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**Spain: Safety Net, Bank Resolution, and Crisis Management Framework—
Technical Note**

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SPAIN

SAFETY NET, BANK RESOLUTION, AND CRISIS MANAGEMENT FRAMEWORK

TECHNICAL NOTE

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Glossary

AMC	Asset Management Company
APS	Asset Protection Scheme
BdE	Banco de España
CAMEL	Capital, Assets, Management, Earnings, Liquidity
CESFI	Comité de Estabilidad Financiera
CMG	Crisis Management Group
CNMV	Comisiòn Nacional del Mercado de Valores
CoCos	Contingent Convertible Bonds
DGFSP	Dirección General de Seguros y Fondos de Pensiones
DGOMPS	Directorate of General Operations, Markets and Payments System
ECB	European Central Bank
ELA	Emergency Liquidity Assistance
EU	European Union
FAAF	Fondo para la Adquisicion de Activos Financieros
FGD	Fondo de Garantia de Depósitos
FROB	Fondo de Reestructuracion Ordenada Bancaria
FSB	Financial Stability Board
G-SIFI	Global Systemically Important Financial Institution
G-SIB	Global Systemically Important Bank
ICAAP	Internal Capital Adequacy Assessment Process
MdE	Ministerio de Economía y Competitividad
MdH	Ministerio de Hacienda y Administraciones Públicas
MoU	Memorandum of Understanding
PCA	Prompt Corrective Action
RDL	Royal Decree Law
RRP	Recovery and Resolution Plan
SABER	Supervisión de la Actividad Bancaria Bajo el Enfoque Riesgo
SIP	Sistema Institucional de Protección

Executive Summary

The financial safety net architecture for the banking sector comprises the *Banco de España* (BdE), the *Fondo de Garantía de Depósitos* (FGD), and the *Fondo de Reestructuración Ordenada Bancaria* (FROB). The *Ministerio de Economía y Competitividad (*MdE) is in charge of defining the overarching financial policy, including measures and rules aimed at ensuring financial stability, while the Ministry of Finance approves public expenditures for state interventions in the banking sector.

The early intervention powers of the BdE, whose objective is to promote financial stability, are strong and flexible, but a more structured and forward-looking approach for dealing with deteriorating weak banks would be advisable. In this framework, supervisors have to consider an array of measures when a bank is assessed to be in a pre-defined overall risk category. This would further ensure early and equal treatment of all cases.

While the overall legal and policy framework for providing emergency liquidity assistance (ELA) is broadly sound and reflects good practices, some features could be further specified. These include stricter definition and interpretation of a "solvent bank", "systemic importance," and "temporary liquidity support."

The practice of managing a financial crisis has changed over time, reflecting the systemic nature of the current crisis. The role of the FGD, which has the objective of guaranteeing bank depositors by pay-outs or by safeguarding the viability of credit institutions, has been taken over by the FROB, the main goal of which is to assist and foster the consolidation and restructuring of the Spanish banking industry. Although the two institutions have separate functions in important respects, they also share many similarities in their powers and organizational structures.

Institutional roles and instruments of the FROB and of the FGD need to be realigned. The FGD intervention should focus on facilitating bank resolution, while the FROB should contribute to the structural consolidation of the banking industry. In this manner, fair burden sharing between the private and the public sector would be further pursued. The FROB capital support should be expected to be accompanied by private sector equity involvement. To underpin the credibility of the deposit insurance system, a contingent credit line from the State should be secured.

To enhance checks and balances, it would be beneficial to redesign the internal governance of financial safety net authorities. The presence of active bankers in the FGD and FROB governing bodies can theoretically lead to increased risks of conflicts of interests when resolution matters are discussed, although conflict-of-interest and confidentiality safeguards are in place and no evidence of misconduct has been found. In any case, the governance of the FGD and FROB could also balance *ex officio* members from the MdE, the *Ministerio de Hacienda y Administraciones Públicas* (MdH), and the BdE with executives and/or other independent members appointed by the authorities.

Given the current crisis, it should be a key priority for the authorities to promptly improve the tools to resolve banks, in line with recent international practices. A series of improvements seem highly necessary, emphasizing the public interest objectives of the resolution process in the interest of financial stability. New legislation should enable allocation of losses to shareholders and creditors, such as through prompt recapitalizations with dilution of existing shareholders, purchase and assumption transactions and bridge banks. Moreover, in the context of a comprehensive review of the bank resolution legislation deriving from the forthcoming European Union (EU) Directive, consideration should also be given to the introduction of depositor preference that could mitigate the cost of resolution for the FGD and ultimately the government. An administrative-based framework could ensure an orderly liquidation of failed banks, with accountability through *ex post* judicial review of the legality of resolution measures.

Table 1. Spain FSAP Update: Main Recommendations

Recommendations and Authority Responsible for Implementation	Priority	Timeframe
With a view to pursuing the public interest objective of financial stability, introduce special tools to resolve banks, such as prompt recapitalizations, purchase and assumption transactions and bridge banks, by also overriding shareholders' rights (all agencies).	High	6-12 months
Conclude a contingency credit line from the State to the FGD (MdH, MdE, and FGD)	High	6-12 months
Further pursue fair burden sharing between the private and the public sector in the restructuring and resolution of banks, by clarifying the financial responsibilities of the FROB and of the FGD (all agencies)	High	6-12 months
Redesign the governance of financial safety net authorities and enhance checks and balances in their activity (all agencies)	Medium	1-2 years
Consider the introduction of depositor preference, including for FGD claims, over the estate of a failed bank (MdE, FGD).	Medium	2-3 years
Establish an administrative-based framework for the orderly liquidation of failed banks, with accountability through *ex post* judicial review (all agencies).	Medium	2-3 years
Devise and implement a more structured and forward-looking approach for dealing with deteriorating weak banks (BdE)	Medium	2-3 years
Further specify the policy features of the ELA framework (BdE)	Medium	2-3 years
Realign institutional roles and instruments of the FROB and of the FGD (all agencies)	Medium	2-3 years

I. Safety Net, Bank Resolution, and Crisis Management Framework[1]

1. **This technical note is structured as follows. Section A provides a brief overview of the impact of the global financial crisis on the Spanish financial sector and the measures adopted by the Spanish authorities to deal with it.** Section B describes Spain' financial sector architecture with a focus on the institutions actively involved in the financial safety net. Sections C, D, and E review the steps taken to address problem banks, from early intervention and liquidity provisioning, to the role of the deposit insurance scheme, to government interventions. Section F describes the mechanisms currently in place to resolve banks, and recommends additional improvements. Section G concludes by suggesting possible features of a revamped bank resolution and crisis management framework, building upon the existing one.

A. Spain and the Global Financial Crisis: A Brief Overview

2. **The Spanish economy entered into the global financial crisis with sizeable domestic and external imbalances.** In particular, large private-sector indebtedness, oversized housing sector, and weak competitiveness had accumulated during an extended period of rapid economic expansion. When the crisis broke out, Spain had already begun a gradual adjustment of its imbalances. However, what started as a soft landing turned into a more complicated adjustment process in the wake of the global liquidity squeeze in mid-2007, which affected both the real economy and the financial sector.

3. **In the unfolding of the crisis, it is possible to distinguish three phases.** The initial impact of the global financial crisis was relatively "mild." The banking sector weathered the first wave of the crisis due to prudent regulation, robust capital and provision buffers, and a retail-oriented business model. Still, financial market disruption severely affected Spanish banks' operating model, because of its reliance on wholesale funding. During this initial phase of the crisis, the authorities decided to assist banks mainly through supporting their funding rather than injecting capital.

4. **In line with the common framework agreed by the euro-area countries, the Spanish government took the following exceptional measures:**

- The limit of the deposit guarantee was raised from €20,000 to €100,000, thus implementing the revised EU Directive 2009/14.

- A €30 billion fund, with the possibility to be raised up to €50 billion, was established to purchase high quality covered bonds and asset backed securities from credit institutions: the *Fondo para la Adquisción de Activos Financieros* (FAAF). The auctions were modeled after, and complemented, the European Central Bank (ECB) liquidity facilities, but with longer maturities up to 3 years. Allocation up to 25 percent of a tender was envisaged through non-competitive bids to credit institutions in proportion to their contribution to credit growth. Limits were set to

[1] Prepared by A. Giustiniani, A. Gullo (LEG), and G. Lind (Riksbank, IMF external consultant).

safeguard sufficient diversification in fund allocation among credit institutions. Reflecting also the ECB measures in support of liquidity in the euro-system, only four auctions were carried out for a total amount of €19.3 billion and the facility was discontinued at the end of January 2009.

- Government guarantee were provided for credit institutions' new debt issues. The amount approved in 2008 budget was €100 billion to be initially used by end-June 2009; while allotment of additional €100 billion was provided for in 2009 budget if market conditions remained dysfunctional. The pricing of the guarantees was agreed among EU partners and it was a function of debt maturity and CDS spreads and/or rating of the originator. This facility has been renewed several times and as of end-2011, about €63 billion securities have been issued by banks with the state-guarantee.

- If necessary, credit institutions' re-capitalization could be carried out through the state's acquisition of non-diluting instruments such as preference shares.

5. **The second-round effects of the crisis (the second phase) had a much greater impact, because the Spanish real estate sector—the main driver of growth—was severely hit.** The domestic economy entered into a severe recession, with construction activity collapsing, unemployment soaring, foreign demand faltering, and competitiveness remaining weak. Banks were facing pressures both on the liability side and the asset side. At that point, the authorities launched the FROB with the aim to encourage an orderly consolidation of the Spanish banking industry by, inter alia, strengthening the capital buffers of credit institutions. When minimum capital requirements were raised in February 2011, the FROB became the fully-fledged capital back-stopper for Spanish banks. From its launch, FROB was also empowered to intervene on banks assessed as non viable by the BdE, acting as administrator and providing to such entities various forms of liquidity or solvency support.[2]

6. **The third phase of the crisis is still underway, reflecting the markets' uncertainties about the debt sustainability of some European sovereigns.** The defining feature of this phase is the strong interconnection between the sovereign and its banking system—with the former affecting the financial health of the latter, and vice versa. This also made more complicated the process of public support to the restructuring of the Spanish banking sector.

