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The Spanish Experience

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1 Introduction: The Build-Up of Problematic Assets

The Spanish financial system has been completely restructured following the outbreak of the global financial crisis of 2007–2008. During the first phase, in 2008–2011, measures implemented by authorities were intended to address a liquidity crisis, for example, by introducing a public guarantee programme on debt issued by banks in the wholesale markets. It was not until 2012 that the real nature of the problem was identified: a highly indebted private sector and a significant amount of problematic assets, concentrated in certain portfolios (real estate) and entities (savings banks).

At end-2008, bank credit to the private sector amounted to 166% of GDP, way above the levels of the European Monetary Union (101% of

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GDP), only behind Ireland (178% of GDP) and Luxembourg (250% of GDP). Leverage was high in all sectors: in the corporate sector, outstanding credit was 87% of GDP (vs. 50% in the EMU), while credit to households was around 82% of GDP (vs. 51% in the EMU).

Behind these extremely high levels of indebtedness, there are both supply and demand factors. On the demand side, the entry of Spain in the European Monetary Union triggered a structural reduction of interest rates that led *real* interest rates (discounting for inflation) reaching negative territory. This is particularly important for a country where the vast majority of mortgages are on variable rates and linked to the Euribor. Therefore, clients had incentives to borrow money today and repay it in the future at a lower price. Besides, the Spanish economy grew at an average rate of 3.8% during the period 2000–2007 (compared to −0.4% in 2008–2015), with the implied high levels of consumption and investment requiring increased bank financing.

One particular feature of the Spanish demand for credit was its concentration in the real estate sector. In 2008, around 24% of total credit to the private sector had been given to construction and real estate firms, while 37% represented housing credit to households. The boom of the real estate sector was fuelled by several factors. These included, inter alia, the need to accommodate a growing population (with a significant inflow of immigrants) as well as a high number of foreign tourists and retirees, the important tax advantages offered for the purchase of primary residence and the benefits stemming from the transformation of rural soils into building land. Regarding the latter, regional politicians were in charge of giving building permits, and in some cases the financial institutions of the region facilitated loans for house purchases and reconstruction purposes (which constituted a significant part of their balance sheets).

From the supply side, one of the factors that contributed to the increase of private sector leverage was the high level of banking competition. After the regulation of savings banks, which allowed them to compete in all sectors and regions, competition increased further. Price wars were relatively frequent in a banking model whose growth was based on volumes, as outstanding credit increased in a sustained way at low prices.

In order to explain the high level of problematic assets that constituted a major burden for the banking system at the beginning of the crisis, two factors have to be taken into account: elevated leverage and a

high proportion of non-performing loans (NPLs). After the outbreak of the global financial crisis, the Spanish NPLs ratio increased considerably, reaching almost 13% by the end of 2013 from levels around 1% of GDP at the beginning of 2008.

It has to be stressed that the Spanish definition of default is stricter than in other EU countries, as all loans over 90 days past due are included in this category by the full amount of outstanding credit, and not just by the defaulted payments. Besides, assets can be considered defaulted due to "subjective" reasons, like knowing that the client has lost his job. On top of that, if a significant proportion of the exposure of a client is defaulted, then all his loans are considered defaulted. In the Spanish legal system, there is another category, called "substandard" loans, for those that have not fallen into default but are close to that, which is not included in the NPL rate. As a result of these criteria, Spanish banks experienced the smallest revisions in their NPLs figures compared to their EU peers in the Asset Quality Review that was part of European authorities' comprehensive assessment in 2014.

Across sectors, differences have been remarkable. Credit to construction and real estate firms reached a 37% NPL rate by end-2013, compared to just 12% for the rest of the Spanish corporate sector. Regarding households, the NPLs rate of housing loans reached a maximum of just 6%, while that of consumption loans recorded a rate of 12%. In particular, credit to construction and real estate firms accounted for 60% of all defaulted exposures by mid-2012, a figure that has been reduced to 39% nowadays (while the weight of this credit on outstanding stock is just 13%).

The evolution of the NPL rate has improved lately. NPLs started to fall in 2014 for the first time since 2006 (excluding the transfer of assets to the bad bank Sareb in 2012–2013), despite the concurrent reduction of the denominator. The economic recovery and the active management of non-performing loans are supporting this trend.

In conclusion, Spain experienced an asset boom concentrated in the real estate sector, where several factors contributed to increased private sector leverage and a high NPL rate. By the end of 2008, Spanish banks had around €63 billion of NPLs (a 3.4% rate). This increased sharply in the following years, reaching €197 billion on 14 January (a rate of 13.5%). Of the total NPLs in December 2008, 44% were concentrated in real estate and construction firms, but this proportion increased to 60% in 2012 (Fig. 4.1).

