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Western Europe

Euro Area: Sovereign Debt Crisis Update

Bank Resolution Rules Agreed

- ECOFIN finally agrees on a blueprint to close or restructure EU banks in trouble. The plan **stipulates a ranking for "bail-in-able" creditors** of failed institutions, with shareholders, unsecured bondholders and large (i.e., above €100K) depositors from large corporations first in line to bear losses. The plan also envisages a **resolution fund** to be set up by each member state within 10 years with a level of at least 0.8% of all insured deposits. While some degree of flexibility has been allowed for national authorities to shield some "bail-in-able" creditors, shareholders and bondholders of any troubled bank will suffer **a minimum loss of 8% of total liabilities** before the resolution fund can be tapped or the bank recapitalised. Comment: agreeing on who should foot the bill when a bank goes bust is another small step in the banking union project. The minimum threshold of 8% losses on private creditors before any taxpayers' money can be tapped aims to reduce (albeit to a small extent) the vicious link between the banks and their sovereigns. Implementation unlikely before 2015 at the earliest. Thorniest issues, such as who should have the final say in shutting or restructuring a bank, remain unresolved.
- **ECB's Asmussen says monetary stance at the moment is right.**
- **Italy postpones July VAT hike by three months**, some direct and indirect tax hikes will replace it, FinMin said. Comment: the postponement is the result of compromise within the coalition government, with centre-right PdL party calling for the VAT hike to be scrapped entirely. The 1pp VAT hike to 22% was estimated to bring some €2bn (0.15% of GDP) into state coffers in 2013 (€4bn from 2014). Some slippage in the budget is very likely in 2013: we expect the fiscal deficit to exceed the 3% target.
- **Italy – Treasury denies its financial derivatives pose any risk to the budget stability**, following newspaper reports that Italy faces potential losses of €8bn on derivatives contract restructured in 2012. Comment: potential losses on these contracts are probably difficult to estimate and, in any case, unlikely to affect the deficit or debt numbers near-term (most of these contracts have long maturities). But uncertainty on the extent of these losses weighs on already fragile Italian public accounts.
- **Portugal has already built up substantial cash buffers,** ensuring smooth financing at least until the end of the year, EU Commission said.
- **Greece –** German FInMin Schäuble rules out new round of PSI in Greece.
- **Germany –** No mandatory social security contributions for Germany's self-employed. Disappointing debut of Deutschland bond.
- **Data releases –** French consumer confidence hits a new historical low of 78 in June. Spanish real retail sales jump 1.3% MM in May, while Spanish HICP inflation rebounds to 2.2% YY in June, above expectations. German unemployment rate falls to 6.8% in June. Euro Area M3 growth edged down to 2.9% YY in May, but the contraction in credit to the private sector accelerated to -1.1% from 0.9% in April.

