

FROB IN THE RESTRUCTURING OF THE SPANISH BANKING SYSTEM. WHERE IT STANDS AFTER A DECADE OF ACTIVITY (2009-2019) AND CONSIDERATIONS FOR THE BANKING UNION

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“Commenting on the behavior of the Bank of England in the crisis of 1825, Thomas Joplin said, ‘There are times when rules and precedents cannot be broken; others, when they cannot be adhered to with safety’. Of course. But breaking the rule establishes a precedent and a new rule, which should be adhered to or broken as occasion demands. In these circumstances, intervention is an art, not a science. General rules that the state should always intervene or that it should never intervene are both wrong.”

*Manias, Panics and Crashes. A history of financial crises, Charles P. Kindleberger*

### Abstract

This article provides a chronological account of FROB’s first ten years of activity, describing the backdrop against which this organization has evolved and the actions it has taken to restructure the Spanish banking system.

It reviews FROB’s development during its decade of existence, the changes in its mandate, its functions and the tools at its disposal, and concludes with some basic reflections on the bank resolution environment in light of FROB’s experience and how the Banking Union and the current resolution framework could be further strengthened.

### 1 Introduction

Ten years ago, on 27 June 2009, the Spanish Official State Gazette published a royal decree-law setting up the Fondo de Reestructuración Ordenada Bancaria (Fund for the Orderly Restructuring of the Banking Sector, “FROB” by its Spanish abbreviation). That legislation conferred on FROB functions, tools and financing mechanisms which were innovative but fell far short of the powers and competences held today by FROB as the Spanish executive resolution authority within the European Single Resolution Mechanism (SRM). Since its creation, FROB has played a fundamental role, focused on driving the process of banking sector restructuring in Spain and channelling the substantial public funds provided to support it.

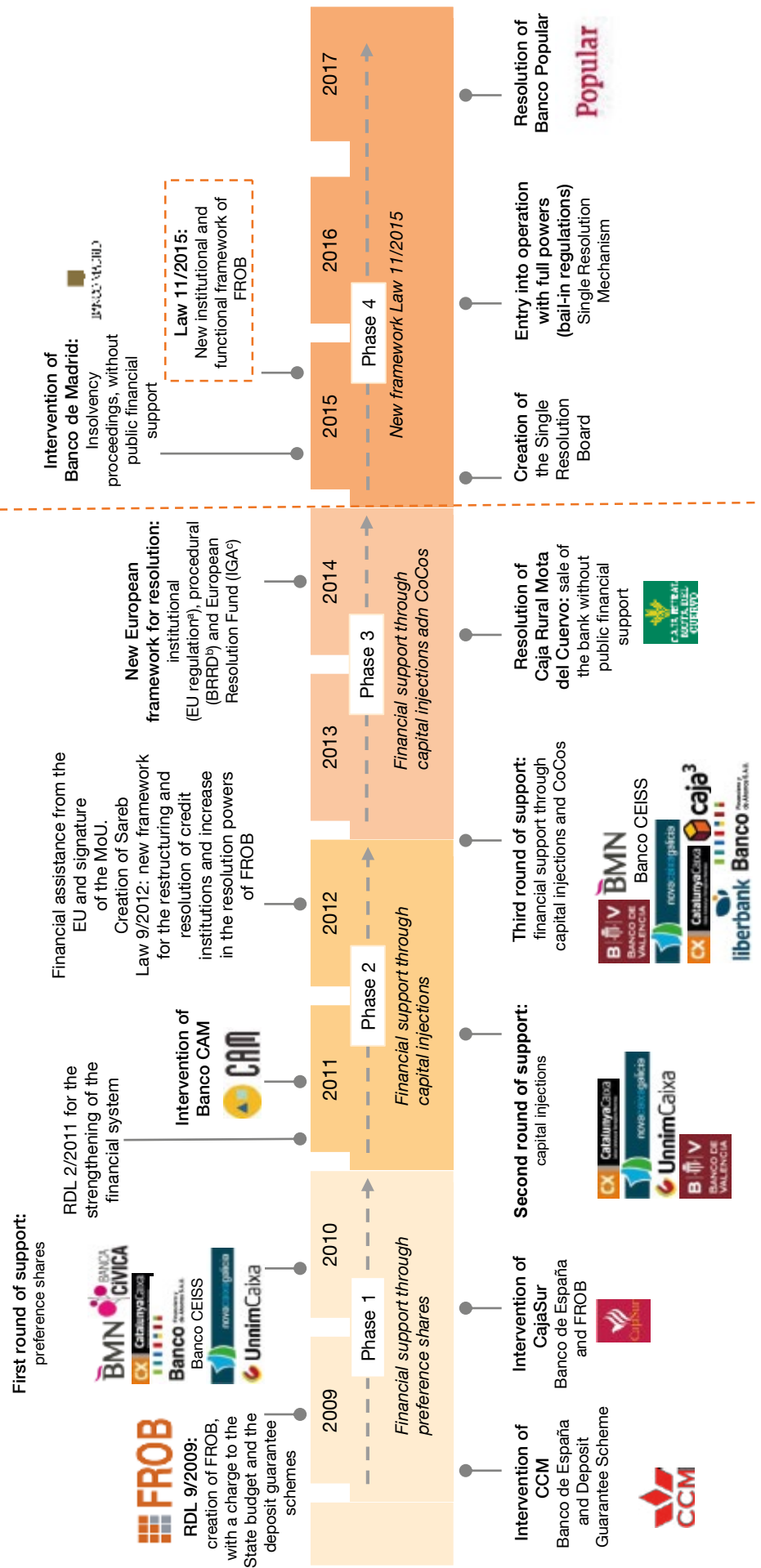
The role of FROB has evolved in parallel with the successive phases of the crisis and the consequent adaptations of its legal framework. There have been many developments since the pre-crisis regulatory framework, which was based on action by the Banco de España and the sectoral deposit guarantee schemes and has now given way to the new scenario of Banking Union under which the SRM has been acting since 2015.

FROB itself has also evolved rapidly as a public authority. What initially began as a “fund” in the strict sense, fed by the deposit guarantee schemes and public money provided to support certain mergers of the former savings banks, has now become an executive resolution authority, financed solely by private contributions from banks and forming part of a European network of authorities led from Brussels by the Single Resolution Board (SRB).

This evolution has had two effects. The first is that the developments of the initial ten years of FROB (see Figure 1) tell perfectly the story of the banking crisis, reflected both in its regulatory and theoretical debates and in the various practical applications designed to address bank resolution. The second is that FROB has taken its place today as an

RESTRUCTURING OF THE SPANISH BANKING SECTOR

FIGURE 1



SOURCE: Devised by the author.

<sup>a</sup> Regulation (EU) No. 806/2014 of the European Parliament and of the Council of 15 July 2014.

<sup>b</sup> Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014.

