

State proposal for allocating the regional government debt to be forgiven. Six regions would end up with leverage ratios of less than 13% of GDP but three would still have debt-to-current income ratios of over 150%.

With the Fiscal and Financial Policy Council set to meet soon, the Spanish government has prepared a draft agreement regarding the amount of regional government debt (regions within the so-called common regime regional financing system) that the state is prepared to assume and the criteria for allocating the amounts corresponding to each. The goal is to reinforce the regional governments' financial autonomy and leave them in a position to raise financing in the capital markets.

Initial amount: the state is proposing to assume the extra debt burden taken on by the common-regime regional governments during the harshest years of the 2010-2013 financial crisis, defined as the difference with respect to the debt taken on in 2020-2023. That difference amounts to **€80.31 billion** and forms the basis for application of the proposed regional allocation criteria.

Debt forgiveness in three tranches: The proposed assignation for each region depends directly on the weighted-adjusted population (adjusted for a series of demographic criteria selected for financing allocation purposes), the extent of 'underfinancing' in the regional financing scheme and the use of the regional authorities' powers to increase taxes:

1. **First tranche:** **75% of the total sum to be forgiven will be allocated as a function of the share of the average adjusted population of each region between 2010 and 2022** (average number of adjusted inhabitants each year during that period).

2. **Second tranche:** structured so as to guarantee that, after the first tranche, all of the regions achieve at least the average percentage of debt forgiveness as at 31 December 2023 as the regional average in the first round (19.33% of the individual debt). **By the end of the second tranche, Valencia will be the region with the highest forgiveness per adjusted inhabitant, at €2,284. This is the upper limit which no region can surpass as a result of application of the conditions for the third tranche. Another limit**, which affects the Canary Islands exclusively, is that **the maximum amount of debt to be assumed by the state in any region will be 50% of its debt as at 31 December 2023.**

3. **Third tranche:** only available to the regions that in 2010-2022 received below average like-for-like financing per adjusted inhabitant under the regional financing scheme (the SFA for its acronym in Spanish), namely Andalusia, Canaries, Castile-La Mancha, Valencia and Murcia) and those that have used their competencies to increase personal income tax. The amount forgiven via this tranche will be allocated as follows:

- **On account of below average like-for-like financing per adjusted inhabitant:** the regions that apply the third tranche via this route will receive additional forgiveness to that obtained after the second tranche such that their debt forgiveness per adjusted inhabitant - after all three tranches - **equals that of the region with the highest level of forgiveness per adjusted inhabitant after application of the second tranche.** That level, as noted above, is presented by Valencia, specifically €2,284, so that this region cannot increase its debt forgiveness via this route even though it qualifies to do so.

- **On account of increasing their regional income tax tranches:** a region is understood to have exercised its powers to increase revenue from income tax between 2010 and 2022 when the difference, for the full period, between the revenue from that tax over which the regions do have regulatory competence and the revenue over which they do not is positive. The ratio between these two aggregates provides the benchmark for applying a complementary haircut estimated at **10% of the total sum forgiven up until that juncture**, if a region's ratio is above the average for the regions that did tighten their taxation, **or 5%** if it is below that average. Insofar as the forgiveness per inhabitant obtained in Valencia after the second tranche acts as a cap, some regions that did increase income tax rates do not qualify for additional forgiveness via this route (Andalusia, Murcia and Valencia itself).

Region	Average adjusted population		PHASE 1: Adjusted population		PHASE 2: Reach Medium % Phase 1		PHASE 3: Regions below-average financing or positive year		Total forgiveness
			75% Forgiveness for Adjusted Population	% Debt forgiven after phase 1	Additional Phase 2 Forgiveness to Reach % Phase 1	Forgiveness per inhabitant Aj. After Phase 2	Regions meet one of the two criteria	Additional Phase 3 Forgiveness	
AND	8,225,276	19%	11,259	29%	-	1,369	✓	7,531	18,791
ARA	1,410,827	3%	1,931	21%	-	1,369	✓	193	2,124
AST	1,101,359	3%	1,508	36%	-	1,369	-	-	1,508
BAL	1,122,461	3%	1,536	18%	122	1,477	✓	83	1,741
CAN	2,174,939	5%	2,977	46%	-	1,369	✓	282	3,259
CNT	591,044	1%	809	24%	-	1,369	-	-	809
CLM	2,156,720	5%	2,952	18%	170	1,448	✓	1,804	4,927
CYL	2,661,110	6%	3,643	26%	-	1,369	-	-	3,643
CAT	7,487,008	17%	10,249	12%	6,371	2,220	✓	484	17,104
EXT	1,140,757	3%	1,562	29%	-	1,369	✓	156	1,718
GAL	2,929,219	7%	4,010	33%	-	1,369	-	-	4,010
RIO	327,381	1%	448	28%	-	1,369	-	-	448
MAD	6,314,728	14%	8,644	24%	-	1,369	-	-	8,644
MUR	1,452,500	3%	1,988	16%	358	1,615	✓	972	3,318
VAL	4,906,812	11%	6,717	12%	4,493	2,284	-	-	11,210
TOTAL	44,002,139	100.0%	60,232	19.3%	11,514	1,631		11,506	83,252

As a result, the levels of forgiveness per adjusted inhabitant would be those shown in the following table:

Adjustment per adjusted inhabitant (€)

VAL	2,284
AND	2,284
CAT	2,284
CLM	2,284
MUR	2,284
BAL	1,551
EXT	1,506
ARA	1,505
CAN	1,498
AST	1,369
CYL	1,369
GAL	1,369
MAD	1,369
CNT	1,369
RIO	1,369

Source: Ministry of Finance

A group of five regions would benefit from higher levels of forgiveness per adjusted population (Valencia, Andalusia, Catalonia, Murcia and Castile-La Mancha), while a group of six would be assigned lower levels (Asturias, Castile and León, Galicia, Madrid, Cantabria and Rioja).

