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Spain: Financial Sector Reform—Third Progress Report

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SPAIN

FINANCIAL SECTOR REFORM: THIRD PROGRESS REPORT

July 2013

Prepared by Staff of the

INTERNATIONAL MONETARY FUND*

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

PREFACE

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

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

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

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

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

The report is organized into two main sections:

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

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

EXECUTIVE SUMMARY

Implementation of Spain's financial sector program remains on track. The vast majority of measures specified in the program have now been implemented, as envisaged under its frontloaded timetable. Most notably, actions to recapitalize parts of the banking sector and the asset transfers to SAREB have provided an important boost to the system's liquidity and solvency. Major reforms of Spain's financial sector framework have also been adopted or are in train.

Notwithstanding this progress, risks to the economy and hence to the financial sector remain elevated. Correction of Spain's large external, fiscal, and financial imbalances is well underway, with policy actions at both the European and Spanish levels helping to ease market pressures over the last year. Nonetheless, further adjustment remains, and the process continues to weigh heavily on domestic demand, with output still shrinking and unemployment rising to record levels. Financial sector dynamics still contribute to recessionary pressures, with credit contraction accelerating, lending standards tightening, and lending rates to firms rising. Looking forward, growth may remain weak for some time unless further reforms to make the adjustment process less costly are adopted at both the European and Spanish levels. Further financial sector measures can significantly assist this effort, thereby supporting economic recovery and financial stability.

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

- ***Bank restructuring and resolution***. Much progress has been made in repairing banks' balance sheets. Further near-term priorities in this area include timely completion of burden-sharing exercises, which the authorities now expect to complete this summer, and the choice of strategies to maximize the value out of each state-owned bank under the FROB's control.

- ***SAREB***. SAREB's management is appropriately giving high priority to addressing technical challenges associated with its start-up phase, including the completion of due diligence on SAREB's assets and ensuring that these assets are properly serviced. However, SAREB's business plan could usefully be based on more conservative projections for house prices, as these are still falling sharply and further correction is likely. Such a change in assumptions may imply the need to adjust elements of the business strategy once the due diligence exercise has better identified the current market values of each asset. Another priority is to ensure that SAREB's governance arrangements sufficiently mitigate potential conflicts of interest.

- ***Ensuring adequate provisioning***. Accurate loan classification and provisioning for loan losses is key to ensuring balance sheet transparency and restoring full confidence in the system. By recognizing losses on distressed assets whether or not banks sell them, adequate provisioning also ensures that banks have proper incentives to dispose of these assets, which helps free space on their balance sheets to expand lending to the growing parts of the economy. In this context, the BdE's recent initiative to promote more consistent and accurate classification of refinanced loans is welcome.[1] Strong implementation of this exercise will be key to ensuring adequate provisioning.

- ***Maintaining capital***. The program has provided an important boost to the system's capital, such that all banks covered by the stress test exceeded regulatory requirements at end-March 2013 once the estimated effects of pending capital-augmentation measures (e.g., completion of burden-sharing exercises) are included. Nonetheless, with macroeconomic uncertainty still high, risks remain that banks may face pressure to support capital ratios by further accelerating credit contraction, with adverse effects on the economy. In this context, supervisory actions to strengthen solvency and reduce risks should prioritize measures that increase nominal capital over ones that reduce lending. Such measures include, for example, requirements to issue equity, as well as restrictions on cash dividends and bonuses, both of which should be tightly constrained given current risks. Consideration should also be given to increasing the quality of banks' capital via the conversion of banks' deferred tax assets (DTAs) into transferable tax claims, conditional on banks undertaking actions that have positive externalities in the current environment (e.g., more equity issuance, forgoing dividends for several years, stepping-up provisioning and disposal of distressed assets, and/or easing the pace of credit contraction). Bolstering the quantity and quality of capital through such measures should promote financial stability and help ease credit conditions and macroeconomic adjustment by both reducing banks' funding costs and increasing their capital buffers over regulatory requirements.

- ***Further measures to ease credit conditions and support recovery***. Efforts by the government to clear public sector arrears are welcome and should be furthered, as they promote financial stability by assisting the creditworthiness of suppliers and reducing their nonperforming loans. Other measures to explore include revenue-neutral tax reforms (e.g., less reliance on real estate transaction taxes) to reduce impediments to asset disposal.

- ***Measures at the European level***. Measures at the European level are also key to supporting growth and financial stability. This includes moving faster to full banking union, which would help break the sovereign/bank loop by allowing Spanish firms to compete for funds on their own merits, independent of their country of residence; continuing monetary support from the European Central Bank (ECB); and keeping state-aided banks' restructuring plans under careful review to ensure they are sufficiently flexible to changing circumstances and avoid any unnecessary constraints on the supply of credit.

- ***Savings bank reform***. The draft law to reform the savings bank system—a welcome reform aimed at enhancing these banks' governance and reducing risks to financial stability—has been transmitted to parliament. The priority now is to ensure timely adoption and strong implementation.

[1] For expositional ease, "refinanced" is used throughout this report to refer to refinanced and restructured loans. Under Spain's loan classification rules, a restructuring implies a situation of financial difficulty of the debtor.

Summary of Recommendations[2]

Bank restructuring and resolution

- Complete the remaining burden-sharing exercises by end-July, as currently planned (¶6).
- Decide on strategies for maximizing the value out of the state-owned banks remaining under the FROB's control (¶7).
- Keep restructuring plans under state aid rules under review to provide sufficient flexibility to changing circumstances and to avoid any unnecessary constraints on credit provision (¶16, ¶28).

SAREB

- Base SAREB's business plan on more conservative assumptions for real estate prices (¶9).
- Further assess how SAREB's balance sheet would evolve under a few key alternative scenarios and accordingly review its business strategies and develop contingency plans (¶10).
- Rigorously enforce conflict-of-interest rules (¶11).

Safeguarding financial stability and promoting economic recovery

- Continue close monitoring of financial sector health, including via rigorous and regular forward-looking scenario exercises on bank resilience to help guide supervisory decisions (¶18).
- Focus supervisory actions to bolster solvency and reduce risks on measures that, while boosting banks' capital situation, do not exacerbate already-tight credit conditions. This includes encouraging banks to prioritize capital building over distributions of cash dividends and bonuses (¶19-21).
- Consider establishing a mechanism to convert DTAs into transferable tax claims, conditional on the degree to which banks take actions that have positive externalities (¶22).
- Strongly implement the current review of banks' classification of refinanced loans so as to ensure adequate provisioning for these loans (¶23-25).
- Consider revenue-neutral reforms to reduce tax impediments to asset disposal (¶27).
- At the European level, move faster to full banking union and provide further conventional and unconventional monetary support (¶28).

Savings bank reform

- Ensure timely adoption and vigorous implementation of the draft law now in parliament (¶29).

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

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CONTENTS

THE MACRO-FINANCIAL CONTEXT

Recent macro-financial developments have been broadly in line with projections in past reports, as the economy continues to contract in the face of intense headwinds from the unwinding of pre-crisis imbalances. Nonetheless, financial markets have been broadly stable since the last monitoring report, with Spanish sovereign yields still well below their levels at the start of the program. Despite this positive market sentiment, the outlook for the real economy remains difficult.

1. **The economy continues to unwind large imbalances built up during the boom**:

- *Fiscal correction*: fiscal consolidation improved the cyclically-adjusted primary balance by 3 percent of GDP in 2012, the 2nd largest adjustment amongst advanced economies.[3]

- *House price correction*: house prices fell 6.6 percent (quarter-on-quarter), a record pace of decline, in the first quarter of 2013 and are now down more than 35 percent from their peak.[4]

- *External balance correction*: the current account was essentially zero in the four quarters through Q1 2013, up from a deficit of 3½ percent of GDP a year earlier and 10 percent of GDP on the eve of the crisis. This rapid correction reflects both strong export growth—due in part to improving competitiveness—and import compression amidst recession.

- *Private debt correction*: debt of nonfinancial corporations continues to decline as a percent of GDP as firms cut costs (including labor) and reduce investment to boost cash flows, allowing more debt repayment (Figure 1).

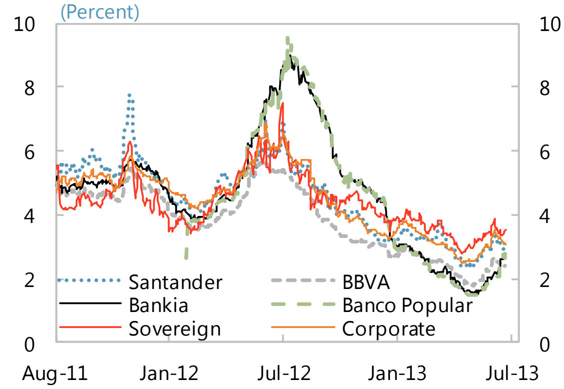
2. **These corrections are reducing associated imbalances, but also sharply compressing domestic demand**. Consequently and as expected, GDP contracted for the seventh consecutive quarter in Q1 2013 (-0.5 percent, quarter-on-quarter), pushing unemployment up to a record 27.2 percent, with youth unemployment reaching 57 percent. Falling incomes have depressed household saving rates and stalled the correction of households' aggregate debt-to-income ratio (Figure 2), despite rapid contraction of nominal credit to households (-4 percent, year-on-year). Such strains on private-sector balance sheets have helped push up the nonperforming loan (NPL) ratio, a trend that is likely to continue until output shifts decisively toward an upturn (Annex 1).

[3] Excludes financial sector support.

[4] Based on data from the National Institute of Statistics.

3. **Financial markets were bullish in early 2013, before experiencing some reversal and rise in volatility during May-June** (Figure 3). Yields on Spanish sovereign debt fell somewhat during the first part of 2013 before giving back some of these gains recently, with bank bond yields following a similar path. Equity prices for most of the largest banks are down somewhat for the year as of end-June (Figure 3).

Spain: 5-year Bond Yield
(Percent)



Source: Bloomberg.

4. **The economic outlook remains difficult**. Though much adjustment has occurred, significant adjustment remains, reflecting the magnitude of pre-crisis imbalances: major fiscal adjustment is still required to stabilize fiscal debt ratios, standard metrics of house prices suggest that house prices will fall further,[5] and household and corporate debt-to-GDP ratios are still well above pre-boom norms. Unless the adjustment process can be made less costly via measures at both the European and Spanish levels, economic growth in Spain may remain weak for some time. Consistent with this, IMF staff projections published in the July 2013 *World Economic Outlook Update* project growth of -1.6 percent in 2013 before turning flat in 2014. This difficult outlook—which is, on average, somewhere between the stress test's base and adverse scenarios—calls for continued economic reform and pro-active oversight of the financial sector to ensure that it can both weather this environment and ameliorate it by providing adequate credit conditions to support recovery.

