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Evaluation of the Financial Sector Assistance Programme

Spain, 2012-2014

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ABBREVIATIONS

AIReF- Autoridad Independiente de Responsabilidad Fiscal

AMC- Asset Management Company

APS- Asset Protection Scheme

AQR- Asset Quality Review

BBVA- Banco Bilbao Vizcaya Argentaria

BdE- Banco de España

BMN- Banco Mare Nostrum

BPS- Basis Points

BRRD- Bank Resolution and Restructuring Directive

CDS- Credit Default Swap

CECA- Confederación Española de Cajas de Ahorros

CEISS- Caja España de Inversiones, Salamanca y Soria

CET1- Common Equity Tier 1

CPI- Consumer Price Index

CSR- Country Specific Recommendations

EA- Euro Area

EBA- European Banking Authority

EC- European Commission

ECB- European Central Bank

EDP- Excessive Deficit Procedure

EFSF- European Financial Stability Facility

EMU- Economic and Monetary Union

ESM- European Stability Mechanism

EU- European Union

EUR- Euro

EWG- Eurogroup Working Group

FROB-Fund for the Orderly Restructuring of the Banking Sector

FSAP- Financial Sector Assessment Program

FSB- Financial Stability Board

FUNCAS- Fundación de las Cajas de Ahorros

GDP- Gross Domestic Product

GVAR- Global Vector Autoregressive

HHs- Households

IFI- Independent Fiscal Institution

IMF- International Monetary Fund

INE- Instituto Nacional de Estadística

LTRO- Long Term Refinancing Operation

MIP- Macroeconomic Imbalances Procedure

MoU- Memorandum of Understanding

NAMA- National Asset Management Agency

NFCs- Non-Financial Corporations

NIIP- Net International Investment Position

NPL- Non-performing Loan

NPV- Net Present Value

OECD- Organisation for Economic Co-operation and Development

OMT- Outright Monetary Transactions

PPS- Purchasing Power Standard

RED- Real Estate Developer

REER- Real Effective Exchange Rate

ROE- Return on Equity

SAREB- Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria

SMEs- Small and Medium Enterprises

SMP- Securities Market Programme

S&P- Standard and Poor's

SRB- Single Resolution Board

SSM- Single Supervisory Mechanism

UK- United Kingdom

ULC- Unit Labour Costs

VAT- Value-Added Tax

VET- Vocational Education and Training

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EXECUTIVE SUMMARY

This document presents an ex-post evaluation of the Financial Assistance Programme for the Recapitalisation of Financial Institutions in Spain implemented from July 2012 to January 2014. The purpose of the evaluation is to assess the intervention in terms of relevance, effectiveness, efficiency, coherence and EU added value in order to draw lessons for future decision-making. This contributes to transparency and accountability of EU policies and may identify areas of improvement for similar on-going or future interventions. An ex-post evaluation of the design, implementation and outcome of the programme is required by European Commission rules and in line with international best practice. ([1])

Acting upon a request from the Spanish authorities, which faced a banking crisis with increasing feedback loops to the sovereign debt market, the Eurogroup approved on 20 July 2012 an envelope of financial assistance of up to EUR 100 billion for the recapitalisation of financial institutions. The envelope, which corresponded to about 10% of Spain's GDP, was approved along with programme conditionality as set out in the Memorandum of Understanding on Financial Sector Policy Conditionality (MoU). The programme entailed financing by the European Financial Stability Facility (EFSF) to be channelled through the Spanish government's Fund for the Orderly Restructuring of the Banking Sector (FROB) to financial institutions in need of public support. The Spanish government remained fully liable for the repayment of the loan. In November 2012, responsibility for providing financial assistance was transferred to the European Stability Mechanism (ESM).

The programme was designed with the main objective of increasing the long-term resilience of the Spanish banking sector, thus restoring its market access. To achieve this, the MoU stated that it was essential to remove doubts about the quality of banks' balance sheets; to facilitate an orderly downsizing of bank exposures to the real estate sector, restore market-based funding and reduce bank's reliance on central bank liquidity; and to enhance risk identification and crisis management mechanisms so as to reduce the occurrence and severity of future financial crises. The broader objective of safeguarding financial stability in the euro area as a whole was embedded in the euro area Summit statement of 29 June 2012 and the Eurogroup statement of 20 July 2012. The programme design was novel in several respects vis-à-vis the former approach to financial assistance programmes for euro area Member States (e.g. it financed the restructuring and recapitalisation of the financial sector, bank recapitalisation was based on independent asset quality review (AQR) and stress tests and mandatory subordinated liability exercises (SLEs) for junior debt were requested).

The evaluators found that focusing the programme on financial sector conditionality while explicitly linking it with Spain's commitments to consolidate public finances and address macroeconomic imbalances under EU economic governance was appropriate. A broad-based tightening in financing conditions in Spain was rooted in the banking sector but had spilled over to the real economy. In addition to measures directed at the financial sector, Spain needed a broader strategy to tackle macroeconomic sustainability issues given the country's large macroeconomic imbalances at the outset of the programme (see Chapter 2). The MoU contained explicit financial sector conditionality and required Spain to fully comply with its commitments under the Excessive Deficit Procedure (EDP) and European Semester recommendations, of which the Macroeconomic Imbalance Procedure (MIP) was of particular relevance. Contrary to standard economic adjustment programmes, the programme did not contain new specific conditions in the areas of fiscal policy and structural reforms, but compliance with those procedures was part of the conditionality and was fully assessed during the programme's review missions. This design contributed to a strong ownership of the programme by the authorities, while investors were reassured that the programme was part of a broader strategy taking into account the need to preserve debt sustainability and correct macroeconomic imbalances. The size of the financial envelope, while overshooting (ex-post) the final needs of the banking system, increased confidence in times of severe financial turmoil in Spain and growing financial market fragmentation across the euro area. Overall, the strategies chosen to deal with impaired assets and to recapitalise banks responded to

([1]) Communication to the Commission (COM), 'Responding to Strategic Needs: Reinforcing the use of evaluation' (SEC(2007)213), http://ec.europa.eu/smart-regulation/evaluation/docs/eval_comm_sec_2007_213_en.pdf

international best practice and significantly reduced uncertainty about the health of banks' balance sheets. They also allowed for a necessary recognition of losses by the banking system. The banks' recapitalisation plans benefited from the assessment of capital needs by independent experts, which provided more precise estimations in times of high uncertainty. Nevertheless, the evaluators found that several important decisions regarding the programme design could have been better communicated through programme-related documents or public statements by the European and Spanish Institutions, notably the ones behind the choice of an asset management company (AMC) and the implementation of burden sharing measures from hybrid capital and subordinated debt holders in banks receiving public capital (see Chapter 3).

Implementation of the programme's financial sector conditionality was overall fast and forceful, with most major measures frontloaded to 2012. Overall, the adopted measures were effective in achieving the programme's objectives in a short period of time (see chapter 4). The use of the financial envelope, less than half of the available amount, achieved the programme's objective while meeting EU competition rules requiring to minimise the amount of granted State aid. Speed was important in the setup of the AMC (Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria – Sareb) to achieve its primary objective of removing doubts about the quality of banks' balance sheets and facilitating an orderly downsizing of bank exposures to the real estate sector. The transmission of ownership of impaired assets from banks to Sareb was fast and allowed for a rapid completion of the banks' recapitalisation process. However, the transfer of the asset management tasks to Sareb and the setup of the team were slower, resulting in some inefficiencies. Overall, bank recapitalisation was well implemented. The MoU's roadmap was followed and the banking system did not require additional State aid after the programme. The subordinated liability exercises were relevant as they responded to the need to minimise the public contribution to the costs of the programme, while they followed the direction of emerging EU legislation. Excluding senior debt from burden-sharing exercises was appropriate on the back of financial stability risks and potential contagion effects to other euro area Member States in mid-2012. Given the absence of a clear framework for bailing in senior debt at the time, doing so in such a context would have created legal uncertainty and its effectiveness would have been constrained by losses incurred by the government given the high levels of State-guaranteed debt held by the banks which were subject to burden sharing exercises. The decision followed the approach taken in 2010 with the economic adjustment programme for Ireland. The implemented reforms in the area of financial regulation and supervision increased the resilience of the banking system and reduced risks to financial stability, but the implementation of the December 2013 Law on Savings Banks, which was a key measure to strengthening the governance of savings banks, accumulated long delays. A faster implementation would have contributed to quickly remove any doubts about weaknesses in the governance of the savings banks.

The exact impact of the programme (effectiveness) is difficult to quantify in the absence of a counterfactual, but the implementation of the programme measures underpinned macro-financial stability. Although important challenges remain (see below), the evaluators found that the programme's objectives were overall achieved and the programme avoided a disorderly deleveraging that would have had harmful consequences for the financial sector and overall macroeconomic stability. A number of financial indicators show an overall improvement in solvency, profitability and financing costs of the banking system, while the negative trend of credit contraction is showing signs of a gradual reversal (see Chapter 6). Banks carried out an orderly downsizing of exposures to the real estate sector, banks' reliance on central bank liquidity declined and risk identification and crisis management mechanisms were enhanced. This supported the MoU's broader objective of safeguarding financial stability in the euro area as a whole. To be sure, the success of the programme also needs to be seen in the context of a number of external actions at European Union/Euro Area level which were of paramount importance, in particular the announcement of the ECB's Outright Monetary Transactions (OMT) scheme and steps towards a Banking Union.

Spain's commitment to comply with the fiscal targets and structural reforms required under the EDP and European Semester/MIP over the programme period helped to foster a virtuous circle of positive news and credibility for the financial sector programme. Positive feedback loops from the implemented reforms under the EDP and the European Semester contributed to the overall success of the programme, as they helped to restore investor confidence about the authorities' capacity to correct macroeconomic imbalances in parallel to the restructuring of the financial sector. Fiscal indicators improved although the original targets had to be revised during the programme due to adverse macroeconomic developments. In parallel, the authorities implemented a range of structural reforms to improve labour and product markets and public administration. These measures facilitated the ongoing correction of macroeconomic imbalances. Recent developments of macroeconomic indicators allow for a preliminary positive assessment about the effectiveness of the programme in enabling a return to sustainable growth (see Chapter 5).

Despite significant adjustments in Spain's financial sector and wider economy during the programme period, several important challenges remain. In particular, despite the improved economic outlook, a still declining stock of credit and high (though decreasing) levels of non-performing loans (NPLs) and foreclosed assets pose risks to banks' profitability. The maximisation of the recovery value with regard to the entities which are still under the control of the FROB remains challenging. In addition, Spain exited the programme with still large general government deficit and public debt levels. Despite significant adjustments in key economic flows over the past few years, further consolidation efforts would be needed to bring the general government debt on a downward path, while the persistently high level of unemployment and low productivity pose significant policy challenges for the period ahead. There are some pending key reforms, such as the reform of professional services and professional associations, which have been delayed, and if adopted, could have a positive impact on productivity growth.

The programme was consistent with EU rules and initiatives and benefitted from them. The implementation of the programme was framed in an evolving environment in the EU with regard to bank supervision and restructuring/resolution structures. A common framework at supranational level for bank restructuring and resolution was being put in place during the programme period, but it had not yet entered into force. The measures implemented under the programme followed the direction of this new framework while they also complied with EU State aid rules (see Chapter 4).

There was value added in setting up a financial assistance programme for the recapitalisation of financial institutions. With Spain's public finances under stress and rising financing costs in the run up to the programme, EFSF/ESM financing within the programme allowed the Spanish State to finance the recapitalisation of the banking system at much more favourable terms. Involving European institutions and bodies and the IMF in the programme design and its implementation reviews introduced a degree of certainty towards investors who at that time questioned the health of the banking system, the rigorousness of banks' supervision and the financing capacity of the State for restructuring the banking system in the absence of financial assistance. In the absence of a programme and other measures taken in parallel at euro area level (e.g. monetary policy measures and steps towards a banking union), macro-financial stability would have been much more difficult to achieve, and it would have been economically and socially more costly, given the favourable financing terms of the programme and the strong tightening of financing conditions in Spain and contagion fears across Member States at the onset of the programme.

The following lessons can be drawn from this ex-post evaluation of the Spanish financial sector assistance programme (see Chapter 7):

Scope of the overall programme strategy and financial assistance (relevance)

A short-in-time, frontloaded, financial-sector specific programme is a very useful instrument to keep in the toolbox of euro area financial-assistance interventions, but it is not suitable in all circumstances. To be

successful, it requires inter alia that systemic risks stem predominantly from the financial sector, a strong technical and administrative capacity in the recipient country and the authorities' commitment and ownership with regard to the programme's measures.

Future programmes would benefit from specific considerations about the distributional and social impact of its measures. Financial-sector programmes could benefit from particular attention to financial consumer protection in order to limit negative spillovers of programme measures on consumers.

In the presence of high financial market volatility and uncertainties about banks' capital needs, the availability of an ample financial envelope provides a credible signal to markets that continued funding will be ensured in the event of unforeseen events. This reinforces the effectiveness of the programme.

Appropriateness of conditionality (efficiency)

Transparency is important when decisions involve re-distributional effects and may have a potentially significant impact on the taxpayer. Therefore, financial assistance programmes should benefit from clear public communication about measures involving burden sharing exercises and other measures which bear a significant social or redistributional impact. This would increase the ownership and credibility of the programme.

Contingency facilities to cover for possible early bank recapitalisations are a useful tool within a financial-sector programme, but the conditions under which those facilities could be drawn upon should be made clear upfront.

An AMC is an efficient tool to deal with impaired assets when there is a need to remove uncertainty from banks balance sheets, the problem is systemic, special powers and skills for asset resolution are needed, and the impaired assets are homogeneous enough to generate economies of scale. These conditions were met in the context of the Spanish programme, but different circumstances in future programmes might warrant different solutions. Thus, future financial sector programmes would benefit from a publicly available ex-ante analysis about the advantages and drawbacks of the strategy chosen to deal with impaired assets, including the implications of that choice for the taxpayer.

Appropriateness of programme implementation (efficiency)

Independent AQR and bottom-up stress tests are very useful tools to assure a financial-sector programme effectiveness and increase transparency and confidence about the estimations of capital needs of the banking system.

In the future, the setup of AMCs would benefit from a rapid transfer of both management and ownership of impaired assets. When the management of impaired assets transferred to the AMC remains temporarily within the banks, as was the case for Sareb, right incentives in servicing agreements with those banks should be established so that they make efforts to extract the maximum value from the transferred assets. It is important to ensure that capacity in terms of management and governance is built up quickly, that the management is independent, and that a realistic business plan is established.

When financial market uncertainty is very high and there is no functioning market for impaired assets to be transferred to an AMC, independent valuations based on the long-term economic value of those assets accompanied by an additional haircut can be an efficient tool to limit risks of potential losses for the AMC.

Clear communication is essential when implementing burden sharing exercises which might be different across programmes, so as to improve the public's perception of those decisions. Reasons leading to different approaches for burden sharing or other important sensitive decisions under different euro area

programmes should be widely available and properly communicated by the institutions involved in those decisions. In this regard, the deep transformation in EU bank resolution and supervision frameworks which developed in parallel to the programme should facilitate a more homogeneous implementation and reduce legal uncertainty in future programmes.

Achievement of the programme's objectives (effectiveness)

Programme conditionality which is realistic and in line with a country's priorities facilitates the achievement of the programmes' objectives.

The achievement of the programme's objectives depends not only on domestic actions but also on the external environment. Possible measures at EU/EA level that could help achieving the programme's objectives are worth evaluating at the early stages of the programme design.

A financial sector specific programme with explicit requirement in the MoU for the country to comply with EDP and European Semester/MIP recommendations may create positive feedback loops and underpin the overall success of the programme, provided that sufficient implementation capacity and political commitment are in place. If those conditions are not in place, a fully-fledged programme with less frontloaded disbursements might be more suitable.

Consideration needs to be given to the aftermath of the programmes in terms of the path of fiscal consolidation and structural reforms. The risk of slowing down reforms after the programme can be reduced by ensuring an as-complete-as-possible implementation of the programme conditions within the programme period, for which frontloading the programme measures can be an efficient tool.

EU value added and coherence with other EU policies

Financial assistance from the EU/EA to a Member State adds high value where the Member State is unable to overcome negative sovereign-bank feedback effects on its own, by reducing financing costs for the State, supporting debt sustainability and thus macroeconomic stability, and by overcoming investors' concerns about the credibility of domestic bank regulators and supervisors.

1. INTRODUCTION

In January 2014, Spain completed a financial stability support programme which had been set up in July 2012 in response to a banking crisis with increasing negative feedback loops into the Spanish sovereign debt market. Amid growing difficulties of the banking and government sectors to access market financing at sustainable terms, increasing the resilience of the banking sector and in particular of the savings banks became imperative in order to stabilise the broader economy. In June 2012, the government requested financial assistance for the recapitalisation of financial institutions by the EFSF, to be subsequently taken over by the ESM, as approved by the Eurogroup in July 2012, and subject to conditionality as specified in the MoU. ([2])

The programme entailed an envelope of financial assistance by the EFSF/ESM of up to EUR 100 billion, to be channelled through the FROB to financial institutions in need of public support. In November 2012, responsibility for providing financial assistance was transferred from the EFSF to the ESM. The Commission, in liaison with the European Central Bank and the European Banking Authority, was responsible for monitoring compliance with programme conditionality during quarterly review missions. The ESM disbursed close to EUR 39.5 billion (of which about EUR 2.5 billion for capitalising Sareb) in December 2012 and a further EUR 1.8 billion in February 2013.

This document presents an ex-post evaluation of the programme design, implementation and outcomes. The purpose of the evaluation is to assess the intervention in order to draw lessons for future decision-making when designing and implementing financial adjustment programmes in the euro area or elsewhere, thus contributing to increase the transparency and accountability of EU policies. The evaluation looks at how the design and implementation of the programme contributed to the attainment of the programme's objectives and to the evolution of the Spanish financial sector and broader economy. The approach is mostly qualitative as the conclusions are based on economic judgement rather than on an econometric model. This is due to the difficulties to construct a credible counterfactual given the changing economic and financial conditions in both Spain and its partners at the time of the programme. While the evaluation has been carried out with the benefit of hindsight, programme decisions have only been evaluated in the light of information available at the time.

This evaluation follows the European Commission's requirement to evaluate the impact of its policies. ([3]) The Commission's internal working arrangements, as well as those in relation to other EU or international institutions involved in the support programme fall outside the scope of the evaluation. A particular focus is given to the specific contribution of the EU/EA context during the programme period. In line with international good practice, particular care was taken to create an institutional separation between the evaluation and the implementation of the programme itself, to ensure the independence and impartiality of the exercise. Annex 1 provides more details on these arrangements.

Using the framework set out in the European Commission's evaluation standards, the evaluation assesses the relevance, appropriateness (efficiency) and effectiveness of the programme's inputs in terms of their contribution to the programme's objectives. The evaluation also assesses the added value of the EU's involvement and the coherence of the programme with other EU policies. ([4]) The remainder of the report is organised as follows. Chapter 2 gives a short overview of the roots of the crisis that led to the programme. Chapter 3 presents an overview and assessment of the programme's strategy and design.

([2]) See the full MoU in European Commission Occasional Paper N° 118, "The Financial Sector Adjustment Programme for Spain", pages 54-66, October 2012.

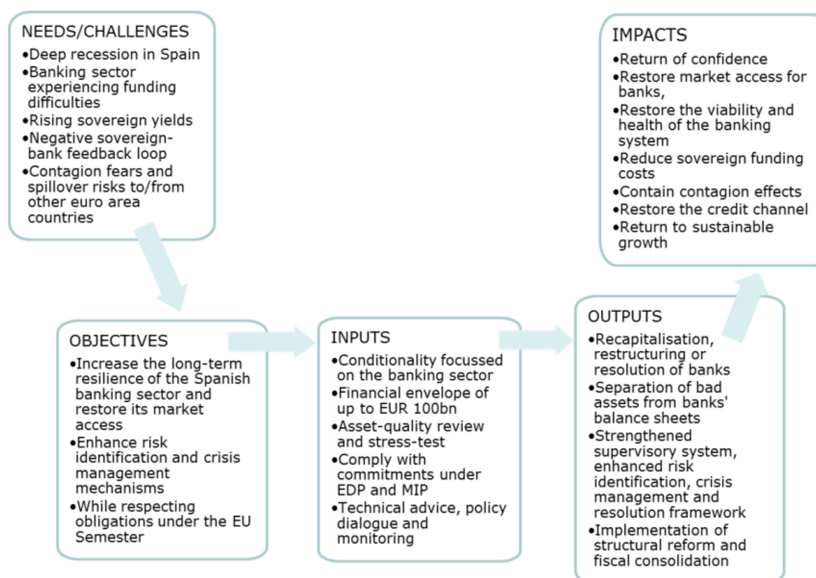
([3]) Evaluation standards were set out in the Communication to the Commission, 'Responding to Strategic Needs: Reinforcing the use of evaluation' (SEC(2007)213), http://ec.europa.eu/smart-regulation/evaluation/docs/eval_comm_sec_2007_213_en.pdf.

([4]) The evaluation mandate set out the following questions for the evaluation to answer: (i) Whether the objectives of the intervention corresponded to the needs (relevance); (ii) Whether those objectives have been achieved or can be expected to materialise in the medium/long term (effectiveness); (iii) Whether the intervention (financial assistance and conditionality) was appropriate in relation to the outputs to be produced and the broader macro-financial impacts to be achieved (efficiency); (iv) Whether the intervention was coherent with other EU policies/activities (coherence); and (v) Whether there was value from EU/euro area intervention compared to what could have been achieved at national level (EU value added).

Chapter 4 assesses the implementation of the financial sector conditionality as explicitly set out in the MoU. Chapter 5 assesses the progress made by the Spanish authorities with regard to the Excessive Deficit and European Semester procedures, which was part of the MoU's conditionality. Chapter 6 looks at the programme's impact on the financial sector vis-à-vis the MoU's objectives. Chapter 7 concludes and discusses some broader lessons from the experience of the economic adjustment programme.

The method and process followed for this ex-post evaluation are described in Annex 1. The Spanish authorities' views on the ex post evaluation are reported in Annex 2.

Intervention logic of the Financial Stability Support Programme for Spain



2. THE BOOM-BUST CYCLE IN SPAIN

2.1. ECONOMIC EXPANSION AND ACCUMULATION OF IMBALANCES

Prior to the economic and financial crisis, Spain experienced fifteen years of rapid growth, with strong employment and wage gains and rising public revenues. The expansion was driven by domestic demand, in particular investment in residential property and private consumption. The economy grew at an average rate of 3.8% during 1999-2007, well above the euro area average growth rate (see Graph 2.1a), while the gross public debt-to-GDP ratio declined to 35.5% in 2007. Rapid growth was fuelled and accommodated by the build-up of sizeable internal and external imbalances, notably growing levels of domestic and private foreign debt and an overheating of the housing market. Foreign capital inflows financed an increasing saving-investment gap of the domestic economy, virtually without facing external financing constraints.

Both external and domestic factors contributed to the Spanish housing boom. Easy access to external financing, very low real interest rates ([5]) and rising demand for housing boosted a credit boom and over-investment in real estate. Such investment was underpinned by population growth, an increase in the number of households, demand for second homes and policy incentives to promote home ownership. House prices rose, along with employment and wages in the construction sector and related services. Between Q1 1997 and Q1 2008, house prices grew by about 200%, whereas the GDP deflator rose by some 40% (Graph 2.1b). Wealth effects and income growth stimulated consumption and further demand for housing, putting in place the conditions for an overheating of the market.

The construction boom had benign socio-economic impacts, reducing incentives to contain the excesses. *First,* the public finance situation improved, helped by the tax-rich composition of domestic demand and a large tax base due to persistent current account deficits. *Second,* employment rose and unemployment declined amid an immigration-driven increase in the labour force, due to the labour-intensive nature of the construction industry. *Third,* household net wealth rose as house prices increased, stimulating consumption and spreading the economic gains beyond the construction and real estate sector. *Fourth*, financial soundness indicators seemed robust, as suggested by low levels of NPLs, rising collateral values, capital above the statutory minimum and strong profitability of the system as a whole.

The prolonged economic boom period was accompanied by an accumulation of imbalances:

High private sector indebtedness: In the run-up to the crisis, annual credit growth to the private sector exceeded 25%, up from 12% in 2001. In 2008, household debt stood at more than 80% of GDP and non-financial corporations' debt at about 120% of GDP, favoured by loose financing conditions and strong competition among banks. Credit was increasingly directed to property-related activities and the increase in house prices created an illusion that such lending was a safe asset. ([6])

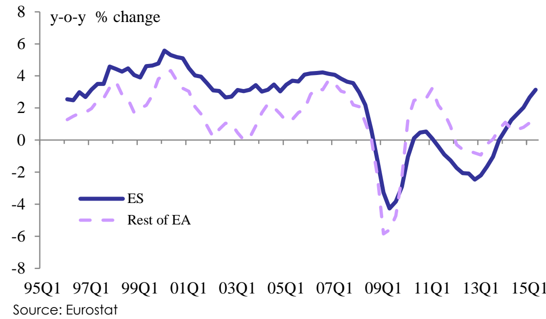
Build-up of financial stability risks: Loans to the real estate and construction sector increased from about EUR 190 billion in 2004 to about EUR 470 billion in 2008. In mid-2007, banks' exposure to the sector stood at 25% of total loans to the private sector and almost 50% of corporate loans. The bias was even more pronounced for the *cajas,* which had based their expansion of market share (from 20% in 1980 to 40% in 2010) on real estate-related lending. ([7])

([5]) Convergence of long-term interest rates and prices in the euro area following the introduction of the euro resulted in very low real interest rates in Spain, in particular during the mid-2000s. The 3-month real interest rate in Spain was 5.3% during 1990-1998, but dropped to zero in the period 1999-2005 (Santos, 2014). Strong competition between savings banks eager to raise their market share may have also contributed to a decline in mortgage rates.

([6]) See for instance the European Commission "European Competitiveness Report 2010" highlighting accumulated imbalances and distortions in the Spanish economy related to the housing bubble.

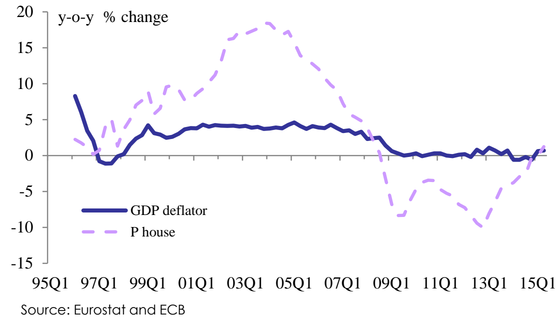
([7]) At the peak of the bubble, the percentage of corporate loans tied to the real estate sector (construction companies and real estate developers) reached 61% on average for the *cajas* and 41% for the banks (Santos, 2014).

Graph 2.1a: **GDP growth Spain and rest of EA**



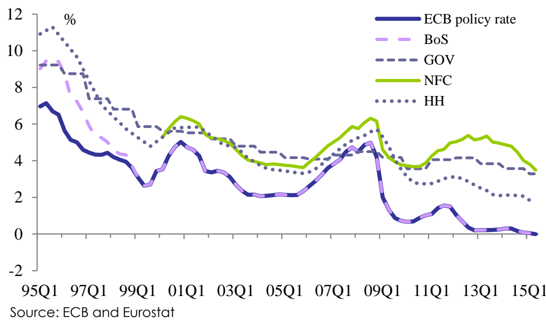
Source: Eurostat

Graph 2.1b: **GDP deflator and house price**



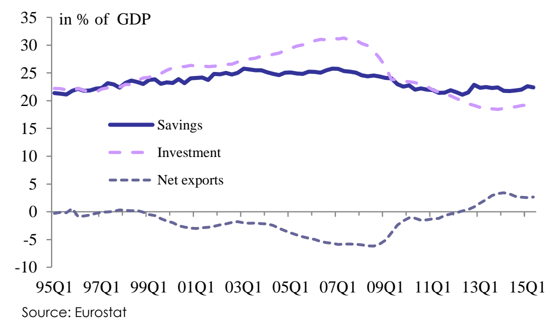
Source: Eurostat and ECB

Graph 2.1c: **Nominal interest rates**



Source: ECB and Eurostat

Graph 2.1d: **Savings, investment and net exports**



Source: Eurostat

Sizeable external liabilities: Excessive expansion of the domestic banking sector's total assets (around 320% of GDP in 2006) could not be financed by deposits. The funding gap was filled through borrowing from wholesale funding markets and international capital markets. Such funding was to a significant extent short-term and made banks vulnerable to changes in external financing conditions and interest rates. In 2008, total external debt stood at some 150% of GDP, with one quarter financed short-term.

Deteriorating competitiveness: Spain's relative competitiveness vis-à-vis the euro area declined, as a result of above-average inflation (more than 1 percentage point higher than the euro-area average during 2001-2007) and wage increases (partly resulting from wage indexation), combined with low productivity growth. ([8]) Spain's real effective exchange rate based on unit labour costs appreciated by some 16% during the period 1999-2009. Spain's export market share nevertheless held up relatively well compared to other euro area Member States, as exporting firms tended to be larger and more productive than the average firm (Ubide, 2013) and export orientation shifted towards dynamic emerging markets. Yet few new firms entered export markets prior to the crisis, reflecting the high number of SMEs with lower levels of productivity and the boom in domestic demand. This resulted in a shift of productive structures towards the non-tradable sector and high import intensity of domestic demand, generating persistent current account deficits and a growing stock of external debt.

Sectoral shifts in the economy: The Spanish housing boom was unusually long (1997-2007) and concentrated significant shares of investment and employment. At the peak of the bubble, construction investment accounted for more than 12% of GDP and 13% of total employment (Ubide, 2013). As the bubble burst, housing investment shrank to about half of its pre-crisis level and the economy was left with an oversupply of residential real estate and a huge number of unemployed with limited employability prospects. Recovering the drop in GDP requires resources to be redirected to other sectors and workers to be retrained.

([8]) See for instance the European Commission "European Competitiveness Report 2008".

2.2. THE BURST OF THE BUBBLE AND THE BANKING CRISIS

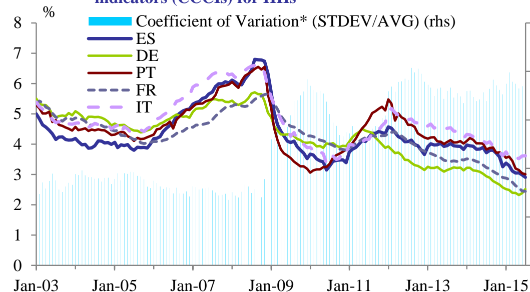
The growth model exposed its weaknesses as financing conditions started to tighten. From late-2006, interest rates rose, slowing down credit growth in an environment of already high private sector debt and softening demand for new housing and amid global financial market tensions stemming from the subprime crisis in the US in 2007-2008. House prices in Spain started to fall from mid-2008, affecting the real economy through wealth effects and investment and employment dynamics in the real estate and construction sector, while the financial sector was hit through the deterioration of asset valuations in banks' balance sheets. Debt servicing costs of existing loans, largely extended on variable rates, increased as the Euribor rose in 2007-2008, reducing households' disposable income and private consumption.

The Spanish economy entered recession in mid-2008. Real GDP declined by some 5% until the end of 2009, driven by a 25% drop in investment and a 5% decline in consumption, which was partly offset by a positive contribution from net exports. The government implemented a stimulus programme in 2009, which helped stabilising the economy in 2010. The banking sector as a whole resisted relatively well the early phase of the crisis, thanks to dynamic provisions (see below), relatively high capital buffers at the time and the retail-oriented business model with low exposure to complex structured products.

Some of the imbalances accumulated during the boom period started to correct. The current account deficit narrowed substantially and was close to balance in 2012, led by a strong recovery of exports, while import compression also contributed, particularly in the early stages of the crisis. Indicators of price competitiveness improved, reflecting productivity gains from labour shedding and wage moderation. However, the necessary unwinding of large stocks of private and external debt continued to weigh on growth.

In mid-2011, the tightening of financial conditions in the euro area emerged as a major shock to countries with large external liabilities, including Spain. The economy fell back into recession, which was shallower than the first one but lasted longer and was accompanied by fiscal consolidation measures. New imbalances emerged as a result of the prolonged economic downturn. Financial sector fragmentation in the euro area increased, with vulnerable euro area Member States recording significantly higher financing costs than Member States with stronger macroeconomic fundamentals.

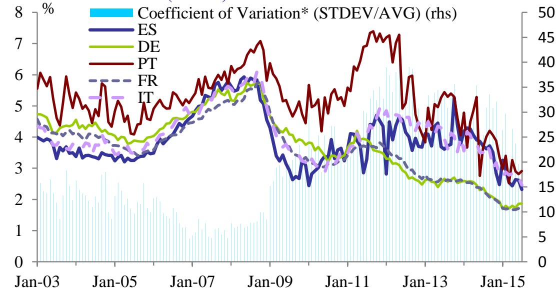
Graph 2.2a: **Country-specific composite credit cost indicators (CCCIs) for HHs**



*Based on data for 9 EA countries

Source: ECB, DG ECFIN calculations

Graph 2.2b: **Country-specific composite credit cost indicators (CCCIs) for NFCs**



*Based on data for 9 EA countries

Source: ECB, Bloomberg, Bank of America Merrill Lynch, DG ECFIN calculations

The public finance situation deteriorated. The recession exposed the extent to which the pre-crisis improvement in public finances was linked to the boom in domestic demand. While windfall revenues stemming from the real estate boom dropped, significant expenditure slippages were recorded notably at regional level amid weaknesses of the institutional framework governing budgetary compliance by the

regions. ([9]) The Spanish budget balance changed from a surplus of 2% of GDP in 2007 to a deficit of 11% of GDP by 2009 and improved only slightly during 2010-2011, notwithstanding consolidation measures from 2010 onwards. The public debt-to-GDP ratio surged from 36% in 2007 to close to 70% in 2011 and was set to increase further, driven by persistently high deficits and capital injections into banks.

Stress on banks increased notably from mid-2011, due to the weakening of the economy and the intensification of the sovereign debt crisis in some euro area Member States. Sovereign financing costs rose gradually, which fed back into the banking sector and the real economy through an increase in banks' funding costs and a further deterioration of lending conditions for households and non-financial corporations. New loans for house purchases declined (see Chapter 6), complicating the absorption of the large stock of new dwellings. The fall in house prices accelerated and the real estate and construction sector faced increasing difficulties to service their loans. In the first quarter of 2012, NPLs in real estate and construction reached 22%, driving up the system-wide NPL ratio to over 9% in June 2012. In addition to reported NPLs, banks made extensive use of loan restructuring and debt-for-equity swaps with property developers (FSB, 2011). The latter made bank balance sheets directly vulnerable to the decline in property prices.

Capital and provision needs rose, in particular among savings banks with heavy real estate-related portfolios. ([10]) The authorities established additional requirements on banks' capital and liquidity and continued with a gradual restructuring process for ailing savings banks. By December 2011, the FROB had injected some EUR 15 billion of own funds into banks (about 1.5% of GDP). The private sector had contributed about EUR 8 billion to capital injections through the Deposit Guarantee Fund. Between October 2008 and December 2011, the government guaranteed some EUR 110 billion in bank senior bond issuances (about 11% of GDP) and purchased some EUR 19 billion of high quality asset backed securities (IMF FSAP, 2012) ([11]). The restructuring of the savings banks was mostly focused on mergers and the so-called "cold mergers", which were not successful in enhancing the efficiency of the savings banks sector. ([12]) From early 2010 to 2012, the number of *cajas* decreased from 45 to 11 and their average size by assets tripled. The most prominent concentration of *cajas* was BFA-Bankia in December 2010, the bank whose failure would later trigger the request for external assistance in 2012.

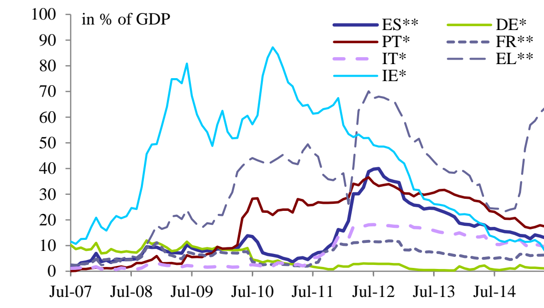
To increase the loss-absorbing capacity of the banking sector, regulatory requirements were gradually being stepped up. From September 2011, banks had to comply with a higher minimum capital ratio requirement (principal capital) of 8%, which was raised to 10% for non-listed banks with less than 20% private equity investment and heavy dependence on wholesale funding. The Bank of Spain (BdE) also strengthened disclosure requirements for real estate and construction exposures and amended the accounting rules to accelerate the process of deleveraging and loss recognition. In February and May 2012 banks' provisioning requirements against losses and in particular related to real estate assets were significantly increased. System-wide earnings fell from around EUR 34 billion in 2007 to a loss of around EUR 70 billion in 2012 (IMF, 2014).

As the euro area sovereign debt crisis intensified, access to funding was becoming a major challenge. Wholesale funding costs for banks were closely correlated with sovereign yields across the euro area, a correlation that seemed weaker before the onset of the sovereign debt tensions (see Box 2.1). During the second half of 2011 and the spring/summer 2012, segments of the banking sector were losing access to market funding on affordable terms. Spanish banks were becoming increasingly reliant on

([9]) See Council Recommendation with a view to bringing an end to the situation of an excessive government deficit in Spain, ECOFIN 669, UEM 252, 9 July 2012.
([10]) In Q4 2008, the outstanding balance of real estate developer loans was EUR 318 billion; about EUR 172 billion were held by the *cajas* and EUR 132 billion by the banks (Santos, 2014).
([11]) IMF Financial Sector Assessment Programme (FSAP) for Spain, country report 12/137, June 2012.
([12]) The “cold-mergers” (Institutional Protection Schemes) were arrangements between savings banks where some resources (e.g. capital) were pooled among the participating entities but each saving bank kept its own balance sheet and legal independence.

