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Selected Issues

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SELECTED ISSUES

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Prepared By European Department

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HOUSEHOLD SAVINGS RATIO IN SPAIN—HOW LOW CAN IT GO?[1]

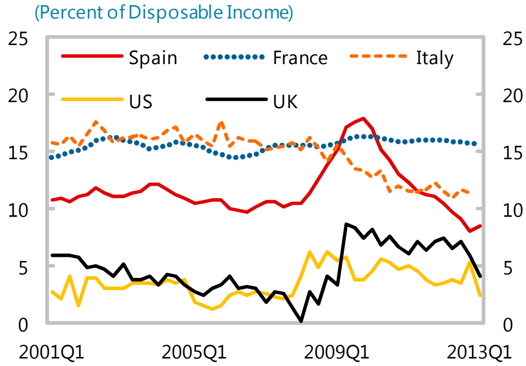
The household savings ratio has fallen to its lowest historical rate in 2012, as households cut back savings to support consumption in response to negative income shocks. Household savings fell across all households, but the declines were likely more material among lower-income and highly-indebted groups. Declining household income and savings slowed deleveraging and put household balance sheets under pressure. Looking ahead, households may need to restrain consumption further to free resources for repaying debt. Household savings rates will likely stay below historical levels for some time then slowly increase.

Recent Developments

1. **The Spanish household savings rate has fallen to its lowest historical level** (Chart 1)**.** Household savings rate in Spain had been relatively stable, on average 11 percent, in the pre-crisis years. The temporary stimulus measures that boosted personal income accompanied by the fear of unemployment and tight financing conditions led to the sudden rise in the savings rate at the onset of the global financial crisis. Since then, the household savings rate continued to decline, hitting 8.1 by end-2012, on the back of Spain's deep and lengthy recession and high unemployment. The ratio was significantly below its historical level and those of euro area peers.

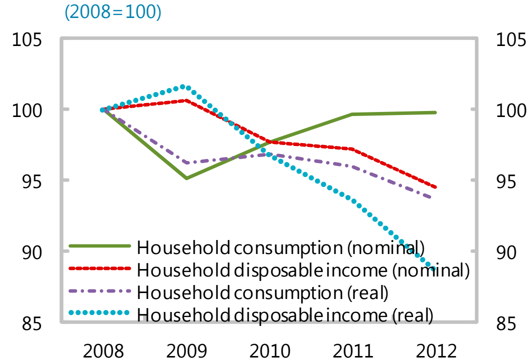
2. **Households cut savings to support consumption in response to negative income shocks** (Chart 2)**.** Household disposable income declined 5.5 percent in nominal terms or 11.4 percent in real terms since the start of the crisis in 2008. In response to negative income shocks, households reduced their savings to support consumption. Household consumption in nominal terms has rebounded from its sharp contraction and stayed at around its pre-crisis level.

Chart 1: Household Savings Ratio 1/
(Percent of Disposable Income)



Source: Haver, IMF Staff Calculations

Chart 2: Spain: Household Income and Consumption
(2008=100)



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[1] Prepared by Piyaporn Sodsriwiboon (EUR).

Nonetheless, persistently high inflation—partly resulting from the increases in VAT rates and regulated prices—lowered households' purchasing power[2]. Household consumption in real terms fell, though at slower pace than real incomes as Spanish real consumption tends to be particularly smooth.

3. Household income and balance sheets were heavily affected by prolonged economic stress and ongoing fiscal consolidation. The rise in unemployment and wage moderation following labor market adjustments significantly reduced household income. The efforts to reduce the large fiscal deficits further strained disposable income, as personal income taxes increased. Adverse income and unemployment shocks exacerbated the vulnerabilities of household balance sheets through reducing households' debt servicing ability and making household deleveraging more difficult. Household debt fell gradually but leverage remained high. Wealth buffers—housing and net financial wealth—fell by 140 percent of GDP or about 20 percent change in level since its peak in 2007. This fall of household net worth in Spain was more than the US and UK, and as a ratio of disposable income (233 percent), was the same as Japan in the 1990s (Table 1).

Table 1. Change in Household Net Worth during 2008 Crisis

	Household net worth in level Percentage change from peak-trough	Household net worth in percent of disposable income Change in ratio from peak-trough
Spain 1/	-20.4	-232
US	-15.7	-182
UK	-12.4	-121
IRL 1/	-36.3	-273
Japan (1990s crisis)		-233

Souces: BdE, ECB, OECD, Haver

1/ Change from peak to 2012, ongoing adjustments are expected.

4. Adverse economic shocks reduced household savings across all households, but the impacts were likely more material among lower-income and highly-indebted groups (Table 2). More granular information from the 2008 household survey data of the Bank of Spain, taking into account the extent of income and unemployment shocks at the aggregate level during the crisis years, reveals household savings likely declined significantly across the board as household financial positions were affected by adverse shocks. The shocks likely did not affect all households evenly, as the lower income group experienced much larger decline in savings. Highly-indebted households appeared to save less than average households in the same income level and their savings likely reduced significantly in the face of continued economic stress.The share of distressed households with negative savings might have more than doubled after the crisis. Households with negative savings were increasingly stretched and likely running down their—already low—assets, as access to financing became more difficult.

[2] The effects of VAT increases on inflation in 2012, however, are expected to be temporary. As the price indices re-base, this could help to slowdown the negative impact on household purchasing power.

Table 2. Spain: Household Savings from Micro-Level Data 1/2/

	Household Survey 2008		
	Household Savings Rate (Percent of Disposable Income)		Proportion of households with negative savings (Percent of all households in each group)
	Median	Of which: highly indebted households (Debt-to-Income > 3)	
All households	40.5	37.8	14.4
Income percentile			
Less than 20	23.4	12.8	22.8
Between 20 and 40	37.5	33.9	14.1
Between 40 and 60	41.6	34.0	13.9
Between 60 and 80	43.2	42.8	13.7
Between 80 and 90	48.7	46.4	12.3
Between 90 and 100	64.6	55.5	3.4

Sources: BdE, IMF Staff Calculations

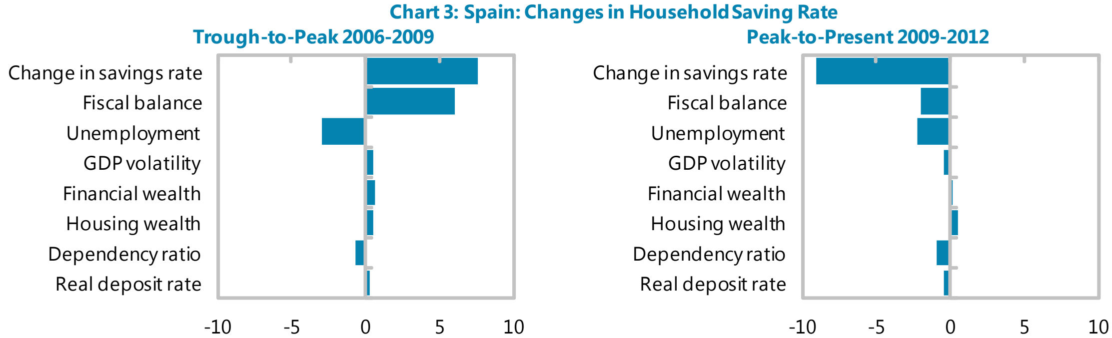
1/ Household savings is defined as household disposable income less total consumption expenditures including food, other non-durable goods, cars and other vehicles, and other durable goods. Household disposable income applies tax rates appicable for 2008 ranging from 24 to 43 percent income after personal allowances.

2/ The developments of the micro-level savings rates replicate the aggregate savings trend, although the savings rates from survey data and flow-of-fund data may not entirely match due to different accounting treatments, coverage of households, the adjustments for valuations, imputed rents and others.

What Explains Household Savings Dynamics?

5. Dramatic changes of Spanish household savings rates during and after crisis seem largely driven by fiscal adjustments and unemployment (Chart 3). Households appear Ricardian in Spain, as in other advanced countries. Large fiscal deficits at the beginning of the crisis allowed a temporary increase in household income and savings as households would expect future fiscal consolidation, but these have been reversed thereafter. Rising unemployment also makes it more difficult for households to save. The two factors explain of about half of the savings rate changes in Spain. Large asset price corrections have partial impacts on savings rate changes in Spain, although such impacts are more prominent in "Anglo-Saxon" countries where changes in wealth can more directly affect households' liquidity constraints and consumption.

Chart 3: Spain: Changes in Household Saving Rate



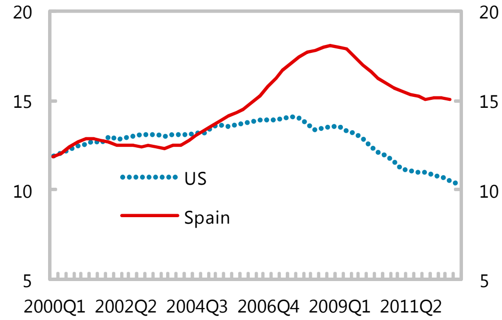
Source: IMF Staff Calculations

1/ The decomposition uses the estimates from household savings regression results similar to IMF (2010, 2011). The economic factors underlying household savings behavior include permanent income, interest rates, liquidity constraints, uncertainty, wealth, government savings, or demographics (Berry and Williams, 2009). The panel consists of Canada, France, Germany, Italy, Japan, Spain, United Kingdom, United States, and Ireland. The annual data are from 1980 to 2011.

Household Savings and Balance Sheet Adjustments

6. The balance sheets of Spanish households remain under pressure. Households' debt servicing ability has been affected by falling income. Household debt service payments as a ratio of disposable income remained high at around 15 percent in 2012, compared the historical average of about 12 percent (Chart 4). In contrast to the U.S. where the ratio stood at around 10 percent in 2012 and was falling, the Spanish debt servicing ratio is high and may be set to rise further as disposable income is contracting. Households under stress including unemployed, poor, and young households are most vulnerable, as the distribution of debt service burden was not proportional across households and in particular largely negatively skewed toward these vulnerable households (IMF, 2012a).

