks' assets and liabilities should serve to protect state resources when public money is injected.
- **Broad toolkit.** The authorities can now deploy a wide range of tools quickly and effectively. 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 is also allowed to promptly recapitalize ailing institutions, including through emergency procedures. Banks' problematic assets can be transferred to an AMC upon the FROB's

request. Banks incurring capital deficits as a result of such transfer would then be restructured or resolved, as appropriate based on their viability.

- **Mandatory SLEs.** 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 (i.e., a SLE), thus reducing fiscal costs. The FROB determinations may include a wide range of mechanisms (e.g., maturity extensions, principal or interest reductions, debt-to-equity swaps). Mandatory SLEs may also be preceded by voluntary exercises whereby banks, under FROB steering, may agree with holders of hybrid capital and subordinated debt instruments to restructure their claims. Such exercises would be carried out under threat of mandatory SLEs if voluntary exercises are unsuccessful. In line with emerging international best practices, SLEs should help minimize taxpayers’ costs, improve market discipline, and help preserve the going concern value of distressed banks.
- **Balance between financial stability and private property rights.** The RDL 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 would be compensated in the scenario that they would receive more if the concerned bank were to be liquidated.
- **Institutional framework.** Institutional changes are generally positive, though the key test will be their operation in practice. Of note:
  - The better separation of the FROB and BdE’s functional responsibilities should enhance checks and balances. Indeed, the FROB’s stronger role should encourage early intervention by the BdE, once a bank starts experiencing financial distress, to prevent the need for restructuring and resolution under the FROB. At the same time, the BdE’s supervisory and financial stability perspective remains essential in the restructuring and resolution process. Cooperation between these agencies should occur smoothly and be steered by the government, which is ultimately responsible for financial stability. Toward this end, the BdE and FROB are working on a framework for cooperation. Its prompt finalization seems advisable to clarify the respective new roles and responsibilities.
  - The RDL contains general sound safeguards on the FROB’s accountability and transparency, and the FROB has a diversity of government representatives sitting on its board (including a minority of members designated by the BdE). The FROB is set to meet the upcoming challenges, and its staffing is being strengthened. However, its multiple roles—resolution authority, shareholder in troubled banks or in the AMC, or creditor thereof—may not always be aligned. Although the RDL also has an enabling clause allowing possible conflicts to be addressed through appropriate internal governance arrangements, possible conflicts in the conduct of FROB activity—given its ongoing heavy involvement in crisis management—

should be monitored. Safeguards to reduce these potential conflicts of interest or misaligned incentives could include (i) internal control mechanisms and separate, dedicated functions with different reporting lines and (ii) expanding FROB governance arrangements to include independent members or advisory committees. Hiring additional resources having a broadly diversified range of expertise and background should also be beneficial.

- Lastly, clear and easy-to-monitor ownership policies for nationalized entities should be formulated and disclosed. Banks that will be recapitalized with public resources and placed under a restructuring plan stretching over 5 years may remain under FROB control until economic conditions improve sufficiently to return them to private ownership. In the meantime, they require a governance model that preserves the autonomy of their management teams while also ensuring accountability. This could be achieved through management contracts that incorporate the provisions of each bank's restructuring plan.
- **Relationship with the deposit guarantee scheme.** International best practice is to require contributions from the banking sector to insure against costs that may be incurred to facilitate the smooth exit of failed banks and the possible acquisition of their critical functions by the remaining institutions. Deposit guarantee schemes (in Spain, the "Fondo de Garantía de Depósitos" or FGD) typically channel such contributions. However, in a crisis environment the cost of restructuring the banking sector and dealing with legacy assets lies primarily with the state. The distinction between viable and nonviable institutions is important: the restructuring for the former category could be financed by the state, as the aided banks will remain in the market, allowing state-provided financing to be recouped with a return. In contrast, the costs of resolving nonviable entities should ultimately be paid by the industry, and thus by the FGD. The RDL goes in the right direction by broadly delineating the financial responsibilities of the state and FGD along these lines. Also, in clarifying that the latter would borrow from the former when it finances resolution, it sets out the commendable principle that costs of public support would be recouped *ex post* from the industry over time.<sup>9</sup>

45. **By enabling the authorities to allocate losses on shareholders and creditors, the RDL should enhance cost-effective handling of problem banks and mitigate moral hazard.** The new regime enables the authorities to dilute equity holders and haircut creditors on a going concern basis, whereby the concerned institution continues to operate and hybrid capital and subordinated debt can be restructured in SLEs. The new regime also adds new tools for resolving banks on a gone concern basis (e.g., by transferring parts of a business to a bridge bank and leaving certain assets and liabilities behind). The implementation of these burden-sharing

---

<sup>9</sup> Resolutions may be financed by the FROB, but the FGD would act to recover any losses to the state *ex post*.

mechanisms will promote a more equitable contribution of existing stakeholders to the clean-up of the banking sector, thus reducing its fiscal costs.

46. **The addition of depositor preference would significantly strengthen the resolution framework.** The RDL does not grant depositors and the FGD preferential rights over other unsecured creditors upon insolvency of a bank. Depositor preference facilitates the transfer of the deposit base to a healthy institution, in that depositors have a higher ranking than other creditors, which can then be left behind in the failed bank. By doing so, this mechanism helps to preserve franchise value and avoid disorderly liquidation. It also protects state resources, as the government would ultimately need to reimburse depositors in a straightforward liquidation. Nonetheless, divergent views exist on the impact of granting preferential ranking to depositors, and the authorities are understandably concerned about the funding costs that depositor preference would introduce, putting Spanish banks into a competitive disadvantage. However, in the current circumstances where resolution has to be operationalized, the absence of depositor preference may go to the detriment of financial stability and does not minimize taxpayers' costs.

47. **Most importantly, the implementation phase should be quickly operationalized.** With the RDL having set out the general legal framework, the authorities should now make full use of the available tools. Taking prompt action will inevitably entail costs and difficulties, including litigation risks, but will not delay recognition of losses, thus ultimately minimizing taxpayers' losses. Restructuring and resolution strategies need to be targeted, ensuring an adequate differentiation in the fate of single entities—thus avoiding mergers if they are not sound for the system—and not excluding more intrusive measures. Where appropriate, decisive action must be taken to quickly wind down unviable entities in an orderly manner and in line with well-defined creditor hierarchy rules.

48. **In particular, the commitment to proceed to SLEs through coercive action deserves special monitoring.** Burden-sharing exercises are a critical element and should be carried out under decisive and credible time-bound plans, also bearing in mind the goal to minimize the overall costs for taxpayers under a clear cost-benefit analysis. Any consumer protection concerns raised by the holders of the instruments (e.g., for mis-sale) should be handled by a separate process from these burden-sharing exercises. For example, to take into account the understandable social implications raised by such concerns, consideration could be given to developing general protocols that set uniform and rigorous rules to deal with mis-sale allegations in an efficient and orderly manner. This would also facilitate the gathering of reliable information so as to quantify possible costs arising from mis-selling allegations.

49. **Regulations implementing the RDL could clarify ways in which resolution will be implemented in a cost-effective manner.** A fundamental principle in resolution is the no-creditors worse off rule: creditors should receive no less than what they would collect in liquidation. Provided that this principle is respected, the authorities should use the flexibility to depart from the *pari passu* treatment of creditors when appropriate, as envisaged in the RDL and in line with emerging international best practices (e.g., FSB Key Attributes). For instance,

derivative counterparties whose collateral may not be sufficient to cover their exposures may be treated better than other unsecured creditors when counterparty arrangements are deemed critical to the banks' ongoing business that is being transferred elsewhere (e.g., to a bridge bank). Such departure from *pari passu* should be justified on a sound public policy rationale, such as preserving financial stability and maximizing the value of a troubled bank in order to minimize taxpayer costs. This approach would also benefit creditors as a whole. It would thus be useful to adopt some interpretive guidance or regulations implementing the RDL, clarifying the criteria for this flexible approach and detailing how resolution would work in practice. Such rules could also clarify other relevant aspects, such as the parameters for independent valuation of banks' assets and liabilities, thereby helping to guide parties' expectations.