Eurosystem liquidity and were among the largest beneficiaries of the 3-year LTROs in December 2011 and February 2012. In May 2012, borrowing from the Eurosystem stood at 30% of GDP.

Graph 2.3: **Central bank's lending to EA credit institutions**



*Related to Monetary Policy Operations **Total to domestic MFIs
Source: National central banks

Box 2.1: **Sovereign-bank feedback loops in the euro area during 2011-2012**

The crisis highlighted the mutual interdependence of funding conditions of banks and sovereigns in the euro area:

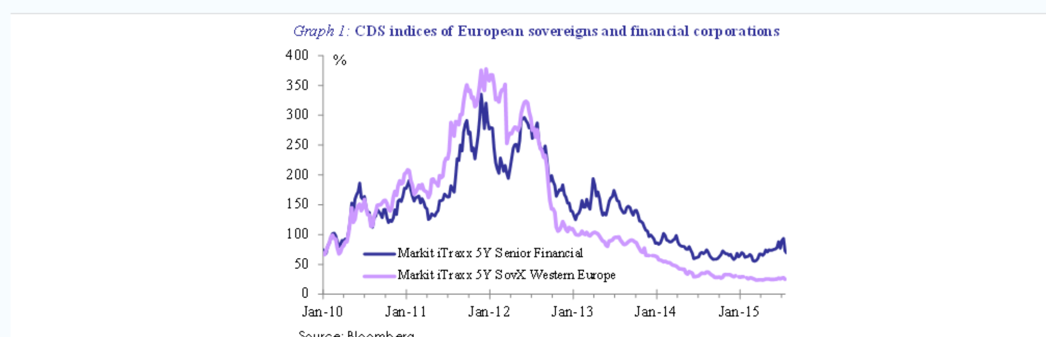
Absent a fully-fledged supranational bank resolution mechanism, sovereigns constitute the ultimate backstop to national banking systems. During the crisis, governments in many euro area Member States assumed or guaranteed, explicitly or implicitly, a substantial portion of banks' liabilities. The existing frameworks for the support of ailing banks, while limiting spill-overs from individual institutions, tended to increase the explicit and contingent liabilities of the sovereign. As fiscal positions worsened, the quality of the backstop deteriorated, eroding the funding benefits that banks derived from public guarantees. Bank default risk was averted at the cost of increased sovereign credit risk, which fed back into banks' funding conditions and balance sheets. Through this channel, problems concentrated in parts of the banking sector could spill over to the entire system, increasing financial fragmentation along national borders.

Banks hold a portion of their assets in the form of sovereign bonds due to their liquidity, safety and collateral value, as well as for investment purposes. During the crisis, banks tended to increase their sovereign bond holdings, as uncollateralised lending tightened, central bank liquidity was ample, sovereign debt holdings often benefited from zero risk-weight and deteriorating economic conditions increased the riskiness of lending to the private sector. As the quality of bonds issued by certain Member States declined, banks' counterparty risk increased while the collateral value of those bonds shrank. Funding became more costly and more difficult to obtain, eating into profits. In some cases, losses on sovereign bonds (e.g. Greek bonds) also directly impacted bank solvency (see Correa and Sapriza, 2014).

Real economic developments reinforced the negative sovereign-bank feedback loop. Lending constraints caused by deteriorating balance sheets of banks and the sovereign implied macroeconomic costs, which further weakened fiscal accounts and tightened banks' access to funding. Weak economic performance also affected asset quality through an increase in non-performing loans. Negative feedback effects between funding conditions and the real economy were strongest in countries with a significant debt overhang – reflecting inter alia the extent to which the pre-crisis boom was driven by credit supply.

Empirical research confirms the intensification of sovereign-bank feedback loops in the euro area during 2010-2012. Alter and Schueler (2011) found that before public support was given to banks, bank credit risk spilled over to the sovereign, whereas after bank support, sovereign credit risk spilled over to banks. Neri (2013) provided empirical evidence that banks in countries facing sovereign debt tensions increased lending rates to non-financial corporations and households, thus amplifying the impact of sovereign distress on the economy. Acharya et al (2012) found that an increase in sovereign credit default swap (CDS) spreads increased bank credit risk even after controlling for bank credit ratings, due to the lower quality of the implicit state guarantee.

Graph 1: **CDS indices of European sovereigns and financial corporations**



Source: Bloomberg

(Continued on the next page)

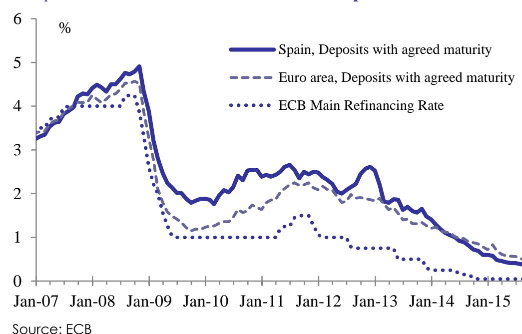
Box (continued)

The ECB's bank lending survey sheds light on the evolution of sovereign-bank feedback loops. The responses suggest that the negative effect on banks' funding conditions was strongest in Q4 2011, and after a slight improvement in Q1 2012, which likely reflected the impact of the 3-year LTROs and the expansion of eligible collateral in late-2011, resurfaced again in Q2 2012. Most respondents attributed the negative impact of the sovereign debt crisis to the reduced collateral value of sovereign bonds. The negative effect diminished during Q3 2012 and disappeared in Q4 2012, consistent with the decline in sovereign risk spreads. From 2013, banks reported a positive impact from rising collateral values on funding conditions.

The funding squeeze was strongest for the savings banks, which used to rely heavily on securitisation market to finance their rapid expansion. Securitisation vehicles were used to raise funds on wholesale markets, most of which were bought by euro area banks and pension funds. In 2008, the *cajas* accounted for almost two thirds of outstanding securitisation deals, i.e. EUR 270 billion out of a total of EUR 450 billion, a three-fold increase from 2005 levels (Santos, 2014). As the cycle turned, assets that were once considered as safe were found to load on common factors, such as exposure to Spanish real estate prices (Jimeno and Santos, 2014). Issuances of covered bonds also became increasingly expensive. New issuances declined to only a fraction of their pre-crisis level and "home bias" increased. ([13]) In July 2012, yields for 10-year issuances exceeded 8%, and in August 2012, banks were effectively cut off from the market (see for instance Arregui and García Mora, 2012).

Outflows of non-resident deposits and competition for domestic savings added to funding pressures. Between June 2011 and July 2012, deposits in Spanish monetary and financial institutions by euro area residents outside Spain dropped by around EUR 37.9 billion, while residents in the rest of the world reduced their deposits by EUR 59.9 billion over the same period. ([14]) Outflows of domestic deposits to euro area banks outside Spain remained contained, but the shortage of other sources of funding seemed to have pushed up deposit rates in a "war for deposits", weakening the pre-crisis correlation between deposit rates and the ECB's main policy rate (see Graph 2.4). The rise in deposit rates was halted in mid-2011 as the authorities made deposits paying unusually high rates subject to higher contributions to the deposit guarantee fund. The measure seemed to have contributed to the subsequent shift from deposits to commercial paper. Between October 2011 and May 2012, resident deposits decreased by around EUR 60 billion, whereas investment in fixed-income securities by residents increased by EUR 30 billion (Bank of Spain, 2012).

Graph 2.4: **Interest rates on NFCs and HHs deposits**



Source: ECB

([13]) During the crisis, the vast majority of new securitisation vehicles were acquired by the originators themselves ("retained securitisations"), with a view to increasing collateral for Eurosystem liquidity operations (Bank of Spain, 2012).

([14]) http://www.bde.es/f/webbde/SES/Secciones/Publicaciones/InformesBoletinesRevistas/BoletinEconomico/12/Sep/Fich/be1209-art2.pdf

2.3. THE SAVINGS BANKS AT THE ORIGIN OF FINANCIAL INSTABILITY

The banking crisis in Spain exposed weaknesses in several areas: governance problems in savings banks, inadequate management of macroprudential risks, and the lack of adequate crisis resolution tools. The combination of these factors may explain why emerging risks in the banking sector were not addressed in time and remedial action was only gradually being implemented.

Corporate governance of savings banks

The Spanish banking crisis was essentially a crisis of the *cajas*. All banks in need of public support were either *cajas* or controlled by them. The major problems were concentrated in some 30% of the banking sector, while a large share of the sector remained healthy but increasingly exposed to unsustainable funding costs. Even within the *cajas* sector, heterogeneity was large and some of them remained sound.

Corporate governance structures may partly explain the weak performance of parts of the sector. Savings banks were non-profit credit institutions governed by a General Assembly of which different groups of representatives were part. They grew mainly on the basis of retained earnings. Equity investment *(cuota participativa)* did not accord voting rights – the latter were allocated to local and municipal governments, depositors, employees and the founders (the Members of the General Assembly). As shares were not publicly traded, market discipline through stock valuation was absent and transparency was generally poorer compared to listed banks.

The governance structure of the savings banks allowed for political interference by regional and municipal governments. The 1977 and 1985 laws regulating *cajas* established the principle of representation of municipal and regional governments in the governing bodies. Local governments were often notably represented in the management bodies of the *cajas* and some of them were run at some point by local or national politicians.

In several institutions, risk management was poor and lending aggressive. Akin et al (2014) explore the differences in the lending behaviour between banks and *cajas* in the run-up to the crisis. They found that the intervened institutions granted mortgages with the highest loan-to-value ratios. In addition, savings banks were disproportionately exposed to the real estate sector, while their funding was relatively less stable (high share of external funding via covered bonds). As a result, some of the *cajas* were more exposed to loan losses and tightening liquidity conditions.

The corporate structure and a multitude of stakeholder interests complicated crisis management and delayed intervention. When the capital levels of some *cajas* were being depleted, *cajas* were unable to attract external capital, while they also lacked an internal recapitalisation mechanism. *Cajas* could not be taken over by banks though banks could be taken over by *cajas*. *Cajas* could however be merged among them, subject to approval of the owners and their respective regional governments, which did not fundamentally change the basic model of savings banks (IMF FSAP, 2012). Thus, the consolidation of the *cajas* was a lengthy process that had to cater to a multitude of stakeholder interests.

Responding to the challenges exposed by the crisis, the authorities had taken gradual steps to reform the legal framework governing the *cajas* sector. New laws were adopted in June 2010 and February 2012, with the aim of aligning financial ownership and voting rights in a new corporate model for the banking business of the *cajas* and reducing the weight of public authorities in the General

Assembly (from a maximum of 50% to 40%). ([15]) In addition, new requirements on governance and professionalism of management were put in place, including mandatory cooling-off periods for ex-politicians serving in the governing bodies.

New capital requirements in February 2011 prompted almost all *cajas* to spin-off their banking business into newly created commercial banks ([16]). The *cajas* would act as holding companies of the banks or convert into foundations with stakes in the banks. The new banks could raise capital on the market and were exposed to market disciplining forces. The BdE retained the power of monitoring solvency and leverage of the holding company. However, the remaining *cajas* continued to be subject to two tiers of regulation by the State and the regional governments (e.g. with regard to corporate governance), even if as shareholders of commercial banks they were subject to prudential requirements by the BdE. This gave room to potential overlaps or inconsistent governance rules (IMF FSAP, 2012).

Management of macroprudential risks and lack of an adequate crisis resolution framework

Measures to reinforce Spain's prudential framework prior to the crisis proved insufficient to withstand a large financial shock. In the mid-2000s, the regulation and supervision of the Spanish banking system was internationally assessed to be overall sound, but important shortcomings had already been identified. ([17]) The BdE had a reputation as a supervisor with highly experienced and professional staff. Moreover, it was renowned for its innovative approach to loan-loss provisioning and the conservative treatment of securitized assets (IMF, 2006; Santos, 2014). In 2009, Spanish banks had more favourable solvency positions than EU peers and the leading institutions were expanding into UK, US and Asian markets.

The Bank of Spain pioneered counter-cyclical capital buffers. In reaction to the rapid increase in credit growth, the BdE implemented 'dynamic' provisions in July 2000. The measure required banks to set aside funds during the upturn, without reference to any specific loan. Thus it would smooth provisioning requirements throughout the cycle and reduce the pro-cyclicality of bank lending, i.e. cool credit expansion during the good times while mitigating its contraction during the bad times. Initially, the tool seemed to have worked as intended, mitigating pro-cyclicality in credit supply (Jiménez et al, 2012). However, it was insufficient to dampen the credit cycle. The BdE also took measures to reduce risks related to asset securitisation (Santos, 2014).

The measures were insufficient to shield the banking sector from the combined shocks of the domestic housing market collapse and the euro area sovereign debt crisis. As the crisis deepened, the funds set aside (about 3% of GDP at their peak in 2004, less than 1.5% of total loans) were quickly depleted (Garicano, 2012; Santos, 2014). While the impact of the real estate bust on the asset side of banks' balance sheets had been underestimated, the liability side of balance sheets had not been considered a source of fragility in the monetary union. An unprecedented shock struck the banking sector and funding costs rose in line with the sovereign risk premium. ([18])

([15]) Royal Decree Laws 6/2010, 11/2010 and 2/2012.
([16]) Royal Decree Law 2/2011.
([17]) The IMF's FSAP report of June 2006 highlighted that Spain's prudential framework was "at the cutting edge of innovation" and was underpinned by "long-standing professional credibility, recognized technical expertise and operational independence". It concluded that Spain’s financial sector was "vibrant, resilient, highly competitive, and well supervised and regulated". Notwithstanding the overall positive assessment, the report already addressed many of the issues that turned out crucial for the fate of the Spanish banking sector as the crisis deepened, in particular the ownership structure of the *cajas*, the role of regional governments in the regulation of the *cajas*, limitations to the authority of the BdE to issue norms and sanction violations and weaknesses in securities regulation (IMF 2006).
([18]) The example of Banco Santander illustrates the difficulties of the Spanish banking sector: In June 2010, Banco Santander had a long-term rating of "AA" and was trading at a CDS fee of 207 basis points. Meanwhile, the German bank WestLB had a long-term rating of "BBB+" and was trading at a CDS fee of 158 basis points. Even though the rating suggested a much stronger creditworthiness of Santander compared to WestLB, the default risk was assessed to be higher (see Acharya et al., 2012).

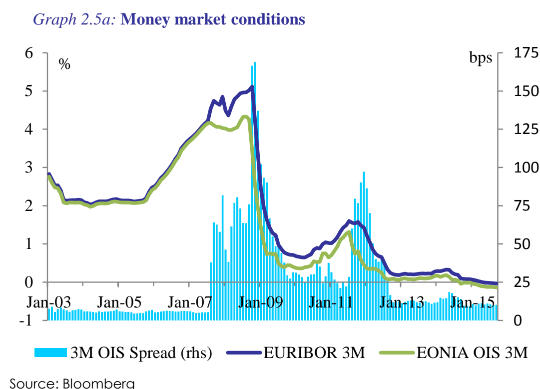
Political economy problems may have discouraged more forceful pre-emptive measures to address the build-up of risks. Such measures would have required standing up to vested interests, in particular the political control of the *cajas*, which in some cases was used to fund real-estate projects that were not based on the most efficient criteria. ([19]) In this context, more autonomy of the BdE to issue prudential regulation, a clear mandate and more intensive use of sanctions could have dampened the accumulation of risks (IMF FSAP, 2012).

The financial sector regulatory framework was not prepared for dealing with a crisis of such magnitude. *First,* the authorities lacked a suitable framework for bank resolution (outside liquidation) while a common EU resolution framework was not yet in place. *Second,* spill-over effects in the euro area, the volatility of capital flows and the necessity not to penalise the viable banks did not allow for massive bail-in including senior debt. *Third,* public finance constraints did not allow for sizeable bail-out (Ordóñez, 2012). Faced with constraints from various fronts, the authorities adopted a gradual approach to corrective action, which allowed ailing banks to continue to operate to the detriment of financial stability (IMF FSAP, 2012).

2.4. SOVEREIGN DEBT DISTRESS AND THE RUN-UP TO THE PROGRAMME

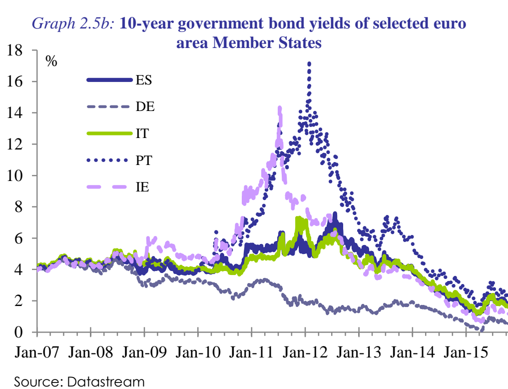
The funding squeeze in the Spanish banking sector was partly related to developments in other euro area countries. In late-2011, the sovereign debt crisis entered a new phase, with signs of contagion from Greece to larger euro area Member States, the freezing of wholesale funding markets for many euro area banks and deteriorating growth prospects. Following the agreement by euro area Heads of State or Government in July 2011 about a voluntary contribution of the private sector to fully cover Greece's financing gap, bond holders seemed to have reassessed sovereign credit risks. Banks in many countries withdrew from investments in vulnerable sovereigns and yield spreads to benchmark German bonds reached new highs. In mid-November 2011, the spread of Spanish yields over Germany's reached 500 basis points (bps) for 2-year maturities and close to 450 bps for 10-year maturities (Graph 2.5b). Banks' funding conditions worsened significantly, as indicated by the increase in the Euribor-Overnight Index Swap (OIS) spread, an indicator of counterparty risk in unsecured interbank markets (Graph 2.5a).

Graph 2.5a: **Money market conditions**



Source: Bloomberg

Graph 2.5b: **10-year government bond yields of selected euro area Member States**



Source: Datastream

Ample liquidity provision by the ECB temporarily calmed down bank and sovereign funding stress in the first quarter of 2012. Two three-year LTROs (in December 2011 and February 2012) provided euro area banks with EUR 1 trillion of liquidity, while the expansion of eligible collateral further eased

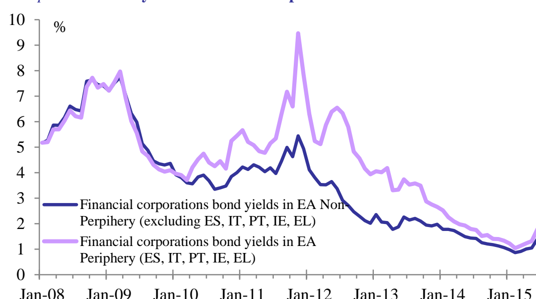
([19]) On the influence of local politicians in certain *cajas*, see for example Santos (2014) and Fernández-Villaverde, Garicano and Santos (2015).

funding pressures. Spanish and Italian banks made substantial use of LTROs, accounting for two-thirds of the total increase in Eurosystem lending between the end of November 2011 and the end of March 2012. Conditions in bank bond markets stabilised, with an increase in issuances by Spanish and Italian banks in both the covered and senior unsecured bond markets. On the sovereign bond market, yields declined gradually. In mid-March 2012, the gap between Spanish and German sovereign yields stood at 220bps in the 2-year segment and at 330bps in the 10-year segment. Spanish banking institutions seemed to have been the main buyers of Spanish government bonds, whereas non-euro area investors were net sellers.

Other policy measures at euro area and national level also contributed to a transitory improvement in confidence. Euro area Member States agreed on a second programme for Greece, established a "fiscal compact" ([20]) and made progress with euro area financial backstops. In addition, several Member States introduced bold fiscal consolidation and structural reform measures. The Spanish government adopted *(i)* a draft Budget Stability Law to strengthen fiscal rules, including in relation to regional governments; *(ii)* a labour market reform, comprising changes to employment protection legislation, collective bargaining and active labour market policies; and *(iii)* measures to increase specific and generic provisions for banks, requiring additional capital buffers of some EUR 50 billion.

Financial market tensions resurfaced in March 2012. As the short-term impact of the ECB's liquidity boost faded, attention shifted back to the increasing link between banks and sovereigns. Spanish and Italian government bond yields rose markedly from late March 2012, while German Bund yields declined amid safe-haven flows. European stocks dropped, led by banks, with Spanish and Italian indices underperforming. Issuance by euro area banks in both the covered and uncovered bond market declined significantly in April and May 2012. Spanish government bond auctions on 4 April and 19 April attracted only modest demand, mostly by domestic investors.

Graph 2.6a: **Bond yields of financial coporations**



Source: Bloomberg, Bank of America Merrill Lynch

Graph 2.6b: **Euro area banks and Spanish equity indices**

Source: Bloomberg

Rating agencies' actions reflected increasing linkages between sovereigns and banks. On 26 April 2012, S&P downgraded Spain by two notches to BBB+, citing expectations of a further deterioration of public finances as a result of the contracting economy and the potential need for additional bank support. In a direct reflection of the sovereign downgrade, S&P on 30 April 2012 lowered the credit rating of 16 Spanish banks.

The potential financing needs of the Spanish banking sector became one of the main sources of market concern throughout April and May 2012. Doubts were mounting about deep financial problems in Bankia, the fourth-largest bank which held 10% of total bank assets and had heavy exposure to property-related lending. On 25 April 2012, the IMF in its mission concluding statement of the FSAP review ([21]) suggested that a group of ten Spanish banks were vulnerable and would likely need further

([20]) The "fiscal compact" is an intergovernmental treaty signed by 25 EU Member States.
([21]) See https://www.imf.org/external/np/ms/2012/042512.htm.

public support. On 10 May 2012, the government announced the partial nationalisation of Bankia by converting the FROB's EUR 4.5 billion preference shares into voting shares. Following a review of the bank's balance sheet and the restatement of the 2011 results, the new management on 25 May 2012 requested a capital injection of EUR 19 billion (about 2% of Spain's GDP). ([22]) On the same day, S&P downgraded Bankia and four other Spanish banks to speculative grade.

A key issue for the government was determining the source of funds to recapitalise Bankia. The appeal for public support came at a time when the government was facing increasing difficulties to tap the market. Ten-year yields reached 6.5% at the end of May 2012, a 530 bps spread over German Bund yields and a 60-70 bps spread over Italy's long-term yield. Public and privately-funded backstops had been depleted. The 2012 deficit target and Spain's 2013 deadline for the correction of the excessive deficit appeared out of reach, which further weakened confidence. Meanwhile, the collapse of Bankia had eroded the credibility of the supervisor.

The publication of the IMF's FSAP review on 8 June 2012 opened the way towards the negotiations on the programme. Capital needs of the Spanish banking sector were estimated at some EUR 55 billion, although market estimates of bank recapitalisation needs were higher at an EUR 60-90 billion range (IMF 2012). On 9 June 2012, the Spanish authorities informed the Eurogroup about its intentions to formally request financial assistance for the recapitalisation of financial institutions. The Eurogroup issued a statement that it would respond favourably to such a request, approving an envelope of financial assistance of up to EUR 100 billion.

([22]) See for instance: Financial Times, The bank that broke Spain, 21 June 2012, http://www.ft.com/intl/cms/s/0/d8411cf6-bb89-11e1-90e4-00144feabdc0.html?siteedition=intl#axzz3fx4MzIH3.

3. PROGRAMME STRATEGY AND DESIGN

3.1. MAIN FEATURES OF THE PROGRAMME

On 25 June 2012, the Spanish government requested financial assistance under the terms of Financial Assistance for the Recapitalisation of Financial Institutions by the EFSF. Following an assessment of Spain's eligibility for such financial assistance by the Commission, the Eurogroup concluded on 27 June 2012 that financial assistance to Spain was warranted to safeguard financial stability in the euro area. On 29 June 2012, euro area Heads of State and Government specified that the assistance would be taken over by the ESM once it was fully operational, without the ESM gaining seniority status compared to other creditors of the Spanish sovereign. ([23]) The financial assistance programme was approved by the Eurogroup on 23 July 2012, along with programme conditionality as set out in the Memorandum of Understanding on Financial Sector Policy Conditionality.

The main objective of the programme was to increase the long-term resilience of the Spanish banking sector. Given the nature of the financial support, the objectives were sector-specific, based on three pillars:

- Remove doubts about the quality of the banks' balance sheets, allowing them to carry out their financial intermediation function;
- Facilitate an orderly downsizing of bank exposures to the real estate sector, restore market-based funding and reduce bank's reliance on central bank liquidity support;
- Enhance risk identification and crisis management mechanisms pertaining to the Spanish banking sector so as to reduce the occurrence and severity of future financial crises.

The Eurogroup approved an envelope of financial assistance of up to EUR 100 billion, corresponding to about 10% of Spain's GDP. Financing by the EFSF/ESM would be channelled through the FROB to the financial institutions concerned. The Spanish government remained fully liable for the repayment of the loan. ([24]) The financial envelope was intended to cover capital requirements to be estimated by a diagnostic exercise which the Spanish authorities had commissioned to external evaluators and international auditors, with an additional safety margin. Following approval of banks' recapitalisation and restructuring plans by the Commission, the funds were to be disbursed in several tranches ahead of the planned recapitalisation dates. In order to provide a readily available backstop in the event of an emergency, the MoU allowed for the use of the first EUR 30 billion tranche ahead of the adoption of restructuring decisions by the Commission, subject to approval by the Commission and the Euro Working Group. The duration of the programme was 18 months, with conditionality heavily frontloaded.

To this aim, the MoU required the completion of a comprehensive asset quality review and bank-by-bank stress-test by the second half of September. This should be done under the guidance of a committee comprising the Spanish authorities, the Commission, the ECB, the EBA and the IMF. Following the exercise, banks were to be classified into groups according to their ability to cover the diagnosed capital shortfalls. Banks in need of support had to present recapitalisation and restructuring plans. In order to limit public capital injections, programme conditionality requested loss-sharing by shareholders and hybrid capital and subordinated debt holders. The real estate portfolio and foreclosed

([23]) According to the ESM Treaty, signed by euro area Member States on 2 February 2012 and entering into force on 27 September 2012, ESM loans will enjoy preferred creditor status, except if ESM loans follow a European financial assistance programme existing at the time of the signature of the ESM Treaty, see http://www.consilium.europa.eu/en/workarea/downloadAsset.aspx?id=27068.

([24]) According to the euro area summit statement of 29 June 2012, direct recapitalisation of banks by the ESM could be possible under certain conditions once an effective single supervisory mechanism was established, see https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf.

assets of state-aided banks had to be transferred to an external asset management company (see Chapter 4 for further details).

The MoU required a further strengthening of the operational independence of the Bank of Spain and its supervisory procedures. This built on IMF recommendations in the context of its Financial Sector Assessment Programme update for Spain of June 2012. The sanctioning and licensing powers of the Ministry of Economy were to be transferred to the BdE by 31 December 2012. The supervisory procedures of the BdE were to be further enhanced, for which the BdE was to conduct a review of its procedures by the end of October 2012. The aim was to ensure that the findings of on-site inspections translated effectively and without delay into remedial actions. The authorities committed to analyse the need for improvements in the communication of vulnerabilities and risks in the system to the decision making bodies, so as to adopt corrective actions. In addition, the MoU mandated an upgrade of the bank resolution framework.

The MoU also required the completion of the reform of the savings banks. The role of the savings banks in their capacity as shareholders of credit institutions had to be clarified and the stakes of the former *cajas* in the banks were to be reduced to non-controlling levels. Fit and proper rules had to be further strengthened, and incompatibility requirements had to be introduced regarding the governing bodies of the *cajas* and the commercial banks that they controlled.

The MoU required Spain to strengthen consumer protection and securities legislation aimed at limiting the sale of subordinate debt instruments to non-qualified retail clients and increasing the transparency on the characteristics and risks of such securities.

In parallel to the financial sector conditionality spelled out in MoU, Spain committed to comply fully with its obligations under the Excessive Deficit Procedure and the European Semester. This implied in particular a commitment by Spain to correct the excessive deficit situation by 2014 and to implement provisions regarding transparency and control of budget execution. The authorities also committed to implement structural reforms aimed at correcting macroeconomic imbalances as identified in the Commission's in-depth review. These included changes to the tax system with a view to supporting sustainable growth, labour market reforms and measures to improve the business environment.

The Commission, in liaison with the European Central Bank and the European Banking Authority, was responsible for monitoring compliance with programme conditionality during quarterly review missions. In addition, the institutions were granted the right to conduct on-site inspections in the beneficiary financial institutions. Quarterly review missions also covered progress in meeting the obligations under the EDP and the European Semester recommendations.

Unlike in other euro-area financial assistance programmes, the IMF was not party to the programme, but served as an independent adviser to Spain and the EU institutions, in the form of technical assistance under Article V, Section 2(b), of the IMF's Articles of Agreement. The modalities of IMF support were defined in the Terms of Reference for Fund Staff Monitoring in the Context of European Financial Assistance for Bank Recapitalisation.

3.2. THE EXTERNAL CONTEXT OF THE PROGRAMME

In the summer of 2012, concerns about the political and financial viability of the euro area intensified. The irreversibility of the common currency was being called into question and risk premia in distressed euro area countries reached new highs. Policy makers took decisive action on various fronts to tackle the problems that threatened the existence of the monetary union. The financial assistance to Spain for the recapitalisation of the banking sector was part of a broader package of measures, thus its design and impact have to be assessed within a broader context.

On 29 June 2012, the euro area summit took important decisions aimed at breaking the vicious bank-sovereign circle and deepening EMU. In particular, applying the lessons from bank failures in the euro area, it tasked the Commission and the Council to start negotiations on the single supervisory mechanism (SSM). The Summit also clarified that the ESM loan to Spain for the purpose of bank recapitalisation would not gain seniority status with regard to other creditors.

The European Central Bank also acted decisively. On 5 July 2012, the ECB cut its key policy rates, with the main refinancing operations rate being lowered by 25 bps to 0.75%, amid dampening inflationary pressure over the policy-relevant horizon and a materialisation of previously identified downside risks to the euro area growth outlook. However, fragmented money and bond markets had already seriously impaired the transmission of lower official interest rates to the real economy. On 2 August 2012, a new bond purchase scheme was announced, the details of which were communicated on 6 September 2012. The ECB's Outright Monetary Transactions (OMT) scheme was designed to allow for purchases of government bonds of distressed euro area countries on the secondary market, subject to the respect of strict and effective conditionality attached to an EFSF/ESM programme.

Box 3.1: The OMT scheme and financial conditions in Spain and the euro area

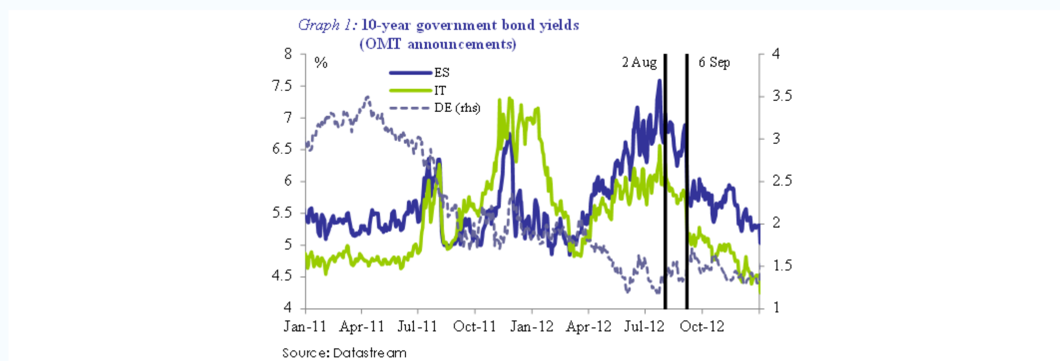
The agreement on a programme to finance the recapitalisation of banks did not lead to an immediate alleviation of tensions on Spain's sovereign debt market. Throughout the summer of 2012, Spanish government bond yields remained high and volatile. In late July 2012, Spanish yields reached a new euro-era high at above 7.5%, fuelling speculation about the need for a fully-fledged financial assistance programme. Italian sovereign yields also drifted higher, to above 6.5%, but remained below the peaks seen at the end of 2011. Meanwhile, German Bund yields reached new record lows amid safe-haven flows.

At the beginning of August 2012, following the announcement by the ECB of a new bond purchase scheme, yield spreads declined, particularly among the shortest maturities. However, pressure on Spanish sovereign yields intensified again at the end of August/beginning of September 2012, amid news about significant financing needs for several autonomous regions and uncertainty about the capital gap of Bankia. Yields rose to close to 7%, while Italy's ten-year yield reached 5.9% (see Graph below).

A major change in trend, as well as the largest single drop in the yields of Italy and Spain, occurred on 6 September, after the announcements of the details of the OMT scheme. In contrast to the earlier securities market programme (SMP), the ECB clarified that bond purchases would be *'pari passu'* with private bondholders in case of default and without ex ante quantitative limits, conditional on an EFSF/ESM programme. According to some analysts, the change in the seniority stance of the ECB marked a departure from the ECB's earlier position and was the single most important factor behind the success of the OMT compared to the earlier SMP (Steinkamp and Westermann, 2014).

The success of the OMT, which was never activated, in reducing bond yields of distressed countries has been well documented. Using an event study methodology, Briciu and Lisi (2015) found that among several balance sheet policies conducted by the ECB during 2008-2015, the OMT had by far the largest immediate impact on sovereign risk spreads in the euro area. Altavilla et al (2014) found that over a five-day window, the OMT announcements had the strongest impact on Spanish sovereign yields, reducing rates by 130 bps in the 10-year segment and by 280 bps in the two-year segment. In the case of Italy, yields fell by 90 bps and 170 bps, respectively. A 30 bps increase in Germany's 10-year yield further contributed to the narrowing of long-term spreads in the euro area. Over a 5-month window (August to December 2012), countries under financial assistance programmes seem to have benefitted the most (ECB, 2013).

Graph 1: **10-year government bond yields (OMT announcements)**



Source: Datastream

The analysis suggests that the OMT scheme was an essential complementary factor to the financial assistance programme for recapitalising Spain's banks. By removing tail risks about the irreversibility of the euro, it facilitated continued access to market financing for the Spanish sovereign, while it also contributed to a gradual easing of funding conditions for banks. Together with the agreement on Banking Union, it weakened the dangerous bank-sovereign feedback loop that threatened to destabilise the euro area.

3.3. ASSESSMENT OF PROGRAMME STRATEGY AND DESIGN

3.3.1. A new type of financial assistance programme in the euro area

The Programme differed from the earlier approach to financial assistance in the euro area. By helping Spain stem the cost of financial sector repair, the programme targeted one of the triggers of potential threats to sovereign financing. It aimed to address the legacy costs of the real estate boom and bust and weaken the sovereign-bank feedback loop through an overhaul of the financial sector.

The programme was the outcome of a negotiation process between Spain, euro area Member States, the European Commission and the ECB. The adequacy of the programme strategy is assessed along the following lines: *(i)* eligibility for financial assistance for the recapitalisation of financial institutions by the EFSF; *(ii)* Spain's role in the euro area sovereign debt crisis; and *(iii)* resources and limitations of euro area financial backstops.

Eligibility criteria

Focused conditionality was in line with political deliberations and the guidelines of the EFSF. In July 2011, euro area Heads of State and Government agreed to finance recapitalisation of financial institutions through loans to governments, including in non-programme countries. ([25]) The EFSF Guidelines ([26]) further specified that more focused intervention and conditionality would be required "when the origin of financial distress is strongly anchored in the financial sector and not directly fiscal or structural". The aim was to preserve financial stability in the euro area as a whole and limit contagion of financial stress by ensuring the capacity of governments to finance recapitalisation at sustainable borrowing costs. The Guidelines further specified that support should be provided "against appropriate conditionality, i.e. not necessarily in the context of a macro-economic adjustment programme, but under another more focused form of conditionality."

The granting of the loan was preceded by an assessment of the eligibility conditions. Following the request by the Spanish authorities, the Commission, in liaison with the ECB, the EBA and the IMF, reviewed the situation in the light of the criteria spelled out in the EFSF Guidelines. ([27]) It was concluded that Spain fulfilled the conditions: *First,* recapitalisation and restructuring of parts of the Spanish banking sector was urgent to avoid a serious systemic impact on other parts of the Spanish financial sector and other euro area Member States. *Second,* Spain had followed the requested hierarchy of actions, i.e. the private sector had contributed to the resolution of the crisis (notably through the deposit guarantee fund), while the sovereign was found to be no longer in a position to address the problem on its own. ([28]) *Third,* the impact on Spain's debt sustainability was judged as manageable, allowing Spain to repay the loan.

In the Spanish banking sector, weak asset quality was a rather localised problem, affecting some 30% of the system. Nevertheless, factors related to the banks' home country were starting to dominate the credit characteristics of individual banks. The increase in funding costs had started to affect the entire sector, including large and internationally active banks with sound asset quality and solvency levels. Several experts interviewed by the evaluators during the stakeholder consultation process considered that, without the sharp increase in funding costs, Spain could have resolved the crisis on its own without resort to financial assistance. However, the increase in funding costs was also related to a loss of confidence by

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([25]) See Council of the European Union, Statement by the Heads of State or Government of the Euro Area and EU Institutions, Brussels, 21 July 2011; https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/123978.pdf

([26]) EFSF Guideline on Recapitalisation of Financial Institutions via loans to non-programme countries http://www.efsf.europa.eu/attachments/efsf_guideline_on_recapitalisation_of_financial_institutions.pdf

([27]) Assessment of Spain's eligibility for an EFSF/ESM loan to recapitalize certain financial institutions, 26 June 2012. Joint report provided by the Commission, in liaison with the ECB, EBA and IMF.

