Statement on the Fourth Financial Sector Monitoring Mission to Spain

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A staff team from the International Monetary Fund (IMF) visited Madrid September 16-30 for the fourth independent monitoring mission of the financial sector in the context of the European financial assistance for bank recapitalization, as agreed with the Spanish authorities and the European Commission (EC) on July 20, 2012 (see Terms of Reference). The team met with official and private-sector representatives and discussed its preliminary findings with the Spanish authorities and their European partners at the end of the visit. Staff will convey a final report to the authorities and the EC by mid-November.

The mission found that implementation of Spain's financial sector program remains on track. Nearly all measures specified in the program have now been implemented, as envisaged under its front-loaded timetable. Of note, capital-augmentation measures arising from last year's stress test are now essentially complete, as is SAREB's organizational development. SAREB is deploying a wide range of strategies for liquidating its assets, which it is now doing at an accelerating pace.

Actions under the program since its inception have bolstered the financial system's capital, liquidity, and efficiency. Such effects have added to key policy measures at the European level to help support improved financial market conditions and a sizeable fall in Spain's sovereign risk premium since mid-2012. These trends have continued since the last monitoring mission. Recent macroeconomic developments have also been positive, with output and unemployment stabilizing. Nonetheless, the economy is still undergoing a difficult process of correcting pre-crisis imbalances that continues to pose headwinds and risks for the economy and hence also for the financial sector.

Strong financial-sector policies will help safeguard and build upon the program's gains going forward. Priorities include measures to further enhance banks' ability to lend and support recovery:

- *Enhanced monitoring and supervision*. To ensure that banks maintain strong and transparent balance sheets, it will be essential to continue pro-active monitoring of financial sector health, with a view to identifying risks at an early stage and addressing them with prompt supervisory action when needed. Such capabilities should be enhanced by the ongoing work at the Bank of Spain to develop more rigorous forward-looking scenario exercises on bank resilience as a regular tool for informing its supervision. Thorough implementation of the ongoing review of banks' classification of refinanced loans will also be key to ensuring adequate provisioning for loan losses.
- *Maintaining sufficient capital*. To avoid exacerbating already-tight credit conditions, supervisory actions to strengthen solvency and reduce risks should continue to prioritize measures that increase nominal capital (e.g., limiting cash dividends and issuing equity) over ones that reduce lending. In this regard, the Bank of Spain's recent guidelines recommending that banks limit cash dividends to no more than 25 percent of profits are welcome. Improving the quality of bank capital by converting deferred tax assets arising from timing differences in provisioning rules into tax claims could also be helpful, but should be accompanied by actions by banks, such as those mentioned above, to further strengthen their balance sheets which, in turn, should increase their ability and incentives to provide the credit necessary to foster and assist economic recovery.
- *European policies to ease funding costs*. At the euro-wide level, further progress on banking union and additional monetary policy support would also help ease credit conditions and assist economic recovery.

Further progress on structural reforms of the financial sector is also important to promote sound governance and a more stable financial system over the longer term. A near-term priority in this regard is to adopt savings bank reform, which is a goal of the program and currently in parliament, in a timely manner and without watering down its provisions.

The fifth financial sector monitoring mission is expected to take place in December 2013.