



ISSN 1725-3209 (online)
ISSN 1725-3195 (print)

EUROPEAN ECONOMY

Occasional Papers 193 | May 2014

Spain - Post Programme Surveillance Spring 2014 Report



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 staff and cover a wide spectrum of subjects. Views expressed in unofficial documents 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
Unit Communication
B-1049 Brussels
Belgium
E-mail: 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 http://ec.europa.eu/economy_finance/publications/.

More information on the European Union is available on <http://europa.eu>.

KC-AH-14-193-EN-N (online)
ISBN 978-92-79-35377-2 (online)
doi:10.2765/ 74899 (online)

KC-AH-14-193-EN-C (print)
ISBN 978-92-79-36120-3 (print)
doi:10.2765/ 78047 (print)

© European Union, 2014

Reproduction is authorised provided the source is acknowledged.

European Commission

Directorate-General for Economic and Financial Affairs

Spain – Post Programme Surveillance

Spring 2014 Report

ACKNOWLEDGEMENTS

The report was prepared in the Directorate General for Economic and Financial Affairs under the direction of Servaas Deroose, Deputy Director General and general oversight of Massimo Suardi, Head of Unit - Spain.

Contributors:

Francisco de Castro, Luis Garcia Lombardero, Lucas Gonzalez Ojeda, Peter Grasmann, Oskar Grevesmuhl, Magda Lewandowska, Mihai-Gheorghe Macovei, Maria-Cruz Manzano, Magdalena Morgese Borys, Massimo Suardi, Sonia Vila-Nunez, Corina Weidinger Sosdean, Jakub Wtorek, and the financial crisis task force of the Directorate General for Competition. Co-ordination and editing were ensured by Magdalena Morgese Borys and technical assistance was provided by Michel Gerday.

The report was prepared in liaison with the ECB.

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

Massimo SUARDI
European Commission
Unit ECFIN.F.4
B-1049 Brussels

Massimo.Suardi@ec.europa.eu

or

Peter GRASMANN
European Commission
Unit ECFIN.E.1
B-1049 Brussels

Peter.Grasmann@ec.europa.eu

The cut-off date for the data included in this report is 23 April 2014
--

Executive Summary	5
1. Introduction	8
2. Recent macroeconomic and financial sector developments	9
3. Public finances and growth-enhancing reforms	14
3.1. Public finances	14
3.2. Structural reforms to boost economic growth and job creation	17
3.2.1. Labour market	17
3.2.2. Product markets	17
4. Financial sector restructuring and reform	20
4.1. Bank restructuring	20
4.2. Financial sector reforms	21
Main economic and financial indicators	24

LIST OF GRAPHS

2.1. Real GDP growth and contributions	9
2.2. Confidence indicators	9
2.3. Competitiveness indicators	10
2.4. HICP inflation	10
2.5. Bank deposits	11
2.6. Bank loans	11
2.7. Non-performing loans	12
2.8. Bank sector profitability	13

LIST OF BOXES

3.1. Long-term projections of general government debt dynamics	15
3.2. The temporary flat rate social security contribution for new indefinite contracts	18
3.3. The reform facilitating corporate debt restructuring	19

ABBREVIATIONS

ADIF	Administrador de Infraestructuras Ferroviarias (Administrator of Railway Infrastructures)
AIREF	Autoridad Independiente de Responsabilidad Fiscal (Independent Authority for Fiscal Responsibility)
CERSA	Compañía Española de Reafianzamiento, S.A. (Spanish Rebonding Company)
CNMC	Comisión Nacional de Mercados y Competencia (National Commission for Markets and Competition)
CNMV	Comisión Nacional del Mercado de Valores (Securities Exchange Commission)
CRR/CRD IV	Capital Requirement Regulation No. 575/2013 and Capital Requirement Directive 2013/36/EU
DGIPF	Directorate General for Insurance and Pension Funds, Ministry of Economy
DTAs	Deferred Tax Assets
EBA	European Banking Authority
EBITDA	Earnings Before Interest, Taxes, Depreciation and Amortization
EC	European Commission
ECB	European Central Bank
EDP	Excessive Deficit Procedure
EIB	European Investment Bank
ESM	European Stability Mechanism
ESRB	European Systemic Risk Board
FROB	Fondo de Reestructuración Ordenada Bancaria (Fund for Orderly Bank Restructuring)
GDP	Gross Domestic Product
HICP	Harmonized Index of Consumer Prices
ICAC	Instituto de Contabilidad y Auditoría de Cuentas (Accounting and Auditing Institute)
ICO	Instituto de Crédito Oficial, State-owned bank attached to the Ministry of Economic Affairs and Competitiveness
IDR	In-Depth Review
INE	Instituto Nacional de Estadística (National Statistics Institute)
LTD	Loans-To-Deposits
MARF	Mercado Alternativo de Renta Fija (Alternative Fixed-Income Market)
MIP	Macroeconomic Imbalance Procedure
MoU	Memorandum of Understanding
MTO	Medium-term Budgetary Objective
NFCs	Non-Financial Corporations
NPL	Non-Performing Loan
OECD	Organisation for Economic Co-operation and Development
PES	Public Employment Services
pp.	percentage point
PPS	Post Programme Surveillance
RDL	Real Decreto-Ley (Royal Decree-Law)
Sareb	Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria S.A.
SGP	Stability and Growth Pact
SMEs	Small and Medium Enterprises
SSM	Single Supervisory Mechanism
VAT	Value Added Tax

EXECUTIVE SUMMARY

This first post-programme surveillance report provides an assessment of Spain's economic, fiscal and financial situation following its exit from the Financial Assistance Programme in January 2014.⁽¹⁾ Overall, the positive trends of policy progress, ongoing economic adjustment and diminishing financial stress that formed the basis for Spain's programme exit have continued, although important challenges to sustained economic and employment growth, public finances and the banking sector still remain. This assessment is consistent with the conclusions of the Commission's 2014 in-depth review (IDR) under the macroeconomic imbalances procedure that vulnerabilities are still present and continue requiring specific monitoring and decisive policy action.⁽²⁾

The correction of macroeconomic imbalances has continued, supporting a return to positive economic growth and prospects of a stabilisation in the labour market. The recovery is firming, as exports remain robust and domestic demand stops being a drag on growth amid rising confidence, easing financial conditions and a pick-up in employment. Following a contraction of 1.2% in 2013, the Commission services' Winter forecast projected GDP growth of 1% in 2014, while national forecasts are at present at slightly higher growth rates. Employment has started a mild expansion in the last quarter of 2013, as the recovery in output continued and reforms put in place started bearing fruits. Unemployment has declined from a peak of 27.2% in the first quarter of 2013 to 26% in the fourth quarter of 2013, still a very high level. Inflation is expected to stay low as the internal adjustment of prices, supporting the redirection of resources towards the tradable sector and international competitiveness, continues.

Still high stocks of private and public debt and of external debt continue to pose risks for sustained growth and financial stability. Spain will have to continue on the economic adjustment path for quite some time to free itself from the burden of existing imbalances and reduce unemployment from the current alarming levels. Well-working product and factor markets, supporting the reorientation of the productive system towards the tradable sector and greater competition in the internal market, as well as reversing the rise in government debt remain essential.

The budget deficit was 6.6%⁽³⁾ of GDP in 2013, marginally above the EDP target, confirming that fiscal consolidation continued last year. Given the improved economic outlook, the 2014 deficit target should be well within reach with rigorous budgetary execution. However, reaching the deficit targets in 2015 and 2016 will still require considerable additional discretionary efforts on top of the support coming from positive GDP growth. Information on the measures planned to deliver the required fiscal adjustment in 2015 and 2016 is expected to be included in the forthcoming Stability Programme. In order to bring public debt back on a downward path, there would be merit in exploiting positive growth surprises to accelerate deficit reduction.

Several measures have been adopted to strengthen further public finance management. Measures have been taken to underpin the sustainability of pension system, contain health-care expenditures and monitor more closely and avoid the emergence of new arrears in public administrations. Spain's Independent Fiscal Institution (AIREF) is gradually becoming operational, although later than originally planned. Finally, an independent expert committee submitted detailed proposals to simplify the tax system and increase its growth-friendliness. The government is now preparing its reform plans.

Spanish financial markets have continued to stabilise and banks' liquidity situation and financing structure have strengthened further. Sovereign risk premia have declined significantly (the 10-year bond yield spread over Germany was around 160 basis points in early April) and yields are at historical lows. Banks are shifting towards more stable funding, such as deposits, and are relying less on borrowing from the Eurosystem. Their overall cost of funding has declined. This turnaround in financial markets is

⁽¹⁾ A staff team from the European Commission (EC), in liaison with staff from the European Central Bank (ECB), undertook the first visit to Spain in the context of the post-programme surveillance on 24-28 March and on 3 April. The European Stability Mechanism (ESM) participated in the meetings on aspects related to its own Early Warning System.

⁽²⁾ See http://ec.europa.eu/economy_finance/publications/occasional_paper/2014/op176_en.htm for more details.

