Spanish Guarantee Scheme for Credit Institutions

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Abstract

Given Spanish banks' heavy investment in the housing and construction markets in the lead-up to the Global Financial Crisis, the collapse of the subprime mortgage market and Lehman Brothers' bankruptcy on September 15, 2008, impelled the government to implement stabilization measures to calm, recapitalize, and restructure its domestic banking sector. The Spanish Guarantee Scheme for Credit Institutions (the 'Guarantee Scheme') was one of the first interventions to be enacted, having been announced by the Spanish Ministry of Economy and Finance on October 13, 2008 by the Royal Decree-Law 7/2008 on "Urgent Economic and Financial Measures in relation to the Concerted Action Plan of the Countries in the Euro Zone." The scheme entered into force upon the signing of Ministerial Order EHA/3364/2008 on November 21, 2008. The program, funded by Spain's annual budget, initially committed up to €100 billion for the state guarantee of new and unsecured debt instruments issued by credit institutions, consolidated groups of credit institutions, and pools of credit institutions registered in Spain. Later, it was expanded to €164 billion. Per the terms of the original Ministerial Order, debt with maturities ranging from three months to three years – or between three and five years under special circumstances – would be covered under the Guarantee Scheme. Between November 21, 2008, and December 31, 2011, the Spanish government guaranteed €69.7 billion in debt issuances.

Keywords: Spain, government guarantee, credit institutions, short-term debt, medium-term debt

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Spanish Guarantee Scheme for Credit Institutions

At a Glance

Having heavily invested in the housing and construction markets in the lead-up to the height of the Global Financial Crisis in the fall of 2008, Spain's economy was severely impacted by the collapse of the subprime mortgage market and the subsequent bankruptcy of Lehman Brothers. One of the first steps the government took in order to calm markets and restore confidence in lending institutions was to introduce the Guarantee Scheme for Credit Institutions ('the Guarantee Scheme').

Announced on October 13, 2008, through the Royal Decree-Law 7/2008 on "Urgent Economic and Financial Measures in relation to the Concerted Action Plan of the Countries in the Euro Zone." It was implemented with the signing of Ministerial Order EHA/3364/2008 on November 21, 2008. Initially, the Guarantee Scheme committed up to €100 billion in funding for guaranteeing debt issued by participating credit institutions. In 2009 this amount was adjusted to €164 billion. Eligibility was restricted to credit institutions, consolidated groups of credit institutions, and pools of credit institutions registered in Spain. Regardless of type, applicants to the program would have to meet certain capitalization requirements, possess a share equal to at least 1/1000 of the domestic credit market, and have issued debt similar to that covered by the Guarantee Scheme.

Initially, new and unsecured debt instruments, including promissory notes, bonds, and other obligations admitted to trade on the official secondary markets in Spain, with maturities ranging from three months to three years were eligible for coverage under the program. Debt with maturities of up to five years could also be guaranteed if granted special permission from the Bank of Spain. Although there were no currency restrictions associated with Guarantee Scheme, the program required that the notional value of each debt issuance covered be at least €10 million.

Although originally set to expire on June 30, 2009, the issuance window of the Guarantee Scheme was extended five times to conclude on December 31, 2011. Between December 29, 2008 and December 31, 2011, the Spanish government guaranteed a total of €69.7 billion in debt issued mainly by regional Spanish credit institutions.

Summary of Key Terms	
Purpose: To restore confidence in the financing mechanism of credit institutions and to support increased lending to businesses and households	
Announcement Date	October 13, 2008
Operational Date	November 21, 2008
Date of First Guaranteed Loan Issuance	February 3, 2009
Issuance Window Expiration Date	Originally June 30, 2009; Extended to December 31, 2011
Program Size	€100 billion (initial) Increased to €164 billion in 2009
Usage	€69.7 billion. Total of 229 issuances by 44 credit institutions
Outcomes	No defaults
Notable Features	High fees relative to value of guarantee given low sovereign credit rating

Summary Evaluation

While there has not been much explicit evaluation of the Guarantee Scheme, the intervention was seen as having been an important and early step in the stabilization of the credit markets that would later allow for the vital restructuring and recapitalization of major Spanish financial institutions.