Key Macro Variables
(annual rates, percent)

	Assumptions in Stress Tests									Latest IMF Staff			
	Base case				Adverse case				Actual	Forecasts 1/			
	2012	2013	2014	Average 2012-14	2012	2013	2014	Average 2012-14	2012	2013	2014	Average 2012-14	Comments on latest actual observation or forecast
Real GDP growth	-1.7	-0.3	0.3	-0.6	-4.1	-2.1	-0.3	-2.2	-1.4	-1.6	0.0	-1.0	Between base and adverse
Nominal GDP growth	-0.7	0.7	1.2	0.4	-4.1	-2.8	-0.2	-2.4	-1.3	-1.0	0.8	-0.5	Between base and adverse
Unemployment rate	23.8	23.5	23.4	23.6	25.0	26.8	27.2	26.3	25.0	27.2	27.0	26.4	Worse than adverse
Harmonized CPI growth	1.8	1.6	1.4	1.6	1.1	0.0	0.3	0.5	2.4	1.4	1.2	1.7	Near base case
GDP deflator growth	1.0	1.0	0.9	1.0	0.0	-0.7	0.1	-0.2	0.1	0.6	0.8	0.5	Between base and adverse
House price growth	-5.6	-2.8	-1.5	-3.3	-19.9	-4.5	-2.0	-8.8	-9.0	...	...	...	Between base and adverse
Land price growth	-25.0	-12.5	5.0	-10.8	-50.0	-16.0	-6.0	-24.0	...	...	...	...	...
Spain sovereign yield, 10-year	6.4	6.7	6.7	6.6	7.4	7.7	7.7	7.6	5.9	...	...	...	Better than both cases
Credit to households 2/	-3.8	-3.1	-2.7	-3.2	-6.8	-6.8	-4.0	-5.9	-3.5	...	...	...	Better than both cases
Credit to nonfinancial firms 2/	-5.3	-4.3	-2.7	-4.1	-6.4	-5.3	-4.0	-5.2	-8.0	...	...	...	Worse than adverse

Sources: Haver; Oliver Wyman; IMF staff estimates.
1/ Based on projections published in the July 2013 *World Economic Outlook* update.
2/ From the flow-of-funds data. Includes loans from resident credit institutions, off-balance-sheet securitized loans, and loans transferred to SAREB.

[5] Such metrics include house price-to-rent and house price-to-income ratios relative to their historical averages.

PROGRESS ON FINANCIAL SECTOR REFORM

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

A. Bank Restructuring and Resolution

5. **The program's process for identifying and addressing undercapitalized banks is almost complete**.

- In September 2012, an independent stress test of banks' balance sheets identified ten banks that were projected to face capital shortfalls. These banks were divided into three groups: Group 1 (banks with large capital needs that were already controlled by the Fund for Orderly Bank Restructuring, or FROB); Group 2 (banks that could not fill their capital shortfall on their own); and Group 3 (banks that could fill their capital shortfall through their own means). Banks in the first two groups were then either put in a process of resolution (if deemed non-viable) or restructuring (if deemed viable) in line with EU state aid rules.

- Capital shortfalls identified under the September 2012 stress test totaled €56 billion, or about 5½ percent of GDP.[6] These shortfalls have since been almost completely filled, mainly through injections of public capital invested in ESM bonds (see table below).

- Banks receiving state aid (Groups 1 and 2) were also required to transfer all of their foreclosed assets and real estate development loans (over a minimum size) to an asset management company (SAREB—see next section for more details). In exchange, these banks have received government-guaranteed SAREB bonds that can be used as collateral for ECB financing.

- This balance sheet clean-up has provided a major boost to the financial system's capital and liquidity. All banks covered by the stress test exceeded minimum regulatory capital requirements (CT1 of 9 percent) at end-March 2013 once the estimated effects of pending capital augmentation measures are included. These banks also now have significant excess collateral for purposes of ECB financing.

- Nonetheless, the system is still exposed to large risks given the difficult macroeconomic environment (Annex 1).

[6] Shortfalls were relative to a benchmark of a 6 percent CT 1 capital ratio by end-2014 under an adverse scenario. Using a 9 percent CT1 ratio instead would add 5 percent of GDP to the estimated shortfall.

Expected Measures to Meet Spanish Banks' Capital Shortfall

(Millions of euros)

	Bank name	Oliver Wyman capital shortfall	Measures Expected to Be Taken to Meet Capital Shortfall 1/						
			Injection of public capital 2/	Issuance of new private equity	Capital augmentation through SLEs	Reduction in capital need from transfer of assets to SAREB	Reduction in capital need from sale of assets	Reduction in capital need from revaluation of assets	Other 3/
Group 1	BFA-Bankia	24,743	17,959	0	6,593	191	0	0	0
	Catalunya Banc	10,824	9,084	0	1,553	188	0	0	0
	Nova Caixa Galicia	7,175	5,425	0	2,027	-276	0	0	0
	Banco de Valencia 4/	3,462	4,500	0	426	208	0	0	0
Group 2	Banco Mare Nostrum 5/	2,208	730	0	182	382	851	0	63
	Liberbank	1,197	124	0	714	145	215	0	0
	CEISS	2,062	604	0	1,196	263	0	0	0
	Caja3	779	407	0	36	228	0	108	0
Group 3	Banco Popular	3,223	0	2,500	0	0	328	85	332
	Ibercaja	225	0	0	0	0	150	0	93
	Total	55,898	38,833	2,500	12,727	1,329	1,544	193	488

Sources: Bank of Spain; FROB.

1/ Figures are only estimates, as some operations, such as subordinated liability exercises (SLEs), are still ongoing and not yet final.

2/ State aid (injections of capital and cocos by the FROB). For BFA-Bankia, €4,500 million was already contributed by the FROB in September, 2012.

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

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

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

6. **Burden-sharing exercises at a few banks are the main unfinished elements of the recapitalization plans**.

- To reduce the cost to taxpayers of recapitalization, burden-sharing exercises are bailing-in the affected banks' common equity (largely wiping it out) and hybrid debt (via haircuts on its face value, with the remaining amount converted into common equity or, in some cases, senior debt). The deposit insurance scheme has also announced that, for retail investors, it will offer to purchase the common equity resulting from bail-in operations of the two non-listed G1 banks (NCG and Catalunya Banc) at a discount of 13.8 percent against the equity's economic value. Given this and the market prices of listed banks (as of June 20), the effective final haircuts on the original face value of bailed-in hybrid debt range from 10 to 90 percent, with this variation reflecting factors such as the degree of a bank's undercapitalization.

- The bulk of these conversions, which are expected to fill more than 20 percent of the capital shortfall, are now complete, including those for the largest state-owned bank (Bankia). Exercises for four banks are still ongoing, accounting for the final ¼ percent of GDP of planned recapitalization measures, which the authorities now expect to complete by end-July, well behind the original end-2012 deadline (Annex II, measure 10).

- To allow completion of burden-sharing exercises, the authorities have extended the legal authority to undertake them—which initially expired at end-June 2013—to end-December 2013. Further extension of these powers to be effective until Spain fully introduces resolution powers under the forthcoming EU directives would ensure the absence of any time gap during which the authorities would lack resolution powers.

- Litigation based on allegations that instruments subject to burden-sharing were originally mis-sold is likely to be ongoing for some time. So far, the authorities have put in place arbitration processes (for Group 1 banks) to try to address mis-sale allegations in an efficient and orderly manner. Nonetheless, the potential costs of ongoing litigation should be closely monitored, with contingency plans developed to ensure that banks remain adequately capitalized under all plausible scenarios.

7. **The authorities are developing strategies to maximize the value out of each state-owned bank that the FROB controls**. For some state-controlled banks, the near-term direction is fairly clear (e.g., Bankia is expected to remain under the control of the FROB for the foreseeable future). For other banks, however, a firm decision on the process and timing of their sale to the market has not been taken. Such decisions and any follow-through actions should ideally occur in the near future, as uncertainty surrounding the outcome of this process may adversely affect some of the state-owned banks' business conditions during the interim, ultimately increasing taxpayers' costs. However, such considerations must also be balanced against the need to consider all options carefully and to maintain sufficient discretion to respond appropriately to changes in market conditions.

B. SAREB

8. **SAREB's opening balance sheet is now complete**:

- ***Real estate assets*:** Nearly 200,000 real estate-related assets were transferred by Group 1 (€36.5 billion) and Group 2 (€14.1 billion) banks in December 2012 and February 2013, respectively and as scheduled. On average, the transfer price was 47 percent of the gross book value.

- ***Capital***: Initial capital was €4.8 billion, of which €1.2 billion is equity and €3.6 billion is subordinated debt (15-year callable convertible bonds). This is 8.7 percent of the assets transferred, slightly higher than the targeted 8 percent. The FROB owns 45 percent of the equity and 46 percent of the subordinated debt; 27 private investors own the rest.

- ***Senior bonds***: In exchange for their assets, banks received listed, floating-rate, government-guaranteed senior bonds issued by SAREB with maturities of 1-3 years. The bonds are eligible collateral in the Eurosystem's monetary policy operations, where they are valued close to par, and have been used as collateral in repos with Spain's Treasury. The use of these bonds as repo collateral with private counterparties and their outright sales have been negligible.

- ***Due diligence***: SAREB expects the due diligence on its assets to be completed in the summer. This exercise will enable SAREB to better value its assets and design its liquidation strategies. Consultants and law firms are supporting SAREB's management in this thorough exercise, which includes four work streams: (i) assessment of the legal documentation supporting the acquired assets; (ii) valuation of real estate assets and loan collateral; (iii) review of transfer prices based on asset classification; and (iv) establishment of data- and documentation-management tools.

9. **The due diligence should shed light on SAREB's ability to achieve the targets in its business plan**.

- SAREB's Board of Directors adopted the business plan on March 21. Despite small expected losses in 2013 and 2018, the plan projects an internal rate of return for SAREB's shareholders of 13 percent on average over the lifetime of the vehicle (15 years).

- This high projected return hinges on three main assumptions:

    i) SAREB acquired its assets at competitive prices because they were on average consistent with the stress test's adverse scenario;

    ii) SAREB can deploy a well-diversified mix of liquidation strategies, including the development of rental businesses, and thus adjust to evolving market conditions; and

iii) House prices will only fall modestly in 2013 and 2014, stabilize in 2015-2016, and then gradually increase.

- The validity of the first assumption will become clearer once the due diligence is completed this summer. Preliminary results show a large dispersion of the asset valuations around the transfer prices (i.e., SAREB probably paid above market prices for some assets and below market prices for others). SAREB should be ready to adjust its liquidation strategies, including its sales prices, based on the outcome of the due diligence.

- The third assumption appears optimistic, as most standard metrics of house price valuation (e.g., price-to-rent and price-to-income ratios relative to their historical averages) imply that significant further correction of house prices is likely. Incorporating more conservative assumptions on future real estate prices would be advisable. Such a change in assumptions may imply the need to adjust elements of the business strategy once the due diligence exercise has provided better estimates of the current market value of each asset.

10. **Further contingency planning could be helpful, given high macroeconomic uncertainty**. SAREB has buffers to absorb some negative shocks, including a large cash balance and its ability to adjust liquidation strategies. Nonetheless, the prices and the pace of SAREB's sales as well as the performance of the loans in SAREB's portfolios depend on the highly uncertain macroeconomic outlook. Various other risks, such as changes in the legal environment (e.g., a recent regional law weakening mortgage creditor rights) or new operational challenges could erode SAREB's cash flows, profitability, and capital. Therefore, SAREB could usefully deepen its analysis of how its balance sheet would evolve under a few key alternative scenarios and accordingly review its business strategies and develop contingency plans.

11. **SAREB's internal organization is progressing, though it is still working through technical challenges associated with its start-up phase**.

