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Financial Assistance Programme for the Recapitalisation of Financial Institutions in Spain. Fourth Review – Autumn 2013

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Abbreviations

ABS	Asset-Backed Securities
AMC	Asset Management Company
BBVA	Banco Bilbao Vizcaya Argentaria
BdE	Banco de España (Bank of Spain)
BMN	Banco Mare Nostrum
bps	basis points
CDS	Credit Default Swap
CoCos	Contingent Convertible Securities
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
CSRs	Country-Specific Recommendations
DBPs	Draft Budgetary Plans
DTAs	Deferred Tax Assets
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
EDP	Excessive Deficit Procedure
EPPs	Economic Partnership Programmes
ESM	European Stability Mechanism
FCPs	Funding and Capital Plans
FGD	Fondo de Garantía de Depósitos de Entidades de Crédito (Deposit Guarantee Fund)
FROB	Fondo de Reestructuración Ordenada Bancaria
HICP	Harmonized Index of Consumer Prices
IBEX	Spanish Stock Market Index
ICAAP	Internal Capital Adequacy Assessment Process
IMF	International Monetary Fund
IRS	Interest Rate Swap
LTRO	Long-Term Refinancing Operation
MARF	Mercado Alternativo de Renta Fija (Alternative Fixed-Income Market)
MoU	Memorandum of Understanding
NFCs	Non-Financial Corporates
NIIP	Net International Investment Position
NPL	Non Performing Loan
NRP	National Reform Programme
OW	Oliver Wyman
RDL	Real Decreto Ley (Royal Decree Law)
RED	Real Estate Development
RWA	Risk Weighted Assets
Sareb	Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria S.A.
SGP	Stability and Growth Pact
SLEs	Subordinated Liability Exercises
SMEs	Small and Medium Enterprises
SSM	Single Supervisory Mechanism
y-o-y	year on year

EXECUTIVE SUMMARY

This Fourth Review report provides an assessment of the progress made by Spain with respect to its Financial Assistance Programme for the Recapitalisation of Financial Institutions since the beginning of the programme, based on the findings of a joint European Commission (EC)/European Central Bank[1] (ECB) mission to Madrid during 16-27 September 2013. The mission found that the stabilisation and repair of the financial sector have advanced further amid tentative signs of economic recovery. The timely and adequate implementation of the policy conditionality of the programme, together with visible progress with growth-enhancing structural reforms, has been accompanied by a return of investor confidence. A continuation of the positive trends is required for the successful completion of the programme according to the planned timeline.

1. **Since the start of the programme, investor confidence has gradually returned and Spain's access to financial markets continues its path towards normalisation, a trend which gained further traction in recent months.** Both the Spanish sovereign and private borrowers, including banks, can now fund themselves at more favourable costs and conditions following the clean-up of banks' balance-sheets and other financial sector reforms. The significant improvement was also due to positive developments in global capital markets and effective initiatives at the European level. Government bond yields declined by around 250 basis points since mid-2012, and the wholesale funding by banks gradually resumed since then. The improved liquidity position of Spanish banks is best reflected in the positive growth of their deposit base over the course of this year and the significant decline in their reliance on the Eurosystem funding, which diminished by about 25% since the peak reached in August 2012. Nevertheless, access to unsecured funding, especially short-term, is still subdued and for some weaker banks inter-bank borrowing remains constrained to repo operations.

2. **The balance-sheet repair of the weak part of the banking sector has been nearly completed.** The bottom-up stress-test finalised by Oliver Wyman in September 2012 revealed a capital shortfall of around EUR 57 billion which was primarily covered via the State-aid injected by FROB[2] of around EUR 39 billion, with the rest being generated from subordinated liability exercises (close to EUR 13 billion), private investors, sales of assets or capital relief from the transfer of assets to Sareb[3] (the Spanish Asset Management Company). The solvency position of all Spanish banks exceeds now the minimum required by the Memorandum of Understanding (MoU)[4], except for one which is about to be taken over by a bank with a solid capital position. Despite the significant progress achieved so far, consolidating the banks' solvency should continue in order to underpin lending to the real economy. In particular as, compared to their peers, the Spanish banks are not amongst the ones with the highest capital ratios.

3. **The process of restructuring of banks having received State aid is well underway, guided by the restructuring plans adopted by the European Commission.** The foreseen burden-sharing exercises with banks' shareholders and junior bond holders are virtually completed. In addition, the planned transfers of assets to Sareb have been achieved in two stages, in December 2012 and February 2013 respectively, and Sareb has become operational. Sareb has performed the first sales of assets and now faces the major challenge

[1] The mission also involved expert teams from the European Stability Mechanism and the European Banking Authority. The International Monetary Fund participated in the meetings as part of its independent monitoring.

[2] Fondo de Reestructuración Ordenada Bancaria.

[3] Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria S.A. http://www.sareb.es

[4] Core Tier 1 capital ratios above 9% according to EBA standards.

of implementing its business plan, i.e. successfully managing and eventually divesting its portfolio, while market conditions for the Spanish real estate have not bottomed out yet. However, prospects for some of the banks that received State aid remain challenging.

4. **Despite positive developments, the economic environment continues to weigh on the banking sector and constitutes the main risk factor going forward.** Lending to the real economy is still contracting at a rapid pace against the backdrop of weak solvent demand for new lending and a large increase in the banks' holdings of government securities. While there are early signs of a general economic stabilisation, supported in particular by net exports, the central scenario going forward remains one of a mild recovery in activity, as both the private and public sector need to reduce much further their debt stocks, and the adjustment in real estate price is not yet completed. Both elements impinge on the profitability prospects of banks, together with the reclassification of restructured/refinanced loans and the legal challenge of mortgage floors. After significant losses in 2012 due to a massive build-up of provisions, bank profitability turned positive in the first half of 2013. However, a significant part was related to carry-trade, exceptional gains from the subordinated liability exercises and assets sales. In this context, the recent initiatives by the Banco de España (BdE) to harmonise treatment of restructured loans and to carry out a forward-looking exercise of the banking sector, as a useful supervisory tool, are welcome as effective ways to increase the transparency of the banks' balance sheets and closely monitor the sector's capitalisation.

5. **Compliance with the horizontal policy requirements in the MoU has been completed, although full implementation is still required in a few areas.** Thereby, the governance, regulatory and supervisory framework of the Spanish banking sector has been strengthened, which translates into higher shock resilience of the banking sector going forward. Efforts to adopt the agreed measures and their implementation need to continue as envisaged, in particular in the area of the reform of the governance of the savings banks. Steps have already been taken aiming at improving non-banking financial intermediation, which should help smoothen the contraction in lending.

6. **The adjustment challenges remain significant, calling for a continuation of recent advances with structural reforms and full adherence to budgetary commitments.** Recent visible advances in the comprehensive reform agenda, broadly in line with the Council country-specific recommendations under the European Semester, have contributed to the recovery in confidence on the Spanish economy. Notable recent measures include reforms to stabilise the pension system, unify the Spanish internal market for goods and services, liberalise professional services, deliver more effective local and public administration and address the electricity tariff deficit. This reform momentum needs to be kept to reap fully the expected positive growth and competitiveness effects from the reforms, many of which are still in the process of being adopted and/or being fully implemented. Fiscal consolidation advanced further in the first half of the year but there are risks to the attainment of the 2013 deficit target. Progress with fiscal consolidation will be reviewed in detail in the forthcoming assessment of effective action under the June 2013 Council Recommendation under the Excessive Deficit Procedure and Commission's opinion on Spain's 2014 Draft Budgetary Plan.

7. **There is at present no reason to foresee further programme disbursements until Spain's exit from the programme.** Two disbursements were made so far in a total amount of about EUR 41.3 billion for the recapitalisation of State aided banks and the capital injection into Sareb. The rest of the Spanish banks either were not diagnosed with a capital shortfall in the stress test or were able to cover it by private means.

1 INTRODUCTION

8. This report assesses Spain's compliance with the conditionality of the Financial Assistance Programme and financial and economic developments in Spain since the beginning of the Programme and with a special focus on the previous quarter. A delegation from the European Commission (EC), in liaison with the European Central Bank (ECB), completed the fourth review of the financial sector assistance programme for Spain from 16 to 27 September 2013. The International Monetary Fund (IMF) also participated in the review, fulfilling its role as an independent monitor. Meetings were also attended by the European Stability Mechanism (ESM) and the European Banking Authority (EBA).

9. The Programme, which was agreed by the Eurogroup on 9 July 2012 and covers a period of 18 months[5], entails an external financing by the euro area Member States of up to EUR 100 billion. On 3 December 2012, the Eurogroup made the first review on the progress of the Programme[6] and welcomed the decision by the European Stability Mechanism (ESM) to authorise the disbursement of the first tranche of up to EUR 39.5 billion. Spain used close to EUR 37 billion for the recapitalisation of Group 1 banks, for which the EC had adopted restructuring and resolution plans on 28 November 2012, and around EUR 2.5 billion for capitalising Sareb. On 21 January 2013, the Eurogroup endorsed and on 28 January 2013 the ESM approved the second disbursement under the programme[7] of about EUR 1.9 billion for the recapitalisation of Group 2 banks, for which the EC had adopted restructuring plans on 20 December 2012. Thereby, the total amount of funds disbursed under the Programme reached EUR 41.3 billion.

10. The Programme continues to be on track. The Memorandum of Understanding provides for bank-specific conditionality, in line with State aid rules, as well as horizontal conditionality. Conditionality has been met *stricto sensu*, although some of the legislative measures and reforms initiated on the basis of the MoU conditions still need to be fully implemented.

11. The bank-specific conditionality has been finalised, although the monitoring of the implementation of Sareb's business plan targets and of the restructuring plans for the State-aided banks continues:

- First, a comprehensive, independent diagnostic as regards the capital needs of individual banks, based on a robust asset quality review and evaluation process, and bank-by-bank stress tests was performed. The due diligence process started with a top-down stress test in June 2012 and finished at the end of September with the publication of the results of a more granular bank-by-bank (bottom-up) stress test. The stress test revealed a capital shortfall of about EUR 57 billion for the entire banking sector.
- Second, an external Asset Management Company called Sareb was set up and became operational. The segregation of troubled assets from the balance sheet of banks receiving public support and their transfer to Sareb was achieved from both Group 1 (end-December 2012) and Group 2 (February 2013) banks. The business plan of Sareb has been approved by its Board and sales of assets through the retail channel

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

6 See Spain's first compliance report with the programme conditionality at: http://ec.europa.eu/economy_finance/publications/occasional_paper/2012/op121_en.htm

7 See the update on Spain's compliance with the programme conditionality at: http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/op126_en.htm

have significantly picked up in recent months while the firm has also begun effecting sales via the wholesale channel. A due diligence process on a significant part of Sareb's portfolio showed that the asset transfers were well designed and executed and that there was only a limited number of instances resulting in the adjustment of the transfer price.

- Third, the restructuring and resolution plans of the banks with a capital shortfall identified in the stress test and unable to cover it fully by private means were adopted. The recapitalisation of viable banks is completed and the restructuring of the State-aided banks needs to be fully implemented now. Subordinated liability exercises were undertaken in order to minimize the taxpayer's burden. The close monitoring of the implementation of the restructuring plans continues.

12. **The horizontal conditionality that applies to the entire banking sector was completed *stricto sensu*, in particular as it was frontloaded in the programme.** The horizontal conditionality includes 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. In a limited number of areas, follow-up measures and legislative processes which derive from the programme conditionality need to be finalised. These areas include in particular the reform of the governance of the savings banks that provides incentives for former savings banks to gradually divest their controlling stakes in commercial banks, a reform of supervisory procedures at the BdE (taking into consideration also the nascent Single Supervisory Mechanism - SSM) and measures to strengthen non-bank financial intermediation.

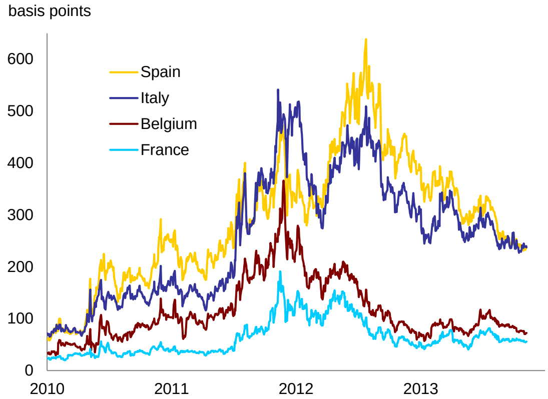
2 RECENT FINANCIAL, MACROECONOMIC AND FISCAL DEVELOPMENTS

2.1 FINANCIAL SECTOR DEVELOPMENTS

13. **Since the beginning of the programme, the situation on Spanish financial markets improved markedly, due to both international developments and national reform actions.** The government bond market stabilised and both yields and spreads declined significantly. The 10-year yield decreased by more than 200 basis points to 4.1% in November 2013 compared to 6.4% at the beginning of July 2012 (see Graph 1). At the same time, the 10-year spread over German bund almost halved from 490 basis points to around 240 basis points at present. The growth of investors' confidence has been particularly visible over the past few months due to the ECB's enhancement of its unconventional measures to restore the monetary policy transmission mechanism in the euro area, the political impetus in moving towards a European Banking Union and the improving economic prospects for Europe. At the same time, the announcement by Fed that it may start tapering purchases of government securities triggered a general sell-off on global bond markets and an increase of benchmark yields also in the euro area periphery. However, unlike in the case of Italian and Portuguese bonds, the increase of Spanish government bond yields was only marginal and as a result, the 10-year government bond spreads to German bund declined below the Italian ones for the first time since the beginning of the program. This shows that Spain also gained in credibility on the merit of its economic and financial sector reforms, beyond the progress made due to measures taken at the euro area level. The government bond market is also characterised by a much lower degree of volatility than a year ago.

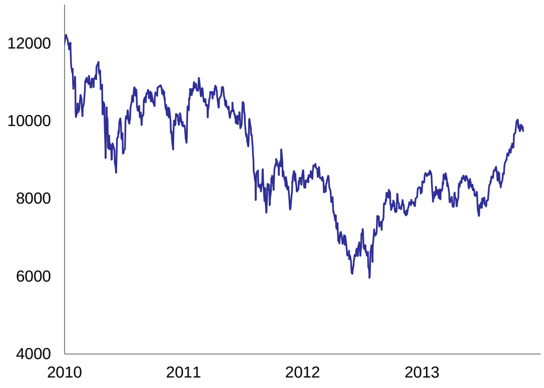
14. **The Spanish stock market experienced a similar improvement over the past year, with a rising interest from international investors.** IBEX 35 briefly topped 10 000 points but consolidated in November to around 9,800 points, compared to about 7,000 points in July 2012 (see Graph 2). This significant increase is a reflection of growing investors' confidence and better than expected economic data over the past couple of months. However, it should be noted that the improvement over the past year was accompanied by a relatively high degree of volatility. Moreover, a recent sharp increase was accompanied by lower than usual average daily volumes. The fact that developments in the stock exchange markets are in line with the evolution of sovereign debt reinforces other leading indicators which point to economic recovery.

Graph 1: Euro area sovereign spreads to the 10-year German bund



Source: IHS Global Insight and own calculations

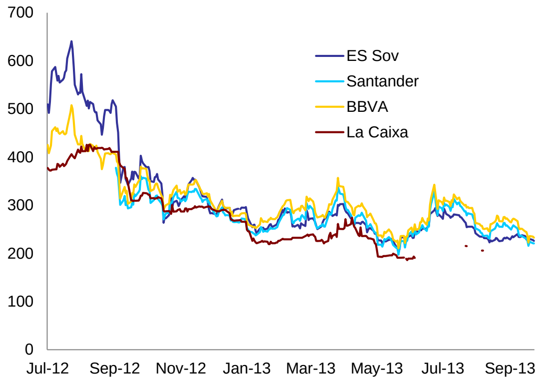
Graph 2: IBEX 35



Source: IHS Global Insight

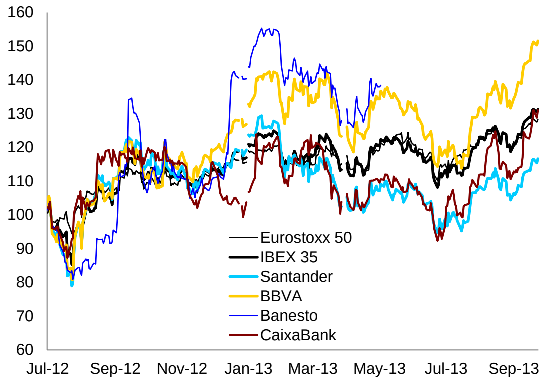
15. The share prices of the Spanish banks displayed a strong upward trend in the third quarter of 2013 after having experienced some volatility and decline in the second quarter. At the same time, banks' risk premia have been declining slowly since the beginning of the year. In line with sovereign exposures, credit default swap (CDS) spreads for banks have declined over the last months showing an improved market sentiment on banks' risks. Stock prices for several banks have rebounded in mid-August and increased sharply outperforming the market (see Graphs 3 and 4).

Graph 3: CDS spreads



Source: Bloomberg, own calculations

Graph 4: Stock exchange indices

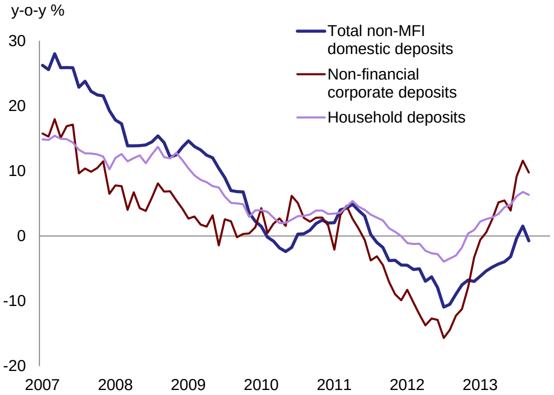


Source: Bloomberg, own calculations

16. Despite the reassuring return of confidence, the Spanish financial sector and markets remain vulnerable to adverse international and domestic developments. The analysis carried out by the European Commission under the Macroeconomic Imbalances Procedure in April 2013 shows that the levels of domestic and external debt are still high, in particular as public debt has also surged in recent years. The cleaning up of the banks' balance sheets has significantly advanced and the banks' exposure to the construction and real estate development (RED) sectors declined, but at the same time the restructuring process of the savings banks is still on-going and the amount of NPLs continues to rise. The deleveraging of both the financial and non-financial private sectors contributes to a contraction in credit which affects economic recovery and bank profitability. Therefore, banks should maintain comfortable capital levels that support lending to the real economy and provide a buffer to mitigate the risks of the still weak economic activity.

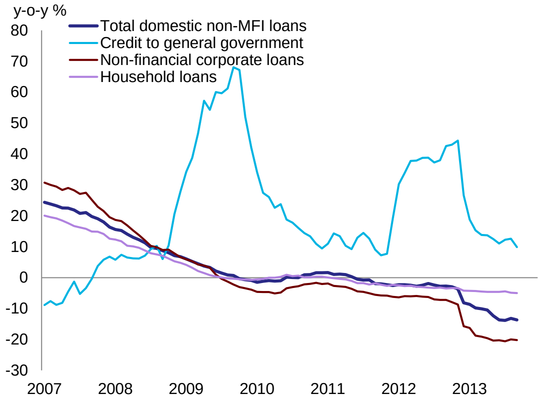
17. The easing of the banks' financing conditions from the start of the financial assistance programme consolidated further during recent months, with regards both to the access to wholesale funding and its cost. A normalisation of the inter-bank activity with other euro area banks was also recorded, but only in the segment of secured operations. Equally important, the fall in in resident retail and corporate deposits that peaked in mid-2012 was reversed. The annual growth rate of household and non-financial corporate deposits accelerated and reached more than 13% and about 6%, respectively as of September 2013 (see Graph 5). At the same time, the interest rate paid to depositors has been on a steady declining trend, helping banks finance themselves at more advantageous costs. The weighted average interest rate on new deposits decreased by about 100 bps and 50 bps for retail and corporate deposits, respectively, from December 2012 to July 2013. Furthermore, the significant outflow of non-resident deposits of about EUR 156 billion during 2012 was stopped and the issuance of debt securities by banks also improved (see next paragraph). Nevertheless, despite the better access to wholesale funding, banks are reducing their reliance on this source of financing in order to cut their interest costs. In parallel, net borrowing from the Eurosystem declined to EUR 241 billion at the end of September 2013 from a record EUR 400 billion in mid-August 2012. The two largest Spanish banks participated in the early repayment of the Long-Term Refinancing Operation (LTRO) in late January 2013 with a significant amount of about EUR 40 billion. The decline in net borrowing from the Eurosystem has slowed down in recent months, mainly as banks try to boost their profitability by carry-trade operations using this cheap source of funding.

