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SPANISH FINANCIAL SECTOR REFORM

On 11 May 2012, the Spanish Government has announced yet another reform of the financial sector under Royal Decree-Law 18/2012 on clean up and sale of property assets held by financial entities ("Royal Decree-Law 18/2012"), which was published in the Official State Gazette and entered into force on 12 May.

Royal Decree-Law 18/2012 is a second attempt by this Administration, after February's Royal Decree-Law 2/2012, to restore confidence in the Spanish financial sector, which has been suffering of late as a consequence of continuing value deterioration in troubled property portfolios sitting in lenders' balance sheets.

Royal Decree-Law 2/2012 dealt with problematic property assets and stepped up provision and bank capital requirements along the year 2012 (2013 for banks involved in concentration or merger processes).

Royal Decree-Law 18/2012 mainly focuses on:

- The introduction of increased provision requirements for property-related loans, but this time for those qualifying as ordinary (non-delinquent) risk. Following the trend of Royal Decree-Law 2/2012, Banks are required to provide details to the Bank of Spain about the manner in which they plan to meet the extra requirements.
- Ensuring the financial support of the Fund for Orderly Bank Restructuring (FROB) for those institutions having trouble to comply with the additional capital charges.
- Transferring out foreclosed assets acquired from land and construction developers into separate entities managed independently from the relevant lender.

1. EXTRA PROVISION REQUIREMENTS

1.1 Amount of the required provisions

In addition to the 7% required under Royal Decree-Law 2/2012, Spanish financial institutions will be required to set aside the following provisions in respect of property development loans (including land and construction developments), where classified as normal risk (performing assets):

TYPE OF LOAN		ADDITIONAL PROVISION
Secured with mortgage	Land	45 %
	Development in progress	22 %
	Development finished	7 %
Unsecured		45 %

The Preamble of the Royal Decree-Law 18/2012 states that "the methodology used respects the international accounting standards' approach in that it purports to align reduced market expectations with those implied in the institutions' financial statements, as evidenced by market capitalisations significantly lower than their net book values, and so a loss shall be accounted for where the recoverable value of an asset is lower than its book value, thus revealing a presumed minimum loss that shall be taken into account".

1.2 Term for compliance

The new provision requirements shall be complied with by 31 December 2012, except for those entities that in the course of 2012 become involved in concentration or merger processes, those entities being allowed an extra 12 months since the date of authorisation of the relevant concentration or merger. In order to benefit from the extra term, the concentration process must (i) involve a material transformation of entities not belonging to the same group, (ii) involve either a structural change (merger or global transfer of assets and liabilities) or the acquisition of entities majority-owned by the FROB (as of today Catalunya Bank and Nova Caixa Galicia, and in the near future Bankia) or those in which the FROB has been appointed interim administrator (as of today Banco de Valencia), (iii) include measures aimed at the improvement of its corporate governance, and (iv) include a plan for divestment of assets related to property risks and undertakings to increase the provision of credit to families and SMEs.

1.3 Compliance plan

By 11 June 2012, financial institutions must submit to the Bank of Spain a compliance plan with details of the measures to be adopted in order to meet the new requirements, including (i) a divestment programme for property-related assets, although Royal Decree-Law 18/2012 does not specify the required contents of such a programme and (ii) a timetable for implementation of the compliance plan.

If the compliance plan reveals an insufficient level of core capital or equity, it must specify which steps will be taken to restore the required levels under an implementation term of not more than 5 months. The Bank of Spain will approve the plan within 15 working days, subject to any amendments it may request, including the adoption of additional measures such as the application to FROB for financial support, through the subscription of shares or convertible securities, as provided under the FROB regulations.

Hermosilla, 3 - 28001 Madrid - Spain
Telephone +34 91 514 52 00 - Fax +34 91 399 24 08

1.4 Non-compliance of the plan

Royal Decree-Law 18/2012 establishes that any serious breach of a measure specified in the approved plan that jeopardises the achievement of its objectives may give rise to the institution being subject to administration, without prejudice to the liability of its directors and officers.

1.5 Authorisations to the Minister of Economy and Competitiveness and the Bank of Spain

Royal Decree-Law authorises the Minister of Economy and Competitiveness to amend the required provision levels and the applicable timeframe for compliance.

The Bank of Spain is instructed to amend Circular 4/2004 in line with the provisions of Royal Decree-Law 18/2012, and authorised to make whatever changes to it as necessary to ensure its effectiveness. The Bank of Spain is also authorised to amend the provision levels required under Royal Decree-Law 18/2012 as from 31 December 2012.

2. FINANCIAL SUPPORT FROM FROB

Royal Decree-Law 18/2012 has introduced slight changes to the FROB regulations in order to allow FROB to provide financial support as explained above.

In any event, the provision of financial support by FROB, either through convertible securities or shares will require clearance by the European Commission in respect of a) the initial support as rescue aid and b) a restructuring plan for the relevant institution under the European Union state aid rules.

3. PROPERTY ASSETS' HIVE-OFF

3.1. Compulsory transfer of property assets

Royal Decree-Law 18/2012 requires credit institutions to transfer into a separate company all foreclosed property assets acquired from land and construction developers operating in Spain.