Chart 4: Household Debt Service Ratio
(percent of disposable income)



Sources: BdE, FRB

7. Spanish households have made little progress on deleveraging so far, but households may restrain consumption to free resources for repaying their debts in the coming years. Household debt has fallen by about 4 percent of disposable income from its 2010 peak in Spain (Chart 5). The decline was much less pronounced than elsewhere—most comparators (for example, the US, UK and Ireland) have reduced their households' debt-to-income by 20–30 percent so far, although the debt reduction partly resulted from debt write-offs. Households in these countries raised their savings significantly in line with debt deleveraging (Chart 6). These current deleveraging episodes as well as historical experiences on household deleveraging, e.g. from the Nordics, suggest Spanish households will likely adjust their consumption-savings behaviors in the coming years. By exactly how much the savings needs to rise and how long the balance sheet adjustments will take will depend on the overall economic outlook, policies, and structural reform progress.

Chart 5: Progress on Household Deleveraging
(Percent of Disposable Income)

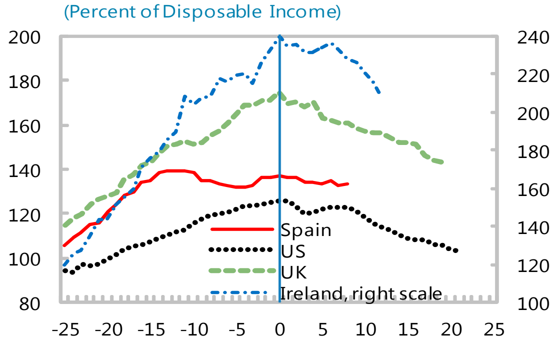
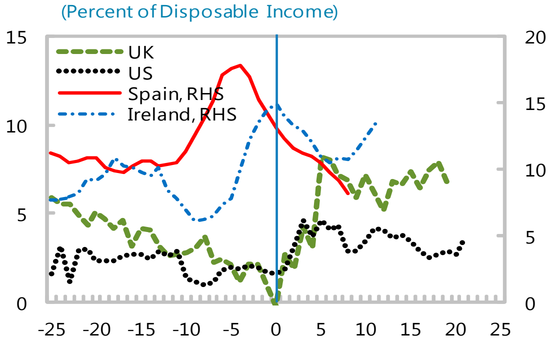


Chart 6: Household Savings Ratio
(Percent of Disposable Income)



Sources: Haver, ECB and IMF Staff Calculation
1/ Data are quarterly. 0 is the peak of household debt for each country ie Spain 2010Q4, US 2007Q3, UK 2008Q1 and Ireland 2009Q3.

Possible Evolutions of Household Savings Rate

8. The household savings rate will likely stay below its historical level for some time then slowly increase (Chart 7). Under the baseline scenario and gradual private sector deleveraging, household savings rate will likely fall further over the next few years and gradually increase toward the medium term. Household debt will fall by 15 percent of disposable income from the current level (Chart 8). Nonetheless, a slight pick-up in household savings rate in the first quarter of 2013 indicated risks to private consumption and growth that could further deteriorate, should the rate continue to increase. Under the downside scenario, worse economic outlook with sizeable fiscal consolidation and financing constraints will force households to save more. The household savings rate under such scenario will rise further from the baseline. But, debt-to-income ratios will stay above the baseline, as disposable income would be significantly lower. Under the upside scenario, the positive impacts from reform commitment and swift implementation will help to boost household disposable income and allow financial space for households to save more. Household savings rate could pick up faster and debt-to-income ratios to fall further from the baseline.

Chart 7: Spain: Household Savings Rate
(Percent of Disposable Income)

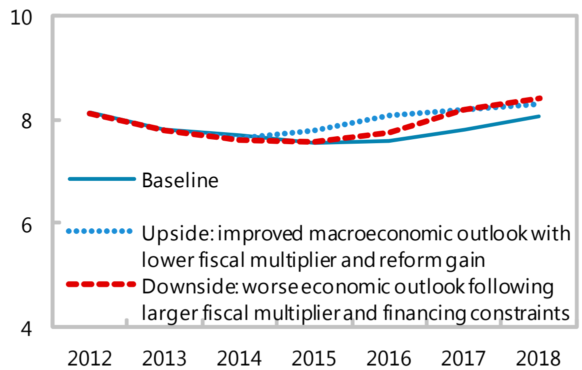
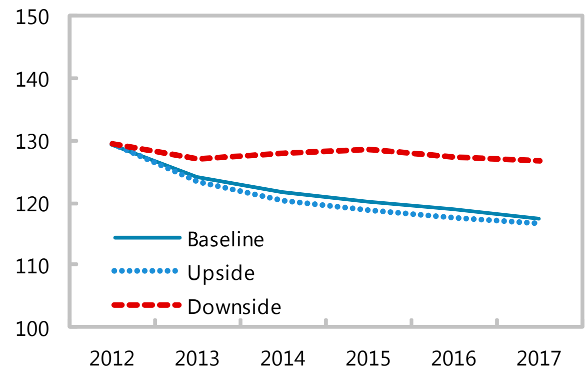


Chart 8: Spain: Household Debt
(Percent of Disposable Income)



Sources: Haver, IMF Staff Projections

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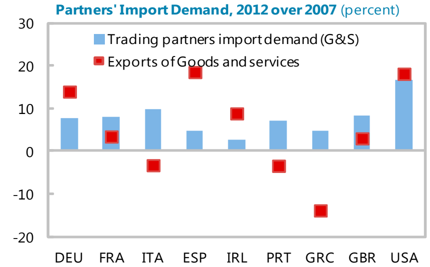
CURRENT ACCOUNT ADJUSTMENT IN SPAIN: HERE TO STAY?[1]

Current account adjustment to date in Spain has been remarkable, led mostly by improvement in exports. Import volume also contracted but not so much import value. These recent export improvements seem to reflect Spain's shift to trading partners with higher growth, and the improvement in unit labor costs may have not yet fed fully through to export competitiveness. Staff's baseline suggests that Spain will run sizable current account surpluses in the medium term, consistent with its need to improve net IIP. The permanency of the adjustment would depend on whether unemployment remains high–achieving long-run full employment would likely entail much weaker current accounts and real exchange rates. Real exchange rates appear to remain about 8-12 percent too strong to be justified by fundamentals. The adjustment would be supported by reforms to expand the tradable base.

1. **Spain's current account adjustment has been remarkable.** The current account deficit has moved from about 10 to 1 percent of GDP in 5 years. About 75 percent of Spain's adjustment comes from trade of goods and service balances and the rest from the income account. Within the trade balance, exports improvement accounts for about 5.5 percent of GDP improvement in trade balance; the other 1.1 percent comes from import compression. Indeed this episode of adjustment is unprecedented in Spain's recent history. Unlike other periphery countries, Spain has never had such a large adjustment (or deficit). Spain had gone through three adjustment episodes in 1977, 1983 and 1992.[2] In these episodes, the current account deficits at the beginning of the episodes were only between 2.6 and 4 percent of GDP. The turnaround took 2-3 years but in two of the three episodes involved a large real effective exchange rate (REER) depreciation.

2. **World market share in nominal terms has been fairly stable but in volume term Spain has performed better than most peers.** With the surge of emerging markets trade, Spain's share in world exports value has declined by around 13 percent since 1999/2000, a much better performance compared to other euro area (EA) countries, except Germany. However, Spain's export volume growth since euro entry exceeded that of trading partners' import demand, together with Germany and Ireland. The performance appears to reflect Spain's post-crisis catch-up when Spain increased export volume more than other EA countries. Up until 2007, Spain's export growth remained below trading partners' demand growth (implying a loss in market share).

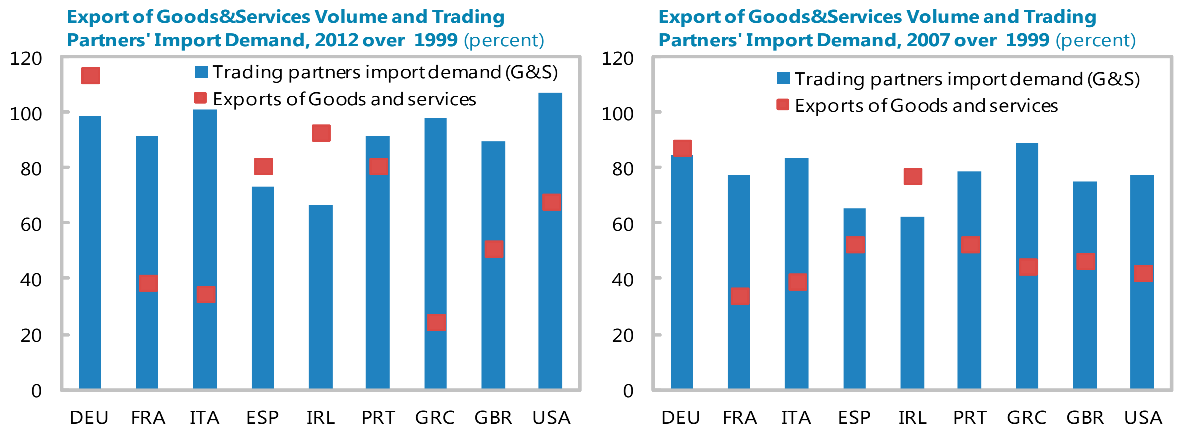
Export of Goods&Services Volume and Trading Partners' Import Demand, 2012 over 2007 (percent)



Sources: WEO; and IMF staff calculations.

[1] Prepared by Mali Chivakul (SPR)

[2] Algieri, B and T. Bracke (2007), "Patterns of current account adjustment: Insight from past experience," ECB Working Paper No. 762



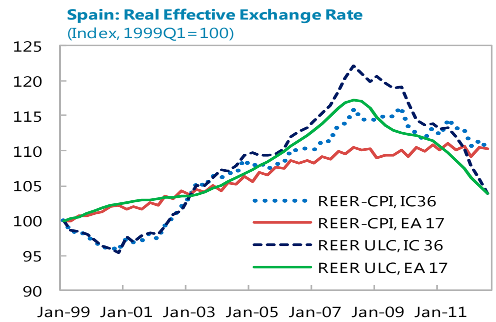
Sources: WEO; and IMF staff calculations.