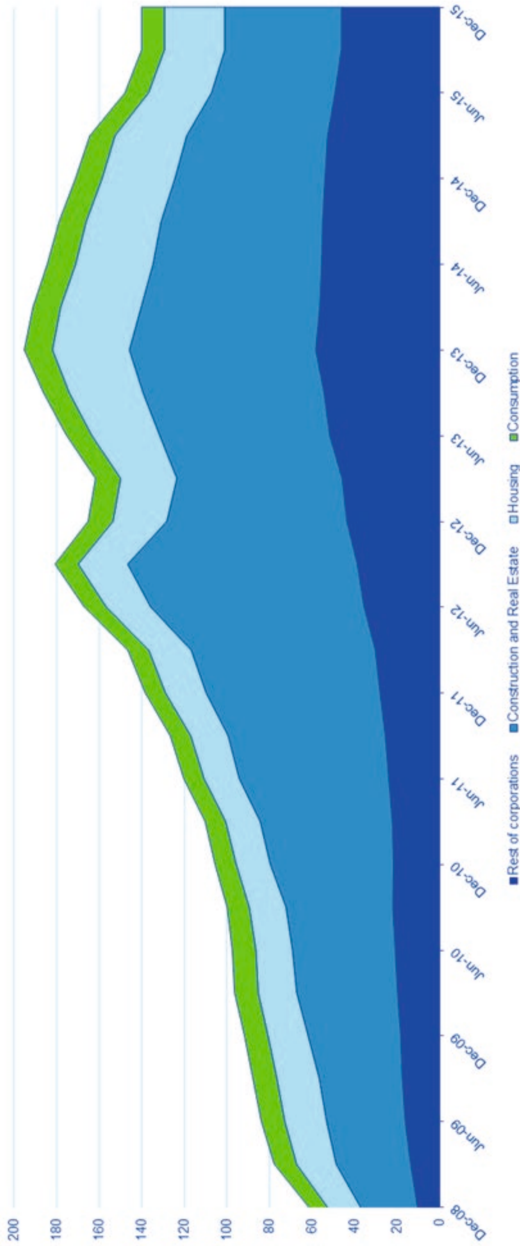

Fig. 4.1 Non-performing loans stock (€ billion). *Source*: BBVA research based on Bank of Spain

2 Strategy to Deal with Debt Insolvency and NPLs

2.1 Restructured/Refinanced Loans and Foreclosed Assets

Since the beginning of the crisis, Spanish financial institutions were very active in the refinancing and restructuring of problematic exposures in order to find a solution for highly indebted borrowers, arrest the rising trend in the NPL ratio and ensure some potential income from those loans and delay foreclosure (in the case of collateralized loans). The difference between refinancing and restructuring is that, under Spain's loan classification rules, a restructuring implies a situation of financial difficulty of the debtor, a case which is not applicable to refinancing. Related schemes offered to debtors include, inter alia, a moratorium on payments, a reduced interest rate or a cancellation of pending amounts.

To ensure consistent classification of forborne loans (refinanced or restructured) across institutions, the Bank of Spain issued the Circular 6/2012 (which came into force in September 2012) and a letter on 1 May 2013, to further clarify the criteria for determining whether refinanced loans should be classified as performing, substandard or non-performing. The importance of this regulation is that performing loans require no specific provisions. However, banks are required to maintain generic provisions equal to 30% of their loans to real estate developers (due to two Royal Decree-Laws from 2012), in addition to a limited amount of generic provisions under Spain's dynamic provisioning framework.

As part of the financial sector reform agreement of 2012 (the Memorandum of Understanding), Spanish entities started the publication of detailed data on refinanced loans. The IMF described this as "a level of transparency on this issue that is higher than almost anywhere else in Europe".

At the beginning of 2013, the amount of forborne exposures was around €183 billion, equivalent to 12% of total credit. What changed after the Bank of Spain letter of May 2013 was the split of this portfolio by credit risk category, but not the total amount. As of September 2013, the

respective amount was still €181 billion or 13% of total credit, but forborne loans classified as normal had gone down from 40% to 27%, substandard loans increased modestly from 20% to 23% and NPLs went up from 39% to 51%.