- ***Servicing agreements***: SAREB and the participating banks have signed agreements that specify procedures, key performance indicators, fees, and penalties aimed at ensuring that the participating banks adequately service the transferred assets. Servicers have ample margins of action for the numerous small assets transferred to SAREB, while SAREB´s own organization focuses on the larger assets.

  However, the implementation of these agreements has proven problematic, mostly due to delays in the activation of the IT, operational, accounting, and information flow arrangements. These delays might have been exacerbated by the fact that some participating banks appear to have put their servicer units up for sale. Such sales could eventually promote quality servicing of SAREB's assets if the units are bought by strong servicers. However, there are also risks that sales of these units could increase conflicts of interests if the buyers are active in the liquidation of their own real estate assets in Spain.

In this context, SAREB should ensure that it has an appropriate strategy in place for maximizing the quality of the servicing of its assets.

- ***Vendor financing***: Such financing (provided to buyers of SAREB's assets) could facilitate the sale of SAREB's assets. The servicing agreements include a framework for vendor financing, while the specific parameters of such framework have been included in bilateral agreements between SAREB and the servicers. SAREB should also continue pursuing vendor financing agreements with banks outside the G1 and G2 perimeter (the first such agreement was signed in June 2013), in order to further improve the terms and increase the amount of available vendor financing.

- ***Staffing and organization***: While SAREB's top management team is complete, SAREB's internal organization and staffing is still a work-in-progress and is expected to be completed by the third quarter of 2013.

- ***Conflict of interest***: SAREB's bank shareholders could be subject to perceived or real conflicts of interest, as these banks are also in the process of selling part of their real estate portfolios and may also be purchasers of SAREB's assets. In order to address these issues, on March 21 SAREB's Board of Directors adopted a policy on conflicts of interest, which reinforces the conflict-of-interest rules under Spain's general corporate regime. The new policy foresees that the directors will neither be able to access information nor contribute to the decisions on assets for which they could be in a conflict of interest. The rigorous enforcement of these rules will enhance SAREB's profitability. More generally, the potential for conflicts of interest should be monitored closely and appropriately addressed, including if necessary by further revising governance arrangements.

12. **Mechanisms have been established to promote the continued flow of credit to profitable companies whose loans have been transferred to SAREB**. First, SAREB has been given the authority to roll over performing maturing loans and will do so on a case-by-case basis, using standard commercial criteria. Second, SAREB can decide (and in some cases is contractually obligated) to allow participating banks to lend the undrawn portion of performing credit lines that have been transferred to SAREB. In these cases, banks will be able to transfer this additional credit to SAREB in exchange for either cash or new government-guaranteed SAREB bonds, with the choice between these instruments being at SAREB's discretion.

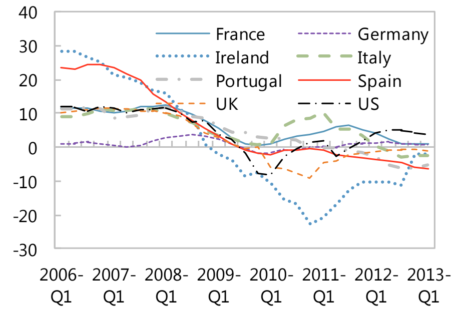
C. Credit Conditions

Recent developments

13. **Financing conditions for Spanish firms and households remain difficult**. The bank clean-up and complementary measures at the European level (e.g., OMT) have averted a disorderly unwinding of a significant part of Spain's financial system. Although this very adverse scenario for credit conditions and the economy has been avoided, credit conditions nonetheless remain tight amidst intense headwinds from the unwinding of pre-crisis imbalances and Spain's

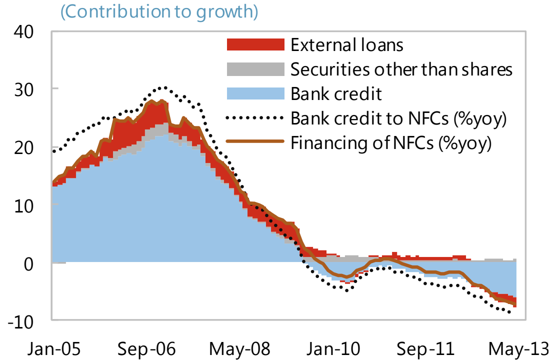
resultant recession. More specifically, the contraction of bank credit to the private sector accelerated in the first part of 2013, reaching -7 percent in May (year-on-year, adjusted to remove the effects of asset transfers to SAREB), while lending rates to businesses rose further to levels well above those in the euro area core (Figure 4). The picture is similar for total credit to the private sector from all sources, as nonbank financing in Spain is negligible. The pace of credit contraction in Spain has been one of the fastest among advanced economies.

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



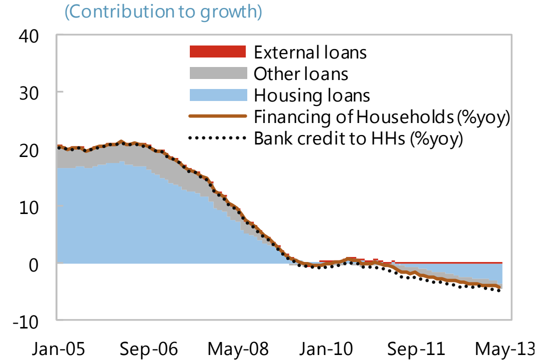
Sources: Haver, BdE
1/ Numbers for Spain are adusted to remove the effect of the transfer of loans to SAREB.

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



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

Spain: Financing of Households
(Contribution to growth)



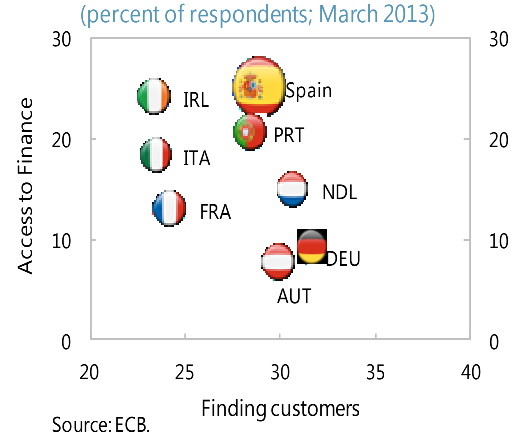
Source: BdE.

14. **Credit contraction reflects both supply and demand factors**. Weak demand due to the ongoing recession and the desire of households and firms to delever is undoubtedly a major driver of credit contraction. At the same time, some key indicators suggest that shocks to credit supply have also been important:[7]

- ***Rising lending rates***. Higher lending rates indicate a significant adverse shock to credit supply, as adverse shocks to demand should reduce interest rates.

- ***Survey data***. The percent of firms citing "access to credit" as their most pressing problem is higher in Spain and the rest of the periphery than in the euro area core. This occurs despite the periphery's larger deleveraging needs (which should reduce

SMEs' Most Pressing Problem
(percent of respondents; March 2013)



Source: ECB.

[7] The discussion in this report defines reduced creditworthiness of borrowers as a supply factor, as changes in borrower creditworthiness causes the credit supply curve to shift (i.e., it changes the amount of credit that banks are willing to lend at any given interest rate).

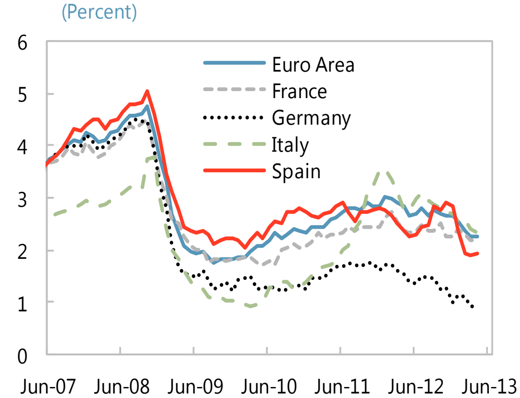
firms' demand for credit, making access to finance less of a concern) and deeper recession (which should make "finding customers" SMEs' most pressing problem if falling credit is driven entirely by weak demand).

15. **Tight credit supply reflects various interrelated factors, the relative importance of which are difficult to quantify with any precision**. These include:

- ***Reduced creditworthiness of borrowers***. A major factor behind banks' reduced willingness to lend is the lower creditworthiness of borrowers, whose balance sheets have been hit by the recession. That said, this factor cannot completely explain tighter credit supply, as banks indicate in surveys that they continue to tighten lending standards to new highs, even holding the borrower's degree of creditworthiness constant (Figure 4).

- ***Funding costs***. Banks' wholesale funding costs fell significantly following OMT-related announcements last summer, as noted in the previous section. However, rates on retail deposits—banks' primary funding source—did not start to fall significantly until early 2013. Since then, deposit rates have fallen sharply in response to (i) large injections of liquidity and capital under the program and (ii) reduced price competition among banks for deposits following expressions of concern by the BdE that such competition and the resulting upward pressure on deposit rates could have a significant adverse effect on banks' profits and, eventually, capital.

Deposit Rates 1/
(Percent)



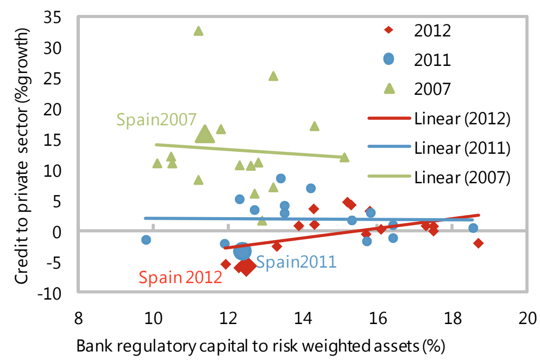
Source: ECB.
1/ All maturities, weighted average, for new deposits by households and NPISHs.

Although the transmission of lower deposit rates into lower lending rates is not yet evident, this may just reflect transmission lags. Alternatively, banks' decisions to compete less vigorously for deposits may have reduced the importance of deposits as a source of funding for new lending at the margin. As a result, the drop in deposit rates may not significantly reduce banks' marginal cost of funding and hence may not significantly affect lending conditions.[8] Banks' marginal funding cost could instead rise if their marginal funding source switches to more expensive types of financing. Banks' marginal borrowing costs could rise further if ECB term funding facilities are phased-out, eliminating this relatively cheap source of term financing.

[8] This assumes that banks' lending rates depend mainly on their marginal cost of funding rather than their average cost. However, even if lower deposit rates are not passed through into lower lending rates, banks' profitability will improve. Over time, this should increase capital, which could help ease lending conditions.

- ***Capital***. All Spanish banks are expected to be above regulatory minima once burden-sharing exercises are fully completed (Annex 1). Nonetheless, banks still face pressure to continue supporting capital ratios, including through deleveraging, given the need for ongoing provisioning for bad assets, high macro uncertainty, and market pressure on banks to reach Basel III capital standards well ahead of schedule. Indeed, lending growth has become more correlated with bank capital levels during the crisis (text chart below). Although this correlation could simply reflect that contractionary economic environments tend to produce both weaker credit growth and less buoyant capital ratios, it is less clear why this relationship should have strengthened during the crisis. In contrast, pressure on banks to improve their capital ratios has clearly increased during the crisis, strengthening the effect of capital levels on lending decisions. The chart also indicates that Spain's banking system has relatively low capitalization when measured against risk-weighted assets. Spain's system performs better in terms of leverage ratios, as it has a relatively high ratio of risk-weighted assets to total assets.

