ISSN 1725-3209

EUROPEAN ECONOMY

Occasional Papers 118 | October 2012

The Financial Sector Adjustment Programme for Spain

Economic and Financial Affairs

Occasional Papers are written by the Staff of the Directorate-General for Economic and Financial Affairs, or by experts working in association with them. The "Papers" are intended to increase awareness of the technical work being done by the staff and cover a wide spectrum of subjects. Views expressed do not necessarily reflect the official views of the European Commission. Comments and enquiries should be addressed to:

European Commission
Directorate-General for Economic and Financial Affairs
Publications
B-1049 Brussels
Belgium
E-mail: mailto:Ecfin-Info@ec.europa.eu

Legal notice

Neither the European Commission nor any person acting on its behalf may be held responsible for the use which may be made of the information contained in this publication, or for any errors which, despite careful preparation and checking, may appear.

This paper exists in English only and can be downloaded from the website
ec.europa.eu/economy_finance/publications

A great deal of additional information is available on the Internet. It can be accessed through the Europa server (ec.europa.eu)

KC-AH-12-118-EN-N
ISBN 978-92-79-22918-3
doi: 10.2765/24435

© European Union, 2012
Reproduction is authorised provided the source is acknowledged.

European Commission

Directorate-General for Economic and Financial Affairs

The Financial Sector Adjustment Programme for Spain

EUROPEAN ECONOMY

Occasional Papers 118

BACKGROUND

A joint mission, including EC, ECB, EBA, EFSF, and IMF visited Madrid from 27 June to 4 July 2012 following a request by the Spanish government for external financial assistance under the terms of the Financial Assistance for the Recapitalisation of Financial Institutions by the European Financial Stability Facility (EFSF).

On 4 July the mission concluded a staff level agreement for a financing package of up to EUR 100 billion for recapitalisation and restructuring of the Spanish financial sector. The Heads of State and Government at the Euro Area Summit of 29 June 2012 specified that the assistance will subsequently be taken over by the European Stability Mechanism (ESM), once this institution is fully operational, without gaining seniority status. The Memorandum of Understanding (MoU) was signed on 23 July. The full implementation of this MoU will take into account all other relevant considerations contained in the Euro Area Summit statement of 29 June 2012.

This report by European Commission staff provides an overview of the challenges faced by Spain and its financial sector, discussions with the authorities, and the objectives and design of the financial sector adjustment programme.

ACKNOWLEDGMENTS

Preparation of this report was coordinated by Servaas Deroose, Deputy Director General of the Directorate General Economic and Financial Affairs of the European Commission.

Contributors: Alvaro Benzo, Katia Berti, Carlos Cuerpo Caballero, Lucas Gonzalez Ojeda, Peter Grasmann, Oskar Grevesmuhl, Mihai-Gheorghe Macovei, Maria-Cruz Manzano, Magdalena Morgese Borys, Peter Pontuch, Etienne Sail, Christoph Walkner, Corina Weidinger Sosdean and Norbert Wunner. Technical assistance was provided by Michel Gerday.

Comments on the occasional paper would be gratefully received and should be sent, by mail or e-mail to:

Peter GRASMANN
European Commission
Unit ECFIN.E1
B-1049 Brussels
Peter.Grasmann@ec.europa.eu

Or

Norbert WUNNER
European Commission
Unit ECFIN.F2
B-1049 Brussels
Norbert.Wunner@ec.europa.eu

Outline of the Occasional Paper

1 EXECUTIVE SUMMARY 7

2 THE MACROECONOMIC BACKGROUND: FROM BOOM TO BUST 8
2.1 Causes and drivers of imbalances 8
2.2 Burst of the housing and construction bubble 10
2.3 Ongoing adjustment of the imbalances 10

3 INTERNAL IMBALANCES AND THE LINK WITH THE FINANCIAL SECTOR 12
3.1 Housing market adjustment 12
3.2 New emerging imbalances and their impact on the financial sector 14

4 SNAPSHOT OF THE SPANISH BANKING SECTOR 15
4.1 Size and structure 15
4.2 Regulation and supervision 18

5 CHALLENGES FACING THE BANKING SECTOR 21
5.1 Funding difficulties 21
5.2 Legacy assets 22
5.3 Banking sector capitalisation 23
5.4 Corporate governance of savings banks ("cajas de ahorros") 24

6 THE POLICY RESPONSE SO FAR 25
6.1 Public support provided to the banking sector 25
6.2 Restructuring of the savings banks sector 26
6.3 Increased provisioning requirements 27

7 FINANCIAL ASSISTANCE FOR BANK RECAPITALISATION 29
7.1 Run-up to the financial assistance 29
7.2 Programme objectives 30
7.3 Restoring and strengthening the soundness of the Spanish banks: bank-specific conditionality 30
7.4 Ensuring a sound framework for the banking sector: horizontal conditionality 38
7.5 Programme financing 50
7.6 Programme monitoring and implementation 52

8 MEMORANDUM OF UNDERSTANDING ON FINANCIAL-SECTOR POLICY CONDITIONALITY 54

LIST OF GRAPHS

Graph 1: Net lending/borrowing by sector (% of GDP) 8
Graph 2: Net lending/borrowing by components (% of GDP) 8
Graph 3: Decomposition of Net IIP (% of GDP) 9
Graph 4: Decomposition of total debt (% of GDP) 9
Graph 5: Developments in ULC 10
Graph 6: Developments in REER 10
Graph 7: Triad of housing and mortgage markets imbalances over the last cycle, growth rates 12
Graph 8: Triad of housing and mortgage markets imbalances over the last cycle, levels 12
Graph 9: Investment in construction, historical episodes 13
Graph 10: Real house price, historical episodes 13
Graph 11: Total assets Spain vs. euro area, average (% of GDP) 15
Graph 12: Liabilities structure of Spanish banks (% of total) 15
Graph 13: Credit to the private sector (billion EUR) 16
Graph 14: Funding structure of Spanish banks excluding ECB financing 21
Graph 15: Net lending to the Spanish banks from the Eurosystem (billion EUR) 22
Graph 16: Evolution of non-performing loans: total, household sector and productive activities 22
Graph 17: Non-performing loans in the industry and construction sector 23
Graph 18: Capitalisation of Spanish banking sector (%) 23
Graph 19: Gross debt ratio scenarios (% of GDP 51

LIST OF TABLES

Table 1: Flow of funds via the Spanish banking sector 16
Table 2: Expected losses in the base and adverse scenario, per portfolio segment 32
Table 3: Restructuring of the Spanish Banking Sector: Timeline 34

LIST OF BOXES

Box 1: The emergence of banking sector problems in Spain 17
Box 2: Main features of EU state aid rules 31
Box 3: Results of the bottom-up stress test 32
Box 4: IMF May 2012 FSAP conclusions on the Spanish banking supervision 43
Box 5: Public debt sustainability 51

ABBREVIATIONS

AMC	Asset Management Company
APS	Asset Protection Schemes
BBK	Bilbao Bizkaia Kutxa (Basque for 'Bilbao Biscay Savings Bank')
BBVA	Banco Bilbao Vizcaya Argentaria
BdE	Banco de España, (Bank of Spain)
BFA	Banco Financiero y de Ahorros
BLS	Bank Lending Survey
CA	Current Account
CAM	Banco CAM S.A.U.
CET	Common Equity Tier
CNMV	Comisión Nacional del Mercado de Valores (National Stock Exchange Commission)
COCOs	Contingent Convertible Securities
CRR	Capital Requirements Regulation
CSRs	Country-specific recommendations
DGSFP	Dirección General de Seguros y Fondos de Pensiones (Directorate General of Insurance and Pension Funds)
EA17	Euro area
EBA	European Banking Authority
ECB	European Central Bank
ECC	Expert Coordination Committee
EDP	Excessive Deficit Procedure
EFSF	European Financial Stability Facility
ESA95	European system of national and regional accounts
ESAs	European Supervisory Authorities
ESM	European Stability Mechanism
ESRB	European Systemic Risk Board
EU	European Union
EUR	euro
EWG	Euro Working Group
FAAF	Fondo para la Adquisición de Activos Financieros
FGD	Fondo de Garantía de Depósitos de Entidades de Crédito (Deposit Guarantee Fund)
FROB	Fondo de Reestructuración Ordenada Bancaria (Fund for the Orderly Restructuring of the Banking Sector)
FSAP	IMF's Financial Sector Assessment Program
GDP	Gross Domestic Product
HICP	Harmonized Index of Consumer Prices
IC35	a group of 35 industrial countries
ICAAP	Internal Capital Adequacy Assessment Process
IIP	International Investment Position
IMF	International Monetary Fund
INE	Instituto Nacional de Estadística (Spanish National Statistics Institute)
KA	Capital Account
LORCA	Ley 31/1985, de 2 de agosto, de regulación de las normas básicas sobre Órganos Rectores de las Cajas de Ahorro (Constitutional Law on the Regulation of Savings Banks)
LTRO	Long-Term Refinancing Operations
LTVs	Loan-to-value ratios
MdE	Ministerio de Economía y Competitividad (Ministry of Economy and Competitiveness)
MFI	Monetary Financial Institution
MIP	Macroeconomic Imbalances Procedure
MoU	Memorandum of Understanding
MTO	Medium-Term Objective
NEER	Nominal Effective Exchange Rate
NPL	Non-Performing Loans
OMT	Outright Monetary Transaction
OW	Oliver Wyman
P&L	Profit and Loss

PD	Probability of Default
pps.	percentage points
RDL	Real Decreto-ley (Royal Decree Law)
RED	Real Estate Development
REER	Real Effective Exchange Rate
RWA	Risk Weighted Assets
SAN	Banco Santander
SCC	Strategic Coordination Committee
SCI	Sectoral Concentration Index
SGP	Stability and Growth Pact
SIP	Sistema Institucional de Protección (Institutional Protection Scheme)
SLEs	Subordinated Liability Exercises
SMEs	Small and Medium Enterprises
ULC	Unit Labour Cost
VAT	Value Added Tax

1 EXECUTIVE SUMMARY

The housing and construction bubble that built up until 2008 was fuelled and accomodated by rapid lending of the Spanish banking sector. Following the burst of this bubble, many Spanish banks have come under severe stress and higher scrutiny of domestic and international financial markets. Large accumulated stocks of problematic, real-estate related, assets as well as relatively low capitalisation of some of the banks, especially the savings banks, have given rise to concern. The Spanish authorities have responded with a series of reforms and measures aimed at restructuring and recapitalising the Spanish banking sector. Nevertheless, the severity of the challenges facing Spanish banks and ensuing market pressure have remained elevated. Thus, it has become evident that in order to effectively deal with the impaired assets of banks linked to the real estate bubble and to more broadly restore the viability of the Spanish banking sector, external assistance providing a sufficiently large and credible backstop has become necessary.

On 25 June 2012, the Spanish Government requested external financial assistance under the terms of the Financial Assistance for the Recapitalisation of Financial Institutions by the European Financial Stability Facility (EFSF). The Heads of State and Government at the Euro Area Summit of 29 June 2012 specified that the assistance will subsequently be taken over by the European Stability Mechanism (ESM), once this institution is fully operational, without gaining seniority status. The Memorandum of Understanding (MoU) was signed on 23 July. The full implementation of this MoU will take into account all other relevant considerations contained in the Euro Area Summit statement of 29 June 2012. The execution of the entire range of the programme is very closely monitored by the European Commission and the ECB, and also partly by the European Banking Authority (EBA) and the EFSF. The IMF is also closely involved.

The main objective of the financial sector programme in Spain is to increase the long-term resilience of the banking sector as a whole, thus, restoring market access for the Spanish banks. The conditionality attached to the financial support provided to Spain concentrates on the financial sector. It consists of two main building blocks: first, a clear roadmap to bank-by-bank recapitalisation and restructuring in line with European Union (EU) State aid rules (bank-specific conditionality), and second, horizontal conditionality applying to the banking sector or the regulatory and supervisory framework at large. A key componenet of the overall strategy is to effectively deal with the impaired assets by transferring such impaired assets into a separate vehicle, i.e. asset management company. By improving the quality and transparency of banks' balance sheets in this manner, the programme aims to facilitate an orderly downsizing of bank exposures to the real estate sector, restore banks' market-based funding, reduce banks’ reliance on central bank liquidity support and allow them to carry out their financial intermediation function. Additionally, it is essential to enhance the risk identification and crisis management mechanisms at the level of banks and of supervisors which reduce the probability of occurrence and severity of future financial crises.

In parallel to the financial sector conditionality Spain committed to comply fully with its commitments and obligations under the excessive deficit procedure (EDP) and the recommendations under the European semester. Fulfilling Spain's obligations under the EDP and the recommendations to address macroeconomic imbalances within the framework of the European semester is key to ensure the effectiveness of the bank recapitalisation facility. Progress in meeting these obligations under the relevant EU procedures will be closely monitored in parallel with the regular review of programme implementation.

2 THE MACROECONOMIC BACKGROUND: FROM BOOM TO BUST

The global financial and economic crisis exposed weaknesses in the growth pattern of the Spanish economy. Spain recorded a long period of strong growth, which was, in part, based on a credit-driven domestic demand boom. Very low real interest rates triggered the accumulation of high domestic and external imbalances as well as a real estate bubble. The sharp correction of that boom in the context of the international financial crisis led to a recession and job destruction.

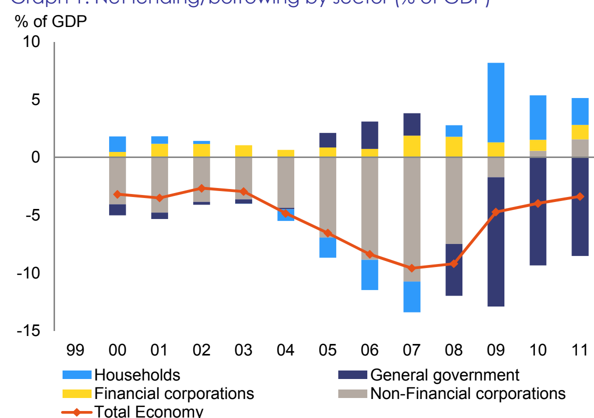
The unwinding of these economic imbalances is weighing on the growth outlook. Private-sector deleveraging implies subdued domestic demand in the medium term and a profound shift in the composition of demand. A shift to durable current account surpluses will be required to reduce external debt to a sustainable level. Public debt is increasing rapidly due to persistently high general government deficits since the beginning of the crisis and the need for financial rescue measures.

The challenges that face segments of the banking sector continue to weigh on the economy via several channels, including a rise in financing costs and subdued flows of credit to the non-financial sector. In particular, sizeable exposure to the real estate and construction sectors have eroded investor and consumer confidence. As the linkages between the banking sector and the sovereign have increased, a negative feedback loop has emerged. Therefore, restructuring (including, where appropriate, orderly resolution) and recapitalisation of banks is key to mitigating these linkages, increasing confidence, and spurring economic growth.

2.1 CAUSES AND DRIVERS OF IMBALANCES

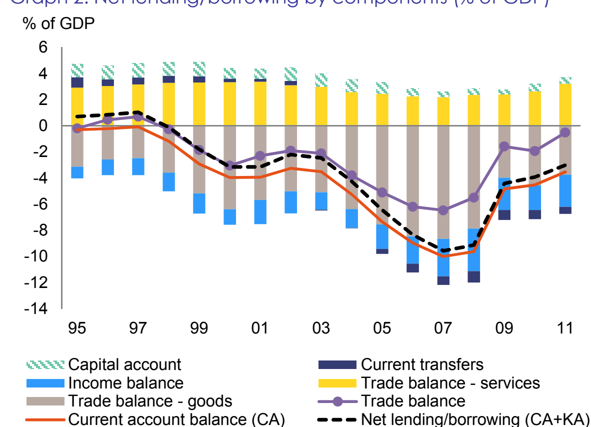
The long period of expansion of the Spanish economy was shaped by several factors that contributed to the intensity and duration of the boom. In particular, Spain's accession to the euro area led to the almost disappearance of its country risk premium. This produced two important effects. On the one hand, Spanish interest rates fell sharply[1]. On the other hand, capital inflows increased, as foreign investors sought to take advantage of investment opportunities offered by Spain. As a result, the external financing constraint for the Spanish economy virtually disappeared.

Graph 1: Net lending/borrowing by sector (% of GDP)



Source: INE

Graph 2: Net lending/borrowing by components (% of GDP)



Source: Eurostat

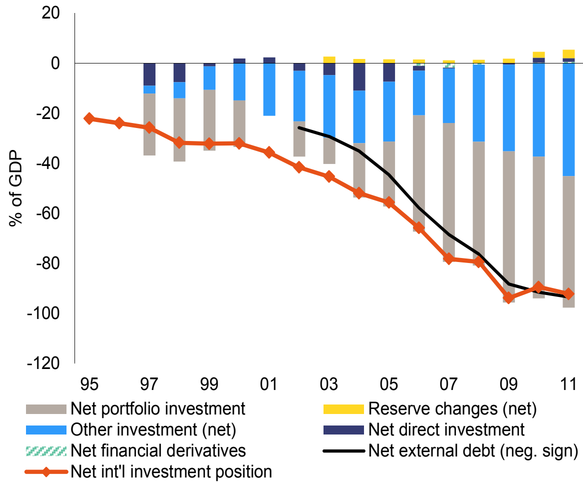
The relatively high returns offered by the Spanish economy were in turn linked to Spain's lower starting position in terms of per capita income and the ensuing catching-up process. In fact, part of this inflow of financial resources was used to increase the capital intensity of the Spanish economy, with investment in equipment increasing its weight in GDP by 1.4 pps. between 1995 and 2007, twice the euro-area average. In addition, an important share of these external financial resources went to the non-tradable sector, and more specifically to construction and real estate activities, implying a limited impact on future growth. This huge increase of external financing was, unavoidably, accompanied by an increasing current account deficit (Graphs 1 and 2).

[1] Taking as reference, the one-year interbank interest rate was 10% in 1995 and 4% in 1998.

The reduced cost of capital and easier access to credit, combined with policy incentives promoting house ownership, fuelled housing demand. Indeed, the reduction of the country risk premium and high availability of foreign capital implied very low nominal interest rates (and even negative real interest rates) during some periods (2005-06). Housing supply followed, but only with a lag. As a result, house prices started to accelerate in 1998, registering annual increases of more than 10% up to 2006 and smaller but positive rates of growth until the second half of 2008. The emerging housing boom was underpinned by demographic factors. Population growth - both total and working age –accelerated from 1999 to 2008, and the number of households rose. This had its origin in the entrance of the 1970s baby-boom cohorts into the labour force, an increase in female labour force participation and large immigration flows. While the immigrant population accounted for 2% of total population in 1999, its weight reached 10% by 2007. Finally, economic growth started to generate significant job creation (averaging 3.7% of growth between 1997 and 2007), further adding to the demand for housing.

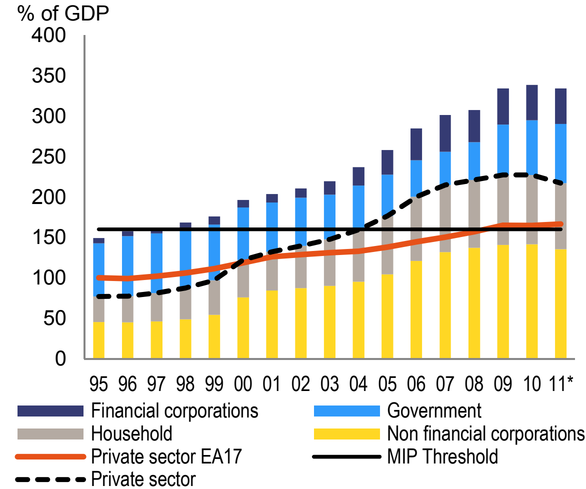
A number of factors led to a creation of a housing bubble that produced a sharp increase in housing production and prices. In particular, the combination of low interest rates, accessible financing, demographic pressure, rising house prices and the perception that these higher prices would be sustained, made house purchases appear to be a safe investment, feeding a housing bubble with fast rising prices and investment in housing. Indeed, house prices almost tripled between 1997 and early 2008, while production of housing more than doubled from the 1995 level. Over 6.5 million new homes were built between 1996 and 2009. As a result, the share of investment in construction reached 22% of GDP in 2006-2007, compared with 15% in 1995. This represented a significant diversion of productive resources towards the construction sector. Construction employment reached 14% of total employment in 2007, compared with 9% in the years before the expansion period.

Graph 3: Decomposition of Net IIP (% of GDP)



Source: Eurostat

Graph 4: Decomposition of total debt (% of GDP)



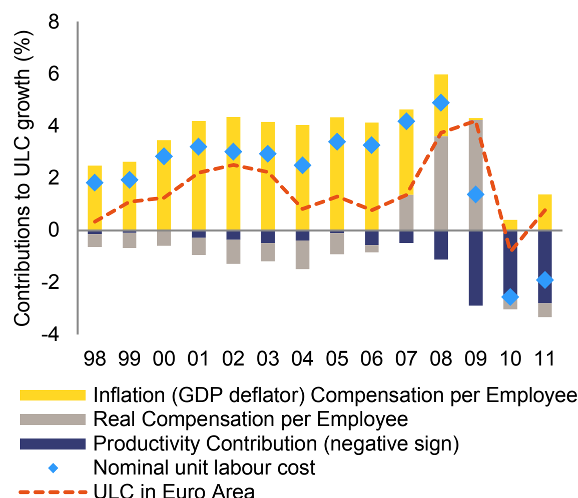
Source: Eurostat

The transfer of financial resources to the construction sector exceeded the scale of transfer of production factors, given that the financing needs of this sector are usually higher than in the rest of the economy. Indeed, in 1995, 39% of total Monetary Financial Institutions (MFI) credit to enterprises and households was related to construction and housing (loans to construction companies, real estate and loans for the purchase and renovation of dwellings). In 2007, these loans accounted for 65% of total MFI credit, after growing at an annual average rate of 22% between 1996 and 2006. This expansion of credit to the construction sector was significantly helped by the easing of financing conditions. However, it was not only the credit associated with construction that rose sharply in the period of expansion. Credit to other productive activities and to household consumption also experienced a boom, with an average growth rate of 12% between 1997 and 2007. As a result, private sector debt rose substantially and reached 227% of GDP in 2010. The level of total accumulated foreign debt reached 165% of GDP in 2011. However, external financing was not only used for internal operations in Spain, but also to finance investment by Spanish companies abroad. Consequently, the (negative) net international investment position (-91% in Q2 2012) has risen more slowly than total external debt (Graph 3).

The inflow of sizeable external financial resources, which financed consumption and to an even greater extent investment (Graph 4), resulted in the appearance of sustained and increasing external deficits. Indeed, the gap between imports and exports rose, as the strength of domestic demand pushed up imports.

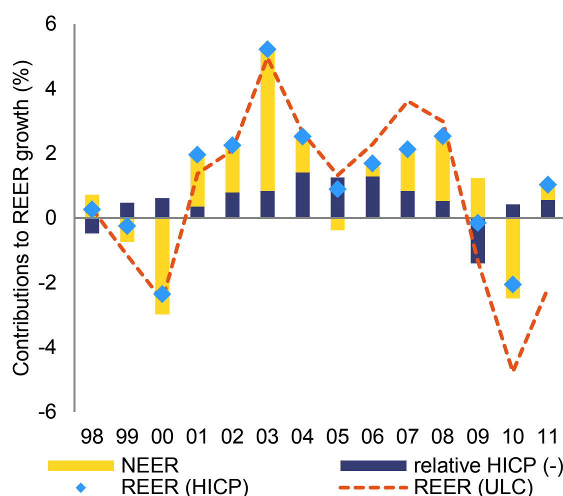
At the same time, foreign capital inflows and the induced domestic demand boom pushed up wages and prices, contributing to a steady deterioration in the cost and price competitiveness of the Spanish economy. The gap between wage growth (3.2% annually on average in the period 1996-2007) and a historically subdued productivity growth (0.4% annually on average in the period 1996-2007) widened and unit labour costs rose significantly (2.8% on average over the same period and more than double the euro-area average) (Graph 5). Thus, in the period 1999-2009, the real effective exchange rate (REER) based on unit labour cost (ULC) vis-à-vis IC35[2] appreciated by 16%, which imposed a drag on the expansion of Spanish exports. In addition, it was also an indication of a loss of competitiveness of Spanish products in the domestic market (Graph 6).

Graph 5: Developments in ULC



Source: AMECO

Graph 6: Developments in REER



Source: AMECO

2.2 BURST OF THE HOUSING AND CONSTRUCTION BUBBLE

The extended housing and credit boom between 1997 and mid-2008 led to the accumulation of various imbalances. These included an excessive weight of the construction sector, excessive credit growth to the private sector, sustained loss of competitiveness and excessive reliance on external financing. The turning point in the real estate and housing market had already been reached in late-2006 and early-2007. Interest rates started increasing in 2006, which, combined with already high levels of household debt, led to an easing of demand for housing and credit. By that time, the affordability ratio associated with buying a house had increased to 46% of household disposable income (compared to 28% in 1999). This also affected private consumption, which started to decelerate in 2007. As the economy still grew by close to 4% in 2007, the adjustment was relatively soft. However, the economic and financial crises in 2008 triggered a much sharper correction.

