Recent progress on bank restructuring and recapitalization in Spain

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Spain has made recent progress in implementation of key actions, such as restructuring, recapitalization, loan reclassification, and bank balance sheet clean up, as required by the Memorandum of Understanding (MoU) signed with the EU for aid to the financial sector. These actions may have potential consequences on provisioning requirements, and subsequently credit to the private sector, and in the case of Spain's bad bank, the SAREB, the ultimate ability of the country to resolve its banking crisis.

Over the period from March to May 2013, Spain has taken key actions in several areas as stipulated by the MoU with the EU, including: i) the restructuring and recapitalization of nationalized banks, complete with burden-sharing mechanisms for Group 1 and Group 2 banks; ii) the establishment of guidelines for reclassification of loans; and, iii) the approval of an updated business plan for the SAREB, which aims at selling almost half of the assets transferred by banks in 5 years. As for the burden-sharing mechanisms, the Steering Committee of the FROB has approved haircuts on preferred stock and subordinated debt of Group 1 and Group 2 banks with a range from 13% to 60%. In the case of loan reclassifications, the actions are expected to have potential impact on provisioning requirements, and as a consequence, credit conditions. The Bank of Spain has informed that there are 208.21 billion euros in refinanced and rescheduled loans and 45.7 billion euros correspond to doubtful loans, which are not covered by provisions. In the case of actions related to the SAREB, these will likely influence housing prices, banks' real estate exposure, as well as their general balance sheet health. The success of the SAREB will be a large determinant of whether or not the government will be able to resolve the banking crisis overall.

Recent recapitalization and burden-sharing actions

One of the main challenges in the process of resolution of the banking crisis in Spain and other EU countries is how to deal with nationalized banks. This is a task that goes beyond the financial crisis as it frequently takes many years for the public sector to dispose of acquired stakes in these banks. The Memorandum of Understanding (MoU) signed by Spain with the EU authorities includes a number of important milestones to be

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completed in 2013, mainly affecting nationalized banks. Some of these actions have already taken place from March to May 2013 and they mainly referred to restructuring, recapitalization and burden-sharing measures.

On March 22nd, 2013, the Steering Committee of the Fund for the Orderly Restructuring of the Banking Sector (FROB) took various important decisions regarding the restructuring and winding up of some nationalized Spanish banks: BFA-Bankia, NCG Banco and Calalunya Banc.

In the case of Bankia, the first step in the process of recapitalization required a reduction of the nominal value of the equity of this bank. The value of Bankia was set at -4.14 billion euros. The MoU required that shareholders should be the first to absorb losses with practically their entire shareholding value. In particular, as part of the burden-sharing mechanism, Bankia shareholders have had to face a reduction of the nominal value of the existing shares from 2 euros down to 1 euro-cent. Following the capital reduction, in order to reduce the number of shares outstanding and to make the trading of the shares operatively more tractable, the FROB also decided that a reverse-split or bundling of shares was to be carried out in the proportion 100x1. The split was effective on April 22nd. This made it possible to return the nominal value of the shares to a figure of around 1 euro.

The second step in the recapitalization of Bankia was to inject the necessary capital as to comply with regulatory capital adequacy ratios. This has been done with two simultaneous transactions: i) a capital increase with pre-emptive subscription rights for 10.7 billion euros; and, ii) a second capital increase for 4.5 billion euros, with exclusion of pre–emptive subscription rights, to bring the holders of preferred stock and subordinated debt of Bankia into the new Bankia capital structure. As for the 10.7 billion euros injection, this was virtually subscribed by BFA, an institution fully-owned by the FROB. As for bondholders, they become Bankia shareholders with some haircuts that we specify below.

Following the MoU, the mandatory measures or the management of hybrid instruments in the BFA-Bankia Group assume that FROB will make "the entity buy back its preferred securities and perpetual subordinated debt instruments from holders at discounts against the nominal value resulting from application of the methodology contained in the Plans approved by the FROB and the Bank of Spain, and in the European Commission decisions." In the case of Bankia, the average haircut for holders of perpetual subordinated debt has been 36%. As required by the European Commission, the proceeds of the buyback will be reinvested in Bankia shares following the principles mentioned above. As for the holders of subordinated debt with a maturity date, they will have the option of exchanging it either for shares at the subscription price after application of the corresponding haircut or for bank deposits or bonds with the same maturity (also with a haircut). The average haircut in this case is estimated at 13%.