3. Post-crisis export growth reflects a large increase in the number of exporting firms and more diversification towards trading partners with higher growth. The number of exporting firms has increased by 10 percent on average in 2011 and 2012. Moreover, post 2007/8, exports of goods have benefited from growth in emerging markets, especially in Africa and Latin America which make up for slow growth in the EA(panel figure 1). Demand from the UK and North America has also helped hold up service exports. Growth in EMs came at the expense of the EU. The EA still accounts for about half of Spain's exports, but the overall importance of the EU has slightly shrunk from 73 percent to 67 percent of total exports. On a sectoral basis, Spain has gained market share in some sectors that are important in its total exports, but most of these sectors are not the ones with higher growth in the world. Some of the sectors that have experienced growing market shares are also due to global prices (e.g., mineral fuels). Although export prices have improved sharply since the trough of the crisis, terms of trade has actually declined. Export regressions suggest that the relationship between exports and trading partners' demand and relative prices has remained more or less the same in the post-2008 period.

4. Slightly higher oil and service imports have kept the reduction of import value in percent of GDP relatively small (panel figure 2)**.** The sharp oil price rebound as well as Spain's dependence on oil imports has kept oil imports stable. Non oil imports fell by about 2 percent of GDP. However it was offset by 0.7 percent increase in oil imports and 0.1 percent increase in service imports over 2008–12. Import volume fell sharply, especially for capital goods. Non-machinery construction-related imports also fell more dramatically than other imports but the share of these imports are relatively low.[3] The share of these imports to total non-energy imports has now gone back to the level in mid 1990s. Import regression confirms that there is a small one-time shift in imports in the post crisis period; however the relationship with domestic demand, exports and relative prices appear stable.

[3] Construction and housing related imports include 35 items at the 3-digit SITC code related to construction material such as metal, cement, wood, glass and furniture. This small share is confirmed by the BdE's calculation based on input-output table that the share of construction investment imports is lower than 10 percent.

5. CPI based REER still remains about 10 percent above the euro-entry value against most major trading partners.[4] The large appreciation of about 16 percent has seen a limited reversal of about 4 percent in the last couple of years. Other measures of CPI based REER that takes into account value added gives similar results. The ULC-based REER shows almost a full reversal of pre-crisis appreciation, mainly reflecting productivity gains from labor shedding with wage moderation contributing in the more recent period.



Source: Price and Cost Competitiveness database.

6. Staff baseline forecasts suggest that current account adjustment would continue in the medium term. The improvement would come from increases in exports as well as subdued imports. Income balances are expected to moderately worsen over the medium term as the increase in global rates and the end of LTRO offset the decline in net foreign liabilities. In the baseline, the improvement in the current account would contribute to an improvement of net IIP to reach just above -60 percent of GDP by 2018.

7. Cyclically adjusted current accounts based on baseline output gaps suggest that the improvement in the current accounts is mostly permanent.[5] Assuming that the output gaps would almost close in 2018, the cyclically adjusted balances would closely track the actual CA, with 2012 value at -1.9 percent against the actual of -1.1 percent. Filter based cyclical procedures (e.g., HP or BK filter) give similar results. Using unemployment gaps, however, could result in different outcomes, depending on the steady state unemployment rate assumptions. For example, if we assume that the baseline unemployment rate in 2018 at 25 percent is the full employment level and apply Okun's coefficient of 0.85, the cyclical component of the current account improvement from 2012 onward would also be smaller in the medium term (but larger in the pre crisis period). Smaller steady state unemployment rates would reduce the permanency of the adjustment.

8. According to the model-based External Balance Assessment (EBA) analysis, the cyclically adjusted CA in 2012 is close to the norm. Spain's norm is estimated to be -1.5 percent of GDP which is close to the cyclically adjusted CA in 2012 of -1.9 percent. The main drivers of this estimate are the highly negative net foreign asset position, oil dependency, expected growth improvement as well as having a reserve currency.

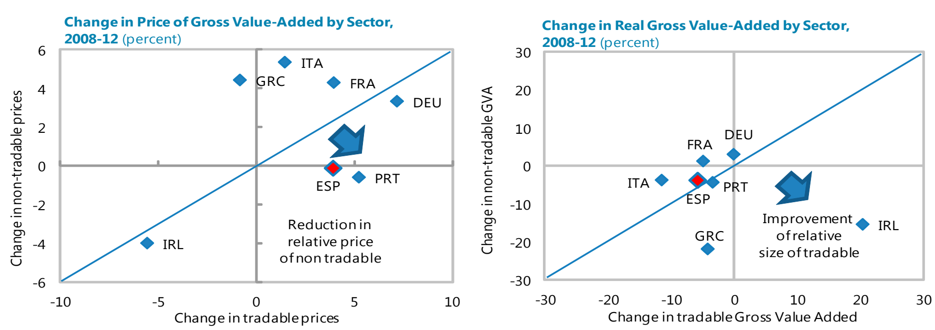
[4] In 1999, Spain's current account deficit was 3 percent of GDP

[5] Only non-oil trade balances and private transfer balances are subject to cyclical adjustment. Cyclically adjusted non-oil trade balances and private transfer balances are then added to oil balances, public transfer balances and income balances to arrive at cyclically adjusted current account balances. Trading partners' output gaps are from WEO and trading partners' weights are computed using combined goods (IMF DOTS) and services (OECD and Eurostat). Export and import elasticities of 1.2 and 2 are used.

9. However, as a country emerging from financial crisis, the overriding concern should be the sustainability of the external position. Highly negative net IIP and large needs for external financing leaves Spain vulnerable to changes in market sentiment and financial market shocks. Improving net IIP to a safer level would require that Spain runs current account surpluses (instead of the small deficits implied by the norm) through the medium term. Running continued deficits in this instance is not a sustainable solution. If Spain runs an average of 1-3 percent of GDP in current account surpluses, it would bring net IIP to -45 to -65 percent of GDP, about two-thirds or half of today's level in 10 years. Higher surpluses would deliver the IIP improvement faster. This would imply a current account gap around 3-5 percent.

10. Model-based equilibrium REER from the EBA suggests that the current level of real exchange rate is about 11 percent stronger than fundamentals imply. These fundamentals include, for example, private sector credit (indicating debt boom or overhang), growth, and the interest rate differential. For Spain, the very high private sector credit to GDP is one key driver of the results. The debt overhang indicated by the credit level has induced current account deficits and REER appreciation. To reverse the process, the REER would need to depreciate.

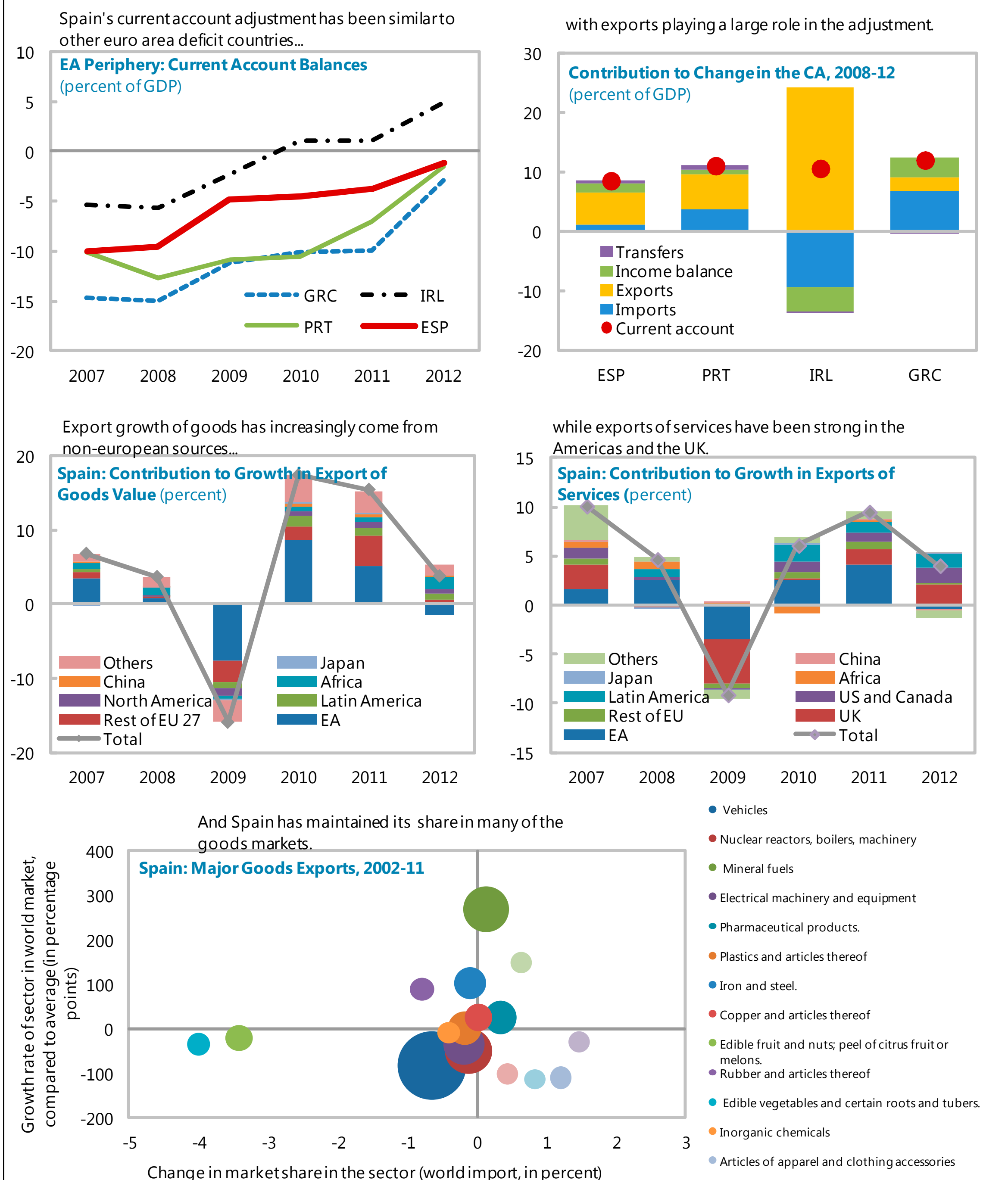
11. Price adjustment is not the only solution; in fact, adjustments in the current account would be made easier if reforms would help expand the tradable sector. Closing external imbalances, after all, is about shifting resources towards the tradable sector, either by expanding the size of the sector or inducing the change through price adjustment. The burden of adjustment would therefore depend on the current size of tradable expenditures. The relatively small base of tradables implies a need for larger relative price adjustment to close the imbalances. Spain's share of tradables either measured by the size of exports in GDP or the GVA of tradable sector appears slightly smaller than other EA countries, and has gone down since euro entry.[6] It has remained about the same since 2008. The relative price of nontradables (though this is hard to define) has increased by about 10 percent from 2000–08 but has since corrected by about 4 percent, mainly from the increase in tradable price and frozen nontradable prices, suggesting ongoing correction. Wage and price competitiveness could also help increase the size of tradable sector through foreign investment. One good example of this is the auto industry which has recenly attracted large foreign investors to set up production in Spain.



