# RESTRUCTURING OF SPANISH SAVINGS BANKS

Situation at 29 June 2010

## I. Introduction

With the four merger plans approved earlier today by the Banco de España, the restructuring of the Spanish savings bank sector is now almost complete. This process, encompassing a number of mergers that have been, or are in the process of being, authorised, is the biggest overhaul of the Spanish banking sector in recent history.

This notice outlines the reasons for this restructuring process, its fundamental design features and the figures that define its content, scope and significance.

## II. Savings bank sector restructuring: essential for the Spanish banking system

On 26 June 2009 the Royal Decree-Law creating the Fund for the Orderly Restructuring of the Banking Sector (FROB) was approved. For almost two years, financial markets and financial systems throughout the developed world had borne the impact of the international financial crisis. Spanish institutions had proved extremely resilient, and the great majority remain resilient to this day.

The FROB was created in response to the need to restructure or resize the Spanish banking sector, especially the savings banks. This need was driven by factors relating to the sector as a whole and to the individual institutions.

From the sectoral standpoint, the banking system had grown in size, in keeping with the volume of financial transactions which had risen to unprecedented levels as a result of the prolonged period of strong economic growth. As business adjusted to the new demand conditions, it became clear there was excess capacity, implying the need to adjust the size of the banking sector.

As regards individual institutions, the economic environment had made it more difficult for them to conduct their business efficiently, especially looking to the future, with various factors simultaneously putting pressure on their income statements: rising defaults, as a result of the impact of the economic crisis on borrowers' ability to repay their loans; tightening financing conditions on the wholesale markets, due to increased risk perception, with the consequent effect on financing costs; and the adjustment in business volume mentioned above.

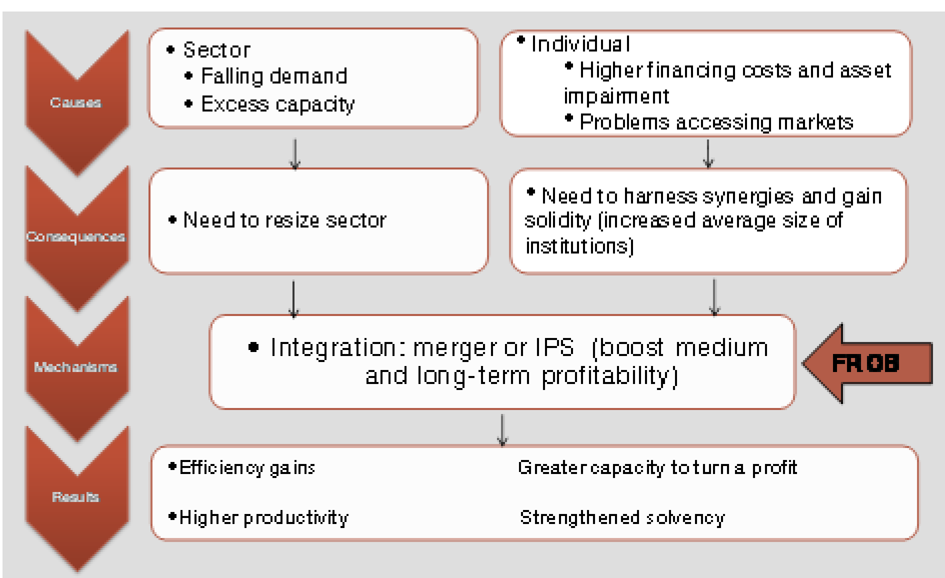
In turn, the high growth of past years, fuelled by the concentration of transactions on the real estate sector, had altered somewhat the traditional balance between the assets and liabilities sides of the balance sheet, generating a high level of reliance on the debt markets which, at a time of widespread growth in uncertainty, made liquidity management particularly challenging.

In addition, there were the intrinsic constraints on the savings banks preventing them from generating core capital by any means other than capitalisation of profits, as the doubts as to how attractive the *cuotas participativas* (non-voting equity units), the only instrument available to them, may be to investors have hindered their development.

