BANCO DE ESPAÑA
Eurosistema

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# Note on the savings bank restructuring process

Situation in July 2011

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Royal Decree-Law 9/2009 of 26 June 2009 laid the legal foundations in Spain for the restructuring of the savings bank sector. It is a painstaking process because of the variety and significance of the regulatory adjustments required and because of the complex decisions and negotiations entailed. This note updates the information already provided and appropriately frames the final stage of this process.

The restructuring of the savings bank sector was unavoidable. The sector had several structural limitations associated with its legal nature, such as the legal restrictions on raising high quality capital other than via retained earnings and a complex and rigid system of governance not conducive to best corporate governance practices. The outbreak of the international financial crisis in 2007 and the subsequent economic crisis underscored the importance of those limitations.

This unfavourable environment also brought to light the negative consequences of some imbalances in the sector which had built up mainly during the surge in lending growth that preceded the crisis: concentration in the real estate development and construction sector, dependence on wholesale market funding, excess capacity, small average size of institutions, loss of profitability, etc.

Royal Decree-Law 9/2009, known as the FROB Law, set in train an intense process of savings bank mergers and integrations which radically altered the landscape of this sector in Spain.

Another milestone in this process was the reform of the legal framework for savings banks by Royal Decree-Law 11/2010 of 9 July 2010, which permitted savings banks to opt to pursue their activity through a commercial bank and thus enabled them to tap capital markets to strengthen their core capital and improve their governance.

Finally, Royal Decree-Law 2/2011 on the strengthening of the Spanish financial system, adopted on 18 February 2011 and validated by Parliament on 10 March 2011, initiated the last stage of the process of savings bank restructuring. This legislation introduced a new capital ratio of either 8% or 10% to be met with core capital instruments and provided for financial support by the Fund for the Orderly Restructuring of the Banking Sector ("FROB" by its Spanish abbreviation). The financial support would be provided through share subscription to those institutions that did not reach the minimum required capital levels and had not used alternative means of recapitalisation. Since that date, the necessary steps have been under way to meet the timetable and objectives set in the

Royal Decree-Law, so as to ensure that the institutions not meeting the minimum core capital requirements shall have implemented their recapitalisation strategies by 30 September.[1]

The final execution of the recapitalisation strategies of that small group of institutions (13 in total, 9 of them savings banks) will bring to a close the restructuring of the sector and mark the completion of the stages of balance sheet write-down, merger or integration of institutions, change of corporate model with the conversion of nearly all savings banks into commercial banks, improvement of governance and recapitalisation.

This overall strategy also includes the stress tests on the EU banking sector, the results of which will be made public in a few days' time. Under Article 1.4 of this Royal Decree-Law, the institutions not reaching the level of capital required in stress tests on the whole system can be obliged by the Banco de España to increase their capital to comply with that level. Therefore, in such cases, institutions have to raise additional capital and, to do so, they can, ultimately, receive assistance from the FROB.

## 1 Restructuring milestones

- FROB Law

| Date | Key moment | Consequences |
|---|---|---|
| 08/07/2009 | Parliament validates Royal Decree-Law 9/2009 of 26 June 2009. | - Support to the **voluntary merger/integration of viable institutions** wherever it improves efficiency, rationalises management and reduces capacity. |
| | | - Promotion of **crisis resolution at non-viable institutions** when a solution cannot be found within the framework of the Deposit Guarantee Funds. This involves replacement of the institution's directors by the FROB and the drafting of a restructuring plan. |

- Savings Bank Law

| Date | Key moment | Consequences |
|---|---|---|
| 21/07/2010 | Parliament validates Royal Decree-Law 11/2010 of 9 July 2010. | - Savings banks are permitted to **conduct banking activities through a commercial bank**, thus making it easier for them to tap funding markets. |
| | | -Spurs the **professionalisation** of their governing bodies. |

1The Royal Decree-Law also provides for an extension of three months (six months in the event of an initial public offering (IPO)) for operating reasons, but only in those cases in which the Banco de España considers it to be fully justified.

