From the current Spanish economic situation to a European Banking Union

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What has been at stake in Spain?

Spain has experienced a housing bubble, the collapse of the savings banks, the renewable energy bubble and the bubble of the unnecessary infrastructure built with astronomical costs for the benefit of builders and to the detriment of taxpayers.

The big problem of indebtedness of the Spanish economy is in the private sector derived from the property boom, with 95% attributed to the large companies (not families). Private debt in Spain increased excessively during the housing boom during which was built half of all homes that were built in France, Germany and the UK together. This was due to the lack of international financial regulation, supervision and measures to prevent and break the bubble. But even then, the Credit Rating Agencies gave Spain the highest credit rating and foreign banks, mainly German, lent money to Spanish banks unhindered by the German banks or the ECB.

The differential deficit of Spain with the EU average (11.2% vs. 5.6% of GDP in 2009) was not caused by changes in spending, but the collapse of revenues. The crisis accelerated a process of redistribution of spending in Spain, where the Autonomous communities of Spain manage 36% of total resources, the Social Security 30%, the central government 21% and local governments the remaining 13%.

During Spain’s property bubble, politically dominated cajas (savings banks), lent massively to fund local construction project across Spain. This mix of business, regional and political interests often resulted in poor financial management that has all but ruined the Spanish savings banks, most of which are now under state control or have been sold to larger rivals. Bankia is a financial entity resulting from the merger of seven savings banks. It is the eighth nationalized bank in Spain since the start of the crisis. The mismanagement of Bankia unleashed a loss of confidence in the solvency of financial institutions as a whole and it had demonized the Bank of Spain, forcing Spain to seek the bank bailout.

Spain is the fourth member of the euro area rescued, although its assistance, being just a bank bailout to recapitalize its banks, will be softer and less interventionist. The Spanish Government requested €100,000 million to the Eurogroup on June 2012. The result of the stress tests by the American consultant Oliver Wyman announced on the 28th September that the needs of Spanish banks are €53,745 million (spread over 7 entities), nearly half of the € 100,000 million that Europe established for the rescue of Spanish banks. The Spanish government hopes that following increases in capital on behalf of institutions, only claiming to Brussels some 40,000 million.¹

The funds will be provided by the European Financial Stability Facility (EFSF) and/or European Stability Mechanism (ESM). The money will be received by the Fund for Orderly Bank Restructuring (FOBR), acting as an agent of the Spanish Government, which will channel the funds to the banking sector. The loan will have an interest rate of around 4% of the bailout. The bailout fund will inject bonds with an average refund of 12.5 years in the FOBR. The

audited entities will have to pay back the aid within two years and the rescued entities have from five to seven years.

Spanish Prime Minister, Rajoy, will not decide whether to seek help from the European rescue fund to buy Spanish debt bonds until he knows the conditions this entails. According to the Financial Times, Spain has begun to negotiate if they could use part of the bank bailout to buy Spanish sovereign debt. According to the opposition, the government is waiting until Basque and Galician elections are over on the 21st October to avoid losing votes.

### Different Eurozone Bailouts Plans

<table>
<thead>
<tr>
<th>Countries</th>
<th>Date</th>
<th>Amount</th>
<th>Refund</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greece</td>
<td>2nd May 2010</td>
<td>€110,000 million</td>
<td>For the period 2010-12</td>
</tr>
<tr>
<td></td>
<td>21st July 2011</td>
<td>€130,000 million</td>
<td>For the period 2010-12</td>
</tr>
<tr>
<td>Ireland</td>
<td>28th November 2010</td>
<td>€85,000 million</td>
<td>3 years</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(IMF gave €22,500 million)</td>
<td></td>
</tr>
<tr>
<td>Portugal</td>
<td>16th May 2011</td>
<td>€78,000€ million</td>
<td>3 years</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(€52,000 million from the EU, €26,000 million from the IMF)</td>
<td></td>
</tr>
<tr>
<td>Spain</td>
<td>Before November 2012</td>
<td>Total possible €100,000 million</td>
<td>Up to 15 years</td>
</tr>
<tr>
<td>Eurozone</td>
<td>Rescue fund of € 750,000 million for countries with debt problems only until 2013</td>
<td></td>
<td></td>
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</tbody>
</table>

Source: El País

The rescue is very different from those carried out by the governments of the United Kingdom and the USA (for them they were with their own funds and supervisory authorities were national), and also of Ireland (because the size of the rescue there was equivalent to 30% of GDP and in Spain it will be 10% of GDP).

