Final
Assessment[1] of Spain's eligibility for an EFSF/ESM loan to recapitalize certain financial institutions

Background

On 25 June 2012, the Spanish Government applied for external financial assistance in the context of the ongoing restructuring and recapitalization of the Spanish banking sector. The assistance of up to EUR 100 billion, pursuant to the Eurogroup statement on Spain of 9 June 2012, is sought under the terms of the Financial Assistance for the Recapitalisation of Financial Institutions of the European Financial Stability Facility (EFSF). It could be subsequently taken over by the European Stability Mechanism (ESM) once this institution is fully operational. The purpose of the assistance is two-fold: (1) provide the necessary resources to recapitalise certain financial institutions in distress and (2) ensure a financial backstop for a system-wide clean-up of legacy assets in the banking sector via liability management schemes and bank resolution. Both actions will facilitate the sovereign's access to market financing at sustainable yields and an orderly deleveraging of the banking sector while maintaining the flow of credit to the real economy.

Pursuant to the "EFSF Guideline on Recapitalisation of Financial Institutions (FIs) via loans to non-programme countries", this document provides an independent assessment by the European Commission (EC) in liaison with the European Central Bank (ECB) and the European Banking Authority (EBA) and IMF of the eligibility of Spain's request. The assessment is underpinned by the results of a top-down stress test carried out by two consultancy firms (Oliver Wyman and Roland Berger) published on 21 June 2012, as a first step in determining Spain's degree of financial sector viability and financial needs for further sector restructuring, as well as identifying viable institutions that may require public support.

1. Assessment of the origin and degree of distress of the concerned financial institutions

The distress of the concerned financial institutions originates in the overall vulnerability of the Spanish financial sector following the burst as of 2008 of a real estate bubble that had built up in Spain over several years. Over-reliance on wholesale funding in an environment of high global liquidity and low interest rates and lack of sufficient action by the supervisory authority led to excess leveraging and exposure to the construction and real estate sectors. The Spanish banking sector weathered relatively well the onset of the global financial crisis, due to its relatively high capital buffers, the benign macroeconomic environment and the low exposure to derivatives markets. However, many banks lost access to the wholesale funding markets as uncertainty started to spill over and, simultaneously, the Spanish real state bubble burst. Following the collapse of the construction sector, the economy moved into recession, and unemployment soared. Meanwhile, asset quality deteriorated significantly as the ratio of non-performing loans surged (8.7% of total loans in April 2012), and the reliance of banks on ECB funding

[1] Joint report provided by the Commission, in liaison with the ECB, EBA and IMF.

has reached historical levels (i.e. roughly 11% of total assets). The exposure of the financial system to the construction and real estate sector was about 40% of GDP in December 2011 with around 20% of the loans non-performing.

The crisis has mainly impacted the majority of former savings banks, which were heavily exposed to the real estate and construction sector and, in general, had a business model characterised by a strong business concentration on the domestic market. In addition, due to the savings banks regulation, their ability to raise external equity capital was very limited, especially at the beginning of the crisis.

Although the savings banks sector has been partially restructured via downsizing, mergers and acquisitions, regulatory changes and government interventions, some of the resulting entities (now commercial banks) are too weak to deal with the potential losses stemming from the valuation of their stock of legacy assets, the new provisioning requirements and the consequences of a recessionary economy on the quality of their credit portfolios. Hence, a more radical overhaul of the system is needed.

2. Assessment of the need to urgently restore their long-run viability

Credible restructuring and recapitalisation plans have to be implemented in the concerned financial institutions in line with competition rules, in order to restore their long-run viability provided that they are systemically important or, otherwise, to ensure their orderly resolution. This would bring back confidence in the Spanish banking sector as a whole and in the sovereign and avoid a potential lock out of the stronger banks from the wholesale funding market. The coexistence of the distressed banks with the sound part of the financial sector poses a serious risk of contagion. This can happen either directly via asset impairment of the sound banks or by limiting access to wholesale funding.

At this stage of the crisis, the interconnection between sovereign risk and the banking system has increased significantly leading to a risk of negative feedback loops. Recently, the yields of the 10-year Spanish sovereign bonds have reached levels above 7% on the secondary market. This signals the need for a rapid restructuring of distressed financial institutions in order to restore access to market funding at reasonable cost both for the banking system and the sovereign. The sooner the cleaning-up and restructuring of the banking sector take place, the faster lending to the economy will resume, thus supporting the recovery from the recession.