## D. Regulatory and Supervisory Framework

### *What is being done?*

50. **The MoU includes a number of measures to strengthen Spain's regulatory and supervisory framework to improve the financial sector's longer-term resilience.** These measures include a strengthening of (i) regulatory requirements (on capital, loan-loss provisioning, credit concentration, and related-party transactions), (ii) the supervisory framework (e.g., on BdE powers and consumer protection and securities legislation), and (iii) the governance of key financial safety net participants (e.g., the FROB and FGD) and regulated entities (e.g., savings banks).

51. **The authorities have already legislated some of the above issues, anticipating in certain cases the MoU timetable.** In addition to overhauling the bank restructuring and resolution regime, the RDL covers a number of regulatory and supervisory aspects. In particular:

- **Consumer protection and securities regulation.** The RDL strengthens disclosure and suitability obligations of investment services providers, including by requiring (i) that additional information be given to investors in case of placement of securities different from stocks by credit institutions and (ii) that certain types of "documented actions" be taken when providing investment advice and other services to clients and that written evidence be maintained.
- **Governance.** The MoU and the FSAP call for the review of governance arrangements of financial safety net agencies to avoid—perceived or real—conflicts of interest. In anticipation of the January 2013 deadline under the MoU, the RDL revamps FROB governance and removes active bankers from its board. A similar reform for the governance of the FGD still needs to be adopted.
- **BdE powers.** Pending the changes that will arise from the EU single supervisory mechanism, the RDL transfers licensing and sanctioning powers from the government to the BdE, with a gradual implementation phase. However, the Ministry of Economy remains the forum for appeals against sanctions issued by the BdE.

**Assessment**

52. **As with the bank restructuring and resolution measures, the targets set in terms of regulatory and supervisory legal reforms have been met in the RDL.** The new consumer protection and securities regulation draws appropriate lessons from the crisis and from allegations of mis-selling by credit institutions of their own securities: overall, they seem to reinforce investor protection. However, active supervision and enforcement by the capital markets supervisor (the Comisión Nacional del Mercado de Valores) of both these new regulations and existing ones will be equally important. Indeed, for those cases of mis-selling still in the pipeline where a positive finding is made, the adoption of significant sanctions could be a strong deterrent and help realign behavior.

53. **Progress is also being made on other key supervisory and regulatory matters.** The BdE is on track to implement new capital requirements, including tighter definitions, in line with the MoU deadline of the start of 2013. The regulation to implement these requirements has already been approved. The assessment of loan-loss provisioning, credit concentration, and related-party transaction rules are underway, and the circular on reporting transparency was approved. BdE supervisory powers have been strengthened. Reports on the important issues of (i) reviewing the BdE's supervisory and decision-making processes and (ii) further empowering the BdE to issue binding guidelines were completed on time at end-October and are now being reviewed by international partners.

54. **One issue where deadlines are shortly approaching and progress has been less apparent is the review of the savings bank regime, which deserves high priority.** Governance flaws and supervisory loopholes in the savings banking regime have been at the core of the Spanish financial sector crisis. Under the MoU, the authorities have committed to adopt measures to strengthen fit and proper rules and to revise the relationship between commercial banks and the savings banks that have controlling ownership of them. The strategy should also entail the eventual divestiture of savings banks' controlling stakes, whether exercised alone or jointly, and a roadmap for the listing of those commercial banks that have benefited from State aid as part of the restructuring process. The two steps need to be closely aligned. Savings banks losing control over commercial banks are now required to be transformed into special financial foundations. An adequate general framework for these foundations needs to be put in place: these foundations should not hinder the sound governance and access to market funding of commercial banks, if these foundations continue to hold significant stakes over such banks. As the deadline to adopt these measures is approaching, prompt progress is needed on this front.

55. **In sum, all deadlines for MoU-committed reforms of the supervisory and regulatory framework have been met so far, but key tests lie ahead.** Concrete implementation of recently enacted legal reforms will be paramount. The issues to address in this regard are numerous, with clusters of deadlines approaching.

**Table 1. Spain: Main Economic Indicators, 2008–2017 1/**  
(Percent change unless otherwise indicated)

	2008	2009	2010	2011	Projections					
					2012	2013	2014	2015	2016	2017
Demand and supply in constant prices										
Gross domestic product	0.9	-3.7	-0.3	0.4	-1.5	-1.3	1.0	1.6	1.7	1.7
Private consumption	-0.6	-3.8	0.7	-1.0	-2.2	-2.4	0.9	1.1	1.2	1.2
Public consumption	5.9	3.7	1.5	-0.5	-4.1	-5.4	-2.1	0.0	0.5	0.7
Gross fixed investment	-4.7	-18.0	-6.2	-5.3	-8.9	-4.1	-0.3	1.2	2.0	2.7
Construction investment	-5.8	-16.6	-9.8	-9.0	-11.0	-4.8	0.0	1.0	1.4	2.2
Other	-3.2	-24.5	3.0	2.4	-6.8	-3.6	-0.8	1.9	3.7	4.2
Stockbuilding (contribution to growth)	0.1	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Total domestic demand	-0.5	-6.2	-0.6	-1.9	-4.0	-3.3	0.1	0.9	1.2	1.4
Net exports (contribution to growth)	1.5	2.9	0.2	2.4	2.4	1.9	0.9	0.7	0.5	0.4
Exports of goods and services	-1.0	-10.0	11.3	7.6	2.4	3.5	4.5	4.6	4.8	4.8
Imports of goods and services	-5.2	-17.2	9.2	-0.9	-5.7	-2.8	1.9	3.0	3.8	4.4
Prices										
GDP deflator	2.4	0.1	0.4	1.0	1.2	1.3	1.2	1.3	1.2	1.2
HICP (average)	4.1	-0.3	1.8	3.2	2.5	2.4	1.5	1.5	1.4	1.4
HICP (end of period)	1.4	0.8	3.0	2.4	3.3	1.4	1.4	1.4	1.4	1.4
Employment and wages										
Unemployment rate (percent)	11.3	18.0	20.1	21.7	24.9	25.1	24.1	23.2	22.0	20.5
Unit labor cost in manufacturing	6.0	0.5	-7.2	-4.0	-2.5	-2.5	-1.7	-0.9	-0.7	-0.7
Labor cost in manufacturing	4.8	5.1	1.4	3.0	-3.3	2.6	0.4	0.8	1.0	1.0
Employment growth	-0.5	-6.8	-2.3	-1.9	-4.4	-0.1	1.5	1.5	1.8	2.3
Labor force growth (percent) 2/	3.0	0.8	0.2	0.1	-0.2	0.1	0.2	0.3	0.2	0.4
Balance of payments (percent of GDP)										
Trade balance (goods)	-7.9	-4.0	-4.6	-3.7	-2.6	-1.0	-0.1	0.5	1.1	1.6
Current account balance 3/	-9.6	-4.8	-4.5	-3.5	-2.0	-0.1	0.7	1.3	1.8	2.2
Net international investment position	-79.3	-93.7	-89.8	-92.5	-94.4	-94.1	-90.9	-86.6	-81.8	-76.7
Public finance (percent of GDP)										
General government balance	-4.2	-11.2	-9.4	-8.9	-7.0	-5.7	-4.6	-3.9	-3.2	-2.8
Primary balance	-2.6	-9.4	-7.4	-6.5	-3.9	-1.7	-0.3	0.6	1.6	2.3
Structural balance	-4.9	-9.3	-7.6	-7.7	-5.7	-3.7	-2.8	-2.6	-2.4	-2.3
General government debt 4/	40.2	53.9	61.3	69.1	85.0	91.3	94.5	95.7	96.1	96.1

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

1/ IMF staff projections corresponding to the October 2012 WEO, unless otherwise noted.

