FROB Fondo de Reestructuración Ordenada Bancaria

APPEARANCE BY THE CHAIRMAN OF THE GOVERNING COMMITTEE OF THE FROB BEFORE THE SENATE ECONOMY AND COMPETITIVENESS COMMITTEE

4 December 2013

Thank you Mr. President. Ladies and gentlemen, I thank you for this opportunity to appear for the first time before the Senate Economy and Competitiveness Committee as Chairman of the Fund for the Orderly Restructuring of the Banking Sector (FROB). I am delighted to do so, mindful of the FROB's responsibility to citizens and their representatives, and given its role in preserving such an important public good as financial stability and its management, to this end, of a very large volume of taxpayers' funds.

1. INTRODUCTION

As you know, the FROB came into being in 2009 via Royal Decree-Law 9/2009 of 26 June 2009. Its purpose is to facilitate management of the solvency and liquidity problems at certain Spanish financial institutions which emerged further to the international financial crisis that broke in 2007 and to the start of our economy's recessionary phase. The legislation equipped the FROB with various instruments to facilitate public intervention in vulnerable institutions and, specifically, the provision of assistance as part of restructuring processes.

These instruments were added to in Royal Decree-Law 2/2011 of 18 February 2011, which provided for the possibility of the FROB subscribing ordinary shares in the institutions affected.

With these tools, the FROB undertook various actions at seven banks, all of which created from savings banks, which had evidenced appreciable solvency weaknesses. Undoubtedly, these actions contributed to averting a widespread crisis of confidence in the sector.

But the deepening of the economic crisis in Spain, with a double-dip recession ensuing from the second quarter of 2011, against a background of intense turbulence on European debt markets, accentuated the weakness of a part of our financial system, while a significant deterioration in public finances became evident.

The combination of these factors led to a destabilising feedback loop between the perception of sovereign risk and banking risk, giving rise to uncertainty over the ability of Spanish public finances to ensure the stability of the banking sector.

As you will recall, the outcome of this situation saw, towards mid-2012, the yield on long-term Spanish public debt widen to stand at 630 basis points above the German benchmark bond.

This is the background to the origins of the external financial assistance programme approved by the Eurogroup on 20 July 2012. It involved making European funds available for a maximum amount of €100 billion and a Memorandum of Understanding (MoU) agreed by the Spanish and European authorities, with the participation of the IMF, that set out a strategy to strengthen our banking system.

An essential part of the strategy consisted of reinforcing the powers of the FROB so as to make the restructuring of the weakest part of our banking system possible. Specifically, further to the approval of Law 9/2012 of 14 November 2012 – which officially passed Royal Decree-Law 24/2012 of 31 August 2012 – the FROB obtained the necessary legal and operational framework to pursue the restructuring and, where appropriate, orderly resolution of credit institutions.

These regulations are among the most advanced in respect of resolution, largely stealing a march on the measures included in the draft European Directive on Bank Recovery and Resolution, which is expected to be approved shortly.

Specifically, the above-mentioned regulations equip the FROB with the commercial and administrative powers enabling it, for the attainment of a higher goal, such as the safeguarding of financial stability, to replace the Annual General Meeting or the Board of Directors of a public limited company. That paves the way for the swift adoption and implementation of resolutions such as capital increases or reductions, statutory amendments, etc.

The FROB is further enabled to implement burden-sharing exercises with a view to minimising State aid and effectively pursuing the principle whereby shareholders and creditors contribute to restructuring or resolution costs. These powers have allowed the FROB to manage bank bailouts, striking a reasonable balance between the proper protection of bank customers and the lowest possible cost to taxpayers.

The FROB should therefore be understood as a product of the economic crisis and an effective instrument for preserving financial stability at the lowest possible public cost. Its actions have been pivotal to successfully seeing through the reform of the banking system that began with the signing of the Memorandum of Understanding 18 months back.

