EUROPEAN CENTRAL BANK

EUROSYSTEM

OPINION OF THE EUROPEAN CENTRAL BANK

of 9 March 2011

on the strengthening of the financial system

(CON/2011/21)

Introduction and legal basis

On 3 March 2011 the European Central Bank (ECB) received a request from the Spanish State Secretary for Economic Affairs for an opinion on Royal Decree-Law 2/2011 of 18 February 2011 on the strengthening of the Spanish financial system (hereinafter the 'Royal Decree-Law').

The ECB's competence to deliver an opinion is based on Article 127(4) 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 of the Royal Decree-Law

The Royal Decree-Law states that it has two goals. The first is to strengthen the solvency of Spanish credit institutions by establishing a demanding top-quality capital requirement in order to dispel any doubts about such institutions' solvency. The second is to accelerate the final phase of the restructuring processes of credit institutions by virtue of the framework created by Royal Decree-Law 11/2010 on savings banks' governing bodies and other aspects of their legal regime. The Royal Decree-Law also states that these two goals will guarantee the financial sector's function of generating credit within the economy. In the case of savings banks, this role is made compatible with the indispensable goal of continuing their social activities.

The Royal Decree-Law is organised around two sets of provisions: the first establishes stricter capital requirements and the second adapts the Spanish resolution fund, the Fund for Ordered Bank Restructuring (hereinafter the 'FROB'), which was set up by Royal Decree-Law 9/2009 of 26 June 2009 on bank

1 OJ L 189, 3.7.1998, p. 42.

restructuring and reinforcement of credit institution's own funds[2] to provide recapitalisation where required in order to facilitate compliance with such capital requirements.

In particular, the Royal Decree-Law establishes for all credit institutions a core capital ratio of 8% of their risk-weighted assets by 31 December 2010. This ratio is 10% for institutions having less capacity to access capital markets as shown by reliance on wholesale funding higher than 20% of net loans and less than 20% of equity being held by private investors. Institutions not fulfilling these requirements from 10 March 2011 must submit a compliance strategy and schedule to the Banco de España, together with a recapitalisation plan, if they intend to receive support from the FROB. These institutions must aim to comply with the capital requirements by 30 September 2011 or, subject to the Banco de España's authorisation for justifiable reasons, by the end of 2011, or, where an initial public offerings is planned, by the first quarter of 2012. A breach of capital requirements is treated as a serious or very serious infringement of Law 26/1988 on discipline and intervention of credit institutions.

Where capital needs cannot be met through the market, the FROB acts as a backstop, in compliance with domestic and Union provisions on competition and State aid. Savings banks applying for recapitalisation via the FROB must transfer their financial activities to a commercial bank. The FROB's investments, limited to a maximum period of five years and carried out using competitive procedures, are subject to a recapitalisation plan based, *inter alia*, on specific goals to reduce structural costs, comply with good corporate governance practices and extend credit to businesses and households. The validity of every recapitalisation plan is subject to Union State aid rules.

2. General observations

2.1 The Spanish Government has already adopted and published the Royal-Decree Law on an urgent basis, thus giving it immediate legal effect. Therefore, this opinion relates to the parliamentary debate in the validation phase of the Royal Decree-Law, to any further legislative amendments to it and to its subsequent implementation. Regarding the latter, the ECB expects to be consulted on any proposed implementing legislation to be adopted under the Royal Decree-Law that materially influences the stability of financial institutions and markets.

2.2 Again the ECB reiterates the legal obligation on the Spanish authorities under Article 4 of Decision 98/415/EC to ensure effective compliance with their duty to consult the ECB, in particular by consulting it at an appropriate stage in the law-making process.

2.3 The ECB welcomes the fact that the Royal Decree-Law is broadly in line with the conclusions and recommendations of the International Monetary Fund's (IMF) Staff Report on Spain of 29 June 2010[3] and of the Financial Stability Board's (FSB) peer review of Spain of 27 January 2011[4]. It also welcomes the implementation by the Royal Decree-Law of measures that follow the Basel III

2 See Opinion CON/2009/62.

3 Available on the IMF's website at http://www.imf.org/external/pubs/ft/scr/2010/cr10254.pdf.

4 Available on the FSB's website at http://www.financialstabilityboard.org/search/?sp_q=peer+review+of+Spain&adv=1.

Accord, such as the definition of core capital in line with 'common equity tier 1' and the introduction of a capital buffer technique, which is similar to the relevant provisions of the new Basel framework. Although the calculation of capital ratios is different to that under the Basel III Accord, the ECB welcomes the fact that the new capital requirements are a step in the right direction that improves the resilience of financial institutions.

3. Specific comments

3.1 *Capitalisation measures*

The Royal Decree-Law provides for several possibilities for the capitalisation of all credit institutions and for specific measures for the capitalisation of savings banks. It contains an implementation procedure which has a very demanding timetable. These measures are welcomed by the ECB, with two observations: (a) the exact methods of capitalisation of the banking sector require a critical evaluation of the asset side of credit institutions' balance sheets in the current downturn stage of the cycle and in unusual situations for some parts of the market, in particular the real estate sector: although up until now the Banco de España has taken a conservative approach to such valuations, the opportunity offered by the Royal Decree-Law should be used to strongly address any remaining doubt about such valuations; (b) given appropriate capitalisation efforts to credibly address credit institutions' balance sheet vulnerabilities related to challenging cyclical conditions for the Spanish economy, the advancement of some two years in the global calendar for the implementation of the Basel III Accord for credit institutions' capital could be demanding on such institutions and may increase the risk of adverse temporary effects on the credit flows to the real economy. It should be kept in mind that the studies by the Basel Committee on Banking Supervision/FSB Macroeconomic Assessment Group indicated relatively modest macroeconomic transitional costs for introducing Basel III under the envisaged phase-in arrangements. However, this would not be the case under the advanced implementation provided for in the Royal Decree-Law. Such effects should nevertheless be carefully assessed given the particular situation of the Spanish economy. Furthermore, it should be noted that the Basel Committee had specifically opted for transitional provisions to reconcile the needs in relation to higher financial stability and credit availability.