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

3/ Capital account not included.

4/ WEO projection adjusted to reduce expected government borrowing for bank recapitalization from €100 billion to €40 billion following the bottom-up stress test results published on September 28, 2012.



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

(Percent or otherwise indicated)

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

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

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

2/ Including real estate developers.

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

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

5/ Senior 5 years in euro.

**Table 3. Spain: Monetary Survey, 2008–2017**  
(Billions of euros, unless otherwise indicated; end of period)

	2008	2009	2010	2011	Projections					
					2012	2013	2014	2015	2016	2017
Aggregated Balance Sheet of Other Monetary Financial Institutions (OMFIs) 1/										
Assets	3,409	3,447	3,471	3,621	3,560	3,319	3,288	3,277	3,284	3,335
Cash	9	9	8	7	7	7	7	7	8	8
Deposits at the ECB	54	35	27	51	35	27	21	12	8	6
Claims on other MFIs	218	217	211	203	203	192	186	182	177	178
Claims on non MFIs	1,924	1,906	1,936	1,887	1,830	1,737	1,719	1,737	1,781	1,838
General government	53	64	79	89	135	135	135	135	135	135
Private sector 2/	1,871	1,842	1,857	1,797	1,695	1,602	1,584	1,602	1,646	1,703
Corporates	952	915	896	840	776	726	715	723	746	775
Households and NPISH	880	873	876	857	817	776	765	773	788	811
Shares and other equity	93	99	103	163	176	167	162	157	153	150
Securities other than shares	412	515	520	544	562	557	556	554	554	556
General government	100	152	158	193	224	221	218	216	213	211
Claims on non-residents 3/	421	420	374	386	407	400	391	389	392	395
Other assets	278	245	293	381	341	231	246	238	210	205
Liabilities	3,409	3,447	3,471	3,621	3,560	3,319	3,288	3,277	3,284	3,335
Capital and reserves	242	270	283	367	448	418	414	413	414	420
Borrowing from the ECB	93	91	62	168	391	334	305	194	167	153
Liabilities to other MFIs	229	217	211	206	203	192	185	181	177	177
Deposits of non MFIs	1,656	1,694	1,728	1,650	1,486	1,424	1,435	1,461	1,504	1,558
General government	76	82	79	70	64	64	63	64	65	66
Private sector	1,580	1,612	1,648	1,581	1,422	1,360	1,372	1,397	1,439	1,492
Corporates	213	216	219	197	168	155	156	160	165	173
Households and NPISH	680	704	727	727	698	674	682	694	715	739
Debt securities issued	399	440	433	435	377	319	304	340	345	351
Deposits of non-residents 3/	505	508	512	493	349	331	343	384	373	369
Other liabilities	286	228	244	302	306	301	302	304	304	306
Money and Credit 4/										
Broad Money (M3)	1,181	1,163	1,140	1,121	1,111	1,106	1,125	1,152	1,181	1,211
Intermediate money (M2)	1,013	1,035	1,031	977	968	964	980	1,004	1,029	1,055
Narrow money (M1)	478	528	515	506	501	499	508	520	533	546
(Percent of GDP)										
Broad Money	108.6	111.0	108.7	105.4	105.0	104.5	104.0	103.5	103.1	102.6
Private sector credit	172.0	175.8	177.1	169.0	160.1	151.4	146.5	144.0	143.7	144.3
Corporates	87.5	87.3	85.4	79.0	73.3	68.6	66.1	64.9	65.1	65.7
Households and NPISH	80.9	83.3	83.6	80.6	77.2	73.3	70.7	69.5	68.8	68.7
Public sector credit	4.9	6.1	7.5	8.4	12.8	12.8	12.5	12.1	11.8	11.4
(Percentage change)										
Broad Money	10.1	-1.5	-2.0	-1.6	-0.9	-0.5	1.7	2.4	2.5	2.5
Private sector credit	6.4	-1.6	0.8	-3.2	-5.7	-5.5	-1.1	1.1	2.7	3.5
Corporates	6.6	-3.9	-2.1	-6.2	-7.7	-6.4	-1.5	1.1	3.2	4.0
Households and NPISH	4.8	-0.8	0.3	-2.2	-4.6	-5.0	-1.4	1.1	1.9	2.8
Public sector credit	23.5	22.1	21.9	13.6	51.2	0.0	0.0	0.0	0.0	0.0
<b>Memo items:</b>										
Loans to deposits (% of other resident sector) 5/	158.0	151.5	149.2	150.0	151.1	149.1	145.9	144.7	144.3	144.0
Retail deposits (% change) 6/	9.9	3.0	2.9	-2.3	-6.4	-4.2	1.1	2.0	3.0	3.7
Wholesale market funding (% change)	4.6	6.0	-8.8	-1.4	-20.2	-11.4	-1.4	12.0	-0.5	0.6
Wholesale market funding (% assets)	23.8	24.9	22.6	21.3	17.3	16.4	16.4	18.4	18.3	18.1
Capital and reserves (% total assets)	7.1	7.8	8.1	10.1	12.6	12.6	12.6	12.6	12.6	12.6

Sources: Bank of Spain; and IMF staff estimates.

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

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

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

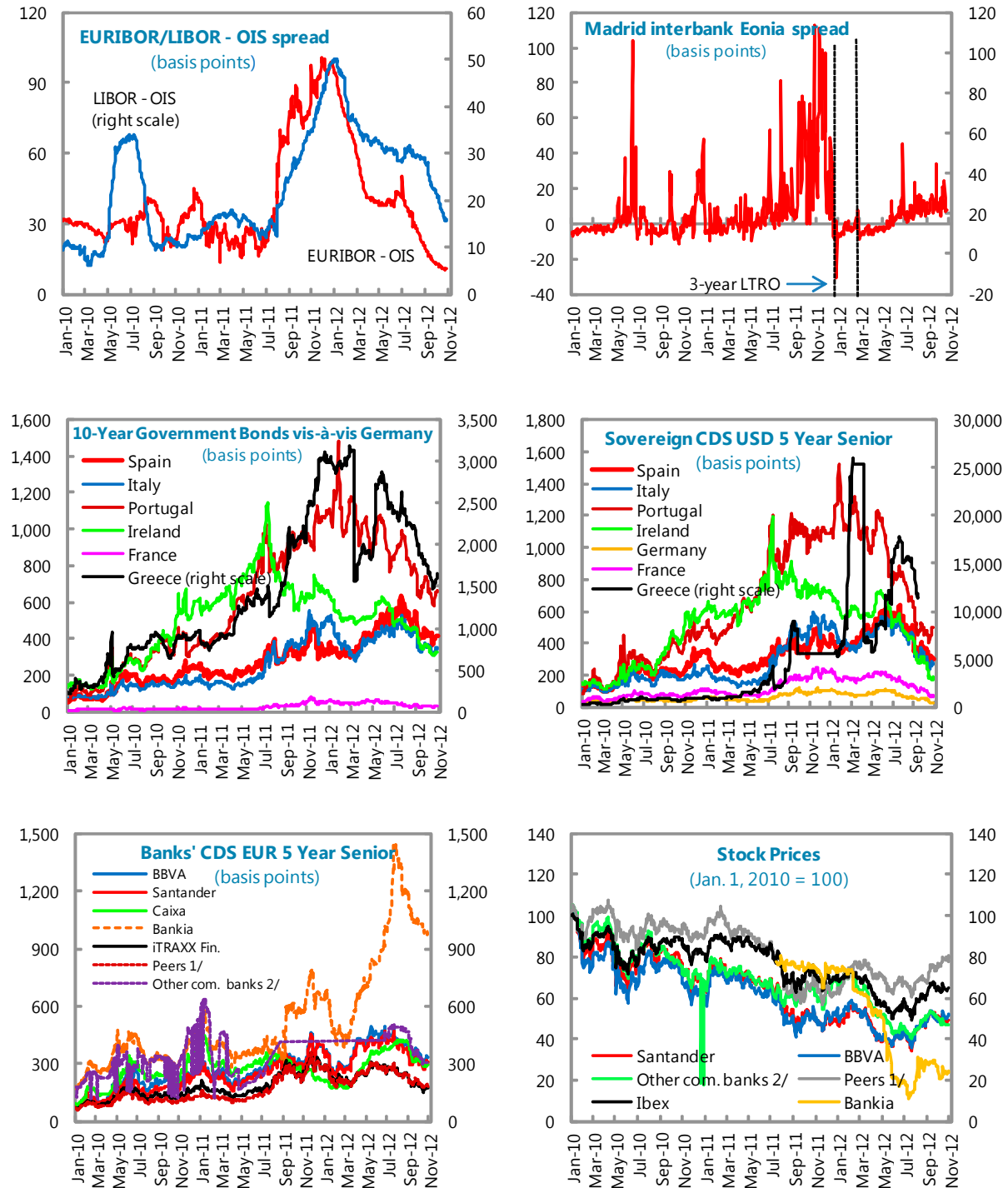
4/ Broad money (M3) comprises M2 plus repurchase agreements, money market fund shares and units as well as debt securities with a maturity of up to two years.