Similarly to the stock of NPLs, refinanced or restructured credit to the domestic private sector has also been on a declining trend since early 2014. By mid-2015, resident private sector refinanced exposures have fallen by 4.5%, reaching €163.8 billion or 13% of total credit (slightly down from 14.2% a year earlier), a proportion still highly influenced by forborne exposures to real estate development and construction companies (with almost a 30% forborne rate). Just 15% of credit to other firms has been forborne, while the proportion of mortgages forborne is around 7% and the rest of households' credit has a 20% forbearance ratio.

Regarding credit risk categories, substandard loans whose payments are attended become normal over time. The performing category has increased to 33% of total refinanced loans, the substandard one has fallen to 18% of the total, while the non-performing one remains broadly constant at 49%.

In summary, Spanish financial institutions have been very active regarding the forbearance of their loans, and the proportion of refinanced or restructured loans decreases gradually since 2013 (from €180 billion to around €160 billion nowadays). Of those loans, the more significant portfolio is that of construction and real estate firms (32% of forborne exposures and almost 30% of credit to the sector) and loans are gradually progressing towards performing from the substandard exposures.

In the case of foreclosed assets, even after the transfer of part of them to the bad bank (see next section for further details), these exposures amounted to €81 billion as of June 2015, having fallen by a modest 0.9% in the previous year. The decreasing pattern is accelerating, as during the last six months these assets have been reduced by 2%. Repossessed assets have not fallen at a more significant rate as new assets are coming from court proceedings that started 2–3 years ago, so the inflow will continue in the near future.

By type of asset, around 35% of the total is land and the 25% is completed buildings. These two portfolios are gradually losing importance. However, other types of assets are gaining weight: assets from house

purchases (22% of the total, 0.5% higher than a year earlier) and buildings under construction (7% of the total, with a 1.6% y-o-y growth rate). The foreclosure of assets from house purchases by individuals has damaged the reputation of financial institutions during the crisis, although most of these cases were the result of voluntary foreclosure agreements. In Spain, a typical judicial foreclosure lasts for 2–3 years, although several regulatory initiatives were taken to accelerate the process.

2.2 Sales of NPLs/Problematic Assets

Another alternative to deal with debt overhang and to reduce the level of problematic assets in banks' balance sheets is the sale of loan portfolios or real estate assets. According to several consultancy firms (KPMG, EY and Deloitte[1]), Spain is one of the most active markets in Europe (behind UK and Ireland) for loan sale activity with around €20 billion in closed transactions in 2014. In 2015, the volume of transactions was lower, totalling around €14 billion according to KPMG. The fact that Spain is a buoyant market is not surprising given that banks have been active in cleaning their balance sheets, while continuing with their deleveraging process. The most active sellers are major banks (that could not transfer assets to Sareb) and the asset management company Sareb, although the contribution of the latter is less significant than in prior years.

In 2015, there was an increase in the sale of real estate-backed portfolios, particularly in the residential mortgage and commercial real estate sectors, which together accounted for approximately 65% of the total market by volume. Many of the largest portfolios that successfully closed were residential mortgage portfolios, which made up approximately 21% of the portfolios transacted by number and 43% by face value. Nevertheless, in 2015 there was an increase in the number of portfolios where sales were delayed or withdrawn from the market due to high bid-ask spreads. However, given the gradual improvement in the macroeconomic environment and the increase in real estate prices, it is likely that investors will remain interested in purchasing loan portfolios and real estate assets in the Spanish market. According to KPMG, there has recently been a narrowing of the bid-ask spread, notably for real estate-backed loans.

Up to date, the largest transactions materialized in 2014 with deal values of €6.4 billion (Project Hércules) and €4.5 billion (Project Octopus). The former was done by Catalunya Banc (at the time controlled by FROB) just prior to its privatization and involved the sale of a portfolio of loans and real estate assets to Blackstone in July 2014. The latter was performed by Eurohypo (Commerzbank), which sold real estate assets and loans to Lone Star and JPMorgan in June 2014. In mid-2015, Bankia put for sale a portfolio of €4.8 billion (Big Bang Project) but the transaction was postponed for 2016. Overall, these were rather extraordinary transactions as usual deal sizes are lower than €1 billion. Despite the past clean-up of banks' balance sheets, the level of NPLs and real estate assets remains elevated and therefore it is likely that loan portfolio sales will remain buoyant in the coming years.

2.3 Asset Management Companies: Sareb

The Memorandum of Understanding (MoU) signed in July 2012 envisaged the creation of a Management Company for Assets Arising from the Banking Sector Reorganisation (Sareb, in Spanish). Banks that were in financial difficulty had to transfer their real estate assets to Sareb in order to mitigate the associated risks via an orderly divestment of those distressed assets.