Sources: Eurostat; and IMF staff estimates. Tradable sector is defined narrowly as agriculture and industry (ex construction).

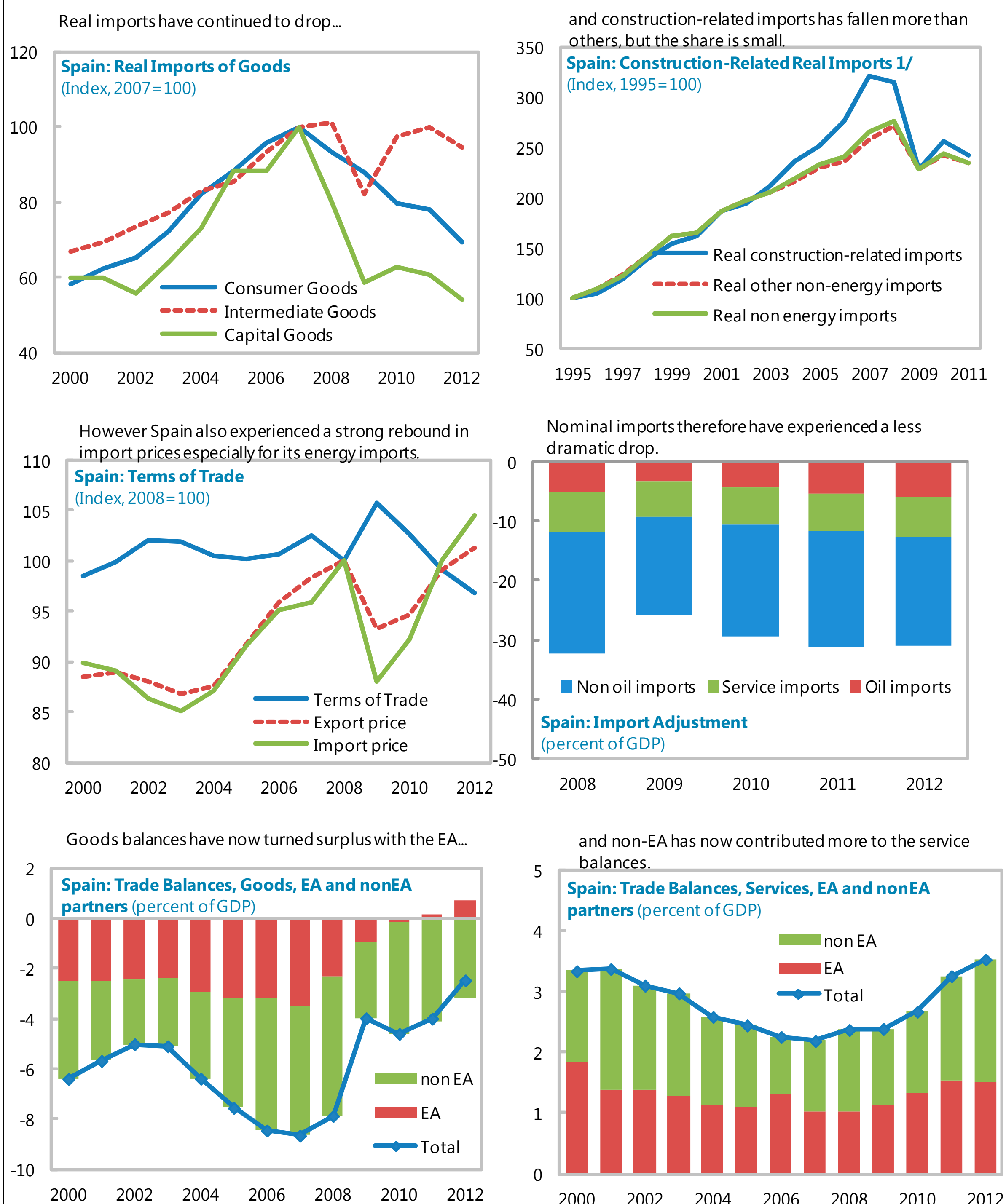
[6] Narrow definition includes industry (excluding construction) and agriculture. Broad definition adds service share in GVA which is derived by using the share of service exports to goods exports.

Figure 1. Spain: Current Account Developments I



Sources: WEO, IFS, Haver, UN COMTRADE and staff calculations.

Figure 2. Spain: Current Account Developments II

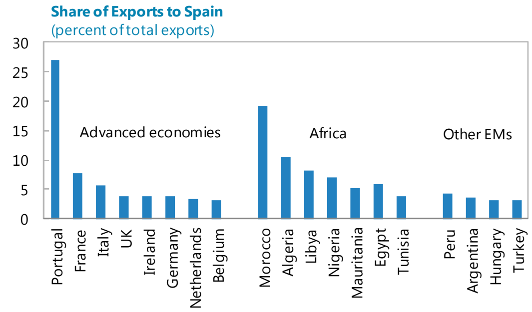


Sources: WEO, Haver UN COMTRADE, and staff calculations.
1/ Construction and housing related imports include 35 items at the 3-digit SITC code.

OUTWARD SPILLOVERS FROM SPAIN[1]

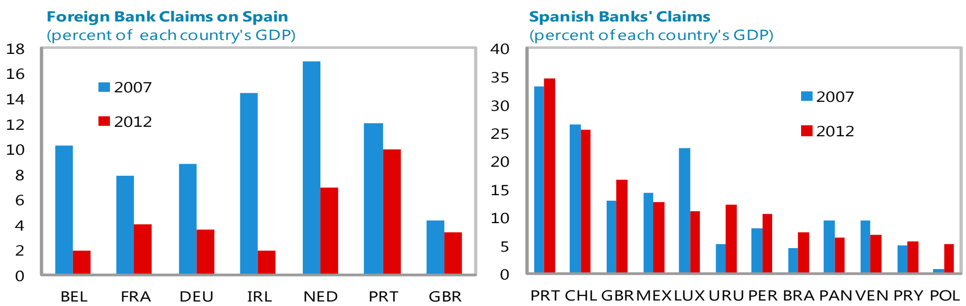
Spain's external spillovers through the trade channel are important to some of its neighbors but the potential systemic spillovers work mainly through the financial channel. Strong sovereign-bank linkages as well as sizable exposures to the rest of the world through financial asset and liability cross holdings have made Spain an important hub for receiving and transmitting shocks.

1. Spillovers through the trade channel are important to some of Spain's neighbors. Portugal and the Maghreb countries have the strongest trade exposures to Spain and are likely to be affected most, with Portugal and Morocco having especially strong ties with 27 and 19 percent of their exports directed to Spain (or 10 and 7 percent of respective GDP). Indeed they have already felt the recession in Spain; both countries' export value of goods to Spain dropped by about 12 percent in 2012.



Source: IMF GEE database.

2. Spillovers through banking exposures could be significant, but seem contained. Foreign banks that hold Spanish assets can be affected by changes in Spanish asset value. However, most foreign banks have already reduced their exposures strongly and by end-2012, only Portuguese and Dutch banks have more than 5 percent of GDP exposure to Spain. Spanish banks also have large claims on many countries especially in Latin America, mainly through FDI relationships. While these large exposures are subject to possible cross-border deleveraging by Spanish parent banks in theory, in practice these subsidiaries are largely locally funded and subject to regulations that would prevent such large-scale flows. In fact, Spanish bank claims on most EMs have been stable. The only notable deleveraging was from Luxemburg, most likely reflecting portfolio asset repatriation.



Sources: BIS; and IMF staff calculations.

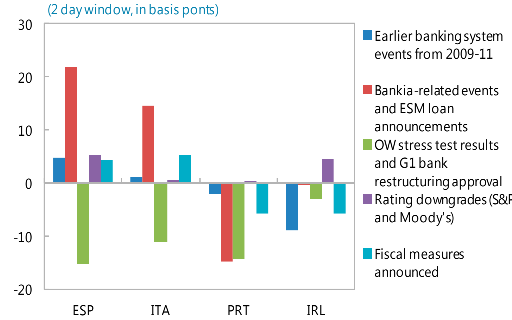
3. Spain's outward spillovers through the financial market channel, however, have been systemic for Europe. Financial market spillovers work mainly through changes in risk sentiment and confidence in the euro area. A number of studies have identified Spain as a significant source of

[1] Prepared by Mali Chivakul (SPR)

shocks on (and from) other euro area countries. IMF (2012) for example shows that core euro area banks that were more exposed to Spanish (and Italian) sovereigns experienced higher declines in stock prices and higher increase in CDS spreads when Spanish (and Italian) sovereign bond yields rose. Claeys and Vasicek (2012) find, through a GVAR framework over 2007–12, that Spanish bond spreads explained 20 percent of the variation in Italian spreads and 11 percent of variation in Greece/Ireland/Portugal spreads. In addition, they also find that the Spanish bond market has become the most systemic, both receiving and sending out shocks to other EU bond markets. Their GVAR results of bank returns also show that BBVA and Banco Santander are among the top three most systemic banks in Europe.

4. **Financial market co-movement with Italy appears strong when the banking system was in the spotlight.** Looking at a 2-day window of changes in asset prices, Spanish sovereign yield movements due to events in the banking system in 2012 seem to be highly correlated with Italy's yield, beyond the average correlation over time[2]. Other announcements of fiscal measures or rating downgrades did not have significant impacts on the Spanish market or abroad. However, once controlled for other common factors in a formal event study, the spillovers from these banking events in 2012 are not statistically significant.

Average Changes in Sovereign 10Y Yields for Each Group of Events
(2 day window, in basis ponts)



Sources: Bloomberg; and IMF staff calculations.