Also on March 22nd, 2013, the Steering Committee of the FROB approved the average haircuts applicable to the different classes of financial instruments of the other banks classified as Group 1 following the MoU principles. As for NCG Banco, the FROB has required this bank to buy back its preferred stock and perpetual subordinated debt instruments from holders with a haircut. The average haircut estimated for preferred stock holders will be 43%. The average haircut for holders of perpetual subordinated debt will be 40%. As in the case of Bankia, holders of subordinated debt with a maturity date in NGC Banco will have the option of exchanging the bonds for NCG shares or for bank deposits with an average haircut of 13%. In the case of Catalunya Banc, the FROB also required it to buy back its preferred securities and perpetual subordinated debt instruments from holders with a haircut against the nominal value. In this case, the average haircut is estimated at 61% for holders of preferred stock. The average haircut for holders of perpetual subordinated debt will be 40%. As in the previous cases, the holders of subordinated debt with a maturity date will have the option of exchanging it for shares or for bank deposits or bonds with the same maturity, after application of an average haircut of 15%.

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It is also important to note that FROB has to set some burden-sharing processes for Group 2 banks. In particular, for Banco Mare Nostrum, Liberbank and Cajatres. Banco Mare Nostrum received a capital injection from the FROB in the form of shares for 0.7 billion euros, while the aid received by Liberbank (0.12 billion euros) and Cajatres (0.40 billion euros) was made in the form of contingent capital (CoCos). As for the other Group 2 bank, Banco Ceiss, this bank approved a restructuring plan –including salary and workforce adjustments– as of May 10th, 2013 and will merge with Unicaja.

A somehow different case is Banco Gallego. The FROB also required this bank to buy back its preferred stock and perpetual subordinated debt instruments from holders with an average haircut of 50% estimated for preferred stock and 39% for perpetual subordinated debt. However, the FROB initiated an auction process for the sale of this bank. In April 2013, the Steering Committee of FROB announced that Banco Sabadell was acquiring Banco Gallego for 0.24 billion euros with the transfer of all the shares of Banco Gallego to Banco Sabadell for one euro.

Loan refinancing transactions: A new regulatory treatment

One of the most controversial issues surrounding the different assessments on the status of Spanish banks –and, in particular, those of the various stress test undertaken– has been the extent that the reported quality of the bank loans may be affected by classification practices. Specifically, the main concern is that the true quality of some loans may not be observed as these loans are refinanced.

At the beginning of 2013, an Internal Committee of the Bank of Spain issued a report with recommendations on bank supervision procedures. This was one of the requirements of the MoU. The report includes the establishment of a standardized framework for the adaptation of supervisory measures based on the risk profile of credit institutions. The plan mentioned the need to refocus the on-site supervision and the recommendations made on bank information disclosure. In part, as a result of these efforts, the Executive Committee of the Bank of Spain issued a note on April 30th, 2013, with recommendations on the reporting of loan refinancing transactions and loan rescheduling. The recommendations are expected to effectively force banks to recognise as "substandard" some loans currently classified as "normal". Substandard loans are those that have a risk of default –because of the economic environment or problems in a specific business sector– even if the borrower has not missed its payments. As banks must partially provision for losses on substandard loans, the recommendations may imply more provisions. Given the possibility that differences across banks in refinanced and rescheduled loans "are due to accounting practices", the supervisor issued the abovementioned note to detail the criteria on loan refinancing and rescheduling. Following the note, the banks will be bound to review the accounting classification of refinanced or rescheduled loans to ensure compliance with these criteria. The banks will have to inform the Bank of Spain of the outcome of this review and of the related accounting effects before September 30th, 2013.

