DECISIONS

COUNCIL DECISION

of 23 July 2012

addressed to Spain on specific measures to reinforce financial stability

(2012/443/EU)

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 136(1)(b), in conjunction with Article 126(6) thereof,

Having regard to the proposal from the European Commission,

Whereas:

(1) Article 136(1)(b) of the Treaty on the Functioning of the European Union (TFEU) foresees the possibility of setting out economic policy guidelines specific to the Member States whose currency is the euro.

(2) In the Recommendation on the National Reform Programme 2012 of Spain and delivering an opinion on the Stability Programme for Spain, 2012-2015 [1], the Council recommended that Spain take action to 'implement the reform of the financial sector, in particular complement the on-going restructuring of the banking sector by addressing the situation of remaining weak institutions, put forward a comprehensive strategy to deal effectively with the legacy assets on the banks' balance sheets, and define a clear stance on the funding and use of backstop facilities'.

(3) Abundant availability of external financing at low cost in the 2000s fuelled a credit-driven domestic demand and asset boom in Spain, concentrated in particular in the real estate sector. The burst of the real estate and construction bubble and the economic recession that followed have adversely affected the Spanish banking sector. As a result, with the exception of a few large and internationally diversified credit institutions, Spanish banks have largely lost access to wholesale funding markets on affordable terms and, thus, have become highly dependent on Eurosystem refinancing. In addition, their borrowing capacity has been severely limited by the impact of rating downgrades on collateral availability.

(4) The sizeable contraction of the economy in recent years, which is affecting employment and unemployment in a very negative way, has deteriorated substantially the budgetary position in Spain. According to a Commission services update of the 2012 spring forecast, the general government deficit is projected at 6,3 % of GDP in 2012, which compares to an expected deficit of 5,3 % of GDP in the 2012 stability programme and the draft 2012 budget law. Gross public debt rose to 68,5 % of GDP in 2011, and according to the Commission services update of the 2012 spring forecast it is expected to surge to 80,9 % of GDP in 2012 and to 86,8 % in 2013, based on a no-policy-change scenario, thus exceeding the Treaty reference value in all years. Risks related to the macroeconomic scenario and the budgetary targets, as well as to additional financial rescue measures, may contribute to a further increase in public debt. In view of these developments, on 10 July 2012 the Council issued a recommendation to Spain under the excessive deficit procedure (EDP) to put an end to the present excessive deficit situation by 2014.

(5) The Spanish authorities have taken a number of important measures to address the problems in the banking sector. These measures include the clean-up of banks' balance sheets, increasing minimum capital requirements, restructuring of the savings bank sector, and significantly increasing the provisioning requirements for loans related to Real Estate Development (RED) and foreclosed assets. These measures, however, have not been sufficient to alleviate market pressure.

(6) In February 2011, the Spanish authorities raised the minimum capital ratio requirement ('capital principal') to 8 % of banks' risk weighted assets and gave banks until September 2011 to comply with this new regulation. For banks more dependent on wholesale funding and characterised by a limited market access the

[1] OJ C 219, 24.7.2012, p. 81.

minimum capital ratio was increased to 10 %. In February and May 2012, new legislation required banks to build higher provisions and capital buffers against possible losses on both performing and non-performing loans on the legacy stock of construction and real estate assets. The expected overall volume of these new provisioning requirements amounted to approximately EUR 84 billion.

(7) As of April 2012, the total gross financial contribution by the Spanish State (excluding bond issuance guarantees) amounted to about EUR 15 billion. The capital support was provided via the Fund for Orderly Bank Restructuring (FROB) endowed with a capital of EUR 15 billion, of which EUR 9 billion was already paid in. The State has also provided guarantees to bank senior bond issues by banks amounting to about EUR 86 billion (out of this total, about EUR 58 billion in guarantees was outstanding). Although the FROB still had a remaining capacity of three times its capital allocation, public sector support will not be sufficient to provide a sufficiently large backstop for conducting the required system-wide clean-up of the banking sector.

(8) Concerns about the need for further banking sector recapitalisation have contributed to increasing market pressures on Spanish government bonds. Sovereign bond yields have reached levels of well over 500 basis points in late June 2012 and early July 2012, increasing the funding costs for the Spanish sovereign. The rising interest burden adds to the challenge of consolidating public finances in Spain and correcting the excessive deficit. Therefore, comprehensive banking sector restructuring and recapitalisation is an important element in reducing pressure on public finances.

(9) On 25 June 2012, the Spanish authorities officially requested financial assistance in the context of the ongoing restructuring and recapitalisation of the Spanish banking sector. The assistance is sought under the terms of the Financial Assistance for the Recapitalisation of Financial Institutions by the European Financial Stability Facility. The assistance provided is subject to specific financial sector conditionality, as foreseen in the Memorandum of Understanding (MoU) negotiated between the Spanish Government and the Commission, in liaison with the European Central Bank (ECB) and the European Banking Authority (EBA), with the technical assistance of the International Monetary Fund (IMF). It will include both bank-specific conditionality in line with State aid rules and horizontal conditionality. In parallel, Spain will have to comply fully with its commitments and obligations under the EDP and the recommendations to address macroeconomic imbalances within the framework of the European Semester.

(10) Increasing the long-term resilience of the Spanish banking sector is critical to preserving financial stability in Spain and limiting the contagion of financial stress to other euro-area economies and, thus to avert adverse effects on the proper functioning of the economy and of economic and monetary union. Significant measures taken so far to address these problems have not been fully sufficient. Further measures are therefore necessary. In particular, Spain should implement additional specific measures to effectively deal with legacy assets, restore market-based funding, reduce banks' reliance on central bank liquidity support, and to enhance the risk identification and crisis management mechanisms.

