Highlights of Spain's new financial sector reform

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The Spanish government's new financial sector reform aims to accelerate the clean-up of banks' balance sheets and restore confidence in the Spanish financial system. The reform has clear advantages in boosting transparency and credibility, as well as tackling core issues. Next steps will need to include defining backstop mechanisms.

Spain has just approved its second financial reform this year, containing complementary measures to those approved last February, with an aim to clean-up banks' balance sheets. The reform also incorporates the creation of so-called asset management companies (SGAs in their Spanish initials) that will serve as the instruments through which troubled real estate assets of banks will first be transferred, and subsequently sold, over the next few years. This note summarizes the main elements of the new reform and makes a preliminary assessment of its potential impact.

The fifth financial sector reform since 2009

On May 11th, the Spanish government approved a new financial reform. The first was Royal Decree-law 9/2009, creating the Fund for the Orderly Restructuring of the Banking Sector (FROB). The second was Royal Decree-law 11/2010, improving governance and other aspects of the legal framework of the savings banks. The third was Royal Decree-law 2/2011, for the reinforcement and recapitalisation of the financial system. The fourth, approved last February, was Royal Decree-law 2/2012, increasing the provisioning requirements related to impaired assets.

The new reform will be enforced mainly through Royal Decree-law 18/2012 of May 11th, 2012 on the clean up and sale of real estate assets of the banking sector (published in the Spanish Official Bulletin 114 of May 12th, 2012: http://www.boe.es/boe/dias/2012/05/12/pdfs/BOE-A-2012-6280.pdf). The Decree is in line with the decision of the Spanish Council of Ministers to make a general assessment of the global credit portfolio of banks in Spain. To that end, two independent entities will be appointed. As the Spanish Minister for Economic Affairs and Competition has pointed out, the goal of the reform is "to dissipate any kind of doubt or uncertainty regarding the balance sheets of the banks" and the assets included in these balance sheets". Additionally, as noted in RD-l 18/2012, the reform seeks to "promote recovery of credit and drive the sale of property at fair value."

Approval of this new reform comes only three months after the February reform. Market pressure on Spanish banks has significantly intensified over March and April and there have been several recommendations from international organizations

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calling for further action in the area of banking sector reforms in Spain to dissipate some of the current concerns and uncertainties. Probably among the most influential of these recommendations were the preliminary conclusions of the Financial Sector Assessment published by the International Monetary Fund on April 25th, 2012. The IMF noted that *"the assessment confirms the need to continue with and further deepen the financial sector reform strategy to address remaining vulnerabilities and build strong capital buffers in the sector. A carefully designed strategy to clean up the weak institutions quickly and adequately is essential to avoid any adverse impact on the sound banks. Furthermore, dealing effectively and comprehensively with banks' legacy problem assets should be the priority of the next stage of the financial reform strategy."*

In this short note, we provide detail on the financial reform's new provisioning requirements and discuss how it offers new tools to try to provide more confidence in the Spanish banking sector. In section 2, we address the main elements of the reform and in Section 3 we make a brief preliminary assessment.

Main components of the reform

New provisions and FROB funding

The new financial sector reform has been presented as a second phase of the reform approved last February. The basic idea has been to anticipate the clean-up of a hypothetical deterioration of the performing (healthy) real estate portfolio. For performing loans in the real estate sector – estimated by the government to be 123 billion euros as of December 2011 - an average increase in the current (generic) provisions level from 7% to 30% will be required by December 2012. According to the government, this will imply around 30 billion euros of additional provisions.

Importantly, the banks in need of capital as a result of the new provisioning requirements will have to fund themselves either through the market, or through financial support from the FROB. In particular, by June 11th, banks will have to present compliance plans for achieving the new levels of provisions. The Bank of Spain will then have 15 working days to make its own assessment of the plans. If the Bank of Spain considers that the plans would result in a shortfall of own funds or "capital principal" (concept similar to core capital), the banks will be required to present new measures to avoid such a shortfall, as well as an execution plan, within the next five months. In any event, if the Bank of Spain considers that compliance is unlikely, additional measures can be adopted, including financial support from the FROB.

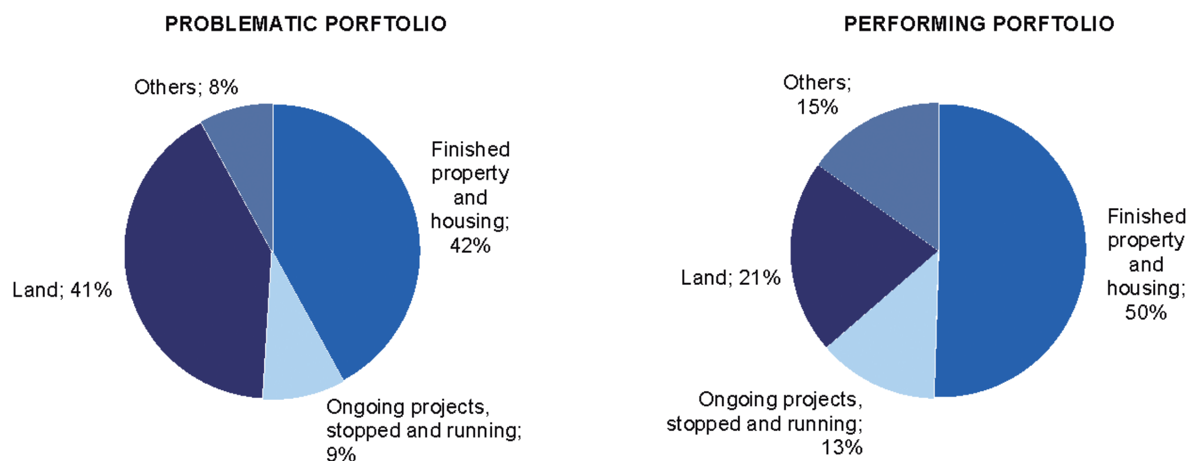
The FROB will be able to provide capital through two instruments: shares or contingent capital (CoCos). Since this funding will be considered as refundable, these recapitalization possibilities will not be included in the public deficit.