3. Assessment of the systemic relevance of the concerned financial institutions

The Spanish financial sector is dominated by banks, which are large relative to the economy. The total assets of the banking sector (excluding foreign branches) amount to about 320% of GDP, pointing to the systemic relevance of the Spanish banking sector for the euro area financial sector. Taken individually, while the (former) saving banks could hardly be classified as systemically relevant on the basis of the criteria size, interconnectedness (with other banks) and substitutability, the disorderly default (as opposed to a recapitalisation or an orderly restructuring / wind-down) of a medium-sized Spanish bank would threaten the financial stability in Spain and possibly - through contagion - beyond. Moreover, taken together, the (former) saving banks hold about 41% of the total Spanish assets and thus if several of them need to be resolved

simultaneously, they can play a systemic role for the stability of the whole financial sector in Spain and beyond.

It should be stressed that the situation of the Spanish banking sector can entail potential risks for other EU and particularly euro area countries, if vulnerabilities are not resolved properly and timely. Countries that have large exposures of their banking sectors to Spanish assets, such as the UK, Germany and France can be directly impacted. Moreover, a potential bank run on the deposits of the Spanish banking sector could also spread quickly to other euro area members. Finally, developments on Spanish sovereign bonds can also impact on other euro area sovereigns due to the increased correlation between sovereigns.

4. Assessment of the respect of the pecking-order for the provision of the support

From the beginning of the crisis, authorities have embarked on a reform of the Spanish financial sector financed by both private and public resources.

The savings banks were restructured through several mergers and acquisitions and, as a consequence, their number was reduced from 45 in June 2010 to 11 in March 2012. In February 2011, the Spanish authorities raised the minimum capital ratio requirement ("capital principal") to 8% of banks' risk weighted assets and gave banks until September 2011 to comply with this new regulation. The larger Spanish banks have strengthened their capital base under the EBA's Recapitalisation Recommendation to reach 9%, after a sovereign buffer, by June 2012. For banks more dependent on wholesale funding and characterized by a limited market access the minimum capital ratio was increased to 10%. In February and May 2012, new legislation required banks to build higher provisions and capital buffers against possible losses on both performing and non-performing loans on the legacy stock of construction and real estate assets. The overall volume of expected new provisioning requirements will amount to approximately EUR 84 billion.

The involvement of the private sector in the process of restructuring has taken place through the Deposit Guarantee Fund (FGD), which contributed to the funding of FROB (EUR 2.25 billion) and restructuring of three distressed institutions in the form of capital injections and asset protection schemes (EUR 7.5 billion). The total industry involvement could increase up to EUR 34 billion if the asset protection schemes are fully called. At the current juncture, the capacity of parts of the banking sector to cover additional capital shortfalls through private sector solutions has become very limited.

The total gross financial contribution by the Spanish State (excluding bond issuance guarantees) amounted to about EUR 34 billion (3.2% of GDP) as of April 2012. The capital support was provided via the Fund for Orderly Bank Restructuring (FROB) endowed with a capital of EUR 15 billion, of which EUR 9 billion were already paid in[2]. As the FROB has been capitalized mostly with government bonds, the value of the capital actually available is subject to market fluctuations. FROB has a leverage capacity of three times its capital allocation, which can be increased up to six times and

[2] EUR 6,750 million were contributed by the State Budget and EUR 2,250 million by the Deposit Guarantee Fund when the FROB was set up. Additional EUR 6 billion were committed through the Royal Decree Law 2/2012, but have not yet been disbursed.

benefits by a sovereign guarantee for its debt issuance[3]. The State has also provided guarantees to bank senior bond issues amounting to about EUR 86 billion (out of this total, about EUR 58 billion guarantees are outstanding). In May 2012, the State accepted the conversion of preferential shares subscribed by the FROB in BFA (the parent undertaking of Bankia) (around EUR 4.5 billion) into ordinary shares, taking control over BFA-Bankia, the fourth largest bank. Following the review of the bank's balance sheet, the new management of BFA-Bankia requested an additional capital injection from the Spanish government (EUR 19 billion), raising the total required public sector involvement to EUR 23.5 billion.

Although the FROB still has a remaining funding capacity of about EUR 27 billion (as of April 2012), the authorities' request for financial assistance from the EFSF/ESM is justified by the need to put in place a sufficiently large backstop for conducting the system-wide clean-up of the banking sector. In addition, the EFSF/ESM financing would come at a more favourable cost, thus alleviating the market pressure for the sovereign and strengthening its debt sustainability.

