A finance facelift

Spain's banking sector is still in the midst of a restructuring that is affecting it on an unprecedented scale. And while Portugal's banks have been recapitalised, they are still under very strict deleveraging requirements. A key challenge for both countries remains the liquidity gap. And alternative sources of financing are proving the 'go-to' funding to cover the lack of traditional bank financing.

Since its bank bailout last year, Spain's banks and finance institutions are cutting costs and divesting their non-core assets and non-performing loan portfolios. But they are having a hard time obtaining funding and the majority of liquidity they have gained from the European Central Bank (ECB) is being used to tackle the deficit.

According to lawyers, however, the banking system does seem to be fulfilling its requirements under the Troika. But as banks focus on deleveraging, this has led to a dramatic reduction in credit, and liquidity is therefore one of the major problems Spanish companies are now facing.

While liquidity is also a big issue for Portugal, it is further along the road than its Iberian counterpart. The major problem is that while Portuguese banks are well capitalised, money is still not flowing into the wider economy, as the banks keep any gains within their portfolios to serve as collateral with the ECB.

And across Iberia, traditional financing as we know it has taken a backseat to alternative sources of funding, something that has the potential to change the face of the sector in the long run.

Good and bad banks

Following the July 2012 restructuring and recapitalisation plan to restore trust and stability to Spain's banking sector, there has been a massive clean-up of the banks, affecting the sector on an unprecedented scale. "This process has resulted in the virtual disappearance of a whole sub-sector – the savings banks – which accounted for roughly half of the deposit-market," says Fernando Mínguez, Banking Partner at Cuatrecasas, Gonçalves Pereira. The State has also taken over a number of institutions, accounting for a significant stake of the system's assets, some of which have already been reprivatised through auctions.

The Spanish financial sector has therefore suffered a big transformation, explains Francisco Uría, Head of Financial Services, Legal at KPMG Abogados, the milestones of which have been the consolidation process (from 60 banks to nearly 20 in two years), the transformation of the savings banks into private banks and the restructuring process, with thousands of branches now closed.

The key challenge for the sector, however, is the liquidity gap. And, according to Eduardo García, Corporate & Finance Partner at Clifford Chance, this is prompting a change in attitude from those Spanish companies that usually opt for traditional financing solutions and that are being forced to move towards alternative sources. "But there's an educational and cultural change that needs to happen if companies are to access any type of financing."

Banks have decreased or even partially cancelled the amount of working capital credit facilities, says Francisco José Bauzá, Co-Head of Finance and Capital Markets at Ramón y Cajal Abogados, and the majority of Spanish companies are paying their obligations with a substantial delay – usually between 90 and 120 days. And while the biggest banks do have liquidity, adds Fernando Lillo, Of Counsel at Jones Day, unfortunately they also have a limited level of risk with many of their clients, so cannot refinance or extend credit as they cannot

Las instituciones financieras en España están recortando y diversificando sus activos y su cartera crediticia. Sin embargo, la reestructuración de los bancos ha conllevado a una reducción dramática del crédito y la liquidez, convirtiéndose en un grave problema para el país. Por otro lado, los bancos portugueses se han recapitalizado, aunque aún no se percibe el flujo crediticio en la economía general, ya que los bancos mantienen sus ganancias en sus carteras internas. Esto conlleva que en la Península Ibérica, las formas de financiación tradicionales se están quedando atrás frente a nuevas formas de financiación que pueden cambiar el paisaje del sector financiero y bancario a largo plazo.

"Those entities that can provide liquidity to Spanish companies have different rules to those that they are accustomed to, and we need to solve the problem of how to combine traditional and alternative financing, different mentalities, rules, objectives and laws. And we have to find solutions from a legal perspective."
Rafael Mínguez Prieto, Finance Partner, Cuatrecasas Gonçalves Pereira

assume a bigger risk.