Importantly, the CoCos will be remunerated at a 10% interest rate, which represents approximately twice the Spanish Treasury's funding cost for 5 year maturities, the same period allotted for refunding of state aid. Any bank receiving FROB support will have to submit an additional restructuring plan to the Bank of Spain explaining how the funds will be refunded.

It is worth highlighting that the government has provided data on the composition and quality of the performing real estate portfolio and the problematic portfolio. There are significant differences in composition. As shown in Exhibit 1, problematic land (74 billion euros) represents 24% (74 billion euros out of 307 billion euros) of total assets linked to loans to developers, while non-problematic land (25 billion euros) represents 8% (25 billion euros out of 307 billion euros) of total assets linked to loans to developers. In any event, the effort ahead for Spanish financial institutions will be considerable.

Exhibit 1

Composition of problematic and performing portfolio of assets linked to loans to developers in the Spanish banking sector



Source: Spanish Ministry for Economic Affairs and Competition

Additionally, the Ministry for Economic Affairs and Competition has conducted a preliminary stress test on the potential effectiveness of the new provisioning rules (combining both the measures adopted in RD-l 2/2012 and RD-l 18/2012). Under a stress scenario, where 75% of performing assets (that is, 92.2 billion euros) become impaired, total problematic assets would increase from the current 184 billion euros to 276 billion euros and the provisions would cover 50% of these problematic assets.

Specific measures for banks engaging in new merger processes

The new banking reform allows those banks that engage in further mergers to enjoy some advantages. In particular, the deadline to meet the new provisioning requirements will be extended until December 2013. Additionally, the government will allow the write-down of impaired assets against equity for these merging institutions. Merging banks may also benefit (if they decided to do so) for the FROB's margin of action, allowing for acquisition of CoCos until December 2013.

In return for these potential advantages for merging institutions, the reform establishes some strict conditionality on the mergers. In particular, merging banks will be required to submit a plan to the Ministry for Economic Affairs and Competition by June 30th, 2012 and the merger will be expected to be fully operative as of January 1st, 2013. The merged institution will need to have a balance sheet 20% higher than the largest participating institution. Improvements in corporate governance could also be required, as well as further reductions in the exposure to real estate assets and "an increase in lending to productive activities".

Asset management companies (SGAs) and independent third-party valuation of all assets

RD-l 18/2012 also includes two very important additional features. The first one is the creation of the so-called asset management companies

(SGAs). The goal is to isolate problematic real estate assets from the bank's balance sheet. The regulation predicts an "initial transfer of only foreclosed problematic assets". The transfer is expected to be made "at fair value (book value net of provisions, considering high provisioning levels for these assets)". The creation of an SGA will be compulsory for all Spanish financial institutions (one SGA for each one the banks).

The second very relevant additional feature is that two independent risk valuations from reputed independent experts will be requested by the government. The valuation will cover the entire portfolio and not only the real estate portfolio.

Preliminary assessment

As for any significant economic reform, an accurate assessment requires time to evaluate the medium to long-term impact of the actions undertaken. In any event, the most obvious filter that will determine the success of the new reform will be the extent to which it contributes to calm markets and foreign investors and to improve financial stability and confidence in the Spanish banking sector.

Among the advantages of the reform is a clear improvement in transparency over the market value of banking assets - the independent valuation of the assets will be a key feature. The result of this independent valuation will get closer to the real magnitude of the challenge that Spanish authorities and banks may face in solving asset impairment problems.

Another advantage of the reform is that it clearly deals with the most problematic set of assets in the loan portfolio, those linked to construction and development.

In any event, there are still a few problems and uncertainties that will probably require further clarification or action to make the reform as effective as it aims to be. The main question is how the potential losses that will emerge from the legacy assets will be covered/guaranteed. In particular, if the independent valuation of the banks' asset portfolio reveals that the magnitude of the impairment is higher than expected. Hence, it is critical to define how the so called backstop mechanism will provide the necessary resources to assist the troubled banks and guarantee potential losses. This feature is particularly relevant considering two additional issues that are a source of concern for financial analysts today. The first one is the extent to which the transfer of assets to an SGA at book value (net of provisions) will be considered an effective recognition of the asset impairment in the banks' balance sheets. The second (and probably most important) concern is the extent to which other assets - and not only those related to loans to construction and development - will be affected if macroeconomic conditions keep on deteriorating. Mortgages constitute the main concern and the independent assessment on the value of all banking assets should also reveal the magnitude of this potential problem.