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5. Initially, up to €100 billion could be guaranteed under the program. 4

6. Eligibility for the Guarantee Scheme was restricted to credit institutions, consolidated groups of credit institutions, and pools of credit institutions registered in Spain. 4

7. New and unsecured debt instruments, including promissory notes, bonds, and other obligations admitted to trade on the official secondary markets in Spain, were eligible for coverage under the Guarantee Scheme. The Guarantee Scheme required the notional value of each debt issuance covered be at least €10 million. 4

8. Initially, debt ranging in maturity from three months to three years could be issued under the Guarantee Scheme. 5

9. All currencies appear to have been eligible. 5

10. The Ministry of Economy and Finance imposed individual caps on participation based on the proportion of the participant's domestic market share. 5

11. The fee for issuing debt pursuant to the Guarantee Scheme varied based on the soundness of the issuing institution and the maturity of the debt guaranteed. 5

12. The Spanish government would permit a waiver of the *beneficium excussionis* historically associated with State guarantee programs. 6

13. There does not appear to have been any restrictions on executive compensation or dividend payments. 6

14. The Guarantee Scheme issuance window was extended five times and expired on December 31, 2011 before it was reintroduced, with slightly different terms, in February 2012. 7

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I. Overview

Background

Having been heavily reliant on the housing and construction markets in the lead-up to the height of the Global Financial Crisis, Spain's GDP began to decline rapidly in the third quarter of 2008 and continued to fall for five consecutive quarters during the remainder of 2008 and throughout 2009 (Ortega and Peñalosa 2012). This contractionary cycle reflected that of other EU member states, but was especially impactful given the nation's substantial exposure to the subprime loan crisis. Furthermore, a sharp increase in the external deficit, the widespread overvaluation of exports, soaring unemployment, and the inability of the European Monetary Union to adequately address Spain's deteriorating economic condition collectively contributed to the severity of the recession that would outlast that of most peers (Ortega and Peñalosa 2012).

In response to this severe market disruption, the Spanish government sought to enact stabilization measures that would safeguard its domestic economy and relieve the negative impacts of the international credit crunch. One of the first interventions to be put into effect was the Guarantee Scheme for Credit Institutions (the 'Guarantee Scheme'), announced by the Spanish Ministry of Economy and Finance on October 13, 2008, and implemented upon the signing of Ministerial Order EHA/3364/2008 for the granting of State guarantees on December 29, 2008. Its dual purpose was to "[reestablish] confidence in the financing mechanism of credit institutions and to increase lending to businesses and households" ("Corrigendum to the Guarantee scheme").

Program Description

Under the initial terms of the Guarantee Scheme, Spain committed up to €100 billion for the guarantee of new and unsecured debt issuances by credit institutions, consolidated groups of credit institutions, and pools of credit institutions registered in Spain. This funding would be drawn down from the national government's annual budgets for 2008 and 2009, and could be increased to €200 billion if the Bank of Spain deemed it necessary given current market conditions. In 2009, the overall budget was adjusted to €164 billion for 2008 and 2009 pursuant to Royal Decree Law 9/2009.

In order to participate in the program, credit institutions would need to receive explicit approval from the Directorate General of the Treasury and Financial Policy. Subsidiaries of foreign credit institutions were eligible for participation but would be subject to the same regulations as those registered in Spain. However, branches of foreign credit institutions would not be covered under the Guarantee Scheme.

All applicants, regardless of type or association, would need to be "sufficiently capitalized in line with the national legislation" in order to qualify for admission.[2] Eligibility was

[2] According to Law (Ley) 36/2007 dated 16 November 2007, modifying Law 13/1985 dated 25 May 1985, and Royal Decree (Real Decreto) 216/2008 dated 15 February 2008).

further restricted to applicants that possessed equal to at least 1/1000 of the domestic credit market and had issued since October 13, 2003 (five years previous to the entry into force of Royal Decree-Law 7/2008), instruments "similar to the ones covered by the present Guarantee Scheme" ("Corrigendum to the Guarantee scheme").[3] For consolidated groups of credit institutions and pools of credit institutions, only one subsidiary would have to meet the aforementioned criteria.