⁽³⁾ This figure excludes capital transfers related to support to banks of about 0.5% of GDP.

gradually feeding into some improvement in lending conditions and volumes to the private sector. In particular, larger corporates are issuing more securities, the contraction of outstanding balance of the domestic bank private credit is decelerating, and flows of new credit have reached a turning point, especially for smaller loans to NFCs and consumer loans. However, the transmission to interest rates for small loans (a proxy for SME loans) is very gradual, and these loans remain relatively onerous.

The banking sector returned in 2013 to profitability, also due to one-off factors, but bank profitability remains under pressure. Profits were supported by non-interest income, as well as by a significant contribution from non-recurring items in some banks, while interest income fell. Going forward, the decline in provisioning may continue, as well as a decline in funding costs, thus supporting banks' profitability. At the same time, the economic environment is still challenging, lending activity remains constrained and the non-performing loan ratio has not yet stabilized (13.4% in February 2014). Furthermore, a slowdown in emerging markets, in particular in some Latin-American countries, could weaken the profitability of some banks.

Solvency ratios have increased, also supported by a significant accounting impact for some institutions of amendments to the tax code regarding deferred tax assets (DTAs).⁽⁴⁾ The supervisor continues to monitor banks' efforts to keep and reinforce, where needed, capital ratios amidst current regulatory and supervisory challenges. Average solvency ratios stood at 11.5% at the end of 2013, up from 10.5% in June 2013, despite the significant build-up of provisions and recognition of other losses during 2012 and 2013. Robust capitalisation is essential in the context of an evolving regulatory and supervisory landscape – namely the new solvency regulation in the CRR/CRD IV package and the ongoing ECB comprehensive assessment.

Financial sector reforms, including the restructuring of banks having received State aid, have progressed as planned. The restructuring of banks having received State aid is well underway, with burden-sharing exercises completed, although litigation is still ongoing. NCG Banco has returned to private ownership, and a 7.5% public stake in Bankia has been sold. Measures to strengthen the regulatory and supervisory framework and to develop non-bank sources of finance have advanced. Sareb's⁽⁵⁾ challenge of divesting its large asset portfolio while maximising value also remains significant, as indicated by the latest revision of its strategic business plan which includes important changes to its strategy and expected financial results based on improved knowledge of the portfolio of assets received.

Reabsorbing the large number of unemployed requires fully implementing, closely monitoring and, where needed, further strengthening the structural reform agenda. While the introduction of a temporary flat social security contribution rate on new additional permanent contracts could support a short-term increase in permanent contracts, ongoing reforms of active labour market policies are still to be completed and to deliver effects. Large long-term unemployment and skills mismatches complicate the challenge of reducing unemployment substantially in the medium term.

Progress with product market reforms continues, although with some delays. A noteworthy recent reform is the March revision of the corporate pre-insolvency framework to facilitate debt restructuring, which has the potential to avoid unnecessary bankruptcies and speed up corporate deleveraging. Conversely, the adoption of the law on professional services and associations keeps being delayed, and it could also turn out less ambitious than originally planned. The complex implementation of the market unity law will continue to demand intense attention.

⁽⁴⁾ The reform of the fiscal treatment of DTAs prevented their deduction from capital under the new CRR/CRD IV rules.

⁽⁵⁾ Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria S.A., an asset management company for bank restructuring, <http://www.sareb.es>

On the basis of the analysis in this report, repayment risks for the ESM loan are very low at present. Market access conditions for the Spanish sovereign have considerably strengthened owing to policy actions at national and European level and recovering confidence in the Spanish economy and public finances.

1. INTRODUCTION

1. Spain exited successfully the financial assistance programme for the recapitalisation of financial institutions in January 2014. The Programme had been agreed by the Eurogroup on 9 July 2012 for a period of 18 months⁽⁶⁾ and provided an external financing by the euro area Member States of up to EUR 100 billion. Eventually, Spain used only close to EUR 38.9 billion for bank recapitalisation, under restructuring and resolution plans approved by the EC under State-aid rules, and around EUR 2.5 billion for capitalising Sareb. Both the bank-specific conditionality and the horizontal conditionality included in the Memorandum of Understanding were fulfilled as scheduled.⁽⁷⁾

2. Staff from the European Commission (EC), in liaison with the European Central Bank (ECB), undertook the first post-programme review for Spain from 24 to 28 March 2014 and on 3 April. The European Stability Mechanism (ESM) participated in the meetings on aspects related to its own Early Warning System. Post-programme surveillance (PPS) aims at a broad monitoring of the repayment capacity of a country having received financial assistance.⁽⁸⁾ There is no policy conditionality under PPS, although the Council can issue recommendations for corrective actions if necessary and where appropriate. PPS is biannual in terms of reporting and missions. Following the conclusions of 2014 IDR, PPS in case of Spain will also cover the specific monitoring in relation to the adjustment of macroeconomic imbalances in the context of macroeconomic imbalances procedure (MIP).⁽⁹⁾

⁽⁶⁾ However, the restructuring of the banks receiving public support under the State aid rules is expected to take up to five years.

⁽⁷⁾ For more details see the fifth review report: http://ec.europa.eu/economy_finance/publications/occasional_paper/2014/op170_en.htm

⁽⁸⁾ PPS is foreseen by Art. 14 of the two-pack [Regulation \(EU\) N°472/2013](#). It starts automatically after the expiry of the programme and lasts at least until 75% of the financial assistance has been repaid.

⁽⁹⁾ See Communication from the Commission to the European Parliament, the Council and the Eurogroup: "Results of in-depth reviews under [Regulation \(EU\) No 1176/2011](#) on the prevention and correction of macroeconomic imbalances" <http://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:52014DC0150>

2. RECENT MACROECONOMIC AND FINANCIAL SECTOR DEVELOPMENTS

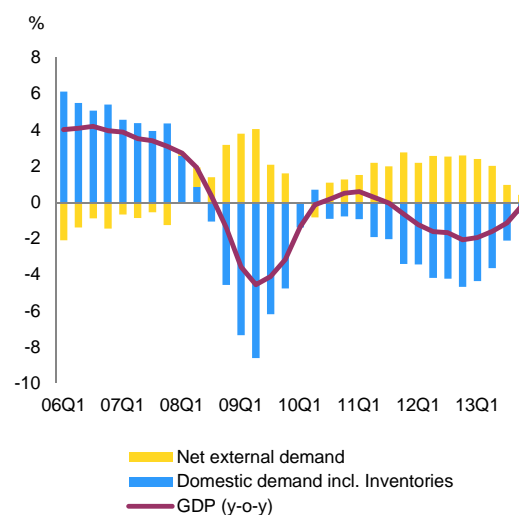
3. The correction of macroeconomic imbalances has continued, supporting a return to positive economic growth and prospects of a stabilisation in the labour market. While the flow variables have adjusted swiftly (i.e. current account balance, credit flows, competitiveness indicators, etc.), it is going to take several years to reduce significantly the large accumulated stocks of both private and public sector debt, as well as net external liabilities, during which the economy will continue to be vulnerable to shocks.⁽¹⁰⁾ The challenge for Spain is to find a balanced path allowing both a resumption of growth and continuation of deleveraging, but the two are not incompatible.

4. A gradual economic recovery appears to be firming, amidst improved confidence and positive employment growth. GDP returned to positive growth rates of 0.1% and 0.2% in the third and fourth quarters of 2013, respectively (see Graph 2.1), backed by rising confidence (see Graph 2.2) and a mild relaxation of financial conditions, although the latter are still relatively tight for smaller borrowers (see Section 2.2). The Commission services' 2014 Winter forecast projects the extension of these trends and a GDP growth of 1% for 2014 as a whole. Growth will be supported by exports, expected to remain robust on the back of improving competitiveness (see Graph 2.3), but also by a more positive domestic demand momentum.

5. Inflation is expected to stay low and below the euro area average. HICP inflation fell to -0.2% year-on-year in March, 0.7 pp. below the euro area average (see Graph 2.4). Still weak domestic demand and contained production costs as a result of wage moderation imply an absence of domestic price pressures. Lower inflation is consistent with the process of internal devaluation and enhancing competitiveness. Moreover, a relaxation of financing conditions would allow firms to lower profit margins, which have been used by firms for own financing under tight credit

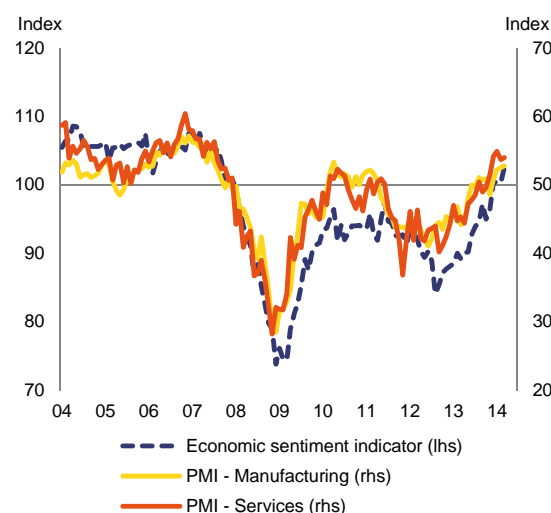
conditions, further containing domestic price pressures.