Bank Capital and Credit to Private Sector 1/
(Percent RWA, and percent growth)



Sources: Haver, IMF *Financial Soundness Indicators*, and IMF staff estimates.
1/ Sample includes 16 euro area countries, the UK and US. End-2012 data for Spain are augmented by projected proceeds of SLEs and G2 recap.

Outlook

16. **Banks' projections of their quarterly balance sheets provide some information regarding the future evolution of credit**. As envisaged under the MoU (Annex II, measure 21), the BdE compiled a first version of these projections, or Funding and Capital Plans (FCPs), and shared them with international partners. Banks' projections for credit contraction are broadly in line with those of the BdE and IMF staff in aggregate, with significant differences between G1/G2 banks (which target rapid credit reduction, as required under their restructuring plans) and G0 banks (which project a much milder pace of credit contraction). This projected rebalancing of credit growth across banks does not appear to have materialized in Q1, as the pace of credit contraction to the private sector (excluding RED loans) for the two groups of banks was essentially identical and faster than the contraction projected for aggregate credit to the private sector in the FCPs. Although quarterly data can be noisy and should be interpreted with caution, the Q1 data point to risks that G0 banks may be unable to increase their market share of lending as much as envisaged. If G1/G2 banks are unable to pick up the slack due to limits on their lending under their restructuring plans, credit to the economy will contract faster than expected. In such a scenario, restructuring plans may need to be revisited to remove any unnecessary constraints on lending (conditional on maintaining the key goal of returning banks to viability), with the planned pace of ECB repayments also eased.

D. Safeguarding Financial Stability and Supporting Economic Recovery

17. **A set of mutually-reinforcing actions in the financial sector can help safeguard financial stability and promote faster economic recovery**. Actions taken by the authorities under the ESM-supported program have helped tackle the legacy risk from the real estate boom-bust, but macroeconomic risks still loom large. The challenge now is to ensure that policies push the economy and financial system into the virtuous circle—in which reduced funding costs bolster profitability and capital, thereby facilitating easier credit and more balance sheet transparency, which in turn pushes up growth and confidence, yielding yet lower funding costs—and away from the vicious circle in which these dynamics operate in reverse. The measures below aim to assist these ends.

Enhanced monitoring

18. **Continued close monitoring of financial sector health is key to safeguarding the program's gains**. Toward this end, and as noted in past progress reports, the BdE plans to develop rigorous and regular forward-looking scenario exercises on bank resilience to help guide its supervisory decisions—an approach that is welcome. The BdE is making steady progress toward this end through its ongoing technical work.

Ensuring sufficient capital

19. **Risks to capital persist**. Ongoing provisioning needs, high macro uncertainty, legal risks (e.g., mis-sale litigation), and market pressure on banks to adopt Basel III capital levels early all raise risks that banks may face pressure to support capital ratios by further accelerating credit contraction, with adverse effects on economic growth.[9]

20. **In this context, supervisory actions to strengthen solvency and reduce risks should focus on boosting banks'nominal capital (the numerator of banks' capital ratios) to avoid exacerbating already-tight credit conditions**. Such actions could include requirements to issue equity and restrictions on cash dividends and cash remuneration, among others. Such an approach has several advantages:

- Bolstering capital in this way should help ease credit conditions by reducing banks' funding costs and increasing their usable capital space over regulatory minima. For the same reasons, such efforts would also reduce financial stability risks.

- For banks with market access, new equity issuance is the fastest path toward capital-building and should be strongly encouraged. Gains from other measures can also be significant, especially if sustained over time. For example, the percentage of dividends paid in shares by Spain's largest banks has risen since the start of the crisis (2008), with

[9] Another example of legal risks is the recent Supreme Court ruling declaring that interest rate floors on many variable-rate mortgages are illegal.

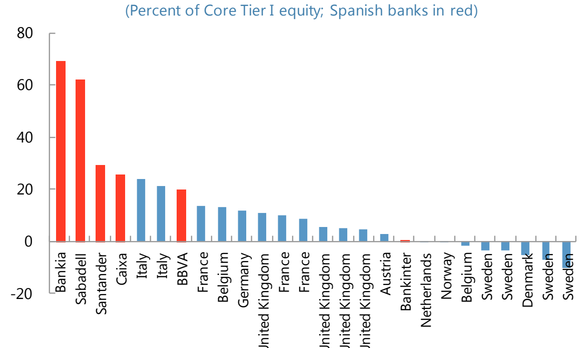
the cumulative amount of this additional capital exceeding these banks' current capital buffers over regulatory minima. Had these banks gone even further and paid all dividends in shares rather than cash during this period and assuming for simplicity no other changes in the evolution of these banks' balance sheets, these banks would already meet Basel III capital requirements, fully loaded.[10]

- Encouraging banks to provide a higher proportion of employee remuneration in the form of bank equity (for more senior employees) could not only support bank capital, but also lessen corporate principal-agent problems by better aligning employee and shareholder interests, especially if the equity is not redeemable or transferable for several years to ensure that managers' incentives are to maximize their bank's longer-term economic value. Limits on cash remuneration also prevent major shareholders who are also bank executives from circumventing limits on cash dividends via higher wage/bonus payments.

21. **In the direction of this approach, the authorities recently advised banks to limit cash dividends**. On June 27, 2013, the BdE sent a letter to banks recommending that dividend distributions be limited and that, in any event, cash dividends paid this year not exceed 25 percent of attributable consolidated profit.

22. **The conversion of Deferred Tax Assets (DTAs) into transferable tax claims could further support capital**. DTAs reflect factors such as past negative profits that can be carried forward to reduce future profits for tax purposes. DTAs are a low-quality asset because they are valuable only if a bank generates profits at some point in the future. For the same reason, DTAs may be unable to absorb losses in the event of insolvency. Given this, DTAs will be increasingly deducted from CT1 capital as Basel III/CRD4 rules are gradually phased in. Spanish banks have a large amount of DTAs—5 percent of GDP, or 37 percent of their CT1 under current regulatory definitions at end-2012—due to their large losses in 2012 arising from stepped-up provisioning. As a result, Spanish banks do not appear strong when compared to their peers on a fully-loaded Basel III basis, a measure on which markets increasingly focus. To dispel uncertainty regarding the degree to which Spanish banks will be able to make use of their DTAs and improve the quality of their capital, a mechanism could be created to allow banks to convert DTAs into transferable tax

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



Source: SNL.
1/ Bankia's end-2012 CT1 is increased to include the effects of bail-in operations in 2013.

[10] This example is only intended to be illustrative of relative magnitudes. In reality, an increase in equity resulting from a lower cash dividend may also affect other parts of a bank's balance sheet (e.g., it may spur lending and thus raise risk-weighted assets and/or lessen other equity-raising efforts, absent constraints) and on its profitability, with these dynamics affecting the bank's final capital ratio.

claims (Italy did this recently).[11] The amount of such conversions that a bank is eligible for should be made conditional on the degree to which banks take actions that have positive externalities in the current environment. Candidates for such actions could include forgoing cash dividends for a period of years, issuing more equity, stepping-up provisioning and disposal of distressed assets, complying with restructuring plans, and/or easing the pace of credit contraction.[12]

Ensuring adequate provisioning

23. **The authorities have significantly stepped-up provisioning requirements over the last 18 months**. This has raised the ratio of banks' credit reserves to NPLs from 37 percent at end-2011 to 43 percent at end-2012 (Table 1). Nonetheless, concerns remain that some banks may still not be fully provisioning for likely losses. Supporting evidence for this concern are recently released data showing that 13.6 percent of loans have been refinanced and that about half of these loans (with a book value of about 9 percent of GDP) are classified as performing and hence with no specific provisions.[13] Although some of these loans may be correctly classified as performing, the concern is that some of this refinancing may represent "evergreening" of nonperforming loans. There is also significant heterogeneity across banks regarding how refinanced loans are classified.

24. **To ensure consistent classification of refinanced loans across institutions, the BdE issued a letter on May 1, 2013, to further clarify the criteria for determining whether refinanced loans should be classified as performing, substandard, or nonperforming** (Annex 1). Banks have until September 30, 2013 to re-classify refinanced loans in light of these clarifications. The BdE will then conduct follow-up reviews to ensure that banks have complied appropriately. These pro-active efforts by the BdE to address this issue are welcome, as is the publication of detailed data on refinanced loans as envisaged under the MoU—a level of transparency on this issue that is higher than almost anywhere else in Europe.

25. **Strong implementation of this exercise will be important to ensuring adequate provisions**. Reviews should occur expeditiously, and accurate classifications should be rigorously enforced, which is expected to result in an increase in provisions and reported NPLs. Such an approach will help ensure balance sheet transparency and promote market confidence in reported financial positions. Higher provisioning will also reduce banks' incentives to hoard assets to avoid paper losses that may be incurred by selling assets at their true value. In this way, higher provisioning will facilitate asset sales that could free space on banks' balance sheets to

[11] The amount of DTAs that could be converted by Spain will be lower than the total amount of DTAs cited above, as the latter number includes all DTAs held by Spanish banks, including those generated in other tax jurisdictions.

[12] The fiscal implications of any DTA conversion should be carefully assessed before its adoption, with compensating measures, such as the amount of conditionality, calibrated accordingly.

[13] However, banks are required to maintain generic provisions equal to 30 percent of their loans to real estate developers, in addition to a limited amount of generic provisions under Spain's dynamic provisioning framework.

increase lending to other parts of the economy. For all of these reasons, it is important that provisions be sufficient to deal with loan losses. While higher provisioning will reduce reported capital, concerns in this regard are best addressed not by light provisioning but rather by measures such as a prudent (yet pro-growth) approach to capital distribution and issuance, as discussed above.

26. **The September 2012 stress test's estimate of capital needs includes an adjustment for the mis-classification of refinanced loans**. Specifically, the stress test assumes higher default rates on refinanced loans than on non-refinanced loans. How these adjustments will compare to actual losses on refinanced loans is difficult to assess, at least until more information regarding the outcome of the re-classification exercise becomes available this Fall.

Further measures to ease credit conditions

27. **Further measures to help ease credit conditions and support recovery should be considered**. Efforts by the government to clear public sector arrears are welcome and should be furthered, as they promote financial stability by assisting the creditworthiness of suppliers and reducing their NPLs. As discussed in the previous progress report, the authorities are also developing a number of initiatives to increase credit from the nonbank sector and to small and medium-size enterprises. Efforts in this direction are broadly welcome, though it will be important to design measures such as credit guarantee schemes carefully so as to ensure that they are well-targeted, fiscally responsible, and yield additional lending (or lower rates) while not undermining incentives to undertake due diligence nor fostering adverse selection or moral hazard. Other measures to explore include (i) further legal reforms to promote prompt restructuring of viable firms through out-of-court work-outs (for more on this issue, see the forthcoming 2013 IMF Article IV staff report on Spain) and (ii) revenue-neutral tax reform (e.g., replacing real estate transaction taxes with higher taxes on property values) to reduce impediments to asset disposals, as these could free space on banks' balance sheets for additional lending.