The adjustment in the construction sector has been very rapid since 2008. Over the period 2008-2011, the share of construction investment in total GDP fell below the pre-boom level (14%). Employment in the construction sector fell by around 1.4 million over the same period and the weight of construction in employment reached its lowest level since 1976. House prices have fallen by 26% in nominal terms and by 32% in real terms since their peak and this decline gathered pace in the first quarter of 2012, when house prices registered a reduction of 13% year-on-year. The drop in housing demand, which occurred from 2008 onwards, along with the tightening of credit conditions, contributed to a contraction of credit throughout 2011. Finally, the current account deficit decreased from 9.6% of GDP in 2007 to 3.4% in 2011.

2.3 ONGOING ADJUSTMENT OF THE IMBALANCES

Despite the progress in correcting imbalances in terms of flows in the wake of the crisis, the adjustment of imbalances in terms of stocks has so far advanced only to a limited degree. The stock of credit to the private sector has decreased by 10 pps. of GDP, but remains very high (217% of GDP as of 2011). The net international investment position has continued to fall in line with sustained current account deficits, reaching -91% of GDP at

[2] IC35 refers to a group of 35 industrial countries

the end of the first quarter of 2012 (from -92.5% in 2011). Putting external debt on a downward path would require a shift to structural external surpluses for a prolonged period, based on further improvements in the competitive position of the Spanish economy. Since the beginning of the crisis, the loss in competitiveness during the expansion period has only partly been corrected.

The adjustment of large external and internal imbalances built up in the years prior to the crisis is propelling the Spanish economy through a period of subdued economic growth combined with very high unemployment. These developments, in turn, slow down the ongoing deleveraging process and the adjustment in the housing sector. They also have adverse effects on the financial sector, by leading to an accumulation of problematic assets on the banks' balance sheets. This in turn reduces the flow of credit and putting an additional brake on economic growth. Moreover, due to the size and nature of the accumulated imbalances, Spain is vulnerable to external shocks, such as rises in interest rates. Such external shocks may have adverse effects on the ongoing adjustment. In sum, as the adjustment of the economy progresses, there is a risk of negative feedback loops between private and public sector deleveraging, compressed domestic demand, high levels of unemployment, further adjustment in the housing sector, financial sector stability and credit availability.

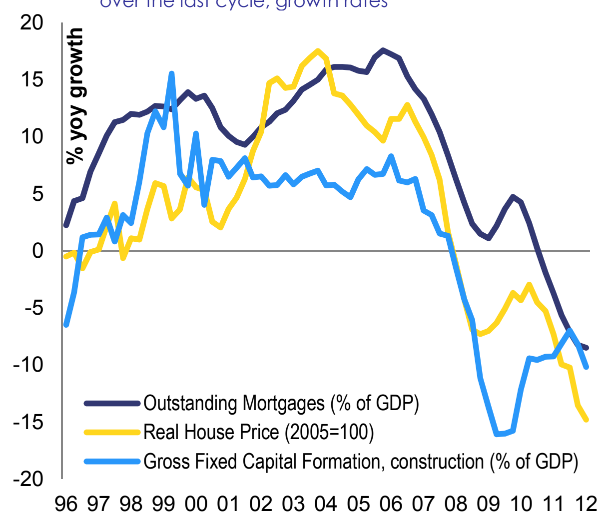
3 INTERNAL IMBALANCES AND THE LINK WITH THE FINANCIAL SECTOR

3.1 HOUSING MARKET ADJUSTMENT

The last Spanish housing market upswing was unusually long and intense by historical and cross-country standards. As can be seen in Graph 7, real house prices grew at an average pace of 8% during the 11 years preceding the 2007Q3 peak, amounting to a cumulated growth of 155%. In parallel, investment in the construction sector grew at 6% on average, fuelling a re-allocation of resources from the tradable to the non-tradable construction sector. Moreover, movements in house prices went hand in hand with credit growth to the private sector. As a result, Spanish households and firms were left with high levels of accumulated debt (82% and 135% of GDP in 2011, respectively).

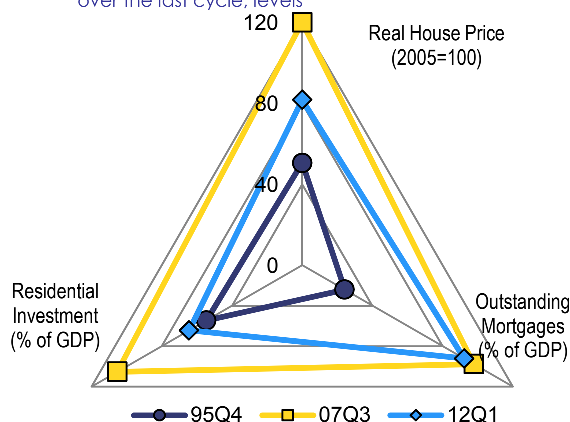
Since the beginning of 2008, a sharp (although uneven) correction has taken place in all three dimensions, namely house prices, residential investment and credit growth (Graph 8**).** Moreover, the ongoing adjustment is sharper than previous downswings (Graph 9). Lastly, despite already occurred significant corrections in house prices, recently the decline has accelerated and further adjustment is to be expected gauging by the outlook of stagnant demand and existing oversupply[3]. Also looking at historical experiences, there is room for further adjustment. Compared with previous downturns, the current adjustment is not unheard of as it looks similar in its severity to the experience following the oil price shock (Graph 10). Indeed, in line with declining house prices, households have adjusted downward their expectations and are postponing their housing purchases and this coupled with the severity of the financial crisis heralds a sharp post-crisis adjustment in house prices.

Graph 7: Triad of housing and mortgage markets imbalances over the last cycle, growth rates



Source: BdE, European Commission services

Graph 8: Triad of housing and mortgage markets imbalances over the last cycle, levels



Source: BdE, European Commission services

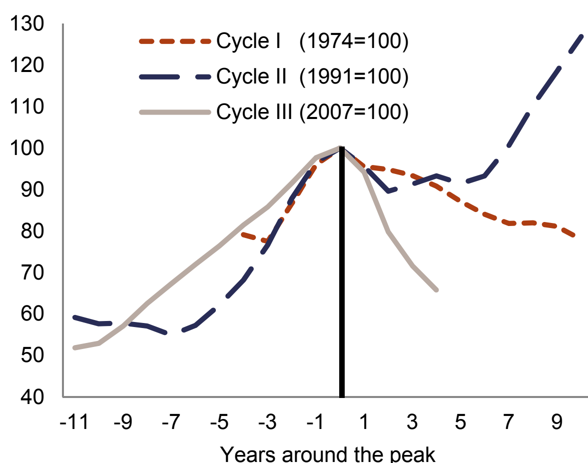
Bearing this in mind, different scenarios for the main house price determinants[4] are considered. They are based on assumptions regarding real disposable income per capita (proxied by GDP per capita), projected evolution of urban population, projected evolution of total credit to the private sector, and projected evolution of housing stock. According to these scenarios real house prices are expected to drop over the next 4 quarters (2012Q2-2013Q1) by between 8% and 15%.

---

[3] Which will be exacerbated by the entry into the market of the unsold stock of houses repossessed by the banks.

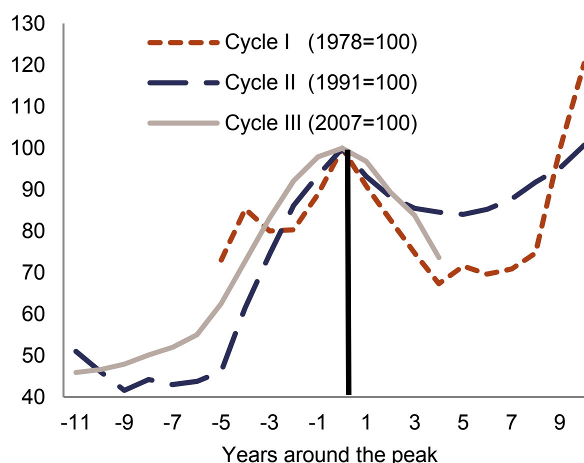
[4] In a baseline scenario, real disposable income per capita, proxied by GDP per capita, evolves according to the European Commission economic forecast - spring 2012 forecasts (-1.7%). Moreover, urban population, proxied by total population, follows the path anticipated by the Instituto Nacional de Estadística (Spanish National Statistics Institute, INE)) short-term population forecasts (i.e. a drop of 0.2% in total population over the next 10 years). According to the latest ECB Bank Lending Survey (BLS)) results, credit tightening is expected to ease and demand for credit is expected to go back from negative to neutral territory. The assumption for credit flows to the private sector in 2012 will thus be based on the evolution of total credit to the private sector over the last 4 quarters (-1.48%, according to the Banco de España). Finally, moderation in the housing stock following the stagnation of the construction sector can be expected for the next few years as the overhang of unsold stock is absorbed. In an alternative scenario, the assumptions for demographics and the housing stock are kept as these variables tend to move in longer cycles and are thus less prone to short-term shocks. However, one might impose more subdued assumptions on real disposable income and credit (an extra 0.5% fall for the former and a 5.6% drop for the latter).

Graph 9: Investment in construction, historical episodes



Source: INE

Graph 10: Real house price, historical episodes



Source: Eurostat, OECD, European Commission services

3.1.1 Impact of the correction in house prices on the real economy and the financial sector

The magnitude and the pace of the necessary correction in house prices have a critical impact on the real economy and financial stability. This correction affects the real economy mainly through consumption and investment dynamics while the impact on financial stability is channelled through the deterioration in the valuation of the assets in the banks' balance sheets.

There are different channels that contribute to the propagation of effects stemming from house price developments to the rest of the economy. The way they function varies across countries, depending on national institutional and regulatory features of housing and mortgage markets. First, rising real estate prices can positively affect household consumption spending through a wealth effect. Some empirical analyses suggest that the impact of a significant fall in real estate prices may be even more important than an equivalent decline in stock prices. Second, rising real estate prices relative to construction costs can stimulate housing construction through higher profitability. The reverse is true for falling house prices. A sudden decline in property prices renders investment less attractive and reduces the profitability of the construction sector. As a result, investment may dry up and contribute to an economic slowdown.

Both channels are reinforced via a financial accelerator effect. Booms and busts in real estate markets are often correlated with large movements in monetary and credit aggregates with possible implications for macroeconomic imbalances and financial stability. In particular, in periods of falling house prices lending is reduced due to the collateral effect of real estate assets. This financial accelerator is further strengthened by banks' deteriorating balance sheets. Reduced aggregate activity and worsening availability of finance lead to an increase in non-performing loans (NPL) and, in turn, to higher loan loss provision needs that erode bank equity.

Modelling the interlinkages between these variable in an econometric model[5] shows that the impact of the foreseen drop in house prices on the real economy can be quite significant. Indeed, the cumulated drop in GDP after one year amounts to 0.42% in the baseline scenario and to 0.82% under the alternative scenario. The fall in consumption is of the same order of magnitude, while residential investment is affected more heavily, falling around 2.82% during the first year in the baseline scenario and 5.8% under more severe conditions. Moreover, in the baseline case of a fall of real house prices of 8% over the upcoming four quarters, ceteris paribus, the NPL rate rises up to 10.3% in 2013Q1. If house prices fall by 15%, the NPL rate reaches 11.4% in 2013Q1.

---

5 This follows a twofold econometric approach. First, the main macroeconomic aggregates (GDP, consumption, residential investment, current account balance, GDP deflator, lending-deposit rate spread and the real house price deflator) are modelled in a Bayesian VAR Value-at-Risk framework. Second, an econometric model is formulated where the Non-Performing Loans ratio is a function of the house price index, the unemployment rate and the private debt to GDP ratio.

3.2 NEW EMERGING IMBALANCES AND THEIR IMPACT ON THE FINANCIAL SECTOR

In the wake of the crisis, new imbalances emerged, most notably in the labour market and with regards to public finances. The weak macroeconomic outlook, with a second recession within 4 years, is further aggravating this situation. In particular, lower GDP growth implies lower revenues and higher government spending, thus, pushing up the government deficits and debt. At the same time, the subdued macroeconomic outlook limits the ability of Spanish economy to create jobs despite recent comprehensive labour market reforms.

Unemployment soared following the downsizing of the construction sector and the cyclical adjustment in the rest of economy. While unemployment was 8.3% in 2007, it reached 21.6% in 2011. Employment was affected disproportionately by the economic downturn due to its high degree of labour market duality between permanent and temporary workers. In addition, the centralised collective bargaining, which limits the sensitivity of wages to cyclical conditions, was responsible for the lagged response of wages. A comprehensive reform of the labour market adopted in February 2012 is aimed at addressing these issues by reducing severance pay and allowing for greater flexibility in collective bargaining. However, the employability of the large number of low-skilled workers made redundant in the construction sector still poses a challenge. In addition, as the economy entered into a second recession at the end of 2011, the outlook for job creation remains bleak. As consequence, unemployment reached 24.6% in 2012Q2 and is expected to record 24.5% for the whole year 2012, according to the European Commission's European economic forecast - spring 2012[6].

The weak macroeconomic outlook and high level of unemployment have also a direct negative impact on the financial sector by raising the risk of defaults, thus eroding the quality of banks' balance sheets. However, partly due to institutional factors, such as the full recourse on mortgage repayment, the ratio of non-performing loans in the household sector has remained considerably below those for other loans (see section 5.2 for more details). Nevertheless, further increases on delinquencies on mortgage loans cannot be ruled out, given the protracted economic downturn and high unemployment. The recession also further complicates the absorption of the large stock of accumulated unsold houses. In the absence of policy measures, the likely scenario would be further defaults of real estate development companies and a further increase in the number of foreclosed assets held on the balance sheets of banks. Therefore, the MoU aims to break the linkages between the real estate development (RED) sector and the banks through a compulsory transfer of RED assets to an Asset Management Company (AMC) by those banks that will require public capital in the course of the restructuring process.

The general government net lending position increased in the boom years, thus offsetting to some extent the debt accumulation in the private sector. The combination of a steady appreciation of the real effective exchange rate, the reduction of the risk premia and the increase in population in Spain was supportive of a demand-based growth model, highly rich in taxes. The booming domestic economy provided a steady stream of government revenues, recording a particularly steep increase in personal and corporate tax revenues related to the housing market and private consumption (see Martínez Mongay et al. 2007)[7]. However, during the boom period, government expenditures also increased significantly, and, as a result, the government savings increased at a slower pace than revenues. Indeed, as demonstrated by recent developments in public finance, the net lending position of the government proved insufficient to accommodate the disappearance of the extraordinary revenues on which this position was based.

As a result, the government balance deteriorated rapidly from 2008 onwards as the government stepped in to support the domestic demand and economic growth in the context of significant private sector deleveraging. That led to the emergence of large government deficits and has significantly increased the public debt level. Public debt can be considered an emerging but also a rapidly increasing imbalance in Spain. While its level is still relatively low compared to other euro-area countries, its fast rise is a source of concern. From a level of 40% of GDP in 2008, it is expected to reach close to 90% of GDP by 2013, according to the European economic forecast - spring 2012, despite ongoing fiscal consolidation. One of the important effects of increasing fiscal deficits and growing public debt has been a significant increase in Spanish risk premia demonstrated by a widening of the spread between Spanish and German government bond yields. These increasing risk premia also impact the real economy, mostly through the financial sector as the lending conditions for households and non-financial corporations deteriorate.

---

[6] http://ec.europa.eu/economy_finance/publications/european_economy/2012/ee1upd_en.htm

[7] Martínez Mongay, C., L. A. Maza and J. Yaniz (2007): "Asset Booms and Tax Receipts: The case of Spain, 1995-2006". European Economy. Economic Papers. 293. November 2007.

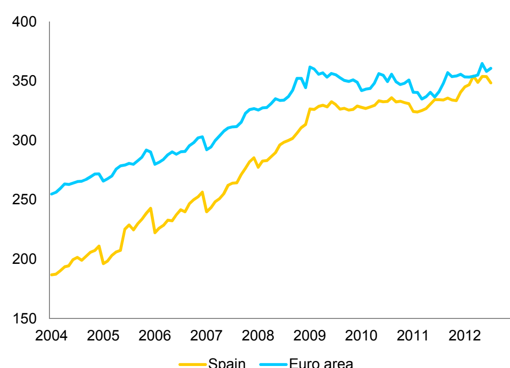
4 SNAPSHOT OF THE SPANISH BANKING SECTOR

The Spanish banking sector has been under pressure to deleverage and adjust its business model since the burst of the real estate bubble in 2008. As a result, Spanish banks underwent a serious restructuring process, in particular as regards the former savings bank component. As of the second half of 2011, lending started to contract more rapidly and access of the banks to wholesale funding deteriorated markedly. The asset quality also worsened significantly especially on the real estate and construction sector, while the authorities asked for higher provisioning and a better disclosure of problematic assets. The current regulatory and supervisory framework failed to fully restrain the excessive credit growth in the boom years and allowed only gradual steps in restructuring the weak banks once problematic assets started to accumulate in certain banks.

4.1 SIZE AND STRUCTURE

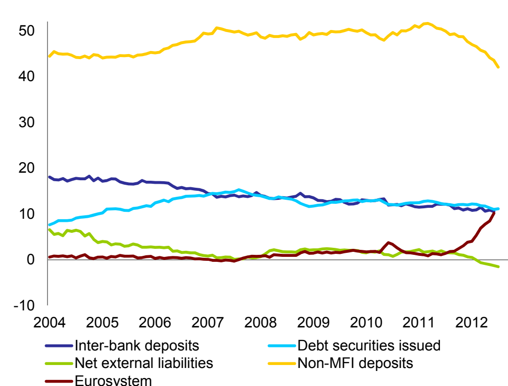
The total assets of the Spanish banking sector amount to around 340% of GDP as of June 2012, being slightly below the euro area average of about 355% of GDP (Graph 11**)**. However, the expansion of the Spanish banks has been very dynamic over the last decade, which led to a rapid catching up with the euro area average. The total amount of assets has more than doubled in nominal terms from 2004 to 2011, while as a share of GDP the gap between the euro area average and Spain was reduced by about 50 percentage points over the same period. Important drivers of the excessive leveraging process in Spain were loans to construction and real estate, rising from 10% of GDP in 1992 to 43% of GDP in 2009 and subsequently declined to about 37% of GDP at the end of 2011. In addition, consumer and mortgage loans more than doubled in nominal terms from 2004 to 2011. Thus, total lending has also advanced very fast from around 148% of GDP at the end of 2004 to 208% of GDP at the end of 2011.

Graph 11: Total assets Spain vs. euro area, average (% of GDP)



Source: ECB

Graph 12: Liabilities structure of Spanish banks (% of total)



Source: ECB, IMF

On the funding side, a strong increase in the banks' reliance on wholesale market funding occurred during the boom years (Graph 12). The issuance of debt securities doubled its share in the banks' total liabilities from about 7.6% in January 2004 to 15.3% in August 2007. This increase can be easily explained by the large amount of asset backed securities issued during the real estate boom. At the same time, the reliance on private sector deposits also increased by around 7% points while the funding via inter-bank deposits and external liabilities registered a slight decline over the same period. The contribution of the Eurosystem to the funding of Spanish banks was negligible, less than 1% of total liabilities, until the start of the global financial crisis in the summer of 2007. Until then, Spanish banks had been small net creditors to the Eurosystem (see Table 1).

The rapid growth of the balance sheet of the Spanish banking sector came to an end once the global financial crisis erupted in full force as Lehman Brothers went bankrupt in October 2008. The banking sector weathered fairly well the onset of the global financial crisis, due to its relatively high capital buffers, a relatively benign macroeconomic environment and low exposure to complex derivatives markets. However, many Spanish banks progressively lost access to wholesale funding markets, amid tensions in global financial markets and the simultaneous bursting of the local real estate bubble. Following the collapse of activity in the construction sector, the economy moved into recession and unemployment soared. In consequence, asset quality has deteriorated significantly with the ratio of non-performing loans surging to 9.4% of total loans in June 2012 while the reliance of banks on the Eurosystem funding has reached historically high levels (i.e. more than 10%

of total liabilities as of June 2012). The development of the banking sector problems is presented into more depth in Box 1.

Table 1: Flow of funds via the Spanish banking sector

EUR billion - flows over periods	Jan 04-Aug 07	Sep 07-Dec 11	Jan 12-Jun 12
1. Net financing of the government	**-62.2**	**148.0**	**89.1**
+ claims	-58.3	167.8	85.2
- deposits	3.9	19.8	-3.9
2. Net financing of the economy*	**287.8**	**33.3**	**39.1**
+ claims	974.6	349.2	-57.5
- deposits	686.8	315.9	-96.6
3. Net financing of other banks	**0.2**	**62.4**	**12.5**
+ claims	95.7	50.1	6.2
- deposits	95.5	-12.3	-6.3
4. Net external financing	**97.0**	**-18.0**	**71.2**
+ assets	107.2	31.6	33.6
- liabilities	10.2	49.6	-37.6
5. Net other and fixed assets	**42.1**	**98.8**	**21.2**
TOTAL FUNDING NEEDS	**364.9**	**324.2**	**233.3**
Average monthly need	8.29	6.23	38.89
1. Long-term funding**	**373.4**	**185.0**	**-6.7**
2. Net refinancing at the Eurosystem	**-8.5**	**139.2**	**240.0**
Eurosystem funding as % of total needs	-2.3%	42.9%	102.9%
End-of-period borrowing from the Eurosystem	18.7	190.8	425.2
End-of-period deposits at the Eurosystem	18.0	50.9	45.3
End-of-period borrowing from the Eurosystem, as % of total liabilities	0.7%	5.3%	11.4%

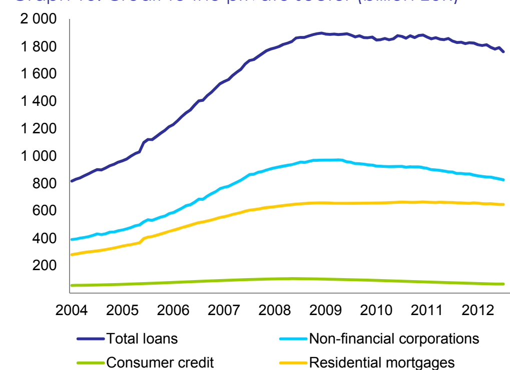
* The term "economy" designates the non-monetary and non-government sector

** Long-term funding includes change in the banks' capital and band issuance on capital markets

Source: ECB statistical data warehouse, IMF, DG ECFIN calculations

Starting from the second half of 2011, the deleveraging process gained speed, and credit growth entered into negative territory (Graph 13). As of June 2012, total banking sector credit declined by 1.5% year-on-year despite a significant increase in credit to the government by around 38% year-on-year. The increase in lending by Spanish banks to the government occurred against the background of a gradual withdrawal of foreign investors from the domestic debt market and a heavy participation of Spanish banks in last December's Long-Term Refinancing Operations (LTRO). In comparison, domestic credit to the private sector dropped by around 5% in June 2012 compared to the previous year. The fall in credit is driven by both demand and supply factors. On the one hand, the economy slipped into recession again and households and the corporate sector are working on reducing their indebtedness. On the other hand, funding difficulties intensified in parallel with rising recapitalisation needs on the basis of growing asset impairments.

Graph 13: Credit to the private sector (billion EUR)



Source: ECB

BOX 1: THE EMERGENCE OF BANKING SECTOR PROBLEMS IN SPAIN

The burst of the housing market bubble had a swift but lasting impact on the balance sheet of the banking sector. As the exposure of the banking sector to the construction and real estate development sectors had zoomed to EUR 470 billion in 2008 from only about EUR 190 billion in 2004, the housing market correction immediately multiply the amount of non-performing bank assets. As a matter of fact, the amount of non-performing loans has been quite negligible during the boom years and still represented only about 0.6% of total loans in the sector in 2007. The indicator jumped however to 5.7% in 2008 and continued to increase strongly to a staggering 22.1% in the first quarter of 2012. Although the amount of non-performing loans did not increase at a similar fast pace for other categories of loans such as consumer loans and retail mortgages which only grew to 5.9% and 3.1% of total at the end of March 2012, the contribution of the construction and real estate development sectors was instrumental in bringing up the NPL ratio for the entire economy to 9.4% in June 2012.

The sharp increase in the amount of non-performing loans raised the amount of provisions set aside by banks, dented their profitability and required recapitalisation actions in many banks. The amount of asset impairment losses on the lending activity, which reflects specific and general provisions, almost doubled between 2008 and 2012, exceeding EUR 100 billion as of June 2012. As a share of net operating income, asset impairment losses grew from less than 50% at the end of 2008 to more than 80% at the end of 2011. Together with the declining growth of credit and shrinking interest rate margins, the provisioning for bad loans contributed to a sharp decline in the banking sector profitability. The return on equity for the entire banking sector declined from about 17% in mid-2008 to 2.8% at the end of 2011 (subsequently revised to a loss after the BFA-Bankia group significantly revised its income statement downward). Therefore, the average profitability of the sector masks a large difference between the relatively sound core of the banking system which remained profitable and the saving banks sector posting large losses by certain banks where the Fondo de Reestructuración Ordenada Bancaria (FROB)[8] has become majority stakeholder.

