

## Fund for Orderly Bank Restructuring – Spain

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### Introduction

Through Royal Decree Law 9/2009, which came into force on 28 June 2009, the Spanish government has created the Fund for Orderly Bank Restructuring (FROB; Fondo de Reestructuración Ordenada Bancaria – see *Annex* for a chart that details the FROB's structure and functions). The creation of the FROB is one of a number of emergency measures taken by the Spanish government and forms part of the concerted action plan adopted by the different European countries since October 2008 to manage the effects of the international financial markets crisis on their banking systems. By creating the FROB, the government now provides the Spanish banking system with a full range of instruments, including capital and liquidity, to help support banks and ensure financial stability. The FROB also aims to encourage an orderly reshaping and consolidation of the Spanish banking system and will seek to address the issue of over-capacity created by the significant branch expansion carried out by the Spanish banks since 2004. It enables institutions with sound financial fundamentals, at their own initiative, to receive capital support from the FROB if they merge and trim down productive capacity.

### Implications for the Spanish Banking System and Ratings

In Fitch Ratings' opinion, the FROB clearly defines how support, if needed, will be executed by the Spanish financial authorities and the government, and will help to promote an orderly restructuring of the Spanish banking sector through two processes – “the integration process” (which will focus on currently sound institutions that have to prepare for a more challenging environment) and “the restructuring process” (which is aimed at institutions that already have significant weaknesses). The FROB provides a stimulus for the reorganisation of the Spanish banking system within a short timeframe and in the most efficient manner through close monitoring by the Bank of Spain (BoS) and the FROB itself, avoiding what could have been a very lengthy process in view of the existence of a degree of political influence in the savings bank or “caja” sector. The fact that a capital injection from the FROB will only be made as part of an integration process as defined earlier, could speed up the consolidation process for the Spanish financial sector and, if voluntary integration does not take place, the BoS and the government will have the means to force a restructuring process.

### Financial Institutions Impact

Fitch views the roll out of the FROB framework positively as the fund recognises the growing challenges facing small and medium-sized institutions, particularly Spanish savings banks, whose main source of capital is reserves from internal capital generation. While many financial institutions continue to navigate well through the current downturn, others are facing serious asset quality and liquidity challenges, particularly those entities that have grown aggressively in recent years. Fitch expects that funds available under the FROB programme will be used by financial institutions to support consolidation and would ideally involve stronger entities taking over entities with good franchise value but more limited financial flexibility heading into this downturn. Consolidation should also improve the cost efficiency and longer-term profitability of the sector.

The agency also views positively the key role of the BoS in most of the phases of the orderly restructuring and integration process. The potential mergers that are currently being discussed are between cajas in the same autonomous community, indicating that political influence is still present. Fitch is concerned that this

political influence could potentially cloud the economic sense of a merger and lengthen the process. The BoS involvement mitigates this concern to some degree, but its complete control over any process only comes in if there is an intervention process in place whereby the BoS substitutes the administrators of the institution in question. It is expected that once a financial institution has been the subject of intervention by the BoS, the risk of political influence will significantly diminish.

While the FROB framework is a clear sign of support for the Spanish banking system, Fitch does not expect that it will have a direct impact on banks' existing Support Ratings and Support Rating Floors, as the agency understands that this support does not represent an explicit guarantee and is temporary in nature. However, the essence of the FROB is to foster the reorganisation of the sector in an orderly manner and in the most financially efficient way, even in the event of a BoS intervention, should this be necessary. The agency will review any FROB-supported integration or restructuring process on a case-by-case basis and the corresponding impact of these initiatives on the ratings of the financial institution. However, Fitch notes that the FROB may reduce negative rating migration (or multi-notch downgrades) in the near term as the jump-to-default risk has been significantly reduced by the introduction of the programme.

### Structured Finance Impact

From a structured finance perspective, Fitch views the announcement of the FROB positively as it may help mitigate potential counterparty risk concerns. In recent quarters, negative rating migration has caused several Spanish banks to implement remediation actions relating to outstanding securitisation transactions. These actions have included replacing account bank and swap counterparties, cash-collateralising derivative contracts, implementing commingling risk reserves and amortising CDO participations in transactions due to trigger breaches. Particularly affected have been those small and medium-sized cajas that have grown aggressively in recent years, and which have financed much of that growth through wholesale funding sources including securitisation. While the number of financial institutions that could receive any type of FROB support remains uncertain, Fitch believes that the announced framework will allow for a well-organised consolidation process and will reduce the jump-to-default risk for financial institutions that act as counterparties in securitisations.

While acknowledging the benefits noted above, Fitch believes FROB-supported consolidation may also introduce some new risks to outstanding structured finance transactions. These risks include potential shifts in the risk profile of existing CDO or multi-issuer cédulas hipotecarias transactions including increasing portfolio obligor concentrations and operational risk associated with the integration of different IT and servicer platforms.

As it stands, FROB will have a neutral affect on outstanding Spanish structured finance ratings and any later developments will be analysed on a case-by-case basis.

