# Implementing the MoU for Spanish banks: Setting up explicit resolution mechanisms

**Santiago Carbó[1] and Francisco Rodríguez[2]**

**As in past historical international experiences of banking crises, Spain is currently undergoing a transition period from implicit resolution mechanisms –including regulatory forbearance and restructuring- to more explicit resolution actions –including early intervention tools, burden sharing regimes and deep recapitalization schemes. The catalyst for such a transition has been the acceptance of EU financial assitance which incorporates a number of conditions included in the Memorandum of Understanding (MoU). The set of new resolution tools being implemented seems sound and significant, however the implementation of these tools will be as important as the tools themselves.**

*The approval of the Royal Decree-Law 24/2012 on "a new framework for the restructuring and resolution of financial institutions" represents a milestone in the resolution of the banking crisis in Spain. The new decree incorporates some of the conditions imposed by the MoU in a timely manner. In particular, it pays special attention to early resolution mechanisms by providing the Bank of Spain and the Fund for Orderly Restructuring of Banks (FROB) with expanded prompt-corrective action powers that even include the resolution of banks through different mechanisms. The decree also incorporates some burden sharing principles with which troubled banks will have to comply before getting any public aid. These burden-sharing exercises may potentially result in significant losses for bondholders of these banks, although the magnitude of these losses will depend on implementation. This is also the case of the Asset Management Company (AMC) that pools together some of the impaired assets of those banks. Some of the relevant features such as the transfer prices or the structure of the AMC itself, are still to be determined.*

## From regulatory forbearance to explicit resolution: The Spanish case

The banking crises that have taken place during the last fifty years have provided very useful lessons on the effectiveness of different resolution mechanisms. Although the circumstances that may condition the implementation and effects of a variety of policy actions may vary across countries and over time depending on a number of political, economic and sociological factors, there are some common lessons and grounds. Many of the most important banking crisis and, in particular,

[1] Bangor Business School and Funcas.

[2] University of Granada and Funcas.

the so-called big five –including Spain in the 1970s, Sweden, Finland and Norway in the 1980s and Japan during the 1980s and 1990s– have shared some similar causes although they were addressed through different policies. In these crises, for example, there was always some initial common (and limited) response in the form of regulatory forbearance, which somehow permits banks to avoid the costs of regulatory compliance. For example, some bank solvency regulations are subject to modifications at the beginning of the banking crises, creating transitory regimes that seek to allow banks to recapitalize themselves or follow some restructuring paths (including mergers and acquisitions) without imposing costs on taxpayers. Regulatory forbearance is then considered a pseudo-resolution mechanism which is based on the beliefs that economic contractions and price adjustments in real estate markets will not be long lasting.

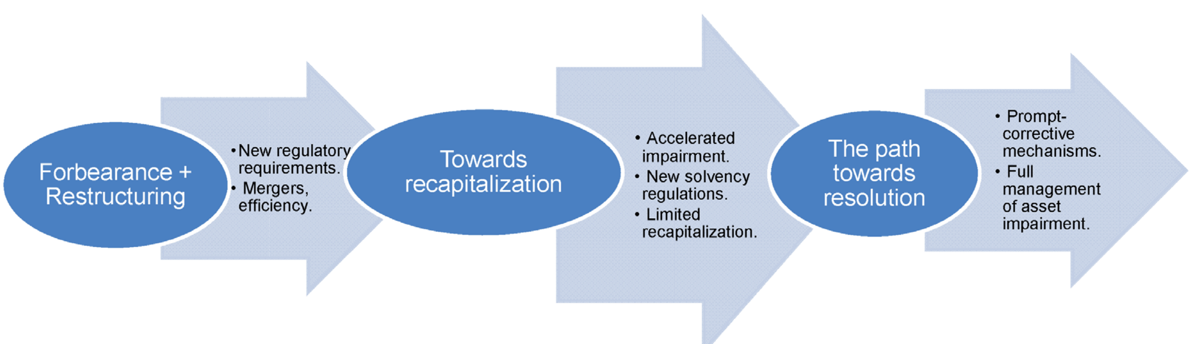
From a historical standpoint, when a banking crisis lasts longer than initially expected and regulatory forbearance proves to be an inefficient strategy, other explicit actions are needed to avoid dramatic events such as bank runs, suspension of convertibility and fire-sale losses that result from asset liquidation.