Intermediate money (M2) comprises M1 plus deposits with an agreed maturity of up to two years and deposits redeemable at notice of up to three months. Narrow money (M1) includes currency in circulation and overnight deposits.

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

6/ Deposits from households and nonfinancial corporations. More detailed information on deposit developments can be found in the BdE's quarterly economic bulletin, "Analysis of Recent Changes in Bank Deposits in Spain," September 2012.

**Figure 1. Spain: Financial Market Indicators**

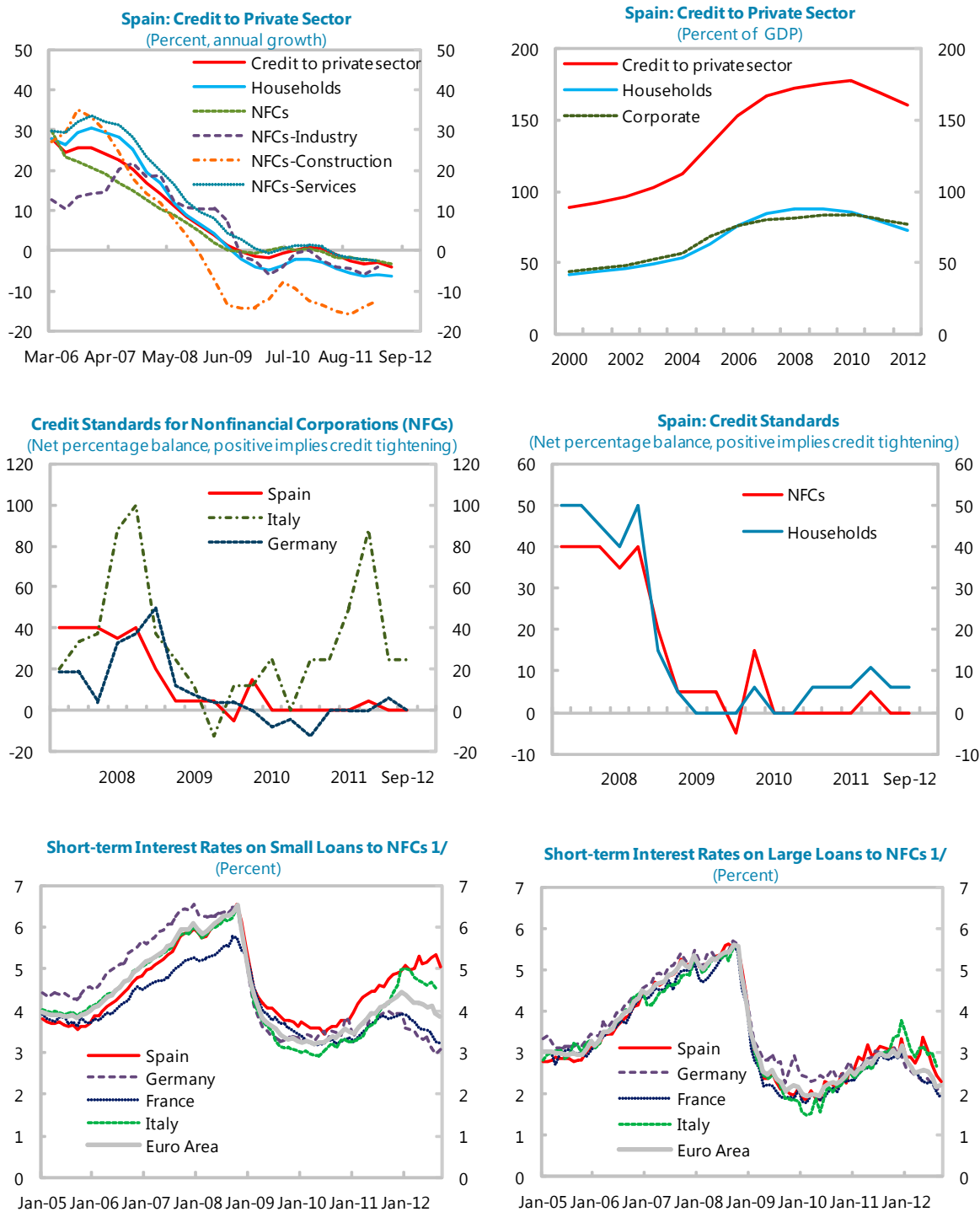


Sources: Bank of Spain; Bloomberg; and IMF staff estimates.