Graph 2.1: Real GDP growth and contributions



Source: INE

Graph 2.2: Confidence indicators



Source: European Commission and Ministry of Finance

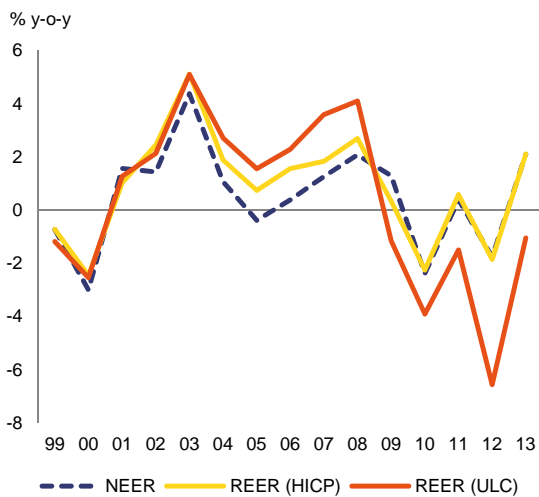
6. The labour market is showing timid signs of recovery. The fourth quarter of 2013 recorded the first positive growth of employment since the first quarter of 2008 (national accounts data). Positive social security affiliates data for the first quarter of 2014 support the expectation that annual employment growth will be positive in 2014,

⁽¹⁰⁾ For a more detailed assessment on the progress with adjustment of macroeconomic imbalances see the latest in-depth review for Spain:

http://ec.europa.eu/economy_finance/publications/occasional_paper/2014/op176_en.htm

contributing to lower the very high unemployment rate. The unemployment rate stabilised at 26.0% in the fourth quarter of 2013, down from 26.3% in the second quarter of 2013. This reduction was still largely due to a further decrease in the active population. The unemployment rate is particularly high in the 16-24 age bracket and for the low skilled, and a substantial share of unemployment is long-term. The Commission services' 2014 Winter forecast projects a moderate reduction in the unemployment rate to a still very high level of 24.6% in 2015.

Graph 2.3: Competitiveness indicators



Source: Ameco

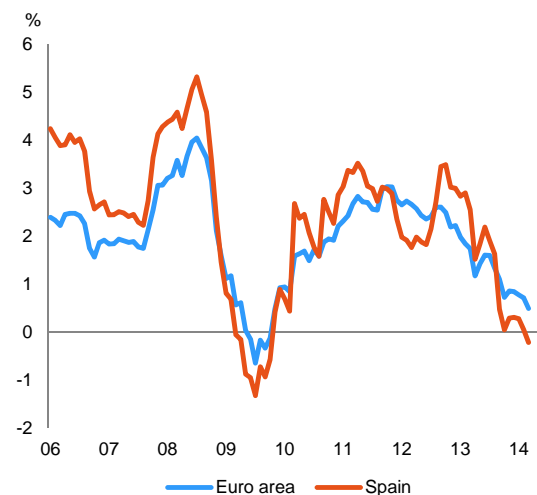
7. The housing market and construction sector appear to be approaching stabilisation.

The fall in house prices accelerated since 2012 and the cumulative decline at end-2013 since the peak in the third quarter of 2007 reached 37% in nominal terms and 45% in real terms. While there are tentative indications of a stabilisation in the price correction, given the still weak demand for housing and the remaining large stock of unsold houses, some further adjustment cannot be excluded. The evolution of the housing market remains important for banks' future profitability and the success of Sareb. Given large regional differences in terms of the evolution of the house prices before and after the boom, population determinants, as well as the size of stock of unsold houses, the time needed for the adjustment is likely going to be heterogeneous across regions.

8. Spanish financial markets have continued to stabilise.

The 10-year government bond yield fell to an all-time low of 3.2% in early April 2014, compared to 6.4% at the beginning of July 2012. The 10-year spread over the German bund has also shrunk to around 160 basis points. Banks are seeking more stable funding, such as deposits, and are less dependent on net borrowing from the Eurosystem. Both household and non-financial corporate deposits were growing at about 2.5% y-o-y, respectively in February 2014⁽¹⁾ (see Graph 2.5), despite greatly reduced interest rates on new term deposits. Several Spanish banks have now good access to capital markets with a declined cost of borrowing. Consequently, unsecured issuance has increased. Net borrowing from the Eurosystem was around EUR 183 billion at the end of March 2014, down from a record EUR 400 billion in mid-August 2012. This continued improvement of the market sentiment is related to the cleaning-up of the Spanish banking sector, the ongoing adjustment of imbalances, signs of an economic recovery as well as to the reduction of financial uncertainty in euro area financial markets in general. This is also reflected by upward trend in share prices, including those of Spanish banks.

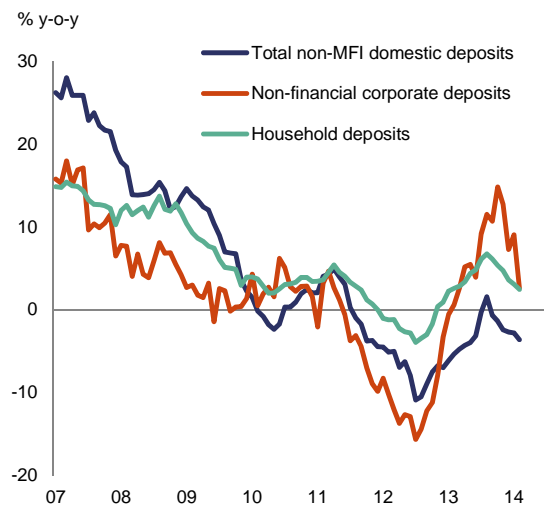
Graph 2.4: HICP inflation



Source: Eurostat

⁽¹⁾ The substitution of commercial paper holdings has exacerbated first the negative and later the positive evolution of deposits.

Graph 2.5: Bank deposits



Source: BdE, own calculations

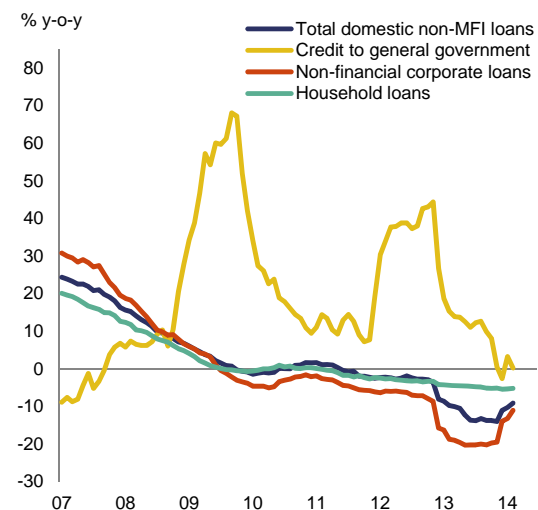
9. The contraction of private credit is decelerating, and new bank lending might have reached a turning point.

The decline in the stock of private domestic credit decelerated to around 8.6% y-o-y as of February 2014. This reflected a lower decline in domestic credit to households at around 5% y-o-y and in bank lending to non-financial corporates (NFCs) at about 11% (see Graph 2.6). The access by Spanish NFCs to finance was partially alleviated by external borrowing and issuance of bonds. As a result, the rate of contraction in the total stock of financing to NFCs also decelerated to around 5.7% y-o-y as of February 2014. The contraction in the stock of credit to the private sector reflects the deleveraging process in the economy and the reduction of macroeconomic imbalances. At the same time, the flow of new credit has improved significantly in recent months, in line with the pick-up in economic activity.

10. There are encouraging signs about the access to financing by small and medium enterprises (SMEs). Since October 2013, new lending to NFCs on loans below EUR 1 million has been increasing relative to 2012 and grew by 7% in February 2014 (y-o-y, 3-month moving average). The strong and steady increase in the volume of ICO on-lending facilities to Spanish banks since the summer of 2013 is another proof of the broad-based increase in new bank lending to

SMEs.⁽¹²⁾ Moreover, the acceptance rate of credit applications by NFCs has been on the rise in recent months, consistent with the Bank Lending Survey for the fourth quarter of 2013⁽¹³⁾, which showed a relaxation of banks' standards for approving credits for SMEs. Banks expect this trend to accelerate in the first quarter of 2014. In parallel, banks report a slight decrease in their margin on SME and mortgage loans, which could reinforce the positive lending developments, as well as an increase in the demand for loans after more than two years of severe contraction. Mainly loan demand by SMEs and households is bottoming out, whereas the demand for lending by large enterprises is expected to stabilise only over the course of this year.

Graph 2.6: Bank loans



(1) The significant decline in loans in December 2012 and February 2013 partially reflects the accounting effect of the extraordinary transfer of assets from Group 1 and 2 banks, respectively, to Sareb.