My appearance before the Senate could not be more timely. Just a few weeks ago the Eurogroup attested to our fulfilment of the undertakings made under the programme and confirmed its finalisation in January 2014 on the basis of the assessments issued by the European Commission, the ECB and the IMF. Accordingly, I consider this is a favourable juncture to review the milestones of the reform and, in particular, those in which the FROB has been involved; to highlight the key tasks now ahead; and, finally, to discuss the effects of the process undertaken on the current situation and the outlook for the Spanish financial system.

2. THE REFORM PROGRAMME STRATEGY

The reform programme strategy essentially comprised five components.

- First, the identification of each bank's specific capital needs.

- Second, the adoption of plans to cover the capital shortfall through measures by the banks themselves and, where necessary, through public assistance.

- Third, the clean-up of the balance sheets of all vulnerable banks, through the transfer of real estate-related assets to an external asset management company.

- Fourth, the approval of bank restructuring or resolution plans with public assistance, with a view to shoring up the efficiency of viable institutions and to promoting the orderly disappearance of non-viable banks as independent institutions .

- Finally, the programme included the adoption of reforms and legal changes aimed at strengthening the banking system as a whole.

The FROB has played a prominent role throughout the process, acting always in coordination with the Ministry of Economy and Competitiveness, the Ministry of Finance and General Government, and the Banco de España.

Allow me briefly to summarise the main measures taken at each stage of the strategy, with the exception of the regulatory reform, which I consider unnecessary since the Senate has in its legislative capacity participated directly in this reform .

3. THE IDENTIFICATION OF CAPITAL NEEDS

The first step of the strategy was to identify the capital needs of Spanish banks. This was based on an exercise conducted by an external consultant and in which the four main audit firms, along with companies specialising in the valuation of real estate assets, all collaborated. The exercise was divided into two phases: first, an exhaustive review of the quality of bank assets, covering their accounting treatment; and second, a bottom-up, bank-by-bank stress test.

Despite the exercise being conducted at great speed, in scarcely three months, it was possible to meet the highest standards.

These were, namely, the broad scope of the exercise (encompassing 90% of the system), the exhaustiveness of the information used, the harshness of the macroeconomic scenarios considered and the sound governance structure, with the direct participation of national and international authorities to which the external consultants hired would regularly report.

I believe it is illustrative of the stringency of the analysis conducted that the European Central Bank should have used it as a reference for the design of its European bank valuation exercise, which must be performed before the Single Supervisory Mechanism commences its activities next year, in accordance with the recently approved Community Regulation.

As you will recall, the results of the stress test were presented in September 2012. The results revealed that the capital needs of the system as a whole, under an adverse scenario, amounted to somewhat less than €57 billion, clearly below the maximum support envisaged in the financial assistance programme. Also, almost 90% of these needs were concentrated in the four banks in which the FROB already had a majority holding at that time. As a result, the exercise revealed that the core of the Spanish financial sector (almost 80%) did not require additional capital or could obtain it without public assistance.

I believe this latter fact has not been sufficiently emphasised, i.e. the sound solvency position of most of the Spanish banking system, despite the deep-seated crisis our economy has undergone and the collapse of its real estate sector. That has marked a significant qualitative difference from the widespread banking crises undergone in other jurisdictions, which has tempered the scope of the crisis and made management of the reform process appreciably more straightforward.

4. RECAPITALISATION

Once the capital needs of each credit institution were identified, the next step on the roadmap involved recapitalising the banks that needed this.

As you know, the public assistance ultimately provided was less than the needs estimated in the stress test, owing to the capacity of banks to generate capital by their own means, the effect of the segregation of assets to Sareb and, mainly, the assumption of losses by holders of hybrid instruments (preference shares and subordinated debt), to which I shall refer later.

In conformity with Law 9/2012 and under the terms of the MoU, the recapitalisation strategy was included in the plans submitted to the Banco de España and the European Commission for their approval.

The resolution plans for the Group 1 banks – those in which the FROB had a majority stake, namely BFA/Bankia, Catalunya Banc, NCG-Banco and Banco de Valencia – were drawn up by the FROB and approved first by the Banco de España and then by the European Commission in November 2012. The plans for the Group 2 banks, i.e. banks in which the FROB had no stake and which required State aid (namely Banco Mare Nostrum, Grupo Banco Caja3, Ceiss and Liberbank), were approved in December 2012.