Sareb is a private company (55% of its equity is owned by private institutions) and thus it does not have to consolidate in the public accounts. The remaining 45% of equity is owned by the Fund for Orderly Bank Restructuring (FROB), the public entity created to manage the restructuring process. Sareb private shareholders include 14 national banks, 2 foreign banks, a utility company and 10 insurance companies. Its capital represents 8% of its assets, and is composed of 25% equity and 75% subordinated debt.

Sareb received assets worth €50.8 billion, of which 80% loans and 20% property. There were two transfers: one in December 2012 by the four nationalized banks (Bankia, Catalunya Banc, Banco de Valencia and NCG-Banco Gallego) worth €36.6 billion and another one in February 2013 by the other four banks that received State capital injection (Liberbank,

BMN, Caja3 and Banco CEISS) worth €14.1 billion. Assets eligible for transfer included: foreclosed real estate assets (> €100,000 in value), loans to real estate businesses (> €250,000) as well as other impaired assets.

According to Sareb's business plan, the entity has up to 15 years to sell these assets to both retail investors (mainly via the branches of the contributing banks) and institutional investors. A positive aspect of the transfer scheme was the low value of the transfer price, which infringed losses on transferring entities but improved Sareb's prospects and the probability of finding investors and buyers: the original haircut was 63% for foreclosed assets and 45.6% for loans. These low prices allowed the company to announce high expected profitability (ROE of 14–15%).

During its three years in operation, Sareb reduced its overall portfolio by approximately 15% (implying that, at the current pace, it would need 20 years to dispose all of its assets). Furthermore, it has generated total revenue of €12.1 billion and has repaid €7.3 billion of the issued debt (€2.1 billion in 2015).

The new assets valuation accounting standards approved by the Bank of Spain in October 2015 triggered a re-valuation of all acquired assets that revealed capital losses of €3.0 billion. Once provisions were discounted, €2.0 billion had to be written down so a conversion of €2.2 billion of subordinated debt into equity had to be approved. After retroactively applying the provisions, the company ended 2015 with gross losses of €472.3 million, 53% less than in 2014. Therefore, the target of reaching a 14% ROE remains a distant prospect.

It is important to emphasize that this scheme focused on the most damaged entities and portfolios (i.e., in the real estate sector). That means that transfer prices were pretty low and transfers were concentrated in time, without an overly severe impact on public finances. Yet, as already explained, the profitability target seems hard to reach. Furthermore, Sareb has been criticized by its long answer times to buying offers. In retrospect, it appears that a bad bank should have been created in the initial stages of the crisis. In any case, it is a long-term project that helped to regain market confidence on the prospects of the Spanish banking system post restructuring. This experience reinforces the importance of facing the banking problems as soon as possible and in the most comprehensive way, absorbing all the losses in an initial phase so as for them not

to continue growing. Partial solutions may end up being more costly and market confidence may be more difficult to regain.

2.4 Code of Good Practice

A significant part of Spanish households have faced severe economic difficulties during the global financial crisis. Similarly to other recessions, evictions and inequalities have intensified. One of the measures implemented in 2012 by the Spanish government is the Code of Good Practice for mortgage debtors. At present, 95 Spanish financial institutions (the majority of them) have voluntarily joined the initiative.

The Code only applies to mortgages granted to acquire a primary residence and contains three stages:

1. A viable mortgage restructuring plan, with an outstanding five-year period of grace, lower interest rates—paying EURIBOR + 0.25%—elimination of minimum instalment clauses if appropriate, and extension of the repayment period for up to 40 years since the signing of the contract;
2. A voluntary write-off of outstanding debts by the financial entity can be solicited by the debtor if viability—or a mortgage payment below 50% of the monthly household income—is not reached. Nevertheless, in practice this option is rarely used; and
3. If the above schemes do not apply, the debtor can ask for the surrender of the residential property in lieu of payment within 12 months after having requested the restructuring plan. The financial institution must accept it compulsorily and the mortgage must be extinguished. Optionally, the debtor can remain as a tenant with favourable rental terms for two years.

At present, the Code can be applied to debtors (or their guarantors if it is the case) whose annual family income is lower than €22,365.42, and are included in one of the following two categories: (i) debtors whose family suffered a severe worsening of its financial situation in the previous four years and (ii) those considered to be in vulnerable circumstances.