*When a banking crisis lats longer than expected and regulatory forbearance proves to be an inefficient strategy, other explicit actions are needed to avoid dramatic issues.*

The current banking crisis in Spain has not been an exception. Four banking sector-specific reforms have been approved since 2009 but these reforms (and, in particular, their execution) have put emphasis on restructuring measures seeking to improve efficiency and to foster private solutions within the banking sector, mainly through mergers. These reforms have proven to fall short in their objectives. The situation of the banking sector, and the financing conditions of the private sector have only worsened in the last few years (Exhibit 2). The latest data available -as of July 2012- show that lending to households and firms was falling at an annual rate of 3.4% and 3.5%, respectively. At the same time, the ratio of non-

Exhibit 1

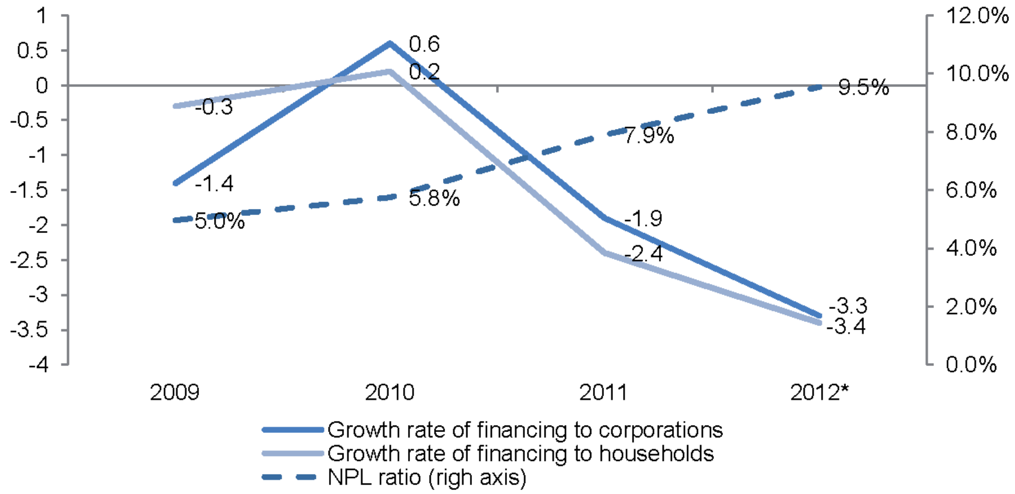
**The path from regulatory forbearance to explicit resolution**




*Source: Own elaboration.*

Exhibit 2

**Lending to the private sector in Spain: Annual growth rates and non-performing loans (NPL) ratio**




**July 2012 for financing data and June 2012 for NPL data.*
*Source: Bank of Spain and own elaboration.*

performing loans has grown from 5% in 2009 to 9.5% in June 2012.

*The fact that the banking crisis in Spain has been related, to a large extent, to a sovereign debt crisis, has made the resolution challenge even more complex. In particular, solvency problems have been accompanied by sovereign risk and reputation problems that have considerably limited the access of Spanish banks to funding markets.*

On top of these problems, the fact that the current banking crisis in Spain has been related, to a large extent, to a sovereign debt crisis, has made the resolution challenge even more complex. In particular, solvency problems have been accompanied by sovereign risk and reputation problems that have considerably limited the access of Spanish banks to funding markets. In this context, more explicit resolution mechanisms have been needed (see Exhibit 1). However, the magnitude of the banks' asset impairment has been such that it has required the support of the EU authorities through contingent financial aid for the recapitalization of Spanish banks for 100 billion euros. The aid embedded a conditionality agreement (the Memorandum of Understanding) that includes those explicit resolution measures such as the creation of an Asset Management Company (AMC) –the so-called bad bank that will absorb and manage the real-estate related impaired assets-, the implementatio of Subordinated Liability Exercises (SLEs) –that will define the extent to which bondholders will share losses with the shareholders and the establishment of a number of new prompt-corrective action powers that will be mainly shared between the Bank of Spain and the Fund for the Orderly Restructuring of Banks (FROB)[3].