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

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

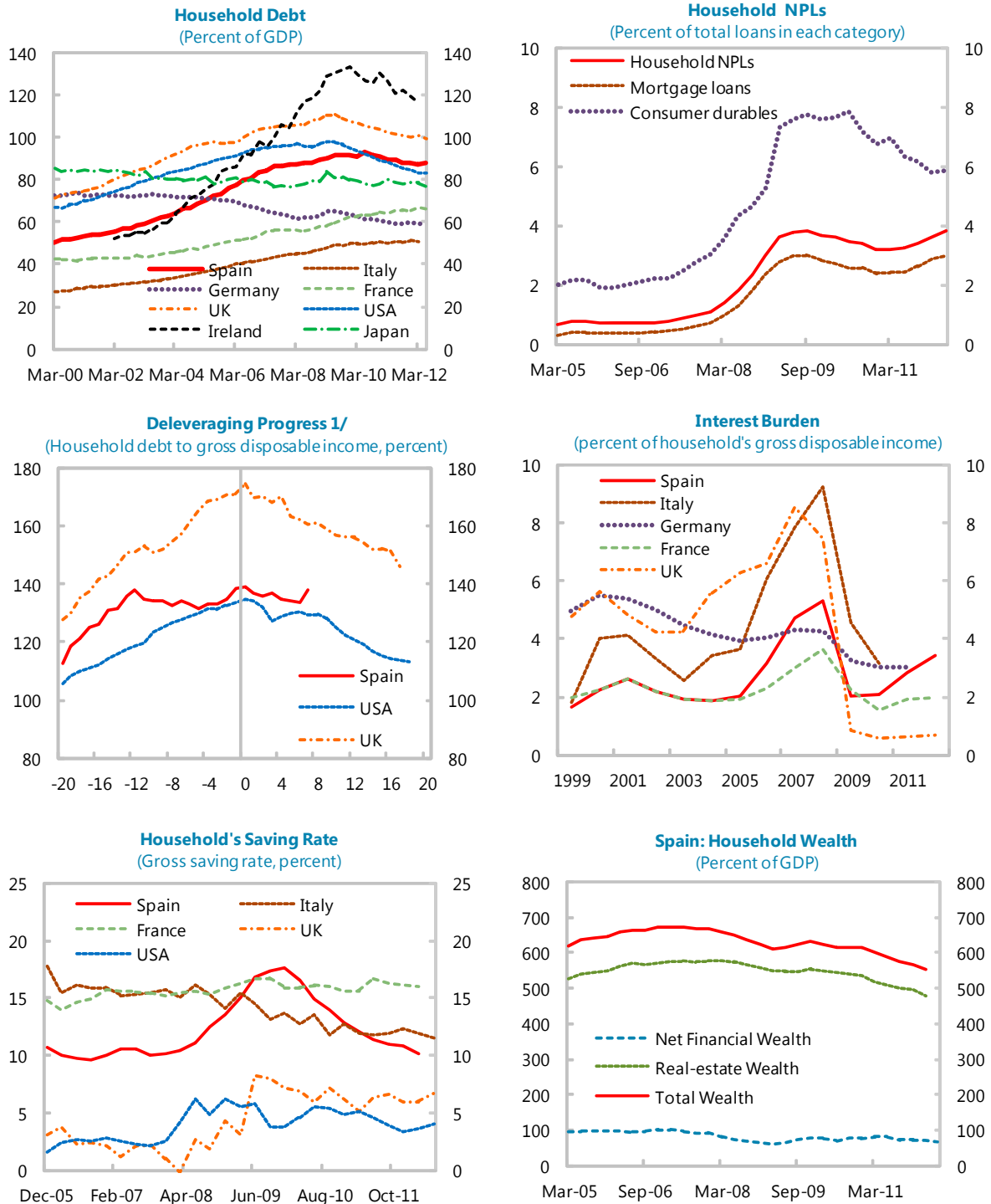
**Figure 2. Spain: Credit Conditions**



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

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

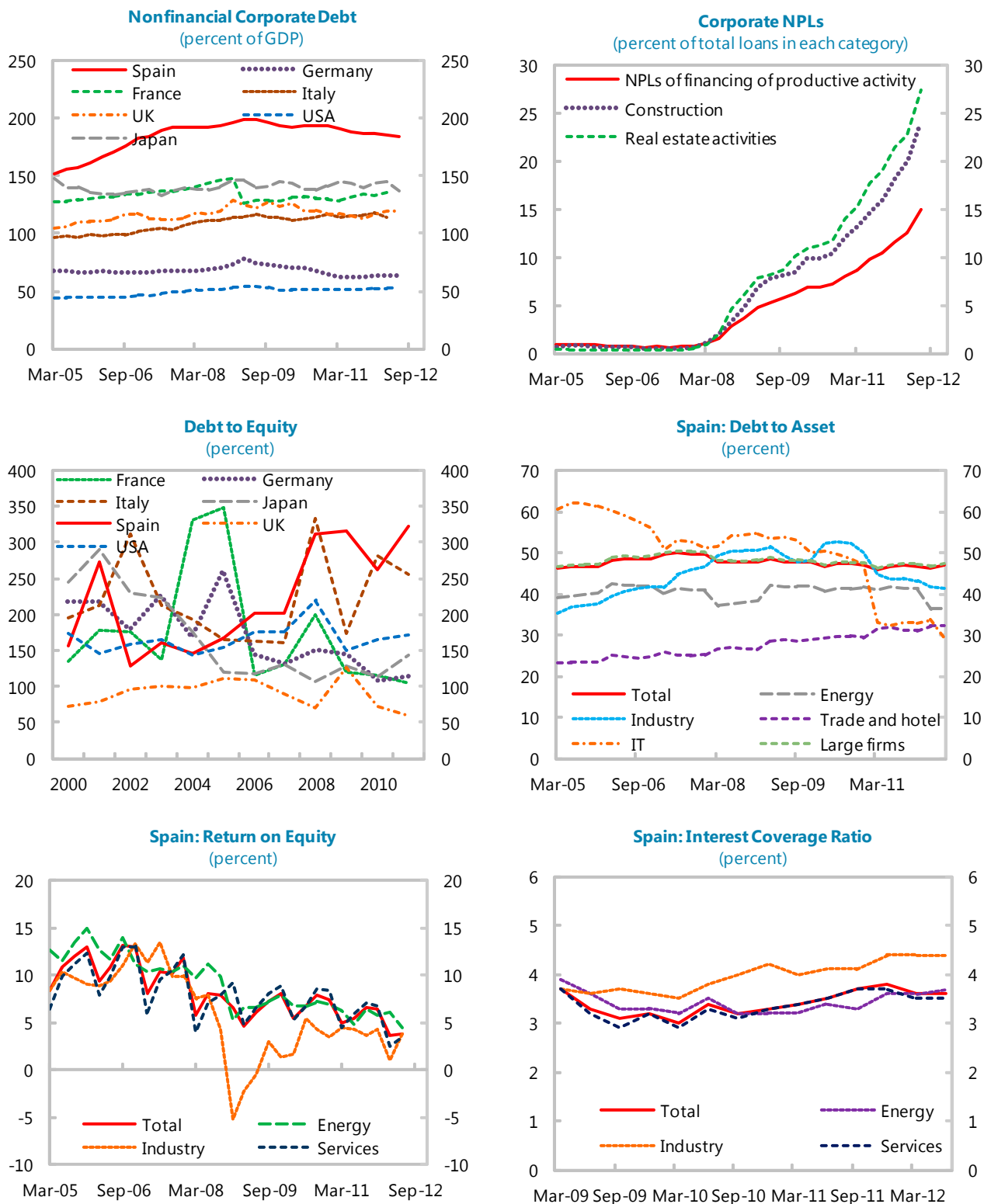
**Figure 3. Spain: Household's Financial Positions**



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

1/ Zero on the x-axis corresponds to the quarter in which the debt ratio peaked.

**Figure 4. Spain: Nonfinancial Corporate's Financial Positions**



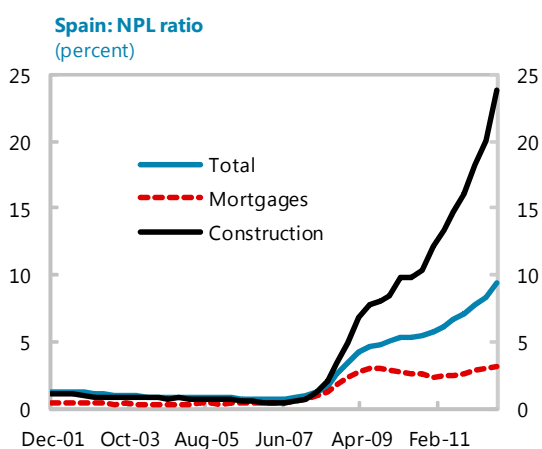
Sources: BdE; IMF's corporate vulnerability utility; and Haver.

## ANNEX I: BANKING SECTOR DEVELOPMENTS

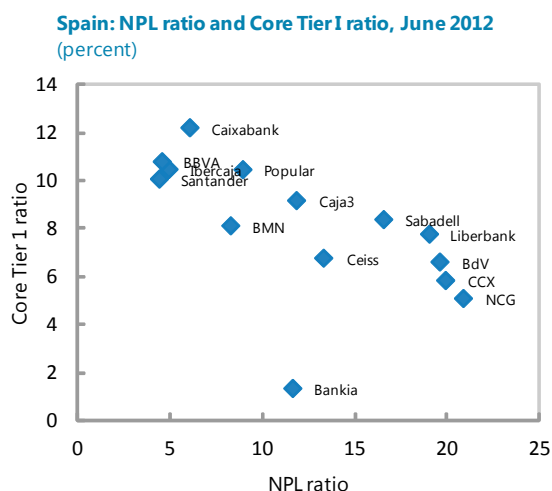
As expected, Spanish banks' financial profile continued to deteriorate during the summer of 2012, as an adverse macroeconomic environment and deflating real estate bubble drove mounting credit risk that drained credit reserves and absorbed a large chunk of pre-provision profits. The system is increasingly polarized, with the largest and geographically diversified banking groups having a better risk profile than the more domestically oriented. While the recent improvement in market conditions has eased funding conditions for the stronger banks, banks' liquidity remains a key risk that is mitigated only by extensive Eurosystem support. Given the expectation of future loan losses, it is imperative to swiftly recapitalize and restructure or orderly resolve the weakest banks, as envisaged under the financial sector reform program.