Graph 5: Bank deposits



Source: BdE, own calculations

Graph 6: Bank loans[8]



Source: BdE, own calculations

18. The structure of funding by the Spanish banks has changed over past year, with less reliance on wholesale funding, while Spain managed to regain market access for the issuance of bank debt. The cost of funding declined due to a favourable change in market sentiment and lower volumes of issuance. The average price Spanish banks had to pay (swap + 200 bps) is substantially lower than in mid-2012 (swap + 600 bps). Nine Spanish banks had managed to raise funds in the markets in 2013. Despite a higher cost, top names engage in regular debt issuance operations (mainly covered bonds) in order to remain present in the capital markets. However, no single bank in Spain has been able to tap the market with short-term commercial paper. As regards the seven State-aided banks, none of them have been able to issue any security type (neither covered bonds, nor senior debt) but they all continue accessing external funding thanks to their holdings of ESM bonds. In particular, they have been able to replace part of the ECB funding by entering into repo operations on the international market. Overall, as of August 2013, Spanish banks issued EUR 43bn worth of bonds this year, compared to EUR 62bn in the same period of 2012, which translates into a 30% decrease (see Box 1). The decrease in the amount of debt issued by banks is due to lower financing needs as balance-sheet deleveraging advances and a recovery in other sources of finance, such as deposits. As far as types of securities issued are concerned, the most significant decline was recorded for covered bonds (70% y-o-y) and unsecured issues (30% y-o-y).

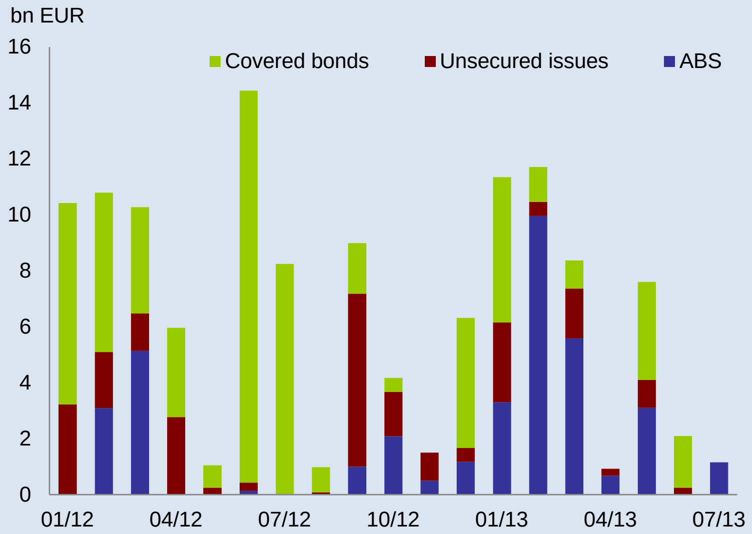
19. Since the beginning of the programme, the contraction in domestic private credit accelerated, also driven by the transfer of assets to Sareb and the restructuring of bank balance-sheets. Recent data points to a bottoming-out of the trend. The contraction in lending decelerated somehow during the summer, but resumed its trend in September 2013, as the deleveraging process and the rebalancing of the economy continue. The non-MFI domestic credit declined by about 9% y-o-y at the end of September 2013, driven by the contraction of credit to the private sector of around 13.3% y-o-y. Adjusted for

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

Box 1: Trends in banks' access to funding

- The access of Spanish financial sector to funding continues to improve. In 2012 Spanish banks issued about EUR 83 billion worth of bonds, while in first eight months of 2013 about EUR 43 billion was issued. While most of the issuance was retained by the banks as collateral with the Eurosystem, some parts were placed to final investors in the market, especially in 2013.
- During 2012 the market for senior unsecured debt was only available to Santander and BBVA. Recently, Caixabank, and Banco Popular have issued EUR 1billion and EUR 750 million, respectively. In late 2012, once doubts about the integrity of the euro vanished, Spanish banks started to regain access to the market. For example, BBVA issued EUR 2 billion of a 5-year covered bond in November 2012. Most recently, in the second and third quarter of 2013, the market sentiment for Spanish bank debt has increased substantially, in parallel with market appetite for bank debt issued also in other peripheral countries.
- As regards asset backed securities (ABSs), at the moment very little amounts are placed to final investors. For example, CajaMar issued in March 2013 an ABS on SME loans in amount of EUR 675 million of which only EUR 175 million were placed to final investors. Santander Finance has issued ABSs on car loans in 2012 and 2013 with the amounts placed totalling EUR 500 million and EUR 480 million, respectively.

Graph 7: Bond issuances by Spanish banks



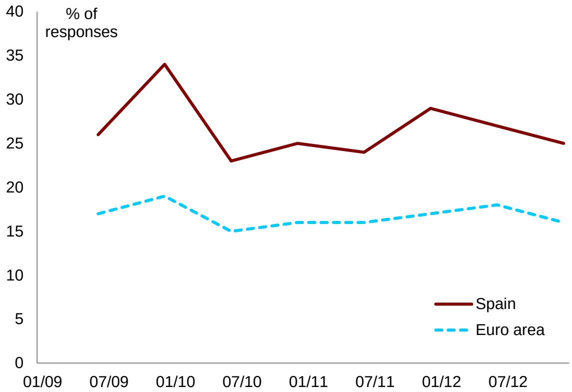
Source: Bloomberg

the transfer of assets to Sareb, private domestic credit declined by a lower rate of around 9% y-o-y as of September, which has slightly decelerated from the June and July levels. Whereas domestic credit to households declined at a slower pace of about 5% y-o-y as of September 2013, the annual contraction in credit to non-financial corporates remains high at about 11% (see Graph 6). In contrast to the large contraction in credit to the private sector, credit to government (including government securities) continued to advance at a quick pace – about 10% y-o-y as of September 2013 – offering banks an important source of income from carry-trade activities. While in the short-run lending to the government may be supportive for the banks, in the long-run it may crowd out credit to the private sector with a negative impact on the economic recovery.

20. The financing of Spanish non-financial corporations is based not only on domestic credit, but also on external borrowing and issuance of bonds, which have somewhat alleviated the decline in domestic credit. As of September 2013, the volume of debt securities issued by the non-financial corporate sector, including by medium-sized enterprises, increased by about 11% y-o-y, although from a relatively low level and the external loans contracted by the non-financial corporates declined by around 5.5% y-o-y. Therefore, the rate of contraction in total financing to non-financial corporates has decelerated to around 7% y-o-y as of September 2013. As regards the lending dynamics to various economic sectors, the biggest annual contraction in lending took place in the construction and real estate sectors. Lending to other economic sectors contracted at a slower pace, pointing to the reallocation of resources in the Spanish economy towards a more sustainable growth pattern.

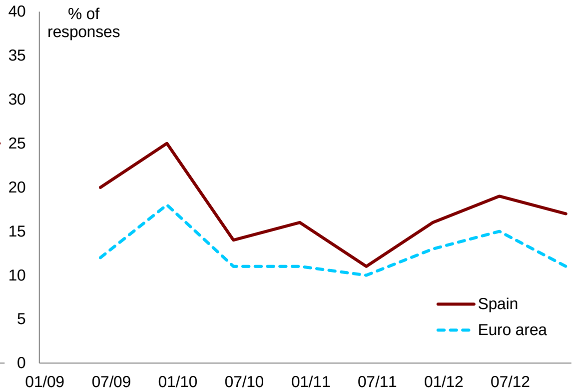
21. While banks consider the weak solvent demand as the main contributor to the ongoing decline in lending to the private sector, there are also supply factors affecting this decline, although some stabilisation signs are in sight. The contraction in credit reflects the deleveraging needs of both the financial and non-financial sectors and the aversion for long-term investments while the economic adjustment is still unfolding. The parallel increase in government credit and carry-trade activities has reinforced bank profits but, at the same time, has reduced banks' incentives to take more risk and lend to the real economy. The most recent Bank Lending Survey, covering developments in the second quarter of 2013[9], revealed that standards for approving credits have remained broadly unchanged from the previous quarter, although a slight increase in the perception of risk regarding the industry or firm-specific outlook was noticed. This represents a notable bottoming-out of the increasing tightening trend observed since the beginning of the crisis. The terms and conditions for loans to enterprises have been marginally tightened, despite the significant improvement in the funding cost for banks. Banks continued to report a decrease in the demand for loans (the eighth quarter in a row), which concerns primarily long-term loans and large enterprises. The main contributors to the decline in credit demand seem to be the shrinking financing needs for fixed investment (consistent with the macro-economic picture) and the increasing use of internal financing and issuance of debt securities. A similar picture can be inferred by looking at lending trends to households. On average, there has been no tightening of standards for approving credits to households, while lending conditions deteriorated marginally in terms of pricing for all types of loans and lending maturities.

Graph 8: SMEs' most pressing problem: access to finance



Source: ECB

Graph 9: SMEs' rejected bank loan applications



Source: ECB

22. On average, both large companies and SMEs report that access to finance is their second most pressing problem after finding customers (see Graph 8) and that the availability of external financing deteriorated over the past six months[10]. Surveys and

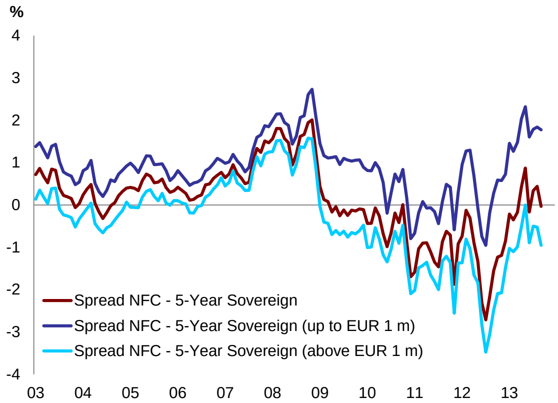
[9] See the report at http://www.bde.es/webbde/en/estadis/infoest/epb.html

[10] See the ECB 's *Survey on the access to finance of SMEs in the euro area (SAFE)*, at http://www.ecb.europa.eu/stats/money/surveys/sme/html/index.en.html

anecdotal evidence point to increased difficulty for some SMEs to access finance as valuable information about their past banking relationships has been lost when banks have restructured their geographical presence and staff composition in front offices. More than a quarter of the surveyed SMEs applied for external financing during the previous six months and only about 17% were rejected (see Graph 9) , which was only slightly higher than the Euro Area average. More Spanish companies than their euro area peers note that the terms and conditions for bank financing, as regards the interest rate, other financing costs, the size and maturity of loans and the collateral requirements, have become more onerous during the previous six months. However, this is consistent with the fact that about half of the large companies and 60% of SMEs report that their income generation capacity deteriorated over the same period, which is much above the euro area average.

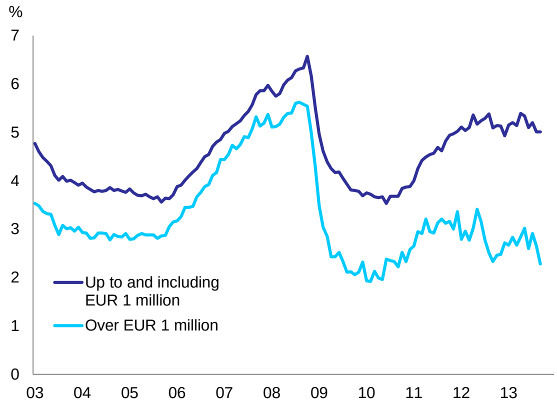
23. **The recent reduction in the banks' cost of funding has not been passed on to clients yet, so that lending rates to non-financial corporates (NFCs) have been more or less constant in nominal terms since the beginning of the year (see Graph 11).** However, their spread to the sovereign (see Graph 10) increased somewhat, signalling that the improvement in the risk perceptions regarding the sovereign did not extrapolate to the Spanish corporate sector. Overall, and in historical perspective, the cost of new borrowings for the corporate sector remains relatively low in nominal terms, in particular for large loans, although the spreads at which Spanish companies borrow relative to their peers from the core euro area countries have increased to persistently high levels in the crisis.

Graph 10: Spread over the sovereign for interest rates on NFC loans



Source: ECB, IHS Global Insight and own calculations

Graph 11: Cost of borrowing for NFCs

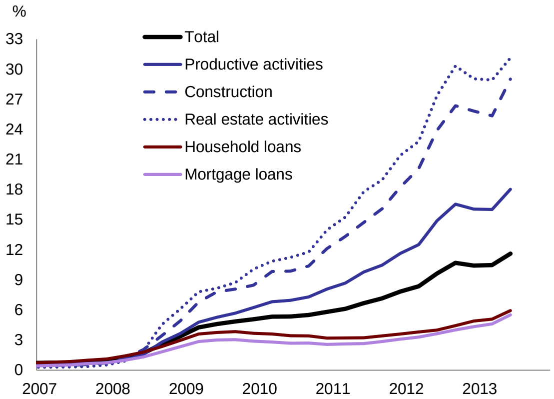


Source: ECB

24. **Going forward, the deleveraging process is set to continue while the decline in lending to the non-real estate corporate sector is expected to bottom-out as of next year.** The second set of funding and capital plans (FCPs) submitted by the Spanish banks, which include actual data for the first quarter of 2013, differ only marginally from the previous submission as regards credit developments. On aggregate, a higher decline in lending to the private sector in 2013 is expected in the current FCPs, in particular for SMEs and to a small extent also for other non-financial corporations. At the same time, the private credit evolution projected in the first submission of FCPs was consistent with the actual outcome in the first quarter of 2013, with a difference of allocation. Credit to SMEs underperformed, but this was compensated by higher credit volumes for households. Overall, the lending trends presented in the FCPs submitted in the previous quarter remain generally valid: credit to companies is projected to fall more than credit to households, driven by the real estate sector (a major contributor being the transfer of real estate assets to Sareb). Thereby credit to companies other than the real estate ones is projected to increase slightly until the end of 2015, with the exception of SMEs.

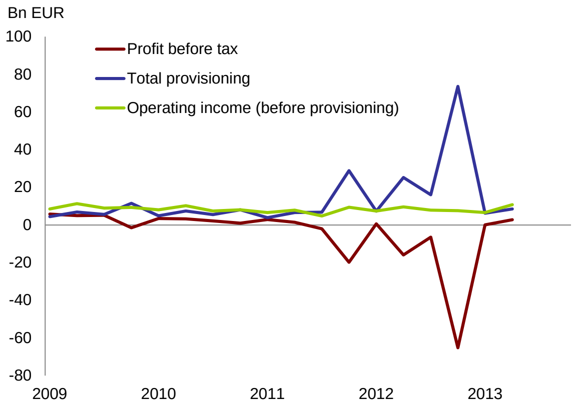
25. Non-performing loans (NPLs) have continued to increase in recent months, despite the positive impact of the transfer of RED assets of Group 1 and Group 2 banks to Sareb. Following the transfer of RED assets to Sareb, impaired assets at system level declined to below 11% at the end of February 2013 (compared with 11.7% at the end of November 2012), but this trend has been reversed in recent months (see Graph 12). The deterioration in asset quality has continued throughout the second quarter of 2013, with NPLs increasing to 12.1% at the end of August 2013 compared with 11.5% at the end of March. Non-performing loans in the household sector continued to remain significantly below the system level, but edged up to 6% at the end of June 2013. The performance of the residential mortgage portfolio has also deteriorated slightly, as non-performing loans for mortgage loans stood at roughly 5.8% at the end of June 2013 compared with 4.3% at the end of December 2012. A sustained increase in NPLs was recorded in the corporate sector, which displays a relatively high and growing NPL ratio even outside of the construction and real estate sector (see Box 2).

Graph 12: Non-performing loans



Source: BdE, own calculations

Graph 13: Bank sector profitability



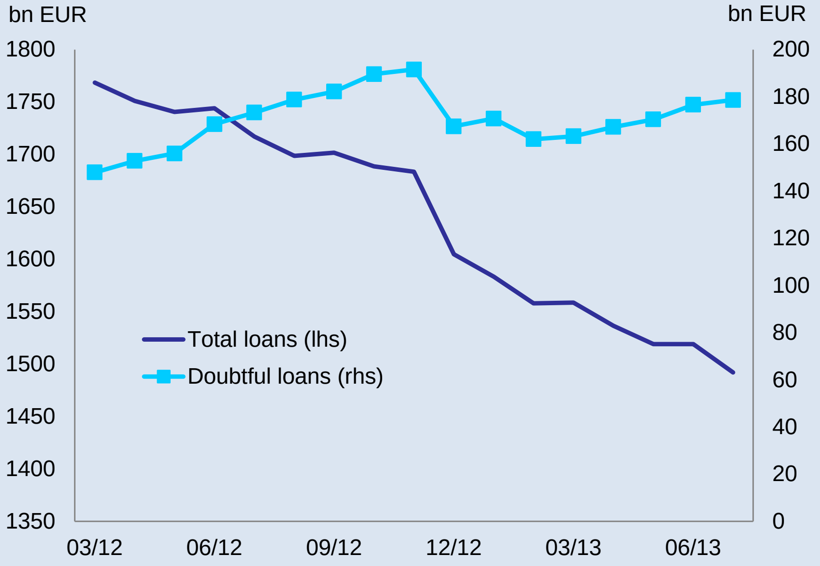
Source: BdE, own calculations

26. At the end of September 2013, banks submitted the results of the loan-by-loan analysis of their restructured/refinanced operations to BdE. The end-2012 data on refinanced/restructured loans published by credit institutions on the basis of the provisions of Circular 6/2012 revealed differences among banks both as regards the percentage of restructured/refinanced loans in the total loan portfolio and the quality of these loans. To address this situation, BdE sent two letters to banks in April 2013 to further clarify the application of provisions on restructured/refinanced loans including their classification in normal, substandard and non-performing. Banks performed a loan-by-loan analysis of the restructured/refinanced operations in order to identify possible loan reclassifications and additional provisioning needs. BdE is currently assessing the results of the analysis performed by banks based on March 2013 data. Notwithstanding the need for banks to further increase loan-loans provisions for restructured loans classified as substandard and non-performing, no additional capital shortfalls are expected to emerge from this analysis.

Box 2: What is behind the rising NPL ratio?

- The increase in the NPL ratio at system level has been driven both by the deterioration in the quality of assets held by banks and the contraction of the total loan portfolio (denominator effect) due to the on-going deleveraging process. The stock of impaired assets reached EUR 192 billion at the end of December 2012 and subsequently declined to EUR 162 billion at the end of February 2013, due to the transfer of RED assets of the Group 1 and Group 2 banks to Sareb. The stock of impaired assets went up by roughly EUR 17 billion between February 2013 and July 2013, whereas the reduction in the total loan portfolio amounted to EUR 66 billion during the same period. The deterioration in asset quality has been fuelled mainly by the increase in impaired assets in the corporate sector and to a lesser extent by the quality of loans to private individuals.

Graph 14: Evolution of total loans and impaired assets



Source: BdE

27. Lower volumes of new provisioning requirements in comparison with 2012 and the decreasing trend of operating expenses have returned the banking sector to profitability in the first half of 2013. During 2012, the sizeable increase in loan-loss provisions, due to the two one-off effects of Royal Decrees 2/2012 and 18/2012 led to a negative performance at a system level (see Graph 13). A loss before tax of roughly EUR 65 billion was recorded at the end of 2012, on the back of the significant losses posted by the Group 1 and Group 2 banks, which were not offset by the positive results of the internationally active banks. Although pressures from rising NPLs persist, the high coverage ratios and the transfer of problematic portfolios to Sareb have reduced new provisioning requirements during the first half of the year, and all banks returned to profitability (i.e. including all Group 1 banks). As a result of this, some banks took the opportunity to frontload future provisioning requirements on restructured loans as part of the necessary balance sheet repair process. Against this background, the return on equity at system level stood at 8.9% at the end of June 2013 compared with -21% at the end of 2012. Profitability in the first quarter of 2013 was on average above the projections of the Oliver Wyman stress test. Some banks, however, recorded profits mainly due to the positive contribution of non-recurring profits.

28. Attaining sustainable profitability is still a challenge given the uncertain economic outlook and the low interest rate environment and it has a direct bearing on the capitalisation of credit institutions. During the second quarter of 2013 banks' profitability reinforced the positive trend of the first quarter of the year and remained on average above both the baseline and strongly above the adverse scenario projected by Oliver Wyman for the 2012 stress test. At the same time, the positive evolution of bank profitability in the first half of 2013 was facilitated in several cases by a significant contribution from non-recurrent items (see Box 3). Banks' net interest incomes have generally experienced a downward trend due both to the deleveraging process and the low interest rate juncture. This should be closely monitored given future capital needs, also in view of the application of the new EU Regulation on capital requirements[11] and the comprehensive assessment to be carried out by the ECB in connection with the entry into force of the new single supervisor in the euro-zone as well as the EBA EU-wide stress test. Looking forward, the banks' Funding and Capital Plans project bank profitability to recover. While net interest income will remain rather flat, as decreasing volumes offset higher interest margins, administrative costs (in particular with staff) and impairments are likely to decline, boosting profits. Therefore, the recent decline in the cost of funding may not be reflected in a fast decrease of lending rates.

29. Since the beginning of the programme capital levels improved markedly. The uncertain economic environment calls, however, for comfortable levels of capitalisation, both in order to cushion the absorption of potential losses on banks' legacy assets and embolden banks to take more risk in lending to the real economy. The recapitalisation of banks with a capital shortfall as a result of the stress test performed by Oliver-Wyman was completed. At present, all banks comply with the 9% core tier 1 EBA solvency ratio, except for one which is in the process of being taken over by a bank with a solid capital position. Banks, such as Sabadell and Popular, issued capital in 2013, showing that some banks retain access to equity markets. Thus, they can boost their solvency levels, further decrease their funding costs and expand lending.

30. Excluding those banks which received State aid, the overall level of solvency of Spanish banks slightly decreased in 2012, but recovered in the first half of 2013, while the quality of capital has increased. The total capital ratio stood at 11.2% in December 2012, 90 basis points below the 2011 level due to the large bank balance sheet clean-up and provisioning effort that took place in 2012. Together with profitability, capitalisation rebounded in the first semester of 2013 and the total capital ratio increased again to about 12%. In parallel, the core tier 1 ratio increased to 10.5% in June 2013 from 9.4% at the end of 2012. However, compared to their peers, Spanish banks are not amongst the banks with the highest capital ratios, but rank favourably in terms of overall leverage.

