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### **Briefing note on Royal Decree-Law 24/2012 on restructuring and resolution of credit institutions**

Banco de Espana/Central Bank of Spain

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## **Briefing note on Royal Decree-Law 24/2012 on restructuring and resolution of credit institutions**

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Royal Decree-law 24/2012 (RDL) on restructuring and resolution of credit institutions (“banks”) was approved by the Spanish government on 31 August 2012 and entered into force immediately<sup>1</sup>.

The RD-I covers the essential tools for managing banking crises. The mechanisms available to the Spanish authorities to strengthen and restructure the Spanish financial system are significantly enhanced, enabling them to ensure that the credit system functions properly. The ultimate aim is to safeguard the stability of the financial system as a whole, beyond the problems of any particular bank.

The RD-I is an important element of the government’s financial sector reform programme. It introduces most of the legislative measures required by the Memorandum of Understanding of 20 July 2012, which establishes the conditionality associated with the financial assistance agreed by the Eurogroup for recapitalising Spain’s financial sector.

The RD-I includes six types of measures:

1. A new enhanced framework for the management of crisis situations at banks, which will allow effective restructuring or orderly resolution, as necessary.
2. New regulation of the Fund for the Orderly Restructuring of the Banking Sector (FROB), which defines its powers and significantly enhances the tools for intervention in all phases of crisis management.
3. Stronger protection of retail investors.
4. A legal framework for the creation of an Asset Management Company (AMC).

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<sup>1</sup> In parallel, and pursuant to the provisions of Article 86(2) of the Constitution, Royal Decree-Law 24/2012 was debated and all of its provisions put to a vote in the session of Congress (the lower house in the Spanish Parliament) held on 13 September 2012. Congress resolved to validate this Royal Decree-Law and to consider it a draft law subject to the expedited procedure. This will allow technical amendments to be made to improve the current text of the Royal Decree-Law, without any change to its essential aspects, given the Government’s majority in Congress. Congress can be expected to approve the Law for the Restructuring and Resolution of Credit Institutions in late December 2012.

5. A burden sharing system to ensure that the costs of intervening in banks are shared by the public sector and private creditors (as required by the Memorandum of Understanding).
6. Finally, other aspects are regulated, such as the strengthening of bank capital requirements, new limits on the pay levels of executives of State-aided banks and the transfer of powers to the Banco de España.

## 1 A new crisis management framework

The RD-I establishes a complete legal system for dealing with banks in difficulty. To this end, it introduces into Spanish law certain aspects of the draft future European Directive on Crisis Resolution.

It distinguishes three levels of seriousness of the situation of banks, and envisages early-action measures (for minor difficulties), restructuring (when weaknesses are temporary and can be resolved through the injection of public funds) and resolution (for unviable banks).

The processes of bank restructuring and orderly resolution must respect a number of objectives and principles such as avoiding effects prejudicial to the stability of the financial system, assuring more efficient use of public funds, and ensuring that shareholders and subordinated creditors are the first to assume losses taking into account the established order of priority of creditors.

**Early-action measures** are applied when a bank has minor difficulties, i.e. when it fails to comply with its capital requirements, or when it is reasonably foreseeable that it will be unable to comply with them, but it has the capacity to return to compliance using its own resources.

These measures are included in the most ordinary phase of bank supervision and are directed by the Banco de España. They aim to ensure that the bank recoups its stability and complies with its regulatory requirements, so that public funds do not have to be injected or only injected on an exceptional and temporary basis (to be repaid within a maximum of two years).

**Restructuring** is envisaged when a bank requires public financial support to be viable and there are objective reasons that make it reasonably foreseeable that this support will be repaid or recovered within the maturity period of each instrument. Restructuring will also be applied when, despite the absence of these objective reasons, the alternative to restructuring, i.e. orderly resolution, would seriously harm the stability of the financial system as a whole.

The instruments that may be used in this phase to make a bank viable again, include financial assistance (through the granting of guarantees, loans or contributions to share capital), the transfer of impaired assets to an asset management company or any other early-intervention measure.

**Resolution** will take place when a bank is unviable or will foreseeably be so in the near future, and it is necessary to avoid ordinary winding-up proceedings for reasons of public interest and financial stability.

Resolution means that the business will be sold or the assets and liabilities transferred to a “bridge bank” or asset management entity, which may receive public financial support to ensure its efficacy.

## **2 New regulation of the FROB**

The other major section of the RD-I strengthens the powers of the FROB, which, along with the Banco de España, is the public institution responsible for bank restructuring and resolution. The RD-I describes in detail the FROB's legal and financial regime, its governing bodies and structure, its functions and powers and its system of responsibility and accountability. It will have initial funding from the State budget and may raise financing from third parties up to a limit set at €120 billion for 2012. It will have a governing committee comprising representatives of the Ministry of Finance and Competitiveness, the Ministry of Financial Affairs and Public Administration and the Banco de España and will have a Director General with full executive functions.

