Recent measures for refinancing and restructuring Spain´s corporate debt: Opportunities and impact on the banking sector

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The high level of Spain´s private debt, particularly of non-financial corporations, is often cited by international institutions as the main obstacle to a sustained economic recovery. The recent Royal Decree-Law 4/2014 adopts urgent measures in the area of corporate debt refinancing and restructuring, aimed precisely at opening new paths towards narrowing the gap between what banks can expect to recover and what viable companies can actually pay.

Royal Decree-Law RDL 4/2014 adopts urgent measures on corporate debt refinancing and restructuring, aimed to ensure survival of viable companies that cannot make due on their debt servicing obligations due to the current economic climate together with their elevated debt levels. This article provides a brief analysis of the most important measures adopted, as well as an estimate of the impact of the reclassification of refinanced loans on the income statements and the solvency of Spanish banks. Results are highly sensitive to the percentage of debt converted into capital, or the loan's level of coverage. In most cases, however, the new treatment of restructured transactions would be positive, as it facilitates the debt restructuring of viable companies and encourages an analysis of operations, which could improve banks´ capital positions.

Introduction

Royal Decree-Law RDL 4/2014 adopts urgent measures on corporate debt refinancing and restructuring aimed at facilitating refinancing arrangements outside formal insolvency processes. The objective is to ensure the survival of viable companies that, owing to their elevated debt levels and the economic climate, cannot sustain current debt servicing commitments.

The text envisages, inter alia, refinancing via haircuts or debt capitalizations, suspension of enforcement actions, elimination of effective veto powers held by minorities, tax exemptions and improvements to the treatment of provisions made by banks for refinanced and restructured credit.

With regard to the latter, the Bank of Spain has established that the outstanding amounts owed following a refinancing arrangement are to be

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classified as "standard risk" as long as there are objective factors that point to the probable recovery of the loan.

Given the wide variety of channels of impact that this regulatory change may have on the income statements and solvency of Spanish banks, this article presents several quantitative and qualitative examples and analyzes their possible effects on banks' ability to generate capital. The results are highly sensitive to parameters, such as the percentage of debt converted into capital or the loan's level of coverage.

Current situation

The high level of private debt in Spain, particularly of non-financial corporations, is often cited by international institutions –such as the IMF, the European Commission, and the OECD– as the main obstacle to a sustained economic recovery. For some time, these international bodies have been calling for steps to narrow the gap between what banks can reasonably expect to recover on outstanding loans and what companies must record as debt on their balance sheets. This recognizes the reality that it makes no sense in the majority of cases to continue to assume that all the debt will be repaid.

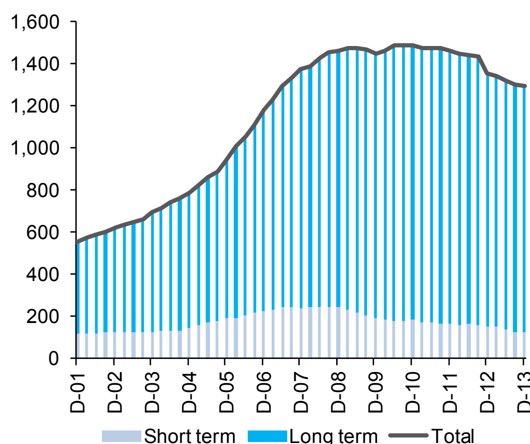
> *The elevated private debt level in Spain, and particularly of non-financial corporations (130% of GDP in 2013), is often cited by international institutions as the main obstacle to a sustained economic recovery.*

First, it would be useful to analyse how much debt is recorded on the balance sheets of non-financial corporations, and how much they have managed to reduce since the onset of the crisis; and, second, how much credit (gross and net of provisions) is shown on banks' balance sheets.