Injecting EFSF/ESM funds into individual private sector banks will be conditional on contributions of the respective bank’s shareholders and (subordinated) bondholders to the cost of the restructuring, as the recapitalisation will be done according to the EU State aid rules and EFSF Guidelines. This requires an adequate burden sharing by shareholders and other private creditors and the Spanish authorities will be requested to facilitate this burden sharing by urgently implementing an adequate resolutionframework.

5. Assessment of the impact of the loan on the fiscal situation of Spain

Given the sharp deterioration in the public finances following the reversal of the housing and construction boom and the severe decline in economic activity, the general government deficit has exceeded the reference value under the EDP since 2009. Spain is currently under EDP and has a deadline for correction of the excessive deficit of 2013. So far, Spain has taken effective action under the EDP. Nevertheless, due to unexpectedly weak revenues and the deterioration in the economic outlook since the EDP recommendation was issued in December 2009, correction of the excessive deficit by 2013 no longer appears feasible. The Commission is currently preparing a proposal for extending the deadline for correction of the excessive deficit by one year, which appears warranted given these adverse developments.

According to the March 2012 EDP notification, the general government deficit reached 8.5% of GDP in 2011, down from 9.3% in 2010. In keeping with the Commission services' spring 2012 forecast (under the usual no-policy change assumption), it is projected to reach 6.4% in 2012 and 6.3% in 2013. General government debt rose to 68.5% of GDP in 2011, and according to the Commission’s 2012 spring forecast it is expected to reach 80.9% of GDP in 2012 and 87.0% in 2013. A large part of the projected increase in debt in 2012 is due to the plan to finance arrears with suppliers of regional and local government.

[3] A state guarantee of up to EUR 27 billion was already granted.

The EFSF/ESM loan would further increase Spain's government gross debt level, but at the same time should facilitate access to financial markets at better funding conditions not only for the banking sector but also the sovereign. If this is the case, the impact on debt sustainability should remain manageable also given Spain's still below euro area average debt ratio and provided that substantial fiscal consolidation is delivered. However, there is still a relative lack of detail embedded in fiscal adjustment plans for 2013 and beyond and the fiscal framework needs improvement. At this point, the exact size of the loan and important details, including the interest rate and maturity, are unknown. Nevertheless, Spain appears to have a sufficient capacity to reimburse the loan granted based on the assumption that borrowing costs fall from the current high levels and the medium-term fiscal targets are achieved.

Conclusion

In conclusion, Spain fulfils the eligibility conditions for obtaining a recapitalisation loan from the EFSF/ESM:

- There is an urgent need to de-risk, recapitalise and restructure, in line with EU State aid rules, parts of the Spanish banking sector that could otherwise have a serious systemic impact on other parts of the Spanish financial sector and other Member States of the euro area. In this context, the Spanish authorities will be requested to perform a system-wide clean-up of legacy assets in the banking sector.

- Spain has followed the required hierarchy of actions to restructure its banking sector, trying to mitigate contagion and systemic risk. The contribution by the private sector to the resolution of the crisis came primarily via the financial contribution of the Deposit Guarantee Fund and the private mergers and acquisitions. Injecting EFSF/ESM funds into individual banks will be conditional on contributions to the cost of the restructuring of the banks' shareholders and (subordinated) bondholders, as the recapitalisation will be done according to the EU State aid rules and EFSF Guidelines. This requires an adequate burden sharing by shareholders and other private creditors and the Spanish authorities will be requested to facilitate this burden sharing by urgently implementing an adequate resolution framework.

- The government has also intervened either directly by providing funds for bank recapitalisation or indirectly by issuing funding guarantees and other liquidity support. However, the capacity of the FROB to act as a national public backstop facility is facing constraints given the increasing costs of issuing new debt and also the sovereign started to face serious challenges in issuing debt at sustainable costs. Spain is thus no longer in a position to address this problem alone, in particular as it seeks a system-wide clean-up of the balance sheet of banks and the economy has entered a recessionary phase.

- The EFSF/ESM loan would further increase Spain's public debt, but at the same time should facilitate access to financial markets at better funding conditions for the sovereign. If this is the case, its impact on Spanish debt sustainability should remain manageable given Spain's below euro area average debt ratio and provided that substantial fiscal consolidation is delivered. Therefore, Spain appears to have a sufficient capacity to reimburse the loan granted based on the assumption that borrowing costs fall from the current high levels.