These factors painted an adverse scenario for the savings banks in particular, making it advisable to undertake a large-scale transformation of their structure. This has taken the form of corporate moves, aimed at gaining solidity and raising efficiency, as an essential condition in order to enhance not only the savings banks' competitive position but also their market credibility, increasing the average size of the institutions or groups and harnessing synergies.

The momentum in both these areas – at the sector level, with the need to resize and recapitalise, and at the individual level, with the need to take advantage of synergies – has combined to create the ideal environment for the merger activity seen among the savings banks in the past year (Figure 1).

**Figure 1. A schematic representation of the restructuring process**




## III. Design of the restructuring process

*The Fund for the Orderly Restructuring of the Banking Sector (FROB): two objectives*

The FROB was created by virtue of Royal Decree-Law 9/2009, approved on 26 June 2009. One of the Fund's functions is precisely to support the above-mentioned mergers, between viable institutions that voluntarily resolve to enter into mergers or other similar agreements with a view to enhancing their efficiency, rationalising their administration and resizing their capacity, aiming, ultimately, to improve their future prospects.

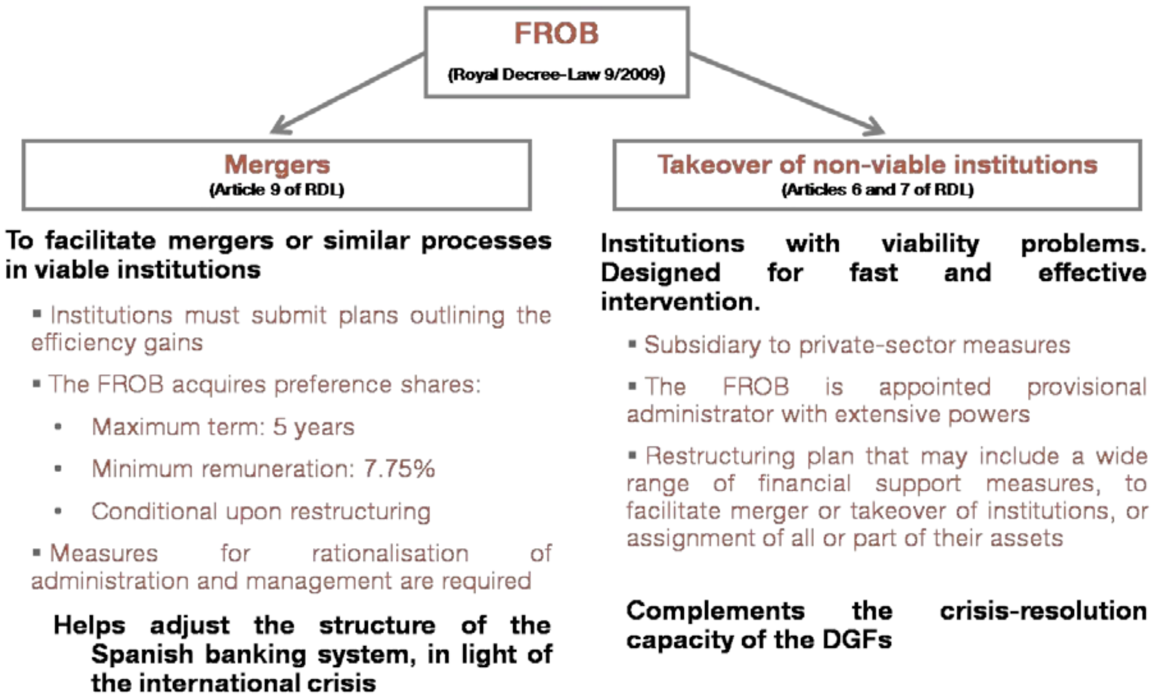
Specifically, these support measures take the form of purchase of preference shares, qualifying as Tier 1 capital, which must be bought back within five years (extendable to a total of seven years) and must be remunerated in accordance with the criteria established by the European Commission (in effect, at a minimum of 7.75%). The institutions involved must draw up a merger plan, which must be approved by the Banco de España, detailing the specific undertakings and measures envisaged to meet the efficiency-enhancing objectives, in keeping with the principle of the most efficient use of public resources.

