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ECONOMIC REFORMS IN SPAIN

January 10th, 2012

Economic Reforms

- Labor Market Reform
- Fiscal Reform
- Financial Reform

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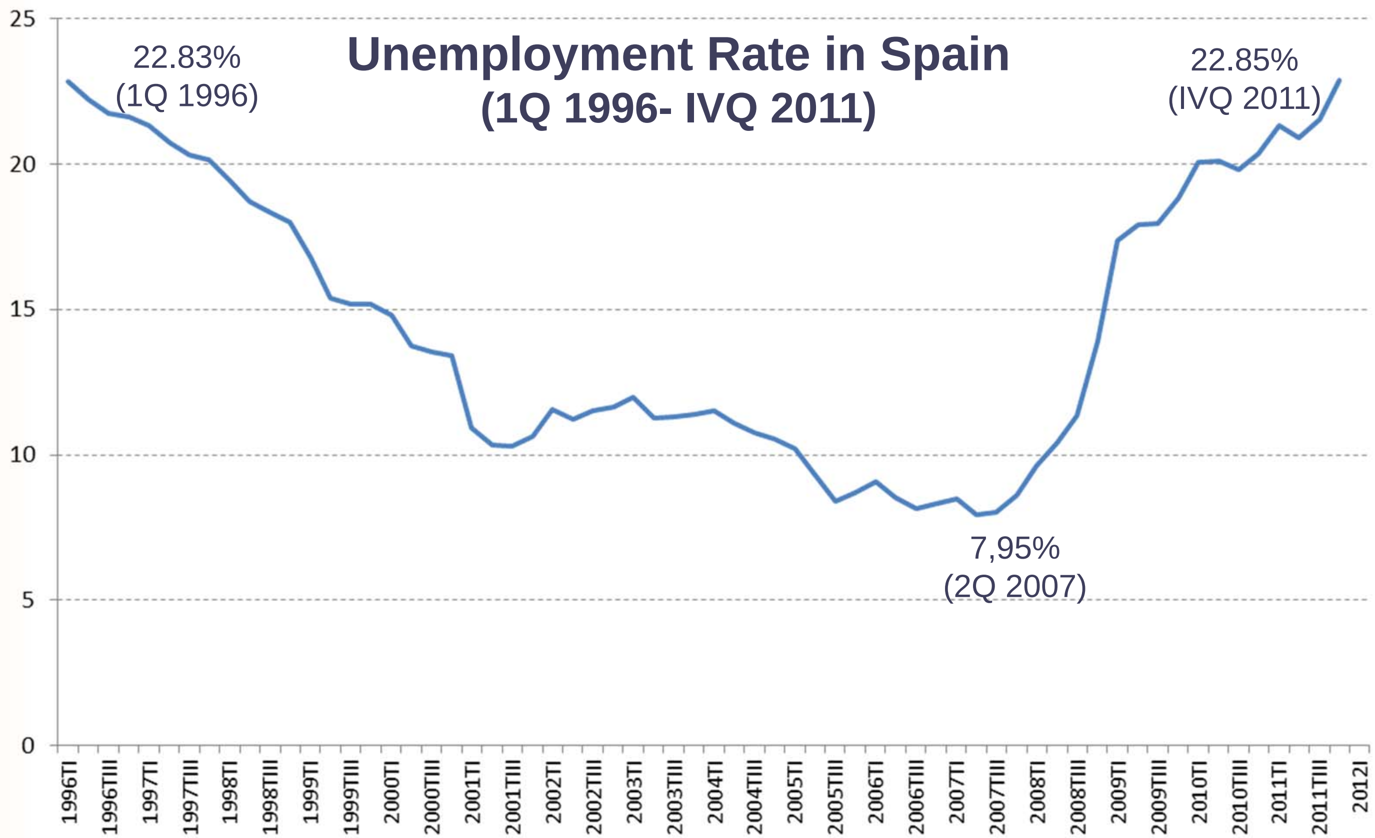
LABOR MARKET REFORM:

“Royal Decree Law on urgent measures for labor market reform”

Current situation. Facts

- As result of the current economic crisis, unemployment has risen much more steeply in Spain than in other countries



Source: Spanish National Institute. Labor Force Survey.

