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The 2008-14 banking crisis in Spain

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The 2008–14 banking crisis in Spain

Patrizia Baudino, Mariano Herrera and Fernando Restoy

July 2023

JEL classification: G21, G28, G33

Keywords: AMC, competition, convergence, recapitalisation, resolution, savings banks, SLE, stress tests
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Authorised by the Chair of the FSI, Fernando Restoy.

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ISSN 2707-9511 (online)
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The 2008–14 banking crisis in Spain

Executive summary

This paper covers the banking crisis in Spain that started in 2008. The crisis had severe repercussions for the Spanish economy and public finances for several years. The financial cost of the crisis can be currently estimated at around €80 billion; slightly less than three quarters of this were covered by the state, and the rest by the banking industry through its contribution to the deposit guarantee scheme.

The weaknesses in the Spanish banking sector stemmed from a combination of conjunctural and structural factors. Starting in the mid-1990s, the Spanish economy had experienced rapid credit growth and banks’ balance sheet expansion, amid favourable financing conditions triggered by the convergence process and the adoption of the euro in 1999. Credit was especially directed to the real estate sector, and a construction boom ensued. The rapid expansion of savings banks that had started in the mid-1980s generated additional financial stability risks as many of these firms were characterised by little market discipline and poor governance, which led to weak risk management and a deficient selection of investment opportunities. Savings banks also became increasingly dependent on relatively unstable wholesale funding sources. In addition, constraints in the charter of these banks implied a very limited capacity to increase capital.

The vulnerabilities in the Spanish banking sector—which were not sufficiently addressed by the regulatory and supervisory framework—became apparent at the time of the Great Financial Crisis (GFC). Against the backdrop of tightening global liquidity and increased risk aversion at the start of the GFC, the Spanish banking sector experienced considerable stress. Although it was not directly exposed to the US subprime market, turbulence in global financial markets highlighted its weaknesses, setting in motion a deep reassessment of the riskiness of Spanish banks.

Starting in 2009, Spanish authorities gradually introduced response measures, which proved insufficient. Considering the weaknesses of many savings banks, the authorities initiated a reform of their governance. They also attempted to steer a consolidation process in the banking sector, with the support of a dedicated fund (the Fund for Orderly Bank Restructuring (FROB)). The gradual approach taken since 2009, possibly the only one that was economically and politically feasible at the time, was predicated on the assumption that conditions would ease in the following years. However, the recovery did not materialise. On the contrary, starting in 2010, Europe faced a sovereign crisis that directly affected a few euro area countries, including Spain, and the situation deteriorated in July 2011 following the Greek crisis. This led to the pricing of currency redenomination risk, due to the perceived challenges for the continuation of the monetary union.

In 2011 and the first half of 2012, as the situation worsened, Spanish authorities took actions that were bolder but which failed to stem the crisis. These included the injection of public resources in weak banks, the expansion of the FROB’s powers to deal with banking crises and additional

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capital and provision requirements for exposures to the real estate sector. But, as became increasingly clear in the assessments performed at the time, including by the IMF in the first half of 2012, these measures were insufficient to restore confidence in Spanish banks and address the root cause of a crisis that was contributing to instability in the euro area.

In mid-2012, the Spanish government formally requested financial assistance from the European authorities, opening the way for the introduction of deeper reform measures, which successfully contained the crisis. Faced with some Spanish banks’ mounting recapitalisation needs, a weakened fiscal capacity and the stressed sovereign bond markets, the Spanish authorities opted to request a programme of financial assistance. This was accompanied by both bank-specific and sector-wide conditionality contained in a memorandum of understanding (MoU) agreed between Spanish and European authorities. The MoU envisaged: (i) the conduct of an asset quality review and stress test for the large majority of banks in Spain; (ii) the recapitalisation, restructuring and/or resolution of weak banks; and (iii) the transfer of problem assets to an asset management company (AMC). The MoU also entailed the performance of a burden-sharing exercise that imposed losses on junior bank creditors – mostly retail investors – and a downsizing of the banks requiring public support. Sector-wide conditionality involved several measures to strengthen the regulatory and supervisory framework.

The banking crisis in Spain raises several important general lessons, for both crisis prevention and crisis management. In terms of crisis prevention, the conditions in the sector before the crisis highlight how determined supervisory action is essential to identify, and foster a swift correction of, unsustainable business strategies and poor governance. Addressing these weaknesses in a timely way cannot rely solely on standard instruments, such as minimum capital requirements or loan-loss provisions. Rather, this requires supervisors to also be empowered to directly induce adjustments in business models and management procedures through appropriate corrective measures. When the crisis unfolds, the speed and intensity of intervention need to achieve an adequate combination of determination and pragmatism. In this phase, the available fiscal room plays a key role. Separately, macroprudential instruments – of which Spain was an early adopter with dynamic provisions – can increase banks’ resilience, but those based on countercyclical bank buffers have a limited capacity to address macro-financial imbalances.

For crisis management, the Spanish approach, as agreed with European authorities, offers lessons for the design of the response strategy. Its success requires an internally consistent package of measures addressing both the urgent needs and the sector’s structural weaknesses, together with adequate funding. At the national level, the feasibility and credibility of the response require broad political and social support. For a euro area country, support at the regional level is equally important – the involvement of the relevant European bodies and their explicit endorsement of the reforms is essential. Adequate communication – with the right combination of rigour and depth – plays a key role in helping to restore market confidence and to provide transparency. More broadly, authorities should make full use of systemic crises to adopt ambitious reforms that may have been long overdue.

The Spanish case also sheds light on the performance of some resolution tools. Resolution actions, including creditors’ bail-in, can satisfactorily be implemented– ie with no or little successful litigation – if supported by sufficiently robust legislation and careful implementation. Yet hybrid capital and subordinated debt instruments lose much of their ability to provide gone-concern resources when retail investors hold them. Creating an AMC can be a very powerful tool in a crisis as it helps to clean up banks’ balance sheets, but it is not cost-free. Depending on its design, it may help spread over time the costs for the state. The restructuring of the sector should primarily be led by efficiency and financial stability considerations while minimising, to the extent possible, the competitive distortions created by providing public support to weak entities. As for exit strategies, a relatively rapid disinvestment of public stakes in banks subject to resolution, when feasible, is generally preferable.
Section 1 – Introduction

1. **Starting in the mid-1990s, the Spanish economy experienced a long and rapid expansionary phase, which eventually proved unsustainable.** Taking advantage of the convergence process and the adoption of the euro from its inception in 1999, Spanish borrowers could access funding at significantly lower nominal interest rates as risk premia differentials for countries in the euro area fell dramatically. Spain experienced a substantial increase in capital inflows, in the context of abundant global liquidity since the early 2000s. Over this period, the international competitiveness of the Spanish economy progressively deteriorated, and macro-financial imbalances – including rapidly increasing private indebtedness and substantial house price inflation – emerged.

2. **The banking sector, which suffered from structural weaknesses, supported the expansion of the Spanish economy, providing abundant resources to the real estate sector.** The Spanish banking sector was composed primarily of two types of banks, commercial banks and savings banks. The latter were in many cases mired by poor governance, which manifested itself in weak risk management, and limited capacity to increase capital. While all banks increased lending to the real estate sector, the exposure of savings banks became particularly pronounced. In their case, not only did lending grow faster, but it was also more often directed to poor quality assets. Moreover, despite the increase in deposits, the credit expansion, given its magnitude, had to be financed also via wholesale funding, mostly obtained in European markets.

3. **A deterioration in global economic and financial conditions since the outbreak of the Global Financial Crisis (GFC) revealed the weaknesses of the structure of the Spanish banking sector and the strategies followed by financial entities.** Following the start of the GFC with the crisis in the US subprime mortgage markets in 2007, Spanish banks' access to foreign funding became more constrained. Moreover, the worsening of economic prospects and falling funding availability triggered a sharp correction of credit growth and real estate prices. Even if the direct exposure to the US banking sector was very limited, a global reassessment of risk put Spanish banks under closer scrutiny.

4. **The Spanish authorities adopted measures to address the financial sector problems, in various rounds.** Reflecting the worsening of the international context, and the first episodes of financial stress, Spanish authorities started introducing several measures to strengthen the banking sector. These included the tightening of prudential regulation, initiatives to introduce elements of market discipline for savings banks, the creation of a resolution fund and, most importantly, various rounds of consolidation in the banking sector.

5. **By the end 2011, the measures taken by the Spanish authorities had proven insufficient.** In a context of protracted crisis in the European Union, due to the deepening of the sovereign and banking crisis in several euro area countries and the emergence of redenomination risk in euro area capital markets, financial conditions for the Spanish private and public sector became even tighter. Fiscal capacity, which had appeared to be robust in Spain at the start of the crisis, was much weakened after the first round of support measures to the banking sector. This, in turn, fed the perception of fiscal unsustainability and of large financial stability risks linked to the sovereign-financial adverse feedback loop.

6. **A major turnaround was the signing of the memorandum of understanding (MoU) with the European authorities in 2012.** The MoU provided the resources – through a financial assistance programme – and the credibility needed to introduce a forceful response to the banking sector crisis. Weak banks were required to restructure or were resolved, following a thorough diagnostic exercise, comprising an asset quality review and a stress test. Moreover, all banks requiring public support were required to transfer their real estate assets to an Asset Management Company (AMC). In addition,
legislation was introduced to establish a fully fledged bank resolution framework and to convert savings banks into regular commercial banks.

7. **This paper reviews the policy measures taken by the Spanish authorities.** The policy response in Spain relied on a combination of several instruments. It aimed to address the most pressing financial stability issues and the structural vulnerabilities of the banking sector, as well as the deficiencies of the institutional setup. The paper aims to shed light on the design of the different measures, the challenges faced, the trade-offs involved and the main outcomes.

8. **Several sources were used for the preparation of the paper.** Those include the publications by the Spanish authorities, international organisations and EU authorities. The paper also benefited from an extensive number of contacts with both public and private sector officials who held relevant positions during the crisis either in Spanish, European or international institutions.

9. **The paper is organised as follows.** Section 2 reviews the origins of the crisis, covering relevant developments in both the macroeconomic environment and the banking sector. Section 3 describes the initial crisis response between 2008 and 2010, before the outbreak of the European sovereign crisis. Section 4 focuses on the second round of crisis response measures, taken over 2011 and the first half of 2012, when the situation worsened considerably. Section 5 is devoted to the analysis of the measures and reforms adopted on the basis of the MoU between the European authorities and Spain. Section 6 concludes with some general lessons that can be drawn from the Spanish experience.

Section 2 – Origins of the crisis

10. **This section covers the long-term drivers of the banking crisis in Spain.** It provides an overview of macroeconomic conditions starting from the mid-1990s, which generated deep macroeconomic imbalances by the second half of the first decade of the 2000s. It also describes developments in the banking sector up to the outset of the crisis, highlighting several structural vulnerabilities. The combination of these factors deeply affected the viability of part of the Spanish banking sector. These vulnerabilities came to the fore from 2009 onwards and triggered the banking crisis in Spain.

Macroeconomic aspects

11. **The Spanish economy enjoyed a long expansionary phase starting in the mid-1990s, up to 2007.** Over the period 2000–07, cumulative real GDP growth was 34.5%, with an annual average rate of 3.8% (Graph 1). Per capita GDP also increased significantly, closing the gap with European averages – by 2007, Spanish per capita GDP stood at 94.8% of the euro area average. Employment also increased, although less rapidly than output, with the employment rate raising by 12.2 percentage points over the same period. This was against the backdrop of strong immigration flows and a significant increase in female labour force participation.

12. **Spain’s adoption of the euro was the main trigger of the expansionary phase.** Spain joined the monetary union from its launch, in 1999. With the elimination of foreign exchange risk and the near disappearance of country risk premia across the euro area, Spain could borrow at significantly lower nominal interest rates. Moreover, access to euro money and capital markets facilitated inflows from the rest of the common currency area. These flows were substantial, as foreign investors sought to take

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advantage of investment opportunities offered by Spain. These capital inflows occurred against the backdrop of the global abundant liquidity since the early 2000s.

13. **Over this phase, macro-financial imbalances started building up.** In particular, private sector debt increased substantially for both households and non-financial corporates, reaching over 80% of GDP and over 100% of GDP in 2007, respectively (Graph 2). Banks substantially expanded their

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Sources: World Bank; Bank of Spain.
exposure to the real estate sector as a consequence of the large expansion of mortgage lending and, especially, of loans to developers. This pattern was mainly the result of favourable financial conditions, but it also reflected the traditional preference of Spanish households for home ownership, which was also supported by favourable tax treatment. The credit boom triggered a substantial increase in borrowing from abroad, particularly from the rest of the euro area, resulting in a large negative net international investment position (IIP) for Spain, amounting to 80% of GDP by 2007. Despite the expansion of the housing supply, persistently strong housing demand led house prices to soar, on average doubling in value in real terms and growing by 150% in nominal terms over 2000–07 (Graph 2).

Developments in the Spanish economy

[Graph 2]

14. **The international competitiveness of the Spanish economy markedly deteriorated during this period.** Spain accumulated significant inflation differentials and current account deficits over the period. This was only partially the benign consequence of a catching-up process, whereby productivity gains in the tradable sector would lead to higher wage growth and, therefore, higher prices

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3 Over 2000–07, loans for house purchases exhibited an average annual growth rate of 19.7% – or 252% in cumulative terms – in comparison with 14.6% for loans for other purposes, mostly consumer loans.

4 Over 2000–07, bank loans to the construction and real estate sectors grew at an average annual rate of almost 30%, compared with 12% for loans to other sectors. Over the same period, and in cumulative terms, lending to the real estate sector rose by 513%, while lending to all other sectors rose by just 120%.
in the economy as a whole. In fact, inflation differentials mainly reflected strong demand pressure in the non-tradable sector and rigidities in the labour market. As a result, Spain’s unit labour costs increased markedly in comparison with those of its main trading partners in the euro area, without a corresponding increase in productivity.

15. **The imbalances were well documented, but not addressed at the time.** In the years leading up to the 2008 financial crisis, domestic and international institutions extensively documented the financial imbalances (particularly excess indebtedness and housing overvaluation) as well as weaknesses in the real sector (low productivity, losses of competitiveness), thereby suggesting concerns about the sustainability of growth patterns in the Spanish economy. However, those analyses, while often stressing the risk of disorderly developments, tended to consider a gradual absorption of those imbalances as the most likely scenario. Arguably, no analysis of the pre-crisis period anticipated the sharp correction of those imbalances that occurred starting in 2008.

16. **Policy actions by domestic authorities did not help mitigate the existing imbalances.** In particular, fiscal policy was not sufficiently tightened in the expansion and was excessively relaxed when the first symptoms of deceleration appeared. In addition, labour market reforms did not manage to create enough flexibility. Importantly, the single monetary policy for the euro area was too accommodative for the needs of an overheating economy such as Spain, and global conditions of abundant liquidity in financial markets contributed to exuberance in market valuations. Some prudential measures were adopted by the Bank of Spain (BdE), as discussed below, but, while innovative and in the right direction, they ended up being too timid and were not able to correct the excessive credit expansion or contain the accumulation of credit and funding risks on banks’ balance sheets.

17. **Deterioration of global economic and financial conditions marked a turning point for Spain, both in 2008 and 2011.** When global financial markets were hit by turbulence in the US financial sector, starting in 2007, Spain was relatively unaffected, due to the limited exposures to the US subprime mortgage sector. The macroeconomic impact that followed, and the collapse of the real estate and construction sectors, however, put the already unsustainable imbalances in the Spanish economy and its banking sector under considerable strain. Regional factors also played a role in the deepening of the financial crisis in Spain in 2011. By that time, the global crisis had taken a specific turn in Europe, becoming a sovereign crisis affecting countries with fragile banking sectors and/or weak fiscal positions. Moreover, uncertainty about banks’ solvency and the credit quality of their assets impaired the euro area interbank and securitisation markets, turning access to funding into a major challenge for euro area banks, especially in countries affected by sovereign risk. As a result, it became extremely hard for Spanish banks to maintain access to European funding. Spain’s fiscal position had been relatively solid in the early 2000s, although revenues were heavily dependent on the rapid growth in the real estate sector. Since then, it had been negatively affected by the economic contraction starting in 2008 and the

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5 This is known in the economic literature as the Balassa-Samuelson effect, which explains prices and real exchange rate differentials on the basis of productivity growth differentials between the sectors producing tradable and non-tradable goods. Higher productivity in the tradable goods sector bids up wages in that sector and, with labour being mobile, wages in the entire economy rise.


8 See eg for the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD), IMF (2006) and OECD (2005, 2007).

9 According to the OECD, by 2005 labour market reforms, especially those implemented in 1997 that lowered severance payments and social security contributions for some workers, had improved conditions in the labour market. However, employment protection legislation, active labour market policies and unemployment benefits still required comprehensive reforms (OECD (2005)).

10 See eg Otero-Iglesias et al (2016) for a discussion of this point.
expansionary fiscal response to it. By 2011, Spain suffered from a combination of a vulnerable fiscal position and a weakened banking sector that was experiencing extreme stress. This combination further deepened the macroeconomic contraction, and the cost of funding to the economy and banks. As discussed below, the worsening in external and internal conditions in 2011 marked a turning point in the response to the Spanish crisis.

Banking sector aspects

18. In the years preceding the banking crisis, the banking sector in Spain was composed of three main types of banks. These were commercial, savings (cajas de ahorros) and cooperative banks. The first two dominated the market, while the cooperatives represented only a minor share of banking sector activities and are therefore not covered in this paper.

19. A striking development in the structure of the banking sector was the considerable expansion of savings banks. Starting in the mid-1980s, savings banks increased their share of activities in the banking sector, in terms of both their collection of domestic deposits and their provision of loans to the private sector (Graph 3). This expansion followed legislative changes in the late 1970s and the 1980s, which gave savings banks the ability to operate like commercial banks and allowed them to expand the scope of their activity to the national level.\(^\text{11}\)

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11  As discussed in Santos (2018), a 1977 decree had already established the operational equivalence between commercial and savings banks (RD 2290/1977), thus allowing savings banks to expand their lending options. A 1985 law (Ley 31/1985) attempted to improve the governance structure of savings banks, endowing them with governance institutions that resembled those of publicly traded companies. A 1988 decree (RD 1582/1988) allowed savings banks to collect deposits and provide credit at the national level; prior to that, they had been restricted to operations in the province, and later in the region, where they were headquartered.
20. **Savings banks had an unusual setup.** They were private banks with a specific legal status and governance reflecting their original welfare role. In a narrow, legal sense, they had no owners and all their distributed profits were devoted to social goals. As they became more similar to commercial banks, and competed with them for banking business, their structure became increasingly unsuitable. In particular, it made them vulnerable to capture by political interests, leading to substantial distortions in their risk management (Santos, 2017). A second major characteristic of savings banks was the restriction on raising high-quality capital. As these institutions lacked shareholders, they could not issue common equity. They could only increase their capital levels through profit retention. Although savings banks issued large amounts of debt instruments in capital markets, they were subject to limited market discipline. Lastly, the sale of savings banks to healthier commercial banks was restricted by their legal status, and cross-region mergers had to be approved by the regional governments.