Also, the relationship between the FROB and the Deposit Guarantee Fund is clarified. The latter's functions will be limited to guaranteeing deposits and, if appropriate, supporting orderly resolution processes up to the limit of the guaranteed amount of deposits so as to protect depositors. It therefore ceases to have powers to impose measures in relation to the reorganisation and restructuring of banks.

## **3 Allocation of restructuring costs: management of hybrid instruments**

Under the RD-I, the holders of hybrid capital instruments (preference shares and subordinated debt) may be obliged to assume part of the losses of a bank that is restructured or resolved. The purpose of this is to reduce, as much as possible, the cost of restructuring for taxpayers, as required by European rules on State aid.

The RD-I allows the FROB to impose a specific exchange exercise if it considers that the first phase of loss absorption by creditors (voluntary action proposed by the bank itself) has been insufficient.

These operations may consist of: exchange offers for the bank's capital instruments; repurchases through direct cash payment or conditional upon the subscription of capital instruments or any other banking product; reduction of the nominal value of the debt; and early repayment at a value other than nominal value. These actions shall take into account market value, applying a discount to the nominal value in accordance with European law.

#### **4 Asset Management Company**

The Asset Management Company (AMC) will allow certain troubled assets to be removed from the balance sheets of banks that receive public support, so as to facilitate the restructuring of these banks and their return to viability.

The FROB may oblige companies receiving public support to transfer to the AMC any impaired assets judged appropriate. The AMC will manage them until their subsequent divestiture and, consequently, will have a temporary mandate that will terminate when all the assets acquired have been divested.

The RD-I provides the necessary legal authority to ensure the AMC is operational by December this year.

#### **5 New mechanism to protect retail investors**

New mechanisms are established to protect investors and improve transparency in the sale to retail customers of financial instruments (especially preference shares) not covered by the Deposit Guarantee Fund. The purpose is to prevent a repeat of the irregular practices of recent years, which have led to products of this type being offered to people for whom they are not suitable.

The marketing of preference shares and other equally complex products to the public is discouraged through the introduction of a tranche for professional investors of at least 50% of the issue and a minimum investment of €100,000 for unlisted shares and of €25,000 for listed shares.

The National Securities Market Commission's powers of control over the sale of investment products are strengthened, especially when they are complex. In particular, retail customers are required to hand-write a statement that they have been warned that the product is unsuitable for them, should this have been the result of the suitability test.

Regarding the placement of bank promissory notes with retail investors, the CNMV is empowered to warn customers about the differences between instruments of this type (which may be confused with traditional deposits) and deposits. Also, to encourage banks to resume the taking of deposits instead of issuing bank promissory notes, the extra contribution to the Deposit Guarantee Fund by high-yield deposits has been eliminated.

#### **6 Other matters**

Another feature of this RD-I is the change in the requirements for *capital principal* applicable to banks and consolidable groups under RD-I 2/2011 of 18 February 2011 on the strengthening of the financial system. Specifically, the current requirements of 8% and 10% (8% as the standard level and 10% for banks which have limited access to the markets and for banks whose funding is mainly wholesale) will be replaced by a single

requirement of 9% which has to be met by all banks from 1 January 2013. Not only is the requirement for *capital principal* changed, but also its definition is adapted to the definition of capital used by the European Banking Authority in its recent recapitalisation exercise<sup>2</sup>. This change does not in practice significantly alter the requirements already in place for banks.

The RD-I also clearly separates the functions of the Banco de España from those of the Ministry of Economic Affairs and Competitiveness in the area of bank authorisation and sanctioning. The Banco de España is entrusted with the functions in this area which were previously the responsibility of the Ministry of Economic Affairs and Competitiveness. The Banco de España will have the power to authorise banks and impose penalties for very serious infringements.

Finally, a new lower ceiling is set for the total fixed compensation of executive chairmen, managing directors and managers of banks which, although not majority owned by the FROB, receive financial assistance. This upper limit is lowered from €600,000 to €500,000.

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<sup>2</sup> As mentioned, Royal Decree-Law 2/2011 of 18 February 2011 introduced the concept of *capital principal*, in relation to which Spanish banks and consolidable banking groups are subject to certain requirements. As stated, Royal Decree-Law 24/2012 made a modification to this definition, which will enter into force on 1 January 2013. Under this new definition, *capital principal* will be the same as the concept of *core capital* used in the EBA's recapitalisation exercise. The differences between the old and the new definition are as follows:

.- the EBA's definition of *core capital* does not include issues of mandatory convertible bonds with certain features, which are, however, included in the old definition. In addition, the EBA's definition of *core capital* makes certain partial deductions which were not made under the old definition of *capital principal*.