Debt eligible under the Guarantee Scheme included new and unsecured debt instruments, including promissory notes, bonds, and other obligations admitted to trade on the official secondary markets in Spain, with maturities between three months and three years. Under exceptional circumstances, the Bank of Spain reserved the right to guarantee debts with maturities between three and five years. Securitization notes and subordinated debts were not eligible. Furthermore, although the original Royal Decree-Law 7/2008 initially provided for the possibility of covering other financial instruments such as interbank deposits, Ministerial Order EHA/3364/2008 – which legally enforced the Royal Decree-Law and upon which the European Commission based its authorization – excluded interbank deposits, options, derivatives, and other instruments "for which the amount of risk might be difficult to assess by the guarantor" ("Corrigendum to the Guarantee scheme").

Although there were no currency restrictions or limits on the issuance of non-guaranteed debt associated with the Guarantee Scheme, the original terms required that the notional value of each debt issuance covered be at least €10 million. Additionally, the Ministry of Economy and Finance imposed individual caps on participation based on the proportion of the participant's domestic market share, but reserved the right to further limit the cap if deemed necessary to "reduce the risk involved with granting the guarantee" ("Corrigendum to the Guarantee scheme").[4]

Spain assessed individual participation fees according to the European Central Bank's "Recommendations on government guarantees on bank debt" of October 20, 2008. These fees would thus vary based on the soundness of the issuing institution – determined by five-year CDS spreads between January 2007 and August 2008 – and the maturity of the debt to be guaranteed. Credit institutions would be required to pay the appropriate fees to the Spanish government upon each issuance of guaranteed debt.

As part of the terms of the Guarantee Scheme, the government agreed to waive the *beneficium excussionis* historically associated with Spanish guarantee programs.[5] As such, in the case that a participating institution were to default on a covered debt issuance, the Bank of Spain would be required to assume responsibility for the principal and interest through maturity. The associated interest rate could be either fixed or variable and had to "be placed within the market yield of emissions and issuers with similar characteristics"

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[3] According to the epigraph "2.4 Loans and credits. Other sectors" ("2.4. *Préstamos y créditos. Otros sectores*") of the Statistic Bulletin of the Bank of Spain from September 2008)

[4] As defined in epigraph 2.4 of the Statistic Bulletin from the Bank of Spain, Sept. 2008

[5] Embodied in Article 1.830 of the Spanish Civil Code, the *beneficium excussionis* "refers to the right or benefit of the guarantor not to be compelled to pay as long as the principal has enough property" ("Corrigendum to the Guarantee scheme").

("Corrigendum to the Guarantee scheme"). The principal amount would later need to be repaid to the Bank of Spain in a single payment.

Outcomes

Although the Guarantee Scheme was introduced as a temporary stabilization measure with an expiration date of June 30, 2009, the program's issuance window was extended five times, each for a period of six months, until December 31, 2011 (see Appendix A).

While the government guaranteed debt issued throughout the three-year duration of the program, all issuances made were assigned to either the 2008 or 2009 annual budget according to the General Budget Law. Under the 2008 annual budget, 44 credit institutions issued €47.3 billion in guaranteed debt. Under the 2009 annual budget, 32 of the same 44 Spanish credit institutions issued €22.4 billion in guaranteed debt. A majority of these issuances were made by regional savings banks, while none of the Spanish 'Big Four' – Santander, BBVA, Caixabank, and Bankia – took advantage of the Guarantee Scheme. All debts outstanding under the program were fully amortized by May 10, 2016.

The Guarantee Scheme was reintroduced, with slightly different terms, in February 2012 as part of a series of government stabilization measures designed to aid the domestic economy at the height of the Eurozone crisis. The original terms of the Guarantee Scheme remained unchanged over the years, but amendments were included to reflect the ongoing consolidation of Spanish credit institutions and to facilitate a phasing-out of the program beginning in July 2010 ("Reintroduction of the Spanish Guarantee Scheme"). The second iteration of the program concluded June 30, 2013 (see Appendix B).

II. Key Design Decisions

1. **Spain implemented a Guarantee Scheme as one of the first of many independent stabilization measures announced in response to the Global Financial Crisis.**

Other interventions, implemented independently throughout an extended period spanning from late 2008 through 2014, included the creation of a fund for the acquisition of failing assets and a comprehensive recapitalization scheme for many major Spanish banks and credit institutions. A majority of the later actions were taken in response to deteriorating conditions exacerbated by the European sovereign debt crisis.

