1.- Introduction

The Royal Decree 2/2011 (hereafter, the RDL) has the dual objective of strengthening the solvency of all credit institutions, and of accelerating the final phase of the restructuring process of the Savings Banks via the framework created by Royal Decree 11/2010(1).

The entire content of the new regulation is analysed below, in four major sections. First, a review is made of the definition of the new requirements and the periods and steps established or complying with them; next, details are given of the most notable aspects of the role played by the FROB in the recapitalization process; followed by the complementary measures for facilitating the integration and restructuring and finally, measures of a fiscal nature are analysed.

2.- Reinforcement of the equity of credit institutions

(1) Royal Decree 2/2011 and the updated version of Royal Decree-law 9/2009 can be consulted in the Financial Regulations Database.
A) New capital requirements

it is established that all credit institutions and consolidated groups of credit institutions which attract deposits from the public must have a core capital of 8% of their total risk weighted exposure. This requirement will be raised to 10% for those credit institutions meeting the following two conditions;

- They have a wholesale funding ratio of over 20% in line with Bank of Spain regulations
- An amount equal to or greater than 20% of their share capital or voting equity has not been placed with third parties

The new RDL introduces elements proper to Basel III, notable among which is the technique of capital buffers. Accordingly when an institution presents overall an insufficiency of core capital of less than 20% of the minimum required (in other words, it comes within the band of between 8% and 10% for institutions with a requirement of 10%, and between 6.4% and 8% for institutions with a requirement of 8%), the Bank of Spain will impose restrictions that could affect the dividend distribution, the endowment for social works, the variable remunerations for directors and executives, payments of preferred stock and buying back of shares. These restrictions would cease to apply once sanctioning proceedings have commenced.

The level of capitalization that is demanded could become greater as a consequence of the weaknesses detected in the stress tests conducted on the system as a whole.

In any case, these new requirements do not affect those currently existing in equity by virtue of the Solvency Law (Law 13/1985, of 25 May 1985), which remains in force.

B) Sanctioning system

Breach of the core capital levels that are imposed will be regarded as very serious or serious infringement in accordance with the provisions of articles 4.c) and 5.h) of the Law on Discipline and Intervention of Credit Institutions. More precisely, and pursuant to those provisions, insufficient coverage of the core capital level will be regarded as a very serious infringement when it is below 80% of the minimum required and if this situation persists for a period of at least six months. If the level holds at above 80% (also for at least six months) the infringement will be considered serious.

Both the sanctioning system and the system of restrictions due to breach of the capital buffers will come into force when institutions failing to meet the established minimums have executed the compliance strategy approved by the Bank of Spain.
C) Definition of core capital
According to the explanation of motives in the RDL, the definition of core capital is in line with the content of what is known as ‘common equity tier 1’ foreseen for in the Basel III Accord”, and is defined as:

a) The sum of:

i. Share capital (except redeemable shares and non-voting shares), foundation funds and “cuotas participativas” of Savings Banks, association “cuotas participativas” in CECA (Spanish Confederation of Savings Banks), contributions to the capital of credit cooperatives; less the treasury stock of any of these instruments;

ii. Paid out issue premiums relating to the instruments of the previously mentioned;

iii. Cash reserves and reserves, as well as elements classified as such in the regulations on equity, and eligible retained earnings

iv. Capital gains (adjusted for fiscal effects) Minority holdings (ordinary shares in companies of the consolidated group) according to the regulations on equity;

vi. Eligible instruments subscribed by the FROB;

vii. Temporarily: Convertible bonds. The requisites for their inclusion depend on whether they were issued before or after publication of this RDL:

1. Before: If they contain clauses for their obligatory conversion into shares prior to 31 December 2014;

2. After: They must comply with the following criteria:

   a. That they provide for their obligatory conversion into shares no later than 31 December 2014, or earlier in the case of reorganization or restructuring of the institution or its group;
   b. That the conversion ratio has to be determined at the moment of the issue;
   c. That the issuer can, at its discretion, decide on non-payment of a coupon if the solvency of the institution or its group requires this;
   d. That they do not contain characteristics which would prevent their registration as a capital instrument in the net worth of the institution;
   e. That their trading complies with that established by the CNMV (Spanish Securities and Exchange Commission), especially in relation to proper protection for the investors. In addition, in the event of having a minority participation,
their quotation in an official secondary market will be obligatory (both the debt instrument and the capital instrument).

b) Less the following items:

i. Losses and losses carried forward
ii. Capital losses (adjusted for fiscal effects)
iii. Intangible assets (adjusted for fiscal effects)

D) Compliance strategy

Institutions must comply with these new requirements before 10 March 2011. The risk weighted assets that will be taken into account will be as at 31 December 2010. In later verifications during 2011, the amount to consider may not be less than this, unless the compliance strategy has incorporated operations of an extraordinary nature such as sales of branch networks, strategic participations or credit portfolios.