The savings banks were most affected by the crisis because their previous aggressive expansion with a flawed business model. The market share of the saving banks had increased steadily, from around 20% of total assets in the 1980s to about 40% in 2010. Their credit expansion went in a much higher proportion to the real estate sector compared to the other banks and was increasingly funded on the wholesale markets. Moreover, there was a significant involvement of regional and local governments in the ownership and management of the saving banks, which may have impacted negatively their business decisions and ultimately their performance. The rate of non-performing loans of the saving banks soared to almost 10% of total loans at the end of 2010 from about 1% in 2007, compared to a banking system wide average of 4.7%. Their buffers for loan-loss provisions were quickly depleted from almost 100% in 2007 to about 40% in 2010. As a result, capital and provision buffers needed to be strengthened together with the corporate governance. A gradualist reform process started with the transformation of saving banks into commercial banks and the consolidation of the sector via mergers and takeovers, with the active support of FROB. This overhaul and clean-up of the sector continues to this day (see also chapter 6.2).

2. **Domestic credit to non-financial corporations went down by about 6% year-on-year and was largely driven by the reduction in credit to construction and real estate development companies.** Consumer credit was also down by more than 11% year-on-year. On the liabilities side, net funding by the Eurosystem[9] increased by about EUR 240 bn (6% of total liabilities) in the first half of 2012. The rapidly growing recourse to the Eurosystem financing reflects the high degree of disruption of financial markets in the euro area and a loss of deposits. Funding from the euro-area inter-bank and corporate debt markets declined by around EUR 26 billion over the same period of 2012, while household and corporate deposits fell by about EUR 100 bn.

The Spanish banking sector is dominated by deposit-taking institutions, namely banks and saving banks, and to a lower extent credit cooperatives accounting for less than 2% of the total assets in the system. The degree of concentration in the sector is moderate. The five largest credit institutions in the country accounted for about 45% of the total assets in 2010. During the crisis, the number of credit institutions has declined by 27 (7.5% of the total) from 2008 to 2011, following the restructuring process initiated by the Spanish authorities and private sector consolidation. Over the same period, the number of bank branches fell by about 13%, while the number of employees was also reduced by around 11% (see section 6.1 for more details).

[8] Fund for the Orderly Restructuring of the Banking Sector, http://www.frob.es

[9] Including both net lending to MFIs and holding of securities

The impact of the crisis on the Spanish banking sector has been uneven due to its heterogeneous structure:

1. **Two large internationally active banks, accounting for about 30% of the banking system assets**[10] (almost half of the system at consolidated level), enjoying sound profitability due to their foreign operations (only one third of their net profits originate domestically) and managing to cover capital shortfalls identified by EBA[11] from private sources. These banks also succeed in retaining some access to market funding by placing secured and unsecured issuances in 2012, even though this advantage came under pressure lately. This group of banks has the lowest exposure to the real estate and construction sector and mainly to completed buildings.**The group of saving banks had the biggest relative exposure to the real estate sector and suffered also under serious corporate governance deficiencies.** This group underwent a thorough restructuring process, and their number was reduced from 45 (in June 2010) to 11 (in March 2012) via several mergers and takeovers (see chapter 6 for more details). Currently, this group accounts for about 40% of the banking sector assets and can be divided into two sub-groups: (i) a sub-group of former saving banks that have not received any state support and have an above average exposure to residential mortgages; and (ii) a group of banks which rely heavily on the government and on the FROB for capital and liquidity support. They have a large exposure not only to the mortgage lending, but also to the real estate and construction loans. This sub-group also has the largest share of foreclosed assets.

3. **There is a group of medium and small private sector banks which cover about 11% of the banking sector assets and have an above-average exposure to the corporate sector.** Together with the first group, these banks have the highest loan-to-deposit ratios at about 150%. They were also among the largest borrowers relative to their total funding needs in the recent ECB LTROs.

4.2 REGULATION AND SUPERVISION

In Spain, the regulation and supervision of financial institutions and securities markets is carried out by several institutions. Banco de España (BdE) is responsible for regulating and supervising credit institutions and other financial institutions, the Comisión Nacional del Mercado de Valores (CNMV)[12] for securities markets and investments firms, and the Dirección General de Seguros y Fondos de Pensiones (DGSFP)[13] for insurance and pension funds. While there is in principle a clear distribution of tasks across these supervisory bodies, in 2006, a Financial Stability Committee combining all three supervisors, was set up to coordinate supervisory guidelines and actions, crisis prevention and management issues and to exchange information, with the aim to maintain financial stability.

The BdE has the responsibility to promote the proper working and stability of the financial system. In addition, BdE supervises, without prejudice to the functions of the ECB, the proper functioning of the national payment systems as well as solvency and compliance with the specific rules for credit institutions and other entities and financial markets, for which it has been assigned supervisory responsibility. The status of the BdE, its functions, tasks, responsibilities and sanctioning powers are mainly defined in two laws: the Law of Autonomy of the BdE (Law 13/1994, of 1 June[14]) and the Law of Discipline and Intervention of Credit institutions (Law 26/1988, of 29 July[15]).

The Law of Autonomy empowers the BdE to adopt any regulation that it deems necessary in order to develop legislation in its area of competence, which is however sometimes restricted by higher-order legislation. These regulations issued by the BdE are called 'circulares'. Notwithstanding, financial regulation is in the hands of the Parliament, the Government and the Ministerio de Economía y Competitividad (MdE), approving laws and decrees, which in many cases are subsequently further developed by circulares. Thus, BdE's

---

[10] Excluding foreign branches

[11] According to the decision of the European Council of 26 October 2011, systemically important EU banks are required to build up exceptional and temporary capital buffers to reach a Core Tier 1 capital ratio of 9% after accounting for sovereign debt holdings at market prices.

[12] National Stock Exchange Commission

[13] Directorate General of Insurance and Pension Funds, a directorate of the Ministerio de Economía y Competitividad (Ministry of Economy and Competitiveness) http://www.dgsfp.meh.es/

[14] http://noticias.juridicas.com/base_datos/Fiscal/l13-1994.html

[15] http://noticias.juridicas.com/base_datos/Fiscal/l26-1988.html

authority to issue prudential regulations is restricted to the areas specifically delegated by a law, a royal decree or a ministerial order.

As regards supervision, the independence of the BdE to exert its sanctioning power and to promptly implement remedial actions and disciplinary sanctions has been limited. According to its role as supervisor and financial stability watchdog, the BdE has been empowered by the Law of Autonomy and the Law of Discipline and Intervention of Credit Institutions (Law 26/1988 of 29 July) to make sanctioning proposals to the Minister of Economy, but the Ministry has the sanctioning power for very serious infractions and resolution capacity.

The supervisory model of the BdE **focuses on ensuring that credit institutions are adequately capitalised, that they comply with the regulations in force and prudently manage and control their business and risks.** In addition to traditional supervisory activities (close supervision of financial statements and their compliance with accounting rules, banking regulations and prudential valuation rules), a risk-based supervisory approach has been progressively implemented from the late 1980s, in parallel with international developments.

In order to achieve its objective, the BdE **has traditionally carried out two types of supervisory procedures:**

- **Off-site monitoring and analysis of credit institutions on an individual level and in relation to the peer group and different aggregations of entities, combining both quantitative and qualitative instruments.** This analysis is based on a highly developed Supervision Database System and includes an internal credit assessment of the main borrowers and individual operations of banking institutions to be taken as a reference by banks. The Central Balance Sheet Office and the credit Register which exist at the BdE provide input for this assessment.
- **Inspection visits for all credit institutions and specific on-site continuous monitoring in the case of the largest banking institutions with potential systemic repercussions.** These inspections are a fundamental tool to provide inspectors direct contact with the internal risk control systems of banks and a direct cross-checking of data and information received.

The supervisory approach taken has been conservative in order to reinforce the solvency of entities. This has been pursued not only through a close monitoring of the compliance with capital requirements and the proper working of internal control system, but also by creating the correct incentives to moderate risk-taking. For example, Spain has introduced the dynamic provisioning or the so-called countercyclical provisioning at the beginning of the 2000s. The BdE has also issued regulations and recommendations through 'circulares' in order to improve the risk management of banks, to strengthen soundness and also to increase the degree the transparency and accountability of financial statements. However, as mentioned before, the BdE has lacked authority to issue prudential regulations except in specific areas delegated by the MdE which has been the body in charge of issuing financial regulation.

The supervisory framework has been broadly stable since the start of the crisis. The 2012 IMF Financial Sector Assessment Program(FSAP) of Spain makes a nuanced assessment of the banking supervision framework developed in the BdE[16]. As the IMF points out, that framework shows some main weaknesses, including, the (1) insufficient regulatory independence by the BdE, (2) the lack of adequate authority and mandate to address pre-emptively the build-up of risk in the system, and (3) the lack of fully effective remedial action and sanctioning regime. Also, in some cases, decisive remedial actions were not proportional to the seriousness of the problems detected by the supervisory services in the early stages of the crisis.

In conclusion, the mentioned structural weaknesses, together with the fact that the regulatory framework and oversight of concentration risks were not fully adequate, explain the progressive concentration of risks linked to real-estate activities mainly in some savings banks. The latter had to be subsequently recapitalised and in some cases supported by the state through the FROB. The involvement of Autonomous Communities[17] – regional governments - in the prudential supervision of savings banks has jeopardised the role

---

[16] The IMF mentions that the core supervisory process at the Banco de España is strong and is supported by an experienced cadre of inspectors, and that highly experienced and respected professional staff has been supported by good information systems and through supervisory processes.

[17] According to the Law of Autonomy "the Bank shall supervise, in accordance with existing regulations, the solvency activities and compliance with specific regulations of credit institutions, and any other financial institution or market it has been called on to oversee,

of the BdE in the supervision framework. Moreover, the steps to take remedial actions have been slowed down because the limitations imposed by the special regulatory regime of savings banks which implied the need to put into agreement all the parties involved with criteria not always subordinated to financial stability.

As explained in more detail in Chapter 6, in response to the crisis, and in particular since the creation of FROB in 2009, actions were progressively taken to reinforce capital buffers of the Spanish banking system, to improve disclosure by banks of risks mainly related to real estate activities and to demand recapitalization plans when required. The reforming and restructuring measures finally taken in relation to the saving banks have been focused not only on a case-by-case resolution by the FROB but also on addressing of the main weaknesses affecting the saving banks model, which as a result has been thoroughly reformed.

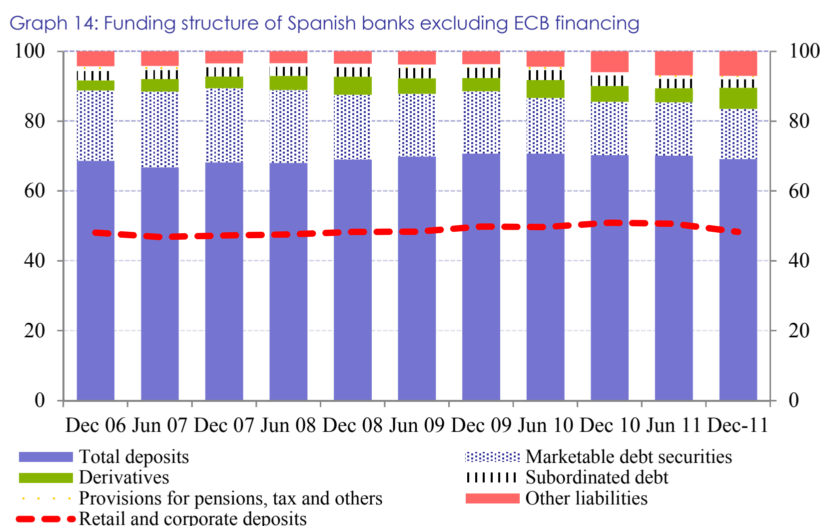
without prejudice to the prudential supervision of Comunidades Autónomas in their areas of responsibility, and the co-operation between these Comunidades Autónomas and the Bank in performing such regional supervisory tasks" (see Chapter II, article 7).

5 CHALLENGES FACING THE BANKING SECTOR

5.1 FUNDING DIFFICULTIES

Since mid-2011, the increasingly difficult access to funding of Spanish banks has been the outcome of both external and internal factors. On the back of increasingly unfavourable developments in the euro area sovereign debt markets, the negative feedback loop between the sovereign and the banking sector as well as concerns about the sizeable exposure of banks to the real estate and construction sector, the access of Spanish banks to medium- and long-term wholesale funding has become seriously increasingly impaired. Banks have increasingly relied on short-term markets (money markets), including interbank markets. However, the high uncertainty related to euro area developments has also adversely impacted these markets. Against this background, the European central counterparty clearing houses have played an important role as an alternative to the traditional interbank financing. Since mid-2011, Spanish banks have increased their repo financing through private international and domestic clearing houses (for instance, LCH.Clearnet Group Ltd[18], MEFFRepo[19]). However, this source of funding has also become increasingly expensive, as the increase in spreads on sovereign debt has put also upward pressures on margin requirements which tend to follow these spreads.

Graph 14: Funding structure of Spanish banks excluding ECB financing



Source: BdE

The tensions on the wholesale funding markets are increasingly reflected in the developments concerning marketable debt securities. The weight of marketable securities and subordinated debt in the total funding of credit institutions has steadily declined since December 2009 (Graph 14). Given the difficulties in accessing wholesale funding markets, Spanish banks have increased their efforts to attract retail funding. The heightened competition for deposits has significantly driven up interest rates on both sight and term deposits. To counteract this dynamic and discourage the competition for deposits, authorities introduced in June 2011 new prudential provisions requiring higher *ex-ante* contributions of banks to the Fondo de Garantía de Depósitos de Entidades de Crédito (FGD))[20], which reflect their risk profile.[21] In an attempt to circumvent these prudential rules, banks have offered to clients short-term securities ('pagares bancarios'), which, however, are not covered by the deposit guarantee scheme. The weight of retail and corporate deposits in the total funding of banks has been on a declining trend since June 2011, *inter alia*, due to the reduction of deposits held by non-residents.

The reliance of the Spanish banks on ECB financing has increased markedly since August 2011. This increased dependence on ECB financing has been triggered by the above-mentioned impaired access to wholesale funding, the increasing cost of retail funding and the several downgrades by rating agencies. . The net

---

[18] http://www.lchclearnet.com/

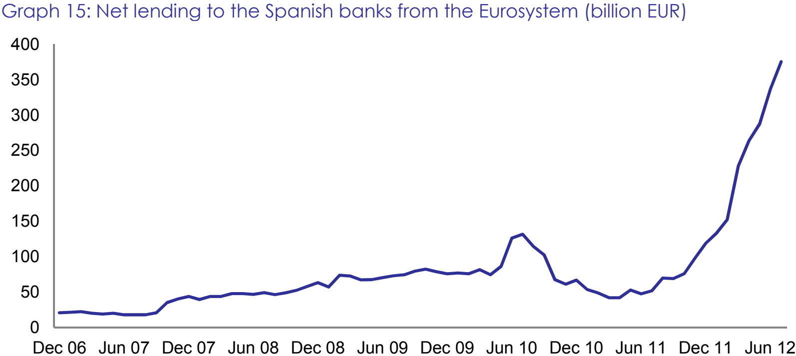
[19] http://www.meff.es/aspx/Comun/Pagina.aspx?l1=Repo&f=Definicion&id=ing

[20] Deposit Guarantee Fund, http://www.fgd.es

[21] These provisions apply to all banks which contribute to the FGD (i.e. credit institutions incorporated in Spain). They do not apply to branches of foreign banks, since the latter contribute to the FGD in the home country.

lending to the Spanish banking system from the Eurosystem spiked to the record level of EUR 375.5 billion in July 2012, which corresponds to an increase of 11% compared to June 2012 and 621% compared to July 2011 (Graph 15). Spanish banks were also one of the main beneficiaries of the two rounds of long-term refinancing operations (LTROs) of the ECB in December 2011 and February 2012. The two LTROs have alleviated somewhat funding pressures, as banks were able to cover their wholesale funding maturities for 2012. However, these LTROs have also led to an increase in the exposure to the sovereign of Spanish banks, as several of them engaged in carry-trade activities.

Graph 15: Net lending to the Spanish banks from the Eurosystem (billion EUR)



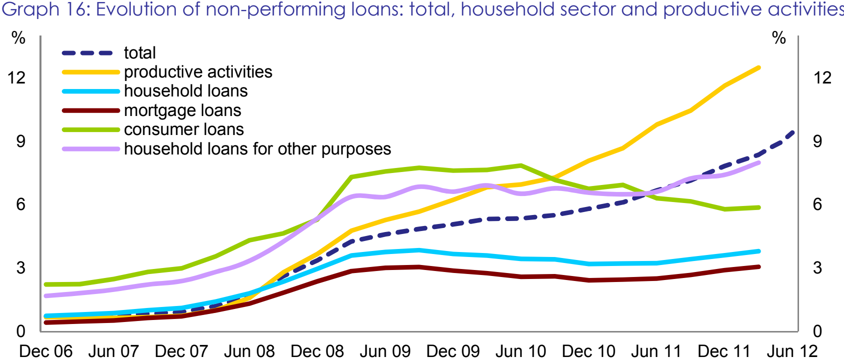
Source: ECB; BdE

5.2 LEGACY ASSETS

One of the major challenges of the Spanish banking sector has been its sizeable exposures to the real estate and construction sector. According to the BdE, the total exposure of the Spanish banking sector to the real estate and development sector amounted to EUR 308 billion at the end of December 2011. The total volume of real estate and development assets totalled EUR 184 billion at the end of last year, which corresponds to an increase of roughly 5% compared to the end of June 2011. Of this amount, half corresponds to land and unfinished property development projects, whereas the other half relates to finished property. Troubled assets, which make out roughly 60% of total real estate and development assets, include doubtful loans (especially due to payment delays), substandard loans as well as foreclosed assets.

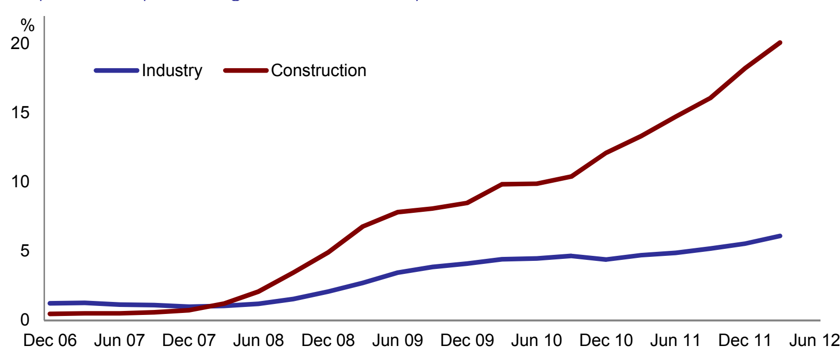
The deterioration in asset quality at system level has accelerated since March 2011. Non-performing loans reached 9.9% at the end of July 2012 compared to only 0.9% at the end of December 2007 (Graph 16). This spike in asset delinquency has been the outcome of both the deterioration in economic activity but also of a more forceful recognition of losses by banks and restructuring of banking sector. The impaired assets in the real estate and development sector have been the main driver for the increase of non-performing loans at system level. Non-performing loans in the real estate and construction sector soared from 0.7% at the end of December 2007 to 20.1% at the end of March 2012 (Graph 17). By contrast, the increase in impaired assets in the industry sector was more subdued, as non-performing loans went up from 1.0% at the end of December 2007 to 6.1% at the end of March 2012. Non-performing loans in the household sector have remained considerably below the system level, due to the relatively low level of impairment on mortgage loans, which reached 3.1% at the end of March 2012. However, given the protracted downturn and high unemployment, further increases on delinquencies on mortgage loans are likely going forward.

Graph 16: Evolution of non-performing loans: total, household sector and productive activities



Source: BdE; European Commission services

Graph 17: Non-performing loans in the industry and construction sector

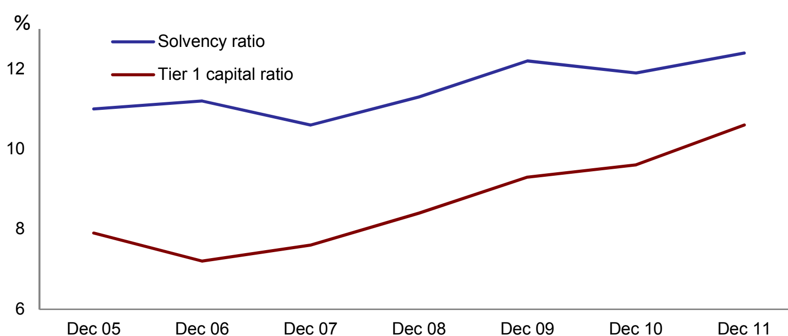


Source: BdE; European Commission services

5.3 BANKING SECTOR CAPITALISATION

The capitalisation of the Spanish banking sector has improved over the last couple of years. The solvency ratio at system level perked up from 11.9% at the end of December 2010 to 12.4 % at the end of last year. Meanwhile, banks have boosted their Tier 1 capital ratio, which at system level went up from 7.6% at the end of December 2007 to 10.6% at the end of December 2011 (Graph 18). Capital has been, however, unequally distributed among banks. The largest three banks in the system have reassuring capital buffers, whereas other banks including the group of banks under FROB control are the most vulnerable, *inter alia*, due to their portfolio of troubled exposures to the real estate and construction sector. Market concerns about further recapitalisation needs have continued to linger despite capital increases and balance sheet repairs. According to the BdE, the cleaning-up of balance sheets done until now resulted in large write-downs amounting to EUR 105 billion (3% of total assets) from January 2008 until June 2011.

Graph 18: Capitalisation of Spanish banking sector (%)



Source: IMF; BdE

In line with the ECOFIN Council decision of 26 October 2011, the largest EU banks with cross-border operations had to build up temporary capital buffers to reach a Core Tier 1 capital ratio of 9%.. According to final figures published by the European Banking Authority (EBA) on 8 December 2011, the five largest Spanish banks (i.e. Santander, BBVA[22], Bankia, Caixa Bank and Banco Popular Español) needed additional capital amounting to EUR 26.2 billion. Bankia, which initially submitted a capital plan to meet the identified capital shortfall, started an intensive restructuring process at the beginning of May 2012 and will, therefore, be monitored separately by the Spanish authorities. In its July 2012 statement on the implementation of the European recapitalisation plan, the BdE indicated that the four Spanish banks complied with the terms of the recapitalisation at the end of June 2012 and that no significant deviations are expected once final data will be available.

The capitalisation of the banking sector was bolstered by the recapitalisation process of the savings banks based on the requirements introduced through the Royal Decree Law 2/2011 (see section 6.1 for more details). In March 2011, based on end-December 2011 data, the BdE identified eight savings banks or savings banks groups which had to increase their capital buffers to reach a core capital ratio of 8% or 10% (depending on their reliance on wholesale funding and private investors involvement). According to the first estimates of the

[22] Banco Bilbao Vizcaya Argentaria

BdE, the additional capital needs of these eight entities amounted to EUR 14.077 billion. According to the recapitalisation plans submitted to the BdE, four savings banks/bank groups (CAM[23], Catalunyacaixa, Novacaixagalicia and UNNIM[24]) requested capital support from the FROB to meet the new capital requirements.[25] Bankia and Banca Civica opted for stock market listing, whereas Mare Nostrum and Liberbank for capital increases through private investors. Several savings banks managed to attract private capital, thereby reducing their capital requirements from 10% to 8%. As a result, the total capital needs of the savings bank sector declined to EUR 13.4 billion at the end of September 2011. The total capital support provided by FROB amounted to EUR 7.6 billion, whereas the additional capital obtained by the savings banks from the market amounted to EUR 5.8 billion.

5.4 CORPORATE GOVERNANCE OF SAVINGS BANKS ("CAJAS DE AHORROS")

Over the last couple of years, the corporate governance of savings banks has been strengthened considerably. The 2010 amendments to the law on savings banks (LORCA)[26] targeted, *inter alia*, the enhancement of the transparency of governing bodies of savings banks, the reduction of the influence of the regional governments on the internal organisation of *cajas* and strengthening of the fit and proper rules as well as professional qualification requirements for managers. These amendments reduced the ceiling on voting rights of public administrations from 50% to 40%.[27] Furthermore, the participation of the regional governments in the governing bodies of *cajas* has to unfold through members of recognised professional qualification, nominated exclusively by the legislative assemblies. Regarding fit and proper rules, the amendments introduced an incompatibility clause according to which persons with penal conviction, unable to fulfil public functions or manage financial institutions cannot be elected in the governing bodies of *cajas*. The 2010 amendments also strengthened the professional qualification of the members of the board of directors and staff in charge of internal control. Concerning the latter, regional governments have no longer the right to nominate a member in the internal control commission.