31. As regards the quality of capital, an area of concern for a number of banks is the high volume of deferred tax assets registered in Spanish banks' balance sheets. These deferred tax assets (DTAs) have mainly been accumulated as a result of the build-up of provisions. The large amount of DTAs held by some banks will have to be deducted from the core tier 1 capital under the new EU Regulation on capital requirements throughout a phase-in period except for those that stem from temporary differences that do not rely on future profits. The Spanish authorities are working on legislative initiatives in order to strengthen the loss-absorbency of part of DTAs and, thus, avoid the deduction. In any case, any legislative initiative needs to comply with the regulation on capital requirements. In addition to this, both the fiscal impact and the competition angle should be carefully assessed.

[11] Regulation no.575/2013, on prudential requirements for credit institutions and investment firms and amending Regulation no.648/2012 (Official Journal of the European Union 27.06.2013).

Box 3: Recovery of profitability despite shrinking bank activity

Main findings

- Bank profitability of the Spanish business in the first half of 2013 lead to a pre-tax profit of about EUR 3 billion compared to a loss of around EUR 15 billion in the same period of 2012.
- The pre-provisioning profits of banks are on average well above the adverse scenario estimated in the 2012 Oliver Wyman stress test and above the baseline in the majority of cases.
- This recovery was primarily driven by the sharp reduction in impairment allowances. Total provisioning almost halved from one period to the other, but still represented about EUR 15 billion in the first semester of 2013.
- The positive evolution of bank profitability in the first half of 2013 was facilitated in some cases by some important non-recurrent items such as: revenues from the burden sharing exercises for some State-aided banks, incomes from the carry trade activity and sales of assets.

Evolution of margins

- One of the main weaknesses of the profitability of banks is decreasing net interest margins. Although margins in terms of average assets remained roughly constant, the actual margin volume declined by around EUR 3 billion from the second half of 2012, as both interest income and interest costs diminished on shrinking business volumes.
- In addition to this, the unprecedented low interest environment has a negative impact especially on mortgages, of which a vast majority are floating-rate.
- Although the cost of new deposits has been on a sharp downward trend, the average interest rate on deposits is still high as a consequence of the competition between banks during 2012.
- The declining net interest income was compensated by higher fees, other non-interest incomes and lower administrative costs due to the banks' restructuring efforts.
- At the same time, banks have to set aside new one-off provisioning requirements stemming from the reclassification of restructured loans as a result of the exercise carried out by banks in application of the criteria issued by BdE on the classification and provisioning needs for these assets. Furthermore, for some banks income will be negatively affected by the legal claims on the lack of transparency while selling mortgage floor clauses.
- Some of these new provisioning requirements have been already recorded during the first half of the year as some banks have taken advantage of the above mentioned extraordinary profits in order to be able to frontload the impact of these additional provisions.

32. In view of the above mentioned challenges and amid weak economic growth, Spanish banks need to follow prudent policies in order to maintain or increase their capital ratios. In this regard, the recommendation issued by BdE on a maximum 25% of paid in cash dividends is very welcome. Credit institutions should persist in carrying out actions to shore up their capital ratios and in particular retaining the highest possible portion of profits. In this regard, some banks have already put in place alternative dividend policies in order to reduce pay-out levels through the so-called "scrip dividends".

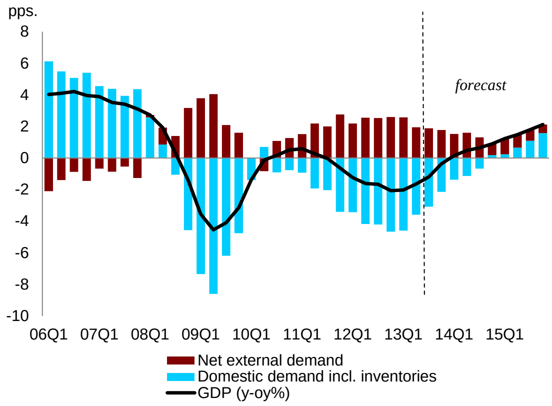
33. The restructuring of the banking sector accelerated since the beginning of the banking programme, led by the savings banks segment. The number of deposit taking institutions has declined by about 30 or 10% of the total since mid-2012. The number of bank branches has also declined by more than 2000 units or 5% of the total over the same period in parallel with the number of bank employees. The restructuring and deleveraging process is advancing at a fast pace in the savings banks sector, as revealed by the implementation of restructuring plans for the savings banks that have received State aid (see Section 3.2). A number of divestitures took place, such as the sale of the EVO Banco, a division of Group 1 bank Nova Caixa Galicia, to a US private equity group, the sale of assets by Bankia, including its stake in the airline group IAG (a British Airways – Iberia joint venture) and its U.S.-based City National Bank of Florida, or the divestiture of Caja Penedes by Banco Mare Nostrum. Nova Caixa Galicia has also divested Banco Gallego and Banco Etcheverria and some Asturian branches. At the same time, the Spain's two largest international banks continued to shed their assets abroad, boosting their profitability and capital buffers. The FCPs submitted by the Group 1 and 2 banks foresee a further reduction of their staff and administrative costs until the end of 2015, suggesting that the number of staff is likely to continue the downward trend. In parallel, the efficiency ratio of these institutions is expected to improve notably.

2.2 MACROECONOMIC AND FISCAL DEVELOPMENTS

34. Economic activity is bottoming out (see Graph 15). The Spanish economy entered in a double-dip recession in the second quarter of 2011 as financial sector stress, private sector deleveraging and the need for fiscal consolidation took their toll on economic activity. After falling for nine quarters, GDP has turned marginally positive in the third quarter of 2013 (0.1%), according to preliminary data. Unemployment fell from a peak of 27.2% in the first quarter of this year to 26% in the third quarter. The decline was largely due to seasonal factors and a contraction of the labour force, but also to a slower decline in employment levels (see Graph 16). According to the Commission services' autumn forecast, GDP is expected to grow by 0.5% in 2014 after contracting by 1.3% in 2013.

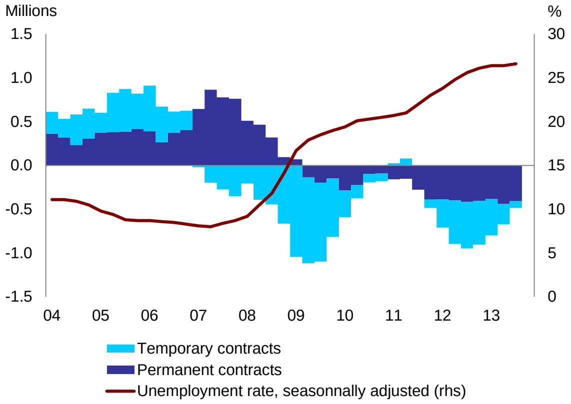
35. While the rebalancing of the economy towards export-led growth has continued, the contraction of domestic demand appears to start easing. In Q2 2013 domestic consumption and equipment investment showed signs of stabilisation. Hence, domestic demand has reduced its negative contribution to GDP growth, while the positive contribution of net external demand declined on the back of accelerating imports, notwithstanding a still robust export performance. These trends are expected to continue over the coming quarters, with the composition of growth gradually becoming more balanced as domestic demand is exerting less of a drag. The central expectation remains one of moderate expansion, as high unemployment, balance-sheet adjustment and still relatively tight bank credit conditions will continue to put a lid on growth.

Graph 15: Real GDP growth and contributions



Source: European Commission services

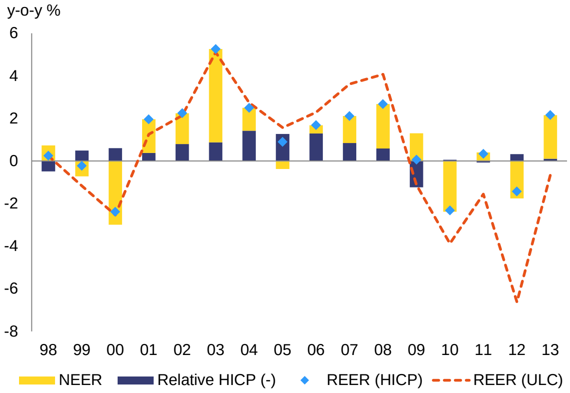
Graph 16: Evolution of permanent and temporary contracts and unemployment rate



Source: INE, Eurostat

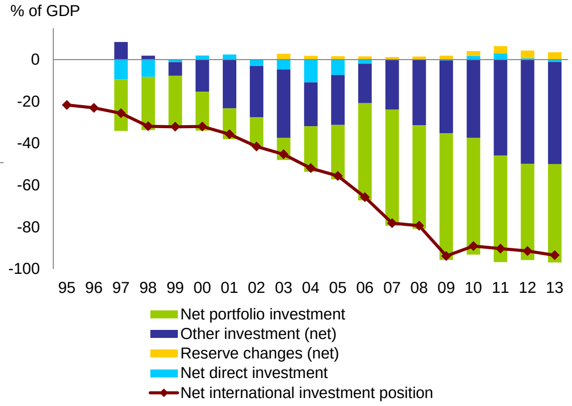
36. The current account recorded a surplus of 0.7% of GDP in Q2 2013 (four quarters moving average), due to an increasing surplus in the trade with goods and services. The increase in the trade balance is explained by both the dynamism of Spanish exports and the crisis-induced contraction of imports. Price and cost-competitiveness have improved further, due to a combination of extended productivity improvements initially largely driven by labour shedding and, more recently, moderating wage developments (see Graph 17). While productivity growth is expected to decelerate, wage moderation will still allow for further improvements in nominal unit labour costs. The balance of transactions with the rest of the world recorded a surplus of 1.5% of GDP in Q2 2013 (four quarters moving average). However, the Net International Investment Position (NIIP) has slightly deteriorated as a ratio to GDP, due to negative valuation effects[12] and the GDP contraction (see Graph 18). Both the trade surplus and the current account surplus are expected to increase further over the forecast horizon, although at a slower pace than in recent quarters.

Graph 17: Developments in REER



Source: Ameco

Graph 18: Decomposition of Net IIP



Source: Eurostat, own calculations

37. Inflation has fallen significantly. HICP inflation dropped to 0.5% in September and to a lower-than-expected 0.1% in October, as the effects of last year's rises in administered prices and VAT rates fall out from year-on-year growth rates. Inflation is expected to remain low, as the impact of fiscal measures taken in 2012 disappears, domestic demand remains weak and wages do not push up production costs. This lower inflation contributes to wage moderation and competitiveness, and supports real incomes of households.

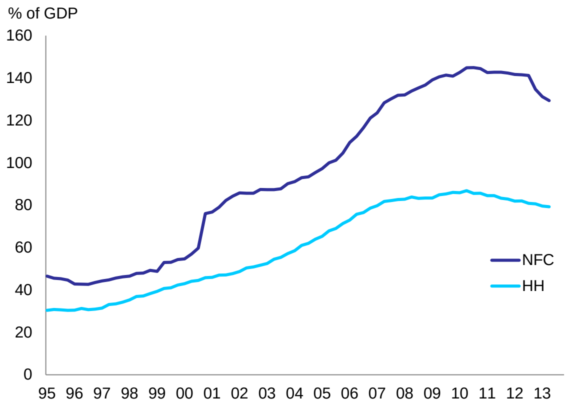
38. Budgetary data in 2013 presents a mixed picture so far. Fiscal consolidation advanced further in the first half of the year. Yet, recent improvements appear limited considering that sizeable consolidation measures took effect in the second half of 2012 and were partly of a one-off nature. Recently announced new tax measures will have only a small impact this year and the general government deficit is currently expected to narrow to 6.5% of GDP for the full year (net of bank recapitalisation costs of about 0.3% of GDP), even though considerable downside risks remain. The 2014 draft Budget Bill confirmed previously announced expenditure and revenue measures, and against the background of positive, albeit weak, real GDP growth, the general government deficit is expected to shrink to 5.9% of GDP in 2014.

39. General government debt is high and still rising. The debt-to-GDP ratio jumped from about 86% of GDP at the end of 2012 to around 93% in July 2013. The increase was due to the still high deficit and to frontloading of issuance by the Treasury. The average cost of issuance has been falling, in line with trends in secondary market rates, and the average maturity of issuance lengthened. On current trends, the debt-to-GDP ratio will exceed 100%

12 partly due to the recovery in Spanish financial asset prices.

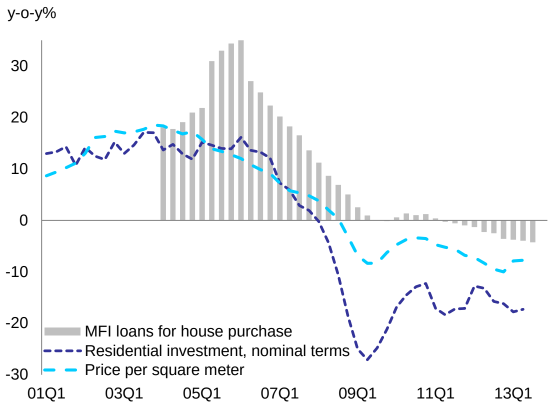
by 2015. In absolute terms, general government debt more than doubled in the period 2008-2012.

Graph 19: Indebtedness of private sector



Source: BdE,

Graph 20: Dynamics of housing and mortgage markets imbalances



Source: Eurostat, Ministerio de Fomento, own calculations

40. Deleveraging is gradually advancing (see Graph 19). Household debt has fallen from 87.4% of GDP in Q2 2010 to 79.9% in the Q2 2013, i.e. by 7.5 percentage points. While credit flows have been strongly negative, the reduction of the stock of debt is slow, on account of the long period of maturity of mortgages (around 20 years on average). The reduction of the debt level of NFCs has been more intense. From a peak of 143.9% of GDP in Q3 2010, NFCs' debt has fallen to 129.4%, i.e. a reduction of 14.3 percentage points. Shorter maturities and higher recourse to insolvency procedures explain the faster advance than for households. While lending to households declined by 5% in September (y-o-y), credit to NFCs declined by 11% (adjusted for the transfer of assets to Sareb).

41. The adjustment in the housing market is still on-going despite the severity of the correction registered so far (see Graph 20). Permits for new house building are around a level of 30,000 dwellings in 2013, compared to more than 600,000 dwellings in the years before 2008. As a consequence, the weight of the construction sector on GDP is at a historic minimum and still falling (from 12.2% of GDP in 2007 to 7.7% in 2012). The stock of unsold new dwellings remains huge - between 700,000 and one million dwellings depending on the estimates - as demand has remained low. House prices have adjusted sharply and were still falling at a 12% year-on-year rate in Q2 2013. The cumulative fall since Q3 2007 has reached 37% in nominal terms and 44% in real terms. Standard valuation metrics suggest that the adjustment might have further to run, although there is also much differentiation across locations. The acceleration of business activities of Sareb (the asset management company) could contribute to a faster price adjustment.

42. Overall, the adjustment process is progressing but challenges and vulnerabilities remain significant. The turnaround in flows impacts stock variables only gradually. Addressing remaining structural shortcomings, building on the recent reform progress outlined later in this report, is essential to support both growth and the rebalancing process.

3 BANK RECAPITALISATION AND RESTRUCTURING

3.1 IDENTIFYING IMPAIRED ASSETS AND BANK CAPITAL SHORTFALLS

43. The identification of losses and capital needs was done through a comprehensive asset quality review and a rigorous bank-by-bank stress test, revealing a capital shortfall of about EUR 57 billion for the entire banking sector. The due diligence process started with a top-down stress test in June 2012 and finished at the end of September 2012 with the publication of the results of a more granular bank-by-bank (bottom-up) stress test. The latter was carried out by an independent expert, Oliver Wyman (OW). In addition, four auditors (PwC, Deloitte, Ernst &Young and KPMG) conducted an independent review of accounts and operations used for sampling purposes while real estate appraisers reviewed about 1.7 million real estate appraisals and 8 000 complex real estate asset valuations to inform the asset valuation process.

44. The following main conclusions could be drawn from the exercise:

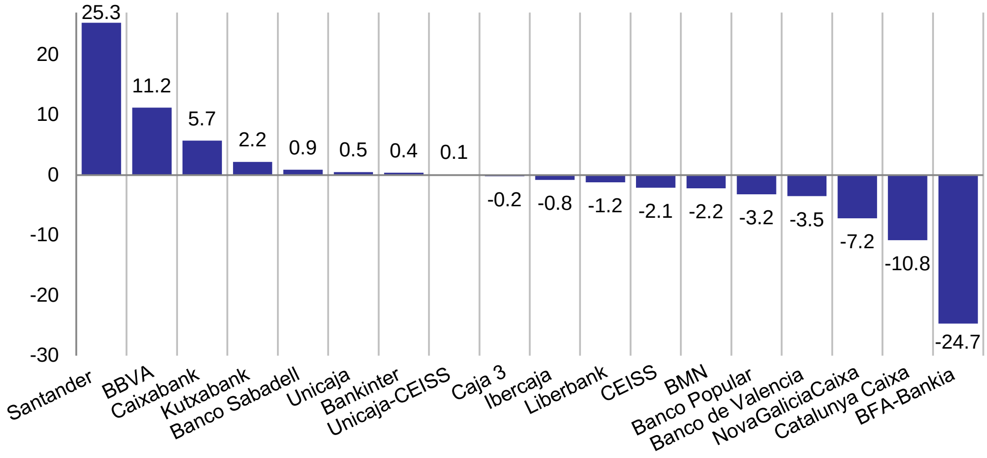
- The weaknesses in the Spanish banking system, and in particular the capital shortfalls, were not widespread, but rather located in a specific group of banks, mainly the banks having already received aid from the FROB.
- **Losses in the bottom-up exercise were consistent with those estimated by Oliver Wyman in the top-down exercise**. However, the bottom-up exercise has provided a much more accurate distribution of losses across banks, increasing capital needs in those banks that had already been identified as being problematic in the top-down exercise.
- **The loss absorption capacity of the Spanish banking system was high but unevenly distributed amongst banks**. While banks like Bankia required as much as EUR 25 billion under the adverse scenario, other banks like Santander had an equally high excess capital buffer (EUR 25 billion) in the adverse scenario.

45. On the basis of the stress test results and the presented plans to address any identified capital shortfalls, the banks were categorised in four groups (see Graph 21).

- ***Group 0*** comprised those banks for which no capital shortfall was identified and no further action from the public side was required: **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**[13] and **Banco de Valencia.**
- ***Group 2*** consisted of banks with capital shortfalls identified by the bottom-up stress test as unable to meet those capital shortfalls privately without having recourse to State aid: **Banco Mare Nostrum, CEISS, Liberbank and Caja 3.**
- ***Group 3*** included banks with capital shortfall identified by the stress test with credible recapitalisation plans and able to meet capital shortfalls from private sources without recourse to State aid. **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.

[13] NCG Banco has its roots in Galicia and operates there under Novagalicia Banco.

Graph 21: Capital surplus/shortfall after taxes (EUR bn)



Source: BdE

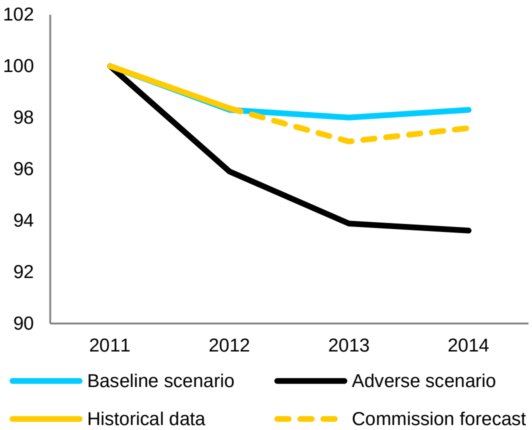
46. The ten banks identified with a capital shortfall under the adverse scenario of the stress test had to present recapitalisation plans on the basis of which it was determined whether they could cover the identified capital shortfall by their own means or they needed to resort to State aid. The latter option involved both capital injections and the transfer of the banks' real estate related foreclosed assets and real estate development (RED) assets to Sareb (see Section 3.2). The asset transfer was completed in December 2012 for Group 1 banks and in February 2013 for Group 2 banks and a total amount of EUR 38.8 billion was injected in the banks by the Fondo de Reestructuración Ordenada Bancaria (FROB). The rest of the capital shortfall was generated through the subordinated liability exercises (close to EUR 13 billion), sale of assets, private capital increases and capital relief due to the transfer of assets to Sareb. The capital shortfall identified for the banking sector has thus been covered.

47. In order to assess whether the assumptions of the stress-test are still valid, in April 2013 the BdE back-tested the bottom-up stress test carried out by OW in light of more recent economic and financial developments and more updated economic projections. The BdE compared the results of the OW exercise with developments effectively observed in 2012 (retrospective exercise) and updated the scenarios used by OW to estimate the probabilities of default of the portfolios considered (forward-looking exercise). The BdE retrospective exercise concluded that in 2012 actual defaults were, on the aggregate level, significantly below the probabilities of default estimated by OW under the adverse scenario in all cases and even below the baseline scenario in most cases. Furthermore, pre-provisioning profits were, on the aggregate level, above both the baseline and the adverse scenarios and the macroeconomic variables turned out better than expected even when compared to the baseline scenario, except in the case of the unemployment rate and housing prices, which were close to the levels assumed in the adverse scenario. The forward looking exercise showed that default probabilities and core Tier 1 solvency ratios remained, at aggregate level, in line with the OW findings when the macroeconomic scenarios were updated.