The public assistance finally disbursed amounted to approximately €39 billion, €36.98 billion relating to Group 1 and €1.87 billion to Group 2.

The choice of the instrument to channel this financial support – ordinary shares or convertible instruments eligible as core capital – depended on the balance sheet position of each bank. Specifically, the Group 1 institutions received the funds through the subscription of newly issued ordinary shares. They all had negative economic and accounting values and, consequently, high capital needs.

As for the four Group 2 banks, three of these received the financial support through the subscription of contingent convertible bonds (CoCos by their Spanish name), while for the fourth (BMN), the FROB underwrote a capital increase.

In all instances, the shareholders of the institutions contributed to restructuring costs, absorbing losses before the injection of public funds and withstanding a very marked dilution effect. The scope of these measures was very extensive, to the point that the savings banks which controlled the Group 1 banks that were bailed out lost their entire stake in these.

It should thus be pointed out that the public funds provided have not been used to bail out the former owners of the banks receiving support, but rather to protect bank depositors and other creditors in order to preserve the stability of the financial system.

But at this juncture we may well ask what the total cost of these measures by the public authorities has been for taxpayers in relation to the stability of the banking system. Let me attempt to answer this drawing on the detailed information that the Banco de España has published on the subject.

Under the MoU, as I stated, the full amount of public assistance required by national banks was €39 billion.

Before the MoU and from May 2009, public assistance in various forms was provided through the FROB, both under the FROB 1 programme, established by Royal Decree-Law 9/2009 of 26 June 2009, and under FROB 2, further to Royal Decree-Law 2/2011 of 18 February 2011. Overall, the public assistance afforded by these two programmes amounted to €14.4 billion. Finally, the aid provided by the Deposit Guarantee Fund for Credit Institutions in the case of Unimm, CAM and CCM totalled €7.88 billion.

In total, the overall contribution of public funds stands at approximately €61.37 billion, committed in various forms of capital since May 2009.

This figure does not take into account the volume of guarantees granted by the State to the banks, nor the contingent support in the form of asset portfolio protection schemes in certain merger processes.

The public assistance in question thus stands at a figure close to 6% of GDP. This is a very significant figure, but one which does not stand out much relative to that recorded in other European countries affected by the financial crisis. Indeed, the public assistance granted in Spain accounts for approximately 15% of the European Union total since 2008. In terms of

GDP, the aid afforded in Spain stands at a level comparable with that in the United Kingdom, Belgium, the Netherlands and Portugal, and substantially below the figure for countries such as Cyprus, Greece and Ireland.

5. INSERT: BURDEN-SHARING EXERCISES

One of the most sensitive and complex components of the reform process has been the burden-sharing exercises whereunder holders of preference shares and subordinated debt have assumed a notable portion of banks' recapitalisation costs.

As set out in the MoU, and for the purpose of easing the burden on taxpayers, following the assignment of losses to shareholders, the stipulated procedure called for the application of measures to distribute the burden among hybrid capital and subordinated debt holders, whether through voluntary or obligatory exercises.

In short, the measures implemented entailed a haircut to the face value of the securities, and their subsequent reinvestment in shares or other capital instruments. Holders of dated subordinated debt broadly had the option of choosing, as an alternative to shares, the reinvestment of their securities – after the appropriate haircut – in a senior debt product with an identical maturity to that of the subordinated instruments and a 2% coupon payable on maturity.

However, the treatment of the securities – with regard both to the haircut and to the asset offered in exchange – varied depending on the original instrument, the interest rate and the maturity date, in accordance with the requirements laid down by the European Commission.

Overall, the burden-sharing exercises have affected a total volume of €14.75 billion, which has translated into a sizeable reduction in the cost of bank recapitalisation for taxpayers.

That said, Spain’s experience has been a most singular one, in that a significant number of holders of preference shares and subordinated debt were retail investors. Specifically, 83% of the volume invested in hybrid instruments was in the hands of 611,500 retail investors at the time the exercises were executed.

