

Spain
Presale Report

Fondo de Reestructuración Ordenada Bancaria

Expected Issue Ratings

Class	Amount (EURm)	Final Maturity	Rating
FROB	3bn	Nov 2014	AAA

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Related Research

- *Kingdom of Spain* (August 2009)
- *Ratings of Non-US Public Sector Entities* (September 2009)
- *Fund for Orderly Bank Restructuring - Spain* (July 2009)
- *Major Spanish banks Semi-Annual Review and Outlook: A Mixed Bag* (October 2009)

Rating Rationale

Fitch Ratings has assigned the first issue by the Fondo de Reestructuración Ordenada Bancaria (Fund for Orderly Bank Restructuring; FROB) an expected Long-Term Local-Currency Rating of 'AAA'.

FROB is to have an important role in the rationalisation and re-structuring of the Spanish banking sector. Although the collapse of the Spanish property sector and the recession is affecting all Spanish banks, it is among the savings banks (cajas) that most of the consolidation will take place. The aim of the FROB will be to ensure that the failure of one or more cajas does not turn into potential systematic risk for the entire banking sector.

Key Rating Factors

- The rating reflects the irrevocable and unconditional guarantee of the Kingdom of Spain of EUR27bn for 2009 to cover bond issues undertaken by FROB, as established under Royal Decree Law 9/2009 of 26 June. Under Article 116 of the General Budgetary Law 47/2003 of 26 November, guarantees issued by the General Administration of the State also have to be approved by the Minister of the Economy and Finance. This authorisation was granted under a Ministerial Order dated 26 October. The Royal Decree stipulates that, following authorisation of the Minister of the Economy and Finance, FROB can obtain external funding up to EUR90bn.
- The rating also reflects the link with Spain's 'AAA' sovereign rating.

Issue Information

Amount: The bond will be for EUR3bn with a bullet maturity due in November 2014 and a fixed coupon rate paid annually.

Paying Agent: The Bank of Spain will act as paying agent under an agreement dated 22 September 2009 and also under a treasury arrangement between the FROB and the Bank of Spain dated 15 July 2009.

Risk Consideration: The issue is zero risk weighted and is European Central Bank repo-eligible.

Law: Spain

Security: The bond is irrevocably and unconditionally guaranteed by the Kingdom of Spain. The bond is senior unsecured and will rank pari passu with all previous and future obligations of the guarantor.

Timeliness: In circumstances where FROB considers that it will be unable to meet payments under the guaranteed bonds, it should notify the Director General of the Treasury and Financial Policy at least 15 days before the payment date.

Purpose: The bonds will be issued by FROB under its programme to recapitalise Spanish financial institutions or to assist it in its general role of restructuring the Spanish banking sector.

General Terms of the Guarantee

- The guarantee is unconditional and irrevocable.
- The maximum that can be guaranteed in 2009 is EUR27bn, including principal and ordinary interest.
- The bond issue has to be a senior and unsecured obligation of the issuer and the repayment period cannot exceed seven years.
- The bonds have to be issued/or loans drawn before 15 December 2010.
- The Bank of Spain has to act as the paying agent.
- The Director General of the Treasury and Financial Policy will have to confirm in writing that the financial operation of the FROB falls within the terms and conditions of the Royal Decree 9/2009 and the Ministerial Order, enabling it to benefit from a state guarantee.
- FROB has to advise the Director General of the Treasury and Financial Policy annually of the amount outstanding under the guarantee, including accrued ordinary interest.
- The guarantee is payable on demand and the Kingdom of Spain has waived its right, under the 1830 Civil Code, to require the beneficiary of the guarantee to first seek payment from FROB. Also under Article 54 (as amended) of the Spanish Budgetary Law for 2009, the Kingdom of Spain has reserved EUR27bn for this operation, and therefore no further budgetary or parliamentary approval is required.