In the event that on 10 March any institution is in breach of the requirements, they will be granted 15 working days for presenting the Bank of Spain with the strategy and timetable for compliance with the new requirements. These measures must be approved by the supervisor within a period of 15 working days, who will be able to demand the inclusion of any modifications or additional measures that he regards as necessary.

If the measures incorporated into the compliance strategy imply a reduction in the risk weighted assets along the lines described above, the institution must notify the supervisor before 1 September that said measures have finally been carried out, so this can be taken into account when calculating the core capital ratio.

Both the measures for sale of assets and those relating to the attracting of private investors must be accompanied by alternative measures in case the plans cannot be materialized. These measures can include turning to the financial support of the FROB, in which case that government agency must be presented with a recapitalization plan within a period of one month from when the institution or the Bank of Spain determines that compliance through resorting to other alternative routes is impossible.

The measures included in the compliance strategy must be carried out before 30 September 2011. Nevertheless, if the processes and operations required by those measures mean that the institution considers that it will be unable to meet that deadline, it must inform the Bank of Spain of this before 10 September, justifying the reasons for the delay. In view of this, the supervisor will be able to grant a postponement of no more than three months, which can be extended to six months in the event that the measures imply processes of listing of shares for negotiation. In this latter case the following at least will be necessary: (1) that there exists an agreement from the competent body of the issuing institution that will serve as the basis for applying for listing; and (2) that one or more managing
institutions have been granted a mandate to direct the operations relating to the design of the listing conditions, as well as for the coordination of relations with the supervisory authorities and others involved (article 35 of Royal Decree 1310/2005, of 4 November 2005).

Finally, it is imperative that the trading of securities for complying with the new requirements must comply with the criteria of the Spanish Securities and Exchange Commission, and if part of the issue is targeted at the retail market the application for admission in an organized secondary market is required.

3.- Reform of the Fund for Orderly Bank Restructuring

The functioning of the FROB is modified in the following aspects:

A) Government of the FROB

Its main modification relates to the composition of the Governing Committee of the FROB, with the incorporation of two members representing the Ministry of Economy and Finance. Various provisions are also introduced relating to the life of the mandate and situations of resignation of the members of the Governing Committee.

B) Instruments for the reinforcement of credit institutions

The RDL modifies articles 9 and 10 of Royal Decree-law 9/2009, of 26 June 2009, on bank restructuring and reinforcement of the equity of credit institutions, and it creates three new articles 11, 12 and 13. Their most notable aspects are as follows:

- **Article 9**: This article authorizes the Fund for Orderly Bank Restructuring (FROB) to adopt financial support measures, such as the acquisition of ordinary shares or contributions to share capital, of institutions that need to have their equity base reinforced.

  For the entry of the FROB into the capital it will be necessary as a prior step for the applicant institution to present a recapitalization plan, which must be approved by the Bank of Spain. In order to determine the price at which the subscription has to be made, the economic value of the institution will be calculated by means of methodologies widely accepted on the market. In this process, account will be taken of extraordinary reorganizations which the institutions have been able to carry out earlier on. The subscription must also be consistent with Spanish and European regulations on competition and State aid.

  The capital subscription by the FROB will also imply its presence on the board of directors of the institution, having percentage of voting rights in proportion to its holding in the share capital.
A **maximum period of five years** is established, after which the corresponding securities will proceed to be disposed of by means of processes that ensure competition. Nevertheless, during the **first year** it will be possible for the institution to buy back the shares (or designate an investor to do so), with the FROB selling its participation at market prices, and in such a way that implies an efficient use of public resources. This period can be extended to **two years**, in which case the FROB will be able to demand additional commitments from the applicant institutions within their recapitalization plan.

The FROB will be able to acquire **other securities** issued by the credit institutions which have commenced negotiation for the purpose of asking the Fund to acquire them in order to reinforce their equity. These acquisitions will be able to refer to preferred holdings convertible into ordinary shares or participating shares, in which case the system provided for in the new article 10 of Royal Decree-law 9/2009, of 26 June 2009, shall apply, mutatis mutandis.

Moreover, **preferred participations** whose subscription has been agreed to by the FROB **prior to the coming into force of the RDL** will continue to be subject to the system existing at the moment of their subscription. If those participations have been issued by a Savings Bank, then if that Bank subsequently passes its financial activity over to a commercial bank (whether it be for indirect exercise or by transformation into a foundation of a special nature), the convertibility of them will be understood to refer to the shares of corresponding commercial bank.

- **Article 10**: This article authorizes the FROB to acquire preferred participations convertible into contributions to the share capital of credit cooperatives needing to reinforce their equity with the exclusive end of carrying out integration processes and they request this.

