BRIEFING

The resolution of Banco Popular

This briefing focusses on the resolution of Banco Popular by the Single Resolution Board.

What happened on 6 and 7 June 2017?

On 6 June 2017, the ECB announced that Banco Popular was "failing or likely to fail". The ECB indicated that "*the significant deterioration of the liquidity situation of the bank in recent days led to a determination that the entity would have, in the near future, been unable to pay its debts or other liabilities as they fell due*". Therefore, in line with Article 32(4)(c), the ECB determined that the bank was failing or likely to fail and communicated its decision to the SRB. A non-confidential version of the decision was published on the ECB website on 14 August 2017.

On the following day, the Single Resolution Board (SRB) adopted a resolution decision, transferring all shares and capital instruments of Banco Popular Español S.A. (Banco Popular) to Banco Santander S.A (Santander) for one euro, under the new framework for the recovery and resolution of credit institutions and investment firms (Directive 2014/59/EU and Regulation 806/2014/EU). On the basis of valuation carried out in line with Article 20 SRMR, the SRB wrote down, prior to the transfer of the shares to the purchaser, the ordinary shares and additional tier one instruments and the banks, and converted tier 2 instruments into shares which were subsequently transferred to the purchaser. The resolution decision was addressed to the Spanish resolution authority (the FROB) for implementation.

On the same day (7 June 2017), the European Commission approved the resolution scheme of Banco Popular under the "*EU's bank recovery and resolution rules*", noting that the scheme involved no State aid nor aid from the Single Resolution Fund. In particular, the Commission noted that the three conditions for resolution were met (the bank was failing or likely to fail, there was no alternative private measure nor supervisory action which could have prevented the failure, and it was necessary in the public interest).

What are the origins of the difficulties faced by Banco Popular?

The capital position of Banco Popular had been under pressure for months. In June 2016 the bank completed a capital increase of EUR 2.5 billion, in view of the results of the stress test carried out by the EBA and disclosed on 29 July 2016. Those stress tests determined that under the adverse scenario, the CET1 of the bank would reach 7.01% in 2018. The bank booked large losses in 2016 on its portfolio of real estate, resulting in net loss of EUR 3.5 billion for the exercise. As a consequence, the management of the bank of the bank was reshuffled and the new banks attempted to define a new strategy by raising capital or selling the bank to a competitor (see box1).

The sale process was ongoing when a sudden deterioration of the liquidity of the bank forced the supervisor to determine the bank was failing or likely to fail. The bank had not benefited from State guarantees, and it was reported in the press that the bank ran short of eligible collateral for central bank refinancing. However contradicting rumours were reported in the Spanish press on this issue, some claiming the ECB had imposed haircuts of up to 90% on the eligible collateral, others claiming the bank had not presented all its eligible collateral at the refinancing desk of the ECB. It was confirmed by the Spanish Minister of Finance that a number of local authorities were involved in the deposit outflows preceding the failure of the bank.

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Box 1: Banco Popular - Timeline of events (including information taken from the financial press)

26/05/2016:	Banco Popular announced a capital increase of EUR 2.5 billion, to be completed in June 2016; the bank is said to be anticipating stronger capital requirements by the ECB at the end of 2016 through the annual SREP process, as well a further provisioning of real estate portfolios by up to EUR 4.7 bn
29/07/2016:	Publication of the 2016 stress test: Banco Popular's transitional CET1 ratio reaches 13.45% in the 2016 in the baseline scenario, down to 7.01% in 2018 in the adverse scenario
01/12/2016:	Banco Popular announced the replacement of its executive chairman, Mr Angel Ron, by Mr Emilio Saracho, in the course of Q1 2017
03/02/2017:	Banco Popular reports a EUR 3.5 bn loss for 2016 because of impairments on its real estate portfolio, which heavily drags the CET1 ratio, a key measure of financial health. The bank is predicted to raise capital again
20/02/2017:	Mr. Emilio Saracho replaces Mr. Angel Ron as Chairman of the bank; he is the former head of investment banking at Santander, and has worked for several investment banks
03/04/2017:	CEO Pedro Larena quits after an audit reveals under-provisioning of bad loan portfolios for EUR 600 million as well an unreported loans to clients to buy shares in the 2016 capital increase; the 2016 financial statement are partially restated
10/04/2017:	General assembly of shareholders; the CEO indicated that the bank needed a capital increase and could possibly be sold to a competitor
05/05/2017:	Banco Popular announces a first quarter loss of EUR 137 million. According to the financial press, the capital needs exceed the bank's current market valuation
16/05/2017:	Banco Popular declares it has been contacted by several potential buyers
31/05/2017:	Reuters reports that Mrs E. König, chair of the SRB, warned EU officials that Banco Popular "*may need to be wound down if it fails to find a buyer*"
01/06/2017:	Banco Popular's AT1 bonds trade at distressed levels following the Reuters report of 31/05/2017
05/06/2017:	Banco Popular requested EUR 2.0 bn of Emergency Liquidity Assistance, according to the financial press
06/06/2017:	Banco Popular requested another EUR 1.6 bn of ELA according to the financial press, and then fell short of eligible collateral: it cannot reopen on the following day; it is reported in the Spanish press that the bank deposited in total about EUR 40 billion in collateral but could only withdraw EUR 3.5 billion in cash; Mr de Guindos, Spain's economy minister, also confirmed on 12/06 that local authorities had been involved in the withdrawal of large deposits in the last days before the resolution The bank is deemed failing or likely to fail by the ECB The SRB then triggered the resolution and launched an accelerated sale process; the provisional value of the bank as assessed by an independent expert was said to be negative in the order of magnitude between EUR (8.2) billion and EUR (2.0) billion
07/06/2017:	The bank was sold to Santander for 1 euro; the FROB (Spanish resolution authority) implements the resolution scheme adopted by the SRB
12/06/2017:	Spanish regulators announce a ban on short selling of Liberbank shares for fear of contagion

