

Why Germany did not agree on direct bank recapitalization through the ESM in Spain

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The decision to defer, some would say claw back, some of the agreements of the June 29 euro area summit at the recent October 18 summit has created a great deal of confusion about Germany's commitment to the Eurozone, and in particular the communication strategies adopted. A fuller understanding of the events requires an understanding of context, in particular of Spanish and German banking in the past years and in general of the Eurozone support strategy for both sovereign and bank debt.

That support in the past three years has focused on taking either secured/preferred or at most senior unsecured financing positions. For example, ECB bank funding operations are technically secured by bank assets while the ESM has preferred creditor status. Even the potential government debt purchases by the ECB announced in August can be interpreted as preferred, since they will focus on short-term debt. Only the programs of the EFSF had ventured into unsecured positions, and promptly gobbled up high risk for taxpayers in particular in the Greek case. EFSF programs are being replaced by ESM programs for new applicants, starting with Spain.

Debate is justified over whether the approach pursued at present is not too defensive and more unsecured positions should be taken to share risk with investors. However, the call for direct bank recapitalization pushed through by a coalition of France, Italy and Spain at the June summit would have meant going far beyond this and jumping from the top of the capital structure to its very bottom. Typical positions taken by governments for recapitalization purposes are in hybrid capital, i.e. non-voting shares or silent profit/loss participations, and assume junior rank to all other debt positions of the bank, including senior unsecured and junior debt.

How much loss-sharing would be implied by injecting capital through the ESM with the rest of the euro area is a matter of local banking sector context: in the particular Spanish case on the table of the June summit, in the past years double-digit billions in junior bank debt that could have been used for such loss-absorbing 'bail-in' had been redeemed or converted into senior

unsecured under very favorable conditions for investors. Only the Troika Memorandum of Understanding in August 2012 finally ended the capital hemorrhage.¹

The disastrous de-capitalization process had been overseen by the Bank of Spain. The regulator might, however, be partly excused since her hands were likely as much tied by Spain's politicians on the public Cajas as e.g. earlier Germany's bank regulator was kept by German politicians from acting to preserve capital in the case of the public Landesbanken. In 2009 the EU had to take action against Germany to stop payouts on junior bank debt and even silent participations from half a dozen Landesbanken that were clearly insolvent.

The Spanish capital depletion process had been given cover through severely delayed loss recognition in conjunction with yearlong tactics concealing the scale of real estate finance losses. Again, this has a parallel in Germany's denial of banking losses in the United States, which to the present day have not been officially quantified. Germany's government-owned bad banks push much of the loss recognition into the future.

Resistance to use whatever capital had remained for loss absorption by 2012 also is high in Spain, and this is a unique factor, because of the mis-selling scandal of junior bank debt to consumers on a large scale dating back to the series of mergers of Cajas in 2011. The strategy adopted turned a large financial problem into a large political one, i.e. asking consumers rather than professional investors or the government to pay up for banking losses.

Compensating for the loss of bail-inable capital could have been to deeper cut into remaining investors, i.e. into senior unsecured debt. But this was deemed risky by all involved parties, as already was the Eurozone policy in Ireland.

Essentially, therefore, by delaying loss recognition and by allowing capital available for a bail-in to disappear, or never to seriously be created in the first place, as in the case of debt sold to consumers, Spain had destroyed its own case for direct ESM recapitalization.

Germany had lost tens of billions of Euros in similar lavish investor protection operations in private banks, especially IKB and Hypo Real Estate. In the Landesbanken cases, however, the federal government had asked the state and local governments to fully absorb individual losses. Several states had massively increased their debt, the worst case being Northrhine-Westphalia, which is deemed to have lost 20 billion Euros over the years in Westdeutsche Landesbank. Only in 2012 it had been finally decided that even this state would have to fully pay back federal bailout capital received.

¹ By 2010 according to RBS computations reported in FT Alphaville the Spanish banking system had ca 100 billion EUR in junior bank debt outstanding. <http://ftalphaville.ft.com/2010/12/09/431891/italian-sub-debt-differenza/>. Bank research figures circulating in July 2012 indicated a range of between 55 and 65 billion EUR remaining, however, this research usually quoted late 2011 data reported by Spanish banks. Early 2012, however, saw massive junior bond conversions and redemptions, so the likely true July 2012 figure is lower. There is no official reporting with sufficient detail on Spanish national or ECB level on bank capital structure data.

In the similar state-federal setup between Spain and the euro area, political hopes were nourished for a long time that the outcome would be different. The argument was that the risk of a failure of the sovereign borrower could not be taken. Under strong pressure from Bundestag the German finance minister in July decided to take this risk and asked for a Spanish sovereign guarantee for ESM funds to be injected as capital.

Later in August, he demanded the anticipation of the bank bail-in regime designed by the European Commission to 2015. In September, finally, the decision was made to not permit ESM funds at all to become comingled with legacy assets. Legacy assets can be defined as those for whose doubtful character today national supervision failure in the past had been responsible, and certainly not the ECB that the June summit only designated as European bank supervisor from 2013 onwards.

The specific decisions taken on Spain, and the subsequent broader decisions, together terminated the ideas of some protagonists of banking union as a historic loss mutualization and de-facto sovereign debt restructuring vehicle.

Rather, the design is now being laid out of a system of *future* risk mutualization under ECB or another central entities' supervision, coupled with the general protection framework by ESM and ECB of the sovereign shouldering historic losses. Given such diverse factors as the realities of day-to-day supervision, language barriers, diverging fiscal strategies such as social housing policies, the desire to protect national banking champions, the push for larger investor participation and experiences made already with state-federal risk mutualization in the German Landesbanken cases even the future risk mutualization through the banking union will likely only be partial.

The German government's communication strategy between June and October can only be described as chaotic and confusing. Damaging was certainly a limited awareness of the Spanish banking sector context. A sober analysis of the situation would have forbidden the agreement of the Chancellery to swift direct bank recapitalization on the June summit. Also damaging has been the repression of critical analysis of Germany's own public bank rescue, for fear to expose much of Germany's political system that was deeply implicated in the genesis of bank losses. The German rescues had largely avoided bail-in and, noting that the Cajas even had copied Landesbanken funding instrument silent participations, likely had also served Spain as a model to follow and stiffen her intransigence. The difference however was that Germany could rather easily afford large subsidies to bank investors compared to Spain.

When political leaders and their top civil servants are either unwilling or unable to learn from their own failures, or successes, in bank resolution at home, they are certainly not in a good position to lead the euro area discussion in banking sector matters. The result is an unsatisfactory stop-and-go of external demands, initial vagueness and later, when facts are sorted out with the help of the inevitable expert discussion, rejection and possibly change of course. The Eurozone, and in particular Germany, which has a leading position to fill, are challenged to beef up analytical, decision-making, negotiating and general communication

qualities in order to avoid a repetition of the failures seen during the last summits. These are now promising to seriously delay the steps towards what realistically can be expected to become the future European banking union.