In spite of significant improvements, including through new provisions included in the Royal Decree Law 2/2012[28] on the banking sector reform, several corporate governance arrangements need further attention. (see section 6.2 for further details) Since most savings banks have transferred their credit activities to commercial banks, the size of their governing bodies needs to be aligned to their current situation. Furthermore, incompatibility requirements for the governing bodies of the former savings banks and the banks controlled by them need to be further enhanced as well as the fit and proper requirements for the governing bodies of the former savings bank. Last, but not least, the appointment process for the governing bodies of the former savings banks could be further revisited.

---

23 CAM was the Caja de Ahorros del Mediterráneo, which dates from the foundation of Caja de Ahorros y Monte de Piedad de Alcoy in 1875

24 UNNIM BANC SA is the result of the merger of Caixa Manlleu, Caixa Sabadell y Caixa Terrass, now part of BBVA Group.

25 The recapitalisation of Catalunyacaixa, Novacaixagalicia and UNNIM through the FROB constituted a de facto nationalisation of these cajas. The participation of the FROB corresponded to 89.8% of the capital of Catalunyacaixa, 93.2% of the capital of Novacaixagalicia and 100% of the capital of UNNIM.

26 Ley 31/1985, de 2 de agosto, de regulación de las normas básicas sobre Órganos Rectores de las Cajas de Ahorro

27 According to the law on saving banks (LORCA) adopted in 1985, in several cases, local authorities held a combined share of over 70% of the voting rights in the governing bodies of the cajas. Since 2002, through the changes introduced via the Ley Financiera, the voting rights of the public administration have been reduced from 70% to 50%.

28 http://noticias.juridicas.com/base_datos/Admin/rdl2-2012.html

6 THE POLICY RESPONSE SO FAR

6.1 PUBLIC SUPPORT PROVIDED TO THE BANKING SECTOR

6.1.1 Capital support

Spanish authorities have been pursuing a strategy of burden sharing between the public and private sector in the process of bank restructuring and resolution. Public resources have been channelled through FROB, while private resources have been drawn from the FGD.

FROB was created in 2009[29] to manage restructuring and resolution processes for credit institutions. It has two main functions: 1) providing financial support to the voluntary merger of viable institutions and 2) overseeing crisis resolution of non-viable institutions if a solution cannot be found within the framework of deposit guarantee schemes. FROB is fully controlled and managed by the BdE. Any State aid that it provides is subject to approval by the European Commission on a case-by-case basis.

FROB's initial capital was EUR 9 billion, raised to EUR 15 billion in February 2012. In addition, FROB may raise funds by issuing fixed-income securities, receiving loans, applying for the opening of credit lines and entering into any other debt-incurrence transactions. FROB can borrow each year up to the limit set by the relevant annual State budget laws, which was set at EUR 120 billion for 2012. In addition, the State central government may provide guarantees for FROB, and EUR 66 billion was allocated in the 2012 State budget law for this purpose. To date, FROB has had four bond issuances totalling EUR 9.15 billion. It has also issued additional EUR 3 billion of syndicated debt in conjunction with other financial institutions. Its total commitments so far amounted to EUR 13.9 billion[30]. In the context of the financial assistance provided to Spain, the European funds will be provided to the FROB with the purpose of recapitalising Spanish financial institutions in accordance with EU State aid Rules.

In the second phase of reforming the Spanish banking sector when the focus was to increase its solvency, the FGD, which is funded by the contributions from the banking sector, shared some of the financial burden with FROB. It provided a total of EUR 6.2 billion both in terms of capital injection as well as asset protection schemes granted in the competitive sale process. FGD was created in October 2011 by merging the three previously different deposit guarantee schemes (for banks, savings banks and cooperative banks). The annual ex-ante contributions of banks to the FGD will not surpass 0.2% of the guaranteed deposits, depending on the features of the respective credit institutions. Apart from consolidating the different guarantee schemes, the new provisions aimed to strengthen the bank resolution "arm" of the FGD.

The strategy of burden sharing between private and public sector in crisis management and resolution is based on the right principle but in Spain it has led to an overly gradualist approach. As a result, while the impact on public finances was minimized, the necessary clean-up of the balance sheets and recapitalization required to deal with the post-boom economy was insufficient in size and took too long. In addition, as explained in the section 7.4.6.6, the governance arrangements in the two safety net agencies - FROB and FGD – should be reviewed to avoid potential conflict of interests.

6.1.2 State interventions

Spanish authorities have intervened in several weak credit institutions since 2009. These interventions included: Caja Castilla La Mancha (March 2009), Cajasur (May 2010), CAM (July 2011) and Banco de Valencia (November 2011). FROB has also acquired majority stakes in several institutions during the integration and recapitalization process, including Unnim, Catalunya Banc, Novagalicia Banco (see section 5.3 for additional

[29] FROB was created by the Real Decreto-ley 9/2009 (labelled as FROB 1.0 – consolidation phase), later amended by the Real Decreto-ley 2/2011 (labelled as FROB 2.0 – increasing solvency phase), and Real Decreto-ley 5/2012 (labelled as FROB 3.0 - cleaning up balance sheets phase). It is currently governed by the recently approved Real Decreto-ley 24/2012 of 31 August 2012.

[30] FROB 1.0 provided a total of EUR 10.1 billion to the savings banks to support their integration and restructuring processes. It injected the capital through convertible preference shares, which must be repurchased by these institutions within a period of five years (with a possible extension of additional 2 years). FROB 2.0 provided EUR 3.8 billion for the recapitalisation of savings banks through ordinary shares, which terminate after 5 years (in the first 2 years the institution can buy back the shares). FROB 3.0 was amended to provide financial support needed to comply with new provisioning requirements (see section 6.3 for more details).

details). In addition, in May 2012, following the request of the board of directors of BFA-Bankia, FROB approved the conversion of preferential shares subscribed in Banco Financiero y de Ahorros (BFA) into ordinary shares, corresponding to a partial nationalization of Bankia (45% stake).

FROB has been pursuing a strategy of restructuring of the acquired banks with a view of selling them to the private investors in the context of a competitive bidding process in line with State aid rules. As part of the transaction, the buyers were also granted an asset protection scheme for a predetermined portfolio of assets. In this way, Cajasur was sold to Bilbao Bizkaia Kutxa (BBK) (July 2010), CAM to Banco Sabadell (December 2011) and Unnim to BBVA (March 2012).

There are currently four institutions under the control of FROB. These include: Catalunya Banc, Novagalicia Banco, Banco de Valencia, and BFA-Bankia. These institutions are in different stages of restructuring. Competitive bidding processes had been under way for Catalunya Banc and Banco de Valencia, but were postponed when Spain applied for the financial assistance for the restructuring of its financial system.

Corrective actions could have usefully taken place earlier in some of these cases[31]. Weak banks were allowed to continue to operate despite the timely recognition of weaknesses and recommendation for corrective action. More detailed recommendations for improvement in supervisory practices with respect to bank intervention and resolution are discussed in section 7.4.6 on supervisory framework.

6.1.3 Other measures

Spanish authorities adopted a number of measures in October 2008 to support the financial sector as part of the EU-wide effort. First, the deposit insurance limit was increased to EUR 100,000. Second, a Fondo para la Adquisición de Activos Financieros (FAAF) was established to provide liquidity to banks of up to EUR 50 billion, out of which 19.3 billion have been used to buy high quality asset-backed securities issued by banks. All the operations carried out by FAAF have reached their maturity and the outstanding amount is zero. Finally, a guarantee scheme for financial institutions was established under the state aid rule of the European Commission. Under this programme, a maximum of EUR 100 billion of state guarantees could be granted in each of the two years: 2008 and 2009. This programme was prolonged for five times, finally expiring on 31 December 2011. As of 4 September 2012, the outstanding issues guaranteed by the state in 2008-2009 programmes amount to around EUR 32 billion. In February 2012, the European Commission approved a new scheme of state guarantees, with maturities between 2015 and 2017, which was in force until 30 June 2012. Outstanding guarantees issued under this scheme amount to EUR 41.2 billion.

6.2 RESTRUCTURING OF THE SAVINGS BANKS SECTOR

Following more forceful policy action since mid-2010, the savings bank sector has undergone significant consolidation and recapitalisation. This two-phase restructuring process was fostered by amendments to the savings bank law (LORCA) in July 2010 and the introduction of more stringent solvency requirements for commercial, savings and cooperative banks in February 2011. The amendments to the LORCA have enabled, inter alia, cajas to strengthen their capital base by transforming non-voting 'cuotas participativas' into voting equity units, improving governance structures and adopting new organisational and business models (e.g. the transfer of credit activities to a separate banking entity). The new capital requirements, introduced in February 2011, require cajas to maintain a core capital ("capital principal") ratio of 8% or 10% in certain cases (high reliance on wholesale funding or less than 20% of share capital owned by private investors). This recapitalisation process of the cajas ended at the end of September and led to a combined capital increase of EUR 13.4 billion for the cajas identified by the BdE as in need of additional capital (see section 5.3 for more details).

The consolidation of the savings bank sector has unfolded through several integration processes. These integration processes included mergers, institutional protection schemes – SIP[32], and takeovers and involved 43 out of the 45 savings banks. Apart from the reduction in the number of savings banks from 45 to 15, the consolidation process had an important impact on the size, business model, balance sheets and efficiency of these banks. Following the different mergers, the average total assets per savings bank has increased from EUR 29 billion to roughly EUR 85 billion. This increase in size has improved the capacity of savings banks to

[31] As also pointed out in the IMF FSAP report

[32] Sistema Institucional de Protección

compete with other credit institutions. The large majority of savings banks have transferred their credit activities to commercial banks, which constitutes a major step forward as regards corporate governance. Moreover, the consolidation process has resulted in excessive capacity adjustments, including staff reductions between 9% and 23% and branch closures of 10% to 30% by end-September 2011.

Despite these positive achievements, the restructuring process of savings banks has also had a number of shortcomings. Some of the mergers have focused on mergers and less on adjusting the business models and the cost base. They therefore resulted in bigger but not necessarily stronger entities and they continue to pose challenges to the financial stability of the Spanish banking sector. In addition, as discussed in section 5.4, further improvements with respect to the corporate governance of savings banks are recommended.

6.3 INCREASED PROVISIONING REQUIREMENTS

To further improve the prudential framework for the recognition of impaired assets, the Spanish authorities amended the loan-loss provisioning rules in June 2010. Until the introduction of the new amendments, Spanish banks provisioned non-performing loans according to four different calendars depending on the counterparty and type of collateral involved. After the merger of the four previous loan-loss provisioning calendars into one, the following rules apply: loans overdue of up to six months have to be 25% provisioned, between six and nine months overdue 50% provisioned, between nine and twelve months overdue 75% provisioned, whereas loans which are already one year or more overdue have to be completely provisioned. For credit exposures backed by real estate collateral, the provisioning rules introduced in June 2010 take into account the value of collateral to a higher extent. The new prudential rules request banks to build up loan-loss provisions only for the outstanding value of loans not sufficiently secured by real estate collateral. Banks have to provision the outstanding value of loans after deducting the value of real estate collateral. The latter is adjusted beforehand by the application of haircuts depending on the type of collateral.

The particularly critical situation of lending to real estate developers required increasing and special attention. The exposure of the financial system to the real estate developers was EUR 307 billion at end-December 2011 (10% of the total consolidated assets of MFIs or 22% of their lending portfolio). Spanish banks' overall amount of problematic exposures to this sector was approximately EUR 184 billion (60% of the total exposure to this sector), evenly split between land and unfinished property (EUR 91 billion) and finished property, including foreclosed assets (EUR 93 billion).

In February and May 2012, the Spanish government adopted a set of measures to boost banks' financial robustness and dispel doubts concerning banks' exposures to the real estate developers (RED) sector by increasing the industry's coverage of potential losses on these assets. Real Decreto-ley (RDL) 2/2012[33] increased provisioning requirements and capital buffers on non-performing real estate assets, in particular land and unfinished properties. RDL 18/2012[34] extended higher provisions also to performing real estate assets in order to anticipate a hypothetical worsening of this portfolio. These were one-off measures targeting the stock of the legacy assets as of 31.12.2011. As a result of these additional requirements, the total coverage of potential losses on both problematic and performing real estate assets linked to RED assets will increase significantly. The two above-mentioned RDLs require banks to increase provisions and capital buffers against possible losses on both performing and non-performing RED loans. The total cost for the financial sector was estimated at EUR 80 billion.[35]

The two RDLs envisage the possibility of additional public support for institutions which cannot meet the additional requirements by the established deadlines (see also section 6.1). FROB can inject capital by the subscription of ordinary shares in stand-alone banks or contingent convertible securities (COCOs) in the case of integration processes (i.e. mergers) of credit institutions which need to strengthen their own funds. In addition, FROB support can also be made in the form of Asset Protection Schemes (APS) designed by the FROB, which will insure the banks against first losses on selected assets. Credit institutions involved in integration processes will have to present an integration plan which includes specific measures aiming at increasing their efficiency,

---

33 http://noticias.juridicas.com/base_datos/Admin/rdl2-2012.html

34 http://noticias.juridicas.com/base_datos/Fiscal/rdl18-2012.html

35 More specifically, the following provisioning requirements apply: 1. as regards non-performing loans and foreclosed assets (specific provisions and capital buffers): for land related assets: from 31% to 80%, for unfinished property assets: from 27% to 65%, for finished property assets: from 25% to 35%; 2. as regards performing loans (general provisions): for land related assets: from 7% to 52%, for unfinished property assets: from 7% to 29%, for finished property assets: from 7% to 14%, for other assets: from 7% to 52%.

rationalising their administration and management, downsizing their capacity in order to improve their future prospects.

Spanish credit institutions presented their plans to comply with the new requirements by mid-June 2012 in order to fully meet the new standards by end 2012. However, credit institutions involved in a merger process will have an extra 12 month period (starting on the date of approval of the merger) to fulfil the new requirements.

7 FINANCIAL ASSISTANCE FOR BANK RECAPITALISATION

7.1 RUN-UP TO THE FINANCIAL ASSISTANCE

The policy response to deal in particular with the real estate-related legacy assets and the additional capital requirements of banks proved insufficient to restore investors' confidence. The rather gradualist approach, which aimed at minimizing the effect of bank restructuring on public finances and relied primarily on private sector solutions, proved non-sustainable, in particular as the economic downturn turned out deeper and more protracted than expected. As a result, the funding cost of both sovereign as well as Spanish banks has significantly increased (see section 5.1 for more details).

The results of the IMF's assessment of the soundness and stability of Spain's financial sector under the FSAP were published in June 2012. According to the results of its stress test, the core of the system appeared resilient, but significant vulnerabilities remained in some segments. Under the adverse scenario, the largest banks would be sufficiently capitalized to withstand further deterioration, while several banks would need to increase capital buffers by about EUR 40 billion in aggregate to comply with the Basel III transition schedule (core tier 1 capital of 7%). In particular, a group of banks, most which have received state support and were in varying degrees of resolution strategy, were identified as being vulnerable.

On 9 May 2012, the board of directors of BFA-Bankia announced that it will request the conversion of preferential shares subscribed by the FROB in BFA[36] into ordinary shares. The conversion of preferential into ordinary shares, amounting to EUR 4.47 billion, corresponded to a partial nationalization of Bankia, as the FROB participation represents roughly 45% of the share capital of Bankia. Following the review of the bank's balance sheet, the new management of BFA-Bankia requested additional EUR 19 billion from the Spanish government to comply with the new reforms of February and May 2012 (increased provisions and capital buffer), to mark-to-market its industrial participations and to write-off deferred tax assets. Bankia's announcement of higher-than-expected capital shortages further aggravated already difficult market conditions with mounting pressures on the sovereign. Taking into account Bankia's capital needs as well as projected needs of other credit institutions, the Spanish authorities expressed their intention to formally request financial assistance once there was clarity on banks' actual capital needs.

The authorities launched reviews of the actual capital needs of Spanish banking system. A top-down stress test was carried out by two consultancy firms (Oliver Wyman and Roland Berger) to estimate the aggregate capital needs. Its results were published on 21 June and pointed to additional capital needs of EUR 16-26 billion for the Spanish banking sector as a whole under a baseline macroeconomic scenario and a core capital ratio of 9%, increasing to EUR 51-62 billion under a severe stress scenario and a core capital ratio of 6%.

On 9 June, following the announcement by Spanish authorities of their intention to formally request financial assistance, the Eurogroup committed to an amount of up to EUR 100 billion. This amount would cover estimated capital requirements in the context of the ongoing restructuring and recapitalisation of the Spanish banking sector and provide an additional safety margin.

On 25 June 2012, the Spanish Government officially requested external financial assistance under the terms of the Financial Assistance for the Recapitalisation of Financial Institutions by the EFSF. Following this request, the European Commission in liaison with the ECB, the European Banking Authority (EBA) and the IMF conducted an independent assessment of the eligibility of Spain's request for such assistance. This assessment concluded that Spain fulfils the eligibility conditions. The Heads of State and Government at the Euro Area Summit of 29 June 2012 specified that the assistance will subsequently be taken over by the ESM, once this institution is fully operational, without gaining seniority status. The Memorandum of Understanding (MoU) was endorsed by the Eurogroup on 20 July 2012 and signed on 23 July 2012. The full implementation of this MoU will take into account all other relevant considerations contained in the Euro Area Summit statement of 29 June 2012.

[36] Banco Financiero y de Ahorros

7.2 PROGRAMME OBJECTIVES

With the signature of the MoU on 23 July, the financial-sector programme for Spain entered into force. It has a length of 18 months. The core of the programme foresees a recapitalisation and restructuring of Spanish banks, where needed. Up to EUR 100 billion are being made available for this purpose by the EFSF/ESM.

The main objective of the programme is to increase the long-term resilience of the banking sector as a whole, thus, restoring its market access. As an essential part of the overall strategy, the programme requires a clear segregation of impaired assets from banks' balance sheets. By improving the quality and transparency of banks' balance sheets in this manner, the programme aims to facilitate an orderly downsizing of bank exposures to the real estate sector, restore market-based funding, and reduce banks' reliance on central bank liquidity support. This should also allow banks to better engage in lending to the non-financial sector. Additionally, enhancing the risk identification and crisis management mechanisms will reduce the probability of occurrence and severity of future financial crises.

The recapitalisation and restructuring will occur, under the MoU, following a clear, sequenced and well-structured blueprint comprising:

a. due diligence of banks by external auditors and consultants to assess the exact needs and to prepare the separation of impaired assets from banks,

b. segregation of these assets by transferring them into an Asset Management Company,

c. establishment and approval of restructuring plans for the banks in need of public capital injection,

d. burden sharing of shareholders and junior bond holders,

e. tapping the private capital markets in order to close any capital shortfall (where possible),

f. recapitalisation with the help of EFSF/ESM funds to be channelled via the FROB, and

g. execution of the restructuring plans. These will partly extend beyond the end of the programme and will therefore be monitored under the normal State aid procedures.

7.3 RESTORING AND STRENGTHENING THE SOUNDNESS OF THE SPANISH BANKS: BANK-SPECIFIC CONDITIONALITY

7.3.1 Introduction

The key feature of the financial assistance programme for the Spanish financial sector is an overhaul of the vulnerable and weak segments of the Spanish financial institutions enabling their recapitalisation and restructuring. This is essential for enabling them to withstand the current crisis and return to long-term viability in order to perform their lending function on a sounder basis.

This overhaul will be comprised by three key elements. First, it will include an identification of individual bank capital needs through a comprehensive stress diagnostic exercise in the form of an asset quality review of the banking sector and a bank-by-bank stress test, based on that asset quality review. Second, the recapitalization, restructuring and/or resolution of weak banks will take place based on plans to address any capital shortfalls identified in the stress test. Finally, problematic assets in those banks receiving public support without any credible plans to address their capital shortfalls by private means will be segregated and transferred to an external AMC. Main features of the European Union State aid rules are presented in Box 2.

Box 2: Main features of EU state aid rules

During the crisis, Member States have taken a number of state aid measures for banks to ensure financial stability and the maintenance of credit flows to the real economy. The role of the European Commission under EU state aid rules is to ensure that these aid measures do not generate unnecessary distortions of competitions between financial institutions operating in the market or negative spill over effects on other Member States. This has also the broader aim of avoiding harmful subsidiary races, limiting moral hazard and ensuring the competitiveness and efficiency of European banks within the EU and international markets.

Under EU state rules, when a financial institution receives state aid, the Member State granting the aid has to submit a restructuring plan. When the European Commission is assessing the restructuring plan, three key elements are crucial:

First, the restructuring plan has to demonstrate that the bank is able to restore its long-term viability over time. For restoring long-term viability, the bank need to review its business models with the aim of regaining the ability to lend and compete after their restructuring period without State support, thus ensuring lending to the real economy on a solid basis. This review may require, depending on each individual case, a refocus on the banks' core business and the close-down of risky and/or loss-making activities.

Second, in order that aided banks not to enjoy an undue advantage in the form of cheap or free capital, there is a need to re-pay the received state aid or remunerate it according to market rates as quickly as possible. To ensures that state aid is kept to the minimum necessary, banks should first try to cover the restructuring cost through internal measures like divestments, and other burden sharing measures from its capital holders (such as equity holders, or junior creditors) with state aid only covering the remaining gap. This "minimum necessary" principle helps also to address moral hazard and thus incentivises capital holder to be vigilant towards "their" bank with the aim of not repeating the mistakes of the past.

Third, there is a need for temporary safeguard measures for addressing the competition distortion created by banks which have received large amounts of aid. In practical terms this will be addressed via divestments and other behavioural measures such as an acquisition ban.

7.3.2 Contingent facility

As a precautionary measure to address immediate financial stability concerns quickly, the programme began by making available a first tranche amounting to EUR 30 billion in July 2012. This contingent facility provides the possibility to act before the comprehensive stress diagnostics are being performed. The facility has to be seen against the background of continued sovereign funding strains and extremely limited access by some banks to external funding as of summer 2012 and a continued tight financial situation of banks. Therefore, until the recapitalisation of banks has been fully effected, individual banks may find themselves at risk. Under these conditions, the availability of a credible backstop can be mobilised in any contingency to cover for the costs of such interventions. The possible use of this tranche ahead of the adoption of restructuring decisions by the European Commission will require a reasoned and quantified request from the BdE. Any request will be scrutinized in detail and has to be approved by the European Commission and the Euro Working Group (EWG) and in liaison with the ECB.

7.3.3 Agreed process

The recapitalisation and restructuring of banks will advance according to a well-specified timeline, and along several milestones.

(1) Thorough stress diagnostics

Stress diagnostics were performed to determine the capital needs of 14 banking groups comprising 90% of the Spanish banking system. The results of the bank-by-bank stress test conducted by an external private sector consultant and based on input provided by four independent auditors (PwC, Deloitte, Ernst &Young and KPMG) in order to establish the capital needs for each bank were published on 28 September (see Box 3). Based on a predefined sample of operations, the accounting review included: (i) data quality analysis, including the appropriate identification of restructured/refinanced loans; (ii) verification of the proper classification of operations; (iii) review of the calculation of impairment losses; and (iv) computation of the impact of the new

provisioning requirements for both performing and non-performing loans in the real estate and construction sector.

BOX 3: RESULTS OF THE BOTTOM-UP STRESS TEST

The consulting firm Oliver Wyman (OW)[37] has conducted a bottom-up exercise to assess the resilience of the Spanish banking system and its ability to withstand a severe adverse stress of deteriorating macroeconomic and market conditions, and to estimate the capital that each individual bank would require in the event of such an adverse scenario. The adverse scenario foresees a very severe shock implying a 6.5% cumulative GDP drop, unemployment reaching 27.2% and additional drops in house and land price indices of 25% and 60% respectively, over the 3-year period from 2012 to 2014. The scope of the exercise included 14 entities, representing around 90% of the Spanish banking system.

The results of the stress test were published on 28 September 2012. Without taking into account yet-to-be agreed mergers, they show system-wide pre-tax capital needs in the adverse scenario of EUR 59.3 billion and post-tax capital needs in the adverse scenario: EUR 55.9 billion.

Seven of those entities register capital shortfalls under stress. Bankia registers the highest capital shortfall (EUR 24.7 billion) amounting to approximately 42% of the total shortfall. Catalunya banc and Novacaixagalicia register high capital shortfalls of EUR 10.8 billion and EUR 7.2 billion. The three largest institutions (SAN, BBVA, Caixabank) represent 43% of the exposure under consideration and have an estimated capital excess of EUR 37 billion in the adverse scenario. Overall losses from the system, in the adverse scenario are EUR 270 billion. The system has a total loss absorption capacity of approximately EUR 252 billion. Expected losses vary considerably between portfolio segments (see table below).

