

corporate

6-2013
May, 2013

CRITERIA FOR APPLICATION OF CIRCULAR 4/2004 ON LOAN REFINANCING AND RESTRUCTURING

1. INTRODUCTION

On April 30, 2013, the Bank of Spain's Executive Commission approved a letter to be sent to regulated institutions setting out the Bank of Spain's criteria on the application of the provisions of Circular 4/2004 on loan refinancing and restructuring ("refinancings"), as regards their definition, documentation, monitoring and review.

According to the press release attached to the letter, on the basis of the information obtained following the publication of Circular 6/2012, the Bank of Spain has observed differences in institutions' accounting policies with respect to refinancings. The letter seeks to establish general uniform criteria.

The essential idea reflected in the criteria is that loan refinancing policy is a necessary instrument for management of risk with customers undergoing difficulties, provided such difficulties are transitory. If the customer's difficulties prove not to be transitory, the institution must recognize that situation and reclassify the loans as doubtful or substandard, according to the severity of the difficulties experienced.

2. CRITERIA TO BE APPLIED IN REFINANCINGS

In general, refinancings are credit risk management instruments that must be used appropriately and prudently, without distorting the timely and prompt recognition of impairment of the transactions due to default risk.

In particular, the following criteria are defined:

- **Individual analysis of the borrower's income sources.** Decisions must be based on an individual analysis of the borrower's current income sources that determine his ability to pay, not only the debt held with the institution but also any other previous debt held, on the basis of a recurrent, sufficient and demonstrable generation of income.

In addition to the analytical practices indicated in Circular 4/2004 (section 1.c) and d) of Annex IX), the institution must take into account the payment track record and the experience with the borrower, in particular the existence of previous refinancings and, where appropriate, the frequency and terms of such refinancings.

- **Terms and conditions and determination of a regular payment schedule.** The refinancing terms and conditions (for example, interest rates, term or grace periods) must be based on a realistic payment schedule according to the foreseeable expectations regarding the borrower's ability to pay and the general economic climate. For that reason, the transactions should preferably be structured in the form of periodic installments consistent with the borrower's income stream or, alternatively, through arrangements that are, in any event, financially equivalent.
- **Current market value of collateral, considered a secondary source of recovery of financing.** Institutions must have sufficiently updated estimates of the value of the existing collateral, adapted to market conditions. Contribution of new collateral, which must in all cases be seen as a secondary and exceptional source of recovery of the amounts due, will be accompanied by analysis of its effectiveness and value, bearing in mind how quickly and how easily the institution could, if necessary, turn it into liquid collateral, in light of the existing and foreseeable conditions.
- **Periodic review of policies and procedures, including an internal system permitting individual transaction monitoring.** The decisions adopted on refinancing policies and procedures must be periodically reviewed, to check for the possible existence of incidents, to substantiate their effectiveness and to assess the timeliness of improving or adding to them in light of the results obtained. Specifically, institutions should have information in their internal systems with mechanisms allowing them to monitor refinancings on an individual basis.

3. CLASSIFICATION OF REFINANCINGS

In general, refinancing transactions will be classified in the financial statements as "standard risk", "substandard risk" or "doubtful risk", in accordance with the provisions of Circular 4/2004 (Annex IX).

Accordingly, any transactions that do not satisfy the objective requirements to be classed as "doubtful" or "standard" risk, on the basis of the criteria described previously, would be classed as "substandard risk".

Specifically, they are required to be classified as follows:

- **Standard risk.** Transactions for which there is objective and verifiable evidence that recovery of all the amounts due is highly likely, bearing in mind the following factors:
 - **Absence of lengthy grace periods;** there should be no clauses that prevent assessment, in the short term, of the borrower's ability to pay, such as clauses granting lengthy grace periods.
 - **Debt repayment schedule consistent with income sources,** without the installment payments exceeding 50% of income. The debt repayment schedule must be consistent with the borrower's demonstrable recurrent income stream, following deduction of any amounts needed to meet any other previously held debt. For example, for transactions with individuals structured through monthly installments, the borrower should not need to use more than 50% of his recurrent monthly income to pay those installments.

- **New collateral or guarantors.** The addition of new collateral or guarantors of unquestionable solvency, or of new effective collateral, will be taken into consideration.
- **Semi-annual individual review.** In order for loans to be classified as “standard” risk, institutions must have the results obtained reviewed in a semi-annual individual review program, to assess the timeliness of continuing with or modifying the management strategy adopted.
- **Doubtful risk.** Transactions will be classed as doubtful risk where evidence of marked weakness in the borrower’s ability to pay makes this advisable. In this respect, the following factors will be taken into consideration:
 - **New collateral and interest payments:** The inclusion of new effective collateral, or receipt of all the interest outstanding with no increase in the previous risk.
 - **Grace periods of more than 30 months:** The granting of grace periods in respect of repayment of principal of more than 30 months, unless the agreement includes terms that significantly improve the chances of recovery.
 - **Existence of previous refinancings:** The source of previous refinancings, unless there is evidence of the borrower’s ability to meet its commitments in the contractually established time and form.

A transaction can only be transferred from the “doubtful” or “substandard” risk categories to a lower risk category if, following analysis:

- there is an improvement in the borrower’s ability to pay; and
- sufficient time has elapsed in which the borrower has fulfilled its contractual obligations.

In general, transactions or borrowers that have met their commitments within a period of at least one year since the refinancing or restructuring was formalized (six months in the case of loans with monthly installments and mortgage collateral consisting of the borrower’s principal residence), or where the principal of the transaction has decreased by at least 10%, will be reclassified as “standard risk”.

Institutions should review the accounting classification of refinancings in accordance with these criteria and inform the Bank of Spain before September 30, 2013.

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