[3] See the Spanish Economic and Financial Outlook n.2 for a detailed description of the MoU principles.

## The Government´s first response to the MoU: A new framework for the restructuring and resolution of financial institutions

On August 31st, 2012, the Spanish government approved the Royal Decree-Law 24/2012 (RDL 24/2012 from here onwards) on "a new framework for the restructuring and resolution of financial institutions".

*The destabilizing potential of short positions on financial institutions is enhanced by the existing capital requirements on banks. Very aggressive short selling may drive down the market value of a financial institution, making it more difficult to meet capital requirements.*

The title is quite illustrative of the aim of getting from restructuring measures to a final resolution setting for the banking crisis in Spain[4]. The RDL 24/2012 constitutes the first main step of the compliance with the MoU requirements. In particular, the new decree aims to meet, as a minimum, the following conditions of the MoU:

- "Introduce legislation to ensure the effectiveness of SLEs, (by End-August 2012)".
- Upgrade of the bank resolution framework, i.e. strengthen the resolution powers of the FROB and the Deposit Guarantee Fund (DGF) (by End-August 2012).
- Prepare a comprehensive blueprint and legislative framework for the establishment and functioning of the AMC (by End-August 2012).

Given the timeframe established by these MoU conditions, it is not surprising that the new decree was approved exactly on August 31st, 2012, in time to comply with these time constraints. The RDL 24/2012 even includes preemtive action as it shows some progress on commitments agreed to be implemented before the end of 2012 such as the strengthening of retail investors protections and the transfer of responsibilities for sanctioning and licensing of new banks from the Ministry of Economy and Competitiveness to the Bank of Spain.

Importantly, even if the MoU agenda is quite specific and clear in both its content and progress, the RDL 24/2012 acknowledges that the implementation of the MoU is taking place within an environment of significant foreseeable regulatory changes in Europe that may force Spain to adopt some of these going measures to a new EU legal framework, in particular where the provision of EU funds and the functioning of the available funding mechanisms (the EFSF and/or the ESM) are concerned. Specifically, in the motivation of the Royal Decree it is said that "as soon as the EU agrees on a legal text for a Directive on bailout and resolution mechanisms for banks, this decree will be adapted to that Directive".

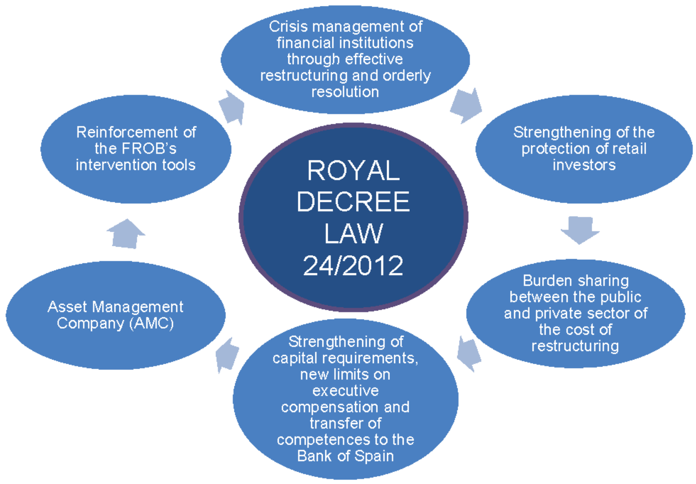
*The RDL 24/2012 acknowledges that the implementation of the MoU is taking place within an environment of significant foreseeable regulatory changes in Europe that may force Spain to adopt some of these ongoing measures to a new EU legal framework, in particular where the provision of EU funds and the functioning of the available funding mechanisms (the EFSF and/or the ESM) are concerned.*

As shown in Exhibit 3, The Royal Decree-Law includes measures on six main subjects:

[4] The legal text of the RDL 24/2012 can be found here: http://www.boe.es/boe/dias/2012/08/31/pdfs/BOE-A-2012-11247.pdf

Exhibit 3

**The structure and content of the Royal Decree-Law 24/2012 on Restructuring and Resolution of Financial Institutions**




*Source: Own elaboration.*

i) A new and strengthened framework for crisis management of financial institutions that allows for effective restructuring and orderly resolution if necessary (chapters II, III and IV of the legal text of the decree).

ii) Reinforcement of the FROB's intervention tools at all stages of crisis management (chapter V and Chapter VIII).

iii) Strengthening of the protection of retail investors (Chapter VII).

iv) Establishment of an Asset Management Company (AMC) (Chapter VI).

v). Burden sharing between the public and private sector of the cost of restructuring resulting from the restructuring of entities (Chapter VII).

vi) Other aspects such as the strengthening of capital requirements, new limits on executive compensation and transfer of competences to the Bank of Spain (Chapter IX).