48. The most recent data also point to the fact that the assumptions of the OW stress-test remain broadly valid. The contraction in output is more persistent than assumed in the base scenario included in the Oliver Wyman stress test, but output levels remain well above the adverse scenario. The actual decline of real GDP in 2012 turned out to be less severe than assumed in the base scenario while it is expected to be more negative in 2013. Taking into consideration the expected cumulated impact on output, both real and nominal GDP remain closer to the base scenario and well above the adverse scenario (see

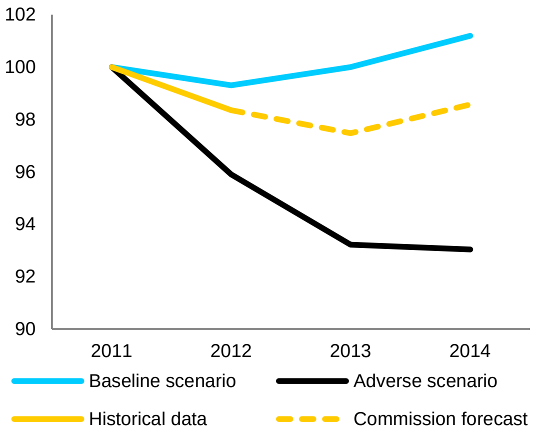
Graphs 22 and 23). However, the rise in unemployment (see Graph 24) and decline in house prices have been more in line with the adverse scenario (see Graph 25).

Graph 22: Real GDP projections



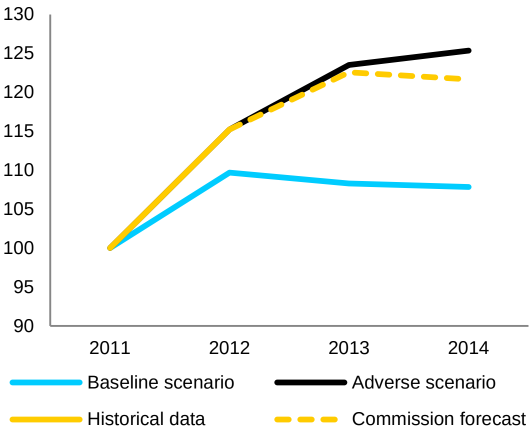
Source: IMF, Ameco, Commission forecasts autumn 2013

Graph 23: Nominal GDP projections



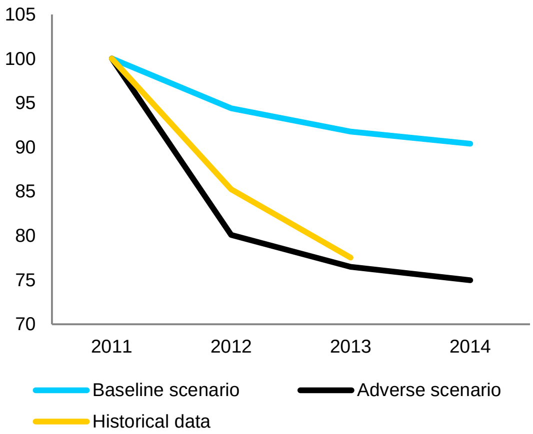
Source: IMF, Ameco, Commission forecasts autumn 2013

Graph 24: Unemployment rate projections



Source: IMF, Ameco, Commission forecasts autumn 2013

Graph 25: Housing price projections



Source: IMF, Eurostat

49. As part of its supervisory toolkit, the BdE is committed to assess the strength of the banks on a regular basis through forward-looking exercises. Recognizing the usefulness of a permanent monitoring of the banks' quality of assets and adequacy of capital levels together with its importance for maintaining a positive market sentiment, the BdE is in the process of expanding its range of prudential supervisory tools. The resilience of the banking sector will be tested on a regular basis and the BdE has just finalised its first Forward-Looking Exercise on Spanish Banks (FLESB), the methodology and results of which were published in the November 2013 Financial Stability Report[14]. The exercise was performed on the same set of 15 institutions covered by the OW stress test under three macroeconomic scenarios. At aggregate level, the CET1 capital ratio (Basel III definition) for the institutions considered would be 11.3% in the baseline scenario, 10.8% in the unfavourable scenario and 10.2% in the adverse scenario in 2015. Even in the latter, the worst, scenario, loss-absorption capacity exceeds expected losses by EUR 28.6 billion at system level. Despite using quite granular information at the level of each bank, the used methodology was not considered at this stage accurate enough to estimate precisely the prospective solvency position of each bank.

[14] See the report at http://www.bde.es/f/webbde/Secciones/Publicaciones/InformesBoletinesRevistas/InformesEstabilidadFinancera/13/IEF_Ing_Noviembre2013.pdf

3.2 SEGREGATING THE BANKS' LEGACY ASSETS

50. One of the major weaknesses of the Spanish banking sector was its sizeable exposure to the construction and real-estate development sector. According to the BdE, the total exposure of the Spanish banks to this sector amounted to EUR 308 billion at the end of December 2011. Therefore, the key component of the overall strategy of the financial assistance programme has been to effectively deal with the impaired assets by transferring them into a separate vehicle, i.e. asset management company (called Sareb). By improving the quality and transparency of banks' balance sheets in this manner, the programme has aimed to facilitate an orderly downsizing of bank exposures to the real estate sector and thus contributing to reviving confidence in the sector. By the end-2012, the exposure of Spanish banks to the construction and real-estate development sector decreased by around 50% of the total (net of provisions). Somewhat more than half of the reduction is explained by the transfers to the Sareb, while 40% of the reduction derives from the provisions made by institutions as a consequence of RDL 2/2012 and RDL 18/2012.[15]

51. Against the background of a necessarily demanding timeline, the Spanish authorities have succeeded in designing, implementing and operationalizing the asset management company.[16] Its main objective is to manage and disinvest the portfolio of assets transferred by State-aided banks in an orderly manner, servicing its debt, optimizing levels of recovery and value preservation, and minimizing the cost for the taxpayer and market distortions, within a maximum timeframe of 15 years. The key principle underpinning the separation of RED assets was their transfer to Sareb at a conservatively set transfer price. This transfer price was established on the basis of a thorough asset quality review process, drawing on the individual valuations used in the Stress test. The average haircut applied to the assets transferred to Sareb was 52.7% relative to gross book value.

52. The first few months of Sareb have proven operationally challenging, resulting in some initial delays in starting its commercial activity. The Sareb management team faced the daunting task of quickly operationalizing the enterprise. This involved hiring large numbers of staff, establishing policies and procedures, developing a business plan and organizing sales and servicing arrangements. In addition, a considerable effort was necessary in relation to the due diligence and valuation exercise covering a significant part of Sareb's portfolio in order to provide management with important disaggregated information and to prepare assets for sale. These difficulties combined with possibly an initially excessively rigid pricing policy from Sareb delayed asset sales through the retail channel (via transferring banks).

53. Due diligence on a significant part of Sareb's portfolio has been completed. The overreaching objective of this exercise was to have a pool of assets ready for sale with updated valuation and correct data file. Overall, the results indicate that the assets transfer process was well designed and executed as there were only limited number of instances resulting in the adjustment of the transfer price (see Box 4 for further details).

54. After some initial delays, Sareb's commercial activity is now accelerating. Sales through the retail channel have significantly picked up in the recent months and sales

[15] According to the BdE's Financial Stability Report (May 2013).

[16] A comprehensive AMC blueprint was prepared by the Spanish authorities by end-August 2012. Primary legislation on AMC was included in the RDL 24/2012, which was adopted on 31 August. Secondary legislation, including key elements of the design of Sareb, was adopted on 16 November as a Royal Decree. After the two transfers of assets from Group 1 (end-December 2012) and Group 2 banks (February 2013) to Sareb, total real estate related assets amounted to EUR 50.6 billion. Out of this amount, EUR 11.35 billion were foreclosed real estate assets, EUR 13.5 billion were performing real-estate developers (RED) loans and EUR 25.72 billion were non-performing loans.

through the wholesale channel have begun. Sareb has agreed on weekly targets in terms of sales for each transferring bank and it provides a regular feedback on each bank's performance in relation to the target and to the performance of other banks. In addition, there is a Sareb representative appointed at each servicer (hired and paid by Sareb) to allow for an additional layer of scrutiny. This new strategy seems to have worked well and there have been noticeable improvements in terms of asset sales, which have visibly accelerated from March. Despite stronger sales in recent months, Sareb will most likely not be able to realize its sale projections for 2013 included in the business plan due to lower volumes in the first few months of the year.

Box 4: Main results of the due diligence on the transfer of assets to Sareb

Scope

- The exercise covered 100% of the real-estate foreclosed assets (REOs) (350 000 assets) and 20% of the loans amounting to over 80% of the transfer value. The scope of the exercise was increased to include file repairing on the database for collaterals as it was discovered that a significant portion of collateral was missing from the system or the documentation was incomplete. This exercise included four work streams: (i) assessment of the legal documentation supporting the acquired assets; (ii) valuation of real estate assets and loan collateral; (iii) review of transfer prices based on asset classification; and (iv) establishment of data- and documentation-management tools.

Main results

- The asset transfer process was well executed as there was only a limited number of instances resulting in the adjustment of the transfer price, all in favour of Sareb (1.77% for REOs and 3.51% for loans);
- The transfer price was conservative and according to the current valuation of Sareb's portfolio there is still a positive buffer despite a continued decline in real estate prices;
- There is large dispersion around the mean in the valuation of REO and loans, which is consistent with the nature of the transfer, which was based on average discounts for each category;
- A large part of balance sheet of Sareb is composed of mostly liquid assets, including collateral, which provides some comfort for the sale process going forward.

55. Sareb has signed financing agreements with most of the Group 0 banks: Santander, CaixaBank, Sabadell, Banco Popular, and BBVA. These banks will offer the potential buyers of Sareb's assets the same financing conditions as they offer for the sale of their own assets. Each of these banks has set-up a 2 year credit line of EUR 1 billion to finance Sareb sales. The target is mostly the sales of residential property, including through FAB (Fondo Activos Bancarios or Bank Asset Fund), but sales of commercial real estate or portfolios of assets is not excluded. Importantly, Sareb has also secured a special line of financing for protected/subsidized interest properties.

56. The wholesale channel has been set up and is now fully operational. First transactions are either well advanced or have been completed including the setting-up of the first FAB - project 'Bull'. The portfolio comprises around 1 000 homes valued at EUR 100 million. It has attracted a healthy interest from international investors and was finally awarded to HIG Capital through a competitive bid process in early August. These properties will be managed by Monthisa, an independent servicer selected by the investors. Instead of a direct sale of portfolio of assets, FAB is a joint venture, where Sareb retains a significant share (49% in case of project Bull), thus allowing it to participate in future potential gains on the portfolio. At the same time, Sareb continues to keep part of the risk on its balance sheet, unlike in the case of a direct sale. It will be important to closely monitor the impact of this type of transactions on Sareb's financial outcomes to ensure that potential gains outweigh the costs.

57. **In terms of value, the majority of Sareb's portfolio is composed of loans and, hence, it is important to have a sound divestment strategy aimed at optimizing their recovery value over a 15-year horizon.** All exit strategy decisions with respect to loans are made under a 'hold vs. sell' analysis. In addition, Sareb has been developing a strategy to monitor and proactively manage loans in a consistent way across the transferring banks, including revised repayment schedule and loan execution. Income from non-performing loans (through the repayment of debt and interest) amounted to around one-quarter of the total cash collections generated by loans.

58. **Sareb has completed one of the largest interest rate swap (IRS) transaction in the history of the euro.** The aim is to hedge the majority of its senior bonds portfolio (EUR 42 billion) that was issued to pay the contributing banks in return for transferring their assets. Sareb has issued bonds with maturities of 1, 2 and 3 years, which are linked to the 3-month Euribor, plus the spread, which at no point may exceed 200 basis points. The IRS is aimed at eliminating the uncertainty with regard to the impact of changes in Euribor on Sareb's interest expense. From the time of its entry into force on 31 December 2013 and for the next 9 years, Sareb will substitute the 3-month Euribor floating pay on its senior bond portfolio for a fixed pay.

59. **Despite significant progress, Sareb will be faced with a number of challenges in the coming months, which need to be carefully monitored, including**:

- **The adjustment of the housing market appears to be taking longer than expected in the business plan projections.** The housing market continues to adjust and at present there are no signs of a quick turnaround. In particular, house prices have continued falling and even accelerated their decline in the first half of 2013. In addition, investment in construction continues contracting and there are further falls in new residential projects and house sales. With no sign of the stabilization in the housing market, in contrast to predictions included in the current business plan (based to a large extent on OW assumptions), there is a risk that the initial business plan expectations may be too optimistic. In this context, Sareb may need to revise its business plan to take into account these recent developments (Sareb is legally required to revise its business plan at least once a year, i.e. in January of each year) and to devise strategies to respond to the new market conditions.
- **The changing landscape of the market for real estate assets and real estate loan servicing can be the source of uncertainties and operational risk for Sareb, at least in the short-term.** Some G1 and G2 banks are already in the process of selling their portfolios of real estate assets and loans and/or servicing platforms to professional investors and others are rumoured to do so in the near future. In the longer-run, this process is expected to have a positive impact on Sareb and is in line with its medium-term strategy of moving away from the current 9 service providers (transferring banks) to a more specialized structure, with each service provider specialising in one particular type of assets, i.e. servicing of rented residential properties. In the short-run, however, this process may negatively impact Sareb's commercial activity through delays caused by transition to the new providers and increased uncertainty. There are also risks with respect to possible conflict of interests if the new service providers are also actively involved in liquidation of their own real estate assets in Spain.

- **Sareb is competing with other domestic banks that are also deleveraging large real estate-related portfolios.** Some banks are applying aggressive commercial strategies, with steep haircuts on the price of assets, to boost sales.

3.3 BANK RECAPITALISATION AND RESTRUCTURING

60. The EC adopted the restructuring plans for Group 1 banks on 28 November 2012 and for Group 2 banks on 20 December 2012. The EC approved the restructuring plans for all Group 1 and Group 2 banks and in the case of Banco de Valencia approved the State aid required for the orderly resolution of the bank through its takeover by CaixaBank. In the absence of the takeover, Banco de Valencia would have been wound down, as it was not possible to envisage a viable business model for the bank on a stand-alone basis.

61. On 13 May 2013, the EC approved a modified restructuring plan for Banco CEISS opening the door for the acquisition of the bank by Unicaja Banco. The new plan is similar to the plan approved in December 2012 in operational terms. The main difference is that Banco CEISS was recapitalised with EUR 604 million in the form of convertible securities (CoCos) subscribed by the FROB rather than via an injection of ordinary shares, so to allow the repayment of the CoCos during the restructuring period by the new entity. The sale of the bank was foreseen in the initial restructuring plan approved in December 2012.

62. Sales of other state aided banks are also considered. The Spanish authorities are also actively considering the sale of other Spanish State-aided – and State-owned – banks. While a sale of a bank undergoing a restructuring process to another bank or any other solid entity is to be welcomed, the acquirer also has to respect the obligations arising out of the restructuring plan. Any changes to the restructuring plan would have to be discussed and approved by the EC beforehand.

63. The restructuring plans of Group 1 and 2 banks secure the banks' solvency, and restore the profitability and liquidity profile over the course of the five-year restructuring period. In particular, the focus of the plans is to restore an adequate margin structure. Over time this will also reinforce the banks' capital position. Another priority is to address the funding gap and thus reduce the banks' reliance on wholesale funding and on Eurosystem funding. This will enable banks to restore sustainable lending patterns towards the real economy.

64. The restructuring plans foresee that banks refocus their business model on retail and SME lending in their historical core regions. Group 1 and 2 banks will exit from lending to real estate development and other overly risky activities and limit their presence in wholesale business. They will also reduce their exposure to mortgage lending and public sector financing to adequate levels. The plans furthermore envisage deleveraging of the banks in the most overleveraged sectors and areas. By contrast, they maintain a continued capability to finance SMEs and corporates. In order to boost their profitability and solvency, banks will improve their cost base, by cutting both staff and branches. The plans will refocus the banks' activities in those regions and areas where the banks have the capacity to operate efficiently.

65. Group 1 and Group 2 banks have a combined share of total credit in Spain of just above 20%.[17] This means that 80% of the loan market is not constrained by the targets foreseen by the restructuring plans. The other Spanish banks can contribute to cover the credit demand that cannot be satisfied by the banks under restructuring.

66. Furthermore, the restructuring plans address moral hazard, and potential distortions of competition with behavioural commitments on top on the structural commitments such as acquisition bans, a ban on aggressive commercial behaviour and commitments as regards remuneration of employees. Overall capital needs have been reduced by close to EUR 5 billion as a result of capital generating divestitures by the affected banks (such as the divestiture by Banco Mare Nostrum of Caja Penedes).

67. The State aid for Group 1 and 2 banks consists of capital injections and the transfer of problematic assets to Sareb (see section 3.1)**.** Capital injections are the first instrument to be applied in order to re-establish financial market confidence into distressed banks and allowed them to comply with the regulatory solvency ratios.

68. In order to assess the parameters of the asset transfer, the Commission took an active role. The EC assessed the conditions of the transfer of assets to Sareb with the help of external experts and concluded that the former were in line with EU State aid rules. More specifically it verified that the transfer price based on the base case value of the stress test exercise, plus a variety of haircuts related to the specific conditions of the transfer to Sareb, was in line with the so-called real economic value, i.e. the long-term hold to maturity valuation.

69. The restructuring plans, in line with the MoU, ensure that State aid remains limited to the minimum amount necessary, so as to minimise the cost to the taxpayers. Consequently, not only will former owners of these banks contribute to the needed capital injection, but losses were also allocated to holders of preference shares and subordinated debt holders of these banks through deep haircuts coupled with a conversion of their existing securities into equity or senior debt instruments. This had been achieved by implementing both voluntary and, where necessary, mandatory subordinated liability exercises which are now finalised. The initial estimated amount of capital needs has been reduced by almost EUR 13 billion through burden sharing measures.

70. The Spanish authorities have recently approved a mechanism which aims to provide liquidity to the retail hybrid holders willing to sell the ordinary shares they got through an SLE in banks which are not listed. Under the mechanism, the Spanish Deposit Guarantee Fund offers to buy the shares in Caixa Catalunya and Nova Caixa Galicia – which are not traded on a stock exchange - obtained by individuals as result of the SLE. The offers from deposit guarantee fund are based on calculations by an independent expert, taking into account an illiquidity discount on the economic valuation of the shares.

71. In the process of bank restructuring, focus has shifted now on monitoring the effective implementation of the plans. The EC is now actively monitoring the implementation of the restructuring plans with the help of a monitoring trustee for each bank. In addition, there will be continuous contacts with the Spanish authorities and monitoring reports will be drafted.

[17] This figure excludes banks which are absorbed by competitors (Banco de Valencia, Caja3 and Caja Penedes): for these the new non-aided buyers will be free to decide on the credit policy.

4 ENHANCING BANK TRANSPARENCY, REGULATION AND SUPERVISION

72. The front-loaded horizontal conditionality was met relatively early during the programme. Nevertheless, full implementation of the legal initiatives and measures which derive from the MoU are still on-going in some areas. The main reforms initiated under the MoU concern the adoption of a new resolution legal framework and strengthening the governance arrangements of the FROB, enhancing the regulatory and supervision frameworks and strengthening BdE's competences, enhancing the governance structure of savings banks and increasing bank transparency, capital requirements and consumer protection. The effective implementation of a few reforms such as reforming the governance structure of savings banks, upgrading the supervisory procedures at the BdE (taking into consideration also the nascent Single Supervisory Mechanism) and improving non-bank financial intermediation is still on-going, although *stricto sensu*, Spain has finalized all the measures agreed in the MoU.

Enhancing bank supervision and regulation

73. The authorities fulfilled the MoU requirements regarding the enhancement of the operational independence of BdE (MoU conditions 13 and 24). Authorities agreed to empower the BdE to issue binding guidelines *ad intra* as well as binding replies to queries. To implement these changes, authorities will have to amend the Law on the Autonomy of BdE and the solvency regulation. The amendments to the solvency regulation and the Law on the Autonomy of the BdE will be part of the legislative package for the transposition of the CRR/CRD IV. Furthermore, the operational independence of BdE was enhanced through the transfer of sanctioning and licencing powers for credit institutions from the Ministry of Economy to BdE. The transfer of these powers was implemented through provisions included in the RDL 24/2012, later approved by Law 9/2012.

74. The MoU requirements on the in-depth internal review of the supervisory processes of BdE have been complied with (MoU condition 14). The main findings and recommendations of the internal review are included in a report released in October 2012, which benefitted from comments from the international partners. In line with the main recommendations of the 2012 October report, there will be semi-annual supervisory reports and subsequent letters of requirements for entities subject to on-site continuous monitoring. On-site continuous monitoring was extended to all major banking groups, accounting for 90% of total banking sector assets. Furthermore, the *de facto* rotation period for head of supervisory divisions will decrease to roughly three to four years. The updated supervisory procedures of BdE (Circular 2/2013) were finalized and approved by the BdE Executive Board. Going forward, the implementation of the recommendations included in the 2012 October report will be significantly conditioned by the new tasks of the ECB concerning prudential supervision of credit institutions in the framework of the Single Supervisory Mechanism (SSM). Related to this issue, the government is considering to propose a Regulation lengthening the cooling-off period applicable to BdE officials moving to the financial sector from six months to two years. This change would clearly reinforce the initiatives by the BdE to strengthen the supervisory process and be in line with the suggestions of international partners and discussions in the SSM framework.