<sup>c</sup> Inter-governmental agreement on the Single Resolution Fund.

experienced national and international authority, which puts it in an excellent position to examine resolution rules critically and reflect on the tasks pending to strengthen the banking sector's resilience to future crises. These two topics, along with the historical milestones of FROB and the main lessons learned and debates pending, are discussed in this article.

## 2 FROB during the financial crisis

### 2.1 ORIGIN OF THE CRISIS AND INITIAL MEASURES

This is not the place to analyse the economic situation at the outbreak of the crisis, although, to give an idea of the setting in which FROB was created, I will cite some basic economic data which help define the importance of the financial crisis and the impact it had on Spain.

In the year FROB was created, 2009, the advanced economies were decelerating at a rate not seen since the Second World War (-3.4% of GDP). Spain's GDP contracted by 3.6% and this adjustment was worsened by the seriousness of the job destruction. In that same period, 7% of jobs were lost and unemployment reached 19%. At worldwide level, a battery of measures on a huge scale, aimed at monetary flexibility, fiscal expansion and financial sector support, had already been set in train.

Focusing our attention on the banking sector, the balance sheets of Spanish banks, whose business model focuses on retail banking, did not initially seem to be contaminated by what were then known as toxic assets, created by the structuring and sale of complex products. However, their balance sheets contained a high proportion of loans to the real estate sector, which had in turn leveraged itself in a vertiginous expansion of bank credit and was in those years approaching the burst phase typical of any speculative bubble. The non-performing loans of Spanish banks did not stop rising until December 2013, when they represented 13.60% of total credit.

Furthermore, Spanish banks were not immune to the problems of confidence besetting the world financial sector in general and the European system in particular. These problems crystallised in a drastic reduction in access to interbank credit and capital markets, on which Spanish banks had become strongly dependent in the years of frenetic expansion of real estate development credit. This meant the whole sector, including the part least affected by loan impairment, was faced with a serious liquidity problem, with a subsequent impact on the volume and conditions of credit to households and firms, which were already highly indebted (the bank debt of households and firms as a proportion of GDP remained above 200% until 2012 in non-consolidated terms<sup>1</sup>). As a result of the vicious circle usual in any financial crisis, the high cost of funding further aggravated the financial situation of the country and reduced the quality of banks' assets. To this must be added the difficulties for half of the Spanish banking industry which were posed by the legal nature and corporate governance of savings banks.

The situation led the Spanish government to adopt initially measures focused on alleviating the liquidity problems, in line with those taken in other European Union countries. A fund was made available to banks for the purchase of financial assets<sup>2</sup> and their securities issues were deemed eligible to be backed by the guarantee of the State of Spain.<sup>3</sup>

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<sup>1</sup> Total debt, including debt to the same sector.

<sup>2</sup> Royal Decree-Law 6/2008 of 10 October 2008 creating the Fund for the Acquisition of Financial Assets.

<sup>3</sup> Royal Decree-Law 7/2008 of 13 October 2008 on urgent economic and financial measures relating to the concerted plan of action of the euro area countries.

And in those circumstances, with the prospect that on this occasion the liquidity measures, instruments and authorities used in other crises and the private funds available might not be sufficient to protect financial stability, FROB was set up. As the crisis became more drawn out and its intensity continued unabated with no respite in the level of non-performing real estate assets, the focus of attention turned to the solvency of some banks whose viability seemed shaky in the short and medium term and might (as indeed it did) jeopardise the whole of the Spanish economy.

## 2.2 CREATION OF FROB. FROB I AND FROB II

In March 2009, barely three months before the creation of FROB, the Banco de España ordered the intervention of Caja Castilla-La Mancha for failure to meet its capital requirements. This bank, with a balance sheet of €26,000 million, represented less than 1% of the system and its intervention made use of what may be considered strictly pre-FROB instruments. The Banco de España replaced its directors and the Deposit Guarantee Scheme provided liquidity of €7,000 million, sold the bank and granted an asset protection scheme.

This intervention framework was able to deal with an idiosyncratic crisis like that described above. However, it was insufficient to handle a crisis of the system as a whole such as that already seen in the United States and the United Kingdom and which was gathering force in the Spanish banking sector. A restructuring of the financial sector, led and financed by the public sector, then became unavoidable to prevent the potentially systemic effects of the failure of one or more banks at the same time.

The intervention of Caja Castilla-La Mancha was in March that year (2009). FROB was created in June<sup>4</sup> and in May 2010 it provided the legal framework for the next intervention, namely that of CajaSur. FROB, then under the leadership of the Banco de España, came into being with powers to act either in support of voluntary processes of integration or to facilitate the restructuring of failed institutions when a solution could not be found within the traditional scope of action of the Deposit Guarantee Scheme. And, more importantly, to carry out this task FROB's intervention could be accompanied by financial support in the form of guarantees, loans, subordinated financing or purchase of convertible preference shares.

At the end of March 2010, FROB initiated the provision of financial support. It granted €9,674 million of convertible preference shares in seven separate integration processes (see Table 1), to facilitate the bank concentration measures approved by the Banco de España in the form of mergers or institutional protection schemes, against a backdrop in which access to the capital markets was complicated. It also participated in a restructuring process, namely that of the aforementioned Caja de Ahorros y Monte de Piedad de Córdoba (CajaSur). After its Board of Directors rejected a merger with Unicaja, the Banco de España decided to restructure it and provisionally replace its Board of Directors, designating FROB as its provisional administrator. FROB's support consisted of the purchase of equity units for €800 million and in providing a line of credit for a maximum amount of €1,500 million.

Despite the large amount of public funds committed in these initial interventions, shortly afterwards it became apparent that the sector's underlying problems persisted. Either because the support instruments used, i.e. convertible preference shares, were not as

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<sup>4</sup> On 27 June Royal Decree-Law 9/2009 of 26 June 2009 on bank restructuring and the strengthening of own funds of credit institutions came into force.

