EUROPEAN CENTRAL BANK

EUROSYSTEM

OPINION OF THE EUROPEAN CENTRAL BANK

of 9 January 2013

on early intervention, restructuring and resolution of credit institutions

(CON/2013/3)

Introduction and legal basis

On 21 August 2012, the European Central Bank (ECB) received a request from the Under-Secretary of the Spanish Ministry of Economic Affairs and Competitiveness for an opinion on a draft Royal decree-law (hereinafter the 'Royal Decree-Law') that establishes a comprehensive regime for the restructuring and resolution of credit institutions (hereinafter 'CIs').

The Royal Decree-Law was approved on 31 August 2012 by the Council of Ministers and was then submitted to the Parliament to be processed as an ordinary law, allowing amendment prior to its final approval by the Parliament.

The ECB's competence to deliver an opinion is based on Articles 127(4) and 282(5) of the Treaty on the Functioning of the European Union and on the third and sixth indents of Article 2(1) of Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions[1], as the Royal Decree-Law relates to the Banco de España and to rules applicable to financial institutions insofar as they materially influence the stability of financial institutions and markets. In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council has adopted this opinion.

1. Purpose and contents of the Royal Decree-Law

The Royal Decree-Law establishes an innovative and comprehensive framework for early intervention, restructuring and resolution processes for CIs. It also modifies the legal regime for the Fund for Orderly Bank Restructuring (FROB) and the conduct of management activities of hybrid capital instruments and subordinated debt.

The main objectives of the Royal Decree-Law are: (a) to ensure the continuity of systematically important activities of CIs, as well as systems for payment, set-off and liquidation; (b) to avoid harm to the stability of the financial system, preventing contagion to the financial system as a whole; and (c) to minimise public financial support.

1 OJ L 189, 3.7.1998, p. 42.

Intervention is based, *inter alia*, on the following principles:

(a) shareholders, stakeholders or partners will first bear losses;

(b) subordinated creditors will absorb losses after shareholders, in accordance with the hierarchy of creditors established under Law 22/2003 of 9 July on insolvency (hereinafter 'Law 22/2003')[2];

(c) creditors of the same rank will be treated equally;

(d) no creditor will bear losses greater than those it would have borne if the entity had been liquidated as part of an insolvency procedure. For the purposes of ensuring an adequate distribution of the restructuring or resolution costs, the FROB is not included as a shareholder, stakeholder, partner or creditor.

All interventions will be based on a valuation of the CI or of its assets and liabilities by independent experts. In the valuation process, the actual or potential financial support received or to be received by the CI will be disregarded.

1.1 *Early intervention measures*

Early intervention measures apply where a CI cannot meet requirements on solvency, liquidity, organisational structure or internal control, but is in a position to be able to comply again with requirements without support. Early intervention measures are considered to be supervisory measures, and therefore fall under the responsibility of the Banco de España. Where a CI cannot meet the above requirements, it must present to the Banco de España, or the Banco de España may request, an action plan describing the measures that it intends to adopt to guarantee its long-term viability without public support. The Banco de España must then approve the action plan and may require amendments. Among the early intervention measures that the Banco de España may adopt, such as calling a shareholders meeting, or requiring the renegotiation of debts, are recapitalisation measures that must be approved by the FROB. These measures relate to shares or convertible securities repayable or convertible within two years. If the measures are not sufficient, the Banco de España may order the replacement of the Board of Directors of the CI.

The CI must report to the Banco de España every three months on measures taken under the action plan. If the CI recovers from its 'deterioration' situation, the Banco de España will conclude the process of early intervention. However, the Banco de España will move to open a restructuring or resolution proceeding in the following situations: (a) where a CI is unable to recover from its 'deterioration' situation; (b) where no action plan is presented; (c) where the CI is not viable or does not comply with the early intervention measures.

1.2 *Restructuring of a CI*

A CI will be restructured in the following situations: (a) where it requires public funds to guarantee its viability; (b) where objective criteria indicate that such support from public funds will be repaid or recovered within a fixed period; (c) in the absence of such objective criteria, where the orderly resolution

2 *Ley Concursal*, BOE 164, 10.7.2003.

of the institution would have seriously damaging effects on the stability of the financial system as a whole, as determined by the Banco de España (i.e. where the CI is systemic in nature).

