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THE SPANISH BAIL-OUT BACKGROUND AND FAQ'S

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INTRODUCTION

In the history of the Eurozone crisis, Spain has been a special case. It was always the “teachers pet” when it came to sovereign debt, that is, until recently. On 9 June 2012, Spain received an offer of up to EUR 100 bn in financial support from the EU for its ailing banking sector. What does that mean for Spain and the rest of the Eurozone and how did Europe’s fourth-largest economy find itself in this state?

BACKGROUND

Spain has been unlucky in many respects. Its story is a different one from Portugal’s and Greece’s although somewhat similar to Ireland’s in its origins.

Spain’s economy grew rapidly after it joined the Euro, mainly founded on a property bubble which caused house prices to rise¹, the size of mortgages to increase and the construction sector to boom, which contributed around 18% to GDP. Its economy grew, on average by 3.7% per year between 1999 and 2007. Up until the eve of 2008, Spain’s borrowing was zero; it ran a balanced budget.

Unlike many other ailing Eurozone economies, Spain’s problems lie within the private sector and not in the public sector. In fact, Spain’s public spending was only 68.5% of GDP last year, lower than that of Germany. However, take public and private debt² as an aggregate and we see Spain’s debt ratio jump dramatically, in some expert estimations, to around 90% of GDP.

When the housing bubble burst in 2008, the construction sector collapsed and put millions out of work. This led to (i) a massive increase in social security payments (ii) a sharp decrease in available funds through loss of tax revenues and (iii) and Spanish banks finding themselves saddled with billions in bad housing loans and unsellable assets. Spain needed to borrow money from the international markets to meet its spending needs and the Spanish banking system began to deteriorate.

The ensuing credit crunch, followed by the general economic downturn within the Eurozone over the last 5 years, has served to exacerbate Spain’s position. Its budget deficit is currently 8.9% of GDP, 5.9% higher than the rate tolerated under EU rules. Even with the extra year it has recently been granted to bring the deficit down, it will struggle to do so without austerity biting sharply. Spain is currently in its second recession in three years and its economy is expected to shrink 1.7% this year. Previous Eurozone bail-outs, the sheer size of Spain’s economy (over twice the size of Greece, Ireland and Portugal together), its acute economic problems and its rising bond yields³, dangerously close to the 7% mark⁴, left the markets feeling nervous about whether Spain can service its growing pile of debt.

“Portuguese Law Firm of the Year”
Chambers European Excellence Awards, 2009, 2012/ Who’s Who Legal Awards, 2006, 2008, 2009, 2010, 2011/The Lawyer European Awards-Shortlisted, 2010, 2011

“Best Portuguese Law Firm for Client Service”
Clients Choice Award - International Law Office, 2008, 2010

“5^a Most Innovative Law Firm in Continental Europe”
Financial Times – Innovative Lawyers Awards, 2011

“Corporate Law Firm of the Year - Southern Europe”
ACQ Finance Magazine, 2009

“Best Portuguese Tax Firm of the Year”
International Tax Review - Tax Awards 2006, 2008

Mind Leaders Awards™
Human Resources Suppliers 2007

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¹ According to the Spanish ministry of housing data, house prices rose 44% between 2004 and 2008. They have since fallen by 25%.

² Private sector debt is currently estimated at EUR 1 trillion

³ 10-year bonds

⁴ 7% yield on 10-year bonds is deemed, by experts, the point at which debt is unsustainable and the mark at which Portugal, Ireland and Greece all asked for financial assistance. Although, it should be noted that Italy hit the 7% mark last year but survived without needing to ask for a bail-out.

THE SPANISH BAIL-OUT

WHAT'S WRONG WITH SPAIN?

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SPAIN'S BANKS

General

Spain's banks had been thriving during the property boom. However, its collapse caused large scale defaults from borrowers who suddenly found themselves bankrupt. The value of the assets, property, on which the loans were based, plummeted and the banks found themselves now, not only saddled with bad or 'toxic' loans, but also with devalued assets that were hard to sell.

