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New banking crisis management framework in Spain

INTRODUCTION

On 31 August 2012, the Spanish government approved Royal Decree-law 24/2012 on the restructuring and resolution of credit entities, which is the third substantial reform on the financial system since the People's Party (*Partido Popular*) took office at the end of 2011. The reform, among other things, aims to implement some of the agreements reached with the Eurogroup in the Memorandum of Understanding made public this summer. While the first and second reforms focused mainly on increasing coverage of real estate "legacy" assets through loan losses provisions, the new reform comprehensively amends the crisis management framework of credit institutions in Spain advancing some of the emerging European regulations on banking crisis management.

The new Royal Decree-law introduces a wide range of novelties in the Spanish banking regulations. For example, new resolution tools such as the bridge bank or the sale of business available to the administrative authorities; a new burden-sharing scheme, where subordinated creditors will assume part of the banking crisis costs; or a newly-created asset management company which will acquire the legacy assets from the restructured and resolved banking institutions. In addition, Royal Decree-law 24/2012 has also been designed to introduce certain rules in the Spanish regulations developing the commitments agreed with the Eurogroup in the Memorandum of Understanding; among the most noteworthy are the determination of a 9% ratio of core capital (*capital principal*) for any banking institution within the Spanish financial system, and the reform of the Deposit Guarantee Fund.

PHASES OF THE CRISIS MANAGEMENT PROCEDURE

The new Spanish banking crisis management system is structured around three very different phases:

- The first phase (called "early intervention" phase) comes into play when its measures are applied, thus is more a preliminary phase than a real phase of the crisis management of credit institutions. Early intervention measures will apply to institutions that breach, or are likely to breach, solvency, liquidity, organisational structure or internal control requirements, provided that it is foreseeable that such institution will be able to overcome the situation by its own means. Any credit institution under this situation will have to file a recovery plan with the Bank of Spain with a strategy to achieve long-term viability without public financial support. The measures contained in the recovery plan must be executed within three months following its approval by the Bank of Spain (unless it grants a longer term). Although the *Fondo de Reestructuración Ordenada Bancaria* (Fund for Orderly Bank Restructuring , "FROB") has been chosen as the resolution authority in Spain and as such has been granted wide powers, the characteristics of the early intervention measures entail that the Bank of Spain, as supervisory authority, plays a more important role during this phase. Among the range of measures available, the power to temporarily and provisionally replace the management body of the institution and the capacity to require in exceptional cases the recapitalisation of the institution by the issuance of publicly-underwritten contingent capital, are particularly relevant.
- The second phase includes the "restructuring" of the institutions as a going concern, and will apply to institutions that require public financial support to ensure their viability but can be objectively considered as being able to repay the support within the periods of time granted (mainly buy-backing or redeeming convertible instruments or shares subscribed by the FROB within five years). In addition, in exceptional cases unviable institutions may be restructured when their resolution may have systemic consequences for the financial system. The measures applicable in this second phase aim to ensure the long-term viability of institutions and include, among others, public financial support from the FROB, as well as the transfer of assets and liabilities to an asset management company and the subordinated management exercises as described more in detail below. All the applicable measures will be included in the restructuring plan that the credit institution must prepare and file with the Bank of Spain and the FROB. As with recovery plans, restructuring plans must be executed within three months following their approval by the Bank of Spain (unless it grants a longer term).
- "Resolution" is the third and final phase of the Spanish crisis management framework and will apply to those institutions considered "unviable", but which insolvency would be detrimental to the general public interest. It is worth noting that this is the first time that a definition of "non-viability" is provided in Spanish regulations and it is consistent with European proposals. Once the Bank of Spain decides to initiate the resolution phase, which it may do at its own initiative or at the FROB's request, the FROB will draft a resolution plan for the institution or establish the need to start insolvency proceedings. Moreover, if the FROB does not already control the credit institution's management body, a substitution of the management body will be agreed. The regulation provides the following resolution tools: (i) the sale of business (by transferring either its shares or all or part of its assets and liabilities, without

the consent of the shareholders or any other third party being required for any event); (ii) the transfer of the institution's assets and liabilities to a newly created bridge bank; or to (iii) an asset management company; and (iv) the granting of public financial support. These resolution tools are clearly inspired in the European directive proposal on the crisis management of credit institutions, except for the bail-in tool, which is not foreseen in the Spanish crisis management framework. Nevertheless, the liability management exercises available not only in the resolution phase but also in the restructuring phase can be considered to have the same effect, at least when it comes to hybrid instruments. The FROB is entitled to use any of these tools individually or all or some of them simultaneously depending on the situation and the needs of the credit institution in question. In addition, the FROB, as national resolution entity, has been granted unprecedented wide commercial and administrative powers to make the implementation of the abovementioned tools easier.