The CI must present a restructuring plan to ensure its long-term viability and this plan must be approved by the FROB and ultimately by the Banco de España. The plan must contain management actions for hybrid capital instruments and subordinated debt, as well as the instruments for restructuring. The CIs may use financial support measures and may transfer assets to an asset management company (AMC).

Provided that the conditions for resolution are met, the Banco de España may commence resolution in the following situations: (a) where the CI is unable to recover from its 'deterioration' situation; (b) where financial support has not been repaid within the deadline; or (c) where there are implications for the stability of the system.

1.3 *Orderly resolution*

Orderly resolution will be implemented where: (a) a bank is non-viable or is expected to become so in the future; and (b) for reasons of public interest, it is necessary or advisable to proceed to its orderly resolution.

A resolution will also be applied in the following circumstances: (a) where a CI subject to a restructuring process has not presented a restructuring plan; (b) where a plan which has been presented is inadequate; or (c) where a CI fails to apply the restructuring measures.

For the purposes of resolution, a CI will be considered non-viable if: (a) it significantly fails to meet solvency requirements; (b) its liabilities exceed its assets or it is reasonably foreseeable that they will do so in the near future; (c) it cannot meet its obligations promptly or it is foreseeable that it will not be able to do so in the near future; and (d) it is not reasonably foreseeable that the CI in question will be able to alter its situation within a reasonable period whether by its own funds, by going to the markets or by a restructuring.

The Banco de España will inform the Ministry of Economic Affairs and the FROB about any resolution process it launches, and will replace the Board of Directors of the relevant CI with persons appointed by the FROB. Within two months the FROB must present a resolution plan setting out: (a) the conditions justifying the resolution process; (b) the resolution tools to be used; (c) the financial support measures provided by the Deposit Guarantee Fund (DGF); (d) an economic assessment of the relevant CI; (e) any actions for the management of hybrid capital instruments and subordinated debt to be performed; and (f) the time frame for the execution of the plan. The plan must be approved by the Banco de España.

1.4 *Resolution tools*

(a) Sale of business of the CI: this tool allows the FROB to sell shares, assets or liabilities of the CI without the shareholders' consent. The sale will take place under market conditions, in a competitive process and will exclude costs incurred by the FROB.

(b) Bridge bank: the FROB may transfer all or part of the assets and liabilities of a CI to a bridge bank participated in by the FROB. The bridge bank will be subject to supervisory rules, and will exist for a maximum duration of five years. When all assets and liabilities of the bridge bank have been transferred to another institution, or if the FROB no longer participates, the bridge bank will lose its

banking licence and will be liquidated through an insolvency procedure within one year from the FROB's divestment.

(c) Financial support measures: the measures described under 1.5 below shall be granted, where necessary, in order to facilitate the implementation of any of the other resolution tools.

(d) AMC: this resolution tool is described under paragraph 5 below.

The tools under (a) to (c) above can be accelerated in urgent cases, with the prior approval of the Banco de España. To this end, the FROB can use an urgent valuation system, which dispenses with independent expert reports.

1.5 *Financial support measures*

The following financial support measures may be provided by the FROB: (a) the issuing of guarantees; (b) the granting loans or lines of credit; (c) the acquisition of assets or liabilities; or (d) recapitalisation using either (i) ordinary shares or share capital contributions; or (ii) instruments convertible into ordinary shares or share capital contributions (CoCos), which will be repaid under market conditions, or converted within five years or earlier, if the FROB considers repurchase within the specified period improbable.

The shares or CoCos provided by the FROB will be treated as basic equity and principal capital. The subscription or acquisition price of those shares or CoCos may be paid in cash or through the transfer of securities representing public debt, issued by the European Financial Stability Facility or the European Stability Mechanism, or issued by the FROB itself.

1.6 *AMCs*

The FROB may oblige a CI to transfer to an AMC particular categories of toxic or potentially harmful assets, so that such assets can be excluded from the institution's balance sheet and can be independently disposed of. The AMC will be a limited liability company and may issue bonds and debt securities. The transfer of assets to the AMC will not require third party consent, and will be based on a valuation pursuant to criteria to be established by a regulation.

1.7 *Management of hybrid capital instruments and subordinated debt*

The Royal Decree-Law allows liability management in the context of restructuring and resolution of hybrid capital instruments and subordinated debt to ensure a proper distribution of the costs for the restructuring or resolution of the institution. The Royal Decree-Law establishes a two step process.