Other considerations

- Full priority will be given to forgiving the regions' loans with the state funds over borrowings with third parties.
- Neutral impact on the deficit and public debt of the Kingdom of Spain, so that articulation and execution of these measures will be guided by the overriding principle of minimising any potential impact on these metrics.
- Take it or leave it: the beneficiary regions must accept the application of these measures on the terms regulated.

Impact on the regional debt portfolios

The impact on the regional debt portfolios would vary from one region to the next. We would highlight the following conclusions:

- There are five regions (Madrid, Galicia, Castile and León, Canaries and Asturias) that do not have enough debt with the state funds so that the forgiveness would have to take the form, at least partially, of the cancellation of debt with third-party creditors.
- In terms of GDP, the biggest debt reduction would materialise in Andalusia. There, the debt ratio would come down by 9pp, compared to just 2.8pp in Madrid. In addition to these two regions, the borrowing ratios in Galicia, the Canaries, Asturias and Rioja would fall below the 13% threshold set down in the Stability Act. The case of the Canary Islands stands apart as it would present leverage of just 5.7% of its GDP.
- In terms of debt-to-current income, Murcia's ratio would come down by nearly 56pp, compared to just 27.4pp in Cantabria. However, Murcia would continue to report a ratio of 159% to current income, with Catalonia at 174% and Valencia still over 200%. Note that the credit rating agencies view a ratio of over 175% as excessive debt.

Impact of the forgiveness measures on the regional debt portfolios

EUR millions	Total Debt 3Q24 (current)	Forgiveness volume	Total debt after forgiveness	Forgiveness through the FFCA	Forgiveness via transfers	Current GDP debt	GDP debt after forgiveness	Debt/GDP change	Current IC Debt	IC debt after forgiveness	Debt/IC variation
AND	39,842	18,791	21,051	18,791	-	19.0%	10.0%	-9.0%	103.8%	54.8%	-49.0%
CAT	88,917	17,104	71,813	17,104	-	30.1%	24.3%	-5.8%	215.5%	174.0%	-41.4%
CVA	59,498	11,210	48,288	11,210	-	40.8%	33.1%	-7.7%	275.6%	223.7%	-51.9%
MAD	36,915	8,644	28,271	-	8,644	12.0%	9.2%	-2.8%	141.0%	108.0%	-33.0%
CLM	16,473	4,927	11,546	4,927	-	29.2%	20.5%	-8.7%	172.9%	121.2%	-51.7%
GAL	12,154	4,010	8,144	2,089	1,921	15.0%	10.1%	-4.9%	97.7%	65.5%	-32.2%
CYL	14,006	3,643	10,363	1,774	1,869	18.9%	14.0%	-4.9%	118.7%	87.8%	-30.9%
MUR	12,802	3,318	9,484	3,318	-	30.3%	22.4%	-7.9%	215.0%	159.3%	-55.7%
CAN	6,467	3,259	3,208	1,286	1,973	11.4%	5.7%	-5.7%	64.2%	31.9%	-32.4%
ARA	9,365	2,124	7,241	2,124	-	19.2%	14.8%	-4.4%	142.1%	109.9%	-32.2%
BAL	8,661	1,741	6,920	1,741	-	19.7%	15.7%	-4.0%	154.6%	123.6%	-31.1%
EXT	5,453	1,718	3,735	1,718	-	20.9%	14.3%	-6.6%	90.5%	62.0%	-28.5%
AST	4,096	1,508	2,588	586	922	13.8%	8.7%	-5.1%	80.4%	50.8%	-29.6%
CNT	3,248	809	2,439	809	-	18.5%	13.9%	-4.6%	109.9%	82.5%	-27.4%
RIO	1,632	448	1,184	448	-	14.7%	10.7%	-4.0%	102.7%	74.5%	-28.2%
TOTAL	319,528	83,252	236,274	67,925	15,327	22.1%	16.3%	-5.8%	155.8%	115.2%	-40.6%

Source: Afi, Ministry of Finance, Bank of Spain

We believe that the ultimate aim of this process must be a return to the capital markets by the regional administrations. Therefore, the state mechanisms should only remain accessible to the regions that, even after this debt forgiveness process, cannot achieve full financial autonomy under the terms and conditions established under the umbrella of the so-called Regional Financial Prudence Resolution. However, as noted, borrowings in some regions would remain high, making it hard to deleverage from current levels without reforming the regional financing scheme.