5-2012
February, 2012

FINANCIAL SYSTEM REFORM

ROYAL DECREE-LAW 2/2012 OF FEBRUARY 3, 2012, ON FINANCIAL INDUSTRY REFORM

1. PURPOSE

A new royal decree-law reforming the financial industry was published in the Official State Gazette on February 4, 2012 (Royal Decree-Law 2/2012).[1]

Taking forward earlier measures passed to avoid or reduce the consequences of future financial downturns, the aim of this new legislation is to build up the confidence, credibility and strength of the financial system so that it can recommence funding economic growth and the creation of jobs. Such goals are to be achieved through a significant tightening of write-down requirements for real estate assets and the provision of incentives for further consolidation in the industry (in the form of extended periods for balance sheet adjustments and assistance from the state's Fund for Orderly Bank Restructuring of FROB). As highlighted in the decree's Preamble, the financial industry will be expected to shoulder the whole of the cost of the reform.

The new legislation has also amended Royal Decree-Law 9/2009, of June 26, 2009 on Bank Restructuring and Reinforcement of the Capital of Credit Institutions (the **"Restructuring Royal Decree-Law"**), regarding the forms that FROB funding can take, and Royal Decree-Law 11/2010, of July 9, 2010 on Governing Bodies and Other Aspects of the Regulatory Framework of Savings Banks (the **"Savings Banks Royal Decree-Law"**), seeking mainly to simplify the governance structures of savings banks that conduct their business indirectly through shareholdings in other institutions.

In one of its most controversial provisions, the new royal decree-law places caps on boardroom and executive pay at institutions that receive public funding to help straighten out their finances or for a restructuring.

Another key measure brought in, aside from the reform of the banking system, is the long-awaited extension of the rules for computing losses for the purposes of mandatory capital reductions or winding-up at capital companies, as provided in Royal Decree-Law 10/2008, of December 12, 2008.

It also sets out other ancillary provisions for achieving these main aims.

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[1] Correction of mistakes published in the Official State Gazette on February 15, 2012.

2. WRITE-DOWNS OF REAL ESTATE ASSETS AT CREDIT INSTITUTIONS

The new legislation requires further provisions and capital charges in 2012 for lending and foreclosed assets or assets received in payment of debts (those existing as of December 31, 2011, and those derived from a refinancing of debts at a later date) where they are related to land for property development or construction or property development projects, in either case in Spain, as described in the following section.

Before March 31, 2012, every institution must provide the Bank of Spain with a plan setting out the measures it intends to adopt. The Bank of Spain's approval of the plan must be granted within 15 business days and may include amendments or further measures.

The obligations laid down in the new legislation are treated as discipline and control provisions subject to the penalty regime under Law 26/1988, on Discipline and Control of Credit Institutions.

2.1 Rules for recognizing lending and foreclosed assets related to the real estate industry (classified as non-performing or subprime)

The rules for determining the impairment of these assets, detailed in Annex I to the new royal decree-law, are as follows:

DELINQUENT ASSETS (LENDING)	**MINIMUM COVERAGE RATE FOR CURRENT RISK**	
	Classified as non-performing *(dudosas)*	**Classified as subprime** (*subestandar)*
Transactions to finance finished construction or property development projects involving all kinds of assets	25%	20% (with collateral) 24% (without collateral)
Transactions to finance land for property development	60%	60%
Transactions to finance construction or property development projects involving all kinds of assets that are under construction, with work on hold	50%	50%
Transactions to finance construction or property development projects involving all kinds of assets that are under construction, with work in progress	50%	24%

DELINQUENT ASSETS (BUILDINGS, LAND)	Length of time on balance sheet	Required coverage
General rule: real estate assets received in payment of debts (regardless of the asset and its use, therefore including principal residences)	More than 36 months	At least 40%
Foreclosed assets, consisting of (i) finished construction or property development projects, and (ii) residential units that have not been the borrower's principal residence	Since foreclosure	At least 25%
	More than 12 months but not in excess of 24 months	30%
	More than 24 months but not in excess of 36 months	40%
	More than 36 months	50%
Foreclosed assets consisting of land for property development	Since foreclosure	60%
Foreclosed assets consisting of construction or property development projects in progress	Since foreclosure	50%

2.2 Provisions for lendings related to land for property development and for construction or property development projects that are up to date with payment (in the "normal risk" category)

In addition to the new measures described above, institutions must record a provision equal to 7% of the outstanding balance as of December 31, 2011, for lendings related to property development placed in the "normal risk" category as of that date (that is, where the transaction is up to date with payment and the credit institution expects payments to be kept up, under applicable accounting rules). This coverage must be recorded once only, before December 31, 2012.