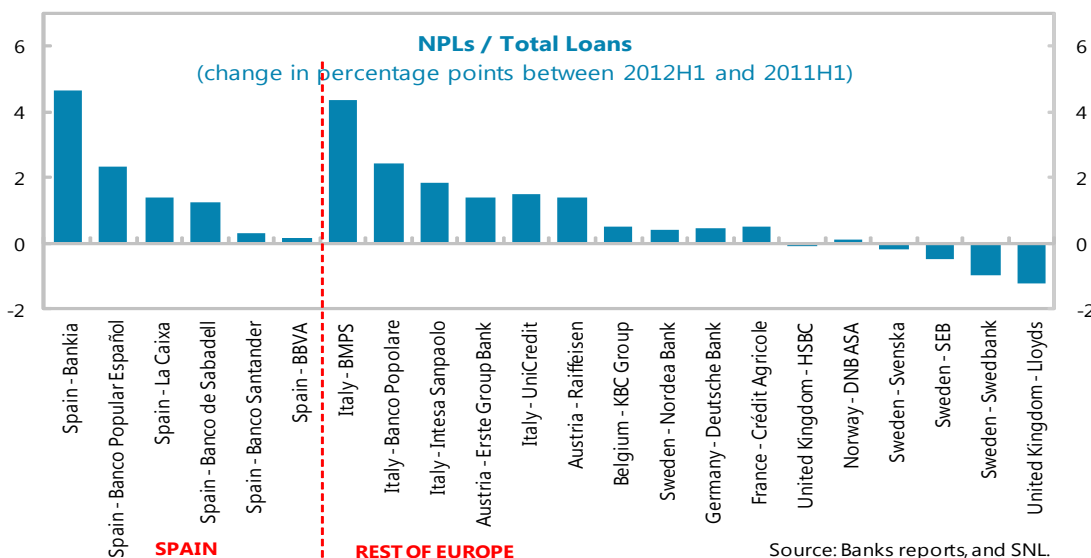
### Asset quality

**Ongoing economic contraction and strained private-sector balance sheets continue to weaken banks' asset quality at a rapid pace, albeit as expected.** The banking system's nonperforming loan (NPL) ratio reached 10.8 percent in August 2012—up from 8.4 percent in March and twice the NPL ratio from two years ago. Of this increase, 0.3 percentage points reflects recent reclassifications following the asset quality review undertaken as part of the financial sector reform program. NPLs continue to be especially high in the construction sector, where they now exceed 20 percent on average (a record high). In contrast, the NPL ratio for mortgage loans remains low at 3 percent, reflecting a relatively low loan-to-value ratio (62 percent on average, versus 100 percent in Ireland and 80 percent in the US), among other factors. The increase in NPLs during the last 12 months has varied significantly across banks.

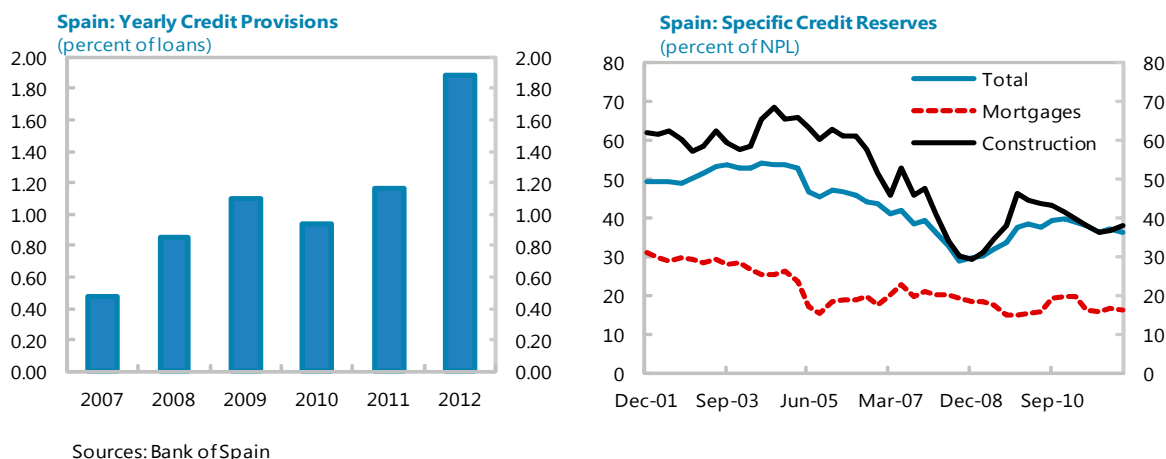


Sources: Bank of Spain





**Reserve coverage of NPLs remains below pre-crisis levels.** The stock of credit reserves has more than doubled over the last three years, to €59 billion in 2012, reflecting Spanish banks’ considerable effort to provision for bad loans. The yearly flow of new credit provisions increased significantly, from 0.4 percent of the stock of loans in 2007, to the current 1.8 percent (annualized). However, with NPLs rising sharply as well, the coverage ratio (specific credit reserves as a percent of NPLs) is, at 36 percent (18 percent for mortgages), still well below pre-crisis coverage ratios. This change is especially pronounced in the construction sector.



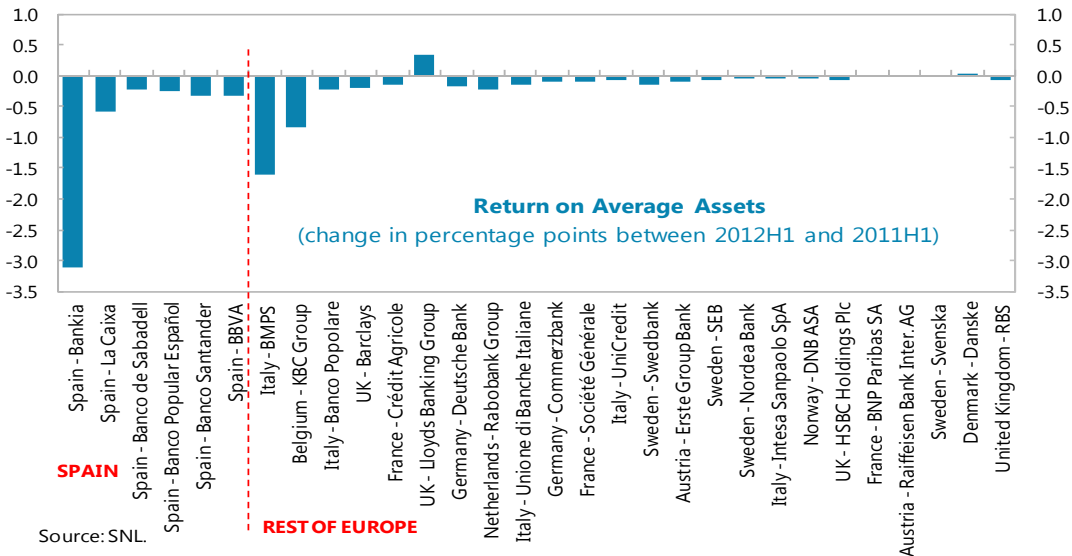
**The enactment of two RDLs is raising regulatory demands on banks’ credit reserves.** RDL 2/2012 forces banks to reach, by end-2012, minimum levels of specific provisions for problematic assets in the construction and development portfolios, ranging from 20 percent (for finished developments) to 80 percent (for land). The law also requires banks to build a generic provision on performing loans. RDL 18/2012 further increases the generic provisioning requirement on performing loans in the construction sector. All in all, the two RDLs will raise credit reserves on

