Who Will bail out Spain?

13th June 2013

The capitulation of the Spanish banking system will pose a number of interesting questions over the next week. The Spanish government have gone to great lengths to make sure the bailout by the Eurozone is framed as a "bank bailout", however the Spanish 10 year is telling a different story.

The European Financial Stability Facility (the EFSF) is the counter party to the Spanish bank bailout; this means that it is indeed Spain that is being bailed out. The EFSF can only deliver funding to a sovereign state, accepting these funds is conditional upon the debtor nation agreeing to terms imposed by the commission. Now in this case the conditions are moderate (just do what you have already promised), but they are there nonetheless. The first cut is never the deepest when dealing with the EU commission, if the current debt spiral continues to lead to the Spanish missing their numbers, the measures and actions will get tougher.

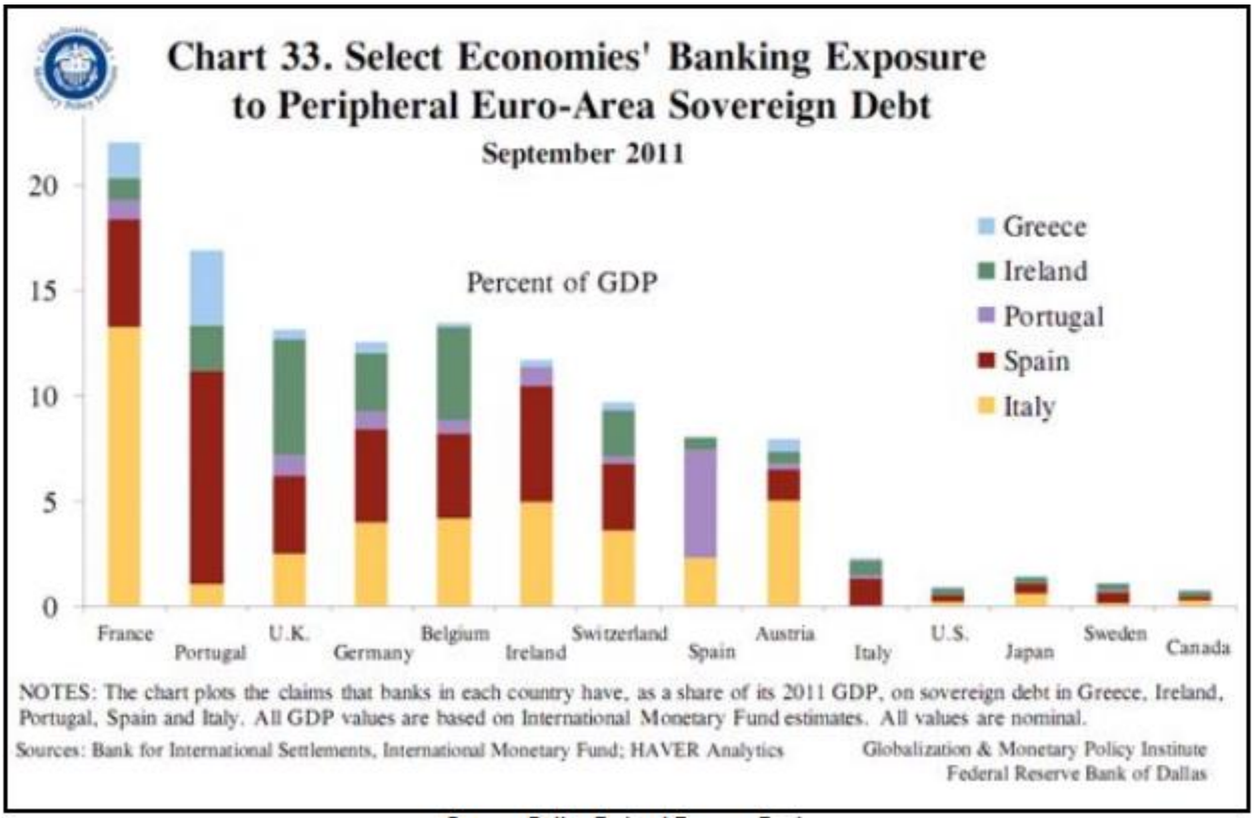
Ultimately the inter connected nature of the European banking system means that counterparty failure can have seismic consequences, which is why ultimately governments are bail out in when their banking system falls. Spain are in the gun, more specifically that means that the Spanish tax payer is responsible for the enormous bank losses that are still being under reported, if the current trading levels of Spanish RMBS are anything to go by. DB indicated in their piece that the 100 billion dollar figure is big enough to restore banking sector confidence without it being big enough to force a rush to the exit from Spanish sovereign risk. The problem is that the market is right across what has happened here.