28. **Some key measures to support growth and financial stability must be taken at the European level**. This includes moving faster to full banking union, which would help break the sovereign/bank loop by allowing Spanish firms to compete for funds on their own merits (independent of their country of residence), and continuing monetary policy support from the ECB.[14] To allow the latter to be effective, supervisors should also not discourage banks from accessing ECB facilities or encourage them to make early repayments, unless there are strong reasons to do, as such repayments effectively tighten money supply and credit conditions in Spain. Keeping funding costs low (including by accessing, as necessary, ECB facilities) will also be key to keeping banks sufficiently profitable to weather legacy costs, such as credit losses related to the real estate bubble and low margins on the existing stock of variable-rate mortgages.

[14] For more detail on IMF staff views on banking union, see the recent staff discussion note on banking union and the forthcoming 2013 Article IV staff report on the euro area.

While restructuring plans for G1/G2 banks must be geared toward ensuring a return to viability, they should also be kept under review to ensure that they do not place unnecessary constraints on credit provision, especially as viability could in theory be enhanced by a slower pace of deleveraging in some cases (e.g., if a bank has large legacy costs, but its new operations are profitable at the margin, such that expanding them would boost profitability and its ability to offset its legacy costs). Flexibility in restructuring plans will also be important to allow banks to adjust to changing circumstances as appropriate.

E. Structural Reforms to Promote More Resilience Going Forward

29. **Progress continues on several structural reforms that will promote financial stability going forward and that should now be completed in a timely manner**.

- ***Savings banks reform***. The draft law to reform the framework for former savings banks (Annex II, measure 20) was approved by the Cabinet of Ministers on June 7 and has now been transmitted to Parliament. Overall, the law is a major advance, as discussed in detail in the previous progress report. It should be adopted in a timely manner and without any watering down of provisions.

  One key objective of the law is to increase incentives for former savings banks to reduce their stakes in commercial banks below controlling levels. During the authorities' internal review of the law, they decided to lessen some of the incentives to disinvest that are of a governance nature on the grounds that they were too onerous or unduly affected ownership rights. Although these changes are understandable, they also further heighten the importance of strongly implementing the incentives of an economic nature, as discussed in the previous progress report.

- ***Enhancing supervisory procedures***. Last October, the BdE completed a review of its supervisory procedures, which made a number of useful recommendations for reform. The authorities have made some progress in implementing supervisory reforms, such as establishing a new SAREB Supervisory Unit and a new group for the supervision of compliance. However, a number of other recommendations have not yet been implemented. As noted in the last progress report, the reform effort would benefit from an action plan with specific timelines for implementing the recommendations in the October report. As the SSM mechanism will condition the BdE's supervisory framework, this plan should be fully consistent with the preparatory work for the creation of the SSM to ensure a smooth transition to this mechanism.

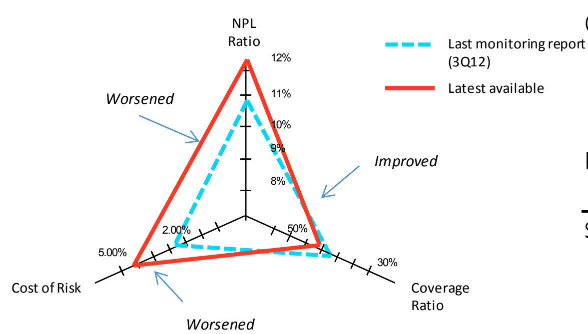
Annex 1. Banking Sector Developments

Major progress under the financial sector program has helped make Spain's banking system stronger and safer. However, risks to the broader economy are still elevated, and credit losses are likely to remain high until economic recovery is firmly established. Funding and liquidity conditions have improved markedly over the last year, but remain far from normal, reflecting ongoing financial sector fragmentation in the euro area. It will be important to remain proactive in ensuring that banks remain adequately capitalized, with swift provisioning for new credit risk.

Asset quality

Credit quality continues to deteriorate. The stock of nonperforming loans (NPLs, or doubtful loans) continued to rise, reaching 11.3 percent of total loans as of end-March 2013.[15] The coverage ratio (credit reserves to NPLs) nonetheless improved due to exceptional provisioning, as banks moved to comply with two Royal Decree Laws requiring banks to undertake more conservative provisioning. Different asset classes continue to show quite different levels of stress.

Asset Quality Deterioration in Spain,
Since Last Monitoring Report

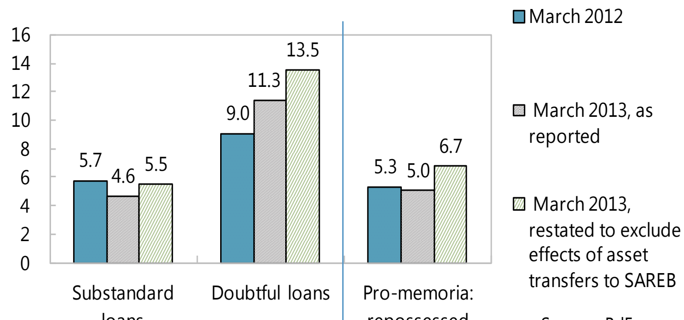


Spanish domestic banking sector: NPL and coverage ratios, by sector

	Gross NPL ratio	Coverage ratio	Net NPL ratio
Companies	18.2	45.6	11.0
o/w: construction	47.5	47.9	34.0
o/w: large companies	6.8	46.7	3.8
o/w: SMEs	14.1	40.9	8.9
Private individuals	5.2	28.7	3.8
o/w: first home	4.3	21.4	3.4

Source: BdE. Data as of 1Q 2013, after transfer of assets to SAREB.

Stock of Non-normal Loans
(percent of total)



Sources: BdE, SAREB.

A broader definition of distressed assets shows that a considerable portion of banks' assets are non-normal. Together, substandard and doubtful loans (as reported) summed to 15.9 percent of total loans as of March 2013, up from 14.7 percent one year earlier. Repossessed assets added a further layer of non-normal assets equal to 5.0 percent of loans and repossessed assets.[16] The system's high rate of non-normal assets suggests that households and businesses are

[15] The NPL ratio is estimated to be 13.5 percent if it is adjusted to eliminate the effect of the transfer of real estate development NPLs to SAREB by Group 1 and Group 2 banks. Also, these numbers are for deposit-taking institutions only and thus differ from the NPL ratios in Table 1, which are for all credit institutions.

[16] These systemwide data mask a wide dispersion of values between the strongest and weakest players.

experiencing widespread difficulties servicing loans on time, as one would expect given the very difficult economic environment.

Reclassifications of refinanced loans are likely to further push up NPLs and provisioning needs in the near term. As part of the MoU, banks are now requested to disclose data on refinanced (or restructured) loans. Spain is one of the first countries in Europe to take this important step toward improving transparency. The end-2012 data reveal a non-negligible amount of refinanced loans that are classified as performing, even though the resort to refinancing may indicate a higher credit risk that would justify a classification as substandard or NPL. However, the BdE has asked banks to review their classification of such loans by end-September 2013, taking into account the BdE's clarification of the criteria for such classification, and to provision accordingly.[17] These revisions are expected to increase further the stock of substandard and non-performing loans.

Refinanced/restructured loans: stock and provisions

	Normal	Substandard	NPL
Total loans (Eur million)	88,279	42,890	77,036
as percent of total system stock	*7.5*	*65.6*	*52.1*
Provisions (Eur million)	0	7,892	31,277
Coverage (percent)	0.0	18.4	40.6

Source: BdE. Data as of end-2012.

The impairment rate (impairments as a percent of assets) is still below, but nearing, that in the stress test's base-case scenario. According to staff's estimates based on data covering about 90 percent of the Spanish banking system, the impairment rate (impairments/assets) on loan and assets at the end of Q1 2013 was slightly below the impairment rate expected in the stress test's base-case scenario.[18] Real estate developer (RED) loans are already provisioned close to the adverse scenario if generic provisions on performing RED loans are included (according to RDL 18/2012).

Spanish banks' credit losses: materialized 2012 vs projected 2014

Asset class	Losses materialized, current (percent) 1/	Projected losses, 2014 (percent) 2/	
		Base case	Adverse case
Repossessed assets	36.1	55.5	63.4
Real estate developers 3/	41.6	28.6	42.8
Retail mortgages	1.3	1.8	4.1
Large Corporates	4.1	5.8	10.0
SMEs	6.7	10.6	16.7
Total	8.6	9.6	14.3

Sources: BdE; IMF staff calculations.

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

2/ Source: Oliver Wyman stress test exercise.

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

[17] The BdE previously provided guidance on this issue in Circular 6/2012, which came into force in September 2012. However, recent evidence suggests heterogeneous application of this circular across banks, which prompted the BdE to issue further clarifications in its May 2013 letter to banks.

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

However, much uncertainty remains regarding the eventual extent of credit deterioration, which is likely to continue for some time. IMF staff's baseline projection as of the July 2013 WEO is that growth will remain weak into 2014. The time lag between macroeconomic developments and their effect on credit quality implies that provisioning needs will likely remain high for some time across all asset classes. Supervisors should therefore ensure that any further weakening of asset quality is matched by increased provisions (in the case of loans) or impairments (in the case of repossessed assets).

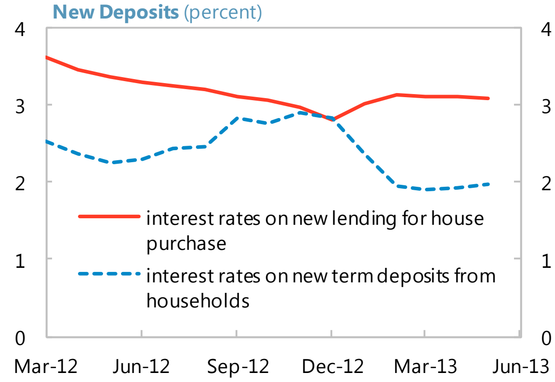
Profitability

The banking system posted significant losses in 2012 due to higher provisioning requirements. The cleanup effort on assets in 2012 was necessary and desirable, but also significantly affected banks' reported profitability. Specifically, the largest 17 banks posted a record consolidated net loss of €51 billion, with €63 billion losses in Spain being partially offset by €12 billion profits abroad. Group 1 and Group 2 banks registered especially large losses. The largest Group 0 banks posted significant losses on their domestic operations, but were compensated by very large profits generated abroad, highlighting both the benefits of international diversification and these banks' strong dependence on future performance from foreign operations (mainly Latin America, but also the UK). The potential importance of the latter risk factor going forward cannot be ruled out.

On a positive note, pre-provision profits in Spain rose in 2012 and were higher than forecasted under the stress test's base case. The main positive dynamics were lower interest expenses (reflecting mainly cheaper Eurosystem funding), higher income on sovereign bonds, and lower operating expenses and staff costs. These factors more than counterbalanced lower interest income (due to lower loan volumes and lower margins) and lower commission revenues. At about €19 billion in 2012, domestic pre-provision earnings compare to €16 billion in the stress test's base scenario and to €14 billion in the adverse.

A recent drop in deposit rates should assist deposit-lending margins. Deposit rates dropped sharply in early 2013, as discussed in the main text (paragraph 15). If lower deposit rates are sustained and not undermined by deposit outflows (e.g., migration of funds to money markets), these lower rates could help offset shrinking interest rates on existing retail mortgages, which represent about 40 percent of Spanish banks' loan book. Falling rates on existing mortgages reflect the large drop in EURIBOR, the rate to which most mortgages in Spain are linked, over the last year. This drop is still feeding through into mortgage rates, as these are typically reset only once a year in Spain.