2. **The Spanish Ministry of Economy and Finance implemented the Guarantee Scheme upon the signing of Ministerial Order EHA/3364/2008 on November 21, 2008.**

On October 13, 2008, the Spanish Ministry of Economy and Finance proposed the Guarantee Scheme in its adoption of the Royal Decree-Law 7/2008 of October 13 on Urgent Economic and Financial Measures in relation to the Concerted Action Plan in the Euro Zone. The Ministerial Order EHA/3364/2008 for the granting of State guarantees was then adopted on November 21, 2008, published on November 24, 2008, and amended and signed into force in its final form on December 29, 2008.

3. **In accordance with State aid rules, European Commission approval was required for the implementation of the Guarantee Scheme.**

The European Commission authorized the passage of Ministerial Order EHA/3364/2008 on December 23, 2008.

4. **The Guarantee Scheme was administered by the Ministry of Economy and Finance.**

5. **Initially, up to €100 billion could be guaranteed under the program.**

This amount could be increased to €200 billion "if the Spanish authorities consider it necessary given market conditions" ("Corrigendum to the Guarantee scheme"). These funds were to be drawn down from, and distributed equally over, the Spanish government's annual budget for 2008 and 2009 according to the General Budget Law. In 2009, the overall budget was adjusted to €164 billion for 2008 and 2009 pursuant to Royal Decree Law 9/2009.

6. **Eligibility for the Guarantee Scheme was restricted to credit institutions, consolidated groups of credit institutions, and pools of credit institutions registered in Spain.**

Applicants to the program would need to receive explicit approval from the Directorate General of the Treasury and Financial Policy.

Subsidiaries of foreign credit institutions were also eligible for participation in the Guarantee Scheme but would be subject to the same regulations as those registered in Spain. The Guarantee Scheme would exclude branches of foreign credit institutions.

Credit institutions would have to meet specific market share, issuance, and capitalization requirements in order to be fully eligible for the Guarantee Scheme. Each credit institution, or at least one subsidiary of a consolidated group or pool of credit institutions, would have to meet the following criteria:

- Possess a share equal to at least 1/1000 of the domestic credit market[6];
- Have issued since October 13, 2003 (five years before the entry into force of the Royal Decree-Law) instruments "similar to the ones covered by the present Guarantee Scheme" ("Corrigendum to the Guarantee scheme").

Regardless of type, credit institutions would need to be "sufficiently capitalized in line with the national legislation".[7]

7. **New and unsecured debt instruments, including promissory notes, bonds, and other obligations admitted to trade on the official secondary markets in Spain,**

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[6] According to the epigraph "2.4 Loans and credits. Other sectors" ("2.4. *Préstamos y créditos. Otros sectores*") of the Statistic Bulletin of the Bank of Spain from September 2008)

[7] According to Law (Ley) 36/2007 dated 16 November 2007, modifying Law 13/1985 dated 25 May 1985, and Royal Decree (Real Decreto) 216/2008 dated 15 February 2008

were eligible for coverage under the Guarantee Scheme. The Guarantee Scheme required the notional value of each debt issuance covered be at least €10 million.

Securitization notes and subordinated debts were not eligible. The original Royal Decree-Law initially provided for the possibility of covering other financial instruments such as interbank deposits. However, Ministerial Order EHA/3364/2008 – which held legal force and upon which the European Commission based its authorization – excluded interbank deposits, options, derivatives, and other instruments "for which the amount of risk might be difficult to assess by the guarantor" ("Corrigendum to the Guarantee scheme"). There was a minimum issuance requirement for all debt issuances of €10 million.

8. **Initially, debt ranging in maturity from three months to three years could be issued under the Guarantee Scheme.**

Initially, debt with a maturity of up to five years could be guaranteed by the government only subject to European Commission approval based on a specific request and report from the Bank of Spain.

In 2009, Spain requested to the European Commission to extend guarantees for debt with maturities up to five years. The Commission approved the measure but limited these issuances to a maximum of one-third of the overall budget.