(11) As part of the overall strategy, it is key to effectively deal with the legacy assets by requiring a clear segregation of problematic assets of aided banks from the banks' balance sheets. This should apply, in particular, for loans related to RED and foreclosed assets. Such segregation would remove any remaining doubts about the quality of the banks' balance sheets, allowing them to better carry out their financial intermediation function.

(12) In addition, improving the transparency of banks' balance sheets in this manner can facilitate an orderly downsizing of bank exposures to the real estate sector, restore market-based funding, and reduce banks' reliance on central bank liquidity support.

(13) Ensuring a sound framework for the Spanish banking sector requires that the risk identification and crisis management mechanisms are enhanced. An effective strategy should comprise changes aimed at strengthening the regulatory and supervisory framework, taking into account the experiences of the financial crisis. In addition, corporate governance shall be enhanced in line with international best practices,

HAS ADOPTED THIS DECISION:

Article 1

1. The Commission, in consultation with the ECB, the EBA and the IMF, has agreed with the Spanish authorities the specific financial-sector policy conditions attached to the financial assistance. Those conditions are laid down in the MoU to be

signed by the Commission and the Spanish authorities. The detailed financial terms shall be laid down in a Financial Assistance Facility Agreement.

Spain shall adequately recapitalise and thoroughly restructure its banking system. In that regard, Spain shall develop in coordination with the Commission and in consultation with the ECB a strategy for the future structure, functioning and viability of the Spanish banks which will identify how to ensure that they are able to operate without further state support. This strategy will be further specified in the MoU, developing further the policy conditions embedded in this Decision.

2. The key components of this strategy shall be an overhaul of the weak segments of the Spanish banking sector and a strengthening of the regulatory and supervisory frameworks for the banking sector.

3. The overhaul of the weak segments of the Spanish banking sector shall be comprised of the following three elements:

(a) identification of individual bank capital needs through a comprehensive asset quality review of the banking sector and a bank-by-bank stress test, based on that asset quality review. On the basis of the stress test results, banks in need of capital injection will be divided in three different groups. Each group will be subject to the obligation to present restructuring and resolution plans, and all the complementary and subsequent measures, as provided in the MoU;

(b) recapitalisation, restructuring and/or resolution in an orderly way of weak banks, based on plans to address any capital shortfalls identified in the stress test. These plans will be based in the principles of viability, minimising the cost for taxpayers (burden sharing) and limiting distortions of competition. To that effect, Spain will adopt legislation to: (i) allow the implementation of Subordinated Liability Exercises, including mandatory forms of burden sharing, and (ii) upgrade the bank resolution framework in order to incorporate relevant resolution powers for FROB and the Deposit Guarantee Fund (DGF), and taking into account the EU regulatory proposal on crisis management and bank resolution, including special tools to resolve unviable banks;

(c) segregation of assets in those banks receiving public support in their recapitalisation effort and their transfer of the impaired assets to an external Asset Management Company (AMC), to realise their long-term value. Spain, in close consultation with the Commission, the ECB and the EBA and with the technical assistance of the IMF, will prepare a comprehensive legislative framework for the establishment and functioning of the AMC, in order to make it fully operational by November 2012.

4. In order to ensure a sound framework for the banking sector, Spain shall also strengthen the regulatory and supervisory frameworks as well as reinforce governance. The strategy and conditionality, which is comprehensively specified in the MoU, shall, inter alia, include the following measures:

(a) requiring Spanish credit institutions to increase their Common Equity Tier (CET) 1 ratio to at least 9 % according to the definition of capital established in the EBA recapitalisation exercise;

(b) requiring, from 1 January 2013, Spanish credit institutions to apply the definition of capital established in the Capital Requirements Regulation (CRR);

(c) re-assessing the legal framework for loan-loss provisioning. In particular, on the back of the experiences of the financial crisis, the Spanish authorities shall make proposals to revamp the permanent framework for loan loss provisioning, taking into account the temporary measures introduced during the past months, as well as the EU accounting framework;

(d) further strengthening, the operational independence of the *Banco de España*; in line with the international recommendations and standards, transferring the sanctioning and licensing powers of the Ministry of Economy with respect to the banking sector to the *Banco de España*;

(e) further enhancing the supervisory procedures of *Banco de España* based on an internal audit;

(f) reviewing the governance arrangements of the financial safety net agencies (FROB and DGF) to avoid potential conflicts of interest;

(g) strengthening the rules on the governance of the savings bank sector and of the banks owned by savings banks;

(h) amending consumer protection and securities legislation to limit the sale by banks of subordinate debt instruments (or instruments not covered by the DGF) to non-qualified retail clients, and strengthening compliance monitoring by the authorities;

(i) taking steps to minimise the cost to taxpayers of bank restructuring. After allocating losses to equity holders, the Spanish authorities will require burden sharing measures from hybrid capital holders and subordinated debt holders in banks receiving public capital;

(j) committing to capping pay levels of executive and supervisory board members of all State-aided banks;

(k) enhancing the public credit register.

5. The authorities will provide to the Commission, the ECB, EBA and the IMF, under strict conditions of confidentiality, the data needed for monitoring of the banking sector.

6. The Commission, in liaison with the ECB and EBA, will verify at regular intervals that the policy conditions attached to the financial assistance are fulfilled, through missions and regular reporting by the Spanish authorities, on a quarterly basis. Monitoring of the FROB activities in the context of the programme will take place regularly.

Article 2

This Decision is addressed to the Kingdom of Spain.

Done at Brussels, 23 July 2012.

For the Council

The President

C. ASHTON