B. Spain's Financial Sector Institutional Framework

7. **In Spain, the financial sector supervisory architecture is organized along functional lines with the MdE playing a critical role in light of its legislative and sanctioning powers and political responsibility.** The BdE, the *Comisión Nacional del Mercado de Valores* (CNMV), the *Dirección General de Seguros y Fondos de Pensiones* (DGSFP, acting within the MdE) are respectively responsible for the supervision of credit

[2] See Annex II for a description of the strategies for handling impaired assets.

institutions, securities markets, and insurance companies and pension funds.[3] The MdE is in charge of defining financial policy, including adopting those measures and rules aimed at ensuring financial stability.[4] The MdE also has important sanctioning powers following the recommendation of the individual supervisory authorities.

8. **The financial safety net institutional framework is complemented by two other agencies, the FGD and the FROB.** As discussed in more detail later, the FGD does not act as a mere pay-box but it has in conjunction with the BdE a wide range of financing mechanisms and it has been the main crisis management "instrument" until the creation of the FROB. In June 2009, the Spanish authorities created the FROB with the view to assisting and fostering the reorganization of the Spanish banking industry, especially savings banks. FROB, unlike the FGD, is empowered to take over managerial functions in distressed banks.

9. **There is a considerable degree of interconnectedness among the different safety net institutions.** The law establishes that the three national supervisory authorities have to cooperate to harmonize criteria, practices and supervisory techniques, and exchange the required information to fulfill their functions. Several memoranda of understandings (MoUs) have been concluded between the relevant authorities further specifying the modalities for cooperation and information-sharing, including for crisis prevention and crisis management.[5] Cooperation among supervisors is further supported by considerable cross-membership in the governing bodies of the supervisory authorities.[6] In addition, with the view to strengthening coordination and exchange of information among institutions, the authorities established the *Comité de Estabilidad Financiera* (CESFI), where the three agencies are represented, together with the State Secretary for Economic Affairs acting as Chair. The CESFI is a forum for exchange of information and views on financial stability and crisis prevention and management issues and it has no decision-making powers.

C. Early Intervention and Liquidity Provision

10. **As a banking supervisor, the BdE possesses and uses a wide range of tools to identify weak banks and apply preventive or remedial measures.** The tools for identification are linked to the intensity and focus of the supervision, in line with

[3] Oversight and supervisory responsibilities regarding payments and settlements systems are the purview of the BdE and the CNMV, respectively.

[4] During some periods including in the recent past, the economy and budgetary functions were performed within the same ministry.

[5] BdE and DGSFP's MoU was signed in 2004; BdE and CNMV's MoU was updated in 2009.

[6] For instance, the CNMV Vice-President is a member of the BdE Governing Council. Similarly, the Governing Council of the CNMV includes the Deputy Governor of the BdE. In both Councils, the Government is represented by the Director General of the Treasury and Financial Policy. Representatives of the BdE, the MdE, the MdH, and the FGD seat in the Managing Board of the FROB, while the Board of the FGD comprises representatives of the BdE and the industry.

international best practices. BdE grades banks based on quantitative and qualitative data and using supervisory judgment.

11. **The BdE has developed a risk-based supervisory methodology approach known by its Spanish name SABER (*Supervisión de la Actividad Bancaria Bajo el Enfoque Riesgo*).** Following this methodology, the supervisory risk profile of each institution is established and updated. Such supervisory risk profile, together with the due consideration of the systemic importance of each credit institution, guides the frequency and intensity of supervision and the assessment of the different risks guides the focus of the supervision.

12. **The BdE uses a judgmental approach for applying remedial measures on banks.** The BdE has at its disposal a wide range of remedial instruments to deal with weak banks; for instance, it may restrict a bank's activities, require increased provisioning or a capital add-on. Corrective measures are not escalated based on certain quantitative triggers, such as in a prompt corrective action (PCA) type framework, but a downgrade in the supervisory risk profile rating will also affect the supervisory attitude towards a bank. The BdE's position that supervisory action should be based on judgment in addition to quantitative information, e.g., on bank capital, deserves to be supported.

13. **However, a more structured and forward-looking approach for dealing with weakening banks that have not yet violated any regulatory rules is advisable.** Other countries, such as Canada, apply a structure in which supervisors have to consider various measures when a bank is assessed to be in a pre-defined overall risk category. The measures include contacts with other relevant authorities such as the deposit insurer and the resolution authority, as appropriate. The supervisor has the option to decide not to take any measures. The advantage of such a process is that it ensures equal and early treatment of all cases. It would also be more forward-looking than the current process in the BdE. Indeed, the presently used risk-based SABER approach is highly useful but could be supplemented to ensure early and transparent decisions on weakening banks, including informing other involved authorities about the situation. Both the SABER and the BdE's overall planning of supervisory activities are mainly means to optimize risk-based supervision rather than to take immediate decisions on remedial actions for weak banks.

14. **The BdE has strong early intervention powers.** When the solvency or liquidity of a bank is in jeopardy, or even when such a situation is merely likely, the BdE may appoint "interventores", who can have veto powers over management's decisions, or may directly take over the bank management. The BdE may exercise this power regardless of the occurrence of a serious or very serious violation of the legal and regulatory framework. In principle, such early intervention may also take place when for instance capital requirements fall below (in any percentage) the prescribed minimum, or even if capital requirements are complied with, if there are serious doubts about the quality or the evaluation of the bank assets.

15. **Provision of ELA by members of the Eurosystem such as the BdE must be framed within the restrictions of the System.** ELA may only be provided to an

individual bank which is considered solvent, but which faces temporary liquidity problems. A national central bank that provides ELA must give to the ECB a predefined set of information. While granting the ELA remains a decision of the national central bank, carried at the risk of said bank, liquidity support through ELA needs to be coordinated with the ECB Governing Council also depending on the relevant amounts.

16. **While not explicitly regulated, the BdE authority to grant ELA derives from its statutory function to promote the stability of the financial system.** Under its statute, the BdE may carry out all operations—such as granting of loans—necessary to perform its functions. The BdE interprets the law so as to restrict the range of ELA beneficiaries only to credit institutions: this is due also to the understandable rationale of maintaining a closer oversight over the institutions to which ELA is given, by means of the BdE supervisory functions. The terms and conditions to provide ELA are not specified in advance, neither are they publicly disclosed, following the "constructive ambiguity" tradition common to central banking. In line with international practices, special rules govern the realization of the collateral by the BdE, outside of ordinary bankruptcy proceedings. The Directorate of General Operations, Markets and Payments System (DGOMPS) collects market information on liquidity positions of individual banks. This information is shared and discussed with the BdE supervisors, which uses it in its assessments of the financial system and of individual banking institutions.

17. **Since the beginning of the crisis, there has been only one case of ELA provision by the BdE, namely to Caja Castilla La-Mancha (CCM) in 2008.** In the authorities' view, CCM faced a temporary liquidity problem but it was deemed to be solvent and to have adequate collateral, based on the assessment of the supervisors. Furthermore, this institution was involved in a merging process with another regional savings bank whose aim was to reinforce its liquidity and financial long-term position. About one month after the ELA provision, the BdE requested the government to guarantee the ELA, based on operational and cost-efficiency concerns. The total period for the ELA was about 15 months, which was far longer than initially expected, as the situation of CCM worsened to a liquidity crisis due to its exclusion from the normal liquidity distribution channels. Rumors and intervention news stigmatized this institution, amid an impaired market environment, extremely concerned by counterparty risk.

18. **The above mentioned ELA case raises, however, some reservations.** The total period for this ELA was far longer than normal liquidity support and mirrored the length of the merger negotiations and the resolution process (see Appendix III). Also, CCM' solvency—as measured by its capital adequacy ratio—albeit positive, was extremely low; the circumstance that, about one month after the ELA provision, the BdE requested the government to issue a guarantee may indicate the existence of concerns about the bank's solvency. *Ex post*, these elements raise questions about the real solvency of this institution at the time the ELA was granted and the soundness of the merger pursued, which indeed failed.

19. **After the CCM case, the BdE has fine-tuned its protocol for the provision of liquidity in emergency situations, in order to clarify the respective functions of the**

Director General of Supervision and the DGOMPS. Such protocol, approved by the Executive Committee of the BdE, establishes a procedure for the granting of ELA, based upon the initial 2005 protocol and previous IMF recommendations. In particular, the DGOMPS is entrusted with the assessment of the quality of the collateral, while the Supervision Department evaluates the solvency of the beneficiary bank. The final approval is given by the Executive Committee. The BdE has also prepared a standard form of contract, which would need to be tailored to the specific circumstances.

20. **While recognizing the need for flexibility, the BdE could strengthen its internal guidelines for using the ELA tool.** The existence of the above described protocol and contractual arrangement positively contributes to crisis preparedness and to uniformity of practices. Further improvements may be achieved by defining more strictly the interpretation of "a solvent bank", of "systemic importance" and of "temporary liquidity support", as well as of the remedial plans required to the beneficiary bank. Some of these elements may also be publicly disclosed to further ensure transparency and uniformity of actions. This approach would allow to ensure certainty and well-established practices, without the need for enshrining any specific provision in the primary law.

D. Deposit Insurance

21. **The FGD is a private law entity wholly prefunded by the member credit institutions.** Originally, there were three FGDs; one for each segment of the banking industry (commercial banks, savings banks, and credit cooperatives). With the Royal Decree-Law (RDL) 16/2011 of October 14, 2011, the three sectoral funds were merged into a single fund and the premiums have been made uniform across the board. The Management Board of the FGD consists of 12 members: 6 from the BdE and 2 from each segment of the banking industry (commercial banks, savings banks and cooperatives); the chairman is the Deputy Governor of the BdE. Certain major decisions—such as on provision of financial assistance in resolution and on the collection of extraordinary premiums—are subject to a two-third majority of its members.