What are the resolution tools applied to Banco Popular?

The SRB decided to apply two resolution tools: the sale of assets tool and the bail-in tool. No use of the Single resolution Fund was needed. The provisional valuation carried out by an independent expert estimated that the value of the bank was negative and would range from EUR [-8.2] billion in an adverse scenario to EUR [-2] billion in the baseline scenario, according to the FROB. Therefore the SRB wrote down the equity and additional tier one instruments, while the tier two instruments were converted into shares before the transfer of the shares to Santander. Additional tier one and tier two instruments amounted to EUR 2 billion in total.

The use of sale of business tool was facilitated by the fact that the Bank had been attempting to find a buyer in the preceding weeks. Therefore the potential purchasers had already had the opportunity to analyse the books of Banco Popular. In addition the SRB indeed decided on 3 June 2017 in an extended executive session that the FROB should begin an open tender process to sell the bank. The FROB contacted interested parties and once the tender closed the SRB acknowledged that the marketing requirements and commercial terms set out in Article 24.2 SRMR had been complied with. The FROB indicates that Santander was the only purchaser to fulfil the requirements for acceptance.

How was the decision taken?

It seems that on 3 June 2017 an extended executive session of the SRB planned the resolution of Banco Popular. The FROB decision mentions the SRB decision taken that day, which provides that the tender should comply with a number of conditions. In particular, "*the SRB decision explicitly considered the possibility of the sale process being undertaken regardless of whether the final resolution scheme included the sale of the business or any other tool (...)*". This underlines that a draft resolution scheme was already being discussed four days prior to the actual resolution decision.

The following Monday and Tuesday, important deposit outflows were observed, and it was confirmed that a number of local authorities participated in this development. On Tuesday 6 June at 15.30, the bank ran out of liquidity and notified the Spanish supervisor. By 21.30 the ECB concluded that the bank was failing or likely to fail. According to the Spanish press, the negotiation with Mrs Botín, president of Santander, was led by Spanish authorities (Bank of Spain, FROB, Ministry of Finance). Santander was notified on 6.00 on Wednesday 7 June that its offer was accepted and the signature took place at 7.00. The banks had to secure a capital increase and several regulatory approvals overnight.

What's next for the Single Resolution Board?

According to the financial press, investors filed a lawsuit against the SRB at the beginning of August 2017, claiming inter alia that its decision relied on "incomplete information".

What's next for Santander?

On 13 July, Santander announced its intention to offer a compensation to retail customers affected by the resolution of Banco Popular, setting aside nearly EUR 1 billion for that purpose. On 26 July, Santander announced that it managed to raise EUR 7 billion of capital, required in particular to address the provisioning deficit that Santander uncovered in Banco Popular's books (in particular, Santander intends to book EUR 7.9 billion of additional provisions, including EUR 7.2 billion on real estate exposures); the rights issue was more than eight times oversubscribed.

On 8 August, Banco Popular announced that it had sold a majority stake in its real estate portfolio to the investment firm Blackstone. Banco Popular will transfer assets with a gross book value of approximately EUR 30 billion as well as equity to a new company in which Blackstone owns a majority 51% stake; the assets will therefore no longer be fully consolidated on Banco Popular's balance sheet. The valuation of the assets is consistent with the valuation and provisions made by Santander during the acquisition of Popular and does hence not result in any material capital gain or loss for Santander or Popular.