- Royal Decree-Law on Recapitalisation

| Date | Key moment | Consequences |
|---|---|---|
| 10/03/2011 | Parliament approves Royal Decree-Law 2/2011 of 26 March 2011 | - **New core capital ratio**: 8% of risk-weighted assets (10% for institutions with greater risks). |
| | | - Need to set out a strategy and recapitalisation timetable and, for institutions resorting to the FROB, a **recapitalisation plan**. |
| 10/03/2011 | The Banco de España publishes all institutions' capital needs | - 12 institutions (4 commercial banks, 8 savings banks) do not reach 8-10% of core capital. |
| | | - The system's overall shortfall is €15.15 billion.[2] |
| 14/04/2011 | The Banco de España approves the strategies and compliance timeframe | - 2 subsidiaries of foreign institutions receive a capital injection from their parents. |
| | | - 2 domestic commercial banks have stated their strategy to be to issue instruments qualifying as core capital. |
| | | - 4 groups of savings banks have opted for a stock market launch or to raise capital through private investors, with backing by the FROB if necessary. |
| | | - 1 savings bank is considering merging with another more capitalised institution, also with FROB backing if necessary. |
| | | - 4 savings banks are resorting directly to the FROB. |
| 15/04/2011 | The FROB formally undertakes to contribute the funds needed | Legal provision specifying FROB support to institutions whose strategy entailed resorting to the FROB for aid. |
| 28/04/2011 | Recapitalisation plans submitted to the Banco de España | The Banco de España, the FROB and the European Commission **analyse the plans in depth:** business plans (efficiency, profitability, levels of leverage, liquidity, etc.) and commitments. |
| 30/09/2011 | Deadline for the recapitalisation of the financial system[3] | **All institutions shall comply with the core capital levels** set in the Royal-Decree-Law. |

## 2 Transparency and stress tests

Transparency has been one of the priorities in the restructuring process. Accordingly, it was decided that the stress tests on the European banking sector conducted in July 2010 should include in Spain all listed banks and all savings banks (more than 90% of the total assets of the Spanish banking sector, although the minimum requirement was only 50% of total assets). In

[2] After the collapse of the Banco Base SIP and the separation of CAM from the other 3 partners in the project, the number of institutions not meeting the 8-10% objective rises from 12 to 13, and total commercial and savings bank recapitalisation needs are revised upwards to €17.02 billion. This figure is the result of including the amount committed in terms of preference shares by the FROB for the initial project, totalling €1.49 billion, which was finally not disbursed, and of adjusting the specific needs of CAM (€2.8 billion) and separating them from those for the new project involving Cajastur, Caja Extremadura and Caja Cantabria (€519 million).

[3] See footnote 1.

addition to publishing the data on a bank-by-bank basis using the commonly defined format, additional detailed information was published on each institution, including risk in the real estate development and construction portfolio. As regards the stress tests whose results are about to be published, the Banco de España has also considered it important that in this exercise, with the restructuring of savings banks about to be completed, a most extensive sample of our banking sector should be subjected to the tests, on a par with the previous exercise.

This transparency drive has been broadened to other areas. Last November, the Banco de España decided to require institutions to publish in detail their exposure to loans to the real estate construction and development sector, along with extensive information on their funding strategies.[4]

## 3 Restructuring: the progress made

The restructuring of the savings bank sector has had most significant consequences in terms of:

1. Write-downs
2. Consolidation
3. Reduction in capacity
4. New corporate model
5. Improved governance
6. Increase in solvency requirements
7. Capitalisation

### 3.1 Balance sheet write-downs

The integration processes have provided for considerable balance sheet write-downs at entities, since by applying the fair value convention in "business combinations" and "joint businesses", savings banks charged additional capital losses on loans and foreclosed assets for a value of €22 billion to equity in 2010. The previous effort made by the entities through provisioning against income and the use of the general provision for a total of €33 billion should be added to this figure, meaning that the recognition of the impaired value of their loans from January 2008 to end-2010 accounts for €55 billion (approximately 5% of GDP). These figures refer only to savings banks. The overall write-down drive by the entire Spanish banking sector in the three years from 2008 to end-2010 stands at an amount equivalent to 9% of GDP.

[4] Some months back, in July 2010, the Banco de España had amended and enacted the regulations on the calculation of provisions for doubtful loans, in order to recognise the value of collateral with sizeable prudential haircuts, to shorten the timeframes determining the minimum percentage of provisioning in terms of the time elapsed since default, and to standardise a minimum timetable of provisions, additional to those resulting from appraisal values, for assets received in payment of debts, in terms of the length of time the assets remain on the balance sheet.