The FROB participates in these merger processes when requested to do so by the institutions concerned. Not all of the mergers agreed have needed or requested aid from the FROB.

The FROB legislation also envisages a second objective, i.e. to facilitate crisis resolution at non-viable institutions, when no solution is possible within the traditional sphere of activity of the deposit guarantee funds. In such cases, the FROB is designed for fast and effective intervention, taking over management of the institution concerned and drawing up a restructuring plan, which may include merger or takeover of the institution or assignment of all or part of its assets and liabilities, and which outlines in detail the support measures envisaged.

Thus on the one hand, the FROB contributes to the resizing and restructuring of the Spanish banking system, against the backdrop of the international financial crisis, and on the other it complements the role of the deposit guarantee funds in crisis resolution at individual institutions. Figure 2 summarises these two facets of the FROB in schematic form.

**Figure 2. FROB objectives**




Although the two facets are legally separate, and although the FROB's activity in each area responds to different circumstances, the very existence of a clear legal framework providing for institutions that prove to be non-viable to be quickly and directly taken over, has prompted institutions to look for merger agreements that will strengthen their position in the medium and long term.

*Financial resources: the FROB and the Deposit Guarantee Funds*

*The FROB:*

In order to comply with its legal purpose, the FROB has €9 billion of capital (75% provided by the Treasury and 25% provided by the deposit guarantee funds) and its maximum financing capacity, through various channels, is €90 billion. A specific expression of this funding capacity was an initial €3 billion bond issue. Consequently, as of the date of this notice, the funds available for undertaking the restructuring processes of credit institutions amount to €12 billion.

*The Deposit Guarantee Funds:*

The FROB complements but does not replace the role of the three traditional Deposit Guarantee Funds in Spain (for banks, savings banks and credit cooperatives, respectively). These funds are financed by contributions from their respective member institutions and have, on one hand, a compensatory function, whereby they reimburse depositors for the amount of the deposits which an institution has been unable to refund (up to a maximum of €100,000 per account holder) and, on the other, the function of contributing to the restructuring of an institution by providing it aid, when this option is more economical than compensating depositors.

In order to fulfil these functions, the three guarantee funds currently have available assets of approximately €5 billion, net of the aid already provided or committed to Caja Castilla-La Mancha.

Figure 3 summarises the financial resources of the FROB and the Deposit Guarantee Funds.

**Figure 3. Financial resources of the Funds**

| CONCEPT | Legal maximum | Paid out at 30.06.2010 |
|---|---|---|
| FROB capital | €9 billion | €9 billion |
| Treasury | €6.75 billion | €6.75 billion |
| DGFs | €2.25 billion | €2.25 billion |
| Financing | €90 billion | €3 billion |
| Total FROB | €99 billion | €12 billion |

| | |
|---|---|
| Available in DGFs | €5 billion |

*The integration processes: mergers and institutional protection systems.*

The integration processes have been in the form of mergers or the creation of institutional protection systems (IPSs). Under this latter alternative, through contractual agreements between participating institutions, a central common institution is usually created (a credit institution with the status of a bank) which is charged with determining essential management aspects.

The mergers and IPSs are essentially the same as far as the relevant end-effects are concerned. This is because of the following: first, the above-mentioned attribution to the central institution of the power to define the principal policies and strategies; second, the high degree of commitment between participants to support each other in terms of solvency and liquidity; and, third, the participants' sharing of a high percentage of the profit from their activity. The degree of pooling of solvency must be at least 40% of capital and at least 40% of profits, although in practice, in the case of solvency, mutual support reaches 100% in the agreements which have been drawn up. Furthermore, the obligation to remain in the institutional protection system for at least 10 years ensures the stability of the agreement and means it is most unlikely that any participant would consider withdrawing from the agreement in the future.

*A busy year of regulatory modifications and negotiations*

A year has elapsed since the Royal Decree-Law creating the FROB was approved. It has been a very busy time in which all the necessary, numerous and complex steps have been taken with the result that, at the date of this notice, restructuring processes are under way at 39 of the 45 Spanish savings banks (excluding CECA), whose assets amount to 92% of total assets in the sector.