21. **Lending to the real estate sector increased markedly in the lead-up to the crisis, especially by savings banks.** Between 2000 and 2007, the cumulative growth of loans to Spanish households for house purchases exceeded 250%, and the corresponding number for lending to the aggregate real estate sector (mainly property developers) rose to 513% (Graph 4). Savings banks became especially exposed to the real estate sector. Commercial banks accounted for 37%, and savings banks for 57%, of the increase in lending to households for house purchases. For lending to non-financial companies in the real estate sector, savings banks increased their lending by an average annual rate of 31%, while the corresponding figure for commercial banks was less than 28%.

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12 Savings banks were established in the first half of the 19th century to provide basic financial services to the poor. Their mandate was expanded in the following decades. They were credit institutions subject to private law although they were created through initiatives by local and regional authorities and other public bodies. They have often been characterised as private foundations with a public interest (Latorre (1997)). Local corporations were represented in the governance structure together with other stakeholders, depositors, employees, founders etc. Since the 1980s, the autonomous regions assumed some regulatory functions in relation to savings banks, although these banks were also subject to the BdE’s prudential oversight.

13 Not all savings banks performed poorly in the 2000s, but most did, as explained in the sections on the response to the crisis. For bank-level details on resolution and closure in the financial crisis, see FROB (2019).

14 A change took place in 1988, when savings banks were able to issue cuotas participativas, special equity units that counted as regulatory capital. Those instruments allowed the holders to receive part of the profits although they did not confer voting rights. In practice, they proved to be unattractive to investors.

15 For more information on the reform of Spanish savings banks, see eg IMF (2012b).
22. **The banks funded their credit expansion via deposits, the issuance of covered bonds and other forms of securitisation.** The volume of deposits from firms and households more than doubled between 2000 and 2007. However, the sustained increase in the provision of credit necessitated recourse to other funding sources. Spanish banks expanded the issuance of securities, especially covered bonds (cédulas hipotecarias). They securitised part of their assets, which were then transferred to off-balance sheet securitisation vehicles that funded themselves through debt instruments with different risk profiles (tranches). Adoption of the euro facilitated the sale of these securities to other banks and institutional investors, mostly located in foreign jurisdictions. For instance, in 2007 more than 60% of the outstanding amount of securitisation instruments, including covered bonds, issued by Spanish banks were held by foreigners.

23. **The spike in issuance of securitisation instruments, including covered bonds, was primarily driven by savings banks.** Spain created the largest securitisation market in the euro area.

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16 Total credit by Spanish banks increased from €559 billion in 2000 to €1,760 billion in 2007.

17 This type of covered bond exclusively uses mortgages as the reference assets. Several conditions were in place to ensure the robustness of covered bonds. For instance, the covered bond volume was limited to 90% of the issuer’s collateral pool, which was in turn constrained to first-lien mortgages with loan-to-value ratios capped at 80% (70%) for residential (commercial) mortgages (IMF (2006)). These bonds remained on the issuing banks’ balance sheets and were primarily used by banks for funding purposes.
and the second largest in the European Union (EU), after the United Kingdom. By end-2006, the outstanding amount of securities originated by Spanish banks, including covered bonds, reached €243 billion (Graph 5). Of this amount €135 billion corresponded to origination by savings banks, against €82 billion by commercial banks. This issuance accelerated before levelling off in 2009, so that by 2010 Spanish commercial banks accounted for €146 billion of the outstanding stock, against €278 billion by savings banks.

### Securitisation

<table>
<thead>
<tr>
<th>Issuance</th>
<th>Outstanding amounts</th>
</tr>
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</table>

Graph 5

Sources: Bank of Spain, Reports on Banking Supervision for the years 2000–10.

24. **The accounting and prudential treatment of securitisation in Spain was relatively conservative.** The regulator required banks to consolidate securitised assets whenever the risk was retained within the balance sheet of the bank originating them. As a result, the exposure remained subject to capital charges and accounting provisions. The securitised assets could only be removed from the bank’s balance sheet if the risks and benefits of these assets had been substantially transferred. As a consequence of this regulation, 95% of the assets securitised after 2004 were not removed from banks’ balance sheets. This was a more conservative approach than that in other jurisdictions, where securitisation could more readily be used to derecognise risks, deconsolidate assets and reduce capital requirements.

25. **The banks’ supervisory authority was the BdE.** The legal framework made the Ministry of Economy and Finance (MdE) the principal agency charged with issuing financial regulation, although, in
practice, the BdE had regulatory powers in areas specifically delegated by law or the MdE. The BdE was in charge of implementing regulation that reflected EU-wide directives and regulations, which in turn were closely aligned with global standards. In particular, starting from the late 1980s, bank solvency regulation reflected the first vintage of the Basel capital accord, i.e., Basel I. Basel II was introduced in the EU in 2006 and in Spain in early 2008. The BdE was also in charge of the supervision of all credit institutions, including savings banks. For the latter, the BdE and the regional authorities shared regulatory competences.

The BdE had delegated powers to set banks’ accounting standards. This setup allowed the BdE to introduce before 2004 accounting provisions for loan losses that were unusual at the time. The BdE adopted what was then perceived as a prudential perspective — i.e., to limit risks in the financial system — rather than a pure transparency focus. The BdE approach explicitly attempted to increase banks’ resilience against future impairments at times of booming credit demand and limited incurred losses, as well as to reduce the procyclicality of lending. To this aim, the BdE required banks to adopt a system of so-called dynamic provisioning, which incorporated a countercyclical element according to which provisions were supposed to increase during credit expansions and decrease in credit contractions. This approach was slightly adjusted in 2004 after the adoption of the international accounting standards in the EU. Over the expansionary phase, the dynamic provisions helped Spanish banks to accumulate more provisions than what would have been required under a strict application of the prevailing accounting standards. Eventually, the stock of provisions proved insufficient to cover the sizeable impairments suffered. Nonetheless, it provided a buffer of almost €26 billion to absorb the first round of losses at the start of the crisis.

A privately funded deposit guarantee scheme was available to manage bank-specific weaknesses. The first Spanish scheme was established in 1977. Initially there were three sectoral schemes (for commercial, savings and cooperative banks). In 2011, they merged into the current

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18 IMF (2012a) noted that the independence of the BdE in its regulatory capacity is clearly distinct in Spanish law from that in its monetary authority role. There was therefore a risk of prudential regulation becoming dependent on government action, which could delay changes in the regulatory framework.

19 In particular, the regional authorities were in charge of the application and development of the specific rules set for savings banks at the national level, particularly in terms of governance arrangements (Otero-Iglesias et al. (2016)).

20 Contrary to what is currently the case, that transparency objective was perceived at that time to be better served by credit impairment criteria that reflect incurred rather than future expected losses.

21 With dynamic provisions, banks were required to cover at all times the expected loss through the cycle on the loan portfolio. As a result, banks would create additional provisions (against the income statement) during upturns, when non-performing assets were relatively low, and release them, crediting them to the income statement, in a downturn.

22 The dynamic provision was established as a complement to the standard loan loss (specific) provisions held by banks to cover incurred losses for each of their exposures. It was calibrated as a combination of two components: the first one was linked to the growth of the credit portfolio (new credits); the second component (which was the one countercyclical in nature) was determined as the difference between the average specific provision for the entire system over the last credit cycle and the current specific provision of each bank. The provisioning fund thus generated had a floor and a cap to ensure a minimum supply and avoid excess thereof, respectively. See Saurina and Trucharte (2017a) for more details.

23 According to Regulation (EC) 1606/2002 of the European Parliament and the Council of 19 July 2002, the international accounting standards were applicable to the consolidated financial statements of the companies whose securities were publicly traded in regulated markets of the EU. The BdE implemented the standards through Circular 4/2004, applicable to consolidated and individual financial statements, trying to maintain as much as possible the main characteristics of Spanish regulation but making it compliant with international accounting standards.

24 For a discussion, see e.g. Herring (2017) and Neves (2017).

25 Bank of Spain (2017) remarks that the countercyclical provisions were calibrated on the basis of the credit cycle that preceded Spain’s entry into the euro area. Although this period included the 1993 recession, that was far less intense than the banking crisis that started in 2008.
scheme, known as the Fondo de Garantía de Depósitos (FGD).\textsuperscript{26} They were funded by banks and the BdE until 1996, but in 1997 the BdE stopped making contributions. The FGD had a dual role. It guaranteed customer deposits should a member bank face a liquidity constraint,\textsuperscript{27} and it helped to restructure failing credit institutions. In order to do that, the FGD could recapitalise a bank through the acquisition of ordinary shares in commercial banks (or cuotas participativas in savings banks; see Box 1) if the bank approved a capital increase. However, the FGD did not have the legal power to impose the decision to activate crisis management instruments on the shareholders. It also did not have sufficient resources to face a systemic crisis. As explained below (see also Box 1), that changed with the establishment of a dedicated fund, the Fund for Orderly Bank Restructuring (FROB) in 2009.

28. **Pre-GFC bank failures were managed by the BdE and the FGD.** Spain had experienced two banking crises in recent history. The first ran from the mid-1970s to the early 1980s, following efforts to liberalise and deregulate the Spanish banking sector, and coincided with the 1970s oil crisis. The second took place around the time of a severe recession in the first half of the 1990s. Like most other advanced economies up to the late 2000s, Spain did not have a well-established framework for dealing with systemic banking crises. As a result, in those crisis episodes the BdE had a leading role, although it required government approval for the disbursement of public support. The FGD was also involved, according to its dual mandate.

**Section 3 – Early crisis response, 2008–10**

29. **In 2008, turmoil in global financial markets, which had initially spared Spain, increased pressure on the financing of Spanish banking and public sectors.** Starting in mid-2007, global financial markets had been shaken by the banking crisis that originated in the US subprime debt market. Spanish banks, however, were broadly unaffected, thanks to limited direct exposures and their traditional business model. Nonetheless, funding pressures started to materialise in 2008 given a global reassessment of risk in the banking sector in general. In addition, conditions in Europe changed in late 2009, given concerns about the negative feedback loop between sovereign and banking sector risks. These concerns led to the programmes of economic and financial assistance for a number of euro area countries (for instance, Greece in May 2010, Ireland in November 2010 and Portugal in June 2011). Loss of confidence about the viability of banks in several euro area countries resulted in funding difficulties. Spanish banks also faced liquidity shortages, and new wholesale funding evaporated. Fiscal capacity in Spain also deteriorated, as revenues from the real estate sector dried up, expenses increased to support the weakening economy and contingent liabilities associated with the weak banks started building up.

30. **Initially, crisis response measures focused on supporting banks’ access to liquidity.** The European Central Bank (ECB) responded to the funding pressure on euro area banks in some countries with a series of exceptional liquidity programmes.\textsuperscript{28} The Spanish authorities adopted temporary measures to support liquidity of all banks, in order to avoid stigmatising individual institutions. A

\textsuperscript{26} The FGD was managed by a board composed of six members representing the BdE, and six members representing financial institutions. One of the members representing the BdE was the chair of the board and had the casting vote. This was changed in June 2014 and currently, the composition of the board is four members representing the BdE, two members representing the Ministry of the Economy and the Finance Ministry, and five members representing financial institutions.

\textsuperscript{27} In 2008, the amount guaranteed per depositor was raised from €20,000 to €100,000 (RD 1642/2008, of 10 October).

\textsuperscript{28} Measures included fixed rate full allotment in the ECB refinancing operations, extension of the maturity of liquidity provisions, broadening of collateral eligibility and the covered bond purchase programme. The latter applied to covered bonds issued by Spanish banks (cédulas). In cooperation with some foreign central banks, the ECB also provided currency swaps. For more details and a discussion of the measures, see Cour-Thimann and Winkler (2013).
€43 billion fund\(^{29}\) was established to purchase high-quality securities issued by banks and collateralised with new lending. The acquisitions were designed to complement the ECB liquidity facilities and eventually provided €19 billion to 54 banks. In parallel, a €111 billion state guarantee scheme was launched to support new debt issuances.\(^{30}\) Spanish banks’ reliance on ECB funding increased from 5% to 15% of GDP between 2008 and 2010.

31. **The BdE’s 2009 intervention in a failing savings bank was an early illustration of both the underlying solvency issues and the limits of the crisis management framework at the time.** Caja Castilla-La Mancha (CCM) (corresponding to less than 1% of total Spanish banking sector assets) had serious governance deficiencies and a large overexposure to real estate lending. Once on-site inspections revealed capital shortfalls and deposit outflows escalated, an intervention was inevitable. The management was replaced and the bank was sold to a competitor. However, the sale needed the approval of the savings bank’s governing body, since the BdE and the FGD lacked powers to override shareholders’ rights. The resolution involved a considerable use of funds (16.2% of the bank’s assets), provided by the FGD. The latter injected capital of €1,740 million and granted an asset protection scheme (APS)\(^{31}\), which had a final cost of €2,475 million.

32. **The FROB was established in 2009, with a mandate to promote and financially support the consolidation of weak banks.** The FROB was established to overcome the limitations of the Spanish resolution framework that became apparent with the CCM crisis. It was initially endowed with €9 billion\(^{32}\) and empowered to boost the general level of bank solvency. Its involvement was legally foreseen in two scenarios. In one, the FROB could support the restructuring of non-viable banks by replacing managers, submitting a restructuring plan to the BdE and eventually merging or transferring the bank’s business to third entities. In the other scenario, in an attempt to promote efficiency and stronger governance and, particularly, encourage savings banks’ integrations, the FROB was enabled to support voluntary integration processes between viable but weak institutions. In the case of non-viable institutions, the restructuring plan could involve the FROB’s acquisition of ordinary shares of commercial banks or cuotas participativas of savings banks, while in the case of voluntary integration of viable banks, the FROB could support those integration processes with the acquisition of convertible preferred shares (participaciones preferentes). Box 1 discusses these instruments in more detail.

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\(^{29}\) RDL 6/2008 of 10 October 2008 created the Fund for the Acquisition of Financial Assets (FAFA). The FAFA was wound down in June 2012 with benefits for the state of approximately €650 million (Bank of Spain (2019)).

\(^{30}\) This generated state revenue of €3,060 million from fees (Bank of Spain (2019)).

\(^{31}\) APS protect the acquiring bank from most of the losses on the reference portfolios.

\(^{32}\) It also had the capacity to borrow another €27 billion under government guarantee. This limit could be exceeded up to a maximum amount of €90 billion with the authorisation of the MdE.
To circumvent the legal and political constraints to restructuring weak savings banks, the authorities promoted the creation of strengthened institutional protection schemes (IPS). In particular, regional authorities were reluctant to authorise cross-regional mergers. In fact, the four mergers of savings banks that took place in 2010 were among institutions from the same region (Catalunya Caixa and Unnim in Catalonia, CEISS in Castilla y León and Novacaixagalicia in Galicia). The strengthened IPS were contractual mechanisms used by several financial institutions to mutualise profits, solvency and liquidity. Economically, IPS had effects similar to those generated by a merger, although the savings banks remained separate legal entities and thus faced fewer obstacles from the regional governments than the mergers. While potentially helpful to promote the sector’s consolidation and circumvent political opposition, IPS were convoluted structures subject to complex governance arrangements.
The 2008–14 banking crisis in Spain

Box 2

Institutional protection schemes (IPS)

The integration process of some banking groups was implemented through mergers (this was the case of CatalunyaCaixa, Unnim, Novacaixagalicia and CEISS), but this was not always possible. A major obstacle was resistance to the disappearance of the individual savings banks by their controlling groups, which were in many cases linked to the local and regional authorities.

To avoid opposition to the mergers, the same legislation that established the FROB (RDL 9/2009) also established that the integration processes that the FROB could support were not only mergers, but also those IPS – ie agreements among financial institutions to support their mutual solvency and liquidity – which had economic effects comparable to those of mergers. In 2010, a new regulation (RDL 6/2010) established that IPS could be considered as consolidated groups if they met some additional requirements (strengthened IPS). These included the establishment of a central institution responsible for the business strategy and the internal and risk control of the IPS, the mutualisation of at least 40% of the solvency and earnings, and the commitment to maintain the agreements for a minimum period of 10 years. That commitment could only be broken with the authorisation of the BdE after analysis of the viability of the resulting institutions. In practice, the IPS that were created in 2010 (Table 1) mutualised 100% of the solvency, liquidity and profits of their members. As a result, even if legally the savings banks still existed as separate entities, economically the IPS were equivalent to a merger. However, in order to adjust the valuation of the assets of all the savings banks involved in a strengthened IPS in line with fair value, it was necessary to demonstrate that, even if one of the savings banks had a majority stake in the new entity (as was the case in BFA, where Caja Madrid had a 52% stake), there was joint control by the integrating banks of the central institution that was created by the IPS. This joint control was implemented through the requirement of qualified majorities for the adoption of some pre-specified decisions by the General Assembly as well as by the board.

34. The first round of FROB interventions involved the acquisition of convertible preferred shares for €9,674 million to support seven savings banks’ integration projects (FROB I). Between 2007 and 2011, the number of savings banks fell from 45 to 15.33 In particular, the FROB supported four mergers and three IPS projects by subscribing convertible preferred shares that reinforced the capital levels of the new groups (Table 1). Among the three IPS was BFA, which became the fourth largest bank in Spain, with 10% of the total assets of the banking system. In all these cases, the pricing conditions of the preferred shares34 were in line with European state aid rules.35 In addition, in May 2010 the BdE replaced the managers of another failing savings bank, CajaSur, and appointed the FROB as administrator.36

35. In 2010, the legal framework of the savings banks was reformed to strengthen governance and stimulate the transfer of banking activities to commercial banks. The limit on voting rights of public entities was lowered from 50% to 40% and elected political representatives and senior officials from the public sector were prohibited from serving on governing bodies. Fit and proper criteria were strengthened, including stricter requirements of experience and integrity for managers. The regime for in-house committees was upgraded to improve internal control and risk management.

33 Five integration processes took place without financial support from the FROB or the FGD. These were La Caixa-Girona, Unicaja-Jaén, Kutxabank (BBK, Caja Vital and Kutxa), Liberbank (Caja Asturias, Caja Cantabria and Caja Extremadura) and Caja 3 (Caja inmaculada, Caja Círculo Burgos and Caja Badajoz).

34 They yielded 7.75%, subject to the presence of distributable profits.

35 In the European framework, any aid granted by a member state which distorts competition is incompatible with the internal market and is prohibited except under some special circumstances to remedy a serious disturbance of the economy of a member state. In that case, the state aid has to be authorised by the European Commission and is subject to strict conditions. State aid regulation is defined in articles 107 and 108 of the Treaty of Functioning of the European Union.

36 In June 2009, the BdE had approved the merger between Unicaja and Cajascal, but after a year of negotiations Cajascal rejected the merger.
The rules on equity instruments in savings banks (cuotas participativas) were substantially modified, granting them voting rights and removing the individual holding limit of 5%. More importantly, the new legal framework made it possible for savings banks to transfer their banking business to a commercial bank, either retaining their special corporate nature as savings banks or becoming a foundation. This latter option would be compulsory as part of the resolution process of a failing savings bank or if the stake of the savings bank in the commercial bank was below 50%. Finally, the new legal framework enabled the FROB to acquire securities issued by viable banks even if they were not undergoing an integration process when, in the BdE’s opinion, they required an urgent strengthening of their equity.