Description of the Issuer

FROB was established to maintain confidence in the Spanish banking system. It will have wide-ranging powers and its functions will be to: facilitate the integration (by way of mergers or acquisitions) of financial institutions that have sound financial fundamentals but will need to rationalise in order to compete in a more challenging environment; or to manage the restructuring process for financial institutions that are in financial difficulties. The Bank of Spain will have a key role in these processes.

Under the integration process, FROB will provide temporary capital support by way of convertible preference shares for a maximum of five years. By the end of the period the institution should have completed the integration process and will be required to buy back the preference shares from FROB. Alternatively, FROB could convert these convertible preference shares into ordinary shares, “cuotas participativas”, or capital injections.

Where the financial viability of the entity is in question, FROB can apply the restructuring process. In these cases FROB’s role will have three main pillars:

1. Finding privately funded help for ailing financial institution;
2. Implementing direct measures through the Deposit Guarantee Funds (DGFs) to deal with material weakness of a financial institution; or
3. If the previous two measures fail, directly intervening in the institution.

FROB is an “entidad de derecho público” (entity under public law) and has legal personality and full public and private capacity to implement the objectives as laid down by law. It is managed by a governing body consisting of eight members, appointed by the Minister of the Economy and Finance, of whom five are nominated by the Bank of Spain and one by each of three DGFs of the banks, savings banks and cooperative banks. The chair of the governing body is the Deputy Governor of the Bank of Spain and a representative of the state’s general audit department will also

attend the management committees but will not have voting rights.

The role and responsibilities of the governing body will be:

- To approve the execution of any funding transactions;
- To approve FROB's accounts, which must be submitted to the Minister of the Economy and Finance;
- To take any action necessary to ensure the adoption of measures aimed at dealing with any weaknesses affecting the viability of credit institutions, and to lead the ordered re-structuring of any institutions involving the FROB; and
- To enhance the resources of credit institutions by acquiring preferential holdings convertible into shares, ownership quotas or contributions to the company's capital.

FROB's funding sources will be a mixture of state budgetary contributions and contributions from the DGFs. FROB's capital will be EUR9bn, of which EUR6.75bn will be provided by the state and EUR 2.25bn by DGFs (at 26 October 2009 EUR6bn had been paid, with the remaining EUR3bn expected by the second week of November).

FROB can seek external financing, but this will be limited to 3x its paid-up "capital" and in any event limited to EUR27bn. After 1 January 2010 the Minister of the Economy and Finance can authorise this limit to be exceeded but it will continue to be capped, at 10x capital (ie EUR90bn). Repayment of the external financing will be through the sale of the preference shares acquired or sale of equity stakes.

Given FROB's legal status, its importance in the stability and confidence of the Spanish banking sector and its tight control by the Spanish government, Fitch has classified FROB as a dependent public-sector entity of the Spanish state under its rating criteria. However, the rating is assigned to the issue and not the issuer.

Description of the Guarantor

On 3 August 2009 Fitch affirmed the rating of the Kingdom of Spain with a Stable Outlook. The rating affirmation and outlook were underpinned by the authorities' robust response to the global financial crisis, the resilience of Spain's larger, systemically important banks and ambitious medium-term fiscal consolidation targets, including planned cuts in public expenditure from 2010.

Spain is experiencing unprecedented fiscal stress, with pressure on expenditure, reducing fiscal revenue and sharply rising unemployment. However, the sharp widening of Spain's fiscal deficit needs to be viewed in the context of a massive swing into financial surplus by the private sector as investment rates are slashed. Although economic rebalancing was inevitable in light of the widening of the current account deficit, the process has been made much harder by the global recession. Against this backdrop the government used headroom from earlier public debt reduction to engage in an aggressive fiscal stimulus that is easing the macroeconomic adjustment process.