For fixed interest investors this is now the interesting part, the consequences of moral hazard. If as we assume the debt burden is Spanish, they still need to pay back this amount, if they can't Spanish bond yields will surge (after all, the bond holders have just been subordinated by the EFSF), meanwhile the senior paper of the banks within the Spanish banking system are seemingly guaranteed against foreclosure at least until the 1st of January 2018 when the new ECB bail in rules take effect, this off course assumes the EU holds together. This is the interesting point in all of this, the banks in Spain are more systemically important to the Union and the Global Financial system than the bonds of the kingdom of Spain and off course the Spanish taxpayer. Why? Well Spain going broke, CDS being triggered and bond holders getting a haircut is a lesser evil when compared against the perils of counter party failure. In simple terms Spain's five largest banks maintain an asset base which is 220% of GDP, they are an entrenched part of the European banking system, which in turn is an entrenched part of an OTC derivatives market which has a notional size of some 600 trillion US dollars. This notional figure off course heavily overstates the real money in play, as the net exposures are generally managed to maintain an acceptable net level of exposure, until off course one of the counterparties that is providing the contra trade isn't there, and then it's a whole other ball game.

The Spanish were doing everything in the prior weeks to get the European Union to bail out the banks directly, but it was never going to happen without the Spanish Kingdom and all its subjects going guarantor for their banking system, which is why the attention now turns to Spanish government debt. The next week will be fascinating, ultimately holders of sovereign debt are risk averse by nature, they are not in Spanish bonds for the potential capital performance but rather were there on the belief that they were a store of value, they are no longer which in turn means that the natural buyers of these bonds' changes from risk averse investors to speculators.

The Eurozone will prime the market and will likely stop the Spanish bank run which is a definite win and guards against a much greater cost than a Spanish debt write down, however the cause must have effect. Ultimately if the market decrees that the Spanish government cannot afford to pay back a debt to GDP which will now climb well over 100% (as we suggested in our note in March) spreads have to rise and rise they will.

The other question is where are the Germans in all of this? Through the process of forcing the nations of the South into EFSF complying bail out terms the Germans are consolidating their power base within the European union, the Germans through the commission and the EFSF are effectively calling the shots on the Irish, Spanish, Portuguese and Greek budgets via the TROIKA. This leaves the Italians, who if they were to fall would imperil the French banking system (even further). This would in turn erode the French fiscal power base (see French exposure to Italy) delivering Germany unprecedented power within the union. The concern for the Germans has been being able to have say and control on how monetary balances are utilised by the debtor nations, which is why the Greek election and potential repudiation is a particularly important event. The Germans cannot afford for the Greeks to go off the reservation, it would endanger the whole shooting match, and however they can afford the Greeks to do as they please even less. The Greeks need to take heed that ultimately Europe will protect its banking system first, which means that they cannot have nations walking away from the responsibility of their debts and those of their financial system.



Source: Dallas Federal Reserve Bank

The current circumstances present yet more questions than answers, the Greek election starts to loom very large as an event. The European banking system will survive because it has to; the global financial system relies on it. This in turn means that Sovereigns are subordinated to their banks; the question then becomes where the bail in line within the bank capital structure is? So far senior unsecured bond holders have been untouched (as opposed to holders of subordinated, hybrid debt and equity), however the EU commission has proposed that changes from 2018 onward, the question then becomes what happens in the meantime?