([28]) Specifically, it was found that the capacity of the FROB to act as a public backstop was facing constraints given increasing costs of issuing new debt and also the sovereign started to face serious challenges in issuing debt at sustainable costs.

investors in domestic-only crisis management. In this regard, external financial assistance with specific conditionality tailored to increase the resilience of the Spanish financial sector was helpful to overcome the lack of investor confidence.

The size of the programme measured as a share of GDP (less than 5% in actual disbursements) was the smallest by far among all euro area countries requiring external assistance. In normal times, raising the amount in the market should not have posed problems for the Spanish government. However, the country was unable to overcome negative sovereign-bank feedback effects on its own, underlining the relevance of external assistance and the value added of an intervention by the euro area.

With the benefit of hindsight, the choice of a banking sector programme was appropriate given the overall state of the Spanish economy and the limited amount of assistance finally required. However, there was no certainty in mid-2012 that the relatively small programme envelope for the recapitalisation of Spain's banks would suffice to safeguard the sovereign's continued access to capital markets. Empirical evidence suggests that the latter was facilitated by the ECB's OMT scheme (e.g. Altavilla et al., 2014; Beirne et al., 2014; Briciu and Lisi, 2015), rather than being the impact of the bank recapitalisation programme alone. Still, the swift resolution of the crisis in Spain after the ECB's OMT announcement suggests that some of the factors that generated financial stress had their origin in an incomplete set-up of the euro area and not only in Spain's macroeconomic fundamentals in the run-up to the programme. The strong increase in exports already ahead of the programme period underlines a certain degree of flexibility of the economy and its adjustment capacity in response to a change in economic conditions. The current account balance adjusted once the credit flow ceased, from a deficit of 9.6% of GDP in 2007 to a deficit of 0.4% of GDP in 2012, to which both an increase in exports and a fall in imports contributed. In addition, unit labour cost (ULC) developments in the tradable sector were substantially more favourable than in the non-tradable sector, suggesting that relative price changes distorted the allocation of resources during the boom period. Finally, public debt prior to the onset of the crisis was very low, below 40% of GDP, and it was still below the euro area average in late-2011. Still, in addition to measures directed at the financial sector, Spain needed a broader strategy to tackle macroeconomic sustainability issues given the country's large macroeconomic imbalances at the outset of the programme, which were being addressed by the European Semester/MIP recommendations.

Spain's role in the euro area sovereign debt crisis

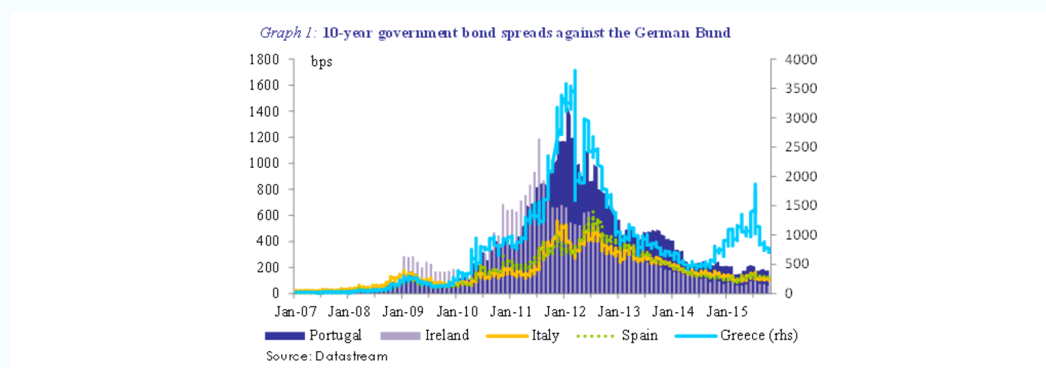
The systemic nature of Spain's crisis justified external intervention. The literature on contagion effects during the sovereign debt crisis suggests that Spain was at the centre of turmoil as the sovereign debt crisis deepened. Claeys and Vasicek (2013) found that from April 2010 (when Greece requested financial assistance), the Spanish stock market became the most systemic in the EU, sending and receiving shock waves to and from all other countries. Spillovers intensified during the second half of 2011. Outward spillovers seem to have been more intense than inward spillovers, which the authors explain by the strong outward integration of the largest Spanish banks, Banco Santander and BBVA, whereas foreign banks were minor players in the Spanish market. ([29]) Alter and Beyer (2014) analysed the impact of a shock in Spanish sovereign and bank CDS on other sovereign CDS spreads. They found evidence of spillovers from Spain to other countries. Spillovers strengthened during mid-2011 and mid-2012, and started to affect both core and non-core countries in broadly similar terms. The takeover of Bankia by the Spanish government in May 2012 was identified as major event that reinforced spillovers from Spain.

([29]) Foreign banks represented some 7% of the system's assets in 2009, whereas the foreign assets of Spanish banks accounted for some 24% of their total consolidated assets (FSB, 2011).

Box 3.2: Spill-over effects in euro area financial markets

Following the introduction of the euro, Member States' financial systems became increasingly interconnected. With exchange rate risk eliminated and against the background of low risk aversion, long-term bond yields converged towards the levels of the most creditworthy Member States, despite large differences in fiscal and external positions. At the end of 2007, the average spread of long-term yields with respect to German Bund yields stood at below 20 bps. The convergence of sovereign bond yields, by establishing the benchmark rate for the safest assets, also led to a convergence of lending rates for households, banks and non-financial corporations. The result was a highly integrated financial market, with cross-holdings of assets and liabilities within the currency union.

Graph 1: **10-year government bond spreads against the German Bund**



Source: Datastream

The financial turmoil triggered by the Lehman Brothers bankruptcy initiated a re-emergence of sovereign risk spreads. Spreads started to increase somewhat from September 2008, reflecting global uncertainty and flight to safety, but remained below 100 bps on average. From late 2009, stress intensified on Greek sovereign debt markets, after Prime Minister George Papandreou revealed the country's severe fiscal problems. Spreads on Greek long-term yields reached around 250 bps by the end of 2009 and exceeded 500 bps in April 2010. Meanwhile, spreads in other vulnerable euro area countries remained below 150 bps.

During the spring 2010, the long-held belief that advanced economies would always have access to capital markets was being called into question. Investors started to discriminate among sovereigns according to macroeconomic fundamentals. From April/May 2010, spreads increased in countries with worse fiscal records and stronger external imbalances, i.e. Ireland and Portugal, and to some extent, Spain and Italy. Several authors (De Santis, 2014; Giordano et al., 2013; Beirne and Fratzscher, 2013) found that the rise in spreads was due to investors' higher sensitivity towards fundamentals ("wake-up call contagion") rather than an actual increase in risk. Others (e.g. Arghyrou and Kontonikas, 2012; Clays and Vasicek, 2014) attributed the increase in spreads to the euro area response to the Greek debt crisis and the transfer of sovereign risk across Member States.

From late 2010, concerns about loss sharing by the private sector and the seniority status of official creditors added to perceptions of sovereign risk. ([1]) Assertions of the sustainability of Greek public debt were gradually losing credibility and restructuring was considered a possibility (Mody, 2013). Financial assistance by Member States, through its impact on average funding costs, tends to make a country's debt burden more sustainable, but at the same time there is a risk that losses, if any, would hit the private sector

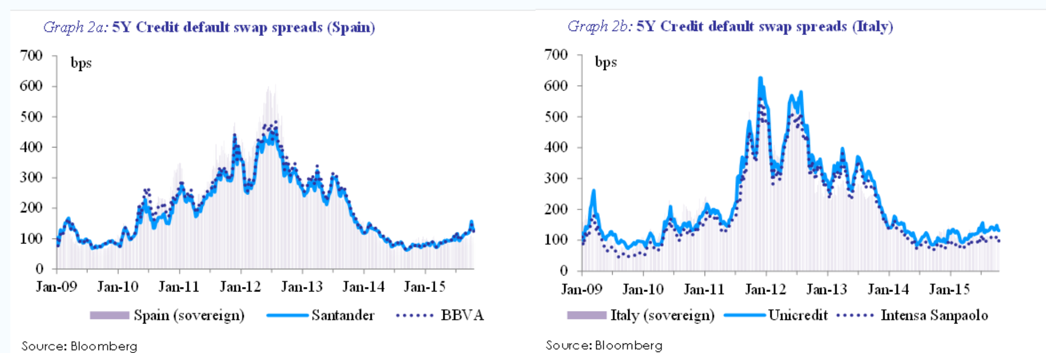
([1]) Some stakeholders were of the view that the October 2010 "Deauville agreement" between Chancellor Angela Merkel and President Nicolas Sarkozy was at least partially accountable for the intensification of sovereign funding stress from late 2010. The two leaders reportedly agreed that future financial assistance by the ESM might require losses to be imposed on private creditors (see Mody, 2013). Mody challenges this view, arguing that the "Deauville agreement" was not novel and spreads moved in the normal range established by the variability prior to Deauville.

(Continued on the next page)

Box (continued)

disproportionately. With restructuring on the table, seniority concerns might have accelerated the rise in the perceived riskiness of investment in vulnerable sovereigns.

The summer of 2011 saw an intensification of the euro area sovereign debt crisis and the emergence of a strong link between banks and sovereigns. Several authors attributed the increase in financial market tensions to contagion effects from Greece (De Santis, 2014; Giordano et al., 2013). The announcement of a second financial assistance programme on 22 July 2011 included a (voluntary) haircut on private bond holders, exposing the risk that sovereigns might be unable to honour their liabilities and private creditors could be forced to take losses.



During late-2011 and early 2012, a re-nationalisation of sovereign risk took place, increasing the fragmentation of financial markets. Euro area banks, which at the same time were facing increasingly demanding regulatory requirements, divested from vulnerable sovereigns. Yield spreads of Italy and Spain reached about 500 bps in November 2011, before coming down temporarily amid the provision of two 3-year LTROs by the ECB. The extra liquidity was partly used by banks in vulnerable countries to buy bonds of their own sovereign. ([2]) As a result, the cost of bank failure and the cost of sovereign default became increasingly intertwined.

The analysis suggests that sovereign risk spreads in euro area countries during the crisis were to a significant extent determined by factors outside national control. Several authors have quantified the importance of spill-overs effects. Claeys and Vasicek (2012), using a global vector autoregressive (GVAR) framework, found that about two thirds of the variation in sovereign bond spreads among EU countries during 2008-2011 could be explained by shocks to bond markets in other countries, while one third of the variation was caused by domestic factors. Their analysis suggests that spill-overs were stronger within the euro area compared to non-euro area countries and had strengthened as the sovereign debt crisis deepened. Vulnerable countries had been affected more than core countries. IMF analysis, decomposing risk premium developments for ten euro area Member States, suggests that common factors dominated spread dynamics during 2010-2012, while the contribution of country-specific factors was overall rather modest (IMF, 2012). However, the analysis found that in the case of Spain, the solvency of the financial system became an important domestic driver of spread developments from late-2011.

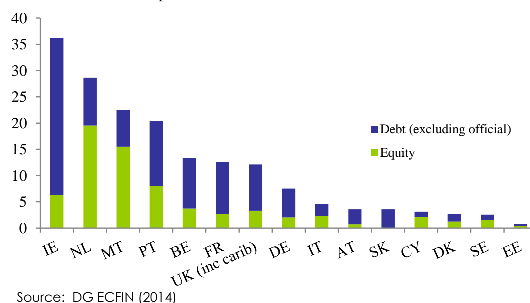
([2]) Quasi-automatic links between sovereign and bank credit ratings, together with higher returns on bonds issued by some distressed sovereigns, partly explain the "home country bias" of banks in vulnerable euro area Member States during the crisis (see Angelini and Grande, 2014).

The IMF also highlighted strong outward spillovers from Spain through financial markets, driven by strong sovereign-bank linkages and sizeable exposures through asset and liability cross-holdings. The IMF found that core euro area banks that were more exposed to the Spanish (and Italian) sovereign experienced stronger declines in stock prices and a higher increase CDS spreads when Spanish (and Italian) sovereign bond yields rose (IMF, 2012). In addition, there was a strong co-movement of Spanish and Italian yields, suggesting that shocks to one of the countries could quickly spill-over to the other.

The systemic nature of Spain may be explained by the size of its economy and banking sector, combined with deep financial linkages with the euro area. Spain is the fourth-largest euro area economy and its banking sector, the third-largest, accounts for some 14% of euro area banks' total assets (10% of EU banks' assets). Hobza and Zeugner (2014) found that in the years preceding the crisis, the most important bilateral financial relationship in the euro area was between Germany and Spain, with German banks financing or intermediating a large share of Spain's external funding needs. As German banks reduced their exposure to Spain from 2009 onwards, French banks stepped in, but pressure on them heightened in 2011 due to their strong exposure to sovereign debt of stressed euro area countries, in particular Italian, Spanish, Greek and Portuguese bonds. When French banks started to dispose some of their sovereign bond holdings, funding gaps arose.

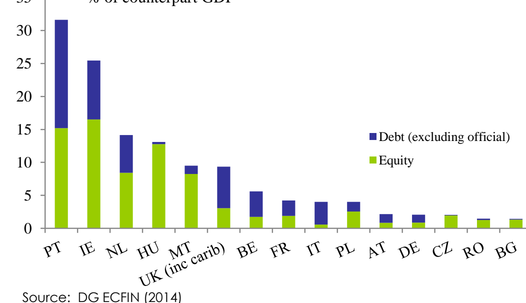
Strong financial outwards spillovers are consistent with Spain's role as a major debtor to other euro area Member States. The charts below illustrate cross-holdings of assets and liabilities between Spain and its EU partners, expressed as a percentage of the partner country's GDP. It shows that small countries such as Ireland and Portugal, but also medium-sized countries such as the Netherlands held Spanish debt and equity liabilities equivalent to more than 20-35% of their respective GDP. Holdings were also sizeable for France, UK and Belgium, exceeding 10% of their GDP. The role of Spain in the funding of EU partners was somewhat smaller, accounting for 25-30% of the foreign financing of Portugal and Ireland, and less than 15% in the case of the Netherlands. Among the large countries, the UK received significant funding from Spain, amounting to some 10% of its GDP. Interestingly, two-way interconnections seem to have been strongest with Ireland and Portugal, suggesting rather intensive transmission of stress among the three countries.

Graph 3.1a: **EU Partner's exposure to Spain's liabilities in 2012 (gross ES foreign liabilities, top 15 EU countries, excl LU)**



Source: DG ECFIN (2014)

Graph 3.1b: **Spain's funding of EU partners in 2012 (gross ES foreign assets, top 15 EU countries, excl LU)**



Source: DG ECFIN (2014)

Given the strong interconnectedness of Spain and the dire financial situation in some euro area Member States in mid-2012, resolving the Spanish crisis was considered essential to stabilise the euro area as a whole. The Spanish banking system had been both a source and an amplifier of shocks, which subsequently spread to other euro area Member States. There was a risk that sovereign-bank linkages would start affecting the whole of the Spanish banking sector, including the largest banks with large operations across the euro area and the EU, potentially intensifying stress in the euro area.

Euro area financial backstops

While cross-border balance sheet exposures of the private sector overall decreased during the crisis, interconnections via euro area financial assistance facilities increased. Where private funding to sovereigns was no longer available, euro area Member States stepped in, providing loans through the EFSF, which transferred recipient countries' sovereign risk onto other Member States' public balance sheets. Following agreements to grant financial assistance to Greece, Ireland and Portugal, and a series of rating downgrades of euro area sovereigns, it was becoming increasingly clear that the EFSF's structure

and resources might be insufficient to stem the cost of assistance to a large euro area sovereign. According to several observers, the threat that Spain would be forced to ask for a fully-fledged financial programme was one of the most serious dangers to the euro area at the time (Delbecque, 2012; Gros, 2011; De la Dehesa, 2011). Several features may have added to concerns:

***First,* the lending capacity of euro area financial backstops was limited.** Full financing of Spain's public debt roll-over needs, budget deficit and bank recapitalisation could have exhausted the remaining lending capacity of the EFSF in mid-2012 (under the assumption of a loss of market access, see Box 3.3). Many media reports published in mid-2012 showed that investors were concerned that a fully-fledged programme might have required some EUR 300 billion. ([30]) They saw the surge in Italian two-year bond yields that followed the worsening of the crisis in Spain in the second half of July as a sign that Italy could be the next country to ask for a programme, which would have fully depleted the euro area financial backstops. Many investors considered that it would be difficult to maintain debt sustainability with 10-year sovereign bond yields in Italy and Spain which were at the time above 6% and 7%, respectively, in view of the high public deficit and debt levels of both Member States. After the granting of programmes to Greece, Ireland and Portugal, the EFSF's remaining lending capacity was about EUR 248 billion out of a total of EUR 440 billion. The ESM, whose coming into force was being accelerated but still required ratification by a number of Member States, had a maximum lending capacity of EUR 500 billion.

***Second,* Spain was among the largest guarantors of EFSF bond issuances, contributing 12.8%.** ([31]) Art. 2(7) of the EFSF framework agreement stipulated that euro area Member States benefitting from EFSF financial assistance could request their suspension from guaranteeing future bond issuances. Suspension of Spain as a guarantor would have put a significant extra burden on the remaining guarantors, undermining the credibility of the backstop. A request for financial assistance for bank recapitalisation did not entail the possibility of stepping out from EFSF bond guarantees. ([32])

***Third,* due to the guarantee structure, even a package that was small in terms of Spain's GDP would have had a non-negligible impact on other Member States' debt ratios.** ([33]) The EUR 100 billion package, if funded by the EFSF, would have added at least 1-1.2 percentage points to each Member States' debt-to-GDP ratio. The total cost of financing Spain's public deficit and debt roll-over needs, in addition to bank recapitalisation, as estimated in mid-2012, could have added at least 5 percentage points to other Member States' debt ratios (assuming sufficient EFSF financing capacity). Given that public debt in the euro area was approaching 90% of GDP on average, a large-scale EFSF programme for Spain carried some risks for a weakening of market confidence in certain countries. The latter might have further undermined the credit ratings of individual Member States and the EFSF.

The ESM was expected to address some of these problems by disconnecting ESM liabilities from Member States' public finances, as its direct recapitalisation instrument could allow it to take a direct stake in a euro area financial institution if considered systemic and viable. This would contribute to cutting the link between sovereigns and banks. However, as long as the ESM was not yet operational (i.e. until October 2012), the risk of contagion from a potential loss of market access by Spain appeared extremely high, while at the same time there would not have been sufficient funds to credibly backstop another large Member State.

([30]) See for instance Financial Times: "Some unpleasant Eurozone arithmetic", 22 June 2012; Bloomberg: "Europe's brutal game of dominoes", 26 July 2012; Reuters: "Spain discussed 300 billion euro bailout with Germany", 27 July 2012.

([31]) The creditworthiness of the EFSF is ensured by pro-rata guarantees of euro area Member States. To ensure the highest possible rating, an "over-guarantee" was put in place. Member States are liable for 165% for their share in the EFSF's bond issuances.

([32]) See EFSF Framework Agreements, http://www.efsf.europa.eu/attachments/20111019_efsf_framework_agreement_en.pdf and EFSF, Frequently Asked Questions, http://efsf.europa.eu/attachments/2015-03-19%20EFSF%20FAQ.pdf.

([33]) EFSF programmes affected euro area Member States' public debt-to-GDP ratios according to their share in the paid-up capital of the ECB, adjusted for the shares of guarantors whose commitments had been suspended.

Box 3.3: **Market access under financial assistance programmes**

Conventional financial assistance programmes are typically implemented after the beneficiary country has lost market access, thus requiring full financing of the public deficit and debt roll-over needs. One of the arguments for granting a programme for bank recapitalisation to Spain was that a fully-fledged programme would test the limits of the EU firewalls available at the time, thus it was imperative that Spain kept access to capital markets. This raises the question whether programmes necessarily require full financing of the deficit and debt roll-over needs, or whether Member States could in principle maintain access to capital markets while being partially supported by official means. The question is mainly theoretical, as programme conditionality tends to be intrusive and political resistance in beneficiary countries may only be overcome *after* market access has been lost. However, lessons could be drawn for future programme design, in particular with regard to the so-far untested EFSF/ESM Instruments (Primary Market Purchases, Precautionary Programmes), which attempt to support the beneficiary Member State's access to market financing rather than replace it.

Financial assistance needs to improve investors' expected returns. Sovereign bond holders' main interest is to maximise returns on assets which are considered "low-risk". A request for financial assistance by a sovereign may imply some trade-offs for creditors: On the one hand, it reduces default risk by lowering financing costs for a given amount of debt, thus increasing expected returns. On the other hand, it may imply the presence of a senior creditor in the event of debt restructuring, which could decrease expected returns.

Creditor seniority matters. The presence of a senior creditor implies that in the case of default, non-senior lenders might have to bear a disproportionate share of the losses. The higher the share of senior creditors, the lower the expected recovery value for non-senior creditors at a given default probability (see Gros, 2010). Creditor seniority is rarely made explicit. When default becomes a possibility, the presence of an actual or perceived senior creditor could generate a sudden adjustment of credit risk faced by private bond holders, thus requiring higher interest rates. Empirical research has found a close relationship between the senior tranche share of public debt and the yield spreads of distressed euro area countries (Westermann and Steinkamp, 2014). According to Gros (2010), large financial assistance packages could be a signal that losses, if they occur, would be concentrated on long-term private creditors, pushing up market rates.

The seniority status of euro area official lending has evolved over time. Funding by the EFSF did not in principle enjoy preferred creditor status. ([1]) Also bilateral loans to Greece in early 2010 were non-senior. On the other hand, the restructuring of Greece's public debt in 2012 via voluntary private sector involvement exempted the EFSF, Member States and the ECB from taking losses. The ESM Treaty explicitly grants ESM loans seniority status, junior only to IMF funding.

Rating agencies reacted to subordination concerns. Steinkamp and Westermann (2014) analysed rating decisions by S&P and Moody's during 2011-2012. They found that in the cases of Greece, Ireland, Portugal and Cyprus, sovereign rating downgrades were explicitly motivated by concerns about subordination of private bond holders to (prospective) EFSF/ESM loans. For example, S&P on 29 March 2011 downgraded Greece and Portugal, arguing that the subordination of private bond holders to (future) ESM loans was detrimental to commercial creditors of sovereigns borrowing from the ESM. ([2]) Moody's on 27 February 2012 stated that the ECB's bond swap prior to the private sector involvement in Greece was a credit negative

([1]) See EFSF, FAQ A10, http://www.efsf.europa.eu/attachments/faq_en.pdf: "Unlike the IMF, the EFSF will have the same standing as any other sovereign claim on the country (pari passu). Private investors would be reluctant to provide loans to the country concerned if there were too many preferred creditors."

([2]) See http://www.standardandpoors.com/en_AP/web/guest/article/-/view/sourceId/6566242: "The concluding statement of the European Council meeting of March 24-25, 2011, addressing the terms under which EU sovereigns may borrow from the European Stability Mechanism (ESM) confirms our previously published expectations that (i) sovereign debt restructuring is a potential pre-condition to borrowing from the ESM, and (ii) senior unsecured government debt will be subordinated to ESM loans. Both features are, in our view, detrimental to the commercial creditors of EU sovereign ESM borrowers and represent a major departure from the decision to make European Financial Stability Facility (EFSF) issuance pari passu with commercial debt."

(Continued on the next page)

Box (continued)

factor for sovereign ratings. ([3]) By contrast, in the case of Spain, Moody's on 26 June 2012 considered the seniority of EFSF/ESM loans to be less of a negative factor, due to its sector-specific nature and the small size of the loan. ([4])

Yield developments in Greece, Ireland and Portugal during 2010-2012 suggest that a request for financial assistance may not support market access in the short run. In all three countries, long-term bond yields continued to trend upwards for some time after the start of the programme and stayed at very high levels for at least 9 months (significantly longer for Greece and Portugal). This suggests that it may take some time to convince the markets that financial assistance contributes to an increase rather than a decrease in the recovery value of privately-held bonds. Whereas IMF financial assistance had a long history of improving recovery values, experience with EFSF funding had been untested.

Even if debt restructuring is unlikely to happen or official lending is provided on a *pari passu* basis in the context of a financial assistance programme, there remain risks to market access. In a fragile environment, a small piece of bad news, or changes to the seniority status of official lending, can cause a drastic re-evaluation of sovereign risk. Also, an announcement of financial assistance could act as a "wake-up call". The stigma attached to requesting financial assistance and the attached conditionality is usually so big that when it happens, it could be seen as an indication that the situation is worse than perceived, intensifying tensions. Early action, quick decision-making and clear communication appear key for the successful implementation of programmes which attempt to keep the beneficiary country's access to the market.

Spain's bank recapitalisation programme fulfilled the conditions which allow for continued access by the sovereign to the capital markets. *First,* public debt was below the average in the euro area and judged as sustainable. *Second,* the financial envelope was limited to some 10% of Spain's GDP and 14% of outstanding public debt. *Third,* the ESM explicitly renounced its seniority status for the bank recapitalisation programme, lending on a *pari passu* basis. *Fourth*, there was a commitment by the Spanish authorities to frontload most of the programme's measures which quickly removed possible doubts about policy credibility. Nonetheless, it had taken the market a couple of months, which saw a series of additional policy measures, until Spanish long-term yields embarked on a downward trend.

While a downgrade to the seniority status of official lending may be effective in lowering market interest rates for the beneficiary country, it also implies that official lenders assume a (higher) share of the default risk. From the creditor point of view, there is thus a trade-off between accepting higher credit risk and supporting the funding conditions of the recipient Member State, which in turn may increase the prospects of programme success.

([3]) See Moody's, "Greek Bond Pact Confirms Seniority of Eurosystem's Sovereign Debt Holdings", 27 February 2012.
([4]) See Moody's, "Key Drivers of 13 June Decision to Downgrade the Kingdom of Spain's Rating to Baa3 and Review for Further Possible Downgrades", 26 June 2012.

The limitations of the euro area's financial backstops available and operational in mid-2012 seem to have played a strong role in the choice of EFSF instrument and type of programme, militating in favour of a swift, focused intervention. Euro area partners felt that Spain's banking sector problems had to be tackled urgently to avoid an intensification of the sovereign debt crisis, which could have triggered a loss of market access of Spain and potentially another large Member State. The potential threat to the credibility of the EFSF as a backstop could provide an explanation for the systemic importance of Spain's bond market during the crisis.

3.3.2. Adequacy of conditionality

Conditionality was based on a sound assessment of the problems facing the Spanish banking sector. It benefitted from an assessment of the financial sector by the IMF carried out in May 2012 (IMF FSAP, 2012). The MoU partly built on measures which the authorities had already undertaken before the start of

the programme, thus supporting ownership. In several areas, financial sector conditionality improved upon weaknesses detected in earlier programmes, e.g. the design of an asset management company. Nevertheless, given the repercussions of the choice of an AMC to deal with impaired assets, the evaluators found that official programme-related documents could have benefited from some more clarity about the justification of the choice (see below). The evaluators also found it difficult to assess upfront the scope of the MoU's requirement to carry out subordinated liability exercises with regard to the type and amount of liabilities to be subject to haircuts (see Chapter 4).

The commitment to comply with the European Semester process in the MoU reflected a compromise between Spain and its creditors. While the Spanish government had a preference for a financial sector-only programme that clearly distinguished itself from other euro area financial assistance programmes, some creditors would have preferred more extensive conditionality including macroeconomic-specific conditions. The latter was considered by the Spanish authorities as being too intrusive and likely to be accompanied by a loss of market access by the sovereign. In their view, remaining part of the European Semester process would convey a sense of normality, while progress with regard to fiscal consolidation and structural reforms could still be reviewed more comprehensively than in other non-programme countries in parallel to programme monitoring missions ("enhanced surveillance"). Chapter 5 includes the evaluators' assessment of the programme's structure with regard to the link to the Excessive Deficit Procedure and European Semester/MIP.

The choice of an asset management company to deal with impaired assets

Several factors supported the decision to create an AMC as compared to other possible options to deal with impaired assets. *First,* there was a risk that banks would concentrate resources on problematic assets and would not restart lending as long as such assets dominated their bank balance sheets. An AMC would bundle expertise and generate economies of scale and thus be better able than individual banks to maximise the return from troubled assets. *Second,* there was a need to clear banks and the sovereign from contingencies which had affected confidence. This was embedded in the objectives of the programme, specifically the need to remove doubts about the quality of banks' balance sheets. *Third,* banks needed liquidity, and the government-guaranteed AMC bonds could be used as collateral in ECB liquidity operations. *Forth,* the FROB could better dispose of entities once bank balance sheets were transparent and clean, thus an AMC would facilitate divestment. *Fifth*, Spain's experience with asset protection schemes (APS) in the run up to the programme had not been very effective.

The creation of an AMC to deal with impaired assets seems to have been an efficient solution, though the evaluation team felt that the decision could have been better explained in programme documents. Creating an AMC to deal with impaired assets was one of the most crucial decisions of the programme, given its repercussions for both burden sharing and financial stability. A more substantiated explanation in the programme documentation published by the involved institutions (e.g. occasional papers) backing the decision would have contributed to improve the communication and understanding of the programme. In particular, the evaluators found that it was difficult to derive from programme documents why the choice of an AMC to deal with impaired assets was considered to be the best option to achieve some of the programme's objectives vis-à-vis other options such as an APS, or a combination of both. Nevertheless, the evaluators were of the opinion that 'better communication' should not be detrimental to the effectiveness of the programme (i.e. it should not delay key decisions). A large majority of stakeholders engaged in the consultation element of the evaluation agreed that an AMC was preferable to, for instance, an APS for individual banks. This was because of the need to act quickly, the huge uncertainty about banks' balance sheets (which required a transparent solution), the dire liquidity situation of the banks (bonds issued by the AMC could be pledged as collateral in ECB liquidity operations), the need to break with the previous strategy (APS had been used prior to the programme, with limited success), divestment considerations (selling banks with APS had proven difficult as the sovereign financing situation had come under strain), the public finance situation (need to place the AMC outside general government), and the need for banks to concentrate resources on new lending (see Box 3.4).

Box 3.4: **The choice of an asset management company to deal with impaired assets**

The MoU envisaged the transfer of the real estate portfolio and foreclosed assets of banks receiving public support to an external asset management company. Other options to deal with impaired assets existed but the MoU did not provide background supporting the choice of an AMC vis-à-vis other possible options. Stakeholders interviewed by the evaluators stated that there had been internal discussions within and across national and international institutions involved in the programme about different options to deal with impaired assets, notably between the choice of an asset management company and an asset protection scheme. An APS, basically consisting of guarantees, seemed to be the second major option under consideration. Setting up an APS would have implied that the impaired assets would have remained on the balance sheets of banks, with a (typically State) guarantee covering losses up to, or in excess of, a certain level. The latter was closer to the strategy followed by the Spanish authorities in the run up to the programme. The main principles guiding the discussions were the need to enhance solvency of banks and restore market confidence, to maintain incentives to comply with the programme's conditionality, to reduce the impact on sovereign debt and to ensure compliance with State aid rules. This reflected the spirit of existing legislation in the EU with regard to the treatment of impaired assets in the banking sector. ([1])

The evaluators were of the view that, while the programme documents would have benefited from more clarity and analysis about the choice to deal with impaired assets, several reasons backed the option of an AMC as an efficient tool to reach the programme's objectives:

- Removing doubts about the quality of banks' balance sheets and downsizing bank exposures to the real estate sector was a major objective of the programme.

- The choice of an AMC seemed in line with international best-practice in the treatment of impaired assets following financial crises. The IMF's assessment within its Financial Sector Assessment Programme of June 2012 stated that centralised AMCs could be relatively more efficient when the size of the problem was large, special powers for asset resolution were needed or the required skills were scarce within the system. Fixed assets such as foreclosed properties and loans requiring foreclosure or settlement with debtors seemed reasonable to be transferred to AMCs. This fit the circumstances of the Spanish banking sector.

- Given the loss of confidence by investors on Spain's banking sector and the high degree of uncertainty about the health of banks' balance sheets, it seemed important to opt for an approach that would reduce uncertainty and weaken the negative feedback loop between the banks and the sovereign, while reducing the costs for the tax payer. In this regard, the creation of an AMC with a majority stake of the private sector and with appropriate haircuts of the transferred assets seemed a reasonable choice.

- An AMC allows for economies of scale if it takes over homogeneous assets. This can allow for a concentration of internal expertise, higher efficiency and better sales and returns under difficult market developments. The main risks in the Spanish banking system related to a specific category of assets, which was real estate development (RED) and foreclosed assets. An AMC also allows a clear separation between the banks transferring assets and their impaired assets so as to avoid conflicts of interest. Under an APS, the management of the loans remains with the banks and the risk is not fully removed from the system.

- If the AMC has the capacity to issue government guaranteed bonds, their holding is typically not subject to capital charges. AMCs allow banks to better use their resources and refocus on lending activities rather than working out high stocks of nonperforming loans (ECB, 2013).

- An APS implying a transfer of assets within the banks, even if subject to State guarantees, would not have led to significant changes in the risk profile of those banks' portfolios (although this might depend on whether the State guarantee would lead to a significant decline in risk weightings). The overall fall in real

([1]) Notably the Communication from the Commission on the treatment of impaired assets in the Community banking sector (2009/C 72/01), Official Journal of the EU (C72/1, pages 1-22), March 2009.

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Box (continued)

estate asset prices that continued after the setup of the programme would have likely implied higher loss provisions and calls on the State guarantee, hindering confidence in the system.

- APS may facilitate a more gradual disbursement of the financial assistance, as EFSF/ESM funds would have been injected when losses would be recognised in the banks' balance sheets. In addition, an APS would not increase immediately Spain's sovereign debt (unlike outright capital injections of funds from the EFSF/ESM to banks via the FROB). However, these advantages need to be weighed against the sizeable contingent liabilities for the government that an APS would have resulted in, as well as against the positive effect that frontloading aid within the Spanish programme had on investor confidence.

- An APS would not involve upfront costs to the banks' capital, but it might not have the potential liquidity-injecting effect of an AMC (which Sareb had thanks to the eligibility of its bonds as collateral with the Eurosystem), as the assets remaining on the balance sheet of the banks are not substituted by other higher-quality assets (even though they might in some cases increase their collateral valuation).

All in all, the evaluation found that the factors above seem to back the option of an AMC to deal with impaired assets vis-à-vis an APS. That said, the evaluators found that such a crucial part of the programme's design could have benefited from a more explicit ex-ante analysis in the programme-related official documentation (e.g. an occasional paper by the Spanish or European institutions involved in the programme). Chapter 4 analyses the details regarding the implementation of the AMC, i.e. the setup of Sareb.

Bank restructuring and burden sharing

Conditionality with regard to the restructuring and resolution of credit institutions was designed in a context of transition from national solutions compliant with EU State aid rules to a common resolution framework. In June 2012, the European Commission launched a proposal for a directive establishing a framework for the recovery and resolution of credit institutions and investment firms. It aimed at minimising the risk to financial stability and was based on the principle that shareholders and creditors should bear an appropriate share of the losses when resolution action is taken. Compared to the existing frameworks in most Member States at the time, the proposal overall extended the possibilities for burden sharing by the private sector. The burden sharing provisions in the MoU followed the spirit of the discussions on the common resolution framework at the time, considerably expanding loss sharing compared to previous euro area programmes. Partly as a result of this evolving framework, bail-in provisions were not fully consistent across the euro area (see Chapter 4).

The decision to impose loss sharing by shareholders and subordinated debt holders was in line with the EFSF guidelines for bank recapitalisation programmes. The guidelines stipulated that the conditionality attached to financial assistance for bank recapitalisation could draw from the future EU bank resolution framework, including bail-in tools. The extent of loss sharing was to be determined according to the size of the capital gap, the availability of "bail-inable" instruments, their seniority, coupon and maturity. In order to avoid strains to the funding of viable banks and negative spillovers to other euro area countries, burden sharing was to be restricted to subordinated liabilities (see Chapter 4 for a discussion of burden sharing).

While the programme included a set of measures to improve financial sector supervision, the MoU would have benefited from more specific conditionality in this area. In particular, the MoU required the supervisory procedures of the BdE to be further enhanced based on a formal internal review. The aim was to ensure that findings of on-site inspections would translate effectively and without delays into remedial actions. The MoU also requested the Spanish authorities to analyse the need for 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. The MoU would have benefited

from a clearer identification of the problems and a better description of what needed to be done in the area of supervision to achieve the programme's objective of reducing the occurrence and severity of future financial crises. In particular, the MoU could have offered more clarity with regard to whether problems with internal procedures and communication also meant political interference and stakeholders' interests. Some stakeholders involved in the programme stated that conditionality in this area was built on the basis of the IMF's 2012 FSAP report for Spain. The report pointed to problems of enforcement and possible deference to stakeholders' interests in some areas. The evaluators found that focusing more on the need to ensure enforcement rather than on procedures would have streamlined the conditionality in this area. In this regard, the Commission's occasional paper published in October 2012 was a good complement to the MoU as it explained the FSAP findings and helped to understand the problems and necessary policy actions in this field. ([34]) Nevertheless, a majority of stakeholders interviewed and the evaluators were of the opinion that the entry into force of the Single Supervisory Mechanism had been a key step to limit delays in remedial action in the future and rendered some of the measures in the MoU less relevant now than they would have been otherwise.