## FROB I. SUMMARY OF INTEGRATION AND RESTRUCTURING PROCESSES

TABLE 1

Bank	Structure	Date approved by FROB	Type of aid	Status	Amount of aid (€m)	Date disbursed
<b>Integration Processes</b>						
UNIÓ DE CAIXES (UNNIM) Caixes d'Estalvis Comarcal de Manlleu, Sabadell and Terrassa	Merger	25.03.2010	Preference shares	Suscribed and paid in	380	28.07.2010
CATALUNYA CAIXA (CX) Caixes d'Estalvis de Catalunya, Tarragona and Manresa	Merger	25.03.2010	Preference shares	Suscribed and paid in	1,250	28.07.2010
CAJA ESPAÑA DE INVERSIONES, SALAMANCA Y SORIA (CEISS) Cajas de Ahorros Caja España and Caja Duero	Merger	25.03.2010	Preference shares	Suscribed and paid in	525	29.10.2010
NOVACAIXAGALICIA Caixa Galicia and CaixaNova	Merger	29.06.2010	Preference shares	Suscribed and paid in	1,162	30.12.2010
BANCO FINANCIERO Y DE AHORROS Cajas de Ahorros de Madrid, Bancaja, Caja Ávila, Caja Segovia, Caja Insular de Canarias, Caixa Laietana and Caja Rioja	IPS	29.06.2010	Preference shares	Suscribed and paid in	4,465	28.12.2010
BANCO MARE NOSTRUM Cajas de Ahorros de Murcia, Caja Granada, Caixa Penedès and SaNostra	IPS	29.06.2010	Preference shares	Suscribed and paid in	915	31.12.2010
BANCA BASE Cajas de Ahorros del Mediterráneo (CAM), CajaAstur, Caja Cantabria and Extremadura	IPS	29.06.2010	Preference shares	Subscribed but NOT paid	—	Suspended
BANCA CÍVICA Cajas de Ahorros de Navarra, CajaSol (including Guadalajara), General de Canarias and Municipal de Burgos	IPS	22.12.2010	Preference shares	Suscribed and paid in	977	11.02.2011
<b>Total integration processes</b>					<b>9,674</b>	
Restructuring processes CAJASUR	Assignment of business	15.07.2010	Equity units	Subscribed and paid in	800	17.06.2010
<b>Total restructuring processes</b>					<b>800</b>	

SOURCE: Devised by the author.

effective as hoped (they are not top-quality capital and entail a high cost for weak banks), or because the actual losses continued to be incompletely written off, or because the worsening of the economic situation was more than many banks could cope with or, what was more likely, because of a hard-to-determine combination of all these factors, the doubts over the solvency of the Spanish financial sector, far from fading, grew. As a result, some months after the so-called FROB I support, Spanish legislators increased the capital requirements for Spanish banks<sup>5</sup> in terms of both quantity and quality of own funds.

Royal Decree-Law 2/2011 not only raised capital requirements but also provided incentives for groups with a high dependence on wholesale funding to access the capital markets. And, to tone down this regulatory requirement and facilitate compliance by already-fragile banks, FROB's mandate was changed to allow it to recapitalise banks by means of ordinary shares whenever so requested. These new requirements led to four banks receiving fresh support in 2011, known as FROB II (see Table 2), through the subscription of shares for some €5,700 million.

<sup>5</sup> Royal Decree-Law 2/2011 of 18 February 2011 for the strengthening of the financial system.

Bank	Effective amount of aid (€m)	Date of agreement
CATALUNYA CAIXA (CX) Caixes d'Estalvis de Catalunya, Tarragona and Manresa	1,718	29.09.2011
NOVACAIXAGALICIA Caixa Galicia and CaixaNova	2,465	29.09.2011
UNIÓ DE CAIXES (UNIM) (a) Caixes d'Estalvis Comarcal de Manlleu, Sabadell and Terrassa	—	29.09.2011
BANCO DE VALENCIA	998	21.06.2012
<b>Total recapitalisation processes</b>	<b>5,181</b>	

SOURCE: Devised by the author.

a Although the FROB subscribed €568 million in September 2011, the final cost of this aid was borne by the Deposit Guarantee Fund.

### 2.3 FINANCIAL ASSISTANCE PROGRAMME. FROB III

Macroeconomic activity again contracted in 2012. There was a certain slowdown at global level, but in the euro area the fall was sharper in 2012 than in 2013, and was particularly violent in those countries whose financial instability prompted a lack of confidence in their fiscal capacity to sustain sovereign debt (particularly Greece, but also Spain and Italy). The dangerous sequence of events which follows bouts of financial mistrust reappeared with greater virulence than in the previous years. To the uncertainty in the private financial markets was added that of government indebtedness, while the doubts over the quality of bank balance sheets persisted. Hence the whole of the Spanish economy found itself enshrouded in a climate of mistrust, not only of bank solvency, but also of the country itself. This climate also worsened the financing conditions of all economic activity and left the government almost completely without any room for manoeuvre to mobilise resources to stabilise the banking sector.

Against this background, the Spanish government formally requested European financial assistance to stabilise the financial sector. In July 2012 Spain and the European Commission signed the Memorandum of Understanding on financial-sector policy conditionality (MoU), which included up to €100,000 million earmarked specifically for bank recapitalisation and entailed a series of commitments relating to the financial sector.

Once again the new phase of the crisis brought an organisational and operational refounding of FROB (see Table 4). In August 2012, scarcely a month after the signature of the MoU, Royal Decree-Law 24/2012 of 31 August 2012 on credit institution restructuring and resolution (later Law 9/2012) was approved. One of its main features was the strengthening of FROB's intervention powers to transform it into one of the main resolution authorities clearly aligned with international initiatives in this area. The Royal Decree-Law took into account, firstly, the key attributes<sup>6</sup> approved by the Financial Stability Board (FSB) in November 2011 and, secondly, the initial work of the European Commission for a future restructuring and resolution directive. It introduced into Spanish law a homogeneous, consistent and effective regulatory system for crisis management which strengthened extraordinarily FROB's mechanisms and intervention powers. FROB thus became a fully-fledged resolution authority separate from banking supervision, in line with international recommendations and standards.

<sup>6</sup> <http://www.fsb.org/2014/10/key-attributes-of-effective-resolution-regimes-for-financial-institutions-2/>.



		2009-2011	2011-2012	2012-2015	2015-PRESENT
<b>Legislation</b>		Royal Decree-Law 9/2009, of 26 June 2009 on bank restructuring and the strengthening of credit institutions' own funds.	Royal Decree-Law 9/2009, of 26 June 2009 on bank restructuring and the strengthening of credit institutions' own funds*.	Royal Decreeo-Law 24/2012 of 31 August 2012 on credit institution restructuring and resolution and, subsequently, Law 9/2012 of 14 November 2012 on credit institution restructuring and resolution.	Law 11/2015 of 18 June 2015 on the recovery and resolution of credit institutions and investment firms.
<b>Governing Committee</b>					
<b>Composition</b>	<b>Number of members</b>	8	9	9	11
	<b>Origin</b>	Five at the proposal of the Banco de España.  Three representing the respective Deposit Guarantee Schemes.	Four at the proposal of the Banco de España.  Three representing the respective Deposit Guarantee Schemes.  Two representing the Ministry of Economic Affairs and Finance.	Four appointed by the Banco de España.  Secretary of the Treasury and Financial Policy.  Under-Secretary of Economic Affairs and Competitiveness.  Chair of the Spanish Accounting and Audit Institute.  Director General for Economic Policy.  Director General for Budget.	Chair of the FROB.  Four appointed by the Banco de España.  Three representatives of the Ministry of Economic Affairs and Competitiveness.  Deputy Chair of the Spanish National Securities Market Commission.  Two representatives of the Ministry of Finance and Public Administration.
<b>Chair</b>		Deputy Governor of the Banco de España.	Deputy Governor of the Banco de España.	Deputy Governor of the Banco de España.	Chair of the FROB.
<b>Vice-Chair</b>		No express rule. In practice the vice-chair was selected from the members appointed at the proposal of the Banco de España.		Secretary of the Treasury and Financial Policy.	Deputy Governor of the Banco de España.
<b>Attending (with right to speak but not vote)</b>		A representative of the National Audit Office designated by the Minister for Economic Affairs and Finance at the proposal of the Auditor General.		A representative designated by the Auditor General.  A representative designated by the Attorney General-Director of the Spanish State Legal Service.	
<b>Ordinary management</b>					
		Not addressed. However the Governing Committee appointed a Director General.		Director General, appointed by royal decree of the Council of ministers, at the proposal of the Minister for Economic Affairs and Competitiveness.	Chair of the FROB, appointed by royal decree of the Council of Ministers, at the proposal of the Minister for Economic Affairs and Competitiveness, upon consultation with the supervisory authorities, and after appearing before Parliament.  Non-extendable mandate of five years. Specified reasons for termination.