Annex 1: Background information on Banco Popular

Banco Popular is a Spanish banking group with approximately 12.000 employees (20% fewer than in 2015), 90% of whom work in Spain where the bank operates 1.600 branches. Its business strategy is in particular focused on small and medium-sized enterprises (SMEs). Its exposure to SMEs (29% of all exposures) is significantly higher than that of other Spanish banks (10% on average 10%).

At the end of 2016, Banco Popular had a balance sheet size of EUR 147.9 billion, which is 6.8% lower than in the year before. Looking at the bank's activities by business line, next to the SME business the Real Estate Business forms another considerable part of the total assets on the balance sheet (EUR 24.3 billion, or 16,4%).

Banco Popular booked a net loss of EUR 3.5 billion in 2016, due to a non-recurring balance sheet clean-up and the conclusion of a restructuring plan that aimed to reduce costs (in 2015 the bank reported a profit of EUR 106 million). Provisions amounted to EUR 5.7 billion; the coverage ratio of non-performing and non- written-off balances improved from 45.5% in 2015 to 52.3% in 2016.

The capital adequacy was slightly below that of his peers. At 31 December 2016 the phased-in CET1 ratio stood at 12.13%[1] against 12.59% for the average of Spanish banks directly supervised by the ECB.

As regards the liquidity situation of the bank, the bank was compliant with the regulatory Liquidity Coverage Ratio (LCR). The LCR was developed to ensure that banks have sufficient High Quality Liquid Assets to survive a significant stress scenario lasting 30 calendar days. The minimum LCR target level is 80% in 2017, and 100% in 2018. Banco Popular's consolidated LCR at December 2016 was 134.8%.

The results for 2016 as presented in the initial Annual Report 2016 were later on partially restated, according to the information filed with the Spanish Securities Market Commission (CNMV) on 3 April 2017 (see picture 1). Banco Popular sets out in the 1Q17 Results Presentation (p. 11) that "*According to the Significant Event announced the 3rd of April, the €160M provision shortfall linked to NPLs collaterals, which was statistically estimated at first, and the €145M NPL book (net of provisions) in regards to potential derecognition of collateral, are both being analyzed. Final impact due to be announced by 2Q17*".

[1] The phased-in ratio allows for the gradual application of the capital requirements introduced by the CRD IV directive and CRR regulation; Banco Popular's CET1 fully-loaded ratio at the end of 2016 was notably lower and stood at 8.19%.

Annex 2: Snap-shot of the resolution procedure

On 7 June, the **SRB transferred all shares of Banco Popular to Banco Santander** for a symbolic price of 1 euro, meaning that Banco Popular with immediate effect operates under normal business conditions as a solvent and liquid member of the Santander Group. The following "snap-shot" sketches which authority had to decide about which aspect in the resolution procedure of Banco Popular, and cites some respective key assessments:

Institution	Key consideration	Assessment
European Central Bank	Is the **bank failing** or likely to fail?	The ECB determined that Banco Popular Español S.A. was failing or likely to fail. *"The significant deterioration of the liquidity situation of the bank in recent days led to a determination that the entity would have, in the near future, been unable to pay its debts or other liabilities as they fell due"*. Press release 7 June 2017
Single Resolution Board	Which resolution tool is the most suitable? Is a **private sector solution** possible? Is a resolution in the public interest?	*"There was no reasonable prospect that any alternative private sector measures or supervisory action would prevent the failure of the Institution within a reasonable timeframe"*. *"Resolution action would be necessary in the public interest"*. Press release 7 June 2017; Accompanying note
Spanish Executive Resolution Authority FROB	**Implementation** of the necessary resolution actions	"*...the SRB obtained a valuation from an independent expert... This valuation estimates an economic value of the entity of a negative two billion euros (€2,000,000,000) in the baseline scenario and a negative eight billion, 200 million euros (€8,200,000,000) in the most adverse scenario.*" "*The economic value and the offer received in the sale of business tender... evidence the existence of losses that must be borne, firstly by shareholders losing their stakes in the entity...*"; "*The FROB's execution of the power to write down and convert the capital instruments fulfils the instructions issued by the SRB in the resolution scheme...*" Decision adopted by FROB's Governing Committee on June 7, 2017 concerning Banco Popular Español S.A
European Commission	**Approval** under EU Bank Recovery and Resolution rules	*"It [the resolution by sale of business] was the best course of action to ensure the continuity of the important functions performed by the bank and to avoid significant adverse effects on financial stability. In this specific case, losses were fully absorbed by shares and subordinated debt."* *"No State aid nor aid from the Single Resolution Fund has been provided and the sale is subject to normal merger and regulatory review."* Press release 7 June 2017