HOW SPANISH REFORMS AFFECT NON-FINANCIAL CORPORATES - ALLEN & OVERY

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Since 2008, financial regulation is materially affecting banking sector globally, and Spain is not isolated from this trend.

During the first semester of 2012, the Spanish banking sector underwent two financial reforms: RDL 2/2012 on February 3rd, and RDL 18/2012 on May 11th. Additional actions have been announced or are ongoing.

Many lawyers outside the banking sector may be wondering what these rules are about and their impact. The purpose of this article is to answer these questions using plain language.

RDL 2/2012 and RDL 18/2012 have the same main aim and use broadly the same strategy.

RDL 2/2012 identified two issues that hinder the ability of Spanish banks to get new capital and financing from international capital markets: high exposure to real estate assets (loans granted in relation to real estate development and building, and assets received in payment of such debts) and the excess of capacity.

In this context, the strategy was simple. If excess valuation of real estate assets was a ground for mistrust of potential lenders/investors, the solution was to compel the Spanish banks to reflect a high level of impairment losses and keep additional core capital in their balance sheets to protect them from potential losses for deterioration. If assets reflected their market value, market participants would be willing to subscribe new capital and lend to Spanish credit institutions. For this reason, RDL 2/2012 forced the banks to reflect high impairment losses and keep additional capital with respect to assets held as at December 31st, 2011, consisting of doubtful and sub-standard loans related to real estate development and building, and real estate assets received in payment thereof. An additional seven percent for same loans classified as normal risk (without payment defaults) and held as at December, 31st, 2011.

Three months later, RDL 18/2012 increased the level of impairment losses for those loans classified as normal up to a 14 percent minimum and 52 percent maximum. Both RDL 2/2012 and 18/2012 permitted those entities in a merger process to comply with their provisions at a later date. RDL 18/2012 also forced banks to pass all the real estate assets received in payment of loans (plots of land or buildings) to special companies for disposal and management. The Government also set out a neutral tax regime for contribution and other rules favouring the acquisition of such assets before December 31st, 2012.

The key question is whether the ability of Spanish banks to lend will be impacted by these reforms and whether in the short to medium term this will have a negative effect. To grant credit, a bank needs to maintain core capital ratios (a proportion between capital and loans) and solve the liquidity gap (it needs to borrow in order to be able to lend). High impairment losses reduce the core capital and result in losses or reduced profits. Banks that cannot increase the core capital and get financing will probably be forced to reduce their assets, sell loan portfolios and non-strategic assets, reduce their credit lines, manage their liabilities and carry out other regulatory driven transactions.

Such an accelerated process in a country so dependent on bank financing may deepen the credit crunch, which, in combination with austerity measures, may lead to recession. Saving banks more affected by the financial bubble may required intervention by the Fund for Orderly Bank Restructuring (FROB). Financial conditions may, therefore, worsen.

EU and Spanish financial reforms have instigated the sale of assets and bank deleveraging. When the process is over, it may result in more solvent banks. In the meantime, however, many are beginning to predict a worsening of financial conditions and the flourishing of banking M&A transactions.

The effects of this are still to be seen, but what we cannot take for granted is that regulation is going to be a key driver of transactions and banking business during coming years.

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