Spain's investment boom was not only driven by a real estate bubble – non residential investment, including investment in infrastructure and machinery and equipment, was also very dynamic. The sharp decline in real interest rates after European Monetary Union (EMU) was also a key driving factor in excessively rapid investment growth; however, while interest rates remain low this impulse will not be repeated. Competitiveness adjustment is working in Spain, as indicated by the negative inflation differential against EMU partners that has opened up since the start of the global recession. Moreover, Spanish export competitiveness does not seem to have suffered too much from the appreciation of the real exchange rate, as suggested by the relatively stable export market share throughout this decade.

Product market deregulation has been an important contributor to improved supply-side performance.

The labour market remains a source of inflexibility, with a highly protected “primary” labour market co-existing with a large secondary sector dominated by temporary contracts where job losses have been very rapid. This pattern is unlikely to be conducive to wage adjustment or productivity performance and could prolong the macroeconomic adjustment process. Fitch expects Spain to suffer two consecutive years of negative GDP growth.

The sharp increase in unemployment has also exacerbated the deterioration in the fiscal balance. In addition to the large stimulus package, higher unemployment benefits payment and the collapse in property-related revenue have caused Spain to suffer one of the fastest deteriorations in fiscal balance in the ‘AAA’ rated sovereign universe.

The health of the major banks has been a key support for Spain’s creditworthiness through the global crisis, but the savings bank sector is clearly suffering. Fitch’s public debt projection assumes the full EUR90bn of FROB borrowing capacity will be used. Even so, public debt ratios will, despite a very large increase, remain below those in other large ‘AAA’ rated sovereigns in the next two years.

Spanish Banking Sector Overview¹

The Spanish banking system has weathered the global financial crisis successfully to date with no need for capital support from the state due to its retail banking focus, prudent regulation and very limited exposure to structured products and complex instruments. However, the strong economic adjustment that Spain is experiencing, a sharp rise in unemployment in a short period and the large exposure to the Spanish property sector have had knock-on effects on revenue and domestic loan quality, affecting H109 operating profitability.

The impact is nevertheless mixed, as the large, systemically important banks have easily absorbed a high level of credit costs while maintaining sound operating profitability in H109 due to diversification and/or niche franchises. Despite challenges from the current downturn they should continue to maintain sound performance. However, other players, particularly some of the small to medium-sized savings banks or “cajas”, have suffered a sharp fall in operating profitability in H109. Even within the caja sector, the effects are mixed, as some institutions continued to report sound performance, backed by strong fundamentals, while others were affected by much higher credit impairment charges, weaker revenue and a high non-interest cost base.

Managing the sharp deterioration in asset quality, mainly attributable to the large exposure to the deteriorated Spanish property sector, is a key challenge faced by Spain’s major banks and the other domestic players. At end-June 2009 lending to the construction and real estate development sectors accounted for 25% of total lending in the system. In Fitch Ratings’ opinion, the institutions facing greater difficulties are those that grew their loan books aggressively during 2004-2007, particularly to the Spanish construction and real estate sectors, and if this is accompanied by single-name concentration. Other short-term challenges for the system include revenue pressure from the recession and low interest rates, the need to rebalance funding structures towards customer deposits and an improvement in the level and quality of the capital at some institutions. In a separate report to be published shortly, Fitch will address the impact of all these challenges for the sector in general.

¹ Extract taken from Fitch Special report *Major Spanish Banks Semi Annual Review and Outlook: A Mixed Bag* (see Related Research link on the first page)

The major Spanish banks have not needed capital support from the state and Fitch expects this to continue being the case. Nevertheless, the severe recession and the sharp deterioration in the Spanish property sector are severely affecting asset quality, performance and solvency at some Spanish financial institutions.

Only one institution has so far received temporary liquidity support from the state. Caja de Ahorros de Castilla La Mancha (CCM; rated 'BB+'/'B'/'3'/'F') was the subject of regulatory intervention by the Bank of Spain on 29 March 2009. CCM's large exposure to the Spanish property sector through loans and equity investments, with a high level of single-name concentration, led to a rapid deterioration in asset quality. The loss it reported in 2008 significantly eroded its capital base and EUR1.3bn in preference shares was injected through the cajas' Deposit Guarantee Fund.

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