SOURCE: Devised by the author.

From that time on, the intervention in the financial sector was unprecedented in terms of the volume of public funds mobilised and the institutions affected. A detailed examination of those interventions is beyond the scope of this article, although, in order to assess properly their full significance, their main features are listed below:

- The total aid disbursed amounted to €41,270 million.
- Between December 2012 and March 2013, FROB channelled €39,078 million for the recapitalisation of eight credit institutions under restructuring or resolution.
- The other €2,192 million were used to purchase FROB's stake in the capital of Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria (Asset Management Company for Assets Arising from Bank Restructuring, "Sareb" by its Spanish abbreviation) and to purchase a portion of its subordinated debt:
  - Around 200,000 troubled real estate assets were transferred to Sareb at a transfer price of €50,700 million and a time horizon of 15 years for their liquidation.
  - The use of this tool allowed the financial sector recapitalisation requirements to be reduced by €1,300 million and bank balance sheets to be cleaned up. The consequent recovery of confidence in financial institutions allowed their managers to focus once again their attention and efforts on ordinary business.
  - Notably, the senior debt issued by Sareb, for €50,700 million, was backed by the guarantee of the Treasury.
- Mention should also be made of the losses for a nominal amount of around €14,000 million incurred by shareholders and subordinated creditors, imposed to minimise State aid in accordance with Spanish regulations which drew on the principles set out in the MoU by the European authorities. Of these stakeholders, 70% of those that acquired preference shares were retail investors who had been sold the product in transactions which, as became clear in subsequent court rulings, were significantly lacking in transparency.
- Lastly, in accordance with European legislation on State aid,<sup>7</sup> banks were obliged to apply adjustment plans which, among other things, reduced staff and branches by a quarter and a third, respectively.

Clearly, this was not a minor government intervention in economic activity and, unfortunately, the restructuring had to be made using large amounts of public funds against a background of fiscal weakness. But otherwise the consequences would have been more serious. Importantly, the total assets of the banks that received government

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7 These are compensatory measures taken to limit the impact on competition caused by State aid. They aim to stimulate the internal market by favouring the entry of competitors. [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, (2009/C 195/04)]. The FROB monitored achievement of the commitments given by all banks in their so-called recovery and resolution plans. In April 2018 all the banks concluded their restructuring periods. All the commitments given by them were achieved and their objectives were met. Also, the FROB made a significant effort to execute the divestment of most of its investees except the BFA-Bankia group.

support at that time accounted for a highly significant percentage (18%) of total assets. Thus, in 2012 the total deposits at Spanish banks were around €1.3 trillion, of which some 700,000 million were covered by the Deposit Guarantee Scheme, of which it is in turn estimated that about €250,000 million were at the banks that received aid.

This is a clear example of a government bail-out helping to protect financial stability, motivated by the protection of the general interest. Subjecting the distressed banks to ordinary insolvency proceedings would have had a major impact in terms of depositors' losses, contagion to healthy banks, loss of confidence and instability in the financial markets, widespread deterioration in lending to firms and households and a general worsening of employment and economic growth.

#### 2.4 OTHER INTERVENTIONS

After the interventions made under the financial assistance programme and Law 9/2012, but before the new European banking union framework got fully under way, FROB again had occasion to use some of the powers conferred on it by that law, when it resolved a credit cooperative through the sale of the business in 2014 and decided on the resolution of a bank intervened by the Banco de España in 2015.

In January 2014, FROB resolved a small rural credit cooperative, Caja Rural Mota del Cuervo, Sociedad Cooperativa de Crédito de Castilla-La Mancha, which represented less than 0.01% of the assets of the Spanish banking system.<sup>8</sup> It had become apparent that it would soon be unable to meet its obligations and would foreseeably be incapable of remedying the situation on its own (its general assembly had rejected a plan to be merged into another bank), so the Banco de España resolved to initiate a resolution process. After FROB had been appointed as its provisional administrator, the institution was sold to another cooperative bank (Globalcaja) in an emergency procedure executed on a weekend. The failure to take this measure would have been detrimental in terms of confidence in and stability of the sector, despite the bank's small size. Notably, its resolution did not entail the provision of public funds of any type.

The second case was the intervention of Banco Madrid, an institution with a balance sheet of €1,300 million. In March 2015, the *Financial Crimes Enforcement Network* (FinCEN) of the US Treasury Department announced its decision to consider the Andorran institution BPA as a foreign financial institution of primary money laundering concern. Additionally, it issued a proposed resolution in this respect which consisted, among other measures, in prohibiting US financial institutions from opening or holding accounts in the name of BPA or any other entity in its group, including Banco de Madrid, SA (Banco Madrid). In view of this circumstance, and following the intervention and replacement of directors by the Banco de España, the bank requested the competent court to authorise voluntary insolvency proceedings. The court informed FROB of the suspension of the proceedings so that the FROB could inform the court of whether it was going to initiate a recovery or a resolution process. After analysing whether the circumstances were considered to be those requiring resolution, FROB considered that the initiation of such a process was inappropriate and informed the judge of this. Immediately afterwards, the guarantee of deposits covered by the Deposit Guarantee Scheme was activated for the first and only time during the recent crisis. Most of the payments of the amount guaranteed were made without significant incidents and took place during the maximum legal period of 20 working

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<sup>8</sup> The bank had a single branch with a staff of 11 employees. Its total assets were €82.55 million, equal to 0.003% of the assets of the Spanish financial system. Its deposits were €74.32 million and its loans €73.34 million.

days from the date of entry into insolvency proceedings. Nearly four years later the courts had yet to hand down a ruling, underlining the scant effectiveness of these ordinary procedures for winding up credit institutions.

### 3 Amount of aid

The total amount of aid granted by FROB in diverse capital instruments amounts to €56,545 million. This figure does not include the estimated €20,182 million provided by the Deposit Guarantee Scheme, which were financed by the credit institutions themselves, nor does it take into account the €178,000 million of liquidity support to banks (through State guarantees and liquidity facilities), all matured and repaid except for the guarantees given on Sareb issuances, the outstanding balance of which is currently €36,435 million.