And aside from refinancings and restructurings, the most active segment of the market is that of secondary sales. These transactions, driven by the need to deleverage balance sheets in anticipation of Basel III requirements and the need to raise cash, include both core and non-core businesses and portfolios of distressed loans, explains Joaquín Sales, Banking & Finance Partner at SJ Berwin. Also, in many cases, corporate loans are purchased so as to try to reach the control of a company through the 'back door' or to obtain a substantial profit/discount out of them.

The recent creation of the Sociedad de Gestión de Activos (SAREB) has undoubtedly contributed to restructuring the Spanish financial system, say lawyers, as banks bring their distressed real estate assets to the so-called 'bad bank'. However, it is still unclear whether or not the valuation of the assets brought to SAREB, which was fixed by the Spanish Government, sufficiently took into account the deterioration of the market value of these assets, says Luis Manuel García, Head of Banking and Finance at Lupicinio Abogados International Attorneys. "Moreover, the 15-year period granted to SAREB to get rid of those assets means that there is not going to be a rapid exit from the real estate crisis in Spain."

According to Fausto Romero-Miura, Corporate Partner at Pérez-Llorca, however, it is expected that the cleaning-up of these toxic assets from the balance sheets will allow the banks to inject additional liquidity into the system. "Nevertheless, this is something that is yet to be seen."

And while the positive effects of the restructuring of the Spanish system are not very visible yet, they will soon be felt, says Rafael González-Gallarza, Finance Partner at Garrigues in Spain. He points to the latest successful issuance of covered bonds by Caixabank, at a fairly low interest rate, for example, signals the growing confidence of the market in the banks.

Bailouts

2012 saw the recapitalisation of the major Portuguese banks (CGD, BES, Millennium BCP, BPI and Banif) through the injection of new funding that met the capital requirements established by the Troika. But the big development has been the raising of the capital ratio to 10 percent by the Bank of Portugal, compared to nine percent in the rest of Europe, in order to preserve the stability of the financial system. This was to make banks more capable to resist and absorb losses, explains Pedro Cassiano Santos, Banking, Finance and Capital Markets Partner at Vieira de Almeida & Associados (VdA). What he views as, in some cases, to be able to bear the consequences of their prior excessive or irresponsible lending.

The restrictions added by banks, in light of the bailout and rise in core capital ratio, have therefore impacted on the way traditional finance is provided, says Hugo Rosa Ferreira, Banking and Finance Partner at PLMJ. And 2013 will demonstrate exactly how this is affecting SMEs and whether the benefits of the bank restructurings are being passed on to their customers.

The liquidity of the banks themselves has improved as a result of the longer-term financing programmes recently launched by the ECB and by the strong deleveraging of credit portfolios and by the strengthening of deposits, says Manuel Magalhães Senior Partner and Co-Head of Finance and Governance at Sérvulo & Associados. "The combination of these factors significantly increased the short- and long-term liquidity ratios of the Portuguese banking system."

But, according to Cassiano Santos at VdA, the banks are still under very strict deleveraging requirements, so they have to shrink their balance sheets and sell off part of their assets, including their non-performing loans, in order to survive and move forward. So liquidity to the market is still very much constrained.

Large corporates are solving such constraints by borrowing from foreign banks and issuing bonds into the market, explains Alexandra Maia de Loureiro, Banking and Finance Partner at SRS Advogados, and the remaining limited liquidity of Portuguese banks has been directed at the financing of public sector companies and manufacturing companies within the exporting sector.

For SMEs, however, the inability to obtain credit from banks and finance institutions has left them, in many cases, struggling to meet their exposure. Therefore the number of insolvencies has increased significantly, adds Sofia Santos Machado, Banking & Finance Partner at Abreu Advogados, as well as the need to resort to PER – the Special Revitalisation Procedure. This was brought in last year by the new Insolvency & Restructuring Code as a means for viable companies to negotiate with creditors to avoid insolvency proceedings.

But there are also good signs in the market. In particular, over the past few months the Portuguese State and certain banks have successfully placed unsecured debt and covered bonds in the international debt capital markets, thus reopening them to Portuguese issuers, according to Pedro Ferreira Malaquias, Finance Partner at Uría Menéndez - Proença de Carvalho.

