

The Spanish government's plan to strengthen the solvency and credibility of the financial sector

On 20 February 2011 Royal Decree-law 2/2011, of 18 February, on the strengthening of the financial system ("**RDL 2/2011**") came into force. RDL 2/2011 has dual objectives: on the one hand it seeks to strengthen the solvency of all credit institutions by establishing a high threshold in relation to top quality capital and, on the other, to accelerate the final stage of the restructuring processes of such institutions. These objectives will guarantee the financial sector's function of channelling credit into the economy and, in the case of savings banks, will ensure their charitable work is maintained.

Strengthening solvency

RDL 2/2011 establishes a demanding, forward-looking application of the new international capital standards (Basel III). In accordance with the RDL 2/2011, the consolidable groups of credit institutions and those credit institutions not belonging to a consolidable group of credit institutions will have to meet the following core capital requirements, in relation to risk-weighted assets corresponding to 31 December 2010, before 10 March 2011:

- the minimum core capital level is 8%;
- the above percentage will be 10% for those institutions that meet the following two requirements: (a) they have a wholesale funding coefficient higher than 20% according to the definition established by the Bank of Spain, and (b) they have not distributed instruments representing their share capital or voting rights representing a percentage equal to or greater than 20% of the same among third parties; and
- the Bank of Spain may stipulate a core capital level higher than that indicated if the institution in question, in the worst-case scenario of a stress test of the system as a whole, fails to reach the minimum level of capital required under such a test and up to such level.

In order to verify compliance with the capital requirements after 10 March 2011 to be applied during 2011, the figure of risk-weighted assets used will not be less than that of 31 December 2010. However, this latter figure may be adjusted to reflect the effect of operations of an extraordinary nature that consist of true sales of branch networks, of strategic stakes or of a portfolio of tangible assets or credits, as well as by the effect that changes in the calculation methodology may have in relation to the capital requirements that have the mandatory Bank of Spain authorisation.

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As of 31 December 2011, and thereafter, the figures for risk-weighted assets will be those that correspond at any given time pursuant to the rules on capital requirements applicable to credit institutions.

Elements comprising core capital

The core capital of a credit institution will be taken as the result of adding the following capital elements:

- The share capital of public limited companies, excluding, as the case may be, redeemable and non-voting shares; founding funds (*fondos fundacionales*) and the participation quotas of savings banks and the association participation quotas issued by the Spanish Confederation of Savings Banks; contributions to the share capital of credit cooperatives (excluding the qualifying shares or securities held by the institution or any consolidable institution).
- Issue premiums.
- Effective and express reserves, as well as the elements classed as reserves and the qualifying positive results of the financial year.
- Positive adjustments due to the valuation of financial assets available for sale that form part of the net assets, net of tax effects.
- Representative stakes of minority interests which correspond to ordinary shares of the companies of the consolidable group.
- Qualifying instruments subscribed by the FROB.
- Debt instruments issued prior to the entry into force of RDL 2/2011 which are mandatorily convertible into ordinary shares prior to 31 December 2014.
- Debt instruments issued after the entry into force of RDL 2/2011, which are mandatorily convertible into ordinary shares, provided they fulfil the following conditions:
 - a) the mandatory conversion must be by 31 December 2014 at the latest, or earlier in the event of the restructuring of the institution or its group;
 - b) the conversion ratio must be determined at the time the debt instruments are issued;
 - c) the issuer must be able, at its discretion, to decide not to pay the accrued coupon if its situation of solvency or that of the group so requires;
 - d) they must not have any characteristics that prevent their registration as a capital instrument within the net assets of the institution; and,
 - e) they must be marketed in accordance with the criteria established by the Spanish Securities Market Commission to ensure due protection of investors and, specifically, the effectiveness of the conversion ratio proposed to investors. In addition, in the event that part of the issue is marketed to retail investors, both the debt instrument and the capital instrument will have to be admitted to trading on an official secondary market.

Debt instruments that are mandatorily convertible into ordinary shares may not represent more than 25% of the core capital.

The following will be subtracted from the above total:

- Negative results from previous financial years, which are included in the accounts as the debtor balance of the accumulated reserves (losses) account, and the losses of the current financial year, including the amount of the results of the financial year (losses) attributed to the minority, as well as the debtor balances of the net asset accounts equivalent to negative results. To that end, the negative results due to the valuation of financial assets available for sale will be considered net of tax effects.

- Intangible assets, including goodwill resulting from business combinations, consolidation or the application of the participation method. The value of such assets will be calculated pursuant to the provisions of the Bank of Spain.

Strategy for meeting capital requirements

In view of the possibility that some institutions may have difficulty meeting the new capital requirements, RDL 2/2011 contemplates a progressive compliance strategy:

- Those institutions or consolidable groups of credit institutions that on 10 March 2011 do not have the necessary core capital figure will have 15 working days, as of that date, to present a strategy and calendar for meeting the new requirements to the Bank of Spain. That strategy must set out the specific measures that the institutions plan to adopt in order to meet the capital requirements before 30 September 2011. These measures will have to be approved by the Bank of Spain within 15 working days and the latter may demand modifications or additional measures.
- Such measures may include: (a) adjustment operations in the structure of assets (true sales of branch networks, of strategic stakes or of a portfolio of tangible assets or credits); (b) capturing third-party resources, and (c) applying for financial support from the Fund for Orderly Bank Restructuring (FROB). In the event that the plan for compliance contains any of the operations mentioned in sections (a) and (b) above, it will also include alternative measures in case the former are not finally carried out, which may include applying to the FROB for financial support.

In the event of the sale of instruments that are marketed in part to retail investors, such instruments will have to be admitted to trading on an official secondary market.