Establishing a new bank resolution framework and strengthening the governance of the FROB

75. As per MoU conditions 5 and 6, the entering into force of RDL 24/2012 (Law 9/2012) equipped both the Fondo de Reestructuración Ordenada Bancaria[18] (FROB) and the BdE with the legal toolbox to restructure and resolve credit institutions, conduct mandatory burden sharing, improve the institutional framework and enhance capital requirements and bank transparency. RDL 24/2012 provided the legal framework under which the EC assessed the restructuring plans submitted by the Spanish authorities for the banks that need public support in order to cover the capital shortfall identified in the stress-test. Burden sharing measures (SLEs) have been successfully implemented, in compliance with the sound and well-designed regulatory framework approved under MoU condition 5, thus largely reducing subsequent litigation.

76. In line with MoU conditions 6 and 27, the resolution powers and the governance arrangements of the FROB have been strengthened through the adoption of RDL 24/2012 (Law 9/2012). Moreover, FROB has improved its management and control of the nationalised banks and is currently designing the sale of Nova Caixa Galicia and Catalunya. The Fondo de Garantía de Depósitos (FGD)[19] does not have a seat in the FROB anymore, and the role of the FGD has been redefined to provide financial support measures in case of resolution of a credit institution.

77. RDL 24/2012 (Law 9/2012) also put into place the legal framework necessary for the set-up and proper functioning of the Asset Management Company (AMC) (MoU condition 7). As a result, the selection of Sareb´s management and key staff complied with the necessary adequate professional standards and the AMC launched its first operations. Due to initial delays in starting its commercial activity, Sareb's results in terms of assets sales are likely to be lower than the business plan projections for 2013. At the same time, Sareb finalized with positive results a due-diligence process on a significant part of its portfolio.

Increasing bank transparency, capital requirements and consumer protection

78. In line with the MoU requirements, the authorities complied with the condition to increase transparency through enhanced disclosure requirements for credit institutions (MoU conditions 3 and 9). Following discussions with the international partners, BdE approved Circular 6/2012 at the end of September 2012. This Circular includes, *inter alia*, provisions aimed at enhancing and harmonising disclosure requirements for all credit institutions on key areas of their portfolios such as restructured and refinanced loans, as well as on sectoral concentration.

79. In keeping with the MoU (paragraph 25 and condition 29), Law 9/2012 on bank restructuring and resolution established:

- **a set of rules limiting the sale of hybrids to retail customers:** i.e. setting out a minimum nominal amount for each investment excluding *de facto* small retail clients and imposing a minimum percentage of professional clients for any issuance, and
- **several amendments of Law 24/1998, on Securities Market in order to increase transparency of instruments different than deposits:** i.e. improving the information in all prospectuses highlighting the difference of these products and the ordinary bank deposits to the investor in terms of risk and liquidity.

[18] Fund for Orderly Bank Restructuring (FROB), http://www.frob.es

[19] Deposit Guarantee Fund

80. The MoU condition 26 aimed at increasing the amount of capital of banks and aligning its definition with the international ones, as Spain will be subject to the forthcoming EU Capital Requirements Regulation. Additional capital was injected in the banking system so that all institutions comply with the 9% ratio using the definition of capital approved by the European Banking Authority (EBA) for its 2011 EU-wide recapitalisation plan. For this purpose, Law 9/2012 adopted this capital definition and required its application as of the beginning of 2013. The BdE approved on 30 November a new Circular 7/2012 on some technical details on the minimum capital requirements.

81. Both micro prudential supervision and the macro prudential analysis will benefit from the enrichment of the data on credit risk available through the renewed credit register (MoU condition 30). The BdE presented in October 2012 a complete set of reforms on the credit register. The new Circular 1/2013 that includes all these improvements was discussed with the international partners during the first months of 2013 and was approved by BdE in May 2013.

Enhancing the governance structure of savings banks

82. Spain has prepared legislation to reform profoundly the ailing savings banks sector. The envisaged reforms do not only comply with conditions 18 and 20 of the MoU, but also set up a complete new consistent legal framework for the sector which overcomes the structural deficiencies observed in the previous behaviour model of these institutions. The legislative process for the adoption of the draft law on savings banks has advanced further. The draft was revised in line with the recommendations of the State Council that in its opinion made suggestions that did not alter its substance. The draft law was submitted to the Parliament on 21st June 2013. Until the 22nd of October, political amendments were presented. The most contentious political issues are: a) the incompatibilities between the governing bodies of the banking foundations and the banks where they hold stakes and b) the obligation for banking foundations to create a reserve fund (which is a cost for these institutions). The final adoption is expected by the end of the year, thus ensuring full compliance with the MoU conditionality.

83. The approval of the draft law on savings banks will involve a profound restructuring of the legal framework under which savings banks operate. The law, in accordance with the MoU, will confine savings banks to their original social nature and vocation (small institutions with a limited geographical scope and retail activity) and it will strengthen the independence of their governing bodies in order to avoid political interference in their management. At the same time, the draft law introduces the concept of "fundaciones bancarias" (bank foundations) to accommodate the legal treatment of former savings banks which have significant stakes in commercial banks (equal or greater to 10%) or have a size greater than that considered appropriate by the law for a saving bank. Legal requirements and constraints are imposed on the bank foundations in order to assure and reinforce the independence of the governing bodies of the banks under their control. In addition, a set of incentives is set up in the draft legislation to encourage banking foundations to reduce over time their stakes in banks (see Box 5).

Box 5: Key features of the new legislation on savings banks

Savings banks have played an important role in the Spanish financial system as intermediaries in the retail business segment. Their non-profit maximizing nature, social objectives and strong links to *Comunidades Autonomas* where they operated, contributed to make some savings banks particularly sensitive to political interference and to a high concentration of risks, mainly linked to real estate activities, without a proper capital structure backing such risks. The crisis unveiled some important weaknesses accumulated in the sector which, in some cases, triggered the need for recapitalisation and State aid. A relevant restructuring process had to be implemented. The reforming and restructuring measures finally taken were focused not only on a case-by-case resolution of the most distressed institutions by the FROB but also on addressing of the main weaknesses affecting the savings banks business model.

The MoU signed in July 2012 requested Spanish authorities to make a proposal to strengthen the governance structure of former savings banks and of commercial banks controlled by them and to clarify the role of savings banks in their capacity as shareholders of credit institutions with a view to eventually reducing their stakes to non-controlling levels. Spanish authorities prepared a Law proposal on savings banks which was presented to the Spanish Parliament in June 2013 to design a new complete legal framework which definitely overcomes previous weaknesses. It is expected that the proposal is approved by the Spanish Parliament by the end of 2013.

- The major part of savings banks will be converted into a new legal figure, *fundaciones bancarias*, without bank licence, having transferred their banking activity to a bank, and only a few savings banks (which have to comply with strict conditions that severely limit the volume and scope of their business) will be able to operate as credit institutions.
- The governance of both savings institutions and fundaciones bancarias are regulated to make their governing bodies professional and independent, creating incompatibilities between the governing bodies of both institutions. In the case of *fundaciones bancarias*, a set of incentives is introduced to get a reduction over time of controlling level stakes of *fundaciones* at banks.
- The BdE is empowered with special powers to monitor and supervise the relation between *fundaciones bancarias* and the banks where they hold stakes in order to safeguard the prudent and sound management of such banks.
- A set of incentives is introduced for those *fundaciones* holding stakes equal or greater than 30% at banks, to reduce their participation: the need to subscribe a management protocol where the management of the stake of the *fundacion bancaria* at the bank be explained and the elaboration of a financial plan, which develops how the fundacion bancaria will satisfy any capital need of the bank where they hold stakes, both to be approved by the BdE.
- In addition, those *fundaciones bancarias* with controlling stakes at banks have the obligation to subscribe a diversification plan of investments and risk management to be set by the BdE, they have to create a Reserve Fund whose main goal will be to assure that the *fundacion bancaria* can provide capital support to the bank, apart from complying with other conditions[20]. In case of improper working or management of the banks controlled by *fundaciones bancarias*, the BdE is entrusted with the capacity to oblige the *fundaciones* to reduce their participation in banks.

During the 4th Review mission, the Spanish authorities informed that certain amendments could be introduced in the Law, provided that they do not change the substance of the proposal.

[20] The loss of additional political rights if a fundacion bancaria subscribes new capital at the bank already controlled and the distribution of dividends by a bank controlled by a fundacion bancaria will be subject to the approval of at least 2/3 of the stakeholders.

84. As regards the provision of a roadmap for the eventual listing of banks which have received public aid (MoU condition 19), plans have been fully implemented except in the case of BMN (Banco Mare Nostrum) where conditions for listing are not there yet.

Other measures

85. In keeping with the MoU condition 17, the Spanish authorities adopted in November 2012 an Action Plan containing measures for strengthening non-bank financial intermediation. The implementation of the plan advanced in several key areas. Most of the measures have been initiated and some have even reached an advanced stage of implementation, including those related to enhancing the capital market access for SMEs, creating a national business incubator system, providing capital seed for new businesses, promoting a network of "business angels" and creating a start-up co-investment fund, while the capital of the state counter-guarantee company has been increased. The borrowing ceiling for ICO was increased and its on-lending programme for SMEs via commercial banks is gaining speed. The new ICO Fond Global (managed by the AXIS Fund) was already launched and will leverage around EUR 1.2 billion into about EUR 4 billion of SME equity. All legal changes necessary for the launching of the alternative bond market for SMEs (MARF)[21] were approved and in the entrepreneurship law passed by the Parliament, some fiscal benefits were introduced for business angels.

86. In 2012 BdE submitted a comprehensive document analysing the current provisioning framework and some of the shortcomings identified in it, thus complying with condition 22 in the MoU. Upon the request of the international partners BdE developed its analytical work on the calibration of the dynamic provision. In addition to this, the provisioning framework has been amended in order to reinforce and clarify the treatment of restructured loans as it is seen as one of the pockets of vulnerabilities for the banking sector. The outcome of the application of these new rules has been submitted to BdE at the end of September 2013 and should be further checked by the supervisory authority.

87. The authorities complied with the MoU requirements on the review, preparation and implementation of strategies for dealing with impaired assets (MoU condition 25). The BdE sent in December 2012 to all banks included in the bottom-up stress test a legally binding letter of requirements. In line with this letter, the internal audit departments of banks were requested to review the strategies, policies and procedures for managing impaired assets. Furthermore, banks were supposed to provide an overview of the refinancing and restructuring policies in line with the requirements of Circular 4/2004 and Circular 6/2012. Banks submitted to BdE at the end of March 2013 plans including measures for addressing the identified shortcomings. They were expected to implement the measures aimed at improving their strategies and policies to deal with impaired assets by September 2013, except for some IT improvements which have to be made until the end of 2013. The banks with the biggest weaknesses regarding their arrears management systems will be subject to on-site inspections in the first quarter of 2014.

88. The authorities completed the analytical work on credit concentration, which is part of the efforts to strengthen the regulatory framework for credit concentration and related party transactions (MoU condition 28). BdE submitted in mid-January 2013 a comprehensive report on the regulatory framework for credit concentration and related

[21] Mercado Alternativo de Renta Fija (MARF)

party transactions. Since the outbreak of the crisis, progress has been made to address the vulnerabilities stemming from the high credit concentration on the real estate and construction sector, *inter alia*, through enhanced disclosure and transparency. As further progress was warranted in this area, the international partners asked the authorities to advance the analytical work on the calibration of capital surcharges under Pillar II. According to the results of a retrospective simulation on a selected sample of banks, a higher level of capital surcharges under Pillar II would have mitigated somewhat the level of sectoral concentration like the one on the construction sector. The methodology for the calibration of capital surcharges under Pillar II will be introduced in the ICAAP (Internal Capital Adequacy Assessment Process) at the end of this year.

5 SUSTAINABLE PUBLIC FINANCES AND GROWTH-ENHANCING REFORMS

5.1 STRENGTHENING PUBLIC FINANCES

89. Reining in the fast-rising public debt demands further fiscal consolidation and strengthening of public finance management. On 19 June 2013, the Council issued a revised recommendation under the Excessive Deficit Procedure (EDP) to Spain, extending the deadline for correcting the excessive deficit by two years to 2016. The headline deficit targets leading to the correction of the excessive deficit by 2016 are set at 6.5% of GDP for 2013, 5.8% of GDP for 2014, 4.2% of GDP for 2015, and 2.8% of GDP for 2016. Based on the Commission services' 2013 Spring Forecast extended to 2016, achieving these targets requires an estimated improvement in the structural balance of 1.1%, 0.8%, 0.8%, and 1.2% of GDP in the years 2013-2016, respectively. Progress with fiscal consolidation is analysed in detail in the documents under the Stability and Growth Pact (SGP) and the two-pack legislation (analysis of effective action under the EDP; assessments of Draft Budgetary Plans – DBPs[22]– and Economic Partnership Programmes – EPPs[23]) issued by the Commission on 15 November. In 2013, Spain appears to have taken effective action in line with the Council EDP recommendation. However, there is a risk that the Draft Budgetary Plan for 2014 may not fulfil the requirements in the EDP recommendation as the headline deficit target is subject to downside risks and the recommended structural effort may not be delivered.

90. To ensure the success of the fiscal consolidation strategy, the Council also recommended to further strengthening the fiscal framework. To that effect, the Spanish authorities should (i) strengthen the effectiveness of the institutional framework by raising further the transparency in implementation of the Budgetary Stability Law as well as by establishing an independent fiscal council to provide analysis, advice and monitor compliance of fiscal policy with national and EU fiscal rules, (ii) undertake concrete steps to rein in the increasing structural deficit in the social security system, and (iii) give a greater emphasis to the growth friendliness of the consolidation, including by conducting systematic reviews of expenditure and the tax system.

91. Several important reforms are underway to strengthen durably public finance management. Significant steps have been taken to address shortfalls in the pension system (with changes to the rules for early retirement and the draft law to regulate the sustainability factor) and implement measures to curb health care expenditures. Legislation to reduce the reliance on indexation clauses in the public sector is expected to come into force as from 2014. Ongoing reforms of the public administration and of local administration (the latter currently debated in Parliament) aim at reducing the administrative burden and generating budget savings. In both cases, implementation relies on cooperative relations between the central government and the regions. The law setting up an independent fiscal council is expected to be adopted soon by the Parliament, so as to allow the new body to be operational as of the beginning of 2014. A comprehensive overview of progress with reforms relevant for the correction of macroeconomic imbalances can be found in Annex 6.3.

[22] http://ec.europa.eu/economy_finance/economic_governance/sgp/budgetary_plans/index_en.htm
[23] http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/countries/spain_en.htm

5.2 STRUCTURAL REFORMS TO BOOST ECONOMIC GROWTH AND JOB CREATION

92. Overall, there has been a visible stepping up of the pace of structural reforms relevant for growth and the adjustment of imbalances over the last months. Despite some delays, the reforms have been progressing largely in line with the commitments in the Spanish National Reform Programme (NRP) and the Stability Programme of last April and with the country-specific recommendations (CSRs) adopted by the Council in July 2013.

93. The successful completion of the reform agenda remains key to the rebalancing of the economy, the recovery of economic activity and employment and thereby the preservation of macroeconomic and financial stability. Many reforms are in the legislative and/or in the initial implementation phases and in most cases, effective implementation requires the full commitment and cooperation of all levels of government. Watering down of the proposals or partial implementation would reduce their effectiveness and the expected positive impact on the economy. Moreover, the NRP and the CSRs foresee the presentation of a number of important reforms in the coming months

94. Further progress towards a well-functioning labour market would help reduce unemployment and support the economic adjustment. At 26%, unemployment is unsustainably high. Long-term unemployment (longer than one year) has reached 58.4% of the total. Most unemployed have limited education and skills. The welcome stabilisation in the unemployment rate in latest data partly results from a declining active labour force. The 2012 labour market reform appears to have helped avoiding even worse outcomes. Together with the Inter-confederation Agreement of January 2012, the new provisions seem to have created the conditions for increased labour market resilience and to have contributed to wage moderation, hence limiting, ceteris paribus, employment losses. Yet, it is too early to judge if the recent reforms will be sufficient to ensure a fast recovery in job creation and less labour market duality going forward. Work continues on the modernisation and reinforcement of employment services and to boost active labour market policies (ALMP) as well as their links with passive policies. However, implementation, which requires effective co-operation between the central government and the regions, is taking time.

95. Several recent and on-going important initiatives aim at improving the business environment and fostering greater competition in the non-tradable sector. A legislative proposal to improve the functioning of the Spanish internal market (the law on the guarantee of market unity) has been submitted to the Parliament. The law aims at removing measures that may directly or indirectly obstruct the free movement and establishment of economic operators, goods and services throughout Spain, and at improving regulation. Conditional on full and swift implementation, the law has the potential to reduce fragmentation and spur competition, allowing companies to exploit economies of scale and bringing lower prices to consumers. A first draft law reforming professional services is under consultation. The law reforms professional bodies and liberalises most professions; it safeguards the principle of market unity in the access and exercise of professional services and reserves decisions on compulsory membership to professional associations to the central legislator. The recent law on entrepreneurship has brought about, amongst other measures, improvements to the framework for corporate insolvency and more flexible company forms. A reform in the electricity sector is tackling the excessive gap between fast-rising regulated costs, reflecting *inter alia* generous support for renewable energy production, and regulated revenues, including mandated tariffs for end consumers.

6 ANNEXES

6.1 MAIN ECONOMIC AND FINANCIAL INDICATORS

	1995-1999	2000-2004	2005-2008	2009	2010	2011	2012	2013 (e)	2014 (f)
Core indicators									
GDP growth rate	3.7	3.6	3.0	- 3.8	- 0.2	0.1	- 1.6	- 1.3	0.5
Private consumption (annual % change)	3.5	3.7	2.8	- 3.7	0.2	- 1.2	- 2.8	- 2.6	0.1
Public consumption (annual % change)	2.7	5.0	5.4	3.7	1.5	- 0.5	- 4.8	- 3.0	- 2.1
HICP (annual % change)	2.8	3.2	3.5	- 0.2	2.0	3.1	2.4	1.8	0.9
Domestic demand incl. stocks	4.2	4.3	3.6	- 6.7	- 0.6	- 2.1	- 4.1	- 3.4	- 0.8
Unemployment rate (% of labour force)	17.2	11.2	9.3	18.0	20.1	21.7	25.0	26.6	26.4
Gross fixed capital formation (% of GDP)	22.5	26.7	29.8	23.6	22.2	20.7	19.2	17.5	16.8
Gross national saving (% of GDP)	22.0	22.6	21.1	19.1	18.4	17.3	18.5	19.5	19.9
General Government (% of GDP)									
Balance	- 4.2	- 0.5	0.3	- 11.1	- 9.6	- 9.6	- 10.6	- 6.8	- 5.9
Gross debt	64.7	52.5	39.8	54.0	61.7	70.5	86.0	94.8	99.9
Interest expenditure	4.6	2.7	1.7	1.8	1.9	2.5	3.0	3.4	3.6
Households									
Households saving rate	13.2	11.3	11.3	17.8	13.9	12.7	10.4	10.5	10.5
Rest of the world (% of GDP)									
Trade balance	- 0.1	- 2.8	- 6.0	- 1.9	- 2.2	- 1.1	0.7	2.8	4.0
Trade balance, goods	- 3.3	- 5.7	- 8.1	- 4.0	- 4.6	- 4.2	- 2.5	- 0.8	0.2
Trade balance, services	3.2	2.9	2.0	2.1	2.4	3.1	3.3	3.6	3.9
Current account balance	- 0.8	- 4.4	- 9.0	- 4.8	- 4.4	- 4.0	- 1.2	1.4	2.6
Net financial assets	- 27.0	- 39.7	- 70.1	- 91.8	- 87.0	- 89.6	- 92.4	- 92.9	n.a.
Net international investment position	- 26.9	- 41.3	- 69.7	- 93.8	- 89.1	- 92.0	- 93.2	- 94.6	n.a.
Competitiveness (index, 2005=100)									
Real effective exchange rate relative to the rest of the euro area	91.4	95.8	104.1	104.9	103.6	101.7	96.7	94.3	92.7
Real effective exchange rate relative to the rest of the European Union	93.8	95.3	103.8	107.7	105.2	103.3	97.5	95.7	93.9
Real effective exchange rate relative to the rest of 37 industrialised countries	92.2	92.6	104.6	109.1	104.8	103.2	96.4	95.9	94.5
Banking sector									
Assets (% of GDP)	173.7	194.9	274.5	329.2	332.0	346.1	348.0	318.8	n.a.
Private domestic credit (y-o-y %)	11.8	14.7	18.9	- 1.6	0.8	- 3.2	- 9.9	- 13.3	n.a.
Non-performing loans (NPLs), total	3.3	1.1	1.5	5.1	5.8	7.8	10.4	12.1	n.a.
NPLs, productive activities	n.a.	1.2	1.5	6.2	8.1	11.6	16.1	18.0	n.a.
" of which, construction, and	n.a.	1.0	1.7	8.5	12.1	18.2	25.8	29.0	n.a.
" real estate activities	n.a.	0.6	1.8	10.1	14.0	21.4	29.1	31.1	n.a.
NPLs, residential mortgages	n.a.	0.4	1.0	2.9	2.6	3.1	4.3	5.5	n.a.
Tier 1 ratio (%)	n.a.	n.a.	n.a.	9.3	9.6	10.2	9.7	n.a.	n.a.
Interest rates									
10 year spread vis-à-vis the Bund	1.6	0.2	0.1	0.8	1.5	2.8	4.3	3.1	n.a.
CDS 5 year	n.a.	n.a.	n.a.	92.9	203.4	318.1	427.2	256.5	n.a.