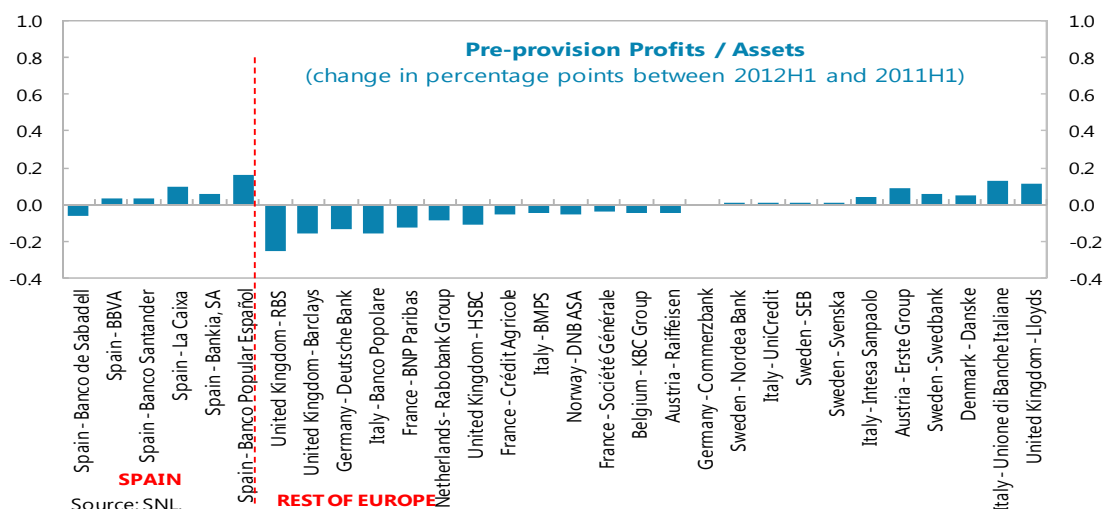


problematic loans in the construction sector to about 54 percent and on the performing portfolio to 30 percent, for a total estimated reserve increase of about €80 billion. These are welcome steps to promote financial sector resilience and reduce risks to taxpayers, even if in the near term they will further pressure banks' profitability and capital cushions.

**Profitability**

**The deterioration in asset quality is weighing heavily on banks' profitability.** Net income during the first half of 2012 fell for all banking groups in Spain, and the second part of the year will likely see many banks posting operational losses in their domestic businesses, due to the aforementioned credit provisioning entailed in the RDLs. On the positive side, banks benefited from cheap LTRO funding and restrained personnel and administrative costs. The geographically diversified banks also continued to enjoy strong profitability across their Latin American subsidiaries, which helped cover these banks' credit losses at home. Consequently, several banks did improve pre-provision profits in the first half of the year, despite lower business volumes and higher interest rates on customer deposits (reflecting tight competition for deposits given banks' limited access to wholesale funding markets). However, this was not enough to counterbalance new provisions on deteriorating loans, which on average doubled from a year ago.





### Capital buffers

**Capital adequacy ratios for the Spanish banking system as a whole have been near European averages (or slightly above) throughout the crisis, but vary significantly across banks.** Spanish banks (excluding those owned by the FROB) buttressed their average core Tier I capital ratio from less than 7 percent in mid-2008 to about 10 percent (including state support) as of end-June 2012, a level in line with the European average. Most of the recapitalization has been achieved through retained profits, conversion into equity of hybrid instruments, and below-par debt pre-payments. Some de-risking of banks' total assets has also taken place, partly reflecting the decline in credit to the private sector. Average levels mask, however, very different situations at the single bank level. Indeed, as discussed in detail in the main text, the independent asset quality review and stress test in September found that several banks require further significant capital injections to keep capital ratios above regulatory minima given the potential size of future credit losses.

### Liquidity and funding

**Deposits have declined significantly, although much less than what headline numbers suggest.** Foreign deposits have declined by €150 billion—about 4 percent of bank assets—since mid-2011, partly reflecting falling investor confidence and a drop in outstanding repos after the LTROs. Domestic deposit outflows persist, with some flight to quality, but about two-thirds of the decline is an artificial effect related to the accounting treatment of securitized bonds.<sup>10</sup> The drop of "true" domestic deposits was driven by a combination of weak household and firm financial positions and a temporary shift from bank deposits to commercial papers ("pagares") due to an

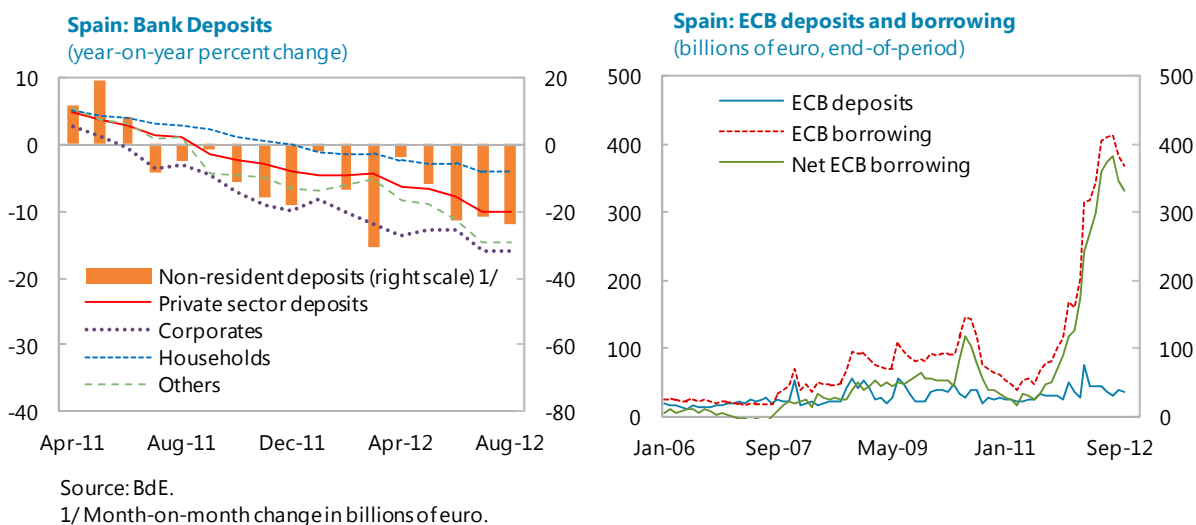
<sup>10</sup> Spanish accounting rules require that retained securitizations—securitization transactions in which the originator acquires all of the securities issued—to be recorded as both a security on the asset side and a deposit on the liability side of a bank's balance sheet. These securitizations can be used for ECB collateral. As collateral values declined in recent months, Spanish banks made early redemptions of such transactions, thus reducing these deposits on bank's balance sheets.

increase in deposit insurance premia (since reversed). With credit also contracting, the loan-to-deposit ratio has been broadly stable, though, at 150 percent, it remains high, indicating continuing liquidity risks for banks.

### Spain: Change in Spanish Deposits, Jul 2011-Aug 2012

	Change Jul 2011- Aug 2012
Change in Spanish Deposits	-356
Domestic deposits from private sector	-174
Household and Corporate	-62
Replacement of deposits by bank promisory notes	-30
Net decline of household and corporate deposits	-32
Securitization companies and funds	-113
Non-resident deposits	-181
Non-resident MFIs	-83

Source: BdE.



**Most banks continue to rely heavily on ECB liquidity support.** As noted in the main text, the stronger banks took advantage of the recent improvement in market conditions to tap international bond markets (albeit at a high price). Despite this bright spell, liquidity remains a key concern for most banks, especially as unencumbered assets eligible as collateral for obtaining ECB financing—while adequate for the system as a whole—have become more patchy in their distribution, leaving the weakest banks with little margin for maneuver. Moreover, collateral remains vulnerable to ratings downgrades and margin calls (Box A.1).

**Given these challenging conditions, strong implementation of Spain's financial sector recapitalization and reform program remains essential.** As discussed in the main text, steadfast implementation of this wide-ranging program should enhance Spanish banks' financial strength, increase market confidence, and help restore banks' market access.