The approval of the Royal Decree-Law marked the starting point for a series of prerequisites for the merger or equivalent agreements to take shape. Additional measures were required, in effect, relating to the suitable fit of these operations from the mercantile, corporate, fiscal and accounting standpoints and from that of compatibility with European rules on state aid.

By way of example, in December 2009 Law 3/2009 regulating the system of mergers, spin-offs and overall transfer of assets between credit institutions was amended; the Spanish system of capitalisation of credit institutions envisaged in the FROB regulations was finally approved by the European Commission on 28 January 2010 (the Commission noted that this system was compatible with Article 107.3.b) of the Treaty on European Union); based on the European Union's decision, the criteria and conditions governing the FROB's actions in integration processes of credit institutions was approved by the FROB on 29 January 2010; and the legal framework of institutional protection systems was defined by Royal Decree Law 6/2010 of 9 April 2010 so that the resulting legal structure can be considered by the Banco de España as a group for regulatory purposes.

At the same time the principal characteristics of the accounting framework applicable to these integration processes took shape, taking into account the features associated with the legal nature of savings banks.
In addition to the measures required for a suitable regulatory "fit", in this period of almost 12 months, credit institutions interested in a common project have had to

approach one another and hold negotiations, which involves various time-consuming phases: identification of potential alliances, technical examinations, negotiations between institutions, decisions of governing bodies and labour agreements, among others.

Following completion of the various stages, the Banco de España has authorised the integration plans submitted by the savings banks participating in the processes which involve aid from the FROB, complying with the 30 June deadline set by the European Commission for the application of the general framework envisaged in its communication of 28 January 2010.

## IV. The savings banks restructuring process in figures

*Quantitative scope of savings bank integration processes.*

The savings bank sector is being restructured through 12 integration processes involving 38 of the 45 Spanish savings banks. Considering that another institution, Cajasur, is currently under the administration of the FROB and pending a solution within the framework of the latter, in total 39 savings banks are participating in the restructuring of the sector and only 6 savings banks have not been involved in the mergers and integration processes referred to in this report. These six institutions represented 8% of the savings banks' total assets as of 31 December 2009 (see Figure 4).

Of the 12 processes, 7 requested aid from the FROB totalling €10.19 billion and 5 were undertaken without public aid. Caja Castilla-La Mancha, which was placed under administration by the Banco de España pursuant to legislation existing prior to that of the FROB and which also received €3.78 billion of aid from the Deposit Guarantee Fund, is participating in one of these processes.

**Figure 4. Scope of the restructuring of the savings banks**

| Savings banks | Institutions involved | Number of processes | Total assets |
|---|---|---|---|
| Operations with FROB aid | 26 | 7 | 768.25 bn |
| Operations without FROB aid | 12 | 5 | 393.70 bn |
| Institutions taken over* | 2 | - | 43.61 bn |
| **Total restructuring** | **39** | **12** | **1.18 trn** |
| **Remainder** | **6** | | **102.69 bn** |
| **Total savings banks**** | **45** | | **1.28 trn** |

* One of these is involved, in turn, in a merger
** Not including the CECA (Spanish Confederation of Savings Banks)

*Detail of the integration processes which have been authorised, are pending authorisation and are at the negotiations stage*

The principal characteristics of the above-mentioned processes are detailed below in Figure 5.