The breakdown of aid is shown in Table 3.

There is much debate on the matter of recovery of aid. Here a distinction must be made between the aid that has already been recovered and the factors which will determine the ability to recover the rest of the aid.

The amount of aid already effectively recovered to date is €5,911 million, of which €4,477 million come from the various bank sales and capital instrument repayments and €1,434 million are interest received by FROB on these instruments. Additionally, it should be noted that this list does not include the more than €2,800 million received by BFA from Bankia as dividends (around €740 million) or the proceeds of the sale of a package of shares of Bankia in 2014 for €1,304 million or the €818 million for the sale of shares in December 2017.

The factors determining the ability to recover aid are threefold. The first depends on how events unfold in the pending divestment of the indirect stake in Bankia, following its merger with BMN. At present FROB has a stake of 61%, which must be divested within the stipulated legal period (presently December 2021), by a procedure ensuring due competition.

The second factor will depend on the performance of Sareb, which is subject to significant risks derived from the behaviour of the real estate market, the pace of divestment and the ability to absorb its assets, all against a background of high financial costs and overheads. These variables are difficult to predict over a period as long as Sareb's remaining eight years. However, it is advisable to be cautious and FROB's accounts already estimate a scant recovery of its investment.

The third factor will depend on the final behaviour of the guarantees offered by FROB in the divestment processes, particularly if there are deviations from the expected loss currently estimated at around €2,500 million.

Unquestionably, in the recent crisis all the world authorities, almost without exception, had to take unprecedented measures, basically to provide significant liquidity to the credit market and make available the public funds needed to avoid the bankruptcy of banks and, consequently, of many firms and households. Spain was no exception and, like many of its European neighbours, has had to bail out banks. Although the high absolute amount used is beyond question, it is nevertheless useful to put this on a relative basis. Here it is instructive to look at what happened in the European countries. In the European Union, between 2008 and 2010 alone the European Commission authorised aid to 215 financial institutions for an overall amount of €4.3 trillion (36% of European GDP), of which however,

## HISTORICAL TABLE OF FROB AID

TABLE 3

Bank	APSS and guarantees	Shares, preference shares or CoCos	Recoveries (FROB) (a)
CATALUNYA BANC Catalunya, Tarragona, Manresa	526	12,052	782
CEISS Caja España-Caja Duero	430	1,129	604
NOVACAIXAGALICIA Caixa Galicia, CaixaNova	382	9,052	783
Banco Gallego (separated from NCG) (a)	95	245	—
BFA-BANKIA Madrid, Bancaja, Laietana, Insular, Rioja, Ávila, Segovia	—	22,424	—
BANCO MARE NOSTRUM Murcia, Penedès, Sa Nostra, Granada	—	1,645	—
BANCA CÍVICA Navarra, Cajasol-Guadalajara, General de Canarias, Municipal de Burgos	—	977	977
BANCO DE VALENCIA	666	5,498	—
LIBERBANK G. Cajastur, Caja Extremadura, Caja Cantabria	—	124	124
CAJA3 CAI, Caja Círculo, Caja Badajoz	—	407	407
CAJASUR	392	800	800
<b>Interest received on coupons and other</b>	—	—	<b>1,434</b>
<b>Aid provided by FROB</b>	<b>2,491</b>	<b>54,353</b>	—
<b>Sareb</b>	—	<b>2,192</b>	—
<b>Total</b>	<b>2,491</b>	<b>56,545</b>	<b>5,911</b>

SOURCE: Devised by the author.

a The aid finally recovered will depend on the performance and final divestment of the investees of the FROB (BFA/Bankia with BMN and Sareb). This column does not include €1,304 million resulting from the sale of 7.5% of Bankia in January 2014, or €818.3 million from a recent divestment of 7% of Bankia in December 2017, or €742 million of dividends distributed by Bankia out of profits for 2014, 2015, 2016 and 2017 (in April 2019 an additional €219 million were received out of 2018 profit), since in all cases the amounts received remain at BFA.

only €1.2 trillion (10.5% of GDP) were used, mostly (60%) to provide liquidity by means of guarantees.

The countries with greatest recourse to capital aid between 2008 and 2015 used between 20% and 25% of their 2015 GDP and were Greece, Ireland and Cyprus. They were followed by Portugal and Slovenia, which used nearly 9%, after which came Spain, Belgium and Luxembourg (between 5% and 6%) and Denmark, the United Kingdom, Austria and the Netherlands (between 3% and 4%).

The restructuring entailed a drastic adjustment of the financial sector, but also offered the occasion for it to undertake a far-reaching transformation. As the IMF acknowledged in its 2018 Article IV report on Spain,<sup>9</sup> the profitability of most Spanish banks has improved substantially, their efficiency in terms of cost is among the highest in Europe, they have made adequate process in meeting the new regulatory requirements and credit is again flowing. The situation has changed with respect to that a decade ago.

<sup>9</sup> <https://www.imf.org/en/News/Articles/2018/10/03/Spain-IMF-Staff-Concluding-Statement-of-the-2018-Article-IV-Mission>.

#### 4 FROB within the Banking Union. Institutional framework and European resolution of Banco Popular

In all these years of financial instability, the euro project has been subjected to its own stress test. The doubts over the ability of some States to withstand the impact of the bankruptcy of their banks, the consequent fragmentation of the financial markets and the difficulties in achieving effective monetary policy transmission did not result in the collapse of the euro, but rather prompted a project, still unfinished but essential, to create a Banking Union.

##### 4.1 INSTITUTIONAL FRAMEWORK

In Spain the adaptation to this new framework was undertaken through the approval of the still current Law 11/2015 of 18 June 2015, which, although representing a continuation of the aforementioned resolution principles and instruments, included some important new features. First, it established in Spain the preventive and planning phase of resolution entrusted to the Banco de España and the National Securities Market Commission (CNMV by its Spanish abbreviation). Second, it set up the National Resolution Fund as an instrument financed by banks themselves and serving to obviate the use of public funds. Finally, it defined Spain's participation in the Single Resolution Mechanism (SRM). It should be kept in mind that since the Single Resolution Board (SRB) was set up, it has been in charge of the effective functioning of the SRM and, in particular, directly responsible for the resolution of significant institutions in the euro area.

European resolution legislation<sup>10</sup> establishes that the ordinary path is to create resolution authorities separate from the supervisory authorities. This is the model applied in the architecture of the banking union, which separates the supervisory functions of the Single Supervisory Mechanism from the resolution functions of the Single Resolution Mechanism. In the words of the preamble to Law 11/2015, the basis for this is the "necessary separation of supervisory and resolution functions for the declared purpose of removing the conflict of interest which could be faced by the supervisory authority if it were to simultaneously have resolution powers". However, the European directive also offers Member States the possibility of adopting another organisational approach, which is to include the resolution function in the central banks or supervisors, provided that clear independence is ensured. It even allows a system in which there is more than one resolution authority, provided that only one of them is designated as the contact authority. This latter arrangement has been adopted in Spain, where the resolution functions have been divided among three authorities, as described below.