### Box A1. Sovereign Ratings and Collateral Eligibility: ECB Rules and Current Situation in Spain

#### What are the ECB's rules for collateral acceptance?

For central government debt instruments posted as collateral, haircuts are applied depending on the credit quality, residual maturity, and type of coupon. For credit quality, the haircut on any given instrument rises by 5 percent once the sovereign rating drops below A-. If the sovereign rating drops below BBB-, central government debt instruments are no longer accepted as collateral.

The Eurosystem recognizes four rating agencies: DBRS, Fitch, Moodys, and S&P. For the definition of the credit quality threshold, the highest rating is taken into consideration. In the case of a sovereign under an on-track OMT-eligible program, the ratings thresholds for its central government debt instruments are waived and all such instruments are accepted as collateral, regardless of the ratings level.

#### What are Spain's sovereign ratings?

Spain Sovereign Ratings

	Long Term	Outlook	Date of last rating action	ECAF credit quality threshold 1/
DBRS	A(low)	Negative	8/8/2012	BBB
Fitch	BBB	Negative	6/7/2012	BBB-
Moody's	Baa3	Negative	10/16/2012	Baa3
S&P	BBB-	Negative	10/10/2012	BBB-

1/ ECAF= Eurosystem credit assessment framework.

#### What would happen in case of a downgrade?

Thanks to DBRS's rating in the A category, debt issued or guaranteed by the sovereign is still accepted with no additional haircut. If this rating were to fall to the B category, this would trigger a 5 percent additional margin call on Spanish government collateral used for ECB liquidity (€5-10 bn in margin). Downgrades below BBB- would not affect collateral eligibility unless all four rating agencies fell below this level.

#### When are the rating agencies likely to make their next move?

- Fitch indicated that a further downgrade may not be immediate: "Spain's sovereign ratings at 'BBB' are robust to some further deterioration" (June 7th press release).
- The other rating agencies have not given a precise timeline; rather, they link possible further downgrades to a further deterioration of the economy, increase in political risks, or loss of market access.

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

	<b>Measure</b>	<b>Deadline included in the July 20 MoU</b>	<b>Current status</b>	<b>Comments</b>
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	Improvements are ongoing; further progress expected in the near future.	Delayed start, with effective access in September
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	Submission of plans to EC completed; review by EC nearing completion.	No IMF staff involvement
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	Finalized	
4.	Provide information required for the Stress Test to the consultant, including the results of the asset quality review.	Mid-August 2012	Completed	

Measure	Deadline included in the July 20 MoU	Current status	Comments
5. Introduce legislation to introduce the effectiveness of SLEs, including to allow for mandatory SLEs.	End-August 2012	Completed as part of the August 31 <sup>st</sup> RDL	The framework is broadly in line with IMF staff advice; implementation will now be key.
6. Upgrade of the bank resolution framework, i.e. strengthen the resolution powers of the FROB and DGF.	End-August 2012	Completed as part of the August 31 <sup>st</sup> RDL	The framework is broadly in line with IMF staff advice; implementation will now be key.
7. Prepare a comprehensive blueprint and legislative framework for the establishment and functioning of the AMC.	End-August 2012	Completed on schedule	Key design features of the AMC have been defined and the legislative package is about to be completed
8. Complete bank-by-bank stress test (Stress Test).	Second half of September 2012	Completed on schedule in late September	Provides sound basis for proceeding with bank-specific plans

	<b>Measure</b>	<b>Deadline included in the July 20 MoU</b>	<b>Current status</b>	<b>Comments</b>
9.	Finalize a regulatory proposal on enhancing transparency of banks	End-September 2012	Proposal completed	
10.	Banks with significant capital shortfalls will conduct SLEs.	before capital injections in Oct./Dec. 2012	Will be part of the restructuring plans under preparation	
11.	Banks to draw up recapitalization plans to indicate how capital shortfalls will be filled.	Early-October 2012	Completed. The authorities' review of these plans was also completed in late October.	These plans were relied upon to distribute banks between Groups 2 and 3 on October 31, 2012.
12.	Present restructuring or resolution plans to the EC for Group 2 banks.	October 2012	Completed	These plans are now being reviewed.
13.	Identify possibilities to further enhance the areas in which the BdE can issue binding guidelines or interpretations without regulatory empowerment.	End-October 2012	Completed	The October 31 <sup>st</sup> report is now being reviewed by EC-ECB-IMF staff.

	<b>Measure</b>	<b>Deadline included in the July 20 MoU</b>	<b>Current status</b>	<b>Comments</b>
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	Completed	The October 31 <sup>st</sup> report is now being reviewed by EC-ECB-IMF staff.
15.	Adopt legislation for the establishment and functioning of the AMC in order to make it fully operational by November 2012.	Autumn 2012	Ongoing, expected to be completed in the next few weeks	High priority should be given to addressing implementation risks and establishing the right incentive structure.
16.	Submit for consultation with stakeholders envisaged enhancements of the credit register.	End-October 2012	Completed	
17.	Prepare proposals for the strengthening of non-bank financial intermediation including capital market funding and venture capital.	Mid-November 2012	A wide range of initiatives are being proposed	
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	Ongoing	



	<b>Measure</b>	<b>Deadline included in the July 20 MoU</b>	<b>Current status</b>	<b>Comments</b>
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	Ongoing	A roadmap for the eventual listing of banks will be included in the restructuring plans.
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	Ongoing	Faster progress may be needed to meet deadline
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	Ongoing	
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	Under consideration	

Measure		Deadline included in the July 20 MoU	Current status	Comments
23.	Issues CoCos under the recapitalization scheme for Group 3 banks planning a significant (more than 2% of RWA) equity raise.	End-December 2012	The two Group 3 banks are expected to cover their capital needs by end-December 2012.	CoCos could still be issued if Group 3 banks fail to meet their capital needs by year-end.
24.	Transfer the sanctioning and licensing powers of the Ministry of Economy to the BdE.	End-December 2012	Completed as part of the August 31 <sup>st</sup> RDL	BdE supervisory powers have been enhanced.
25.	Require credit institutions to review, and if necessary, prepare and implement strategies for dealing with asset impairments.	End-December 2012	Ongoing. Instructions ready, to be sent to banks soon	
26.	Require all Spanish credit institutions to meet a Common Equity Tier 1 ratio of at least 9% until at least end-2014. Require all Spanish credit institutions to apply the definition of capital established in the Capital Requirements Regulation (CRR), observing the gradual phase-in period foreseen in the future CRR, to calculate their minimum capital requirements established in the EU legislation.	1 January 2013	Requirements adopted as part of the August 31 <sup>st</sup> RDL	Additional technical details to be implemented by the BdE

Measure		Deadline included in the July 20 MoU	Current status	Comments
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	Completed as part of the August 31 <sup>st</sup> RDL	In line with IMF staff advice. The concrete role of the FROB in crisis management and its multiple roles will now need to be monitored to ensure that possible conflicts of interest are mitigated.
28.	Review the issues of credit concentration and related party transactions.	Mid-January 2013	Ongoing	
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	Completed	The general legal framework is good; enforcement and supervision remain now crucial, and effective sanctioning will be a powerful deterrent for the future.

Measure		Deadline included in the July 20 MoU	Current status	Comments
30	Amend legislation for the enhancement of the credit register.	End-March 2013	Preliminary review underway	
31.	Raise the required capital for banks planning a more limited (less than 2% of RWA) increase in equity.	End-June 2013	The two Group 3 banks are expected to cover their capital needs by end-December, 2012.	Implementation will be closely monitored.
32	Group 3 banks with CoCos to present restructuring plans.	End-June 2013	The two Group 3 banks are expected to cover their capital needs by end-December, 2012.	CoCos could still be issued if Group 3 banks fail to meet their capital needs by year-end, with the CoCos then converted into ordinary shares if not bought back by end-June 2013.