### 3.2 Consolidation

The overall restructuring of the savings bank sector embarked upon in mid-2010 has taken the form of 12 integration processes (7 mergers or acquisitions and 5 IPSs), which have reduced the total number of institutions from 45 to 18. All the operations are completed, the resolutions having been adopted and the necessary authorisations having been obtained so that the integration processes are conclusive under the terms set by the Banco de España. Moreover, a further two integration processes are currently at the negotiation stage and, if they are completed as scheduled, that would reduce the number of savings banks or groups of savings banks to 15. These processes are redressing the excessive fragmentation of the sector: the figure of average total assets per institution has risen from €29 billion to €72 billion, thereby reinforcing their competitive position and making them more efficient.

**Savings bank merger and integration processes, aid received from the FROB and core capital needed**

| | | Savings bank groups | Integration model | FROB aid (€m) | Additional capital RDL. 2/2011 |
|---|---|---|---|---|---|
| Processes concluded | 1 | BFA-Bankia | IPS | 4,465 | 5,775 |
| | 2 | Effibank | IPS | - | 519 |
| | 3 | Grupo BMN | IPS | 915 | 637 |
| | 4 | Banca Cívica | IPS | 977 | 847 |
| | 5 | Caja 3 | IPS | - | Not needed |
| | 6 | Catalunyacaixa (CX) | Merger | 1,250 | 1,718 |
| | 7 | Unnim | Merger | 380 | 568 |
| | 8 | CEISS | Merger | 525 | 463 |
| | 9 | Novacaixagalicia | Merger | 1,162 | 2,622 |
| | 10 | Unicaja + Jaén | Merger | - | Not needed |
| | 11 | Caixa + Girona | Merger | - | Not needed |
| | 12 | BBK + Cajasur | Acquisition | 392 | Not needed |
| Other savings bank | 13 | CAM | - | - | 2,800 |
| | 14 | Ibercaja | - | - | Not needed |
| | 15 | Vital | - | - | Not needed |
| | 16 | Kutxa | - | - | Not needed |
| | 17 | Onteniente | - | - | Not needed |
| | 18 | Pollensa | - | - | Not needed |

| | | |
|---|---|---|
| Processes under way | 1 | CEISS + Unicaja |
| | 2 | BBK + Vital + Kutxa |

### 3.3 Reduction in capacity

Mergers also allow the problem of excess capacity in the sector to be tackled. This excess is apparent in networks and central services that have been oversized from the outset, and even more so at the time of integration, given the overlapping of functions and commercial and representative locations. The scheduled adjustments in the integration plans are most significant, as they involve cuts of between 10% and 25% in the number of offices and of between 12% and 18% in staffing. These cuts are on top of those made by these institutions before this process began; offices had been cut by 5% and staff by 4% from their peaks in 2008, and this is a significant quantitative and qualitative leap in terms of efficiency. These figures do not incorporate the additional adjustments that will be specified when the recapitalisation plans submitted to the Banco de España under Royal Decree-Law 2/2011 are approved.

### 3.4 New corporate model for savings banks

The reform of the Savings Bank Law introduced the option whereby a savings bank or group of savings banks could, while maintaining its legal status, pursue financial activity indirectly through a commercial bank in which it controlled at least 50% of the capital (if the stake were below this threshold, the savings bank would be converted into a special foundation, retaining the welfare fund assets). The indirect engagement in financial activity through commercial banks is a necessary condition for savings banks that are going to apply for the contribution of funds by the FROB to be able to receive these funds through the subscription of shares. But other savings banks have also availed themselves voluntarily of this new possibility following the reform of the Savings Bank Law in July 2010.

The resort by most savings banks to the indirect engagement in financial activity through commercial banks reinforces market discipline. Of the 18 savings banks or groups of savings banks at present, 16 are immersed in various processes involving the establishment of 14 commercial banks[5] in order to pursue through these their financial activity, which accounts for more than 99% of the total risk-weighted assets of this sub-sector.

This ongoing segregation of savings banks' financial business to newly created commercial banks is at a very advanced stage. Once the 14 commercial banks have been set up, the savings bank assemblies comprising them must formally approve the transfer of the respective assets and liabilities, a move already made in 7 cases.