While there are important developments regarding these six issues, some of them –in particular, some specific aspects of the AMC- will still need to be determined during the months of September and October of 2012.

The following is a summary and critical review of the decree's main contents:

## Strengthened framework for crisis management of financial institutions

Since the early 1990s several jurisdictions, starting with the US, have progressively implemented different types of prompt corrective action or early intervention measures. Although the Bank of Spain -as the banks' main supervisory authority- already had several early intervention powers –and the regulatory reforms since 2009 have somehow reinforced them- the new Royal Decree has extended those powers and it has divided them mainly between the Bank of Spain and the FROB. In the decree, these prompt corrective actions have been undertaken "to deal with viable institutions which may require an exceptional and temporary support (no longer than two years) through the use of contingent capital instruments (CoCos)”.

Early intervention of a bank will take place in any of the following situations:

- Solvency requirements are not being met or there is a reasonable expectation that they will not be met.
- Liabilities of the bank are (or are expected to be) larger than the assets.
- Banks cannot (or are expected not to be able to) meet their financial commitments.

The decree provides the Bank of Spain with the power to directly remove the board of directors and other executive representatives of a bank. The Bank of Spain may also force the Board of Directors to set a board meeting and may force the board to negotiate a program of debt restructuring with the debtors of the institution. The orderly resolution of an institution might also take the form of partial business sales or an asset and liability sale to a bridge-bank (a bank where the assets are transferred and managed by the FROB) or to an asset management company.

Banks in these situations will be required to present a work plan. They will have 15 days to elaborate the plan that has to be approved by the Bank of Spain. If the plan includes the injection of public funds then the FROB will also have to approve it and the funds should be made available in 10 days.

The content required for the work plan are quite ambitious as they include efficiency and recapitalization measures with very specifically scheduled goals. The banks in this situation will have to give detailed monthly information to the Bank of Spain and the FROB on the execution of the work plan. If all the conditions are met according to the plan, then the Bank of Spain will make official the end of early intervention actions.

As mentioned above, a troubled bank may be required to make assets sales and/or to transfer asset to the AMC. Additionally, the FROB may require the transfer of all assets to a so-called bridge-bank that would be controlled and managed by the FROB itself. The FROB should dispose of its capital shares in the bridge-bank in 5 years.

The FROB could also decide to provide financial aid to the acquirers of troubled banks to help in the restructuring of the bank without taking control of it. This way the FROB could eventually minimize the public funds used.

In the cases where the FROB decides to inject funds in a bank as part of a restructuring process or to support the acquirers of a troubled institution, the funds could be provided as ordinary shares or as CoCos (convertible bonds). As far as CoCos are concerned the FROB can convert them into capital in the 6 months following the fifth year of their subscription. The six months deadline can be increased to 2 years depending on the entity’s situation. As for the ordinary shares –as in the case of the bridge bank- the FROB should dispose of them in 5 years.

## The reinforcement of the FROB’s intervention tools

The decree reinforces the FROB’s powers, sharing some important supervision and discipline powers with the Bank of Spain. The decree highlights that “the FROB will be in charge of managing the restructuring and resolution processes in the Spanish banking sector”.

As described earlier, the FROB –in coordination with the Bank of Spain- may determine and monitor a number of early intervention actions and the current decree gives the FROB full rights to take control of financial firms and effectively manage them if necessary.

The FROB will be funded by the State Budget and its leverage limit is increased from 90 to 120 billion euros. It will be ruled by a board formed by representatives of the Bank of Spain and the Ministries of Economy, Public Administrations and Finance, and it will also have a General Director with full executive powers.