With respect to the former, total borrowing amounted to 1.3 billion euros in 2013, equivalent to 130% of Spanish GDP. This volume has decreased by nearly 170 billion euros since 2008, although

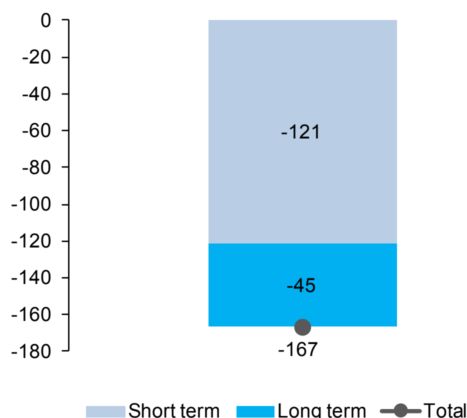
Exhibit 1

Corporate borrowing by type
(Millions of EUR)



Source: Bank of Spain, AFI.

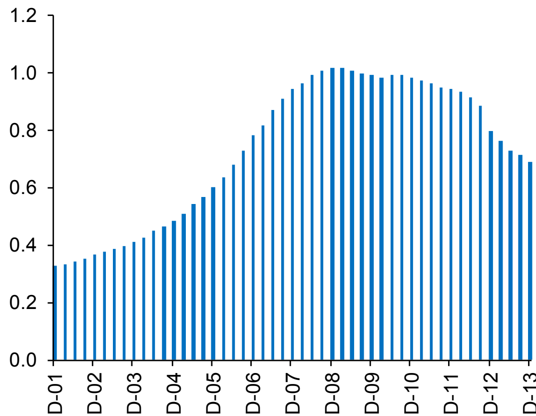
Cumulative change in corporate borrowing by type, Q308-Q413
(Billions of EUR)



Source: Bank of Spain, AFI.

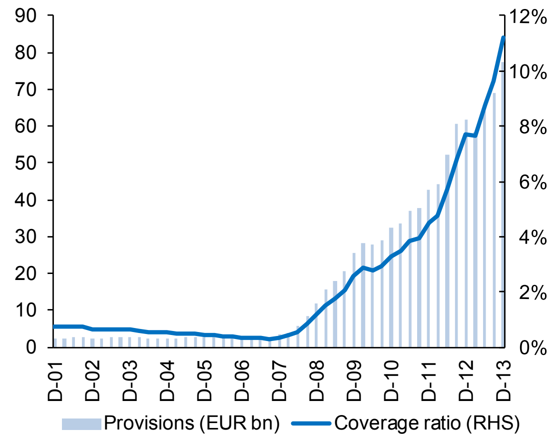
Exhibit 2

Bank credit to companies
(Billions of EUR)



Source: Bank of Spain, AFI.

Specific allowance provisions of bank credit to companies and coverage rate



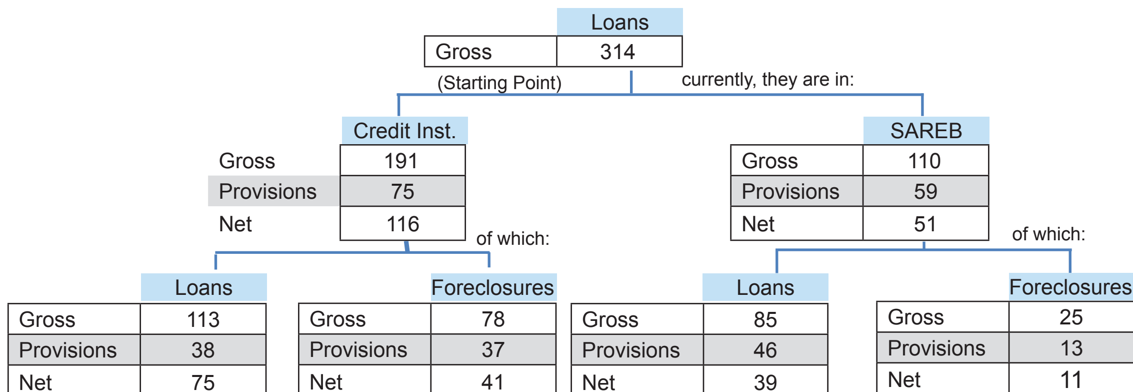
Source: Bank of Spain, AFI.

this is due to a larger decrease in performing rather than non-performing debt. However, the European Commission and the ECB[2] believe that Spain's corporate debt needs to fall further, by approximately the same amount again, in order to reach a sustainable level.