**Figure 5. Savings bank mergers/IPSs**

| | Institutions | Type | Total assets (€bn) | % of TA of sector | FROB aid (€bn) |
|---|---|---|---|---|---|
| | **Approved by the Banco de España, with FROB aid** | | | | |
| 1 | Catalunya/Tarragona/Manresa | Merger | 79.33 | 6.1% | 1.25 |
| 2 | Sabadell/Terrasa/Manlleu | Merger | 28.46 | 2.2% | 0.38 |
| 3 | España/Duero | Merger | 46.35 | 3.7% | 0.53 |
| 4 | CAM/Cajastur+CCM/Cantabria/ Extremadura | IPS | 127.27 | 9.9% | 1.49 |
| 5 | Caixanova+Banco Gallego/Galicia | Merger | 77.48 | 6.0% | 1.16 |
| 6 | Madrid/Bancaja+Banco de Valencia/ Laietana/Insular de Canarias/Ávila/ Segovia/Rioja | IPS | 337.26 | 26.3% | 4.46 |
| 7 | Murcia/Penedés/Sa Nostra/Granada | IPS | 72.11 | 5.6% | 0.92 |
| | **Approved by the Banco de España without financial aid** | | | | |
| 8 | Navarra/General de Canarias/ Municipal de Burgos | IPS | 45.72 | 3.6% | |
| 9 | Unicaja/Jaén | Merger | 35.16 | 2.8% | |
| | **Authorisation in process, without financial aid** | | | | |
| 10 | La Caixa/Girona | Merger | 260.56 | 20.3% | |
| 11 | Cajasol/Guadalajara | Merger | 31.45 | 2.4% | |
| 12 | CAI/CC Burgos/Badajoz | IPS | 20.81 | 1.6% | |

*Figures may not tally exactly due to rounding.*

*Effect of mergers/IPSs on branch and staff numbers*

As explained above, the restructuring of the savings bank sector is motivated by the need for sound, efficient banks or groups able to compete in an increasingly demanding market in which the question of confidence is fundamental. In the case of operations carried out with FROB aid, the generation of synergies to improve efficiency, rationalise administration and management, and downsize productive capacity is, moreover, a legal requirement. Consequently, all FROB-backed operations include specific and verifiable measures to achieve this aim.

In the case of operations with merger/IPS plans approved by the Banco de España and aid approved by the FROB, these plans include a reduction of 10%-30% in the number of branches, and a reduction of 11%-27% in staff.

*Application of precautionary measures in two savings banks*

Since the onset of the international financial crisis, only two savings banks have seen their solvency deteriorate to such an extent as to require application of the precautionary special measures envisaged in Spanish law for particularly serious situations.

> Caja Castilla-La Mancha (CCM). The Banco de España decided to replace the CCM's directors on 29 March 2009. This decision thus predates the creation of the FROB. The crisis at this savings bank was thus dealt with in the traditional manner, with the participation of the Savings Bank Deposit Guarantee Fund, which is legally empowered to act in bank restructuring processes. The DGF granted €3.8 billion of aid to CCM, of which €1.3 billion consisted of preference shares and €2.5 billion were in the form of additional guarantees of asset value. It also granted €350 million of bridge financing. Cajastur, the recipient of CCM's banking business through its investee Banco Liberta, is participating in one of the merger/IPS processes described above. This operation is subject to receipt of the corresponding authorization.
>
> Cajasur. On 29 July 2009 the Banco de España Executive Commission approved the action plan requested jointly by Cajasur and Unicaja, which envisaged the merger of these two savings banks and the application for aid from the Deposit Guarantee Fund. This project, which was sound and had merited the consensus of the authorities involved and the approval of the respective institutions' boards of directors, took the steps necessary to resolve the difficulties which Cajasur had been undergoing. On 21 May 2010 the Board of Directors of Cajasur communicated to the Banco de España its non-approval of the merger project. Accordingly, that same day the Banco de España Executive Commission resolved, pursuant to Article 7 of Royal Decree-Law 9/2009, that the institution's situation required its orderly restructuring with the intervention of the FROB, which was appointed provisional administrator. The FROB granted temporary aid of €800 million in non-voting equity units, although it also provided €1.5 billion in liquidity support, which so far it has not been necessary to use. The aid to be finally granted will be defined in the legally stipulated competitive process through which Cajasur's business will be assigned to an institution of recognised solvency.

*Assessment of the funds assigned to savings bank restructuring*

The FROB aid to savings bank merger/IPS processes to strengthen own funds amounts to €10.2 billion (see Figure 6).

In addition, the FROB will provide the aid needed for the Cajasur restructuring process, which will be determined during the competitive procedure under way to assign the bank's business to a bidder of recognised solvency.