And the belief among lawyers is that, while not completely solved, the problem of a lack of liquidity is in a much better state than last year.

Market concerns

Across Iberia, the main issues for law firm clients continue to be the challenging markets and the difficulties in accessing new sources of financing. "After more than five years of decline, even the more robust and less leveraged Spanish companies are suffering from these restrictions," notes Pedro de Rojas, Partner Banking & Finance at Linklaters in Spain. The need for cash is forcing the undesired sales of assets, and refinancings are imposing new restrictions on the day-to-day operation of businesses.

And, according to Alberto Campo, Director at Deloitte

Abogados, companies that have already gone through one or several debt restructuring processes are also encountering severe challenges when it comes to persuading credit entities that it is necessary to restructure their debt again.

The challenge for the Portuguese SME market this year is their restructuring and insolvency plans. In the economic boom, insolvency was seen as a shameful end result, says Rosa Ferreira at PLMJ. "But under the new Insolvency & Restructuring Code introduced in 2012, SMEs are looking at restructuring plans as a way to renegotiate debt plans."

The main client concern in Portugal, therefore, is on the recovery of bad loans and the restructuring of debts, especially those related to acquisition finance. Also regarding the mobilisation of distressed assets and portfolios, says Alexandre Jardim, Banking and Finance Partner at pbbr, to comply with regulatory and exposure ratios and capital adequacy requirements, and to raise funds.

Portuguese banks themselves will also face numerous challenges in 2013, say lawyers, including the maintenance of adequate liquidity ratios in an economy in recession, and adapting to a new and much more demanding and complex regulatory framework. "This will force banks to maintain a certain deleveraging of credit portfolios and to adopt judicious lending policies aiming at avoiding mismatches between funding and assets," explains Magalhães at Sérvulo & Associados, "and to achieve adequate margins between the cost of funding and the remuneration of the assets."

Banks will not be able to lend as much as they did before the crisis as their revenues will undoubtedly be hit, and they will need to find new ways to be profitable. And when it comes to their clients, banks are generally trying to reach a restructuring plan under a PER rather than filing for insolvency, notes Maria João Ricou, Co-Managing Partner at Cuatrecasas Gonçalves Pereira in Portugal, which is the last thing they want to do at this stage.

The financial institutions in Spain are also facing a completely new scenario. They are having to conduct

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>
> Ignacio Ruiz-Camara, Finance Partner, Allen & Overy

divestment in non-core and non-strategic assets pursuant to approved restructuring plans and sell non-performing assets on provisioned accounts rapidly to clean-off balances, explains Manuel Mingot, Banking and Finance Partner at Broseta. They also have to slow wholesale and investment banking activities, which traditionally generated high revenues and fees, he adds.

And banks continue to struggle with the refinancing of their risk portfolios, processes that are very complex and critical in timing, which, according to Xavier Foz, Banking & Finance Partner at Roca Junyent, poses major challenges for legal advisers representing lenders and borrowers alike. "In both cases, the fact that some of the entities forming part of the pool are often nationalised or subject to integration processes compromises the ability to move forward with the refinancing."

New players

The bank restructurings in Portugal have opened a window of opportunity for an influx of alternative financing to traditional banking, in particular through hedge funds, private equity and capital ventures operations.

Private equity funds have been active in Portugal, seeking to turn the recession into an advantage for specific investment transactions, says Antonio Mendonça Raimundo, Partner at Albuquerque & Associados, and the market has even seen the birth of some new funds. Lawyers note an appetite for investment in distressed, but viable, businesses and distressed debt. But there is still a

Regulatory developments – Spain

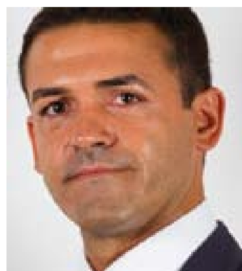
A key driver for regulatory change has been the Troika MoU in July 2012, which prompted the introduction of legislation based on the so-called 'European Crisis Management Directive'.

