Spain to Cede Bank Control

Draft of $123 Billion Bailout Deal Puts Bond-Loss Burden on Smaller Investors

By MATINA STEVIS and GABRIELE STEINHAUER

BRUSSELS—Spain will be forced to give up most of the control over its banks to European institutions—and will be required to impose losses on local investors—in return for a bailout of as much as €100 billion ($123 billion), according to the draft agreement accompanying the rescue.

The requirements, some of which could prove to be explosive politically, suggest that holders of junior bonds and preferred shares issued by bailed-out banks will incur losses.

Analysts said a significant proportion of such investors in Spain are small depositors who bought the securities through the banks’ branches.

The conditions are a first glimpse into what could be the new framework for euro-zone banks once a new, powerful supervisor has been established—as leaders of the 17 euro countries agreed at a summit in June.

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The leaders said at the summit that a stricter euro-zone oversight system for lenders would be a precondition for allowing their bailout fund to directly inject money into struggling banks, rather than funneling the money through the government—a move that could eventually help Spain avoid an even-larger rescue.

In the short run, however, the bailout agreement, a copy of which was seen by The Wall Street Journal and on which finance ministers are expected to sign off by on July 20, gives a taste of the level of control that governments will have to give up in return for euro-zone assistance.
Policy makers say they hope stringent stress tests and tighter oversight from the European Commission, the EU’s executive, and the European Central Bank will force banks to finally get to the bottom of a brutal meltdown of real-estate prices in Spain and recognize the losses from bad loans they made.

After the stress tests, which should be done by early autumn, banks that have capital shortfalls will either have to raise that money on the market or request help from the government, which by then will have access to the bailout money.

But crucially, the banks won’t get taxpayer funds until they have come up with a burden-sharing arrangement with investors. According to the draft document, those investors include not only equity holders, but also owners of hybrid capital and subordinated debt.

The idea behind this exercise, for which Spain still has to create a legal basis, is to limit the amount of taxpayer-funded bailout money that has to be pumped into the banks.

But in the case of Spain, such arrangements may still hit ordinary citizens directly, as hundreds of thousands of them bought preferred shares in local banks. Holders of senior debt aren’t mentioned in the document, implying that they may escape losses for now—as they have in other large bank rescues in Europe in recent years.

"Senior bondholders within and outside of Spain may be protected whereas pensioners and the little guy who were sold these securities may have to bear a larger share of the burden,” said Sony Kapoor, managing director of economic think tank Re-define.

Spanish Finance Minister Luis de Guindos on Monday declined to confirm that retail investors who own preferred shares will be hit by losses, but also didn’t rule it out.

The bailout deal has “no explicit reference” to preferred shares, he told reporters in Brussels, where he discussed the deal with his euro-zone counterparts.

The document, however, appears to be very strict on sharing losses with private investors in banks that receive aid.

"Any capital shortfall stemming from issues arising in the implementation of SLEs [burden-sharing exercises] will not be covered by the EFSF assistance,” it says, referring to the euro zone’s bailout fund.

In addition to these requirements, the bailout deal also mandates an overhaul of Spain’s current supervisory system and allows regulators from the Commission to visit banks that receive support.

"This is a step toward the closer economic government and may provide a template on how things may be done” once a banking union has been set up in the euro zone, said Mr. Kapoor.

The finance ministers in Brussels also discussed how to help Greece meet its financing needs—without reaching any firm conclusions. On Tuesday, two Greek officials said the country has enough cash reserves to meet its operating needs until at least early August, despite earlier warnings Athens could run out of money as early as this month.

—Christopher Bjork in Madrid and Geoffrey T. Smith and David Román in Brussels contributed to this article.

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