Pace and timing of the measures

The programme was heavily frontloaded, with most of the conditionality to be fulfilled during the first six months of the programme. The evaluators and stakeholders agreed that speed was key for the overall effectiveness of the programme. However, in the case of the creation of the AMC (Sareb), some stakeholders felt that the deadline was too tight (4 months), as it allowed only limited time for asset valuations and the development of a business plan. Such limited time was conditioned by the need to allow the speedy shift of impaired assets out of the banking system. The evaluators and a majority of stakeholders were of the opinion that a fast setup of the AMC was crucial for two main reasons: The programme was put in place amid an urgent crisis situation with a strong intensification of financial stress in Spain in mid-2012. Reducing quickly the uncertainty linked to the balance sheets of credit institutions was of paramount importance in that context. In addition, a slower implementation of the AMC would have implied a delay in the much-needed recognition of losses in the Spanish banking system and the associated recapitalisation plans. In this regard, the prompt creation of the AMC and the rapid clean-up of bank balance sheets supported financial stability. Nevertheless, the ambitious roadmap in this area had the downside that it was difficult to build capacity for asset management in the AMC or to contract independent service providers to recover the highest possible value from the impaired assets, which required adaptations later on. The evaluators found that, in future interventions, the marginal costs and benefits of allowing more time to establish AMCs should be weighed if it may lead to increase their efficiency. However, this should not be to the detriment of financial stability.

3.3.3. Institutional set-up and financial envelope

The institutional set-up was a consequence of the specific design of the programme. In line with the strategy employed in other euro area financial assistance programmes, creditors wanted to have the IMF on board, as this would in their view enhance the credibility of the adjustment efforts in the eyes of financial investors. Also, the IMF was renowned for its financial sector expertise. The IMF, however, could not provide financial support without a fully-fledged macroeconomic adjustment programme. It could only provide technical assistance, which had to be impartial. Thus, the IMF acted as an adviser to both parties to the programme, the Spanish authorities and the EU institutions. However, the monitoring of the programme was structured and resulted in rather formal reviews. The Terms of Reference for Fund Staff Monitoring stipulated that IMF staff would participate in all financial assistance monitoring missions conducted by the European Commission and that reporting on staff monitoring findings would be done quarterly. It also specified that monitoring would include assessing progress against the programme's conditionality. This was assessed by stakeholders consulted by the evaluators to have worked well in the programme. Those stakeholders and the evaluators were of the opinion that the Fund's

([34]) See European Commission Occasional Paper N° 118: "The financial sector adjustment programme for Spain", October 2012.

experience in banking crises resolution was particularly useful in the context of a programme for the recapitalisation of financial institutions.

The decision to opt for an ample financial envelope seemed pertinent, as the cost of bank restructuring was difficult to forecast ex-ante. An assessment of banks' asset quality was needed, which was to take several weeks to be completed. In addition, the exact amount of "bail-inable" securities in banks' requiring state aid was unknown, as was the extent to which loss sharing could be imposed on shareholders and creditors. ([35]) At the time of the programme's inception, estimates of financing needs of the Spanish banking sector were surrounded by significant uncertainties, ranging between EUR 30 billion and well above EUR 100 billion. The IMF solvency stress-test, released in the FSAP report of June 2012, was considered the most reliable estimate. Impairment losses were calculated to amount to some EUR 55 billion. In this context, the financial envelope of up to EUR 100 billion was to some extent determined politically. It was first announced by the Eurogroup on 9 June 2012, ([36]) the day after the publication of the IMF's FSAP review and more than two weeks before Spain formally requested financial assistance for bank recapitalisation. The envelope was supposed to provide a sufficient safety margin, enhance the effectiveness of the backstop and calm the markets. The specific amount to be requested was to be determined based on a bottom-up assessment of capital needs of individual banks, discounted by the bail-in of equity and subordinated liabilities.

Actual financing needs proved substantially smaller than the overall envelope. The ESM disbursed EUR 39.5 billion (of which about EUR 2.5 billion for capitalising Sareb) in December 2012 and a further EUR 1.8 billion in February 2013. The loan was priced at the market rate of the bonds issued plus an operational service fee and margin. The total envelope of the programme amounted to some 4% of Spain's GDP, significantly smaller than fully-fledged financial assistance programmes in other euro-area Member States. For the duration of the programme, the ESM's remaining lending capacity was reduced by EUR 100 billion, to EUR 400 billion from a maximum of EUR 500 billion. Meanwhile, the EFSF's remaining lending capacity was EUR 248 billion out of a total of EUR 440 billion. Against this background, the size of the financial envelope struck a good balance between reassuring markets about the firing capacity of the external assistance and the need to maintain EFSF/ESM resources for other possible interventions.

([35]) In the absence of a clear framework for bank resolution, loss sharing by creditors had to respect the "no creditor worse off than in liquidation" principle. Thus, the extent of burden sharing by creditors depended on the overall situation of the bank and could only be established after the completion of the diagnostic exercise.

([36]) See Eurogroup statement on Spain, 9 June 2012; http://ec.europa.eu/spain/pdf/eurogrupo-espahna-09.06.pdf.

4. IMPLEMENTATION OF FINANCIAL SECTOR CONDITIONALITY

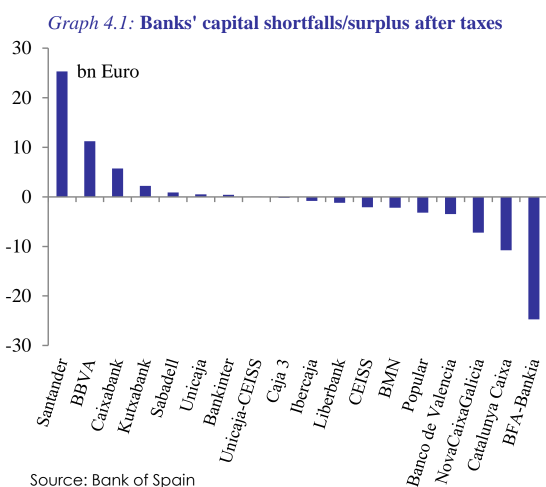
4.1. OVERVIEW OF THE MAIN MEASURES TAKEN TO FULFIL FINANCIAL SECTOR CONDITIONALITY

This section describes the main measures taken by the Spanish authorities in order to implement the MoU's financial sector conditionality. This is done according to three main areas of intervention: the treatment of impaired assets; bank recapitalisation and restructuring; and enhancing bank transparency, regulation and supervision. Royal Decree-Law 24/2012 on a new framework for the restructuring and resolution of financial institutions set the legal framework for the implementation of the most important financial-sector related conditions specified in the MoU. The Decree-Law, which was then discussed in the Parliament and passed as Law 9/2012 in November 2012, inter alia established an AMC to deal with impaired assets, incorporated burden sharing principles for bank restructuring and included provisions to strengthen investors' protection and to transfer responsibilities for sanctioning and licensing from the Ministry of Economy to the Bank of Spain. The following are the main measures taken by the authorities in every of these areas. ([37])

4.1.1. Treatment of impaired assets

An independent bank-by-bank stress test was carried out in 2012 to identify losses and capital needs of the Spanish banking system. The results of the bank-by-bank stress test exercise (bottom-up stress tests) were published in September 2012. Graph 4.1 shows the identified capital gaps in the stress test exercise. The stress tests were carried out by Oliver Wyman, while international audit firms and real estate experts were hired to enhance the transparency of the process. ([38]) The process and methodology of the stress tests was closely monitored and agreed with an expert coordination committee composed of the BdE, the Ministry of Economy and Competitiveness, the EBA, the European Commission, the ECB and the IMF. Interim and final results were agreed by a steering committee consisting of representatives of the same institutions.

Graph 4.1: **Banks' capital shortfalls/surplus after taxes**



Source: Bank of Spain

([37]) For a detailed review of all the measures taken by the authorities with regard to the MoU's financial sector conditionality, see the European Commission reviews of the Financial Assistance Programme for the Recapitalisation of Financial Institutions in Spain, available in the following website:
http://ec.europa.eu/economy_finance/assistance_eu_ms/spain/index_en.htm

([38]) PwC, Deloitte, Ernst & Young and KPMG and several appraisal companies participated in the process.

The authorities set up Sareb in order to implement the MoU's requirement to create an asset management company. Sareb was created in November 2012. It received nearly 200,000 assets valued at EUR 50.8 billion in two phases. A first tranche of EUR 36.6 billion was transferred in December 2012. It was contributed by the four nationalised banks: Bankia, Catalunya Banc, Banco de Valencia and NCG-Banco Gallego. A second tranche amounting to EUR 14.2 billion was transferred in February 2013 by the other four banks that received State funding: Liberbank, BMN, Caja3 and Banco CEISS. The main purpose of Sareb was to segregate real estate development assets above a certain threshold from banks requiring public capital injections so as to eliminate concerns about banks' solvency, to maximise the value of the transferred assets and to allow banks to focus on their core activities (see Box 4.1). Initially, the assets transferred to Sareb were managed by the transferring banks through service level agreements, until Sareb had full operational capacity.

Box 4.1: **Main features of Sareb**

Scope and size:

- Sareb was set up as a for-profit company with a majority holding of 55% subscribed by private investors and 45% owned by FROB.
- Its life span was established for a maximum of 15 years.
- The planned return on equity, based on the provisional business plan, was 14-15%.
- The eligible assets to be transferred to Sareb were real estate developer exposures: foreclosed real estate assets above EUR 100,000; loans to real estate developers above EUR 250,000 (total per borrower) and controlling stakes in real estate companies.
- The volume of assets transferred was limited to EUR 90 billion.
- The cut-off date for the classification of assets was 30 June 2012, though taking into account reclassifications carried afterwards in the context of the bottom-up stress test exercise.
- Banks transferring assets to Sareb were those belonging to Groups 1 and 2 as well as any Group 3 bank (see point 4.1.2.) if they had failed to raise the required capital from private sources.

Transfer price:

- Transfer prices were set on the basis of their real economic value, based on Oliver Wyman's base case scenario, plus additional adjustments by asset type.
- The additional adjustment covered for aspects such as: the 'en bloc' acquisition of the assets; asset management and administration costs, including financial costs; or the outlook for the timing of the divestment of the assets transferred.

Capital and funding:

- Participating banks received bonds issued by Sareb and guaranteed by the State.
- Sareb also required perpetual subordinated debt and common equity.
- Subordinated debt and common equity were set to amount about 8% of total assets.

Corporate governance:

- The management was to be composed of a Board of Directors with a minimum of 5 and a maximum of 15 members, consisting of the Sareb shareholders and a number of independent directors.
- The BdE is in charge of the supervision of Sareb.
- An external Monitoring Committee formed by the Ministry of Economic Affairs and Competitiveness, the Ministry of Finance, the BdE and the National Securities Market Commission (CNMV) oversees compliance with the general objectives for which the company was formed.

Sareb was set up with a 45% stake retained by the FROB, with the remainder of its ownership held by some Spanish private banks which did not receive State aid, foreign banks and insurance companies. Equity and subordinated debt together were set at 8% of assets to provide protection to senior debt (roughly 2% equity and 6% subordinated debt, totalling some EUR 4.8 billion). The subordinated tranche was structured to absorb losses after the equity would be fully written off. Senior debt totalled an amount of EUR 50.8 billion; it was guaranteed by the Spanish State and it financed the impaired assets transferred by the banks through the injection of Sareb bonds into their balance sheets.

The pricing of the assets transferred to Sareb was based on their real economic value, using as a reference an independent assessment by Oliver Wyman, with an additional haircut to cover managing costs. This resulted in an average haircut of about 63% vis-à-vis the gross book value of the foreclosed assets and of some 46% for loans to real estate developers. The haircuts ranged from a maximum of 79.5% for foreclosed land to a minimum of 32.4% on loans to developers for finished houses. ([39])

Table 4.1:
Haircuts on assets transferred to Sareb

	Asset class	Average haircut
RED foreclosed assets	New housing	54.2%
	Developments	63.2%
	Land	79.5%
	Foreclosed assets (average)	63.1%
Loans to real estate developers	Finished housing	32.4%
	Unfinished projects	40.3%
	Urban land	53.6%
	Other land	56.6%
	Other with collateral	33.8%
	Other without collateral	67.6%
	Loans (average)	45.6%

Source: FROB

4.1.2. Bank recapitalisation and restructuring

Banks were categorised in four groups on the basis of the stress test results and the presented plans to address any identified capital shortfalls. In line with the roadmap set in the MoU, the stress test exercise identified banks which would face capital shortfalls under an adverse scenario and banks were split into three groups pre-set in the roadmap. The exercise revealed capital shortfalls in ten banks, totalling about EUR 56 billion, which had to present recapitalisation plans. The European Commission adopted the restructuring plans for Group 1 banks on 28 November 2012, and for Group 2 banks on 20 December 2012. Group 0 comprised banks for which no capital shortfall was identified, requiring no public action: Santander, BBVA, Caixabank, Sabadell-CAM, Bankinter, Kutxabank and Unicaja. Group 1 was pre-defined as banks already owned by the FROB: BFA-Bankia, Catalunya Banc, NCG Banco and Banco de Valencia. Group 2 consisted of banks identified by the bottom-up stress test as unable to meet their capital shortfalls without having recourse to State aid: Banco Mare Nostrum, CEISS, Liberbank and

([39]) It is worth noting that book values in Spain were already significantly stressed during the first part of the crisis via allocation of provisioning needs. For an overview of the methodology to set transfer prices to Sareb, see FROB's press release of 29 October 2012 on "The transfer prices to the Asset Management Company (Sareb) will be sharply adjusted to ensure its profitability": http://www.bde.es/f/webbde/GAP/Secciones/SalaPrensa/InformacionInteres/ReestructuracionSectorFinanciero/Archivo/Ficheros/frob291012e.pdf

Caja 3. Group 3 included banks with capital shortfalls but with credible recapitalisation plans without having recourse to State aid. ([40])

The restructuring plans of Group 1 and 2 banks aimed at securing the banks' solvency and restore their profitability and liquidity profile over a five-year restructuring period. In particular, the plans were meant to restore an adequate margin structure, which was supposed to reinforce over time the banks' capital position. In addition, the plans were supposed to address the funding gap and thus reduce the banks' reliance on wholesale funding and particularly on central bank financing. This would enable banks to achieve the ultimate objective of restoring sustainable lending patterns towards the real economy.

Decree-Law 24/2012 provided the FROB and the BdE with more powers, among which the possibility to impose burden sharing on the holders of hybrid instruments and subordinated debt. Burden sharing could be implemented on a voluntary basis but, failing this, also on a compulsory basis where the FROB had control of the institution. The authorities implemented burden sharing exercises for holders of preference shares and perpetual subordinated debt, firstly by applying a haircut to the nominal amount of the instrument and subsequently through conversion of those securities into equity or equivalent instruments. Holders of dated subordinated debt were given the choice between conversion into equity or into a senior debt instrument after taking an appropriate haircut. The estimated amount of banks' capital needs was reduced by some EUR 13.6 billion through burden sharing measures (see section 4.2).

The restructuring plans of banks receiving State aid foresaw that those banks should refocus their business model on retail and SME lending in their historical core regions. This implied exiting from lending to real estate development and other activities considered risky and limit their presence in wholesale businesses. This was supposed to allow them to improve their cost base, by cutting both staff and branches. The plans concentrated banks' deleveraging in the most overleveraged areas. They included limits on new loans for real-estate development and reductions in exposure to mortgage lending and public sector financing. In contrast, they had continued capability to finance SMEs and corporates. The plans aimed at refocusing banks' activities in those regions and areas where they had a capacity to operate efficiently.

4.1.3. Enhancing bank transparency, regulation and supervision

The authorities implemented a wide range of measures to enhance banks' regulation, supervision and transparency. They introduced measures aimed inter alia at strengthening the regulatory, supervisory and bank resolution frameworks, enhancing the governance structure of savings banks and of commercial banks controlled by them, improving consumer protection legislation as regards the sale by banks of hybrid capital and subordinated debt instruments and measures to strengthen non-bank financial intermediation.

The restructuring process of credit institutions under the programme embodied the transition from a domestic resolution strategy largely based on mergers to a new EU framework including bail in. Royal Decree-Law 24/2012 overhauled the legal framework for the restructuring and resolution of financial institutions in Spain. The framework took into account the Commission regulatory proposal from June 2012 on bank recovery and resolution (BRRD). ([41]) It incorporated burden sharing principles for bank restructuring, with the magnitude of losses for shareholders and bondholders depending on a case-by-case implementation. The strategy adopted to restructure and recapitalise Spanish banks under the programme deviated from previous actions taken by the Spanish authorities for the restructuring of the

([40]) Banco Popular and Ibercaja presented credible plans to reduce their capital shortfall to zero by the end of 2012 and were eventually included in Group 0. In the case of Banco de Valencia, the Commission approved the State aid required for the orderly resolution of the bank through its takeover by CaixaBank.

([41]) Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms, COM(2012) 280, June 2012.

banking sector, which had largely relied on mergers, had not recognised losses to the necessary extent and had not managed to stabilise the system.

The Spanish authorities carried out an internal review of the supervisory process of the BdE, as requested in the MoU. The main findings of the internal review were made public in the October 2012 report on the internal review of the supervisory processes of the BdE. ([42]) The authorities committed to focus on further strengthening the formalisation of supervisory actions and enhancing the enforcement of provisions related to the rotation of supervisory staff. On-site continuous monitoring was extended to all major banking groups, which accounted for 90% of total banking sector assets. The ensuing reorganisation of the Directorate General Supervision in 2013 led to the reinforcement of horizontal supervisory teams, including the setting up of an inspection team for Sareb and to the rotation of supervisory staff. Furthermore, the BdE committed to analyse the existing provisions on the cooling off periods for heads of departments and divisions.

In order to increase the transparency of banks' data reporting, the BdE clarified the provisions applicable to restructured/refinanced loans. Together with provisions to increase transparency requirements concerning exposures to the real estate and construction sector, the BdE's Circular 6/2012 introduced new definitions on restructured, refinanced, roll-over and renegotiated loans. In order to address differences in accounting practices among banks as regards restructured/refinanced loans, the BdE required banks in April 2013 to provide clarifications on the application of provisions on loans including their classification into normal, substandard and non-performing. Banks performed a loan-by-loan analysis of their restructured/refinanced operations in the course of 2013 in order to identify possible loan reclassifications and additional provisioning needs following the clarifications made by the BdE.

Spain adopted a Law on Savings Banks in December 2013 to comply with the MoU's requirement to strengthen the governance of savings banks, with some delays coming into force. The Law 26/2013 of 27 December 2013 on savings banks and bank foundations set a complete new legal framework for the savings banks sector and imposed the conversion of almost all savings banks into banking foundations. The main goal of the Law was to make the governing bodies of savings banks and banking foundations more professional and independent in order to avoid interference in the proper management of bank activities. The Law also set incentives to reduce controlling stakes of banking foundations in banks so as to impose additional costs on banking foundations that had significant controlling stakes in banks. The Law required the issuance of secondary legislation. A Royal Decree and a Circular of the BdE were adopted in October 2015 and November 2015, respectively.

These actions were complemented by other measures as a follow up of the MoU's horizontal conditionality. The authorities introduced measures for strengthening non-bank financial intermediation. The Spanish authorities carried out analytical work on credit concentration following a report submitted in mid-January 2013. The BdE approved a Circular (1/2013) in May 2013 containing a complete set of reforms on the credit register so as to enhance both micro prudential supervision and the macroprudential analysis. ([43]) These measures responded to MoU requirements. In addition, the economic situation and rising social concerns on residential foreclosures and evictions led to several legislative initiatives which were not foreseen in the MoU. A two-year suspension of evictions for vulnerable families was decided together with other initiatives in Law 1/2013 of May 2013 on measures to reinforce protection of vulnerable mortgage debtors, debt restructuring and social housing. ([44])

([42]) Banco de España, Análisis de los Procedimientos supervisores del Banco de España y Recomendaciones de Reforma, 16 October 2012.
([43]) This was preceded by a modification of several provisions at law and Ministerial Order Level (for which Royal Decree 6/2013 of 2 March 2013 and Ministerial Order ECC 747/2013 had been approved).
([44]) The suspension was initially stated in Royal Decree law 27/2012 of 25 April 2012. The two-year suspension was extended to four years by Law 25/2015 of 28 July 2015.

4.2. ASSESSMENT OF THE IMPLEMENTATION OF FINANCIAL SECTOR CONDITIONALITY

The implementation of the programme's financial sector conditionality was overall fast and forceful, with no need for amendments or additions to the MoU. Reviews by the EU Institutions and the IMF found that the programme was constantly on-track. The MoU had structured the conditionality around the main pillars of segregation of impaired assets, recapitalisation, restructuring and resolution of financial institutions and strengthening the regulatory and supervisory frameworks. Overall, the evaluators and all parties interviewed shared the view that the implementation of the programme in all these areas was swift and closely followed the conditions and timeline set in the MoU's roadmap.

The thorough implementation of the programme was largely owed to the high administrative and personnel capacity within the Spanish institutions and a strong commitment by the authorities. The Spanish authorities considered that overall ownership was maintained as an important share of the programme's conditionality was in line with previous government's actions (e.g. reform of the savings banks). The stability and quality of the teams on both sides of the negotiating table was considered important by the evaluators as well as by most counterparts interviewed during the evaluation, while the IMF's experience with financial crisis resolution and the technical input of the EBA for some specific topics (e.g. stress tests) were overall appreciated. All these factors underpinned a smooth implementation of the programme.

4.2.1. Treatment of impaired assets

The setup of Sareb was a central pillar of the programme, with important implications for both financial stability and burden sharing between taxpayers and investors. While the MoU established that an AMC should be created to deal with impaired assets, its main features were not determined. The capital structure of Sareb and its future economic performance are essential factors determining an important part of the final costs borne by the taxpayers from the restructuring of the banking system under the programme.

The capital structure of Sareb resulted in a relatively highly-leveraged company although it has so far been operating without a need for additional support. Looking ahead, the risk of further recapitalisation needs cannot be ruled out. Sareb's share of capital and subordinated debt was low compared to the share of senior debt. This was possible partly due to the fact that Sareb was an AMC and not a bank subject to banking regulation and notably to substantial capital requirements. Thus, its leverage was relatively large and the risks for the State and ultimately the taxpayer potentially sizeable. ([45]) The final capital structure and ownership of Sareb reflected a number of concerns, among which the wish to limit the impact on public debt by having it classified outside the general government sector, ([46]) the difficulties to attract private stakeholders at the time, the need to have a sufficient amount of own resources to absorb future potential losses and the need for Sareb bonds to be compliant with Eurosystem's eligibility criteria for their use as collateral in refinancing operations. The evaluators found that ensuring a majority stake by private healthy banks and other investors in Sareb was a difficult task in the existing environment at the time and its achievement was an efficient way to reduce risks for taxpayers in the event of losses. Involving healthier private banks in the ownership of Sareb was also an efficient way to make the sounder part of the banking system be part of the solution to deal with impaired assets of troubled banks.

([45]) Nevertheless, Sareb was less leveraged than for instance NAMA (NAMA's capital amounted to only EUR 100 million at its inception, while the book value of the loans it took over totalled almost EUR 80 billion) although significantly more than other AMCs such as Sweden's Securum, which was capitalised with SEK 24 billion while it took over assets from Nordbanken for a gross figure of SEK 67 billion.

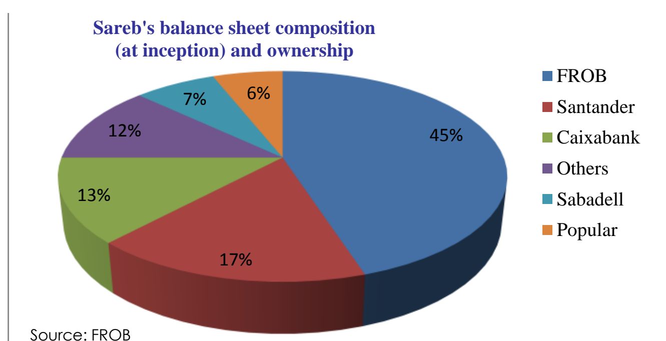
([46]) Eurostat agreed with the Spanish statistical authorities that Sareb should be classified in the financial corporations sector. See letter from EUROSTAT to INE of 26 March 2013 on "Formal ex-ante consultation on the classification of Sareb"

Several stakeholders consulted by the evaluators pointed out to possible conflict of interests of private banks being stakeholders of Sareb. This is because those banks might compete with Sareb in selling real estate portfolios and might have also been purchasers of Sareb's assets. In March 2013, Sareb's Board of Directors approved a policy on conflicts of interest and related-party transactions. According to this policy, the directors are obliged to notify the Board of any direct or indirect conflict of interest with the interests of the company in which they may be involved. Once Sareb becomes aware of the existence of a conflict of interest, either on its own or through notification by the director, it shall not provide information about the transaction in question to the director, and the latter shall not take part in the debate, or vote, on the matter giving rise to the conflict of interest. The evaluators found that such governance provision was appropriate and that ensuring strict enforcement was important. Some stakeholders consulted during the evaluation process were of the view that there would be merit in considering a role for the ESM or the Single Resolution Board (SRB) to take a stake in future AMCs in cases where it is difficult to attract private stakeholders, and that this would reduce potential conflicts of interest by private investors. The evaluators found that this could be worth being evaluated at the early stages of the programme design, though it obviously raises broader questions that go beyond the scope of this evaluation.

Table 4.2:
Sareb: Balance sheet (at inception)
(billion Euro)

Assets	Liabilities
Cash 4.8	Equity 1.2
	Subordinated debt 3.6
REAs 11.4	Senior debt 50.8
Loans 39.4	

Source: FROB



A conservative valuation of the assets transferred from banks to Sareb was an important way to prevent losses that could lead to additional recapitalisation needs. The valuation was conservative to the extent that it applied an additional haircut to the estimated real economic value of the assets (see below). Other provisions were introduced to protect Sareb's senior debt in view of the high uncertainty about real estate asset valuations at the time. For instance, Sareb had to dedicate at least 92% of its excess business cash flow to amortise senior debt guaranteed by the government. ([47]) In addition, a recapitalisation by shareholders once equity and subordinated debt would be fully depleted could be called for before senior debt would have to absorb losses. All these factors offered some protection to senior debt and therefore the taxpayer but could prove insufficient if Sareb's results continue undershooting the business plan. ([48])

The choice of assets eligible for transfer to Sareb struck a reasonable balance between efficiency and financial stability. Considering the high complexity associated with the management of a large AMC with a high number of assets, the setup of thresholds by categories of assets to be transferred to Sareb appears to have been an efficient decision. It helped to avoid transferring too granular portfolios which would have been difficult to manage but represented only a limited risk for financial stability. For instance, loans below EUR 250,000 represented only some 2% of total real estate and developer (RED) exposures at the time but 30% of the total number of RED loans. Foreclosed real estate assets below EUR

([47]) Sareb adopted a cash protocol to reduce risks on senior debt, requiring it to use 92% of its cash surplus to repay senior debt principal. The remaining 8% was to be retained in an escrow account, which could be used to call the subordinated bonds or distribute dividends after five years if certain conditions were met.

([48]) Sareb's initial business plan, drawn at the end of 2012, had to be adjusted in March 2013 amid a negative evolution of real estate prices which affected Sareb's cash flows. Sareb's earnings for the fiscal years 2013 and 2014 were below expectations. It recorded losses of EUR 261 million and EUR 585 million in 2013 and 2014, respectively.

100,000 represented 14.5% of the total value but 56% in terms of number of assets. Thus, those thresholds reduced notably the complexity of managing the assets for Sareb while still avoiding a large exposure to RED assets in the transferring banks. The choice of eligible assets was also in line with the eligibility requirements of the Commission Communication on the Treatment of Impaired Assets in the Community Banking Sector which cited as eligible assets those that triggered the financial crisis and allowed for the possibility to "extend eligibility to well-defined categories of assets corresponding to a systemic threat upon due justification, without quantitative restrictions". ([49]) With hindsight, the decision to exclude retail mortgages and non-REDs loans to SMEs from the assets transferred to Sareb was efficient and consistent with minimising the amount of State aid to achieve the programme's objectives, as NPLs in these segments remained considerably below the system level, before and after the programme's period (see Chapter 6). Including those categories of assets would have also made the management of Sareb more difficult due to the large granularity they would have added to Sareb's portfolio.

The call to an independent external consultant to carry out valuations helped to increase the transparency of the process and to limit the risks on the taxpayer. The process of transferring bank assets to Sareb was surrounded by high uncertainty with regard to the value of those assets and the future evolution of house prices. The evaluators and stakeholders interviewed considered the involvement of an independent consultant to be an important element introducing confidence about the state of the balance sheets of troubled credit institutions. Nevertheless, when the assets were transferred to Sareb, their market value was lower than the price initially estimated by Oliver Wyman, as the latter was based on the real economic value but also due to unfavourable real estate market developments, resulting in further impairments with direct impact on the profit and loss account of Sareb.

Table 4.3:
Sareb: Total transferred assets (Transfer price in billion Euro)

		Group 1	Group 2	Total
Loans	Net	28.3	11.1	39.4
Assets	Net	8.4	3.0	11.4
Total	Gross	78.8	27.7	106.6
	Net	36.7	14.1	50.8

Source: FROB

The calculation of the value attributed to the assets transferred to Sareb followed European Commission guidelines on the application of State aid rules to asset relief measures. The calculation was based on their long-term economic value (on the basis of underlying cash flows and broader time horizons), which is a standard practice in the treatment of impaired assets in the EU when State aid is involved. The 2009 Communication from the Commission on the Treatment of Impaired Assets in the Community Banking Sector stipulated that the value attributed to impaired assets in the context of an asset relief program (the 'transfer value') will inevitably be above current market prices in order to achieve the relief effect. To ensure consistency in the assessment of the compatibility of aid, the Commission considers a transfer value reflecting the underlying long-term economic value (the real economic value) of the assets to be an acceptable benchmark indicating the compatibility of the aid amount as the minimum necessary. The Communication also stated that while a transfer value above the market value implied State aid, pricing on the basis of the real economic value could be perceived as counterbalancing market exaggerations fuelled by crisis conditions which had led to the deterioration or even collapse of certain markets.

([49]) Communication from the Commission on the Treatment of Impaired Assets in the Community Banking Sector (2009/C 72/01), Official Journal of the EU (C72/1), March 2009.

Thus, the transfer price of assets was conservative to the extent that an additional haircut was applied to the real economic value, but it was above market prices. Even if the transfer price of assets were based on the real economic value and included an additional haircut, significant uncertainty remained about the valuation of the assets. This was due, for instance, to the fact that assets were classified in portfolios and transferred to Sareb as a whole, with every portfolio receiving the same haircut in spite of their different characteristics of assets within a portfolio. This made it difficult to calculate the exact price of each asset transferred and their real margin. In addition, between the time of definition of the categories of assets to be transferred and the effective date of the transfer, the portfolios changed due to, for instance, sales of assets or amortizations. This partly contributed to a valuation of eligible assets below what investors were willing to pay. ([50]) This highlights the importance to clearly define the assets to be transferred to an AMC in order to limit valuation gaps between the identification of eligible assets and their actual transfer. The evaluators found that the involvement of independent experts in the valuations of assets transferred to Sareb and the setup of a margin above the estimated real value of the assets helped to limit loses for Sareb. This was particularly relevant as the market for the types of assets transferred to Sareb had dried up, making their pricing particularly challenging. Overall, while the valuations of the assets transferred to Sareb seemed to have somewhat underestimated the operating costs of the company and housing market developments in the short term, these costs are typically higher in the first years of operation. Given the large average haircut to the value of the transferred assets, it was difficult to conclude that larger haircuts were needed.

Importantly, Sareb served well the financial stability purpose for which it had been created. Two objectives should be differentiated when assessing Sareb's success: the short-term aim of segregating assets and removing uncertainty from the bank's balance sheets, and the longer-term objective of managing the orderly disposal of assets over 15 years. In this regard, Sareb's profitability ratios need to be assessed over the long term. The short-term purpose related to increasing financial stability was achieved, not only through its impact on banks' balance sheets but also through stabilising the downturn in the housing market and avoiding fire sales of real estate assets. A rapid implementation of Sareb was essential for the authorities to be able to carry out the banks' recapitalisation plans, which was of outmost importance given the weak situation of part of the banking sector and the overall financial market stress at the time. This was consistent with a very rapid pace of restructuring as detailed in the MoU's roadmap. The creation of Sareb also helped in guiding the banking system with regard to asset valuations and thus in establishing appropriate levels of provisioning on RED assets to other market participants. Furthermore, Sareb was a key pillar helping to improve the weak liquidity position of the banking system in times of financial stress, as Sareb's bonds were eligible as collateral in Eurosystem's refinancing operations. It also reduced risk-weighted assets in the transferring banks and was a central element for the much-needed recognition of losses in the system. Overall, the setup of Sareb reflected well the spirit of existing legislation in the EU with regard to the treatment of impaired assets in the banking sector, which establishes that a common Community approach to deal with asset relief measures should follow the objectives of boosting market confidence, limiting negative spillovers among Member States, protecting the single market in financial services and ensuring compliance with State aid and other legal requirements and minimising moral hazard. ([51]) Most stakeholders consulted by the evaluators considered that Sareb was a good model of an AMC in the euro area.

Sareb's return on equity (ROE) target appears ambitious, although profitability targets need to be assessed over Sareb's foreseen lifetime of 15 years. Sareb's envisaged ROE was 14-15%, calculated under what was considered a conservative scenario. This ratio appears high, partly as a consequence of the relatively small equity share and relatively high leverage of the company. It compares to an average ROE of Spanish deposit institutions of some 6% for the sector as a whole in 2014. The ROE was

([50]) See for instance the Commission decision on the restructuring and recapitalisation plan of the BFA Group (State aid SA.35253 (212/N)).
([51]) Communication from the Commission on the treatment of impaired assets in the Community banking sector, OJ C 72, 26.03.2009.

calculated taking into account modest profitability results in the early years of Sareb's operations (when sales are low and financing costs high given the large stock of assets financed) and still-declining house prices. Achieving the envisaged ROE might be challenging and would need a favourable evolution of real estate asset prices. Developments in the first two years of operations have been worse than initially planned, but it is too early to judge whether profitability in terms of equity was overoptimistic over Sareb's time frame. Looking ahead, the application of a new accounting Circular approved in September 2015 by the BdE might result in higher provisions against potential losses in 2015 and 2016. This is likely to hinder Sareb's profits and might require subordinated debt to be converted into equity. ([52]) The recent developments in Spain's real estate market offer initial signs of an improvement which, if sustained, should help improve Sareb's profitability going forward. ([53]) In addition, the management and sales administration contracts recently concluded with specialised companies are expected to enhance portfolio management efficiency and better value for Sareb's asset sales. ([54])

The governance of Sareb was difficult to set up in an efficient way in a short time. The decision to delink Sareb from the banks receiving State aid was efficient as it allowed detaching the risk associated with the transferred assets from the ailing banks, therefore contributing to one of the main objectives of the programme, which was to remove uncertainty from troubled banks' balance sheets. With regard to the management of Sareb, there was merit in a fast and complete change in the ownership and management of transferred assets (De Juan, 2014), and Sareb achieved the former but not the latter. Some of the consulted stakeholders pointed out that banks transferring assets to Sareb had little incentives to actively manage and divest those assets while they remained the asset managers. This calls for specialised independent servicers to deal with impaired assets once their ownership is transferred. It also highlights the importance for future AMCs to ensure from their inception that the right incentives are in place allowing for the effective management of the transferred assets and that the AMC management is independent. This would allow for higher returns and reduce risks for the taxpayer.

4.2.2. Bank recapitalisation and restructuring

The new legal framework introduced by Royal Decree-Law 24/2012 set a clearer strategy of loss recognition and subsequent recapitalisation, including contributions from public and private sources. The banks' restructuring and recapitalisation process was a key step in restoring confidence in the Spanish banking system. It implied the preparation and approval of restructuring plans for banks with capital gaps with a very tight deadline (November 2012). The timing of the implementation was remarkable as in less than six months restructuring plans respecting EU State aid rules had been adopted for eight credit institutions as stipulated in the MoU's roadmap. No further recapitalisations requiring public support were required thereafter. Thus, the plans fulfilled the programme's objective of restoring the viability of the restructured institutions without additional State aid. This supports the idea that using only part of the financial envelope available for the programme was an efficient way to achieve the programme's objective.

([52]) Circular 5/2015 of Bank of Spain, developing the specific accounting rules of Sareb. The Circular required Sareb to reorganise its asset portfolio by individual categories of assets, implying that valuation losses will not be able to be compensated with valuation surpluses across different categories of assets.
([53]) According to Spain's National Statistics Office (INE), the annual growth rate of the housing price index turned positive in the second quarter of 2014 and has remained positive thereafter. The growth of prices for new houses seems to have recently accelerated, while the increase in prices of second-hand houses decelerated in the first quarter of 2015. The IMF's staff report for the 2015 Article IV on Spain pointed out that there are signs that the real estate sector might have begun to turn the corner, also underpinned by investment and employment in construction having started to recover.
([54]) At the end of 2014, Sareb awarded to specialised companies service contracts for the management and administration of several asset portfolios which until then were being handled by various banks that had transferred assets to Sareb.