The latter class comprises large families, single-parent families with two dependent children, households with a disabled member and debtors over 60 years old. According to BBVA Research calculations based on the 2011 Survey of Households finances, around 975,000 Spanish households fulfil the aforementioned requirements.

Moreover, the Code is only applicable to mortgages granted to houses with a maximum purchase price which is 20% above the index reported by the Spanish Ministry of Public Works and Transport. That is up to a ceiling of €300,000 (€250,000 for the surrender of the property in lieu of payment). In case of write-offs and lieu of payment, more restrictive conditions must be fulfilled. For instance, households must not own other assets with which to cancel the debt.

Until the end of 2015, more than 60,000 applications have been submitted, of which only 25% were up to date with mortgage payments. About 30,000 proceedings have already been authorized, resulting in a viable restructuring plan in the majority of cases (≈80% of the approved cases) versus other options such as the lieu of payment (≈20%). These constitute a very limited proportion of outstanding mortgages. Although there are no official statistics on the number of existing mortgages, only in February 2016, 24,887 new housing mortgages were granted. Dividing the outstanding stock of housing credit in Spain (€560 billion) by the average amount of new mortgages granted in February 2016 (€108,466) yields an estimated number of 5 million outstanding mortgages in Spain. The authorized proceedings of the Code of Good Practice represent just 0.6% of the above figure. The requirements that have to be fulfilled to apply to the Code are so strict that debtors tend to negotiate directly with the bank. In fact, the proportion of outstanding forborne mortgages is around 7%.

2.5 Personal and Corporate Insolvency Law

Well-designed insolvency frameworks are key to promote efficient debt restructuring and deleveraging, both by providing out-of-court mechanisms in which debtors and creditors mutually benefit (internalizing externalities such as the costs of foreclosure and insolvency procedures)

and by providing efficient last-resort solutions (fresh start or discharge). As already explained, facilitating private sector debt restructuring has been very important for Spain given (i) the high levels of indebtedness when compared with the European average and (ii) the fragile situation particularly of the corporate real estate sector, with high levels of non-performing loans.

Personal Insolvency Law

Overview of law prior to weform

In 2015, the Spanish government passed legislative changes to the legal regulation of personal insolvency. Prior to the introduction of the Royal Decree-Law 1/2015 of 27 February 2015, the general rule laid down that individuals in debt were liable for their entire assets and earnings, both present and future (unlimited liability principle), which impeded Spanish obligors—both consumers and entrepreneurs—to invoke a second chance. After bankruptcy, the debtor remained liable for debts which had not been satisfied in the procedure and therefore the use of personal insolvency procedures was very limited. There were four exceptions to this general rule:

1. In the case of mortgage foreclosures of first residence, certain protection was offered to debtor's income after five or ten years of the foreclosure date. The debtor would see a full discharge of its debt if after five years (ten years) it had paid 65% (80%) of its outstanding debt at the time of foreclosure. This exception was implemented in 2013 but still seemed quite demanding for debtors.
2. The possibility of being fully discharged of debts (excluding those owed to the fiscal authority and the social security system) after the liquidation of all of the debtor's assets, provided that: (i) all credits against the estate and privileged creditors had been paid in full and (ii) at least 25% of ordinary claims had been paid. For very indebted borrowers, these conditions would still be very difficult to achieve.
3. Limitations on protected income/assets (ingresos y bienes inembargables) such as furniture and house utensils, clothing, books and tools necessary to the profession, sacred goods as well as amounts explicitly

declared by law, such as non-seizable and wages, salaries or pensions up to the amount of the minimum wage.

4. Within the Code of Good Practices, which applies to debtors close to social exclusion, a moratorium was introduced for foreclosures and in the case of datio in solutum (transfer in lieu of payment) the debtor could stay in the house paying rent for a period of two years, without being discharged from his unpaid debt.

Given the very exceptional cases in which debtors could get full discharge of their debts, it was not surprising that the number of personal bankruptcies has been very limited in Spain (around 1000 per year) which compares with more than 100,000 in Germany or England and more than 200,000 in France.

In this context, international organizations such as the IMF and the European Commission advised the Spanish authorities to reform the personal insolvency framework with a view to make it more debtor-friendly and allow for the possibility of a fresh start. Initially, there had been concerns that such reform might undermine the strong payment culture that existed in Spain, particularly considering the high ratio of non-performing loans and its impact on the cost of credit. On the other hand, it was understood that allowing a fresh start to indebted (yet viable) borrowers could increase entrepreneurship, allow a gradual reduction of the non-official economy and contribute to a mitigation of unforeseen shocks affecting families' income such as unemployment, diseases and death.