Integration processes in the first round of FROB intervention in viable banks via preferred shares, 2009–10 (FROB I)

<table>
<thead>
<tr>
<th>Type of action</th>
<th>Amount (EUR mn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unnim (Caixa Manlleu, Caixa Sabadell and Caixa Terrassa)</td>
<td>Merger</td>
</tr>
<tr>
<td>CatalunyaCaixa (Caixa Catalunya, Caixa Tarragona and Caixa Manresa)</td>
<td>Merger</td>
</tr>
<tr>
<td>CEISS (Caja Duero and Caja España)</td>
<td>Merger</td>
</tr>
<tr>
<td>Novacaixagalicia (Caixanova and Caixa Galicia)</td>
<td>Merger</td>
</tr>
<tr>
<td>Banco Financiero y de Ahorros (BFA) (Caja Madrid, Bancaja, Caja Insular, Caja de Ávila, Caixa Laietana, Caja Segovia and Caja Rioja)</td>
<td>IPS</td>
</tr>
<tr>
<td>Banco Mare Nostrum (BMN) (Cajamurcia, Caixa Penedès, La General and Sa Nostra)</td>
<td>IPS</td>
</tr>
<tr>
<td>Banca Cívica (Caja Navarra, CajaSol (including Caja de Guadalajara), Caja Canarias and Caja de Burgos)</td>
<td>IPS</td>
</tr>
</tbody>
</table>

Total 9,674

(1) In brackets are the names of the banks that were part of each integration process.

Source: FROB (2019).

36. These measures proved to be insufficient. The restructuring of the savings banks did not address the ultimate cause of their weaknesses, in particular their inappropriate governance structure and the need to insulate banking activities from political interference at the regional level. Although IPS had similar economic effects to regular mergers, they entailed complex governance arrangements (Box 2). Separately, the FROB had limited operational capacity at this stage. Its mandate was narrow, and it could not directly recapitalise banks via capital injections except in the case of the restructuring of non-viable banks.

Section 4 – Second round of crisis response measures, 2011–12

37. The deterioration of macroeconomic conditions in Spain and increasing concerns about banking sectors in the euro area required a new round of policy actions. After the outbreak of the crisis in 2009 and the first round of response measures, Spanish authorities had espoused the view that a turnaround in economic conditions would allow for a progressive and not too disruptive adjustment in the banking sector. However, the second economic recession in Spain in 2011, and the worsening of the sovereign crisis in the euro area, made this approach untenable. Access to liquidity for Spanish banks...
continued to deteriorate, and Spanish banks were becoming increasingly reliant on ECB financing – they absorbed a large share of ECB three-year refinancing operations in December 2011 and February 2012.

38. The Spanish authorities introduced new measures as part of the crisis response in 2011 and the first half of 2012. This section covers the response measures up until the request of an international programme of economic and financial assistance with the European Commission (EC). These include a new round of recapitalisations, as well as the request for additional provisions and capital for assets associated with construction and real estate development in the first half of 2012. At the end of this period, the collapse of Bankia forced the Spanish authorities to request an EU-funded financial assistance programme.

A new round of recapitalisations

39. In 2011, several measures were taken to strengthen the solvency of financial institutions. In February 2011, a new regulation (RDL 2/2011) was introduced to try to dispel doubts about the solvency of the Spanish banking sector, and to align bank regulation with the new global regulatory framework that was being developed, ie Basel III. This raised capital requirements in terms of quality and quantity, introducing the notion of high-quality, or core, capital and, as a general rule, required credit institutions to have a minimum core capital of 8% of risk-weighted assets (RWA). This minimum level was raised to 10% for credit institutions with less than 20% of their capital held by third parties and with a wholesale funding ratio above 20%. The second requirement in particular forced most of the savings banks to face a 10% core capital requirement unless they were able to place at least 20% of their capital in the market, therefore demonstrating the trust of private investors in their business model. If they could not raise the capital required, the FROB was authorised to acquire shares from those institutions (FROB II).

40. The FROB's powers were extended (FROB II). The same regulation (RDL 2/2011) allowed the FROB to acquire ordinary shares, but not cuotas participativas, of the banks which, while viable, needed to strengthen their capital levels in line with the more stringent capital requirements for core capital introduced by that regulation. This acquisition of ordinary shares required those savings banks that needed to strengthen their capital and the FROB's support to transfer their assets and liabilities to a commercial bank.

37 High-quality capital, or capital principal in the Spanish legislation, included capital, reserves, share premium, revaluation surpluses, minority interests and the instruments subscribed by the FROB. Revaluation losses and intangible assets were deducted from these items. The law explicitly defined the components of this capital aggregate, as the Basel III framework was not yet finalised by that time.

38 The FROB would participate in the bank's board of directors in proportion to its share of ownership in the capital.
Recapitalisation processes in 2011 and the first half of 2012

Caja de Ahorros del Mediterráneo (CAM) was not able to submit a plan with the appropriate measures to ensure its viability. Therefore, after the transfer of the business of CAM to a commercial bank (Banco CAM), the BdE decided, on 22 July 2011, to replace CAM and Banco CAM’s directors with the FROB. On 7 December 2011, the FROB accepted the offer made by Banco Sabadell, in a competitive procedure, to buy Banco CAM. The offer included the need for a capital injection of €5.249 billion and an APS on a predetermined asset portfolio, composed mainly of the assets related to construction and real estate. The APS would cover 80% of the losses that might arise in that portfolio. The FROB had previously valued Banco CAM at a negative amount of €727 million. This negative valuation determined that the injection of capital into Banco CAM gave the subscriber 100% of the bank’s capital. Eventually, the €5.249 billion capital injection and the APS were provided by the FGD. On 30 May 2012, the restructuring plan for Banco CAM was approved by the EC and on 1 June 2012 Banco CAM was sold by the FGD to Banco Sabadell for €1.

The three other institutions which requested financial assistance from the FROB (Novacaixagalicia, Catalunya Caixa and Unnim) had their recapitalisation strategies approved by the BdE in April 2011. In October 2011, after the approval of the recapitalisation plans by the EC and the transfer of the assets and liabilities to new banking institutions, NCG Banco and Catalunya Banc, the FROB injected the capital needed in NCG Banco (€2.465 billion) and Catalunya Banc (€1.718 billion). According to the economic value determined by the FROB, the injection gave the FROB a stake of 93.16% in NCG Banco and 89.74% in Catalunya Banc. In both cases, and according to the provisions of RDL 2/2011, the FROB granted a share buyback to the savings banks and to the investors proposed by them at the price at which the FROB had subscribed the shares. Only in the case of NCG Banco did private investors use this option, for a total stake of 2.59% of the capital of the bank (€70.7 million). As a result, the FROB’s stake fell to 90.57%.

In the case of Unnim, the BdE decided in September 2011 that it was unlikely that the repurchase of the convertible preferred shares subscribed by the FROB as part of FROB I (€380 million) would be carried out. Therefore, the FROB decided to call for the conversion of those preferred shares into ordinary shares of a new banking institution, Unnim Banc, after the transfer of the assets and liabilities of Unnim to Unnim Banc. According to Article 7 of RDL 9/2009, the BdE decided that the orderly restructuring of Unnim Banc should be carried out and the FROB agreed to provide financial support by subscribing shares of Unnim Banc for a total amount of €568 million. The FROB had previously valued Unnim Banc at a negative amount of €594 million. This negative valuation determined that the injection of capital into Unnim Banc gave the FROB 100% of the capital of the bank. On 7 March 2012, the FROB selected the offer made by BBVA, in a competitive procedure, to buy the 100% stake of the FROB in Unnim Banc for €1. The sale also included an APS similar to the APS granted to CAM. Eventually, the loss resulting from the sale to BBVA of the 100% stake in Unnim Banc, amounting to €953 million, and the cost of the APS were covered by the FGD.

In the process of the segregation of assets from BFA to Bankia in April 2011, the shareholding of Banco de Valencia remained in BFA. In November 2011, the Board of Directors of Banco de Valencia acknowledged its weak financial situation and the impossibility of finding a viable solution. Therefore, on 21 November 2011 the BdE decided, according to Article 7 of RDL 9/2009, to replace the Board of Directors and appoint the FROB as provisional administrator. In June 2012, a capital increase of €1 billion was approved and only €2 million was subscribed by private shareholders. As a result, the FROB had to subscribe €998 million.

1. The FROB developed a methodology for determining institutions’ economic value. That methodology was in line with EU legislation on state aid and consisted of two components: a due diligence performed by an audit firm and a valuation of the institution by three independent experts.
2. The initial expected loss of the APS for the FGD was €1.34 billion, but eventually the FGD had to pay Banco Sabadell a total of €7.39 billion.
3. The economic value was €181 million for NCG Banco and €196.5 million for Catalunya Banc.
4. €380 million of preferred shares converted into capital, €5 million of capitalisation of accrued interests of those preferred shares and €568 million of the capital injection approved in September 2011.
5. The initial expected loss of the APS for the FGD was €860.5 million, but eventually the FGD had to pay BBVA €2 billion.

41. In March 2011, the BdE published the individual bank capital needs in line with the requirements introduced in February, and required banks to prepare recapitalisation plans.
accordingly. According to the BdE calculations, 13 institutions\(^{39}\) had a capital shortfall of €17.02 billion.\(^{40}\) Those institutions had 15 days to submit to the BdE their strategy for complying with the new capital requirements. Eight of them opted to raise capital without the support of the FROB.\(^{41}\) This included Bankia, which had a capital shortfall of €5.775 billion. CEISS opted to merge with Unicaja. The remaining four institutions (Novacaixagalicia, Catalunya Caixa, Unnim and CAM) requested financial assistance from the FROB. In the cases of CAM and Unnim, the support was eventually granted by the FGD instead of the FROB. The FGD took a 100% stake in both banks and sold them in the first half of 2012. Apart from that, in November 2011 the FROB had to intervene in Banco de Valencia, which was a listed subsidiary of Bancaja, one of the seven savings banks integrated in the IPS BFA (Box 3). The total capital injection in this round of recapitalisations of the FROB/FGD amounted to €10,998 million (Table 2).\(^{42}\)

### Capital increases with FROB (FROB II)/FGD support via ordinary shares, 2011–12

<table>
<thead>
<tr>
<th>Institution</th>
<th>Capital injected by</th>
<th>% of capital acquired by FROB/FGD</th>
<th>Amount (EUR mn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>CAM</td>
<td>FGD</td>
<td>100.00</td>
<td>5,249</td>
</tr>
<tr>
<td>NCG Banco</td>
<td>FROB</td>
<td>93.16</td>
<td>2,465</td>
</tr>
<tr>
<td>Catalunya Banc</td>
<td>FROB</td>
<td>89.74</td>
<td>1,718</td>
</tr>
<tr>
<td>Unnim Banc</td>
<td>FGD</td>
<td>100.00</td>
<td>568</td>
</tr>
<tr>
<td>Banco de Valencia</td>
<td>FROB</td>
<td>90.89</td>
<td>998</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td><strong>10,998</strong></td>
</tr>
</tbody>
</table>

Source: FROB (2019).

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### Request for additional provisions and capital, and the collapse of Bankia

In the second half of 2011, the Spanish economy entered a second recession, which lasted until 2013. Contrary to the forecasts of the main national and international institutions, which pointed to modest but positive GDP growth, Spanish GDP suffered a contraction of 0.8% in 2011, 3.0% in 2012 and 1.4% in 2013. The unemployment rate also increased, reaching a historical peak of 27% in the first quarter of 2013. This was accompanied by a sharp rise in non-performing loans (NPLs; Graph 6)\(^{43}\) and a significant decline in lending. In this context, and despite the efforts made to

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\(^{39}\) The list of banks was published on 10 March 2011. It is available on the BdE website at www.bde.es/f/webbde/GAP/Secciones/SalaPrensa/NotasInformativas/11/Arc/Fic/presbe2011_9e.pdf.

\(^{40}\) Initially the number of institutions was 12 and the total shortfall €15.15 billion. Eventually, it amounted to 13 institutions with a shortfall of €17.02 billion, because of the breakup of the IPS Banco Base. The shortfall of Banco Base was €1.45 billion, while the shortfall for the institutions resulting from the breakup was €2.8 billion for CAM and €520 million for Liberbank. Of the total capital shortfall, €15.95 billion corresponded to savings banks and only €1.07 billion to commercial banks.

\(^{41}\) Liberbank initially opted to raise capital but finally managed to reduce its capital needs through internal actions.

\(^{42}\) Apart from those injections of capital, the FGD had to grant an APS, on predetermined asset portfolios, to the acquirers of Banco CAM and Unnim (Box 3).

\(^{43}\) The repricing of impaired exposures, reflecting deterioration in credit quality, was relatively slow in Spain due to the lack of a market pricing mechanism for NPLs. For instance, in the US, where such a mechanism already existed, the launch of the Public-Private Investment Program in 2009 was an opportunity not only to remove NPLs from banks’ balance sheet, but also to increase transparency and promote price discovery. Price discovery was much slower in Europe, where the recourse to a market-based mechanism to price NPLs was less well established (IMF (2009)). For a discussion of the evolution of the attention to the NPL issue during the banking crises that started in 2007 and the role of the IMF, see also Veron (2016).
restructure banks’ balance sheets since the beginning of the crisis, and especially the recapitalisation associated with FROB II, concerns over the soundness of certain parts of the Spanish banking system persisted.

43. **The new government introduced two regulatory packages to increase loan provisions and bank capital.** In December 2011, a new government came to power and in January 2012 it announced a new round of loan loss provisions and set a target to increase provisions by €50 billion. In order to achieve the provisioning target and to reduce the uncertainty about the valuation of banks’ assets associated with construction and real estate development, the government introduced two regulatory packages. The first introduced additional provisions (from 20 to 60%, depending on the type of asset) for troubled assets linked to construction and real estate development lending (including non-performing and substandard loans and foreclosed assets), a capital surcharge for troubled assets linked to land and to developments in progress as well as a one-off 7% provision for performing loans associated with land, construction and real estate development. The second regulatory package established two additional measures. First, one-off additional provisions (from 7 to 45% depending on the type of collateral backing the loans) were required to cover performing loans linked to the real estate sector. Second, bank-specific asset management companies had to be formed, and each bank was required to transfer the foreclosed assets associated with land, construction and real estate development there.

44. **Banks were required to submit to the BdE plans to comply with the regulatory packages introduced in the first half of 2012.** The BdE was required to review and, as appropriate, approve the plans. For most banks, meeting the additional requirements was not problematic. A notable exception was BFA-Bankia (Box 4).

45. **The introduction of provisioning requirements by an ad hoc law was unprecedented.** In principle, accounting provisions are governed by the accounting code, which, as explained above, was derived from international financial reporting standards (for consolidated statements) or the BdE’s regulations (for solo statements). An alternative option would have been to introduce additional capital requirements as a function of real estate exposures. This would have been more in line with the prudential framework, the practice followed in other jurisdictions and the macroprudential instruments that were developed after the crisis. Yet at that time the approach based on provisions was considered to be more effective to convey the message of far-reaching balance sheet cleanups.

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44 The total amount of loan writedowns between 2008 and 2011 amounted to €138 billion (Bank of Spain (2017)).
45 RDL 2/2012 of 3 February.
46 RDL 18/2012 of 11 May.
47 For the whole banking sector, the total amount of provisions required by these measures amounted to €62.604 billion and the additional core capital to €15.573 billion.
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Spanish banks’ asset quality

Non-performing loans to the resident private sector in Spain

Coverage ratio, non-performing loans to the resident private sector in Spain

NPL - Ratios, Non-performing loans to the resident private sector in Spain

1. By type of institution

2. By purpose

Sources: Bank of Spain; World Bank.
At around the same time, the International Monetary Fund (IMF) was completing its Financial Sector Assessment Program (FSAP) of the Spanish financial system. On 25 April 2012, the IMF made public the FSAP’s preliminary conclusions. The assessment confirmed that a major restructuring of the savings bank sector was taking place, but the financial sector reform strategy needed to continue in order to address remaining vulnerabilities. It stated that for some banks it would be difficult to meet the new loan loss provision requirements introduced earlier in the year. While the largest banks were sufficiently capitalised and showed strong profitability, 10 banks were identified as being vulnerable – among them, even if not explicitly mentioned, was BFA-Bankia. In particular, the FSAP stated that “to preserve financial stability, it is critical that these banks, especially the largest one, take swift and decisive measures to strengthen their balance sheets and improve management and governance practices”.

BFA-Bankia’s difficulties with complying with the new provision and capital requirements triggered its nationalisation. Faced with the emergence of large recapitalisation needs, management at the bank changed in May 2012 and asked for the conversion of the €4.465 billion of the FROB’s convertible preferred shares into ordinary shares. The bank also estimated an additional recapitalisation need of €19 billion. With the conversion of the preferred shares, in June 2012 the FROB took control of BFA and Bankia.

The birth and collapse of BFA-Bankia

BFA was the result of the merger of seven savings banks and, with a balance sheet of €328 billion, it was considered to be of systemic significance. As mentioned in Box 2 and Table 1, it was set up in 2010 as an IPS which received €4.465 billion in convertible preferred shares from FROB I. In December 2010, the assets and liabilities of the seven savings banks were transferred to a new bank, BFA. Considering that BFA did not have capital held by third parties and its wholesale funding ratio was above 20%, compliance with the measures introduced in early 2011 (RDL 2/2011) implied that the bank was required to hold high-quality capital of at least 10% of RWA. This implied a capital shortfall of €5.775 billion.

To reduce this shortfall, in the recapitalisation plan submitted to the BdE BFA proposed to launch an initial public offering (IPO), which would reduce the high-quality capital requirement to 8% and the shortfall to €1.795 billion. This shortfall would in turn be covered by the capital raised in the IPO.

To implement the IPO, BFA set up a subsidiary, Bankia, which would be listed on the stock market. Bankia received most of the group’s banking business. Apart from its holding in Bankia, BFA retained government bonds, financial investments (including the stake in Banco de Valencia), non-performing or substandard risks with real estate developers and foreclosed land, and the subordinated debt (including the convertible preferred shares subscribed by the FROB). The objective was to maintain in BFA the assets whose valuation was surrounded by more uncertainty, so as to make the IPO of Bankia more attractive. On 20 July 2011, Bankia was floated, raising €3.092 billion in capital and reaching a high-quality capital ratio of 8.5%. BFA’s stake in Bankia fell to 52.41%.

The worsening of the economic situation and the 2012 capital and provision requirements (RDL 2/2012) strongly affected BFA-Bankia. BFA-Bankia submitted a plan to comply with these requirements and normalise its financial situation. The BdE required additional measures to make the administration and management of the group more professional, as well as a divestment programme. At the same time, discrepancies emerged between the managers of BFA-Bankia and the auditor on the financial accounts for the year 2011. These discrepancies were not resolved before 30 April 2012, which was the deadline for publication of the 2011 annual accounts. In early May, the group published the accounts without the auditors’ report. Those accounts showed €125 million in losses before taxes.