22. **Members' contributions are the main source of funding, but alternative mechanisms are also envisaged.** The FGD may be funded in three ways by (i) ordinary annual contributions[7]; (ii) extraordinary contributions; or (iii) issuing bonds or by borrowing from third parties, including the government or the FROB.[8]

23. **There is an explicit fund target.** Should the level of the fund be deemed sufficient to carry out its duties, the MdE is enabled to reduce the contributions. The law

[7] Under the current version of RDL 16/2011, each member institution currently pays a premium of 2 per thousand of its insured deposits; such premium may be increased up to 3 per thousand of insured deposits. The premium does not vary according to risk, with one exception, namely that banks which provide deposits with an excessive interest rate (defined in relation to the Euribor rate) must pay a premium that can be five times higher than the ordinary one on those deposits.

[8] At the end of 2011, the accumulated amount in the FGD is some €300 million. The yearly premiums for 2011, paid at end-February 2012, amount to about €2 billion. The four largest banks—Santander, BBVA, Caixa and Bankia—will contribute more than half of the total amount.

also envisages that when the FGD assets reach a level equal to or greater than to 1 percent of total deposits (approximately €10 billion), banks' contributions are discontinued.

24. **The FGD has the objective of guaranteeing bank depositors by pay-outs or by safeguarding the viability of credit institutions.** When the financial condition of a bank makes it likely that pay-out obligations will be triggered, the FGD may adopt preventive or supporting measures in the context of an action plan presented by the bank. If such plan is approved by the BdE, the Management Board of the FGD will decide whether to provide any financial support aimed at restoring the viability of the bank. The decision shall be based on a least-cost analysis, i.e., whether the net cost for the FGD of such financial assistance is less than the cost of payouts—reduced by the expected recoveries from the assets of the failed bank—which the FGD would have to make upon bankruptcy or liquidation of the bank.

25. **The range of financing mechanisms that the FGD can deploy is broad and includes both liquidity and solvency support.** Such financing varies from credit lines to a bank (although this possibility has not been used), guarantees, subordinated loans or subsidies, to the acquisition of bad assets, to the injection of capital including in the context of mergers or take-over, to support asset and liability transfers.

26. **The recent RDL16/2011 has further widened the FGD's options for supporting bank resolution.** In particular, the FGD may financially support the restructuring and resolution of the viable and non viable institutions recapitalized or intervened by the FROB, including through non-refundable contributions.[9] Such a decision ought to satisfy the least cost criteria. As a matter of practice, this determination will be more discretionary if support is given to a viable, ongoing entity: in such case the absence of the alternative between resolution and bankruptcy (the latter triggering a direct pay-out) will lead to a more complex assessment on the viability of the entity and its prospects for recovery.

27. **In case of bank liquidation, neither the FGD nor depositors enjoy any preferential rights over the estate of a failed bank.** The FGD does not have access to banks' records; data on insured deposits are collected yearly by the BdE as banking supervisor, and reconciled more frequently when the financial condition of a bank deteriorates. In case of bankruptcy, the FGD appoints the liquidator, thus controlling the pay-out process. Upon paying the insured amounts to the depositors, the FGD is subrogated in the latter's rights vis-à-vis the bankrupt entity, ranking as unsecured creditor together with (uninsured and insured, to the extent of their remaining claims) depositors.

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[9] These amendments are in line with the objective of imposing the burden of the restructuring and resolution processes mainly on the private sector. (Also, the triggers for the FGD to provide financial support may be different from the ordinary ones, as they relate to the recapitalization and intervention process under the FROB framework). In relation to the concern that in some instances this solution may unduly impose on the private sector the cost of certain structural measures regarding the restructuring of the Spanish banking system (see paragraphs 29 and 54).

28. **The accumulated assets of the FGD are currently very low.** The FGD support to Banco CAM acquisition (see below) has de facto depleted the FGD resources that have partially recovered with the latest ordinary contribution by credit institutions. However, funds remain low and demands in the near future cannot be excluded, not least due to the recent higher provisioning requirements which will necessitate capital replenishments in some banks and subsequent closures or restructurings. It is formally possible to raise unlimited funds from the member banks, but too high demands on already burdened banks might be counterproductive. Also, market funding as a means to replenish FGD funds may not be available in a crisis situation. Extraordinary levies would still be subject to the consent of (at least some) banks representatives, as they require a 2/3 qualified majority of the FGD Management Board, including therefore at least two representatives of the banking industry.

29. **While the FGD has a number of well developed features, some areas for improvement exist.** In particular, it is worth highlighting the following:

- The breadth of the financial techniques which can be made available by the FGD is in line with good international practices, but the triggers for FGD intervention need to be reconsidered. In the context of its interaction with the FROB, the FGD may financially support both non viable banks—intervened by the BdE and the FROB—and viable ones, undergoing a recapitalization process. Moreover, under its general framework, the FGD could adopt "preventive measures" targeted at entities whose viability is not (yet) compromised. The FGD interventions take place not at its full discretion but only upon the events prescribed by law and according to the information conveyed by the BdE, which validates an action plan. However, the fact that some of the early triggers for the FGD intervention are not linked to the non viability of an entity, coupled with some possible forms of support such as capital injections, raises concerns of a possible "open bank assistance". Such concern also derives from the lack of special resolution mechanisms in the Spanish regime, which may lead the FGD to financially intervene in a process that does not follow emerging best practices on resolution. Lastly, certain forms of intervention seem to overlap with the tasks of other agencies, such as the central bank liquidity support.

- The FGD intervention should focus only on facilitating bank resolution, thus ensuring an effective use of funds and continuity of banking services, and the mandate of the FGD should reflect such renewed focus. Subject to the least-cost test, the FGD financial support would be linked to the transfer of the ailing bank or of its business to a healthier institution or to a bridge bank, while the BdE retains the possibility to provide emergency liquidity assistance to a solvent but illiquid bank. Forms of liquidity support from the FGD may still be envisaged but in a resolution context, whereby, similarly to what the FROB does currently, the FGD could give loans to a troubled credit institution to assist in its orderly liquidation or to facilitate a smooth transition to a healthier acquirer.[10] Other financing techniques—such as

[10] The authorities pointed out that a liquidity support by the FGD would still be warranted in case of liquidity shortage, beyond the option of the ELA support by the central bank. However, the authors' view is

(continued)

recapitalizations, guarantees or purchase of doubtful assets—should, if maintained, be carefully designed to mitigate moral hazard concerns, for instance ensuring that shareholders are diluted and that the intervened bank is properly restructured. In light of the same concerns, capital support could preferably be given to a bridge bank and the possibility for the FGD to grant non-refundable contributions should be excluded as it may foster moral hazard.

- Consideration should be given to introducing depositor preference in the Spanish insolvency law. Typically, the rationale for depositor preference—which would extend to the FGD as deposit insurer—lies in the goal to reduce resolution costs for deposit insurance schemes (and therefore ultimately for the government) and to mitigate the risks of depositors' runs. Such a preferential treatment may also facilitate the implementation of certain resolution techniques such as purchase and assumption transactions, as it would be easier to transfer deposits to another institution: a creditor hierarchy distinguishing depositors from unsecured creditors could reduce legal challenges from those creditors left behind in the failed bank. The trade-off inherent in the introduction of depositor preference—such as the above mentioned arguments on the overall costs of resolution, on the one hand, and the effects on the structure, maturity and costs of bank funding, on the other hand—should be carefully considered.

- Governance arrangements should reflect the public policy objective pursued by the FGD. The Management Board of the FGD includes six active bankers, in practice representing the major institutions within each banking category. Information on resolution cases is sensitive when it concerns banks in competition since it might be unduly exploited by competitors and trigger or accelerate runs on the problem bank. Provisions for avoiding conflicts-of-interest preclude an FGD Board member to attend discussions concerning her own bank or another bank in which she or her bank is closely involved. Confidentiality safeguards are also in place, and no evidence of misconduct has been found. However, the concern still exists that active bankers represented in the Management Board may, given their position, take undue advantage of the information made available to the FGD. The augmentation of the FGD resources may also be blocked by banks' representatives, given the 2/3 majority necessary for approving extraordinary levies. The argument is often made that banks contribute to the resources of the FGD and therefore have a legitimate interest in the proper functioning of the FGD. While acknowledging this argument, the solution could be to have non-active bankers representing the banking sector, or to create an advisory council comprising representatives from the bankers association or other member-bank officials to address bankers' concerns.[11]

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that such forms of forms of liquidity support should fall only in the remit of the BdE. Any liquidity support by the FGD to solvent but illiquid banks would in most circumstances not be cost-effective since there is no guarantee that it will prevent the eventual resolution of the bank.

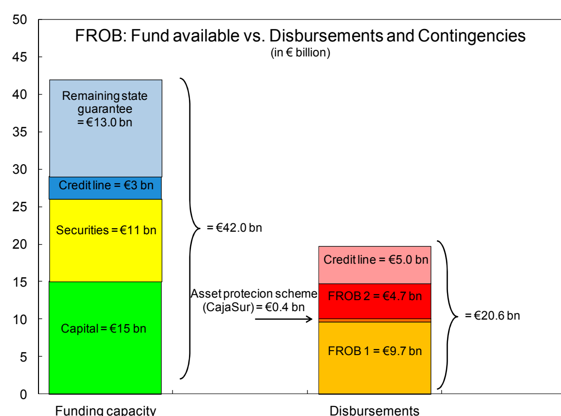
[11] Such argument holds more for the appointment of the administrators of a problem bank—that are indeed expected to "run a bank"—than for the governing bodies of a deposit insurance scheme. Changes in the

(continued)

- While the ex ante funding of the FGD is a positive element, an explicit backstopping from the state should be considered in the current circumstances. According to the law, the FGD is allowed to borrow from third parties, either private or public, should it find itself with insufficient funds to meet its obligations at any time. Building upon this existing legal authority, putting in place an explicit contingency credit line from the Government or from the FROB at a market rate would increase the stakeholders' confidence that the FGD will be able to fulfill its obligations also in the short term. Such loans would have to be repaid by the FGD members over the medium term.