Step one represents a voluntary offer conducted with the holders of hybrid instruments and subordinated debt. This voluntary offer can be made by way of: (a) exchange offers for other capital instruments; (b) repurchase offers; (c) reduction of nominal value; or (d) advance amortisation at a different value.

Step two represents a coercive regime under which the FROB will be authorised to enforce mandatory burden sharing. The coercive regime can be conducted by way of: (a) deferment, suspension, elimination or modification of certain rights, obligations, terms and conditions of the issues; or (b) repurchase of the securities at a price determined by the FROB. The Royal Decree-Law contains appropriate safeguards, a no worse-off principle and allows for the ex-post judicial review of the liability management exercise. To evaluate the management activity, the FROB must take into account criteria such as, *inter alia*, the

proportion represented by the hybrid capital and subordinated debt with respect to the CI's total assets received, the amount of public aid received by the CI, the market value of subordinated instruments or the capacity of the CI to attract market resources.

The subordinated debt and hybrid capital subscribed by the FROB will be exempted from the management activities.

1.8 *FROB*

1.8.1 The FROB will implement the restructuring and orderly resolution processes. Under the Royal Decree-Law its powers are enhanced and its legal structure is modified. It will be financed by the State general budget, although the Royal Decree-Law does not provide for a specific amount.

The FROB's Board will be composed of nine members, four of which are appointed by the Banco de España. The remaining five will be high-ranking officials from the Ministry of Economic Affairs and the Ministry of Finance. In the absence of a conflict of interest, observers may attend board meetings.

The FROB is subject to parliamentary oversight on a quarterly basis, and must inform the Parliament whenever it implements a restructuring or resolution plan. The FROB is also subject to secrecy obligations, but must cooperate with other national and international authorities involved in the supervision, restructuring or resolution of CIs.

1.8.2 The FROB will enjoy commercial and administrative powers. The FROB's use of resolution powers will not be subject to any further authorisation, and its decisions will enter into force immediately. The FROB will make public the implementation of resolution and restructuring measures. It may also suspend certain payment obligations or guarantees derived from contracts.

The FROB's decisions may be challenged before the commercial courts or the Administrative Branch of the National Audience, depending on their nature. The Banco de España's decisions confirming the restructuring or resolution plans proposed by the FROB may also be challenged before the Administrative Branch of the National Audience.

1.9 *Other measures*

The Royal Decree-Law contains other miscellaneous provisions, including on:

the legal structure for the AMC, with the details to be established by a regulation;

the trading of preferred shares, convertible debt securities and subordinated financing, whereby at least one half of these securities must be addressed to professional investors and a minimum investment of EUR 100 000 will be required; and

the requirements of core capital for CIs are amended to a general requirement of 9% from January 2013. The definition of core capital is amended and harmonised with the definition provided by the European Banking Authority.

2. General observations

2.1 The Royal Decree-Law is a complex and innovative piece of legislation adopted in the context of the Memorandum of Understanding on Financial Sector Policy Conditionality for Spain[3] (hereinafter the 'MoU'), and in the context of the on-going restructuring and recapitalisation of the Spanish banking sector. The Royal Decree-Law will strengthen the framework for early intervention, restructuring and resolution measures, as well as the Subordinated Liability Exercises (SLEs) over holders of hybrid capital instruments and subordinated debt[4].

2.2 The ECB welcomes the introduction of a comprehensive bank resolution framework which aims at safeguarding the financial soundness of CIs, the interests of guaranteed depositors and the stability of the financial system. This opinion suggests some technical improvements to the overall good quality of the Royal Decree-Law.

2.3 The ECB understands that the enactment of a legal framework on bank recovery and resolution is somewhat complicated due to the absence of a stable legislative proposal at Union level, and invites the consulting authority to review the content of the law in the light of the future Union regulatory framework on bank recovery and resolution, in particular with regard to resolution tools and the powers of resolution authorities, and of the forthcoming recast of Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes[5]. The same applies with respect to the development of a single supervisory authority in the coming months.

3. Role of the Banco de España

The Banco de España plays an extensive role in intervention for CIs under the Royal Decree-Law. It will adopt and implement early interventions. It will also determine the systemic nature of a CI, thus allowing for its restructuring where there are financial stability implications. It may trigger the resolution process and may be involved in the use of some resolution tools, such as the AMC, where it fixes the value attributed to the assets for transfer purposes in accordance with the expert valuation report.