48 Most of these banks had received State support and were in varying degrees of resolution process.

The 2008–14 banking crisis in Spain
The 2008–14 banking crisis in Spain

Request for an EU-funded financial assistance programme

48. The worsening economic and political situation in Greece in the second quarter of 2012 and the emerging fiscal concerns in other countries, including Italy and Spain, were seriously affecting the stability of capital markets in the whole euro area, where the pricing of currency redenomination risk started to appear. In this context, and with a worsening of the recession in Spain, doubts about the solvency of the Spanish financial system intensified and funding conditions in wholesale markets for Spanish banks became tighter. In addition, rating agencies downgraded Spain’s government debt based on prospects of a further deterioration in public finances due to the contracting economy and the potential need for support to the banking system. The net outflow of funds from abroad that started in 2011 became even more pronounced in 2012, leading to a significant increase in Spanish banks’ reliance on ECB funding, which reached €417 billion (40% of GDP) over the summer of 2012.49 In addition, Spanish sovereign debt ended up increasingly in the hands of domestic banks, intensifying the sovereign-bank linkage and thereby raising tail risks of an adverse and self-reinforcing circle of financial stress. Concerns about a sovereign-bank doom loop became more acute, and the spreads of the Spanish 10-year Treasury bond started to increase by the end of March 2012, reaching a peak of 6.78% in July 2012, the highest since the start of the monetary union (Graph 7).

At the BFA-Bankia group and profits of €384 million at the Bankia sub-group. On 7 May, the chair of BFA and Bankia resigned, and on 9 May a new chair was appointed.

The new management of BFA-Bankia, deeming the redemption or repurchase of the convertible preferred shares subscribed by the FROB in 2010 to be unlikely, asked for its conversion into ordinary shares. On 14 May, the FROB decided to approve the conversion into capital of the €4.465 billion of preferred shares. The BdE asked BFA-Bankia to provide a new restructuring and recapitalisation plan. At the end of May, the new management submitted the plan and restated the 2011 accounts, showing losses of €2.978 billion at Bankia’s level and €3.318 billion at group BFA level. At the same time, the new management of BFA-Bankia estimated a recapitalisation need of €19 billion, in addition to the €4.465 billion in convertible preferred shares. On 27 June 2012, those convertible preferred shares were converted into ordinary shares of BFA, once the FROB had performed the valuation of the institution, which resulted in a negative value of €13.365 billion. This negative valuation determined a reduction of BFA’s capital to zero, which wiped out the shares of the seven savings banks that had set up BFA-Bankia. As a result, the FROB became the sole shareholder of BFA. This meant that indirectly it took 45.54% of Bankia through BFA.

49 Among the exceptional support measures introduced by the ECB at the time were its Outright Monetary Transactions (OMTs). Started in August 2012, OMTs were purchases of sovereign bonds in secondary markets, for countries under a European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) programme. While reliance on net borrowing from the Eurosystem declined rapidly for stronger Spanish banks, exiting from excessive reliance on ECB financing by the weaker part of the banking sector took until 2015.
49. **Following the suggestion by European authorities, the Spanish government promoted an independent, top-down stress test to determine the capital needs of the country’s financial sector.** In May, two independent consultants\(^{50}\) were hired to carry out an aggregate valuation of the resilience of the Spanish banking sector. The results of this exercise were published on 21 June 2012 and showed recapitalisation needs of €16–26 billion under a baseline scenario and €51–62 billion under an adverse scenario.

50. **The publication of the IMF FSAP for Spain highlighted the need for a new round of measures for the financial system, to be implemented immediately.** The report was published on May 30 (IMF (2012a)) and, while acknowledging the Spanish authorities’ efforts thus far, it concluded that four sets of measures should be taken immediately. These were: (i) completing the recapitalisation of banks, complementing the top-down review by the external consultants with a thorough review by audit firms of all banks’ loan books and real estate assets; (ii) implementing time-bound restructuring plans for banks reliant on state support, including measures to strengthen capital buffers, profitability and governance practices; (iii) designing and implementing a roadmap to deal with banks’ legacy assets; and (iv) introducing special tools to resolve banks.

51. **The FSAP also discussed how to operationalise the measures it proposed to the Spanish authorities.** The report considered it critical “to communicate clearly the timetable for the diagnostic review, a strategy for providing a credible backstop for capital shortfalls, and a plan for dealing with

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\(^{50}\) Oliver Wyman and Roland Berger.
impaired real estate exposures”. The report also highlighted the need to deal with the banks’ legacy assets. It acknowledged that the authorities had required all banks to make an initial transfer of foreclosed assets into bank-specific asset management units (RDL 18/2012), but this might not be enough and further steps to manage impaired assets should be determined based on the results of the diagnostic review. The review should also provide guidance on the transfer price if impaired assets were to be moved from balance sheets.

52. The growing financial fragmentation in the euro area and increasing concerns about a risk of reversibility of the single currency led to the initiative to build a banking union in the euro area. The main objective was to try to break the perverse feedback loop between sovereign and banking risk. The Bankia crisis, which affected one of the largest euro area economies, gave the project momentum. On 26 June 2012, the Van Rompuy Report, or Four Presidents’ Report, proposed, among other measures, the creation of an integrated financial framework with three central elements: a single European banking supervision, a common deposit insurance and a common resolution framework. The first step would be the establishment of a centralised supervisory system (Single Supervisory Mechanism), with the ECB as central authority.

53. On 25 June 2012, in view of the recapitalisation needs of some Spanish banks and the stressed situation of the sovereign bond market, the Spanish government formally requested financial assistance from the European authorities. Such assistance was approved by the Eurogroup, ie the group of euro area ministries of finance, at the Brussels Summit of EU leaders on 29 June. The documents with the terms and conditions of that assistance, among them the Memorandum of Understanding on Financial-sector Policy Conditionality (MoU), were signed in July.

Section 5 – Systemic crisis response

The memorandum of understanding with the EU authorities

54. The MoU, signed on 23 July 2012 between the EC and Spain, contained financial sector-specific conditionality, including both bank-specific and sector-wide conditionality. These conditions were linked to the financial assistance facility agreements signed on 24 July 2012 between the European Financial Stability Facility (EFSF) and Spain to cover estimated capital requirements with a safety net. The available amount of the loan totalled €100 billion. On 28 November 2012, the commitment was transferred to the newly created European Stability Mechanism (ESM). The objective

51 As the provision of privileged lending to vulnerable countries to address banks’ troubles did not fully address this issue, it was perceived that only a direct recapitalisation of weak but viable banks with European funds could be a workable solution. However, that would require putting in place a centralised European-wide prudential regime (Restoy (2019)).

52 President of the European Council (2012). The President of the European Council prepared the report in cooperation with the Presidents of the European Commission, the Eurogroup and the ECB.

53 The EFSF was created as a temporary solution in June 2010, and it was replaced by its successor, the European Stability Mechanism (ESM), on 8 October 2012. They were both set up to address a problem that arose early in the sovereign debt crisis in the euro area: the lack of a backstop for euro area countries no longer able to access financial markets.

54 The recapitalisation of banks was conditional on the EC approval of the restructuring or resolution plans. However, to have a credible backstop immediately available, a first tranche of €30 billion was prefunded and kept in reserve by the EFSF to be used, if necessary, ahead of the adoption of the restructuring measures by the EC. Using this tranche would require a reasoned and quantified request from the BdE and should be approved by the EC and the Euro Working Group (a group of representatives of the euro area member states, the EC and the ECB) in liaison with the ECB. That tranche was not drawn down.
of the programme was to increase the long-term resilience of the banking sector and therefore, restore its market access.  

Bank-specific conditionality had three components: (i) an asset quality review (AQR) and stress test; (ii) recapitalisation, restructuring and/or resolution of weak banks; and (iii) transfer of problem assets to an asset management company (AMC). Banks receiving state aid should be restructured if they were viable and resolved if they were not. Banks’ viability should be assessed based on the results of the stress test, and the restructuring and resolution plans should be based on the principles of limiting distortions of competition, through downsizing, and minimising the cost to taxpayers, through burden-sharing from hybrid capital and subordinated debt holders. All banks receiving state aid should transfer their problem assets to an external AMC.

Horizontal, or sector-wide, conditionality for banks involved several measures to strengthen the regulatory framework and the supervisory framework. The regulatory measures included the requirement to meet, until at least end-2014, a Common Equity Tier 1 ratio of at least 9%, the reform of the framework for loan loss provisioning, the revision of the regulatory framework on credit concentration and related party transactions and the reform of the regulation of savings banks and former savings banks, to strengthen their governance and clarify their role as shareholders of commercial banks. The supervisory measures included the strengthening of the operational independence of the BdE and the enhancement of its supervisory procedures, as well as the requirement that banks implement strategies to deal with impaired assets.

The programme duration was 18 months, during which the EC, together with the ECB, the European Banking Authority (EBA) and the IMF, monitored compliance with the conditions of the MoU. The last review under the programme took place in December 2013. Eventually, out of the available amount of €100 billion, the total used was €41.333 billion: a first disbursement of €39.468 billion took place on 11 December 2012 and a second one of €1.865 billion, on 5 February 2013. The repayment of the loan principal was scheduled to take place between 2022 and 2027. At present, €21.254 billion have been repaid, making the outstanding amount €20.079 billion.

The financial conditions of the loans granted by the ESM were very favourable. The weighted average maturity was initially 12.5 years. The interest is the actual cost of funding for the EFSF for each disbursement. As the financial assistance was initially provided through notes issued by the ESM, the interest to be paid was that of the notes: between 0.02% and six-month Euribor minus 0.06% (for the first period of interest, that was equivalent to interest rates between 0.02 and 0.27%).

The diagnosis tools: AQR and stress test

59. As part of the agreement under the MoU, in 2012 a diagnostic exercise was launched, composed of an AQR and a stress test. The analysis was performed to assess the viability and estimate the actual capital needs of each of the relevant banks. This exercise was therefore complementary to the top-down stress test, published in June 2012, aimed at producing a broad estimate of the aggregate capital needs for the system. According to the timeline set by the MoU, the diagnostic exercise was completed in September 2012, when bank-level results were published. The experience in Ireland, which had conducted an AQR and a stress test in 2011 as part of its own programme of economic and financial assistance, indicated that combining a robust assessment of banks’ exposures, as well as the underlying collateral, with a rigorous stress test could help to stabilise markets. The drivers of Ireland’s financial crisis also bore considerable resemblance to those of Spain, in particular in terms of banks’ heavy exposure to the real estate sector.

60. The MoU set specific conditions for the diagnostic exercise. It was to be conducted by an external consultant based on information assessed by four auditors. Reliance on third parties was expected to enhance the assessment’s credibility. The exercise was comprehensive, as it covered 14 banking groups, representing roughly 90% of the Spanish banking system. The AQR provided an economic and accounting value assessment of the credit portfolios and foreclosed assets, to address concerns about hidden losses on banks’ balance sheets. Building on the AQR, the stress test projected the solvency position of all banks under alternative macroeconomic scenarios.

61. As part of the AQR, auditors reviewed asset classification and performance. To provide a better understanding of the quality of each bank’s assets and refine the estimates for credit loss parameters across the different portfolios, auditors assessed potential misclassifications and under-provisioning in the lending book. They also reviewed the materiality of restructured loans in the portfolio. Banks were assessed by firms different from their ordinary auditors. As the diagnostic exercise was to be completed over a few months only, the review covered a sample of files for each banking group (in total, this amounted to more than 16,000 loan files across the different banking groups). To make the samples representative of the main risks affecting the banks, the sample for each bank consisted of its largest exposures (in particular, covering real estate developers and large corporates) and a random sample across all asset classes representative of each portfolio.

62. The AQR also included a valuation of real estate assets. In order to derive an independent assessment of the market price at the time, representative samples of real estate assets held by the banks were valued by six appraisal firms with in-depth expertise in the Spanish real estate market. This assessment combined 1.7 million simple housing valuations and 8,000 complex and on-site valuations. The real estate asset sample was selected from the foreclosed assets and the collateral pools, covering residential housing, commercial real estate, developments in progress and land. Additionally, the largest exposures for each entity were selected by the appraisers. Finally, data on actual selling values from the banks (accounting for approximately 110,000 transactions) were also used in the exercise in combination with the above valuations.

63. The AQR and the stress test were rather conservative and tightly interlinked with each other. In particular, the stress test conducted under the MoU, known as the bottom-up exercise, was designed to be more robust than the top-down exercise conducted earlier in the year. Conservatism was introduced by not only correcting the reported values of the assets, according to the AQR, but also

59 For additional details, see Oliver Wyman (2012).

60 Information on the loans was obtained from the BdE Declaración de Riesgo Crediticio (DRC), which is the official report reconciling the bank’s accounting and credit portfolio figures. It contains information on the distribution of loan balances across several key dimensions including the purpose of the loan, collateral type, loan status (performing or non-performing) and product type.
when projecting these values over the time horizon of the stress test scenario. To this effect, (i) the bank-
level data had been thoroughly checked thanks to the AQR, and amended as needed, in a prudent way;
and (ii) the estimation of key parameters was conducted on the basis of the revised data obtained from
the AQR, as well as detailed bank-level data. The methodology for loss forecasting drew on the
granular data collected for the AQR, and allowed for a more refined calculation of possible losses.
Conservatism in the results was also strengthened by incorporating latent risks in the valuation of losses,
and the application of additional value haircuts to reflect possible market tensions at times of asset
disposal. Banks were also required to present business plans detailing their deleveraging strategy in line
with the MoU objectives, and the projections in the stress test reflected them. When considering banks’
loss absorption capacity, assumptions about banks’ business plans were assessed against system-wide
modelled outputs, including adjustments for projections that were considered to diverge substantially
from the historical track record of each bank as well as the scenario context and the nature of the
exercise (eg projected prices were not allowed to rise). The combination of the AQR and the stress test
in a single exercise, notwithstanding the challenges of conducting such complex projects almost
simultaneously, was essential to ensure the robustness of the diagnostic exercise.

64. The diagnostic exercise included adjustments to address some of the limitations of
banks reporting of NPLs. At the time of the exercise, there was no common European definition of
non-performing exposures, and accounting standards (under IAS 39) required banks to compute
provisions on the basis of incurred rather than expected losses. Therefore, even when correctly
computed, assets’ book values did not accurately reflect the asset quality, both in terms of its value at
the time of appraisal and its development over time. To better capture the expected losses associated
with credit exposures, the diagnostic exercise adopted a more prudent approach to assess the expected
impairment of loans for property purchase over the relevant horizon and under different scenarios, on
the basis of several factors, such as the macroeconomic variables, specific features of the loan or the
business model of the bank. All of those factors were combined using a structural approach, which
was consistently applied to all banks. The diagnosis also corrected for possible biases in reporting the
foreclosed assets, as the average quality would deteriorate over time with the earlier disposal of better
exposures.

65. The bottom-up exercise adopted the conservative criteria already used in the top-down
stress test. In particular, the macroeconomic scenarios were the same. Both the baseline and, in
particular, the adverse scenarios of the top-down stress tests had been generally perceived as
sufficiently conservative. The thresholds for calculating the capital needs were also the same for the

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61 The probabilities of default (PD) and loss-given-default (LGD) were estimated also drawing on loan tape data sets and data
from the central credit register, and the DRC. Moreover, each bank in the sample was required to provide information on
their historical financial performance. They were also required to prepare and provide forward-looking business plans,
broken down into key P&L and balance sheet components. These data were used to calibrate loss forecasting parameters
as well as to estimate and assess the banks’ loss absorption capacity. In addition, the use of full bottom-up data from BdE
databases was essential to compute credit losses. These databases covered characteristics and default/non-default status
of approximately 36 million loans and 8 million collaterals, ensuring the exercise’s proper granularity, accuracy and
credibility.

62 The absence of a commonly agreed definition of non-performing exposures in Europe at the time also increased the
complexity of separating bad and good assets on banks’ balance sheets. Improvements in the definition of NPLs was one
of the outcomes of the banking crises in Europe at the time. A major step towards improving the recognition and the
management of NPLs in Europe came with an action plan to reduce NPLs by the European Council (European Council (2017))
and Guidance on NPLs by the ECB banking supervision (ECB, 2017). The action plan required the EBA to issue general
guidelines on NPL management, consistent with the guidance prepared by the ECB banking supervision, with an extended
scope applying to all banks in the entire EU. It also required the EBA to issue detailed guidelines on banks’ loan origination,
monitoring and internal governance.

63 The scenarios’ horizon extended to three years, one year longer than in regular stress tests for credit risk that authorities
would typically conduct at that time. Although the macroeconomic scenarios were the same, the projections of financial
two exercises, ie a minimum CET1 ratio of 9% in the baseline, and 6% in the adverse scenario, the latter being above the standard applied in other jurisdictions and by the EBA (which had set a minimum adverse scenario threshold of 5% on 2011), in order to reinforce the credibility of the Spanish diagnostic.

The diagnostic exercise estimated the capital needs of individual Spanish banks. In the adverse scenario, the system’s total (pre-tax) capital needs were estimated to be around €60 billion. This was not considerably different to the results obtained under the top-down exercise, where the capital needs for the same banks were estimated to be within the range of €51-62 billion. In addition, the three largest banking groups (Santander, BBVA and Caixabank), which represented over 40% of the exposure under consideration, were expected to have a capital surplus even under the adverse scenario. The capital shortfalls identified in the exercise were below those expected by several observers. Those expectations proved inaccurate as they were often based on incomplete analysis and a mechanistic inference from other country experiences. For instance, some observers directly extrapolated data on ratios for mortgages in arrears in Ireland (which peaked at 16% in 2013) to the Spanish case, where those figures were simply unrealistic in any scenario (they peaked at 6.3% in the first quarter of 2014).

Communication was a key supporting factor for the credibility of the results. Re-establishing market confidence in the condition of the Spanish banking sector, by drawing a line under the possible losses on banks’ balance sheets, was a major objective of the diagnostic exercise. To ensure that the release of the results would satisfy market requests for transparency, a communication strategy was carefully designed. In particular, it was considered essential to shift focus from the exercise’s output – in terms of capital needs – to the inputs – such as the methodology and assumptions – ensuring those were well understood and properly addressed key market concerns. Explaining the exercise’s technical features and processes was expected to create a factual basis on which to evaluate the rigour of the exercise. Detailed material explaining the technical features of the diagnostic exercise was published (Oliver Wyman (2012)), and several presentations, involving Spanish and European authorities, were made to market analysts and the media.

The diagnostic exercise was well received and helped to create confidence in the market. The rigorous approach, the severity of the adverse scenario and the thorough review of the asset quality contributed to the credibility of the diagnostics. The direct involvement of European authorities and the IMF was also instrumental in achieving the desired market impact. Moreover, the fact that the results were not substantially different to those under the top-down exercise reinforced the credibility of the analysis and may have also helped to reinforce trust in the approach taken by the Spanish authorities.

sector variables, such as real estate prices or probabilities of default, were refined in the bottom-up exercise thanks to the input from the AQR. In this context, a major challenge was the projection of real estate prices over the time horizon, as the crisis under way was far deeper than any other real estate crisis experienced by Spain in the past.

In addition, the sample of banks and the reference date (December 2011 data) were also the same for the top-down and the bottom-up exercises.

Under the baseline scenario, the capital needs were estimated to be €24.1 billion (pre-tax) and €25.9 billion (post-tax), after taking into account mergers within the scope of the exercise. Under the adverse scenario, the (pre-tax) capital needs amounted to €59.3 billion (post-tax, €53.7 billion), which was expected to be reduced to approximately €57.3 billion with the mergers under way and within the scope of the diagnostic exercise. In particular, this included the merger of Unicaja and CEISS, which, however, took place two years later than the conclusion of the stress test, and the merger between Ibercaja, Caja3 and Liberbank, which was conducted only partially and at a later stage (Ibercaja and Caja3 merged in 2013, and Liberbank never merged with the two other banks). As a result, the total capital needs were slightly revised; for instance, under the adverse scenario, the post-tax capital needs amounted to €55.9 billion.