Households: Interest Rates on New Lending and on New Deposits (percent)



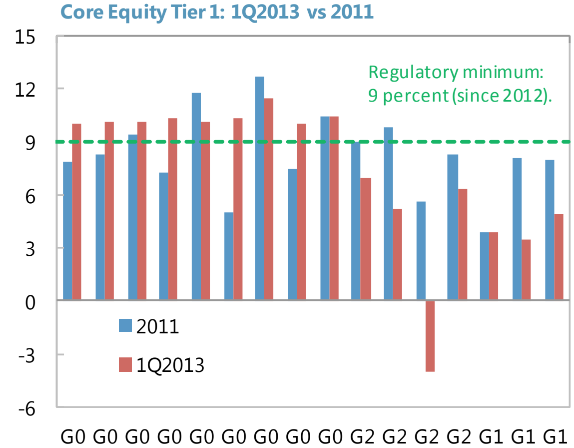
Sources: BdE; and IMF staff calculations.

Going forward, banks' earnings generation capacity will likely remain under pressure until economic recovery has been established. Although data for a single quarter should be interpreted with caution given their volatility, the first quarter results for 2013 nonetheless show higher profits than a year ago for the system as a whole, for state-aided banks as a whole, and for non-state-aided banks as a whole. However, profits for the rest of 2013 may be adversely affected by, among other factors, further credit deterioration, the need to increase provisioning for refinanced loans in line with recent BdE guidance, and falling interest income on variable-rate mortgages, as these are reset at lower rates and as the removal of interest rates floors on some retail mortgage loans (in response to a court ruling) is implemented. Falling loan volumes due to deleveraging and a growing stock of non-productive assets (NPLs and repossessed assets) may also constrain future profit generation. On the other hand, margin pressures could be mitigated by cheaper deposit funding and further carry-trade on domestic government bonds, though scope for this may diminish as the LTROs expire.

Capital buffers

Capital has been strengthened, but the buffer needs now to be maintained. At end-March 2013, all banks covered by the stress test exceeded the minimum capital requirement (which the BdE raised under the program to now be Core Tier 1 of 9 percent (EBA definition)) if the estimated effects of pending capital augmentation measures under the program are added to these banks' capital. Nonetheless, the fragile economic environment underscores the need for Spanish banks to continue efforts to maintain the recently achieved capital levels, including by issuing equity and exercising restraint on cash dividends and remuneration, with supervisors requiring actions in this direction, given continued heightened uncertainty.

Core Equity Tier 1: 1Q2013 vs 2011



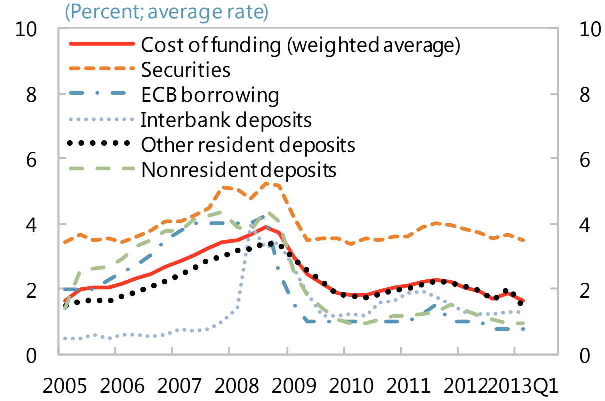
Source: BdE.
Note: 1Q2013 data for G1 and G2 banks do not include capital augmentation measures that were still pending at end-March 2013. Capital ratios for 2011 are estimates.

Spanish banks have a relatively large amount of DTAs as a percent of equity. Due to losses posted in the recent past, Spanish banks held about €51 billion in DTAs at end-2012. This weakens the quality of their capital, as Basel III/CRD4 deducts most DTAs from Tier 1 capital, though this change will be phased in gradually (see paragraph 22 in the main text for further discussion on DTAs).

Liquidity and funding

Banks' market funding conditions have improved in 2013 so far. In first part of 2013, Spanish banks' average cost of new funding declined, as deposit rates dropped sharply in 2013 for the reasons noted in the main text (paragraph 15), while the stock of corporate and household deposits has increased marginally. Borrowing rates in wholesale

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



Sources: BdE; and IMF staff calculations.

funding markets also narrowed thanks to declining sovereign yields. After a strong start in January, gross issuance of bank debt has been modest in 2013, as banks seek to reduce their reliance on wholesale funding.

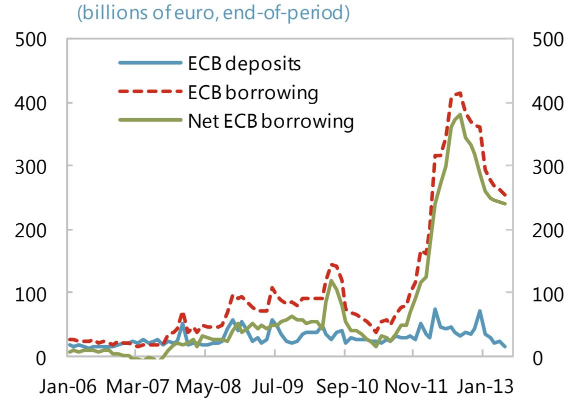
Spain: Change in Deposits, 2013
(month-on-month change, billions of euro)

	Jan	Feb	Mar	Apr 1/	May
Change in deposits					
Domestic household and corporate deposits	-2	6	9	-7	8
Households	1	3	5	-3	1
Corporate	-3	4	4	-4	7
Non-resident deposits	13	10	11	0	-14
Non-resident MFIs	12	3	7	9	-11

Source: BdE.
1/ The outflow of household and corporate deposits in April 2013 reflected seasonal factors. See BdE "Briefing note on deposits data in April 2013", May 29, 2013.

Reliance on ECB borrowing has declined. Improved market funding conditions and rapid credit contraction allowed banks to reduce their borrowing from the Eurosystem by 24 percent, or €86 billion in Q1 2013, driven mainly by early repayment of LTROs by some of the largest banks. These repayments—together with the capital and liquidity injections into Group 1 and 2 banks of nearly 10 percent of GDP in ESM and SAREB bonds—have resulted in almost all Spanish banks now having a large amount of unencumbered collateral assets that are eligible for Eurosystem financing.

Spain: ECB deposits and borrowing
(billions of euro, end-of-period)



Source: BdE.

Nonetheless, funding conditions have not yet fully normalized. Despite recent improvements, Spanish banks' wholesale funding costs and deposit rates remain expensive compared to their Northern European peers, with wholesale funding markets constrained (or even completely closed) for all but the strongest players.

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

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

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

Measure		Deadline included in the July 20 MoU	Current status	Comments
14.	Conduct an internal review of supervisory and decision-making processes. Propose changes in procedures in order to guarantee timely adoption of remedial actions for addressing problems detected at an early stage by on-site inspection teams. Ensure that macro-prudential supervision will properly feed into the micro supervision process and adequate policy responses.	End-October 2012	Implemented	An implementation plan with specific timelines for adopting the recommendations in the report (consistent with preparatory work for the SSM) would be useful.
15.	Adopt legislation for the establishment and functioning of the AMC in order to make it fully operational by November 2012.	Autumn 2012	Implemented	
16.	Submit for consultation with stakeholders envisaged enhancements of the credit register.	End-October 2012	Implemented	
17.	Prepare proposals for the strengthening of non-bank financial intermediation including capital market funding and venture capital.	Mid-November 2012	Implemented	Action plan under implementation
18.	Propose measures to strengthen fit and proper rules for the governing bodies of savings banks and introduce incompatibility requirements regarding governing bodies of former savings banks and commercial banks controlled by them.	End-November 2012	Implemented	Draft legislation has been submitted. Prompt enactment and forceful implementation will be key.
19.	Provide a roadmap (including justified exceptions) for the eventual listing of banks included in the stress test which have benefited from state aid as part of the restructuring process.	End-November 2012	Implemented	

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

Measure		Deadline included in the July 20 MoU	Current status	Comments
25.	Require credit institutions to review, and if necessary, prepare and implement strategies for dealing with asset impairments.	End-December 2012	Implemented	At end-March 2013, banks submitted to the BdE the results of their internal review and their plans to address identified shortcomings.
26.	Require all Spanish credit institutions to meet a Common Equity Tier 1 ratio of at least 9 percent until at least end-2014. Require all Spanish credit institutions to apply the definition of capital established in the Capital Requirements Regulation (CRR), observing the gradual phase-in period foreseen in the future CRR, to calculate their minimum capital requirements established in the EU legislation.	1 January 2013	Implemented	RDL24/2012 Additional technical details implemented by BoE (Circular 7/2012)
27.	Review governance arrangements of the FROB and ensure that active bankers will not be members of the Governing Bodies of FROB.	1 January 2013	Implemented	RDL 24/23012
28.	Review the issues of credit concentration and related party transactions.	Mid-January 2013	In progress	Analytical work is in progress, with a view to finalizing it in Q4 2013.
29.	Propose specific legislation to limit the sale by banks of subordinate debt instruments to non-qualified retail clients and to substantially improve the process for the sale of any instruments not covered by the deposit guarantee fund to retail clients.	End-February 2013	Implemented	RDL 24/2012
30	Amend legislation for the enhancement of the credit register.	End-March 2013	Implemented	

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

Table 1. Spain: Selected Financial Soundness Indicators, 2007-2013

(Percent or otherwise indicated)

	2007	2008	2009	2010	2011	2012	2013 (Latest available)
Solvency							
Regulatory capital to risk-weighted assets 1/	11.4	11.3	12.2	11.9	12.2	11.5	
Tier 1 capital to risk-weighted assets 1/	7.9	8.2	9.4	9.7	10.3	9.9	
Capital to total assets	6.3	5.5	6.1	5.8	5.7	5.5	
Profitability							
Return on average assets	1.1	0.7	0.5	0.5	0.0	-1.4	
Return on average equity	19.5	12.0	8.8	7.2	-0.5	-21.5	
Interest margin to gross income	49.4	53.0	63.7	54.2	51.8	54.1	
Operating expenses to gross income	43.1	44.5	43.5	46.5	49.8	45.4	
Asset quality 2/							
Non-performing loans (billions of euro)	16.3	63.1	93.3	107.2	139.8	167.5	163.2
Non-performing to total loans	0.9	3.4	5.1	5.8	7.8	10.4	10.4
Provisions to non-performing loans	39.2	29.9	37.7	39.6	37.1	42.6	
Exposure to construction sector (billions of euro) 3	457.0	469.9	453.4	430.3	396.9	300.4	
of which : Non-performing	0.6	5.7	9.6	13.5	20.6	28.2	
Households - House purchase (billions of euro)	595.9	626.6	624.8	632.4	626.6	605.3	
of which : Non-performing	0.7	2.4	4.9	2.4	2.9	4.0	
Households - Other spending (billions of euro)	221.2	226.3	220.9	226.3	211.9	199.1	
of which : Non-performing	2.3	4.8	6.1	5.4	5.5	7.5	
Liquidity							
Use of ECB refinancing (billions of euro) 4/	52.3	92.8	81.4	69.7	132.8	357.3	265.0
in percent of total ECB refin. operations	11.6	11.6	12.5	13.5	21.0	32.0	30.1
in percent of total assets of Spanish MFIs	1.7	2.7	2.4	2.0	3.7	10.0	7.7
Loan-to-deposit ratio 5/	168.2	158.0	151.5	149.2	150.0	137.3	131.7

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

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

2/ Refers to domestic operations.