Spain will have until 2014 to meet the deficit of 3% of GDP. This year it will have to reach 6.3% while its current deficit is 8.9%.

**Lending the Spanish Government €100 billion is going to lead to a major deterioration in Spain's public debt.** The result is that Spain has been forced to borrow at rates of over 5% in the short term and Spanish 10-year government bonds have been trading at yields above 7%, which is unsustainable in the medium term. On 6th September, the ECB has launched a new program to buy government debt unlimited "WTO: Monetary Transactions Outright" in which it will buy short-term (maximum 3 years) debt relieving the immediate pressure on States’ liquidity.

Spaniards also face the **problem of regional debt**. In August 2012 Catalonia asked the national government for more than €5 billion in emergency financing, from the Autonomic Liquidity Fund (FLA) for rescuing autonomous regions and endowed with €18,000 million, followed by the regions of Valencia and Murcia.

Spain confronts a very severe external debt problem. The best way to reduce that debt problem is by imposing losses on international and local creditors to Spanish banks.

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2 El País 8/06/2012 : http://economia.elpais.com/economia/2012/06/08/actualidad/1339143676_754077.html
What is a Banking Union?

It is said that the Spanish situation lead the European Union to the banking union. The Spanish and Irish cases prove the damage involved for sovereign and tax payers by the burden of saving its own banks and savings banks.

If a bank fails in one country, this will unfavourably affect other banks for that country, what could also mean an increase in the funding costs for other banks. Inadequate recapitalization or bad regulation in one Member State is very destructive to the others, especially inside a Monetary Union.

The current debate is if sharing sovereignty will be worth the benefits of mutualising banking policy among the member states.

The purpose of a banking union is the foundation of a shared deposit insurance scheme and a connection between the liquidity operations of a central bank and the fiscal resolutions. The incorporation of a resolution framework that focuses on the involvement of creditors and private shareholders would decrease fiscal costs remarkably.

A political challenge would be if it was formed by the Euro-zone countries to ensure the stability of the monetary union, which is urgently needed, or with all the EU countries for the integrity of the single market. If it is created with non eurozone countries a unique supervisor will have to co-exist with several deposit insurance systems in the diverse currency areas and a two-speed Europe will probably be created. This last option has more risks and incertitude and it is too ambitious for the moment.

On the liability side, deposits-to-GDP ratios of the banking systems in Europe diverge extensively from the different member states. Exclusively a complete banking union can wholly eliminate the feedback loop. A connection between banking risks and domestic sovereign could be the common deposit insurance if its breadth is broad enough to mutualise a meaningful part of the risks. For example, the Spanish saving banks were a significant fiscal risk for the country and the Eurozone having very little international business.

The economic think tank Bruegel advises in its policy contribution “What kind of European Banking Union?” how the banking union should be made up:

- **European supervision** is needed to control banks’ activities and risk taking for minimising risks to taxpayers. This is the precondition for direct ESM intervention. It is more likely to have the ECB as the supervisory authority for its expertise on liquidity conditions affecting banks than an agency that is more remote from markets. In this case it would be necessary to reduce the conflict of interest between supervisory action and monetary policy. If the ECB became the European supervisor, the augmentation of policy instruments would give a lot of power to this institution as well as political pressure.

A temporary European Banking Sector Task Force working with the ECB and other authorities would be recommended as well.
A European resolution authority with a common resolution fund should stabilise the main functions of systemic importance, especially the core intermediation functions and deposits, having access to the ESM resources. It should restructure the banks, managing their insolvency. This means that it will not be necessary to rely on intermediaries and national authorities for the Eurozone fund to intervene.