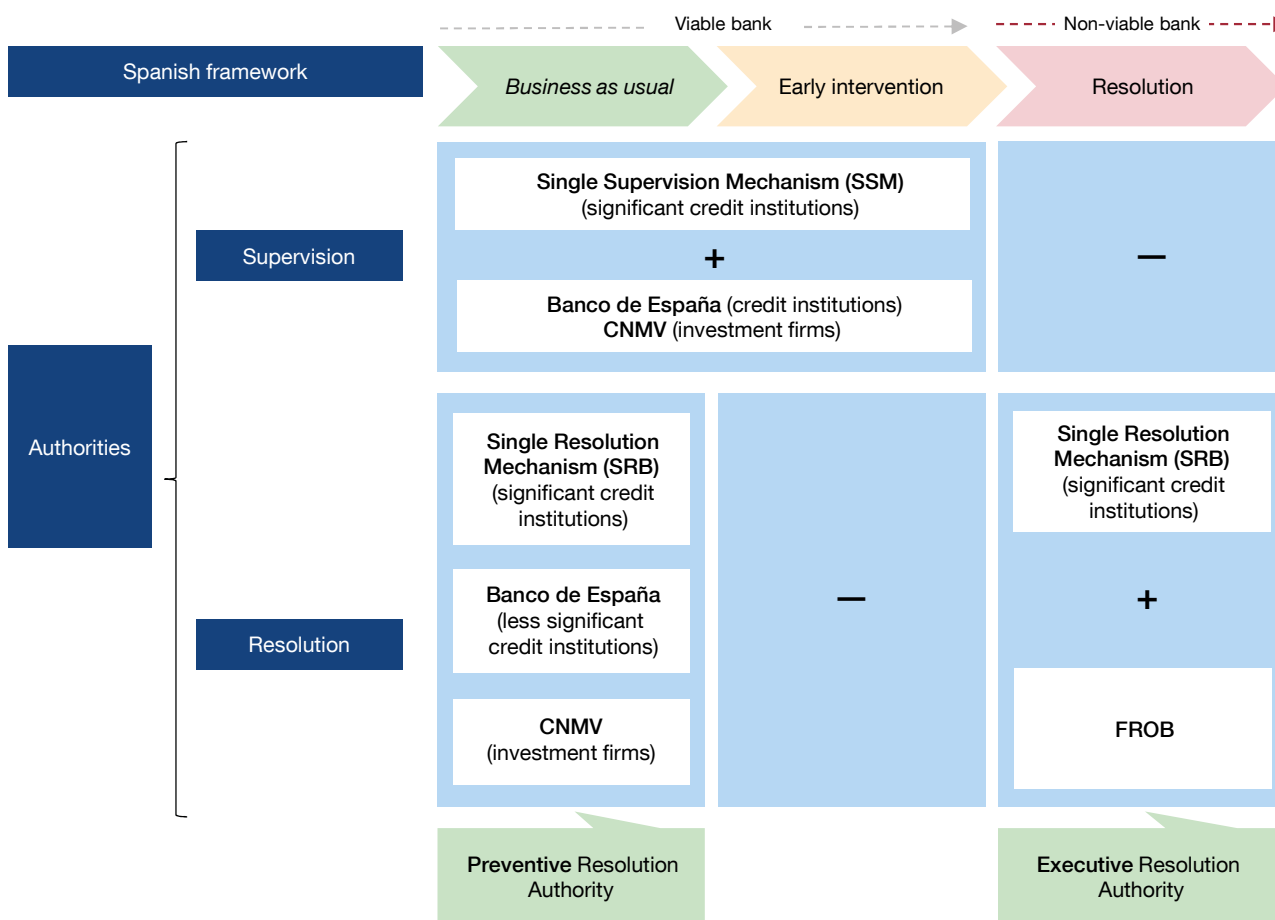
An executive resolution authority, FROB is entrusted with executing the resolution decisions adopted by the Single Resolution Board for significant institutions and with the direct exercise of these competences for other institutions. In addition, it exercises Spanish representation before the SRB and it is the contact and coordination authority at international level. FROB also collects the contributions of all Spanish institutions to the Single Resolution Fund and manages the National Resolution Fund, fed by contributions from investment firms not forming part of groups of credit institutions.

Two preventive resolution authorities, the Banco de España and the CNMV, are responsible for drafting resolution plans for less significant credit institutions and investment firms,<sup>11</sup> respectively. The Banco de España cooperates with the SRB in the drafting of resolution plans for significant institutions.

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<sup>10</sup> Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms.

<sup>11</sup> It should be noted that the CNMV exercises resolution functions over institutions of such a limited size that its importance for stability purposes is minimal.



SOURCE: Devised by the author.

The allocation of national competences, combining the competences of the European banking union authorities with the responsibilities of the supervisors in the early phases of a bank crisis, are set out in Figure 3.

Additionally, FROB continues to manage the activities relating to monitoring of the pre-restructuring processes mentioned above.

The Spanish institutional framework is completed by the Deposit Guarantee Scheme, which also has a vital function in the event of failure of credit institutions that do not affect financial stability and may thus find themselves in common insolvency proceedings. Its remit is to ensure coverage of up to €100,000 in retail deposits. To perform this function, not only does it engage in collection and management tasks, but it may also take measures to assist the resolution of an institution, including the use of its funds to prevent liquidation, provided that it is less costly than payment of depositors. Also, like FROB, it manages guarantees and stakes arising from previous resolution processes.

The foregoing institutional model of separation between preventive resolution and executive resolution responsibilities is not completely in line with the most widely accepted models at international level.<sup>12</sup> Although specialised independent authorities like FROB are

<sup>12</sup> Within the European Union, it has similarities only to those of Denmark and Croatia.

frequent (examples are the euro area itself with the Single Resolution Board, the USA with the Federal Deposit Insurance Corporation, Canada, Mexico, Finland, etc.), these usually monopolise all resolution powers, including planning, execution, depositor protection and, commonly, the insolvency proceedings and resolution of other financial institutions (insurers, CCPs). The most frequent arrangement in euro area Member States is to entrust the resolution function to the central bank or the authority responsible for prudential supervision. In this case, the resolution competences, in the broad sense, are usually also concentrated in a single body. The authorities always have separate legal personality (“agency within an agency” model, such as that of the French *Autorité de Contrôle Prudentiel et Résolution*) or particularly robust hierarchical independence, in which the resolution agencies report directly and exclusively to the authority’s top executive body (UK, Germany, the Netherlands and Belgium).