Table 2: Expected losses in the base and adverse scenario, per portfolio segment

	2011 Balance (billion)	Base Scenario	Adverse Scenario	Top-down Adverse
Real Estate Developers	227	28.60%	42.80%	42-48%
Retail Mortgages incl. Foreclosed Housing	622	3%	5.50%	5.90%
Large Corporates	254	5.80%	10.00%	12-15%
SMEs	237	10.60%	16.70%	15-18%
Public Works	41	12.50%	21.30%	21-23%
Other Retail	74	11.80%	18.60%	15-20%
Total Credit Portfolio	1,436	9.00%	15%	15-17%
Foreclosed RED & Other	87	55%	64%	55-65%

The following main conclusions can be drawn from the exercise:

- The results of the stress test confirm the diagnostic from the IMF FSAP as well as from OW's top-down stress test: the weaknesses in the Spanish banking system are not widespread but rather located in a specific group of banks, mainly the banks having already received aid from the FROB.
- Losses in the bottom-up exercise are consistent with those estimated by Oliver Wyman in the top-down exercise. However, the bottom-up exercise has provided a much more accurate distribution of losses, increasing capital needs in those banks that had already been identified as being problematic in the top-down exercise.

This process was overseen by the Strategic Coordination Committee (SCC), involving the Spanish authorities, the European Commission, the ECB, the EBA and the IMF. In addition, it was closely monitored by a technical Expert Coordination Committee (ECC), which provided the SCC with regular updates.

The mandate of the due diligence process of the auditors also captured the data required for an economic value assessment of the assets. The information obtained from the auditors was combined with additional bank

[37] http://www.oliverwyman.com

specific data, as requested by the consultant, from official authorities and directly from banks through direct interaction as needed. In addition, a rigorous appraisal of the value of collateral and foreclosed assets value was required to fully inform a comprehensive asset quality review carried out by the external consultant. This comprehensive asset quality review formed the basis for a bottom-up Stress test. It will also form the basis for any future valuation of Spanish bank assets. This Stress Test built on the scenarios developed for the top down exercise, and benefited from the granular information and asset quality review that was gathered by independent firms through data verification and validation and took into account its loss absorption capacity.

Based on the results of the bottom-up Stress test, the BdE and the European Commission, in consultation with the EBA and in liaison with the ECB, will establish the specific capital needs of each participating bank, and also determine the cases where there is no need for further capital.

(2) Four Groups

On the basis of the bottom-up Stress test results and the presented plans to address any identified capital shortfalls by the banks, the banks will be categorised in four groups.

- Group 0 will comprise those banks for which no capital shortfall is identified and no further action from the public side is required.
- Group 1 has been pre-defined as banks already owned by the FROB (BFA/Bankia, CatalunyaCaixa, NCG Banco[38] and Banco de Valencia).
- Group 2 will consist of banks with capital shortfalls identified by the bottom-up Stress Test as unable to meet those capital shortfalls privately without having recourse to State aid. Finally,
- Group 3 will constitute banks with capital shortfall identified by the stress test with credible recapitalisation plans and able to meet those capital shortfalls privately without recourse to State aid.

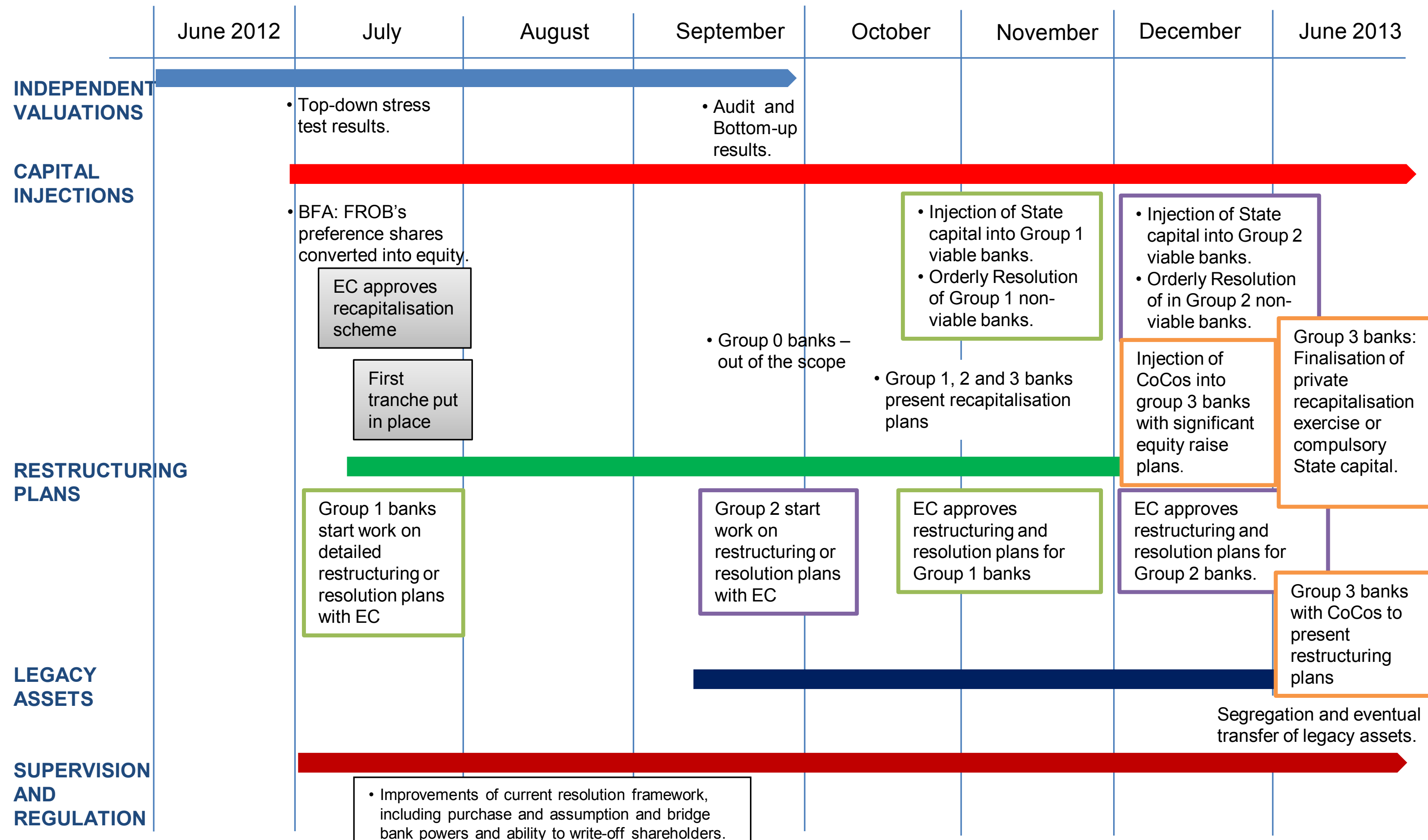
The distribution of banks between groups 0, 2 and 3 will be established in October, based on the results of the bottom-up Stress test and an assessment of those plans. The agreed timeline foresees that banks in Groups 1, 2 and 3 will present restructuring plans or resolution plans. Under the State aid rules of the European Union, the approach to bank restructuring and resolution is based on the principles of viability, burden sharing and limiting distortions of competition in a manner that promotes financial stability and contributes to the resilience of the banking sector identifying how they intend to fill the capital shortfalls identified by early-October. The content of restructuring plans is defined in more detail further below.

There are several ways in which banks can raise capital. These include raising capital from internal measures, asset disposals, liability management exercises, raising equity or State aid. The Spanish authorities and the European Commission will assess the viability of the banks on the basis of the results of the bottom-up Stress test and the presented restructuring plans. Banks that are deemed to be non-viable will be resolved in an orderly manner.

For Group 1 banks, the Spanish authorities have started preparing and discussing restructuring or resolution plans with the European Commission from July 2012 onwards. These plans will be finalised in light of the Stress test results and presented in time with the aim of putting the European Commission in a position to approve them by November 2012. On this basis, State aid will be granted and the restructuring plans can be implemented immediately. The process of moving impaired assets to an external AMC will be completed by year end. Based on the expectations as of the time of the signing of the MoU, these banks are expected to have the largest capital needs.

[38] NGC Banco has its roots in Galicia and operates there under Novagalicia Banco

Table 3: Restructuring of the Spanish Banking Sector: Timeline



Group of banks:

- Group 0: Banks with no capital shortfall are out of the scope;
- Group 1: FROB banks (BFA/Bankia, CatalunyaCaixa, NovaCaixaGalicia, Banco de Valencia): banks for which State aid needs are – largely - known before the Stress Test and which will need to be validated on this basis;
- Group 2: Banks with capital shortfall identified by the Stress Test, with no possibility to raise privately capital, and thus which will need to recourse to State aid.
- Group 3: Banks with capital shortfall identified by the Stress Test, aiming at raising this privately.

EC: European Commission

For Group 2 banks, the Spanish authorities will need to present a restructuring or resolution plan to the European Commission by October 2012 at the latest. Given the need to incorporate the findings from the bottom-up Stress Test, the approval process is expected to run until end-December when these banks will be recapitalized or resolved in an orderly manner. All Group 2 banks must include in their restructuring or resolution plan the necessary steps to segregate their impaired assets into an external AMC.

For banks in Groups 1 and 2, no aid will be provided until a final restructuring or resolution plan has been approved by the European Commission, unless use has to be made of the funds of the contingency facility.

Group 3 banks planning a *significant* equity raise *corresponding to more than 2% of risk weighted assets (RWA)* will, as a precautionary measure, be required to issue contingent convertible securities (COCOs). These COCOs will be issued under the recapitalisation scheme to help banks meet their capital needs by end December 2012 at the latest. They will be subscribed by the FROB using programme resources and can be redeemed until 30 June 2013 if the banks succeed in raising the necessary capital from private sources. Otherwise they will be recapitalised through the total or partial conversion of the COCOs into ordinary shares. They will have to present restructuring plans in any case, but if they succeed in repaying the State aid until 30 June 2013, this would result in a lesser need for measures related to burden sharing and measures addressing competition distortions. Group 3 banks planning *a more* limited equity raise corresponding to less than 2% of RWA will be given until 30 June 2013 to do so. Should they not succeed, they will be recapitalized by means of State aid. Group 3 banks that still benefit from public support under this programme on 30 June 2013, and thus having not succeeded in raising the required equity by private means, will be required in their restructuring plans to transfer the impaired assets to the AMC, unless it can be shown for banks requiring less than 2% of RWA in State aid that other means to achieve full off-balance sheet segregation are less costly**.**

(3) Restructuring plans and/or resolution plans

Recapitalisation plans involving the use of public funds will trigger a restructuring process. The restructuring plans of the banks requiring public funds will have to lay open the source of the bank's difficulties and any other risks, including from problematic assets. They have then to convincingly demonstrate that the long-term viability of the bank can be ensured without continuing State aid. The plans should focus on the bank's capacity to generate value for shareholders given its risk profile and business model, as well as the costs linked to the necessary restructuring. The degree of restructuring required will take due account of the relative size of the public support provided. While the restructuring period should be as short as possible so as to restore viability quickly, the Commission will take into account the current crisis conditions and may therefore allow some structural measures to be completed within a longer time horizon than is usually the case [specify?], notably to avoid depressing markets through fire sales. However, restructuring measures should be implemented as soon as possible and should not last more than five years to be effective and allow for a credible return to viability of the restructured bank. As the EU Treaty is neutral as to the ownership of property, State aid rules apply irrespective of whether a bank is in private or public ownership.

Restoration of viability

Long-term viability is achieved when a bank is able to cover all its costs including depreciation and financial charges and provide an appropriate return on equity, taking into account the risk profile of the bank. The restructured bank should be able to compete in the marketplace for capital on its own merits in compliance with relevant regulatory requirements. The expected results of the planned restructuring need to be demonstrated under a base case scenario as well as under "stress" scenario.

Restructuring plans will address the banks' ability to generate sustainable and profitable business going forward and their funding needs. The restructuring plans should be based on significant downsizing of unprofitable business with a focus on divestitures wherever feasible, de-risking through the separation of the most problematic assets, rebalancing of the funding structure, including a reduction of the reliance on central bank liquidity support, improved corporate governance and operational restructuring primarily through the rationalisation of branch networks and of staff. This should lead to a sustainable improvement in the cost-to-income ratios of the banks concerned. Non-listed entities should also present a credible timeline to eventually become publicly traded.

In the current crisis banks are recapitalised on terms chosen primarily for reasons of financial stability rather than for a return which would have been acceptable to a private investor. Long-term viability therefore requires that any State aid received is either redeemed over time, as anticipated in the restructuring plan, or is remunerated according to normal market conditions at the end of the restructuring period, thereby ensuring that any form of additional State aid is terminated.

An orderly winding-up (resolution) of a failed bank should always be considered where a bank cannot credibly return to long-term viability. An exit of non-viable players should take place within an appropriate time frame that preserves financial stability. Therefore, the Spanish authorities have to submit an orderly resolution plan for non-viable banks in need of public funds. Orderly resolution plans should be compatible with the goals of maintaining financial stability, in particular by protecting customer deposits, of minimising the burden of the resolution on the taxpayer and of allowing healthy banks to acquire assets and liabilities in the context of a competitive process. The orderly resolution process will involve the transfer of certain assets to the external AMC.

Given the urgency, the Spanish authorities will take early and timely action on the restructuring and resolution plans. The authorities have liaised with the European Commission to ensure timely delivery of the restructuring plans. The restructuring plans will be submitted to the European Commission for assessment under State aid rules, and will be made available, once finalised, to the ECB, EBA and IMF. The Spanish authorities will provide all the necessary information on the restructuring or resolution plans as soon as the need for state aid is known. The process will commence immediately for Group 1 banks. For these banks, the Spanish authorities will work to put the European Commission in a position to approve the restructuring or resolution plans by November 2012. For those banks for which capital needs will become clear only with the result of the bottom up stress test, the Spanish authorities will enter into the same process with the aim of ensuring that restructuring plans can be approved by the European Commission by December 2012. Recapitalisations will only take place after the adoption of a restructuring decision by the European Commission, requiring burden sharing and restructuring, unless funds of the first tranche are deployed.

Restructuring aid should be limited to covering costs which are necessary for the restoration of viability. This means that an undertaking should not be endowed with public resources which could be used to finance market-distorting activities not linked to the restructuring process. For example, acquisitions of shares in other undertakings or new investments cannot be financed through State aid unless this is essential for restoring an undertaking's viability.

Segregation of impaired assets: Asset Management Company

A key reason for limited access of Spanish banks to funding markets and insufficient flow of credit is uncertainty about the valuation and location of problematic assets. While banks have already taken steps to address the problem of impaired assets via higher provisions and substantial write-downs in asset values, the problem has not been resolved to a sufficient degree. The depth of the economic slowdown now suggests a further and more extensive deterioration in credit quality of bank assets. Problematic assets of aided banks should be quickly removed from the banks' balance sheets. Asset relief would directly address the issue of uncertainty regarding the quality of bank balance sheets and therefore help to revive confidence in the sector. It could also help to avoid the risk of repeated rounds of recapitalisation of banks as the extent of asset impairment increases amid a deteriorating situation in the real economy.

This applies, in particular, for loans related to Real Estate Development (RED) and foreclosed assets. In principle, it will also apply to other assets if and when there are signs of strong deterioration in their quality. The principle underpinning the separation of impaired assets is their transfer to an external AMC at a conservatively set transfer price. This transfer price will be established on the basis of a thorough asset quality review process, drawing on the individual valuations used in the Stress test. The respective losses must be crystallized in the banks at the moment of the separation. The Spanish authorities, in consultation with the European Commission, the ECB and the IMF, prepared a comprehensive blueprint and legislative framework for the establishment and functioning of this asset separation scheme by end-August 2012. Furthermore, they will adopt the necessary legislation in the autumn with a view to assuring that the AMC will be fully operational by November 2012.

The AMC will manage the assets with the goal of realising their long-term value. It will have the possibility to hold them to maturity. The FROB will contribute cash and/or high quality securities to the AMC for an amount corresponding to a certain percentage (to be determined at the time of the establishment of the AMC) of the transfer value of the assets purchased. In exchange for the assets, the banks will receive bonds issued by the AMC and guaranteed by the State, or cash and/or high quality securities. The bonds issued by the AMC will be structured in such a manner that they will meet the conditions set out in the ECB´s "Guideline on monetary policy instruments and procedures of the Eurosystem"[39].

Burden sharing

In order to minimise the cost to tax payers, limit distortions of competition and address moral hazard, aid should be limited to the minimum necessary, and an appropriate own contribution to restructuring costs should be provided by the aid beneficiary. The restructuring plans of viable banks requiring public support will provide for the detail in this respect. The bank and its capital holders should contribute to the restructuring as much as possible with their own resources. More specifically:

1. banks receiving State aid will contribute to the cost of restructuring as much as possible with their own resources. This is necessary to ensure that rescued banks bear adequate responsibility for the consequences of their past behaviour and to create appropriate incentives for their future behaviour. Actions include the sale of participations and non-core assets, run off of non-core activities, bans on dividend payments, bans on the discretionary remuneration of hybrid capital instruments and bans on non-organic growth.
2. banks and their shareholders will take losses before State aid measures are granted and ensure loss absorption of equity and hybrid capital instruments to the full extent possible. After allocating losses to equity holders, the Spanish authorities will require burden sharing measures from hybrid capital holders and subordinated debt holders in banks receiving public capital, including by implementing both voluntary and, where necessary, mandatory Subordinated Liability Exercises (SLEs). Burden sharing will not be imposed on any senior creditors. The BdE, in liaison with the European Commission and the EBA, will monitor any operations converting hybrid and subordinated instruments into senior debt or equity.

Banks not in need of State aid will be outside the scope of any mandatory burden sharing exercise. As foreseen by the MoU, the Spanish authorities introduced legislation by end-August 2012 to ensure the effectiveness of the SLEs. This new legislation allows for mandatory SLEs if the required burden sharing is not achieved on a voluntary basis. These amendments also include provisions allowing that holders of hybrid capital instruments and subordinated debt fully participate in the SLEs. The BdE will immediately discourage any bank which may need to resort to State aid from conducting SLEs at a premium of more than 10% of par above market prices until December 2012.

Banks with capital shortfalls and needing State aid will conduct SLEs. These SLEs will be performed in accordance with the revised legal framework and State aid rules, by converting hybrid capital and subordinated debt into equity at the time of public capital injection or by buying it back at significant discounts. For Group 3 banks this rule will apply on 30 June 2013, if they still are in receipt of public funds. For non-viable banks, SLEs will also need to be used to the full extent to minimise the cost for the tax payer. Any capital shortfall stemming from issues arising in the implementation of SLEs will not be covered by the EFSF assistance.

Under the MoU, the bank resolution framework had to be further upgraded. By end-August, the Spanish authorities, in consultation with the European Commission, the ECB and the IMF, modified the bank resolution framework in order to incorporate relevant resolution powers to strengthen the FROB. This amendment took into account the EU regulatory proposal on crisis management and bank resolution, including special tools to resolve banks, such as the sale of business tool and bridge banks; the legislation will also include a clarification of the financial responsibilities of the FGD and the FROB. The legislation also includes provisions on overriding shareholders rights in resolution processes.

[39] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32011O0014:EN:NOT

For all banks, the Spanish authorities commit to cap pay levels of executive and supervisory board members of all State-aided banks to EUR 500 000 and 100 000 respectively (fixed and variable remuneration) respectively. For State-aided banks for which the FROB has the control the cap on remuneration will be EUR 500 000 and 60 000 respectively Redundancy packages will be capped according to Real Decreto-ley 3/2012[40] of urgent measures to reform the employment market. Compensation of the top 20 earners of each State-aided bank should be made public, in line with international best practices.

Measures addressing competition distortions

Whilst State aid can support financial stability in times of systemic crisis, with wider positive spillovers, it can also create distortions of competition in various ways. Where banks compete on the merits of their products and services, those which accumulate excessive risk and/or rely on unsustainable business models will ultimately lose market share and, possibly, exit the market while more efficient competitors expand on or enter the markets concerned. State aid prolongs past distortions of competition created by excessive risk-taking and unsustainable business models by artificially supporting the market power of beneficiaries. In this way it may create moral hazard for the beneficiaries, while weakening the incentives for non-beneficiaries to compete, invest and innovate. Finally, State aid may undermine the single market by shifting an unfair part of the burden of structural adjustment and the attendant social and economic problems to other Member States, whilst at the same time creating entry barriers and undermining incentives for cross-border activities. Measures to limit the distortion of competition should be tailor-made to address the distortions identified on the markets where the beneficiary bank operates following its return to viability post restructuring.

7.4 ENSURING A SOUND FRAMEWORK FOR THE BANKING SECTOR: HORIZONTAL CONDITIONALITY

Strengthening the regulatory and supervisory framework is critical to enhance the resilience and long-term viability of the Spanish banking sector. Therefore, the Spanish authorities will take additional measures in the following areas:

7.4.1 Regulatory capital targets

One of the key elements of the financial sector adjustment facility will be to ensure a certain minimum level of regulatory capital for all credit institutions. Hence, the strength of the banking sector has to be measured in terms of its level of solvency and therefore in its preparation to be able to absorb future losses if necessary. In addition, ensuring a sufficiently high level of regulatory capital is essential not only to shore up the soundness of each individual Spanish bank but also to restore the confidence in the Spanish banking sector as a whole.

Therefore, the MoU sets out that Spanish credit institutions will be required, as of 31 December 2012, to meet until at least end-2014 a Common Equity Tier (CET) 1 ratio of at least 9%. This minimum level requirement is in line with the highest international requirements and above what will be required by the forthcoming EU Capital Requirements Regulation (CRR) as of January 2013[41]. In December 2011, the EBA issued a recommendation on the creation and supervisory oversight of temporary capital buffers to restore market confidence. Under this recommendation, banks were asked to meet a predetermined capital target of 9% core tier 1 capital. The scope of application of the exercise does not include all banks in the EU but a sample of those considered of systemic importance. In Spain, that criterion includes the biggest five institutions: Santander, BBVA, Caixabank, Banco Popular and Bankia. According to the preliminary assessment of the EBA published in July 2012, all these Spanish banks, except Bankia, have met their targets.

A key issue is the proper definition of Core Tier 1 capital. As one of the aims of the bank recapitalisation facility is to increase regulatory capital, a clear and rigorous definition has to be used. However, there are some differences between several definitions (EBA recapitalisation plan; Basel III; forthcoming CRR; capital principal, etc.).

---

[40] http://noticias.juridicas.com/base_datos/Laboral/rdl3-2012.html

[41] Taking into account its gradual implementation from 2013 to 2019.

Against this background,

- as of 31 December 2012, the definition of capital used will be based on that of eligible capital established in the ongoing EBA recapitalisation exercise;
- from 1 January 2013, institutions will apply the definition of capital established in the CRR), observing the gradual phase-in period foreseen. However, the additional capital needed to meet the 9% capital ratio will be calculated based on the capital definition established in the ongoing EBA recapitalisation exercise. In any case, Spanish credit institutions will not be allowed to reduce their capital base with respect to December 2012 figures, without previous approval from the BdE.

7.4.2 Provisioning regime

Spanish banks have to comply with one of the most demanding provisioning regimes in the EU. As a result of these specificities of Spanish accounting rules, loan loss coverage ratios were very high before the crisis.

The general provisioning regime applicable to Spanish banks is ruled by BdE **Circular 4/2004**[42]. Annex IX of this Circular establishes a complete set of rules regarding the application of this regime to all assets in the banking book and the asset classification depending on their quality (doubtful, substandard and normal). Required provisions for each asset are calculated according to (i) the quality of the guarantee and (ii) the date of the impairment. Hence, specific provisions cover incurred losses individually identified in specific assets. In addition, dynamic provisions for normal/performing assets are, within the EU, only applied in Spain. They require a certain amount of provisions for each performing asset, depending on the type of counterparty or the potential risk of each asset.

The purpose of the entire provisioning regime is to build up an excess of provisions in good times, negatively impacting the profit and loss (P&L) **account and then allow the bank to use it during bad times** taking into account that specific provisions will increase within this period. Such automatic instrument is conceived as a countercyclical mechanism to avoid sudden impact of provisioning requirements on the P&L account.

Although the Spanish provisioning framework is very comprehensive and demanding, the rapid increase of non-performing losses during the crisis and the length of the crisis has (i) forced the Spanish authorities to increase provisions for certain counterparties (mainly RED) and (ii) depleted existing provisions buffers. Consequently, the crisis has shown that the current framework should be reassessed. The Spanish authorities are requested to make proposals to revamp the permanent framework for loan-loss provisioning:

1. taking into account the temporary measures introduced during the past months; and
2. exploring the possibility to revise the calibration of dynamic provisions on the basis of the experience gathered during the current financial crisis.

The Spanish authorities might in this context assess the possibility of increasing the total amount of provisioning requirements under the current and permanent regime, but also to focus dynamic provisions requirements on such sectors and assets that the crisis has demonstrated that are especially risky.