## The protection of retail investors

In order to avoid some of the significant controversies that retail investors have recently faced regarding hybrid financial instruments –in particular, preference shares and subordinated debt- the RDL 24/2012 has included some preventive conditions for future investments. In particular, significant restrictions to the future sale of these hybrid products are adopted, For example, these issuances will have a minimum wholesale tranche of 50% and a threshold for retail investments of 25,000 and 100,000 euros, respectively for listed and non-listed companies. As noted in the decree, "supervision powers of the National Securities Commission (CNMV) are reinforced in this sense and non-suitable retail customers will be requested to handwrite a statement saying they were warned about their non-suitability to buy that product".

## The Asset Management Company (AMC)

The decree has only incorporated some general aspects of the Asset Management Company (AMC). In particular, the AMC is said to adopt the form of a limited company or a trust fund. The AMC will allow for the removal from the balance sheet of state aided banks of (real estate-related) problematic assets in order to ease their viability. This AMC has a temporary role. It will be entitled to issue debt if necessary.

*The Bank of Spain will be in charge of setting transfer prices for the assets. This is a critical aspect, as historical experience shows that the success of an AMC depends on a combination of an accurate price setting and the specification of a proper financial structure over the years of functioning.*

The Bank of Spain will be in charge of setting the transfer price for the assets. The value of the assets will be first calculated by independent experts commissioned by the Bank of Spain, who ultimately will decide on the price considering the reports of the experts as well as other sources of information that it may collect. This is a critical aspect, as historical experience shows that the success of an AMC depends on a combination of an accurate price setting and the specification of a proper financial structure over the years of functioning. The AMC will be committed to sell the assets in 15 years.

## The burden sharing of the cost of restructuring

Another very relevant and controversial issue in the MoU was the burden sharing regime between the public sector and the private stakeholders. The RDL 24/2012 defines this burden sharing as the owners of hybrid capital instruments could be forced to bear part of the losses of a troubled institution. According to the decree, "the objective is to reduce, to the maximum extent possible, the cost for taxpayers of restructuring, according to the European rules of state aids". The troubled banks themselves will be able to offer a number of possibilities to the owners of hybrid capital including haircuts on the value of the outstanding debt, the early buy back or anticipated sale of the debt instruments at discounted prices, a conversion of hybrid capital to any other form of equity capital or "any other instrument offered by the bank". Importantly if the FROB considers that the loss absorption by private owners is not enough, it will be able to impose on them specific exchange exercises. These exercises could consist of exchanges into capital instruments, direct or conditioned cash repurchases, or reduction and anticipated amortization of the nominal value of the instrument. All these actions will take into account market values, applying a haircut as established in the European rules.

## Other aspects of the RDL 24/2012: A new minimum capital requirement

Other aspects of the decree are probably more specific but they are also very relevant. The main example is that the decree sets a new minimum Common Equity Tier 1 ratio. Specifically, the current requirements of 8% and 10% (8% as a general rule and 10% for entities with difficult access to capital markets and for those for which wholesale funding is predominant) become a single requirement of 9% that all the entities must comply with as of January 1st 2013. The new regulation adapts the definition of the Tier 1 ratio to the one established in the European Banking Authority.

## Further challenges ahead

The contents of the Royal Decree-Law 24/2012 is key ingredients to follow a solid resolution path for the Spanish banking sector. In any event, it is worthwhile to note that not only the elements of the decree are relevant in this context but also their implementation. Hence, the development of this wide set of early intervention, recapitalization and burden sharing actions will require a very efficient and clear execution.

Some aspects such as the transfer prices and the structure of the AMC are still to be determined and they will be a reference point for investors trying to determine to what extent the price adjustment in real estate assets is convincing as to participate in the AMC and, importantly, to reduce the uncertainty in the capacity of Spain to correct one of its most important current imbalances. The details of the AMC will be determined in parallel to other very relevant features in this context, such as the publication of the bank-level stress tests (which according to the MoU are expected to be released in the second half of September 2012).

Other remaining regulatory challenges this year will be to finalize a proposal on enhancing transparency of banks (with is due by End-September 2012) and, of course the practical implementation at the bank level of the burden sharing exercise as banks with significant capital shortfalls will have to set SLEs –and inform their bondholders on the losses that they will assume- before any public capital injections are received.