The amount recorded in the provision can only be used to provide the specific coverage that may be needed if the debts are later reclassified as non-performing or subprime assets or if the assets are foreclosed in payment of those debts.

2.3 Minimum core capital level

Credit institutions and consolidating groups of credit institutions that were already under obligation to meet a minimum core capital level, under Royal Decree-Law 2/2011, of February 18, on Reinforcement of the Financial System (the **"Reinforcement Royal Decree-Law"**), are required to have an additional amount of capital, equal to the sum of the amounts calculated as specified below, as detailed in Annex II of the new royal decree-law, in relation to delinquent real estate assets, and the provisions recorded for those assets as described in point 2.1 above must be deducted from those amounts.

- Subprime or non-performing assets:

TYPE OF LOAN	% OF CURRENT RISK
Loans to buy land	80
Loans for development projects in progress (except subprime with projects in progress)	65

- Foreclosed assets or assets received in payment of debts

ASSET TYPE	% OF CARRYING AMOUNT
Land	80
Development projects in progress	65

3. CONCENTRATIONS BETWEEN CREDIT INSTITUTIONS

3.1 Incentive to consolidate

To promote further sector consolidation in fiscal year 2012, the period allowed for the institutions involved to record the capital charges described in section 2 above, has been extended to up to 12 months following clearance for the transaction.

3.2 Clearance for concentrations

The concentration must be cleared by the Ministry of Economy and Competitiveness.

Application for clearance must be filed with the Secretary-General for the Public Treasury and Financial Policy before May 31, 2012, unless it is an acquisition involving an institution majority owned by the FROB (currently, at the date of approval of the royal decree-law, NCG Banco, Unnim Banc, and Catalunya Banc) in which case this time limit will not apply. In all cases, prior reports will be needed from the Bank of Spain and the CNMV (the Spanish National Securities Market Commission).

Clearance for the concentration will be given within a month following submission of the application, and no other clearance from the authorities will be required, except in relation to antitrust matters, where applicable.

A special reference is made to the supervision of any master agreements or other arrangements entered into the institutions involved where one of them is given a higher degree of control than is commensurate to their interest in the resulting institution. In such cases, clearance may be subject to the prior amendment of those agreements.

3.2 Requirements to be met

These rules will apply to the concentration processes initiated on or after September 1, 2011, where the following requirements are met:

3.2.1 Size of the resulting institution

The total initial balance sheet of the resulting institution must exceed that of the largest participating institution by at least 20%. This requirement may be waived, according to the prevailing circumstances in transactions of a similar scale, by the Ministry of Economy and Competitiveness, following a proposal by the Bank of Spain, although the increase in the total balance sheet cannot be lower than 10% in any case.

3.2.2 Structural modification or acquisition

The concentration can only be carried out through (i) transactions involving structural modifications under the legislation in force (merger, spin-off or global transfer of assets and liabilities), or (ii) acquisitions of institutions controlled by the FROB. This appears, therefore, to rule out simple acquisitions of entities not owned by the FROB if they are not accompanied by a subsequent structural modification. Processes based solely on contractual arrangements (institutional protection schemes) are expressly excluded, except for transactions that only involve credit cooperatives.

3.2.3 Corporate governance plan

The institutions involved must adopt the required measures to improve their corporate governance and file a boardroom and executive pay plan. In these matters, the institutions must generally adapt to comply with the recommendations of the Unified Code of Good Governance (which seems to imply that it will be allowed not to follow all of the recommendations) and fulfill the requirements in article 13 of the Restructuring Royal Decree-Law (between 5 and 15 directors, with a majority of non-executive members; 12-year limitation on the term of office of independent directors; obligation to have an appointment and remuneration committee, among other requirements).

3.2.4 Undertaking to lend to households and small and medium-sized businesses

The concentration plan must include a quantified undertaking to increase household lending and lending to small and medium-sized businesses in the three years following the concentration.

3.2.5 Divestment plan

The concentration plan must also include a program for divestment of assets carrying risks associated with real estate in the three years following the concentration.

3.2.6 Viability

The resulting institution must be economically and financially viable (therefore the business plans and supporting estimates necessary to be able to examine the viability are likely to be required).

3.2.7 Dates of approval by the shareholders' meetings or assemblies

The shareholders' meetings or general assemblies of the institutions involved in the concentration must approve the transaction before September 30, 2012.