European deposit insurance centralised and financed by principally private sector contributions to protect the value of all EU bank deposits, prevent a bank run and deal with the current and future crises. The deposit insurance will be backed by governments to cover all imaginable risk scenarios. A system of partial reinsurance at the beginning would be advisable. It could be a centralised deposit insurance scheme into one single federal system or a supranational reinsurance funded by contributions from the EU countries’ governments or a European reinsurance fund with its own federal fiscal backing.

European banking regulation would help to stabilise finances preventing consumer protection and money-laundering. It reduces the exposure of governments to bail out bank creditors for banks failures and it shares the full cost of regulation among individual countries. A new institution should be created strong linked with the ESM and with some degree of direct supervisory authority. It could be the same institution in charge as well of the European deposit insurance system.

The four pillars are deeply connected. The severe interdependence between sovereign and banking crisis is one of the main problems of the Euro-zone. A banking union will break the vicious circle between sovereigns and banks and it will strengthen and stabilise the financial integration of the monetary union.

European banking union is one of the best essential factors for a prosperous creation of jobs and overcoming of the crisis, but it has to go together with a fiscal and political union.

The European Commission will make legislative proposals in September 2012 and the proposed bank and fiscal union will be discussed at the October EU Summit 2012.

The Restructuring of the Spanish Banking Sector

Spain has made efforts to enable banks to regain their ability to channel savings into investment and restore confidence in the Spanish system.

The Spanish think tank Fundación Ideas, explains in its report “Crisis financiera y rescates bancarios en Europa: Ideas sobre el caso español” the six stages have been implemented in the process of restructuring from 2008 to the application of rescue in June 2012:

2) Creation of the Fund for Orderly Bank Restructuring (FOBR) and financial support of fusion processes that increased efficiency of banks as its capitalization in 9/2009
3) Modification of the legal regime of the savings banks in 2010
4) Strengthening the financial system with the socialist government in 2/2011
5) Reorganisation of the financial sector with the Popular Party in 2/2012
6) Reorganisation and sale of real estate assets in the financial sector on 11th May 2012

The reorganisation of the Spanish financial system, which started with the creation of the FOBR, has reduced the 45 savings banks that existed in 2009 to 11 saving banks in June 2012, solving one of the major structural problems in the sector: its high fragmentation. The total cost of the reorganisation process of the Spanish financial sector until March 2012 according to the IMF has been of €140,400 million.

The central problem of the financial system is in the low capitalization of most of the financial institutions to absorb the necessary reorganisation to organise balance sheets and allow ordered restitution of credit flow.

Spanish banks fall under Spanish law and jurisdiction and that cannot be easily changed. The EU does not have the authority to do bank resolution and it would take years until the indispensable practical and legal challenges can be overcome. However there is a de facto moving control of the financial system and banks to the Commission (with ECB, EBA and IMF). The Commission will exercise strong conditionality on policy actions taken on banks. The resolution authority should have the jurisdiction to impose losses on creditors to guarantee that taxpayers are not the only ones to share the burden of restructuring.

**Conditions of Spain's bank rescue**

The Spanish Government requested €100,000 million from the Eurogroup on June 9, 2012. The consultant Oliver Wyman estimated that €53,745 million was required to clean up the Spanish banks. The funds will be provided by the EFSF and/or the ESM. The funds will be received by the FOBR, acting as an agent of the Spanish Government, which will channel these funds to the banking sector in the form of pure capital or through Contingent Convertible Bonds (CoCos).

In the last EU Summit of 28-29 June 2012 leaders approved direct recapitalization of banks by European funds without going through the state. This release of liability to the public sector will not occur until a single banking supervisor is approved (not before 2013), for the time being the funding must go through the state. The aid program will be overseen by the ECB, the European Commission, the European Banking Authority (EBA) and the International Monetary Fund (IMF).

The 14 Spanish financial groups will be divided into four groups:

1) Banks that do not need capital (the main ones are Santander, BBVA and La Caixa)

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3 CoCos: A convertible bond in which the price of the underlying stock must reach a certain level before conversion is allowed. All convertible bonds have a conversion price, that is, the price one pays in order to exchange the bonds for stocks. Contingent convertible bonds, however, have a second, higher price that the underlying stock must meet before a bondholder is allowed to convert.
2) Nationalised banks like BFA-Bankia, Caixa Catalunya, Banco de Valencia and Novacaixagalicia. The restructuring plans began in July 2012.