3.2 *Banco de España's powers*

The ECB emphasises that in order to achieve the underlying key goal of restoring market confidence in the soundness of the Spanish financial system, the Royal Decree-Law should provide the Banco de España with all the powers needed to ensure that a sound supervisory technical assessment will be inherent in any necessary intervention to strengthen the financial conditions of credit institutions. In this context, the ECB welcomes the powers attributed to the Banco de España to further raise the higher capital requirements established by the Royal Decree-Law, in accordance with the upcoming Union-wide stress test to be conducted by the European Banking Authority in

cooperation with the ECB. Moreover, the ECB welcomes the fact that credit institutions intending to request the FROB's intervention have to prepare a recapitalisation plan that must be approved by the Banco de España, and that the latter will also be authorised to regularly monitor credit institutions' compliance with the measures contained in the recapitalisation plan and to intervene when needed.

3.3 *Recapitalisation via the FROB*

The FROB has an initial allocation of EUR 9 000 million and a debt capacity of EUR 27 000 million, with an explicit, unconditional and irrevocable guarantee from the Kingdom of Spain. Its debt capacity can additionally be extended up to EUR 90 000 million. Thereby, the overall EUR 99 000 million potential capacity that the FROB may make use of should suffice to cover the recapitalisation needs of the savings banks sector even under a very conservative valuation of their assets. At the same time, the agreement of the Ministry for Economic Affairs and Finance is needed for the FROB to issue debt beyond EUR 27 000 million.

3.4 *Corporate governance of savings banks*

The ECB welcomes the continuation of the reforms to the governance of savings banks started by Royal Decree-Law 11/2010 of 9 July, which was aimed at improving the professionalism and dedication of the members of their decision-making bodies. An essential requirement to maintaining public trust and confidence in the banking system, critical elements to the proper functioning of the banking sector as a whole, is the establishment of effective corporate governance practices. The Royal Decree-Law contains two rules in this regard: (a) it imposes on decision-makers of all savings banks the duties under law which apply to members of the Board of Directors of limited and public limited companies by shares; and (b) makes the governance code currently applicable to listed companies mandatory for those savings banks being capitalised by the FROB. External influences on the professional and dedicated governance and management of savings banks should be avoided, irrespective of the options for capitalisation available under the Royal Decree-Law. The Banco de España, as the banking supervisor, is the competent authority to require savings banks to implement robust governance arrangements and for the sake of political independence, more powers could be established to guarantee such indisputable competences. In this regard, supervisory experience should be used to obtain all the necessary information and to decide on the sufficient level of expertise and integrity of board members and senior management, which should be subject to periodic review. To this end, the Banco de España should have the statutory power and ability to assess the fitness and propriety of board members and senior managers of savings banks on a regular basis.

Corporate governance arrangements should also safeguard an independent risk management function which has access to the respective board. These arrangements should ensure that the risk management function is properly resourced and that its responsibilities are carried out independently and effectively. Overall, the post-crisis global and Union parameters for the sound

governance of credit institutions are needed to complement capitalisation measures, irrespective of their method under the new law, in order to be successful in accessing capital markets.

3.5 *Governance of the FROB*

The Royal Decree-Law introduces a reform to the FROB's governing body which has the effect of terminating the majority held by the representatives of the supervisor until now. The IMF in its Financial Sector Assessment Program, and the FSB in its peer reviews, demonstrate the need to strengthen the independence of financial sector supervisors, insulating them from any objective other than financial stability and market integrity. The relevant reform in the Royal Decree-Law introduces the presence of politically-appointed persons in the FROB's governing body. While the use of public money by the FROB justifies a role for the Ministry for Economic Affairs and Finance, its previously existing veto right already provided the right balance between autonomous prudential decision-making by the FROB and the protection of public finances. Any increase in possible political intervention in the process of capitalisation, temporary nationalisation and management of credit institutions, and in their eventual sale, is inconsistent with the above recommendations, in an area where only prudential and stability considerations are relevant. The ECB notes, however, that the Vice-Governor of the Banco de España is appointed President of the FROB's governing body. In addition, the Banco de España is given important responsibilities in the overall process. These responsibilities include: approving or amending the compliance strategy and schedule; requiring higher capital ratios to be applied to individual institutions as a result of stress tests carried out for the whole system; authorising extensions for compliance for up to six months; deciding on restrictions to dividend distribution, to managerial remuneration, etc. in the case of temporary non-compliance with capital requirements, and approving the recapitalisation plan required prior to capital subscription by the FROB. Moreover, the capital subscription by the FROB is temporary and divestment needs to be within a maximum period of five years.

3.6 *Takeover bids*

Finally, the ECB supports the exemption from the duty to make a takeover bid for any entity which has achieved control of a listed company as a result of the restructuring or integration procedure under the Royal Decree-Law on the FROB or of intervention by the Deposit Guarantee Fund (DGF), when these have been financed by FROB or DGF. The ECB finds that this approach is in line with the principle that the restructuring should be of the lowest cost possible to the taxpayer, as making a public offer would increase such cost.

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

Done at Frankfurt am Main, 9 March 2011.

[signed]

The President of the ECB

Jean-Claude TRICHET