In the bottom-up exercise, these three banks were expected to have an estimated capital excess of €37 billion in the adverse scenario.

Oliver Wyman (2012) provides a detailed explanation of the comparatively low NPL ratio for mortgage loans in Spain by stressing relatively lower loan-to-value ratios; very low default rates in mortgages in historical data, the large majority of mortgages being for first residences; full personal liability; a very low proportion of mortgage being reclassified in the AQR etc.
Those factors helped analysts assume estimated capital needs that, while material, were comfortably within the size of the financial assistance package that Spain had negotiated with the European authorities and perceived as manageable given Spain’s fiscal capacity. Finally, more qualitatively, the results confirmed that the largest commercial banks were generally robust and could absorb the losses under the adverse scenario. This allowed them to make a positive contribution to the reduction of stress in the banking sector (eg through their contribution to the FGD and the Spanish AMC and via the acquisition of weak banks). The outcome of the diagnostic exercise also indicated that the most relevant weaknesses in the Spanish banking sector were concentrated in several institutions in the subsector of former savings banks.

Bank restructuring and recapitalisation

69. **Banks were classified into four groups depending on the results of the diagnostic exercise, with implications for their recapitalisation plans.** Banks in Group 0 did not exhibit a capital shortfall, thus no further action was required. Banks in Group 1 were already owned by the FROB, and were BFA-Bankia, Catalunya Banc, NCG Banco and Banco de Valencia. Banks in Group 2 exhibited capital shortfalls and were unable to meet those shortfalls privately, without having recourse to state aid. Banks in Group 3 had capital shortfall and credible recapitalisation plans, so they were considered able to meet those shortfalls privately without recourse to state aid.

70. **The recapitalisation strategy of the banks in the three relevant groups reflected the principles underpinning the MoU.** As the MoU was inspired by the principles of viability, burden-sharing and limiting distortions of competition in a manner that promotes financial stability and contributes to the resilience of the banking sector, the banks in Groups 1–3 were allowed to raise capital in different ways. They all were required to submit recapitalisation plans shortly after the publication of the results of the diagnostic exercise. In particular, reflecting the peculiarities of the European framework, strict conditions were imposed on the use of state aid, in order to preserve a level playing field between banks receiving such support and the others. As banks in Group 1 were already under the control of the FROB, the use of state aid was allowed, and restructuring or resolution plans were approved by the EC by November 2012. For banks in Group 2, the Spanish authorities had to present a restructuring or resolution plan to the EC by October, with approval by the EC due by December 2012. Banks in Group 3 were required to complete their recapitalisation by December 2012 (for banks requiring a more substantial capital increase) or June 2013. Should a bank in Group 3 fail to raise the required capital from private sources, it would be required to prepare a restructuring plan.

71. **Banks in Groups 1 and 2 were required to transfer their real estate assets to an AMC.** Considering the burden of impaired assets on the weakest banks’ balance sheets, transferring these assets to an AMC was expected to give them the best chance to return to viability (see the section below for a description of the AMC in Spain). For Group 1 banks, the transfer took place by the end of 2012. For banks in Group 2, the transfer was completed in February 2013.

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68 As banks in Group 1 were not viable, they were subject to resolution plans, except BFA-Bankia, which was also not viable but, in view of its systemic nature, was subject to a restructuring process, as explained later in the main text and in Box 5.

69 Banks in Group 3 that had to raise capital for a value higher than 2% of their RWA were required to issue by end-December 2012 contingent convertible securities (CoCos) to meet their capital needs, should they not manage to raise capital from private sources by December 2012. The CoCos were to be subscribed by the FROB using programme resources and could be redeemed until 30 June 2013 if the banks succeeded in raising the necessary capital from private sources after December 2012 and before the end of June 2013. Banks in Group 3 that needed a lower amount of capital, in relation to their RWA, were given until 30 June 2013 to raise new equity capital. In case they failed to do so, they were to be recapitalised by means of state aid and were required to present restructuring plans.
72. **The recapitalisation of the banks in Groups 1–3 was completed within the set timeframe.**

For banks in Group 1, the recapitalisation plans could be implemented speedily, with the capital increase, equivalent to €36.968 billion, by the FROB. The banks in Group 2 had to submit recapitalisation plans, which were approved in December 2012. Of the four banks, Banco Mare Nostrum, Caja3 and Liberbank were considered viable. In March 2013, they received a capital injection (state aid), amounting to €1,261 million (see Table 3 for details). The fourth Group 2 bank, Banco CEISS, was eventually deemed non-viable by the Spanish authorities, and it was asked to prepare a resolution plan. This was approved in December 2012 and was completed with state aid of €604 million, in CoCos. The interventions for banks in Group 1 and 2 are known as FROB III. For both Group 3 banks (Banco Popular and Ibercaja), the Spanish authorities concluded that they could cover their capital needs without resorting to public support. More broadly, all the restructuring or resolution measures imposed on the affected banks were fulfilled within the required deadlines.

<table>
<thead>
<tr>
<th>Recapitalisation of banks (FROB III) – €millions</th>
<th>Table 3</th>
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<tbody>
<tr>
<td>Institution</td>
<td>Type of plan</td>
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<tr>
<td></td>
<td></td>
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<tr>
<td>BFA-Bankia</td>
<td>Restructuring</td>
</tr>
<tr>
<td>Catalunya Banc</td>
<td>Resolution</td>
</tr>
<tr>
<td>NCG Banco</td>
<td>Resolution</td>
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<tr>
<td>Banco de Valencia</td>
<td>Resolution</td>
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<tr>
<td>Banco Mare Nostrum</td>
<td>Restructuring</td>
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<tr>
<td>Liberbank</td>
<td>Restructuring</td>
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<tr>
<td>CEISS</td>
<td>Resolution</td>
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<tr>
<td>Caja3</td>
<td>Restructuring</td>
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<tr>
<td>Banco Popular</td>
<td>Restructuring</td>
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<tr>
<td>Ibercaja</td>
<td>Resolution</td>
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<tr>
<td>Total</td>
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<tr>
<td>Banco Gallego (c)</td>
<td>Resolution</td>
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<tr>
<td>Total</td>
<td></td>
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</table>

(a) The sum of the measures indicated in the table, which reflects actual amounts, does not always correspond to the estimated amounts. A major source of difference is the fact that, when recapitalisation plans were put into practice, the outcome could be different from what initially envisaged (eg in relation to the SLE or sale of assets). (b) Reduction of capital needs due to the transfer of assets to Sareb, the sale of assets and other measures, respectively. (c) Banco Gallego, originally part of NCG Banco, was resolved separately, and required an additional amount of state aid.

Sources: Bank of Spain (2017); FROB (2019).

73. **The performance of customer deposits during the crisis also facilitated the restructuring process.** Notwithstanding the turbulence in the Spanish banking sector over the years until the

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70 That amount was supplemented in April 2013 with a capital contribution of €245 million to Banco Gallego (Table 3).

71 This aid was in the form of CoCos, except for Banco Mare Nostrum, where shares were subscribed.
implementation of the MoU, resident deposits remained broadly stable and no major bank runs ensued. This was primarily driven by the strong customer relationship between banks and their depositors, and the relatively small size of depositors’ balances, on average, bringing them within the scope of the deposit insurance mechanism. In addition, the experience in the early phases of the crisis response, when banks were merged or sold to other banks, showed that deposits were protected, possibly creating confidence in the treatment of deposits in the event of bank restructuring. The support offered by the European authorities under the MoU may have also helped to reassure depositors of the safety of their funds once the reorganisation of the banking sector under the terms of the MoU was launched.

**Box 5**

**The recapitalisation of BFA-Bankia after the MoU**

The post-tax capital shortfall for BFA-Bankia in the diagnostic exercise was estimated to be €24.7 billion under the adverse scenario and €13.2 billion under the baseline. This bank was placed in Group 1, as it was already owned by the FROB by that time. Contrary to the other banks in the same group, BFA-Bankia was not put into resolution, but was selected for restructuring. BFA-Bankia had already received a capital injection of €4.5 billion in early September from the FROB, following the publication of the half-yearly results in June. The capital increase, which was necessary to comply with regulatory capital requirements, was allowed by the Spanish authorities and the EC, as an advance payment of the capital injection expected by the FROB after the conclusion of the diagnostic exercise.

In November 2012, the BdE, the FROB and the EC approved the BFA-Bankia restructuring plan. According to it, the bank’s capital needs would be reduced due to the transfer of assets to the AMC and the implementation of burden-sharing. The capital needs amounted to €24,743 million. They were satisfied with €17,959 million of state aid, €6,669 million from the burden-sharing exercise and a minor amount from the sale of assets to the AMC.

In April 2013, the FROB issued a resolution containing the necessary agreements for completing the recapitalisation of the BFA-Bankia group. This included a capital reduction of Bankia via a decrease in the nominal value of its shares from two euros to one cent – this exchange implied an almost full wipe-out of the shareholders. In order to allow Bankia’s shares to continue trading after this change, the resolution also included two capital increases and a reverse share split. The latter implied that shareholders were entitled to one new share of Bankia for every 100 old shares. Concerning the capital increases, the first, amounting to €10.7 billion, had a preferential subscription right guaranteed by the FROB through its ownership interest of 100% in BFA. The second amounted to up to €4.852 billion and was subscribed by holders of hybrid capital as part of the subordinated liability exercises, as explained later in the main text.

**Balance sheet cleaning – Sareb**

Assets linked to real estate development and foreclosed assets of all banks receiving state aid were transferred to an external AMC. In the previous phases of the crisis, the resolution of failing savings banks (CCM, Cajasur, CAM and Unnim) involved the provision of APS, especially covering portfolios related to real estate developers, to the acquiring banks. This worked as an adequate solution for selling individual banks. Yet, in order to manage a systemic crisis and to fully eliminate market concerns on the quality of the assets of weak banks, an external AMC was considered a better solution, even if it might involve complex operational issues. It was also required that the AMC be operational by November 2012. To that effect, RDL 9/2012, of 31 August (replaced by Law 9/2012, of 14 November) and RD 1559/2012, of 15 November, regulated the constitution and functioning of this new AMC that should be created by the FROB under the name of Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria72 (Sareb). The FROB was granted the power to oblige banks receiving state

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72 The Spanish name of the company means “Management Company for Assets Arising from Bank Restructuring”.

The 2008–14 banking crisis in Spain
aid to transfer their problem assets to Sareb. The assets transferred were the foreclosed assets with a carrying amount over €100,000 and the loans to finance real estate developments with a carrying amount over €250,000. Sareb was set up with a maximum 15-year lifetime.

75. **Sareb was classified as a private financial institution not controlled by the government.** The regulation established that the state could not directly or indirectly have a majority stake in Sareb. Sareb was capitalised with several issuances of capital and subordinated debt, between December 2012 and February 2013, totalling €1.2 billion of capital and 3.6 billion of subordinated debt. The FROB had a significant stake in Sareb (45% of capital and 45.9% of subordinated debt) but the remaining capital and subordinated debt was in the hands of private, mainly financial, companies. This strategy avoided having to add Sareb liabilities to the state’s public debt, even if the state guaranteed them. At a time of significant market pressure on Spain’s financing costs (Graph 7), the selected approach was considered preferable to the alternative of establishing a public asset management company.

76. **According to the MoU, the transfer of the assets should take place at the real long-term economic value rather than at current market prices.** That was consistent with the relatively long disinvestment horizon. The assets of Group 1 banks were transferred in December 2012 and the assets of Group 2 banks in February 2013. The transfer price was determined by the BdE, based on the expected losses estimated under the baseline scenario of the bottom-up stress test under the MoU, with an additional haircut of 14% for loans and 7% for foreclosed assets. These haircuts were the result of considering several criteria such as the coverage of the risk of unfavourable price trends, and Sareb’s operational and financial costs. Because of those valuations, the transfer price of the assets transferred totalled €50.78 billion (loans: €39.44 billion; foreclosed assets: €11.34 billion), which represented a haircut of 52.6% on the total gross amount of those assets (€107.12 billion). The high number of assets affected (close to 200,000) and the short period available to transfer them made it impossible to conduct individual valuations. Rather, the assets were valued by groups of similar characteristics. The EC calculated the amount of state aid granted to the banks with the transfer of assets to Sareb as the difference between the transfer and the market values. To that effect, it estimated the market value of the impaired assets transferred to Sareb. The haircuts used for calculating the estimated market value were between 10 and 20 percentage points higher than those applied to determine the transfer values.

77. **In order to fund the payment to acquire the assets, Sareb issued bonds that were fully guaranteed by the state, with floating rate coupons.** Those bonds were directly provided to the originating banks in exchange for the transferred assets. While they were not tradable, they were eligible to be used as collateral for the ECB’s lending facilities. They were issued with terms of one, two and three years with Sareb having discretionary power to renew the issues at each maturity date. The initial remuneration of the bonds was indexed to three-month Euribor plus a spread. The choice of a floating rate financing strategy was the result of a strategic decision aimed at allowing Sareb to benefit from the expected successful resolution of the Spanish crisis. Since the whole programme had the objective to break the sovereign-financial doom loop, its success would automatically entail the reduction of the substantial yield spreads that still prevailed at the time of Sareb’s constitution. The issuance of long-term bonds, better matching the expected cash flows (three, five, seven and 10 years) would have made Sareb finances much less sensitive to the expected improvement of financial conditions for the Spanish Treasury.

78. **In August 2013, Sareb decided to cover a substantial part of the interest rate risk of its liabilities.** The successful implementation of the programme facilitated, as expected, a substantial reduction of yield spreads in the first few months of 2013. At the euro area level, the ECB had been reducing its policy rates since the end of 2011. Under such conditions, the risks of a reversal of the downward trend of market rates gained relevance. Due to the highly leveraged financial structure of

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73 In 2021, Eurostat decided that, due to the losses incurred, which had consumed the capital and the subordinated debt, Sareb should be reclassified to be included in the government sector. In 2022, Sareb regulation was modified and the FROB took a majority stake in Sareb.
Sareb and the short duration of its liabilities, higher rates could have entailed significant losses. To cover that risk, Sareb decided to enter into an interest rate swap (IRS). The IRS, which had an initial nominal amount of €42.221 billion and would progressively decrease between 2013 and 2023 depending on the estimated schedule for the payment of the debt of Sareb, set the debt at fixed rates in a range between 0.491 and 3.145% per year. This gave rise to the conversion of most of Sareb’s debt over the term of the hedge into fixed rate debt, as opposed to the floating rate profile of the bonds issued. As a consequence, while monetary policy rates continued decreasing to record lows in the following years, the IRS prevented Sareb from benefiting fully from the more favourable financial conditions in the euro area. The net accumulated financial costs of Sareb since its inception amount to €6.71 billion as of 31 December 2022.

The initial accounting valuation of the assets was set at the transfer price, while for subsequent valuations, the BdE developed the criteria to be used by Sareb. The valuation methodology was required to consider the evolution of market prices. However, as the transfer price had been determined by groups of assets and not individually, Sareb could offset losses on impaired assets against gains on other assets in the same unit (loans and foreclosed assets). These provisions were developed by the BdE in Circular 5/2015, of 30 September. The value of the real estate assets was to be calculated individually and revised at least once every three years. Sareb was required to value, using those criteria, at least 50% of the assets remaining on its balance sheet, by 31 December 2015, and all of its balance sheet by 31 December 2016. According to RDL 4/2016, of 2 December net unrealised losses should no longer be recognised on the profit and loss statement but on the adjustment account for valuation adjustments within the company’s equity. This adjustment account would not be considered for the purposes of capital reduction and dissolution of the company.

The accounting rules of Circular 5/2015 gave rise to the recognition of significant losses that severely affected Sareb’s capital. The valuation adjustment for impairment amounted to –€3.29 billion as of 31 December 2016 and the total equity plus subordinated debt, which amounted to €4.8 billion at the inception of Sareb, fell to –€1.23 billion. To replenish Sareb’s equity, €2.17 billion of the subordinated debt was converted into capital.

The individual valuations carried out in 2015 and 2016, and in the following years, as well as the evolution of the sales of Sareb, have shown that transfer prices of many of the assets were not particularly conservative. Despite the improvement in the real estate market since 2014, the average market prices have remained consistently below the transfer prices. While the transfer price was at an intermediate level between the baseline and the adverse scenario of the diagnostic exercise, the market values continue to be much closer to the latter scenario. In particular, a high proportion of the transferred assets, mainly loans, could not take advantage of the market improvement because, due to their extreme poor quality, they were not marketable in almost any relevant circumstance. While what now appear to be relatively high transfer prices did affect the financial performance of Sareb and eventually its viability as a private entity, it certainly helped to reduce the public resources required to recapitalise the weak institutions when the programme was implemented.

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74 The accounting specificities for Sareb were established by Law 26/2013 of 27 December.
75 The accounting valuation of the assets was based on their appraisal value.
76 Thus, only if losses were realised through the sale of assets were they included in the profit and loss account and affected the part of the equity (capital + reserves + profit and loss) whose reduction could force the liquidation of Sareb.
77 For instance, a group of unsecured loans were transferred at an aggregate transfer price of €2 billion while its real market value was eventually close to zero.
78 Also, the time lag between the date in which the conditions of the transfer were known and the transfer date may have favoured some cherry-picking by selling some of the best assets (those whose market value was above the transfer price) before the transfer to Sareb took place.
82. **The accounting framework might have contributed to the slowing down of the disinvestment process.** In particular, accounting rules might have generated incentives for Sareb to focus, at least until 2020, on selling exclusively those assets whose market price was above the transfer price. The sale of those assets generated a profit. On the contrary, according to its accounting framework, by selling assets whose market value was below the transfer price, Sareb recorded losses, even if the sale price was above the accounting values.79 Those losses could erode Sareb’s capital, putting it at risk of liquidation if the losses reduced the equity to an amount below half the capital, according to Article 363.1e) of the Capital Companies Law. Only when RDL 6/2020 of 10 March established that this article was not applicable to Sareb80 did the company change its sales strategy and start to sell all the assets, regardless of whether the price was above or below the transfer value.81

83. **The management of Sareb has proven to be a highly complex task, subject to significant conflicts of interest.** The urgent transfer of the assets forced Sareb to sign asset management agreements with the transferor banks. Those banks were involved in burdensome restructuring processes and did not have the incentive to manage the assets most profitably. At the same time, the high number of assets transferred,82 due to the low threshold, increased the management challenges. It took between one and two years for Sareb to really know the characteristics of the assets that it had received.83 Eventually, in December 2014 Sareb decided to outsource the management and sale of its assets to four independent specialised servicers. Yet, at least initially, these servicers’ expertise and capacity to manage those assets – particularly real estate loans in arrears – was limited. This might have exacerbated the deterioration of many loans in the first years.84 Moreover, the presence of private banks, most of which still had sizeable portfolios of real estate assets, generated conflicts of interest that may have hampered an effective decision-making process.85

84. **The relatively high transfer price, the excessively onerous financing costs, the slow pace of the assets’ sale process and the intrinsic management complexity largely explain Sareb’s poor performance.**

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79 For instance, if Sareb had an asset whose transfer value was €100,000 and whose valuation, according to the accounting rules set up in Circular 5/2015, was €60,000, the effect of this valuation on the balance sheet of Sareb was an increase of €40,000 in the negative valuation adjustment for impairment, which reduced the equity but not to the effects of the liquidation of the company. If Sareb received an offer to sell that asset at a price of €70,000, this involved a net profit of €10,000 (70,000 – 60,000). But that profit was divided into an improvement (decrease) of €40,000 (100,000 – 60,000) in the negative valuation adjustment for impairment, which did not affect the equity to the effects of the liquidation of the company, and a deterioration of €30,000 (70,000 – 100,000) in the profit and loss account, which affected the equity to all effects. As a result, an operation which economically was profitable for the company was discarded because it would bring Sareb closer to the liquidation trigger.