In one instance, namely that of La Caixa, the new commercial bank is, moreover, already listed. In another two groups, BFA-Bankia and Banca Cívica, plans are under way for listing in the coming days.

[5] Actually, the total number of commercial banks is higher because some savings banks or groups of savings banks have set up or are setting up more than one commercial bank.

**Status regarding the setting up of commercial banks and the segregation of assets and liabilities**

| New commercial banks | Board decision | Registration as commercial bank | Segregation approval by Assembly |
|---|---|---|---|
| Caixa | √ | √ | Yes |
| BBK | √ | √ | Pending |
| Unicaja | √ | Authorisation requested | Yes |
| Caja 3 | √ | √ | Pending |
| Ibercaja | √ | Authorisation requested | Pending |
| BFA-Bankia | √ | √ | Yes |
| Banca Cívica | √ | √ | Yes |
| Grupo BMN | √ | √ | Yes |
| Effibank | √ | √ | Yes |
| Novacaixagalicia | √ | Authorisation requested | Pending |
| Catalunyacaixa | √ | √ | Pending |
| CEISS | √ | Authorisation requested | Pending |
| Unnim | √ | Authorisation requested | Pending |
| CAM | √ | √ | Yes |

## 3.5 Improved governance

The restructuring of the savings bank sector has added clear short-, medium- and long-term incentives for promoting the more professional management of these institutions. As a result of the integration processes already approved under the FROB framework and of the introduction of greater market discipline, management of the new, resulting groups has been reinforced with significant changes in the governing bodies and in the management model. Senior management teams have come under the scrutiny of the adjustment process, and a considerable number of former managers have been removed, leadership has been assumed by the teams from the strongest institutions and new managers of proven repute in the sector have been brought on board.

The implementation of the capitalisation plans arising from Royal Decree-Law 2/2011 means that institutions requesting capital from the FROB undertake to introduce measures that improve their corporate governance, some of which measures are explicitly mentioned in this legislation (number of members and composition of the board of directors, maximum term of office, establishment of an appointments and remuneration committee, etc.).

### 3.6 Increase in solvency requirements

The aim of Royal Decree-Law 2/2011, approved by Parliament on 10 March, was to increase the solvency of the Spanish banking system through requiring higher levels of capital. To do this, it first lays down a new "core capital" ratio, on top of the solvency obligations already in force under Spanish regulations, whereby institutions shall comply with a level of core capital of 8% of risk-weighted assets, or 10% when the risk involved is greater (i.e. when dependency on wholesale funding is greater than 20% and when no more than 20% of their capital is held by external investors).

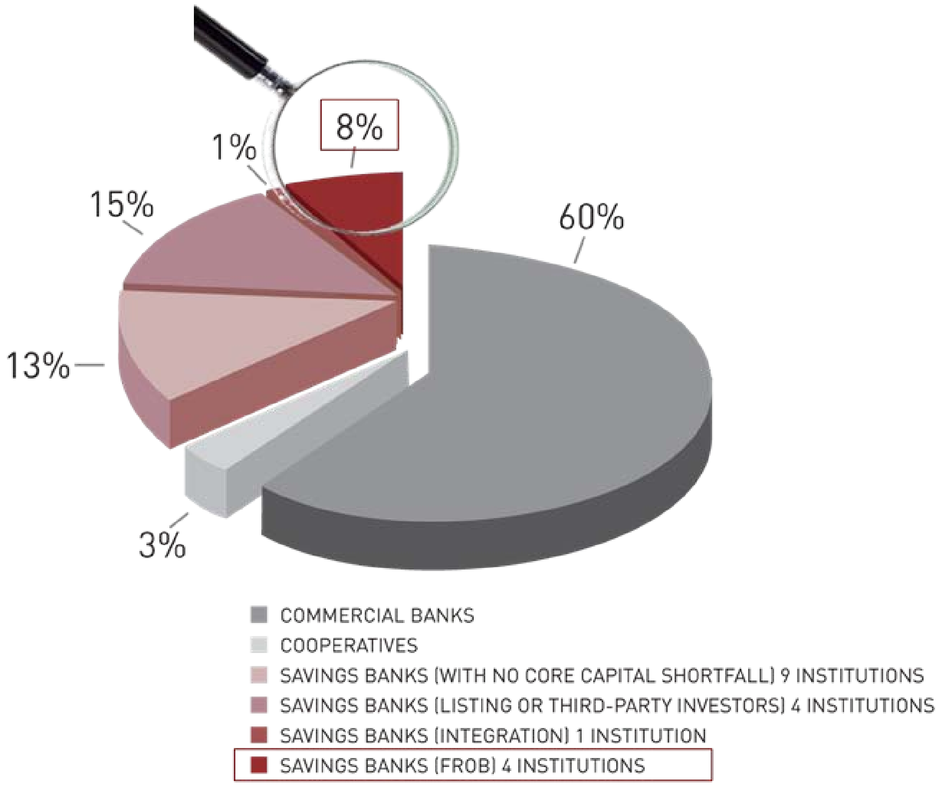
The preventive increase in the core capital threshold for institutions introduced by the Royal Decree-Law significantly raises assurances as to the sector's solvency. It offers the maximum protection against the eventuality of scenarios even harsher than those considered by the stress tests, and defines the appropriate guarantees via the FROB, which has formally undertaken with all the savings banks or groups of savings banks that did not reach the minimum required levels as at 10 March 2011 to provide the funds needed so that they may comply with the new core capital ratio, provided they do not use other means of recapitalisation.