9. **All currencies appear to have been eligible.**

Though not explicitly stated in the implementation documents, the original Ministerial Order stipulated that if the debt were to be denominated in foreign currency, "the order of granting the guarantee will establish mechanisms to minimize the foreign currency risk the State might take" ("Corrigendum to the Guarantee scheme").

10. **The Ministry of Economy and Finance imposed individual caps on participation based on the proportion of the participant's domestic market share.**[8]

This provision applied to participating credit institutions, consolidated groups, or pools. In accordance with Article 118 of Law 47/2003 of November 2003, the Ministry reserved the right to "limit the amount [of guaranteed debt] to reduce the risk involved with granting the guarantee," particularly with regard to the capitalization requirements used to determine an institution's eligibility ("Corrigendum to the Guarantee scheme").

11. **The fee for issuing debt pursuant to the Guarantee Scheme varied based on the soundness of the issuing institution and the maturity of the debt guaranteed.**

The guarantee fee would be determined according to the guidelines presented in the European Central Bank's "Recommendations on government guarantees on bank debt" of October 20, 2008. Fees would be paid by participating institutions to the Spanish government upon each issuance of guaranteed debt by the participating institution. Debt

[8] As defined in epigraph 2.4 of the Statistic Bulletin from the Bank of Spain, Sept. 2008

issuances with a maturity of a year or less would incur a fixed annual guarantee premium of 50 basis points calculated on the nominal value. Those with maturities over a year would incur a fixed annual fee of 50 basis points "plus the variable fee corresponding to the relevant Credit Default Swap (CDS)," to be calculated as follows:

a. For credit institutions with representative CDS, it would be the lower of either:

   i. The median value of the 5-year CDS spread for the credit institution during the period between January 1, 2007, and August 31, 2008;

   ii. The median value of the 5-year CDS spread during the same period aforementioned, "depending on the relevant rating category of the bank concerned based on a representative sample of large banks in the euro zone" ("Corrigendum to the Guarantee scheme"). For a rating of AA, the median would be set at 36.5 basis points; for a rating of A, the median would be set to 44.8 basis points.

b. For credit institutions with a credit rating but no representative CDS spread, the debt issuance would incur a fee based on the median value of the 5-year CDS spread during the period between January 1, 2007, and August 31, 2008, depending on the relevant rating category. For a rating of AA, the median would be set at 36.5 basis points; for a rating of A, the median would be set to 44.8 basis points.

c. For credit institutions with neither representative CDS nor a credit rating, the debt issuance would incur a fee based on the median value of the 5-year CDS spread for the lowest rating category during the period between January 1, 2007, and August 31, 2008. The median for the lowest rating category of A would be set to 44.8 basis points, plus an annual add-on fee of 10 basis points.

In 2010 these fees based on the ECB Recommendation of 2008 were increased by:

a) 20 bp for institutions with a rating of A+ or A,

b) 30 bp for institutions with a rating of A-,

c) 40 bp for institutions with a rating lower than A-.

This increase in fees aimed to incentivize beneficiaries to scale down their guarantees or exit the program.

12. The Spanish government would permit a waiver of the *beneficium excussionis* historically associated with State guarantee programs.

Embodied in Article 1.830 of the Spanish Civil Code, the *beneficium excussionis* "refers to the right or benefit of the guarantor not to be compelled to pay as long as the principal has enough property" ("Corrigendum to the Guarantee scheme").

13. There does not appear to have been any restrictions on executive compensation or dividend payments.

14. The Guarantee Scheme issuance window was extended five times and expired on December 31, 2011 before it was reintroduced, with slightly different terms, in February 2012.

Although the original Ministerial Order EHA/3364/2008 specified an end date of June 30, 2009, the program was extended five times, each for a period of six months, to expire on December 31, 2011 (see Appendix A). This was due to the perceived weakness of the Spanish savings bank sector and the previous heavy investment in the failing housing market.

The Guarantee Scheme was reintroduced for a six-month period with slightly different terms in February 2012. This second iteration of the program was then extended in June 2012 to February 2013 and ultimately concluded on June 30, 2013 (see Appendix B).