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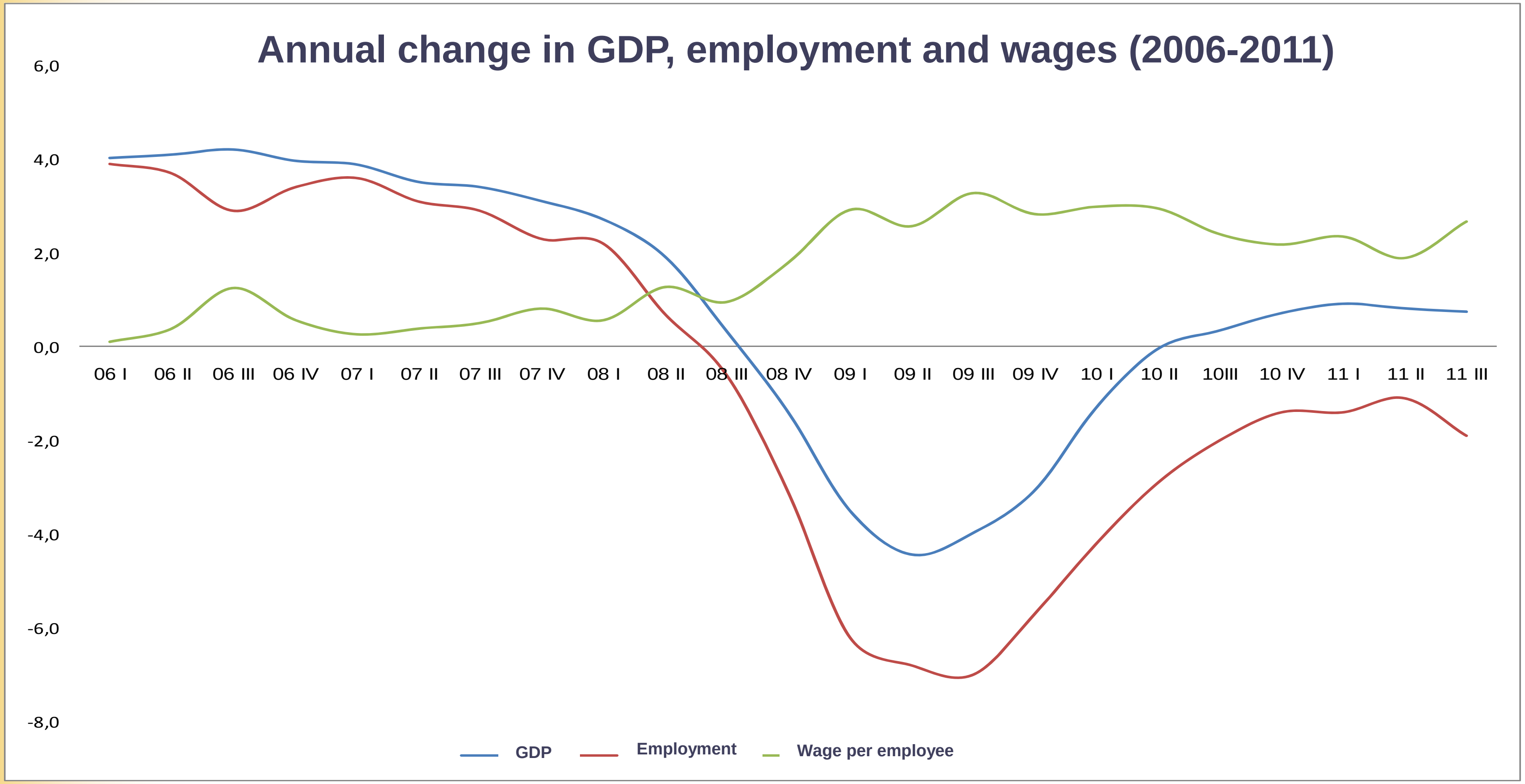
Current situation. Facts