Source: BdE, own calculations

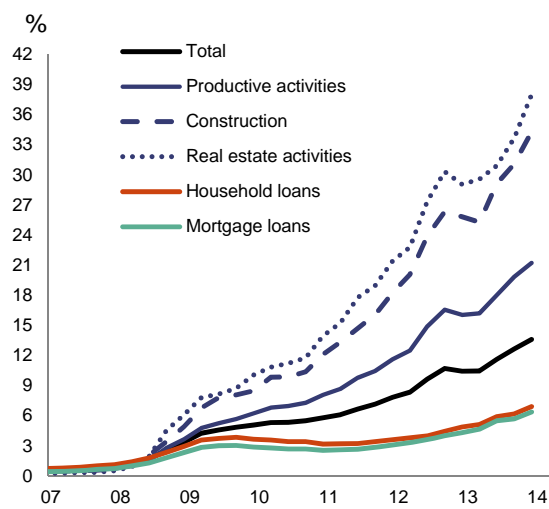
11. Banks' asset quality deteriorated further in 2013 on the back of the increase in impaired assets, the reduction in the volume of total loans and the impact of the reclassification of restructured loans. The deterioration in asset quality continued in 2013, as non-performing loans (NPLs) at system level increased to 13.6% of total loans at the end of December 2013, compared to

⁽¹²⁾ More than 80% of ICO's credit facilities are granted in loans of less than EUR 1 million.

⁽¹³⁾ See the report at <http://www.bde.es/webbde/en/estadis/infoest/epb.html>

12.7% three months earlier. This NPL ratio declined marginally to 13.5% at the end of January 2014 due to a small increase in the volume of total loans in January 2014 compared to December 2013 and the reclassification of credit financial intermediaries into the other resident sector (see Graph 2.7). According to the latest data, NPL remained stable at 13.4% in February. The stock of impaired assets went up by EUR 7.5 billion from September 2013 to February 2014, whereas the total loan portfolio fell by roughly EUR 28.1 billion over the same period. Following the reclassification exercise, restructured/refinanced loans accounted for roughly 15% of the total loans to the private sector at the end of December 2013. Based on the classification criteria of BdE, 51% of restructured/refinanced loans were classified as doubtful, 19% as substandard and 29% as performing loans. Going forward, the NPLs ratio at system level may increase further.

Graph 2.7: Non-performing loans



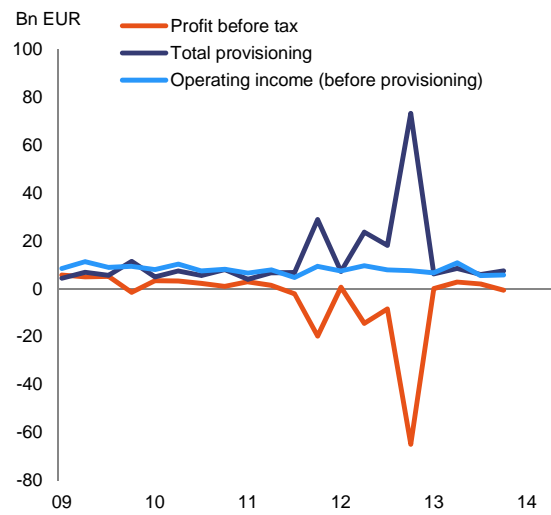
Source: BdE, own calculations

12. After record losses in 2012, banks' profitability turned positive in 2013, driven largely by lower provisioning and exceptional factors, but remains under pressure on account of reduced credit volumes and a low interest rate environment. Spanish banks recorded profits in the fourth quarter of 2013 (see Graph 2.8) and booked positive results for 2013 as a whole, above the baseline and significantly above the adverse scenario of the 2012 Oliver Wyman stress test.

However, net interest income declined on average by around 18% compared with 2012, due to lower interest rates on assets with floating rates (i.e. mortgages), when compared to funding costs, and a shrinking stock of credit. Gross income contracted at a much lower rate due to a favourable evolution of non-interest income. Provisions dropped significantly relative to 2012, even if provisioning requirements were still relatively high (due inter alia to the BdE exercise on restructured loans). This drop in provisions, as well as non-interest income and a significant contribution from non-recurring items in some banks, allowed a profit before tax of around EUR 4 billion to be recorded in 2013. Going forward, the decline in provisioning may continue in 2014, and the steep decline in funding costs and the shift from wholesale funding to retail deposits, together with a more cost-efficient operation of banks, are expected to support profitability. At the same time, lending activity remains constrained, the economic environment is still challenging and NPLs continue to increase.

13. Spanish banks' capital levels increased in 2013 and during the first months of 2014. EBA core tier 1 ("capital principal") stood at 11.5% at the end of 2013. The average total regulatory own funds ratio increased to 13.2%. Taking advantage of the positive market sentiment, some banks have managed to raise equity from private sources during recent months, whereas some others have issued other regulatory non-core capital instruments, such as subordinated debt or contingent capital instruments. Two legislative or regulatory measures have contributed to reinforce banks' own funds: (1) the new fiscal treatment given to the deferred tax assets (DTAs) that will allow banks to avoid the deduction of a significant amount from the fully loaded common equity tier 1; (2) the extension by BdE of its recommendation on a maximum 25% of paid-in-cash dividends to be applied also during 2014.

Graph 2.8: Bank sector profitability



(1) The figures in the chart include the profit or loss of each deposit-taking institution taken individually. In the case of the saving banks that segregated their banking business to newly-created banks, those profit/losses may appear in both entities.

Source: BdE, own calculations

3. PUBLIC FINANCES AND GROWTH-ENHANCING REFORMS

3.1. PUBLIC FINANCES

14. In 2013, Spain marginally missed the 6.5% fiscal deficit target, although the budgetary outcome was slightly better than expected.⁽¹⁴⁾

Excluding support to the financial sector, the general government deficit amounted to 6.6% of GDP in 2013, down from 6.8% in 2012. Unlike in 2012, the fiscal adjustment in 2013 was tilted more to the revenue side, with several tax increases taking effect, in particular most of the full-year effect of the 1 September 2012 increase in VAT rates. However, primary spending was also cut back, especially by regional governments. The outcome for net lending(+)/borrowing(-) by sub-sector was as follows: -4.3% of GDP for central government, -1.5% for the regions⁽¹⁵⁾, +0.4% for local governments and -1.2% for the social security subsector. According to the Commission's Winter forecast, the deficit is expected to fall to 5.8% in 2014, the same as the EDP target.

15. Reversing the rise in government debt requires strict adherence to the fiscal consolidation path. The strong growth of tax bases in the fourth quarter of 2013 and the improved economic outlook, especially in the labour market, bode well for 2014. With strict budgetary execution, the fiscal target for 2014 should not only be within reach but there should be scope for over performance. In this respect, there

⁽¹⁴⁾ On 19 June 2013, the Council issued a revised recommendation under the Excessive Deficit Procedure (EDP) to Spain, extending the deadline for correcting the excessive deficit by two years to 2016. The headline deficit targets are set at 6.5% of GDP for 2013, 5.8% of GDP for 2014, 4.2% of GDP for 2015, and 2.8% of GDP for 2016. On 15 November 2013, the Commission issued a detailed assessment of the progress made towards correction of the excessive deficit, combining i) an assessment of the 2014 Draft Budgetary Plan, ii) an assessment of effective action under the Excessive Deficit Procedure, and iii) an assessment of fiscal and other structural reforms contained in the Economic Partnership Programme. See: http://ec.europa.eu/economy_finance/economic_governance/sgp/budgetary_plans/index_en.htm http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/countries/spain_en.htm

⁽¹⁵⁾ The regional budgetary outcome masks considerable differences across regions. In particular, the following six regions did not reach their 2013 deficit targets: Murcia, Valencia, Catalonia, Navarre, Castilla-la Mancha and Aragón. These regions will now be required to submit or update their respective economic and financial plans, with measures to achieve compliance with the targets over the course of the current and subsequent year.

would be clear benefits to exploit any better-than-expected growth to accelerate deficit reduction. The high debt-to-GDP ratio makes government debt developments vulnerable to adverse shocks and imposes a high interest burden on the public finances (see Box 3.1). Complying with the structural adjustment path recommended by the Council to ensure the correction of the excessive deficit by 2016 and then progressing towards the medium-term budgetary objective (MTO) should ensure a reduction in the debt/GDP ratio after 2016.

16. Several measures have been adopted to strengthen further public finance management.

This is crucial to the durable success of fiscal consolidation and to give a greater emphasis to the growth-friendliness of the consolidation. In particular, Organic Law 9/2013 on the control of the public sector's commercial debt aims to enforce an average payment period to commercial suppliers of 30 days across all general government levels. This is done by periodically publishing payment periods of each administrative body. However, this obligation had been followed only partially by regional governments at the cut-off date of this report. The new law also strengthens the powers of the Ministry of Finance to enforce correction mechanisms and impose penalties on non-compliant public administrations. The amendments can create incentives at all government levels to speed up payments to commercial suppliers, although reducing the payment period of Spain's administrative bodies to an average of 30 days is a challenge, in particular, at sub-central government level.