Consequently, once the aid for the Cajasur restructuring process has been determined, we will know the total amount of the funds provided to the savings bank sector by the FROB for the strengthening of own funds in merger/IPS processes and for the sole case of an unviable institution in which supervisory intervention was required.

**Figure 6. Estimated FROB aid**

| FROB aid: Mergers | | |
|---|---|---|
| *Catalunya+Manresa+Tarragona* | *1.25* | 10.19 bn Preference shares |
| *Sabadell+Terrassa+Manlleu* | *0.38* | |
| *C España-C Duero* | *0.52* | |
| *CAM-Cajastur-CCM-Cantabria-Extremadura* | *1.49* | |
| *C Galicia-C Nova* | *1.16* | |
| *Caja Madrid-Bancaja-Ávila- Segovia-Insular-Laietana-Rioja* | *4.46* | |
| *CajaMurcia-Penedes-Sa Nostra- Granada* | *0.91* | |
| **FROB aid: Takeover** | | |
| *CajaSur (provisional aid) (*)* | *0.8* | *Non-voting equity units* |

**(*) There is also liquidity aid totalling 1.5 billion not used to date**

Also, the Savings Bank Deposit Guarantee Fund allocated €1.3 billion in the Caja Castilla-La Mancha restructuring operation, to which must be added €2.5 billion of guarantees of the value of certain assets, making a total of €3.8 billion.

It should be pointed out that the banking sector itself also made a substantial preventive asset write-down effort in the years prior to the economic crisis, as a result of the introduction of the so-called generic provision in the year 2000. This provision is an accounting requirement of the Banco de España intended to oblige banks to disclose their loan losses without having to wait until they are identified later through the occurrence of a loss event, such as default. In quantitative terms, the generic provision utilised by the banking system as a whole from January 2008 to March 2010 amounts to €18.2 billion.

The ability of Spanish banks to generate profits from ordinary activities has enabled them, in this same period, to absorb asset write-downs of around €41.9 billion in their income statements (individual financial statement figures). The significance of this figure becomes clear when it is considered that in the period 2006-2007 these write-downs only amounted to €14.6 billion.

## V. Mergers/IPSs in other areas of the Spanish banking system

The corporate moves between credit institutions in Spain are not limited to the savings bank sector. Albeit less notable than the savings bank reshufflings, some initiatives by banks and credit cooperatives may be mentioned.

In the case of banks, Banco Guipuzcoano is currently involved in a merger process with Banco de Sabadell, without FROB aid.

In the case of credit cooperatives, the merger of Rural Multicaja with Caja de Abogados, and the IPS of Cajamar with Rural de Casinos, Rural de Albalat des Sorells and Caja Campo have already been approved. At the negotiation stage are a merger (Rural de Toledo con Rural de Ciudad Real) and the IPS of Rural del Mediterráneo with another 13 rural credit cooperatives. These moves involving credit cooperatives without FROB aid will probably continue in the coming months.

## VI. Situation of the Spanish banking system

Now that the new map of savings banks in Spain has been traced out, it is clear that the Spanish banking system remains sound and solvent.

The Banco de España has extensive, detailed information on the situation of Spanish banks, obtained in the exercise of a supervisory function based on in-depth scrutiny and closeness to the supervised party, and which includes the regular performance of stress tests. In order to provide the markets and the general public with accurate information on the current sound situation of the Spanish banking system and its ability to continue contributing on a firm basis to the sustainable economic development of our economy, the Banco de España supports the proposals for greater transparency of the situation of Spanish banks. Therefore, since agreement has been reached in Europe to conduct and publish common stress tests, the Banco de España will join this initiative and publish the results of the stress tests on Spanish banks within this European framework.

One last point to note is that a forthcoming reform of the regulations governing savings banks is pending. This should help make it easier for them to gain access to optimal quality capital instruments and help them improve their corporate governance and promote more professional management. This is essential in the new environment, in which, as a consequence of the regulatory changes worldwide, savings banks will have to meet much more demanding capital requirements. The government has the agreement of Spain's main opposition party for the successful passage of this reform through Parliament; this process should be completed as soon as possible. The Banco de España is contributing to this reform, in its role of adviser to the government.