- The adjustment in our labor market traditionally takes place via dismissals and not through wages



Source: Bank of Spain

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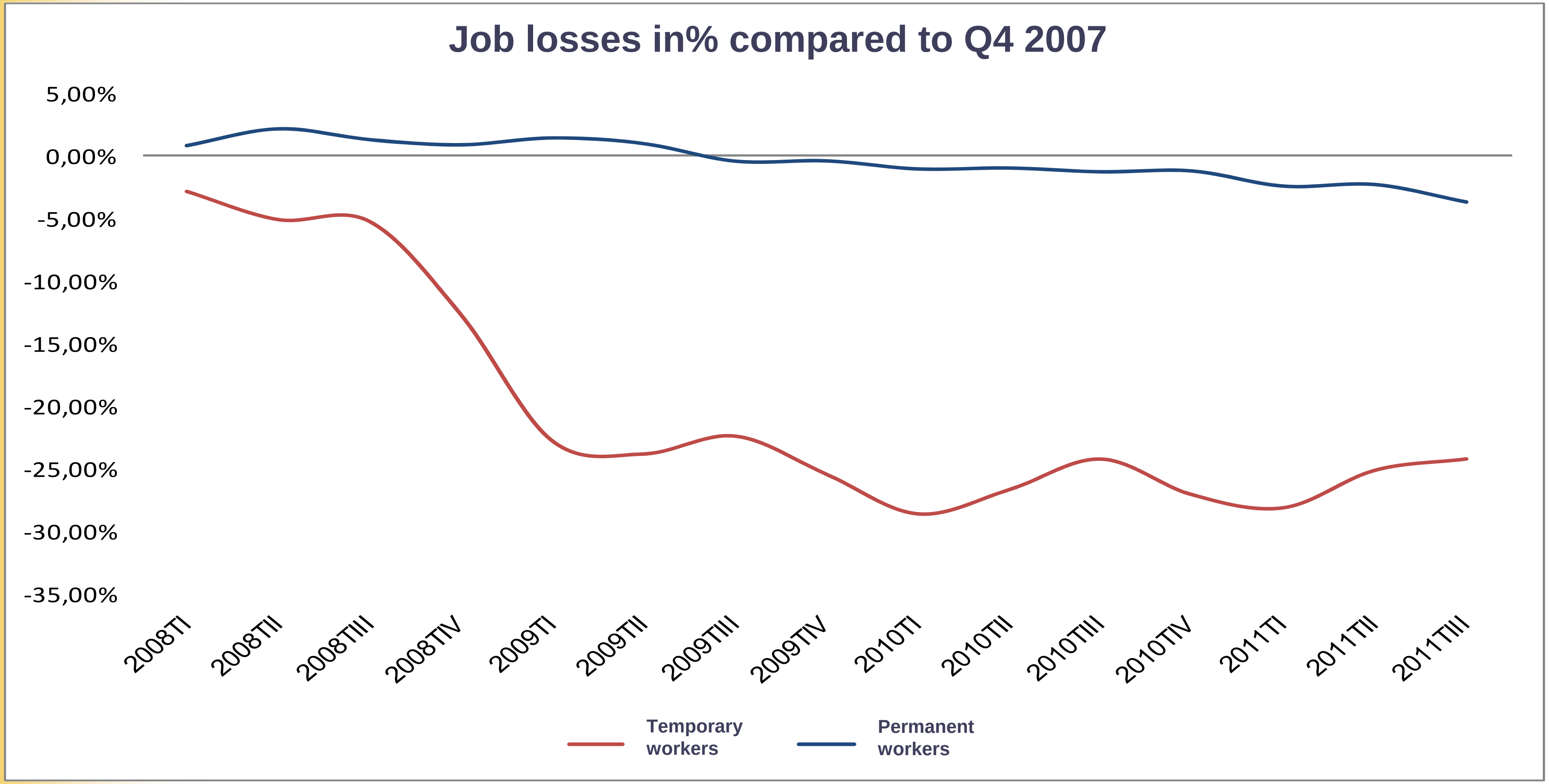
Current situation. Facts

- Dismissals are focused on temporary workers, which are mainly under 25. This creates a huge duality in the Spanish labor market



Source: Spanish National Institute. Labor Force Survey.