This legislation provided for a brand new legal framework for crisis management of financial institutions by introducing three non-judicial or administrative procedures for reorganising or winding up banks: early intervention, restructuring and resolution, says de Rojas at Linklaters. It also regulates the establishment of SAREB, which is playing a significant role in the Spanish banking restructuring process.

The Government is also trying to move the Spanish economy away from a traditional banking base and foster new forms of non-banking finance, in particular for SMEs. "Among those measures being assessed by the Government, worth mentioning is the simplification and increase in transparency of the requirements for listing on regulated markets, with a view to improving the stage for debt issues by non-financial companies," explains Campo at Deloitte Abogados, "together with the creation of an alternative fixed income market targeted at medium-sized companies where they can negotiate corporate promissory notes."

The elimination of the cap of debt that companies can issue under the Spanish Companies Act has been a very good regulatory development ,say lawyers, which will hopefully encourage companies to explore the debt capital markets alternative. Also, a capital ratio of nine percent is established for all credit institutions as of the start of this year, says Sales at SJ Berwin, calculated in accordance with the European Banking Authority rules.

And looking ahead, amendments to the Law on the Autonomy of the Bank of Spain and to insolvency rules will be brought in to implement the Capital Resources Directive IV. In terms of continuing to strengthen the operational independence of the Bank of Spain, the agreed proposal to empower the Bank of Spain to issue guidelines as well as binding replies to queries will be implemented by amending the Law on the Autonomy of Bank of Spain, says Juan E. Díaz Hidalgo, Banking and Finance Partner at Eversheds Nicea. And Law 9/2012, on bank restructuring has established a set of rules that limit the sale of financial hybrids products to retail customers, while amendments of the Law on Securities Market are intended to increase transparency in respect of financial products different to deposits.



"The restrictions added by banks, in light of the bailout and rise in core capital ratio, have therefore impacted on the way traditional finance is provided."

Hugo Rosa Ferreira,
Banking and Finance Partner, PLMJ

gap between sellers' expectations and the requirements of international investors. With distressed assets you can always find buyers, explains Ricou at Cuatrecasas Gonçalves Pereira, but the challenge is getting true value.

And although the international debt capital markets recently reopened to Portuguese issuers, lawyers still believe that the main market players will continue looking towards the international markets in search of funds. There are some international funds looking into Portugal for opportunities to invest through debt and equity instruments, says António Rocha Alves, Banking & Finance Partner at Campos Ferreira, Sá Carneiro & Associados, and the country's existing legal framework can accommodate such an investment. In fact, this framework is extremely favourable to foreign investors, particularly at this moment, notes Nelson Raposo Bernardo, Managing Partner at Raposo Bernardo. This includes specific rules on visas, tax advantages for projects with some dimension, and speed in company incorporation.

Lawyers are also seeing a trend of foreign banks increasing their market share, namely in corporate financing. According to Francisco Ferraz de Carvalho, Counsel at Linklaters in Portugal, there is a great deal of activity in bilateral loans from Chinese Banks to many Portuguese companies, and also some European banks are seemingly willing to lend to top tier companies. "And the recent arrival of Angolan banks in Portugal is significant," says Luís Branco, Banking and Finance Partner at Morais Leitão, Galvão Teles, Soares da Silva & Associados (MLGTS), "although we are yet to know the impact this will have on the domestic market."

While this new financing is good news for the market, ceilings on interest rates imposed by the Bank of Portugal, together with increased withholding taxes, could make investors choose other countries with better ratings to invest their money. "It will then be difficult for banks to help SMEs, due to the imposed target credit/deposit ratio," explains Diogo Leónidas Rocha, Head of Banking & Finance, Garrigues in Portugal, "although some large companies manage to get financed from retail investors by issuing bonds in the local market."