This singularity, combined with the mis-selling of these instruments (as has been administratively and legally evidenced), has appreciably raised the social costs of the burden-sharing exercises and eroded the franchise value of the banks concerned.

Hence the Spanish authorities' strategy has involved, first, using all the headroom permitted by Community and national regulations to ease the burden for retail customers; and, further, providing for the restitution of damages in the case of those investors harmed by mis-selling.

This strategy has been three-pronged and entailed: i) the reduction as far as possible of the haircuts to be applied; ii) the establishment of a liquidity mechanism for investors in the

securities of unlisted institutions; and iii) the setting in place of arbitrage mechanisms as an alternative to the courts for investors presumably affected by mis-selling.

The implementation of the burden-sharing exercises involved an average haircut of 26% on the total issues of preference shares and subordinated debt by the banks that have received public support.

While this is a significant figure, it is below that applied in other countries, such as Ireland, where the haircuts on subordinated debt were over 70%, or the Netherlands.

Further, it is likely that once the future Directive on Bank Recovery and Resolution comes into force, the outstanding balances of hybrid instruments issued will, as a general rule, have to be used in their entirety to recapitalise vulnerable institutions before any injection of funds from outside the institution. .

In order that the European Commission – in compliance with the principles governing State aid – might accept more moderate haircuts than those initially envisaged, the value recoverable by investors took the form of ordinary shares eligible as top-quality capital. In the case of Bankia, for example, shares were received at a subscription price of €1.35, coming to stand in the time elapsed following their listing at a maximum price of €1.18 per share, that is to say at 87.4% of the acquisition cost.

Naturally, the type of exchange implemented proved particularly burdensome for investors in banks such as NCG Banco (NCG) and Catalunya Banc (CX), whose shares are not listed on liquid markets.

To ease this cost, a liquidity mechanism was set in place through the Deposit Guarantee Fund (DGF). Royal Decree-Law 6/2013 of 22 March empowered the DGF to acquire, at market prices, the unlisted shares arising from the obligatory exchanges of hybrid capital instruments and subordinated debt.

By virtue of this regulation, on 4 and 7 June 2013 the DGF Management Committee resolved to make a voluntary offer to purchase the shares of NCG and CX subscribed under the burden-sharing exercises, aimed exclusively at holders with retail customer status.

The deadline for acceptance of the offer was 12 July, and it was predominantly taken up. The bid for the acquisition of the shares of NCG Banco and CX was accepted by holders representing 88.3% of the shares targeted by the bid in the first case, and 97.1% in the second.

The total cost of the operation amounted to somewhat more than €1.8 billion, which will be defrayed by the sector through its contributions to the DGF. It is the DGF that will ultimately assume the risk relating to a possible depreciation of the shares acquired until the time of their disposal.

Finally, to address those cases involving mis-selling of hybrid instruments, voluntary arbitrage mechanisms have been set in place at the institutions in which the FROB has a stake and which had in the past placed these instruments with their retail customers. Arbitrage has been pursued in keeping with the principles published on 17 April 2013 by the Monitoring Committee overseeing hybrid capital and subordinated debt instruments, set up by Royal Decree-Law 6/2013 of 22 March 2013.

To date, 427,802 investors have resorted to the arbitrage processes set in motion at NCG Banco, Catalunya Banc and BFA-Bankia, which accounts for 80% of holders entitled to arbitrage, or 70% of the overall amount. In total, 144,189 investors have already received a favourable arbitral award, equivalent to 34% of the holders who have pursued this avenue.

It should be taken into account that although the process has finished at NCG, where 62% of the investors who requested arbitrage have recouped 100% of their investment as a result of the favourable outcome, the process is still ongoing at CX and Bankia, where it began later. However, the proportion of favourable awards to total requests filed already stands at 30%.

Bearing in mind the experience with NCG, it is likely that, once the processes under way are over, more than half of the retail investors may recoup their initial investment thanks to the favourable arbitral award on possible mis-selling, obtained in the arbitrage processes conducted by FROB-controlled institutions.