Reform of the Personal Insolvency Law—main changes

The changes introduced by the Spanish government intended to facilitate families' deleverage, improve resource allocation and boost entrepreneurial activity, while making the legal framework more akin to that of other European countries. The introduction of Royal Decree-Law 1/2015, of 27 February 2015 established a second chance mechanism in bankruptcy procedure for individuals; widened the scope defining the collective that was protected under the Code of Good Practice, and extended the moratorium on evictions, which was due to expire in May 2015, for a further two years until 2017. Later in July, Law 25/2015, of 28 July 2015 made some changes to the Royal Decree-Law (RDL).

As regards the second chance mechanism, a framework has been developed for personal bankruptcy, modelled on the experience in other EU countries (it was essentially an adaptation of the German and Italian regulations). Specifically, the system of personal bankruptcy proceedings developed in the law comprises two phases.

The first is an extra-judicial payments settlement, and applies when obligors try to reach a settlement with their creditors before the case is brought to Court. The concept of the extra-judicial payment settlement had earlier been brought in under Law 14/2013, of 27 September 2013, but this had solely been reserved for entrepreneurs and self-employed workers. The most notable changes introduced were the following:

1. Broader and more flexible extra-judicial payment settlements, which can affect debtors ranging from those in business, the self-employed and the non-business-owning individuals. The legal effects of such a settlement can extend to dissenting creditors (i.e., those who are not in agreement with the majority, whenever pre-defined majorities are satisfied).
2. Enhancement of the legal concept of the mediator, who is to be appointed by a Notary or Registrar. For non-business-owning individuals the mediator can be a Notary, while for legal entities this can be the Official Chamber of Commerce.
3. The establishment of simplified procedural rules for individuals (shorter time frames for appointing persons, creditors' meetings and rulings—if there is no settlement within two months, bankruptcy proceedings must be instigated within ten days) and a substantial lowering of notarial and registry fees.
4. The time during which an extra-judicial settlement cannot be requested in the future is extended from three to five years.

The second phase, which involves the actual bankruptcy proceedings, makes it possible to reach a situation of full debt discharge if two conditions are satisfied: (i) the obligor acts in good faith and (ii) his assets have previously been liquidated. Specifically, a new system of discharge from debts is provided for (provisional for a five-year period), which applies

after the conclusion of bankruptcy proceedings and is subject to the following conditions:

1. Submitting and committing to a payment plan for non-exempt debt for privileged creditors (i.e., debts to the public sector, wages or court costs), which the judge shall approve and may amend if he deems appropriate.
2. Not having benefited from a debt relief in the previous ten years.
3. Not having turned down a suitable job offer in the previous four years (prior to the declaration of provisional exoneration and only enters into effect one after the law is approved) accepting that the exoneration of the debt be available for inspection in the Public Bankruptcy Records for a period of five years.

Assessment of current framework

The introduction of a personal insolvency framework was a very positive move, in particular extending the extra-judicial payment settlement to individuals and giving a second chance to those over-indebted who have acted in good faith. Suitable regulation should encourage entrepreneurial initiative, soften the negative impact of a fall in income for ordinary individuals and facilitate private sector deleveraging.

Further improvements could be the introduction of a screening filter by income or wealth level (only the €5 million threshold in liabilities applies for access to individual bankruptcy proceedings, which already existed), to weed out opportunistic behaviour patterns or bad faith acts.

In our view, it would be preferable to include public creditors in the restructuring process and making at least those public claims considered ordinary (i.e., 50 % of tax and social security claims) subject to discharge after liquidation. This would likely increase the effectiveness of the system and avoid creating incentives for debtors to strategically prioritize payments to public creditors at the expense of private ones, with a negative effect on the payment culture.

It would also be desirable to include mechanisms to discourage the informal economy. If the payment plan is dependent on a percentage of the debtor's income (and not a lump sum), it encourages people to work unofficially to minimize their payments.

Although straightforward cases involving individuals will go through Civil Courts of First Instance, and those of corporates will be left to Commercial Courts, it would be important to set aside funds in case the number of bankruptcy proceedings rises. Setting up a mechanism to monitor and evaluate second chance legislation would be advisable to correct inefficiencies and make further improvements.

The number of bankruptcy proceedings has not increased (in fact the number was slightly lower in the second half of 2015) although it might be too early to assess this legislation's effectiveness. The number of personal insolvency procedures in 2015 was negligible: 594 individuals without business activity and 175 with it.