E. Government Intervention: The Fondo de Reestructuración Ordenada Bancaria

30. **The objective of the FROB is to assist and foster the reorganization of the Spanish banking industry (RDL 9/2009).** The FROB has legal personality and full public and private capacity to implement its objectives. The initial capital of the FROB amounts to €9 billion, of which €2.25 billion were contributed by the FGD and the rest by the State. The FROB can issue securities guaranteed by the state (and/or it can seek other funding) up to three times its capital (€27 billion), but it can leverage up to 10 times (thus reaching a total capacity of €99 billion) with the approval of the MdH. With the recent RDL 2/2012 on cleaning-up financial sector's balance sheet, the capital of the FROB has been raised to €15 billion, though its total borrowing capability has remained unchanged.



31. **The FROB is administered by a governing committee named by the MdE.** The committee is formed by nine members (i) four are proposed by the BdE, including the Deputy Governor who acts as chairperson; (ii) two members representing the MdE and the MdH; and (iii) three members representing the FGDs (one for each component of the banking industry: commercial banks, (former) savings banks, and credit cooperatives). The members have a renewable term of four years. The governing committee presents a report to the Minister every four months. The Secretary of State for the Economy updates Congress on the activities of the FROB on a quarterly basis and every time there is a FROB action. The FROB is subject to external audit and to control by the *Tribunal de Cuentas* (Spanish Court of Audit).

32. **It is possible to identify three phases in the FROB activity.** The first one aimed mainly at the restructuring and consolidation of the savings bank sector and at the intervention on non viable institutions (FROB1). In the second phase, the objective of

governance setup could also facilitate cross-border cooperation with peers, as they would eliminate possible objections that can be raised on the exchange of information.

recapitalizing credit institutions was added (FROB2). The third phase, started recently with the new government's financial sector reform program, comes back to the objective of promoting consolidation in the sector, although through different types of financial support (FROB3).

33. **In the first phase, the main functions of the FROB were:** (i) to improve capital levels in "integration processes" among Spanish financial institutions through temporary capital support; and (ii) to manage the "restructuring processes" of Spanish financial institutions:

- The integration process was for fundamentally sound institutions that needed a temporary capital injection to support their merger or takeover plans, as approved by BdE. The beneficiaries were deemed to be fundamentally sound when they, according to BdE, did not present weaknesses that could affect their viability and had a core capital ratio of at least 6 percent.

- The restructuring process was directed at those institutions affected by significant weaknesses that jeopardize their viability. Should a market-oriented solution fail, the BdE would directly intervene in the weak institution and appoint the FROB as administrator and subsequently the FROB appoints its representatives. The FROB then devises a restructuring plan, to be approved by the BdE, which would outline the steps necessary to overcome the distressed situation. This could result in a merger with other solvent institutions, or the sale or transfer of its assets and liabilities through an auction process, among others. Support during the restructuring period could come in the form of guarantees, loans at favorable rates, subordinated debt, or acquisition of assets or capital injections.

34. **In the integration process, the capital injection by the FROB took the form of convertible preference shares.**[12] The FROB securities are considered core Tier 1 of the beneficiary institution under the Spanish legislation, slightly differing from the Basel concept, and carry an annual yield equal to the minimum between 7.75 percent and the 5-year Treasury bonds plus 500 bp. The rate is increased by 15 bp each year. The issuer is committed to repurchase the preference shares within 5 years.[13] If the time period expires and the issuer has not repurchased the preference shares, or if the BdE at any time consider the buy-back to be unlikely due to the financial condition of the bank or of its group, the FROB will convert the securities into ordinary shares (or its equivalent for the other credit institutions) and the restructuring process will be triggered.[14]

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[12] To allow the operability of the FROB in the case of savings banks (which are not commercial companies having shares), the law governing those institutions was amended to remove limits on individual holding of cuotas participativas (5 percent) and total amount of cuotas that can be issued (50 percent of capital), and to grant voting power to the cuotas issued in favor of the FROB.

[13] Exceptionally, the buy-back period can be extended for two more years at a penalty surcharge of 100 bp per year.

[14] So far, only the FROB securities issued in favor of Unnim have been converted into shares of the commercial bank (Unnim Banc) which was spun off from the savings bank.

35. **As agreed with the European Commission, the FROB support was subject to behavioral safeguards.**[15] In particular, the beneficiary institution was expected to (i) refrain from non-orderly growth (or downsize of at least 10 percent in case the FROB subscription exceeded the envisaged threshold of 2 percent of risk-weighted assets of the beneficiary institution which was nevertheless considered to be fundamentally sound); (ii) align managers' remuneration to the Commission recommendations;[16] (iii) enhance cost efficiency (in case of support in excess of the above-mentioned threshold); and (iv) cap (or refrain from) dividend distribution; and (v) refrain from implementing aggressive commercial policies. Should these safeguards be breached, the rate of FROB securities is increased by 200 bp.[17]

36. **In the second phase, the FROB operated as capital back-stop for Spanish banks.** As part of the extraordinary measures adopted to strengthen the Spanish financial system (RDL 2/2011, February 18, 2011), the minimum capital requirements were increased and the FROB was authorized to purchase shares in credit institutions. The price of the securities was determined according to the economic value of the issuing credit entity, as established by three independent experts appointed by the FROB. In order to benefit from the scheme, beneficiary institutions needed to draw up a plan, to be approved by the BdE, setting out the specific measures and commitments to be implemented in order to achieve increased efficiency and solvability, and agree on a number of behavioral safeguards. Moreover, the FROB was given the possibility to grant to the beneficiary institutions an option to repurchase FROB equity stake within one or two years. This option was agreed with two banks.

37. **In the new third phase, the FROB might contribute to a further round of banking sector consolidation by subscribing contingent convertible bonds (CoCos).** To allay market concerns on Spanish banks' capitalization, the government has recently raised provisions and introduced a capital buffer on banks' troubled exposure to real estate sector. Banks need to comply with the new regulation by end-2012. However, for those banks that present a merger plan by May 2012, which is accepted by the BdE, the deadline is extended until twelve months after the approval of the integration process. To support the consolidation, the FROB is allowed to subscribe CoCos issued by the beneficiary institution. Although the main characteristics of this new instrument (triggers and remuneration rates) will be decided by the FROB on a case-by-case basis, if a bank is not able to repurchase the issued CoCos by the envisaged 5-year period, the securities will be transformed automatically into equities.

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[15] If the FROB capital support exceeded 2 percent of risk-weighted assets, tighter conditionality would have applied, particularly in terms of divestment and dividend distribution. This limit was subsequently removed by the Commission.

[16] Commission Recommendation of April 30, 2009 on remuneration policies in the financial services sector. The recent RDL 2/2012 includes provisions on the remuneration for managers of banks receiving the FROB support.

[17] State aid N 28/2010 – Spain: Recapitalisation measures in favour of the banking sector in Spain (Brussels, 28.1.2010; C(2010)504 final).

Table 2. FROB Disbursements and Commitments

	FROB 1		FROB 2	
	(€ million)	date of approval	(€ million)	date of approval
Integration and capital support				
CatalunyaCaixa (Catalunya-Tarragona-Manresa)	€ 1,250	3/25/10	€ 1,718 1/	9/30/11
Unnim (Manlleu-Sabadell-Terrassa)	€ 380	3/25/10	€ 568 1/	9/30/11
España-Duero	€ 525	3/25/10		
NovaCaixagalicia (Galicia-Caixanova)	€ 1,162	6/29/10	€ 2,465 1/	9/30/11
Banco Financiero y de Ahorros (Madrid-Bancaja-Laietana-Insular Canarias-Ávila-Segovia-La Rioja)	€ 4,465	6/29/10		
Banco Mare Nostrum (Murcia-Penedés-Sa Nostra-Granada)	€ 915	6/29/10		
Banca Civica (Navarra-Cajasol-Guadalajara-General Canarias-Municipal de Burgos)	€ 977	12/22/10		
Intervention				
Asset protection scheme granted to BBK (takeover of intervened CajaSur)	€ 392	1/1/10		
Caja del Mediterraneo			€ 2,800 1/ 2/ € 3,000	7/22/11 (Credit line)
Banco de Valencia			€ 1,000 1/ € 2,000	 (Credit line)
TOTAL	**€ 10,066**		**€ 7,751**	

1/ Taken over by the FROB.
2/ On December 7, 2011, the DGF acquired the 100 percent of CAM for a total amount of €5,249 million, which includes the €2,800 million committed by the FROB.

38. **The FROB has played a crucial role in the consolidation of the Spanish financial sector (Table 2).** FROB 1 has provided financial support to seven integration processes, while FROB 2 has contributed to the recapitalization of three institutions (one of which had also received previous in the form of preference shares and was fully nationalized since it was at the end deemed unviable; in the other two FROB ended up holding a stake equal to more than 90 percent of equity capital). Two other credit institutions have been intervened and one (Caja del Mediterraneo) has been already auctioned to a commercial bank (Banco Sabadell).

39. **The FROB has followed a transparent approach and has enhanced professionalism in the current reorganization efforts.** Information has been publicly disclosed through the FROB web page; and the auction process has been evenhanded and open, according to participants. Lines of reporting to the Government and to the Parliament ensure accountability. The FROB has a roster of the individuals who are eligible to be appointed as administrators (at least three individuals for each bank) and conducts a selection process based on fit and proper criteria; it then closely oversees the administrators in coordination with the BdE.

40. **However, a number of issues arising from the FROB deserves to be considered**:

- FROB should manage weak institutions more pro-actively. Although minimizing taxpayers' costs and avoiding a generalized recapitalization of non-viable institutions are at the center of the authorities' strategy, there is a risk that the FROB may end up subsidizing weak institutions. The reliance of some institutions on the FROB assistance in more than one instance casts some doubts on the actual viability of those entities. Moreover, the option that was given to some beneficiaries to repurchase FROB equity stakes within one year may potentially affect a speedy resolution. This concern, however, has been mitigated by the recent RDL 2/2012, which has eliminated such option in case of future recapitalizations by the FROB.

- FROB should have the powers to allocate losses to creditors and shareholders. Currently, the FROB may, in its capacity of administrator of intervened banks, conduct measures within the normal sphere of the board of directors, but may not assume the powers of the bank shareholders. Therefore, the FROB cannot carry out purchase and assumption transactions which would empty the intervened bank,[18] or sell the shares in the bank, or conclude a merger. (See also Section F). These powers would be exercised under the direction of the resolution authority, identified along the lines suggested in Section H.

