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IN THE NEWS

Banking & Finance Report 2012: Back-to-basics

Liquidity is the key challenge for both the Spanish and Portuguese economies, say lawyers. Banks are too concerned about their own core capital ratios, in light of reduced inter-bank lending and rising regulatory demands, to finance the needs of the wider economy. The result is that access to working capital is now the major difficulty facing businesses, meaning that the coming year will be one of survival rather than growth.

For many lenders and businesses there is, therefore, an enforced return back-to-basics in how they assess credit worthiness and raise finance, say lawyers.

“Currently, almost all Spain’s banks lack liquidity. For what few transactional operations are underway, no-one is lending,” says Juan Barona, Banking and Finance Partner with Allen & Overy in Madrid. “Many companies are now in need of restructuring, but raising new funds has become much more difficult. The refinance market is practically frozen except for the very best assets and well-managed businesses.”

Almost four years into the downturn in Spain, the situation remains one of financial uncertainty and mistrust among institutions. The collapse of the construction and real estate sector in 2008 left the country’s regional savings banks (cajas) particularly exposed. Concerns over the collapse of the sector prompted the Government to enact new legislation allowing cajas to merge and restructure as private banks, prompting a wave of mergers that has reduced numbers from 45 to closer to 10.

“If you compare the banking sector of a few years ago to what exists now then there has been a dramatic change. Significant players no longer exist and many international banks have reduced their operations or withdrawn from the market – these were key clients for many firms,” says Alberto Manzanares, Finance Partner at Clifford Chance in Madrid.

The pressures facing banks and law firms in Portugal are almost identical, but here a major additional issue has been the downgrade of Portugal’s own credit rating, says Luís Branco, Head of Banking and Finance at Morais Leitão Galvão Teles Soares da Silva & Associados (MLGTS) in Lisbon. “This has inevitably had a knock-on effect across the whole economy. The State no longer functions as the lender of last resort, so banks have had to look elsewhere to secure their own working capital, and heavily restrict lending.”

Interconnected

The two main strategic issues affecting Iberia's banking and finance sector are inter-connected: the changing regulatory arena and the corporate challenges facing institutions, say lawyers. "In Spain, the main issues affecting banks are real estate exposure, a stagnant domestic market, excess capacity and funding difficulties. However, not all banks are facing the same problems or to the same degree," notes Carlos de Cárdenas Smith, Partner at Uría Menéndez in Madrid.

The largest, most international banks, such as Santander, BBVA and CaixaBank (formerly la Caixa) remain relatively healthy thanks to their geographic spread. It is the domestic-focused Spanish cajas that face the most difficulties.

Lawyers point to the impact of ongoing challenges affecting banks, including compliance with increasing national and European stress tests. "Practically all of the Spanish banks underwent stress tests and, except for the savings banks bailed out by the FROB (Fund for Orderly Bank Restructuring), our banking system remains in good shape," says Israel Gómez-Caro, Partner, Banking & Finance Department at GOLD Abogados in Madrid.

In addition to European Banking Association (EBA) demands to raise core capital ratio levels to nine percent by June 2012, under rules introduced by the new Spanish Government, institutions must collectively also now make an additional €50bn in provision for real estate loan defaults (Royal Decree Law 2/2012).

"The most significant issue is clearly complying with the new capital requirements and the new rules governing the provisions that need to be made in respect of the banks' real estate portfolios," says Guillermo Yuste, Partner at Araoz & Rueda in Madrid. "The result may be further consolidation and further integration issue among institutions."

Even some of the new banks created from the merger of the cajas in an attempt to reinforce their collective balance sheets are finding themselves vulnerable. In March 2012, CaixaBank announced that it was to acquire Banca Cívica – formed by Cajasol, Caja Navarra, Caja Canarias and Caja de Burgos – which only last July undertook a €600m IPO to raise new capital ahead of a Bank of Spain deadline. Many are now watching what will happen with larger Bankia, a merger of seven cajas, led by Caja Madrid, which raised €3bn only days before Banca Cívica.