3) Those which need capital and cannot get in the market. The restructuring plans will begin before November 2012.

4) Banks that need capital but have the means to access it without public aid. If they need more than 2% of the stress tests, they will make a shot to the FOBR through CoCos. If they need less than 2% of its stress tests, they will be required to recapitalise before June 30, 2013.

The Eurogroup establishes conditionalities in the banking sector and macroeconomic policies.

The financial sector is establishing special conditions for entities receiving aid as:

- Restrictions on dividend policy.
- A bail-in (share of subordinated debt and hybrid capital in the takeover of losses).
- Asset sales (to improve the position of leverage and liquidity).
- Control of remuneration policies.

In addition there is also the requirement for core capital ratio of 9% for the sector (at least until January 2013).

**Macroeconomic conditions** involve increasing the cuts, austerity measures to achieve the budget requirements. Several were already advised by the European Commission on May 2012.

The Spanish government (PP) announced on July 13th, 2012, the **additional fiscal measures worth €56.440 million**. These measures are the increase of value added tax (VAT) and excise environment, removing the deduction for housing and extra pay to officers, fewer days off officers, reducing the unemployment aid from the seventh month and the pension reform, among others. This is the largest adjustment in the history of Spanish democracy.

The following table shows the estimated impact of these measures in €billion.

<table>
<thead>
<tr>
<th></th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>VAT</td>
<td>2.30</td>
<td>10.13</td>
<td>9.67</td>
<td>22.10</td>
</tr>
<tr>
<td>Corp. Income Tax</td>
<td>2.59</td>
<td>2.45</td>
<td>2.45</td>
<td>7.49</td>
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<tr>
<td>Excise Duties</td>
<td>-0.06</td>
<td>0.39</td>
<td>0.39</td>
<td>0.73</td>
</tr>
<tr>
<td>Pers. Income Tax</td>
<td>0.15</td>
<td>1.93</td>
<td>2.04</td>
<td>4.11</td>
</tr>
<tr>
<td>Additional Expenditures cuts</td>
<td>1.00</td>
<td>0.00</td>
<td>0.00</td>
<td>1.00</td>
</tr>
<tr>
<td>Public Services</td>
<td>5.43</td>
<td>1.92</td>
<td>1.87</td>
<td>9.22</td>
</tr>
<tr>
<td>Employment</td>
<td>1.90</td>
<td>5.81</td>
<td>6.05</td>
<td>13.76</td>
</tr>
<tr>
<td>Social Security</td>
<td>0.07</td>
<td>-1.15</td>
<td>-3.89</td>
<td>-4.98</td>
</tr>
<tr>
<td>Dependence Law</td>
<td>0.16</td>
<td>1.39</td>
<td>1.47</td>
<td>3.02</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>13.53</td>
<td>22.86</td>
<td>20.05</td>
<td>56.44</td>
</tr>
</tbody>
</table>

*Source: Spanish Ministry of Economy and Competitiveness. Press release for foreign media*

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The memorandum of understanding - the contract signed between the Spanish government and the European institutions to give free rein to the rescue of the banks attached to the bailout has 32 conditions. Next a summary of the conditions according to the schedule and procedure for the restructuring of the banking sector:

- **Immediate help**: the EFSF injected in July 2012, €30.000 million to the FOBR to recapitalize most troubled institutions. The rest will be pay out over the next 18 months. The deadline for the refund of the loan will be with an interest rate of 3-4% for the next 12-15 years.

- **The capital requirements will remain at high levels**: the requirement of 9% of core capital until 2014 (this can lead to problems in the flow of credit)

- **Reform of Monitoring**: involves more powers for the Bank of Spain and less to the Ministry of Economy. Spain will provide weekly data on the liquidity position of banks and deposits, and quarterly data on the situation of each entity to the ECB and other European bodies. Moreover it will be an almost complete transfer of powers of the entities which receive assistance.

- **Division by type of banks**: auditing private firms and evidence of resistance will come under the supervision of the authorities and the troika before October.