- **Article 11**: It is established that in the event of a Savings Bank **applying for a recapitalization via the FROB**, it must as a first step **transfer its financial activity to a commercial bank**, resorting to the system of indirect exercise of by means of its transformation into a foundation of a special nature. To do this, it will have a period of no more than **three months** from when its recapitalization plan is approved. Likewise, if the applicant institution is a commercial bank participated in by several Savings Banks formed into an SIP (Institutional System of Protection), these will have to transfer all their financial activity to their central institution, going over to exercising their activity indirectly or by means of their conversion into a foundation.

- **Article 12**: This details the characteristics of the **recapitalization plan** to be presented when applying to the FROB for aid. This plan must include a business plan with objectives concerning efficiency, profitability, leverage levels and liquidity. Also, applicant institutions must take on the following commitments:
a) At the request of the FROB, to reduce structure costs.
b) To improve corporate governance (in general, they will adapt themselves to the standards of quoted companies).
c) To increase the financing for SMEs, in terms compatible with the objectives identified in their business plan.

**Article 13**: Different rules of corporate governance are established which have to be met by institutions applying for aid from the FROB, standing out among which are the following:

a) The number of members of the board of directors is set at between five and fifteen, at least a third of whom will be independent directors.
b) The majority of the board will consist of external directors, directors representing large shareholders, and independent directors; the number of executive directors will be the minimum necessary.
c) Independent directors may not remain as such for a continuous period of more than twelve years.
d) The board of directors will set up a committee, or two separate committees, from among its members, for Appointments and Remunerations.

4. - Other additional provisions

- **Exception on the subject of obligatory TOBs**. Whoever achieves control of a quoted company as a consequence of restructuring processes or integration into the framework of Royal Decree-law 9/2009, of 26 June 2009, or of direct intervention from a deposit guarantee fund (DGF), will not be obliged to formulate a takeover bid always provided the actions are carried out with the financial backing of the FROB or a DGF.

- **Elimination of the time limits on the exercise of the activity**. Newly created banks (set up by one or more Savings Banks in order to transfer their financial activity to it, in the event of setting up a SIP, indirect exercise or conversion into a foundation) will not be subject to the time limitations established for the activity of new banks.

- **Adjustments in the SIP system**. In SIPs in which all the financial business has been handed over to the central institution and in which several Savings Banks exercise their object as credit institutions in a concerted and exclusive manner via their central institution, the requisites of mutualization and reciprocal guarantee provided for in points iii) and iv) of article 8.3.d) of the Solvency Law will be regarded as having been met.

- **Adhesion to the DGFs**. Applied to the case of Savings Banks, credit institutions in which these banks have a majority stake and whose financial worth derives from the prior assignment of assets and liabilities
of a Savings Bank will become incorporated into the Deposit Guarantee Fund in Savings Banks.

- **Decisions relating to participation in commercial banks.** Savings Banks will be able to determine that it is the board of directors which takes decisions relating to their participation in commercial banks via which they undertake their activity as a credit institution.

- **Extension of the system of social administrators.** The duties of social administrators set down in articles 225 to 232 of the Revised Text of the Capital Companies Law will have application to the members of the boards of directors of the Savings Banks.

5. - Fiscal aspects

Fiscal aspects of the integration processes are regulated in order to obtain fiscal neutrality in the following situations:

- **Consolidated groups of Savings Banks formed into a SIP.** Starting from 1 January 2011, these Banks will be able pay their Corporation Tax on a consolidated basis within the fiscal group of which the central institution of the system forms part, always provided they fully consolidate their results, their solvency and their liquidity.

- **Groups of Savings Banks which, together, transfer their business to a commercial bank for carrying out their financial business.** It is considered that the requirements for consolidation of Corporation Tax are met when, directly or in directly, the exercise of the financial activity of the Savings Banks is carried out via a commercial bank to which the business has been transferred, and the bank guarantees the recovery of the fiscal credits which the Savings Banks generated in their financial activity, including in the event that the central institution loses the necessary level of participation for keeping the commercial bank within the same consolidated fiscal group (75% or 70% if the bank is publicly quoted).

- **Indirect exercise of the financial business by an individual Savings Bank.** The recovery of the fiscal credits which the Savings Bank generated in its financial activity is guaranteed, including in the event that the Savings Bank loses the necessary level of participation for keeping the commercial bank within the same consolidated fiscal group (75% or 70% if the bank is publicly quoted).

- **Formation of new consolidated groups and, as the case might be, winding up of the pre-existing ones.** In this last situation of loss of ownership of the commercial bank to below 75% or 70%, the bank will leave the consolidated fiscal group dominated by the Savings Bank or the central institution as the case might be, but this will not result in any taxation on the income that was eliminated during the consolidation, which is deferred until it has to be integrated normally.
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