This analysis would also imply a deep revision of (i) the calibration of the parameters of the formula used to calculate the total requirements of dynamic provisions and (ii) the elements of each category of risks, in order to better capture potential risks of each particular portfolio.

7.4.3 Concentration framework

One of the problems of the Spanish banking sector has been its very strong exposure to certain types of lending, i.e. real estate lending. In principle, existing regulation provides for limits to overconcentration of banks' assets in order to avoid excessive exposure to risk More specifically, the Spanish credit institutions have to comply

---

[42] Circular no. 4/2004 of 22 December 2004. Credit Institutions. Public and Confidential. Financial Reporting Rules and Formats

with the large exposures regime established in Circular 3/2008[43], which is a transposition of EU Directive 2006/48/EC. According to this legal framework, Spanish banks are not allowed to breach a concentration limit of 25% of own funds for each large exposure. This limit ensures that individual banks are not overly dependent on individual single borrowers. However, this binding (Pillar 1) limit does not deal with some other problems of concentration, such as a concentration of bank lending in certain geographical areas or sectors, even if the individual loans in these areas or sectors might very well be below 25% of own funds. Such clusters of loans nevertheless pose significant risk as the default risks of loans in these clusters are highly correlated.

Therefore, limitations to concentrated sectoral or geographical exposure must be addressed by additional, lower-level, legal acts by national supervisors (Pillar 2 measures) under the scope of the aforementioned EU Directive 2006/48/EC.)The BdE published in 2008 new "Guidelines on the Internal Capital Adequacy Assessment Process (ICAAP) at credit institutions"[44]. In order to deal with sectoral concentration risk, credit institutions should calculate a sectoral concentration index (SCI) of their credit portfolio. Institutions using internal-ratings-based approaches should use the in-house methodologies they consider to be most suitable, which they should justify and use in managing this risk".

However, these measurers proved not fully adequate. The recent crisis has led to a huge amount of losses arising from specific sectors, namely the real estate and the construction sector. The vast majority of the former Spanish saving banks were highly concentrated in these sectors, and the impact of this concentration of risks has been overlooked to a certain extent.

As a consequence, the BdE should:

i. **Reassess the concentration regulatory framework**, especially focused on sectorial concentration risk and related parties transactions.

ii. **Improve the information** that credit institutions are obliged to send to BdE regarding concentration risk (sectorial and geographical).

iii. **Strengthen the supervisory oversight of concentration risk**, not only for individual credit institutions but also from a wide financial sector perspective.

7.4.4 Governance of credit institutions

The crisis has impacted the savings bank sector very severely. First, and as mentioned above, the former savings banks were heavily exposed to the real estate and construction sector and, in general, showed a strong domestic concentration of their business to the Spanish economy. Second, governance of these entities has shown some important weaknesses.

The Spanish authorities have adopted some measures to improve the governance of savings banks, and credit institutions in general, over recent years. An important step was the reform of the legal regime governing savings banks, implemented by Real Decreto-ley 11/2010. This RDL contains specific elements aimed at professionalising the financial management of savings banks, enhanced regulation of the incompatibilities regime and stricter requirements regarding the experience of their directors.

These measures are an important part of a more comprehensive enhancement of governance of these institutions. In addition, the governance structure of former saving banks and also of commercial banks controlled by them has to be strengthened. The role of savings banks in their capacity as shareholders of credit institutions should be clarified with a view to eventually reducing their stakes to non-controlling levels.

43 Circular no. 3/2008 of 22 May 2008. Credit Institutions. On determination and control of minimum own funds.

44 Guidelines on the Internal Capital Adequacy Assessment Process (ICAAP) at credit institutions (25 June 2008); updated). Updated by decisions of the Banco de España Executive Commission of 18.03.09 and 26.01.11.

Furthermore, it is of utmost importance to further strengthen fit and proper requirements for the governing bodies of savings banks, including outside board members, tightening conflict of interest rules for representatives in their governing bodies or revisiting rules on the appointment process in the governing bodies.

In addition, transparency of these institutions has to be enhanced. For this purpose eventual listing of banks included in the stress test which have benefited from State aid could be considered as part of their restructuring process, in order to allow capital markets to better scrutinise these banks.

7.4.5 Transparency framework

Since the onset of the financial crisis, reporting requirements to the supervisor and the public have been steadily upgraded. In this respect, the BdE has taken several important measures to increase the quality and quantity of information provided by credit institutions to the supervisor and the general public, especially concerning real estate and construction sector exposures. However, considering that lender forbearance has been one of the main concerns about the loan portfolios of Spanish banks, further improvements in the disclosure requirements for credit institutions on restructured and refinanced loans to both the public and the supervisor are warranted. In June 2012, the BdE released for public consultation a draft Circular (to modify Circular 4/2004) which includes, *inter alia*, provisions aimed at enhancing transparency for restructured and refinanced loans. These new provisions introduce a new reporting format for the information on restructured and refinanced operations of credit institutions to be provided to the BdE on quarterly basis. Whereas these new provisions constitute an important step forward, authorities should envisage further improvements in line with international good practices and similar to those adopted by Ireland in 2011. In this respect, the following aspects should be further addressed:

i. **Disclosure of risk exposures by business segments and geographical areas**: To allow the identification of risk concentrations, credit institutions should disclose information on risk exposures by business segment and geographical areas;

ii. **Probability of default** (PD) **on the portfolio of restructured and refinanced loans**: Credit institutions should record the history of PDs for the pool of restructured and refinanced loans. Furthermore, they should disclose such information in their annual reports over time;

iii. **Loan-to-value ratios (LTVs) of loans, including forborne loans:** Data on the distribution of loans in different LTV intervals (i.e. LTV less than 50%, between 51% and 60%, between 61 – 80%, over 81%) should be disclosed for all asset classes (i.e. mortgage loans, real estate and development loans, loans to small and medium enterprises (SMEs) etc.);

iv. **Forbearance measures and sustainability of forbearance:** Credit institutions should disclose information to the supervisor and the public on the specific forms of forbearance measures applied to different types of loans. Credit institutions should also prepare an assessment of the sustainability of individual forbearance measures. The disclosure of this assessment in their annual reports may also be envisaged;

v. **Impairment of restructured/refinanced loans:** Credit institutions (both listed and non-listed) should also disclose information on second round effects (i.e. restructured and refinanced loans which became non-performing).

7.4.6 Supervisory framework

The IMF FSAP[45] identified some shortcomings regarding banking regulatory and supervisory powers exercised by the BdE and the MdE. The supervisory framework should be usefully strengthened in three main areas: (i) independence of the supervisory banking authority (BdE) (ii) supervisory procedures of BdE and (iii) macro-prudential supervision (see Box 4).

[45] Spain: Financial Stability Assessment, published in June 2012.

7.4.6.1 Independence of the Banco de España

In order to strengthen the operational independence of the supervisory authority from other stakeholders, **the MoU establishes that some key powers should be transferred from the Ministry to the** BdE:

- According to article 18 of Law 26/1988, "*the authority to impose sanctions for very serious infractions shall rest with the Minister of Economy and Finance, at the proposal of the BdE, except for revocation of authorisation, which shall be imposed by the Council of Ministers*". Hence, such power regarding very serious infractions should be transferred to the BdE, as is already the case for other infractions.
- Licensing powers remain also in the MdE (i.e. for banks article 1 Real Decreto 1245/1995[46]). In order to improve the supervisory authority independence this power should be transferred to BdE.
- In addition, the capacity of the BdE to issue binding interpretations on supervisory practices and regulatory issues is currently very limited. The Spanish authorities will have to identify possibilities to further empower the BdE to issue binding guidelines or interpretations.

7.4.6.2 Supervisory procedures of Banco de España

The IMF FSAP review pointed out that one of the main strengths of the supervisory authorities is "their highly experienced and respected professional staff supported by good information systems and thorough supervisory processes". For the particular case of banking supervision, the IMF report underscores that "the core supervisory process at the BdE is strong and is supported by an experienced cadre of inspectors"[47].

Nevertheless, the IMF stressed that a relatively slow approach by the BdE **in taking corrective action allowed weak banks to continue to operate**, and therefore vulnerabilities grew in a significant part of the banking sector. Weaknesses are identified at early stages but that does not always lead to the automatic setting and enforcement of corrective actions. In addition, the IMF states that "action may also have been slowed as a result of deference to stakeholder interests that led to the complex decision making process involved in the mergers of the savings banks."

---

[46] http://noticias.juridicas.com/base_datos/Fiscal/rd1245-1995.html

[47] Paragraphs 59 and 60.

BOX 4: IMF MAY 2012 FSAP CONCLUSIONS ON THE SPANISH BANKING SUPERVISION

Executive summary

The assessment of the financial oversight framework identifies both strengths and weaknesses. Supervisory agencies have highly experienced and respected professional staff, and are supported by good information systems. However, a gradual approach in taking corrective action has allowed weak banks to continue to operate to the detriment of financial stability. The processes and the accountability framework for effective enforcement and bank resolution powers need to be improved.

Strengthening the supervision of the financial sector

58. The assessment of the financial oversight framework identified key strengths and weaknesses. The main strengths of the supervisory agencies are their highly experienced and respected professional staff supported by good information systems and thorough supervisory processes. Although some of the recommendations made in the previous FSAP have been addressed, a number of important weaknesses remain:

- insufficient regulatory independence for the banking and securities regulators, and limitations on the financial/budgetary independence for the insurance and securities regulators;
- lack of adequate authority and mandate for the banking regulator to address preemptively the build-up of risks in the system;
- (…)
- lack of a fully effective remedial action and sanctioning regime in banking supervision and limited use of on-site inspections in the securities supervision.

59. The BdE's slow approach in taking corrective action has allowed weak banks to continue to operate. Weaknesses were identified at early stages and corrective actions were recommended, including the need for additional provisions, but enforcement was gradual. This contributed to growing vulnerabilities as weak banks were allowed to continue to operate. Action may also have been slowed as a result of deference to stakeholder interests that led to the complex decision making process involved in the mergers of the savings banks.

60. The core supervisory process at the BdE is strong and is supported by an experienced cadre of inspectors, as identified in the assessment of Effectiveness of Banking Supervision based on the Basel Core Principles (BCP). Regulatory capital and loan-loss provisioning requirements for real estate exposures also have been tightened and further guidance on best practices for lending in this area has been provided. The authorities have also implemented measures to reduce incentives for equity investments in nonfinancial companies by banks and to manage related conflicts of interest, enhanced coordination and cooperation between financial sector regulators, and adopted additional requirements on internal controls.

61. However, supervisory practices did not always seem to be sufficiently timely or effective for bank intervention or resolution. Areas requiring improvement include timeliness of remedial action, operational independence concerning issuance of regulations and enforcement, and oversight of concentration risk and related party transactions.

62. The BdE's independent authority can be enhanced to expedite corrective action and regulatory response in a number of areas:

- *Sanctioning powers*. The delays in implementation of corrective actions and sanctions have led to concerns regarding the independence of the BdE. While it must be stressed that the assessors have not seen any evidence of government or industry interference in the operation of supervision and its budget in the BdE, it is true that the legal framework for sanctions and regulatory powers does not create an environment conducive to independence. Although sanctioning proposals are made by the Governing Council of the BdE to the Minister of Economy, it is the MdE that has sanctioning power for very serious infractions and resolution capacity. Adopting a more flexible enforcement regime would have enabled the supervisor to quickly adjust its course of action if the original assumptions had proven incorrect, while a more intensive use of sanctions could have been a stronger deterrent to imprudent risk management.

- *Regulatory autonomy*. The legal framework establishes the MdE as the principal agency charged with issuing financial regulation. The BdE currently lacks authority to issue prudential regulations, except in areas specifically delegated by law or the MdE. The banking legislation, Ley de Autonomía del Banco de España, clearly distinguishes the independence and regulatory capacity of the BdE in its monetary authority role from its supervisory role. As prudential regulation in Spain depends on government action, changes in the regulatory framework tend to follow the political cycle and thus may result in delays in the issuance of critical regulations. Having the authority to issue prudential regulations would enable the BdE to address, at an earlier stage, developments of a systemic nature. Establishing BdE's regulatory powers directly by law—rather than through delegation by the MdE—is recommended. The broad presence of the MdE in the sanctioning and regulatory hierarchy clouds the independence of a well-conducted and highly technical supervisory body, or may risk creating false perceptions and potentially undermine the credibility and effectiveness of supervision.

In this line, some information published by the BdE shows that the number of formal corrective actions adopted by its Management Board[48] **has notably decreased during the crisis**. Once an on-site inspection is concluded and a report is drafted by the responsible inspectors, the Management Board receives a brief report by the Department of Supervision. As a result, the Management Board normally sends to the examined institutions a letter including a list of corrective actions in order to be implemented. According to the latest Banking Supervision Annual Report for 2011 (Memoria de la Supervisión Bancaria)[49], the number of letters sent from the BdE to credit institutions has significantly fallen from 63 in 2008 to 19 in 2011 and therefore the official requirements to entities have been reduced during the crisis. For the case of banks, such letters have more than halved from 21 to 10. Regarding specific risks, requirements on the most significant one, credit risk (i.e. recognition of losses in loan portfolios) have dropped very strongly from 177 in 2008 to 127 in 2009, 108 in 2010 and 31 in 2011.

The aforementioned statistics are indicative of possible weaknesses in some essential parts of the current supervisory process, and especially concerning the communication to the decision making bodies of vulnerabilities and risk detected in the banking system**. In particular, the internal review by the** BdE **should necessarily address the following aspects**:

i. **The complete supervisory process should ensure that problems detected at an early stage by on-site inspections teams translate effectively and without delays into remedial actions** in order to guarantee timely adoption of corrective measures.

ii. **The entire supervisory process should be adequately documented and registered**. Every supervisory action and especially on-site inspections should be finalised with a report signed by the on-site inspectors.

iii. **Specifically, the authorities will analyse the need for any further improvements in the communication to the decision making bodies of the** BdE. In order to ensure an appropriate flow of information, the BdE should consider including on-site inspections reports in the package summited to the management bodies of the BdE, as an additional element in order to improve the quality of corrective actions to be decided.

iv. Any other shortcoming that could be identified within the supervisory procedures.

7.4.6.3 Macro prudential supervision

As described above, the recent crisis in Spain has been mainly driven by the accumulation of some major imbalances, as a consequence of strong credit expansion and housing market dynamics. These imbalances have finally had a significant impact on the entire financial sector and damaged seriously the quality of the assets portfolios of Spanish credit institutions. Furthermore, the length of the crisis has worsened economic perspectives and therefore weakened banks' capacity to absorb losses.

Despite the existing strong supervisory mechanisms, recent episodes regarding common problems for all institutions on their significant exposures to the weakest's sectors of the economy (i.e. real estate and construction) and an urgent necessity of increasing provisions show that these imbalances were not sufficiently taken into account in order to (i) to prevent the deterioration of certain bank portfolios and as a consequence, (ii) to implement the necessary actions in order to address the relevant problems identified.

Accordingly, the authorities will ensure that macro-prudential supervision will properly feed into the micro supervision process and adequate policy responses. This implies a continuous flow of information between the Directorate General of Supervision and the Financial Stability Department of Banco de España in order to enrich microprudencial analysis with relevant findings on the macroprudential side to enhance supervisory mechanisms to be applied to the entire sector in line with the EU supervisory architecture, i.e European Systemic Risk Board (ESRB) for macroprudential supervision and the European Supervisory Authorities (ESAs) for microprudential analysis).

---

[48] Comisión Ejecutiva.

[49] http://www.bde.es/webbde/es/secciones/informes/Publicaciones_an/Memoria_de_la_Su/anoactual/

7.4.6.4 Sale of regulatory capital instruments

Certain types of debt instruments were created to be qualified as regulatory capital, namely Tier 1 or Tier 2 own funds, and therefore they are foreseen exclusively to be able to absorb losses if it were necessary. This key characteristic of these hybrid instruments embody higher risks. However, the Spanish regulation for those instruments, Law 13/1985, Real Decreto 216/2008 and Circular 3/2008, does not forbid or limit the sale of preference shares or subordinated debt to retail customers.

Furthermore, legal constraints for former saving banks to increase their capital or operational difficulties facing all credit institutions incentivised institutions to sell regulatory capital instruments through retail branches to non-qualified clients. This practice has created an additional problem in terms of reputational risks: banks have serious difficulties to impose losses to these retail customers, most of them depositors.

In order to avoid this situation in the future, the Spanish authorities will have to:

i. **Amend the current legislation in order to limit the sale by credit institutions** of, high risk own regulatory capital instruments, namely subordinated bonds and preference shares, to non-qualified retail clients.

ii. **Substantially improve the process for the sale** of any instruments not covered by the FGD to retail clients.

iii. **Improve consumer protection and securities legislation in order to strengthen transparency**, under the CNMV monitoring, on the characteristics of these instruments and the consequent risks in order to guarantee full awareness of the retail clients.

7.4.6.5 Information from banks: credit register

The availability of adequate data is crucial both from a supervisory perspective and from the perspective of banks' risk management functions.

Information on the credit history of individual borrowers allows banks to properly assess the risk of borrowers. At the same time, this information allows supervisors reassess risk during on-site inspections and also allows for more system-wide analysis of credit trends.

Moreover, **information on the historical performance of credit both at borrower level and also at individual level allows supervisors to calibrate banks' internal models** properly and also to adjust provisioning requirements.

In this regard, the credit register in Spain has proved to be a very useful risk management tool. **Nevertheless, the crisis has also shown areas where this credit register can be improved**. For example, there is insufficient information on the type of collateral of each exposure or on risk concentrations arising from indirect risk exposures and interlinkages between counterparties.

7.4.6.6 Governance of the financial safety net agencies

Financial safety nets are the core of the crisis management structure of the financial sector. Well- targeted and timely interventions avoid risk propagation and ensure rapid resolution of weak institutions. As the last IMF FSAP points out, the Spanish authorities are pursuing a strategy of burden sharing between the public and private sector in the current regime, using both resolution tools: the FGD (private) and the FROB (public).

Against this background, in order to avoid conflicts of interest taking into account the presence of active bankers in the FROB governing bodies, governance arrangements of these financial safety net agencies should be reviewed. The Spanish authorities will ensure that in the future no active bankers will be members of the governing bodies of the FROB and will review the governance arrangements of the FGD regarding potential conflict of interest.

7.4.6.7 Non-bank financial intermediation

Spanish firms have traditionally very strongly depended on bank credit. In the current context of major challenges to parts of the Spanish banking sector, this has led to credit and liquidity restrictions on borrowers. Therefore, in order to broaden the financing model of the Spanish economy, alternative financing shall be developed to avoid major effects in growth and labour.

Notwithstanding the present and future dominant role of banking intermediation, **the Spanish authorities will develop a holistic plan to improve firms' access to financing.** In this line, it is necessary to implement the necessary proposals for a development of alternative funding channels, such as the strengthening of market based funding.

7.4.7 Parallel commitments under the excessive deficit procedure and the European semester

There is a close relationship between macroeconomic imbalances, public finances and financial sector soundness. At the current juncture, the Spanish economy needs to re-orient towards new sources of growth, including the tradable sector. This can be achieved with the help of structural reforms aimed at making the Spanish economy more competitive, innovative, and business-friendly. Its factor and product markets, especially the labour market, need to become more flexible to accommodate the necessary adjustment. Despite the comprehensive and far-reaching policy response of the Spanish government, there is further room for improvement and more forceful policy actions, especially in the areas indicated in the country-specific recommendations (CSRs) addressed to Spain in the context of the European semester.

The ongoing adjustment of accumulated imbalances, in particular private sector deleveraging, housing and labour market adjustment, and reversal of external financing are pushing the Spanish economy through a prolonged period of subdued growth (see section 2 for more details). At the same time, public deficit and debt have rapidly increased as a mirror image and a consequence of the ongoing adjustment in the private sector. In addition, as the housing boom came to a halt, it exposed a large degree of misalignment between public expenditures and public revenues, which, during the housing boom, were based on a tax-rich base. One of the important effects of increasing fiscal deficits and growing public debt has been a significant increase of Spanish risk premia. However, this higher financing cost is not only limited to sovereign debt, but also affects the cost of financing of Spanish MFIs and ultimately of non-financial private sector. Therefore, continued efforts in addressing the challenges facing the public finance are of key importance to ensure the sustainability of public finance as well as to restore the credibility of the sovereign.

The unwinding of macroeconomic imbalances and the required structural adjustment of the economy, including fiscal consolidation, are also closely linked with the financial sector. On one hand, weak macroeconomic outlook and high unemployment have adverse implications for the debt repayment capacity of households and non-financial corporations. In addition, they further complicate the absorption of the large stock of accumulated unsold houses and other real estate assets, weighing down and constraining the balance sheets of banks. Subdued economic activity with lower number of investment projects and lower consumption further reduces the profit margin of banks. On the other hand, higher ratio of non-performing loans and excessive accumulation of problematic assets on the banks' balance sheets reduces the flow of credit beyond the necessary adjustment, thus, putting an additional brake on economic growth. Therefore, in parallel to monitoring of the progress made with respect to the fulfilment of the financial sector conditionality as outlined in sections 7.3 and 7.4, implementation of the Spanish commitments with respect to CSRs and EDP will be also regularly and closely monitored.

7.4.8 Structural commitments in the context of the European semester

The Spanish authorities are committed to implement the country-specific recommendations (CSRs) in the context of the European semester that were adopted by the Council on 10 July 2012. These reforms aim at correcting macroeconomic imbalances, as identified in the in-depth review under the Macroeconomic Imbalance Procedure (MIP). Beyond the budgetary policy recommendations also reflected in the EDP recommendation, the CSRs include structural fiscal policy recommendations (i) to implement reforms in the public sector to improve the efficiency and quality of public expenditure at all levels of government, (ii) to ensure that the retirement age is rising in line with life expectancy and concrete measures are taken to ensure an increase in the effective retirement age, (iii)

improving the growth-friendliness of the tax system. Regarding labour market policy and education reform, Spain should (i) implement the labour market reform adopted in February, (ii) increase the effectiveness of active labour market policies, (iii) implement the youth action plan to improve the quality and labour market relevance of vocational training and education, and to reduce early school leaving, and (iv) to improve the employability of vulnerable groups. Regarding product market reform, Spain should (i) review spending priorities and re-allocate funds to support access to finance for SMEs, research, innovation and young people, (ii) open up professional services, (iii) reduce delays in obtaining business licences, (iv) eliminate barriers to doing business resulting from overlapping regulations by different levels of government, (v) complete electricity and gas interconnections with neighbouring countries and address the electricity tariff deficit. These recommendations imply the following commitments:

- Improve the efficiency and quality of public expenditure through a reform of the public sector

Various measures to reform the public sector were defined as part of the 2012 budget law and the 2013-14 budget plan. A concrete and detailed timetable, with intermediate steps, for the implementation needs to be established. A comprehensive expenditure review to identify further areas for improving the efficiency of public spending could help identify areas where further progress should be concentrated.

- Adopt measures to ensure that the retirement age is rising in line with life expectancy and concrete measures are taken to ensure an increase in the effective retirement age

The increase in the statutory retirement age and the sustainability factor, formulated in the context of the recently adopted pension reform, could be stepped up. A Global Employment Strategy for Older Workers was adopted last year and concrete measures with a concrete timetable need to be defined and adopted.

- Improve the growth-friendliness of the tax system

The additional budgetary measures adopted in July 2012 envisage an increase in the standard VAT rate, an increase in one of the reduced rates and limiting the scope of application of the reduced rates. Tax advantages for home ownership are going to be abolished.

- Implement the labour market reform adopted in February 2012

A comprehensive labour market reform was adopted in February and finally passed by Law in July 2012. A first impact assessment of the reform should be carried out to take stock whether the desired effects (wage flexibility, greater decentralisation of wage bargaining, reduce labour market segmentation) have materialised with a view to define additional measures if needed.

- Increase the effectiveness of active labour market policies

Improved targeting of active labour market policies, increasing the use and quality of training, advisory and job-matching services, strengthening the links between active and passive policies, and better co-ordination between regional and national employment services would be an important complement to enhance the effectiveness of the labour market reform.

- Implement the youth action plan to improve the quality and labour market relevance of vocational training and education, and to reduce early school leaving

Given very high youth unemployment, there is a need to improve the quality of the vocational training and the education system, with a special focus on early school leaving and improving the labour market relevance of education.

- Review spending priorities and re-allocate funds to support access to finance for SMEs, research, and innovation

In the context of limited resources it is essential to ensure that areas critical for the future growth of Spanish economy are well-prioritised and ring-fenced. In this respect, a comprehensive spending review would help identify key areas for future growth and strategies to promote them.

- Open up professional services, reduce delays in obtaining business licences, and eliminate barriers to doing business resulting from overlapping regulations by different levels of government

The authorities have already expressed their commitment to remove unjustified and disproportionate barriers for highly regulated professions (engineers, notaries, property registry agents, legal representatives). Concrete actions need to be taken to reduce length of procedures to obtain business licences. The authorities should aim to reduce the segmentation of Spain's internal market by reducing the incidence of overlapping regulations by different levels of government, as currently planned.

