

## 5 ROLE OF THE BANCO DE ESPAÑA'S SUPERVISION IN THE FRAMEWORK OF THE RECOVERY AND RESOLUTION OF CREDIT INSTITUTIONS

### 5.1 New area in the prudential framework: resolution

The financial crisis that broke in 2008 revealed the weaknesses of banking crisis resolution systems. At the European level, the absence of a harmonised banking resolution framework gave rise to differences in the management of the crisis across countries, the extensive use of the bail-out of problem banks and the resulting perverse link between the perception of sovereign risk and banks' health.

Hence the need to define a new resolution framework, with the aim of laying the foundations for the orderly resolution of banks, bearing in mind that anticipation and preparation will be key factors.

In order to understand the new resolution approach, one must turn first to the work of the Financial Stability Board (FSB) carried out at the request of the G-20 following the Lehman Brothers insolvency in 2008. In 2011 the FSB published the *Key Attributes of Effective Resolution Regimes for Financial Institutions*<sup>1</sup>, which set out the minimum standards and principles that every resolution regime should have in order to facilitate the orderly resolution of systemic banks:

- i) *Preparation for resolution.* To this end the institutions are obliged to prepare recovery plans and the authorities are obliged to prepare resolution plans. The two documents constitute "living wills" or roadmaps that would enable the institutions and authorities to be prepared to handle potential critical situations or resolutions.
- ii) *Shareholders and creditors should bear the costs of the crisis (bail-in).* Taxpayers should not assume the mistakes of private arrangements.
- iii) *Attribution of powers to administrative authorities and establishment of tools* that ensure the orderly resolution of institutions, preventing repercussions of individual crises on financial stability and enabling the critical and essential functions that institutions perform for the financial system to be maintained.
- iv) *Promote cooperation among authorities from different countries* in order to present a coordinated solution in the resolution of cross-border banking groups.

At the European level, this international initiative has materialised in the Banking Recovery and Resolution Directive (BRRD), which ensures a harmonised resolution framework in the EU. That framework was completed, as part of the creation of the Banking Union, with the institution of the Single Resolution Mechanism (SRM), which has twin objectives: i) to centralise the resolution decision-making process, with the creation of the Single Resolution Board (SRB); and ii) to ensure the uniformity of resolution funding practices, with the creation of the Single Resolution Fund.

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<sup>1</sup> Document updated in 2014.

The BRRD addresses how to define the institutional framework responsible for managing crisis episodes. To this end, the countries must designate one or, exceptionally, several national resolution authorities<sup>2</sup>, which may be: national central banks, competent ministries, public administrative authorities or supervisory authorities. With regard to supervisory authorities, in order to ensure the necessary independence between the prudential supervision function and the resolution function, there must be functional separation between the two activities and independence in the assigned staff.

The BRRD was transposed into Spanish legislation through the approval of Law 11/2015 and Royal Decree 1012/2015 in June and November, respectively.

The law establishes the new institutional framework for resolution, observing the basic principle underpinning the necessary separation of the supervisory and resolution functions in the BRRD. The model draws a distinction between: i) preventive resolution functions, assigned to the Banco de España (which will perform that task independently from its supervisory functions), and ii) executive resolution functions, assigned to the FROB.

Also, the law assigns new functions (focused essentially on the pre-resolution phase) to the Banco de España as supervisory authority, equipping it with new tools which contribute to compliance with the objectives of safeguarding financial stability and minimising the effects on the system of institutions' individual crises.

## 5.2 Phases of the new resolution framework

The design of the new resolution framework covers three phases: i) *pre-crisis or preventive phase*, which seeks to incorporate ongoing analysis of institutions' resolution capacity into their day-to-day operations; ii) *early intervention phase*, with a major role for the supervisor, which is granted powers that supplement the other measures available to it to take action in relation to institutions when they start to show weakness but are still viable; and iii) *resolution phase*.

The following sections discuss the key elements of each phase and the distribution of the most significant tasks in the Spanish institutional framework, taking into account the new competence structure attributed to the ECB in the framework of the SSM and to the SRB as the single resolution authority in the framework of the SRM.<sup>3</sup> They also contain schemes showing the tasks assigned to each party under this legislation.