III. Evaluation

The implementation of the Guarantee Scheme was seen as an important initial step in restoring confidence to Spanish credit institutions and laying a foundation for other recapitalization and restructuring measures ("State aid: Commission approves Spanish guarantee scheme").

Similarly, González Fernández, González Rodríguez, and Motellón García (2010) claim in the *CNMV Bulletin* that the Guarantee Scheme "allowed the financial institutions that availed themselves of this facility to face their financial commitments in 2009 more comfortably." They also conclude that "grant of the State guarantees succeeded in lowering the overall systemic risk, and the successive secured issues allowed the issuers to face 2009 more comfortably" (2010).

In contrast, Caamaño Alegre and Komilova (2013) characterized the Guarantee Scheme as expensive, and linked its high fees to the sovereign rather than to individual banks' participation fees. This was perhaps why larger banks, such as BBVA, used their foreign subsidiaries to issue debt guaranteed under US programs.

Panetta et al. (2009), writing for the Bank of International Settlements, found that the bonds issued under the Guarantee Scheme may have crowded out covered bonds on the national market, as the debt instruments eligible for guarantee were cheaper for banks to issue.

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VI. Appendices

Appendix A: Prolongations/Extensions of the Scheme

Spain Guarantee scheme for credit institutions			
Status	**State Aid Case**	**EC Decision**	**End of Extension**
Scheme	NN 54/B/2008 (ex-CP 277/2008)	Dec/23/2008	Jun/30/2009
1st Prolongation	N336/2009	Jun/25/2009	Dec/31/2009
2nd Prolongation	N588/2009	Dec/01/2009	Jun/30/2010
3rd Prolongation	N263/2010	Jun/28/2010	Dec/31/2010
4th Prolongation	SA. 31921 - N530/2010	Nov/29/2010	Jun/30/2011
5th Prolongation	SA.32990 (2011/N)	Jun/01/2011	Dec/31/2011
Reintroduction	SA.34224 (2012/N)	Feb/09/2012	Jun/30/2012

Appendix B: The 2012 Reintroduction of the Guarantee Scheme

The Guarantee Scheme for Credit Institutions was reintroduced by the Spanish government in February 2012 as part of a new series of interventions intended to provide additional support to the domestic banking sector. As part of the program, the Spanish Ministry of Economy and Finance committed an additional €100 billion for the issuance of guaranteed debt by participating credit institutions.

The main terms and conditions concerning participation remained the same as those stipulated in the original Ministerial Order EHA/3364/2008 of December 29, 2008. However, debt eligibility was restricted to maturities between one year and five years. Guarantee fees were calculated differently. First, the total fee would consist of the following:

1. For banks with CDS data: A base fee of 40 basis points plus a risk-based fee equal to the product of 40 basis points and a risk metric composed of
    a. "50% of the ratio of the beneficiary's five-year senior CDS spread over the three years ending one month before the date of issue of the guaranteed bond to the medial level of the iTraxx Europe Senior Financials five-year index over the same three-year period PLUS
    b. "One-half of the ratio of the median five-year senior CDS spread of all Member States to the median five-year senior CDS spread of the Member State granting the guarantee over the same three-year period" ("Reintroduction of the Spanish Guarantee Scheme").
2. For banks without CDS data or without representative CDS data, but with a credit rating, an equivalent CDS spread would be "derived from the median value of five-year CDS spreads during the same sample period for the rating category of the bank concerned, based on a representative sample of large banks in the Member States" ("Reintroduction of the Spanish Guarantee Scheme"). This determination would be made by the European Banking Authority.
3. The above guidelines listed under point (2) would also apply to banks with neither CDS data nor a credit rating.

Second, the government would charge upfront 0.5% of the total fee calculated in accordance with the aforementioned guidelines. This fee, which was to be paid upon admission to the program rather than upon the first event of default, was introduced in order to increase efficiency and lessen demand for the Guarantee Scheme ("Reintroduction of the Spanish Guarantee Scheme").

The 2012 reintroduction of the Guarantee Scheme was originally set for a duration of six months, but was extended twice to conclude on June 30, 2013. Over the course of the program's operation, 12 Spanish credit institutions issued a total of €41.2 billion of guaranteed debt. All debts outstanding under the program were fully amortized by March 14, 2017.