- Complete electricity and gas interconnections with neighbouring countries and address the electricity tariff deficit

A comprehensive plan should be designed to address the electricity tariff deficit and to improve electricity and gas interconnections.

7.4.9 Public finance commitments under the excessive deficit procedure

With regard to the public finance imbalance, the revised EDP recommendation, which was adopted by the Council of the European Union on 9 July 2012, sets a deadline of 2014 to correct the excessive deficit situation. It establishes a fiscal effort of 2.7%, 2.5% and 1.9% of GDP for the years 2012-14, respectively, to bring the deficit below the reference value of 3%. This implies intermediate deficit targets of 6.3%, 4.5% and 2.8% of GDP in the years 2012-14. Spain should also (i) implement the measures adopted in the 2012 budget and in the rebalancing plans of the regions, (ii) adopt a multi-annual budget plan for 2013-14 which fully specifies the structural measures necessary to achieve the correction of the excessive deficit by 2014, (iii) adopt additional measures in 2012 to ensure the fulfilment of the budgetary plans, and (iv) stand ready to adopt further measures should risks to the budgetary plans materialise. Furthermore, Spain should (i) strictly apply the new provisions of the Budgetary Stability Law regarding transparency and control of budget execution, and (ii) establish an independent fiscal institution. This recommendation implies the following concrete policy commitments:

- Correct the excessive deficit situation by 2014 by implementing the annual structural efforts as specified, with a view to achieving the intermediate headline targets formulated in the EDP recommendation

Spain has adopted additional consolidation measures in July to underpin the revised deficit target for this year. Spain also adopted a multi-annual budget plan for 2013-14 on 3 August with a view to specify the measures required to achieve the budgetary targets in these years..

- Fully implement the budgetary measures adopted so far for 2012 at all levels of government

Close monitoring of the budget execution at all levels of government will be necessary in the remainder of this year. Additional measures to underpin the 2012 deficit target – as requested by the recommendation – were adopted in July 2012.

- Adopt a multi-annual budget plan for 2013-14 that fully specifies the structural measures to correct the excessive deficit by 2014

A multi-annual budget plan for the years 2013-14 was adopted on 3 August. A detailed assessment of these measures will be carried out by the Commission as part of the assessment of effective action

- Adopt and implement the budgetary measures in 2013-14 in accordance with the multi-annual budget plan and ensure the achievement of the budgetary targets at all levels of government

The multi-annual budget plan still needs to be translated into annual budget laws. Budget implementation at all levels of government need to be closely monitored and automatic corrective action should be taken in case of budgetary slippages.

- Strictly apply the provisions of the Budgetary Stability Law, notably as regards transparency, monitoring and control of budget execution.

As part of this commitment, the planned reporting on budget execution by Autonomous Communities on a monthly basis and on a quarterly basis in ESA95 compatible terms should start still in 2012 . In this context, the monthly reporting on budget execution by Autonomous Communities should include data on spending recorded in extra-budgetary accounts. The scope for further improvements in the area of transparency should also be explored.

- Establish an independent fiscal institution

A concrete plan for the establishment of an independent fiscal institution to provide analysis, advice and monitor fiscal policy should be presented.

7.5 PROGRAMME FINANCING

A total of up to EUR 100 billion of the financial package, covering estimated capital requirements with an additional safety margin, is provided under the terms of the Financial Assistance for the Recapitalisation of Financial Institutions by the EFSF[50]. It will subsequently be taken over by the ESM, once this institution becomes fully operational.

The FROB, acting as agent of the Spanish government, will channel the funds to the financial institutions concerned. The funds are to be disbursed in several tranches ahead of the planned recapitalisation dates, pursuant to the roadmap included in the Memorandum of Understanding. These disbursements can be made either in cash or in the form of standard EFSF notes. The average maturity of the financial assistance will not exceed 12.5 years. The maximum maturity of individual disbursements will not exceed 15 years. The duration of the programme is 18 months.

A first tranche, pre-funded and retained in reserve by the EFSF in the form of a contingency facility amounting to EUR 30 billion, was made available at the very beginning of the programme and could be used in case of need for urgent recapitalisation operations.

Spain will pay the actual cost of funding of the EFSF for each disbursement. Moreover, Spain will pay an annual guarantee commission fee of 10 basis points and a service fee consisting of 50 basis points up-front fee and 0.5 basis points annual fee to accrue day to day on the aggregate financial assistance amount in each interest period.

---

50 http://www.efsf.europa.eu/attachments/efsf_spain_ffa.pdf

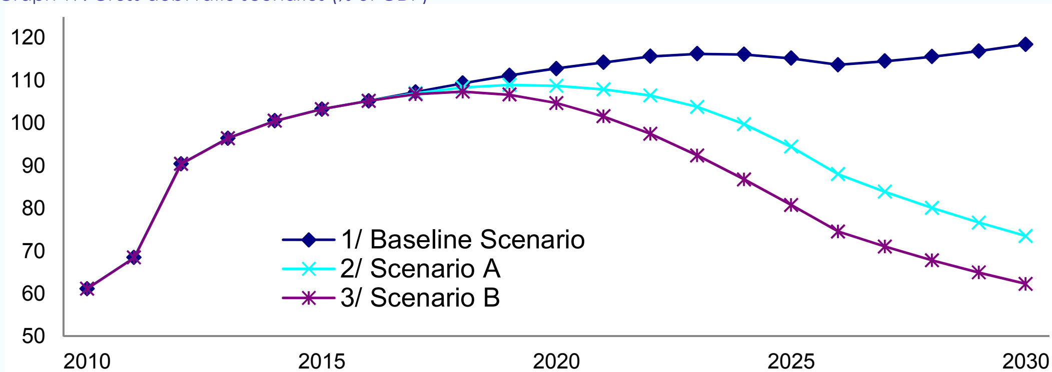
BOX 5: PUBLIC DEBT SUSTAINABILITY

Spanish sovereign debt has been under pressure in recent months, most acutely demonstrated by the yields for 10-year sovereign bonds rising to above 6% over the summer, even if in recent weeks, following the ECB's announcements on planned market interventions, most notably the announcement on the 'Outright Monetary Transaction' (OMT) on 6 September, yields have declined. Nevertheless, continued high levels of interest rates associated with the fast increase of public debt in the recent years raise the issue of public debt sustainability in Spain.

This box explores potential dynamics of debt evolution depending on different scenarios. The baseline scenario is based on the Commission Services' 2012 Spring Forecast (2012-2013), the macroeconomic scenario of the 2012 Ageing Report[51] (2014-2016), and 2012 Debt Sustainability Report[52] (from 2017 onwards)[53]. Inflation is assumed to converge linearly to 2% in 2016, when the output gap is closed, and remains constant thereafter. With regard to interest rates, the baseline scenario considers for 2012 as a whole similar levels to those observed so far (that is, 2% for short-term debt and 6% for long-term debt) and significant improvement in terms of financing costs in the following years. These estimates assume that a maximum amount of EUR 100 billion loan made available under the financial assistance for the Spanish banking sector is used and translated into an increase of public debt as well as that the loan is repaid in full by the end of the considered horizon (by 2026).

In addition to the baseline scenario, two consolidation scenarios are included. They are built on top of the baseline scenario until 2016 and assume subsequent 0.5% (Scenario A) or 1% (Scenario B) yearly consolidation from 2017 until the medium-term objective (MTO) - 0% headline deficit - is reached. For the euro-area Member States, the Stability and Growth Pact (SGP) limits the MTO to a deficit of no more than 1% of GDP. Moreover, the pact requires these countries to make budgetary corrections each year of 0.5% of GDP in structural terms, as a benchmark, towards their MTO.

Graph 19: Gross debt ratio scenarios (% of GDP)



Source: European Commission services

There are two key messages stemming from the results of the simulation exercise. First, under the baseline scenario of no additional consolidation to the spring forecast, the ratio of public debt to GDP exceeds 100% in 2015 and increases thereafter to 120%. It has to be noted that this scenario ignores the additional consolidation measures announced since the spring forecast and, thus, should be interpreted as an upper bound. Under the two consolidation scenarios, a 0% structural deficit (net of cyclical components and one-off measures) is reached in 2027 under the first scenario and in 2022 under the second one. Under the baseline scenario of no additional consolidation the public debt to GDP ratio stabilizes after 2020 but at a very high level. Instead, under the two consolidation scenarios this ratio decreases from 2019-2020 onward and under Scenario B falls down close to the reference ratio of 60% of public debt to GDP ratio as prescribed by the SGP.

---

[51] 2012 Ageing Report: Underlying assumptions and projection methodologies".

[52] Debt Sustainability Report (DSM, Spring 2012)

[53] As a general rule, the output gap is assumed to close in t+5, after which the potential growth rates converge linearly to the Ageing Working Group (AWG) baseline scenario by t+10.

7.6 PROGRAMME MONITORING AND IMPLEMENTATION

7.6.1 Programme monitoring

The European Commission, in liaison with the ECB and EBA, will verify at regular intervals that the policy conditions attached to the financial assistance are fulfilled, through missions and regular reporting by the Spanish authorities, on a quarterly basis. First such mission is scheduled to take place in mid-October. In order to allow regular monitoring of the banking sector as a whole and of banks of specific interest due to their systemic nature or their condition, the authorities have also committed to providing all the data needed to the European Commission, the ECB, EBA and the IMF, under strict conditions of confidentiality.

In addition, state-aided banks and the Spanish authorities will report to the European Commission on the implementation of their restructuring plan via the appointed monitoring trustee. The European Commission in liaison with the ECB and EBA will be granted the right to conduct on-site inspections in any beneficiary financial institutions in order to monitor compliance with the conditions. In parallel, the Council will review on a regular basis the economic policies implemented by Spain under the Macroeconomic Imbalances procedure as well as under the excessive deficit procedure. Unlike in other international financial assistance programmes to countries, the IMF is not party to the programme, but rather an independent adviser serving all parties to the programme, i.e. Spain and the EU institutions. According to the IMF's own Terms of Reference governing its involvement in this programme the IMF is not responsible for the conditionality of the MoU or its implementation. Instead it supports the efforts of the Spanish authorities by monitoring the financial sector as a whole and by providing technical assistance. IMF staff can participate in all financial assistance monitoring missions conducted by the European Commission, but retains its independence of views and recommendations within the monitoring process.

7.6.2 Programme implementation

With the signature of the MoU on 23 July, the financial-sector programme for Spain entered into force. The core of the programme is a sufficient recapitalisation of Spanish banks, where needed, for which up to EUR 100 billion will be made available by EFSF/ESM. This recapitalisation process has started with the due diligence process. Thereafter, banks will have to submit restructuring plans to the European Commission for approval.

The execution of the entire range of the programme is very closely monitored by the European Commission and the ECB, and also partly by the EBA and EFSF. The IMF is also closely involved. However, unlike in other international financial assistance programmes to countries, the IMF is not party to the programme, but rather an independent adviser serving all parties to the programme, i.e. Spain and the EU institutions. According to the IMF's own Terms of Reference governing its involvement in this programme the IMF is not responsible for the conditionality of the MoU or its implementation. Instead it supports the efforts of the Spanish authorities by monitoring the financial sector as a whole and by providing technical assistance. IMF staff can participate in all financial assistance monitoring missions conducted by the European Commission, but retains its independence of views and recommendations within the monitoring process.

This bank-specific part of the programme is accompanied and flanked by horizontal conditionality. Some of this conditionality pertains to necessary legal amendments to allow for the restructuring of the Spanish banking sector as envisioned in the MoU while other elements aim to more generally strengthen the viability of the Spanish banking sector. On 31 August, two important milestones were reached in this regard. First, the government adopted a new law on bank restructuring and resolution, to allow for proper bank restructuring accompanying and reinforcing recapitalisation. Second, a blueprint for the Asset Management Company (AMC) was drawn up to allow for and prepare the segregation of impaired bank assets.

The Royal Decree-Law sets the criteria and content of restructuring and resolution procedures. This includes special tools to resolve banks, such as the sale of business tool and bridge banks; the conditions of public capital injections as a financing support measure and the regime and responsibilities of the FROB as the resolution authority. The law also contains provisions on overriding shareholders rights in resolution processes. The law has been guided by the European Commission legislative proposal on crisis management and bank resolution and it constitutes a key element in the overall context of the programme. It provides for the necessary legal basis to

effectively carry out a comprehensive process of restructuring those Spanish financial institutions that are in need of external support. This restructuring is geared to make these institutions and their business models fully sustainable and viable for the medium term.

Setting up an AMC blueprint by end-August was one of the conditions included in the MoU. Effective segregation of impaired assets from bank balances and their transfer into a new separate vehicle, the AMC, is a crucial element of the Spanish financial sector programme. That blueprint provides for the necessary broad and strategic orientations for this new institution, including the scope of asset to be transferred into the AMC, the valuation of these assets, as well as the governance and capital and financing structure. In order to ensure that the AMC is operational by 1 December, as required by the MoU, legislation on the AMC needs to be developed in the course of autumn. Real Decreto-ley 24/2012 (RDL) on bank restructuring of 31 August[54] incorporates the notion of the asset management company into the Spanish law, while more detailed elements of the design of the AMC will be included in the secondary legislation.

[54] http://noticias.juridicas.com/base_datos/Admin/rdl24-2012.html

8 MEMORANDUM OF UNDERSTANDING ON FINANCIAL-SECTOR POLICY CONDITIONALITY

SPAIN

MEMORANDUM OF UNDERSTANDING ON
FINANCIAL-SECTOR POLICY CONDITIONALITY

20 JULY 2012

With regard to the EFSF Framework Agreement, and in particular Article 2 (1) thereof, this Memorandum of Understanding on financial-sector policy conditionality (MoU), details the policy conditions as embedded in Council Decision […] of 20 July 2012 on specific measures to reinforce financial stability in Spain. Given the nature of the financial support provided to Spain, conditionality will be financial-sector specific and will include both bank-specific conditionality in line with State aid rules and horizontal conditionality. In parallel, Spain will have to comply fully with its commitments and obligations under the EDP and the recommendations to address macroeconomic imbalances within the framework of the European semester. Progress in meeting these obligations under the relevant EU procedures will be closely monitored in parallel with the regular review of programme implementation.

For the duration of the EFSF financial assistance, the Spanish authorities will take all the necessary measures to ensure a successful implementation of the programme. They also commit to consult ex-ante with the European Commission, and the European Central Bank (ECB) on the adoption of financial-sector policies that are not included in this MoU but that could have a material impact on the achievement of programme objectives – the technical advice of the International Monetary Fund (IMF) will also be solicited. They will also provide the European Commission, the ECB and the IMF with all information required to monitor progress in programme implementation and to track the financial situation. Annex 1 provides a provisional list of data requirements.

I. INTRODUCTION

1. **On 25 June 2012, the Spanish Government requested external financial assistance in the context of the ongoing restructuring and recapitalisation of the Spanish banking sector.** The assistance is sought under the terms of the Financial Assistance for the Recapitalisation of Financial Institutions by the EFSF. Following this request, the European Commission in liaison with the ECB, the European Banking Authority (EBA) and the IMF conducted an independent assessment of the eligibility of Spain's request for such assistance. This assessment concluded that Spain fulfils the eligibility conditions. The Heads of State and Government at the Euro Area Summit of 29 June 2012 specified that the assistance will subsequently be taken over by the ESM, once this institution is fully operational, without gaining seniority status. The full implementation of this MoU will take into account all other relevant considerations contained in the Euro Area Summit statement of 29 June 2012.

II. RECENT ECONOMIC AND FINANCIAL DEVELOPMENTS AND OUTLOOK

2. **The global financial and economic crisis exposed weaknesses in the growth pattern of the Spanish economy.** Spain recorded a long period of strong growth, which was, in part, based on a credit-driven domestic demand boom. Very low real interest rates triggered the accumulation of high domestic and external imbalances as well as a real estate bubble. The sharp correction of that boom in the context of the international financial crisis led to a recession and job destruction.

3. **The unwinding of economic imbalances is weighing on the growth outlook**. Private sector deleveraging implies subdued domestic demand in the medium term. Sizable external financing needs increase the vulnerability of the Spanish economy. A shift to durable current account surpluses will be required to reduce external debt to a sustainable level. Public debt is increasing rapidly due to persistently high general government deficits since the beginning of the crisis linked to the shift to a much less tax-rich growth pattern.

4. **The challenges that face segments of the banking sector continue to negatively affect the economy as the credit flow remains constrained.** In particular, sizeable exposure to the real estate and construction sectors have eroded investor and consumer confidence. As the linkages between the banking sector and the sovereign have increased, a negative feedback loop has emerged. Therefore, restructuring (including, where appropriate, orderly resolution) and recapitalisation of banks is key to mitigating these linkages, increasing confidence, and spurring economic growth.

5. **With the exception of a few large and internationally diversified credit institutions, Spanish banks have lost access to wholesale funding markets on affordable terms.** As a result, Spanish banks have become highly dependent on Eurosystem refinancing. Moreover, the borrowing capacity of Spanish banks has been severely limited by the impact of rating downgrades on collateral availability.

III. KEY OBJECTIVES

6. **The Spanish banking sector has been adversely affected by the burst of the real estate and construction bubble and the economic recession that followed.** As a result, several Spanish banks have accumulated large stocks of problematic assets. Concerns about viability of some of these banks are a source of market volatility.

7. **The Spanish authorities have taken a number of important measures to address the problems in the banking sector.** These measures include the clean-up of banks' balance sheets, increasing minimum capital requirements, restructuring of the savings bank sector, and significantly increasing the provisioning requirements for loans related to Real Estate Development (RED) and foreclosed assets. These measures, however, have not been sufficient to alleviate market pressure.

8. **The main objective of the financial sector programme in Spain is to increase the long-term resilience of the banking sector as a whole, thus, restoring its market access.**

- **As part of the overall strategy, it is key to effectively deal with the legacy assets** by requiring a clear segregation of impaired assets. This will remove any remaining doubts about the quality of the banks' balance sheets, allowing them to better carry out their financial intermediation function.
- **By improving the transparency of banks' balance sheets in this manner, the programme aims to facilitate an orderly downsizing of bank exposures to the real estate sector, restore market-based funding, and reduce banks' reliance on central bank liquidity support.**
- **Additionally, it is essential to enhance the risk identification and crisis management mechanisms** which reduce the probability of occurrence and severity of future financial crises.

IV. RESTORING AND STRENGTHENING THE SOUNDNESS OF THE SPANISH BANKS: BANK-SPECIFIC CONDITIONALITY

9. **The key component of the programme is an overhaul of the weak segments of the Spanish financial sector. It will be comprised of the following three elements:**

- identification of individual bank capital needs through a comprehensive asset quality review of the banking sector and a bank-by-bank stress test, based on that asset quality review;
- recapitalization, restructuring and/or resolution of weak banks, based on plans to address any capital shortfalls identified in the stress test; and
- segregation of assets in those banks receiving public support in their recapitalization effort and their transfer of the impaired assets to an external Asset Management Company (AMC).

Roadmap

10. **The recapitalisation and restructuring of banks will advance according to the following timeline.**

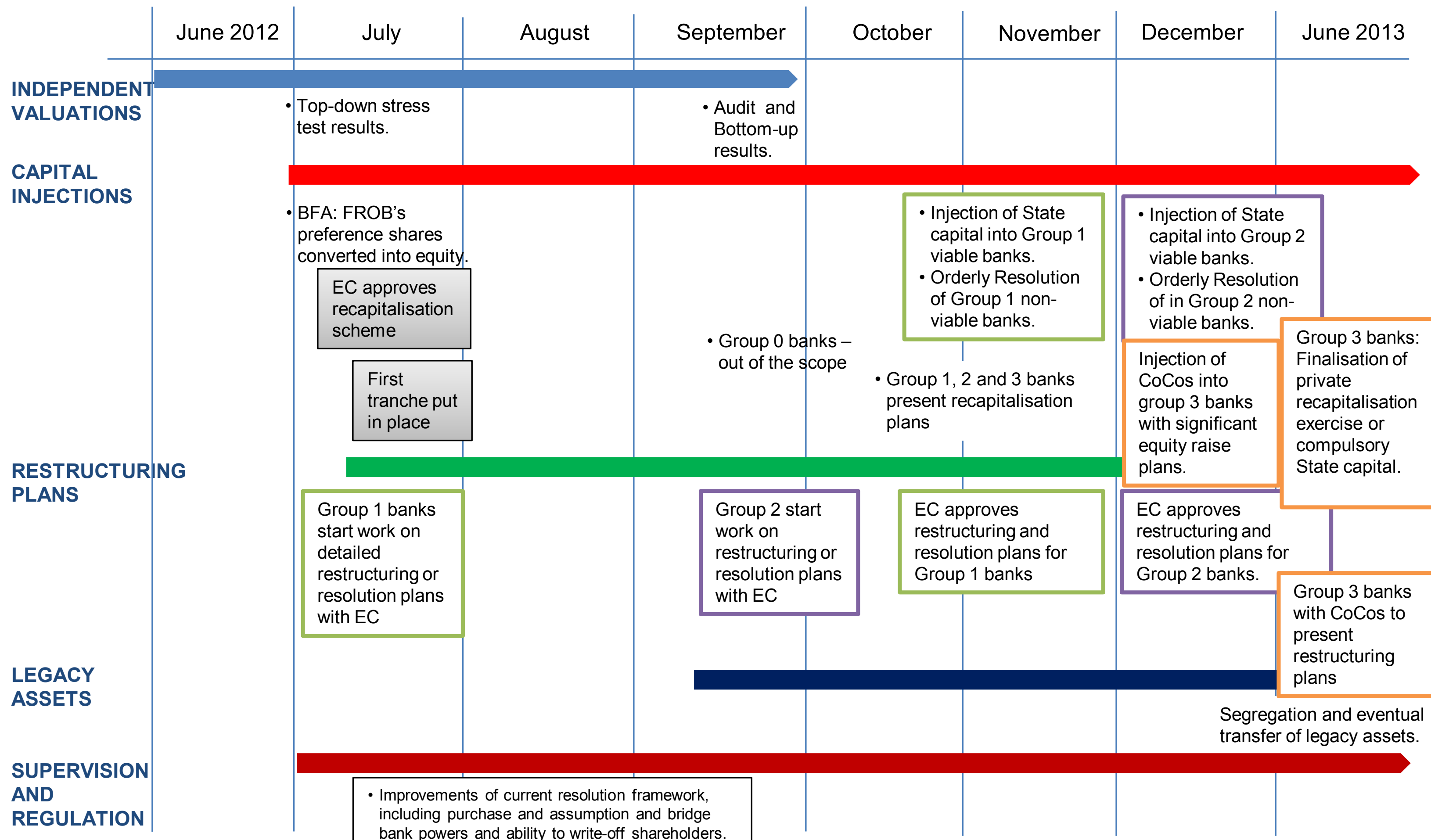
- **In July 2012, the programme will begin by providing a first tranche**. In particular, until recapitalisation of banks has been fully effected, individual banks may find themselves at risk. Against the background of continued sovereign funding strains and extremely limited access by some banks to external funding, the financial situation of banks remains tight. Under these conditions, the ready availability of a credible backstop to be mobilised in case of emergency to cover for the costs of unexpected interventions contribute to restore confidence. The first tranche will have a volume of EUR 30 billion to be prefunded and kept in reserve by the EFSF. The possible use of this tranche ahead of the adoption of restructuring decisions by the European Commission will require a reasoned and quantified request from the Banco de España, to be approved by the European Commission and the Euro Working Group (EWG) and in liaison with the ECB.

- **A bank-by-bank stress test conducted by an external consultant with regard to 14 banking groups comprising 90% of the Spanish banking system will be completed by the second half of September 2012 (Stress Test)**. The Stress Test, following the results of the top-down exercise published on 21 June 2012, will estimate the capital shortfalls for individual banks and give rise to a recapitalisation and restructuring process for groups of banks as set out in Figure 1.

- **On the basis of the stress test results and recapitalisation plans, banks will be categorised accordingly.** Group 0 will constitute those banks for which no capital shortfall is identified and no further action is required. Group 1 has been pre-defined as banks already owned by the Fund for Orderly Bank Restructuring (FROB) (BFA/Bankia, Catalunya Caixa, NCG Banco and Banco de Valencia). Group 2 will constitute banks with capital shortfalls identified by the Stress Test and unable to meet those capital shortfalls privately without having recourse to State aid. Finally, Group 3 will constitute banks with capital shortfall identified by the stress test with credible recapitalisation plans and able to meet those capital shortfalls privately without recourse to State aid. The distributions of banks between groups 0, 2 and 3 will be established in October, based on the results of the Stress Test and an assessment of recapitalisation plans.

Figure 1:

Restructuring of the Spanish Banking Sector: Timeline



Group of banks:
- Group 0: Banks with no capital shortfall are out of the scope;
- Group 1: FROB banks (BFA/Bankia, CatalunyaCaixa, NovaCaixaGalicia, Banco de Valencia): banks for which State aid needs are – largely - known before the Stress Test and which will need to be validated on this basis;
- Group 2: Banks with capital shortfall identified by the Stress Test, with no possibility to raise privately capital, and thus which will need to recourse to State aid.
- Group 3: Banks with capital shortfall identified by the Stress Test, aiming at raising this privately.