### Pre-crisis or preventive phase (business-as-usual)

In the ordinary course of business of the institution, the institution and the supervisory and resolution authorities must plan how to handle a critical situation or a potential resolution. To this end, the following key elements are drawn up:

- *Recovery plans*. All credit institutions must prepare recovery plans annually, for the purpose of defining the measures they would adopt to restore their financial position following a significant deterioration. The plans must include crisis scenarios, schedule which measures to adopt in each scenario and define a series of indicators that will serve as a reference to activate decision-making. They cannot be designed assuming any access to public financial

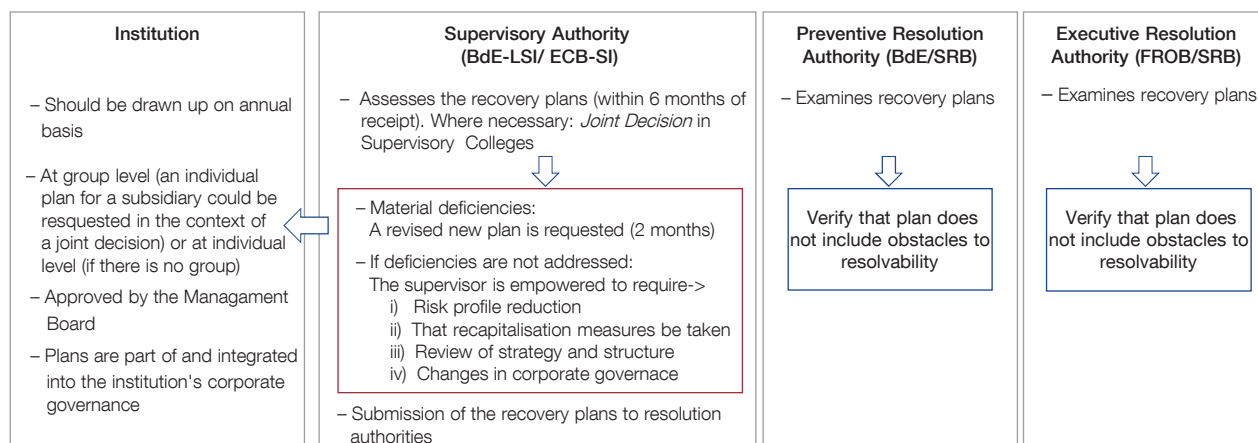
<sup>2</sup> In the case of the euro area countries, those national resolution authorities will act in conjunction with the SRB (the single resolution authority in the euro area, whose powers are extended to the institutions supervised directly by the ECB in the framework of the SSM and other cross-border groups).

<sup>3</sup> In the euro area and in the sphere of resolution, the SRB (which has been fully operational since 1 January 2016) has direct powers over SIs and over other cross-border institutions, and the national resolution authorities have powers over the other institutions.

support. The plans are reviewed by the competent authority, which may require the institution to adopt measures such as a reduction of the risk profile, a review of strategy and organisation, changes in corporate governance and, even, timely adoption of recapitalisation measures. The supervisor will submit the plans to the resolution authority, which will assess whether they include impediments to the institution's resolvability.