80 This new regulation was complemented by RD 1/2022, of 18 January, which also declared non-applicable to Sareb Article 327 of the Capital Companies Law, which states that the reduction of the capital will be mandatory when the losses have decreased the amount of the equity below two thirds of the capital and it has not been recovered in a term of one fiscal year.

81 The 2021 Sareb Activity Report (Sareb, 2022) mentions as one of the milestones in 2020 the change in the sales strategy for offloading all assets and says that, because RDL 6/2020 enabled the company to operate despite being in a negative equity situation, the company can focus on selling its assets, generating maximum value and cancelling debt instead of concentrating sales on assets with a positive margin, thus overweighing the strategy for protecting the company’s equity. This has allowed Sareb to sell assets whose market price was below the amount it paid in 2012 (the transfer price).

82 The total number of assets amounted to close to 200,000, of which 90,000 were loans with close to 500,000 collaterals.

83 Sareb carried out a due diligence of the assets only in 2014.

84 For instance, in the case of the AMC set up in Ireland in the aftermath of the banking crisis, these difficulties were mitigated by retaining the relevant staff in the AMC.

85 In order to mitigate those conflicts of interest, board members representing commercial banks were not allowed to participate in decisions that could directly or indirectly affect their institution.
financial performance. Sareb was created in 2012 with a total capital of €1.2 billion and subordinated
debt of €3.6 billion. Due to the net financial costs (€6.71 billion since inception), the net operating
expenses (€6.14 billion since inception) and the impairments in the assets as a consequence of their low
market value compared with the transfer prices, Sareb’s equity has been decreasing continuously. The
subordinated debt was converted into capital (€2.17 billion in 2016 and the remaining €1.43 billion in
2021) and, as of 31 December 2022, the total equity amounted to –€14.17 billion (Sareb (2023)). As a
result, the total amount of equity plus subordinated debt has decreased by €18.97 billion since Sareb
was established. A more rapid disposal of the assets, by selling them to institutional investors, would
have reduced the financing and operational costs, but was discarded by Sareb as it aimed to sell at a
better price, even if this would take longer.

Yet the establishment of Sareb was a key contributor to the success of the Spanish financial reform. In particular, Sareb enabled a cleanup of the balance sheets of all weak banks by largely removing real estate exposures. The experience of Sareb shows that those exposures were not only highly deteriorated in general, but also subject to an uncertain evolution even in the context of the Spanish economy’s continued recovery. Arguably, the continuation of those assets on banks’ balance sheet would have further depressed the market value of those institutions and delayed the restoration of trust in the health of the Spanish financial sector.

Downsizing of the banks under resolution or restructuring

The orderly downsizing of the business of banks receiving state aid was one of the principles of the MOU. The restructuring or resolution plans involved splitting the bank activities into core and legacy units. The legacy unit included the activities that had to be discontinued and sold. The banks had to transfer problem assets linked to real estate developers and foreclosed assets to Sareb. They also had to focus on retail banking activities and SME banking services in their so-called core areas and divest the portfolio of investees. Prohibition or limits to acquisitions were also imposed. Those measures involved a significant reduction in the size of the balance sheet, and in the number of branches and employees.

The relatively high weight given to competition criteria beyond financial stability or value preservation considerations to restructure weak or failing banks was a unique feature of the European crisis management framework. Restructuring aimed at meeting several not always compatible objectives. In particular, the downsizing of banks receiving state aid aimed to make the banks more viable and less risky, but also to limit the distortion of competition. The transfer of problem assets to Sareb, the divestment of unprofitable business and the rationalisation of branch networks and staff levels was expected to decrease the cost-to-income ratio of the affected banks. But those measures were also based on the EU state aid regulation. The relevant conditions were defined in a series of six communications (Crisis Communications) issued by the EC to provide guidance on the criteria for the compatibility of state aid with the internal market. They also aimed to preserve financial stability and to minimise distortions of competition between banks and across member states in the single market.

The downsizing varied depending on the amount of state aid and on the decision to resolve or restructure the bank. According to points 30–5 of the EC’s Restructuring Communication, measures to limit the distortion of competition should be tailor-made while adhering to a common policy and principles. One of the basic criteria for determining the extension of these...
measures in the Spanish case was the amount of aid, both in absolute terms and in relation to the bank’s RWA. Also, divestment measures were more stringent with resolved banks than with restructured ones. The amount of state aid estimated by the EC for Group 1 banks was above 20% of RWA, while the aid granted to Group 2 banks was below 10% of RWA. As a result, the requirements of reduction of branches, employees and business size in terms of RWA, while being significant for all the banks receiving state aid, was proportionally higher for Banco de Valencia, Catalunya Banc and NCG Banco. The downsizing requirement for BFA-Bankia was more limited in relative terms because it was restructured and not resolved.88

89. **Downsizing did not significantly affect the competitive position and the value of the franchise of Bankia, but it did in the cases of Catalunya Banc and NCG Banco.** As BFA-Bankia was not resolved but restructured due to its systemic nature, the downsizing required89 in terms of employees and branches was more limited than that imposed on Catalunya Banc and NCG Banco. Also, the requirement to divest subsidiaries and important participations had a higher weight in Catalunya Banc and NCG Banco than in BFA-Bankia. Moreover, BFA-Bankia showed a large over-capacity because of the merger that created it, with substantial redundancies and overlaps. As a result, the restructuring measures imposed on BFA-Bankia were not significantly different from those that BFA-Bankia management should have taken in any case.90 Catalunya Banc and NCG Banco were also the result of the merger of the businesses of several savings banks and thus needed to be restructured, but the greater extension of the measures attached to the MoU obliged them to divest profitable business and from geographical areas of activity. This had a negative impact on the market value of those franchises when they had to be sold by the FROB.

**Burden-sharing requirements**

90. **Burden-sharing is a principle of the EU regulation on state aid.** In order to limit distortions of competition between banks and across member states in the single market and to address moral hazard, state aid should be limited to the minimum necessary. The aid beneficiary should provide an appropriate contribution. To that effect, the holders of equity and of other junior instruments should contribute to the restructuring or resolution as much as possible with their own resources. In this way, the costs associated with the restructuring or resolution would not only be borne by the state but also by those who invested in the bank.

91. **The application of burden-sharing before the Spanish financial crisis had not been homogeneous across the EU.** The principle had been developed in some of the Crisis Communications issued by the EC between 2008 and 2011,91 before the signature of the Spanish MoU. However, the EC had not set ex ante thresholds for contributions by shareholders and junior creditors. This led to diverging approaches to burden-sharing between member states, some of them applying relatively mild requirements and others imposing more stringent obligations. This divergence was eliminated with the new Commission Communication on “the application, from 1 August 2013, of State aid rules to support

88 An exception to these criteria was BMN, which experienced a larger downsizing than the other Group 2 banks because in November 2012 it sold the branch network of Caixa Penedès, one of the four savings banks which had merged into BMN.


90 However, there were some exceptions, like the requirement to maintain no more than one branch per province in the non-core regions. As a consequence, some profitable branches had to be closed.

91 The Commission communication on “the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules”, of 19 August 2009, (the Restructuring Communication), points 22–7; the Commission communication on “the treatment of impaired assets in the Community banking sector”, of 26 March 2009, (the Impaired Assets Communication), points 21–5; the Commission Communication on “the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis”, of 25 October 2008, (the Banking Communication), points 25, 26 and 46.
measures in favour of banks in the context of the financial crisis’, of 30 July 2013, (the Banking Communication) which stated that “the minimum requirements for burden-sharing should be raised. [...] before granting restructuring aid to a bank, member states must ensure that the bank’s shareholders and junior capital holders arrange for the required contribution or establish the necessary legal framework for obtaining such contributions” (paragraph 19). In addition, “Hybrid capital and subordinated debt holders must contribute to reducing the capital shortfall to the maximum extent” (paragraph 41).

92. The MoU stated that, to minimise the cost to taxpayers, after allocating losses to equity holders, the Spanish authorities would require burden-sharing measures on hybrid capital and subordinated debt holders. This burden-sharing would have to be implemented through voluntary and, where necessary, mandatory subordinated liability exercises (SLEs). Legislation was to be introduced by end-August 2012 to ensure the effectiveness of the SLEs. Banks needing state aid should convert hybrid instruments into equity or buy them back at significant discounts. RDL 24/2012 of 31 August (later replaced by Law 9/2012 of 14 November), included a chapter on hybrid capital and subordinated debt instruments management. Restructuring and resolution plans had to include management actions for hybrid capital and subordinated debt instruments to ensure an adequate distribution of the costs of restructuring and resolution of the bank in accordance with the regulations on state aid and with the objectives of protecting financial stability and minimise the use of public resources. The first section of the chapter established some measures that could be taken by the banks and voluntarily accepted by investors (voluntary SLE). However, Section 2 established that, if those voluntary exercises were not possible, the FROB could adopt, as an administrative act binding for the banks, hybrid capital and subordinated debt management actions (mandatory SLE). All those measures, voluntary or mandatory, had to consider the market value of the instruments, and apply the haircuts needed in accordance with the regulation on state aid. As a result, the extension of burden-sharing to junior debt holders, incorporated in the Banking Communication in July 2013, was already included in the Spanish MoU in July 2012.

93. A large majority of the SLEs were imposed by the FROB. Although Law 9/2012 incorporated the possibility of voluntary SLEs, eventually almost all the SLEs were mandatory. These exercises involved: (i) a haircut to the nominal value; and (ii) a conversion of the remaining value of the instrument into equity of the bank or, in some specific cases, into a senior debt instrument. The haircut imposed a loss on the holders of the instruments. The calculation of that haircut was based on the net present value of future expected cash flows according to a methodology that involved higher discount factors for preferred shares than for subordinated debt. The preferred shares and perpetual subordinated debt were converted into ordinary shares, after an economic valuation of the bank. The holders of dated

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92  Chapter VII, Articles 37 to 49.
93  Those voluntary actions included exchange offers for equity instruments of the bank; offers to repurchase the securities, either in cash or, according to their current value, in equity instruments or other banking products; reduction of the nominal value; and early redemption at a value other than nominal value.
94  Those mandatory actions included any action that the bank could have carried out and also the postponement, suspension or modification of certain rights or conditions of the holders and the bank’s obligation to repurchase the instruments at a price determined by the FROB.
95  Already in the resolution plan of Banco CAM, approved in May 2012 before the signature of the MoU, burden-sharing had been applied to the holders of hybrid securities (preferred shares and subordinated debt held by institutional investors) (European Commission decision on State aid on the resolution process of CAM and Banco CAM: State aid SA.34255 (2012/N) of 30.05.2012, paragraph 159).
96  In the case of Bankia, there was a second loss since the shares received by the holders of the hybrid instruments were issued with a premium to compensate for the negative economic value of the bank. This premium was based on the high level of aid received by Bankia, on its consideration of being under restructuring and not under resolution and, thus, being able to continue its banking activity and on the liquidity of those shares.
subordinated debt were granted the option to convert the instruments into either equity or senior debt instruments of the bank with the same maturity of the subordinated debt being exchanged and with a haircut on the nominal value proportional to the number of months to maturity. That approach helped maximising the impact of the exercises on banks' capital as that was increased by both the application of haircuts to the nominal value of the liabilities and, in most cases, the conversion of the remaining value into equity. Given that, margins could be kept moderate, thereby mitigating the losses for investors.

94. **The SLEs complied with the no-creditor-worse-off principle (NCWO) and with the order of creditors and shareholders in an insolvency procedure.** Law 9/2012 allowed an administrative authority (the FROB) to impose losses on the shareholders and the holders of preferred shares and subordinated debt (SLEs) in resolving or restructuring a bank. However, the holders of hybrid instruments would not bear higher losses than those that would have been incurred if the institution had been wound up in an insolvency procedure\(^{97}\) (NCWO principle)\(^{98}\) and the credit order of contribution in an insolvency procedure had to be respected. To this end, even if in some cases the shareholders were not fully wiped out,\(^99\) the haircut for the shares was significantly higher than for the hybrid instruments and, among those instruments, the highest haircut corresponded to the preferred shares, followed by the perpetual subordinated debt and, finally, by the dated subordinated debt.

95. **The nominal value of the instruments affected by SLEs amounted to €14.223 billion, with an average haircut of 26.5%**. As a result, after the haircut, the amount exchanged for capital was €9.87 billion and the amount exchanged for senior debt was €585 million. The haircut (€3.768 billion) plus the amount exchanged for capital (€9.87 billion) totalled €13.638 billion, which represents close to 25% of the capital needs resulting from the stress test.

96. **Most of the instruments subject to SLE were held by retail investors.** Out of the total nominal amount of €14.223 billion, €10.046 billion (70.6%) had been sold to retail customers. This posed two problems. First, Catalunya Banc and NCG Banco were unlisted companies and, therefore, the investors were receiving, in exchange for their preferred shares or subordinated debt instruments, non-liquid perpetual instruments (ordinary shares). Second, many of those instruments had been mis-sold to customers who were not fully aware of the risk that those instruments entailed.

97. **To solve the problem for the retail holders of the lack of liquidity of the shares of Catalunya Banc and NCG Banco, the FGD was endowed with the power to acquire ordinary shares of non-listed banks which had been the object of an SLE.**\(^{100}\) Based on this power, in July 2013 the FGD made an offer to acquire shares of Catalunya Banc and NCG Banco that had been granted in the SLEs to the retail holders of hybrid capital and subordinated debt instruments. The offer price included a haircut of 13.8% on the bank’s economic value determined for the SLE. This additional haircut corresponded to the estimate of the effect on the price of the shares’ lack of liquidity. The total amount invested by the FGD was €1.803 billion: €1.001 billion in Catalunya Banc in exchange for 32.4% of its capital and €802 million in NCG Banco in exchange for 25.6% of its capital. At the same time, the FROB granted a guarantee to the FGD for the losses that could arise from the mis-selling of those instruments. The stakes of the FGD in Catalunya Banc and NCG Banco were sold, together with the stakes of the FROB, in 2013\(^{101}\) (NCG Banco to Grupo Banesco) and in 2014\(^{102}\) (Catalunya Banc to BBVA). The estimated

\(^{97}\) Article 44.2.b of Law 9/2012.

\(^{98}\) This principle was later incorporated in the Bank Recovery and Resolution Directive (BRRD) in 2014.

\(^{99}\) The shareholders of Bankia and Banco de Valencia suffered a haircut of almost 100% but were recognised a residual value for their shares.

\(^{100}\) Article 2 of RDL 6/2013, of 22 March, modifying the fifth additional provision of RDL 21/2012 of 13 July.

\(^{101}\) The sale process finished in June 2014.

\(^{102}\) The sale process finished in April 2015.
net price\textsuperscript{103} of those operations, as of 31 December 2022, was €464 million for the stake in Catalunya Banc and €362 million for the stake in NCG Banco.

98. **To solve the problem of inappropriate commercialisation to retail holders of those instruments, an arbitration procedure was established.** A Hybrid Capital Instruments and Subordinated Debt Monitoring Committee was set up by Article 1 of RDL 6/2013, of 26 March. One of its functions was to determine the basic criteria to be used by the banks in which the FROB had a stake to offer their clients the submission to arbitration of controversies arising in relation to those instruments, with the purpose that those clients were adequately compensated for the economic damage suffered, in case of a favourable ruling. The Committee sent those criteria to the FROB, which shared them with the banks controlled by the FROB (Bankia, Catalunya Banc and NCG Banco). For these banks, retail holders of those instruments with a total nominal amount of €3.1 billion obtained a favourable ruling and thus, were compensated by the banks. They recovered their initial investment adjusted to take into account the coupons received, the statutory interest accrued and the value of the shares.

99. **Many retail holders of preferred shares and subordinated debt obtained favourable rulings in court.** Apart from the arbitration procedures, many clients went to court and a high proportion of them obtained favourable rulings ordering the banks to return the investment those clients had made, when the court concluded that there had been mis-selling. For the three banks controlled by the FROB, the total amount of the investment where the courts considered that there had been mis-selling amounted to €3.8 billion. This sum had to be returned to the clients, adjusted to take into account the coupons received, the statutory interest accrued and the value of the shares. Therefore, the total nominal amount recovered by retail holders of hybrid instruments, either through arbitration procedures or through court rulings amounted, for these three banks, to €6.9 billion. This represented 83% of the nominal amount of those instruments owned by retail holders and 64% of the total amount affected by the SLEs of the three banks controlled by the FROB.

100. **Overall, the SLEs conducted in Spain did not achieve the intended outcome.** Due to the arbitration procedure and the court rulings, a significant majority of the retail clients recovered the total amount of their investment. Therefore, even if in principle the SLEs were quite severe and had contributed to reduce to a significant extent the amount of public capital injected, the final reduction was only one third of the initial amount estimated, because of the compensation to retail customers. This increased the final cost for the FROB. At the same time, the imposition of losses on retail holders, who in many cases considered their preferred shares or subordinated debt as a deposit more than a risky investment, had a significant cost for the banks’ franchise. Indeed, at the time, the media regularly reported demonstrations by affected investors and even assaults on the banks’ offices. Therefore, ultimately the taxpayer had to assume not only much of the part of the capital shortfall that was supposed to be covered by the SLEs but also the loss of value of the public stakes on the affected banks that the exercises entailed.

101. **More stringent requirements were introduced to constrain the sale of hybrid capital and subordinated debt instruments to retail investors.** The MoU incorporated, as horizontal conditionality, the commitment of Spanish authorities to introduce specific legislation to improve the transparency on the characteristics of these instruments and the consequent risks in order to guarantee the full awareness of the non-qualified retail clients. To meet that requirement, Law 9/2012 stated that the commercialisation of preferred shares or subordinated debt should comply with the following

\textsuperscript{103} Sale price of the shares plus the amount received for the guarantee granted by the FROB for the losses that could arise from the mis-selling of those instruments. For Catalunya Banc, the sale price of the shares was €383 million and the estimated value of the guarantee granted by the FROB was €81 million. For NCG Banco, the sale price of the shares was €290 million and the estimated value of the guarantee granted by the FROB was €72 million. Those prices are not yet final because the guarantees received from the FROB are still alive and could affect the total amount of payments to the FGD.
requirements: (i) at least 50% of the issuance must be addressed to professional investors and its number must be at least 50; and (ii) if the issuer is listed, the minimum unit nominal value must be €25,000, and if the issuer is not listed, the minimum unit nominal value must be €100,000. Also, the suitability and appropriateness assessments would have to be strengthened, highlighting, in the information provided to the client, the differences between those instruments and bank deposits, warning that these products are not suitable for non-professional investors due to their complexity, and including in the contractual document, together with the client’s signature, a handwritten expression by which the investor states that he or she has been warned that the product is not suitable to them or that it has not been possible for the bank to make the evaluation of the investor’s suitability.