Corporate Insolvency

The Spanish insolvency framework is primarily regulated by the Law 22/2003, of 9 July 2003, of Insolvency (Ley Concursal). There are two kinds of insolvency proceedings depending on its initiative. First, the voluntary insolvency proceeding, which is requested by the debtor when it is (or foresees it will be) unable to meet its debt payments as they fall due. And, the necessary one, applied by one creditor, as long as certain requirements are fulfilled. Prior to the reforms introduced in 2013, 2014 and 2015, the framework comprised the following phases:

1. *Pre-insolvency* (Pre-concurso), in which a debtor seeks protection for a maximum period of three months while negotiating a refinancing agreement. During this period, it is protected from compulsory bankruptcy demands.
2. *Common phase*, in which the debtor files a request for bankruptcy and the Court appoints an insolvency manager.
3. *Creditor's agreement plan*, which must include a detailed payment plan, haircuts and stays, asset sales and a viability plan.
4. *Liquidation*, which can start automatically if no agreement is reached or if the debtor files for liquidation or the insolvency manager deems so appropriate.

One of the most important objectives of the recent Corporate Insolvency Reform was to avoid firms' liquidation. In fact, in Spain around 90% of the companies which file for insolvency proceedings end up in liquidation. Therefore it was important to amplify the range of mechanisms available for debtors and creditors before reaching the point of non-viability and consequently the first efforts in the legislative reforms focused on pre-insolvency and out-of-court procedures.

In 2013 and 2014, the government introduced changes with the goal of driving solutions that would help companies avoid formal insolvency proceedings and have well-functioning out-of-court debt restructurings or refinancing with less court involvement. In a second phase, the focus extended to in-court procedures to address inefficiencies in the whole process and to facilitate the sale of assets or viable portions of the business of companies under bankruptcy proceedings.

One of the instruments of these amendments was Law 14/2013, of 27 September 2013. It introduced a special bankruptcy regime for self-employed individuals and entrepreneurs and contemplated the possibility of a full debt discharge, although excluding privileged creditors. It created an out-of-court restructuring procedure to reach an agreement on a new payment schedule facilitated by a professional mediator. The debtor could continue developing its normal activity during the process and enforcement actions conducted by creditors were suspended for a period of up to three months. The payment plan, which cannot include privileged creditors (secured and public ones), must be approved by creditors representing at least 60% of all liabilities. Any haircuts in the plan cannot exceed 25% and there is the option of a full debt discharge if (i) all claims against the estate (*créditos contra la masa*) and all privileged claims are fully paid and (ii) 25% of all ordinary claims are paid.

A second key instrument was Royal Decree-Law 4/2014, of 7 March 2014, then passed as Law 17/2014, of 30 September 2014, *which included urgent measures on corporate debt refinancing and restructuring*. This legislation modified the regime governing refinancing agreements with the ultimate aim of avoiding insolvency proceedings. The changes were in line with the requests made by the Troika and the banking sector, which demanded a more flexible approach to unlock negotiation processes. Briefly, the new legislation:

1. simplified the procedures eliminating formalities that made refinancing agreements costlier;
2. allowed companies to reach pre-insolvency agreements with only one or more creditors without the consent of the rest as long as the financial position of the debtor was not weakened;
3. strengthened collective refinancing agreements against avoidance actions. The Spanish Scheme of Arrangement for financial claims ("Homologación judicial de créditos") is the figure by which the competent Court can extend certain effects of a refinancing agreement to those financial creditors that have not joined the proposition or have been against it, as long as there is approval from a minimum 51% of the financial liabilities considered;
4. broadened the range of commitments (haircuts, conversion of debt into equity, among others) that may be laid down in refinancing agreements and their effects may extend to dissident creditors. Cram-down terms for secured and unsecured creditors differ depending on the majorities required to validate the refinancing agreement (for which the level of required majorities was reduced). There are two regimes: 1) a majority of at least 60% of financial claims allows deferrals up to five years and/or debt-for-equity swaps within the same period and 2) a majority of at least 75% which enables write-offs, deferrals between five and ten years and/or debt-for-equity swaps within the same period. In case of secured creditors, the Spanish Scheme of Arrangement for financial claims effects applies when a 65% or 80% majority is reached for the cases 1) and 2) above mentioned;
5. established preferential treatment for fresh money and non-subordination of loans extended by financial creditors who become shareholders. This is a very important measure because very frequently to restructure a company, it is necessary to inject fresh money and there was a clear disincentive for creditors to do so if they had not a preferential treatment if, ultimately, the restructuring plan failed. The same applied to the subordination of creditors who had just become shareholders because of the restructuring process;
6. changed the public tender offers regime, relaxed provisions for the viable part of the debt and introduced tax incentives in the case of debt

write-offs/stays and in debt-to-equity swaps, as well as in public deeds documentation;

With this reform, creditors had more incentives to find solutions (or at least were not precluded from reaching them) in case of debtors with a very weak credit profile and to negotiate and make viable restructurings. After these changes, it was easier to eliminate debt overhang in viable companies and to provide funding to viable business plans.