The regulatory spotlight was first on the cajas, to improve their corporate governance and enhance their ability to raise capital, explains Cárdenas Smith at Uría Menéndez. "In 2011, increasing the size and solvency of the savings banks became a priority to restore confidence in what was perceived as the weakest link in the Spanish financial system. Legislative changes have substantially increased capital requirements and encouraged weaker entities to merge with stronger ones or otherwise be taken over by the Spanish Government."

Uría Menéndez, Garrigues, Ramón y Cajal and Deloitte Abogados, among others, have featured prominently in many of the major caja mergers, facilitated through institutional protection schemes or support from the Government's €9bn Fund for the Orderly Restructuring of the Banking Sector (FROB), and fundraisings of the past two years – including the flotation of Bankia (which also saw Davis Polk & Wardwell and Linklaters act).

Further demands

The impact of higher capital requirements from national regulators, the EBA and Basel Committee (Basel III), combined with the European sovereign debt crisis have increased the pressure on banks across Europe. But the demands on Portugal's institutions go even further. Under the terms of the country's €78bn financial assistance package, they must achieve a core tier ratio of 10 percent by the end of the year.

"The regulatory interventions over recent months may be summed up as 'tightening' the requirements applicable to capitalisation, in addition to a few imminently symbolic measures aimed at strengthening confidence in the financial system," says Vítor Pereira das Neves, Partner at AAA Advogados in Lisbon.

The result, nonetheless, is that in order to comply with the rules, institutions have to look again at their cash levels, further restricting lending. Portugal's four largest banks have a combined €6.9bn capital short-fall, which needs to be addressed by June 30th.

"My profound belief is at this point and for the next two to three years there is no room for any flexibility in implementing the requirements of the new measures resulting from the EU, ECB and IMF's intervention in Portugal," says Nelson Raposo, Managing Partner of Lisbon-based Raposo Bernardo.

New regulatory pressures on Portuguese banks are therefore adding to liquidity concerns, but under the terms of its financial bailout, tier one capital ratios must be raised even further by December.

“The Portuguese National Bank had already demanded that domestic banks raise their capital ratios to nine percent by June this year, but under the terms of the Memorandum signed with the European Union, European Central Bank and International Monetary Fund, they must now raise their core capital ratios to 10 percent by December, explains Manuel Magalhães, Finance Partner with Sérvulo in Lisbon.

Banks are working hard on new financing structures, including debt for equity transactions and de-leveraging operations. “Institutions are trying to comply with the new capital ratio requirements but there is inevitably a price to pay by the economy at large through less lending as a whole,” says Maria João Ricou, co-Managing Partner at Cuatrecasas, Gonçalves Pereira in Lisbon.

As part of the financial bailout, €12bn has been set aside for the Portuguese Government to make cash injections through acquiring stakes in banks, but as yet, no such help has been sought. And despite the pressures, few lawyers predict any mergers between the major players.

“I am not sure we will see consolidation among Portugal’s major banks. It is encouraging from a regulatory point of view, and arguably should happen, but probably won’t,” says Pedro Cassianos, Head of Banking and Finance at Vieira de Almeida (VdA) in Lisbon.

Each bank must therefore find its own way of financing or refinancing itself, several say. “Some may go to the Government, while others will put further pressure on their existing shareholders. But this also presents opportunities for new shareholders, and many banks are placing a greater focus on attracting international investment, notably the Chinese, where price is less important than access to the market,” says Diogo Leónidas, Partner at Garrigues in Lisbon.

To date, the only bank sold has been Português de Negócios (BPN), which collapsed in 2009 over accounting irregularities and was nationalised by the Government. In late 2011, it was announced that a buyer had been found in the form of Angolan bank BIC, represented by PLMJ, with MLGTS acting for the Government having taken over the role from Cuatrecasas, say sources.