(e) 2013 estimate or latest available data
(f) 2014: forecast or latest available data
Sources: Ameco, BdE, ECB, Eurostat, IHS Global Insight, Thomson Reuters EcoWin.

6.2 TABLE ON THE STATUS OF MOU CONDITIONALITY

Measure	Date	Status
1. Provide data needed for monitoring the entire banking sector and of banks of specific interest due to their systemic nature or condition (Annex 1).	Regularly throughout the programme, starting end-July	Implemented
2. Prepare restructuring or resolution plans with the EC for Group 1 banks, to be finalised in light of the Stress Tests results in time to allow their approval by the Commission in November.	July 2012 - mid August	Implemented, plans adopted on 28 November 2012
3. Finalise the proposal for enhancement and harmonisation of disclosure requirements for all credit institutions on key areas of the portfolios such as restructured and refinanced loans and sectorial concentration.	End-July 2012	Implemented, BdE Circular 6/2012
4. Provide information required for the Stress Test to the consultant, including the results of the asset quality review.	Mid-August 2012	Implemented
5. Introduce legislation to introduce the effectiveness of SLEs, including allowing for mandatory SLEs.	End-August 2012	Implemented, RDL 24/2012 (Law 9/2012)
6. Upgrade of the bank resolution framework, i.e. strengthen the resolution powers of the FROB and FGD.	End-August 2012	Implemented, RDL 24/2012 (Law 9/2012)
7. Prepare a comprehensive blueprint and legislative framework for the establishment and functioning of the AMC.	End-August 2012	Implemented, RDL 24/2012 (Law 9/2012)
8. Complete bank-by-bank stress test (Stress Test).	Second half of September 2012	Implemented
9. Finalise a regulatory proposal on enhancing transparency of banks	End September 2012	Implemented, BdE Circular 6/2012
10. Banks with significant capital shortfalls will conduct Subordinated Liability Exercises (SLEs).	before capital injections in Oct./Dec. 2012	Implemented
11. Banks to draw up recapitalisation plans to indicate how capital shortfalls will be filled.	Early-October 2012	Implemented
12. Present restructuring or resolution plans to the EC for Group 2 banks.	October 2012	Implemented
13. Identify possibilities to further enhance the areas in which the BdE can issue binding guidelines or interpretations without regulatory empowerment.	End-October 2012	Implemented

Measure	Date	Status
14. Conduct an internal review of supervisory and decision-making processes. Propose changes in procedures in order to guarantee timely adoption of remedial actions for addressing problems detected at an early stage by on-site inspection teams. Ensure that macro-prudential supervision will properly feed into the micro supervision process and adequate policy responses.	End-October 2012	Implemented
15. Adopt legislation for the establishment and functioning of the AMC in order to make it fully operational by November 2012.	Autumn 2012	Implemented
16. Submit for consultation with stakeholders' envisaged enhancements of the credit register.	End-October 2012	Implemented
17. Prepare proposals for the strengthening of non-bank financial intermediation including capital market funding and venture capital.	Mid-November 2012	Implemented, proposals submitted, action plan under implementation
18. Propose measures to strengthen fit and proper rules for the governing bodies of savings banks and introduce incompatibility requirements regarding governing bodies of former savings banks and commercial banks controlled by them.	End-November 2012	Implemented, legal follow-up on-going
19. Provide a roadmap (including justified exceptions) for the eventual listing of banks included in the stress test which have benefited from State aid as part of the restructuring process.	End-November 2012	Implemented
20. Prepare legislation clarifying the role of savings banks in their capacity as shareholders of credit institutions with a view to eventually reducing their stakes to non-controlling levels. Propose measures to strengthen fit and proper rules for the governing bodies of savings banks and introduce incompatibility requirements regarding the governing bodies of the former savings banks and the commercial banks controlled by them. Provide a roadmap for the eventual listing of banks included in the Stress Test, which have benefited from State aid as part of the restructuring process.	End-November 2012	Implemented, legal follow-up on-going
21. Banks to provide standardised quarterly balance sheet forecasts funding plans for credit institutions receiving State aid or for which capital shortfalls will be revealed in the bottom-up stress test.	As of 1 December 2012	Implemented, the second quarterly submission took place
22. Submit a policy document on the amendment of the provisioning framework if and once Royal Decree Laws 2/2012 and 18/2012 cease to apply.	Mid-December 2012	Implemented

Measure	**Date**	**Status**
23. Issues CoCos under the recapitalisation scheme for Group 3 banks planning a significant (more than 2% of RWA) equity raise.	End-December 2012	Not relevant, Group 3 banks recapitalised without State aid
24. Transfer the sanctioning and licensing powers of the Ministry of Economy to the BdE.	End-December 2012	Implemented RDL 24/2012 (Law 9/2012)
25. Require credit institutions to review, and if necessary, prepare and implement strategies for dealing with asset impairments.	End-December 2012	Implemented
26. Require all Spanish credit institutions to meet a Common Equity Tier 1 ratio of at least 9% until at least end-2014. Require all Spanish credit institutions to apply the definition of capital established in the Capital Requirements Regulation (CRR), observing the gradual phase-in period foreseen in the future CRR, to calculate their minimum capital requirements established in the EU legislation.	1 January 2013	Implemented, RDL24/2012 (Law 9/2012) Additional technical details implemented by BdE (Circular 7/2012)
27. Review governance arrangements of the FROB and ensure that active bankers will not be members of the Governing Bodies of the FROB.	1 January 2013	Implemented, RDL 24/2012 (Law 9/2012)
28. Review the issues of credit concentration and related party transactions.	Mid-January 2013	Implemented
29. Propose specific legislation to limit the sale by banks of subordinate debt instruments to non-qualified retail clients and to substantially improve the process for the sale of any instruments not covered by the deposit guarantee fund to retail clients.	End-February 2013	Implemented, RDL 24/2012 (Law 9/2012)
30. Amend legislation for the enhancement of the credit register.	End-March 2013	Implemented, Circular 1/2013
31. Raise the required capital for banks planning a more limited (less than 2% of RWA) increase in equity.	End-June 2013	Not relevant, (Group 3 banks recapitalised without State aid)
32 Group 3 banks with CoCos to present restructuring plans.	End-June 2013	Not relevant, (Group 3 banks recapitalised without State aid)

6.3 REVIEW OF PROGRESS ON POLICY MEASURES RELEVANT FOR THE CORRECTION OF MACROECONOMIC IMBALANCES

Executive summary

Following a protracted credit and housing boom, Spain found itself saddled with high external debt, poor cost competitiveness, high private sector debt, a fragile financial sector and an overheated housing market. The subsequent bust and the international financial crisis brought about additional major problems, namely fast-rising general government debt and a record high unemployment rate with the associated social hardship. In April 2013, the Commission concluded, in the framework of the Macroeconomic Imbalances Procedure (MIP), that macroeconomic imbalances in Spain were excessive. In July the Council addressed to Spain a set of country-specific recommendations (CSRs) mostly directed to support the correction of these imbalances. The MoU foresees that "Spain complies fully with its commitments and obligations under the EDP and the recommendations to address macroeconomic imbalances within the framework of the European Semester. Progress in meeting these obligations under the relevant EU procedures will be closely monitored in parallel with the regular review of programme implementation." Against this background, this Annex reviews the latest economic developments and the main relevant policy measures recently taken by Spain.

Recent economic and financial data point to a stabilisation of the economy. Consumer and business confidence has been on the rise, unemployment appears to be stabilising and the fall in GDP to be bottoming out, heralding the beginning of a moderate recovery in output. Funding conditions in financial markets have improved for the sovereign and for stronger banks and non-financial corporates. However, bank lending has continued to contract sharply. This on-going lending contraction, which is the main deleveraging channel for the private sector, appears to be largely driven by weak demand. Frictions on the supply side and EU financial market fragmentation may also play a role, in particular for SMEs.

The adjustment of imbalances is advancing: the current account is now in surplus, cost competitiveness has been recovering and private debt ratios are slowly declining, more for companies than households. Resources are progressively being reallocated towards the tradable sector. These trends will have to be sustained in order to bring down high domestic and external debt levels durably. A full analysis of imbalances is outside the scope of this report; it will be developed in the next cycle of the MIP.

Financial stability has been bolstered by the recapitalisation and restructuring of the banking sector and the thorough implementation of the July 2012 ESM programme for the recapitalisation of financial institutions, due to expire at the end of 2013. As outlined in the main body of this 4th review report, the programme is on track. A solid banking system is a precondition for satisfying higher credit demand in a recovery. There are also on-going initiatives to develop non-bank financing sources aimed at enlarging both quantitatively and qualitatively the financing opportunities for companies.

Reining in fast-rising public debt (approaching 100% of GDP) demands fiscal consolidation and further strengthening of public finance management. Progress with fiscal consolidation will be analysed in detail in upcoming documents under the SGP and the two-pack legislation (analysis of effective action under the EDP; assessments of Draft Budgetary Plans – DBPs – and Economic Partnership Programmes – EPPs). Important steps have been taken to address shortfalls in the pension system and implementation of measures to contain health care expenditure continues. Legislation to reduce the reliance on indexation clauses in the public sector is expected to come into force as from 2014. A dedicated group of experts has recently started to review the taxation system and is expected to deliver results by early 2014. On-going reforms of the public administration and of local administration (currently debated in Parliament) aim at reducing the administrative burden and generating budget savings. In both cases, implementation relies on cooperative relations between the central government and the regions. The law setting up an independent fiscal council is expected to be adopted soon by the Parliament, so as to allow the new body to be operational as of the beginning of 2014.

A well-functioning labour market is essential to reduce unemployment and support the economic adjustment. At 26%, unemployment is unsustainably high. The welcome stabilisation in the unemployment rate in latest data partly results from a declining active labour force. The 2012 labour market reform (broader and deeper than previous reforms), as well as the social partners' agreement of January 2012, seem to have created the conditions for increased labour market resilience and to have contributed to wage moderation, hence limiting, ceteris paribus, employment losses. Yet, it is too early to judge if the recent reforms will ensure a sufficiently fast recovery in job creation and less labour market duality going forward. Such issues will need continuous close monitoring. Work continues on the modernisation and reinforcement of employment services and to boost active labour market policies (ALMP) as well as their links with passive policies. However, implementation requires effective co-operation between the central government and the regions and is taking time.

Several recent and on-going important initiatives aim at improving the business environment and fostering greater competition in the non-tradable sector. A legislative proposal to foster the functioning of the Spanish internal market (the law on the guarantee of market unity) has been submitted to the Parliament. A first draft law reforming professional services is now under consultation. The law reforms professional bodies and liberalises most professions; it safeguards the principle of market unity in the access and exercise of professional services and reserves future legislation in this area to the central legislator. The recent law on entrepreneurship has brought about, amongst other measures, improvements to the framework for corporate insolvency and more flexible company forms. A reform in the electricity sector is tackling the excessive gap between fast-rising regulated costs, reflecting *inter alia* generous support for renewable energy production, and mandated tariffs for end consumers.

Overall, there has been a visible stepping up of the pace of structural reforms relevant for the adjustment of imbalances over the last months. Despite some delays, the reforms have been progressing largely in line with the commitments in the Spanish NRP and Stability Programme of last April and with the MIP relevant CSRs adopted by the Council in July.

This policy momentum, which has contributed to the positive shift in sentiment towards Spain, should be maintained, as adjustment needs remain very large and the reform process is far from completed. Several of the reforms are in the legislative and/or in the initial implementation phases and, in most cases, effective implementation requires the full commitment and cooperation of all levels of government. Watering down of the proposals or partial implementation would reduce their effectiveness and the expected positive impact on the economy. Moreover, the NRP and the CSRs foresee the presentation of a number of important reforms in the coming months.

1. Introduction

On 28 November 2012, the European Commission presented its second Alert Mechanism Report (AMR) which concluded that a further in-depth analysis was required into whether imbalances existed or risks had emerged in Spain. The subsequent "in-depth review" (IDR), published on 10 April 2013, examined the nature, origin and severity of macroeconomic developments in Spain.[24] The Commission concluded that "*despite significant progress in 2012, Spain still has excessive macroeconomic imbalances. Spain should maintain the reform momentum by including comprehensive and detailed policy measures in its forthcoming National Reform Programme (NRP) and Stability Programme*".[25]

On 30 April 2013, the Spanish authorities submitted the Stability Programme and the NRP. Following the assessment of the two documents, the Commission proposed a set of policy recommendations to address macroeconomic imbalances which were reflected in the CSRs in the framework of the European Semester and eventually adopted by the Council on 9 July 2013. The scope of the MIP relevant recommendations aimed at addressing macroeconomic imbalances is wide-ranging and covers (i) fiscal policy, adequacy of the tax system, effectiveness of public expenditure and the broad functioning of the public sector; (ii) the stability of the financial sector and debt deleveraging; (iii) the functioning of the labour market and the performance of the education system; and (iv) structural measures to boost growth and competitiveness. An overview of the MIP relevant recommendations, NRP commitments and related deadlines is provided in Annex 1.

This report reviews the main measures taken by Spain over the last months that will potentially contribute to the rebalancing process. The analysis has benefited from a fact finding mission that took place on 18-20 September 2013, in parallel to the Fourth Review mission of the bank recapitalisation programme. The Economic Partnership Programme submitted on 2 October by Spain in compliance with Regulation 473/2013, provided useful additional information on policy measures.

2. State of play with MIP-relevant reforms

2.1. Measures to improve the quality of public expenditure and taxation and the efficiency of public administration

Short and medium term fiscal consolidation strategies, which are key policy objectives and highly relevant to the adjustment of imbalances, will be examined under the forthcoming assessment of effective action and assessment of the DBP and EPP.[26] Here the focus is

[24] The IDR concluded that "Spain is experiencing excessive macroeconomic imbalances. Although adjustment is taking place, the magnitude of the necessary correction requires continuous strong policy action. In particular, very high domestic and external debt levels continue to pose risks for growth and financial stability. The decisive policy action at the EU level and by Spain has resulted in a visible adjustment of flows, reduction in financing costs and a reduction of immediate risks". See: http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/pdf/ocp134_en.pdf

[25] See http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/pdf/com(2013)_199_final_en.pdf . Regarding the SGP, the Commission assessment of effective action in the framework of the Excessive Deficit Procedure, along with the assessment of Spain's DBP and EPP, will be presented in mid November.

[26] The Council Recommendation under the EDP of 21 June 2013, sets the 2013 headline deficit target at 6.5% of GDP – progressively reducing to 2.8% in 2016. The Council established the deadline of 1 October 2013 for the Spanish government to take effective action and, in accordance with Article 3(4a) of Regulation No 1467/97, to report in detail the consolidation strategy that is envisaged to achieve the targets. The Council recommendation additionally called upon Spanish authorities to (a) strengthen the effectiveness of the institutional framework by raising further the transparency in implementation of the Budgetary Stability Law as well as by establishing an independent fiscal council to provide analysis, advice and monitor compliance of fiscal policy with national and Union fiscal rules; (b) undertake concrete steps to rein in the increasing structural deficit in the social security system; and (c) give a greater emphasis to the growth friendliness of the consolidation, including by conducting systematic reviews of expenditure and the tax system. See: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2013:180:0004:0008:EN:PDF

limited to structural measures to strengthen public finance management, such as the composition and efficiency of public spending and taxation and a well-functioning public administration, all elements important both for fiscal consolidation and to support growth and rebalancing.

The urgent need to rein in widening public deficits has required significant **expenditure** cuts in recent years. Public investment has been slashed; significant cuts in public consumption have been achieved mainly by limiting the growth in compensation of employees (through a multi-annual wage freeze and a 10% cap on replacing retiring public sector employees) and, especially since 2012, rolling back the surge in public healthcare and education spending.

On-going reforms in key spending areas aim at attaining budgetary savings of a structural and lasting nature, as well as a reduction in the administrative burden for companies and households. These reforms include notably (i) a range of measures to increase the efficiency of the public administration, (ii) a draft reform of local administrations and (iii) recent significant modifications to the pension system. In addition, efforts to limit the cost of healthcare and education continue, and could be underpinned by structural reforms underway also in these areas.[27]

The government presented in June the CORA report (*Comisión para la Reforma de las Administraciones Públicas*), prepared by an expert group with proposals for the reform of the **public administration**. The report has 217 recommendations[28] touching upon horizontal measures, administrative burden reduction and simplification, improved management of ministerial common services, elimination of duplicated structures between the central and regional governments and rationalisation of the so-called central "institutional" administration (i.e. the public sector entities appended to the central government administration). The execution of all recommendations is expected to take up to three years and could yield substantial budgetary savings.[29]

Further savings are expected from the draft **local administration** reform, currently in Parliament. The draft law aims at clarifying the powers/competencies of municipalities (so as to remove duplicities at local level with other general government sub-sectors), streamlining the number of local entities, rationalising the services they provide, and increasing transparency in the costs of provision of local public services.

These expenditure side reforms add to the measures taken in 2012 - mainly freeze on replacing vacant posts, prolonging the minimum working time to 37.5 hours/week, measures to fight absenteeism, reducing special holidays. Given the highly decentralised spending responsibilities in the Spanish administration, the success of these reforms will depend on the implementation of the measures at both central and regional government levels.

Reforms of the **pension system** are ambitious and well-advanced. First, in March 2013 the government curbed access to early and partial retirement. Increases in the voluntary and forced early retirement ages will follow the increase in the statutory age to 67 years (decided in 2012), and ultimately will reach 65 and 63 years, respectively. Longer contribution periods for early and partial retirement will be required. Penalties (reduction coefficients) for early retirement will be more differentiated depending on the length of the contribution period. Second, following the report in June 2013 of a government-mandated expert group, the government has adopted on 27 September 2013 a proposal for the regulation of the

[27] For a summary of official estimates of the impact of these measures, see in Box 1.

[28] Two more measures have been added since June 2013, making a total of 219 recommendations.

[29] On-going reforms in the judicial system could also bring important benefits for economic agents. An assessment of judicial sector is however outside the scope of this monitoring report.

sustainability factor. The proposal (i) changes as of 2014 the yearly indexation of pensions by linking it to the balance of the system and (ii) introduces, as of 2019, an automatic adjustment of future retirees' pensions to life expectancy.

The **dis-indexation law**, submitted to parliament at the end of September 2013 will contribute to reducing the drift of public expenditure. Furthermore it aims at influencing the practice of indexation in the private sector. Once adopted, the law is expected to discontinue current indexation schemes on administered prices and public sector contracts. It will be voluntarily applicable also to indexation mechanisms on privately agreed prices, but not to collective bargaining, financial sector instruments or pensions (the indexation of the latter being addressed by the dedicated instrument discussed above). By contributing to lower inflation inertia, the dis-indexation law could support purchasing power and competitiveness.

On taxation, the Council recommended to Spain a systematic review of the **tax system** by March 2014, as well as to consider further limiting tax expenditure in direct taxation, explore the scope to narrow further the application of the reduced VAT rates, take additional steps in environmental taxation, notably as regards excise duties and fuel taxes and intensify the fight against the shadow economy and undeclared work. In July 2013, the government tasked a group of independent experts with a review of the tax system, with a view to making it simpler as well as employment- and growth-friendlier, while respecting fiscal consolidation needs. The group is expected to deliver its conclusions by February 2014.

In the meantime, some limited tax measures have also been taken. In June 2013, the government adopted a draft law reducing the tax deduction on unrealised losses on securities holdings. It also announced the introduction as from 2014 of an excise duty on fluoride gas and significantly increased the excise duties on alcohol and tobacco.

Following a court decision, the scope of application of the general VAT rate should be further broadened.[30] Moreover, a new optional regime for small businesses will allow them to postpone the payment of VAT to the tax administration until they receive payment of the VAT charged to their clients.[31] Finally, in the spirit of reducing the debt bias, the Entrepreneurship law adopted by parliament on 19 September 2013 has introduced a tax break to foster SMEs' re-investment of profits on fixed assets or on real estate assets linked to the company's economic activities, the limits for the research and development tax credit has been eliminated up to EUR 3 million per year and a new tax incentive for business angels has been added.

2.2. Measures to foster stability of the financial sector and orderly deleveraging of the private sector

Following acute financial sector stress, the Eurogroup agreed on 9 July 2012 on a **financial assistance programme** for the recapitalisation of Spanish banks. The bank-specific conditionality and horizontal policy conditions attached to the financial assistance were specified in the related Memorandum of Understanding (MoU) signed on 23 July 2012. The 2013 CSRs included a reference to compliance with the terms of the MoU, including the measures to promote non-bank financial intermediation. The recently concluded Fourth Review mission found that the programme is on track and has contributed to restore financial stability and confidence. Nevertheless, challenges and risks remain, arising in particular from

[30] In particular it was announced that the normal rate will now be applied to certain medical equipment and inputs used to produce medicines as well as certain notary services, which had hitherto been exempted from VAT.