3/ Including real estate developers.

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

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

Table 2. Spain: Monetary Survey, 2010-18

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

				Projections					
	2010	2011	2012	2013	2014	2015	2016	2017	2018
Aggregated Balance Sheet of Other Monetary Financial Institutions (OMFIs) 1/									
Assets	3,471	3,621	3,581	3,371	3,257	3,128	3,097	3,084	3,085
Cash	8	7	7	8	8	8	8	8	8
Deposits at the ECB	27	51	72	29	25	15	14	13	11
Claims on other MFIs	211	203	209	205	198	194	189	192	195
Claims on non MFIs	1,936	1,887	1,733	1,619	1,564	1,564	1,577	1,594	1,615
General government	79	89	114	114	114	114	114	114	114
Private sector 2/	1,857	1,797	1,619	1,504	1,450	1,450	1,462	1,480	1,501
Corporates	896	840	708	645	619	620	626	634	644
Households and NPISH	876	857	821	776	748	747	751	759	769
Shares and other equity	103	163	167	159	148	147	137	138	129
Securities other than shares	520	544	566	606	596	594	584	589	582
General government	158	193	243	270	268	265	262	261	259
Claims on non-residents 3/	374	386	408	417	412	413	407	413	423
Other assets	293	381	419	329	307	193	181	136	121
Liabilities	3,471	3,621	3,599	3,371	3,257	3,128	3,097	3,084	3,085
Capital and reserves	283	367	403	378	366	351	348	347	345
Borrowing from the ECB	62	168	361	244	209	106	89	72	56
Liabilities to other MFIs	211	206	213	209	202	198	193	197	199
Deposits of non MFIs	1,728	1,650	1,535	1,473	1,447	1,451	1,458	1,470	1,484
General government	79	70	69	64	65	66	67	69	70
Private sector	1,648	1,581	1,466	1,409	1,382	1,385	1,390	1,401	1,414
Corporates	219	197	191	194	198	203	208	214	219
Households and NPISH	727	727	732	743	754	767	779	796	814
Debt securities issued	433	435	394	352	326	317	310	302	302
Deposits of non-residents 3/	512	493	341	384	382	378	372	366	364
Other liabilities	244	302	352	330	325	326	327	330	335
Money and Credit 4/									
Broad Money (M3)	1,140	1,121	1,102	1,087	1,092	1,101	1,116	1,134	1,157
Intermediate money (M2)	1,031	977	960	947	952	960	973	989	1,008
Narrow money (M1)	515	506	497	490	493	497	504	512	522
(Percent of GDP)									
Broad Money	108.7	105.4	105.0	104.5	104.0	103.5	103.1	102.6	102.2
Private sector credit	177.1	169.0	154.2	144.6	138.0	136.4	135.0	133.9	132.6
Corporates	85.4	79.0	67.5	62.0	58.9	58.3	57.8	57.4	56.9
Households and NPISH	83.6	80.6	78.3	74.6	71.2	70.2	69.4	68.7	67.9
Public sector credit	7.5	8.4	10.9	11.0	10.9	10.7	10.5	10.3	10.1
(Percentage change)									
Broad Money	-2.0	-1.6	-1.8	-1.3	0.5	0.8	1.4	1.6	2.0
Private sector credit 5/	0.8	-3.2	-9.9	-7.1	-3.6	0.1	0.8	1.2	1.4
Private sector credit excl. SAREB	-0.4	-3.3	-5.8	...	...	...	...	...	...
Corporates 5/	-2.1	-6.2	-15.8	-8.9	-4.0	0.1	1.1	1.3	1.5
Households and NPISH	0.3	-2.2	-4.2	-5.5	-3.7	-0.1	0.6	1.1	1.3
Public sector credit	21.9	13.6	27.9	0.0	0.0	0.0	0.0	0.0	0.0
Memo items:									
Loans to deposits (%, other resident sector) 6/	149.2	150.0	137.3	125.6	119.1	117.1	115.9	114.7	113.7
Retail deposits (% change) 7/	2.9	-2.3	-0.2	1.6	1.7	1.7	1.9	2.2	2.4
Wholesale market funding (% change)	-8.8	-1.4	-18.7	-2.1	-4.3	-2.1	-1.9	-2.0	-0.4
Wholesale market funding (% assets)	22.6	21.3	17.5	18.2	18.1	18.4	18.2	17.9	17.9
Capital and reserves (% total assets)	8.1	10.1	11.2	11.2	11.2	11.2	11.2	11.2	11.2

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.

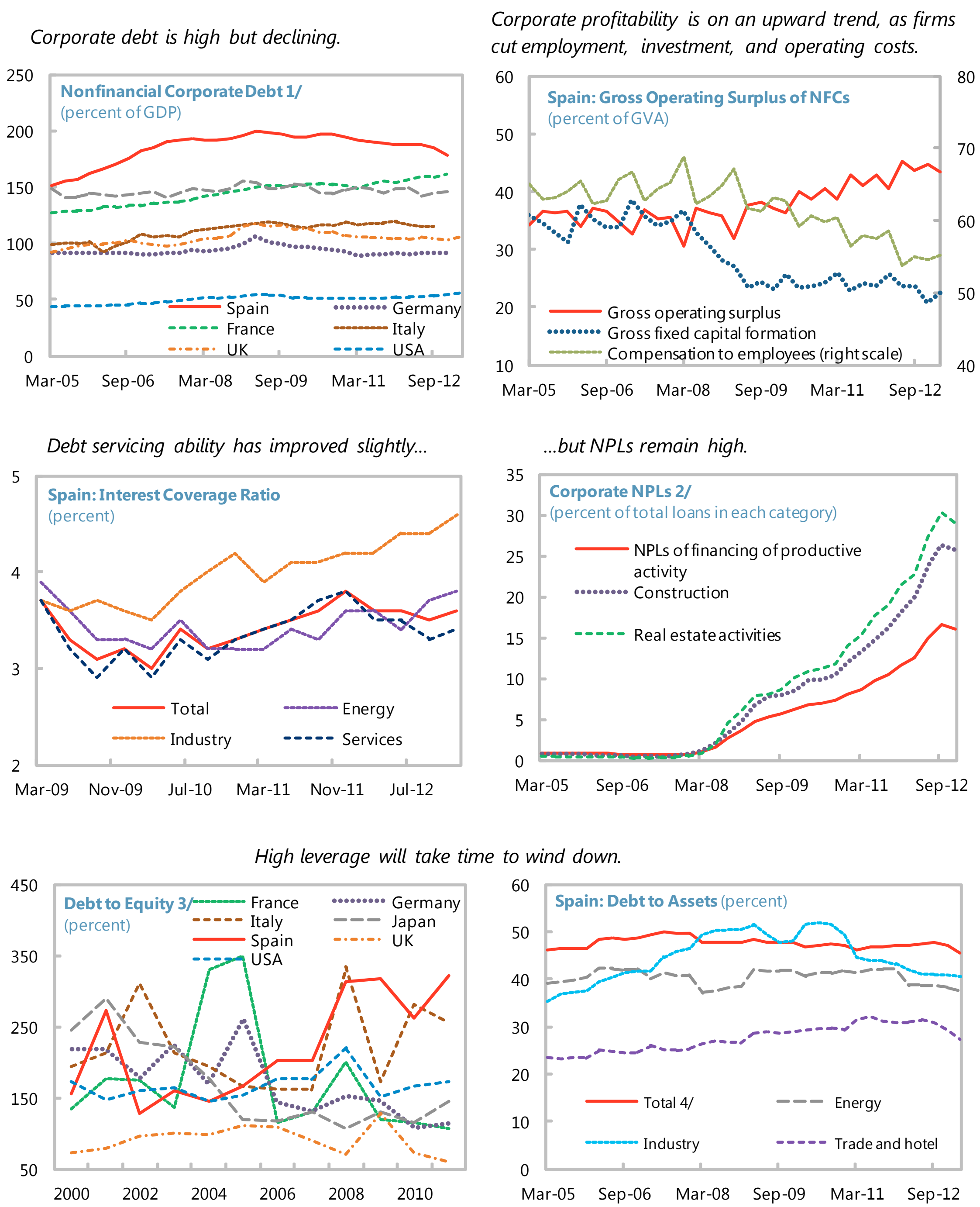
4/ Broad money (M3) comprises M2 plus repurchase agreements, money market fund shares and units as well as debt securities with a maturity of up to two years. Intermediate money (M2) comprises M1 plus deposits with an agreed maturity of up to two years and deposits redeemable at notice of up to three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

5/ The large decline in credit to the private sector at end-2012 partly resulted from the transfer of about €54 billion in real estate developer loans to SAREB.

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

7/ Deposits from households and nonfinancial corporations.

Figure 1. Spain: Nonfinancial Corporate's Financial Positions



Sources: Bank of Spain; IMF's corporate vulnerability utility; and Haver.

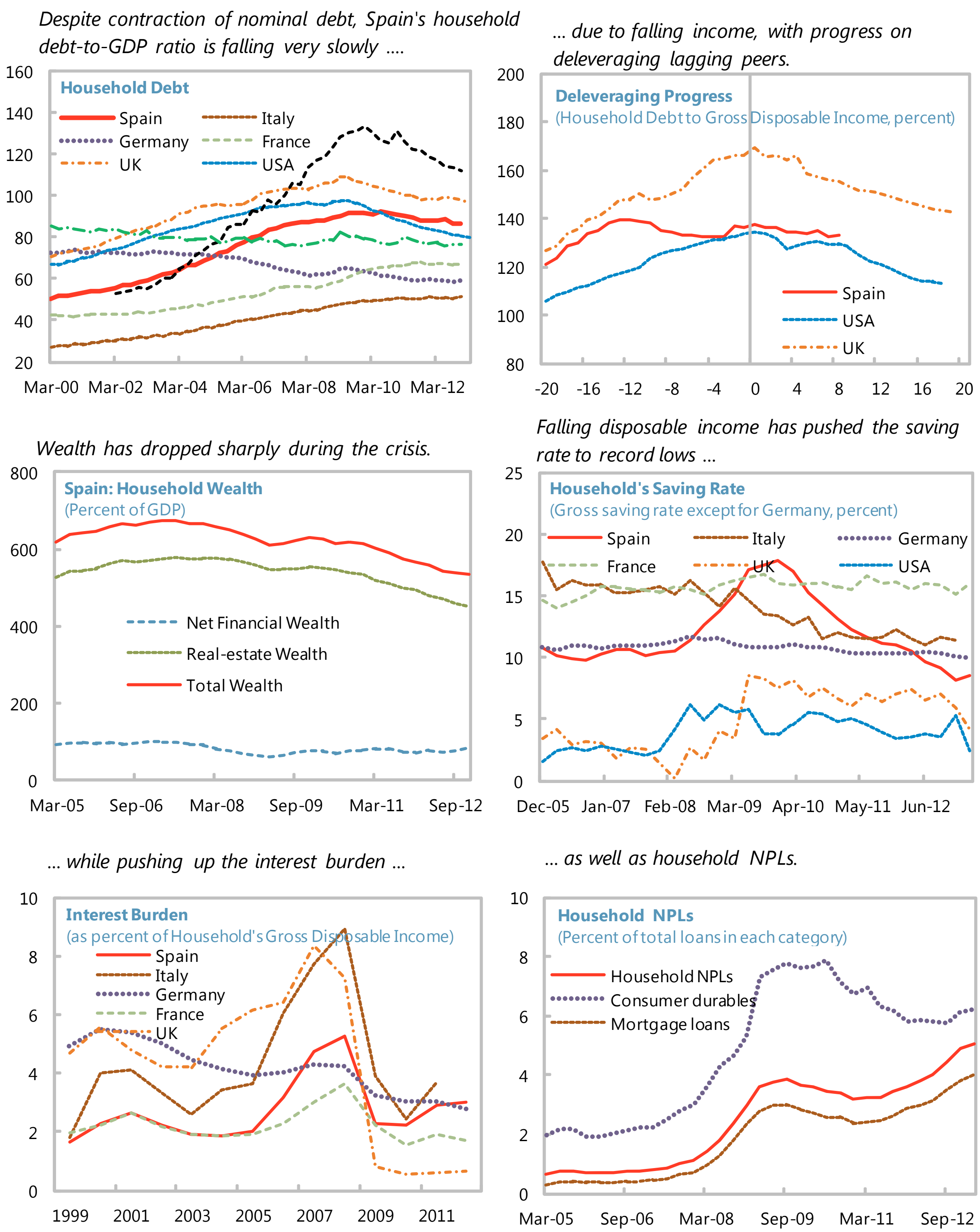
1/ Includes trade credit.