International concerns

Lawyers are also aware that despite the depth of the austerity measures being undertaken by the Spanish and Portuguese Governments, and the regulatory pressures now placed on banks, the flow of finance and liquidity is also dependent on matters beyond their control; notably, the perception of the strength and cohesion of the euro zone and the relative attraction of Spain and Portugal to new international investors.

"Further pressures on the euro or European countries' sovereign debt may lead to further downgrades of the ratings of Spanish banks, which may not only increase the cost of their debt but also even hinder in some cases their access to capital markets and to the interbank market," says Xavier Foz, Banking and Finance Partner at Roca Junyent.

The main issue in Portugal is not the need for more regulation, but instead a lack of liquidity and the increasing risk of default, which is having a devastating impact on leveraged economies like Portugal's, says Nuno Azevedo Neves, Partner at ABBC in Lisbon. "But unlike other countries, Portugal's issues do not result from the market players having gone wild in a liberal and deregulated environment, but instead from poor political decisions, a lack of control over public debt vis-à-vis the country's GDP, and the pressure created by the rating agencies and its impact on the capital and public debt markets."

The ongoing European sovereign debt crisis means that banks are increasingly unable to rely on central banks as a source of funds, leaving the European Central Bank (ECB) as effectively the lender of last resort for many in the market. The lack of liquidity at home has also meant that banks, and companies, are placing ever-greater emphasis on exploring new market opportunities, with the search notably focused on Latin America, the US and Africa.

"If you look at Spain from an outside perspective, there is a total lack of trust in the country, its systems and institutions," says Manzanares at Clifford Chance. "Now, almost any business that can is looking outside of the country for new sources of capital."

The rationale behind some of the largest public banking mergers of recent months in Spain has been not only to build a more balanced domestic operational base but also to build a sufficiently strong platform for international growth. A 2010 partial flotation of Santander Brasil raised $7bn (€5.4bn) – the largest IPO of that year in the world and indicative of the scale of commercial opportunities beyond Iberia.

"There were very important companies that were once Spanish but are now 'international'. They have had to adapt to the world as they find it as the 'made in Spain' label is no longer worth what it once was," says Iñigo Berrícano, Finance Partner at Linklaters in Madrid.

Alternative financing

Yet, while the banks wrestle with managing their own internal issues, the corporate financing continues. However, collateral loans based on shares or assets have suffered as their relative value has dropped, making both new finance and refinancing more difficult to obtain.

"Higher capital ratio requirements for banks, along with new demands to make provisions for real estate loan defaults, mean that many financial institutions are re-calculating the viability of entire loan portfolios," says Manuel Mingot, Finance Partner with Broseta in Madrid.

The increase on core capital requirements has had a dilutive effect on bank shares, competition among all financial entities for the capital, as well as a negative impact on banking lending, says Salvador Ruiz Bachs, a Finance Partner with Allen & Overy in Madrid.

"Only more solvent borrowers get financing or refinancing. Banks are exchanging those financial instruments issued by them which do not compute as core capital, such as preferred shares, by others. Derivatives is also a way to reduce capital requirements so we are seeing more and more of this type of complex structure," adds fellow Madrid Partner Ignacio Ruíz-Cámara.

Sofia Santos Machado, Partner with Abreu Advogados in Lisbon agrees: "In 2012, important rules will be implemented changing the way business is carried on, especially in the derivatives market. New rules on distribution of complex investment products will also involve an effort from the banks/investment firms' compliance department and front office.

But in order for companies to move forward, lawyers also report something of a back-to-basics approach being taken. "There is a focus once again on tangible assets and values, and trying to leverage the financial attraction of these as much as they can – companies are looking to established sources of capital and value and stretching them," says Pedro Cardigos, Principal of Cardigos in Lisbon.

Counsel have a role to play in being more imaginative in demonstrating their own expertise and the value they can bring to clients as they look for finance. But there are clear differences between the relative creditworthiness of businesses, say lawyers.