At the same time, the Spanish banking system reduced its outstanding credit balance with Spanish companies by some 240 billion euros between 2008 and 2013 through debt service, execution of guarantees (generally, real estate) and, above all, through the transfer of real estate credit to the

Exhibit 3

Bank exposure to real estate construction and development
(EUR billion)



Sources: Bank of Spain, CNMV and AFI.

[2] For further information, see the following: http://www.ecb.europa.eu/pub/pdf/other/art2_mb201402en_pp97-114en.pdf

SAREB (85 billion euros). In addition, the banking system has set aside provisions of nearly 80 billion euros up to 2013 (coverage of about 11%), which implies a clear recognition that the banking sector views the recovery of all outstanding debt as utterly impossible.

In the real estate, construction and development sector, the contrast between corporate debt and bank debt is, if anything, even more pronounced. The obligation to set aside provisions for credit to this sector at rates that are much higher than for other productive sectors (pursuant to Royal Decree-Law (RDL) 2/2012 and RDL 18/2012), as well as the transfer of a large proportion of these assets to the SAREB, have resulted in gross lending on banks´ balance sheets of just over 110 billion euros (75 billion euros net).

Opportunities arising from RDL 4/2014

The recent Royal Decree-Law 4/2014, of March 7th, adopts urgent measures in the area of corporate debt refinancing and restructuring, aimed precisely at opening new paths towards narrowing the gap between what banks can expect to recover and what viable companies can actually pay. The point is to facilitate agreements without entering into formal insolvency proceedings, which have proven to be slow, inefficient and hardly conducive to supporting the survival of companies – many of which are viable and key to the economic recovery, but are drowning under a burden of debt that they are unable to pay down under current conditions.

Royal Decree-Law RDL 4/2014 adopts urgent measures on corporate debt refinancing, such as: haircuts or debt capitalizations, suspension of enforcement actions, elimination of effective veto powers held by minorities, tax exemptions and improvements to the treatment of provisions made by banks for refinanced and restructured credit.

The measures enacted include the following:

- **Refinancing.** The regime of court-approved refinancing agreements will be modified. The required majority is reduced from 55% to 51% (i.e., a simple majority), and to 75% for syndicated loans, provided terms and conditions governing the syndication do not stipulate a lower majority. These refinancing arrangements may include the following measures:
  - **Haircuts or write-offs of part of the debt:** For example, at the same percentage as the debt provisioned.
  - **Debt capitalization.** Those who become equity holders due to a debt capitalization agreed as part of a refinancing arrangement will not be considered as subordinate.
  - **Deferrals or rescheduling** of a limited duration, which may affect the principal, interest or any other amount owed.
- **Suspension of enforcement.** During negotiations between the debtor and creditor, court foreclosures will be suspended for four months on assets that are necessary for the ongoing professional or business activity of the debtor. Likewise any other individual enforcement measures sought by financial creditors will also be suspended, provided that at least 51% of the creditors are in favor of the negotiations process. The aim is to allow negotiations to reach a successful conclusion and prevent the enactment of individual enforcement measures by creditors that are unwilling to negotiate.
- **Elimination of minorities' veto power over agreements.** Court-approved refinancing agreements may apply to dissident creditors if the following majorities are obtained:

Table 1
Extension of agreed terms of the refinancing agreement

% creditors who signed the agreement	Extension of agreed terms of the refinancing agreement					
	"Deferrals"	Debt reductions	Debt conversion into: Equity	Participation loans	Other assets	Transfer of property or rights
≥ 60%[1] (or 65%[2])	Period ≤ 5 years	No	No	Period ≤ 5 years	No	No
≥75%[1] (or 80%[2])	Period ≥ 5 years, but ≤10 years	Yes	Yes	Period ≥ 5 years, but ≤10 years	Yes	Yes

Notes: [1] *If credit has no collateral, or the part that exceeds the value of the collateral.*
[2] *For the part of the credit that does not exceed the value of the collateral.*
Source: BOE, AFI.