5. **Growth spillovers to other euro area countries through both trade and especially financial channels have indeed been significant.** Poirson and Weber (2011) estimate a reduced form VAR model and find Spain to have been an important source of growth shocks for most other euro area countries. A 1 percent shock to Spain's growth increases GDP growth in Germany by 0.7 percent, in France by 0.5 percent, and in Italy by 0.3 percent. Dynamic contribution analysis also suggests that over the long run, Spain's growth had been a major source of positive growth spillovers to other European countries from 1975 to 2008, and had important negative spillovers since 2008.

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[2] Banking system-related events refer to Bankia-related events as well as ESM loan events. The chart shows simple averages of changes on sovereign 10 year yields for each group of events. Earlier banking sector events include 9 events (for example, bank intervention and FROB creation). There were 6 Bankia-related events between May and July of 2012, 11 downgrades from S&P and Moody's from 2009 to 2012, and 6 fiscal measure announcements between 2010 and 2012.

SPAIN: PENSION PROJECTIONS[1]

1. **The Spanish pension system has historically been efficient and well-funded.** In the 2012 EC Aging Report, for example, Spain outperforms the EA17 average for pension expenditure, despite relatively high replacement of pre-retirement income. Nevertheless, a combination of unsustainable pension increases in pre-crisis years and downward population revision– critically because of working age outmigration (due in part to migrants attracted by housing related jobs) and lower birth rates – now implies a potentially unsustainable trajectory with emerging short-term fiscal pressures.

2. **The population projection revision published by the Spanish National Statistical Institute (INE) in November 2012 implies a number of important changes to pension projections (see figure below).** Among the most important is the declining population trend, driven in large part by a sharp revision to outmigration from Spain. If these projections materialize in the future, current pension risks are not fully captured by looking at the expenditure side of pension projections. In particular, looking at the long-term population pressures could miss the short-term impact from outmigration and unemployment driving pension deficits. Nevertheless, an upside risk also exists if current population projections extrapolate recent migration shocks that fail to materialize, rendering the current projections overly pessimistic.

3. **Estimates of long-term pension balances based on the Spanish authorities' population projections, benefit formulas, and unemployment and outmigration projections, suggests the gains from the Pension Reform of 2011 have been largely eroded.** In 2009, INE projected positive long-term Spanish population growth; hence, increases in the dependency ratio and in pension costs were driven by the increase in the proportion of elderly. While changing elderly population figures drove expenditure pressures, the revenue side remained stable due to a constantly replenished working population. The 2012 population projection shows a "base effect" from large observed outward migration alongside higher than expected unemployment and the ongoing recession, as well as projected long-term declines in population. This fuels pension deficits from the revenue side despite no change in the short-term dependant population (e.g., elderly).

4. **In response to these pressures, in March the authorities published a reform to deter early retirement.** The early retirement age increased by two years to 65 in 2012, which combined with the increases in the statutory retirement age in 2011 reform to 67, could push the effective to near 66 years, and could suggest annual savings of approximately 0.5-1 percent of GDP. To encourage later retirement, workers were also permitted to earn while receiving half their pension after the statutory retirement age, without paying further contributions other than an 8 percent tax. In addition, unemployment subsidies were reformed to incentivize greater labor participation of older workers, compensation was mandated for companies with disproportionately high layoffs of

[1] Prepared by Rafael Romeu (FAD)

older workers, and the 2012 labor market reform eliminated mandatory retirement clauses. These reforms are likely to deliver important long-term benefits.

5. A second important reform was taken in April of 2013, when the authorities announced a council of experts to design and report on the "sustainability factor". A committee of twelve experts were assigned to write a report for the "sustainability factor," i.e., the automatic adjustment that ensures the pension system is in actuarial balance. In the 2011 Pension Reform law, the design and implementation of the sustainability factor was scheduled to begin in 2027, hence this was an important positive change. The committee's make-up was inclusive of major political parties and social groups, and critically, included well-known and internationally respected academics and economists.

6. The committee's proposed sustainability factor is strong and exemplifies the type of high-quality adjustment measures Spain needs. In its June report, the committee recommended a "sustainability factor" (the annual formula for updating pensions) based on two components: (i) an intergenerational equity factor, and (ii) an annual growth factor. The intergenerational equity factor updates pension benefits for life expectancy—for a given base contribution history, an increase in the retirement period means a decline in the monthly pension benefit. The annual growth factor is a formula that determines the annual increase in pension benefits (see below). Pension benefits increase with inflation and as well as with real growth of pension system revenues—as the system becomes wealthier, benefits grow. Pension benefits decline every year as the number of persons receiving pensions increase and as the average pension increases due to new participants earning higher pensions relative to exiting participants. Finally, the annual growth in pension benefits is adjusted depending on the structural fiscal balance of the pension system (e.g. structural surpluses increase benefits). This ultimately ensures pension system solvency by adjusting pensions to balance the system.

Sustainability Factor Formula for Annual Pension Benefit Growth

Annual benefit growth	=	*Average inflation*	+	*Growth of revenues in real terms*	-	*Growth in the number of pensions*	-	*Difference of new less expiring pensions*	+	*Convergence speed*	x	*Structural surplus or deficit of system*

7. Further reforms can help alleviate pension pressures. The sustainability factor commission recommendations to link the statutory retirement age to life expectancy is welcome. Nevertheless, extending the wage history on which pension benefits are based from 25 years to 30 or 35 could also compliment this policy by improving the structural deficit and lower the substitution effect. In addition, the welcome recommendation to link the growth rate of pension to some proxy for structural pension revenues is sensible, as slowing the growth of real pension benefits from about 2 percent prior to the crisis to below real trend GDP growth will help stabilize the depletion of the pension savings fund. Notwithstanding the uncertainty of long-term projections, these reforms would help very likely stabilize costs and allow

Options for Potential Pension Savings by 2050
(annual savings in percent of GDP)

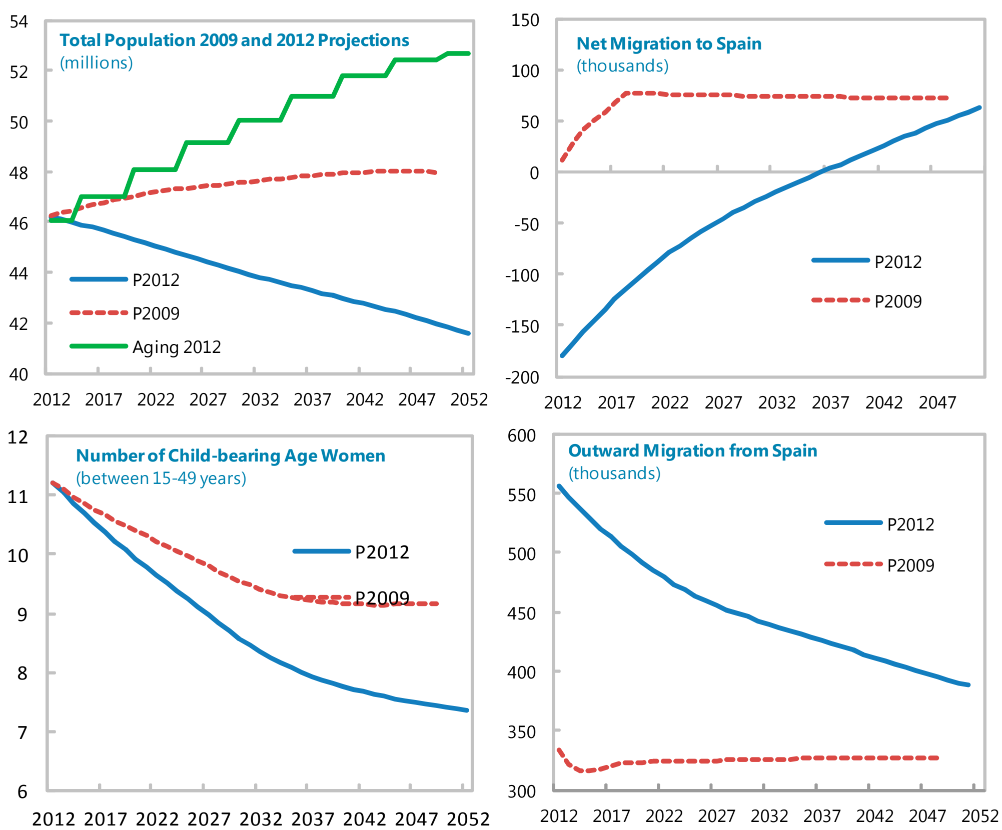
Gradually Retirement Age increase by 2 years	2
Increase reference period to 35 years	0.8

Source: Staff estimates.

revenue accumulation prior to 2030 to finance inevitable increases afterwards. For example, increasing the effective retirement age from 65 to 67 by increasing both the early and statutory retirement ages in line with life expectancy improves the pension system balance by 1 percent of GDP by 2030 and 2 percent of GDP by 2050, even with long transition periods. Increasing the base period for calculating the pension benefit from 25 years to 35 years by 2037 reduces the pension system deficit by 0.8 percent of GDP by 2050.

8. In addition to these reforms, pressures from long-term unemployment will require bringing more people into the system (rather than focusing on cutting benefits). Ultimately population projections with roughly one worker per retiree in the outer years leave little room to maneuver, and current pension deficits reflect, by and large, revenue losses from the newly unemployed and outmigration. Hence, reforms to help bring in workers into the labor force are critical, and could include removing the fixed floor (in euro) on minimum pension contributions, which encourages evasion for workers whom may use the minimum pension in the future. Greater means testing for minimum pensions alongside a closer mapping of lifetime wages to benefits will help incentivize formal sector employment work as well. A low-income tax credit could also help bring workers into the market. Ultimately, however, a stronger labor reform to boost contributors and job opportunities will be the strongest solution to slowing the drivers of the pension deficits.