“Some companies, in particular medium and small companies, are struggling to finance their activity and to satisfy their needs, and this is where the real squeeze is. Larger listed companies have either reduced their levels of investment or are searching for opportunities and financing outside of Portugal, they have many more options open to them,” says João Caiado Guerreiro, Managing Partner of Caiado Guerreiro in Lisbon.

But the current reluctance of the banks to lend to even established clients may yet mean that their influence in the corporate finance arenas weaken, some suggest.

“I think we will see more players in the market able to offer liquidity, particularly hedge and private equity funds and there are now assets available at attractive prices. And while there may still be a difference between the valuations expected by buyers and sellers, this will reduce,” says Antonio Soares, Banking Partner at Linklaters in Lisbon.

The same belief also holds true in Spain. “There are new players and new money, and we are seeing instances of more structured credit and repackagings. But we are also seeing a move towards more club deals, indicating the need for banks to continue to make investments, and for the bridging of high yield bonds,” says Jose Christian Bertram, Finance Partner at Ashurst in Madrid.

Companies that operate within international groups are, in addition, looking to source finance from outside the country, and then lend on to their subsidiaries, while others are trying to monetise their most attractive assets, report lawyers.

“In respect of companies raising capital, refinancing or restructuring their existing debt piles, our experience confirms that mid-size Spanish companies are mainly using current financial debt, converting short-term debt to long-term debt and, at the request of their financial creditors, implementing plans for reducing costs. We have not seen capital-raising transactions but only debt-to-capital transactions – converting debt into equity,” says Francisco José Bauzá, Partner at Ramón y Cajal in Madrid.

Nonetheless, new methods are being used to secure financing, including forward-start loan facilities and, for the most credit worthy institutions, bond issuances.

"In a much tighter bank lending market, companies have to look to raise capital themselves most notably through the debt equity markets. Bond issuances have risen, with high yield and convertible issues, and those companies with the most consistent sources of revenues have the best success," says Rafael González-Gallarza, Finance Partner at Garrigues in Madrid.

The same is true in Portugal, where companies are now looking to revisit previously used financing vehicles. "We see companies that can, use their own funds to finance new operations, and those companies without funds are simply not doing new things. There is an upturn in interest in bond issuances and in Portugal we have seen the first issue of bonds to retail investors in over a decade, opening up entirely new financing routes, and we will see more of this," says Cassiano at VdA who advised on the issue, for EdP, alongside MLGTS, and has subsequently advised on a further €300m retail issue by Semapa acting alongside Linklaters.

Few lawyers in Portugal or Spain expect the equity capital markets to open up in the near future. The Madrid Stock Exchange may have seen the IPOs of Bankia and Banca Cívica last summer, but such a strategy looks unlikely to be repeated any time soon, they say.

Law firms

The lack of liquidity and finance available for transactions inevitably means law firm banking and finance practices are also feeling the impact of the downturn. With little acquisition finance or big-ticket capital markets work, the trend towards refinancing and restructuring is dominant but increasingly seen as commodity work and attracting ever-lower fees, report lawyers.

"As professionals, we need to adapt. We must demonstrate that we can come up with innovative solutions to clients' problems," says González-Gallarza at Garrigues. "We need to identify a series of objectives and guide clients to find formulas to achieve them. All problems have to have a solution. We just have to find the most satisfactory one for each business."

Part of this challenge is clearly finding a route for companies out of insolvency. In Spain, for example, there is no tradition of a secondary market for businesses in trouble. This is as a result largely of a lack of protections for new creditors, and even with changes to the insolvency laws, there still needs to be a shift in of mindset among financiers, say some.

"We have to find solutions that are sufficiently robust. We used to help our clients gain money, now we help them not to lose it; we're not plastic surgeons, we're saving business lives," says Javier López Antón, Finance Partner at DLA Piper.

Financial outlook

Looking ahead, and without significant new liquidity in the markets or major public projects initiatives, the finance trend remains with the need for lawyers to save increasing numbers of business lives.