3.2.8 Time limit for completing the process

The concentration process must be completed before January 1, 2013.

In addition to the requirements described above, although they are not mentioned in the new royal decree-law, additional requirements imposed by the European Commission in the context of the state aid clearance procedure should not be ruled out.

Lastly, the law clarifies, at the risk of stating the obvious, that the special rules do not apply to concentration processes between institutions belonging to the same group of credit institutions.

4. AMENDMENTS TO THE RESTRUCTURING ROYAL DECREE-LAW. SUPPORT MEASURES FROM THE FROB TO BANKING MERGERS

Article 3 of the new royal decree-law amends article 9 (instruments which the FROB may acquire to reinforce the equity of credit institutions in fundamentally viable institutions) and article 10 (convertible instruments to be acquired by the FROB) of the Restructuring Royal Decree-Law, by adding a number of adjustments essentially aimed at providing the FROB with a more flexible operating margin.

To accomplish this, the FROB's financial capacity has been stepped up by increasing the contribution it receives out of the State General Budget by an additional €6 billion.

4.1 Acquisition price payable by the FROB

Under a new provision on the valuation of institutions to determine the acquisition price to be paid by the FROB, the experts appointed by the FROB itself, in a procedure yet to be regulated, will make the valuation on the basis of the economic and financial projections for the institution's operations and will take into account, among other factors, any special write-downs made by the institutions.

4.2 Deadline for disposal of instruments subscribed by the FROB

The deadline by which the FROB must dispose of any instruments it has subscribed to is shortened to 3 years (versus the current 5).

In exchange for this shortened deadline and to make divestment easier, the FROB can grant financial support in accordance with the provisions of article 7.3 of the Restructuring Royal Decree-Law (guarantees, loans, subordinate financing, acquisition of certain assets or others). In other words, in the divestment process the FROB can grant financial support to fundamentally viable institutions (article 9 of the Restructuring Royal Decree-Law) which is similar to the support that could hitherto be granted to unviable institutions (article 6 of the Restructuring Royal Decree-Law).

4.3 Breach of recapitalization plan

The reform provides that if, due to the institution's financial condition or the way in which market conditions are unfolding, the viable institution's recapitalization plan cannot be carried out and the institution goes into the position of weakness defined in article 6 of the Restructuring Royal Decree-Law, the provisions of article 7 of the Restructuring Royal Decree-Law would come into play. In other words, the institution will be placed under control, its management will be replaced, and a restructuring plan will be implemented that will determine the required course of action with respect to the instruments subscribed by the FROB.

4.4 Support from the FROB to concentration processes between credit institutions. Acquisition of contingent capital (contingent convertible instruments known as *"cocos"*)

Under the new measures, the FROB can also acquire instruments issued by credit institutions which, although not in the position of weakness described in article 6 of the Restructuring Royal Decree-Law, are to embark on a concentration process, as described in section 3 above, and need to reinforce their equity.

For this to happen:

- The institutions must draw up a concentration plan which must contain specific undertakings to improve their efficiency, to streamline their administration and management and to right-size their production capacity, all with a view to improve their future prospects.

- The concentration plan must be approved by the Bank of Spain.

- When deciding on the adoption of any of these measures (understood as referring to the acquisition of instruments issued by the credit institution), the FROB must take into account the time frame and risk of the transaction, the need to avoid distortions of competition as well as the need to contribute to the implementation and fulfillment of the concentration plan approved by the Bank of Spain. The decision will be guided in all cases by the principle of securing the most efficient use of public resources.

- The instruments must be convertible into shares or into ownership interests.

- The terms and conditions governing the remuneration of the instruments will be determined by reference to the legislation on state aid (see the Communication from the European Commission of December 1, 2011, on the application, from January 1, 2012, of state aid rules to support measures in favor of banks in the context of the financial crisis[2]).

- The acquisition of convertible instruments by the FROB will require a resolution to eliminate shareholders' preemption rights alongside the adoption of the resolution approving the issue.

- The issuers must undertake to repurchase or redeem the instruments subscribed by the FROB as soon as they are in a position to do so on the terms provided in the concentration plan. If the institution fails to repurchase the instruments within five years from the acquisition, the FROB can ask for them to be converted into shares or into ownership interests of the issuer within 6 months after the end of the fifth anniversary of the acquisition.

- The resolution approving the issue must also state that the instruments are convertible when requested by the FROB, if, before the end of the five-year term, the Bank of Spain considers it unlikely, in light of the position of the institution or its group, that the repurchase can take place within those five years.