Spain: Long-term Population Projections

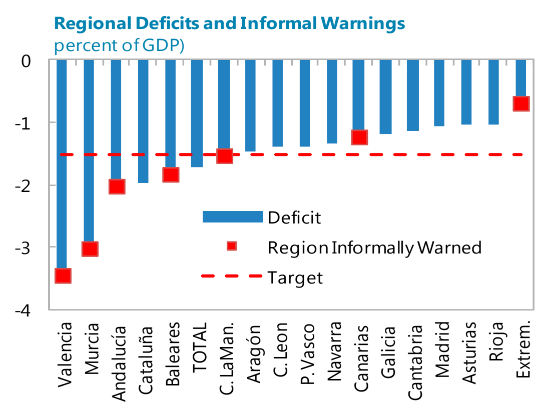


Sources: INE; EC Aging Report 2012; and IMF staff estimates.

IMPROVING REGIONAL FISCAL DISCIPLINE[1]

The enforcement tools of the Organic budget law played a small role in the hard-won fiscal gains of 2012. This is to some extent a result of growing pains from the ongoing implementation of this new law. Nevertheless, the conditions facilitating a cooperative approach—external and internal fiscal consolidation mandates, unprecedented political unity, and regional financing dependence—cannot reliably deliver future consolidations. Developing a gradual and predictable implementation of the tools in the Organic Budget Law could help improve regional monitoring, de-stigmatize enforcement and diffuse center-versus-regions tensions. This will likely require publishing intra-year budget targets and identifying contingent fiscal measures at the regional budgeting stage. It will also call for a strong fiscal council (AIReF) to independently oversee whether intra-year targets are met and whether contingent measures should be enacted. Hence, a strongly independent fiscal council is needed, which requires, inter alia, a longer and non-renewable term for the AIReF President, independent salary and hiring regimes for AIReF presidents and staff.

1. **The enforcement tools of the Organic budget law played a small role in the hard-won fiscal gains of 2012.** The consolidation did not apply the Organic Budget Law sanctions or warnings (Article 19, 25, 26). The monthly monitoring and enforcement was largely done behind the scenes in connection with the extraordinary liquidity mechanisms. For example, in July, informal meetings were reported but no region was warned. Reports due under Articles 17.1 and 17.2 were not issued, in part because regulations were not yet developed at the time they were due (and information on regional budgets were published elsewhere). Short reports stating risks to deviations were published in December (figure), but these predicted compliance successfully in a few cases only and were issued too late in the year to meaningfully inform any policy decision. As the year ended, regions at risk were asked to give additional information about consolidation efforts in 2012 and inform on 2013 plans, but no public sanction was applied.



2. **The conditions facilitating a cooperative approach – external and internal fiscal consolidation mandates, unprecedented political unity, and regional financing dependence—cannot reliably deliver future consolidations.** A confluence of mandates for consolidation alongside very tight subnational financing conditions allowed a cooperative approach and informal regional monitoring that will not always prevail. These favorable conditions helped compensate for the gradual pace of implementation that is to be expected from a fiscal reform as large as the Organic Budget Law. Future success will depend on mechanisms that institutionalize these gains,

[1]Prepared by Rafael Romeu (FAD)

prevent backsliding, and help the remaining regions outside the agreed deficit limits reach their fiscal targets.

3. A gradual and more predictable enforcement of the Organic Budget Law based on monthly targets and surveillance could help improve regional monitoring. The use of enforcement mechanisms may be limited in practice by a center-versus-regions dynamic (see AIReF below). A gradual and predictable implementation mechanism can help improve fiscal discipline and while minimizing frictions across levels of government. This would be possible if subnational budgets included both intra-year fiscal targets and contingency measures. The AIReF could then identify deviating administrations and incrementally trigger contingency measures to bring them back to the consolidation path.

4. A stronger fiscal council could help introduce predictability and diffuse center-versus-regions dynamics. The strong regional autonomy in Spain necessitates a referee to separate political pressure from rational and effective consolidation. This approach has been effective internationally, including in the United States with the military base closing commission. While institutional details differ, the perception of independence is critical, in particular if AIReF is to diffuse regional tensions. Strengthening the independence and staffing provisions in the draft AIReF law would help this institution to play this pivotal role.

A. Gradual and Predictable Regional Enforcement

5. The Organic Budget Law enforcement tools could be triggered predictably based on monthly and quarterly intra-year targets, incrementally applying pre-agreed contingent measures. The coercive and corrective mechanisms in the Organic Law allow the imposition of tax increases and expenditure cuts on administrations deviating from fiscal targets. If contingent measures and intra-year fiscal targets were identified as part of the budget process and Economic and Financial Plans (PEFs), these could be the basis for predictably triggering contingent measures. For regions, monthly revenue is largely known, and expenditure targets could be easily established as most expenditure categories are known (e.g. wages, interest, much of goods and services expenditure). Monthly and quarterly reviews could then incrementally and predictably compensate deviations by imposing pre-agreed measures if regions miss intra-year targets.

6. Figure 3 illustrates a proposed organization of the monitoring and control elements of the Organic Budget Law into a monthly and quarterly surveillance routine. In this scheme, regional outturn is checked against pre-agreed targets and contingent measures developed as part of the annual budget process. Starting from the top, center (box labeled "Monthly Start") the flow chart shows the decision tree that is designed to bring deviating regions back to the agreed budget consolidation path within six months. In this scheme, missing two consecutive monthly targets or one quarterly target is a "yellow card." This brings a warning and the enactment of measures. Missing two consecutive quarterly targets or one quarterly target and failing to impose measures from a prior warning lead to a "red card" and an intervention (as envisioned in Article 25.2 and subsequently, Article 26) by the central government.

7. In a monthly data release, informal warnings could be issued as well as formal warnings. A warning (Article 19) can be issued at any time that the central government detects that a region is deviating according to the Organic Law. In the proposed flowchart in Figure 3 (right), informal warnings result from missing one monthly target, and formal warnings result from missing two consecutive monthly targets (yellow card). Hence, the warning would serve to increase the strength of the current monthly monitoring (imposed through conditionality attached to the various credit lines) and allow for intra-quarterly enforcement. Missing a third consecutive month's target (reflected in missing a quarterly review while being under a warning) would bring intervention (red card, intervention as envisioned in Article 25.2 and 26) as well.

8. Quarterly reviews would trigger formal warnings and interventions (Figure 3, left). The organic law sets out reviews of regions in PEFs as well as surveillance (including at the monthly frequency based on budget accounting, under Article 18). The scheme in Figure 3 proposes two missed quarterly targets trigger a non-disposition of credit decree, pre-agreed tax increases or pre-agreed measures (under Article 25). In the flowchart in Figure 3, a region is intervened (Article 25.2) after failing two consecutive quarterly reviews, or failing a quarterly review after having been formally warned under Article 19 and not taking the required fiscal measures.

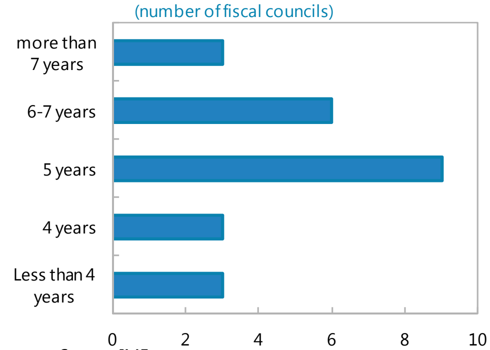
9. In this scheme, formal intervention of a region would occur only in very extreme circumstances. Whether via Article 19 (warnings) or 25 (negative quarterly reviews), predictably triggered adjustments in local taxation and spending would help resolve most intra-year fiscal deviations before politically difficult interventions are necessary. Only in cases where these fail, a delegation of experts or the use of Article 26 could impose a deeper adjustment program. Hence, the center-versus-region dynamics could be diffused by applying pre-agreed contingency measures when an independent body identifies deviations from intra-year targets.

B. Employing the Independent Fiscal Council

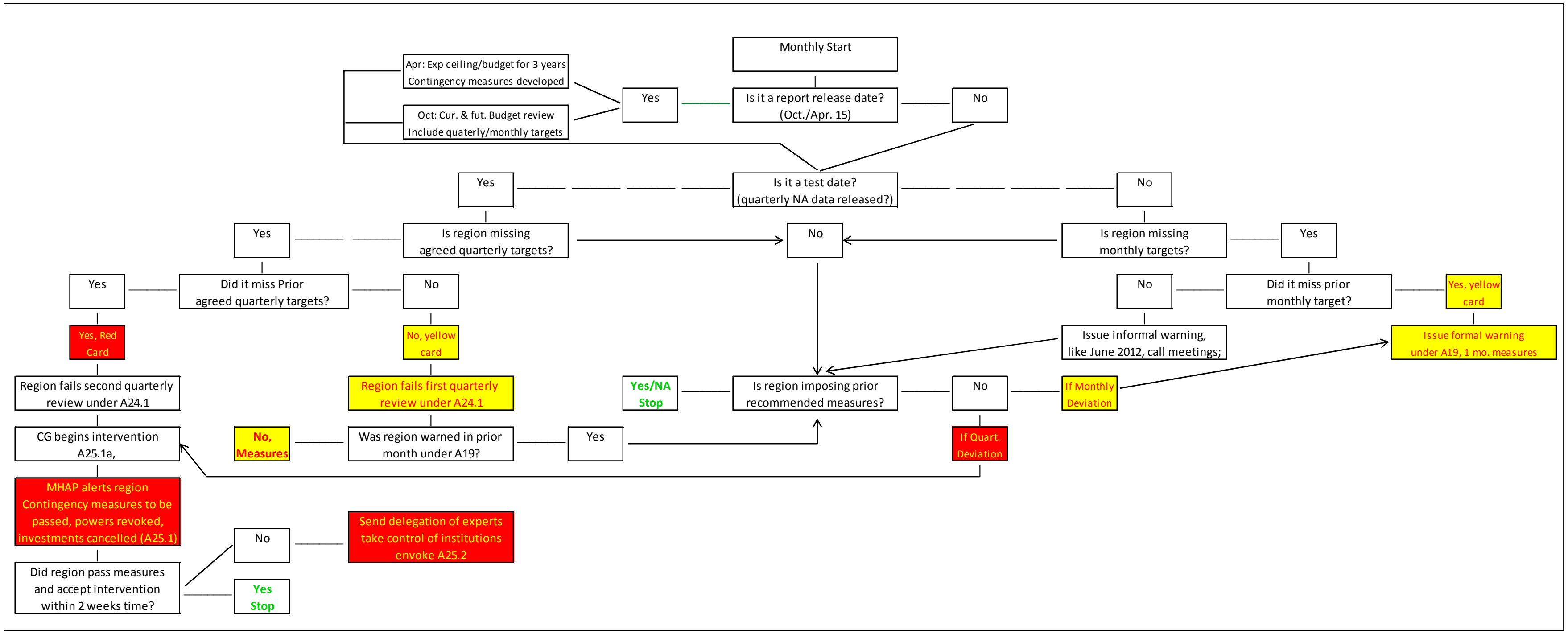
10. AIReF has a key role in cementing fiscal consolidation. The oversight role of the AIReF in setting macroeconomic and regional budget targets is strong, but grey areas in the EU legislation present implementation challenges. Nevertheless, AIReF could permit lighter and more predictable regional surveillance that diffuses center-versus region tensions by identifying deviations from pre-agreed fiscal targets. It could identify these on a monthly basis, as well as situations where deeper corrections are needed, relieving the central government of this pressure. The fiscal council could also help improve efficiency by publishing inter-regional expenditure comparisons and identify best performers, best practice, and help explain the system of subnational transfers. It could contribute to studying the tradeoffs to changes in the five-year reviews of the inter-regional financing system. Finally, AIReF could take an ambitious view of its long-term sustainability mandate, to study the long-term drivers of expenditure across the territory, including the financing of healthcare and education. Given its independence, AIReF is in a unique position to comment on opportunities for economies of scale and scope and redundancies that cut across the entire Spanish territory and remain unexploited.