Finally, the Royal Decree-Law 11/2014, of 5 September 2014, and Law 9/2015, of 25 May 2015 culminated the reform in the Corporate Insolvency framework. Some of the reforms included for out-of-court procedures in 2014, like the possibility of cramming down dissented creditors, were extended to the in-court phase.

Changes affected, among others, the classification of claims in three groups (secured, ordinary and subordinated), the terms of Creditors Agreements, the majorities needed for approval and the transfer of production units in an insolvency proceeding. More specifically, there are different regimes depending on the majorities achieved by the Creditors Agreement: 1) a majority of at least 50% of the ordinary claims enables write-offs until 50% of the liability amount, deferrals up to five years and/or debt-for-equity swaps within the same period and 2) a majority of at least 65% of the ordinary claims allows write-offs above 50%, deferrals between five and ten years and/or debt-for-equity swaps within the same period.

The Creditors' Agreement approval implies the automatic extension of the effects to those subordinated creditors and the ordinary ones that have shown their disagreement. Effects apply to secured claims if certain majorities are reached: a 60% and a 75%, respectively, for the first and second group previously shown. If majorities are not obtained, the Creditors' Agreement is rejected and liquidation is initiated. Additionally, some creditors that had acquired their claims after the start of the insolvency procedure were given voting rights and the majorities to vote for capital increases were also changed.

Although it is too early to make a thorough assessment of the Reforms, different objectives have been achieved. First, there has been an improve-

ment in pre-insolvency restructuring mechanisms that could explain the decline in in-court proceedings in 2014 and 2015 (−28% and −26%, respectively). And second, and probably more important, the pick-up in sales of operating business units of firms under insolvency proceedings to industrial investors and foreign private equity firms. In addition, several companies have successfully refinanced their debts.

3 Conclusion: Assessment and Lessons Learned

The Spanish experience can constitute a good example of a complete restructuring of a financial system comprising both private and public initiatives to deal with a significant private sector insolvency problem.

1. Spain experienced an asset boom concentrated in the real estate sector, where several factors pushed towards a high leverage of the private sector and a high NPL rate. Problems were concentrated in real estate credit and construction firms, with around 60% of NPLs in 2012.
2. Since the start of the crisis, banks were very active in managing problematic exposures. The proportion of refinanced or restructured loans is around 13% of the total and is gradually decreasing.
3. The sale of NPLs or problematic assets is another way to facilitate deleveraging. Spain is one of the most active markets in Europe.
4. Public initiatives, such as the creation of the bad bank Sareb, were successful. The scheme focused on the weakest entities and portfolios (the real estate), it did not entail a severe impact on public finances, transfer prices were relatively low (as it is important to be as close as possible to market prices) and transfers were concentrated in time. This experience reinforces the importance of facing the banking problems as soon as possible and in the most comprehensive way.
5. Another public initiative that was not so successful was the Code of Good Practice for housing debtors. The idea is to offer special financial conditions to distressed households, but prerequisites are so strict that the number of accepted applications has been very low.

6. Regulation on insolvency procedures was also addressed. The personal insolvency framework was adapted to make it more debtor-friendly and include the possibility of a fresh start. However, it is still too early to assess the consequences of this reform. In the case of corporate insolvency, the law was adapted to facilitate the process and to lower the proportion of cases that ended up in liquidation. This reform can be considered effective as (1) the improvement in pre-insolvency restructuring mechanisms resulted in a decline in in-court proceedings and (2) the pick-up in sales of operating business units of firms under insolvency proceedings could be signalling a lower proportion of liquidations.
7. The Spanish case can be considered a success. However, there are still pending issues (such as reducing the time needed for foreclosure) and it is too soon to analyse the full effects of some of the amendments.
8. In summary, the Spanish experience reveals that it is of utmost importance to acknowledge the asset quality problems and to understand their origin in an initial phase of the process. Both private and public initiatives should be coordinated and ambitious, such as to face the problems in a comprehensive way.

Note

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