- The issued instruments will be computed as equity and, additionally, under a new rule, as core capital, with no requirement to be listed on an organized secondary market for these purposes. The instruments will not be subject to the restrictions in the law for determining computable equity and core capital. In an amendment to the Reinforcement Royal Decree-Law, the new legislation provides that debt instruments that are issued after the entry into force of the reinforcement legislation and contain clauses making them convertible into common shares must make it obligatory for them to be converted by December 31, 2018 (thereby extending the hitherto scheduled date of December 31, 2014) and must make it compulsory to convert them where the minimum capital ratio is not met.

- And lastly, before the acquisition takes place, the FROB must submit to the Ministry of Finance and Public Authorities and to the Ministry of Economy and Competitiveness an economic report detailing the financial impact of the acquisition on the funds contributed out of the State General Budget. On the basis of the reports issued by the Secretary-General for the Treasury and Financial Policy and by the Spanish State Auditing Agency, the Ministry of Finance and Public Authorities may object to the acquisition, providing their reasons, within 5 business days after the report is submitted to it.

[2] http://ec.europa.eu/competition/state_aid/legislation/en.pdf

5. CHANGES TO THE LEGISLATION ON GOVERNANCE OF SAVINGS BANKS

The most substantial changes to the Savings Banks Royal Decree-Law affect the savings banks that conduct their banking business through a non-savings bank, the aim of the changes being to confine or reduce the activities of their governing bodies to the operations that they actually conduct themselves.

These obligations will also apply to savings banks which carry on their purposes only as credit institutions as a concerted unit through a credit institution controlled jointly by all of them (i.e. under an institution protection scheme) in accordance with article 8.3 of Law 13/1985, of May 25, 1985, on Investment Ratios, Equity and Reporting Obligations of Financial Intermediaries.

5.1 Governing bodies

- The only governing bodies of these savings banks will be (i) the general assembly and (ii) the board of directors and, optionally, (iii) the supervisory committee.

- There is a general obligation for the number of members of the governing bodies as well as the frequency of their meetings to be determined in the bylaws of the savings bank, by reference to the economic dimension and activity of the institution, without determining any upper or lower thresholds.

- Although certain measures had already been included in other legislation prior to this new royal decree-law, rules have been simplified and laid down in relation to the distribution of representatives of deposit-holders, employees, and municipal corporations that are not founders of savings banks and to the functioning, frequency and calling of general and special assemblies. On this point, the related changes that the regional authorities may make in their respective savings banks laws will have to be taken into account.

5.2 Allocation of unrestricted surpluses

These savings banks may not spend more than 10% of unrestricted surpluses on costs outside their community outreach projects.

The Bank of Spain may, however, authorize the allocation of higher percentages necessary to meet the savings bank's essential operating expenses.

5.3 Exemptions from regulatory compliance

These savings banks have been exempted from certain rules that applied to them as credit institutions, such as establishing a customer ombudsman (obligations contained in section 1a of Chapter V of Law 44/2002, of November 22, 2002, on Measures Reforming the Financial System and its implementing regulations).

In addition, the Bank of Spain may adapt or release these savings banks, individually, from compliance with the prudential and organizational requirements relating to internal control, audits, and risk management contained in Law 13/1985, of May 25, 1985, on Investment Ratios, Equity and Reporting Obligations of Financing Intermediaries, and its implementing regulations.

5.4 Obligation to be converted into a special foundation

If one of these savings banks were to cease to exert control, within the meaning of article 42 of the Commercial Code, or, as a new amendment to the provisions of the original Savings Banks Royal Decree-Law, to reduce its interest and come to hold less than 25% of the voting rights at the non-savings bank through which it conducts its operations, it must waive its authorization to act as a credit institution and be converted into a special foundation in accordance with article 6 of the now amended Savings Banks Royal Decree-Law.

6. CHANGES TO BOARDROOM AND EXECUTIVE PAY AT CREDIT INSTITUTIONS THAT HAVE RECEIVED PUBLIC FUNDS

A number of caps have been placed on the pay of directors and executives at institutions that are FROB owned or FROB funded.

These caps will be determined by reference to all pay levels within the credit institution's group. For these purposes, the fixed pay of chairpersons and executive directors will include the attendance fees they receive for belonging to the board of directors or its subcommittees.

To be able to receive financial support from the FROB, any contracts that the institutions have entered into on their relationships with their directors and executives must contain the minimum contents that the Ministry of Economy and Competitiveness will determine by Ministerial Order. The order will include the following rules.