The danger is also that the Government is wanting to show the outside world that it has learned its lessons, and sometimes is adopting a punitive attitude towards private investors. The real challenge for them, according to Ferraz de Carvalho at Linklaters, is striking the right balance between correcting past mistakes and maintaining the credibility of Portugal as an investor friendly country.

Fresh money

Restrictions to the availability of banking credit in Spain, and the critical need for companies to secure finance, have created a breeding ground for the rise of a new type of lender, such as private equity firms or hedge funds, says Foz at Roca Junyent. "The growth of this 'shadow' banking system raises some concerns for its lack of supervisory control, while also highlighting the need to develop specific regulations that deal with the particularities of this activity."

But lawyers are mainly seeing new financing coming into Spain from Institutional investors, pension funds, insurance companies and sovereign funds, says Ana López, Banking & Finance Partner at Freshfields Bruckhaus Deringer. So while the country's banks are at a standstill, the liquidity gap is currently being filled by entities not based in Spain.

"And we are seeing that this option is becoming increasingly popular among our clients," adds Guillermo Yuste, Banking & Finance Partner at Araoz & Rueda.

Funds may be one of the best alternatives to fill the liquidity gap, agree lawyers. But they expect high profitability, at least, significantly higher than the consideration that Spanish companies are accustomed to pay to their traditional lenders, explains Rafael Aguilera Álvarez, Banking and Capital Markets Partner at Gómez-Acebo & Pombo in Spain. "And we are not sure if Spanish companies, particularly mid-sized, are ready to pay money for lenders with whom they have no relationship. There is a big cultural difference between Spain and the UK, for example, where the credit funds deal in risk rather than relationships."

Spanish companies, therefore, have a real problem, according to Rafael Mínguez Prieto, Finance Partner at Cuatrecasas Gonçalves Pereira in Spain, because they are having to move into another credit landscape and deal with different types of institutions, jurisdictions and laws, and being subject to increasing supervision. "Those entities that can provide liquidity to Spanish companies have different rules to those that they are accustomed to, and we need to solve the problem of how to combine traditional and alternative financing, different mentalities, rules, objectives and laws. And we have to find solutions from a legal perspective."

Also, if we are struggling with easier financing structures, then there is a question as to how we will deal with future ones that will be far more complex, adds César Herrero, Finance and Projects Partner at DLA Piper Spain. "And some alternative funding transactions abroad are having to be refinanced after only one year, therefore we don't know if in the long-term these structures will be successful at meeting all involved parties´ needs and expectations."

When putting in place these alternative financing structures, aside from the higher returns demanded by the credit funds, the requirement of borrowers to fit the long-term financing provided by credit funds with the short-term financing to be provided by banking entities make for complex negotiations, explains Juan Hormaechea, Finance Partner at Ashurst, meaning that clients also have to factor in higher lawyers' fees.

"And, where you have 'dual law' financing, there is a general increase in the complexity of the transactions," says Ignacio Ruiz-Camara, Finance Partner at Allen & Overy, "which is proving a big challenge for the sector."

Another key factor in allowing liquidity to flow into the market is by facilitating transactions. However, the authorities do not appear to be sensitive to this need. According to Yuste at Araoz & Rueda, the existing indirect taxation on security and certain amendments to the Spanish

Insolvency Act in 2011, are often 'deal killers'. The regional authorities, however, tend to increase indirect taxation on security rather than to reduce it, say lawyers, and no steps are being taken to amend Spanish insolvency law so as to remove the existing hurdles.

For smaller and medium sized companies, however, alternative sources of funding aren't an option, and these companies form around 80 percent of the Spanish market. "Their only access is to bank funding and this collapsed for them," says Emilio Díaz Ruiz, Banking & Finance Partner at Uría Menéndez in Spain, "and the only solution is to create some type of tailor-made capital market for these companies."

Ultimately, the question is whether or not companies have a choice when it comes to refinancing. "Where there is no other option because of the existing banking syndicate having to reduce their exposure, they will have to turn to alternative sources of financing," explains Jose Christian Bertram, Finance Partner at Ashurst, "be it credit funds or, if the company has access to them, the capital markets."