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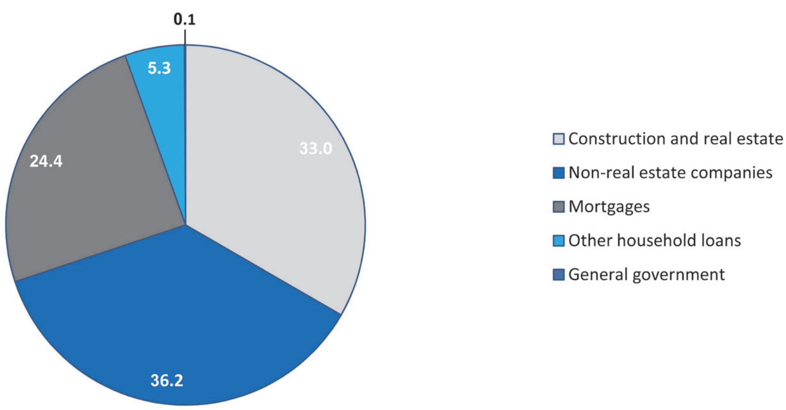
The latest Financial Stability Report (FSR) of the Bank of Spain (May 2013 edition) provides some interesting information on the magnitude and potential impact of loan refinancing and rescheduling. Moreover, the Bank of Spain issued a specific note on May 9th, 2013, with some excerpts from the FSR to highlight "loan refinancing and contrasting of the stress test conducted by Oliver Wyman in 2012". Importantly, the Bank of Spain acknowledged that "with regard to refinanced and rescheduled loans, this is the first time detailed information has been published on them". The FSR shows that refinanced and rescheduled loans amount to 208.21 billion euros, which is 13.6% of total credit to the resident private sector. The breakdown by sector is shown in Exhibit 1. 33% corresponds to construction and real estate development (68.7 billion euros); 36.2% to other companies (75.4 billion euros); 24.4% to mortgages (50.8 billion euros); 5.3% to other household loans (11 billion euros); and 1.1% corresponds to general government (0.2 billion euros). The Bank of Spain points out that "there is some dispersion across banks, which may be indicative of different business and risk-management models, but also of differences in accounting practices".

Notably, 42.4% of the refinancing and rescheduling operations are classified as performing by banks, whereas 20.6% are classified as substandard and 37% as doubtful. Substandard refinanced and rescheduled loans are covered by 18.4%, whereas in the doubtful category the coverage is 40.6%. This implies that there are at least 45.7 billion euros in doubtful loans, which are not covered

Exhibit 1

Restructured and rescheduled loans in the Spanish banking sector as of December 2012. Breakdown by sector (%)



Source: Bank of Spain and own elaboration.

by bank provisions. The fact that a significant share of the refinanced transactions are loans to individuals (including mortgages and other loans) is challenging for banks in the current context of very high unemployment. In particular,

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the FSR shows that the non-performing loans to individuals have increased by 31.7% year-on-year in December 2012, as compared to 12.2% in 2011.

As for the evaluation of the projections made in the stress test conducted by Oliver Wyman (OW) in 2012, it is observed that the defaults in the Spanish banking sector in 2012 have been lower than the probabilities estimated by OW, both in the baseline and in the adverse scenario. However,

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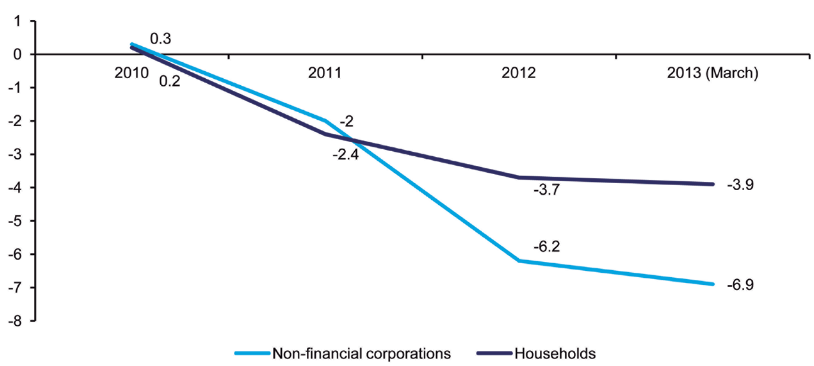
there is one exception: in large corporations and public works portfolios, actual defaults in 2012 are higher than the probability of default estimated for the baseline scenario. Additionally, it is worth noting that the profit before provisions of the banking sector for 2012 was larger than the one estimated by OW.

As for the macro scenario, the evolution of the unemployment rate, and the fall in house prices in 2012 ended up being very close to the estimates of OW under the adverse scenario. The evolution of the economy and the regulatory pressure on loan reclassifications will impose new challenges for Spanish banks in the near future and may make it even more difficult for these banks to foster lending to the private sector. The annual growth rate in lending to resident sectors keeps declining.

Exhibit 2

Lending to the private sector in Spain. Annual growth rates (%)



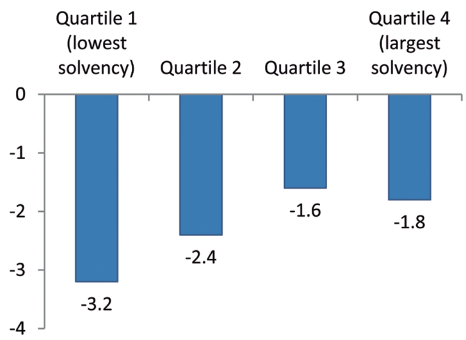
Source: Bank of Spain and own elaboration.