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International Organizations main recommendations on the Spanish labor market

1. Reduce the labor market duality.
2. Reduce dismissal costs and improve its management to prevent fraud
3. Reform the collective bargaining system, especially the opt-out clauses
4. Elimination of wage indexation systems
5. Increase the quality and effectiveness of public employment services
6. Improve active employment policies and training of workers, paying special attention to the problem of youth unemployment

Objectives of this reform

The approved labor reform satisfies these recommendations. Goals:

- Improve efficiency and reduce labor market duality by reducing labor costs of dismissal
- Enhance the employability of workers, specially the young, improving job intermediation and training
- Adjust internal wage bargaining and reform the collective bargaining system
- Implement effective mechanisms of internal flexibility within companies
- Promote job creation through permanent contracts and other measures

I. Dismissal costs reduction to address labor market duality

- **Unfair dismissal**: compensation of 33 days per year worked (up to 24 months). Down from 45 days and 42 months
    - This compensation will apply to new contracts. For those contracts already in force will apply a mixed rule
- Encourage the use of **fair dismissal**: compensation of 20 days per year worked (up to 12 months). New regulation:
    - Clarifies objective causes of fair dismissal
    - Removes of processing wages
    - Eliminates of “express dismissal”
- **Effect:** fair dismissal to be the main channel to end the contract as oppose to now

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I. Dismissal costs reduction to address labor market duality (cont.)

- Reform **collective and objective redundancies** to reduce legal uncertainty and high costs
  - Remove the administrative authorization required on collective redundancies
  - Reform of judicial review of collective and individual redundancies
  - Public Administrations will be allowed to dismiss based on objective causes
- **Effect**: increase agility and the use of collective fair dismissal (compensation of 20 days per year worked)
- Monitor the development of the capital fund for dismissal (Austrian Fund)

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II. Job intermediation and training

- **Temporary Employment Agencies** are now authorized to act as private placement.
  - This will prevent fraud in the unemployment benefit
  - *Previously*, only the public employment service and a few private agencies were involved in job intermediation
- Improve **professional training**:
  - Development of a new individual right to professional training (20 hours per year). Future "*training check*" paid with public funds
  - Increase the supply of professional training by allowing the direct participation of private agents
  - Create a new training account associated to each worker to improve training itinerary in case of unemployment

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II. Job intermediation and training (cont.)

- New **training contract** (youth 16-30 years):
  - No limit in the number of training contracts
  - Allow theoretical training within the company
  - Bonuses to encourage the use of this contract
- Modify the current **permanent part-time contract** to allow overtime and increase its flexibility
- Regulation of **teleworking** to promote its implementation

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III. Internal flexibility and collective bargaining

- Facilitate contract modifications on function, geographical location, wage and working time. Previously, the existence of rigidities allowed little room for contracts adaptation.
- Remove administrative authorizations to suspend the contract or to reduce the working time based on economic, technical, organizational or productive reasons
- Collective bargaining reform:
    - **Objective opt-out clause** of the collective agreement
    - Priority of enterprise collective agreement on the most relevant issues (e.g. wage, number of hours). Previously, sectoral and global collective agreements dominated contracts conditions
    - ***Ultractivity***. Application of terminated collective agreements will be limited up to 2 years. Previously, ultractivity was unlimited in time

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IV. Encouraging permanent contracts

- Creating a **new permanent contract** aimed at SMEs with 50 or fewer workers and freelancers:
    - Duration of the trial period up to 1 year
    - € 3,000 tax deduction for these companies / freelancers who hire their first employee (if less than 30 years)
    - Additional tax deduction of 50% of the employee’s benefit for a year
    - The employee may receive, along with his salary, 25% of employment benefits

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IV. Encouraging permanent contracts (cont.)