Sale of the weakest banks

102. The resolution of non-viable banks involved their sale or liquidation, after the transfer of problem assets to Sareb. The sale of the bank to another market player in the framework of an open, transparent and non-discriminatory procedure was a form of mitigation of potential distortions of competition. The FROB had to sell Catalunya Banc, NCG Banco and Banco CEISS over a maximum period of five years, according to their resolution plans. The sale would be conducted through a competitive tender process. The sale process had to start by the end of July 2015 and, if it had not been completed before end-2016, a divestiture trustee would be appointed to sell the bank. If the sale was not possible, the bank would be wound down according to a resolution plan to be submitted before the end of 2017. In the case of Banco de Valencia, the sale of the bank had to be immediate. Otherwise, the bank would be wound down in an orderly way.

103. Banco de Valencia had to be sold before the approval of the resolution plan. The divestment process of the FROB in Banco de Valencia had started in April 2012, even before the signature of the MoU. It had to be stopped on 21 June 2012, in the context of growing uncertainty around the announcement of the financial assistance programme for financial institutions in Spain, but it was resumed in September. Prior to receiving the offers, four criteria had been established to decide whether to continue the sale process or to launch the process for the orderly winding-down of the bank. One of the criteria was that the buyer should be able to close the transaction by end of November 2012. Only one of the bidders, Caixabank, fulfilled all the criteria. Therefore, on 27 November, the FROB accepted the bid by Caixabank and the resolution plan was approved by the EC on 28 November 2012. Caixabank purchased the FROB’s stake in Banco de Valencia for €1. Previously, the FROB had injected €5.498 billion in Banco de Valencia and offered a series of guarantees, including an APS on a predetermined asset portfolio. The estimated cost of those guarantees, as of 31 December 2022, was €371 million.

104. Banco de Valencia was the only resolved bank that needed an amount of state aid higher than the capital needs estimated in the diagnostic exercise. As shown in Table 3, the capital needs estimated for Banco de Valencia amounted to €3.462 billion, while the total amount of capital injected
in 2012 to comply with the offer made by Caixabank amounted to €4.5 billion.\textsuperscript{110} Adding the €371 million of current estimates of the cost of the guarantees granted to Caixabank, the total would amount to €4.871 billion, 41\% more than the capital needs estimated in the diagnostic exercise and close to the lower bound of the range of estimated cost of an orderly winding-down.\textsuperscript{111} This was an exception, as in all the other banks the state aid granted after the diagnostic exercise, net of recovered amounts, was less than the capital shortfall estimated in that exercise. A key driver of the higher costs was the expeditious sale of Banco de Valencia. It signalled the Spanish authorities’ resolve to immediately proceed to implement the reform process. Yet the highly accelerated timetable – which could not be justified on the basis of a bank run or other sources of major immediate stress – had an adverse impact on the sale price.

105. \textbf{The FROB decided to sell its majority stakes in NCG Banco and Catalunya Banc ahead of the deadlines established by the EC}. The conditions imposed by the EC because of the state aid received by those banks (very significant downsizing, sale of profitable businesses, ban on acquisitions, limitations to the commercial practices, limitations of remunerations, stringent deadline to sell the bank\textsuperscript{112}) made it very difficult for those banks to compete due to the restrictions on their activity and the lack of motivation of the staff and the misalignment in objectives between the managers and the FROB. Therefore, it was very difficult, if not impossible, to preserve the value of those banks. The FROB hired a consultant which recommended, to minimise the use of public resources, a rapid sale of Catalunya Banc and NCG Banco.\textsuperscript{113}

106. \textbf{NCG Banco was sold in December 2013 to Grupo Banesco}. The sale process of NCG Banco took place in 2013 and, on 18 December 2013, the stakes of the FROB (62.75\%) and the FGD (25.58\%)\textsuperscript{114} in NCG were sold in a competitive tender procedure to Grupo Banesco, which had presented the best offer. That 88.33\% was sold for €1.003 billion, of which €713 million corresponded to the FROB and €290 million to the FGD, and a series of guarantees were granted to the acquirer. The estimated cost of those guarantees, as of 31 December 2022, was €349 million for the FROB and €142 million for the FGD.\textsuperscript{115} Up until the sale, the FROB had injected a total net amount of €8.981 billion,\textsuperscript{116} the problem assets had been transferred to Sareb and the SLE had been carried out.

107. \textbf{Banco Gallego, a subsidiary of NCG Banco, was sold in April 2013 to Banco Sabadell}. NCG Banco owned a 49.85\% of Banco Gallego. In the restructuring plan of NCG Banco, Banco Gallego was included in the legacy unit and therefore, it would have to be sold. The sale was to take place by 30 April 2013 and, if this was not possible, the bank would be wound up. In January 2013, Banco Gallego’s shareholders decided to reduce the equity of the bank to zero by absorbing losses and, simultaneously,
NCG increased the capital of Banco Gallego. As a result of that operation, NCG held 99.95% of Banco Gallego. At the same time, the FROB opened a competitive tender procedure for Banco Gallego, which was sold to Banco Sabadell on 19 April 2013. Banco Sabadell purchased Banco Gallego for €1 and the FROB had to inject €245 million. The problem assets of Banco Gallego were transferred to Sareb, and an SLE was carried out.

108. **Catalunya Banc was sold to BBVA in July 2014.** After the suspension of the previous process in March 2013 and the sale of NCG in December 2013, the FROB restarted the sale process of Catalunya Banc in March 2014. To enhance the bank’s value, the FROB designed a dual sale: (i) a portfolio of poorer quality loans (mainly mortgages); and (ii) the rest of the bank as an entity without distressed assets. The low-quality asset portfolio was sold to Blackstone with a total cost of €563 million,\(^{117}\) of which €377 million corresponded to the FROB and €186 million to the FGD according to their stakes in Catalunya Banc (the FROB owned 66.01% and the FGD 32.39%,\(^{118}\) totalling 98.4%). The share of the bank owned by the FROB and the FGD (98.4%) was sold to BBVA, which had presented the best offer. That share was sold for €1.165 billion, of which €782 million corresponded to the FROB and €383 million to the FGD, and a series of guarantees were granted to the acquirer. The estimated cost of those guarantees, as of 31 December 2022, was €228 million, of which €153 million corresponded to the FROB and €75 million to the FGD.\(^{119}\) Up until the sale, the FROB had injected a total amount of €12.052 billion,\(^{120}\) the problem assets had been transferred to Sareb and the SLE had been carried out.

109. **Banco CEISS was sold to Unicaja through an integration process.** In 2011, CEISS had submitted to the BdE a plan to comply with the new requirements of RDL 2/2011, which included, as main option, the merger with Unicaja Banco. This plan was amended in 2012 after the approval of the new provisioning rules of RDL 2/2012. In the bottom-up stress test under the MoU, Banco CEISS was included in Group 2. But, while the other banks included in that group were considered viable, Banco CEISS was placed under resolution and therefore it was to be sold as soon as market conditions permitted and within a maximum of five years.\(^{121}\) In February 2013, Unicaja submitted an offer to acquire Banco CEISS\(^{122}\) with the condition that at least 75% of the holders of hybrid instruments and subordinated debt in Banco CEISS accepted to exchange the securities they would receive, as a result of the SLE, for new securities issued by Unicaja. Also, a guarantee was provided by the FROB to cover possible errors stemming from the transfer of assets to Sareb, with a limit of €200 million. On 4 February 2014, the acceptance period of Unicaja’s offer expired and the 75% minimum threshold was not met. However, Unicaja decided to continue with the offer but with a new guarantee by the FROB to cover litigation costs arising from legal proceedings initiated by investors not accepting Unicaja’s offer, with a limit of €241 million, and the extension of the previous guarantee of €200 million, without increasing the limit but covering also potential claims of mis-selling of securities by Banco CEISS. This new amendment to the plan was finally approved by the EC on 12 March 2014. Up until the sale, the FROB

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\(^{117}\) This €563 million had two components: (i) the difference between the net book value of the portfolio in the balance sheet of Catalunya Banc and the amount offered by Blackstone (€525 million); and (ii) the cost of some guarantees granted to Blackstone (€38 million). The total cost of the sale to Blackstone was assumed by the FROB and the FGD.

\(^{118}\) This FGD's stake was the result of the offer to the retail holders of hybrid capital and subordinated debt instruments mentioned in the main text.

\(^{119}\) The price is not yet final because some of the guarantees are still alive and could affect the total amount of payments to the acquirer.

\(^{120}\) Through FROB I (€1.250 billion), FROB II (€1.718 billion) and FROB III (€9.084 billion).

\(^{121}\) State aid n° SA.34536 (2012/N) – Spain Restructuring and recapitalisation of Banco CEISS, paragraphs (48) and (49).

\(^{122}\) Through the exchange of ordinary shares and necessarily convertible securities in Banco CEISS for equity, CoCos and necessarily convertible instruments issued by Unicaja Banco.
had injected a net total amount of €525 million, the problem assets had been transferred to Sareb and the SLE had been carried out.

The restructuring plan of the BFA-Bankia group did not oblige the FROB to sell its majority stake in the bank within a pre-defined period of time. However, Article 31.4 of Law 9/2012 established that the FROB’s divestment of the shares acquired in the restructuring or resolution processes should be carried out within a period not exceeding five years from the date of its acquisition.

The sale of BFA-Bankia encountered a series of economic and political difficulties. The relatively fast sale processes for the banks under resolution was instrumental to restore normality in the Spanish banking sector, minimise public sector participation in the industry and promote a healthy consolidation. Yet BFA-Bankia’s large size complicated its full acquisition by another bank in a context in which the uncertainties surrounding the banking sector in Spain and Europe had not fully dissipated. Moreover, the sale of major stakes at prevailing market prices would have made evident the difficulty of recovering a significant part of the public support offered to the bank. After consultation with a strategic adviser, the FROB decided to sell its stakes in Bankia through an accelerated bookbuild. In February 2014, following that strategy, the FROB sold 7.5% of the capital for a total of €1.304 billion. However, the process of selling stakes in Bankia was not continued in the following years. Thus, in December 2016 RDL 4/2016 extended the deadline to sell the bank from five to seven years and authorised the government to extend that deadline when deemed necessary to better comply with the objectives of the resolution. Following this authorisation, the government extended the deadline several times, with the current deadline being December 2025. In December 2017, a second stake of 7% of Bankia was sold by the FROB, for a total amount of €818 million, at a significantly lower price than in the 2014 sale (Graph 8). In September 2020, Caixabank and Bankia reached a merger agreement and in March 2021, Bankia was absorbed by Caixabank. As a result, the FROB holds a 17% stake in Caixabank.

123 Through FROB I (€525 million) and FROB III (€604 million). In August 2017, the €604 million in CoCos of FROB III were repaid to the FROB.
112. Reflecting the nature of the crisis, legislative and regulatory changes in the Spanish case fall into two main categories. First, the crisis has exposed limitations in the prudential framework and the supervisory approach. The regulatory regime for banks was overhauled at the global level, thanks to the adoption of a new capital standard, Basel III, which was implemented in Europe via directives and regulations. The Spanish authorities also introduced some regulatory changes before the completion of the European legislative process, to respond to the crisis. Concerning supervision, the BdE implemented adjustments to its supervisory practices, as described below, after which a major shift came with the establishment of the Single Supervisory Mechanism (SSM) in Europe. Second, the case of Spain, as other countries experiencing a banking crisis at the time, has highlighted the limitations of options available to authorities aiming to resolve banks in an orderly manner. Spain has therefore introduced a number of changes which complemented the revisions at the global and European level.

113. Concerning prudential regulation, an important reform was devised for savings banks and foundations. Law 26/2013 on savings banks and banking foundations introduced two key requirements. The first aimed to achieve both greater professionalism of governing bodies and
improved corporate governance of the remaining savings banks. This required, among other things, that individuals in these bodies would meet certain standards of good repute and experience, that the majority of them be independent and that a yearly report on directors’ remuneration be published.

114. **The savings bank reform included a second requirement, aimed at clearly separating the banking business from the original welfare objectives of savings banks.** Savings banks exceeding certain limits, set in terms of their geographical presence or size, had to transform themselves into foundations. This implied they would lose their status as credit institutions and would have to transfer their banking business to a commercial bank, with conditions attached depending on the percentage of ownership of the banking business. Specifically, if the ownership stake was 50% or more, or the foundation continued to control the bank, foundations were required to prepare a management protocol and an annual financial plan, including an investment diversification plan. They were also required to set up a reserve fund to meet potential equity needs of the bank (alternatively, a plan to divest from the investee credit institution within a maximum of five years may be submitted). If the ownership stake was below 50% but above 30%, foundations were required only to prepare the management protocol and annual financial plan.

115. **The separation of the foundations and the banking business, however, did not materialise as intended in the MoU.** The number of banks under some form of influence from the foundations shrank considerably, to only four. Of these, the foundations formally control two. The foundations meet the requirements imposed by the law, including, for these two, the setting up of a reserve fund. The fund was intended as a deterrent to the foundations’ control of banks and a buffer to protect the bank’s capital, but proved to be ineffective. It was too small to achieve the separation of banks and foundations, and additional capital buffers may not be the most suitable measure to address potential governance problems. Personnel links between the banks and the foundations, where they exist, may also contribute to creating informal links between the two, even when formally compliant with independence requirements. The supervision of the foundations may also be hampered by the existence of two authorities in charge – the BdE for economic aspects, the MdE for management and governance issues.

116. **Other changes applied to prudential practices followed by the BdE.** BdE Circular 06/2012 required an increase in disclosure and uniformity in the definition of banks’ loan classification policies (including criteria for loan forbearance transactions to be used for estimating impairments). In 2013, the BdE also clarified a set of criteria that banks had to take into account in preparing and approving their forbearance policies and in classifying the affected transactions for accounting purposes. Law 9/2012 endowed the BdE with powers to authorise credit institutions and impose various types of sanctions on them, substituting earlier provisions that envisaged sharing these tasks with the MdE. An internal BdE Circular of 2013 introduced changes to the supervisory frameworks in line with the conditions of the MoU. In particular, it strengthened the BdE supervisory processes by: (i) establishing a standardised framework for the adoption of supervisory measures based on the risk profile of credit institutions; (ii) introducing continuous on-site monitoring at relevant institutions; (iii) formalising the supervisory conduct; and (iv) binding microprudential supervision to macroprudential supervision.

117. **Spain introduced Basel III following the European approval process.** In 2013, the EU introduced the post-crisis regulatory changes for bank regulation that had been agreed at the global level under the Basel III framework, via Regulation 2013/575/EU (the Capital Requirement Regulation (CRR)) and Directive 2013/36/EU (Capital Requirement Directive, CRD IV) on capital requirements. The

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124 Only two very small savings banks continued to exist after these reforms.

125 In addition, in 2017 the maximum period for reaching the target volume of the reserve fund was extended from five years (with a possible extension of two years, to be approved by BdE), to eight years (with a possible extension of two years to be approved by BdE).
CRR directly applied in all EU member states, and Spain implemented the CRD IV in November 2013. The CRR and CRD IV aimed to increase the quantity and quality of bank capital, introduced liquidity requirements, and complemented the risk-sensitive capital measures with a leverage ratio. Moreover, the new regulatory framework incorporated macroprudential instruments aiming at mitigating the excessive procyclicality of banks’ behaviour, which are partially inspired by the dynamic provisions introduced in Spain before the crisis (Section 2).

118. **Spain joined the SSM.** Following the recommendations in Van Rompuy Report, European governments agreed to the creation of a banking union, which included the establishment of a single supervisory authority. With the establishment of the banking union, leaders aimed to sever the negative loop between sovereign risk and banking risk; to reduce the impact of a bank’s bankruptcy on national public finances, given the principle of private sector bail-in; and to stimulate the provision of credit in Europe. The SSM started operating in 2014, and all euro area countries joined it from the start. With its inception, the supervision of the larger Spanish banks shifted to the ECB, with operational support from the BdE, in line with the common supervisory framework applied in Europe. The BdE remains in charge of direct supervision of the so-called less significant banks.

119. **Concerning resolution, a key regulatory change in 2012 created a new framework in Spain.** According to RDL 24/2012 (later Law 9/2012), the FROB becomes a genuine resolution authority, with both “commercial” and “general administrative” powers. The law also clarified and defined the objectives in resolution. These include: (i) ensuring the continuity of the institutions’ critical functions; (ii) preventing harmful effects on the stability of the financial system; and (iii) ensuring the most efficient use of public resources, minimising the financial support which, on an extraordinary basis, may need to be granted.

120. **The framework set out three types of intervention in Spanish banks.** According to Law 9/2012, the first type, early intervention, applied to banks facing temporary difficulties. In this case, banks would submit action plans to the BdE and public support could be used when replenishing capital levels with CoCos to be subscribed by the FROB. The second type, restructuring, applied to banks that required public funds to guarantee their viability, requiring that official support be repaid within a timeframe of at most seven years. Finally, the third type, resolution, applied to a bank that was failing or likely to fail, and when public interest would make it preferable to adopt resolution instead of insolvency procedures, to best meet the resolution objectives.

121. **Spain joined the Single Resolution Mechanism (SRM).** The SRM, and its Board, the Single Resolution Board (SRB), is another essential component of the banking union. It became fully operational in 2016 and is responsible for adopting all resolution decisions for banks directly supervised by the ECB, for other cross-border groups of less significant institutions and for any other less significant institution in which it has been decided to use the common European funds. Spain remains in charge of the resolution of the banks not falling under the scope of the SRM.

122. **The Spanish resolution framework was updated in 2015, following changes in European legislation.** European rules on the recovery and resolution of credit institutions and investment firms are set out in Directive 2014/59/EU, known as the Bank Recovery and Resolution Directive (BRRD). The BRRD was designed to reduce the use of public money in bank crises and to facilitate the orderly resolution of non-viable banks. In Spain, Law 11/2015 devises a new institutional framework to comply with the principles set out in the BRRD. With the new regulation, there are two separate resolution authorities in Spain for banks supervised by the BdE. The BdE is the preventive resolution authority for these banks, ie it prepares the resolution plans. The FROB is the executive resolution authority, ie it

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126 Concerning commercial powers, the FROB could exercise the powers that commercial legislation generally conferred on the management body and the general meeting or assembly of a commercial company. Concerning administrative powers, the FROB was given the necessary administrative powers to implement the restructuring and resolution instruments.
The institutional setup for bank resolution in Spain is imperfect. The separation between a preventive and an executive resolution authority is quite exceptional and has created some operational challenges. In particular, separating the preparation and execution of resolution plans reduces clear synergies between those two functions. The arrangement can create redundancies, while it is not clear that it may be needed to solve any obvious conflict of interest. The creation of a dedicated resolution authority for banks, possibly within the BdE but sufficiently separated from the supervisory function, seems more in line with the usual arrangements in other European countries.

Cost of the crisis

The direct cost of the crisis has been shared between the banking sector, through the FGD, and the state, mainly through the FROB. In the early stages of the crisis, the cost of financial assistance to failing banks was assumed mainly by the FGD. The FROB assumed the cost of Cajasur, by granting an APS to the acquirer, and it injected funds through FROB I and FROB II, but in banks which were in principle viable. When some of those banks (CAM and Unnim) failed in 2011, the cost was assumed by the FGD. After the Bankia crisis and the signature of the MoU and the Financial Assistance Facility Agreements, the cost was assumed by the FROB. In this last stage of the crisis, the FGD only contributed with the acquisition of shares of Catalunya Banc and NCG Banco. These shares had been received by retail holders of preferred shares and subordinated debt in an SLE, as explained above.