- More private sector involvement should be sought and ownership policies favoring exit strategies may need to be further elaborated. In principle, the FROB's capital support would be expected to be dovetailed by shareholders' capital injection of an equivalent (or close) amount, since mutually beneficial mergers should take place irrespective of that support. Also, the FROB may develop and publish ownership policies spelling how it will exercise its voting rights over banks - for instance to preclude banks from conducting aggressive market activities – and favor appropriate exit strategies.

- The functions of asset management may need more specific guidelines. In providing financial assistance, the FROB (as well as the FGD) can purchase nonperforming assets from weak credit institutions. Under the general principles provided by the law, the FROB must act in a transparent, competitive and non-discriminatory manner, ensuring an efficient use of public resources. Should the option of asset management be further pursued, more specific guidelines should be added in implementing regulations on the proper valuation and management of those assets purchased by the FROB (as well as by the FGD). The functions of recapitalization and asset management should not overlap.

- FROB corporate governance should be strengthened. As in the case of the FGD, the participation of active bankers on the FROB Board might in theory generate conflict-

[18] The FROB can transfer the whole deposits of an intervened bank to a sound institution; this operation would be funded with cash by the FROB itself.

of-interest situations when deciding on interventions in banks, though a number of safeguards on conflict of interests and confidentiality have been taken. A revision in the composition of the Board should therefore be considered. Attention should also be paid to ensuring that conflict of interest rules apply not only when a Board member has a direct interest in the institution concerned, but also when there is an indirect interest at stake (e.g. getting information about competitors).

F. Resolution Tools and Orderly Liquidation

41. **Under emerging international best practices, a toolbox including a wide range of resolution powers should be available to the authorities to manage potential problems and failures of banks.** Such powers should include the possibility to transfer in bulk some but not all rights, assets and liabilities, by allocating losses on shareholders and (left behind) creditors, as well as a bridge bank structure, i.e., a dormant vehicle typically owned by the State and having a temporary duration for acquiring the transferred assets and liabilities. Specific provisions are often needed to specify the rules governing bridge banks in the context of a resolution (e.g, to expedite the procedure that allows for their establishment and for the orderly continuity of activities transferred to them). Other resolution techniques include debt-conversion into equity, selected debt haircuts, and capital reorganizations such as capital increases, mergers or acquisitions. EU law constraints protecting certain shareholders' rights currently hinder a full use of the latter category of techniques, but the EU itself is in the process of drafting a directive on bank recovery and resolution, recognizing that the public interest inherent in cost-effective resolution may override certain protections in favor of shareholders. Several EU countries have adapted their legislation drawing a similar lesson from the crisis.

42. **Special resolution tools are lacking or insufficient in the Spanish framework.** When the BdE intervenes on a problem bank, it appoints the FROB or its own officials as administrators, who assume full managerial control of the bank. The administrators may sell limited portfolios of assets and could take other decisions falling within their managerial powers, but are not empowered to sell the whole business of the bank or very significant sub-sets of assets and liabilities. They could estimate the capital shortfall of a bank, but the formal re-establishment of the balance sheet, whereby losses are recognized and capital is written down, would require the existing shareholders' consent to be diluted: this could hinder any capital increase from new entrants. The bank business may be transferred by applying the legal instrument generally valid for the transfer of going concerns of commercial companies, which does not into account the specific needs arising when a troubled bank is at stake: as a consequence, the allocation of losses on categories of creditors may not be possible and all liabilities of an intervened bank are typically been passed on the acquirer. Lastly, the revocation of the bank license based on its insolvency triggers a court-administered process, which does not take into account that general insolvency laws are unfit to resolve banks and would require creditor consents for a series of restructuring transactions.

43. **The authorities should promptly improve their tools for resolving troubled banks, in line with emerging international best practices.**[19] A series of improvements seem highly necessary, and could be introduced both before and after the stage of license revocation. As regards the former stage:

- The public interest objectives of a resolution process and the tasks to be performed by the administrators should be clearly spelled out in the legislation. The administrators would not owe any fiduciary duty towards shareholders, but rather perform a public function aimed at assessing the bank's condition and at designing and implementing an appropriate course of action. Indeed, the diagnosis of the bank could lead to its restructuring, to the adoption of a resolution technique or to liquidation.

- The legislation should contemplate forced resolution options, including by overriding shareholders' rights. This is particularly crucial if systemic concerns arise. Options might comprise, for example, mandatory transfers of assets and liabilities, bridge bank, or prompt recapitalizations. Useful references can be drawn from the amendments introduced in several EU countries.

- The authorities should be able to allocate losses on creditors. The introduction of a "no-creditor worse-off principle" would allow differentiating among different classes of creditors; creditors "left behind with the failed bank" would receive adequate compensation to the – rare - extent they would have received more in a straightforward liquidation than in resolution. Such principle could also distinguish within a particular class of creditors, taking into account the different business lines of a failed bank: for instance, the acquirer may wish to take over only some of such business lines

- Coordination in the resolution of distressed groups should be enhanced. Consideration should be given to introducing mechanisms for procedural coordination in the resolution of distressed groups, whereby the authorities would take control of several entities belonging to the group, including the holding company. When insurance companies or securities firms are part of the group, a lead authority should be identified, while setting up forms of inter-agency cooperation. .

44. **Resolution should also be available once the license of a bank is revoked.** Currently, the revocation of a bank license based on its insolvency mandatorily initiates a court-based liquidation proceeding, with few special provisions applying to banks.[20] Nevertheless, the opening of a bankruptcy or liquidation proceeding should not exclude the deployment of resolution tools, particularly shortly after its commencement when value can still be extracted. Also, such stage could entail the transfer of assets and liabilities as a pool rather than on a piecemeal basis or other forms of restructurings. The

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[19] See also "Key Attributes of Effective Resolution Regimes for Financial Institutions", Financial Stability Board, October 2011.

[20] For instance, only the FROB is entitled to commence insolvency proceedings for those non-viable entities which have been intervened and where FROB has been appointed as administrator.

BdE or other appointed agencies (such as the FGD or FROB) could be given the exclusive authority to initiate and administer such process with *ex post* judicial review, with the possibility of compensation to the relevant parties.

45. **FROB should be allowed to use more rapid mechanisms to dispose of an intervened bank if systemic considerations arise.** While the current open auction process of intervened banks, managed by the FROB, is working well, the question arises as to whether in all circumstances resolution could be carried out through a public tender. Sometime there may be little time before extraordinary action is needed, such as in the case of a strong and persistent depositor run or when the failing institution is systemic: in these cases some forms of informal bidding could be pursued under strict confidentiality requirements. This could be also relevant when resolution mechanisms would entail losses on certain classes of creditors. In such circumstances, transparency should operate *ex post*, to ensure a fair process. The authorities may wish to retain flexibility as to the choice of option – i.e. open auction which may be protracted for months or informal bidding if severe market conditions exist; accordingly, they may choose one option also depending on whether financial stability is at stake.

G. Cooperation with Foreign Authorities and Organizations

46. **The BdE is empowered to sign agreements, cooperate and exchange information with foreign supervisory authorities, when warranted.** The exchange of information is aimed at an effective consolidated supervision and is subject to professional secrecy requirement requiring reciprocity, in case the foreign authority is not a EU member. The BdE may share information also with deposit guarantee agencies established in foreign countries, as well as with bankruptcy courts. In order to facilitate cooperation and the exchange of information, the BdE has concluded MOUs with a large number of countries in which Spanish banks are present, or whose banks are present in Spain.

47. **For the banks which also have substantial cross-border activities supervisory colleges have been established.** In addition, crisis management groups (CMG), in which the resolution authorities for the main countries are represented, are also envisaged. As earlier noted, certain CMGs discuss, for instance, the drafting of the recovery and resolution plans (RRPs).

48. **The Spanish legal framework could be revised to provide the underpinnings for coordination of resolution efforts with foreign authorities to the extent this is consistent with domestic financial stability.** Building upon the cooperative approach pursued by the Spanish authorities, the law could be amended to require such coordination with other jurisdictions where assets, branches or subsidiaries involved in the cross-border resolution process are established. However, the national authorities

would retain their discretion to act in furtherance of domestic financial stability, if they determine appropriate to do so.[21]

49. **Some clarification may be needed to address the treatment of branches in the resolution process.** This issue does not bear systemic relevance for the time being, also in light of the "stand-alone" approach followed by Spanish authorities and banks (see also Annex I). However, it seems appropriate to clarify how Spanish branches of foreign banks and foreign branches of Spanish banks could be resolved. Particularly for the former category, the authorities could dispose of the same resolution tools available to banking entities, complemented by the above described cooperation duties and taking into account the impact of their decision of financial stability in the home country.

H. Realigning the Spanish Bank Resolution Framework: Roles, Responsibilities, and Instruments of Financial Safety Net Participants

50. **There is a very strong nexus between the authorities involved in bank crisis management and resolution, in particular between the BdE, the MdE, the FROB and the FGD.** Cross-board membership in the respective governing bodies enhances coordination and the flow of information. In addition, some agencies have complementary roles. The MdE is not only responsible for legislation but also for secondary regulation which will guide BdE supervision and crisis management. The BdE may implement certain sanctions on banks, but the MdE has the sole powers to implement sanctions for very serious infringements, which may be the case when resolution measures are warranted.

51. **The practice of managing financial crisis has somewhat changed over time, reflecting also the systemic nature of the current crisis.** The trend seems to be that the FROB assumes an increasing role in the management of the intervened banks, while the FGD assumes any losses provided that the conditions set forth in the law are met. The FROB also conducts, with the assistance of external experts, the due diligence and sales processes of banks. The BdE maintains a key role since it has the supervisory and other knowledge about the individual banks as well as about the overall financial system. This knowledge will be used, for instance, to judge which banks that are viable or non-viable and hence which resolution methods to apply. Ultimately, the BdE is the "triggering authority" which assesses when a weak bank no longer can operate under normal conditions but needs to be intervened. Also the MdE and the MdH are active parties in resolution issues as they have an incentive to minimize the costs of restructuring the banking sector to the state budget. Simultaneously, the MdE aims to make structural changes in the sector, notably among the savings banks, in order to make it more effective and resilient.