SUBORDINATED LIABILITY MANAGEMENT EXERCISES

The subordinated liability management exercises are one of the milestones of the burden sharing scheme under the new Spanish crisis management regulations. Firstly, note that not all creditors can be affected. According to these new regulations, ordinary creditors cannot absorb losses by the subordinated liability management exercises and only hybrid instruments (ie, preferred shares (*participaciones preferentes*), perpetual and dated subordinated debt and mandatorily convertible subordinated debt) may participate in them. In any event, the implementation of these exercises must respect, in general terms, the insolvency ranking of these instruments.

Two types of measures for the management of hybrid instruments are foreseen: (i) management measures that institutions must include in their restructuring and resolution plans in order to ensure burden sharing but which acceptance is voluntary for the security holders; and (ii) measures that the FROB may impose and which will be binding on both the institution itself and the security holders. Among the voluntary measures that institutions can include in their restructuring and resolution plans as part of the subordinated liability management, the Royal Decree-law foresees: (i) exchange offers for equity instruments; (ii) pure repurchase offers or those for its mandatory reinvestment in equity instruments or other banking products; (iii) reduction of the nominal value of the securities; or (iv) early redemption below par value.

These measures must be settled in accordance with the current market value of these instruments and by applying the premiums or discounts established in EU rules on State aid (in this regard, institutions must take into account the explanatory note published by staff of the European Commission's Directorate-General for Competition on 13 June 2012 that caps buy-back prices up to the market value plus 10% of the instrument's face value).

In addition to the voluntary measures, the FROB may order credit institutions under restructuring or resolution to carry out mandatory exercises of management liabilities that, as mentioned previously, will be binding on both the credit institution and the security holders. The mandatory exercises of management liabilities include: (i) the postponement, suspension, extinction or amendment of certain rights, obligations, terms and conditions of all or some of the institution's issues; (ii) the institution's obligation to repurchase the affected securities, and that of the investors to sell them, at the price set by the FROB, which may not exceed the market price (it may be stipulated that the price must be reinvested in equity instruments); or (iii) any other management action that the institution may have taken voluntarily. It is worth highlighting that these measures and their implementation cannot be considered a breach of contract or the early termination of any other obligations with third parties (ie, they avoid cross-default clauses).

BAD BANK

Following the example of Ireland, the Royal Decree-law also establishes the basis for the future asset management company, the "bad bank" of the Spanish financial system. The fact that a systemic bad bank has been chosen to lead the Spanish crisis management reflects the nature of the Spanish financial crisis, which is linked to a deterioration of the bank's real estate exposures.

Although most of the bad bank's legal framework is pending further regulation, it has already been established that the FROB may order institutions in a resolution/restructuring situation to transfer their "legacy" assets (which may be transferred together with liabilities) to an asset management company. This asset management company will be incorporated initially by the FROB, although the Deposit Guarantee Fund, the credit institutions and other financial institutions may also become shareholders. It must be clarified that only restructured and resolved banks must transfer the legacy assets to the asset management company created by the FROB; "healthy" credit institutions are free to manage their legacy assets at their own discretion through their own asset management entities.

As mentioned above, the particulars shaping the Spanish bad bank are subject to further regulation. Matters with undoubted relevance such us the types of assets to be assigned to the bad bank, the methods of payment of the purchase prices or the financing structure of the bad bank need to be clarified in the developing regulations.

CONCLUSION

This new regulation modernises and upgrades the Spanish crisis management framework by introducing further respect for market discipline. The Royal Decree-law introduces through the Spanish crisis management framework the proposed European regulations on the crisis management of credit institutions currently emerging in the European Union, including some of the concepts already tested in other jurisdictions, such as the bridge bank and the bad bank. However, there are significant differences between the proposed European crisis management directive and the Spanish regulation. The bail-in tool is not regulated under the Spanish Royal Decree-law nor are privately financed resolution funds referred to in the European directive proposal. And vice versa, the Spanish regulations contain some novelties such as a commitment to the systemic bad bank and to the subordinated liability management exercises. ■