#### 4.2 FIRST RESOLUTION IN THE BANKING UNION

FROB’s already extensive experience since its creation in 2009 was hugely enriched when, at the mandate of the SRB, it executed the first bank resolution at European level in 2017, namely that of Banco Popular.

In view of the continued worsening of this bank’s situation in the first half of 2017 and, in particular, the deterioration of the liquidity position notified by the European Central Bank, the authorities responsible for the bank’s supervision and resolution stepped up the exchange of information, tightened monitoring of the bank and began work to manage its possible resolution should the difficult situation not improve.

Based on its previous work, the SRB decided to hire experts to support its functions in the event of a hypothetical resolution: one as a legal adviser and another as an independent expert to begin the task of valuing the bank. Also, at the end of May FROB began to engage a legal firm and an investment bank, subject to the SRB’s approval, for the purpose of receiving general advice and, where applicable, cooperation in the execution of the various resolution instruments it might potentially be instructed to apply by the SRB.

In view of the information received from the ECB on the worsening of the bank’s situation and the risk of an imminent outcome, on Saturday, 3 June the SRB Extended Executive Session decided to launch the process of sale of Banco Popular conditional on its eventual entry into resolution. FROB began work to implement the strategy decided by the SRB and, through the investment bank engaged, invited the identified banks to express their interest in participating in the sale process in the event of resolution. Finally, two banks participated in the sale process.

The events came to a head on Tuesday, 6 June with the formal declaration of failure of the bank by the ECB. The resolution process was triggered by the bank’s inability to continue meeting its payment obligations.

In view of the existence of a clear public interest, the option chosen was resolution. Its ultimate purpose was to avoid the consequences that the entry into insolvency proceedings of the sixth largest Spanish bank (listed on the stock exchange) might have for depositors (around €60,000 million, of which €35,000 million were deposits of less than €100,000 euros), customers (around 4.5 million), employees (about 12,000) and, in general, for the financial stability of Spain and of the banking union. The SRB pressed ahead in the formulation of its resolution decision with all its components, including a provisional valuation by the independent expert, and urged FROB to complete the sale.



Early in the morning of 7 June, FROB, as the national resolution authority, signed, upon the instructions of the SRB, the contract of sale of Banco Popular to Banco Santander and approved the resolution whereby the resolution arrangements approved in Europe became strictly enforceable. At the usual time, 8 o'clock in the morning, Banco Popular opened its branches as a bank under the ownership of the Banco Santander group, which provided all the liquidity needed to meet Banco Popular's payment obligations from the very moment of acquisition.

Different international analysts and authorities have qualified the resolution of Banco Popular as an important achievement of the new international resolution regime. One has to be prudent in choosing the words to qualify a bank resolution. It is a process which prejudices many shareholders and creditors and is especially hard on minority interests. However, an objective analysis of the legal mandate of the resolution authorities shows that it has been reasonably well carried out by the Single Resolution Mechanism. And this was done in emergency circumstances which made an already complicated task all the more taxing. Law 11/2015, which is drawn from European Union legislation, which in turn derives from the basic resolution principles agreed at international level by the G20, is very clear in setting the objectives to be pursued in the event of a bank failure. The ultimate aim is to protect two intimately linked public goods: customer deposits and the stability of the financial system as a whole. And it is expressly stated that this is based on the basic principle that shareholders and creditors – and not the public funds of all citizens – must bear the losses of a resolution, subject to the sole reasonable limitation that their losses may not be higher than would have been caused by insolvency proceedings.

## 5 Considerations for the Banking Union

The experience acquired by FROB during the process of reform and recapitalisation of the financial sector just described above was extremely valuable and encompassed a wide variety of circumstances and types of intervention. Thanks to this, it is not difficult to draw pertinent conclusions which can be of use for ongoing efforts to improve the framework of action of resolution authorities in the Banking Union. Some of the key lessons learned are briefly detailed below, although each of these considerations would probably warrant its own in-depth study.

**Rapid diagnosis of solvency problems.** Liquidity and solvency problems usually appear together in weak banks. Although these two difficulties have to be dealt with expediently and effectively, an overriding consideration is to refrain from using liquidity instruments to prolong what are directly problems of balance sheet deterioration. When a systemic crisis strongly impacts the confidence of the financial sector as a whole, separating the two scenarios may be complicated. Despite the enormous difficulty of making estimates in highly uncertain scenarios, it is critical to diagnose solvency problems as promptly as possible so that the best resolution strategy can be employed, rather than simply relying on the economic cycle or future earnings to remedy the situation on their own.

**The application of resolution measures to minority interests has its own impact on financial stability.** During these last few years, burden sharing reduced by approximately €13,000 million the amount of public funds required to deal with bank failures. However, most preference shares were owned by retail investors who had been sold the product in transactions which, as evidenced by subsequent court rulings, were significantly lacking in transparency. The compensation mechanisms applied and the subsequent favourable court decisions allowed retail investors to recover a large amount of their outlay. Thus Spanish experience demonstrates that transparent selling to these investors is crucial, not only in its own right, but also for the appropriate allocation of losses to private shareholders

and creditors in the event of resolution. Even in cases of careful selling practices, the massive presence of retail investors among subordinated debt holders must be closely monitored and handled prudently by the resolution authorities.

**Corporate governance.** Management practices and appropriate corporate governance are crucial factors in bank failure. Therefore, the replacement of the Board of Directors or similar body and the selection of suitable professional managers is crucial to ensure the appropriate leadership of resolution processes. After FROB became a stakeholder in failing banks, this matter became important for it from the standpoint of determining liability. FROB has been active in the detection of misconduct which might have caused financial injury at bailed-out banks and, where appropriate, has directly taken court and out-of-court action to obtain compensation.<sup>13</sup>

**Public interest.** The concept of public interest which justifies intervention in a bank to avoid insolvency proceedings cannot be defined statically, but rather must be adjusted dynamically to the macroeconomic and financial situation prevailing at the time in question and to the specific conditions of the failed bank and the specific risk of contagion to the system. As demonstrated by the resolution of Caja Rural de Mota del Cuervo and the absence of public interest following the Banco Madrid insolvency proceedings, it is not a simple question of balance sheet size. Therefore, it is not feasible to completely limit the analysis of public interest to a preventive, and thus theoretical, phase of bank resolution. This analysis will always be subject to the unpredictable circumstances in which a bank may fail.

**Credit cooperatives.** Credit cooperatives are institutions whose legal form is provided for by law and recognised in the financial sector of Spain and of the rest of Europe. They do, however, present certain special features in the event of resolution. For example, the link between the members and the depositors of a credit cooperative, or the special nature of its capital in the event of application of resolution instruments such as sale of the business or bail-in, or the existence of systems of internal solidarity in the credit cooperative sector are matters which require specific attention from the standpoint of resolution.

