OBSERVATION

TD Economics

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SPAIN REQUESTS EUROPEAN BAILOUT FOR ITS BANKS

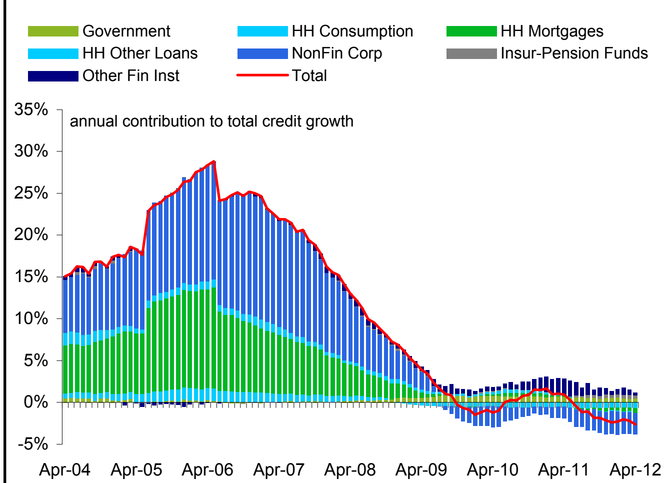
Highlights

- The Spanish government has announced its intention to request financial support to recapitalize its struggling banks.
- Euro zone finance ministers have signalled their intent to provide up to €100 billion.
- Lack of critical details on how the program will be implemented feed lingering uncertainties regarding its ultimate success.
- This loan will increase Spain's debt-to-GDP ratio, which will raise concerns about the country's debt sustainability.

The government of Spain announced on Saturday its intention to seek European financial aid to recapitalize the country's banks. A formal request should follow shortly. Euro zone finance ministers welcomed Spain's announcement and declared they stand ready to provide up to €100 billion in loans via either the European Financial Stability Facility (EFSF) or the European Stability Mechanism (ESM). Furthermore, they have also agreed to channel the funds through Spain's Fund for Orderly Bank Restructuring (FROB). Although Spanish authorities have publicly declared that this "bailout" is different from those of Greece, Ireland, and Portugal, ultimately the impact will still be borne by the sovereign, because the country will retain the full responsibility of the financial assistance. Accessing the facility for the full amount would drive Spain's debt to GDP ratio up by 10 percentage points to roughly 89% for 2012. Based on previous IMF estimates, these additional loans and their associated servicing costs would cause Spanish sovereign debt to peak at around 105% of GDP by 2017.

The €100 billion limit has been decided upon due to the IMF release of its Financial Stability Assessment for Spain, which included three stress test exercises on the Spanish banking system. Under the most severe scenario, Spanish banks would require capital injections of €37 billion. European leaders sought to overshoot this amount by a very significant margin to boost

SPAIN CREDIT GROWTH



Source: European Central Bank, TD Economics

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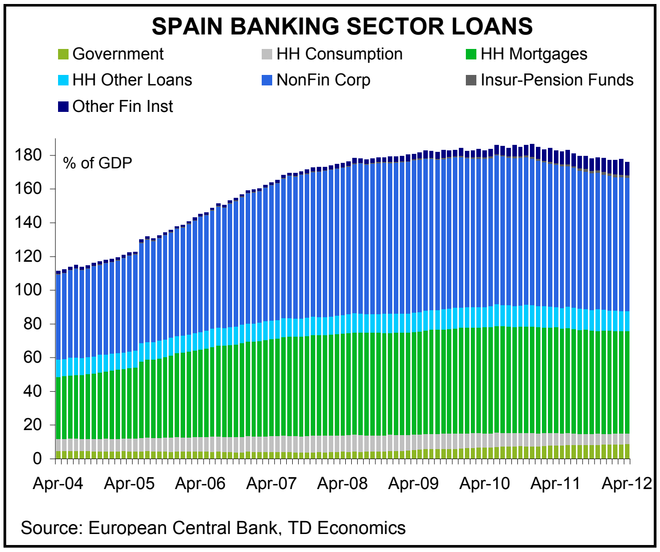

market confidence in the program. However, Spanish authorities are awaiting the results of audits being conducted by two private consultancies, which will identify capital requirements for every institution individually. This is a key element to make the official request for help to the EFSF, given that the Memorandum of Understanding has to identify those institutions that will receive recapitalization funds and the corresponding amounts. The results of these audits are scheduled to be released on June 21st. We should be mindful that there is a risk that the actual recapitalization needs differ from the initial assessment because actual macroeconomic events are likely to deviate from the assumptions used to construct the stress scenarios. In particular, these stress scenarios fail to capture the feedback loops that will likely occur between weakening banks balance sheets and real economic activity.

Although Spain's request will not subject the country to a macroeconomic adjustment program such as those signed by Greece, Ireland, and Portugal; it will still have to comply with appropriate conditionality targeted specifically to its financial institutions. In other words, the fact that the financial assistance program will be targeted to banks rather than the sovereign does not mean that the conditions attached to those loans will be significantly less stringent than those faced by the other three euro zone countries already under adjustment programs.

For instance, monitoring of compliance with institution-specific conditionality will be conducted by the European Commission. Other conditionality elements will be monitored by the Commission in liaison with the European Central Bank and the relevant European financial supervisors. This includes the right to conduct on-site inspections on an ongoing basis in any beneficiary financial institutions. Furthermore, euro zone finance ministers emphasized in their statement that they are confident that Spain will honor its commitments under the excessive deficit procedure and with regard to structural reforms, with a view to correcting macroeconomic imbalances in the framework of the European semester. Progress in these areas will be closely and regularly reviewed also in parallel with the financial assistance.

While the precise source of funding is yet to be finalized, there is a very important distinction between the loans to be provided by the EFSF from those to be provided by the ESM. The latter are senior to any other claims on the Spanish sovereign debt. This means that bondholders of those Spanish banks receiving financial support from the ESM will see their claims subordinated to the official loans. This impact is likely to be reflected in banks' bond valuations, which could circle back to increasing the capital needs of those institutions.

Perhaps more important than this is the uncertainty stemming from the fact that the ESM Treaty is still pending ratification in many euro zone countries. This will most likely have to wait until after the Greek elections on June 17th and therefore will delay the ESM becoming operational.

The other important issue is whether Spain will become a "stepping out" guarantor from the EFSF. It is not clear from the EFSF Treaty whether the same rules that apply to a country requesting a fiscal assistance program would apply to loans targeted to recapitalizing a country's banking system. This distinction is important because it could have material repercussions on the credit ratings of the remaining EFSF guarantors, which in turn could impact the credit rating of the EFSF itself. We should keep in mind that the foundational principle of the EFSF was to pool guarantees to achieve a high credit rating that would allow it to issue debt a significantly lower yields than those confronted by the countries in trouble.

Bottom Line

European leaders have once again made an announcement that lacks all the important details that would allow financial market participants to make a full assessment of its potential implications. The natural outcome is more uncertainty and a very short-lived positive initial market reaction. To be clear, this program could buy Spain and its euro zone partners valuable time to continue to deal with the crisis. However, it does not eliminate the risk of Spain losing access to the markets and being forced to request a financial assistance program for the sovereign rather than its banks. Furthermore, as we emphasized above, many political events will have to yield the right outcomes before we could see a functional program. And, this carries a significant risk, chief among them are the results of the upcoming Greek elections.

Unfortunately, even if all the political risks abate, Spain's macroeconomic backdrop does not offer much support, as the economic recession and high unemployment rates will make the private deleveraging process longer and costlier. To put it simply, we are in for another torrid European summer.

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