Table 4.4:
Capital needs and contributions by FROB (mio Euro)

	Group 1 Entities				Group 2 Entities			
	NCG	**CatalunyaBanc**	**Banco de Valencia**	**Bankia/BFA**	**CEISS**	**Liberbank**	**Caja 3**	**BMN**
Restructuring/Resolution	Resolution	Resolution	Resolution	Restructuring	Resolution	Restructuring	Restructuring	Restructuring
Initial capital needs*	7176	10825	3462	24743	2062	1197	779	2208
Assets transferred to SAREB (Transfer price)	5707	6708	1962	22318	3137	2917	2212	5819
FROB 3	5425	9084	4500	17959	604	124	407	730
Capital injection	5425	9084	4500	17959				730
CoCo bonds					604	124	407	
Economic value	-3091	-6674	-2245	-10444	-288	1113	370	569
Total FROB support	8982	12052	5498	22424	1129	124	407	1645
Capital generated through SLEs	1959	1676	416	6669	1433	850	44	425
FROB's equity after recap. (end-2014)	63%	66%	-	68%	-	-	-	65%

*According to Oliver Wyman adverse scenario
Source: FROB

The independent bottom up stress tests, which set the basis for identifying banks' capital needs, were crucial to increase transparency and confidence in the Spanish banking system. The reliance on independent experts to assist in the assessment of the proposed methodology and the valuation of assets was consistent with existing legislation in the EU. The results of the stress tests were considered technically robust. ([55]) All stakeholders interviewed in the consultation process of the evaluation and the evaluators shared the view that independent and credible stress tests were a central element increasing confidence on the restructuring plans and reducing uncertainty about the size of the overall capital gap in the banking system. The process and methodology of the stress tests, which included a technical expert group and a steering group, was appropriate to separate political and technical discussions. By the end of 2012, the recapitalisation of the Spanish banking system had largely contributed to an overall reduction in wholesale funding and in net borrowing from the Eurosystem (see Chapter 6). Spanish banks' reliance on Eurosystem funding decreased continuously from its record EUR 400 billion in mid-August 2012 to less than EUR 150 billion on average in 2014. The ECB's Comprehensive Assessment disclosed in October 2014 (based on end-2013 data) confirmed that the regulatory capital needs of the Spanish banking system had been adequately filled. ([56])

([55]) See for instance Financial Sector Reform – First Progress Report November 2012 IMF Country Report No. 12/318.
([56]) One former savings bank, Liberbank, failed to be above one of the three capital thresholds envisaged in the ECB methodology, showing a small shortfall of EUR 32 million stemming from the asset quality review. However, Liberbank managed to raise fresh equity amounting to EUR 637 million already during the first half of 2014 and therefore needed no additional capital to meet the comprehensive assessment minimum requirements.

Table 4.5:
Capital ratios of Spanish banks

	AQR Adjusted CET1 ratio (end-2013)*	CET 1 (June 2015)
Banco Bilbao Vizcaya Argentaria	10.5%	12.0%
Banco de Sabadell	10.3%	11.5%
BFA/Bankia	10.6%	12.8%
Banco Mare Nostrum	9.0%	10.1%
Banco Popular	10.1%	12.5%
Bankinter	11.7%	11.8%
Banco Santander	10.3%	12.4%
Ibercaja	10.0%	11.5%
La Caixa (Caixabank)	10.2%	12.8%
Unicaja-CEISS	10.9%	11.9%
Cajas Rurales Unidas, Sociedad Cooperativa de Credito (Cajamar)	9.9.%	10.9%
Catalunya Banc (acquired by BBVA in 2015)	12.2%	15.8%
Kutxabank	12.0%	13.9%
Liberbank	7.8%	13.4%
NCG Banco (Abanca)	10.2%	12.7%

* Common Equity Tier 1 (CET1) in accordance with CRR/CRD IV capital definition (including transitional arrangements). The minimum capital threshold for the ECB stress tests baseline scenario was a CET1 ratio of 8%. The MoU required a CET1 ratio of at least 9% at least until the end of 2014.

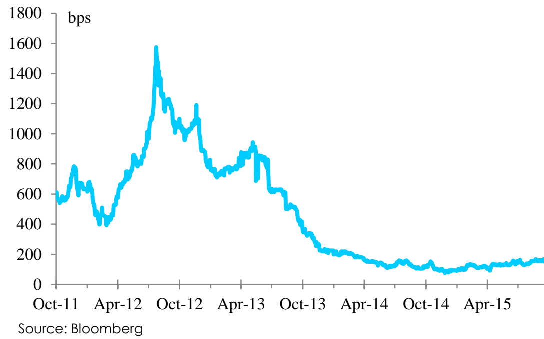
Source: ECB, European Commission

The MoU contained the possibility of mobilising a EUR 30 billion backstop in case of emergency to cover for the costs of unexpected interventions in credit institutions, which was not used. The possible use of this backstop to recapitalise banks ahead of the adoption of restructuring decisions by the European Commission required a reasoned and quantified request from the BdE, to be approved by the European Commission and the Euro Working Group, in liaison with the ECB. Between the signature of the MoU and the approval by the Commission of the restructuring plans of BFA/Bankia, NCG Banco, Catalunya Banc and Banco de Valencia in November 2012, financial market stress intensified partly as a result of losses posted in August by BFA for the first half of 2012, with sovereign bond yields increasing some 60 basis points from 6.2% to 6.8% in the second half of August. Expectations about worsening corporate data results in summer 2012 pointing to further financial strains in Bankia and uncertainty about potential shareholders' losses led to a marked increase in the costs of insuring against a default on Bankia's bonds, as measured by credit default swaps, with spill-over effects on Spain's sovereign bond yields. Despite the turmoil, the EUR 30 billion contingent facility was not activated. ([57]) Given the high financial stress at the time, a question arises whether or not these developments would have justified the activation of the facility in order to recapitalise Bankia. Against this background, the evaluators found that, while foreseeing a contingent facility for its immediate use in case of emergency was warranted by the high volatility in financial markets and the uncertainty about the assumed capital shortfalls of Spanish

([57]) On 3 September 2012, as a result of the losses posted on 31 August 2012 by the BFA Group for the 2012 half-year accounts, the FROB resolved to make a limited capital injection in BFA of EUR 4.5 billion in order for BFA to comply with the minimum regulatory capital requirements and maintain its eligibility as a Eurosystem counterpart for monetary policy operations. The European Commission approved the capital injection on 7 September 2012 (referred to as "the urgent Recapitalisation Decision" – State aid case 35369). Following the capital injection, BFA granted a subordinated loan for the same amount to Bankia. The urgent recapitalisation decision was carried out in anticipation of the submission of the restructuring plan for BFA Group that should lead to its final recapitalisation by the FROB.

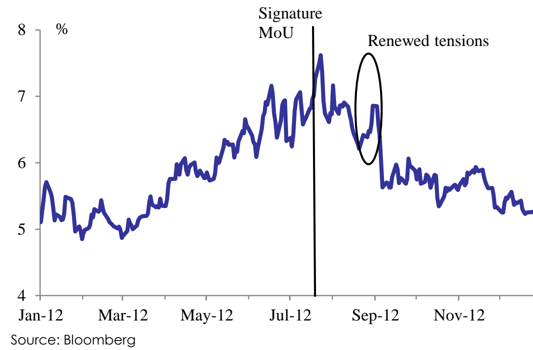
banks, the MoU would have benefited from a more clear description of the conditions under which the facility could be drawn upon.

Graph 4.2a: **Bankia 5Y Credit default swap spread**



Source: Bloomberg

Graph 4.2b: **Spain 10y sovereign bond yield**



Source: Bloomberg

In the absence of an explicit rule-book, there was a certain degree of discretion in the application of burden sharing under the programme's implementation. The MoU required banks and their shareholders to take losses before State aid measures were granted and to ensure loss absorption of equity and hybrid capital instruments to the full extent possible. The subordinated liability exercises carried out in 2012 and 2013 generated close to EUR 14 billion in capital from these instruments, of which about 70% was held by retail investors (some EUR 10 billion). One of the main objectives of the Community framework to deal with impaired assets is that banks should bear the losses associated to the impaired assets to the maximum extent. The "maximum extent" was nevertheless not fully clear. The average haircut applied to assets subject to subordinated liability exercises (initial discount as a percentage of the nominal value) was some 27%, although it ranged from 7% for Liberbank to 86% in Banco de Valencia. ([58]) It is unclear whether banks' shareholders and bondholders bore losses literally to the maximum possible extent, partly because the MoU did not specify whether this implied that junior debt could be fully depleted and whether and/or how this should factor in financial stability or other concerns.

([58]) The implementation of burden sharing for holders of preference shares and perpetual subordinated debt took place through conversion of these securities into equity or equity equivalent instruments. Holders of dated subordinated debt were given the choice between conversion into equity or into a senior debt instrument. The calculation of the fair value of the different financial instruments subject to burden sharing was based on their net present value (NPV). The NPV for each financial instrument was calculated by discounting the cash flows of the instrument according to the terms and conditions upon which the instrument was issued (e.g. coupon, maturity, coupon suspensions). Discount rates varied per type of instrument in order to factor in the different seniority of the instruments (higher discount rate for more junior instruments). A take-up premium on the NPV was allowed so as to reflect normal take up premia observed in market buy backs of securities and an illiquidity premium. The conversion could not be higher than 90% of the face value of the instrument. Differences in capital gaps, share of junior debt and types and conditions of financial instruments held resulted in different haircuts across banks subject to SLEs.

Table 4.6:
Capital generated through burden sharing exercises (mio Euro)

Credit entity	Initial outstanding (nominal)	Initial discount	Initial discount (% nominal)	Purchase price (exchange for capital)	Purchase price (exchange for debt)	Capital generated
BFA Bankia	6911	1817	26%	4852	242	6669
NCG	2047	604	30%	1355	88	1959
CatalunyaBanc	1818	457	25%	1218	142	1676
Liberbank	866	63	7%	787	16	850
CEISS	1433	274	19%	1159	0	1433
Caja3	91	35	39%	9	47	44
BMN	449	116	26%	309	24	425
Banco Gallego	192	45	23%	122	25	176
Banco de Valencia	416	357	86%	59	0	416
Total	**14223**	**3768**	**27%**	**9870**	**584**	**13648**

Source: FROB

The apparent flexibility in the implementation of the MoU's burden sharing conditionality responded to factors ranging from legal to financial stability considerations. First, in 2012 the hierarchy of seniority of claims in the event of a bail-in exercise (outside liquidation) was not totally clear. ([59]) Second, the holders of hybrid instruments were, to a large extent, small investors who in many cases had not been aware of the risks imbedded in hybrid products such as 'preferentes'. ([60]) Third, some stakeholders feared that further bailing in of preference shares might have increased financial stability risks due to losses in banks' deposit base, as holders of those shares were often depositors and clients in the same institutions. Finally, legal uncertainty and the need to respect the "no creditor worse off" principle would have made it difficult to impose higher haircuts to hybrid and subordinated debt. ([61]) These factors led to a degree of discretion in the application of haircuts across the different categories of financial assets when restructuring credit institutions, which seemed to have prevented a loss absorption by equity and hybrid capital instruments to the full extent possible. While the decisions in determining the level of haircuts seemed reasonable, more transparency and clear communication about the implementation of burden sharing would have notably improved the public's perception about those decisions. Likewise, the reasons why different approaches for burden sharing were taken across different euro area programmes were not widely available and properly communicated by the EU institutions and bodies.

The bail in of hybrid capital and subordinated liabilities, while reducing the cost to the taxpayer, to a significant degree hit domestic retail investors and led to social unrest. This was because of the way subordinated liabilities were sold in many occasions in the run up to the crisis. In particular, preference shares were often sold by banks and regarded by investors as a substitute to deposits. In Spain, a large share of those investors was not institutional but mostly households and pensioners with limited knowledge of financial instruments such as hybrid capital. Thus, it is important to differentiate between the application of bail in with regard to hybrid products and subordinated debt in the context of the programme, which applied the order of seniority among assets, and the marketing of those products, which happened prior to the programme. In this context, the setup of arbitration procedures by the Spanish banks was regarded by the evaluators and the interviewed stakeholders as a positive initiative

([59]) It is worth noting that capital requirements regulation existing at the time provided for a scheme of loss-absorbency instruments (equity plus hybrids).

([60]) By July 2015, arbitral awards related to the selling of hybrid products were favourable to clients in more than 50% of the application cases for BFA-Bankia, NCG and Catalunya Bank. With regard to litigation, out of the judged court claims settled by the second half of 2014, favourable resolutions to hybrid-debt investors reached at least 85%, 38% and 80% for for BFA-Bankia, NCG and Catalunya Bank, respectively.

([61]) The "no creditor worse off" principle has to be respected according to EU State aid rules in burden sharing exercises in order to ensure compatibility with the protection of property rights. It implies that subordinated creditors will not receive less in economic terms than what their instrument would have been worth if no State aid were to be granted (e.g. if the restructured banks had been liquidated).

allowing non-qualified retail clients to recover part of their losses through arbitration procedures. ([62]) Some social partners nevertheless pointed out that delays and procedures for litigation against the sale of preferential sales shares as well as for compensation of claims were too long. Where burden sharing is going to be implemented within a programme, there is merit in taking into account the programme's impact on consumers and retail investors.

The inclusion of senior debt in the burden sharing exercises would have allowed for a higher contribution of the private sector to the costs of the programme, but likely to the detriment of financial stability. The MoU did not stipulate the introduction of liability exercises including senior debt or deposits not covered under the Spanish deposit guarantee fund. This emulated the approach followed in 2010 with the economic adjustment programme for Ireland. There was a perception by some investors at the onset of the programme that euro area authorities were considering approaches to include senior bondholders in burden sharing exercises, notably through the proposal for a bank resolution and recovery directive, but there was no clarity on the circumstances in which senior bondholders would be required to participate in burden sharing. There was also uncertainty about whether the application of haircuts to senior debt within the existing insolvency procedure in Spain could be mirrored for cases where a bank would not be declared bankrupt (i.e. a going concern). In this regard, the hierarchy of assets established by Spanish law between deposits and senior debt could have implied a *pari passu* treatment between both categories of assets. Decree Law 24/2012 introduced the legal basis that enabled the carrying out of burden sharing exercises affecting hybrid instruments and subordinated debt as requested in the MoU.

Depositors' concerns about a bail-in of deposits would have likely intensified financial market stress and capital flows out of the Spanish banking system. Some social partners interviewed by the evaluators highlighted that banks should have contributed more to the costs of restructuring the financial sector, but a sizeable contribution by the private sector at the time would have been difficult to achieve without the inclusion of senior debt in burden sharing exercises. Deposits had been key sources of funding for banks in Spain in the run up to the programme, much of which was from foreign investors. Imposing haircuts on senior debt and deposits might have also required higher haircuts of junior debt and have led to increased litigation against such decision. It could have led to deposit outflows and negative contagion to the healthy part of the Spanish banking system (i.e. most credit institutions but saving banks) and probably other banking systems with capital needs in the euro area, hindering their market access. This represented a risk for financial stability not only in Spain but in the euro area as a whole, whose prevention was one of the overarching objectives of the programme. In addition, bailing in senior debt in the banks receiving State aid would have implied some losses for the government, given the high levels of government guaranteed debt held by those banks. Thus the decision not to include senior debt in the burden sharing exercises appeared appropriate given the potential effects on financial stability and the risk of wider deposit outflows, and followed the strategy pursued in the case of Ireland.

The context for applying burden sharing in Spain under the programme was complex due to the lack of consistency across bank resolution regimes in euro area Member States, which was likely to contribute to diverging funding costs across the euro area. The mandatory burden sharing exercises required by the MoU resulted in the first sizeable case of bail in in the euro area. While the BRRD entered into force in January 2015, the approach taken under the Spanish programme to apply bail in was already going in the direction of the directive. The BRRD went further by introducing more clarity about the conditions to apply haircuts to senior debt (senior liabilities should be converted or written down if the subordinate classes have been converted or written down entirely). Prior to that, there was a lack of consistency across euro area Member States' financial assistance programmes with regard to the implementation of bail in (e.g. from no compulsory bail in of hybrid and subordinated debt in Ireland to bail in of depositors in Cyprus), partly because legal systems were different across Member States. This reflected an evolving situation.

([62]) Retail investors had recovered some €1.8bn through arbitration processes and €508M through litigation processes by early 2015. Litigation costs are likely to increase further in the foreseeable future.

The evaluators and all stakeholders consulted agreed that the BRRD was an important step to harmonise and improve the resolution mechanisms across Member States. Contrary to the bail-in framework in the context of the Banking Union, the Commission "Banking Communication" from August 2013 did not require contributions from senior debt holders as a mandatory component of burden sharing once capital raising measures by the bank in question and hybrid capital and subordinated debt would have contributed to reducing the capital shortfall to the maximum extent. ([63]) In this regard, the burden sharing exercise carried out in Spain was also in line with the "Banking Communication". The Communication pointed out that differences in the approach to burden-sharing between Member States had led to divergent funding costs between banks depending on the perceived likelihood of a bail-in as a function of a Member State's fiscal strength. Spain had gone beyond the common practice up to that moment, as there were few cases of far-reaching burden sharing among shareholders and hybrid or subordinated debt and their magnitude was small relative to the exercise in Spain (the nationalisation preceding the recapitalisation of SNS Reaal in the Netherlands in 2013 resulted in far-reaching burden-sharing by shareholders and hybrid capital holders). ([64]) The BRRD entered into force in January 2015 and is fully applicable from January 2016, while the SRB has also been created to organise the funding of bank resolution. This should harmonise approaches to bail-in and provide some element of pre-financed support for bank resolution. As such, they should go a long way to address the open concerns expressed by the 2013 Banking Communication.

The application of EU State aid rules by the Commission to the financial sector in the context of the programme included the objective of ensuring financial stability. The Commission State aid decisions approving aid to Spanish banks aimed at avoiding a serious disturbance of the Spanish economy, while at the same time ensuring that aid was only used for viable entities, that restructuring plans contained sufficient burden sharing measures and that aid did not lead to undue distortions of competition. Several stakeholders interviewed by the evaluators raised concerns about the lack of sufficient transparency with regard to the banks' restructuring decisions as well as on the impact of specific restructuring requirements on private sector deleveraging and overall macro-financial stability, particularly in the event of potential systemic crises. In the State aid restructuring plans of banks under the programme, there were measures which obliged banks to withdraw from non-viable activities or to divest certain (non-core) subsidiaries (for instance for viability or burden sharing reasons). Although the Commission considered that it had shown flexibility in those measures, by for instance accepting relatively long divestment deadlines, concerns were raised by some stakeholders that certain restructuring commitments under State aid rules could be value-destructive for banks under restructuring and therefore for the tax payer. They raised concerns about setting certain numerical targets in restructuring/resolution processes and about the strictness of divestment calendars. It is difficult for the evaluators to assess whether divestment calendars under the banks' restructuring plans in Spain were optimal, as the exact details of the portfolios are not made public. ([65]) For instance, it is difficult to assess whether divestment calendars with regard to portfolios of companies were optimal in terms of efficiency, as divesting certain equity portfolios of sound companies during a low point of the economic cycle might not help maximising the value of divestments. One stakeholder saw merit in setting longer deadlines for selling banks' businesses and not making those deadlines public. ([66]) In contrast, another counterpart raised concerns about setting long deadlines for entities deemed not viable. Against this background, there seems to be merit in considering the application of restrictions in restructuring plans with some flexibility and allow for periodical

([63]) Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis (‘Banking Communication’), Official Journal of the EU (2013/C 216/01), July 2013.

([64]) See Commission Letter to the Member State, State aid SA.35382 (2013/N) – The Netherlands Rescue SNS REAAL 2013, C(2013) 1053 final, February 2013.

([65]) See for instance the Commission decision on the restructuring and recapitalisation plan of the BFA Group (State aid SA.35253 (212/N)).

([66]) During the financial crisis, the Commission has already accepted relatively long restructuring periods (up to five years) and the Commission has already a policy of treating divestment dates - at the request of Member States - as confidential information in the public version of the State aid decision.

revisions of the plans in order to minimise the cost borne by the taxpayer in bank restructuring episodes. ([67])

4.2.3. Enhancing bank transparency, regulation and supervision

The authorities' compliance with the horizontal policy requirements of the (MoU) was overall complete. Wide ranging measures were implemented contributing to overhaul the governance, regulatory and supervisory framework of the Spanish banking sector. The operational independence of the BdE was strengthened, transparency was increased by improving the quality and harmonisation of the information provided by credit institutions and the savings banks governance was overhauled. The reforms in the area of supervision and restructuring of credit institutions led to a clearer separation of powers between the BdE and other bodies. This was important as failures to translate supervision findings into action had been identified as an important problem preventing early action against the accumulation of large imbalances in the Spanish banking system in the run up to the programme. Overall, the reforms were also in line with the recommendations issued by the IMF in the context of its FSAP assessment published a few weeks before the programme was set up. The evaluators and a large majority of stakeholders interviewed assessed positively the steps taken by the BdE to reinforce its independence and to improve internal procedures. Stakeholders interviewed by the evaluators shared the view that the entry into force of the Single Supervisory Mechanism (SSM) was an important reinforcing element to the supervisory framework in Spain. The participation to the SSM itself entailed significant changes for the supervisory procedures of the BdE, including a new organisation chart adopted in September 2014 of its Directorate General Banking Supervision with the aim to mirror the organisation of the SSM.

While the savings bank sector had been gradually reformed prior to the programme, important steps were taken within the programme to better reinforce its governance. Implementation in the area of resolution and supervision was overall comprehensive, but there were some implementation delays with regard to the reform of the savings banks sector. This regards in particular the issuance of subordinated legislation, as the adoption of a Royal Decree by the government and a Circular from the BdE implementing the new legal framework for Spanish savings banks (Law 26/2013) were approved only in late 2015, representing a significant delay after the approval of the Law on savings banks in December 2013. ([68]) The secondary legislation developed crucial aspects regarding incentives to reduce controlling stakes held by banking foundations in banks. The full implementation of Law 26/2013 was important to remove any remaining uncertainty with regard to the governance of savings banks and to underpin the overhaul of the sector carried out over the past few years.

Some measures were introduced in parallel to reinforce consumer protection, albeit some stakeholders interviewed by the evaluators argued that more could have been done. New legislation was introduced to better protect consumers by increasing requirements for disclosure of information from credit institutions to investors, e.g. for placement of certain securities, as well as to ensure that investment advice from investment service providers was transparent and effective. A two-year suspension of evictions for vulnerable families was decided together with other initiatives in Law 1/2013 of May 2013 on measures to reinforce protection of vulnerable mortgage debtors, debt restructuring and social housing. It was targeted to low-income families who met certain standards of vulnerability. The evaluators considered that this was a sensible and timely initiative which provided temporary relief for some vulnerable households and it did not seem to have undermined financial stability. While the outcome of the implementation of the new legislation needs to be monitored, so far it does not seem to have hindered financial stability. The new legal framework in this area aimed at reaching a better balance between consumer protection and financial stability. Some stakeholders interviewed raised concerns about the

([67]) The Commission has already revised restructuring commitments in a number of State aid restructuring decisions after Member States and companies asked for such a revision and it made sure that also under the new restructuring commitments viability was ensured with burden sharing and compensatory measures remaining equivalent.
([68]) Royal Decree 877/2015, of 2 October 2015 and BdE Circular 6/2015 of 17 November 2015.

consumer-protection component of regulatory changes undertaken under the programme, claiming that this aspect should have been more developed. One stakeholder pointed out that the creation of a specialised body for financial consumer protection in the context of an EU programme would contribute to better limit negative spillovers on consumers. This seemed to be a sensible proposal to the evaluators.

The reforms in this area have increased the resilience of the banking system and have overall reduced risks to financial stability. The new range of tools to intervene effectively in weak banks improved the previous framework and have adapted to good international practices and common resolution frameworks in the EU. Reforms have included emergency procedures to recapitalise credit institutions, thus with the system becoming more dynamic. While mandatory burden sharing exercises can be implemented by the FROB when a bank receives public aid, they can still be preceded by voluntary exercises, which is positive and ensures flexibility. The reforms adopted by the authorities were also instrumental to establish a clearer order of seniority of liabilities of credit institutions in the event of burden sharing exercises, which went into the direction of the order established within the Single Resolution Mechanism as major pillar of the Banking Union. While effective, these measures seem well balanced with efficiency as they should reduce the potential burden on public finances, reduce the negative impact on restructured banks and minimise the burden on tax payers while preserving financial stability.

However, challenges for the Spanish financial sector remain. In particular, despite the improved economic outlook, a still declining stock of credit and the current low interest-rate environment pose risks to the long-term sustainability of banks' profitability. Also, the privatisation of the banks still under the control of the FROB remains to be completed and maximising the recovery value for its investment in those entities remains a challenge. Pro-active supervision in order to ensure adequate provisioning and comfortable capital levels, advancing reform in the broader governance of the banking sector and fostering non-bank financial intermediation will contribute to a more resilient financial sector in Spain.

5. EXCESSIVE DEFICIT PROCEDURE AND EUROPEAN SEMESTER

5.1. SPAIN'S COMMITMENTS UNDER THE EXCESSIVE DEFICIT PROCEDURE AND EUROPEAN SEMESTER

The main objective of the Spanish programme was to increase the long-term resilience of the banking sector as a whole, thus, restoring its market access. However, there is a close relationship between macroeconomic imbalances, public finances and financial sector soundness. In parallel to the specific financial sector related conditionality spelled out in Annex 2 of the MoU, Spain committed to comply with its existing 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. Progress as regards these commitments was regularly and closely monitored during the formal review process associated with the programme.

Building on the revised EDP recommendations of July 2012, where the deadline for correcting the excessive deficit was extended for one year, Spain committed to correct the excessive deficit situation by 2014. Spain was recommended to ensure the attainment of the intermediate deficit targets of 6.3% in 2012, 4.5% in 2013 and 2.8% in 2014.

Regarding structural reforms, Spain committed to implement the country-specific recommendations under the European Semester, aiming at correcting macroeconomic imbalances identified in the in-depth review under the MIP. In particular, Spain was recommended to: i. Introduce a taxation system consistent with the fiscal consolidation efforts and more supportive to growth; ii. Ensure less tax-induced bias towards indebtedness and home-ownership; iii. Implement the (already adopted) labour market reforms; iv. Take additional measures to increase the effectiveness of active labour market policies; v. Take additional measures to open up professional services, reduce delays in obtaining business licences and eliminate barriers to doing business; and vi. Complete the electricity and gas interconnections with neighbouring countries, and address the electricity tariff deficit in a comprehensive way.

5.2. ASSESSMENT OF THE PROGRAMME'S LINK TO THE EXCESSIVE DEFICIT PROCEDURE AND EUROPEAN SEMESTER

A financial sector specific programme with an explicit link to commitments under the EDP and European Semester was relevant given the overall state of the Spanish economy. The Spanish authorities considered that including explicit conditions in the MoU on fiscal and structural reforms was not necessary at the outset of the programme, but positive feedback loops from the implemented reforms under the EDP and the European Semester contributed to the overall success of the programme as it helped to restore investor confidence about the overall institutional and administrative capacity in Spain. Spain was already making progress in unwinding macroeconomic imbalances and implementing major structural reforms prior to the programme under the existing mechanisms (EDP, MIP). Several stakeholders interviewed by the evaluators were of the opinion that the link to these procedures served as an insurance for creditors that Spain would implement structural reforms and advance with fiscal consolidation. Some social partners consulted during the course of the evaluation believed that the programme reinforced Spain's obligations under the EDP and the European Semester, which were considered pro-cyclical and they claimed that the programme should have been accompanied by a smoother path of fiscal consolidation. These views considered that the programme on its own account imposed a strong deleveraging in the financial sector which should have been offset by a less frontloaded consolidation of the public finances. Overall, the evaluators found that the explicit link to the EDP and European recommendations was useful, as it enhanced surveillance by EU institutions in this area within

the context of the regular review missions under the programme. This seems to have been supportive to enforcement. Review reports linked both progress and reforms in the financial and EDP/European Semester parts. ([69]) The substantial range of reforms implemented by the authorities and the reduction of the general government deficit restored confidence in Spain' administrative capacity and ability to take effective measures. This reinforced the flow of "good" news and helped to restore credibility. Given that the commitments and obligations under the EDP and recommendations to address macroeconomic imbalances within the framework of the European Semester were sufficiently detailed and clear, the design of the programme avoided an unnecessary intrusive set of conditionality which risked overlapping with existing recommendations. The MoU's reference to the commitment to comply with EDP and European Semester procedures might have also strengthened overall macro-financial stability in Spain, as it reassured investors that the programme was part of a broader strategy taking care of macroeconomic structural adjustment and fiscal sustainability issues. In this regard, the success of the programme was linked to the success of Spain's compliance with those procedures.

The authorities argued that maintaining ownership of the reform programme was important as it made it easier to implement the programme as well as to explain to social partners that this was needed to improve the future economic prospects of Spain. This would have been more difficult in the context of a fully-fledged programme with extensive macroeconomic conditionality. On the other hand, social partners felt that they were not sufficiently consulted by the government taking socially sensitive decisions. The authorities valued constant interaction and close coordination with the EU institutions in the context of the implementation of EDP and European Semester procedures, which facilitated the process.

This type of programme was suitable for Spain because of the high commitment of the authorities and the proper administrative and technical capacity within the Spanish institutions. The experience with the Spanish programme seems to suggest that it is not so important whether conditionality on fiscal and structural reforms are explicitly detailed in the programme or linked to existing procedures, but rather how committed the authorities are to implement certain reforms. Most parties consulted praised the high administrative capacity and commitment of the Spanish authorities to implement reforms. Therefore, while it is useful to have this type of programme in the toolbox of possible intervention at European Union/euro area level, it requires some specific conditions to be strictly met in order to be equally suitable for future potential programmes. In particular, strong implementation capacity and political commitment need to be in place in the beneficiary country. Explicit concretisation in the MoU that the country will comply with EDP and European Semester procedures, of which the Macroeconomic Imbalance Procedure is of particular relevance, may help to create positive feedback loops and underpin the overall success of the programme. In this regard, monitoring progress with commitments under the EDP and European Semester during the programme reviews by the international institutions involved in the programme may support enforcement, particularly if disbursements are gradual and linked to compliance.

5.3. IMPLEMENTATION OF COMMITMENTS DURING THE PROGRAMME PERIOD

Implementation of fiscal consolidation and fiscal reforms

The Spanish financial sector programme started in the context of a severely weakened fiscal position. The Spanish budget balance changed from a surplus of 2% of GDP in 2007 to a deficit of 11% of GDP by 2009. The underlying deficit improved somewhat to 8.9% in 2011 but remained very large. Large uncertainty about the financing needs of the Spanish banking sector and possible implications to the Spanish public finances as well as a still very high general government deficit contributed to the strong deterioration of Spain's financial market access conditions prior to the programme.

([69]) There was also clear peer pressure as during review mission the compliance with the EDP/European Semester conditionality was checked and reported to the EFC/ECOFIN. This increased substantially the frequency and intensity of surveillance.

The government took consolidation measures and strengthened the institutional framework and budgetary execution control, which led to a further improvement of the underlying fiscal position in 2012. The general government budget deficit net of capital transfers to banks, which are considered one-off operations, narrowed from 8.9% of GDP in 2011 to 7.0% in 2012. This, however, exceeded the EDP target of 6.3% of GDP. The deviation from the general government target was linked to a combination of weaker-than-expected revenues (taking into account the impact of discretionary measures and the base effect) and some expenditure overruns, including higher intermediate consumption, and social transfers. A less tax-rich growth composition and a stronger-than-expected deterioration in the labour market implied major revenue shortfalls as well as higher social expenditure. In 2012, the Spanish authorities undertook comprehensive front-loaded fiscal consolidation measures of around 4% of GDP (1.6% on revenues and 2.5% on the expenditure side). In line with the 2012 country-specific recommendations, the very narrow VAT base was broadened by reducing the scope of application of the super-reduced and reduced tax rates. The standard (from 18% to 21%) and the reduced rate (from 8% to 10%) were increased, while the 4% super-reduced rate remained unchanged. Some excise duties were also increased. On the expenditure side, measures included cuts in spending on education and health care, reductions in capital transfers and deep cuts in capital and current spending by the ministries (EC, 2013). ([70])

Implementation of significant consolidation led to an improvement in the structural balance. Spain undertook major discretionary consolidation measures, amounting to around 3 ½% of GDP in 2012 (not including temporary and one-off measures), confirming the conclusion of the effective action taken (EC, 2013). The estimated change in the structural balance was severely affected by revenue shortfalls compared to the scenario underlying the original 2012 EDP recommendation (which required a fiscal effort of 2.7% in 2012), despite additional discretionary current revenue measures taken. Overall, taken these effects into account, the estimated adjusted change in the structural balance amounted to 2.9 percentage points, above the effort required under the revised EDP recommendation. For 2013, after correcting for an unexpected revenue shortfall, additional discretionary revenue measures were taken after the EDP recommendation amounting to some 1.7% of GDP, bringing the adjustment in line with the required effort according to the revised EDP recommendation (fiscal effort of 2.5% in 2013). Due to the measures adopted, some rebalancing of the relative tax burden towards consumption and environmental taxes took place, in line with the 2012 country-specific recommendations (EC, 2013).

Spain also implemented measures to address the debt bias in the corporate income tax and in the treatment of housing in personal income tax and introduced measures to combat tax evasion and improve revenue collection. In 2012, Spain withdrew tax compensation in personal income tax for house purchases made before 2006 and removed home mortgage deductions against personal income tax for purchases from 2013 onwards. The government introduced measures to combat tax evasion and improve revenue collection. In October 2012, an act strengthening the fight against tax fraud and evasion entered into force. Its provisions included stronger penalties, limits on cash payments, new reporting obligations for assets held abroad, and anti-fraud measures in the field of VAT (EC, 2013). Moreover, in March 2013 Spain established a new international tax office to deal with international tax audits. These developments were in line with the 2012 country-specific recommendations. According to the Spanish Ministry of Finance, the tax collection arising from the fight against fraud has increased steadily and amounted to around EUR 12 billion in 2014 (EC, 2015).

The EDP targets for Spain were aligned in 2013 and the deadline extended for the correction of the excessive deficit, which reflected changes in macroeconomic conditions. Unexpected adverse economic developments (including a stronger contraction of the economy and a less tax-rich composition of growth) had major unfavourable consequences for government finances. Against this background, the deadline for correcting the excessive deficit by Spain was extended in June 2013 by two years to 2016,

([70]) The fiscal data about deficits, structural balances and fiscal effort are based on the European Commission official documents related to the EDP at the time of the assessment.

setting intermediate headline deficit targets of 6.5% of GDP in 2013, 5.8% of GDP in 2014, 4.2% of GDP in 2015 and 2.8% of GDP in 2016 (Council, 2013). The improvement in the structural balance implied targets of 1.1% of GDP in 2013, 0.8% of GDP in 2014, 0.8% of GDP in 2015 and 1.2% of GDP in 2016. The targets took into account the need to compensate for the negative second round effects of fiscal consolidation on GDP growth (EC, 2013). The more gradual adjustment path also too into consideration the difficult economic environment and the ongoing major structural transformation of the Spanish economy.

Table 5.1:
Comparison of main macroeconomic indicators and fiscal outcomes (y-o-y % change)

	EC SF 2012			EC SF 2013				EC SF 2014				
	2011	**2012**	**2013**	**2011**	**2012**	**2013**	**2014**	**2011**	**2012**	**2013**	**2014**	**2015**
GDP	0.7	-1.8	-0.3	0.4	-1.4	-1.5	0.9	0.1	-1.6	-1.2	1.1	2.1
Private consumption	-0.1	-2.2	-1.3	-1	-2.1	-3.1	-0.1	-1.2	-2.8	-2.1	1.3	1.6
Public consumption	-2.2	-6.9	-3.5	-0.5	-3.7	-3.7	-0.4	-0.5	-4.8	-2.3	-0.8	-0.7
Gross fixed capital formation	-5.1	-7.9	-3.2	-5.3	-9.1	-7.6	-1.1	-5.4	-7	-5.1	-1.4	4.2
Exports (goods and services)	9	3.2	4.7	7.6	3.1	4.1	5.7	7.6	2.1	4.9	5.5	6.7
Imports (goods and services)	-0.1	-5.6	-0.9	-0.9	-5	-4	2	-0.1	-5.7	0.4	3.4	5.8
HICP	3.1	1.9	1.1	3.1	2.4	1.5	0.8	3.1	2.4	1.5	0.1	0.8
General government balance (% of GDP)	-8.5	-6.4	-6.3	-9.4	-10.6	-6.5	-7	-9.6	-10.6	-7.1	-5.6	-6.1
Structural budget balance (% of GDP)	-7.3	-4.8	-4.8	-7.5	-8.4	-4.3	-5.9	-6.5	-4.1	-2.8	-2.4	-3.9
General government debt (% of GDP)	68.5	80.9	87	69.3	84.2	91.3	96.8	70.5	85.9	93.9	100.2	103.8

Source: European Commission Spring Forecasts

Despite continuing recession and contracting domestic demand, Spain continued fiscal consolidation in 2013. The headline deficit decreased to 6.8% of GDP in 2013, slightly above the revised EDP target of 6.5%. Unlike in 2012, the fiscal adjustment was tilted more to the revenue side, with several tax increases taking effect, in particular most of the full-year effect of the September 2012 increase in VAT rates. Primary spending was also cut back, especially by regional governments. The revised EDP recommendation did not require Spain to adopt additional measures in 2013, further to the measures already announced. The government adopted some further limited tax increases in June 2013 amounting to around ½% of GDP; however, these were largely offset by underlying expenditure overruns. This contributed to the total incremental impact of discretionary measures in 2013, estimated to be about 3¼% of GDP, of which about 2% of GDP on the revenue side and 1¼% of GDP on the expenditure side, broadly in line with the revised 2013 EDP recommendations (EC, 2014).