- **New bonuses for SMEs** specifically aimed to hire:
  - Unemployed young workers (16-30 years): €3,600 for permanent
  - Long-term unemployed (over 45 years): up to €4,500 for permanent contracts
  - Converting training contracts and substitution contracts into permanent ones: up to €1,500
- Reintroduce the prohibition of linking different **temporary contracts** further than 24 months (January 1st, 2013)

FISCAL REFORM:

"Organic Law on Budget Stability and Financial Sustainability of the Public Administrations"

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Objectives of this Law

- Guarantee the budget sustainability of all Public Administrations
- Strengthen confidence in the stability of the Spanish economy
- Reinforce Spain’s commitments to the EU

Budget stability and sustainability are key to economic growth and job creation

Scope of this Law

- Single text for all levels of Public Administration
- Develops Article 135 of the Spanish Constitution
- Incorporates the demands stemming from EU regulations, including the recently agreed fiscal pact.

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General principles

- Principles set forth in current regulations:
  - Stability
  - Multi-annuality
  - Transparency
  - Efficiency in allocating and utilizing public resources
- Principles incorporated into this Law:
  - Financial sustainability
  - Responsibility
  - Institutional loyalty

Budget sustainability: the guiding principle for all levels of Public Administration

Main aspects

- Public debt is introduced as a criterion of budget sustainability: public debt <60% of GDP
- All levels of the Public Administration must present a balanced or surplus budget in ESA terms. None may incur a structural deficit
    - In the event of structural reforms having long-term budget impact, a structural deficit of 0.4% of GDP may be incurred
    - A structural deficit may be incurred under exceptional circumstances (natural disasters, economic recession, or extraordinary emergency)
- EU recommendations will be taken into account when setting stability and public debt targets
- All Public Administrations must approve an expenditure ceiling consistent with the stability target and spending rules

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Main aspects (cont.)

- Public Administrations' spending may not increase above the GDP growth rate, in accordance with European regulations
- Absolute priority for debt servicing costs
- Failure to meet targets will require presenting a 1-year economic and financial plan
    - In the event of non-compliance with the plan: automatic approval of non-availability of credit to guarantee compliance with the established target
- A deficit due to exceptional circumstances will require a rebalancing plan to address the consequences of these situations

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This Law strengthens preventive and corrective mechanisms

- Compliance with targets will be taken into account when:
  - Authorizing debt issues
  - Granting subsidies
  - Signing agreements
- EU corrective mechanisms are transposed:
  - EU sanctions will be borne by the responsible Public Administration
  - In the event of non-compliance with an economic and financial plan, a paid deposit of 0.2% of its nominal GDP will be constituted
  - After 6 months, this can become a fine, if non-compliance persists
  - After 9 months, delegations will be sent to the non-compliant Public Administration to assess the economic and budget situation

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Stengthening the principle of transparency

- Each budget will include the equivalence between budget information and national accounts
- Before approving its budget, each Public Administration must provide information on its key features

Improved coordination on all Public Administrations' economic and financial actions

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Additional liquidity mechanisms for Autonomous Communities and Local Administrations

- Access of Autonomous Communities and Local Administrations to the extraordinary measures for liquidity support will be dependent on adjustment plans
- The adjustment plan will be public, and will include a schedule for its approval, implementation and monitoring
- Information will be sent quarterly to the Ministry of Finance (e.g. guarantees, credit lines, commercial debt, derivatives operations)

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Transitional period

- To converge to the new limits there is a transitional period until 2020 under the following rules:
- Public debt will be reduced to achieve the 60% of GDP as long as the economy is experiencing a positive real growth rate
  - When a growth rate of 2% is achieved (or net employment is generated in annual terms) the debt ratio will be reduced annually by a minimum of 2 GDP points
- The structural deficit will be reduced by an average of 0.8% of national GDP per year
- The deficit and debt paths will be comprehensively revised in 2015 and 2018