For the remaining retail investors, bearing in mind the aforementioned haircuts and the liquidity measures implemented, we estimate that a large majority have recouped or been able to recoup – in the form of cash or liquid shares – more than 50% of their investment, and that only a fairly small proportion will recoup less than 25%. Evidently, these figures offer little relief to those investors who feel they have been most seriously affected; however, they do illustrate that, at the very least, the measures adopted have helped alleviate a wide-ranging economic and social problem.

6. CLEAN-UP: SAREB

I shall now briefly refer to the Asset Management Company for Assets arising from Bank Restructuring (Sareb). This is a centrepiece of the banking sector reform, as it has already contributed to one of the reform's main goals: the clean-up of the balance sheets of the most vulnerable credit institutions.

Sareb came into being on 28 November 2012. Its overall objective is the management and divestment within 15 years of the assets received, seeking to maximise their value. Sareb's capital is 45%-owned by the FROB, with the rest in the hands of private institutions: 14 domestic banks, two foreign banks, four insurance companies and one electric utility.

Its own funds amount to €4.8 billion (8% of the volume of total assets), of which €1.2 billion is capital and €3.6 billion relate to two issues of contingently convertible subordinated debt that is not guaranteed and is subscribed by shareholders.

Sareb commenced operating on 31 December 2012 when the assets of the Group 1 banks (BFA-Bankia, Catalunya Banc, NCG Banco and Banco de Valencia) were transferred to it. On 28 February 2013 the company's balance sheet was completed with the transfer of the assets corresponding to the Group 2 banks (Liberbank, BMN, CEISS, Caja3). Overall, the volume transferred amounted to €50.78 billion in properties and loans intended for real estate development. Following a complex foundation stage, the company is now fully operational.

Indeed, Sareb's trading activity has progressed swiftly, disposing of real estate-related and financial assets through the three channels envisaged: sale of wholesale portfolios, sale of singular assets and retail sale through the transferring entities. Cash flow in the first half of the year amounted to €842 million, €674 million of which are from financial assets and 168 million from real estate assets. As at mid-November, the company had sold 6,500 real estate assets. In its first year, Sareb expects to post gross revenues in excess of €2 billion.

7. RESTRUCTURING AND RESOLUTION

Finally, allow me to address restructuring and resolution, the last reform component I wished to discuss.

To optimise the effectiveness of the public support provided, it is necessary in parallel to demand a reduction in the sector's capacity, through downsizing of the most vulnerable banks and merger processes that enhance the organisation of the banking industry.

Indeed, the restructuring or resolution plans of the banks that have received assistance include an average reduction in the number of offices of 35%, staff cuts of around 30% and an average contraction in balance sheets of close to 35%. Progress to date places these respective reductions at 16% in the case of branches, 17% for staff and 12% for assets.

The process runs at differing degrees of intensity depending on the volume of public assistance received by the institution and its classification as being under restructuring or resolution. The term "resolution" is confined to those processes in which the credit institution is not viable and, therefore, the full repayment of the assistance received is not foreseen. The resolution plans envisage an exit from the market as an independent institution (e.g. through a takeover by another institution) within a period of five years, by means of formulas that continue to safeguard customers and financial stability.

The term "restructuring" is strictly applied to banks that require public financial support to ensure their viability, but which have the capacity to return this financial support within the

periods envisaged for each support instrument. The restructuring of the credit institution can likewise be considered if its resolution were foreseeably to cause seriously harmful effects for the stability of the financial system.

On the basis of the foregoing criteria, Catalunya Banc, Banco de Valencia, CEISS and NCG Banco and Banco Gallego, the subsidiary of the former, were considered as institutions under resolution. For their part, BFA/Bankia, BMN, Liberbank and Caja 3 were classified as institutions under restructuring.

The FROB's strategy to date concerning the recipient banks of public assistance, and which I shall now discuss, can be encapsulated in the sale of two nationalised banks, the promotion of two corporate operations and the drive to list another institution. Moreover, four institutions remain under the control of the FROB, two of which are expected to be disposed of shortly, provided acceptable bids are received.