The situation was made worse by the fact that most banks, rather than using saver's deposits, had actually borrowed money on the international markets to lend to developers and home-buyers. This is considered a much riskier strategy by experts as these borrowed amounts need to be serviced even if the underlying property loan defaults.

Bankia

Spain started to restructure its financial sector. Merging many of the smaller, weaker banks to try and contain and manage the problem.

In December 2010, Bankia was created as a consolidation of seven regional banks. Bankia was initially owned by holding company Banco Financiero y de Ahorros (BFA) and the seven regional banks, in turn, controlled BFA. The most toxic assets from these regional banks were transferred to BFA, which received EUR 4.5 bn from the Spanish government rescue fund FROB⁵ in exchange for convertible preference shares with an annual interest rate of 7.75%, maturing in 2015. As well on 20 July 2011, Bankia was floated on the stock exchange allowing the public to buy its shares as well. The creation of Bankia, made it the third-largest tender in Spain. At the same time, it was also the largest holder of real estate assets with an estimated worth in the region of EUR 38 bn.

On 10 May 2012, the Spanish government announced that, due to the size of the potential hidden losses (of toxic loans) on Bankia's books, it was converting its preference shares in BFA into voting shares, giving it a controlling stake of 45% in Bankia, indicating to the public the seriousness of Bankia's situation and worrying the financial markets as to the degree of financial difficulties Spain now actually found itself in.

On 25 May, Bankia announced it would need a further EUR 19 bn to recapitalise (on top of the EUR 4.5 bn already spent, the IPO and the partial nationalisation). Bankia also revised its earnings statement for 2011, stating that instead of a profit of EUR 309 mn, it had in fact lost EUR 4.3 bn before taxes and asked for EUR 1.4 bn fiscal credit to reduce its loss. In response Standard & Poor downgraded its rating to junk status.

Banking Sector Losses

The exact amount of the losses the Spanish banks are sitting on is not yet known and is the subject of two independent audits which are due to be completed on 21 June 2012. The IMF recently estimated the amount at EUR 40 bn. Fitch Ratings puts it between EUR 60 bn and EUR 100 bn. Some experts believe the actual amount may even be close to EUR 180 bn. To put those numbers in perspective: Spain's budget for 2012 - considered the most austere in 30 years - included tax rises and spending cuts worth EUR 27 bn; not enough to cover even the lower end of the estimates.

With Spain's financial and economic situation deteriorating and its bond-yields rising, it has been struggling to find funds in the market at reasonable rates to keep its finances going. The news that its banking sector needed such a potentially huge cash injection to keep it on its feet, caused the markets, Eurozone leaders and ultimately the Spanish government to look at how they were going to find those funds.

The Spanish Bail-Out (Lite)

On 9 June 2012, the Spanish government conceded to global pressure to accept financial assistance in order to recapitalise its banking sector. It accepted an offer of up to EUR 100 bn of funds which it will draw on once the actual amount of the banking sector losses is known⁶.

⁵ Fondo de reestructuración ordenada bancaria (FROB) - in English, Fund for Orderly Bank Restructuring. It is an agent of the Spanish government.

⁶ Subject to the two independent audits due to be finalised on 21 June 2012.

Spain will present its formal request soon, most likely once it has received the results of its banking sector audit or, at least, any request will likely be conditional upon those results.

You can download a copy of the full official statement from the Eurogroup dated 9 June 2012 here: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/130778.pdf.

The terms of the bail-out are yet to be fully agreed but, according to the statement they will focus on “specific reforms targeting the financial sector, including restructuring plans in line with EU state-aid rules. Spain will present its formal request soon, most likely once it has received the results of its banking sector audit or, at least, any request will likely be conditional upon those results. The IMF will not provide any of the funds, but, instead, it will help monitor the situation. The funds will, most likely, be routed through the FROB, which means that the loan costs will be borne by the government and added to the Spanish debt pile, potentially increasing the debt to GDP ratio by as much as 9 percentage points on top of an already large increase from 68.5% last year, to a predicted 80% for this year.

