

# Client Alert

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## The Spanish Central Bank Proposes to Toughen Risk Management Principles and Provision Requirements to Financial Entities

### Introduction

On 26 May 2010, the Spanish Central Bank opened a public consultation on the amendment of the so-called Circular 4/2004 on the rules of public and reserved financial information and models on financial statements applicable to banks and other credit entities.

The amendment aims to improve the best practices guide on risk coverage attached as Annex IX to Circular 4/2004 to input the experience gained throughout its application over the last several years. In particular, the proposed amendment would imply a simplification and clarification of the provisions regime.

The main amendment proposal covers (i) the introduction of *ex-ante* principles for risk management in the granting of financing; (ii) the modification of the provisions' schedule for the 100 percent of "delinquent loans" from six years to one year; (iii) the recognition of the value of *in rem* guarantees in order to determine that the amount to be provisioned should not be 100 percent, as the guarantee to be enforced would reduce any potential loss; and (iv) the modification of the treatment of the acquisition of real estate assets as payment of debts.

The public consultation will close on 14 June 2010 and the resulting amendment is expected to become effective on 30 September 2010.

### Introduction of *Ex-Ante* Principles for Risk Management

The proposed amendment introduces several *ex-ante* principles that financial entities should apply when defining the policies, methods and procedures applied to the evaluation and grading of debt instruments. Thus, such policies, methods and procedures shall in the future:

- (i) Be based on the payment capacity of the borrower derived from its primary source of income (*i.e.*, cash flow) rather than on personal or *in rem* guarantees
- (ii) Be based on a realistic payment plan in relation to the financing granted
- (iii) In case of land development activities, introduce limits to the percentage of the cost to acquire the land and develop it to be financed (50 percent as a general rule)
- (iv) Determine under which circumstances the entity would exceptionally grant loans outside the approved policies, methods and procedures

"In addition, due to the delicate financial situation of certain Spanish banks and saving banks (cajas de ahorro) the proposed amendment would eventually facilitate the consolidation of the banking sector in Spain."

- (v) Adopt a debt restructuring policy subject to a minimum financing experience with the borrower, to a minimum compliance with the terms of the financing by the borrower and a cap to the frequency of the restructuring during a sufficient number of years
- (vi) Be extremely prudent regarding rating services
- (vii) Provide a minimum frequency for revisiting and update *in rem* guarantees updating them with the market of the relevant collateralized asset

## **Modification of the Calendar to Provision Delinquent Loans**

Under the current regime, there exist different calendars on the obligation to cover the 100 percent of a “delinquent loan” whereby such coverage was to be attained within a range of 24 to 72 months since the classification of the loan as delinquent. The proposed reform unifies the different calendars into a single one that guarantees the total coverage of the credit risk within one year in the following terms:

<b>Calendar</b> (since payment was due)	<b>Coverage</b>
Up to 6 months	25%
Between 6 and 12 months	50%
Between 9 and 12 months	75%
More than 12 months	100%

## **Recognition of *In Rem* Guarantees for Determining the Amount to Be Provisioned**

The current regime only recognized in an indirect way the existence of *in rem* guarantees securing the payment

of delinquent loans for the purposes of determining the applicable provision obligation. The proposed amendment will directly factor in the existence of *in rem* guarantees so to reduce the applicable provision to be made in the following terms:

<b>Type of <i>In Rem</i> Guarantee</b>	<b>Reduction of Applicable Provision</b>
Finished house used as residence of the borrower	20%
Finished country houses, offices, stores and warehouses	30%
Terminated houses (other than those used as residence of the borrower)	40%
Plots and remaining real estate assets	50%

Such a reduction would work only if the guarantee is first rank, duly constituted and registered in favor of the lender.

## **Modification of the Treatment of the Acquisition of Real Estate Assets in Payment of Debts**

The proposal penalizes the acquisition of real estate assets in payment of debts due to the high volume that such acquisitions have experienced over the last few years, and to the fact that the management of real estate assets does not fall within the activities that banks and other credit entities are typically involved with. Thus, when acquiring such real estate assets, the entity shall recognize a 10 percent depreciation of the reasonable value of the asset, depreciation which shall be increased up to a 20 percent (in terms of provisions to be made) when the asset remains in the balance of the entity for more than 12 months, and 30 percent when it remains for more than 24 months.

## **Impact of the Proposed Amendment**

The Spanish Central Bank has calculated that if the proposed amendment of Circular 4/2004 finally enters into force as currently drafted, it would imply an average increase in the provisions to be made by banks and credit entities of 2 percent for 2010 and 7 percent in 2011. In addition, due to the delicate financial situation of certain Spanish banks and saving banks (*cajas de ahorro*) the proposed amendment would eventually facilitate the consolidation of the banking sector in Spain.

Finally, banks and credit entities will be penalized for keeping real estate assets on their balance sheets, and it is likely that they will try to dispose those assets in the Spanish real estate market.

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