6.1 For institutions controlled by the FROB

- **Non-executive directors**: their pay cap will be €50,000 per year, for all items.
- **Executive directors and senior management**: their pay cap will be €300,000 per year, for all items.

They cannot under any circumstances receive bonuses or discretionary pension benefits.

6.2 FROB funded institutions

- **Non-executive directors**: their pay cap will be €100,000 per year, for all items.
- **Executive directors and senior management**: their pay cap will be €600,000 per year, for all items.

Any bonuses will be determined in line with the following conditions:

- They must be expressed as a percentage of their fixed pay, by reference to the bonus paid to similar groups by the median among comparable institutions in terms of size and complexity.

- They will be deferred for three years and will be conditional on the achievement of the level of earnings which, under the plan prepared to obtain support from the FROB, give entitlement to the bonus. The Bank of Spain will determine whether this requirement is met.

6.3 Term for the restrictions

The restrictions can be lifted after the institution has been restructured.

6.4 Impact on new concentrations in the financial sector

When the institutions participate in a concentration process, the above pay caps will only apply to the directors and executives who were directors and executives at the institution that required public funding or that gave rise to the funding, and these institutions must be identified as such in the related concentration plan.

In light of the pay plan filed in the concentration process, the Ministry of Economy and Competitiveness may change the rules and restrictions described in the above points (except for the ban on bonuses and discretionary pension benefits at institutions controlled by the FROB).

6.5 Definition of executive

For the purposes of the above restrictions, "executive" means general managers as well as members of senior management, in line with the definition contained in article 1 of Royal Decree 1382/1985, of August 1, 1985, on the special labor relationship of senior management.

7. OTHER CHANGES

7.1 Computation of losses in cases of mandatory capital reductions at public limited companies and of winding-up at public limited companies and limited liability companies

The new measures further extend, on a seamless basis and for all legal purposes, to the provisions already in force to the effect that the impairment losses recognized in the financial statements in connection with property, plant and equipment, investment property and inventories, do not have to be computed in the fiscal year that ends after the new royal decree-law comes into force.

7.2 Exceptional treatment of outstanding preferred shares

The new measures contain exceptional treatment for preferred shares or debt instruments mandatorily convertible into shares issued before the new legislation on financial industry reform came into force. Issuing institutions may include in the plan to be filed before March 31, 2012 (see section 2 of this Newsletter), a request to defer, for not longer than 12 months, the payment of the planned remuneration even though, as a result of the restructuring that they have decided to carry out under the new legislation on financial industry reform, they do not have sufficient income or unrestricted reserves or there is a shortfall in equity at the issuing or parent institution (the remuneration requested to be deferred would not accrue if these circumstances were present in normal conditions). Any remuneration so deferred can only be paid after the end of the deferral period if the institution has sufficient income or unrestricted reserves and there is no shortfall in equity at the issuing or parent credit institution.

7.3 Exemption from insurance and reinsurance intermediation rules

Institutions participating in concentration processes, as described in section 3 above, will be exempt from applying the provisions contained in article 25.1, in relation to the availability of the distribution network of credit institutions and the fragmentation of that network, and in article 25.4, both of Law 26/2006, of July 17, 2006, on Private Insurance and Reinsurance Intermediation Law, until January 1, 2014. These legislative provisions meant that a credit institution could only make its distribution network available to one bancassurance operator and that these distribution networks could not act simultaneously as auxiliaries for other intermediaries. With this temporary exemption, institutions involved in concentration processes are allowed temporarily (until January 1, 2014) to have more than one bancassurance operator or to act at the same time as auxiliaries for other intermediaries. The aim of the exemption is to avoid or reduce the conflicts that may arise where institutions involved in concentration processes have agreements with various operators, thereby providing a reasonable amount of time for their orderly termination.

7.4 Assets securing transactions with central banks

The law on the autonomy of the Bank of Spain (Law 13/1994, of June 1, 1994) has been amended to require certain adjustments to assets that can be used as collateral for financial transactions with the Bank of Spain, the European Central Bank or other national banks of the European Union. Thus, besides including certain matters that had already been covered in other secondary legislation, the new law allows pledges of non-mortgage loans or collection rights, in relation to which it provides that:

- the forwarding of information on the pledged loans or collection rights will not be a breach of banking secrecy or data protection legislation; and

- the debtor or guarantor under these collateral transactions may not make use against the central banks (or against any other parties to which such central banks may transfer the rights in question) of any of the opposition rights (including set-off) that it would have had against the pledging credit institution.

7.5 Entry into force

The royal decree came into force on Saturday, February 4, 2012, the date of its publication.