Due to the fact that the funds are intended solely for the recapitalisation of its banks and that the loan will not be a “full” Troika loan and subject to the stringent financial discipline required under the other bail-outs, the Spanish bail-out has also been hailed as a “lite” bail-out. Nonetheless, the initial response from the markets has been positive, with analysts seeing it as a clear signal, at least, that the Eurozone is prepared to deploy the firewall “pre-emptively”.

SPANISH BAIL-OUT FAQs

1. Why now?

With the repeat Greek elections on 17 June 2012, the results of which could destabilise markets further, Eurozone leaders wanted Spain shored up. Analysts believe that the bail-out will calm the markets and buy Eurozone leaders some time. However, most agree that this is not the (beginning of the) end of the crisis.

2. What's the next step?

According to the official statement, Spain must “shortly” present a formal request, after which an assessment will be provided by the European Commission in liaison with the ECB, European Banking Authority (EBA) and the IMF. It is likely that this will happen after the results of the independent audits have been received on 21 June or any formal request made earlier, would probably be made subject to those results.

3. How much money will be provided?

The official Eurogroup statement says the loan amount must cover estimated capital requirements with an additional safety margin, and is estimated as summing up to EUR 100 bn in total. That is at the top end of the range of market estimates on the capital needs of the Spanish banks. The Eurogroup wants to make sure that the available funds would be deemed sufficient by the markets. The exact amount required will be announced by Spain when it receives the results of the two independent audits into its banking sector on 21 June 2012. In general, most experts believe the amount will be below EUR 100 bn but above EUR 75 bn to send a clear message to the markets that things are under control and to prevent solvency concerns from returning.

4. Where will the money come from?

The Eurogroup says the funds will come either from the (i) EFSF which is still active but is due to be phased out, (ii) the ESM, which is due to start in July this year, or (iii) a combination of the two. The IMF will not provide any of the money. Existing creditors would likely have a preference for the EFSF providing the money as loans from the EFSF do not have preferred creditor status, whereas ESM loans (except for countries under a programme at the signing of the ESM treaty) would be senior to outstanding government debt. If the ESM provides some, or all of the funds, there are concerns that this, in its own right, could still upset the markets enough to drive bond yields back up.

5. Why is this bail-out different from previous ones?

Spain will not enter into a ‘full’ financial programme with the Troika like Ireland, Portugal and Greece because its bail-out is aimed specifically at its banking sector and not at a public debt problem. In addition, Spain has already implemented significant reforms similar to those that would be ordered under a financial programme to get the situation under control and the Eurogroup recognises this in its statement. The conditions of the loan will, therefore, according

to the statement, be focussed on specific reforms targeting the financial sector, including restructuring plans in line with EU state-aid rules. The IMF will help monitor the reforms but will not provide any funds. This is also different from the previous bail-outs where the IMF has contributed to the amounts provided in return for strict financial discipline.

6) How will it affect Spanish sovereign debt and the financial markets?

According to the statement, the funds could be channelled through the FROB which would then inject capital into the ailing banks. As the FROB is a government agency, the amount of the bail-out loan will be added to government debt⁷. If Spain draws the maximum amount (EUR 100 bn) that could add over 9 percentage points, pushing Spain's debt to GDP ratio further towards 90%⁸. Funds will be provided at the same favourable rates which have been applied in other bail-outs. The bail-out is also expected to calm the bond markets which will, hopefully, start to push sovereign debt yield back down, making it more affordable for Spain to finance itself in the market. However, against the backdrop of the coming Greek elections, the markets will be nervous and hard to predict.

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⁷ 68.5% of GDP last year.

⁸ Currently debt to GDP ratio is estimated to grow to 80% this year; calculations here by ING's senior economist Martin van Vliet.