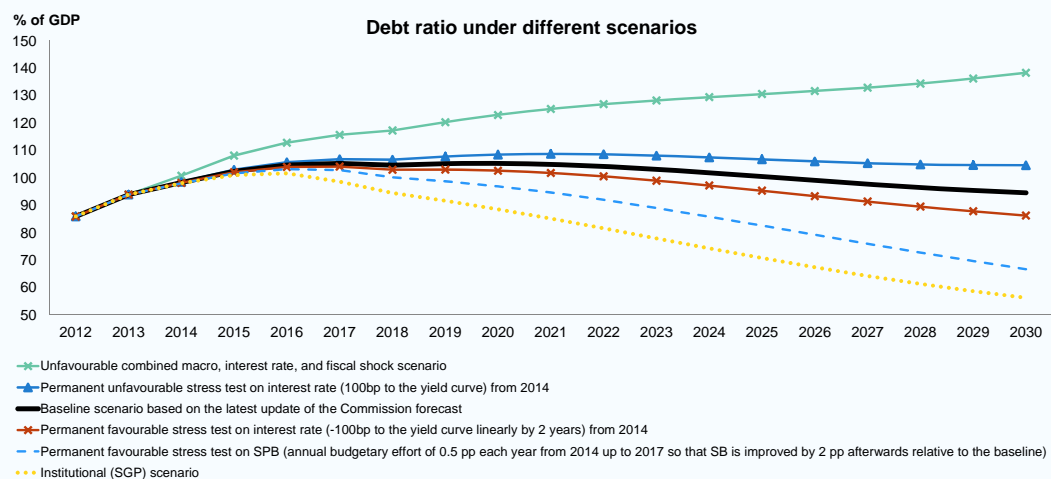
17. Spain's Independent Fiscal Institution ('Autoridad Independiente de Responsabilidad Fiscal' or AIREF) is gradually becoming operational.

Following the parliamentary adoption of the law creating AIREF, its president was appointed in February 2014 and its statute was published in the Official Journal on 29 March 2014. AIREF has a wide mandate: it will issue a series of reports and opinions set out by the law, including the endorsement of macroeconomic forecasts, and it will produce studies upon the request of selected administrative bodies. AIREF has been endowed with a budget of around EUR 4 million for 2014. The entry into operation of AIREF is occurring later than planned and too late

Box 3.1: Long-term projections of general government debt dynamics

The public debt trajectory has been simulated under alternative scenarios. The baseline scenario has been derived on the basis of the latest update of the Commission forecast¹, where the short- and long-term interest rates have been set to be consistent with the forecasted implicit interest rate, on the shares of short-term and long-term public debt, and data on maturing debt. This baseline scenario embeds a number of technical assumptions. First, the structural primary balance is set constant at the value of 2015 beyond the forecast horizon. The cyclical component of the primary balance is calculated using the (country-specific) budget balance sensitivities to the cycle over the period until output gap closure is assumed (2018). Second, long-term and short-term interest rates are assumed to converge respectively to a value above and a value below 3% (in real terms). Third, the inflation rate of the GDP deflator is assumed to converge linearly to 2% in 2018 and remain constant thereafter. Fourth, a short-run temporary feedback effect on GDP growth is introduced in the consolidation scenario (a 1 pp. of GDP consolidation effort impacts negatively on baseline GDP growth by 0.5 pp. in the same year). Fifth, the stock-flow adjustment is set to zero after 2015. Finally, the projected increase in age-related expenditure incorporates the pension reform passed in 2013. The assumptions for GDP growth are those in the macroeconomic scenario in the Commission 2012 Ageing Report. Hence, potential growth is assumed to average 1.3% between 2010 and 2020 and to increase to 2.6% on average between 2020 and 2030. Alternative scenarios are explained in the legend.

The simulations show a mildly downward long-term trend in general government debt in the baseline scenario, leaving it at still high levels by 2030 (95% of GDP). Only under a combined unfavourable macro and fiscal scenario would debt increase significantly over the projection horizon. The so-called 'institutional stability and growth pact (SGP) scenario' in the graph assumes that adjustments to the structural primary balance are set in compliance with the fiscal efforts recommended by the Council (which imply improvements in the structural primary balance by 0.8%, 0.8% and 1.2% of GDP in 2014, 2015 and 2016 respectively) until the excessive deficit is corrected, and thereafter an additional structural consolidation effort is maintained (+0.6 pp. of GDP) until the MTO is reached. Under this scenario, the debt ratio would also start decreasing steeply after 2016, falling below the 60% benchmark by 2030.



¹ This updated forecast includes the impact of revisions to methodology for calculating potential growth agreed by the EPC in March 2014 and the EPC opinion of April 2014 on Spain's pension reform.

for it to produce a full report on Spain's 2014 Stability Programme.

18. An independent expert committee submitted a comprehensive proposal for tax

reform to the government in March 2014. The Committee was set up in July last year with an objective to propose ways of simplifying the Spanish tax system, while making it more growth-friendly, more supportive of social cohesion as

well as guaranteeing a sufficient level of revenues to reach fiscal consolidation targets. Broadly speaking, the Committee's recommendations aim to simplify the tax system and to move the burden of taxation away from direct (in particular on labour) to indirect taxation in a revenue-neutral way. Lowering taxes on labour and offsetting the revenue impact with higher taxes on consumption, environmental taxes and taxes on property would have positive growth and employment effects. Commission services' estimates suggest that to achieve a given reduction in unemployment, a labour tax cut targeted to the low skilled requires a much smaller total tax shift than a cut across the board for all workers.⁽¹⁶⁾ The Committee's recommendations also aim to broaden tax bases, including by eliminating unwarranted exceptions and deductions, in order to allow the necessary room for reductions in nominal and marginal tax rates. The government intends to submit concrete reform measures to Parliament in June 2014, so that they can enter into force as of 2015.

19. Implementation of the public administration reform is ongoing. In June 2013 an experts' group commissioned by the government published a set of 217 recommendations to reform public administration, in the context of a complex division of powers between the central and regional government levels.⁽¹⁷⁾ At the cut-off date of this report, 29% of the measures had been adopted and the remainder had been initiated. The recommendations are comprehensive although some areas could have been developed in more detail, such as better regulation.⁽¹⁸⁾ As in many areas regions are free to

implement the recommendations, regions' ownership of the reform is crucial for its success, including on areas such as the elimination of duplicated structures with the central government and the ambitious implementation of recent legislation on market unity and on environmental assessment. Also relevant is the streamlining of regions' institutional administration (i.e. the public sector entities attached to regional governments, including foundations, consortia, public sector enterprises, etc.), an area where regions are contributing unevenly to the reduction effort.⁽¹⁹⁾

20. At the local government level, an important development was the adoption of the law on local administration reform in December 2013.

It aims to clarify the powers and competencies of municipalities in order to remove duplications at local level with other general government sub-sectors, to streamline the number of local entities,⁽²⁰⁾ to rationalise the services they provide, thus making the cost of providing local public services more transparent. Once implemented, the law is expected to bring significant budgetary savings, the bulk of which will be concentrated in 2015 and 2016 (EUR 6.1 billion, 76% of total savings according to the government estimates). However, the final figure will depend on the implementation of provisions on mergers of municipalities, the coordination of "essential" services" of smaller municipalities by provincial councils, the gradual take up of municipal health and social services competencies by regions and the rationalisation of local entities' institutional administration.

⁽¹⁶⁾ For more details, see: Assessing the impact of a revenue-neutral tax shift away from labour income in Spain, Country Focus No 5/2014, http://ec.europa.eu/economy_finance/publications/country_focus/2014/cf-vol11_5_en.htm

⁽¹⁷⁾ The recommendations fall into the following four categories: i) recommendations to remove duplicated structures at the central and regional government levels; ii) to reduce administrative burdens; iii) to improve the management of common services and reduce overheads (for central government sector only, though regional governments are invited to follow suit); iv) to rationalise the so-called institutional administration of the central government; (regional governments have a dedicated policy on this matter).

⁽¹⁸⁾ In particular, despite progress made by the 2011 law on sustainable economy, the quality of the law-making process in Spain could be further improved by applying best practice, consisting of the publication of impact assessments, quality checks done on those by independent

bodies, as well as carrying out *ex-post* evaluations of enacted legislation.

⁽¹⁹⁾ The OECD has been asked to assess Spain's public administration reform agenda *vis-à-vis* good practices in OECD countries by providing a gap analysis. The report is positive about the proposed reform, while pointing to some risks and challenges. These include among others, the definition of an optimal sequence for the implementation of the reform; the development of multi-level dialogue, co-operation and commitment with regions, also in the context of the sectorial conferences and the need to develop a culture of better regulation throughout the public administrations. The executive summary of the OECD report can be found on <http://www.oecd.org/spain/spain-from-administrative-reform-to-continuous-improvement.htm>

⁽²⁰⁾ In particular, the number of sub-municipal entities while limiting the creation of legal entities depending on municipalities.

3.2. STRUCTURAL REFORMS TO BOOST ECONOMIC GROWTH AND JOB CREATION

21. Progress with structural reforms continues.

Since the end of last year measures have been adopted on labour markets, insolvency procedures, regulation of electricity prices, local governments and to increase competition in rail transport. With many reforms having passed the legislative phase, attention is shifting to the implementation of adopted reforms and the adoption of outstanding items. The law on professional services and the tax reform are scheduled for the first semester of 2014; a revision of the regional financing system is foreseen for the second half of 2014. While there is some evidence of a positive impact of reforms already implemented, the extent of the remaining challenges – first and foremost reabsorbing the large number of unemployed – calls for fully implementing, closely monitoring and, where needed, further strengthening the structural reform agenda.