Table: Main fiscal measures 2012-2014

Revenue	**Expenditure**
2012	
Corporate income tax (0.4% of GDP) Tax amnesty and measures combatting fraud (0.1% of GDP) VAT and excise duties (0.2% of GDP) Personal income tax (1% of GDP) Revenue measures at regional level (0.4% of GDP) Fight against social security fraud (0.2% of GDP) Fees in education (0.1% of GDP)	Investment and capital expenditure (1% of GDP) Public employment (0.6% of GDP) Unemployment benefit reform (0.2% of GDP) Health care and education (0.4% of GDP) Local government reform and adjustment plans (0.1% of GDP) Other measures (0.3% of GDP)
2013	
VAT and excise tax rate increases (1.1% of GDP) Personal income tax (0.2% of GDP) Excise and environmental taxes (0.3% of GDP) Revenue measures at regional level (0.2% of GDP) Social contributions (0.2% of GDP)	Health and education (0.7% of GDP) Christmas bonus reintroduction (-0.4% of GDP) Public employment (0.2% of GDP) Unemployment benefits (0.4% of GDP)

	Long-term care (0.1% of GDP) Local government reform and adjustment plans (0.1% of GDP)
2014	
Corporate income tax (0.2% of GDP) Measures combatting fraud (0.1% of GDP) Revenue measures at regional level (0.3% of GDP) Environmental taxes (0.1% of GDP) Social security (0.1% of GDP) Local government measures (0.1% of GDP)	Public employment (0.2% of GDP) Labour market policies (0.1% of GDP) Regional measures, excl. public employment measures (0.1% of GDP) Local government reform and adjustment plans (0.1% of GDP) Social security (0.1% of GDP)

Sources: EC, 2012; EC, 2013; EC, 2014.

In autumn 2013, the Commission assessed that Spain had taken effective action according to the EDP recommendation. According to the Commission 2013 Autumn Forecast, the expected improvement in the structural balance was estimated at 1.1 percentage points, in line with the revised EDP recommendation. However, the improvement in the structural balance, corrected for revisions in potential output growth and for unexpected revenue windfalls/shortfalls, fell short of the efforts recommended by the Council (EC, 2013). ([71])

With regard to the post-programme period, the general government deficit decline in 2014 was broadly in line with the revised EDP recommendation, but the adjustment in the structural balance fell short of the EDP requirements. The headline general government deficit declined from 6.8% in 2013 to 5.9% in 2014. The improvement stemmed from both the revenue and the expenditure side, indirect tax revenues being boosted by stronger domestic demand and falling unemployment reining in social transfers (EC, 2015). However, according to the Commission Assessment of the 2015 Stability Programme for Spain (EC, May 2015), while the EDP recommendation required Spain to achieve an improvement in the structural balance of 0.8% of GDP in 2014, the Commission estimates based on the 2015 spring forecast yielded only 0.1%. The Commission also saw risks to the achievement of the budgetary targets in 2015-2016. Spain's Draft Budgetary Plan for 2016 saw the headline deficit narrowing to 4.2% and 2.8% of GDP in 2015 and 2016, respectively, while the Commission 2015 Autumn Forecast projected the headline deficit to reach 4.7% and 3.6% of GDP, respectively.

Spain also implemented a set of structural fiscal reforms focused on strengthening fiscal institutions and frameworks as well as regional governance. Spain adopted a Budget Stability Law in 2012 and established an independent fiscal authority. Legislation on budgetary stability introduced more stringent fiscal rules (budget-balance, expenditure and debt rules) as well as a correction framework designed to be broadly in line with EU requirements and the fiscal compact. Spain also strengthened reporting of fiscal data for regional governments to increase fiscal transparency. In 2013, Spain also passed a legislation to reform local administrations in order to remove duplications with other government subsectors and streamlining the number of entities. After some initial delay, an independent fiscal authority (AIReF) was established in 2013 and is now fully operational. The authority can issue recommendations in its reports and opinions which are, however, not legally binding. A public sector reform that aims at streamlining public sector spending is ongoing (EC, 2013; EC, 2014).

([71]) Measuring the size of the structural fiscal adjustment has proven to be quite difficult in a context of prolonged recession and negative potential growth rate projection. Bottom-up measurements as well as the structural balance point to a front-loaded consolidation within the programme period. Even though, it should be noted that the change in the structural balance presents substantial shortcomings as a measure of the policy response during times of strong economic changes.

Implementation of structural reforms in the context of the European Semester

Spain implemented a wide range of structural reforms to tackle labour and product markets that facilitated the correction of the macroeconomic imbalances and aimed at boosting potential growth. In addition to the implementation of the labour market reform approved in February 2012, notable measures approved during the programme period included a reform to stabilise the pension system and to curb healthcare expenditures, a reform to increase efficiency of local and public administration, measures to achieve the unification of the Spanish internal market and a reduction of its fragmentation, the liberalisation of the retail sector and improvements in the business environment, a reform of the electricity sector and measures addressing the electricity tariff deficit.

The structural reforms agenda advanced decisively over the programme period. Many structural measures were taken in accordance with the 2012 and the 2013 Country Specific Recommendations by the Council in view of correcting macroeconomic imbalances in Spain. The labour market reforms and social partners' agreements ([72]) increased flexibility and tempered the fall in employment. The national Youth Employment and Entrepreneurship Strategy 2013-2016 aimed to improve employment opportunities for young people. Measures were adopted to foster closer cooperation between national and regional public employment services and between public employment services and private placement agencies. Some measures in the field of active labour market policies were adopted. In 2013, measures to balance the electricity tariff system were adopted, which had an effect in 2014, and several reforms were introduced to increase competition in the retail sector (a more detailed list of measures is provided in the Table below). Some measures in product and service markets are still in the implementation phase (e.g. the market unity law), while the reform on professional services has been delayed. Full implementation of ongoing reforms will be essential to reap their expected economic benefits.

Table: State of play with MIP-relevant reforms at the end of the programme period (2012-2013)

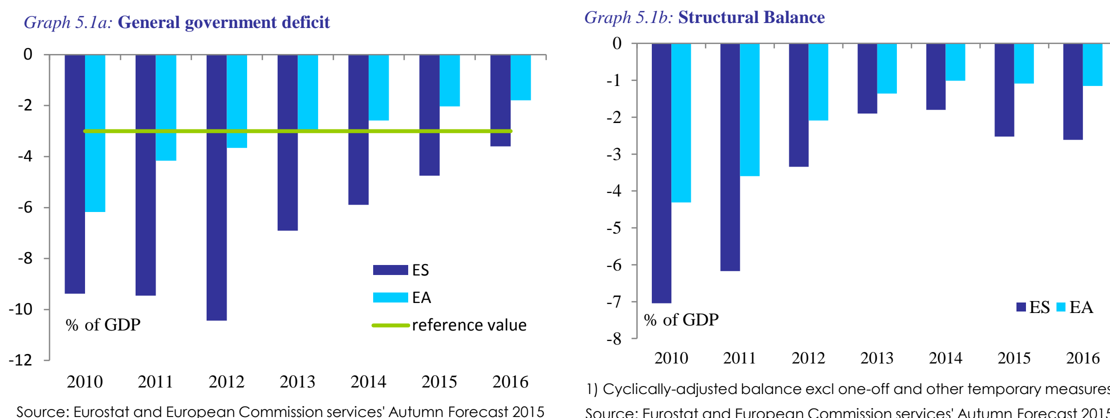
Main components in CSRs	Progress made
Measures to improve the quality of public expenditure and taxation and the efficiency of public administration	VAT increase and VAT base broadened from September 2012, with full effect in 2013. In July 2013 increase of excise duties on alcohol and tobacco. Creation of the National Bureau for International Taxation in April 2013. 2013 plan against irregular work. Spain's Independent Fiscal Institution (IFI) has been created in November 2013, and became operational in mid-2014. Measures to reduce public sector commercial arrears in December 2013. The Law on local administration reform was adopted in December 2013. Measures to curb early and partial retirement adopted in March 2013. Reform of the pension system passed in December 2013. The draft Law on dis-indexation submitted for parliamentary approval in December 2013 (approved in March 2015). In July 2013 an expert committee appointed to improve the tax system, delivered report in March 2014. The reform of local public administration adopted in 2013. In September 2013 measures adopted for the rationalisation of the public sector. In July-September 2013 measures adopted to increase cost-efficiency

([72]) The social partners' agreement linked wages to productivity growth and included guidelines for wage bargaining in 2012, 2013 and 2014.

	of the health-care sector. The government approved a draft law reducing the tax deductibility by companies in June 2013.
Measures to foster financial sector stability and an orderly deleveraging of the private sector	*Implementation in the framework of the bank recapitalisation programme.*
Measures to improve the functioning of the labour market and enhance human capital	Passive labour market policies and their link with active labour market policies were revised in 13 July 2012. The national Youth Employment and Entrepreneurship Strategy 2013-2016, adopted in March 2013 The National Plan against irregular work and social security fraud adopted in 2012. Spain has initiated a reform of the vocational education and training (VET) system to complement the 2012 Labour market reform, in November 2012. The 2013-16 National action plan on social inclusion adopted in December 2013. The organic law on the improvement of the quality of education was adopted in December 2013. Measures to foster part-time employment, December 2013. National Youth Guarantee Implementation Plan approved in December 2013.
Structural measures to promote growth and competitiveness	National Commission for Markets and Competition was created and started operating in 2013. Entrepreneurship law aimed at facilitating funding for entrepreneurs adopted in 2013. Increased flexibility of retail hours and reduction of licenses at municipal level in 2013. The law on the guarantee of market unity entered into force in December 2013. The law on promoting the rental housing market adopted in June 2013. A new law on the electricity sector and on transmission and distribution adopted in December 2013.

Assessment

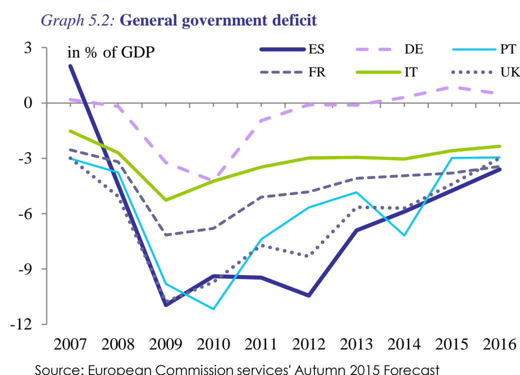
Fiscal indicators improved and were generally in line with the EDP targets during the programme period, although the original EDP targets had to be revised due to unfavourable economic circumstances and fiscal consolidation seemed to slow after the completion of the programme. The reduction of the general government deficit over the programme period helped to reassure investors that the costs of restructuring the banking system would not jeopardise the sustainability of public finances. The adopted measures were appropriate and led to a particularly strong adjustment path during the programme period (2012- 2013).The extension of the EDP deadline in 2012 (right before the start of the programme) to 2014 and once again in 2013 to 2016 ensured that immediate targets were achievable. The fiscal consolidation effort was significantly frontloaded and started before the programme. In 2010-2013, measures were adopted amounting to around 7.5% of GDP (around half of it on the expenditure side) (OECD 2014). However, fiscal consolidation slowed thereafter and a substantial part of the fiscal adjustment remained to be implemented in the post-programme period. Furthermore, the Commission saw risks to the achievement of the budgetary targets in 2015 and 2016 (EC, 2015).



Source: Eurostat and European Commission services' Autumn Forecast 2015

1) Cyclically-adjusted balance excl one-off and other temporary measures.
Source: Eurostat and European Commission services' Autumn Forecast 2015

Frontloading of the fiscal effort at the beginning of the programme was very important to restore credibility in the markets. Most of the stakeholders shared this view, while others argued that the frontloading dragged on growth and in particular as it coincided with a strong deleveraging trend across the private sector. Some stakeholders interviewed reckoned that Spain had built fiscal space before the programme and therefore did not need to go through a very strong fiscal retrenchment and could maintain a relatively light tax system, which laid ground for the current recovery. Others argued that while the fiscal path was appropriate, the mix of fiscal consolidation could have been optimised in a more growth-friendly way. Overall, most stakeholders agreed that fiscal problems were not yet fully solved as deficit and debt remained high. Some of them were of the view that the tax reform of 2014 seemed to be premature (as it was not fiscally neutral). Based on the information available, the evaluators' assessment suggests that Spain implemented substantial fiscal consolidation measures, especially at the beginning of the programme. These were instrumental in reinforcing financial sector confidence and contributed to an easing of financing conditions for the real economy. However, efforts somewhat slowed recently and public debt and deficit ratios remain high.



Source: European Commission services' Autumn 2015 Forecast

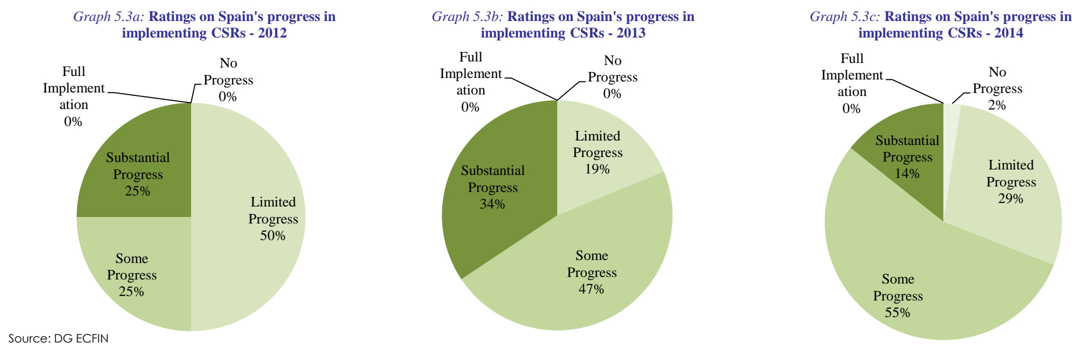
While fiscal consolidation at times relied on across-the-board spending measures, compression of public investment and ad hoc tax increases, policy overall shifted towards more efficient ways to spend and raise revenues. In particular, the 2013 pension reform, which will help to contain long-term pressure on expenditure, and increased cost-effectiveness of the healthcare sector aimed at ensuring the sustainability of the system. The independent fiscal authority council created in 2013 should also help to improve the credibility and design of the fiscal consolidation process, including by monitoring and evaluating policies at all government levels. Studies suggest that establishing an independent fiscal authority can be an important means of strengthening compliance with announced fiscal targets and help depoliticising fiscal policy as well as fostering accountability and encouraging more countercyclical policies (Alesina and Giavazzi, 2013; Sanchez et al., 2015). The ongoing public sector reform is

important to streamline public sector spending by eliminating duplication and overlapping functions within and across different government levels.

Structural fiscal reforms were implemented as originally planned and strengthened the legal setting. They increased the resilience of the public sector, reduced risks to fiscal stability and improved the sustainability of public finances. Legislation on budgetary stability aimed at strengthening Spain's public finances with particular attention paid to the autonomous regions was a positive step. Substantial progress was also made on the reporting of fiscal data for regional governments, which improved fiscal transparency. However, implementation of the budget stability law at regional level was challenging. The provisions with respect to the envisaged early warning and corrective mechanisms to limit deviations from the budgetary targets of the autonomous regions were not implemented in a fully transparent and effective way (EC, 2013). Despite a visible deterioration in regional public finances in 2014, none of the preventive measures were enforced on regions at risk of non-compliance. This could lead to renewed budgetary slippages at the regional level and further changes in both the legal framework and its implementation might be necessary (Cuenca, 2015).

The reform requirements under the European Semester were in line with the previous reforms and reinforced the efforts made by the Spanish authorities. With regard to structural reforms, the threat of losing market access prior to the programme triggered a strong response from the authorities' side to embark on an ambitious reform programme. In May 2012, the Commission concluded that Spain was experiencing very serious imbalances, in particular as regards developments related to the external position, private sector debt levels and the financial sector. In 2013, the Commission found that excessive imbalances existed in Spain. Although starting from a very challenging position, Spain's structural reform implementation was remarkable. ([73]) Spain made substantial or partial progress in implementing all 8 MIP-CSRs in 2012, 8 MIP-CSRs in 2013 and all 7 MIP-CSRs in 2014, which was very high compared to other EU countries (EC, 2013; EC, 2014; EC, 2015) (see Graph 5.3). Despite progress made in several areas and advancing with structural reforms, Spain was assessed as still having "imbalances, which required specific monitoring and decisive policy action" in both 2014 and 2015 under the MIP framework (together with Ireland and Slovenia) (EC, 2014; EC, 2015). The OECD (2014) stated that the implementation of structural reforms to improve the labour market, enhance the fiscal framework, tackle long-standing education and housing issues and improve the business environment was very impressive due to strong ownership by the Spanish authorities. Simulations by the QUEST model (Canton et al. 2014) indicate that the implemented structural reforms could also significantly improve GDP growth potential in Spain.

([73]) It is nevertheless difficult to assess compliance with structural conditionality under the European Semester over the (short) programme period, as some of the reforms adopted before the programme were in the implementation stage, a wide range of additional reforms were adopted during the programme, and some of the reforms were delayed. Furthermore, the relatively short time in which the financial sector programme was implemented in Spain (18 months) was suitable to address effectively the financial sector problems but less so to make substantial progress in the structural areas. This makes the assessment of real progress with structural reforms more challenging as implementation of structural reforms usually stretches over a longer period of time and their effects are not necessarily immediately visible.



Source: DG ECFIN

The 2012 labour market reform contributed to the emerging employment recovery and moderation of the labour costs during the programme period, but labour market duality remains a problem. García Pérez and Jansen (2015) point out that Spain´s 2012 labour reform had a positive impact on accelerating wage adjustment, internal flexibility and collective bargaining. OECD (2014) also assessed that the 2012 labour market reform was likely to have contributed to the moderation of labour costs, but it had not improved the strong duality of the labour market. According to the European Commission (2014), the enhanced internal flexibility brought about by the comprehensive 2012 labour market reform and the agreement with social partners about wages, employment and growth 2012-2014 was likely to have had a positive effect on employment. ([74]) The reform is likely to have contributed to wage moderation, especially in new collective agreements, and created the ground for working hours to react more flexibly to labour market shocks. The IMF (2015) also stated that past reforms were making a difference as labour market reforms and moderate wage growth had supported job creation and helped Spain to regain competitiveness lost during the pre-crisis boom. The OECD's labour market indices measuring strictness for permanent and temporary contracts also confirm modest deregulation of Spain's labour market. However, most of the stakeholders interviewed by the evaluators agreed that there was no evidence to date of a substantial effect on reducing duality of the Spanish labour market between permanent and temporary workers, whereas most new contracts were created on temporary basis. ([75])

There was no progress on the implementation of the recommendations on regulated professions. A first draft law to reform professional services and professional associations was published on 2 August 2013. However submission to the Parliament kept being delayed as the reform faced strong resistance from interest groups (EC, 2015). The possible long run effect was estimated by the Spanish government at 0.7% of additional potential GDP in the medium-term. The Commission stated that an ambitious implementation of the law on market unity as well as professional services reform could have substantial positive effects on productivity growth (EC, 2014).

Despite some recent progress, it is still relatively cumbersome to start up a business in Spain and the administrative burden on business could be further decreased. Several measures have been adopted in further reducing the time, cost and number of procedures required for setting up an operating business. These changes helped to improve Spain's position in international rankings on company creation (EC, MIP 2015). However, it is still more cumbersome to start a business in Spain than in other European countries sharing similar legal systems, which could translate in lower firm dynamics (EC, 2014). Implementation of law on entrepreneurship, adopted in 2013 continues. Other measures were adopted to ease business licencing, such as environmental permits. Some measures have been taken to reduce the

([74]) BBVA Research (2015) estimates that the new labour market regime would have saved as many as 1 million jobs had its provisions been in place before the start of the crisis.
([75]) The duality of the Spanish labour market was rooted in high employment protection for regular permanent contracts and low protection for temporary contracts coupled with a high turnover rate in temporary jobs and low conversion rates from temporary to permanent contracts (EC, 2012).

administrative burden but it is too early to assess their impact. While reforms have been introduced or are in the pipeline, actual progress in improving the business environment has been modest. In part this reflects the complex, duplicated, and burdensome regulatory framework divided among the different levels of government. Spain's ranking on the World Bank's *Doing Business* indicator deteriorated somewhat in 2015 and it remains far from the best performers ([76]), especially in areas such as protecting investors, getting credit, and paying taxes. Spain also ranks low in starting a business and dealing with construction permits. Indicators of education outcomes also remain less strong compared to many of its European peers. The 2013 retail reform made shop opening hours more flexible, liberalised sales periods, and simplified licensing procedures for small retail outlets, which led to a reduction in mark-ups. OECD (2015) indicators measuring the level of market regulation in Spain show that markets for goods and services are freer than they were before the crisis, suggesting that structural reforms have been effective.

The 2013 reform of the electricity system helped to contain the tariff deficit in 2014. ([77]) The reform helped to reduce costs of the system and increase its revenues. The reform was relevant and if strictly implemented will be critical to bring the electricity system into equilibrium as it represents a potentially sizeable contingent liability for the budget. Furthermore, the completion of electricity and gas interconnections with France is crucial to increase security of supply and stimulate competition in the energy markets (EC, 2015).

The fiscal consolidation and substantial structural reforms implemented by Spain were rewarded by rating upgrades after the country successfully exited the financial sector programme in January 2014. Fitch Ratings upgraded Spain's sovereign debt rating to BBB+ with stable outlook in February 2014, followed by Moody's upgrade in April 2014 to Baa2 with stable outlook and by Standard & Poor's to BBB with stable outlook in May 2014. ([78]) These upgrades mainly reflected improving growth and competitiveness of the Spanish economy and its rebalancing towards a more sustainable growth model, supported by the progress made in implementing broad structural reforms, particularly in the labour market and the public pension system, structural fiscal measures and changes to the fiscal framework for the regional governments as well as the restructuring of the banking system. The evident improvement in the Spanish economy and the government's track record of implementation of fiscal and structural policy measures, combined with effects of the ECB's policy announcements and actions led to a substantial improvement in government funding conditions. The upgrades very much reflect the close interlinkages between economic growth, public finances, and structural reforms as well as the financial sector stabilisation to what the programme contributed substantially.

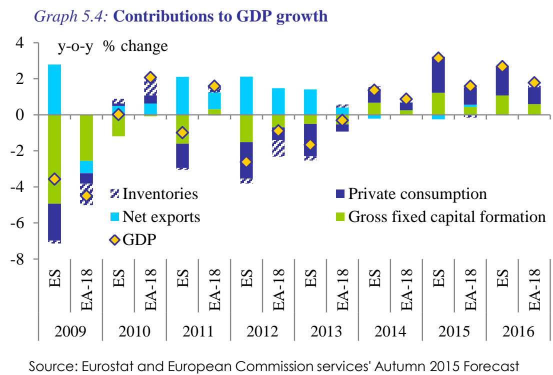
5.4. ADJUSTMENT OF THE ECONOMY AND OUTLOOK

Structural reforms to labour and product markets in Spain helped to improve economic growth prospects and the ability of the economy to adjust to shocks by expanding flexibility and improving the efficiency of how and where productive factors are used. The recent financial and economic crisis prompted Spain to undertake considerable structural reforms, which are now starting to show tentative results and their full benefits may materialise only in the medium-term (Canton et al., 2014). Most stakeholders interviewed during the consultation process shared the view that implementation of these reforms facilitated the current recovery of the Spanish economy.

([76]) Due to changes in the methodology in 2014 it is not possible to compare the ratings for previous years.
([77]) Tariff deficits are shortfalls of revenues in the electricity system, which arise when the tariffs for the regulated components of the retail electricity price are set below the corresponding costs borne by the energy companies. For more details about the electricity tariff deficit in Spain please consult Johannesson Linden et al. (2014).
([78]) In October 2015, Spain's credit rating was further raised to BBB+ by Standard & Poor's, which cited reforms to labour regulations, improved export competitiveness and easier financial conditions for the economy as reasons for the upgrade.

Recent developments of macroeconomic indicators allow a preliminary positive assessment about the effectiveness of the programme in enabling return to sustainable growth. Following a long double-dip recession (with output decreasing by a cumulative 7.5% since 2009), growth in Spain resumed in 2014 and the recovery is now gathering momentum, outpacing euro area average growth. The level of economic activity still remains depressed compared to pre-crisis levels and is likely to recover to pre-crisis size only in 2017 (Tilford, 2015). According to the European Commission 2015 Autumn Forecast, real GDP growth is expected to accelerate from 1.4% in 2014 to 3.1% in 2015 and 2.7% in 2016. The IMF expects growth to reach 3.1% in 2015 and 2.5% in 2016. So far the recovery has been mainly domestic demand driven, supported by improved labour market conditions, loosening financial conditions and renewed confidence but also by a less restrictive fiscal stance.

Graph 5.4: **Contributions to GDP growth**



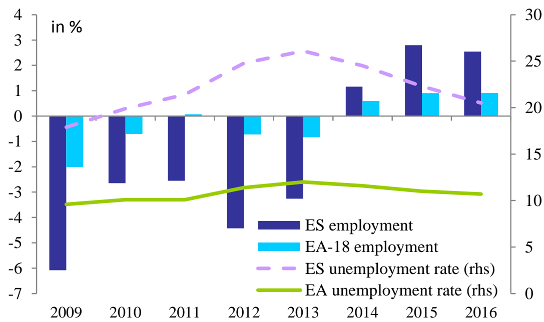
Source: Eurostat and European Commission services' Autumn 2015 Forecast

The labour market is recovering, but it still faces significant structural problems. More than five million people are still out of work in Spain, nearly two thirds of them for more than a year, mainly as a result of the loss of 1.7 million jobs in the construction sector when a decade-long economic boom ended abruptly in 2008. Job creation accelerated with employment increasing by 2.5% year-on-year in Q4 2014 (1.2% in 2014), partly due to the increased flexibility introduced by labour market reforms implemented during the programme, and also to wage moderation. Employment growth accelerated in 2015 and is expected to pick up further in 2016. The unemployment rate – although it still remained very high at 22.2% in Q2 2015 ([79]) – decreased in 2014 for the first time since 2007 from a peak at 27.2% in the first quarter of 2013. It is forecast to fall further to 20% in 2016. Labour market segmentation and duality remains a challenge, with the rate of temporary employment close to 25%. Young people and the low-skilled are particularly exposed to high and prolonged unemployment rates. The very high unemployment rate, namely youth and long-term unemployment, which are among the highest in the EU, risks becoming structural and elevated segmentation, remain major challenges. ([80])

([79]) The quarterly survey shows that the unemployment rate fell further to 21.2% in Q3 2015 and the number of unemployed fell to 4.85 million, for the first time since 2011. Although statistics suggest that majority of these jobs are created in the service sector and dominated by temporary contracts.

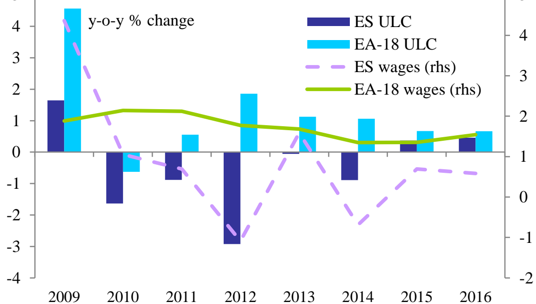
([80]) According to Eurostat, youth unemployment rate was 46.7% in Spain in Q3 2015, the highest in the EU and significantly above the averages of 20.1% in the EU-28 and 22.1% in the euro area. The long term unemployment rate stood at 12.9% of the active population, over half of the unemployed have been jobless for more than a year.

Graph 5.5a: **Employment growth and unemployment rate**



Source: European Commission services' Autumn 2015 Forecast

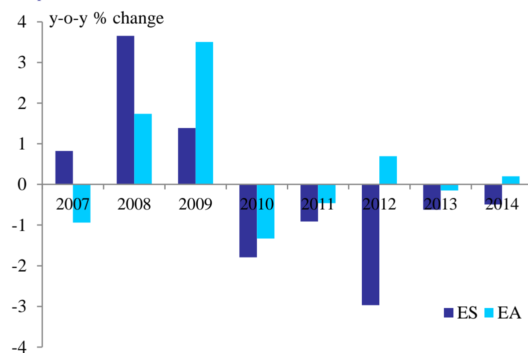
Graph 5.5b: **Nominal unit labour costs and compensation per employee**



Source: European Commission services' Autumn 2015 Forecast

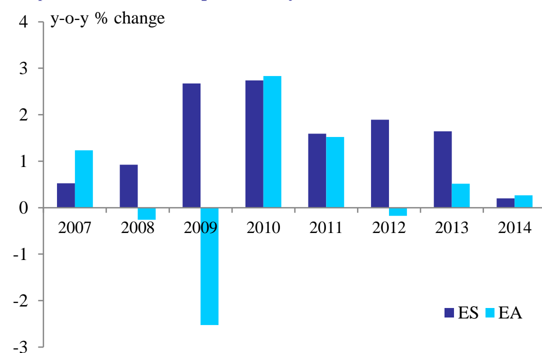
With some delay, nominal wages responded to protracted slack in the labour market and continued supporting job creation. From the beginning of the crisis, wages have been slow to adjust putting the burden of adjustment on employment. The rigidities in the labour market were manifest in the behaviour of wages and low productivity. There were some productivity gains in the Spanish economy from 2009, partly reflecting composition effects as job losses were largely concentrated in low-productivity sectors as construction (EC, 2015). The 2012 labour market reform and the inter-confederal social partners' agreement of 2012-2014 contributed to these moderate wage developments. Reforms of the wage bargaining system have contributed to the responsiveness of wages to labour market conditions. The downward adjustment of unit labour costs is continuing as a result of weak dynamics of wages and improvements in productivity.

Graph 5.6a: **Real unit labour costs**



Source: Ameco and Eurostat

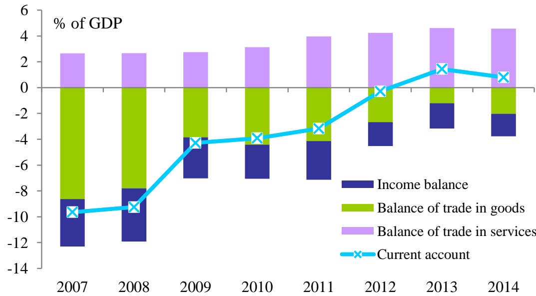
Graph 5.6b: **Real labour productivity**



Source: Ameco and Eurostat

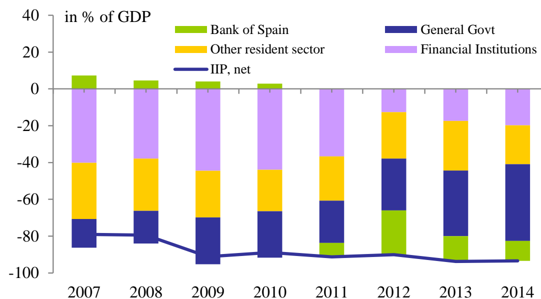
The process of internal devaluation resulting in further progress in price and cost competitiveness continues. The fall in domestic demand and soaring unemployment experienced during the crisis eased inflationary and wage pressures, reversing cost and price competitiveness losses that accumulated in the boom years. Unit labour costs (ULC) have been falling since 2010, on the back of labour shedding induced productivity growth, and more recently, subdued wage dynamics. Since 2009, the real effective exchange rate (REER) and nominal labour costs have fallen by 13.2% and 4.5%, respectively (EC, 2015). According to Laborda and Fernandez (2015), the fall in ULC since 2009 made possible to correct around 80% of the cost competitiveness lost over the preceding decade relative to the rest of the EU. This is one of the factors explaining the strong performance of exports. Some economists highlight the importance of having the flexibility to redistribute productive resources in Spain from non-tradable to tradable sectors as a key factor behind the recovery of the Spanish economy, e.g. Sandbu (2015) attributed more importance to this factor compared to the role of structural reforms or price competitiveness in Spain.

Graph 5.7a: **Balance of payments**



Source: Bank of Spain and Eurostat

Graph 5.7b: **International investment position**

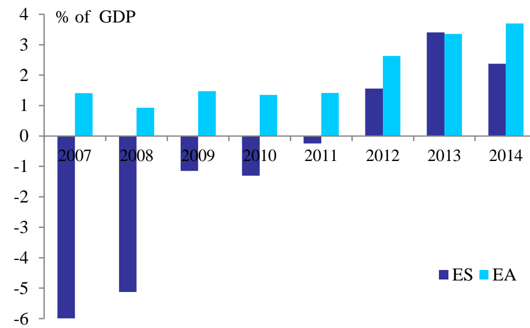


Source: Bank of Spain

The bust of the housing bubble and the financial crisis led to a sharp current account adjustment and improved export performance, part of which seems structural. After almost two decades of negative balances and peaking at a deficit of 10% of GDP in 2007, the current account registered a surplus of 1.5% in 2013. ([81]) It remained at 1% of GDP in 2014 and is forecast to remain in surplus in 2015 and 2016 according to the European Commission 2015 Autumn Forecast. The improvement in the current account balance was mainly due to a higher surplus in the balance of services, and, more importantly, a reduction in the trade deficit of goods. A significant part of the current account adjustment is likely to be of permanent nature, as several indicators suggest a structural improvement in Spain's export capacity (EC, 2014) and partly because of a structural reorientation of the Spanish economy away from import-rich internal demand due to improved costs competitiveness (Orsini, 2015). The IMF suggests that part of the adjustment is cyclical and part is structural (Tressel et al., 2014). Spain's export performance has been very robust, contributing to the rebalancing of the economy. Exports of goods and services increased from, respectively, 17.6% and 8.1% of GDP in 2008 to 22.9% and 9.6% of GDP in 2013. Spain was also able to maintain its export market share. Exports have increased due to both the increase in the number of exporting companies, and the value exported by those companies. Klein (2015) pointed out that Spain's exporting firms increased their debt amid a general private sector deleveraging episode, which indicated an internal (positive) rearrangement of investment among sectors. Considering the fixed costs of penetration in foreign markets, it is unlikely that these gains will be reversed in the near future. Moreover, a significant geographical diversification of Spanish exports took place in the run-up to and during the programme period (EC, 2015). Some other authors argue that most of the external adjustment was cyclical rather than structural and a renewed recovery in domestic demand would lead imports to rise more rapidly than exports, causing a trade deficit (Tilford, 2015).

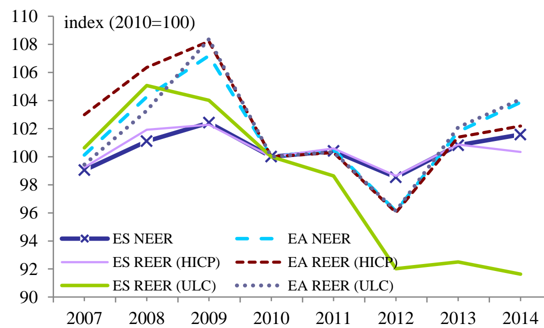
([81]) According to IMF (2014), the recent improvement in Spain's current account over 5 years is very remarkable. Only one non-commodity exporting country has had a similar current account improvement: South Korea in 1997–98. Germany had a similar current account improvement during the early 2000s, but it took 7 years and it benefitted from a vibrant world economy.

Graph 5.8a: **Net exports of goods and services**



Source: Eurostat

Graph 5.8b: **Nominal and real effective exchange rates**



Source: European Commission services

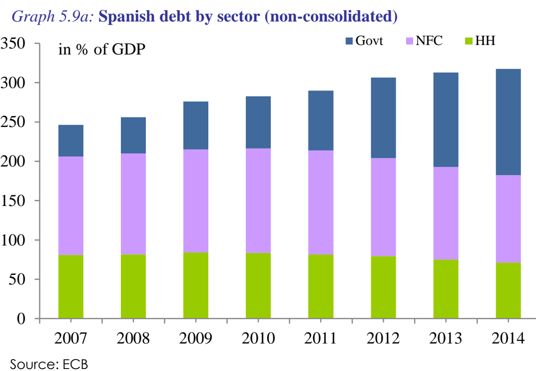
While the adjustment of flows is on-going, the stock of external liabilities remains significant, as reflected in the large negative net international investment position and net external debt. This is a particular cause for concern as the Spanish economy is exposed to liquidity risks. Combined with rapidly increasing government debt, high private sector indebtedness implies substantial deleveraging pressures. Despite the sizeable current account adjustment in recent years, the net international investment position (NIIP) still deteriorated because of negative valuation effects (EC, 2015). In Q4 2014 the negative net international position stood at 95.6% of GDP, around 15 percentage points higher than before the crisis and more than 60 percentage points higher than in the early 2000s. ([82]) While there has been a significant improvement in Spain's trade balance, net foreign liabilities, which by far exceed euro area averages, are raising concerns about long-run sustainability. Spain's gross external debt was still high at around 170% of GDP in 2015 and poses risks. High net external liabilities normally imply high debt servicing costs and make the economy vulnerable to changes in asset prices and financing conditions. Reversing the trend in the NIIP and to bring it down to a sustainable threshold of -35% of GDP (in line with the macroeconomic imbalance procedure) would require further improvements in the current account balance and sustaining it over longer period of time (EC, 2015; ECB, 2013). ([83])

The adjustment process has produced a sharp change in the composition of employment and value added. In relative terms, tradable sectors as a proportion of value added have interrupted their long declining trend. The same applies for total employment. The change in the sectoral composition of the economy was mainly driven by the collapse of the construction sector and real estate development and to a lesser extent by the downsizing of the financial sector (mainly in value added terms). Overall the Spanish economy showed some adjustment capacity (especially reversing the high current account deficit, moving resources from non-tradable to tradable sector) to overcome the crisis back in 2012 without a fully-fledged programme, once tail risks related to concerns about a potential breakup of the euro area would be removed. However, initiated reforms need to be implemented and further structural reforms are necessary to put the economy on a more sustainable development path going forward.

The deleveraging in the private sector is ongoing but is far from completed. The orderly deleveraging of the private sector has continued gradually, with corporates reducing debt levels more rapidly than households, but deleveraging needs remain high. The total stock of non-financial private sector debt was 164% of GDP in 2014, some 38 percentage points of GDP lower than the peak in the second quarter of 2010 (202%, consolidated), but was still high (Eurostat, 2015). ([84]) This process went in parallel with restructuring in the banking sector and a sharp correction in the real estate market and construction (for further details see chapter 6).