- **Only viable entities will remain**: the entities requesting public funds must demonstrate their ability to survive long term without the taxpayer’s money.

- **A bad bank will be created**: financial institutions which receive public funds should remove from their balance sheets all risky assets, valued at its long-term price and should reflect the change, taking the loss. These assets will be purchased by a bad bank which will give shares as payment guaranteed by the state. The bad bank could receive injections of European funding through the FOBR.

- **Minimizing losses to the citizens**: the banks must prohibit the payment of dividends or remuneration of hybrid capital instruments, sell stakes in non-strategic assets and give up activities outside its core business.

**Bank bailouts in Europe**

**Sweden**

From 1991 to 1993 Sweden had a strong banking crisis caused by its financial innovation and liberalization that facilitated the access to credit and thus increased the asset prices, especially in the real estate sector.

The Swedish government, in order to restore confidence in markets and curb its currency speculation, gave a blanket guarantee for all liabilities of all banks. The warranty protected all creditors except shareholders.

The key to their success was to give open-ended funding to the Bank Support Authority (independent of the Government and the Central Bank). This authority had a different deal with the entities according to their solvency.

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The private sector was forced to absorb all the losses before the government intervened. The money pumped into the financial system was recovered in 10-15 years through the sale of bad assets.

**United Kingdom**

UK had a credit crisis in August 2007. Northern Rock was the first bank nationalized in February 2008. In the summer of 2008 with the global economic downturn there was created a bank recapitalization plan acquiring shares of the Royal Bank of Scotland and Lloyds Banking Group with a state contribution of £45,000 and £20,000 million respectively. In 2009 was created the Asset Protection Plan and the British authorities decided to intervene in the Dunfermline Building Society.

The UK government created a system of credit guarantees with £250,000 million (government guarantees), a special liquidity plan with £200,000 million, an asset protection plan and a program of emergency liquidity assistance. The government demanded rescued entities to reformulate the remuneration of senior executives, implement a system to help mortgaged people with difficulties, establish a 50% tax on the bonuses that are above €30,800, disclose the number of employees who earn more than €232,000 in banks, restrict the payment of dividends, appoint independent non-executive directors and maintain 2007 levels of availability and marketing of competitively priced lending.

According to the National Audit Office the losses so far are of £12,900 million. Final losses will not be known until the public sector out of all these banks, but it is estimated to be £50,400 million.

**Ireland**

The large concentration of loans in the real estate sector and the bursting of the bubble ultimately led to the financial crisis in Ireland, with a deficit of 7.3% in 2008.

Key actions of the Irish government were adopting a security system to safeguard all deposits and liabilities and the creation of the Credit Institutions Act in October 2008 and a National Asset Management Agency (NAMA) in November 2009 to acquire toxic assets. In February 2009 the Anglo Irish Bank, Ireland’s third largest bank, was nationalized. Three major Irish banks were recapitalized: the Bank of Ireland, the Allied Irish Banks and Anglo Irish Bank. Recapitalizations were in form of preferred stock, with a requirement of remuneration for the State between 8% and 10% annually.

The Irish government demanded an increase in basic accounts aimed at socially excluded groups, to provide an additional capacity of 30% for first home loans and 10% for SMEs, to assist homeowners falling behind in the payment of the mortgage loan and create a fund €100 million to support investments to reduce carbon.

The assumed cost of the Irish government to get its banks into shape brought the country to ask the EU bailout. Ireland is the European country where the banking system represents the highest percentage of GDP, reaching 268% of GDP in 2010.
**Iceland**

In October 2008, the Icelandic government put the country's three major banks (Glitnir, Kaupthing and Landsbani, which together accounted for 85% of the Icelandic banking system) under control of the Financial Supervisory Authority (IMF).

In the process of restructuring the government divided the broken entities between domestic and international entities business and limited to the public sector to assume the losses of the banking sector and establish conditions for rebuilding the national banking system.

The restructuring program managed sustainable public finances, reduced the size of the banking system and stabilised the exchange rate.