- **Improved treatment of fresh money provided in debt restructuring transactions.** To date, only 50% of the fresh money contributed to a refinancing qualified for preferential treatment in the case of insolvency. As an extraordinary and temporary measure, the new law increases the percentage to 100% of new cash inflows for the next two years. The aim is to strengthen the incentives for additional financing, as such funding is essential to ensure the transitional viability of the company and make any agreement feasible. Two years after the financing is granted, it is considered a loan against any future insolvency estate.

- **Tax exemptions and credits for debt refinancing:**

  - Corporate income tax (IS): The conversion of debts into capital will be exempt from this tax, unless the capitalization was purchased under a derivative acquired by the creditor at a value different from the nominal of the same. For income from haircuts and rescheduling, the new law sets out a system of deferred recognition of income generated in the taxable base, in accordance with financial expenses recognized.

    Further, we must recall that **Law 16/2013,** of October 29th, establishing certain measures on environmental taxation and adopting others on taxation and finance, **eliminated limits to offsetting tax losses on income from haircuts resulting from agreements with creditors.** These limits are 25% and 50% for companies with a turnover of more than 60 and 20 million euros, respectively.

  - Tax on Equity Transfers and Documented Legal Acts (ITP and ADJ in Spanish, respectively): Notarial instruments containing haircuts or reductions of loans, credits and other obligations will be exempt from payment of these taxes.

- **Extension of RDL 10/2008 for one year.** For calculating losses for a mandatory capital reduction, impairment losses on property, plant and equipment, real estate investments and inventories will not count. The measure will apply solely and exclusively to fiscal years that end in 2014. The measure affects not only real estate construction and development, but also a broad range of companies in other sectors, including the SAREB itself and, by extension, banks.

- **Improvement in treatment of provisions set aside by banks for refinancing and restructuring.** The Bank of Spain was entrusted with the task of establishing, within one month, standardized rules regarding the

Table 2
Corporate debts

	Loans	Total		Refinanced loans					
				Standars		Substandard		Doubtful	
	€ Bn	€ Bn	% Total loans	€ Bn	% Refinanced	€ Bn	% Refinanced	€ Bn	% Refinanced
Corporate	427	89	21	30	34	21	23	38	43
Real Estate	232	59	26	6	10	9	15	45	75
Total	659	149	23	36	24	30	20	83	56

Sources: Bank of Spain, AFI and reports of listed entities.

provisioning of the remaining debt following the refinancing agreement. We would note that, as stipulated by the Bank of Spain, refinanced or restructured debts in a normal situation were classified as substandard risk in September 2013. With respect to real estate, construction and development, the impact was more modest, meaning that the bulk of the provisions had already been allocated pursuant to RDL 2/2012 and RDL 18/2012.

The Bank of Spain has established that the outstanding amounts owed following a refinancing arrangement are to be classified as "standard risk" as long as there are objective factors that point to the probable recovery of the loan.

The Bank of Spain stated its position[3] on the latter point on March 18th, setting out general guidelines for the accounting treatment of outstanding debt following a refinancing agreement. Such outstanding amounts will be classified as follows:

– Standard risk, when objective factors exist that lead to the conclusion that the remaining amounts owed will likely be recovered following the application of the refinancing agreement. In this regard, it is important to carry out an evaluation of the effect of haircuts, or conversions of debt into capital on the possibilities of recovering the amount owed, as well as to take into account the debtor's business plan. A report by an independent expert may be used to provide objectivity in this matter.

– Risk other than normal (doubtful or "substandard"), if the future cash flows are likely to prove insufficient to meet the obligations undertaken in a refinancing arrangement. As soon as the grounds for such a classification no longer exist, the credit can be reclassified to a better risk category.

Channels of impact on profit and loss and solvency of banks

The impact on the income statements and solvency of Spanish banks is likely to vary quite widely, and will depend on the state of repair of balance sheets and the implementation of refinancing arrangements (haircuts, debt-for-equity conversions or grace periods) among other factors.

We will now set forth three examples of refinancing arrangements with debt-for-equity conversions, assuming that the initial operation was a loan to an SME classified as doubtful. In the first case, we assume that the conversion does not free up provisions. In the second case, all provisions are freed up except those related to the amount that is capitalized. In the final case, the totality of

[3] For further information, see the following: http://www.bde.es/bde/es/Home/Noticias/Criteriospara b81024ccd05d441.html

provisions are released – a scenario we consider less probable.