[31] This optional regime will be available to those taxpayers with a turnover not exceeding EUR 2 million in the year prior to the option.

the still fragile economic situation and prospects and possible repercussions on asset quality and bank profitability. This warrants continuous close monitoring by supervisors and policy-makers.[32]

Lending to the economy has been contracting sharply (in August, lending to domestic private sector decreased by 7.6% year-on-year – excluding transfers to Sareb). The credit contraction appears to be driven mostly by weak demand but also by some frictions on the supply side ultimately affecting in particular SMEs. These frictions relate to the on-going restructuring process (where some lender/borrower relationships might be cut), regulatory changes (e.g. reinforced capital requirements) and persisting euro area financial market fragmentation. While deleveraging is necessary to return to a more balanced growth path, it is crucial for the rebalancing of the economy that viable companies have access to adequate financing. A recent analysis by the Banco de España has shown that while overall credit flows remain negative, companies that were in better shape before the crisis (had lower level of debt pre-crisis, higher profits, etc.) have maintained access to credit and even increased their debt levels.[33]

While the stabilisation of the banking sector is one essential element to back a smooth allocation of credit, progress is being made in developing **non-bank financial intermediation,** with the aim of reducing the currently excessive reliance on banks and widen the types of capital available to companies, in particular SMEs. Measures include, among others, the creation of an alternative bond market for SMEs (MARF), easing of admission requirements to regulated and alternative markets ('escalator finance law'), greater availability of funds at competitive rates from the public *Instituto de Crédito Oficial* (ICO) to banks for SME lending (credit lines for up to EUR 23 billion have been made available in 2013), increased venture capital by co-investment funds and business angels as well as by the setting-up of a national business incubator system, and strengthening of the mutual guarantee system for SMEs. The re-organisation of support schemes for the internationalisation of firms (foreseen in the September 2013 Law on Entrepreneurship) could also contribute to improving the financing options for exporting companies. Moreover, an enhanced reliance on financial instruments under the EU structural and investment funds could contribute to easing the access to finance for start-ups and SMEs.

Inefficiencies in personal and corporate **insolvency procedures** may delay private sector deleveraging and the re-allocation of resources by impeding swift recognition and work-out of unsustainable private debt or by unnecessarily pushing viable firms into liquidation.

The Law on Entrepreneurship addresses some of the apparent shortcomings of the insolvency framework for corporates, namely by introducing a possibility of a "fresh start". First, a new out-of-court procedure has been established for debtors with a possibility of a partial debt discharge. Second, requirements for debt refinancing agreements have been facilitated under the bankruptcy law. Third, the law has created a limited liability company "in formation" with lower capital requirements. Fourth, in the regime of limited liability entrepreneur, personal liability of individual entrepreneurs has been limited, as they can protect their housing (up to a certain value) from the insolvency proceedings. It will be important to monitor the actual take-up of these enlarged options to gauge their effectiveness.

[32] The Commission and ECB press release is available at : http://europa.eu/rapid/press-release_MEMO-13-836_en.htm?locale=en

[33] See http://www.bde.es/f/webbde/SES/Secciones/Publicaciones/InformesBoletinesRevistas/BoletinEconomico/13/Ene/Fich/be1301-art3.pdf.

Regarding personal insolvency, the current legal framework does not generally foresee the possibility of debt discharge for financially responsible personal debtors. To address debt distress of residential mortgage debtors, in May 2013 the Parliament adopted the Law on strengthening protection of mortgage debtors, on debt restructuring and social housing, which has reviewed the mortgage law and tightened conditions to launch foreclosures.[34] The law establishes a temporary 2-year moratorium on evictions of vulnerable debtors, provides for a partial debt discharge and extends the application of out-of-court workouts. A limited partial discharge is possible after foreclosure of the primary residence.[35] In addition, Spanish banks have voluntarily adhered to a Code of Good Practice, which establishes different measures for viable debt restructuring arrangements for mortgages applicable to families on the “threshold of exclusion”. Altogether, these emergency provisions try to strike a balance between providing relief to over-indebted insolvent households and the need to preserve financial stability. While statistics are patchy, the measures seem to have contributed to a declining number of evictions. A more systematic review of the permanent personal insolvency regime, as advocated in the CSR, does not appear to be currently planned by the authorities.

On 4 June 2013 the Parliament adopted the law on the transition to flexible measures and promotion of the **rental housing** market. The law brings about a series of noteworthy changes, strengthening the legal rights of owners but also providing greater flexibility in the conclusion and termination of rental agreements. A more flexible and efficient rental market may help the adjustment process of the housing market and, together with the elimination of tax deductibility of mortgage payment as of the beginning of 2013, reduce the bias towards home-ownership. It will also support labour mobility and in the long run contribute to diminish the volatility of house prices.

2.3. Measures to improve the functioning of the labour market and enhance human capital

Unemployment has soared to record levels following the downsizing of the construction sector and the adjustment in the rest of economy. Both structural conditions, such as skill mismatches, and existing policy settings have constrained the responsiveness of the labour market during the crisis, greatly aggravating the resulting fall in employment. Policy shortcomings included wide difference in employment protection for permanent and temporary employees, a high degree of rigidity in the regulation of internal working conditions, limited possibilities of adapting collective bargaining to firm conditions and widespread use of indexation clauses. The high unemployment rate (26.2% in August 2013) is concentrated in vulnerable groups (youngsters under 25 and low skilled with unemployment rates of 56.0% and 39.5% respectively) and a high share is made up of long-term unemployed (58.4% of all the unemployed has been unemployed for more than one year).

[34] At least three payments must be missed in order to start foreclosure proceedings, instead of one. The notary can suspend the foreclosure procedure if the mortgage contract supposedly contains abusive clauses. Access of bidders to auctions of foreclosed properties has been facilitated through lower collateral requirements (5% of the value of the property), and through revised asking prices. If a primary residence is being foreclosed, asking prices of 75% and 70% of the original valuation are applied in the first and the second auction, instead of 100% and 60%.

[35] A fraction of the debt (35% or 20%) can be waived after the debtor has paid 65% of the remaining debt within a period of five years, or 80% of the debt within a period of ten years. Moreover, the group of distressed mortgage debtors entitled to out-of-court workouts, introduced by the RDL 6/2012, has been extended. Distressed mortgage debtors are those who have recently undergone significant changes in their economic situation, have income below a poverty threshold, and their mortgage payments represent at least 50% of net income.

Building on previous reforms in 2010 and 2011, a comprehensive **labour market reform** was adopted by the government in February 2012 and passed into law in July 2012.[36] The CSRs included a recommendation to carry out an evaluation of the 2012 labour market reform against its objectives and consider additional measures where the reform appeared not to have fully delivered. The government evaluation was presented to the national Parliament on 29 August 2013. While rightly stressing that such an assessment is complicated by the short time span since entry into force of the reform, the recessionary environment and the simultaneity of other reforms, it reached generally positive conclusions on the outcome of the reform. The government has also requested the OECD to prepare a separate assessment, which should be ready by end 2013.

Indeed, the 2012 reform and the social partner agreement signed in January 2012 seem to have jointly contributed to wage moderation, enhanced the use of internal flexibility as an alternative to redundancy and all in all cushioned the drop in employment. As for the envisaged reduction in duality, scant and mixed data do not allow to reach firm conclusions at this stage. In the context of the negative current economic situation and uncertain outlook, the share of permanent workers in the total stock of employees has increased, mainly on the back of a greater number of expired and not renewed temporary contracts, while despite a timid pick up since the beginning of 2012 in permanent contracts, temporary contracts still constitute about 90% of the total new labour contracts signed.

The government's evaluation has so far not been followed by announcements of significant amendments to labour market legislation. Some fine-tuning has taken place via the Royal Decree Law 11/2013 of August 2013, which introduces some clarification to the collective dismissal procedure, allows for Private Public Partnerships (PPPs) of public employment services with placement agencies and introduces some modifications to the requirements to access unemployment benefits. The government is also working on an administrative rationalisation of the registration of labour contracts, to simplify hiring formalities.[37]

In the context of the reform of **active labour market policies**, the government approved on 2 August 2013 the Annual Employment Plan (*Plan Anual de Politica de Empleo* – PAPE) which to an extent complements the 2012 labour market reform on the employability front. The plan features (i) a results-based allocation of funds to the regions[38] and (ii) improved coordination and information sharing between the regional bodies and the central National Employment Agency. In spite of the recognised urgency to improve the delivery of ALMP, the divided responsibility between the State and the regions implies that the change to the new model will only be gradual and not devoid of implementation risks.[39] The evaluation of the plan in 2014 should allow for further fine-tuning of the formula-based allocation of funds and

[36] The aims of the reform were (i) to favour internal flexibility as an alternative to job destruction, (ii) to modernise collective bargaining in line with the specific needs of companies and workers, (iii) to improve the employability of workers through training and effective labour mediation, (iv) to promote the creation of stable and quality jobs and reduce labour market dualism, (v) to combat unjustified absence from work, and (vi) to strengthen the mechanisms for controlling and preventing fraud, protecting workers' rights and the fight against unfair competition between companies.

[37] Plans include a possible reduction of the number of contractual forms to 5: indefinite, temporary, substitution (early and part-time retirement), internship and training and apprenticeship. This measure could help in particular SMEs, which seem to have exploited the novelties introduced by the reform only partially, possibly also due also to lack of information. However, this administrative simplification is not backed by a streamlining of the very high number (about 40) of contractual arrangements.

[38] The PAPE 2013 contains the 33 agreed common objectives for all Public Employment Services (national and regional). The objectives are divided between structural (29) and strategic/policy (4) objectives. Structural objectives are long-term and stable over time, while the strategic objectives mark priorities for each year. The strategic objectives for 2013 are: (i) Improving the employability of young people and promote entrepreneurship; (ii) Improving the employability of other groups particularly affected by unemployment (people older than 55, long-term unemployed, recipients of PREPARA programme); (iii) improving the quality of the 'professional training for employment' system, and (iv) Strengthening the links between active and passive policies. An initial distribution of weights has also been designed: in 2014, 40% of the funds will be distributed according to results achieved in 2013, 25% with respect to the strategic objectives and 15% responding to the structural ones.

[39] The first evaluation results will be available by April 2014, allowing for the first distribution of the result-based tranche of funding.

possibly a strengthening of the incentives both in the result oriented allocation of resources and in the public private partnerships between placement agencies and public employment services. The new active labour market policies strategy should be complemented by the forthcoming single job portal, which will compile all national and regional public employment services information for jobseekers.

A swift implementation and monitoring of the effectiveness of these new measures remains important. No specific measures were taken so far to modernise and reinforce the public employment service itself, to provide effective, individualised counselling and job search assistance to those looking for jobs.

Youth unemployment is addressed by the Youth Entrepreneurship and Employment Strategy, adopted in February this year, which encompasses approximately 15 short, and 85 medium and long-term measures to promote youth employment, enhance entrepreneurship and reinforce education and training. The Strategy will be subject to a first assessment of results in October 2013.[40]

On 10 October 2013, the Congress adopted the draft law on the quality of **education** (*Ley Orgánica para la Mejora de la Calidad Educativa* – LOMCE).[41] The law aims to address the apparent paradox in the interaction between the Spanish labour market and the education system, namely (i) the coexistence of relatively lower risk of unemployment for holders of formal vocational education and training (VET) and the very low enrolment rates in formal VET on the one hand and (ii) the absence of vocational programmes at lower secondary compulsory level as an option to reduce/prevent school leaving on the other hand.

A new “basic” 2-year vocational training[42] module would allow those without a basic compulsory education diploma to access to vocational training. It is expected to contribute to reducing the number of early school leavers. Furthermore, the new law introduces different pathways in lower secondary education, allowing students to follow VET already in the frame of their lower secondary compulsory education – aiming at a preventive rather than remedial approach with respect to early school leaving.

The design and implementation of dual vocational training is shared between the Ministry of Education and the Ministry of Labour and Social Security. Closer coordination between education and labour market policies is required to eliminate any unnecessary overlap between vocational training provided as part of formal education programmes and work-based training, and to better align actions and incentives in education and training. Reinforced coordination between the autonomous regions and the central authorities and a coherent approach are also key to advance towards a high-quality VET system.

2.4. Structural measures to promote growth and competitiveness

Spain's service and product markets are characterised by multi-layered regulatory and administrative requirements which often result in the fragmentation of the internal market and hamper competition and the re-allocation of resources. There also appears to be scope to strengthen effective competition in parts of the network industries with a view to lower costs

[40] The report evaluating the impact of the labour reform 2012 quotes that 38% of the 100 measures in the strategy have been implemented or are included in legislation being prepared, 73% in the case of emergency or high-impact ones.

[41] Adoption by the Senate and final adoption by Congress should follow shortly, while it is expected that the adoption of the secondary legislation and the adaptation of the curricula will take 2 years, allowing the new measures to be implemented in the school year 2015/2016.

[42] The new module would replace the current PCPI (*Programas de Cualificacion Profesional Inicial*).

for consumers and other industries. Moreover, distorted incentives have in the past led to over-investment in parts of the energy and transport sectors, giving rise to significant contingent fiscal liabilities.

While reforms in these areas have been lagging behind initial plans, several important initiatives have finally moved ahead in recent months, such as the draft law to guarantee the unity of the Spanish internal market and the draft law to liberalise professional services, which is currently in the consultation phase. These draft laws have the potential to bring sizeable economic gains but are also complex and face considerable resistance. Ultimately, their impact will have to be assessed on the basis of actual implementation. The reform of the electricity sector purports to tackle in a permanent way the long-standing accumulation of large annual deficits within the electricity systems. In the transport sector, market opening in railways is lagging behind and railway freight has been losing market shares. Inter-operability between different modes of transport should be enhanced in order to support the rebalancing of the economy towards export-oriented activities. At the same time excessive investment in infrastructure is generating contingent fiscal liabilities in the short-term.

The draft law on **market unity** was adopted by the government on 5 July 2013 and is expected to be approved by the Parliament by the end of the year. The law aims at removing measures that may directly or indirectly obstruct the free movement of goods and services and the establishment of economic operators throughout Spain. To that end, it sets out a series of general principles and provides for their application in practice. For example, implementing the principles of necessity and proportionality to the regulation of economic activities is likely to reduce the number of cases where authorisations (or other administrative acts) are required by authorities. The principle of effectiveness throughout Spain aims at guaranteeing that all legally established economic operators, or all goods legally produced and placed on the market in a given part of Spain, may, *a priori*, perform the economic activity, or circulate throughout all the Spanish territory, without additional authorisations or formalities being required by other competent authorities ("single licence" system). The draft law also provides for institutional arrangements overseeing the application of the law.[43] Conditional on full and swift implementation, including by all local and regional authorities, the law has the potential to reduce fragmentation and spur competition, allowing companies to exploit economies of scale and bringing lower prices to consumers.

A preliminary draft of the law on **professional services** has been put out to consultation by the Council of Ministers on 2 August 2013. The law is planned to be passed by the Parliament in 2014, later than the NRP and CSR target date of end 2013. The draft, which aims at further liberalising professional services following the adoption of the services directive, includes (i) the principles and guidelines to safeguard market unity in the access to and exercise of professional services, (ii) a general (and updated) legal framework for professional associations, (iii) a re-assessment of the activities reserved to holders of specific professional qualifications with a view of lifting exclusive rights to the benefit of other service providers with related qualifications. In particular, access to a profession in any given part of Spain would imply the exercise of that profession throughout the country. Moreover, in the future changes to specific aspects of the regulation on professions would be reserved for laws adopted by the Spanish Parliament,[44] thus avoiding regulatory disparity with regional

[43] Among others, the new Council for Market Unity, is an administrative body for monitoring the implementation of the law and regulating the mechanisms for defending the interests of economic operators. The secretariat of this body will provide a one-stop-shop to file complaints on acts incompatible with market unity. In addition, the National Commission of Markets and Competition is empowered to file an administrative appeal against provisions contrary to market unity.

[44] For example, in areas such as the list of "qualified" professions (*profesiones tituladas*), on restrictions to multidisciplinary activities, as well as the definition of professions with mandatory membership to a professional organisation (profesiones colegiadas).

legislators in those areas. Furthermore, the draft enhances the controls of legality and of efficacy of professional associations by the competent line ministries, reduces and redefines the number of professions requiring mandatory membership to a professional association and provides for a system of certification of professionals (by private and/or public bodies) as a way of proving the competences, knowledge and skills of professionals. Lastly, the draft lifts some reserves in selected professional activities, such as bailiffs, while setting out a procedure to re-assess the activities reserved to engineers and architects in the building sector. It will be important to ensure that this re-assessment will be followed by prompt legislative action removing unjustified reserves. Other provisions call for the revision of regional legislation and of the statutes of professional associations within the year following the approval of the law. As is the case for the law on market unity, the timing and scope of implementation is what will determine the actual impact. A dilution of the measures and further delays would be detrimental in this respect.

The law providing for the creation of the **new Competition Commission** (*Comisión Nacional de Mercados y Competencia* - CNMC) was published in the Official Journal on 5 June 2013. The statutes of the CNMC were adopted by the government on 30 August, and the new board of the CNMC was appointed on the same date. The CNMC is the result of the merger of the national competition authority with six supervisory and regulatory authorities covering the following sectors: energy, telecommunications, postal services, audio-visual industries, railway and air transport. According to the law, the rationale of this merger is to provide for consistent application of regulation across network industries, while at the same time providing for strict implementation of competition principles. The final text addressed some of the concerns that the previous draft raised regarding the independence and the financing of the new authority and the process of the transfer of competences and functions. The Commission services will continue monitoring the impact of the reform on the degree of competition in Spanish markets, which is essential to support the process of reallocation of resources and the rebalancing of the economy. The CSRs also called for the removal of unjustified barriers to entry of large-scale **retail** premises, as a measure to increase competition in the retail sector.[45] No action was foreseen in the NRP or has been announced since then.

Structural inefficiencies in the **electricity** sector have contributed to a misallocation of investment and the build-up of considerable public sector contingent liabilities, *inter alia* on the back of generous subsidies to renewable energy producers. The 'electricity tariff deficit' (i.e. the gap between regulated 'access tariffs' paid by consumers and various regulated costs – including distribution costs and subsidies for renewable energy production) exceeded EUR 5 billion (around 0.5% of GDP) in 2012, well above the official projection of EUR 1.5 billion, while the accumulated tariff debt amounts to more than 2½% of GDP. Some measures to contain the deficit were adopted in 2012 and at the beginning of 2013, including new taxes on energy production, a revision of the annual adjustment of regulated costs and a simplification of the system of support to renewable energy sources. However, these measures proved insufficient to close the deficit, leading the authorities to propose in February an extraordinary credit from the state budget of EUR 2.2 billion.

To remedy this situation in July 2013, the authorities have put forward a legislative package aimed at overhauling the electricity sector and closing the tariff deficit. The package, which included urgent measures adopted by the government in July and a draft law on the electricity sector submitted to the Parliament in September for adoption before the end of the year, aim

[45] It seems in particular that regional authorisation schemes for large outlets limit the entry of new operators.

at: (i) guaranteeing the financial sustainability of the electricity sector; (ii) reducing substantially the costs of the system via regulatory measures; and, (iii) increasing consumers' choice and competition so as to guarantee the electricity supply for consumers at the lowest possible cost. The reform foresees a contribution of all stakeholders in closing the deficit. Firstly, it revises the support mechanism for renewable energy sources, so that yearly rates of return for renewable installations (based on standard costs) are limited to around 7.5%. Secondly, remuneration of transmission and distribution activities is scaled down. Thirdly, the reform foresees a budgetary contribution to the electricity system of some 0.1% of GDP in the coming years. Finally, network access tariffs for consumers have been increased by 3.2% on average as of August 2013. If these measures fall short of closing the tariff deficit, an automatic balancing mechanism would be triggered and access tariffs increased further. The reform appears to be comprehensive and has the potential to eliminate the electricity tariff deficit. Timely adoption of the necessary secondary legislation, including in particular the methodology for calculating the standard costs of investment in renewable energy technologies, and strict implementation of the reform, including the automatic balancing mechanism, will be critical to bring the electricity system into equilibrium.

Transport infrastructure experienced substantial and not always sustainable investment in the pre-crisis period. This investment favoured an extended network for passenger transport to the detriment of better connectivity of production poles with consumption/export sites and interconnectivity with bordering markets. Operators of nine toll motorways registering low traffic flows now face financial difficulties, with non-negligible contingent liabilities for the state. Seven out of these nine have already been declared insolvent. A viable solution to this situation, which would also have to address the structural low profitability linked to underutilisation of the toll motorway network, still needs to be found.

Meanwhile, railway freight has been losing market shares. Rail freight transport has been liberalised in the EU for both national and international services. However, to bring effective competition in railway transport in Spain, the liberalisation would need to be accompanied by additional measures to overcome technical and legal obstacles. Low interoperability with the rest of the European railway network (e.g. different gauge, rolling stock, and technical requirements) and weak connections to seaports hamper new entries into the market.

Against this background the CSRs included a recommendation to set up an independent observatory to contribute to the assessment of future major infrastructure projects and taking measures to ensure effective competition in freight and passenger rail services. No progress can be recorded in the former area and there has been some backtracking in the liberalisation of passenger services: Royal Decree 4/2013 limited competition previously foreseen for commercial and touristic package passenger services to touristic lines only (historic trains excluded). Several measures to promote the effective competition in railway freight are in the pipeline (e.g. splitting the incumbent railway operator, or reviewing access charges to railway infrastructure).