**Germany**

In May 2009, the German government created the law of "bad banks", entities which collected the toxic assets of other private banks, regional public banks, saving banks or federal states in exchange for debt bonds by the State guarantee for a maximum of twenty years.

In June 2009 Hypo Real Estate was the first bank nationalized. In December 2009 WestLB, the first bad bank, was created with a nominal value portfolio of €85.000 million. Hypo Real Estate requested the creation of a bad bank in January 2011 with a value of €210.000 million.

However, according to the OECD statement in February 2012, one of the greatest weaknesses in Germany is its financial system. It seems that these measures have failed to reorganise completely their financial institutions.

**A growth agenda for Spain**

**Spain needs to grow in productivity.** There are grounds to grow: strong companies, human potential, competitive infrastructure and natural advantages. It should be a model of economic growth based on two sectors, the export sector and tourism as correctors of the trade balance and the services sector as the primary source of job creation (80% of the job potential is concentrated in services).

The best opportunities for growth for Spain are: accelerate the restructuring of the construction sector, ensure the infrastructure sector, expand the business services sector, increase the productivity of local services, redefine the tourism model to maintain a leading position in the worldwide and strengthen the trade balance in exported goods to make it more sustainable (increase exports in high-growth markets, advance in the differentiation of Spanish industry, promote the development of bigger and stronger enterprises and increase competitiveness in cost).
Spanish exports are growing from 2009. There was a growth of 16.8% in 2010 and a 14.8% in 2011.

**Spanish Exports 2007-2011 Million €**

![Graph showing Spanish exports from 2007 to 2011 with growth rates indicated.]

Source: Secretary of State of Commerce, Spain

Tourism is increasing in Spain, even more than last year. Spanish hotels are probably the most efficient and attractive in the world and Spanish bars and restaurants offer an excellent combination of variety and quality.

Spanish companies are at the vanguard of renewable energy in Europe. Spain accounts for 2% of world GDP and is paying 15% of the global total premium for renewable energy. This is something that Spain cannot afford, but these bonuses and privileges generate many rents captured by politicians. To finance the bonuses, companies and Spanish families pay the most expensive electricity in Europe, which is a serious loss of competitiveness for the Spanish economy.

Inditex, the multinational that owns Zara, Massimo Dutti, Bershka, Oysho, Pull and Bear, Stradivarius, Uterqüe, is the world's largest fashion group and it continues to grow.

There is also a brain drain of Spaniards that are succeeding abroad and despite the current economic situation, Spain is still one of the countries more secure and you will not see more homeless in Madrid than in London.

The keys to a new economic cycle are: improve innovative activity, promote the availability of capital for entrepreneurship, promote larger company creation (Spain has more smaller companies), support companies in their outward orientation (especially the new sources of growth such as the Asian market), ensuring access to adequate human capital at all levels (increasing vocational training is dramatically needed in Spain) and simplify regulation to

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6 CIDOB: Barcelona Centre for International Affairs. July 2012

facilitate business (according to the World Bank, Spain ranks 147 of 183 countries in terms of difficulty starting a business).

**Conclusion**

Funding from the EU should be used to implement more ambitious reform to reduce the negative effects on the whole economy of the pending reorganisation.

The Spanish bank bailout will not be enough if the recession is prolonged in the coming years and if the Government is not committed to growth policies to rebalance adjustments and minimize social costs. Without stimulus the public sector will not be able to fulfill the deficit targets, which will require further tightening policies of fiscal consolidation, which in turn will deepen the recession and difficulties in the banking sector.

**Spain needs to regain the confidence of the financial markets.**

The Spanish government confuses reforms with cuts and tax increases. In this crisis the biggest adjustment in Spain has occurred in the low-income households, through the direct impact of the cuts in benefits and services or by the decrease in production and employment derived from public spending cuts. **Austerity measures are not working in any country, and are worsening the situation, increasing social differences.**

As it was written in the Financial Times by Wolfgang Münchau “We require a banking union for Spain, a fiscal union for Italy and a political union for Germany”. A banking union will break the vicious circle between sovereigns and banks, it is one of the best essential factors for a prosperous creation of jobs and overcoming of the crisis and it will strengthen and stabilise the financial integration of the monetary union.
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