### Background

The extremely turbulent period that followed the collapse of Lehman Brothers in September 2008 led to a coordinated response by different European countries to take exceptional measures to support their banking systems. Support for Spanish banks had been focused on liquidity support, either through the Financial Assets Acquisition Fund (FAAF; created in October 2008 through Royal Decree Law 6/2008 and providing up to EUR50bn) or through government-guaranteed non-subordinated debt issuance with the possibility of issuing up to EUR100bn by end-2009 (Royal Decree Law 7/2008). Also, the amount guaranteed by the Spanish deposit guarantee funds (DGFs) was raised to EUR100,000 per accountholder from EUR20,000. In some other European countries, support measures had already factored in capital injections into ailing banks. In Spain, while capital support was contemplated in Royal Decree Law 7/2008, given the relative health of the Spanish banks towards

the end of 2008, measures on how capital support could be executed were not developed until now.

Given the limited exposure of Spanish banks to complex structured products and their retail focus, they have to-date weathered the financial and economic crisis comparatively well. Nevertheless, their significant exposure to the Spanish property sector (derived from strong rises in lending in the period 2004-2007), together with rising unemployment and the economic recession, has contributed to a sharp deterioration in asset quality, particularly since the second half of 2008. This has increased pressure on institutions' profitability and hence in their internal capital generation capacity at a time when capital ratios have declined to tighter levels due to recent strong loan growth, particularly at some institutions. Strong branch expansion in this same period by many Spanish institutions, particularly cajas, has further exacerbated the problems arising from exposure to the property sector as they were linked to direct and indirect financing to the housing sector and contributed to an overcapacity within the banking system. The international capital markets remain closed and the operating environment will remain complex, as the global economic downturn has proven to be much deeper than anticipated and, given its association with a financial crisis, subsequent recovery is expected to be more muted.

Fitch believes that the systematically important Spanish banks will continue to report solid results and can ride out the financial and economic crisis without significant stress. While some small and medium-sized players appear to continue to perform well, there are others that could face financial difficulty, which could jeopardise their profitability and internal capital generation.

## Functions of the FROB

As announced in the Royal Decree Law 9/2009, in broad terms the two functions of the FROB are: (1) to manage the "restructuring processes" of Spanish financial institutions; (2) to improve capital levels in "integration processes" among Spanish financial institutions through temporary capital support by the FROB. Both measures are aimed at an orderly reorganisation of the Spanish financial system while promoting financial stability at all times and with the BoS playing a key role in both these processes. The integration process is designed for institutions that have sound financial fundamentals but will need to obtain greater financial muscle to operate in a more muted economic environment; the restructuring process, on the other hand, is aimed at those financial institutions which already have significant weaknesses (ie, relating to asset quality, capital adequacy and capacity to generate recurrent revenues) which could jeopardise the viability of the institution in the medium to long term.

### Integration process

Fitch believes that the route most likely to be followed by institutions, at least initially, is the integration process, which is a private initiative that provides more managerial flexibility; it is for this reason that Fitch has described this process before describing the restructuring process. Capital support in the integration process is temporary and aimed at supporting institutions in their efforts to improve cost efficiency and to boost their productivity to compete more effectively in the new, more muted environment. Capital support will come in the form of convertible preference shares to be exclusively acquired temporarily by the FROB and will be subject to an integration plan which will require BoS approval. Under this plan, the institutions will have a maximum timeframe of five years to carry out any integration process (this can be extended to seven years under certain circumstances with the approval of the BoS) and will benefit from the issuer's commitment to repurchase the preference shares within this time period.

However, if the time period has expired and the issuer has not repurchased the preference shares, or if the FROB at any time deems this will be improbable due to

a lack of progress in the integration plan, the conversion option will be executed. As such, the FROB would then convert these preference shares into shares (for banks), cuotas participativas (for cajas, which will contain voting rights as an extraordinary measure) and capital injections (credit cooperatives). The law also contemplates the possible sale by the FROB of the convertible preference shares or the converted capital instruments to third parties within the five-year timeframe.

## Restructuring process

There are three different phases in the restructuring process.

