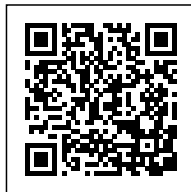


CAJAS: A NEW STEP FORWARD

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New regulation affecting Spain's savings banks (*cajas*) may present institutions with short-term challenges but offers investors with new sector opportunities

The Bank of Spain's first steps to promote restructuring of the Spanish savings banks (*cajas*) were taken in 2009 and included measures that the *cajas* considered entailed major sacrifices for them: mergers or integrations, with significant transfers of powers to central entities, headcount cuts and branch closures, public support through the Government's Fund for the Orderly Restructuring of the Banking Sector (FROB).

However, in February 2011, new regulation was published that places additional requirements on financial institutions, in light of global market demands. We do not intend to discuss either the timeliness or the efficiency of this regulation, but simply to summarise some of the consequences for financial institutions and the opportunities they pose for potential investors in the Spanish financial sector.

The regulation (Royal Decree-Law 2/2011) focuses on the new capital requirements placed on credit institutions and on reform of the public support provided through the FROB.

The first key reform is the establishment of a "core capital" requirement of 8 percent for credit institutions, a percentage that rises to 10 percent for institutions in which: (i) private investors hold less than 20 percent of capital; and (ii) the wholesale funding ratio is above 20 percent. Among the controversial issues is the definition of core capital, which includes concepts distinct from those approved by Basel III, such as mandatory convertible bonds to be converted by end-2014, with a fixed conversion ratio and with no characteristics that prevent them from being classed as equity for accounting purposes.

The plan envisages that all institutions calculate, by March 10, 2011, their capital ratios as of December 31, 2010 using the new rules. Institutions that fail to meet the minimum requirement have until March 28, 2011 to submit a plan to the Bank of Spain enabling them to comply with the ratio by September 30, 2011 or, with the prior authorisation of the Bank of Spain, in exceptional cases, by December 31, 2011. In the case of institutions that opt for stock market flotation as a way to access new capital, compliance with this ratio may be deferred until March 31, 2012.

These rules present a new opportunity for participation in the Spanish financial sector, considering that the regulation places no restrictions on the means of compliance with the minimum capital requirement, which include a stock market flotation, private placement of shares, sale of assets, portfolios or business to generate capital gains, the issue of securities that are classed as eligible capital, or the integration with other institutions (*cajas* or banks).

To make it easier for investors to access capital of *cajas* (including the FROB), this process has been combined with the ability to transfer all *cajas*' financial business to new or already existing banks. Several *cajas* were already immersed in a similar process, having participated in the previous restructuring through institutional protection schemes (IPSSs). This process has now been extended to include all *cajas* interested in attracting new investors.

The other key reform is focused on the design of the public support offered to institutions that are unable to comply with the capital ratios by September 30, 2011. So far, this public support was provided through hybrid instruments (preference securities convertible into equity units at the *cajas* or shares at the banks). In future, and save in the case of credit co-operatives, public support will necessarily take the form of entry by the FROB, as a shareholder, in the institutions' capital.

For this purpose, the *cajas* will not only have to transform into banks, but they will also have to assume certain obligations in terms of business management and corporate governance. However, the FROB's position as a shareholder will be temporary, as it must dispose of these stakes, in a process guaranteeing competition, within a maximum period of five years.

It is, therefore, this divestment process that will open up new acquisition opportunities for investors interested in entering the Spanish financial market.

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