11. Greater confidence gains could be achieved with stronger independence guarantees for AIReF. The most important potential risk is to the independence (real or perceived) of the AIReF president. The three-year AIReF presidential term should be made no less than five years, so as to exceed the electoral cycle in Spain. Optimally, it would be non-renewable as well. This problem is compounded by having the Finance Minister appoint the President. This not only gives the appearance non-independence, but introduces several practical limitations. The rank of sub-secretary also could limit the salary of the AIReF president, along with limitations on outside work (including "cooling off" periods) that could limit the pool of candidates. AIReF independence similar to the Bank of Spain or assigning it as an independent entity dependent on Bank of Spain with a President appointed by the sovereign at the behest of the President of the Government would be preferable. AIReF staffing should ideally be separate (also like the Bank of Spain) with its own hiring/firing rules and salary scale. A rolling 5-year budget would also strongly signal independence, though the existing visibility of the separate AIReF budget line in the national budget is acceptable practice.

Figure 2. Length of Contract of staff
(number of fiscal councils)



Source: IMF.



Source: Author-designed flow chart based on Organic Law, Boletin de las Cortes Generales, Spain, No. 43, April 14, 2012.

Notes: The flow chart represents the monthly review process proposed, which is based on national accounts data releases (both monthly and quarterly) as well as the twice-yearly reports/reviews conducted by the MHAP. Starting from the top, center (box labeled "Monthly Start") the flow chart shows the decision tree that is designed to bring deviating regions back to the agreed budget consolidation path within six months.

DOES SPAIN'S INSOLVENCY FRAMEWORK NEED FURTHER REFORMS TO ADDRESS DEBT DISTRESS IN THE NON-FINANCIAL PRIVATE SECTOR?[1]

Spain has an insolvency law that is generally in line with international best practices for corporate insolvency. However, although designed to facilitate restructuring of viable firms, in practice most proceedings end in liquidation after costly and lengthy court proceedings. Also, while the law applies to individuals, Spain does not have a personal insolvency regime providing for a "fresh start" for financially responsible debtors as in most other EU jurisdictions. Recent measures to strengthen the insolvency regime are certainly steps in the right direction, but shortcomings remain, impeding effective deleveraging of the highly indebted nonfinancial private sector. To address this, the corporate insolvency regime should be further strengthened to support early rescue of viable firms, preferably through out-of-court workouts, and swift liquidation of unviable ones. Consideration should be given to complementing these reforms in the future by introducing a special personal insolvency regime with a fresh start, applying strict conditions in order to maintain the strong Spanish payment culture and ensure financial stability.

The Spanish Insolvency Regime: Overview

1. **The 2004 insolvency law applies to debtors (legal or natural persons) who are facing actual or imminent insolvency.** Insolvency proceedings can be initiated by either the debtor (*"voluntary insolvency")* or its creditors ("*compulsory insolvency*"). While such proceedings are court driven, the insolvency administrators play a dominant role and creditor participation is very limited. The law governs both pre-*insolvency mechanisms* and *formal insolvency proceedings.* The pre-insolvency mechanisms are primarily conducted after a 'pre-insolvency court communication', which allows a debtor a grace period before obligatory filing for insolvency, to negotiate with its creditors either a 'refinancing agreement' or an 'early composition agreement.' The formal insolvency proceedings can be either *simplified* or *regular*. The *simplified insolvency proceedings,* which apply, inter alia, when the debtor has fewer than 50 creditors and the debtor's assets and liabilities do not exceed €5,000,000, are mostly used by SMEs and individuals now. The *regular insolvency proceeding* starts with the *common phase* upon the declaration of insolvency, after which the proceeding will move to either *reorganization* or *liquidation*.

2. **The law is designed to foster reorganization of viable firms with going concern sale as the residual option.** The reorganization phase is anchored in a 'reorganization plan', which can be presented by either the debtor or its creditors. Once approved by the relevant majority of creditors based on value of claims, the reorganization plan needs to be approved by the court, and once

[1] Prepared by Katharine Christopherson (LEG)

approved, binds all unsecured creditors (ordinary and subordinated), as well as those secured and other privileged creditors who consented to it. If no reorganization plan is proposed or approved, the proceeding enters into the *liquidation phase*. This phase aims to dispose of the business (or a part of it) as a going concern. To this end, the insolvency administrator needs to devise a liquidation plan that seeks to maximize the value of the enterprise. Following liquidation, the proceeds from the sale of the business/assets are distributed to creditors in accordance with their ranking and size of their claims.

Shortcomings in the Spanish Insolvency Regime

3. **On corporate insolvency, despite the intended aim of the law, most insolvency proceedings end in liquidation rather than in restructuring.** The causes for this appear to be, partially, issues of legal design, but more importantly, the following:

- S*tructural*. Since creditors are mainly secured, they have no incentives to file for insolvency as they can foreclose on the collateral (mainly real estate), which is perceived as a more effective procedure. Unsecured creditors in turn have no incentives to participate in insolvency proceedings given their low expectations of recovery since the debtor's main assets are normally used as collateral.

- *Cultural*. Despite corporate debtors' duty to file under the law, the apparent stigma associated with insolvency makes debtors delay petition for voluntary insolvency proceedings until it is too late to rescue the firm.

- *Institutional.* The overloaded courts and the lack of expertise of insolvency administrators with reorganization of viable firms render the system inefficient. Also, the costly, lengthy and cumbersome procedural structure constitutes a disincentive for potential users of the system.

4. **On personal insolvency, there is no special regime with a 'fresh start' for financially responsible individuals as in other EU jurisdictions.** While insolvent individuals may resort to insolvency proceedings (normally under the *simplified proceedings),* this does not provide them with the possibility to rehabilitate after fulfilling certain requirements (e.g., payment plan) within a specified period of time (e.g., 3 to 5 years) as in other EU jurisdictions. Instead, following liquidation of all assets in an insolvency proceeding, debtors who are natural persons remain obliged to fully repay the remaining debt with their present and future income.[2] Recognizing the importance of a fresh start, the authorities recently amended the mortgage law to provide a limited 'partial

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[2] The government has also put in place a mechanism that supports a voluntary system (opt in by banks) for out -of-court workouts for residential mortgage debtors, which only applies to the most vulnerable (the so called "Code of Good Practices"). This mechanism, which has recently been reformed to expand its coverage to allow a larger group of individuals to qualify, sets up a framework that includes restructuring of the debt*, dacion in pago* ('datio in solutum' or 'deed in lieu of payment') if the debt after restructuring is unviable. Separately, the authorities also established a mandatory suspension of evictions of up to 2 years.

discharge' after foreclosure of the primary residence of an individual debtor. Although a step in the right direction, this measure only provides 'residential mortgage debtors' a partial discharge (20 to 35 percent) after they have paid a considerable part of the remaining debt (80 percent or 65 percent) within a relatively long period of time (5 or 10 years). Moreover, the part of the debt that is forgiven in this partial discharge regime is currently considered to be taxable income for the debtor. Further, this partial discharge regime does not take into account the debtor's overall ability to pay as a basis for such discharge.

5. **While out-of-court workouts are now more widely used, their effectiveness is limited**. In practice, banks, as key creditors, are leading such workouts (when the debtor is considered viable), as part of a multi-creditor scheme in case of the larger corporates. However, its effectiveness is limited because of legal uncertainty (e.g., risk of avoidance in case of ex post insolvency), lack or limited participation of certain creditors (e.g., tax authority), and high costs (e.g., applicable taxes, lawyers and registration fees for new collateral, etc.) Further, under Spanish corporate income, tax debt forgiveness gives rise to taxable income for the debtor to the extent such income is not offset with tax losses carried forward.

Elements of an Effective Insolvency Regime

6. **International experience shows that effective insolvency regimes are critical to facilitate the rescue of viable firms and speedy exit of nonviable ones**. Insolvency law should allocate risks among market participants in a predictable, equitable and transparent manner. This strengthens the credit system, thereby fostering economic growth for the benefit of all stakeholders. The insolvency system is heavily dependent on an adequate institutional framework.

- *Effective corporate insolvency laws* aim to support orderly rehabilitation (e.g., fast track court approval or prepackaged procedures) and swift liquidation (e.g., flexibility in the liquidation modalities). Key features are: *clear filing criteria, support for rehabilitation of viable firms; automatic stay on enforcement actions; priority status for new financing; speedy liquidation of non-viable firms; and procedural rules on cross-border insolvency*.[3]

- *Special personal insolvency regimes* aim to help rehabilitate individual debtors after a reasonable time and the fulfillment of certain requirements, enabling them to return to economic life. While no international best practices yet exist in this area, key principles for an economically efficient personal insolvency law have emerged from cross-country experience, including *strict entry requirements, discharge of liabilities for financially responsible debtors (typically after 3-5 years); and repayment terms that accurately reflect the debtor's capacity to repay to ensure an effective fresh start only after confirmed satisfactory behavior of the debtor*.