3.2.1. Labour market

22. Employers' social security contributions have been reduced for a period of two years for new open-ended contracts signed between 25 February and end-2014. A monthly flat rate of EUR 100 will replace the 23.6% employer contribution rate for common contingencies applied on the gross salary (see Box 3.2 for more details). This flat rate is conditional on the upkeep of the labour contract over the three following years and on net indefinite employment creation by the hiring company. The flat rate implies that the higher the salary, the higher the savings on the social security contributions for the company and, consequently, the revenue loss for the social security system. The measure could result mainly in a conversion of temporary contracts into permanent ones, thus meeting one of its stated objectives, while its potential to stimulate additional employment creation is more uncertain. In the absence of compensatory measures, it may therefore not be fully budgetary neutral.

23. The modernisation of public employment services keeps being delayed. More generally, achieving substantial progress with active labour market policy measures remains a lengthy undertaking. Ongoing measures include the Single

Job Portal and the public-private partnerships between public employment services (PES) and private recruitment agencies. However, the modernisation of PES would be key to provide effective, individualised counselling and job search assistance to job seekers, also in the light of the implementation of the national Youth Guarantee Plan. In addition, there is still scope to improve the link between education and labour market policies in order to eliminate unnecessary overlaps between formal education vocational training programmes and work-based training, and to better align actions and incentives in education and training.

3.2.2. Product markets

24. The corporate pre-insolvency framework has been substantially revised to facilitate debt restructuring of distressed corporations (see Box 3.3). This reform builds on amendments introduced in September 2013 and aims to strengthen pre-insolvency proceedings, so as to prevent potentially viable companies from being liquidated. New measures facilitate further the negotiation of corporate debt refinancing agreements between creditors and debtors, hence also easing the deleveraging process for non-financial corporations. It will be important to monitor the actual take-up of these enlarged options to gauge their effectiveness, also with regard to its effect for different-sized companies and possible repercussions for their funding costs. Additional reforms are not excluded to tackle shortcomings and rigidities of the insolvency procedures, for instance concerning the procedure for the appointment of insolvency administrators.

25. The authorities remain confident that the 2013 electricity sector reform will close the tariff gap as of 2014. The large gap of 2013 (presently estimated by the authorities at EUR 3.65 billion) would not have repercussions on 2014 as the reform is now fully effective and implementations and legal risks are considered to be small. Meanwhile, the government has introduced a new methodology for setting electricity prices for domestic consumers that should stimulate competition between electricity suppliers in the retail market.⁽²¹⁾ Hence, From July

⁽²¹⁾ See Royal Decree 216/2014 establishing the new methodology for setting electricity prices for domestic consumers. As background information, in December

Box 3.2: The temporary flat rate social security contribution for new indefinite contracts

On 28 February, the Spanish Government adopted the Royal Decree-Law (RDL) 3/2014, on urgent measures to promote employment creation and indefinite hiring, which contains one single measure: a temporary single monthly contribution to Social Security of EUR100 a month, which may benefit all firms and self-employed, during 24 months, who increase their level of net indefinite employment (taking the previous 30 days as a basis to measure the firm's employment level), and maintain it for at least 36 months.

The new flat rate is applicable to the creation of net indefinite employment created between 25 February and 31 December 2014. As such, it applies to either new indefinite contracts or the conversion of temporary into indefinite contracts. The new flat rate has a broad scope. It applies to all firms (regardless of their size), all workers (irrespective of age) and all types of indefinite contracts, either full time or part-time¹. Furthermore, micro firms may benefit of an additional reduction of 50% of the standard social security contribution once the first 2 years of the application of the flat rate expired. The job must be maintained for at least 3 years; otherwise, the amounts saved by the company shall be recovered, totally or partially (recapturing is 100% if the employment contract is terminated during the first year, 50% if terminated during the second year and 33% if terminated during the third year). The new measure is not compatible with other social security reductions, and will have no impact on the benefits to which workers are entitled, which are calculated applying the full contribution base.

According to the Ministry of Labour and Social Security, the new scheme will reduce by 75% the current total contributions to the Social Security. Indeed, the flat rate replaces the 23.6% contribution to the social security for common contingencies (basically, related to pensions and health and safety).² The subsidy is very generous, in particular for medium and high wages, for which the monthly contribution to the Social Security is higher.

It is unclear how many new jobs (i.e. jobs that would not have been created in the absence of the new scheme) and which type of new jobs could be created with this measure. While the flat rate implies a greater subsidy for higher paid workers, the higher labour demand and supply elasticities could still lead to a bigger impact on low-skilled jobs. The Government expects a positive impact of 0.3% on GDP and 0.3% on employment on the first year. It also projects that the measure will be budgetary neutral, assuming that the revenue loss derived from the application of the flat rate could be offset by the impact of the creation of additional jobs and the reduction of excessive rotation (thanks to the conversion of temporary contracts), which could lead to an increase of contributions to Social Security, revenues from personal income tax, corporate income tax and indirect taxes, together with a reduction in expenses on unemployment benefits.

¹ For part-time contracts, the flat rate will be proportional to the working hours: EUR 75 or EUR 50 a month depending on the working time being up to 50% or 75% of a full-time contract).

² The new regulation does not affect the employer or worker's contribution for other contingencies such as unemployment insurance, professional training, and contribution to the wage guarantee fund (FOGASA). Contributions for these contingencies will add to the EUR 100 flat rate, up to EUR 147.4 a month for the lowest salaries and EUR 316 a month for the highest salaries.

2014, the price for domestic consumers will no longer be determined *ex-ante* in a quarterly

2013, the government cancelled the auction carried out to establish the price of electricity for domestic consumers remaining in the non-liberalised segment of the market for the first quarter of 2014. This auction implied increases in the price of the energy component which would have translated into a 10% increase in the consumers' electricity bill. Instead, the price of electricity for the first quarter of 2014 was based on a methodology proposed by the CNMC, based on average electricity pool price in the previous 6 months. Meanwhile, the government committed to define a new definitive methodology.

electricity auction but, instead, will reflect *ex-post* the average wholesale market price. Domestic consumers will have the choice of paying the average wholesale market price over the invoicing period (every hour of electricity consumed for consumers equipped with smart meters) or a fixed tariff defined by the supplier *ex-ante* for the whole year. The new system can result in higher variation of prices between invoicing periods, but can also introduce grounds for more competition between electricity suppliers.

Box 3.3: The reform facilitating corporate debt restructuring

On 7 March the Spanish Government adopted the Royal Decree-Law 4/2014 on restructuring and refinancing of corporate debt. The new law facilitates the restructuring of viable companies by making the refinancing terms of corporate debt more flexible. Refinancing agreements can now more easily include debt discharges or debt-to-equity swaps, thus also promoting a faster corporate deleveraging. The reform does not intend to change the overall balance of power between creditors and debtors: while creditors would sacrifice a part of their claims, debtors would partially give up control over their businesses to reduce indebtedness.

As judicial insolvency procedures have proven to be ill-suited for restructuring, the focus of the reform is to strengthen the pre-insolvency phase. Since September 2013 there have been two parallel collective restructuring procedures in place: one requiring judicial validation and an out-of-court procedure. Nevertheless, the majority of restructuring plans delayed debt repayments rather than facilitating effective restructuring of indebted firms. Moreover, the plans which did not require judicial approval were usually cancelled when the debtor entered insolvency proceeding. In this context, RDL 4/2014 includes the following novelties:

- Possibility of individual agreements. The debtor can reach a refinancing agreement with one or more of its creditors, and such an agreement can be cancelled only in the court.
- Simpler conditions for the restructuring plans requiring judicial validation, with lower majorities of creditors required for approval. The agreements will now also include financial creditors other than banks. The RDL introduces debt-to-equity swaps and longer loan extensions. Moreover, the effects of the restructuring plan can now be extended to secured creditors, even if such extensions will still require higher approval majorities.
- For both types of collective restructuring plans (with or without judicial validation), the RDL extends the stay of individual enforcement actions. This is to prevent certain creditors from hampering the prospects of a restructuring plan, when creditors representing a significant amount of the claims support the negotiations, and a restructuring plan has a reasonable prospect of being implemented.
- The RDL temporarily reinforces incentives to raise "fresh money" to support the restructurings.
- It introduces changes to the tax system to support the restructuring plans.

To give banks incentives to engage in negotiating agreements, BdE revised on 19 March its guidelines on the classification of bank loans. Refinanced loans classified as doubtful can be reclassified as performing in the case of viable firms, according to the assessment carried out as a result of RDL 4/2014.

26. Measures have also been taken to strengthen competition in railway and air transport, including splitting the incumbent *Renfe Operadora* into four entities and reviewing infrastructure access charges. The process of setting rail access charges will be made more transparent: the railway infrastructure manager (ADIF) will set access charges, followed by a consultation with the CNMC and railway operators, to be finally approved as a part of the yearly budget law. Moreover, with the RDL, the major railway safety requirements are given legal status. Other measures planned to strengthen competition in rail freight include setting up a

single window for administrative procedures, opening freight terminals to new entrants and breaking Renfe's quasi-monopoly in rolling stock. To minimise negative spillovers from unprofitable tolled motorways on public finances, the government is setting up a public company to take over the insolvent motorways and has presented a restructuring plan to the creditors. The possible budgetary implications of this operation will depend on the detailed setup of the envisaged public company. However, there has been no progress in the creation of an independent observatory to help assess future major infrastructure projects.