The measure shall include all assets owned as at 31 December 2012 and any further asset foreclosed after 31 December 2011.

The rule appears to apply not only property, but also to shares in companies through which foreclosed property is held and shares in real estate companies surrendered in payment of debts.

3.2. Special rules applicable to FROB-funded institutions

- FROB shall decide whether the rules on compulsory transfer of foreclosed property assets will apply to institutions enjoying FROB financial support or where FROB is acting as interim administrator.

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- Companies where the foreclosed property assets are transferred shall have the sole corporate purpose of managing and selling out, directly or indirectly, their portfolios of property assets.

- Prior to the incorporation of an asset management company, FROB shall submit a financial report to the Ministry of the Treasury and Public Administrations with details of the financial plans for its expected duration, in order for the General Intervention of the State Administration to report to the Ministry on the expected effects of the transaction on the public finances. The Ministry of the Treasury and Public Administration may object to the incorporation of the asset management company within a term of 10 days.

- Within a term of 3 years, each institution shall adopt and implement measures to ensure that any asset management company has no closer relation with it than that of an "associated entity"[1].

- Asset management companies shall dispose every year of 5% or more of their assets to a third party other than the transferring credit entity or any entity of its group. This rule will only be applicable to those entities having sought the financial assistance of FROB in order to meet the provision requirements of Royal Decree-Law 18/2012.

- The directors of asset management companies shall have appropriate levels of experience within the field of property management. This rule also appears to apply only to entities having sought the financial assistance of FROB in order to meet the provision requirements of Royal Decree-Law 18/2012, although this might be an editing mistake in the norm since it would be reasonable for it to be a general requirement of any director of an asset management company.

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[1] Under Bank of Spain Circular 4/2004: An associated entity is an entity over which an investor, acting individually or together with the rest of its group entities, is able to exert a significant influence, other than an affiliate or multi-group entity; the existence of significant influence shall transpire, among others, from situations such as the following:

a) Participation in the board of directors or similar management body of the investee company.

b) Participation in the determination of policies, including dividends and distributions policies.

c) The existence of substantial transactions between the investor and the investee company.

d) The transfer of management personnel between the investor and the investee company.

e) The supply of key technical information.

When determining if there is a significant influence over an entity, account shall also be made of the importance of the investment, the seniority in the management bodies of the investee company and the existence of potential voting rights, convertible or exercisable as at the date of the financial statements.

There is a rebuttable presumption of significant influence where the investor company, either individually or together with the rest of its group entities, holds 20% or more of the voting rights in the investee company.

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3.3. Support of the acquisition of equity in asset management companies

Royal Decree-Law 18/2012 allows the provision by regulation of instruments to offer financial support to the acquisition of equity in asset management companies.

Although further detail on this mechanism is to be expected soon, a financial support scheme such as this one will have to be configured in a manner which is consistent with the European Union state aid rules.

3.4. Term for the transfer of property assets

Property assets shall be transferred by 31 December 2012, other than in the case of entities involved in concentration or merger processes, those entities being allowed an extra 12 months since the date of authorisation of the relevant concentration or merger.

3.5. Valuation of the transferred property assets

Property assets so transferred shall be valued at their fair value[2], except where such value is not available or difficult to assess, in which case they shall be valued at their book value, taking into account the provisions required for the particular type of asset, including those established under Royal Decree-Law 18/2012 and Royal Decree-Law 2/2012. The Bank of Spain will specify the cases in which it will be possible to use the book value instead of the fair value.

There is a special rule in case the financial institution has not yet set aside the requisite level of provisions in respect of the relevant assets at the time of their transfer. In such case, the provisions shall be covered by the beneficiary company on the dates in which they would have been required to the transferring entities.

Assets so transferred are exempt from the general requirement under the Capital Companies Act that they be appraised by an independent expert, provided that the contribution is made within the statutory timeframe under the specific valuation terms of its transfer to the asset management company.

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[2] According to Bank of Spain Circular 4/2004 and, in general terms:

a) Fair value is the price which would be obtained on a rational and founded basis by a buyer, and the most advantageous one for a seller; therefore, the concept would exclude any overstated or understated valuations on the grounds of special arrangements or circumstances, such as liquidation of the entity, sale and lease-back, special financing terms, etc.

b) Fair value is established as at a specified date and it may be inappropriate for another date since market conditions are liable to change over time.

c) Fair value is the price which would be negotiated by interested parties with appropriate information which are mutually independent. In such context, interested and with appropriate information means that both seller and buyer must be basically informed about the nature and features of the asset, the state in which it is, the appropriate market, etc.; mutually independent means that seller and buyer must not have a special relation which could result in the price for the transaction not being typical of a transaction entered into on market terms.

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3.6. Databases

Royal Decree-Law 18/2012 makes it mandatory for the transferring entities to keep databases with the information required for the management of the transferred assets, and those databases shall be transferred to the asset management companies prior to the end of the term for making the necessary provisions. The Bank of Spain shall specify the requirements of such databases within the term of 2 months.