In March 2013, the annual growth rate of lending to non-financial corporations was -6.9% (it was -6.2% in December 2012) and the annual change in lending to households was -3.9% (-3.7% in December 2012).

The FSR of the Bank of Spain offers some interesting information on the relationship between the effort that the banks are making to reinforce their solvency levels and the evolution of lending to the private sector. The average annual change in lending in 2012 for the banks with the lowest level of solvency (8.8% average Tier 1 ratio according to the Bank of Spain) is -3.2% and then the fall is less intense for the banks in the second quartile (-2.4%), the third quartile (-1.6%) and the fourth quartile (-1.8%). Exhibit 3 suggests that the relationship between bank solvency and lending is not linear. The banks in the third solvency quartile have reduced their lending to the private sector to a lesser extent than those in the highest solvency quartile. This can be explained because some banks may be seeking to create solvency buffers to improve their credibility in the market by signaling higher loss absorption capacity.

Exhibit 3

Annual growth rate in lending. Breakdown by bank solvency levels (2012)



Source: Bank of Spain and own elaboration.

SAREB's new business plan and initial steps

The Spanish asset management company SAREB, Spain's "bad bank," which has absorbed a great deal of the impaired assets of the Spanish banking sector, is a key factor for the success of the resolution of the banking crisis in Spain. This is not just because of the role of SAREB as a vehicle to deal with asset impairment but also because it will likely influence house prices in Spain and, therefore, contribute to the remaining adjustment of real estate asset prices to equilibrium levels. SAREB manages 197,474 assets and loans worth 50.7 billion euros. 107,000 of the assets are real estate properties and 90,474 are loans. Hence, its capacity to influence market prices is potentially significant.

Table 1

Transfer of assets to SAREB by Group 1 and Group 2 banks (million euros)

	Group 1 banks (December 2012)	Group 2 banks (February 2013)	Total
Loans			
Gross	54,250	20,071	74,591
Net	39,313	11,056	39,369
Assets			
Gross	24,358	7,172	31,530
Net	8,397	2,967	11,364
Total			
Gross	78,878	27,243	106,121
Net	36,710	14,023	50,733

Source: Bank of Spain and own elaboration.

From January to April 2013, SAREB has been defining its corporate structure and refining its business plan for once market conditions and interest of investors in the assets in SAREB's portfolio have been calibrated. However, even before SAREB had started to manage and sell those assets, its most immediate effect has been on the health of Spanish banks' portfolios. Table 1 shows the gross and net (after the discount is applied) transfer of assets from Group 1 and Group 2 banks (according to the MoU classification) to SAREB.

The exposure to real-estate activities of Spanish banks over 2012 and 2013 –taking into consideration both loans and foreclosed assets and net of provisions– fell by 50%. Around 60% of the reduction is estimated to be due the transfers to the SAREB, while 40% of the reduction has been explained by the provisions made by banks. As for non-performing loans (NPLs), the impact of SAREB has also been significant. Taking the latest data, corresponding to February 2013, the NPL ratio was 10.7%. When both Group 1 and Group 2 banks are excluded from the computations, the doubtful assets ratio is 10.1% in February 2013.

As for the management of SAREB, an updated business plan was presented on March 21st, 2013. The business plan acknowledges the influence of the recommendations of the IMF and the European Commission requiring a "sound and credible" business plan for SAREB as one of the most important requirements to recover financial stability in Spain. The main features of the business plan are as follows:

- Two thirds of the revenues of SAREB are expected to be generated by the sale of assets and one third by the sale of loans.
- SAREB expects to sell almost half of its asset portfolio over the first 5 years of the 15 years life horizon of the asset management company. In particular, 42,500 assets.
- SAREB expects to payback 49.9% of the senior debt received in 5 years.
- The expected profitability for investors is estimated at 13-14%.
- SAREB has now approved internal rules to avoid conflict of interest in the transactions. In particular, those potentially affecting the board members and investors with interest in similar markets as those where SAREB operates.

Overall, the management of SAREB will be one of the critical factors behind the degree of success in the resolution of the banking crisis in Spain. The dynamics of the economy may affect the future scope of the SAREB. There could be, for example, other assets being transferred to the SAREB if the macroeconomic situation deteriorates and not necessarily coming from the banking sector. Overall, SAREB will largely determine the ultimate costs assumed by taxpayers for the bailout of banks in Spain.

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