4. FINANCIAL SECTOR RESTRUCTURING AND REFORM

4.1. BANK RESTRUCTURING

27. The implementation of the restructuring plans for all state-aided banks is well underway with burden-sharing exercises completed. The banks are working to reach their operational targets by re-sizing branches and their work force. Some banks accelerated the planned implementation in order to devote all efforts to the ordinary management of their banking business as soon as possible. As regards the required divestments of subsidiaries, banks are mostly on track although some specific sales are delayed mainly due to the difficulty of selling real estate companies or to sell/liquidate not fully-owned subsidiaries.

28. The banks are adjusting their balance sheet and credit portfolios at a good pace with the double objective of reaching a balanced asset/liability structure. Liquidity and funding positions continue the positive trend shown in previous months, with lower loans-to-deposits (LTD) ratios and a decreasing recourse to ECB funding for most of the entities. In terms of solvency, the capital injected in the banks and the provisions taken in 2012 and 2013 provide a comfortable buffer, with the situation being continuously monitored to assess possible weaknesses in specific situations.

29. During the last months good progress has been achieved regarding the restructuring and sale to private investors of banks having received State aid:

- On 12 March 2014 the Commission approved an amendment to Banco CEISS' restructuring plan, following its integration with Unicaja Banco. An amendment of the previous restructuring plan of May 2013 was necessary to successfully proceed with the acquisition, in particular because the FROB⁽²²⁾ granted new guarantees to Banco CEISS. In line with previous restructuring plan, Banco CEISS will, under the new plan, focus its banking business on retail and SME lending in its core regions, cease lending to real-estate developers and

limit its presence in wholesale business. This will contribute to reinforcing its capital and liquidity positions and reduce its reliance on wholesale and central bank funding.

- The return of NCG Banco to private ownership is underway. In November 2013, the FROB launched the sale of NCG in an open, transparent and non-discriminatory process. The auction was completed in December 2013, with Banesco, a banking group based in Venezuela, winning it in the first round. The Commission is assessing this transaction under State aid rules with a view to agree with the buyer on an amended restructuring plan for NCG Banco.
- The FROB started the partial re-privatisation of Bankia: On 28 February 2013, 7.5% of the shares held in Bankia by BFA were sold in the market through an accelerated book-building exercise. It indicated that possible future disposals might be decided going forward.
- Other banks that received financial assistance from the FROB also plan to tap equity markets in the near future. Liberbank intends to conduct a share capital increase at short notice and use the proceeds to strengthen its solvency and fully repay state aid it received in the form of CoCos⁽²³⁾. BMN, in which the FROB is the main shareholder, intends to get listed in 2015, depending on market conditions; the listing would enable the FROB to dispose its stake in the bank via an accelerated book-building exercise or an initial public offering.

30. The monitoring of restructuring plans will continue in the coming years, including possible adaptations to significant market changes in duly justified situations. The main short-term challenges relate to the disposal of some FROB-owned banks. The restructuring and potential sale of others should continue with the same intensity as observed in the last few months. In parallel to the implementation of the restructuring plans in these banks, the authorities should explore the possibility of returning them to private ownership in a timely manner and with a view to optimize the taxpayer's return.

⁽²²⁾ Fondo de Reestructuración Ordenada Bancaria, Fund for Orderly Bank Restructuring, <http://www.frob.es>

⁽²³⁾ Contingent Convertible securities

31. Sareb has finalised its first full year of operation, which was focused on due diligence of its assets, setting up of all the commercial channels and starting the process of divestment of its large portfolio of real estate and financial assets. Sareb concluded the first year with a loss of EUR 261 million after recognizing EUR 259 million in impairment provisions⁽²⁴⁾ on its financial assets portfolio. Sareb's earnings before interest, taxes, depreciation and amortisation (EBITDA) reached EUR 1.2 billion while the repayment of senior debt amounted to EUR 1.8 billion. Comparing the end-2013 results to the previous business plan, the main difference lies in the relatively higher weight of income generated from the financial assets. Thus, the bulk of income (around 80%) came from the financial assets (including amortisation and cancellation, sales, and interests) while the sale of real estate assets generated about 21% of total income.

32. The overall strategy and projections of Sareb's business plan have been recently significantly changed. Sareb is legally required to annually update its business plan and present it for approval to its Board of Directors by end-February. The updated business plan reflects the information gathered during the comprehensive due diligence exercise conducted in 2013 and the experience with respect to the evolution of portfolio gained during the first year of its operation. The updated business plan for 2014-2017 includes some significant differences compared to the previous one, especially in terms of lower expected prices from the sale of its assets (due to their lower than expected quality), which are partially offset by the positive contribution of new value creating elements introduced by the new strategy. The main idea behind the new strategy is to move away from the 'warehouse' model (i.e. buy, hold, sell), in which Sareb had no control over some of the key elements, i.e. the acquisition price and the evolution of the market, to a 'factory' model, where Sareb manages more actively the value of its portfolio. In general, the idea is to add

⁽²⁴⁾ Sareb is required to perform an annual impairment test on its assets. BdE is in the process of preparing the Circular specifying the exact requirements, while this year it provided some guidelines on the preparation of 2013 financial statements. In the light of that forthcoming Circular the updated business plan will have to be further revised to take into account the potential impact of this requirement.

value to the existing portfolio, including by developing land, giving greater importance to finalising the work in progress developments, developing rental properties, etc. Based on these updated projections, Sareb expects to fully service and amortize its senior debt but the expected return on equity is reduced as compared to its previous business plan. The management structure of Sareb has been recently changed in order to provide more functional specialisation reflecting the new strategy included in the updated business plan.

33. Sareb will face a number of challenges in the coming months. These include the ongoing adjustment of the real estate market and still weak macroeconomic outlook, the changing landscape of the market for real estate assets and real estate loan servicing and the need for more pro-active management of Sareb's portfolio, especially of the financial assets. While the fall in house prices appears to be nearing its inflection point and there are early signals of the housing market slowly stabilizing, the subdued activity is going to pose challenges to Sareb's commercial activity. The servicing market is undergoing significant changes and the final outcome is not yet clear. Sareb needs to closely monitor this evolution and be prepared to mitigate the operational risks related to short-term disruptions of the service as well as more strategic risks related to potential conflicts of interest and the impact on its servicing strategy. Finally, the new strategy requires Sareb to reinforce its asset portfolio management, especially the loan portfolio (a process already launched with the creation of the specialised recovery and restructuring department inside the company), directly as well as indirectly through the servicers. This is going to be a key factor determining the success of Sareb's commercial activity.

4.2. FINANCIAL SECTOR REFORMS

34. The implementation of the Savings Banks and Banking Foundations Law (Law 26/2013) approved on 27 December 2013 is ongoing, even though at a slow pace. Some aspects of the law, mainly related to banking foundations with stakes at banks greater or equal to 30%, and those with controlling levels stakes, will be implemented by a Circular, which is currently finalised by the BdE. Important issues, such as the level of the reserve

fund to be held by banking foundations, the deadline for creation of such a fund and its possible uses, have not yet been settled. In addition, the Ministry of Economy and Competitiveness will approve a Ministerial Order to define the content, structure and publication requirements of the Corporate Governance Report to be submitted by banking foundations. The process of conversion of *cajas de ahorros* into banking foundations can be summarised as follows:

- Regional governments need to adapt their regulations of savings banks to the new legal framework. The process is ongoing.
- In the financial plan to be presented to the BdE, banking foundations need to include information on how they will cover potential capital needs of the bank in which they hold stakes. Such potential capital needs will be calculated taking into account different scenarios included in the internal capital assessment process. While the decision is not yet final, the BdE is considering calculating such needs over a period of three years.
- Regarding the maximum counterparty exposures applicable to banking foundations and the definition of liquid and secure assets, the BdE will closely follow the applicable EU legislation in this regard.
- Importantly, the BdE has not yet decided on the minimum level of the reserve fund in the banking foundations with controlling stakes or stakes above 50%.
- The Circular is expected to be approved by September 2014. The details on the final provisions will impact the strategic decisions of *cajas de ahorros* with respect to the size of their stakes.

35. Further good progress was achieved with regards to the implementation of the November 2012 Action Plan on measures for strengthening non-bank financial intermediation. The first tender for the allocation of investment commitments in the venture and development capital funds of ICO Fond Global (managed by the

AXIS Fund⁽²⁵⁾ took place and six participations were awarded amounting to a total of EUR 189 million. Three other tenders are planned for 2014. The alternative bond market for SMEs (MARF)⁽²⁶⁾ has become operational and the first issuance on this market took place in December 2013, while several others are in the pipeline. The volume of ICO's on-lending programme for SMEs via commercial banks has increased significantly since the summer of 2013, resulting in a close to 20% increase in the facilities granted from 2012 to 2013. In the first quarter of 2014, the total loan production was about 70% higher than in the same period of 2013 and at all-time highs. ICO's funding rates to banks continued to decline, supported also by funding deals with KfW and the EIB. A broad-based legislative package, currently prepared, aims at facilitating the access to finance of SMEs and other NFCs, inter alia by improving (i) access to own financial information for SMEs whose credit line is cancelled or significantly reduced by a financial institution, which also has to notify the firm three months in advance, (ii) the CERSA⁽²⁷⁾ regime of mutual guarantees, (iii) the regime for securitisation, (iv) the two-way transit between the traditional and the alternative stock markets; and (v) the issuance of bonds by NFCs. Additionally, a regime for crowdfunding is foreseen.