3.7. Tax treatment of transfers of property to asset management companies

Royal Decree-Law 18/2012 allows transfers of assets and liabilities made within the context of the incorporation of asset management companies to rely on the tax neutrality regime of section 83, chapter VIII, title VII of the consolidated text of the Companies Income Tax Act, regardless of whether or not they fall into any of the categories of transactions contemplated under such section or under section 94 (mergers, spin-offs, contributions of assets or of securities) of the same Act.

In any event, credit institutions making contributions to asset management companies may request the Bank of Spain to seek a report from the General Directorate of Tax on the tax consequences of the relevant contributions. Such report shall be issued within the term of one month and will be binding on the tax authorities.

Also, the transfer at a later stage of the shares issued by asset management companies will not be subject to transfer tax under the "transfers for consideration" heading. Such exception is also foreseen for the transfer of shares in financial entities subject to concentration plans under Royal Decree-Law 9/2009.

3.8. Notary and registry fees

Royal Decree-Law 18/2012 sets out special rules for registration with the land registry and calculation of registry fees on the transfer of financial or property assets within the context of the restructuring of financial institutions and in the case of novation, subrogation and cancellation of mortgages.

There are also special rules for the calculation of notary fees applicable to deeds of novation, subrogation and cancellation of mortgage loans and facilities.

4. OTHER RELEVANT PROVISIONS OF ROYAL DECREE-LAW 18/2012

4.1. Extension of the term to apply for authorisation of concentration processes

The term within which financial institutions may apply for authorisation of concentration schemes under Royal Decree-Law 2/2012 is extended to 30 June 2012. Institutions managed by FROB on an interim basis, together with those which are majority-owned by FROB, are exempt from such term.

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4.2. Amendment of FROB regulations

Royal Decree-Law 18/2012 amends the FROB regulations - Royal Decree-Law 9/2009- as regards the events of conversion into shares of the securities issued by FROB, in requiring the conversion to take place together with any transaction required to ensure that the conversion is made in accordance with the financial value of the issuing entity, including transfers of shares, contributions or capital reductions under any form (ie. by offset of losses, against reserves or by return of contributions). The completion of any such transactions, to be effected prior to, or concurrently with the relevant conversion, qualifies as an obligation of the FROB-funded institution and of those shareholders which are credit institutions. In the event of non-compliance, FROB is granted wide authority to step in and act as interim administrator in order to ensure the completion of the conversion of securities.

4.3. Exceptional treatment of outstanding preferred shares and other securities

To the extent preferred shares issued by financial institutions cannot make any remuneration payments where their profits or reserves do not reach the required levels, Royal Decree-Law 18/2012 allows financial institutions with preferred shares or debt instruments mandatorily convertible into shares issued prior to the entry into force of Royal Decree-Law 18/2012 to request authorisation to defer the remuneration payments for a term of not more than 12 months.

It is also established that the Government shall issue a Royal Decree setting out the cases in which issuers of preferred shares or subordinated bonds must offer the possibility of their exchange for shares or subordinated bonds of the issuer or other group entity, and the criteria to determine the percentage of the nominal value of those securities which must be offered for exchange.

In any event, regard will have to be made to any limitations on coupon payments under these securities or their repurchase which may be imposed by the European Commission when deciding on the authorisation of the provision of state aid to such entities.

4.4. Exemption of income deriving from the transfer of certain properties

A partial exemption of 50% of positive income and capital gains deriving from the transfer of urban properties acquired for consideration between 12 May and 31 December 2012 is introduced for Corporate Income Tax, Personal Income Tax and Non Resident Income Tax, subject to compliance with certain requirements and tax-specific rules (in the case of Non Resident Income Tax there is no express reference that the assets should have been acquired for consideration).

In all three taxes no exemption shall be available where the transferor and the acquirer are spouses or direct line or collateral relatives, by consanguinity or affinity, up to and including the second degree; nor where the properties are acquired from, or transferred to, an entity being in any of the cases provided for under section 42 of the Code of Commerce with respect to the relevant payer or any of the individuals specified above, irrespective of their residence and of the obligation to prepare consolidated financial statements.

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In addition, the following specific rules shall apply to Corporate Income Tax and Personal Income Tax:

- Corporate Income Tax:

  It is specified that the exemption is only available to positive income deriving from the transfer of urban property qualifying as non-current assets or classified as non-current assets held for sale.

  For the purposes of determining the portion of income entitled to the exemption, no account will be made of the amount of impairment losses corresponding to the relevant assets, nor of any reversion of excess depreciation which had been tax deductible in relation to the recorded depreciation.

  Finally, the exemption is deemed compatible, as the case may be, with the deduction for re-investment of extraordinary profit (plausibly subject to the prior elimination of the exempt amount from the basis of the deduction, although no express provision is made in this regard).

- Personal Income Tax:

  It is clarified that, in the case of transfer of primary residence in which only a partial exemption for re-investment in a new primary residence is available, due to the re-invested amount being lower than the consideration of the transfer, the new 50% exemption must be applied on the otherwise non-exempt amount.

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