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- **ECOFIN agrees to impose a minimum loss of 8% on failed institutions.** EU Finance Ministers finally agreed last night on a blueprint to close or restructure EU banks in trouble. The plan stipulates that
  - (1) the main resolution measures for a failed institution include selling its assets, setting up a "bad bank" to separate good and bad assets and bail-in measures. As for the bail-ins, a ranking of "bail-in-able" creditors has been agreed, with shareholders, unsecured bondholders and large depositors (i.e., above €100K) from large corporations to be the first to shoulder the losses. "Eligible deposits" (i.e., any deposits of individuals and SMEs) would come second in the ranking, while below €100k deposits, and secured liabilities would be always spared from the bail-in.
  - (2) The agreement also envisages countries will have to set up a resolution fund within 10 years with a level of at least 0.8% of all insured deposits. Quite some degree of flexibility has been allowed for national resolution authorities on which liabilities to exclude from the bail-in (but to a maximum of 5% of liabilities). More crucially, a minimum loss of 8% of total liabilities has to be imposed on shareholders and unsecured creditors before national authorities can use a resolution fund to absorb the losses or before they proceed with the bank recapitalisation.
- Comment: the agreement on EU common rules on who should foot the bill when a bank fails is another small step in the banking union project. The minimum threshold of 8% in losses on private creditors before any taxpayers' money can be tapped aims to reduce (albeit to a small extent) the vicious link between the banks and their sovereigns. However, these rules will still have to be approved by the EU Parliament and at the moment are not meant to come into force before 2018 (although some suggestions have been made to move this deadline to 2015). Moreover, the thorniest issues of whether national authorities or a central European authority should have the final say in shutting or restructuring a bad bank remains unresolved – a controversial topic, especially in Germany.
- **Sweden — Customized Swedish bail-in solution.** Sweden managed to get a customized special solution for the application of the bail-in mechanism when EU Finance Ministers yesterday agreed on EU banking crisis legislation – Swedish Finance Minister Anders Borg was not entirely happy with the solution as it restricts Sweden's ability to quickly bring equity when a bank is hit by crisis. Sweden managed to get an alternative threshold for debt reduction of 20% of a bank's risk-weighted assets, instead of 8% of total liabilities, reports Swedish business daily *Dagens Industri*. But to use this opportunity, a country is required to have funded 3% of its deposits in its deposit insurance and national resolution fund; something that Sweden already fulfills. The main reason for this special request is that Swedish banks differ from other banks in Europe via small losses and low risk weights amid the high proportion of mortgages in their balance sheets.
- Frankfurter Allgemeine Zeitung highlights that **EU deal on ESM direct bank recapitalisation would *"decimate"* the firepower of the ESM substantially** - by €180bn if the ESM used up its entire €60bn allocation for bank recapitalisation, as a speaker of the ESM confirmed. The reason would be that to maintain an AAA rating the ESM would need to overcollateralise its exposure. ESM head Regling meanwhile said that €60bn for bank recapitalisation would be enough, but it is important to note that the ceiling could be amended when it becomes clear that direct capital injections would actually take place, while

German FM Schäuble said that ESM direct bank recapitalisation would only be available in special cases and was a tool for emergencies.

- **ECB's Asmussen says monetary stance at the moment is right.** ECB Asmussen said yesterday that he views monetary policy at the moment as appropriate: *"we should not put the foot on the accelerator nor on the brake"*.

- **Italy postpones VAT rate hike by three months,** faces questions from EU Commission on the financial coverage for the delayed tax hike. FinMin Saccomanni announced that some direct tax hikes will replace the VAT rate hike. Comment: the postponement is the result of compromise within the coalition government, with the centre-right party calling for scrapping the tax hike entirely. The VAT rate hike by 1pp to 22% was estimated to bring some €2bn (0.15% of GDP) into the state coffers in 2013 (€4bn from 2014). Some slippages in the budget are very likely to occur in 2013: we expect the fiscal deficit to exceed again the 3% target this year.

- **Italy – Treasury denies its financial derivatives posed any risk to the budget stability,** following newspaper reports from FT and *La Repubblica* that Italy faces potential losses of €8bn on those derivatives contract restructured at the height of the sovereign debt crisis in 2012. The Treasury denied these contracts were used in the late Nineties to hide budget holes and to get into EMU; the Treasury said derivatives were used as a standard means of hedging against foreign exchange and interest rate risks and that there was always a cost for such insurance, which was justified by the protection provided against more serious potential losses. The EU Commission also intervened on the issue saying that Eurostat has extensively examined the Italian accounts and that the Commission does not intend to revise its assessment of Italy's fiscal position after these allegations.

- **Portugal has already built up substantial cash buffers, ensuring smooth financing at least until the end of the year,** EU Commission said in the latest review of the bailout programme. The EU Commission also said the adjustment programme remains broadly on track. Comment: Portugal is approaching the end of its bailout programme (in June 2014) and the recent sharp rise in government bond yields casts some more doubts on its ability to return to full market access. We think some form of precautionary credit line and possibly OMT activation will be necessary to help the country to exit the official financing phase.