Capital generation will come from two different paths:

i. Equity release (ER) due to a reduction of the volume of risk-weighted assets, based on the assumption that the initial loan was originally classified as doubtful and, as a result of the refinancing agreement and application of the swap, would then become a normal risk.

ii. Provision release that, after taxes, would be taken to reserves, assuming no profits are distributed.

Based on these assumptions, all three cases yield a positive result following the application of the refinancing agreement, generating capital for the bank. It should be noted that, in the last two cases, the equity release due to the reduction of risk-weighted assets would yield a negative result. This is because the reduction of the risk weight reclassified as a performing loan would

Table 3

Examples of potential impacts of refinancing agreement through equity conversion
(Million euros)

Assumption	
Amount of the operation (mil. euros)	100
Coverage (% provisioned)	40%
Weighting in RWAs and solvency	
Risk weighting of initial loan (doubtful)	100%
Risk weighting of final loan (normal)	57%
Risk weighting of equity	150%
Capital requirements	10.50%
Equity conversion	20%
Tax rate	30%
Scenarios	
Case 1	No provisions freed up
Case 2	All provisions released except those related to initial amount capitalised
Case 3	All provisions freed up

	Post-refinancing	Post-refinancing		
		Case 1	Case 2	Case 3
Loan (Net)	**60.0**	**40.0**	**60.0**	**80.0**
Gross loan	100.0	80.0	80.0	80.0
Provisions	-40.0	-40.0	-20.0	0.0
Investment in equity (net)	**0.0**	**20.0**	**20.0**	**20.0**
Gross loan	0.0	20.0	20.0	20.0
Deterioration	0.0	0.0	0.0	0.0
RWA	**60.0**	**52.8**	**64.2**	**75.6**
Consumption of capital	**6.3**	**5.5**	**6.7**	**7.9**
Capital freed up		**0.8**	**-0.4**	**-1.6**
Provisions freed up		0.0	20.0	40.0
Impact on net profits		**0.0**	**14.0**	**28.0**
Total impact on capital		**0.8**	**13.6**	**26.4**

Source: AFI.

not offset the increase in net balance resulting from the release of provisions. Nevertheless, this effect would be more than offset by the release of provisions.

Even so, it is important to take into account the very high sensitivity of capital generation to the proportion of debt converted into equity, as well as the initial coverage level of the loan.

As shown in the following tables, it is obvious in case 1 that the higher the level of coverage, the less beneficial it will be to the bank. Keeping the coverage level constant (e.g. at 40%), the larger the conversion of debt into equity, the worse the result will be for the bank. It may even be negative if the coverage is 60% or higher. This is due to the greater consumption of own resources by positions in capital than in loans. In any event,

Table 4

Sensitivity analysis: Impact on equity of the conversion of debt into equity according to percentage of conversion and level of coverage of the initial loan

(Million euros)