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[21] See IMF, "Resolution of Cross-Border banks – A Proposed Framework for Enhanced Coordination," 2010.

52. **The downside of such nexus and flexible interaction may be, however, a lack of clarity on the division of roles for each agency.** It is worth highlighting some elements:

- The BdE may provide ELA to banks under certain conditions but also the FROB and the FGD may provide liquidity to (viable or non viable) banks.
- The BdE power to appoint provisional managers or "*interventores*"—typically, BdE officials—has been somewhat sidestepped by the appointment of the FROB as (temporary) administrator, which in turn appoints three executives taking over the management of the problem bank.
- Both the FROB and the FGD may provide capital to banks. They may also guarantee bank assets and bank borrowing, for instance through senior bonds, or acquire impaired assets from ailing institutions.
- FROB can finance the FGD, which in turn may support the restructuring process of viable banks or the intervention and resolution of non-viable ones. In practice, this may result in the FGD guaranteeing the FROB for the losses incurred.
- FROB can order the transfer of deposits held in intervened institutions and of a securities portfolio to other banks, without the depositors' consent. If it decides to do so, the FROB would then have to provide the necessary liquidity to the transferee bank(s), and would be subrogated into the depositors' rights vis-à-vis the intervened institution. This is equivalent to the situation of the FGD used its payout powers to covered depositors (although the FROB action might include also uncovered depositors).

53. **The respective roles and instruments available to the FROB and the FGD should be clarified, with the aim of avoiding any confusion on who bears the final financial responsibility for the measures taken.** There is significant overlapping between the functions of the FROB and those of the FGD, as the two institutions have to some extent similar tools for intervention in problem banks. The predominant role recently assumed by the FROB is somehow accompanied by the option that the FGD should pay for its losses, subject to the "least-cost test"; the option for the FGD to decline is not realistic in those cases in which the alternative is to let the bank go into bankruptcy, in which case the FGD would be responsible for payouts to depositors. However, the risk is to create a disconnection between the agency responsible for adopting restructuring and resolution measures and those bearing the financial burden: in particular, such disconnection should be avoided with respect to the restructuring measures, i.e. those concerning viable banks.

54. **The financing of the currently envisaged measures on the consolidation of the financial sector should ensure an equitable burden sharing between the public and the private sector.** Measures aimed at the consolidation of the financial sector, such as

those provided under the recent RDL 2/2012, will certainly imply financial and other benefits in the future but will lead to significant costs in the short and medium term.[22] The aim of minimizing the visible costs to the public purse will increase the financial burden on still viable and in many cases well managed banks, in addition to other demands from regulators and the markets. It seems appropriate that FROB (i.e., the Government) funds be used for structural measures regarding viable banks, such as for the consolidation of the savings banks sector. On the other hand, FGD funds, also given their private character, should be used only for non-viable institutions—which will not able to undergo the consolidation process—to financially assist in their resolution as a clear alternative to a pay-out in liquidation.[23]

55. **In a longer term, the authorities should realign and streamline the current resolution framework.** Such framework would build upon the strong coordination mechanisms existing in the Spanish regime and would preserve the improvements made in the recent cases of bank interventions, which have seen a speedier and more transparent action of the authorities. A renewed institutional framework could underpin the special resolution tools to be introduced, as described in Section F, and could be broadly set up along the following lines:

- The Government would preserve its role of overarching political entity in charge of safeguarding financial stability. In carrying out this mission, it will continue to rely on the specific expertise of the other institutions participating to the safety net. Through the MdE and the MdH, the government will be directly competent for any measure involving public expenditures, playing therefore a pivotal role when systemic stability is at stake and balancing through different instruments the various needs to reinforce the banks' equity position and to activate lending to the real economy. Conversely, the government should not involve itself in non-systemic cases. Many countries have concluded that political involvement in a failed bank, when not necessary, might have negative repercussions. For instance, it may lead to unwanted (and undeserved) political accountability for situations which the government could not affect.

- **The BdE would continue to act as the "triggering authority", and would be closely involved in the resolution process.** Indeed, in its supervisory and market operation capabilities the BdE is the best informed about pending problems in banks. It is also appropriate that the trigger is judgmental rather than fixed, so that measures can be taken timely and considering the specific situation of the bank concerned. In the course of the resolution process, the BdE would assess the various solutions being pursued in light of the safety and soundness of the banks involved. As to the precise

[22] Such law increases capital and provisioning requirements for banks having problematic exposures in real estate assets, and incentivizes a process of restructuring through mergers, whereby the FROB would subscribe for contingent capital instruments and sustain the equity position of the banks undergoing such restructuring.

[23] The credit line from the government to the FGD, recommended above in Section D, would concern only such latter category of institutions. In a similar vein, the provision entitling the FROB to pay out depositors upon their transfer to an acquiring institution should be revisited: the pay-out function is directly related to the premiums contributed by banks to the FGD.

identification of the resolution authority, there is no one size-fits-all solution. The EU consultation on bank recovery and resolution, in proposing a new Directive, correctly emphasizes that, regardless of the stance followed by member countries, appropriate safeguards need to be in place in the governance setup of the relevant agency. In particular, a distinction between the supervisory and resolution function would mitigate potential delayed actions and conflicts of interests.

- **The CESFI could be strengthened through a more structured and formalized decision-making process.** For instance, a follow-up process of its findings could be established through appropriate technical work streams. Ultimately, the CESFI would be the "platform" for the set-up of a macroprudential framework, by issuing recommendations on overarching issues of financial stability.

- **The intervention on the problem bank would be managed by appointing an administrator, similarly to what is now done with the FROB.** In the context of a coherent revision of the intervention and resolution framework whereby the FROB takes over the management of distressed entities, it may be advisable to remove the possibility of appointing BdE officials as administrators. These individuals appointed by the FROB in coordination with the BdE should benefit from the legal protection applying to BdE staff, since—while representing the management of the bank—they act as public officials. The alternative practice of appointing "interventores", who work alongside the directors while having veto powers over their decisions, may still offer some flexibility and gradualism in the intervention process.

- **The mandate and operations of the FGD and of the FROB could be simplified.** In line with emerging practices, deposit insurance funds could be complemented by a resolution fund, with pre-funded levies based on banks' non-deposit liabilities. While various options to explore the synergies between these funds are on the table, the overarching principle would be to draw from private resources first and making sure that the State will only need to act as the ultimate backstop.[24] Governance arrangements would reflect the public interest function of a renewed FGD/FROB; for instance, the composition of its governing bodies would balance *ex officio* members from the MDE, the MdH and the BdE with executives and/or other independent members appointed by the authorities, in a system of checks and balances. This system of checks and balances would complement the governance setup of the resolution authority, as described earlier.

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[24] This revisited set-up would dispose of a broad range of financing tools, including liquidity support in a resolution phase. Such support would clearly be distinguished from the ELA, and indeed one of the benefits of enhanced resolution regimes emerging under international practices is to avoid that ELA and forms of short-term financing provided by central banks be given to weak institutions. Appropriate safeguards need also to be in place in favor of deposit insurance or resolution funds providing financing support in a resolution. These may result in a special regime for the realization of the collateral (similarly to what the FROB and the BdE now enjoys), in a preferential right over the estate of the failed bank and/or in a cap on the maximum amounts provided relative to the assets or liabilities of the failed bank.

- **The judiciary would perform the essential role of ensuring ex post accountability of the decisions taken in the resolution process, while preserving the need for efficiency and cost-effectiveness.** Reflecting emerging international practices, the authorities are contemplating the possibility to limit the remedy available to successful claimants—including shareholders—to monetary damages, so that decisions taken to resolve a bank may not be unwound. The courts may also be prevented from staying any resolution measure (something which is already unlikely to happen, as the claimant would need to prove serious and irreparable damages if the stay is not granted. Further thinking may be needed to clarify the scope of discretion given to the authorities, so as to emphasize the principle of deference to their specialized regulatory expertise, while the courts would determine any abuse, misuse or excess of such discretionary powers.

ANNEX I: RECOVERY AND RESOLUTION PLANS

56. **The FSB has requested the presentation by all global systemically important banks (G-SIBs) in FSB member countries, hence including Spain, of RRPs before the end of 2012.** A first phase contemplates the preparation of a recovery plan that includes, inter alia, a set of contingency measures to be undertaken if a bank suffers problems in relation to its capital or liquidity.

57. **A recovery plan should be further embedded in the regular supervisory process**, **as many of the main items in the plan are similar to what is already included in normal supervision, such as the Internal Capital Adequacy Assessment Process (ICAAP).** The BdE guidelines on ICAAPs establish that the ICAAP of every bank will contain contingency plans for the case of unforeseen divergences or events between the capital plan and reality; this reinforces the point that there are close relations between RRPs and ICAAP. The supervisory framework of the BdE already integrates recovery and resolution planning but may need to be fully updated in order to ensure that all aspects of the RRPs are properly included in the ongoing supervisory processes. For instance, the analyses of the ICAAP and of the RRP should include common features and should be streamlined. The BdE intends also to follow the FSB recommendations on RRPs, including that there should also be a clear division of responsibilities so that the bank itself is responsible for the recovery part, and the BdE for the resolution part of the document.

58. **The resolution component should identify interdependencies between different parts of the relevant banking groups and the relation of various banking functions to the individual entities of the groups.** The "stand-alone" policy of the BdE, which encourages Spanish-owned cross-border banks to maintain subsidiaries abroad which are self-sufficient in capital and liquidity, could be expected to facilitate reorganization of a banking group, for instance since the foreign subsidiaries may not need intra-group support. The BdE is currently considering general issues in resolutions plans, such as which banking activities that should be deemed as "economically critical" for the Spanish financial market and clients, and hence should be protected in a restructuring situation.