36. To strengthen financial stability, authorities are about to set up a Financial Stability Council. In order to comply with the ESRB recommendations, the authorities will modify the Law on the Autonomy of the BdE and set up a Financial Stability Council in the coming months. The main objective of the Council will be to preserve the stability of the entire financial system by identifying at an early stage and mitigating financial sector risks.

37. The Single Supervisory Mechanism (SSM) will significantly impact the internal supervisory procedures of the BdE. As part of the MoU conditionality, the BdE reviewed its supervisory procedures and subsequently improved these procedures by ensuring inter alia an adequate information flow from the bank inspection teams to the Executive Committee of the BdE and the

⁽²⁵⁾ <http://www.axispart.com/>

⁽²⁶⁾ Mercado Alternativo de Renta Fija (MARF), Alternative Fixed-Income Market

⁽²⁷⁾ Compañía Española de Reafianzamiento, S.A., the Spanish Rebonding Company, <http://www.cersa-minetur.es>

continuous on-site supervision of the vast majority of banking sector. Under the SSM, the BdE needs to ensure a smooth interaction with the ECB depending on the systemic significance of the supervised credit institutions. The supervision of significant Spanish credit institutions will be performed by the ECB, namely by joint supervisory teams led by ECB staff and supported by inspectors of the BdE. The small credit institutions without systemic importance will remain under the supervision of the BdE. However, even in this case, the BdE supervision will not be fully autonomous as it will be subject to the broad oversight of the ECB within the SSM. The BdE will have to act in line with the ECB guidelines, regulations and manuals of supervisory practices. The supervisory procedures of the BdE will have to be adapted to the SSM supervisory manual. The Supervisory Examination Plan for 2015 will be fully adapted to the SSM supervisory model and will be approved by the ECB in consultation with the BdE. The re-organisation of the Directorate General of Banking Supervision is currently underway in order to mirror the organisation of the SSM.

important responsibilities in the area of financial legislation and regulation appears limited.

38. It is important that financial regulation and supervision authorities are endowed with sufficient human resources to carry out their activities. In Spain, supervisory bodies other than in the banking sector include: CNMV (the Securities Exchange Commission), the Directorate General for Insurance and Pension Funds (DGIPF) in the Ministry of Economy, and the Accounting and Auditing Institute (ICAC). The number and complexity of their responsibilities has been increasing, leading to a situation where they could be to varying degree understaffed. CNMV's responsibilities have expanded significantly in recent years, including participation in EU level initiatives, while the number of its technical staff remained constant and below the level of its European peers. DGIPF is facing the entry into force of the Solvency II Directive, implying a very intense regulatory period in the short-term and requiring sufficient specific expertise. Finally, ICAC, which sets and supervise technical standards for auditors, is required to carry out more annual quality assurance reviews in order to fully comply with the relevant EU Directives, and to enhance its international cooperation activities at the EU level. Finally, the number of technical staff in the Spanish Treasury dealing with its

ANNEX

Main economic and financial indicators

Main economic and financial indicators										
	1995	2000	2005	2009	2010	2011	2012	2013	2014	2015
	-1999	-2004	-2008						(f)	(f)
Core indicators										
GDP growth rate	3.7	3.6	3.0	-3.8	-0.2	0.1	-1.6	-1.2	1.0	1.7
Private consumption (annual % change)	3.5	3.7	2.8	-3.7	0.2	-1.2	-2.8	-2.1	0.6	1.1
Public consumption (annual % change)	2.7	5.0	5.4	3.7	1.5	-0.5	-4.8	-2.3	-0.9	-0.2
HICP (annual % change)	2.8	3.2	3.5	-0.2	2.0	3.1	2.4	1.5	0.3	0.9
Domestic demand incl. stocks	4.2	4.3	3.6	-6.7	-0.6	-2.1	-4.1	-2.7	0.2	0.9
Unemployment rate (% of labour force)	17.2	11.2	9.3	18.0	20.1	21.7	25.0	26.4	25.7	24.6
Gross fixed capital formation (% of GDP)	22.5	26.7	29.8	23.6	22.2	20.7	19.2	17.7	17.4	17.4
Gross national saving (% of GDP)	22.0	22.6	21.1	19.1	18.4	17.3	18.5	19.0	19.5	19.7
General Government (% of GDP)										
Balance (g)	-4.2	-0.5	0.3	-11.1	-9.6	-9.6	-10.6	-7.2	-5.8	-6.4
Gross debt	64.7	52.5	39.8	54.0	61.7	70.5	86.0	94.3	98.9	103.3
Interest expenditure	4.6	2.7	1.7	1.8	1.9	2.5	3.0	3.5	3.6	3.6
Households										
Households saving rate	13.2	11.3	11.3	17.8	13.9	12.7	10.4	10.4	10.6	10.9
Rest of the world (% of GDP)										
Trade balance	-0.1	-2.8	-6.0	-1.9	-2.2	-1.1	0.7	2.4	3.6	4.1
Trade balance, goods	-3.3	-5.7	-8.1	-4.0	-4.6	-4.2	-2.5	-1.2	-0.4	-0.2
Trade balance, services	3.2	2.9	2.0	2.1	2.4	3.1	3.3	3.6	4.0	4.3
Current account balance	-0.8	-4.4	-9.0	-4.8	-4.4	-4.0	-1.2	0.8	1.6	1.8
Net financial assets	-27.0	-39.7	-70.1	-91.8	-87.0	-89.6	-92.4	-94.7	n.a.	n.a.
Net international investment position	-26.9	-41.3	-69.7	-93.8	-89.1	-90.3	-91.4	-98.2	n.a.	n.a.
Competitiveness (index, 2005=100)										
Real effective exchange rate relative to the rest of the euro area	91.4	95.8	104.1	104.9	103.6	101.7	96.7	94.0	93.1	92.4
Real effective exchange rate relative to the rest of the European Union	93.8	95.3	103.8	107.7	105.2	103.4	97.6	95.4	94.3	93.5
Real effective exchange rate relative to the rest of 37 industrialised countries	92.1	92.6	104.7	109.1	104.8	103.3	96.5	95.7	95.7	94.6
Banking sector										
Assets (% of GDP)	173.7	194.9	274.5	329.2	332.0	346.1	348.0	308.0	n.a.	n.a.
Private domestic credit (y-o-y %)	11.8	14.7	18.9	-1.6	0.8	-3.2	-9.9	-10.2	-8.6	n.a.
Non-performing loans (NPLs), total	3.3	1.1	1.5	5.1	5.8	7.8	10.4	13.6	13.4	n.a.
NPLs, productive activities	n.a.	1.2	1.5	6.2	8.1	11.6	16.1	21.2	n.a.	n.a.
" of which, construction, and	n.a.	1.0	1.7	8.5	12.1	18.2	25.8	34.3	n.a.	n.a.
" real estate activities	n.a.	0.6	1.8	10.1	14.0	21.4	29.1	38.0	n.a.	n.a.
NPLs, residential mortgages	n.a.	0.4	1.0	2.9	2.6	3.1	4.3	6.4	n.a.	n.a.
Tier 1 ratio (%)	n.a.	n.a.	n.a.	9.3	9.6	10.2	9.7	10.7	n.a.	n.a.
Interest rates										
10 year spread vis-à-vis the Bund	1.6	0.2	0.1	0.8	1.5	2.8	4.3	3.0	1.8	n.a.
CDS 5 year	n.a.	n.a.	14.6	92.0	204.0	319.6	431.9	235.4	128.6	n.a.

(f) 2014/2015: forecast or latest available data

(g) General government balances include capital transfers related to support of banks

Source: Ameco, BdE, Eurostat, IHS Global Insight

OCCASIONAL PAPERS

Occasional Papers can be accessed and downloaded free of charge at the following address:

http://ec.europa.eu/economy_finance/publications/occasional_paper/index_en.htm

Alternatively, hard copies may be ordered via the “Print-on-demand” service offered by the EU Bookshop: <http://bookshop.europa.eu>.

HOW TO OBTAIN EU PUBLICATIONS

Free publications:

- one copy:
via EU Bookshop (<http://bookshop.europa.eu>);
- more than one copy or posters/maps:
from the European Union's representations (http://ec.europa.eu/represent_en.htm);
from the delegations in non-EU countries (http://eeas.europa.eu/delegations/index_en.htm);
by contacting the Europe Direct service (http://europa.eu/europedirect/index_en.htm) or
calling 00 800 6 7 8 9 10 11 (freephone number from anywhere in the EU) (*).

(* The information given is free, as are most calls (though some operators, phone boxes or hotels may charge you).

Priced publications:

- via EU Bookshop (<http://bookshop.europa.eu>).

Priced subscriptions:

- via one of the sales agents of the Publications Office of the European Union (http://publications.europa.eu/others/agents/index_en.htm).