**Insolvency proceedings.** Insolvency proceedings may be too slow and inefficient to be an effective alternative to resolution in the event of bank failure. With the current allocation of competences in the Single Resolution Mechanism, and with the recent experience both nationally (Banco de Madrid) and abroad (Banca Popolare di Vicenza and Veneto Banca in Italy or ABLV Bank in Latvia), the management of bank crises cannot disregard the bank wind-up regulations contained in insolvency law. However Spanish law (unlike in many other countries<sup>14</sup>) is practically bereft of the effective and flexible legal provisions needed for the bankruptcy of financial institutions. Unlike in other countries, Spanish law does not have a procedure specifically designed for financial institutions, nor does it provide for the possibility that agencies specialised in bank crisis management may have a decisive role in ordinary insolvency proceedings.

In this respect, the Single Resolution Board applies harmonised resolution rules and regulations, but with 19 different legal regimes for solvency proceedings. While not

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<sup>13</sup> The FROB forwarded 57 forensic reports to the public prosecutor's special anti-organised crime and anti-corruption unit. The related financial damages were assessed at a total of €3,704 million.

<sup>14</sup> Financial Stability Institute: How to manage failures of non-systemic banks? A review of country practices. <https://www.bis.org/fsi/publ/insights10.htm>.

overlooking the problems stemming from different treatments for identical liabilities within the banking union, the most important consequence is that, since the concept of public interest is relatively dynamic and flexible, the availability of more or less effective insolvency proceedings may provide arbitrarily different treatments for similar situations. Just as it is imperative to have a shared deposit protection scheme to complete the structure of the banking union, it is essential that a harmonised insolvency proceedings regime for financial institutions be included in the European regulatory agenda. Moreover, the resolution authorities have the most appropriate knowledge and resources to play a decisive role in these winding-up proceedings.

**Time management and preparation for resolution.** A fairly general consideration with a broad scope is that of time management in the adoption of resolution decisions. The search for the right moment at which managers, supervisors and, finally, resolution authorities should intervene to mitigate the effects of failure will always be one of the basic themes of debate. Moreover, it is a key issue because the decision that a bank has failed is highly complex, irrevocable and unleashes enormously rigorous consequences. And, to make things more difficult, it is usually taken in situations of incomplete information, based on estimates and expectations which are difficult to calibrate. Finding a balance between procrastination and haste is not easy, but our accumulated experience leads us to believe that usually the strongest inclination is to trust in palliative measures to resolve the problem rather than in the hypothetical haste of authorities to launch a resolution plan.

The above thoughts lead to other immediate reflections. The first is that managers must be fully conscious that the time they have to resolve their weaknesses is not unlimited. The second is that, in addition to efficient early warning systems and strong supervisory involvement in anticipating critical situations, it would be advantageous for the resolution authorities to have the legal capacity to initiate the early intervention phase. The third is that the preventive resolution phase, including the setting of minimum requirements for eligible liabilities (MREL) to absorb losses at banks, is of prime importance. It must therefore not be forgotten that the ultimate objective is that banks should be capable of managing failures in an orderly manner. At the same time it is crucial to address the challenges posed by certain banks that have the following three characteristics: a medium size, neither very big and financially sophisticated, nor small and readily wound up in insolvency proceedings; limited access to capital markets; and a simple business model with a clear predominance of retail depositors on the balance sheet.

**Information for resolution.** From a more operational standpoint, it should be noted that the quality and availability of a bank's basic data are important for the application of any resolution instrument. Two of the main resolution instruments are cases in point. In the case of the business sale tool, the more information that is available and the better its quality, the more likely it is that the sale will be made under advantageous conditions. In the case of the bail-in tool, to achieve the maximum legal certainty, it is necessary to have all the information on each liability (how, when and by means of which vehicle it was issued, what treatment applies to it in insolvency proceedings, etc.). If to this we add the need for valuation by an independent expert, or we consider the more operationally complex instruments such as asset segregation or bridge banks, it can only be concluded that the absence of high quality, up-to-date and readily available information may pose one of the main obstacles in bank resolution.

**Liquidity in resolution.** Another matter which it has become essential to take into account following the Single Resolution Board's experience with Banco Popular is that of liquidity

in resolution. It is irrelevant to look at the external sources of liquidity used by solvent, viable banks, because that refers to a stage before resolution and does not fall within the remit of the resolution authority. What should be emphasised, however, is a fact which became plain following the resolution of Banco Popular. Current international legislation does not attach sufficient importance to liquidity and the need to establish mechanisms to ensure funding in the post-resolution phase, for example, after implementation of a bail-in.

There are various initiatives underway to mitigate this weakness. First, greater emphasis will have to be put on liquidity measures and on the funding options contained in resolution plans. Approaches such as the specific identification of eligible collateral or of the funding needs to apply resolution instruments are extremely necessary. Second, it is essential to work on a post-resolution communication strategy that is effective, well coordinated between the competent authorities and helps to restore confidence in a resolved bank.

Having said this, the most decisive matter for providing liquidity under resolution will be the launch of the specific institutional mechanisms. The provider of available liquidity is the Single Resolution Fund, but the conditions under which it can provide these funds must be clarified beforehand, and it must be assured that the liquidity approval procedure is rapid, simple and sufficient. In addition, it must be taken into account that the funds of the Single Resolution Fund are limited,<sup>15</sup> so it will be necessary to explore other possible means through the European Central Bank and implement as soon as possible the agreement on a support mechanism through the European Stability Mechanism (Eurogroup, 4 December 2018).

**Institutional model.** The institutional model of Spanish resolution has operated and currently operates with reasonable effectiveness. And recently it has demonstrated its validity, with FROB leading the executive functions and the Banco de España and the CNMV handling the planning functions. In this respect, faced with a genuine resolution situation such as that in 2017, characterised by extreme urgency and complexity, the Spanish system performed satisfactorily, executing the orders of the Single Resolution Board to avoid the failure of a private-sector bank from damaging a superior public interest. Despite these precedents, an examination of the current model is still warranted. It has some inefficiencies derived from a fragmented institutional set-up, the architecture of which was designed ad hoc in response to the Spanish financial sector crisis discussed in this article. Nowadays, without the urgency of the crisis, it is good time to review the system and endow it with the appropriate solidity to address future challenges.

## 6 Conclusión

Nearly ten years down the road from the initial outbreak of the financial crisis and from the creation of FROB, the enormity of the work needed to stabilise and resize the Spanish banking sector is now evident. Progress has been made on many fronts to strengthen the resilience of the system to banking crises. The experience acquired and the work done at European and national level are considerable. However, there are many tasks still to be completed. Now that we have taken stock of what has been achieved, this should serve primarily to convince us to keep working apace to improve the ability of our system to react to failure scenarios in a manner more attuned to the public interest. FROB's track record in meeting this objective demonstrates its ability and commitment to continue being a key player.

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<sup>15</sup> It is estimated that in 2023 the endowment of the Single Resolution Fund will reach €60,000 million.

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