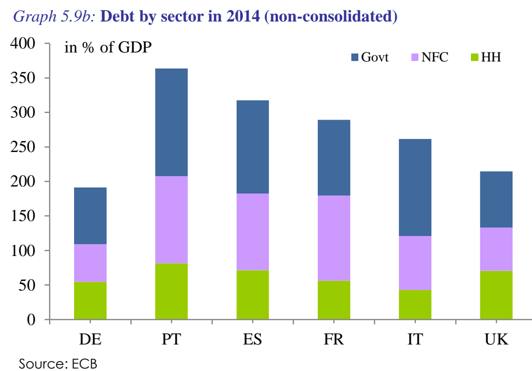
([82]) Please note that the figures are not fully comparable due to a change in the methodology since 2012.
([83]) EC (2015) estimates that even if the current account surplus reached a record level of 3.4% of GDP, it would take about 10 years for the NIIP to reach -35% of GDP.
([84]) According to ECB the non-consolidated private debt was 182% of GDP in 2014.

Graph 5.9a: **Spanish debt by sector (non-consolidated)**



Source: ECB

Graph 5.9b: **Debt by sector in 2014 (non-consolidated)**



Source: ECB

In contrast to the private sector, general government debt is still increasing and bringing it back on a downward trend will require a continued fiscal effort in the long run. Public sector debt was significantly affected by the economic and financial crisis. The collapse of a rich tax base linked to the construction sector, expansion of the aggregate social expenditure due to surging unemployment and the fiscal stimulus in the early years of the crisis caused large general government deficits and a rapid debt increase. It was also spurred by bank recapitalisations and contributions to the EU and euro area financial assistance institutions. Public debt increased from 35.5% of GDP in 2007 to 99.3% in 2014 and is expected to have reached above 100% in 2015 (EC, 2015). Further fiscal consolidation will have to continue in the medium term to put debt on a firm downward path.

5.5. REMAINING CHALLENGES

Overall, Spain has made substantial progress in adopting major structural reforms and adjusting its economy and putting it on a more sustainable path, but challenges remain. Some important reforms have not been implemented such as the professional services reform. Furthermore, it seems that there is also some reform fatigue. However, more attention has been paid to implementation of the adopted reforms (e.g. market unity law, public administration reform), even if it faces some risks stemming from the need for joint delivery by various tiers of government.

On the fiscal side, Spain exited the programme with still very large general government deficit and debt levels. Further consolidation efforts would be needed to bring the general government debt on a downward path. Ensuring strict adherence to the agreed fiscal consolidation paths remains essential in order to lock in the benefits of the fiscal consolidation efforts undertaken so far and credibly anchor financial market expectations. Model simulations indicate that a protracted and sizeable fiscal effort would be needed to bringing the debt back to the neighbourhood of 60% of GDP (EC, 2015). The risks linked to the overall indebtedness of the economy still require decisive policy action. The quality and composition of fiscal consolidation could be improved. Measures aimed at cuts in investment spending may have implications hindering medium-term growth. Furthermore, while there is further scope to improve spending efficiency, there is a case for revenue to play a greater role in fiscal consolidation going forward given Spain's relatively low revenue to GDP ratio compared to euro area peers (EC, 2015).

Fiscal consolidation in Spain is still ongoing, although the pace slackened significantly in 2014 and 2015 relative to the progress made during the programme period. Higher indirect tax revenues supported by stronger domestic demand and falling unemployment reining in social transfers are contributing to an expected improvement of the deficit. The general government deficit is expected to fall to around 4.7% in 2015 and 3.6% in 2016, despite the impact of recently-implemented tax cuts. Due to lower interest rates, interest expenditure will also moderate. However, there seems to be certain consolidation fatigue setting in, as going forward the reduction of the deficit is relying mostly on the

improving macroeconomic outlook and according to the European Commission Autumn Forecast 2015 it does not seem to be assured that Spain would meet the EDP target in 2016, without taking additional measures (EC, 2015).

The European Commission and the IMF urged Spain to maintain the reform momentum also after exiting the programme, ensuring full and effective implementation. Unfinished reforms need to be brought to completion (e.g. the market unity law), or should be complemented with additional measures (e.g. tackling segmentation in the labour market). There are also implementation risks stemming from the need for joint delivery by various tiers of the government. In addition, there are some pending key reforms, such as the reform of professional services and professional associations, which have been delayed, and if adopted, would benefit the whole Spanish economy (EC, 2015). Measures also need to be taken to ensure a reduction in the high rates of unemployment, particularly youth unemployment. Reforms to reduce structural rigidities in labour markets would provide a cost-effective tool to this end.

Despite significant adjustments in key economic flows over the past few years, the persistently high level of unemployment, low productivity, and still sizable public and private debt levels continue to pose policy challenges. While most internal and external imbalances in terms of flows is on-going, the stock of external liabilities remains significant, and the correction will have to be sustained over the next few years. Deep structural problems limit Spain's growth potential going forward and vulnerabilities remain. The high structural unemployment and pervasive labour market duality, and the lack of economies of scale of Spain's many small firms as well as low productivity growth hold back medium-term growth. Public and private debt levels are still high and are likely to keep weighing on consumption and investment. Spain has a large negative net international investment position, which adds to its external vulnerabilities. In this context, a reversal of reforms already carried out would create uncertainty and could hamper the recovery, especially if the external environment were to deteriorate sharply (IMF, 2015). Going forward, the recovery can be sustained only if it does not result into a halt or reversal of the adjustment process, as the ongoing correction of the original imbalances still has a way to go.

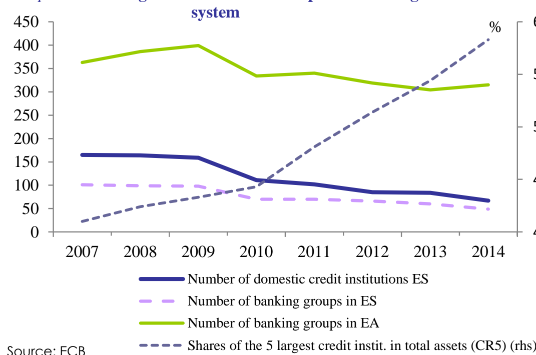
6. PROGRAMME'S IMPACT

The assessment of the programme's impact is assessed against the programme's main objectives described in Chapter 3. Thus, this section analyses i. The extent to which the Spanish banking system has been able to carry out its financial intermediation function since the onset of the programme; ii. The bank exposure to the real estate sector; and iii. The funding conditions of the Spanish banking system. Performance data gathered from a wide range of sources suggest that key performance indicators of the Spanish financial sector have improved substantially, to which the recapitalisation of the system and financial sector reforms under the programme largely contributed.

6.1. BANKS' INTERMEDIATION FUNCTION

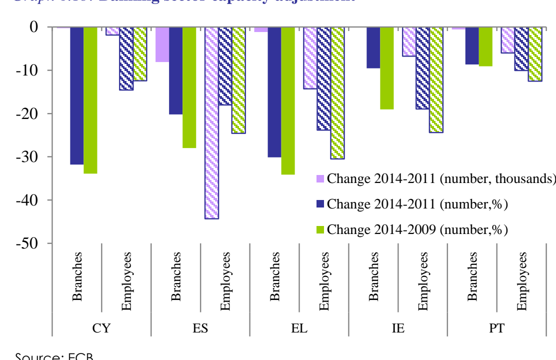
The restructuring plans implemented under the programme led to significant changes in the structure of the Spanish banking system, with the restructuring process affecting to a larger extent the savings banks. While a consolidation of the Spanish banking system started before the beginning of the programme, the structure of the Spanish banking system changed substantially during the programme period. The number of banking groups in Spain declined from 70 in 2011 to 49 in 2014 while the total number of domestic credit institutions diminished from about 100 to 67 over the same period (see Graph 6.1a). The number of savings banks declined from 45 in early 2010 to 2 in 2015. As a result of the restructuring process, savings banks reduced the number of branches by about 37% by the end of 2014 while the number of employees was reduced by about one third (CECA, 2015). Overall, the adjustment of the Spanish banking sector was one of the deepest among euro area countries having received financial assistance programmes (see Graph 6.1b). The restructuring process also led to a significant increase in the concentration of the Spanish banking system, with the five biggest credit institutors representing close to 60% of total assets at the end of 2014.

Graph 6.1a: **Changes in the structure of Spanish banking system**



Source: ECB

Graph 6.1b: **Banking sector capacity adjustment**



Source: ECB

Banks' solvency ratios increased, through a reduction in risk-weighted assets and an improvement in the quality of capital. In December 2014, the common equity tier 1 (CET1) ratio stood at 11.8% for the banking system as a whole, up from 9.7% at the end of 2012 (EC, 2015). While this was below the level in Germany, the UK and France, it was well above the minimum required. All Spanish banks except one small bank (Liberbank – under the adverse economic scenario) passed the ECB's stress-tests carried out between November 2013 and October 2014 in preparation for the SSM to become fully operational. No bank needed to raise additional capital following the exercise. The impact of Asset Quality Review-related adjustments to the CET1 ratio and the impact of the adverse scenario were the lowest among all euro area countries, reflecting proper classification, valuation and provisioning in banks' balance sheets at the end of 2013. As described in Chapter 4, the recapitalisation plans implemented during the programme were a major contribution to the well-capitalised banking system in Spain.

Table 6.1:
Selected financial soundness indicators (IMF) (% or otherwise indicated)

		2008	2009	2010	2011	2012	2013	2014
Solvency								
Regulatory capital to risk-weighted assets [1)]		11.3	12.2	11.9	12.2	11.6	13.3	13.7
Tier 1 capital to risk-weighted assets [1)]		8.2	9.4	9.7	10.3	10	11.9	11.9
Capital to total assets		5.5	6.1	5.8	5.7	5.8	6.8	7.2
Profitability								
Returns on average asstes		0.7	0.5	0.5	0	-1.4	0.4	0.4
Returns on average equity		12	8.8	7.2	-0.5	-21	5.4	5.7
Interest margin to gross income		53	63.7	54.2	51.8	54.1	52.3	57.9
Operating expenses to gross income		44.5	43.5	46.5	49.8	45.4	53.8	55.8
Asset quality [2)]								
Non-performing loans	(billion euro)	63.1	93.3	107.2	139.8	167.5	197.2	172.6
Non-performing to total loans		3.4	5.1	5.8	7.8	10.4	13.6	12.5
Specific provisions to non-performing loans		29.9	37.7	39.6	37.1	42.6	46.9	48.9
Exposure to construction sector [3)]	(billion euro)	469.9	453.4	430.3	396.9	300.4	237	209.6
of which: Non-performing (%)		5.7	9.6	13.5	20.6	28.2	37.1	36.3
Households-House purchase	(billion euro)	626.6	624.8	632.4	626.6	605.3	580.8	564.3
of which: Non-performing (%)		2.4	4.9	2.4	2.9	4	6	6
Households-Other spending	(billion euro)	226.3	220.9	226.3	211.9	199.1	148.3	151.3
of which: Non-performing (%)		4.8	6.1	5.4	5.5	7.5	11.2	10.4
Liquidity								
Use of ECB refinancing [4)]	(billion euro)	92.8	81.4	69.7	132.8	357.3	206.8	141.6
in percent of total ECB refin. operations		11.6	12.5	13.5	21	32	28.8	26.2
in percent of total assets of Spanish MFIs		2.7	2.4	2	3.7	10	6.6	4.8
Loan-to-deposit ratio [5)]		158	151.5	149.2	150	137.3	123	119

1) Starting 2008, solvency ratios are calculated according to CBE Mar-08 transposing EU Directives 2006/48/EC and 2006/49/EC (based on BASEL II). In particular, the Tier 1 ratio takes into account the deductions from Tier 1 and the part of the new general deductions from total own funds which are attributable to Tier 1.
2) Refers to domestic operations.
3) Including real estate developers.
4) Sum of main and long-term refinancing operations and marginal facility.
5) Ratio between loans to and deposits from other resident sectors.
Source: IMF, Spain 2015 Article IV Consultation, Country Report No. 15/232

Bank profitability developments in Spain during 2013-2014 compared favourably to other major EU countries in an environment of subdued credit dynamics and low interest rates. Profitability was driven by declining funding costs and provisioning needs following substantial recognition of losses during 2012. Bank profits in 2014 were supported by a reduction of provisions for impaired assets, while operating income before provisions remained broadly similar compared to previous years. Operating costs were slightly higher in Spain compared to the banking sectors of France, Germany and the UK. Still, the cost-to-income ratio was the lowest among the EU's largest banking sectors (50% in 2013, compared to some 60-70% in the other countries), generating gross operating income of almost 3% of assets by June 2014 – higher than in France and the UK (around 2%) and in Germany (1.5%) (Carbó Valverde and Rodríguez Fernández, 2015, based on ECB and national central banks).

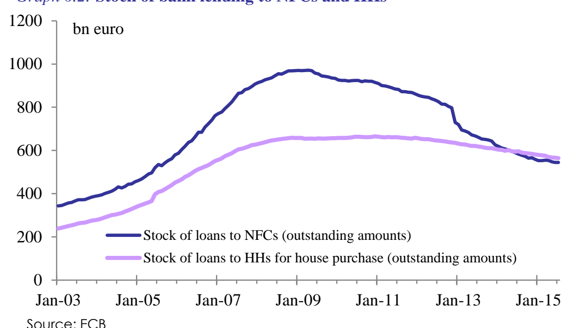
While the NPL ratio in the banking system remained high, the average quality of assets has gradually improved since late 2013. After having peaked at 13.6% in December 2013, the NPL ratio gradually fell to 10.7% by September 2015. New NPLs during 2013 reflected reclassifications of restructured loans, ([85]) which more than offset the impact of the transfer of impaired assets to Sareb. In 2014, new formation of NPLs declined by 47%, mainly as a result of improved economic conditions and an increase in foreclosed assets (Romero and Sola, 2015). However, the fall in the NPL ratio (over total

([85]) With a view to the ECB's AQR in late 2013, the BdE strengthened the definition of 'restructured loans', based on new euro-area wide standards issued by EBA, and required banks to reclassify their forbearance exposure in Q3 2013. More than half of a total of EUR 208 billion of restructured loans had to be reclassified. In spite of the transfer of impaired assets to Sareb, the system-wide NPL ratio increased by the end of 2013.

loans) showed a less pronounced drop than that recorded in absolute values due to the contraction in total credit, although the trend accelerated during the first half of 2015 (García Montalvo, 2015).

Although the stock of bank credit to corporations and households continued to contract, the pace of the contraction recently slowed down and new lending flows showed positive developments from the beginning of 2014. At the end of 2014, the stock of bank credit to the real economy was still contracting by about 7% on a yearly basis (see Graph 6.2), mainly driven by a double-digit negative growth rate in bank credit to the non-financial corporate sector, while credit to households (HHs) was falling by less than 5%. The decline in bank lending activity started to decelerate at the end of 2013. Net lending growth to non-financial corporations (NFCs) was only slightly negative in mid-2015. Even though it is early to conclude that a clear change in bank credit dynamics is taking place, encouraging signs are emerging from recent developments in new bank lending volumes (see Box 6.1), underpinned by the improvement in cyclical conditions of the Spanish economy and the strengthened banking sector stemming from the programme's implementation.

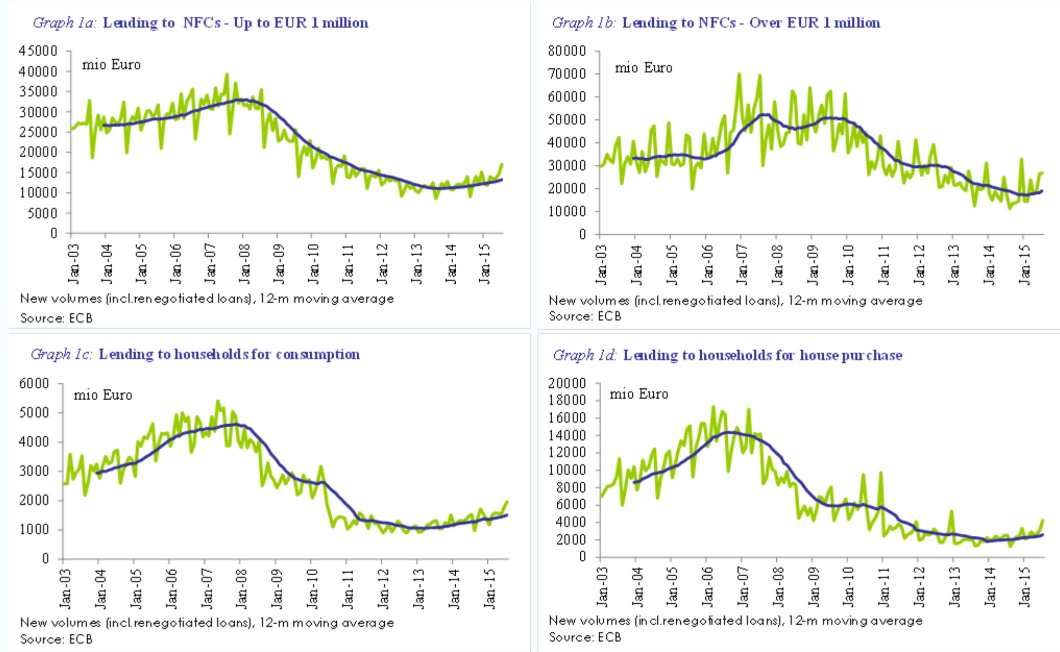
Graph 6.2: **Stock of bank lending to NFCs and HHs**



Source: ECB

Box 6.1: The impact of banks' restructuring plans on lending activity

In the absence of a counterfactual, it is difficult to estimate the impact of the programme on lending activity, but empirical evidence suggests that it was moderate if lending to real estate activities is excluded. At the inception of the programme, some stakeholders interviewed in the course of the evaluation believed that the programme could have a significant negative impact of lending to the real economy, given the sizeable restructuring requirements of a number of Spanish banks (see section 4.2.2). The Bank of Spain developed a simple model to estimate the quantitative impact of the restructuring plans on lending to non-financial corporations (NFCs) taking into account the possibility of substituting lenders by the NFCs (i.e. replacing borrowing from banks under restructuring plans with that from healthier banks). ([1]) In September 2012, NFCs receiving above 50% of their financing from entities under restructuring plans represented some 18% of NFCs and accumulated some 11% of the stock of credit to NFCs. Thus, they represented a relatively small share of total bank lending. The analysis found that restructuring plans under Group 1 banks had a contractionary effect, with loan growth rates 2.6% below that for NFCs which did not depend on banks under restructuring plans. It also concluded that the contraction was not significant for those NFCs depending on credit institutions that were absorbed by healthier banks. The coefficient was even marginally positive for those NFCs which were obtaining credit from Group 2 entities. The BdE estimated that the contractionary impact of the restructuring plans on credit to NFCs between September 2012 and March 2014 was about 0.4%, although this did not take into account the positive side effects on investor confidence from the restructuring and recapitalisation of the banking system.



By size, the estimated contractionary effects of restructuring plans did not seem to differ largely between SMEs and large companies. Credit developments during the programme period need to be seen against the background of a sharp contraction of bank lending which partly reflected the necessary deleveraging of the real estate sector and a shift of productive resources towards less credit-intensive sectors as well as a significant fall in credit demand. It is noteworthy that banks in Group 1 and Group 2 had a combined share of the credit in Spain of just above 20%, thus, about 80% of the system was not constrained by restructuring targets. Despite small or very small NFCs representing a very large share of NFCs that had

([1]) Jorge Martínez Pagés, Impacto de los Planes de Restructuración sobre el crédito a las sociedades no financieras, Banco de España, Boletín Económico Julio-Agosto 2014.

(Continued on the next page)

Box (continued)

a high degree of dependency (75% or more) on Group 1 banks, the BdE found that the contraction in credit to NFCs did not seem to have struck particularly SMEs. New credit to SMEs started growing at the end of 2013 (Graph 1.a above), amid declining nominal interest rates to NFCs.([2]) This was underpinned by the fact that banks' restructuring plans under the programme required banks to refocus on retail banking activities and SME business.

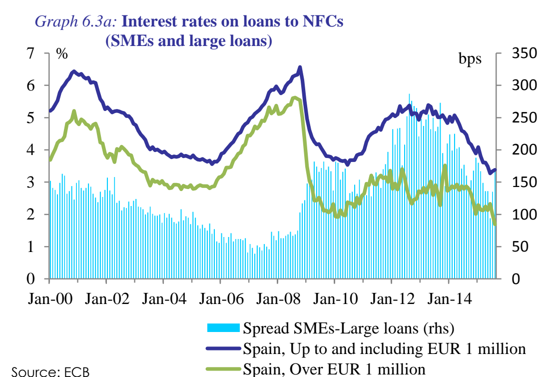
Credit contraction was a major factor driving private sector deleveraging, but it was largely led by debt reduction of NFCs involved in real estate activities. Although private sector deleveraging in Spain was significant over the past few years, with private sector debt falling by some 40% of GDP from its peak of above 200% of GDP in Q2 2010, most of the reduction was due to a fall in NFCs' debt (EC, 2015). While credit contraction was the main channel of private sector deleveraging, it has been taking place rather selectively,([3]) mainly reflecting the need to reduce debt related to real-estate activities accumulated during Spain's construction boom. Furthermore, the contraction of aggregate credit to the private sector has been decelerating since the end of 2013 amid growing new credit flows as banks became ready to fund healthier corporations with positive growth prospects. Thus, the banks' restructuring plans implemented in the context of the programme do not seem to have constrained significantly bank lending across all sectors of economic activity.

Credit dynamics in Spain do not seem particularly weak compared to other deep financial crises. For instance, in the aftermath of the 1997 Asian crisis or Japan's crisis during the 1990s, credit growth to the private sector remained subdued for a very prolonged period of time. ([4]) While the stock of credit continued contracting throughout 2014 in Spain, signs of improvement in terms of credit flows (new loans) were visible already in early 2014. Credit developments in Spain are also not particularly subdued taking into account the stricter regulatory requirements phased in at the time of the programme such as the need to comply with stricter capital ratios or the need to deleverage related to the construction sector. The recent signs of improvement in credit developments were possible thanks to the recapitalisation and restructuring implemented within the programme, but they also need to be seen in the context of important stimulus measures carried out by the ECB over the past months, steps towards a banking union in the EU and an improvement in Spain's cyclical conditions, which were supportive to the objectives of the programme.

([2]) In the graphs above, we take loans below EUR 1 million as a proxy for lending to SMEs.
([3]) See European Commission Staff Working Document: "Country Report Spain 2015: Including an In-Depth Review on the prevention and correction of macroeconomic imbalances", COM (2015) 85, page 25.
([4]) See for instance ECB Monthly Bulletin, February 2012: "Money and credit growth after economic and financial crises – a historical global perspective".

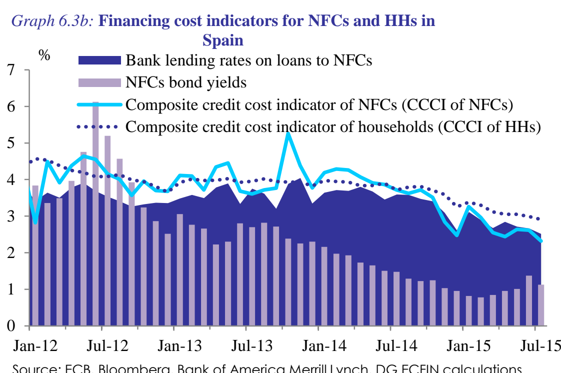
Bank lending flows to some segments of the real economy such as SMEs and households have recorded an upward trend since 2014 amid declining bank lending rates and improved credit demand. The year-on-year growth rate of the 12-month average of new loans below EUR 1 million turned positive in May 2014 and has increased at a double-digit pace since March 2015, amid a significant fall in interest rates over the past two years. Interest rates on loans to SMEs fell by more than 150 basis points from above 5% in 2013 to below 3.5% in May 2015 (see Graph 6.3a). Different composite indicators of credit costs for HHs and NFCs (CCCI) calculated by DG ECFIN also show an easing trend in financing costs of the real economy since the beginning of 2014 (see Graph 6.3b). The easing in overall financing costs appears to have been driven to a large extent by significant declines in interest rates on banks loans, which fell for both HHs and NFCs from close to 4% at the end of 2013 to below 3% in mid-2015 (See Graph 6.3b). Large non-financial corporations started to benefit from lower financing costs and an improved access to market-based funding much earlier, just after the beginning of the programme and following the announcement of the ECB's OMT scheme. The year-on-year growth rate of new loans above EUR 1 million was 7.9% in October 2015.

Graph 6.3a: **Interest rates on loans to NFCs (SMEs and large loans)**



Source: ECB

Graph 6.3b: **Financing cost indicators for NFCs and HHs in Spain**



Source: ECB, Bloomberg, Bank of America Merrill Lynch, DG ECFIN calculations

6.2. EXPOSURE TO THE REAL ESTATE SECTOR

The Spanish banking system reduced significantly its exposure to the real-estate sector, in particular since late 2012. This was due to both banks' own strategies to reduce real-estate related exposures and the commitments made by credit institutions having received State aid in their restructuring plans, which included limits on exposures to construction firms and property developers (García Montalvo, 2015). Real-estate related lending (i.e. lending for construction, real estate activities and to households for house purchases) dropped from a peak of 100% of GDP in 2008 to 70% of GDP in March 2015. The contraction in financing for construction and real estate activities as a share of total lending to the productive sector appears to have gained momentum in late 2012 (EC, 2015). In March 2015, lending to construction firms and real estate activities (excluding household mortgages) accounted for 29% of total lending to productive activities, at about EUR 190 billion, after peaking at some 50% in 2007. Banks' deleveraging of mortgages was significantly more moderate. The *cajas'* exposure to the real estate sector (i.e. constructors and developers) dropped from 19% of their total loan portfolio in 2011 to about 7% in 2014 (CECA, 2015), amid the transfer of real estate assets to Sareb and the continued decline in lending to the sector.

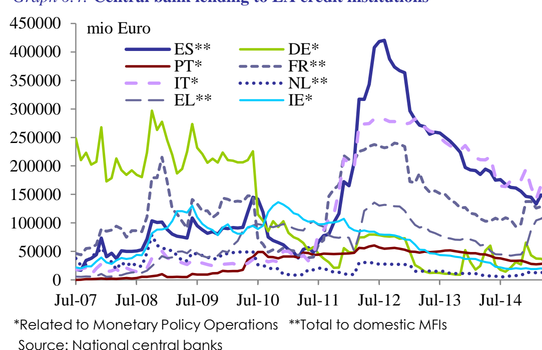
Although the risk exposure to the real estate sector decreased, the refinancing and restructuring of property risk remained high and banks continued to accumulate foreclosed real estate assets in 2013 and 2014. According to García Montalvo (2015), the amount of refinancing and restructuring of property risk declined by EUR 10 billion at the end of 2014 compared to December 2013 to stay at just above EUR 200 billion. At the same time, loans related to the real estate sector (including loans to household for home purchases) represented about 50% of the refinanced loans at the end of 2013, with the majority of them classified as doubtful and substandard according to a Bank of Spain's classification. While foreclosed assets in banks' balance sheets declined temporarily as a result of the asset transfer to Sareb, banks continued to accumulate foreclosed assets in 2013 and 2014, with the stock remaining in mid-2015 at high levels comparable to that recorded before the beginning of the programme in 2011 (BdE, 2015).

The housing market is showing signs of stabilisation, which should help banks to reduce their risk exposure to the real estate sector. According to Spain's National Statistics Office (INE), the annual growth rate of the housing price index turned positive in the second quarter of 2014 and has remained positive thereafter. The growth of the price index for both new houses and second-hand houses accelerated moderately in the first half of 2015. A gradual recovery in the housing market is ongoing amid improved financing conditions, reflecting in a modest rise in housing starts and higher real estate transaction figures and building approvals. This is expected to increase net wealth and bring positive spill overs for the banking system and Sareb.

6.3. FUNDING STRUCTURE AND CONDITIONS OF SPANISH BANKS

Banks' funding became cheaper, more stable and more diversified and net borrowing from the Eurosystem dropped. The reliance of Spanish banks on central bank liquidity support, which was an explicit objective set in the MoU, declined significantly during the programme period. In March 2014, Eurosystem lending to Spanish credit institutions stood at EUR 183 billion, down from above EUR 400 billion in mid-August 2012 (See graph 6.4). The decline in central bank funding in Spain was faster than in other euro area countries, gradually reducing the Eurosystem exposure to Spanish banks from 38% in 2012 to 30% in June 2014 and 26% in March 2015 (FUNCAS, 2015). The share of central bank funding in total liabilities of the Spanish banking system declined from about 15% at the beginning the programme to just below 6% in mid-2015. Deposits in the Spanish baking system grew strongly by 12% from August 2012 to August 2013. The loan-to-deposit ratio of credit institutions decreased to close to 120% in 2014, from nearly 160% at the start of the crisis (see Table 6.1). Banks' access to capital markets improved. Spanish banks issued EUR 28 billion in debt during 2013 (García Montalvo, 2014). Bond auctions by state-owned Bankia and BMN in January 2014 were three times oversubscribed. ([86])

Graph 6.4: **Central bank lending to EA credit institutions**

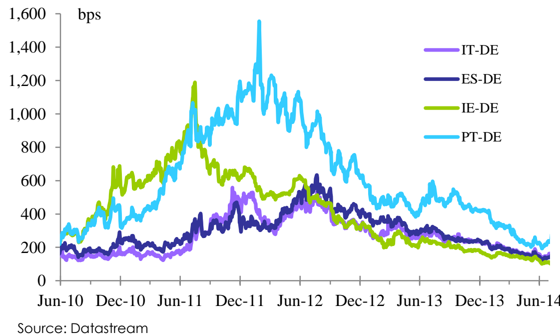


*Related to Monetary Policy Operations **Total to domestic MFIs
Source: National central banks

The financial assistance programme contributed to ease funding pressures on the sovereign as well as on the Spanish banking system. Sovereign funding costs declined and the investor base broadened during the programme period. After having peaked at 7.5% in July 2012, long-term government bond yields decreased to below 6% in early September 2012 and gradually fell further to below 4% at the end of the programme. The share of outstanding sovereign bonds held by foreigners increased from 36% in 2012 to 41% in 2013, though it remained below pre-crisis levels. The fall in sovereign bond yields experienced in Spain during the programme period cannot be dissociated from the impact of other policy actions, such as the ECB's OMT scheme or steps towards the Banking Union in the EU. However, looking at sovereign bond yield spreads of different Member States under financial stress in mid-2012 may help to shed some light about the isolated impact of the programme on the funding costs of the Spanish government. Like Spain, other euro area countries were exposed to financial market tensions stemming from tail risks related to fears of a breakdown of the euro area in mid-2012. Spain's 10-year sovereign bond yield spread against the German Bund fell during the programme period, as was the case for other euro area Member States benefiting from a financial assistance programme. The Spanish sovereign bond yield spread against the German bund, which widened slightly more than that of Italy in the run up to the Spanish programme (i.e. in the first half of 2012), narrowed slightly more than the latter by the end of the programme period, amid the stabilisation provided by the overall smooth programme implementation (see Graph 6.5a). The costs of insuring against default of highly-rated banks (measured by credit default swap spreads) moved closely in line with those of insuring against a sovereign default in Spain (see Graph 6.5b).

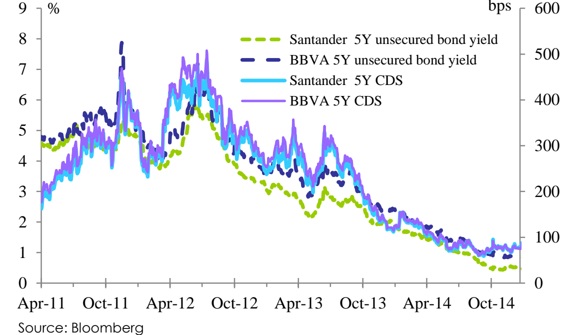
([86]) Bankia issued EUR 1bn in 5-year bonds paying a coupon of 3.6%. BMN issued EUR 500m in 3-year debt at a coupon of 2.6%. The share of foreign investors was 85% in the case of Bankia and 72% in the case of BMN (García Montalvo 2014).

Graph 6.5a: **10-year sovereign bond yield spreads against the German Bund**



Source: Datastream

Graph 6.5b: **Main Spanish banks' CDS spreads and funding costs**



Source: Bloomberg

The credit ratings of the Spanish banking sector improved after the programme concluded in January 2014 along with upgrades of Spain's sovereign debt ratings. Rating agencies frequently mentioned the successful restructuring and recapitalisation process that had taken place under the programme as a positive factor behind their decisions to improve credit ratings for a number of Spanish banks, as well as for Spain's sovereign debt. Although credit ratings for a number of Spanish banks were upgraded following the upgrades of Spain's sovereign debt ratings in spring 2014, some large banks retained a better rating than the sovereign, suggesting a weakening of the link between banks and sovereign. ([87])

While the evaluators found that the main objectives of the programme were achieved, a number of remaining challenges were identified, suggesting that there are still a number of actions to be undertaken in order to further strengthen the resilience of the Spanish banking system. As described above, the programme contributed to the capitalisation of the banking system and the diversification of its funding structure so as to be able to adequately perform its intermediation function. The banking system became less reliant on central bank funding. The large uncertainty over the health of its balance sheets was largely reduced. Exposure to real estate related assets dropped significantly, particularly among the troubled *cajas,* which had a particularly large exposure at the onset of the programme. Financing conditions eased starting in 2012 for both the State and the private sector, as suggested by different composite financing costs indicators. This, together with the structural reforms to overhaul the regulatory and supervisory system put the financial sector in a better position to reduce the occurrence and severity of future financial crises. However, the Spanish financial sector still faces a number of important challenges. In spite of the significant reduction in the absolute value of NPLs, the quality of banks' loan portfolios remains weak as reflected in an NPL ratio above 10% of total loans. The quality of banks' balance sheets has also been further affected by increases in foreclosed assets. At the same time, the sales of loans and properties as a mechanism for reducing the weight of real estate risk exposure of the Spanish banking system was relatively slow, while the stock of foreclosed properties remained high and above the level recorded in 2013. ([88]) The maximisation of the recovery value with regard to the entities which are still under the control of the FROB remains challenging. Thus, additional efforts to improve the overall quality of Spanish banks' balance sheets would create more supportive conditions for lending to the real economy, improve financing conditions of banks with weaker capital positions and further weaken the negative feedback loop between banks and the sovereign.

([87]) In April 2014 Moody's increased the rating of three Spanish banks: BBVA, Santander and Bankinter. In May 2014, two Spanish banks, Santander and BBVA, received rating upgrades from Fitch Ratings on their continued diversification benefits. The rating agency upgraded its long term rating for both banks to 'A-' from 'BBB+', one notch above the sovereign rating. In June 2014, Standard and Poor's upgraded its ratings on several Spanish banks following its decision to raise Spain's sovereign debt rating. S&P raised ratings for Santander, BBVA, Cecabank with positive outlook and changed Bankinter, Caixabank, Banco Sabadell and Bankia outlooks from stable to positive. The ratings were upgraded for Bankinter, Caixabank, Banco Sabadell and Bankia in November 2014. In June 2015, Moody's increased ratings for several Spanish banks, including BBVA, Santander, Bankinter, Sabadell, Caixabank, Cecabank and Bankia.

([88]) See BdE's Financial Stability Report of November 2015.

7. CONCLUSIONS

This report has examined different aspects of the design and implementation of the Financial Assistance Programme for the Recapitalisation of Financial Institutions in Spain. The evaluation has considered the relevance, effectiveness, efficiency, coherence and EU added value of the programme. This chapter summarises the findings of the evaluation and draws lessons for future potential EU/EA interventions.

Scope of the overall programme strategy and financial assistance (relevance)

The evaluation found that the scope of the programme was appropriate. An intervention focused on the financial sector while maintaining Spain's commitments under the EDP and European Semester/MIP procedures suited the needs of the Spanish economy at the time. The strong deterioration in financing conditions in Spain in mid-2012 was rooted in the savings bank sector and was spilling over the broader financial system and the real economy. This was underpinned by Spain's large external imbalances and rapidly-deteriorating public finances and by financial contagion across Member States. Thus, the choice of a financial sector programme requiring Spain to comply with the EDP and European Semester procedures was appropriate given the overall state of the Spanish economy and the limited amount of assistance required. By increasing the resilience of the financial sector, the programme targeted a major source of stress for the financing conditions of the sovereign and the private sector. The time scope of the programme was short relative to other euro area programmes, which was positive to maintain ownership and avoid reform fatigue. The programme was largely frontloaded in all major areas, with most of the conditionality to be fulfilled during the first six months of the programme according to an ambitious roadmap. The focused, frontloaded and limited-in-time intervention, together with measures taken in parallel at euro area level (e.g. monetary policy measures and steps towards a Banking Union), set the basis for a stabilisation beyond the financial sector that supported an improvement in overall economic conditions.

The evaluators found that focusing on financial sector conditionality while explicitly linking it with Spain's commitments under the EDP and European Semester procedures was appropriate. This setup, which was the first of this type among euro area interventions, contributed to a strong ownership of the programme by the authorities while it sent a signal to financial investors that the programme was part of a broader strategy which also tackled macroeconomic sustainability issues. Positive feedback loops between financial sector measures and reforms under the EDP/European Semester procedures underpinned the overall success of the programme. The evaluators found that the explicit link to the EDP and European Semester/MIP recommendations was also useful because it enhanced surveillance by EU institutions in this area within the context of the regular review missions under the programme. This seems to have been supportive to enforcement. The evaluators were of the opinion that this type of programme required some initial conditions to be successful, notably that institutions in the beneficiary country benefit from a high administrative and personnel capacity and the authorities are committed to comply with the programme in a short period of time (see below the point under programme implementation).