FINANCIAL REFORM:

Royal Decree Law on financial sector consolidation

Current situation

Real estate assets linked to loans to developers (€323 billion)*

Troubled assets (€175 billion)		**Non-troubled assets (€148 billion)**
Land and on-going development projects	**Other troubled assets**	• Currently without provision coverage
• Total (approx.): €88 billion • Current provision coverage: around 31% on average	• Total (approx.): €87 billion • Current provision coverage: around 27% on average	

- There are doubts on the valuation of real estate assets owned by credit institutions. This generates:
  - Difficulties for credit institutions to gain access to wholesale funding
  - Insufficient funding available to the private sector
- The aim of the reform is to change substantially the current situation by integrating credit institutions in a viable way combined with a swift and deep-rooted restructuring of the financial sector´s balance sheets.
- Measures will be executed within a specific and short term time frame

* Data at 30th June 2011

Objectives of this reform

- Improve confidence, credibility and strength of the system
- Dispel doubts about the valuation of real estate assets
- Encourage the banking sector to place its real estate assets in the market
- Give institutions better access to capital markets to encourage lending
- Facilitate a correction of excess capacity and improve efficiency
- Strengthen governance of institutions created through mergers
- Not to undermine the public budget

Main aspects

- Significant increase in bank asset write-downs of about €50 billion, both through provisioning and capital requirements (cash buffer)
- Significant incentives to consolidate the system
- Transparent process enabling the specific treatment for each type of asset to be identified
- Financial effort supported by the financial institutions, without the need of public funds
- Reduction in the remuneration of the directors of entities with public financial support

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I. Restructuring of real estate assets

- New provisions and capital requirements: total €50 billion
- **Troubled assets**
  - Specific provision: against profit. The total amount estimated to be €25 billion
  - Capital buffer: 20% for land and 15% for current developments. To be charged against retained earnings, capital increases or conversion of hybrids. The estimated total amounts to around €15 billion
- **Non-troubled assets**
  - Generic provisions: around 7% for non-troubled assets linked to real estate development. The estimated total amounts to around €10 billion
- The deadline for establishing the specific and generic provisions and the capital buffer requirements: December 31st, 2012

