Letter from the Editors

The Spanish banking sector is going through an intense process of institutional and structural changes following the signing this past July of the Memorandum of Understanding (MoU) between the Spanish and European authorities for contingent financial assistance to Spanish banks. Since our last SEFO publication in September, two significant events have taken place within the sector. The first has been the publication of bank-level stress tests results and the second the creation of Spain's "bad bank" solution, the Asset Management Company called Sareb, in line with the terms of EU MoU implementation.

In this November issue of the SEFO, we focus on how these two events represent steps forward in the resolution of Spain's banking crisis and underline what remains to be done. For instance, while Spain's "bad bank" model appears to contain the necessary ingredients for an effective clean-up of Spanish banks' balance sheets, implementation issues, in particular related to governance and ownership, will be critical to its ultimate success. What is clear is that the reforms in the financial sector are now firmly on track. The path taken is in line with IMF and EU recommendations. We also compare the performance of Spain's banking sector relative to its European peers throughout the crisis through an analysis of financial soundness indicators. While the impact of the crisis years has left the Spanish banking sector in a generally weaker position in absolute and relative terms in comparison with the euro area, several strengths and improvements are evident, such as high levels of efficiency, doubtful loan provisions, and solvency ratios. We reiterate the importance of analyzing Spanish financial institutions on an individual basis, given the high degree of variation across the sector.

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Another topic addressed in this issue is the European Covered Bond market. Due to their high credit quality, large choice of maturities, vast liquidity, and solid legal framework, together with attractive capital charges for investors and a favorable treatment by the ECB, Covered Bonds have provided an important source of wholesale funding for cash-strapped peripheral issuers. This has especially been true in Spain, where *Cedulas Hipotecarias,* or Mortgage Covered Bonds, have been heavily relied upon by the Spanish banking sector during the crisis.

Another key issue in this SEFO is the future of Spain's Social Security System, which currently faces both structural and cyclical challenges. Despite the 2011 reform, which aims to tackle some of the system's shortcomings, additional measures within the system's actual parameters will likely be necessary to ensure long-term sustainability.

On the fiscal front, we look at the recently approved 2013 draft budget, as well as a description of the functioning of Spain's regional financing system. As regards the 2013 budget, the overall deficit is estimated at 4.5% of GDP, in line with the agreed upon targets at the EU level. Meeting this target depends crucially on how the economy will perform. The government's optimistic GDP forecast, liquidity injections for nationalized financial institutions, and a larger than anticipated social security deficit could have negative implications on the final deficit outcome.

As regards the region's financing model, the recent political uncertainty surrounding the existing model has produced new tensions. Nevertheless, while the system may need additional reforms, it is worth recalling that a technical model remains in place to guarantee the adequate provision of public services at the regional level.

Finally, we provide comparative macroeconomic forecasts for the Spanish economy, together with a snapshot of the latest key regulatory changes.