"The credit that banks are offering to businesses is not sufficiently forthcoming and this means companies have to adapt their operations accordingly; many simply cannot get new capital to invest in new growth. There is a lack of trust among the lenders, which will likely be with us for another few years yet," says Carlos Rueda Gómez-Calcerrada, Finance Partner at Gómez-Acebo & Pombo in Madrid.

For many businesses, the perception is that if they can emerge from 2012 in no worse a position than how they entered it, then they will have done well. Markets may not be growing, but as competitors fall, their relative market share may do.

But the Spanish and Portuguese economies are also in survival mode, suggest lawyers. There is an ongoing deep reform of the labour markets, a dramatic reduction of public debt obligations, and a drive to attract new international investment.

"Survival is a valid goal but it is not a strategy. In Portugal, at least, we cannot make the same mistakes as we did in the good times and now expect to get away with it. But as a country and as an economy, we are now more focused on the future, and as lawyers, we are better prepared to face it," says Cardigos at Cardigos.

Lawyers do see financing work on the horizon, albeit different to that which many had been used to.

"We will see the banks recapitalising, but I don't see a major sell-off in terms of their capital shares, or the Portuguese Government taking majority stakes. The banks may have less influence going ahead, but they are clearly more focused on managing debt better," says Pedro Ferreira Malaquias, Head of Banking and Insurance at Uría Menéndez-Proença de Carvalho in Lisbon.

Banks now face the same types of issues as many of their clients, adds fellow Lisbon Finance Partner Carlos Costa Andrade. They have to be able to restructure and stick to their commitments – "The new standards of capital on bank adequacy by imposing the more stringent ratios will oblige various banks - after some having executed various LMEs and tried to dispose of some assets – to issue new capital and/or hybrid debt to be subscribed by the Portuguese state – particularly hybrid securities will constitute the preferred alternative to transform under-capitalised banks as it will not undertake a dilutive effect for bank's shareholders."

There will inevitably however be further casualties along the way, say some. The days of easy money have gone and businesses of all types have to learn the lessons of the past few years or they may fail. The corporate environment in Spain and Portugal has been revolutionised.

"I remain optimistic, but I also believe that it may take another generation to fully recover from the economic changes now being imposed on us," says Hugo Rosa Ferreira, who leads the banking and finance team at PLMJ in Lisbon. "I think that, during 2011, the banks began to look at fixing their internal issues, and this was to the detriment of their loan businesses. And yes, we've seen something of a purge. But I think 2012 will present the real clean up."

Four years on from the onset of the financial crisis and the Iberian financial sector already looks very different to that which anyone would have imagined; but more change is to come, predict lawyers. Yet the back-to-basics approach being adopted by institutions – in managing their own liquidity, their loan criteria and the lending focus on only the highest quality assets and companies – means that Spain and Portugal may yet emerge as more effective countries and with more efficient companies, say some.

In such a scenario, and with a smaller financial sector, competition for banking mandates among law firms will inevitably also become fiercer. "The banking and finance market is changing dramatically. The golden years of 2005-2007 will never return. It is impossible to conduct business as usual," says Manzanares at Clifford Chance.

The contraction of the sector has nonetheless already presented many firms with a welcome flow of transactional and regulatory work, and this may therefore continue as banks assess their life chances in the new regulatory environment. "We have had to wrestle with the complexity of transactions where, alongside their inherent problems, firms have also had to struggle with the substantially different regional legislations - and players – involved," says Israel Gómez-Caro, Partner at GOLD Abogados in Madrid.

But corporate life goes on and companies and lawyers will adapt. The most basic measure of success is survival of the fittest. New funds are interested in investing across Iberia, albeit when the price is right.

“We have to remain optimistic. I think we have endured the worst in terms of financial troubles but clearly we still have a long way to go,” concludes Cassianos at VdA.

Source: Iberian Lawyer