As regards the banks under resolution, the FROB provided for the disposal of the shares of Banco de Valencia and Banco Gallego, which were sold to Caixabank and Banco de Sabadell, respectively.

As to NCG Banco (62.75%-owned by the FROB), the formal auctioning of the bank has been recently set in train. This will in principle be a two-stage process which we expect to conclude at the end of the year.

In the case of Catalunya Banc (66%-owned by the FROB), its sale is under analysis. Once potential buyers have been identified, they will be given the necessary information so they may put forward a potential range of prices at which they would be prepared to purchase the institution. This price will determine the launch of the second phase of the process, involving the formal sale of the institution.

The third institution under resolution, Banco CEISS, which is part of one of the two corporate operations mentioned above, has been subject to a purchase bid by Unicaja. The bid is directed at the former holders of hybrid instruments of Banco CEISS who, following the burden-sharing exercise conducted by the FROB, are holders of shares and convertible securities of the bank. Following the approval by the Spanish National Securities Market Commission (CNMV) of the purchase prospectus on 26 November, these investors have 30 calendar days to accept it.

Acceptance of the bid entails forgoing any type of legal action against Unicaja Banco or Banco CEISS. Accordingly, the FROB has offered retail holders of hybrid instruments of Banco CEISS who accept the Unicaja bid the possibility of availing themselves of a mechanism to review the selling processes under which they previously acquired preference shares and subordinated debt. This mission will follow criteria equivalent to those used in the arbitrage conducted at NCG, CX and Bankia. Consequently, this mechanism averts the harm that acceptance of the bid would entail for CEISS retail investors – in relation to the treatment given to investors in other

institutions under resolution – while favouring the success of an operation that is sound from a prudential standpoint and provides for the saving of an appreciable volume of public funds.

As regards institutions under restructuring, in two of these, namely Bankia and BMN, the FROB is the majority shareholder, since public assistance was routed through capital injections. In both cases, the FROB is not expected to divest in the short term, since the two institutions are following the road map laid down, with effective management systems that should translate into an increase in their economic value.

Indeed, in the case of Bankia (in which the FROB has a 68.4% stake through Banco Financiero y de Ahorros), its share is currently listed at €0.93, 63% up on the price of €0.57 at which it closed on 28 May, the first day on which trading in the new shares began. This followed the resolution by the Governing Committee which implemented the burden-sharing exercise and recapitalised the institution.

As regards BMN (which is 65%-owned by the FROB), the milestones of the restructuring plan have been reached, largely thanks to the sale of the network of the former Caixa Penedés to Banco de Sabadell. The plan envisages a market launch before end-2017.

The other two institutions under restructuring, namely Liberbank (which was listed last May) and Caja 3 (whose merger into Ibercaja is about to be completed), received assistance through the subscription by the FROB of contingently convertible bonds, which are expected to be redeemed under the terms established in their respective restructuring plans.

In short, the plans designed for each of the institutions that have received public assistance can be said to be satisfactorily on track. At the same time, the reordering of the Spanish banking system is moving forward, with fewer but more solvent and better managed institutions.

8. RESULTS AND CHALLENGES

It is my belief that the effort expended in implementing the reform of the Spanish banking system has appreciably strengthened the sector. And in a timely manner, too, given the major challenges to be faced in the near future. In the final part of my address I shall refer to the current situation of, and outlook for, the banking sector.

In the recent past, there has discernibly been a substantial improvement in the main indicators. Notable among these is the improved profitability of the sector as a whole, despite the slackness of activity, low interest rate levels and the persistence of an appreciable degree of fragmentation in euro area financial markets. Following the losses associated with the exceptional provisioning drive in 2012, results in 2013 have moved back into positive territory and, foreseeably, for the year as a whole, profits before provisions will stand above the levels envisaged in the scenarios of the stress tests conducted last year.

Most significant progress has been made in cleaning up banks' balance sheets and, in particular, in reducing their exposure to real estate-related risks. This has been possible thanks to stricter provisioning requirements and to the segregation of the assets transferred to Sareb by the banks that required public assistance. In fact, exposure net of provisions to real estate risks has fallen from €240 billion at end-2011 to a little over €100 billion at present.