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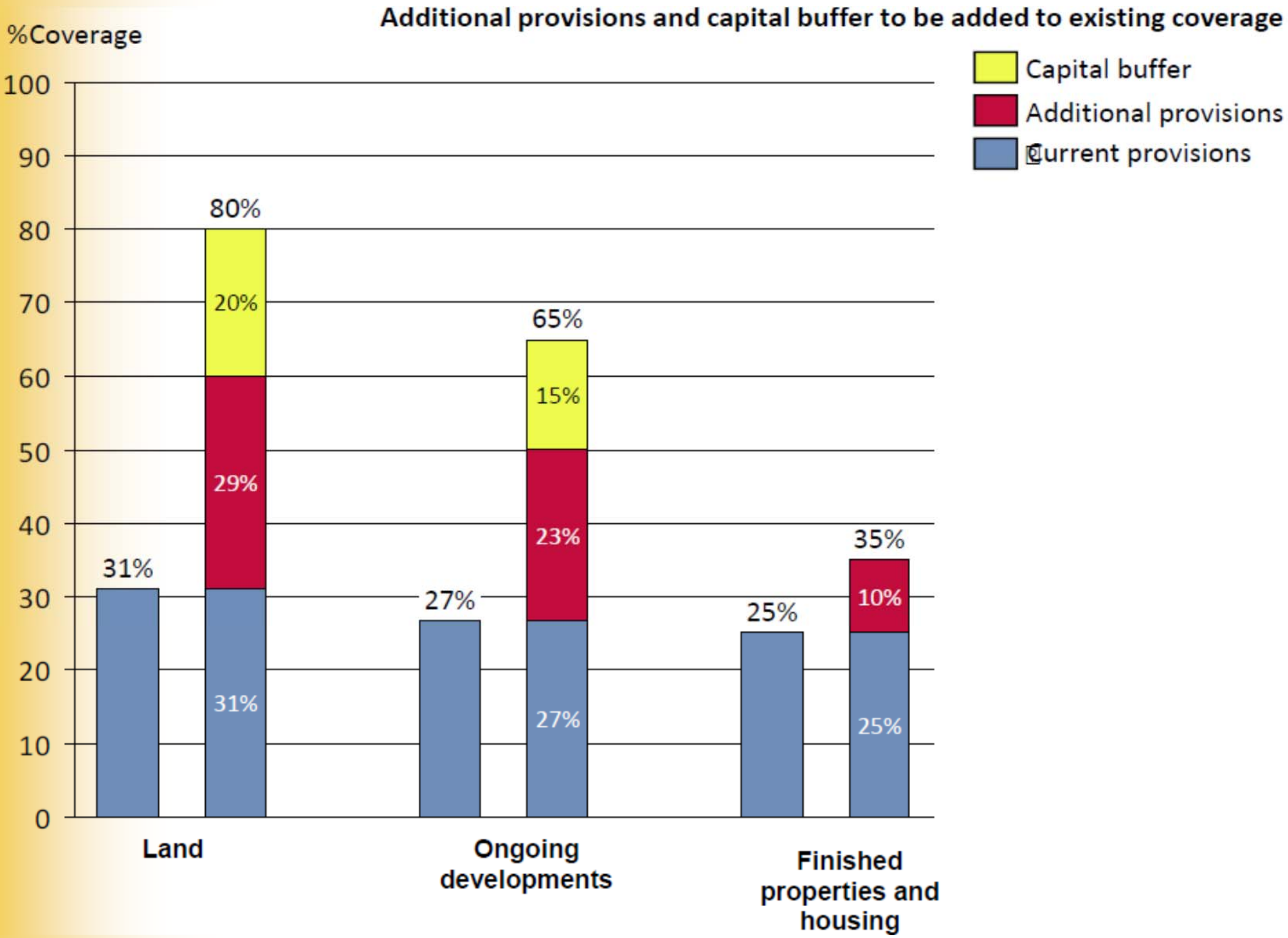
I. Restructuring of real estate assets (cont.)



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I. Restructuring of real estate assets (cont.)

- After the reform, the specific provisions plus capital buffers will raise the coverage of:
  - Land: from 31% to around 80%
  - Ongoing developments: from 27% to aprox. 65%
  - Finished properties and housing: from 25% to around 35%
- The cleanup process will cost €50 billion that will be required as a one-off measure
- From 2008 to June 2011, the Spanish banking sector has set aside specific provisions of around €66 billion

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II. Mergers framework

- The financial reform encourages mergers and consolidations
- **Advantages:**
  - Deadlines: banks that merge will be allowed an additional year for the cleanup
  - The required cleanup could be done at the expense of total assets
  - Banks, using the Fund for Orderly Bank Restructuring (FROB), could do so through the acquisition of contingent convertible bonds
- **Conditionality:**
  - A feasibility plan and corporate governance measures that facilitate rapid and efficient integration (by May 30th, 2012)
  - Increase from 10% to 20% in the overall balance sheet of the acquirer
  - Commitments for extending credit
  - Deadlines for completing mergers will be significantly tight (December 31th, 2012)

III. Fund for Orderly Bank Restructuring (FROB)

- The FROB's capital will:
    - increase from €9 billion to €15 billion
    - maintain the current debt ceiling
    - improve capital/debt ratio (borrowing capacity) from 10% to 18%

- If needed, FROB can acquire convertible bonds in mergers

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IV. Remuneration of entities with public financial support

- Remuneration of directors and executives in these entities will be reduced by 70% regarding average
- The upper limit of directors remuneration will be 600.000 €
- Individual reports will be provided to the Bank of Spain

V. Simplification of the saving banks organizative structure