59. **While it would be a natural priority for the Spanish authorities to focus on protecting the economically critical activities of the parent bank, at the international level there is still a need to obtain a global view of the resolution of the banking/financial group.** The discussion should include all countries in which the bank has significant activities; moreover, harmonization across different jurisdictions on the main contents, rationale and purpose of the RRPs seems highly advisable: while currently, responsibilities for RRPs stop at the domestic level as related powers are national-based, global harmonization is needed. For instance, one point is whether the RRP should be aimed more at informational purposes, or should directly prompt supervisory or resolution action.

60. **It is important that all forms of interdependencies are considered in the RRPs, for instance common service providers.** The stand-alone policy focuses on

capital and liquidity in bank subsidiaries. However, globally active banks often have other interdependencies, such as operational functions (e.g., IT services). Also these functions should be considered in the RRPs—and some RRPs already do so—in order to ensure that the remaining parts of the group may conduct its economically critical functions and to achieve one of the main objectives of a resolution, i.e., maintaining continuity of banking and financial services without disruption to the system. It is a common practice among banks worldwide to solve this issue by using independent service providers, and the RRPs are expected to regulate the fate of the relevant contracts in case of resolution.

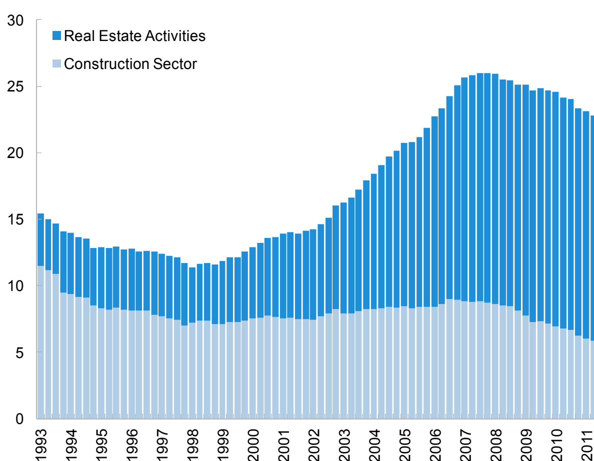
61. **The burden sharing issue remains unresolved.** While improvements in cross-border cooperation are highly welcome, the existence of colleges and CMGs as such will not eliminate conflicts in the incentives to share information on a failing cross-border bank. A systemically significant cross-border bank may likely need to be resolved by drawing from temporary public funding from the governments, with the net costs to be recovered later from the industry.[25] Formulae on ex ante "burden sharing" principles should be designed in a way to incentivize the sharing of information, so that supervisors representing different jurisdictions have an interest in the outcome of the institution as a whole. While burden sharing remain a challenge given differences across jurisdictions, the model of stand-alone subsidiaries could in principle facilitate resolution of large and complex financial institutions.[26]

[25] See IMF, SM/11/178, "Lessons from the European Financial Stability Framework Exercise".

[26] See also "Impact of Regulatory Reforms on Large and Complex Financial Institutions", others on Large and Complex Fina and others, IMF Staff Position Note, November 3, 2010.

ANNEX II: HANDLING IMPAIRED ASSETS

62. **Lending to the real estate sector grew exponentially in the decade leading up to the financial crisis.** Loans to real estate developers increased from less than 4 percent of total lending by credit institutions to the domestic private sector in the early-1990s, to reach a peak of almost 18 percent in 2009, when the housing bubble had already begun deflating. Since then, banks have sought workouts with distressed property developers, including effecting property-to-debt swaps. As of end-June 2011, total repossessed assets amounted to some €73 billion, most of which comprised land. The BdE reported that banks' troubled exposures (doubtful assets, foreclosures and standard loans under surveillance) amounted to about €176 billion, representing 52 percent of total loans to real estate developers and almost 18 percent of GDP.



63. **To deal with the problem of repossessed real estate assets, most Spanish banks have established separate units, or even subsidiaries.** Banks have recruited specialists, such as real estate experts, which manage, package and market the assets. In case of a separate real estate company has been set up within the same bank group, asset transfers take place at book value, after subtraction of existing provisions. BdE supervisors check that the same valuation principles are applied in the subsidiary as in the parent bank. Some banks are already selling significant numbers of real estate units, although at sharply discounted prices (30-50 percent). Private companies specialized in managing distressed assets have also entered into the market. However, the "inventory" of such assets is large and it would take some 7-10 years to sell all of them at present speed.

64. **The possible creation of a "bad bank" to carve out impaired real estate assets from banks' balance sheet has been a hot topic since the beginning of the crisis.** Following the example of other countries, some market analysts, practitioners, and academics have advocated the creation of a centralized asset management company (AMC), or bad bank, to remove from the balance sheet, manage and sell banks' repossessed assets. However, a number of factors militated against that proposal:

- The difficulties in determining a market price at which asset should have been transferred from banks to the AMC, given the lack of meaningful transactions, especially in the case of land.

- The upfront crystallization of losses for transferring banks.

- The implications for the fiscal deficit and government debt, since the AMC was supposed to be state-owned.

- The administrative difficulties as well as the potential for political interference.

The new government opted for a significant increase in provisioning to clean up banks' balance sheet and allay market concerns on the capitalization of Spanish banks.[27]

65. **Most banks also favor the individual bank approach rather than a "bad bank" approach.** The main arguments are:

- The repossessed asset is already adequately provisioned for and may therefore be sold without further loss for the bank.

- The bank originating the loan transactions has the best knowledge and control of the exposure, the specific real estate asset and of its customer and may therefore reach the best possible solution.

- By using external experts, the bank may optimize the sales and receive the best possible values. In a collective AMC, individual banks would not have control of their own assets and the sales process.

66. **While the current approach has its clear advantages, it does not fully remove the uncertainty on banks' balance sheet.** The strategy followed so far by Spanish banks meets two of the general arguments in favor of having an AMC, namely to handle assets effectively and to give managers more time to deal with core bank issues. However, a third reason is not met. By transferring assets to a third party, such as an independent AMC, the value of the remaining bank is easier to assess since there is less uncertainty about its potential future losses. Reduced uncertainty would presumably lead to more interest in the bank from investors and creditors. Transfers only within a bank group, which is consolidated for accounting purposes, do not reduce the uncertainty of the value of the group.

67. **While the creation of an independent state-owned AMC seems out of the table, the setting up of a collective bad bank owned by a number of savings banks/credit institutions has been suggested as potential alternative.** Such an AMC could be useful for a group of small banks or for a specific category of assets, such as

[27] Following the RDL2/2012, Spanish banks are required by end-2012 to:

- provision 60, 50, and 35 percent of their troubled exposure to land, unfinished and finished property, respectively (for some €25 billion);

- set aside an additional general provision of 7 percent on standard exposure to real estate developers (for €10 billion); and

- create an add-on capital buffer equivalent to 20 percent of their exposure to land and 15 percent of unfinished property (for €15 billion).

land. The member banks could contribute to the equity of the AMC, which would be the regulatory minimum for setting up a commercial company, according to some agreed formula. The AMC would then borrow from the market to fund its operations, if necessary supported by state guarantees. Any surplus or deficit of the AMC after having completed its sales would fall back on the contributing banks.

68. **The proposal has some useful features.** The prime advantage of a bank-owned collective AMC would be the lower management costs to deal with large amounts of assets (economies of scale). Furthermore, since several banks together will own the AMC, no individual banks will be regarded as having control of the institution and thus the assets need not to be consolidated with those of the parent banks. This will reduce the risk of further major losses to the parent banks and their attractiveness to investors should be enhanced by such improved transparency. It is obviously crucial for the credibility of the AMC that the transfers of bad assets are undertaken at market values, for instance valued by independent experts and in accordance with a common methodology.

69. **However, the design features of a bank-owned AMC and a thorough cost-benefits test will be critical to avoid a number of shortcomings.** Some banks emphasized the risk that they would have to take part in loss-sharing of less attractive assets transferred from other banks. It also remains to be determined who would be the investors interested in buying the AMC securities despite the government guarantee. Furthermore, since land is unlikely to be developed for several years, the AMC would probably record substantial operational costs resulting in losses for a prolonged period of time thus reducing the market appetite for the AMC securities. Lastly, the corporate arrangements of the AMC would need to be carefully considered, to ensure a strong independent management and to avoid mechanisms of joint control by the banks transferring their assets; at the same time, the corporate governance design of a centralized AMC should reflect the need for flexible and different management strategies based on the heterogeneous location of the troubled assets transferred to the AMC.

70. **In any event, the establishment of an AMC should be viewed in conjunction with special resolution mechanisms.** Indeed, such mechanisms would allow to take over or orderly wind down those institutions which are not able to cope with regulatory requirements after transfer of their assets at market value.

ANNEX III: AN OVERVIEW OF BANK INTERVENTIONS AND RECAPITALIZATION DURING THE CRISIS

Caja Castilla-La Mancha[28]

71. **CCM was a small savings bank with a market share in deposits and loans of around 1 percent.** During the credit spree, CCM embarked in a rapid expansion both in terms of lending and branch network. Excessive reliance on wholesale funding together with excessive loan concentration to the ailing real estate sector brought CCM to collapse. The deterioration in its liquidity condition started emerging in 2007, when the interbank market dried up, and was aggravated by the lack of ECB eligible collateral. Given the rapid increase in impairment and CCM's small operating profits, CCM's solvency ratio dropped to 1.26 percent and its capital fell below the minimum regulatory requirement as of end-2008.

72. **After approving ELA in February-March 2009, the BdE intervened CCM on March 28, 2009.** On April 27, 2009, the managing board of the FGD agreed to provide a €1.3 billion capital injection. While under intervention, CCM bought back at par retail preferred shares for €205 million and made payments on hybrid capital in 2009 despite it was loss-making in 2008.

73. **The search for a buyer of CCM was complex.** The process ended with an auction, and CajAstur's bid was considered the best offer and the cheapest for the FGD.