### 3.7 Recapitalisation

Having identified the funding needed to meet the new requirements imposed, the 13 institutions with core capital below the new defined threshold (4 commercial banks and 9 savings banks) have strategies and a compliance schedule to attain the level of 8-10% required:

- Commercial banks:
  - Two subsidiaries of foreign institutions have been recapitalised by their respective parents
  - Another two domestic commercial banks have considered in their strategy issuing instruments qualifying as core capital
- Savings banks:
  - Four groups of savings banks have considered as their priority option a stock market launch or the raising of capital through investors, their subsidiary alternative being to resort to the FROB in the event that the plan may not be carried out as scheduled. Two of these groups have already put forward their plans to be listed by July. Together, they account for 15% of the assets of the banking sector.
  - Another savings bank, whose assets account for 1% of the system, has expressed its preference to merge with another more capitalised institution, its alternative option likewise being to resort to the FROB.

The other four savings banks have opted to strengthen their capital via FROB participation, without ruling out the possibility of covering a portion of their needs by raising funds from private investors. The institutions planning to resort to the FROB solely account for 8% of the Spanish banking sector's total assets. On 28 April, following the schedule laid down, the institutions that set resort to the FROB as their priority source submitted their recapitalisation plans to the Banco de España. These include a business plan with objectives in terms of efficiency, profitability, leverage levels and liquidity. The Banco de España, the FROB and the European Commission are analysing these plans in depth.




In sum, only four savings banks, accounting for 8% of the banking sector's assets, will necessarily require some type of aid from the FROB. The remaining 92% (60% commercial banks, 3% cooperatives and 29% comprising 14 groups of savings banks) corresponds to institutions that do not need additional capital or, if they do need it, plan to raise it through private means.[6]

The leading audit firms engaged by the FROB are performing due diligence in order to confirm both the reliability of the financial information and the reasonableness of the business plans. With this information independent experts will make an economic valuation of the institutions to which funds are to be provided, this being a prior step to the FROB taking a stake in their capital. The economic valuation will be made using methodological and procedural approaches devised and published by the FROB in late May, on the advice of a panel of experts so as to include best market practices. This valuation will determine the percentage of the capital stock that the funds provided by the FROB will account for.

As envisaged in Royal Decree-Law 2/2011, both these capital contributions by the FROB and funds obtained on the markets, whether through IPOs or through private investors, should have been concluded by 30 September.[7] Accordingly, as at that date the Spanish financial system as a whole will have the high level of capital required by this legislation.

[6] Five of these 14 groups of savings banks, whose weight in the system is 16%, will resort to the FROB only as a subsidiary alternative should the other means (raising private funds or merging with another institution) not come to fruition. Such means are at a very advanced stage of development.

[7] See footnote 1.

In the case of institutions applying for public aid, the RDL stipulates that they should have a viable business plan enabling the FROB to dispose of its stake in no more than five years. The regulations also state that, if the plan were not viable or were not fulfilled, the institution affected should be assigned to a third party through a competitive procedure.