The ECB understands that the tasks allocated to the Banco de España under the Royal Decree-Law do not interfere with the performance of its Eurosystem-related tasks provided for by the Treaty and do not prejudice the financial means necessary for carrying out the Banco de España's Eurosystem-related tasks[6]. Any involvement of the Banco de España and of the members of its decision-making bodies in measures to strengthen financial stability must be compatible with the Treaty and, consequently, with the Banco de España's institutional and financial independence, as well as with the personal independence of the members of its decision-making bodies safeguarding the proper performance of their tasks under the Treaty and the Statute of the European System of Central Banks and of the European Central Bank[7].

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3 Available on the European Commission's website at http://ec.europa.eu.

4 See the Spanish Memorandum of Understanding on Financial-Sector Policy Conditionality of 20 July 2012.

5 OJ L 135, 31.5.1994, p. 5.

6 The ECB's Convergence Report May 2010, p. 22.

7 See paragraph 3.1.4 of Opinion CON/2009/93.

The ECB welcomes the tasks allocated to the Banco de España under the Royal Decree-Law which are broadly consistent with its financial stability role.

Pursuant to Article 51(3) of the Royal Decree-Law, the FROB's cash services will be provided by the Banco de España, with whom it will enter into a necessary agreement to this effect. The ECB understands that the Banco de España will hold FROB deposits. Such provisions do not raise concerns about compliance with the monetary financing prohibition as long as the services provided by the Banco de España do not entail the extension of credit, including overnight overdrafts. In particular, it is essential that the remuneration of such deposits reflects market parameters and it is also important to link the remuneration rate of the deposits to their maturity[8].

4. Priority claim in respect of covered deposits

With respect to the principles of restructuring and orderly resolution of CIs under Article 4 of the Royal Decree-Law, the Spanish authorities should consider including a preference rule for guaranteed deposits. Currently, six Member States - including Bulgaria[9], Greece[10], Latvia[11], Hungary[12], Portugal[13] and Romania[14] - have granted priority ranking to claims that the Deposit Guarantee Scheme (DGS) has acquired by subrogation after having paid out the amounts corresponding to covered deposits, thus further contributing to ensuring that sufficient funding is always available to the DGS.

Views on the impact of granting preferential ranking to depositors are highly divergent, as it is believed that such preferential ranking may have an impact on the funding costs available to banks and that greater efforts will be made by other creditors to secure their claims. On the other hand, this impact would be somewhat mitigated to the extent that priority claims extend to guaranteed deposits only. Furthermore, a legal regime that establishes priority ranking of guaranteed depositors should facilitate the use of resolution measures provided for in the proposed directive (e.g., sale of business tool, bridge institution tool). From a financial stability perspective, the priority claim in respect of the covered deposits is also

8 See the ECB's Convergence Report May 2012, pp. 30-31.

9 Preferred creditor status is established for DGS by Article 94(1) of the Law on bank insolvency (*Darjaven vestnik* No 92, 27.9.2002).

10 Depositor preferred creditor status is established by Article 4(16) of Law 3746/2009 transposing Directive 2005/14/EC on insurance against civil liability in respect of the use of motor vehicles and Directive 2005/68/EC on reinsurance and other provisions (FEK A 27, 16.2.2009). Article 13a(4) establishes the DGS' status.

11 Law of 5 October 1995 on credit institutions (LV 163(446), 24.10.1995). Article 192(1) introduced preferential ranking for guaranteed depositors on 21 May 1998.

12 Law CXII of 1996 on credit institutions and financial undertakings (*Magyar Közlöny* 1996/109, 12.12.1996), and more specifically Chapter XV of the Law on the details of the deposit guarantee scheme . The preferential status of all, and not only guaranteed, deposit claims is established by Article 183(1) of the Law.

13 See Article 166-A of consolidated version of Decree-Law No 298/92 of 31 December on the legal framework of credit institutions and financial undertakings (D.R. No 30, I, 10.2.2012).

14 Government Ordinance No 10/2004 on the proceedings for judicial reorganisation and bankruptcy of credit institutions, as further amended and supplemented, in particular by Article 38, gives a preferential right, after expenses related to the bankruptcy proceedings have been settled to claims arising from guaranteed deposits, including the claims of the DGS arising from repayments to the guaranteed depositors (*Monitorul Oficial al României*, Part One, No 84, 30.1.2004).

supported as it reduces the risks of bank runs, potential losses of the insured depositors in a liquidation phase, as well as the excessive depletion of the DGS[15].