As of 31 December 2022, the total cost of the crisis for the FGD amounts to €23.214 billion. The FGD supported the sale of three failing banks (CCM, CAM and Unnim), with both injections of capital and APS on problem assets. Also, in 2009 the FGD invested €2.25 billion to acquire 25% of the FROB. As a consequence of all that financial assistance the FGD presented, as of 31 December 2012, negative equity of –€1.247 billion, despite an extraordinary contribution approved in 2012 amounting to €2.346 billion. The cost of the APS granted by the FGD has turned out to be much higher than initially estimated: in the 2012 FGD financial statements, the estimated cost was €1.949 billion for CCM, €2.966 billion for CAM and €860 million for Unnim, while the final cost has been €2.475 billion for CCM, €7.386 billion for CAM and €1.998 billion for Unnim (Table 4).

There is a third resolution authority, the Securities Commission (CNMV). The BdE is the preventive authority for banks, the CNMV for investment firms. In both cases, the FROB is the executive resolution authority.

A major conflict of interest existed until 2022, when discussing the condition of entities under the control of the FROB, or in which the FROB held shares, and supervised by the BdE (ie Bankia and Sareb). This was partly addressed by creating two compositions of the FROB’s Board in 2015 (Article 54.6 of Law 11/2015, of 18 June). Initially, the narrow composition, excluding the BdE and the CNMV, would take only decisions which affected the General State Budget, but a modification of the law on 19 January 2022 stated that the decisions related to the management by the FROB of its portfolio of shares, securities and other instruments, should also be taken by the FROB’s Board in its narrow composition. The BdE would join only the extended meetings, devoted to the discussion of resolution plans. As a result, the BdE is now clearly excluded from discussions that do not pertain to resolution.

For a comparison of practices, see Baudino et al (2021).

Paragraph 28 of the MoU stated that “the authorities will ensure that, as of 1 January 2013, there will be no active bankers anymore in the governing bodies of the FROB”. Therefore, the FGD’s participation in the FROB was liquidated according to RDL 24/2012, taking into account the net value resulting from the 2011 annual accounts of the FROB. As that net value was negative, the FGD lost all of its investment.
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As of 31 December 2022, the total estimated cost of the crisis for the FROB was €46.505 billion, but as €2.25 billion of the initial capital of the FROB was injected by the FGD, the actual cost for the state amounted to the remaining €44.255 billion. The banks of Group 1 (BFA-Bankia, Catalunya Banc, NCG Banco-Banco Gallego and Banco de Valencia) and Group 2 (Banco CEISS, BMN, Liberbank and Caja 3) were recapitalised by the FROB through capital injections or CoCos. In two of them (Caja 3 and Liberbank), the CoCos were fully repaid. Another bank (Banca Civica) was absorbed by Caixabank and could repay the total amount of the injection of preferred shares by the FROB (FROB I). But Catalunya Banc, NCG Banco-Banco Gallego, Banco de Valencia and Banco CEISS had to be sold, and the amount recovered was a small proportion of the total injected. In the case of BFA-Bankia and BMN, the FROB still owns a 17% of Caixabank, which absorbed Bankia-BMN in 2021. Taking into account the current share price of Caixabank, the estimated recoverable amount would be between 25 and 30% of the total amount injected by the FROB. Finally, the FROB also invested €2.192 billion in Sareb, which will not be recovered (Table 5).

In addition to the €44.255 billion cost through the FROB, the state has suffered other costs that could be estimated at a net amount of €13.518 billion as of 31 December 2022. In particular, the value of Sareb’s equity amounted to –€14.172 billion. In addition, the accumulated cost of the loans granted by the ESM amounted to €3.056 billion. On the other hand, the liquidity support measures offered by the state between 2009 and 2012 were liquidated with a revenue for the state, via interest and fees, amounting to €3.71 billion (Bank of Spain (2019)).

In sum, the total direct cost of the crisis was almost €81 billion. This resulted from €23.214 billion for the industry (Table 4) and €57.773 billion for the state (Table 5), according to figures as of 31 December 2022.

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126. As mentioned earlier, the bonds issued by Sareb to fund the acquisition of the assets are fully guaranteed by the state. As a result, the state will assume the cost corresponding to the part of those bonds that Sareb will not be able to repay with the proceeds from the sale of these assets.

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<table>
<thead>
<tr>
<th>Total costs of the crisis for the FGD (EUR millions)</th>
<th>Table 4</th>
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<tbody>
<tr>
<td>Bank</td>
<td>Capital and asset acquisitions</td>
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<tr>
<td>CCM</td>
<td>1,740</td>
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<tr>
<td>CAM</td>
<td>5,249</td>
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<tr>
<td>Unnim</td>
<td>953</td>
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<tr>
<td>Catalunya Banc</td>
<td>1,001</td>
</tr>
<tr>
<td>NCG Banco</td>
<td>802</td>
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<tr>
<td>Initial investment in the FROB</td>
<td></td>
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<tr>
<td>Net total</td>
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Source: FGD (2023); FSI calculations.
Section 6 – Lessons and conclusions

129. The Spanish crisis combines some features that are common to other crisis episodes with some that are specific to it. Among the former are the destabilising impact of macro-financial imbalances, the large exposures to deteriorating assets and the unstable funding structure of a large part of the banking system. Among the latter are the vulnerabilities created by the special structure of the banking sector due to the importance of savings banks. Some lessons can be drawn from the crisis which can be relevant for other banking sectors that share some of those features with the Spanish one.
Crisis prevention

130. **Deficient business models and poor governance can be a major source of banks’ instability.** The Spanish crisis resulted from the perverse interaction of adverse global, European and domestic developments. Yet a relevant structural vulnerability of the Spanish financial sector was the significant role played by savings banks. Indeed, while not immune to the risks posed by large exposures to the real estate sector, commercial banks were broadly able to withstand those adverse developments. By contrast, many savings banks had been growing markedly without a solid capital base or governance structure and were subject to considerable influence from regional and local authorities. That led to poor risk management that facilitated an unsustainable concentration of lending in the real estate sector, an excessive exposure to low-quality projects and a heavy reliance on unstable wholesale funding. All of these factors ultimately caused their failure.

131. **Excessive risk-taking associated with inadequate governance and unsustainable business models can hardly be addressed solely by standard prudential instruments.** Particularly in a context, like the one prevailing in Spain before the crisis, of economic expansion driven by the dynamism of the sectors to which banks are most heavily exposed, the usual indicators of asset quality, profitability and solvency do not properly reflect the underlying vulnerabilities. Moreover, standard prudential measures, such as requiring firms to hold additional capital or provisions, cannot compensate for poor management, which can lead to excessively risky investment and financing decisions. In fact, requiring failing banks to have held the capital equivalent to the public support that the state had to inject when they failed would have implied an increase in capital requirements that would have been completely unrealistic at the time.132

132. **Supervisors also need to be empowered to induce adjustments in business strategy and management procedures through appropriate qualitative measures, including by replacing management when necessary.** Arguably, at least with the benefit of hindsight, the strategy followed by most saving banks, characterised by fast balance sheet growth, unstable funding sources, large concentration of exposures and limited ability to raise capital if needed, has all the elements of an unsustainable business model. Under those conditions, it is essential that supervisors have adequate legal powers, tools and internal culture to be able to act pre-emptively and in a timely way in order to effectively achieve the required adjustment in banks’ strategies and risk controls.133 In particular, it is essential to replace the management of the banks receiving public support, as largely done in Spain. Legislative provisions recognising specific business models or governance arrangements – like those relating to savings banks in Spain – can constrain supervisors’ ability to act effectively.

133. **Once problems unfold, achieving a suitable combination of pragmatism and determination in supervisory interventions is both essential and highly challenging in practice.** Unlike in normal times – when an intrusive, forward-looking and risk-sensitive supervisory approach is always the best practice – in times of crisis supervisors need to weigh the impact of their actions on public and market trust. In particular, radical and across-the-board actions that are not fully warranted on the basis of observed and expected domestic or external conditions do not always help maintain financial stability, particularly if they require the deployment of large amounts of fiscal resources. Before the crisis and in its early stages, Spanish authorities had implemented several actions aimed at intensifying supervisory scrutiny and starting the recapitalisation of weak institutions, adopting more stringent prudential standards (like higher capital requirements or the dynamic provision), promoting integration across institutions and introducing elements of market discipline for savings banks. The actions taken were probably in line with the observed deterioration of the situation and its expected

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132 For instance, this would have implied to increase the capital requirements for Group 1 banks (ie BFA-Bankia, Catalunya Banc, NCG Banco and Banco de Valencia) by an average of close to 23 percentage points, over RWA, thus almost quadrupling the required solvency ratio.

133 See Dahlgren et al (2023) for a discussion on this topic.
improvement and with the limited available fiscal room for manoeuvre of the state. Yet those measures did not manage to cover (the then materialised) risks associated with a further worsening of domestic and international conditions. As a consequence, it is clear ex post that those actions, taken gradually over several years, were neither sufficiently conservative nor sufficiently timely to prevent the collapse of a large part of the system. That said, it is unclear whether bolder actions such as the ones taken in 2012 – entailing the recapitalisation, nationalisation, consolidation and change of legal status of former savings banks – would have been politically and economically feasible without the extreme capital market pressure observed in 2012, after the double-dip recession, together with the resources provided and the discipline imposed by the European programme.

134. **The experience with using macroprudential instruments in Spain was instrumental for the design of the post-GFC regulatory reforms.** Spain’s dynamic provisions are often presented as an inspiration for the macroprudential framework developed after the GFC and the related reforms. In particular, the Spanish experience appears to have influenced the countercyclical capital buffer introduced in the Basel III framework. The Spanish innovation was to make banks capable of absorbing macro-financial shocks and to help mitigate excessive credit growth in the expansionary phase of the cycle. Spanish banks accumulated sizeable resources, up to 1.3% of RWA, under dynamic provisions. Those funds reduced the resources required to recapitalise weak institutions by around 15%.

135. **While standard macroprudential instruments can increase banks’ resilience, capital-based instruments face limitations when addressing macro-financial imbalances.** The Spanish dynamic provisions in no way sufficed to avoid a major collapse of those banks that were more exposed to a sharp correction in the booming real estate sector. The Spanish experience confirms that, by themselves, countercyclical prudential requirements, which increase banks’ buffers to absorb losses, have little capacity to decrease the amplitude of the credit cycle unless they are calibrated at very stringent levels in the expansionary phase (Saurina and Trucharte (2017b); Jiménez et al (2017)). Limits to sectoral concentration of exposures, and borrower-based macroprudential measures, such as limits on loan-to-value, debt-to-income, debt-service-to-income or loan maturity, may be more effective in curbing credit excesses (BIS (2018)). These measures are now part of the standard toolbox of macroprudential authorities, but were not well established at the time of the GFC.

**Crisis resolution**

136. **The success of a financial reform programme requires an internally consistent package of measures addressing both the urgent needs and the structural weaknesses of the sector, with timely implementation.** The Spanish programme combined a rigorous, quantitative diagnosis with rather bold measures for bank capitalisation, restructuring and balance sheet cleanup that were implemented with much discipline according to a demanding timeline. It also addressed the deficiencies of the institutional framework and, in particular, the role played by savings banks. Importantly, the whole programme was supported by a sizeable financial backstop and well designed conditionality that provided credibility to the entire reform process. Confidence in the backstop, and the relatively small proportion of deposits not covered by the FGD were essential to prevent bank runs, even in the period between the collapse of Bankia and the approval of the recapitalisation of the weak banks.

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134 Dynamic provisions could also be considered as an inspiration for setting provisions on the basis of expected loss.

135 As explained in Saurina and Trucharte (2013), banks that received public support (Group 1 and Group 2 banks in Table 3) could draw on a buffer of €7 billion, thanks to dynamic provisioning. This amounts only to around 15% of the support they received, even without including the losses experienced by Sareb in the amount of support.
The feasibility and credibility of an ambitious reform agenda require broad political and social support. The measures taken in Spain, mostly concentrated in only a few months in the second half of 2012 and the beginning of 2013, would have been impossible without the implicit agreement of (or at least lack of opposition by) the main political parties and social partners. The reform implied deploying substantial public resources, approving in record time the reform of core aspects of the national legal framework (such as the rights of banks’ creditors), aggressive layoffs of employees of restructured banks and the effective dismantling of the savings bank system, despite the traditional bond these institutions had with the political establishment. Indeed, during the critical phase of the crisis, there were essentially no major demonstrations or even public criticisms by political parties or trade unions, with the only exception being the turmoil generated by the losses imposed on retail holders of hybrid capital and subordinated debt instruments.136

For a country in the euro area, the involvement of the relevant European bodies and their explicit endorsement of the reforms undertaken is essential. In Spain, the availability of European funds and ECB exceptional liquidity measures and, more importantly, the explicit agreement between the Spanish authorities, the EC and the ECB on the programme of actions and normative reforms was crucial. This not only lent credibility to the policy actions but, more importantly, made the costs of the programme more easily acceptable to the population. A major factor affecting support for the programme by political and social agents and the population at large was the conviction that it was necessary to ensure that Spain would continue being a member of the euro area. More broadly, the programme may have also been seen as essential for the continuation of the monetary union itself. The remarkably strong attachment of Spanish people to the European project played a key role in that regard.

Effective and clear communication is an essential ingredient of crisis management. As explained in previous sections, the rigour and comprehensiveness with which the diagnosis exercise was communicated to the analysts and the press was instrumental in achieving the required credibility of the programme right from the start. Some room for improvement can be identified in the way the implications of the crisis were communicated to the public. In particular, authorities often declined the opportunity to convincingly explain the need to deploy public resources to preserve financial stability as an essential public good. Instead, they frequently insisted on the rather unrealistic prospects for a full recovery of the public aid provided to the system once the state would sell all its stake on supported financial institutions.

While relevant, competition considerations should not be overweighted against financial stability or the efficiency of resource allocation. The Spanish programme was implemented right before the adoption of an EU-wide framework for bank resolution. At that time, however, the EU already had in place a state aid framework that allowed the EC to establish conditions under which public support to different companies could be declared to be in compliance with the single market. Since the resolution of the European banking crisis required a massive deployment of public resources, and in the absence of more targeted rules for bank resolution, that framework became the basis for the EC policy approach. While, at least in the case of Spain, this approach was implemented in a sensible and pragmatic way, in some instances the preponderance of competition over other goals was evident. That appears to have been the case when designing the downsizing programmes for banks under resolution. As discussed above, those measures might have deteriorated the value of some of the franchises under public control, thereby raising the net cost of the crisis.

The creation of a properly designed AMC can be a very powerful resolution tool for a systemic crisis linked to deteriorated exposures to a specific sector or sectors, but it is not cost-free. The Spanish experience shows how the transfer of real estate assets to Sareb by all weak banks

Interestingly, the political debate on the measures taken during the crisis gained some traction more recently, once it was already evident that they had been effective in restoring financial stability.
helped recover trust in the financial soundness of the banking system and facilitated the sale process of all banks under resolution. That said, Sareb’s ultimate financial position was poorer than expected and it was eventually nationalised. Therefore, in the end, Sareb’s losses fed into the total cost of the crisis for Spanish taxpayers. While this adverse financial result is partly related to the considerable management difficulties encountered, it is mainly the consequence of relatively high transfer prices. In other words, Sareb’s losses are to a large extent the price that was paid over time for reducing the public resources needed to recapitalise weak institutions at the start. Arguably, that deferral of losses for the public purse might have helped to alleviate the large financial pressure faced by Spain when the programme was implemented. In addition, the management difficulties could have been mitigated by better preserving the expertise for the treatment of the transferred assets.

Resolution actions can successfully be implemented if supported by sufficiently robust legislation. Spain was one of the first countries in Europe (before the BRRD was approved) in which far-reaching administrative actions were adopted to restructure banks, segregate businesses, transfer assets and impose losses on banks’ creditors outside a formal insolvency procedure. That involved taking full control of weak banks and expropriating contractual rights for investors without any ex ante court intervention. The experience showed that this approach was legally sound as it was based on new, targeted legislation that was rigorously applied in all cases. The result was that there was essentially no successful litigation against the resolution actions taken by the FROB.

Hybrid capital and subordinated debt instruments lose much of their ability to provide gone-concern resources when they are held by retail investors. Despite their robust legal basis, burden-sharing arrangements failed to deliver the expected resources to help recapitalise banks. The reason was the practical impossibility of imposing losses on retail holders of hybrid capital and subordinated debt instruments due to different court rulings and arbitration decisions in favour of mis-selling allegations by banks’ clients. Moreover, SLE actions against retail investors created much unrest and ultimately deteriorated the value of the franchise for banks under public control, thereby contributing to the reduction of the proceeds from the sale of those institutions. These experiences also support recent measures to impose constraints on the sale of these instruments to retail investors.

A relatively rapid disinvestment of public stakes in banks subject to resolution, when feasible, is generally the preferable strategy. Spanish authorities decided, in accordance with the MoU, to sell all banks controlled by the state quite rapidly. The only exception to the rapid disposal approach was Bankia, where a substantial part of the original stake was kept and converted into Caixabank’s shares, after the integration process. While a counterfactual analysis is hard to perform, the rapid sale of all banks under resolution looks, in general, to be a sensible strategy due to the deep and rapid deterioration of their franchises. Some caveats are warranted, however, based on the experience of Banco de Valencia, where the rapid sale strategy was taken to the extreme as the bank had to be sold only a couple of months after the publication of the diagnosis exercise, before the stabilising impact of the successful implementation of the programme was visible to potential bidders. The slower pace of the sale strategy followed with Bankia was due to the size and systemic nature of this institution. Yet, looking at the evolution of market prices, it is not hard to conclude that a faster sale of the public stake in this institution could have been feasible and profitable for the state.

A systemic crisis can be turned into an opportunity to adopt ambitious reforms that may have been long overdue. Overall, the Spanish experience shows that Spanish authorities, with the support of the European authorities and the IMF, took advantage, in general, of the critical situation to adopt far-reaching reforms that could hardly be made in normal times. Those reforms, including the recapitalisation, restructuring and consolidation of the banking sector and the overhaul of the savings banks, are still showing – 10 years later – a persistent positive effect on the strength of the Spanish
financial industry.\footnote{137} If anything, it could be argued that the opportunity was missed to deepen some reforms – like the one aimed at addressing the control of banks by banking foundations – that will always be subject to political controversy.

\footnote{137} The most recent IMF FSAP concluded that the post-crisis reform effort had progressed well (IMF (2017)). With the economic recovery and support from the ECB’s accommodative policies, the banking system strengthened and made progress on reducing NPLs. However, the FSAP observed that it was critical to keep the reform process moving and to build on the advances made after the crisis – completing the restructuring of bank balance sheets should be the highest priority. Concerning future action, the IMF argued that Spain should develop a resolution strategy for less significant institutions and that the FGD would benefit from enhancements to its revenue base and the payout system. The crisis resolution setup was tested in 2017 (Banco Popular) and while the FSAP found the immediate handling of the crisis to be orderly, it also pointed out several operational issues that needed work by the FROB and the BdE.
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