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Surgery

Therefore, while there is new financing coming into the markets, the majority is on a long-term basis. The challenge, therefore, is balancing long-term financing with clients' short-term needs, which used to be provided by the banks. "People need to start realising that investing is a serious matter, you cannot just take funds and expect a quick return," says Branco at MLGTS. "Investing needs to be done with a long-term vision."

But there is now a unique opportunity for corporates to combine long-term alternative funding with day-to-day traditional financing, according to Ruiz-Camara at Allen & Overy . "And we are seeing a great appetite for bonds, and broadening the range of financial alternatives available in Spain should be seen as a good thing."

Alternative financing has been done in other jurisdictions so there is no reason that Spain should be any different, says García at Clifford Chance. But until the problems coming out of the restructuring of savings banks are definitively solved, adds Díaz Ruiz at Uría Menéndez, the banking sector will not really be able to go forward.

For the Portuguese economy, the main challenge will be to learn to live without what was its 'oxygen' up until the bailout – bank financing. Deleveraging will continue to be necessary throughout all layers of the economy, says Ferreira Malaquias at Uría Menéndez - Proença de Carvalho, and the faith of the Portuguese economy will be deeply linked to economic and political circumstances at a European level. If the Portuguese State and banks are able to continue to tap the international markets for funds, it may be that the economy gets the oxygen it needs.

Banks need to become active players in attracting foreign investors and convince local ones to invest in existing businesses, according to António de Macedo Vitorino, Managing Partner at Macedo Vitorino & Associados, and corporates need to understand that the easy credit age is gone and that yields for equity and mezzanine investors are much higher than that of mere debt providers.

"The reality is, however, that there is a feeling of resilience, resistance and regeneration, and that we are learning our lessons from the crisis and beginning to understand the concept of efficient investment," says Cassiano Santos at VdA, "although this comes at a stiff price of redundancies, unemployment and insolvencies."

So while both economies continue to suffer, and their banking and finance sectors are still undergoing radical facelifts, alternative financing could prove to be the 'go-to' source of funding until the traditional banking systems get back on their feet.

Regulatory developments – Portugal

The recent major amendment to the Portuguese framework on the reorganisation and winding-up of credit institutions, means the Bank of Portugal now has very extensive powers to intervene in the banks' business, in order to avoid bail-outs with the taxpayers' money, says Ferreira Malaquias at Uría Menéndez - Proença de Carvalho.

It also modifies the General Regime of Credit Institutions and Financial Entities, aimed at recovering institutions in difficulties, or facing liquidation. And the Bank of Portugal has also developed much more of an 'onsite' approach, explains João Caiado Guerreiro, Managing Partner at Caiado Guerreiro, through the establishment of permanent inspection teams in the main banks as well as new methods for evaluating the institutions' risk profile.

This year, therefore, banks will face new and increased challenges from the much stricter supervision with the possibility of stiff sanctions.

Recently Bank of Portugal also put forward a package of regulation, which aims to promote arrears prevention and out of court settlement of such situations arising from credit agreements with consumers, says Nuno Azevedo Neves, Banking & Finance, Corporate & M&A, Tax Partner at ABBC. Namely the Pre-Arrears Action Plan (PRAP) and the Out-of-court Arrears Settlement Procedure (OASP), thus forcing the Banks and Credit Institutions to implement within their organisations both a formal standard PRAP and an OASP. This also promoted the implementation of a nationwide network of support to over-indebted customers, intended to provide advice and assistance in the context of arrears prevention or settlement of any arrears

Finally, Santos Machado at Abreu Advogados notes that the Special Regime on consumer rights, which amended the current consumer credit law, is involving a significant work load for bank´s internal legal teams.

Lawyers believe, however, that the Bank of Portugal's measures will reduce the profitability of the banks and the attractiveness of banking sector as an investment destination.