There has also been a significant improvement in the sector's capital ratios, especially for the Group 1 and Group 2 banks, whose solvency has been reinforced not only by the financial assistance provided but also by the burden-sharing exercises.

Consequently, all the banks currently have core capital ratios of over 9%. Indeed, for the sector as a whole, this ratio will foreseeably stand at over 10% at the end of the year.

These developments have contributed to improving the perception of the soundness of the Spanish banking sector, as shown by the appreciation in the main banks' share prices since mid-2012.

The market price/book value ratio of listed Spanish banks is higher than the European average for selected banks of comparable size, which reflects improved confidence in the profit outlook for Spanish banks and in the quality of assets on their balance sheet.

Nonetheless, the progress I have mentioned should be viewed in its proper context since, as stated, the Spanish banking system still faces major challenges ahead.

These include most notably, and primarily, the weak economic situation. The Spanish economy has just overcome its second recession in less than five years, and the latest data point to a continuation of this improving trend.

Yet the intensity of the recovery is still very moderate, and will likely continue to be so in the short term, in a setting in which high debt levels, and the trend of household disposable income and wealth, will continue to bear down on private spending.

Into the medium term, the ongoing correction of the Spanish economy's main imbalances adds substance to the expectations of a sustained recovery, whose intensity will depend, among other factors, on the extent to which the reform drive is maintained.

Another of the main challenges for the Spanish economy is the continuous contraction in credit. The evidence available would suggest this is due in the main to demand-side factors, such as the deleveraging by households and firms; however, certain supply-side constraints can also be seen, such as those linked to the fragmentation of euro financial markets, which may be hampering access to credit by some solvent borrowers, especially small and medium-sized enterprises. That said, recent data show a change in the patterns observed since the start of the crisis, which is more evident in the case of firms, for which the rate of contraction of loans has tended to diminish since the summer.

The volume of doubtful assets in credit to the private sector has continued to increase, and the non-performing loans ratio, which has risen across the board for all sectors of activity, stands at close to 13% for the sector as a whole. Bearing in mind the habitual lag between the business cycle and the trend of doubtful assets, the non-performing loans ratio will foreseeably continue rising in the coming months.

Finally, the last challenge I should like to mention refers to banking sector regulatory and supervisory changes. The new Basel III capital framework, incorporated into European regulations through the Capital Requirements Directive and Regulation, will from January 2014 introduce new requirements for banks that will progressively become stricter in the coming years. The new rules pose a substantial challenge insofar as they require a significant increase in the amount of capital that will be demanded of banks and an improvement in quality, i.e. of loss-absorbing capacity. In any event, it should be underscored that Spanish banks generally have sufficient leeway to meet the new requirements.

Ordinary capital levels under the Basel III definition could stand on January 2014 at levels close to 10%, clearly above the minimum levels required.

Moreover, the Spanish banking system will have to face the challenges entailed by the move towards Banking Union in Europe. In particular, the creation of the single supervisory mechanism will require banks to adapt to the new rules, criteria and procedures for interacting with supervisors. As a prior step, Spanish banks that will in future be supervised directly by the new single mechanism – more than 90% of our banking system – will be subjected, like other significant European banks, to an exhaustive analysis that will include an asset quality review and a new stress test.

Although the details of the exercise, especially as regards the stress test, have not yet been fully defined, the Banco de España has recently developed a tool enabling it to conduct forward-looking analyses of solvency under different scenarios. The initial results, published recently in the Banco de España *Financial Stability Report*, show that the banks analysed evidence a fairly comfortable solvency position, given that their loss-absorption capacity would exceed expected losses, even under fairly adverse scenarios. These results indicate that the Spanish banking system is, following the reform and the actions undertaken by banks themselves, well-placed to meet the challenges associated with the start-up of the new European supervisory framework.

Evidently, that in no way eases the intensity which financial institutions should deploy in maintaining accounting rigorousness in respect of changes in asset quality, in implementing improvements to their efficiency and, above all, in capital preservation.

Thank you.