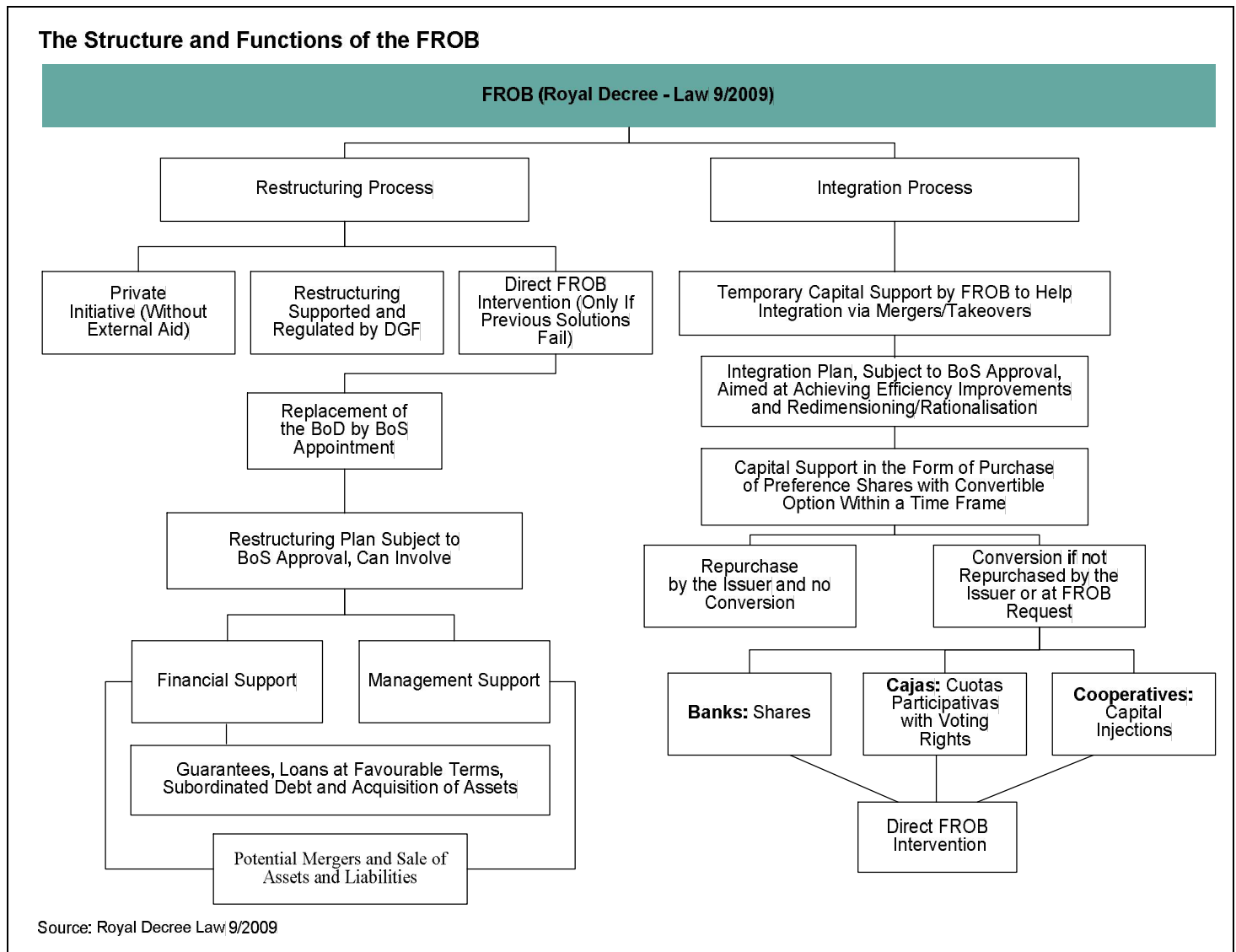
- A private solution will first be sought that does not involve any funding or capital from the FROB and would be taken at the initiative of the institution.
- Support from the DGFs following the creation of an action plan at the initiative of the institution or the BoS. This plan will require the approval of the BoS, which could also make any changes that it considers necessary. The action plan would contemplate the following solutions: capital injections, the merger/takeover of the institution and/or the full or partial sale of assets. To help achieve the action plan, the DGF could also obtain funding from the FROB at market conditions, if needed.
- The financial institution would be the subject of intervention by the FROB for restructuring, if the previous two measures fail. This would imply the substitution of the board of directors and, if necessary, the management of the institution; in such cases, a new board/management would be appointed. It would involve a revision by the FROB of the net worth of the institution and its viability. The FROB would design a restructuring plan to be approved by the BoS which would outline the process the institution would need to carry out to overcome its difficulties. This could result in a merger with other institutions with a high degree of solvency, or the sale or transfer of its assets and liabilities through an auction process, among others. Support during the restructuring period could come in the form of guarantees, loans at favourable rates, subordinated debt, the acquisition of assets or capital injections.

The FROB will initially have EUR9bn in funds, EUR6.75bn of which will be contributed by the state and EUR2.25bn from the different DGF (banks, savings banks and credit cooperatives). The state's contribution would come from the unused portion of the FAAF, which has been extinguished by the Royal Decree Law creating the FROB. The new limit is now EUR43.25bn and has been clarified for the purposes of Spain's budget Law. In addition to the EUR9bn initial contribution to the FROB, the law states that in 2009, the FROB could issue debt of up to EUR27bn in the capital markets, guaranteed by the Kingdom of Spain. After 1 January 2010, the third-party financing for the fund could reach EUR90bn. This amount compares with total equity for the banking system of EUR183bn and assets of EUR3,109bn as reported by the BoS at end-March 2009 and a further EUR47bn in credit impairment reserves, of which EUR23bn were BoS generic reserves. Fitch believes that the amount of the FROB support package should be able to cover the reorganisation process of the system while ensuring the solvency of banks, particularly considering that around 60% of total lending for the system of EUR2,162bn is covered by collateral, mostly mortgages.

The fund will be managed by a "comisión rectora" (a governing body) consisting of eight members, five of whom will be appointed by the BoS (presided by the BoS deputy governor) and three will be representatives of the DGF.

**Annex**

**The Structure and Functions of the FROB**



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