74. **The restructuring plan for CCM was structured as follows:**

- Banco Liberta, a subsidiary of CajAstur, acquired the banking business of the intervened CCM.
- In exchange for the assets transferred to Banco Liberta, CCM received 25 percent of the shares in Banco Liberta (which was rebranded Banco CCM) and transformed into a charitable foundation;
- The €1.3 billion capital injection by the FGD was offset by the transfer of certain assets of CCM, and part of the shares held by CCM in Banco Liberta were pledged in favor of FGD (indeed, the FGD has to realize such assets within a certain timeframe and a loss sharing mechanism operates between FGD and CCM, so that the pledge would be triggered in favor of FGD if needed).
- The FGD provided a five-year guarantee of €2.47 billion on losses exceeding €1.24 billion (first loss covered by provisions) of a €7.7 billion portfolio of impaired assets (mainly real estate developers). The guarantee is pre-paid in installments and the settlement will be made at the end of the five-year period.

75. **On June 30, 2010, 15 months after the intervention, the general assembly of CCM approved the restructuring plan.**

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[28] European Commission, State aid NN 61/2009 – Spain Rescue and restructuring of Caja Castilla-La Mancha, C(2010)4453, Brussels, June 29, 2010.

CajaSur [29]

76. **CajaSur was a small savings banks founded by the Catholic Church of Cordoba.** Like in the case of CCM, CajaSur expanded considerably its lending to the booming real sector over the 2002-07 period. The burst of the real estate bubble took a heavy toll on this small savings bank. The sizeable losses recorded in 2009-10 rapidly dented CajaSur's equity and its solvency ratio stood at 3.9 percent as of end-2009. In July 2009, CajaSur announced the beginning of merger negotiations with Unicaja. The plan, which included a €1 billion financial support from the FGD, was approved by the BdE. Merger negotiations lasted almost a year but were unsuccessful. In the meanwhile, the financial situation of CajaSur continued to deteriorate rapidly and the bank's capital was depleted.[30] On May 21, 2010, the Board of Directors of CajaSur rejected the intended merger with Unicaja. This triggered the intervention by the BdE, which removed CajaSur's Board and designated the FROB as administrator of CajaSur.[31] The FROB injected €800 million in *cuotas participativas*, which enabled CajaSur to meet its regulatory capital requirements and, having voting rights, allowed the FROB to take control over CajaSur's General Assembly.

77. **A tender procedure was launched and BBK presented the best bid.** All the assets and liabilities of CajaSur were transferred to BBK and CajaSur was liquidated. To preserve CajaSur's *obras social*, BBK decided to set up a separate foundation. Although the FROB offered an array of options to financially support the transaction, BBK bidded for a relatively small asset protection scheme: €392 million, paid up-front, against a loan portfolio of €5.54 billion. The whole process was completed in seven weeks.

78. **In March 2010, CajaSur made a coupon payment on its hybrid instruments, despite having reported net losses for the fiscal year 2009, which would have triggered a suspension.** CajaSur then suspended further payments.

Caja del Mediterraneo (CAM)

79. **CAM was Spain's fourth-largest savings bank and ninth largest financial institution by total assets.** Despite growing regional diversification, CAM's main activity remained concentrated in the regions of Valencia and Murcia, among the most affected by the economic crisis. Amid growing market concerns about CAM financial conditions, a *sistema institucional de protección* (SIP) was orchestrated among CAM, Cajastur, Caja Cantabria, and Caja Extremadura in May 2010. In June, the SIP was approved by the BdE and the FROB Governing Council agreed to provide financial support for €1.5 billion.[32] The integration involved the creation of a central credit

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[29] European Commission, State aid N 392/2010 – Spain; Restructuring of CajaSur, C(2010)7710, Brussels, November 8, 2010.

[30] As of end-June, 2010, CajaSur actually had negative equity (-€24 million).

[31] Subsequently, the Governing Committee of the FROB appointed three administrators, to exercise, on behalf of FROB, the appropriate functions and power as administrators of CajaSur.

[32] Given the subsequent breakout of the agreement, this financial support was never disbursed.

institution as the head of the group, and mutual solvency commitments among the member institutions. The new SIP was formed in late December 2010 with the provisional name of Banco Base.

80. **In the meanwhile, the financial situation of CAM deteriorated even further.** At end-December 2010, the savings bank had a problem loan ratio of 9 percent compared with 4.7 percent in 2009 and the 5.4 percent average for savings banks in 2010. In addition to the level of problem loans, CAM's non-earning assets (related to real estate acquisitions) represented 7 percent of the total loan book at year-end 2010, of which only 27 percent were provided for. This results in a high nonperforming asset ratio of 16 percent (problem loans plus real-estate assets).

81. **Reflecting CAM's weak financial conditions, on March 30, 2011, the Assemblies of Cajastur, Caja Cantabria, and Caja Extremadura rejected the segregation of their financial business to Banco Base.** As a result, the SIP of Banco Base was dissolved and the four cajas in the group (including CAM) began to operate independently. CAM was forced to find an alternative solution to complying with new minimum regulatory capital requirements, and on 11 April 2011 presented a recapitalization plan to the BdE, including a request for €2.8 billion from the FROB to bring its core capital ratio up to 10 percent.

82. **Given the growing uncertainty over CAM's future, the bank started suffering a significant deposit outflow.** The development of the plan was objected by the BdE and a new plan was required. The Boards of Directors of CAM and of Banco CAM requested the intervention of the BdE and the replacement of its directors by the FROB. The FROB had to intervene in two stages. Given Banco CAM request of a €2.8 billion capital injection and the need to value the FROB investment on market terms, indeed the FROB had to (i) write down CAM equities in Banco CAM; (ii) approve the issue of new equities, which were eventually subscribed by the FGD, thereby becoming the only shareholder of Banco CAM. . The FROB also granted a credit facility for a total of €3 billion.

83. **Seeking for a market solution was hindered by the continuous deterioration of CAM financial conditions.**[33] Banco Sabadell remained the only bidder.

84. **The acquisition by Banco Sabadell was structured as follows:** [34]

- The FGD acquired the 100 percent of the capital of Banco CAM for €2.8 billion and agreed to an additional capital injection of €2.4 billion (up to a total capital investment of €5.2 billion).

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[33] In the first nine month of 2011, CAM posted net losses of €1.73 billion, compared to a net profit of €142.6 million booked the year before; the nonperforming loan ratio jumped to almost 21 percent compared to 5.2 percent a year earlier.

[34] Banco Sabadell, Hecho Relevante (CNMV) N.154500, December 8, 2011.

- The FGD sold CAM to Banco Sabadell for €1.
- The FGD granted an asset protection scheme on a €24.6 billion troubled loan portfolio whereby the FGD bears 80 percent of the losses exceeding €3.8 billion (first loss equivalent to the accumulated provisions) that can be incurred over a period of 10 years.[35]
- The FROB took on certain contingent commitment to ensure liquidity support.

Banco de Valencia

85. **Banco de Valencia (BdV) is a small commercial bank, which is 27.3 percent owned by Banco Financiero y de Ahorro (the parent of Bankia) through one of its participants, Bancaja Inversiones.** As a result of a BdE inspection, a capital shortfall was detected. The bank announced that it could carry out a €60 million capital increase but it highlighted that this was not enough to cover the bank's capital need. The attempts of BFA-Bankia to sell its subsidiary were unsuccessful and the efforts to agree on a capital increase with BdV shareholders were inconclusive. In light of the slow progress in taking the necessary measures to ensure the bank's viability, the BdE replaced the directors of BdV with management from the FROB on November 21, 2011. At the same time, the FROB Governing Council committed to inject €1 billion of capital and to provide a €2 billion credit line.[36]

86. **This has been the first intervention by the FROB into a commercial bank.**

CatalunyaCaixa, NovaCaixaGalicia, Unnim

The nature of the FROB involvement in these three institutions, which resulted from the integration of a umber of savings banks, is different because it aimed at strengthening the capitalization of entities deemed viable. Following the adoption of new minimum capital requirements,[37] the BdE estimated the capital shortfall in each institution. Banks had to present their recapitalization plans by end-March 2011. In submitting their plans, the three groups indicated the intention to request FROB capital support if other options, such as integrating with another institution, failed.

87. **In order to carry out the capital injection from the FROB, the three institutions segregated their banking activity into newly formed credit institutions.** On September 29, 2011, the Governing Committee of the FROB approved the final valuations and the capital injections for the three entities. As a result, the FROB ended up

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[35] This implies that expected losses equal to 83 percent of the portfolio would be fully covered.

[36] BdV reported a net loss of €887 million in 2011, compared to a profit of €67 million in 2010, thus reducing the capital-to-asset ratio to only 1.6 percent from 5.4 percent a year ago.

[37] The RDL 2/2011 requires that all the groups and institutions operate with a principal capital ratio of at least 8 percent. This ratio rises to 10 percent for those groups and institutions that have not placed at least 20 percent of their share capital or voting rights with third-party investors and whose percentage of wholesale funding, moreover, exceeds 20 percent.

holding 90 percent of the share capital of Catalunya Banc, 93 percent of NovaCaixaGalicia Banco, and 100 percent of Unnim Banc (which was deemed however unviable). This latter has been recently auctioned, while for the other two institutions the FROB granted to the shareholders (i.e., the savings banks) the option to repurchase FROB equity stake within one year.

Key Issues

88. **While acknowledging the progress made over time and the difficulties of taking resolution measures in the current distressed market conditions, the above mentioned cases prompt the following considerations:**

- The attempt of first finding a private sector solution, although commendable, was difficult given market circumstances, but might have in some cases delayed the resolution of weak banks and may have lead to higher resolution costs.
- The reliance of some institutions on the FROB assistance in more than one instance casts doubts on the actual viability of those entities.
- There have been no cases of winding down banks, which could instead serve as a disciplinary device in a crisis.
- The strategy of transferring the whole business activity from weak to healthier institutions may raise issues of moral hazard. In addition, it is difficult to adopt such strategy when shareholders rights are protected.
- In some cases, not having imposed losses on holders of hybrid securities raises doubts on the actual loss absorbing capacity of those instruments.

89. **The systemic crisis environment has made difficult or not feasible to perform certain actions such as imposing losses on creditors and winding down banks.** Moving beyond, the introduction of resolution tools, including the ability to write down equity in distressed institutions, will be instrumental to ensuring prompt action in addressing problem banks and to minimizing resolution costs.