- **Greece – German FInMin Schäuble rules out new round of PSI in Greece**. The FinMin dismisses the idea that Greek privately-held government bonds maybe forced to accept new losses on their holdings, saying the risks associated with the country's adjustment programme were manageable. Comment: additional debt relief is necessary in the case of Greece given that the debt is clearly still on an unsustainable path. However, with 80% of the debt now held in official hands, and with private bondholders having already taken large losses in the first PSI, we think it is more likely that the debt relief will be granted on the official loans. However, negotiations to reach an agreement on how to implement this and the extent to which taxpayers in lender countries will eventually bear the losses are likely to be tough.

- **Draghi talks structural reforms with the French parliament:** In a speech in front of the French parliament, ECB President Draghi on Wednesday stressed the reciprocity that would be included in true solidarity in Europe: Solidarity between the different countries in Europe was now institutionalised through the various rescue mechanisms, but courageous reforms are needed on the other

side *"Reforms are an expression of solidarity between citizens"*, Draghi said. Draghi stressed that it was the young people that were suffering most from the current depressed conditions and that priorities for structural reforms should include reducing the barriers for young people and firms to do business, to reduce the complexity of the tax system and to ease anti-competitive regulation. Draghi also stressed once again that the ECB stood steady to act again, if such action were needed, including activating the OMT, and that the ECB was a long way away from exiting its support policies.

- **No mandatory social security contributions for Germany's self-employed:** *Handelsblatt* reports that the German labour minister van der Leyen has scrapped plans to introduce mandatory social security contributions by the self-employed in Germany, following a petition of 80,000 German enterprises. The proposal had implied minimum social security contributions of 350 to 400 euros per month and was opposed by the FDP party in the governing coalition. **Comment:** Future action of some sort on this front is still likely, as many self-employed in Germany do not save enough on a voluntary basis and therefore run the risk of poverty in old age or of relying on the tax payer for their retirement.

- **Disappointing debut of Deutschland-bond:** Wednesday saw the first issue of the new "Deutschland bond", jointly issued by the German federal state and its regions, at a yield of 1.66% and an issue volume of €3bn for the 7-year bond. For the German federal government, which has a 13.5% share of the issue, the yield is roughly 50bps higher than for an equivalent stand-alone bond. However, the bond yields were no lower than those of the so-called "jumbo bonds", which are jointly issued by some German regions, disappointing the regions' hopes for cheaper financing. The yield of the "Deutschland-bon" is also higher than yields paid by the German state development bank KfW. Comment: Being the first of its kind and coming amid rising rates and high market volatility, the first issue of the bond may not be a good guide to the future of the Deutschland-bonds.

- **France –** consumer confidence drops further to a new historical low of 78 (from 79) in June, on rising unemployment worries.

- **Spain –** real retail sales jumps by 1.3% MM in May, bodes well for Q2 private consumption. HICP inflation rebounds to 2.2% YY in June, above expectations.

- **UK:** The Chancellor announced details of the coalition's public spending plans for 2015/16, the first year after the next election (scheduled for H1-2015). This announcement is not very significant for the economic outlook, given that the coalition's total public spending plans for 2015/16 (and 16/17 and 17/18) were already known and included in our (and, we presume, other) forecasts. The detailed splits of public spending do not materially affect the economy's prospects. The significance of today's announcement is mainly to reinforce the UK's political commitment to fiscal consolidation. For more, see ***UK: Public Spending Plans***.

- **UK:** In common with a range of other markets, UK rates markets have sold off markedly recently: since 1 May, 2-year swap rates are up by roughly 30bp while 10-year gilt yields have risen by 80-90bp. A range of factors probably are at work, including slightly better UK economic data. But – judging from similar trends in a range of other countries – the sell-off seems to be driven mainly by two major global factors: anticipation that the US Fed will begin to taper QE in H2 this year and China's liquidity squeeze. In our view, the effect of these shocks is disinflationary for the UK, and argues for a looser monetary stance or a longer period of low rates. For more, see ***UK: Implications of the Market Sell-off.***

Appendix A-1

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