2/ A slight decline in NPL ratios of the corporate sector at end-2012 resulted from a transfer of loans to SAREB.

3/ Corporate debt-to-equity ratios are from the IMF's corporate vulnerability utility, based on firms listed in Spain and market prices. The results may be affected by valuation changes.

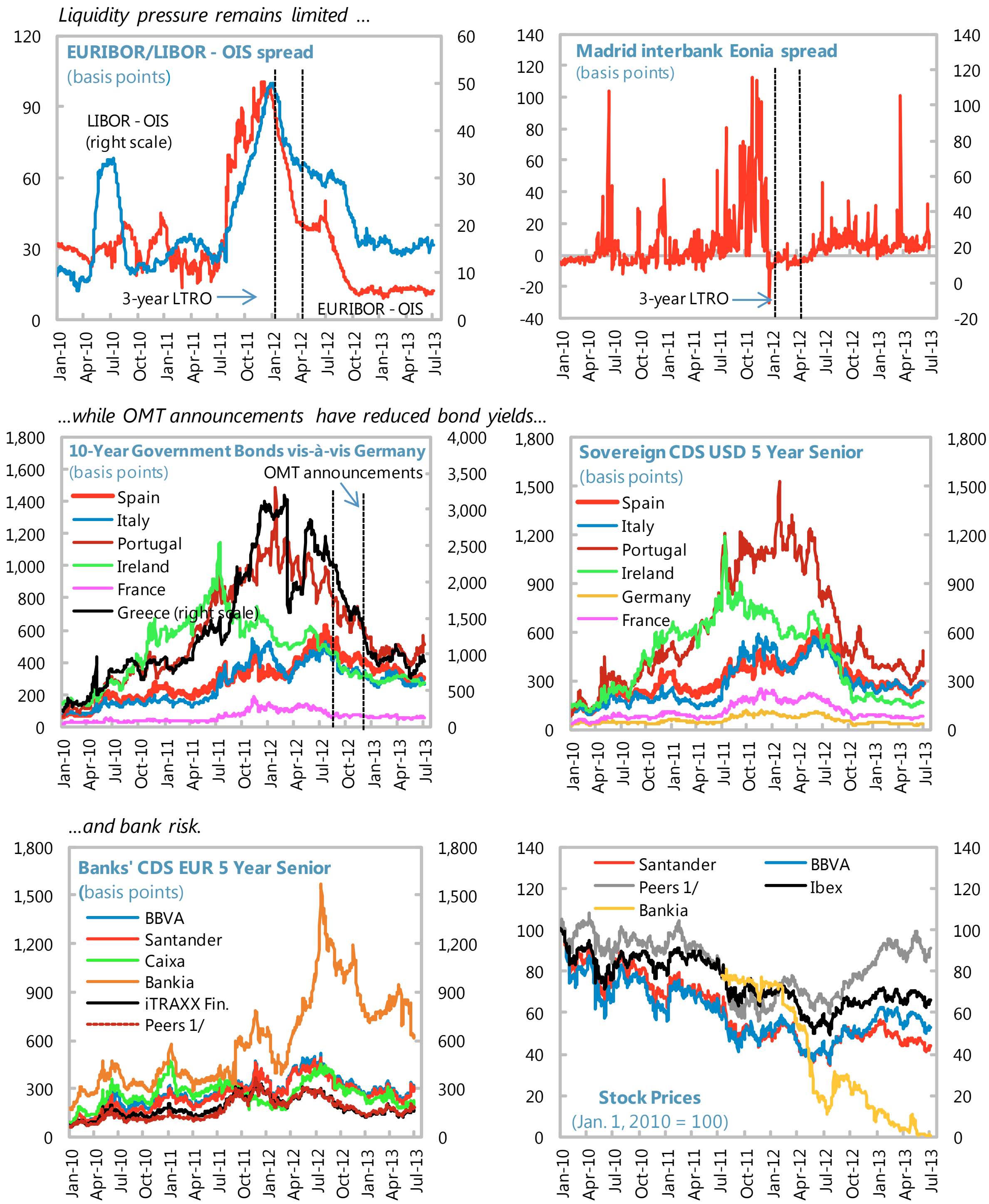
4/ Total includes some components that are not included in the other categories shown.

Figure 2. Spain: Household's Financial Positions



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

Figure 3. Spain: Financial Market Indicators

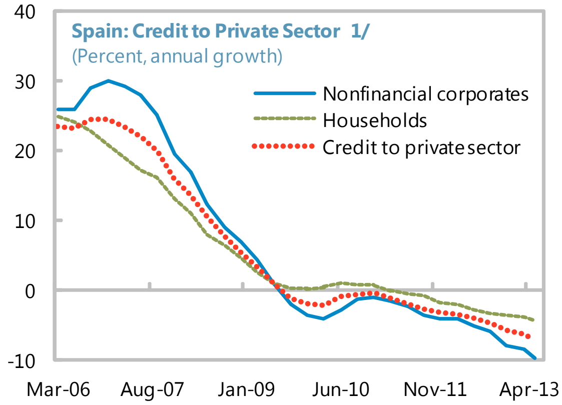


Sources: Bank of Spain; Bloomberg; and IMF staff estimates.

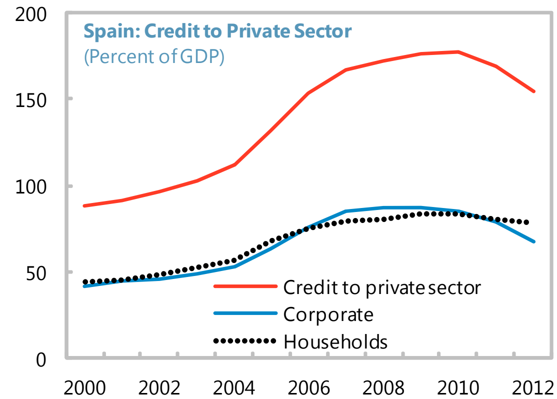
1/ Peers include Unicredit, Intesa-San Paolo, Commerzbank, Deutsche Bank, HSBC, Barclays, UBS, Credit Suisse, Societe Generale, BNP, and ING.

Figure 4. Spain: Credit Conditions

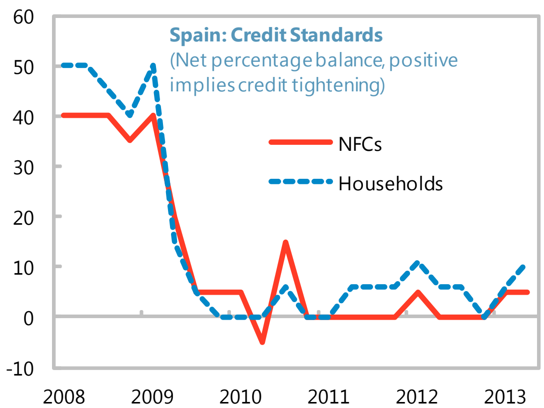
Contraction of credit to the private sector is accelerating …



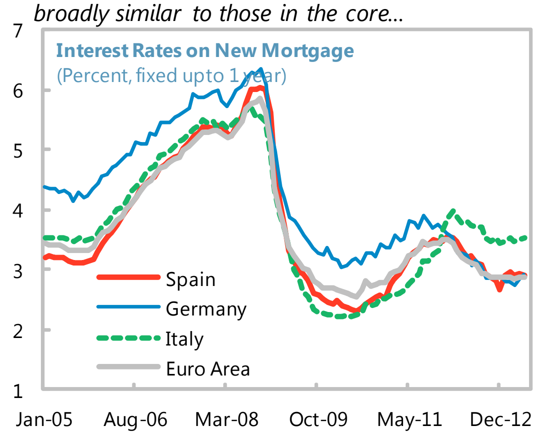
… as the credit bubble unwinds.



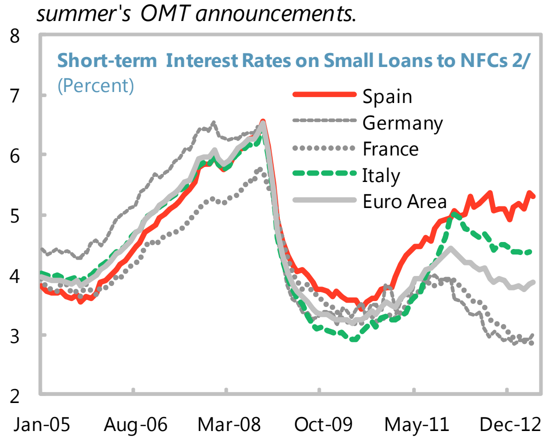
Credit standards continue to tighten …

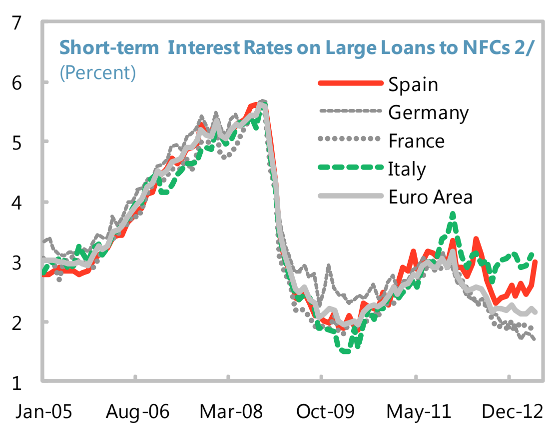


… and though interest rates on mortgages are broadly similar to those in the core…



Frogmentation of lending rates to corporates, and especially SMEs, continues to worsen, despite last summer's OMT announcements.





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

1/ Excludes the effects of the transfer of loans to SAREB.

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