EC: European Commission

- **By early-October, banks in Groups 1, 2 and 3 will present recapitalisation plans identifying how they intend to fill the capital shortfalls identified**. Capital can be raised, chiefly, from internal measures, asset disposals, liability management exercises, and by raising equity or from State aid.
- **The Spanish authorities and the European Commission will assess the viability of the banks** on the basis of the results of the Stress Test and the restructuring plans. Banks that are deemed to be non-viable will be resolved in an orderly manner.
- **For Group 1 banks, the Spanish authorities will start preparing restructuring or resolution plans with the European Commission from July 2012 onwards.** These plans will be finalised in light of the Stress Test results and presented in time to allow the European Commission to approve them by November 2012. On this basis, State aid will be granted and plans can be implemented immediately. The process of moving impaired assets to an external AMC will be completed by year end. These banks are expected to have the largest capital needs.
- **For Group 2 banks, the Spanish authorities will need to present a restructuring or resolution plan to the European Commission by October 2012 at the latest.** Given the need to incorporate the findings from the Stress Test, the approval process is expected to run until end-December when these banks will be recapitalized or resolved in an orderly manner. All Group 2 banks must include in their restructuring or resolution plan the necessary steps to segregate their impaired assets into an external AMC.
- **For banks in Groups 1 and 2, no aid will be provided until a final restructuring or resolution plan has been approved** by the European Commission, unless use has to be made of the funds of the first tranche.
- **Group 3 banks planning a *significant* equity raise *corresponding to more than 2% of RWA* will, as a precautionary measure, be required to issue contingent convertible securities (COCOs) under the recapitalisation scheme to meet their capital needs by end December 2012 at the latest** – COCOs will be subscribed for by the FROB using programme resources and can be redeemed until 30 June 2013 if they succeed in raising the necessary capital from private sources. Otherwise they will be recapitalised through the total or partial conversion of the COCOs into ordinary shares. They will have to present restructuring plans.
- **Group 3 banks planning *a more* limited equity raise corresponding to less than 2% of RWA will be given until 30 June 2013 to do so**. Should they not succeed, they will be recapitalized by means of State aid and present restructuring plans.
- **Group 3 banks that still benefit from public support under this programme on 30 June 2013 will be required in their restructuring plans to transfer the impaired assets to the AMC,** unless it can be shown for banks requiring less than 2% of RWA in State aid that other means to achieve full off-balance sheet segregation are less costly**.**

Diagnostics

11. **The Spanish authorities will complete an accounting and economic value assessment of the credit portfolios and foreclosed assets of 14 banking groups.** The assessment will be conducted by an external consultant, based on inputs from four independent auditors as follows.

- Based on a predefined sample of operations the accounting review will include: (i) data quality analysis, including the appropriate identification of restructured/refinanced loans; (ii) verification of the proper classification of operations; (iii) review of the calculation of impairment losses; and (iv) computation of the impact of the new provisioning requirements for both performing and non-performing loans in the real estate and construction sector.
- The extended mandate of the due diligence process of the auditors will also capture the data required for an economic value assessment of the assets. This will include a wider sample, necessary to assess the systems and appropriateness of loan origination, classification and arrears management to check and adjust the current classification and risk parameters. The information obtained from the auditors will be combined with additional bank specific data, as requested by the consultant, from official authorities and directly from banks through direct interaction as needed. In addition, a rigorous appraisal of the value of collateral and foreclosed assets value will be required to fully inform a comprehensive asset quality review carried out by the external consultant.

12. **The asset quality review will form the basis for a bank-by-bank stress test to be performed by the external consultant.** It will also form the basis for any future valuation of Spanish bank assets (see

paragraph 21). This Stress Test will build on the scenarios developed for the top down exercise, and will benefit from the granular information and asset quality review that is being gathered by independent firms through data verification and validation and take into account its loss absorption capacity. All information required for the Stress Test, including the results of the asset quality review, will be provided to the consultants by mid-August at the latest. The results of the Stress Test will be published in the second half of September 2012. The Banco de España and the European Commission, in consultation with the EBA and in liaison with the ECB, will establish the specific capital needs of each participating bank (if any).

13. **In accordance with the appropriate governance structure established in the Terms of Reference for this exercise, a Strategic Coordination Committee ("SCC"), involving, together with the Spanish authorities, the European Commission, the ECB, the EBA and the IMF and an Expert Coordination Committee ("ECC") will closely oversee the work carried out by the independent firms**. The latter will provide full updates every two weeks to the SCC.

Recapitalisation, restructuring and/or resolution

14. **The approach to bank restructuring and resolution is based on the principles of viability, burden sharing and limiting distortions of competition in a manner that promotes financial stability and contributes to the resilience of the banking sector.** Recapitalisation plans involving the use of public funds will trigger a restructuring process. The restructuring plans of the banks requiring public funds will have to demonstrate that the long-term viability of the bank can be ensured without continuing State aid. The plans should focus on the bank's capacity to generate value for shareholders given its risk profile and business model, as well as the costs linked to the necessary restructuring. The degree of restructuring required will take due account of the relative size of the public support provided.

15. **Restructuring plans will address the banks' ability to generate sustainable and profitable business going forward and their funding needs**. The restructuring plans should be based on significant downsizing of unprofitable business with a focus on divestitures wherever feasible, de-risking through the separation of the most problematic assets, rebalancing of the funding structure, including a reduction of the reliance on central bank liquidity support, improved corporate governance and operational restructuring primarily through the rationalisation of branch networks and of staff levels. This should lead to a sustainable improvement in the cost-to-income ratios of the banks concerned. Non-listed entities should also present a credible timeline to eventually become publicly traded.

- **The restructuring plans of viable banks requiring public support will detail the actions to minimise the cost on taxpayers.** Banks receiving State aid will contribute to the cost of restructuring as much as possible with their own resources. Actions include the sale of participations and non-core assets, run off of non-core activities, bans on dividend payments, bans on the discretionary remuneration of hybrid capital instruments and bans on non-organic growth. Banks and their shareholders will take losses before State aid measures are granted and ensure loss absorption of equity and hybrid capital instruments to the full extent possible.
- **For non-viable banks in need of public funds, the Spanish authorities have to submit an orderly resolution plan.** Orderly resolution plans should be compatible with the goals of maintaining financial stability, in particular by protecting customer deposits, of minimising the burden of the resolution on the taxpayer and of allowing healthy banks to acquire assets and liabilities in the context of a competitive process. The orderly resolution process will involve the transfer of certain assets to the external AMC.
- The Spanish authorities commit to cap pay levels of executive and supervisory board members of all State-aided banks.

16. **The Spanish authorities will take early and timely action on the restructuring and resolution plans.** The authorities will immediately start liaising with the European Commission to ensure timely delivery of the restructuring plans. The restructuring plans will be submitted to the European Commission for assessment under State aid rules, and will be made available, once finalised, to the ECB, EBA and IMF. The Spanish authorities will provide all the necessary information on the restructuring or resolution plans as soon as the need for state aid is known. The process will commence immediately for Group 1 banks. For these banks, the Spanish authorities will work to put the European Commission in a position to approve the restructuring or resolution plans by November 2012. For those banks whose capital needs will become clear with the result of the bottom up stress test, the Spanish authorities will enter into the same process with the aim of ensuring that restructuring plans can be approved by the European Commission by December 2012. Recapitalisations will only take place after the adoption of a restructuring decision by the

European Commission, requiring burden sharing and restructuring, unless funds of the first tranche are deployed.

Burden sharing

17. **Steps will be taken to minimise the cost to taxpayers of bank restructuring.** After allocating losses to equity holders, the Spanish authorities will require burden sharing measures from hybrid capital holders and subordinated debt holders in banks receiving public capital, including by implementing both voluntary and, where necessary, mandatory Subordinated Liability Exercises (SLEs). Banks not in need of State aid will be outside the scope of any mandatory burden sharing exercise. The Banco de España, in liaison with the European Commission and the EBA, will monitor any operations converting hybrid and subordinated instruments into senior debt or equity.

18. **Legislation will be introduced by end-August 2012 to ensure the effectiveness of the SLEs.** The Spanish authorities will adopt the necessary legislative amendments, to allow for mandatory SLEs if the required burden sharing is not achieved on a voluntary basis. These amendments should also include provisions allowing that holders of hybrid capital instruments and subordinated debt fully participate in the SLEs. By end-July 2012, the Spanish authorities will identify the legal steps that are needed to establish this framework, so that its adoption can be completed by end-August 2012. The Banco de España will immediately discourage any bank which may need to resort to State aid from conducting SLEs at a premium of more than 10% of par above market prices until December 2012.

19. **Banks with capital shortfalls and needing State aid will conduct SLEs against the background of the revised legal framework and in accordance with State aid rules**, by converting hybrid capital and subordinated debt into equity at the time of public capital injection or by buying it back at significant discounts. For Group 3 banks this rule will apply on 30 June 2013, if they still are in receipt of public funds. For non viable banks, SLEs will also need to be used to the full extent to minimise the cost for the tax payer. Any capital shortfall stemming from issues arising in the implementation of SLEs will not be covered by the EFSF assistance.

20. **The bank resolution framework will be further upgraded**. By end-August, the Spanish authorities, in consultation with the European Commission, the ECB and the IMF, will modify the bank resolution framework in order to incorporate relevant resolution powers to strengthen the FROB. This amendment will take into account the EU regulatory proposal on crisis management and bank resolution, including special tools to resolve banks, such as the sale of business tool and bridge banks; the legislation will also include a clarification of the financial responsibilities of the FGD (Deposit Guarantee Fund) and the FROB. The legislation will also include provisions on overriding shareholders rights in resolution processes.

Segregation of impaired assets: Asset Management Company

21. **Problematic assets of aided banks should be quickly removed from the banks' balance sheets.** This applies, in particular, for loans related to Real Estate Development (RED) and foreclosed assets. In principle, it will also apply to other assets if and when there are signs of strong deterioration in their quality. The principle underpinning the separation of impaired assets is that they will be transferred to an external AMC. Transfers will take place at the real (long-term) economic value (REV) of the assets. The REV will be established on the basis of a thorough asset quality review process, drawing on the individual valuations used in the Stress Test The respective losses must be crystallized in the banks at the moment of the separation. The Spanish authorities, in consultation with the European Commission, the ECB and the IMF, will prepare a comprehensive blueprint and legislative framework for the establishment and functioning of this asset separation scheme by end-August 2012. The Spanish authorities will adopt the necessary legislation in the autumn with a view to assuring that the AMC will be fully operational by November 2012.

22. **The AMC will manage the assets with the goal of realising their long-term value.** The AMC will purchase the assets at REV and will have the possibility to hold them to maturity. The FROB will contribute cash and/or high quality securities to the AMC for an amount corresponding to a certain percentage (to be determined at the time of the establishment of the AMC) of the REV of the assets purchased. In exchange for the assets, the banks will receive a suitably small equity participation in the AMC, bonds issued by the AMC and guaranteed by the State, or cash and/or high quality securities. The bonds issued by the AMC will be structured in such a manner that they will meet the conditions set out in the ECB´s "Guideline on monetary policy instruments and procedures of the Eurosystem".

V. ENSURING A SOUND FRAMEWORK FOR THE BANKING SECTOR: HORIZONTAL CONDITIONALITY

23. **A strengthening of the regulatory framework is critical to enhance the resilience of the Spanish banking sector**. Spanish authorities will take additional measures in the following areas.

- **Spanish credit institutions will be required, as of 31 December 2012, to meet until at least end-2014 a Common Equity Tier (CET) 1 ratio of at least 9%.** The definition of capital used to calculate this solvency ratio will be based on that (eligible capital) established in the ongoing EBA recapitalisation exercise.
- **From 1 January 2013, Spanish credit institutions will be required 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. However, the additional capital needed to meet the 9% capital ratio will be calculated based on the capital definition established in the ongoing EBA recapitalisation exercise. In any case, Spanish credit institutions will not be allowed to reduce their capital base with respect to December 2012 figures, without previous approval from the Banco de España.
- **The current framework for loan-loss provisioning will be re-assessed**. On the back of the experiences of the financial crisis, the Spanish authorities will make proposals to revamp the permanent framework for loan loss provisioning, taking into account the temporary measures introduced during the past months, as well as the EU accounting framework. Furthermore, the authorities will explore the possibility to revise the calibration of dynamic provisions on the basis of the experience gathered during the current financial crisis. To this end, the authorities will submit by mid-December 2012, a policy document for consultation to the European Commission, ECB, EBA and IMF on the amendment of the provisioning framework if and once Royal Decree Laws 2/2012 and 18/2012 cease to apply.
- **The regulatory framework on credit concentration and related party transactions will be reviewed.** This review, to be carried out by the Spanish authorities by mid-January 2013, will in particular assess whether a strengthening of the regulatory framework is warranted.
- **The liquidity situation of Spanish banks will continue being closely monitored.** For the purpose of monitoring their liquidity position, credit institutions in receipt of State aid or for which capital shortfalls will be revealed in the Stress Test will, as of 1 December 2012, provide standardised quarterly balance sheet forecasts (funding plans) to the Banco de España and the ECB. The Banco de España will provide regular information on the liquidity situation of these banks to the European Commission, the ECB and the IMF, as specified in Annex 1.
- **The governance structure of former savings banks and of commercial banks controlled by them will be strengthened.** The Spanish authorities will prepare by end-November 2012 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. Furthermore, authorities will propose measures to strengthen fit and proper rules for the governing bodies of savings banks and to introduce incompatibility requirements regarding the governing bodies of the former savings banks and the commercial banks controlled by them. Moreover, authorities will provide by end-November 2012 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.
- **Enhanced transparency is a key pre-requisite for fostering confidence in the Spanish banking system.** Several important measures have already been taken to increase the quality and quantity of information provided by credit institutions to the general public, notably concerning real estate and construction sector exposures. The authorities released for public consultation a regulatory proposal aimed at enhancing and harmonising disclosure requirements for all credit institutions on key areas of their portfolios such as restructured and refinanced loans, sectoral concentration. This regulatory proposal will be finalised in consultation with the European Commission, the ECB, the EBA and the IMF and become effective by end of September 2012.

24. **The supervisory framework will be strengthened. The Spanish authorities will take measures in the following areas.**

- **A further strengthening of the operational independence of the Banco de España is warranted.** The Spanish authorities will transfer by 31 December 2012 the sanctioning and licensing powers of the Ministry of Economy to the Banco de España. Furthermore, the Spanish

authorities will identify by end October 2012 possibilities to further empower the Banco de España to issue binding guidelines or interpretations.

- **The supervisory procedures of Banco de España will be further enhanced based on a formal internal review.** The Banco de España will conduct a full internal review of its supervisory and decision-making processes by end-October 2012 in order to identify shortcomings and make all the necessary improvements. In this internal review, the Banco de España will test recent improvements made to the supervisory procedures in order to ensure that the findings of on-site inspections translate effectively and without delays into remedial actions. Specifically, the authorities will analyse the need for any further improvements in the communication to the decision making bodies of vulnerabilities and risk in the banking system, in order to ensure the adoption of corrective actions. Furthermore, the authorities will ensure that macro-prudential supervision will properly feed into the micro supervision process and adequate policy responses.
- **The Banco de España will by end-2012 require credit institutions to review, and if necessary, prepare and implement strategies for dealing with asset impairments**. The Banco de España will determine the operational capability of credit institutions to manage arrears, identify operational deficiencies and will monitor the implementation of these plans. The assessment of the adequacy of loan work-out strategies will also be based on the findings of the external auditors and consultants during the asset quality review.

25. **Consumer protection and securities legislation, and compliance monitoring by the authorities, should be strengthened**, in order 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. This should include increased transparency on the characteristics of these instruments and the consequent risks in order to guarantee full awareness of the retail clients. The Spanish authorities will propose specific legislation in this respect by end-February 2013.

26. **The public credit register will be enhanced.** The Spanish authorities will take additional measures to improve the quantity and quality of information reported to the register. The envisaged enhancements will be submitted for consultation with stakeholders by end-October 2012. Furthermore, the necessary legislative amendments will be in place by end-March 2013. Meanwhile, work on practical arrangements will continue with a view to having the envisaged enhancements operational as quickly as possible.

27. **Non-bank financial intermediation should be strengthened.** In light of the high dependence of the Spanish economy on bank intermediation, the Spanish authorities will prepare, by mid-November 2012, proposals for the strengthening of non-bank financial intermediation including capital market funding and venture capital.

28. **Governance arrangements of the financial safety net agencies will be reviewed to avoid potential conflicts of interest.** In particular, the authorities will ensure that, as of 1 January 2013 there will be no active bankers anymore in the governing bodies of the FROB. The governance arrangements of the FGD will also be reviewed, in particular with regard to potential conflicts of interest.

VI. PUBLIC FINANCES, MACROECONOMIC IMBALANCES AND FINANCIAL SECTOR REFORM

29. **There is a close relationship between macroeconomic imbalances, public finances and financial sector soundness.** Hence, progress made with respect to the implementation of the commitments under the excessive deficit procedure, and with regard to structural reforms, with a view to correcting any macroeconomic imbalances as identified within the framework of the European semester, will be regularly and closely monitored in parallel with the formal review process as envisioned in this MoU.

30. **According to the revised EDP recommendation, Spain is committed to correct the present excessive deficit situation by 2014.** In particular, Spain should ensure the attainment of intermediate headline deficit targets of 6.3% of GDP for 2012, 4.5% of GDP for 2013 and 2.8% of GDP for 2014. Spanish authorities should present by end-July 2012 a multi-annual budgetary plan for 2013-14, which fully specifies the structural measures that are necessary to achieve the correction of the excessive deficit. Provisions of the Budgetary Stability Law regarding transparency and control of budget execution should be fully implemented. Spain is also requested to establish an independent fiscal institution to provide analysis, advice and monitor fiscal policy.

31. **Regarding structural reforms, the Spanish authorities are committed to implement the country-specific recommendations in the context of the European semester.** These reforms aim at correcting macroeconomic imbalances, as identified in the in-depth review under the Macroeconomic Imbalance Procedure (MIP). In particular, these recommendations invite Spain to: 1) introduce a taxation system consistent with the fiscal consolidation efforts and more supportive to growth, 2) ensure less tax-induced bias towards indebtedness and home-ownership, 3) implement the labour market reforms, 4) take additional measures to increase the effectiveness of active labour market policies, 5) take additional measures to open up professional services, reduce delays in obtaining business licences, and eliminate barriers to doing business, 6) complete the electricity and gas interconnections with neighbouring countries, and address the electricity tariff deficit in a comprehensive way.

VII. PROGRAMME MODALITIES

32. **Spain would require an EFSF loan, covering estimated capital requirements with an additional safety margin, estimated as summing up to EUR 100 billion in total.** The programme duration is 18 months. FROB, acting as agent of the Spanish government, will channel the funds to the financial institutions concerned. Modalities of the programme will be determined in the FFA. The funds will be disbursed in several tranches ahead of the planned recapitalisation dates, pursuant to the roadmap included in Section IV. These disbursements can be made either in cash or in the form of standard EFSF notes.

VIII. PROGRAMME MONITORING

33. **The European Commission, in liaison with the ECB and EBA, will verify at regular intervals that the policy conditions attached to the financial assistance are fulfilled, through missions and regular reporting by the Spanish authorities, on a quarterly basis.** Monitoring of the FROB activities in the context of the programme will take place regularly. The Spanish authorities will request technical assistance from the IMF to support the implementation and monitoring of the financial assistance with regular reporting.

34. **The authorities will provide to the European Commission, the ECB, EBA and the IMF, under strict conditions of confidentiality, the data needed for monitoring of the banking sector as a whole and of banks of specific interest due to their systemic nature or their condition.** A provisional list of required reports and data is provided in Annex 1.

35. **State-aided banks and the Spanish authorities will report to the European Commission on the implementation of their restructuring plan via the appointed monitoring trustee**.

36. **The European Commission in liaison with the ECB and EBA will be granted the right to conduct on-site inspections in any beneficiary financial institutions in order to monitor compliance with the conditions.**

37. In parallel, the Council should review on a regular basis the economic policies implemented by Spain under the Macroeconomic Imbalances procedure as well as under the excessive deficit procedure.

ANNEX 1: DATA REQUIREMENTS

Spanish authorities will regularly submit or update, at least on a weekly or monthly basis the following data:

1. Reports and data, on a weekly basis, on bank deposits.
2. Reports and data, on a weekly basis, on banks' liquidity position and forecast.
3. Quarterly bank prudential financial statements as sent to the supervisor, for the 14 banking groups, including additional details on:
   - financial and regulatory information (consolidated data) on the 14 banking groups and the banking sector in total, especially regarding (P&L), balance sheets, asset quality, regulatory capital, balance sheet forecasts;
   - non-performing loans, repossessed assets and related provisions; to include exposure across different asset classes (Land & Development, including commercial real estate), Residential Real Estate, SME lending, Corporate lending, Consumer lending;
   - asset quality across different asset classes (good quality, watch, substandard, NPL, restructured, of which restructured and NPL); provision stock across different asset classes, new lending across different asset classes;
   - sovereign debt holdings;
   - outstanding stock of debt issued, with a break down by seniority (senior secured, senior unsecured, subordinated of which preference shares, government guaranteed), with the amounts placed with retail customers, and amortization schedule;
   - regulatory capital and its components: including capital requirements (credit risk, market risk, operational risk).
4. Until quarterly balance sheet forecasts are available, an agreed template for banks supported by FROB, regarding refinancing needs and collateral buffers, for a horizon of 1 month, 3 months and 6 months should be provided. Funding plans will eventually be required for an expanded sample of banks. Reporting will be expanded to also include capital plans.
5. Reports and data on un-pledged eligible collateral.
6. Reports and data on borrowing amounts in the repo market, either directly or through CCPs.

The Spanish authorities will, at the latest one week after the start of the programme, propose formats and templates for the submission of this information, which will be agreed with the European Commission, the ECB, EBA and the IMF.

Above list is provisional. Further requests may be added at a later stage. For this purpose, a procedure will be set-up for the relevant staff of the European Commission, the ECB, EBA and the IMF to submit additional ad hoc bank data requests as needed.

ANNEX 2: CONDITIONALITY

Measure	Date
1. Provide data needed for monitoring the entire banking sector and of banks of specific interest due to their systemic nature or condition (Annex 1).	Regularly throughout the programme, starting end-July
2. Prepare restructuring or resolution plans with the EC for Group 1 banks, to be finalised in light of the Stress Tests results in time to allow their approval by the Commission in November.	July 2012 - mid August
3. Finalise the proposal for enhancement and harmonisation 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
4. Provide information required for the Stress Test to the consultant, including the results of the asset quality review.	Mid-August 2012
5. Introduce legislation to introduce the effectiveness of SLEs, including to allow for mandatory SLEs.	End-August 2012
6. Upgrade of the bank resolution framework, i.e. strengthen the resolution powers of the FROB and DGF.	End-August 2012
7. Prepare a comprehensive blueprint and legislative framework for the establishment and functioning of the AMC.	End-August 2012
8. Complete bank-by-bank stress test (Stress Test).	Second half of September 2012
9. Finalise a regulatory proposal on enhancing transparency of banks	End September 2012
10. Banks with significant capital shortfalls will conduct SLEs.	before capital injections in Oct./Dec. 2012
11. Banks to draw up recapitalisation plans to indicate how capital shortfalls will be filled.	Early-October 2012
12. Present restructuring or resolution plans to the EC for Group 2 banks.	October 2012
13. Identify possibilities to further enhance the areas in which the Banco de España can issue binding guidelines or interpretations without regulatory empowerment.	End October 2012
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
15. Adopt legislation for the establishment and functioning of the AMC in order to make it fully operational by November 2012.	Autumn 2012
16. Submit for consultation with stakeholders envisaged enhancements of the credit register.	End-October 2012
17. Prepare proposals for the strengthening of non-bank financial intermediation including capital market funding and venture capital.	Mid-November 2012
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

Measure		Date
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
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
21.	Banks to provide standardised 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
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
23.	Issues CoCos under the recapitalisation scheme for Group 3 banks planning a significant (more than 2% of RWA) equity raise.	End-December 2012
24.	Transfer the sanctioning and licensing powers of the Ministry of Economy to the Banco de España.	End-December 2012
25.	Require credit institutions to review, and if necessary, prepare and implement strategies for dealing with asset impairments.	End-December 2012
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
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
28.	Review the issues of credit concentration and related party transactions.	Mid-January 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
30.	Amend legislation for the enhancement of the credit register.	End-March 2013
31.	Raise the required capital for banks planning a more limited (less than 2% of RWA) increase in equity.	End-June 2013
32	Group 3 banks with CoCos to present restructuring plans.	End-June 2013

KC-AH-12-118-EN-N