- The entities will implement the measures envisaged prior to 30 September 2011. However, if for procedural reasons, an institution believes it will not be able to implement them by this deadline, it will notify the Bank of Spain at least 20 days in advance, justifying the reasons for the delay. The Bank of Spain may grant a deferral of the deadline for implementing these measures (up to a maximum of three months) if it considers it reasonably foreseeable that they will be implemented.
- In the case of processes for the listing of shares, the Bank of Spain may exceptionally extend the term until the first quarter of 2012, provided that there is at least a resolution of the issuer entity that serves as a basis for the application for listing, a detailed implementation calendar and provided that one or more lead managers have been granted the corresponding mandate.

Once the transitional period has concluded and when entities have reached the new core capital thresholds, a temporary breach of up to 20% of the minimum core capital ratio required will result in the imposition of restrictions by the Bank of Spain that could affect the distribution of dividends, provisions for charitable work, the variable remuneration of administrators and managers, the remuneration of preferred securities (*participaciones preferentes*) and the repurchase of shares.

Reform of the FROB

The FROB may adopt financial support measures, such as the acquisition of ordinary shares or share capital contributions from the institutions that need to increase their capital and request assistance, subject to the following requirements:

- The applicant will have to prepare a recapitalisation plan to be approved by the Bank of Spain, which will have to communicate it to the Ministry of Economy and Finance via the Directorate General for the Treasury and Financial Policy. This plan will include a business plan that sets objectives in relation to the efficiency, profitability, levels of leverage and liquidity, and the following undertakings:
 - (a) to reduce structure costs in relation to the total amount;
 - (b) to adopt measures aimed at improving corporate governance. In general they will be adapted to the provisions of the standards of good corporate governance of listed companies and, in particular, the following:

- the number of members of the management body will be no less than five and no more than fifteen, of which at least a third will be independent directors. The external, *dominical* (i.e. representing shareholders) and independent directors will make up the majority of the management body, with the number of executive directors being the minimum necessary;
 - the management body will explain the status of each director to the General Meeting or Assembly that must appoint the director(s); moreover, it will review the Annual Corporate Governance Report each year, after verification by the Appointments Commission that must be established at the institution;
 - independent directors will not remain as such for a period of longer than 12 years;
 - the institutions will provide and update information in relation to their directors on their website; and
 - the management body will set up a Commission, or two separate Commissions, to monitor Appointments and Remuneration; and
- c) to increase funding to small and medium-sized institutions in terms that are compatible with the objectives established in the business plan.

The FROB may demand additional undertakings from applicants.

- The FROB will supply the Minister of Economy and Finance with an economic report containing details of the financial impact of that acquisition on the funds supplied from the General State Budget. The Minister of Economy and Finance may raise an objection, duly reasoned, within 5 working days from when they are provided with this report.
- The contributions committed by the FROB may be made in cash, by delivering public debt securities or securities issued by the FROB or by means of offsetting credits it holds against the applicant institutions.
- The price of acquisition or subscription will be set in accordance with the economic value of the credit institution, which will be determined by one or more independent experts to be appointed by the FROB, by means of a procedure that the FROB will set out in line with generally accepted methodologies (and that will take into account extraordinary restructuring operations performed by the institutions, as the case may be). The setting of the subscription price will be performed after a report has been issued by the Office of the Comptroller and Auditor General.

If, during the five years prior to the subscription, a significant percentage of capital has been placed among third-party investors and that percentage was higher than that acquired by the FROB, to ensure that the price paid is the market value, the subscription price will be the same as the pricing of such placement. If, in the case of a significant percentage of capital, such percentage is lower than that acquired by the FROB, the price of that placement will serve as a reference for the subscription price. In any event, the acquisition or subscription will be performed in accordance with Spanish and EU legislation on competition and state aid.

- The subscription of shares and contributions to share capital by the FROB will lead to it joining the management body of the issuer, without the need for any other act or resolution, to ensure fulfilment of the recapitalisation plan.
- The divestment by the FROB will be performed by means of the transfer of the instruments subscribed via procedures that ensure competition and within a maximum term of five years as of the subscription date.

In addition, the FROB may, when subscribing or acquiring instruments, establish the terms in which, within a maximum of one year as of the subscription or acquisition date, it would resell such instruments to the issuer entities or to third-party investors proposed by the beneficiary institution. This

maximum term may be extended up to two years from the date of subscription or acquisition, in which case, the FROB may require that the applicant institutions give additional undertakings, on top of those envisaged in their recapitalisation plan.

- On a quarterly basis, the applicant institution will send the FROB a report on the degree of implementation of the measures contemplated in the approved recapitalisation plan. Depending on the content of this report, the FROB may require the adoption of any actions necessary to ensure that the recapitalisation plan is effectively completed.

The FROB may also acquire instruments consisting of preferred securities convertible into contributions to the share capital of credit cooperatives, issued by those entities that need to increase their capital exclusively for the purpose of carrying out integration processes amongst themselves and if they so request, subject to certain conditions.

Transfer of financial activity in certain cases

- Savings banks may request the support of the FROB in order to increase their capital; in order to do so, they will have to transfer their financial activity to a bank within a maximum of three months from the date on which they are notified of the approval of the recapitalisation plan.

Moreover, they will amend their by-laws in order to establish that the board of directors, as the body responsible for the financial administration and management of the institution, will be authorised to approve any resolutions of the savings bank in relation to its participation in the bank through which it performs its activity as a credit institution.

- If the institution applying for FROB support is a bank in which savings banks hold a joint stake, they will transfer their entire financial activity to the bank within a maximum term of three months from when they are notified of the approval of the recapitalisation plan.

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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