[3] IMF (1999)

- Notwithstanding the above, it is worth noting that a special personal insolvency regime alone is sometimes not enough to address widespread residential mortgage debt distress. International experience shows that in such cases, even the most developed court system would be unable to handle the large number of cases through insolvency proceedings. Thus, complementary mechanisms such as government-sponsored out-of-court debt workouts (e.g., mediation) have been used to convert troubled loans into performing ones.

- *Out of court restructurings are also important* to provide a speedy, cost-effective and market friendly alternative to court supervised insolvency proceedings. This tool is particularly useful where the institutional capacity is distrusted. However, achieving effective out of court restructuring requires a robust insolvency regime and adequate incentives for debtor and creditors' participation (e.g., tax disincentives for debt write-downs or transfer of distressed loans should be removed).

7. In the aftermath of the global financial crisis, several European countries have reformed their corporate and personal insolvency regimes. A recent cross-country study conducted by Fund staff[4] of selected European countries' experience identified corporate insolvency reforms in Estonia, Germany, Greece, Iceland, Italy, Latvia, Lithuania, Moldova, Portugal, Romania, Serbia and Spain[5] since the crisis. The key element of these reforms was to better facilitate debt restructuring of viable debtors (e.g., introducing "fast track" court approval procedures) and expedite the liquidation proceedings for unviable ones (e.g., flexibility in sale modalities). Some European countries (e.g., Greece, Portugal) also adopted special measures to address household debt overhang. Some of these measures are of *ad hoc* nature designed to tackle unsustainable residential mortgage debt subject to very strict eligibility criteria, while a few provide for a mechanism to facilitate out-of-court settlement of distressed mortgages. A number of countries (e.g., Ireland, Italy, Latvia and Poland) adopted or improved their personal insolvency laws.

8. Cross-country experience shows that a comprehensive approach to non-financial private sector debt restructuring is more effective than a piecemeal approach. Measures to protect debtors may undermine creditors' rights to a certain extent. This requires a balanced approach that protects debtors without threatening the stability of the financial sector, which can only be achieved by means of a consistent set of measures that: (i) take into consideration all parties (individuals, firms and banks); (ii) do not contradict each other, and (iii) include both legal and institutional changes. This can only be done properly by a comprehensive strategy that aims for a clear objective. Financial and social crises create a conflict and thus, the aim of the reform ought to be to solve the conflict in accordance with the objective set. Patchwork generates legal uncertainty and creates a risk of overprotection of some to the detriment of others.

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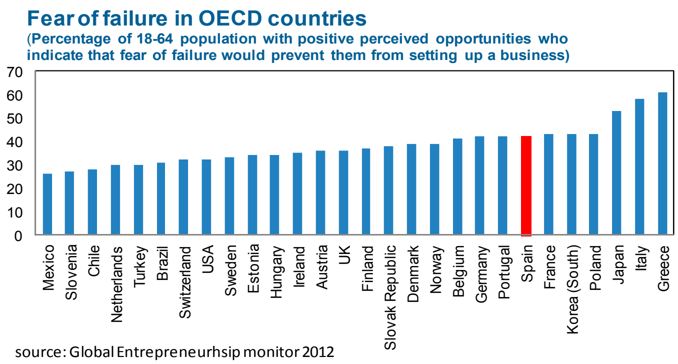
[4] Liu and Rosenberg (2013)

[5] The Spanish insolvency law entered into effect in 2004, and was substantially reformed in 2009 and 2011. Despite the recent reforms aiming primarily at supporting reorganization of viable firms, the system in practice is still not working as effectively as envisaged, as the majority of insolvency filings in Spain end in liquidation.

The Macroeconomic Relevance of Insolvency Regimes and the Case of Spain

9. Insolvency regimes contribute to re-initiating growth following the impairment of balance sheets and thus, revisions of insolvency frameworks have been part of the structural reforms undertaken by several European countries in the aftermath of the global financial crisis. Insolvent households who do not get debt relief have a very strong incentive to remain *permanently* in the informal sector. In addition, entrepreneurship is harmed by the absence of a fresh start, especially as banks increasingly request personal guarantees (and in absence of those, lending rates are much higher). Although self-employment has grown in Spain as employment prospects worsened, surveys indicate that potential entrepreneurs worry more in Spain than in other advanced countries about the risk of bankruptcy. Finally, the risks for financial stability are overplayed as an effective insolvency regime makes the process of recognition of losses that would happen anyway shorter, predictable and thus less costly.



source: Global Entrepreneurhsip monitor 2012

10. The ad hoc measures introduced by the government may in the end not provide the adequate solution envisaged in a personal insolvency regime due to their partial approach. Household surveys indicate that around half a million households are at risk of debt distress (their mortgage payments are higher than 60 percent of income). This number is much larger than the current number of households that are applying for relief under the code of good practices.[6] In addition, many of these vulnerable households also owe several thousand of euros in non-mortgage debt (consumer credit debt), which are not covered by the current code of good practice. With respect to non-vulnerable households with a mortgage, whose typical debt is around €40,000 but whose financial wealth is much smaller (around €6,000), these can benefit from the partial discharge established under Law 1/2013 after foreclosure. However, these debtors may become unable to comply with the terms of the restructuring agreement with the bank (especially if default interest continues to be applied at high rates despite the recently established legal cap—i.e., 12 percent) and thus, continue to be liable for the remainder for the debt. In these circumstances, the existing ad hoc measures for residential mortgage debtors in distress would not provide a solution for their over-indebtedness. Moreover, except for the partial discharge regime, entrepreneurs who are natural persons[7] would remain liable for any remaining debts due to the lack of a fresh start.

Recommendations for Strengthening the Spanish Insolvency Regime

[6] Official data reported that in 2012 around 8 percent of outstanding mortgages were restructured.

[7] The authorities are preparing a draft entrepreneur law that would also include a discharge mechanism.

11. The Spanish insolvency regime could be further improved to better support effective debt restructurings in the nonfinancial private sector. In particular, the law should be further refined to provide adequate incentives for early rescue of viable firms and to eliminate the rigid and burdensome procedural framework to expedite liquidation of unviable firms. Consideration should also be given to introducing a fresh start for financially responsible individuals as part of the personal insolvency regime, which would be complemented by the ad hoc measures already in place for addressing residential mortgage over-indebtedness. The key benefits from implementing these reforms include: (i) increasing the number of rescues of viable businesses, preserving value and saving jobs thereby; (ii) fostering a swift liquidation of unviable firms thus, cleansing the market from unproductive participants and allowing a more efficient reallocation of resources; (iii) incentivizing out of court workouts to alleviate the burden on the overloaded court system and decrease the costs of debt restructuring; (iv) fostering responsible borrowing and lending decisions; and (v) providing deserving debtors a second chance so as to tackle individual over-indebtedness in a comprehensive and effective manner.

12. In order to strengthen the effectiveness of the corporate insolvency regime, consideration should be given to:

- Establishing an 'automatic stay' on enforcement actions against the debtor during the three-month period after the pre-insolvency court communication, to facilitate the debtor's negotiation of refinancing agreements or early composition agreements.
- Clarifying the definition of 'refinancing agreements', lowering the majority required for creditor approval; and establishing a special priority ranking for the full amount of the refinancing granted under these agreements (e.g., "fresh money")
- Extending the period for the debtor to negotiate early composition agreements and revisiting the creditor voting provisions.
- Eliminating the higher burden of proof for filings by creditors and establishing a clear insolvency test to be used by creditors when filing for insolvency petitions.
- Providing for a "creditors committee" to enhance creditors' role and control and oversight of the proceedings and alleviate the current burden on the judge.
- Streamlining the appeals procedure against the insolvency administrator's list of creditors by either setting up 'expedited procedures' for resolving challenges to the insolvency administrator's list or allowing to close the common phase and move to the next stage despite the challenges, where the challenges/appeal will be treated as a parallel procedure.

- Eliminating the limit of a maximum 5 year extension and write off of 50 percent within ordinary composition agreements (i.e., restructuring agreements); revisiting the rules for submitting and approving a reorganization plan, and reducing debtors' powers to block a swift liquidation.

13. With regard to personal insolvency, consideration should be given to complementing the existing ad hoc measures with introducing in the future a personal insolvency regime with a fresh start. In this context, the following key elements of a personal insolvency law should be considered: (i) *a pre-insolvency stage* to allow debtors to settle their obligations with creditors via a pre-insolvency agreement/plan with the aim of avoiding the initiation of an insolvency proceeding; and (ii*) an insolvency stage* that includes strict entry requirements to avoid strategic defaults and abuses of the system; an automatic "stay" on enforcement actions by creditors upon approval of petition; liquidation of debtor's non-exempted assets; definition of debtor's disposable income to support future payments; the establishment of a 'payments plan' and how it would be made binding on dissenting creditors; limited exception for treating debtors with no capacity to repay; repayment period under payment plan (e.g., 3-5 years); rules for debtor's exit due to lack of capacity to implement a plan; and formal discharge and rehabilitation, including a mechanism to avoid stigmatizing debtors after discharge (e.g., delete debtor's name from insolvent list in credit bureaus after discharge).

14. To promote corporate out-of-court workouts, consideration should be given to:

- Issuing centralized guidelines for out-of-court workouts between banks and corporates (e.g., Latvia).
- Establishing tax incentives or eliminate disincentives to promote debt restructuring.
- Introducing a special regime for restructuring SMEs (e.g., Portugal, Italy, Iceland).

15. To support out-of-court debt restructurings for individuals, consideration should be given to:

- Issuing centralized guidelines for out-of-court workouts between banks and individuals.
- Establishing a system of mediation (e.g., Iceland's *Debtors Ombudsman*).

16. To strengthen the institutional framework, consideration should be given to:

- Strengthening commercial courts capacity by (i) increasing the number of judges (through new appointments or the reassignment of judges from other courts, and (ii) improving case management by supporting and speeding the process of digitalization of files.
- Adopting measures to increase the professionalization of insolvency administrators. The creation of a specific professional body of insolvency practitioners with a system of internal and external

controls and oversight could contribute to increase efficiency in their performance and provide for permanent education and adequate system of supervision of the profession.

References

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