5. AMC

The principles, structure, governance and other fundamental aspects of the AMC will be further developed in Spanish legislation over the coming months. The ECB reminds the Spanish authorities that the obligation to consult the ECB concerns any provisions 'which, once they become legally binding and of general applicability in the territory of a Member State, lay down rules for an indefinite number of cases and are addressed to an indefinite number of natural or legal persons', and includes secondary legislation, such as regulations. The ECB expects to be consulted on the further legislation concerning the regulation of the AMC at an appropriate stage in the legislative process. This implies that the consultation should take place at a point in the process which affords the ECB sufficient time to examine the draft legislative provisions, and which also enables the national authorities to take the ECB's opinion into consideration before the provisions are adopted.

6. Restructuring of systemic institutions

Article 13 of the Royal Decree-Law allows the restructuring of a CI, using public financial support, where objective elements do not exist allowing a reasonable prediction that this support will be repaid or recovered. Under Article 13, such a restructuring is only permissible where the CI's resolution would have seriously damaging effects on the stability of the financial system as a whole, in order to minimise the use of public funds.

The ECB is of the view that the restructuring of a non-viable entity as a going concern ('open bank scenario') instead of resolving it as a gone concern ('closed bank scenario') should only be considered under exceptional circumstances, where the orderly resolution of a CI would have seriously damaging effects on the stability of the financial system, with heightened risk of contagion across borders[16].

It is important to note that the proposal for an EU directive on bank recovery and resolution[17] only provides for the recapitalisation of a non-viable entity via 'going-concern bail-in' within resolution[18]. This means that the restructuring of the entity is embedded in the resolution regime, allowing other resolution tools to also be used and the application of resolution safeguards.

In line with the proposed directive, the Royal Decree-Law should make clear that prior to any use of public funds for restructuring a non-viable entity, (a) existing shares/equity instruments are cancelled on a

15 ECB Opinion CON/2012/99, paragraph 8.2.

16 ECB Opinion CON/2012/99, paragraphs 1 and 6.2.

17 Commission proposal for a directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010, COM(2012) 280 final.

18 Article 37(2)(a).

mandatory basis, (b) all available means of creditor participation under the Spanish resolution framework are exhausted, and (c) appropriate measures are taken to address moral hazard, such as the replacement of an entity's management.

7. Mandatory recapitalisation

The ECB welcomes the fact that the Royal Decree-Law entrusts the FROB with administrative capacities which allow for an effective intervention in a CI with the aim of preserving financial stability. However, as far as concerns mandatory recapitalisation under Article 62(d) of the Royal Decree-Law, any overriding of shareholders' rights would require careful consideration in light of shareholders' rights under Union directives. In this respect, the ECB suggests limiting such powers to the resolution of CIs and restructuring of systemic institutions.

Similar issues need to be considered with respect to the enforceability of close-out netting and financial collateral arrangements under Union directives.

8. Use of government bonds to recapitalise CIs

Pursuant to Article 30(2), first sentence, of the Royal Decree-Law, the FROB may fund recapitalisation of CIs by cash or alternatively through the transfer of securities representing public debt or securities issued by the FROB. As stated in previous ECB opinions[19], where a recapitalisation of a CI to restore its solvency takes place by way of direct placement of State-issued debt instruments, the subsequent use of such bonds or financial instruments as collateral in central bank liquidity operations would raise monetary financing concerns in the absence of any alternative market-based funding sources for such State-issued debt instruments. The same concerns would arise if the securities issued by the FROB[20] are used for a bank recapitalisation.

9. Removal of licence of the 'rump' entity following the transfer of assets and liabilities to a bridge bank

The Royal Decree-Law provides that the bridge bank will be subject to the regulations applicable to CIs, including supervisory and sanctioning regimes. It could specify that the bridge bank will be authorised as a CI, which is implied by the paragraph on the withdrawal of authorisation. The Royal Decree-Law does not contain any provisions on the treatment of the banking licence of a CI after most of its assets and liabilities are transferred to a bridge bank. It could specify that, when a bridge bank is granted authorisation, the authorisation for the CI undergoing resolution will be withdrawn.

19 See, for example, Opinions CON/2012/64 and CON/2012/71.

20 The FROB is a public law entity with legal personality and closely dependent on the State.

This opinion will be published on the ECB's website.

Done at Frankfurt am Main, 9 January 2013.

[signed]

The President of the ECB

Mario DRAGHI