Box 1: Potential macroeconomic impact of structural reforms

Simulating the impact of structural reforms is methodologically complex and the resulting estimates are surrounded by significant uncertainty. Notwithstanding these caveats, recent simulations for Spain by the authorities and by the European Commission services point to a sizeable potential impact of structural reforms on growth and employment.

According to the 2013 Spanish National Reform Programme, amongst the reforms on the way, the law on the guarantee of market unity is expected to generate especially positive macroeconomic effects due to a permanent reduction of administrative burdens for enterprises. The estimates therein are of an additional 1.3% of GDP in the first year after its implementation and up to 1.5% ten years later. The planned law on dis-indexation could lead to an increase in GDP of 0.1% in the first year, and 0.4% in the second. Restricting access to early and partial retirement would contribute another 0.2% of GDP in the first year and 0.5% ten years later.

The authorities also provide estimates of the impact of some of the reforms introduced in 2012, e.g. the labour market reform (a significant effect on GDP in the long run, estimated at 4.5 %), the youth and entrepreneurship strategy (tax incentives for entrepreneurship only were estimated to have a potential impact of 0.1% on GDP in the long run), the liberalisation of business opening hours (0.3 % of GDP in the long term). The law to promote rental market, together with previous measures to reduce the tax bias towards home ownership, is estimated to increase GDP by 0.5% after four years.

Moreover, the authorities expect some of the reforms to deliver sizeable structural budgetary savings, notably in social expenditure and the cost of the public administration. The government estimates that the introduction of the sustainability factor in the pension system would bring EUR 1 billion (0.1% of GDP) of savings in 2014 and EUR 5 billion (annually) by 2020. Measures to increase effectiveness of health care expenditure had originally been estimated to have a cumulative impact of EUR 7 billion. However, implementation has so far yielded only a part of these savings (EUR 4.2 billion). According to the Economic Partnership Programme, the projected fiscal savings from the implementation of the CORA report for the reform of the public administration amount to a total of around 0.2% of GDP (i.e. almost EUR 2 billion). These savings are in addition to those originated from other planned public sector reforms, such as the reform of local administration whose projected savings are around €8 billion over 2014-2019. While it will have to be seen whether the whole amount of estimated savings will actually be realised, undertaking fiscal consolidation via structural measures is positive for the credibility of public finances.

The Commission services have made an attempt to estimate the potential macroeconomic impact of structural reforms proposed under the European Semester country-specific recommendations (CSRs) using the QUEST model. The study uses a stylised approach, which simulates the potential impact from reforms in selected policy areas. In practice, benchmark levels for structural indicators in product and labour markets are defined based on the average of the three best performing EU Member States. Reform scenarios are then simulated assuming that a country with CSRs in a given policy area would close half of the gap towards the benchmark.

In the case of Spain, it is assumed that the structural reforms would improve competition in product markets by reducing the final goods mark-ups and would reduce market entry costs. The reforms would also lead to an improvement in skills of the labour force (e.g. by decreasing the share of low-skilled workers), and to higher labour market participation - especially among women, but also men and older workers. Finally, tax reforms would lead to a lower implicit labour tax rate and higher consumption taxes.

The results under this illustrative scenario of convergence towards the best performing Member States suggest a considerable potential impact of reforms on GDP and employment. The whole set of reforms could raise GDP by some 4% after five years and 6.6% after ten years. Employment could increase by 4% after five years and over 5% after ten years. The reforms would help to reduce imbalances, notably by facilitating the reduction in public and private indebtedness and by improving the trade balance (assuming that reforms go further than in partner countries).

Annex I - State of play of MIP relevant recommendations

Main components of CSR	Measures announced in NRP	Ddl NRP	Progress
1: Measures to improve the quality of public expenditure and taxation and the efficiency of public administration			
Improve the efficiency and quality of public expenditure at all levels of government, and conduct a systematic review of major spending items by March 2014.			20/09/2013: Adopted Royal Decree for the rationalisation of the public sector.
Increase the cost-effectiveness of the health-care sector, while maintaining accessibility for vulnerable groups, for example by reducing hospital pharmaceutical spending, strengthening coordination across types of care and improving incentives for an efficient use of resources.	The measures include the review of the design of the basket of services, together with the co-payment schemes for some services, continued reform of reference pricing of pharmaceuticals, development of the new platform for centralised health procurement, development of a digital clinical record for patients, deployment of the electronic prescription system, other improvements regarding a more participative model of health management.	2013	30/07/2013: Signature of the Pact for the Sustainability and Quality of the National Health System. 30/08/2013: The Ministry of Health publishes a press note on the savings allowed by the co-payment in pharmaceutical expenditure (2,125 million euro in the last 13 months). 20/09/2013: Adoption by the Government of a Royal Decree which modifies the regulation of 2004 on the personal healthcare card (to allow its use in all the regions).
Adopt the dis-indexation law to reduce the degree of price inertia in public expenditures and revenues, in time to have it in force by the beginning of 2014 and consider additional steps to limit the application of indexation clauses.	Law of dis-indexation	Draft proposal in May 2013. The objective is to have it in force in 2014.	27/09/2013. Council of Ministers adopts the first draft of the dis-indexation law. Parliamentary approval of the law is expected for January 2014.
Finalise by end-2013 the regulation of the sustainability factor so as to ensure the long-term financial stability of the pension system, including by increasing the effective retirement age by aligning retirement age or pension benefits to changes in life expectancy.	Alignment of legal and real retirement age and regulation of sustainability factor for pensions. Together with this, the sustainability factor for pensions, generically introduced by Law 27/2011 will be regulated.	1st half 2013: Sustainability Expert Group to put forward its conclusions to the Toledo Pact. Before the end of 2013: adoption of a draft Law by the Government.	03/2013: Royal Decree Law on early and partial retirement. 7/06/2013: The independent experts report is sent to the Parliament (Toledo Pact). The Government should adopt a draft Law before the end of the year. 2/08/2013: Royal Decree Law 11/2013 on the social protection of part-time workers. 27/09/2013: The Government approved the draft law on the regulation of the sustainability of pensions, and sent it to the Parliament.
Conduct a systematic review of the tax system by March 2014.			1/7/2013: Creation of an independent experts' group to inform the review of the tax system.
Consider further limiting tax expenditure in direct taxation,	Measures adopted in 2012 will have full impact on 2013: The bias of housing taxation in favour of ownership and against rental has been addressed. Wealth taxation, initially envisaged for 2011 and 2012, has been extended to 2013 (thus contributing to the finances of regions).	Measures adopted in 2012 will have full impact on 2013	28/06/2013: The government adopted a draft law reducing the tax deduction enjoyed by firms on unrealised losses on securities holdings (e.g. resulting from a loss of value of the equity in a foreign subsidiary).
Explore the scope to further limit the application of the reduced VAT rates and	Measures adopted in 2012 will have full impact on 2013: corporate taxation (reduction of deductions and new limits to deduct financial expenses).	Measures adopted in 2012 will have full impact on 2013	

take additional steps in environmental taxation, notably as regards excise duties fuel taxes.			28/06/2013: The government adopted a draft law introducing a new environmental tax on the use of fluorocarbon greenhouse gases (e.g. used in air conditioning or some industrial applications), to be imposed from 2014. 28/06/2013: Royal Decree Law 7/2013, increasing excise duties on alcohol (beer and wine excluded) and tobacco.
Intensify the fight against the shadow economy and undeclared work.	Law 7/2012 modifying the budgetary and tax frameworks Reinforcement of the activities against informal economy of the Spanish Tax Agency (AEAT). Creation of the National Bureau on International Taxation 2013 Plan against irregular work and Social Security fraud.	Adopted in October 2012 In 2013 (according to the 2013 Tax Control Plan) 2013 Launched in April 2012	2/08/2013: (PLMPs): Royal Decree Law 11/2013, which clarifies the competence framework of sanctioning powers of the national and regional Public Employment Services. The RDL also clarifies the requirements to be registered as a job seeker (and to renew such demand) as a prerequisite to receive and hold unemployment benefits and allowances. Moreover, the RDL qualifies as infraction the non-communication of collective measures (contract suspension of reduction of working hours) by the employer. 5/08/2013: creation of single mailbox to denounce labour fraud practices.
Adopt in line with the presented timetable the reform of the local administration and define by October 2013 a plan to enhance the efficiency of the overall public administration.	Final report with the conclusions of the Commission for the Reform of Public Administration (CORA), on the reduction and simplification of administrative barriers and duplicities. Law on Rationalisation and Sustainability of the Local Administration. After the law is fully operational (2014-2015), it will be followed by the reform of the Electoral Law, which will reduce the number of city counsellors. Law on Transparency, Access to information and Good Governance.	June 2013 To be sent to Parliament in July, and approved during Q2/Q3- 2013. 2013	21/06/2013: Report by CORA (*Comisión para la reforma de las administraciones públicas*). The report has 217 recommendations, 139 measures for the central and regional government and 78 for the central government alone. 11 of the 217 measures have a horizontal nature. A three year horizon is foreseen for their full implementation. 20/09/2013: First monitoring report of the CORA (*Comisión para la reforma de las administraciones públicas*) published. 20/09/2013: Adopted Royal Decree for the rationalisation of the public sector. 20/09/2013: Reduction of 1/3 of the public State Foundations (out of 47 public State foundations). 26/07/2013: Approval of the draft Law on local administration reform and submission to Parliament.

Adopt and implement the on-going reforms to enhance the efficiency of the judicial system.	Improvement of the efficiency of the judicial system: professionalization of judiciary has been reinforced, court fees have been reformed and extra-judiciary conflict resolution has been reinforced. A final text for the reform of the Civil Procedure Law is currently being discussed. At the end of 2013, two new projects of law will be in discussion, on the judiciary and on criminal prosecution. During 2013, a Voluntary Jurisdiction Law will be passed in order to reduce the Judges workload.	Professionalization of judiciary: Organic Law 8/2012, adopted on 27 December 2012. The extra judiciary conflict resolution has been reinforced through the Law 5/2012, of 6 July. Implementation on-going.	11/10/2012: Adoption by Government of the Draft Organic Law to reform the Criminal Code; currently pending opinion by the State Council. 11/01/2013: Adoption by Government of draft Law of Free Judicial Assistance; currently pending opinion by the State Council. 03/05/2013: Report on the draft Law on the Reform of Civil Procedure; currently pending reports from the consultative bodies (General Council of the Judiciary, General State Prosecutor, Lawyers' professional association. The CNMC published already its report: "*Informe del anteproyecto de Ley de Reforma de Enjuiciamiento Civil*".
2: Measures to foster stability of the financial sector and orderly deleveraging of the private sector			
Implement the financial sector programme for the recapitalisation of the financial institutions, including the measures promoting non-bank intermediation adopted in November 2012.	Conclusion of the restructuring and recapitalization of the banking system and the strengthening of the regulatory and supervisory framework in the context of the Financial Sector Program. SAREB will also be subject to continuous supervision by Bank of Spain to prevent deviations from its business plan. Enlargement of the funding facilities for business of the Official Institute for Credit (ICO), up to 22,000M. Other products are being implemented such as the ICO-CAF credit facility (300M), the venture capital fund of funds Fond ICO Global (up to 1,200M) , or the facility to support the creation of the alternative bond market (MARF) for SMEs (3.000M from which 1.000M in 2013). First transactions of the new MARF “Elevator Law” to ease up and down movements between the		24/05/2013: Circular 1/2013 on the enhancement of credit register endorsed by BdE (completed Measure 16 of MoU) 11/06/2013: Draft Law on *Cajas de Ahorro y Fundaciones Bancarias* adopted and put forward to Parliament. 29/07/2013: BdE approved a Policy Statement about its supervisory duties of SAREB. May-July: ICO has signed agreements with the EIB and its German counterpart KfW. In addition, ICO launched a new line of funding to support the acquisition by financial institutions notes and bonds issued by Spanish SMEs. May: adoption of regulations and circulars establishing alternative bond market (MARF), which launch is expected in November. 24/09/2013: Fond ICO Global launched the first call for tenders for the selection and

	stock market and the alternative stock market. Modification of the venture capital legal framework will take place in 2013.		investment in venture capital funds.
Take further measures to address the debt bias in corporate taxation	Reduction of 10% of SMEs reinvested benefits		19/09/2013: Law on Entrepreneurship adopted by Parliament. Measure also included in Draft 2014 Budget
By March 2014, review the effectiveness of the regulatory framework to support the development of the housing rental market.	Law on measures to increase the flexibility and foster the rental market	n/a	23/05/2013: the Parliament adopted the Law on Liberalisation and Promotion of the Rental Housing Market (Law 4/2013 of 6 June), providing more flexibility in setting the level of rents and in the eviction procedures.
Review insolvency frameworks for companies and individuals, including through limiting personal liability of entrepreneurs and easing second chances for failed businesses.	Law on entrepreneurship (for limiting personal liability of entrepreneurs and easing second chances for failed businesses and individuals) No specific measures aimed at reviewing insolvency frameworks for individuals	Parliamentary approval of the law on entrepreneurship before end-2013	14/05/2013: Law 1/2013 on measures to reinforce protection of mortgagors, debt restructuring and social rent, including provisions for a partial debt discharge and extending the application of out-of-court workouts. 19/09/2013: Law on Entrepreneurship adopted by Parliament.
3: Measures to improve the functioning of the labour market and enhance human capital			
Finalise the evaluation of the 2012 labour market reform covering the full range of its objectives and measures by July 2013,	Assessment of the impact of the 2012 labour market reform from several perspectives, such as the main labour market indicators, employment creation, unemployment reduction, and the rate of temporary jobs. An independent organism (like OECD) will review the report.	Before July 2013	2/08/2013: Council of Ministers examined the government evaluation of the impact of the labour market reform. 29/08/2013: The national evaluation was presented to the national Parliament and published.
and present amendments, if necessary, by September 2013.		n/a	29/08/2013: The Government announced an administrative simplification of the contractual forms (from the current 41 to 5, although the

			contracts will continue to exist); currently being discussed with the social partners 02/08/2013: Adoption of Royal Decree-Law 11/2013, which has introduced some modifications to the collective dismissal procedure.
Adopt the 2013 national Employment Plan by July 2013	Annual Employment Plan 2013 (the targets and measures of the 2013 Plan will be approved on the basis of the assessment of the actions developed by the regions, and the results of the assessment will determine the distribution of funding for the next period).	2013 (Q2)	2/08/2013: Council of Ministers adopted the Annual Employment Plan for 2013 (PAPE 2013) 02/08/2013: The Royal Decree Royal Decree Law 11/2013, allows for Private Public Partnerships (PPP) of the public employment services with placement agencies and introduces some modifications to the requirements to access unemployment benefits.
and enact swiftly a result-oriented reform of active labour market policies, including by strengthening the targeting and efficiency of guidance.	Pluri-annual Strategy for Employment Activation (2014-2016)	2013 (Q4)	The Government is currently finalising its "activation strategy" based on the Annual Employment Plan 2013, which has already been discussed and agreed with the regions.
Reinforce and modernise public employment services to ensure effective individualised assistance to the unemployed according to their profiles and training needs.		n/a	
Reinforce the effectiveness of re-skilling training programmes for older and low-skilled workers.		n/a	2/08/2013: The Government adopted 19 Royal Decree Laws, which establish 82 professional certificates in different levels, and corresponding to several professional categories.
Fully operationalize the Single Job Portal	Single Job Portal: a common database, for all the national territory, that will include all the training or employment offers managed by public funds.	To be fully operational in October 2013	
and speed up the implementation of public-private cooperation in placement services to ensure its effective application already in 2013.	Public-private partnership is underway in the field of labour intermediation (private agencies will be paid by insertion accomplished, according to the characteristics of the unemployed and the job)	Framework agreement to be signed by regions in the 2nd semester of 2013.	2/08/2013: The Council of Ministers adopted the framework agreement for the public-private cooperation in placement services.

Implement and monitor closely the effectiveness of the measures to fight youth unemployment set out in the Youth Entrepreneurship and Employment Strategy 2013-2016, for example through a Youth Guarantee.	National Youth Entrepreneurship and Employment Strategy 2013-2013		Youth Entrepreneurship and Employment Strategy 2013-2016 adopted in March 2013: 15 out of 85 measures are in place. The MoL will perform an annual assessment of the results of the Strategy; the first evaluation will be published in October 2013.
Continue with efforts to increase the labour market relevance of education and training, to reduce early school leaving and to enhance life-long learning, namely by expanding the application of dual vocational training beyond the current pilot phase and by introducing a comprehensive monitoring system of pupils' performance by the end of 2013.	Reform of the educational system (also with the objective of decrease early school leaving rate to 15% by 2020)	To be fully implemented in school year 2014-15	10/10/2013: Law on Quality of Education (LOMCE) adopted by the Congress and transmitted to Senate.
4: Structural measures promoting growth and competitiveness			
Urgently adopt and implement the draft Law on Market Unity and speed up all complementary actions needed for its swift implementation.	Law on market unity plus screening and adaptation of sector specific regulations	Submission to Parliament by end Q2 2013 Law to be adopted under the emergency procedure before end 2013	05/07/2013: Law adopted and submitted to Parliament.
Ensure the effectiveness, autonomy and independence of the newly created regulatory authority.	Law on Spain's new Competition Commission	Law to be adopted before end June 2013	04/06/2013: Entry into force of Law 3/2013 on the new competition authority (CNMC) 30/08/2013: Adoption of the CNMC Statute
By the end of 2013, adopt and implement the Law on professional associations and services, so as to remove any unjustified restriction to the access and exercise of professional activities,	Law on professional services	Approval of 1st draft before end June 2013 Parliamentary adoption of the law before end-2013	02/08/2013: The Government adopted the first draft law (*anteproyecto de ley*) of professional services and associations.
and the Law on Entrepreneurship.	Law on entrepreneurship	Parliamentary approval of the law before end-2013	28/09/2013: Publication and entry into force of the Law on Entrepreneurship.
Regroup and concentrate support schemes for the internationalisation of firms.			26/07/2013 Draft Law on Chambers of Commerce adopted by Government and submitted to Parliament 19/09/2013: Law on Entrepreneurship adopted by Parliament.

Reduce the number and shorten licensing procedures, including for industrial activities, and spread the use of the "express licence" approach to activities other than retail.	Law on market unity Law on the reform of local administrations Issuance of sample municipal ordinances (*ordenanza tipo*) Law on entrepreneurship (for express licence) Simplification of environmental licensing (NRP page 79) No specific measures on simplification of licensing for manufacturing activities in NRP	Submission to Parliament by end Q2 2013 Submission to Parliament in July 2013. Parliamentary approval before end-2013 n/a Parliamentary approval of the law on entrepreneurship before end-2013 n/a n/a	05/07/2013: Draft Law adopted and submitted to Parliament. 26/07/2013: Draft reform law adopted and submitted to Parliament. 28/09/2013: publication and entry into force of the Law on Entrepreneurship. 28/09/2013: publication and entry into force of the Law on Entrepreneurship. The simplification of licensing for manufacturing activities in that law covers small business only (i.e., those with surface under 500 m2).
Remove unjustifiable restrictions to the establishment of large-scale retail premises.	No specific measure in NRP	n/a	
Tackle the electricity tariff deficit by adopting and implementing a structural reform of the electricity sector by the end of 2013.	Electric tariff deficit: In 2013 the legally binding target is zero ex ante deficit. In December 2012 the Law imposing taxes on electricity generation was passed (15/2012). Royal Decree-law 2/2013 has been approved to reduce the regulated system costs and premiums for renewable generation. In March 2013 a draft Law has been passed by Government to reduce non-mainland extra costs and, as a result, the national tariff deficit. Law on the Reform of the Electricity Sector: intends to revise regulated costs (remuneration) and is another step to stabilise financially the electricity system	To be adopted by the Council of Ministers before 30 June 2013	12/07/2013: The Council of Ministers approved a Royal Decree-Law of urgent measures to guarantee the financial stability of the electricity system. The government aims to balance definitely the electrical system, prevent new imbalances and ensure supply to consumers at the lowest cost. To correct the deficit, electricity system costs will be reduced by € 2.7 billion, the State Budget will provide € 900 million and the access tariffs will rise by € 900 million. 20/09/2013: The Government adopted the draft law on the reform of the electricity sector and sent it to the national Parliament.
Intensify efforts to complete the electricity and gas interconnections with neighbouring countries.			A major electricity interconnection with France continues to be built (to be ready in 2014). Spain recently secured EIB funds for a major gas storage facility.

Reduce the contingent liability for public finances stemming from unprofitable transport infrastructure.	Reform of the 1987 Land Transport Organization Law Implementation of the Plan on airport Efficiency New Plan for Infrastructures, Transport, and Housing 2012-2024	Second quarter of 2013 In 2013 the legal framework regarding slot allocation will be completed, removing obstacles to internal market and fostering competition Draft presented in September 2012	20/09/2013: Adopted plan of dis-investment of the companies participated by Renfe (with the objective of restructuring and rationalising the public sector participation; the dis-investment plan amounts 16.9 million euros) 05/07/2013: Council of Ministers approved a plan to streamline railway passenger services (AVANT and ex-FEVE) bringing around EUR 10 million savings in 2013.
Set up an independent observatory to contribute to the assessment of future major infrastructure projects.	n/a		
Take measures to ensure effective competition in freight and passenger rail services.	Liberalisation of passenger railway transport		In July 12 (RDL 22/2012), the authorities announced liberalisation of the railway passenger services from 31 July 2013. In February 2013 (RDL 4/2013), the Government decided that competition will be applied only to the touristic services. Competition in commercial passenger services will be developed later.

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