Case 1: No release of provisions corresponding to the conversion

Case 2: Provisions freed up except for those relating to amount capitalized

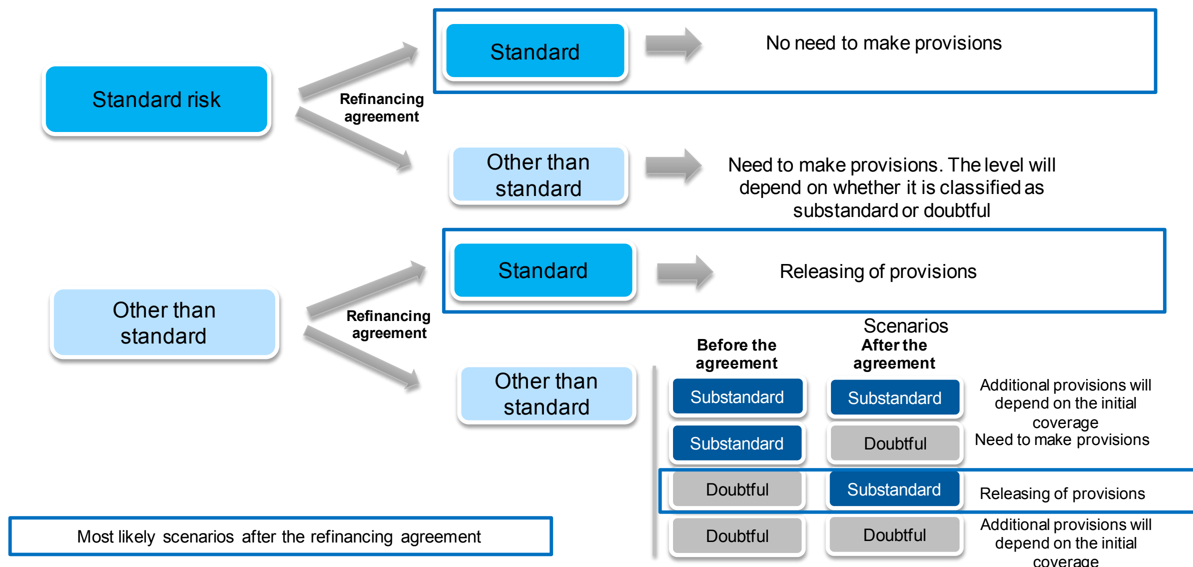
Case 3: Complete releasing of provisions

		Case 1				
		% conversion of debt to equity				
		0%	20%	40%	60%	80%
% Initial Loan Coverage	20%	3.6	1.7	-0.3	-2.2	-4.2
	40%	2.7	0.8	-1.2	-3.2	-5.1
	60%	1.8	-0.1	-2.1	-4.1	-6.0
	80%	0.9	-1.1	-3.0	-5.0	-6.9
		Case 2				
		% conversion of debt to equity				
		0%	20%	40%	60%	80%
% Initial Loan Coverage	20%	16.4	1.7	-0.3	-2.2	-4.2
	40%	28.3	13.6	-1.2	-3.2	-5.1
	60%	40.2	25.5	10.7	-4.1	-6.0
	80%	52.1	37.4	22.6	7.8	-6.9
		Case 3				
		% conversion of debt to equity				
		0%	20%	40%	60%	80%
% Initial Loan Coverage	20%	16.4	14.5	12.5	10.6	8.6
	40%	28.3	26.4	24.4	22.5	20.5
	60%	40.2	38.3	36.3	34.4	32.4
	80%	52.1	50.2	48.2	46.3	44.3

Source: AFI.

Exhibit 4

Impact on provisions of refinanced operations through deferrals of claims



Source: AFI.

we believe that, if a debt capitalization is included in a refinancing arrangement, the conversion percentage would not be very high because banks do not have the objective of becoming managers of companies, but rather to recover the largest possible amount of outstanding loans. That said, if coverage levels are already very high, the less likely the bank makes a debt-for-equity conversion agreement.

This would be similar in cases 2 and 3, as shown in the table above, where the final impact would be much larger due to the release of provisions.

In the event of a haircut instead of a conversion to equity, the impact would be closer to that of case 1 in the previous table. The effect would be more favorable if a rescheduling is agreed instead of a haircut.

In sum, in most cases the impact of the new treatment of restructured transactions would be positive for the banking sector for two reasons: (i) it facilitates the debt restructuring of viable companies, that is, the management of risk, and (ii) an adequate analysis of operations and of their most sensitive aspects could improve banks' capital positions.

Conclusions

Royal Decree-Law 4/2014, adopting urgent measures for debt refinancing and restructuring, extends Royal Decree-Law 10/2008 on the grounds for dissolution and elimination of limits on offsetting of tax losses for income from haircuts under Law 16/2013. This would make 2014 an opportune year for viable, indebted firms to negotiate with banks.

The recently approved law provides no miraculous solutions, but it does encourage the type of actions that can help create a framework for making what banks can actually expect to recover commensurate with what operationally-viable companies can actually pay.

For the banking sector, in most cases the impact of the new treatment of restructured transactions would be positive as it facilitates the debt restructuring of viable companies, and encourages an analysis of operations and of their most sensitive aspects, which could improve banks' capital positions.