Focused conditionality was in line with political deliberations and the EFSF guidelines. The EFSF guidelines contemplated the possibility of focused intervention and conditionality when the origin of financial distress was strongly anchored in the financial sector and not directly fiscal or structural, which matched Spain's situation. This could entail appropriate conditionality not necessarily in the context of a macro-economic adjustment programme. The granting of the EFSF loan to Spain was preceded by an assessment of the eligibility conditions by the European Commission, in liaison with the ECB, the EBA and the IMF, which concluded that Spain fulfilled the conditions. While the sovereign was found to be no longer in a position to address the banking sector crisis on its own, the impact of the intervention on Spain's debt sustainability was judged as manageable, allowing Spain to repay the loan.

The decision to opt for an ample financial envelope seemed pertinent, as the cost of bank restructuring was difficult to forecast ex-ante and financial distress warranted a powerful backstop. An assessment of banks' asset quality was needed to determine the financing needs of the institutions requiring State aid, which was to take several weeks to be completed in a context of an extremely urgent crisis situation. In addition, the exact amount of resources that could be obtained from investors via burden-sharing exercises in those banks was unknown. At the time of the programme's inception, estimates of financing needs of the Spanish banking sector were surrounded by large uncertainties and ranged between EUR 30 billion and above EUR 100 billion. The IMF solvency stress-test, released in the FSAP report of June 2012, was considered the most reliable estimate. Impairment losses were calculated to amount to some EUR 55 billion. In this context, the financial envelope provided a sufficient safety margin enhancing the effectiveness of the backstop, providing a credible signal to markets that the sovereign's continued funding was ensured and helping to limit contagion. While the actual financing needs transpired to be smaller than the overall envelope, at close to EUR 42 billion, this needs to be seen in the context of the total available envelope delivering non-quantifiable benefits beyond the actual financing needs. The safety margin was particularly important given the uncertainty at the time about whether Spain would be able to maintain market access, as losing it would have required much larger financing needs and would have tested the financial capacity of the euro area backstops. The final amount provided by the programme allowed the objective of increasing the resilience of the banking system to be met while being consistent with State aid rules, which required minimising the use of public funds. Spain maintained market access during the programme period and no bank subject to the recapitalisation plans required further injection of public funds after the programme.

The limitations of the euro area's financial backstops available and operational in mid-2012 seem to have played a strong role in the choice of EFSF instrument and type of programme, going in favour of a swift, focused intervention. Euro area partners felt that Spain's banking sector problems had to be tackled urgently to avoid an intensification of the sovereign debt crisis, which could have triggered a loss of market access of Spain and potentially another large Member State.

The MoU did not explicitly address the distributional and social impact of adjustment measures but this did not mean that they had not been considered. Social partners interviewed in the consultation process felt that they had not been involved in the design of the programme and that the MoU did not address distributional effects. They also raised concerns about the consumer-protection component of regulatory changes undertaken under the programme, arguing that this aspect should have been more developed. The consultation with the authorities and the international institutions involved in the programme showed that some of those considerations were an inherent part of the design and implementation of the programme. Responding to the programme's conditionality, the authorities introduced new legislation to better protect consumers by increasing requirements for disclosure of information from credit institutions to investors, e.g. for placement of certain securities, as well as to ensure that advice from investment service providers was transparent and effective. Some measures were also taken in parallel to the programme. The economic situation and rising social concerns on residential foreclosures and evictions led to several legislative initiatives. A two-year suspension of evictions for vulnerable families was decided together with other initiatives in Law 1/2013 of May 2013 (initially stated in Royal Decree Law 27/2012) on measures to reinforce protection of mortgage debtors. The evaluators considered that this was a sensible and timely initiative which provided temporary relief for some vulnerable households and it did not seem to have undermined financial stability. The setup of arbitration procedures by banks for holders of preference shares was also regarded by the evaluators and the interviewed counterparts as a positive initiative allowing non-qualified retail clients to recover part of losses through such procedures. These measures were appropriate and to the extent that they were associated with the implementation of the programme they increased the programme's ownership and credibility.

Lessons for future programmes:

A short-in-time, frontloaded, financial-sector specific, programme is a very useful instrument to keep in the toolbox of euro area financial-assistance interventions, but it is not suitable in all circumstances. To be successful, it requires inter alia that systemic risks stem predominantly from the financial sector, a strong technical and administrative capacity in the recipient country and the authorities' commitment and ownership with regard to the programme's measures.

Future programmes would benefit from specific considerations about the distributional and social impact of its measures. Financial-sector programmes could benefit from particular attention to financial consumer protection in order to limit negative spillovers of programme measures on consumers.

In the presence of high financial market volatility and uncertainties about banks' capital needs, the availability of an ample financial envelope provides a credible signal to markets that continued funding will be ensured in the event of unforeseen events. This reinforces the effectiveness of the programme.

Appropriateness of conditionality (efficiency)

Conditionality reflected well the main problems facing the Spanish banking sector as well as the need to reduce macroeconomic imbalances and improve the public finances. The MoU built to a large extent on measures which the authorities had already undertaken before the start of the programme, thus supporting ownership. The financial sector conditionality benefitted from a timely assessment of the financial sector by the IMF carried out in June 2012, whose recommendations were largely captured in the MoU's conditionality. The MoU structured the conditionality around the main pillars of segregating impaired assets, recapitalisation, restructuring and resolution of financial institutions and strengthening the regulatory and supervisory frameworks. This reflected well the main areas which needed improvement within Spain's financial sector. The MoU requirement that Spain should comply with recommendations under the EDP and European Semester procedures conveyed a sense of normality. This allowed progress with regard to fiscal consolidation and structural reforms to be reviewed more comprehensively than in other non-programme countries in parallel to programme monitoring missions ("enhanced surveillance").

Conditionality with regard to the restructuring and resolution of credit institutions was appropriate and in line with EU State aid rules and followed the direction of the emerging EU common resolution framework. Conditionality in this area aimed at minimising the risk to financial stability and was based on the principle that shareholders and creditors should bear an appropriate share of the losses when resolution action is taken. The burden sharing provisions in the MoU followed the spirit of the discussions on the common resolution framework at the time, considerably expanding loss sharing compared to previous euro area programmes. Partly as a result of this evolving framework, bail-in provisions had not been fully consistent across those programmes. The decision to impose loss sharing by shareholders and hybrid and subordinated debt holders was in line with the EFSF guidelines for bank recapitalisation programmes, which stipulated that the conditionality attached to financial assistance for bank recapitalisation could draw from the future EU bank resolution framework, including bail-in tools. It also followed existing EU State aid rules.

Frontloading bank recapitalisation preceded by a rigorous process benefiting from independent experts contributed efficiently to strengthening the resilience of the banking system. The MoU's requirement to carry out a comprehensive asset quality review and bank-by-bank stress-tests in a short time, under the guidance of the Spanish and international institutions, was essential to restore confidence about the financing needs of the Spanish banking system. The evaluators found that the inclusion in the MoU of a possibility to mobilise a EUR 30 billion backstop in case of emergency to cover for the costs of unexpected interventions in credit institutions provided a credible signal to markets that financing needs would be covered should unforeseen needs arose. This contingent facility was not used in spite of

developments in summer 2012 that might have justified the activation of the facility (in order to recapitalise Bankia). The evaluators found that, while foreseeing a contingent facility for its immediate use in case of emergency was warranted by the high volatility in financial markets and the uncertainty about the assumed capital shortfalls of Spanish banks, the MoU would have benefited from a more clear description of the conditions under which the facility could be drawn upon.

However, some decisions with regard to the programme's conditionality would have benefited from more transparency and publicly-available analyses. For instance, while the conditionality was considered appropriate by the evaluators they found that, given the potential social and distributional repercussions of the choice of an AMC to deal with impaired assets and the foreseen burden sharing exercises, the programme-related documents could have benefited from more clarity and communication about these choices (e.g. in Commission occasional papers). This would have made the programme better understood by a wide audience. It would have also facilitated an assessment of whether those choices were the most efficient ways to reach the programme's objectives.

While the evaluators found that the programme included a comprehensive set of measures to overhaul financial sector supervision, the MoU would have benefited from an expanded diagnosis of the problems that justified the conditionality in this area. In particular, the requirement to revise the procedures of the Bank of Spain could have been more specific by introducing a clearer identification of the problems and a better description of what needed to be done to achieve the programme's objective of reducing the occurrence and severity of future financial crises. The evaluators found that focusing more on the need to ensure enforcement rather than on procedures would have streamlined the conditionality in this area. In this regard, a majority of stakeholders interviewed during the consultation process and the evaluators were of the opinion that the entry into force of the Single Supervisory Mechanism had been a key step to limit delays in remedial action in the future and rendered some of the measures in the MoU less relevant than they would have been otherwise.

Lessons for future programmes:

Transparency is important when decisions involve re-distributional effects and may have a potentially significant impact on the taxpayer. Therefore, financial assistance programmes should benefit from clear public communication about measures involving burden sharing exercises and other measures which bear a significant social or redistributional impact.

Contingency facilities to cover for possible early bank recapitalisations are a useful tool within a financial-sector programme, but the conditions under which those facilities could be drawn upon should be made clear upfront.

An AMC is an efficient tool to deal with impaired assets when there is a need to remove uncertainty from banks balance sheets, the problem is systemic, special powers and skills for asset resolution are needed, and the impaired assets are homogeneous enough to generate economies of scale. These conditions were met in the context of the Spanish programme, but different circumstances in future programmes might warrant different solutions. Thus, future financial sector programmes would benefit from a publicly available ex-ante analysis about the advantages and drawbacks of the strategy chosen to deal with impaired assets, including the implications of that choice for the taxpayer.

Programme implementation (efficiency)

The evaluators and all stakeholders interviewed in the consultation process shared the view that the implementation of financial sector conditionality was overall sound and closely followed the timeline set in the MoU's roadmap. This was largely owed to the high administrative and personnel capacity within the Spanish and international institutions and a strong commitment by the authorities, which underpinned a smooth implementation of the programme.

The setup of Sareb was an efficient way to deal with impaired assets, striking a good balance between financial stability and burden sharing under very difficult real-estate market conditions. Sareb served well the financial stability purpose for which it had been created. It contributed to stabilise the downturn in the housing market and avoided fire sales of real estate assets. It also helped banks implement their restructuring plans, improved their weak liquidity position and was a central element for the needed recognition of losses in the system. Sareb reflected well the spirit of existing EU State aid rules with regard to the treatment of impaired assets in the banking sector, which established that the chosen strategy should follow the objectives of boosting market confidence, limiting negative spillovers among Member States, protecting the single market in financial services and ensuring compliance with State aid and other legal requirements and minimising moral hazard.

Nevertheless, Sareb's capital composition and structure were not free of risks for the taxpayer. Sareb's leverage was relatively large as its share of capital and subordinated debt was low relative to that of senior debt guaranteed by the State. This represented a risk for the State and ultimately the taxpayer. The capital structure and ownership of Sareb reflected a number of concerns, among which the wish to limit the impact on public debt by having it classified outside the general government sector, the difficulties to attract private stakeholders at the time, the need to have a sufficient amount of own resources to absorb future potential losses and the need for Sareb bonds to comply with the Eurosystem's eligibility criteria for their use as collateral in refinancing operations. The evaluators found that ensuring a majority stake by private investors in Sareb was a difficult task under the existing environment at the time and its achievement was appropriate to reduce risks for taxpayers in the event of unforeseen losses. Involving private banks in the ownership of Sareb was an efficient way to make the sounder part of the banking system be part of the solution to deal with the problems of troubled banks. Several stakeholders consulted by the evaluators pointed out to possible conflict of interests of private banks being stakeholders of Sareb, as those banks might compete with Sareb in selling real estate portfolios and might have also been purchasers of Sareb’s assets. In March 2013, Sareb's Board of Directors approved a policy on conflicts of interest and related-party transactions. The evaluators found that introducing those governance provisions was positive and they should be strictly enforced. Some stakeholders consulted during the evaluation process were of the view that there would be merit in considering a role for the ESM or the SRB to take a stake in future AMCs in cases where it is difficult to attract private stakeholders, and that this would reduce potential conflicts of interest by private investors. The evaluators found that this could be worth being evaluated at the early stages of the programme design, though it obviously raises broader questions that go beyond the scope of this evaluation.

The rapid setup of Sareb was important to achieve the objective of removing doubts about the quality of the banks' balance sheets, but it also had some drawbacks. The evaluators and the large majority of stakeholders consulted agreed that speed was key for the overall effectiveness of the programme. However, in the case of the creation of Sareb, some stakeholders felt that the deadline was too tight (four months), as it allowed only limited time for asset valuations and the development of a business plan. Moreover, in the absence of independent loan servicing companies in Spain at the onset of the programme, the management of assets whose ownership had been transferred to Sareb remained with the originating banks, in exchange for a fee paid by Sareb. With management disconnected from ownership, banks had little incentives to collect and recover non-performing loans or divest real estate assets. This highlights the importance to quickly transfer the management of assets to the AMC or to specialised companies with the right incentives to divest those assets at the best-possible value.

The choice of assets eligible for transfer to Sareb struck a reasonable balance between efficiency and financial stability. The setup of thresholds by categories of assets to be transferred to Sareb was an efficient decision. It helped to avoid transferring too granular portfolios which would have been difficult to manage but represented a limited risk for financial stability. The decision to exclude retail mortgages and non-REDs loans to SMEs from the assets transferred to Sareb was consistent with minimising the amount of State aid to achieve the programme's objectives, as NPLs in these segments remained considerably below the system level before and after the programme's period. Including those categories

of assets would have also made the management of Sareb more difficult due to the large granularity they would have added to its portfolio. The call to an independent external consultant to carry out asset valuations increased the transparency of the process and limited the risks for the taxpayer. The process of transferring bank assets to Sareb was surrounded by high uncertainty with regard to the value of those assets and the future evolution of house prices. The calculation of the value attributed to the assets transferred to Sareb followed European Commission guidelines on the application of State aid rules to asset relief measures. It was based on their long-term economic value, which is a standard practice in the treatment of impaired assets in the EU when State aid is involved. The evaluators found that the uncertainty about the evolution of prices of assets transferred to Sareb warranted a prudent calculation, for which relying on independent experts to value the assets and applying an additional haircut was an efficient way to produce credible estimations and to reduce risks for the taxpayer.

The banks' restructuring and recapitalisation process was a key step in restoring confidence in the Spanish banking system. The timing of the implementation of recapitalisation plans was remarkable as in less than six months restructuring plans respecting EU State aid rules had been adopted for eight credit institutions. No further recapitalisations requiring public support were required thereafter. Thus, the plans fulfilled the programme's objective of restoring the viability of the restructured institutions without additional State aid. This also supports the idea that using only part of the financial envelope available for the programme was an efficient way to achieve the programme's objectives. The independent bottom up stress tests, which set the basis for identifying banks' capital needs, were crucial to increase transparency and confidence in the capital needs of the banking system.

The evaluators found that, while the application of burden sharing might have not resulted in hybrid capital instruments absorbing losses to the full extent possible, it did comply with the spirit of the upcoming EU legislation. The MoU required banks and their shareholders to take losses before State aid measures were granted and to ensure loss absorption of equity and hybrid capital instruments to the full extent possible. The evaluators found that there was a certain degree of discretion in the application of such requirement, as it was not totally clear that the "full extent possible" was strictly applied. An apparent flexibility in the implementation of the MoU's burden sharing conditionality responded to sensible factors ranging from legal to financial stability considerations. The hierarchy of seniority of claims in the event of a bail-in exercise (outside liquidation) was not entirely clear in Spain at the time. Further bailing in of preference shares might have increased financial stability risks due to possible losses in banks' deposit base. Amid some legal uncertainty, the need to respect the "no creditor worse off" principle would have made it difficult to impose higher haircuts on hybrid and subordinated debt. Finally, the holders of hybrid instruments were to a large extent small investors who in many cases had not been aware of the risks imbedded in hybrid products such as 'preferentes'.

The inclusion of senior debt in the burden sharing exercises would have allowed for a higher contribution of the private sector to the costs of the programme, but was correctly not convened given risks to financial stability. Depositors' concerns about a bail in of deposits would have intensified financial market stress and capital flows out of the Spanish banking system. The context for applying burden sharing in Spain under the programme was complex also due to the lack of consistency across bank resolution regimes in euro area Member States, partly because of different legal systems. High levels of State guaranteed debt within the banks receiving State aid would have implied that the State would have incurred losses if senior debt had been bailed in. The decision also followed the approach taken in 2010 with the economic adjustment programme for Ireland. The BRRD introduced more clarity about the conditions to apply haircuts to senior debt (senior liabilities should be converted or written down if the subordinate classes have been converted or written down entirely). The evaluators and all stakeholders consulted agreed that the BRRD was an important step to reduce uncertainty by harmonising and improving the resolution mechanisms across Member States.

Compliance with the horizontal financial sector policy requirements of the MoU was overall satisfactory. Wide ranging measures were implemented, contributing to overhaul the governance, regulatory and supervisory framework of the Spanish banking sector. These reforms led to a clearer separation of powers between the Bank of Spain and other bodies. This was important as failures to translate supervisory findings into action had been identified as an important problem preventing early action against the accumulation of large imbalances in the Spanish banking system in the run up to the programme. The new range of tools to intervene effectively in weak banks improved the previous framework and adapted it to good international practices and common resolution frameworks in the EU. The introduction of emergency procedures to recapitalise credit institutions made the system dynamic, while the reforms regarding burden-sharing procedures were instrumental to establish a clearer order of seniority of liabilities in bank restructuring. While effective in increasing the resilience of the banking system, these reforms seemed well balanced with efficiency as they should reduce the potential burden on public finances, reduce the negative impact on restructured banks and minimise the burden on tax payers while preserving financial stability.

Significant steps were taken within the programme to reinforce the governance of the savings banks sector, although with some important delays. Implementation in the area of resolution and supervision was overall fast and comprehensive. However, there were some implementation delays with regard to the reform of the savings banks sector. This regarded in particular the issuance of subordinated legislation, as the adoption of a Royal Decree and a Circular from the Bank of Spain implementing the new legal framework for Spanish savings banks (Law 26/2013) were very delayed (adopted in October 2015 and November 2015, respectively). The secondary legislation developed crucial aspects regarding incentives to reduce controlling stakes held by banking foundations in banks. The full implementation of Law 26/2013 should help to remove any remaining uncertainty with regard to the governance of savings banks and should underpin the overhaul of the sector carried out over the past few years.

Lessons for future programmes:

Independent AQR and bottom-up stress tests are very useful tools to assure a financial-sector programme effectiveness and increase transparency and confidence about the estimations of capital needs of the banking system.

In the future, the setup of AMCs would benefit from a rapid transfer of both management and ownership of impaired assets. When the management of impaired assets transferred to the AMC remains temporarily within the banks, as was the case for Sareb, right incentives in servicing agreements with those banks should be established so that they make efforts to extract the maximum value from the transferred assets. It is important to ensure that capacity in terms of management and governance is built up quickly, that the management is independent, and that a realistic business plan is established.

When financial market uncertainty is very high and there is no functioning market for impaired assets to be transferred to an AMC, independent valuations based on the long-term economic value of those assets accompanied by an additional haircut can be an efficient tool to limit risks of potential losses for the AMC.

Clear communication is essential when implementing burden sharing exercises which might be different across programmes, so as to improve the public's perception of those decisions. Reasons leading to different approaches for burden sharing or other important sensitive decisions under different euro area programmes should be widely available and properly communicated by the institutions involved in those decisions. In this regard, the deep transformation in EU bank resolution and supervision frameworks which developed in parallel to the programme should facilitate a more homogeneous implementation and reduce legal uncertainty in future programmes.

Achievement of the programme's objectives (effectiveness)

The implementation of the programme measures underpinned macro-financial stability. Although important challenges remain (see further below), the evaluators found that the programme's objectives were largely achieved and the programme avoided a disorderly deleveraging that would have had harmful consequences for the financial sector and overall macroeconomic stability. A number of financial indicators show an overall improvement in solvency, profitability and financing costs of the banking system, while the negative trend of credit contraction is showing signs of a gradual reversal. Banks carried out an orderly downsizing of exposures to the real estate sector, bank's reliance on central bank liquidity declined and risk identification and crisis management mechanisms were enhanced. These were explicit objectives stated in the MoU. The achievement of these objectives supported the MoUs' broader objective of safeguarding financial stability in the euro area as a whole. Yet, the success of the programme needs to be seen in the context of a number of external actions at European Union/Euro Area level which were of paramount importance, in particular the announcement of the ECB's OMT scheme and steps towards a Banking Union.

Spain's broad compliance with the fiscal targets and structural reform requirements under the European Semester helped to foster a virtuous circle of positive news and reinforced the credibility of the financial sector programme. Fiscal indicators improved during the programme period although the original targets had to be revised due to adverse macroeconomic developments. In parallel, the authorities implemented a broad range of structural reforms to improve labour and product markets. These measures facilitated the correction of the macroeconomic imbalances. Structural fiscal reforms strengthened the resilience of the public sector, overall reduced risks to fiscal stability and improved the sustainability of public finances. Most reform requirements under the European Semester were in line with previous reforms and reinforced the efforts made by the Spanish authorities. Recent developments of macroeconomic indicators allow a preliminary positive assessment about the effectiveness of the programme in enabling a return to sustainable growth.

Lessons for future programmes:

Programme conditionality which is realistic and in line with a country's priorities facilitates the achievement of the programmes' objectives.

The achievement of the programme's objectives depends not only on domestic actions but also on the external environment. Possible measures at EU/EA level that could help achieve the programme's objectives are worth evaluating at the early stages of the programme design.

A financial sector specific programme with explicit requirement in the MoU for the country to comply with EDP and European Semester/MIP recommendations may create positive feedback loops and underpin the overall success of the programme, provided that sufficient implementation capacity and political commitment are in place. If those conditions are not in place, a fully-fledged programme with less frontloaded disbursements might be more suitable.

Consideration needs to be given to the aftermath of the programmes in terms of the path of fiscal consolidation and structural reforms. The risk of slowing down reforms after the programme can be reduced by ensuring an as-complete-as-possible implementation of the programme conditions within the programme period, for which frontloading the programme measures can be an efficient tool.

EU value added and coherence with other EU policies

The evaluation found that there was value added in setting up a financial assistance programme. With Spain's public finances under stress and rising financing costs in the run up to the programme, EFSF/ESM funds allowed the State to finance the recapitalisation of the banking system at much more

favourable terms. Involving European institutions and the IMF introduced a degree of certainty towards investors who questioned the health of the banking system, the accuracy of banks' supervision as well as the financing capacity of the State for restructuring the banking system. In the absence of a counterfactual, it is difficult for the evaluators to determine with full certitude whether the Spanish government could have achieved a deep restructuring of the banking sector and progress with fiscal consolidation and structural reforms in the absence of external financial assistance. However, the evaluators were of the opinion that tightening financing conditions for the Spanish sovereign and the private sector and increasing financial fragmentation in the euro area would have certainly resulted in much larger budgetary costs, more depressed social and economic indicators and higher risks for macro-financial stability. This would have made the objectives of the programme much more difficult to achieve with the same amount of public resources.

The programme was consistent with EU rules and initiatives and benefitted from other policies. The overall success of the programme cannot be dissociated from important measures taken out in parallel at EU/EA level, in particular accommodative monetary policy measures launched during the programme period and steps taken towards a Banking Union, which supported the objectives of the programme. The measures implemented under the programme complied with EU State aid rules and went into the direction of an evolving EU framework with regard to bank restructuring and resolution.

Lessons for future programmes:

Financial assistance from the EU/EA to a Member State adds high value where the Member State is unable to overcome negative sovereign-bank feedback effects on its own, by reducing financing costs for the State, supporting debt sustainability and thus macroeconomic stability, and by overcoming investors' concerns about the credibility of domestic bank regulators and supervisors.

Remaining challenges

Challenges for the Spanish financial sector and the broader economy remain. In particular, despite the improved economic outlook, a still declining stock of credit and the current low interest-rate environment, together with the high levels of NPLs and foreclosed assets in the banking sector, pose risks to the long-term sustainability of banks' profitability. The maximisation of the recovery value with regard to the entities which are still under the control of the FROB remains challenging. Spain exited the programme with still very large general government deficit and debt levels, while structural problems limit Spain’s growth potential. Despite significant adjustments in key economic flows over the past few years, the persistently high level of unemployment, low productivity, and still sizable public and private debts continue to pose policy challenges. While most internal and external imbalances have improved, the correction will have to be sustained over the next few years. The high structural unemployment and labour market duality, and the lack of economies of scale of Spain’s large share of small firms hold back medium-term growth. Spain has a large negative net international investment position, which adds to its external vulnerabilities. Going forward, the recovery can be sustained only if it does not result into a halt of the adjustment process, as the ongoing correction of the original imbalances still has a significant way to go. There are some pending key reforms, such as the reform of professional services and professional associations, which have been delayed and if adopted could have positive on productivity growth.

ANNEX 1
Evaluation method and process

This ex post evaluation has been designed to comply with both the Commission's evaluation standards and international best practice. This annex describes the main procedural and methodological aspects of the evaluation introduced to ensure compliance with these principles. First, it describes the institutional arrangements to ensure the independence and impartiality of the evaluation exercise. Then it sets out the procedure that was followed in undertaking the evaluation.

The Director General of the European Commission's Directorate General of Economic and Financial Affairs' (DG ECFIN) appointed a Steering Group to oversee the evaluation and guarantee its independence. It was composed of senior officials from DG ECFIN, and officials from DG Competition and DG Financial Stability, Financial Services and Capital Markets Union (DG FISMA). The Steering Group provided guidance, ensured impartial supervision during the overall process and assessed the quality and usefulness of the final outcome of the evaluation. The evaluation was carried out by staff of Unit A.3 'Monetary policy, exchange rate policy of the euro area, ERM II and euro adoption' of DG ECFIN, which was not the operational Unit in DG ECFIN in charge of the Spanish financial sector support programme. After revision by the Steering Group, the evaluation mandate was approved by the Director General of DG ECFIN on 3 December 2014. An inception report was submitted to the Steering Group who discussed and approved it on 26 January 2015. On 19 June 2015, after the finalisation of data collection, the Steering Group discussed and approved the Interim report. The final report was presented to the Steering Group on 26 November 2015. Following a copy being transmitted to the Spanish authorities on 9 December 2015, the Spanish authorities were invited to provide their general views on the evaluation, which are published in Annex 2. During the overall process, inputs have been provided by many actors, including the Steering Group, the Spanish authorities, academics and experts and this open exchange has been fruitful and helpful. In order to maintain the independence of the evaluation exercise, the final report was approved by the Steering Group and was not subject to approval by DG ECFIN's hierarchical line.

The evaluation mandate set out the following questions for the evaluation to answer: (i) Whether the objectives of the intervention corresponded to the needs (relevance); (ii) Whether the objectives have been achieved or can be expected to materialise in the medium/long term (effectiveness); (iii) Whether the intervention (financial assistance and conditionality) was appropriate in relation to the outputs to be produced and the broader macro-financial impacts to be achieved (efficiency); (iv) Whether the intervention was coherent with other EU policies/activities (coherence); and (v) Whether there was value from EU/euro area intervention compared to what could have been achieved at national level (EU value added).

To assess the relevance of the overall programme design and outcomes the evaluators analysed: whether the objectives and scope of the intervention were appropriate with regard to the needs of the Spanish financial sector and the wider economy, the focus of conditionality and the pace and timing of the programme and of its implementation. The assessment of the extent to which the objectives of the programme were achieved (effectiveness) was made by comparing programme conditionality with outcomes and looking at the influence of external factors on outcomes. The efficiency of the programme was assessed against the measures taken within the programme implementation and in particular by looking at the use of resources was optimal (e.g. whether the financial envelope was appropriate or whether burden sharing exercises achieved the objectives of minimising the costs for taxpayers while ensuring financial stability). The coherence with other EU policies of the main measures of the programme were assessed against existing legislation (including 'acquis communautaire') but also taking into account an evolving situation of the EU legal framework, in particular with regard to the Bank Resolution and Restructuring Directive (BRRD). To assess the added-value of an EU-level intervention the evaluators carried out qualitative analysis focused on identifying whether the Member State had its own means to carry out an intervention reaching the same objective without overburdening its public finances an jeopardising financial stability in Spain but also across the euro area. The evaluation identified and examined relevant economic/financial data and complemented this with a qualitative analysis.

In addition to analytical work based on data and published documents, the evaluation team undertook a consultation exercise to collect evidence from individuals and bodies involved in the programme. The inputs into the analytical work included publically available data, Commission, ECB and IMF reports, documents published by the Spanish authorities and other international organisations as well as private sector and academic research. The evaluation team had interviews and meetings with European Commission staff who were involved in the Spanish programme. Representatives of euro area Member States were consulted in their capacity as members of the Eurogroup Working Group (EWG). ([89]) Meetings to collect information and assessments on a number of issues took place with relevant Spanish authorities/bodies (Bank of Spain, FROB, Ministry of Economy and Competitiveness, Sareb, representatives from the banking and savings bank sector and social partners). The Secretary of the Treasury and Financial Policy's office within the Ministry of Economy and Competitiveness provided assistance to the evaluators in identifying the relevant authorities/agencies and the appropriate interlocutors. Meetings with relevant representatives of the EBA, ECB, the ESM, the IMF and with research institutions also took place.

The preliminary findings of the ex post evaluation were discussed during a workshop with academics and experts. The workshop was organised by the evaluator under the guidance of the Steering Group. The final outcome of the evaluation benefited from the resulting open exchange of views. The evaluation is primarily qualitative, in the sense that it is based on economic judgement, rather than on an econometric analysis of data. The approach taken allowed a much wider range of factors to be taken into account, which can deliver conclusions that are more relevant in terms of institutional learning. The alternative of using a macro economic model is not appropriate in the context of an ex post evaluation of such a multi-faceted programme due to the exceptional nature of the crisis (especially in the euro area context of the time) and the importance of the political context and other unobservable and/or exogenous factors.

The evaluation encountered some limitations, but has been able to gather a sufficiently wide range of relevant data and evidence to draw conclusions. Limitations included the non-availability of some individuals involved in programme design/implementation and also the relatively short time since the end of the programme. The programme dates back to 2012; in some cases officials who were directly involved in its design or in the early stages of its implementation are no longer working for DG ECFIN. This is also the case for staff of the other institutions and for Spanish officials. Whenever possible these officials were called to participate in meetings, despite having moved to other assignments. The evaluation found out that, for the main issues, their replacements were generally able to provide the necessary information and assessments. In addition, whilst determining an optimal point of time to evaluate the programme is very difficult, sufficient data was available after the completion of the programme to support the detailed level of analysis undertaken in the evaluation.

To the extent possible, the evaluation is placed back in the context that existed at the time of the programme in Spain and in the euro area in general. During the course of the evaluation, there was sometimes a reasonable degree of disagreement between the various stakeholders on some elements of this context. In these cases, data and/or arguments in favour and against the appropriateness of certain measures have been presented. This is for example the case for the bail-in of hybrid and subordinated debt. The fact that this ex post evaluation started about one year after the end of the programme represents a limitation for making a definitive assessment about the medium-long term objective of return to sustainable growth. However, it seems to allow identifying trends developing in the Spanish financial sector and the wider economy which help to reach conclusions about their longer term impact of the programme.

([89]) The EWG is a subcommittee of the Eurogroup, which is an informal body in which the ministers from the euro area Member States discuss matters relating to their countries' common responsibilities related to the euro.

ANNEX 2

The Spanish Authorities' views on the ex-post evaluation

The Spanish authorities broadly agree with the main conclusions and findings of the report. We welcome the Commission's appreciation of the success of Spain's Financial Assistance Programme for the Recapitalisation of Financial Institutions, and the Commission's recognition of the strong commitment of the Spanish authorities to implement the programme effectively.

The result of any programme should be analysed against the objectives that guided its design. In the case of Spain's Financial Assistance Programme, the goals were to increase the long-term resilience of the Spanish banking sector and safeguard the financial stability in the euro area. Both objectives were achieved within the programme's time frame, so the programme is widely recognised as being a success.

The Spanish financial sector, which constituted the focus of the programme, is now more efficient and better capitalized. Thanks to an effective restructuring process, the Spanish banking system went from being a primary source of concern for financial stability in the euro area as well as a drag on growth, to getting excellent results only one and a half years later under the 2014 EU-wide Comprehensive Assessment.

The Asset Quality Review showed that the assets of the Spanish banks were accurately reflected in their balance sheets. Thus, the required risk-weighted adjustment was the lowest across the euro area and the Stress Test results showed that the impact of an adverse scenario on their solvency would be relatively limited, the second lowest among all euro area countries. In addition, the EBA's 2015 EU-wide transparency exercise has shown that the Spanish banking system has continued to improve its resilience and profitability.

Although the legacy of the crisis was heavy and the stock of credit is still diminishing, flows of new credit to households and companies are growing strongly. The NPL ratio is on a downward trend since late 2013 and our entities are better prepared to deal with NPLs since the coverage ratio of doubtful loans has increased since 2008 to reach its current level of 47%, above the EU average according to EBA data.

Currently the financial sector is underpinning the economic recovery. The macroeconomic situation in Spain has made a U-turn, and the economy is growing in a balanced and sustainable way. Spain's GDP is expected to grow above 3% in 2015, twice as fast as the euro area, and this path of growth is expected to continue in the following years. The structural reforms undertaken in recent years are a crucial factor explaining such trend.

The solid improvement in the flows of the main economic indicators (regarding labour creation, external surplus, private deleveraging, public deficit reduction, etc.) is translating into the correction of Spain's accumulated imbalances in terms of stocks, which should disappear in the medium term. However, in spite of all these achievements, important challenges for the economy remain, so reform efforts should be maintained.

As far as the Financial Assistance Programme is concerned, Spain implemented the programme swiftly, delivering all commitments within the agreed deadlines. The strong implementation record culminated in a successful exit from the programme on schedule, without any follow-up programme. As of January 2016, Spain has also proceeded with three voluntary prepayments redemptions of the ESM loan, clearly signaling Spain's good economic performance.

The current economic performance of Spain is a clear sign that the Financial Assistance Programme has been a success and a key factor to restore confidence in the Spanish economy. It must be recalled that the Spanish programme was the first and so far the only financial assistance programme by the ESM for the recapitalisation of financial institutions. Such a distinctive fact allows us to underline some important elements that, in our view, contributed decisively to the success of the programme. Further reflection on these issues should provide very valuable input for future experiences.

Tailored design. It is essential that programmes are tailor-made so that they address country-specific challenges. This was the case of Spain, whose programme focused on its main vulnerability, the financial sector. The programme supplied a credible financial source to fund the recapitalisation of the financial system. Conditionality was also targeted to the financial sector, the recipient of the programme's funds.

Coordination with other European supervisory processes (such as the European Semester and EDP) was another highlight of the programme that enabled a comprehensive strategy to be implemented at a national level. In this sense, the authorities' ownership of the programme and the stable majority in Parliament helped to pass all measures fast and forcefully.

Commitment of national authorities. The strong commitment of the Spanish authorities, as recognized in the report, was paramount in order to avoid a fully-fledged programme, opting for a targeted programme.

Frontloading. The frontloading of both the programme disbursements and conditionality was also a right choice. In a period of financial stress, reducing rapidly the uncertainty, and consequently the premium both the banks and the sovereign are paying, is crucial. In this respect, Spain approved all 16 legislative measures included in the MoU within the expected time frame avoiding any delay in the implementation of the programme. This strong commitment restored the credibility of the country rapidly.

Size of the envelope. Rightly setting the amount of the funding envelope is an element of key importance, as market expectations and ESM's remaining firepower depend on it. In the Spanish case, the size of the funding package, €100 billion, was set in the higher end of the range of estimates. In the end, total disbursements amounted to €41.3 billion, substantially below the maximum amount granted. Despite the fact that such a big funding envelope contributed to increasing confidence and making the backstop credible, financial markets could have interpreted it as a negative signal about the actual situation of the Spanish financial system. Therefore, the size of the programme is an element that should be carefully calibrated in future occasions as a means of avoiding potential negative spillover effects.

Preserve market access. To minimise the cost of the programme it is important to preserve market access of Member States. In case of losing market access, great efforts should be directed to recover it as soon as possible. In the Spanish case, the fact that the sovereign retained its market access mitigated the cost and size of the programme.

Swift decision making. When a country asks for a programme, there is typically some urgency. Therefore, it is important that decisions are taken swiftly, avoiding negative disruptive turmoil in the financial sector of the euro area as a whole.

Asset Management Company. The quick set up of Sareb was a milestone of the programme to remove doubts about the quality of banks' balance sheets, which also provided benefits in terms of financial stability. Making Sareb a private company was of the utmost importance to limit the impact on public debt and to make the whole financial sector contribute to the problem of impaired assets of troubled banks. Looking ahead, Sareb´s success will depend on the evolution of the real estate market in Spain, thus, ultimately, on the strength of the economic recovery.

Banking Union. The Spanish financial crisis stressed the importance of breaking the feedback loop between the sovereign and financial sector. A lot has been accomplished with the Banking Union: a common regulation, supervision, resolution and restructuring approach have been set up, ensuring a more efficient, transparent and accountable banking sector in the euro area. A Single Deposit Guarantee Fund will complete the last pillar of the Banking Union.

Conclusions

We would like to thank the Commission staff for their helpful cooperation during the whole process, including the negotiations, the implementation and the evaluation of the Financial Assistance Programme.

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