## RECOVERY PLANS

SCHEMA 5.1



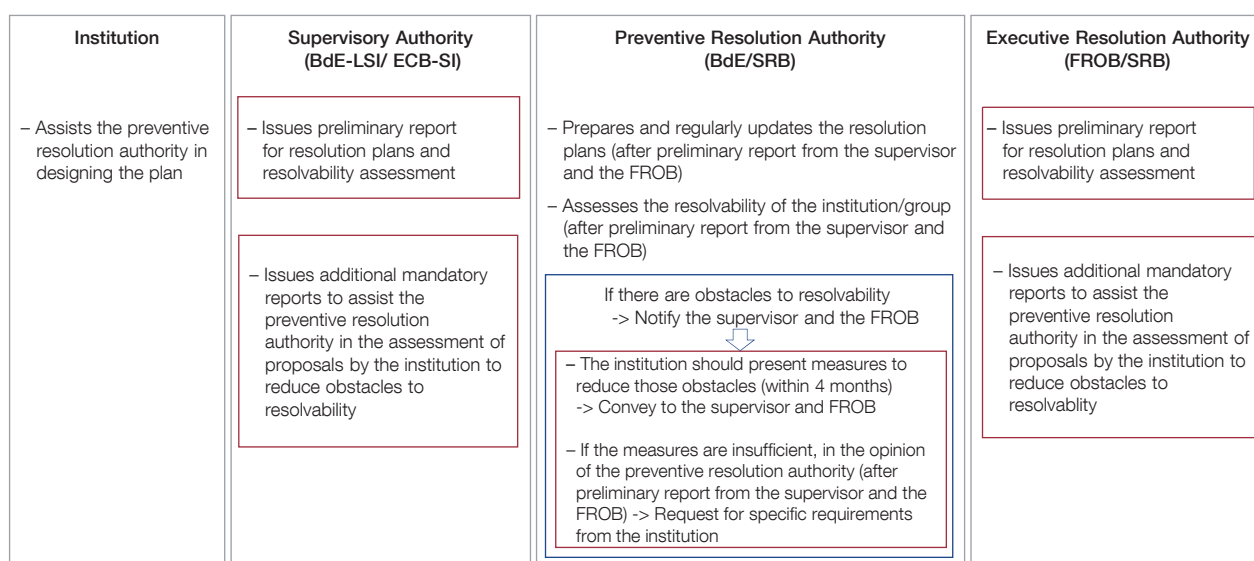
SOURCE: Banco de España.

- *Resolution plans.* The resolution plans are prepared by the preventive resolution authority and they include the likely strategy to be followed to resolve the institution, if necessary, and they describe the actions which, as and when the time comes, may be adopted. They cannot be designed assuming any access to public financial support either.

In the normal course of business of an institution, the institution (or its group) must ensure that it has an operational and legal structure that permits the

## RESOLUTION PLANS

SCHEMA 5.2



SOURCE: Banco de España.

continuity of the critical functions and does not prevent the swift execution of a potential resolution. Accordingly, at the same time as the preventive resolution authority prepares the resolution plan, it conducts resolvability assessments, and it may require the institutions to carry out structural or organisational changes or changes in lines of business in order to ensure that, if the institution becomes non-viable, it can be resolved.

The legislation allows the supervisor and the preventive resolution authority to establish that certain institutions are subject to “simplified obligations” in the preparation of recovery plans and in the design of resolution plans, respectively. To this end, some elements will be assessed with the purpose of analysing the negative effect that the failure of an institution and its winding up under normal insolvency proceedings might have on financial markets, on other institutions, on funding conditions and on the real economy.

- *Minimum requirement for own funds and eligible liabilities* (MREL) to be met by institutions as from January 2016, so that they have a liability structure that ensures sufficient loss-absorbing capacity and, as the case may be, adequate recapitalisation of the institution. The resolution authority will establish a transition period for achieving the MREL target it sets for institutions.

The MREL is to be complied with at consolidated and individual level (parent and subsidiaries).<sup>4</sup> The level is determined by the preventive resolution authority specifically for each institution (following consultation with the supervisor), taking two elements into consideration: “loss absorption” and “recapitalisation”<sup>5</sup> (which may be adjusted according to certain requirements).

In the international area, the FSB implemented a requirement for G-SIIs known as “total loss absorption capacity” (TLAC), the concept of which is similar to that of the MREL, although its calculation and characteristics are different (the details are given in section 1 of Chapter 6).

## SETTING THE MREL

SCHEMA 5.3

Supervisory Authority (BdE-LSI/ECB-SI)	Preventive Resolution Authority (BdE/SRB)	Executive Resolution Authority (FROB/SRB)
<ul style="list-style-type: none"> <li>– Advisory task or issuance of preliminary report (depending on cases) for setting the MREL</li> </ul>	<p>Sets the MREL:</p> <ul style="list-style-type: none"> <li>– SRB, if it is the group resolution authority (After consulting competent supervisory authority)</li> <li>– BdE, if it is the group preventive resolution authority (After preliminary report from the FROB and after consulting competent supervisory authority)</li> </ul>	<ul style="list-style-type: none"> <li>– Issues preliminary report for setting the MREL</li> </ul>

SOURCE: Banco de España.

- *Intra-group financial support agreements.* These are framework agreements entered into between institutions (parent and/or subsidiaries) of a group subject to supervision on a consolidated basis for the provision of financial

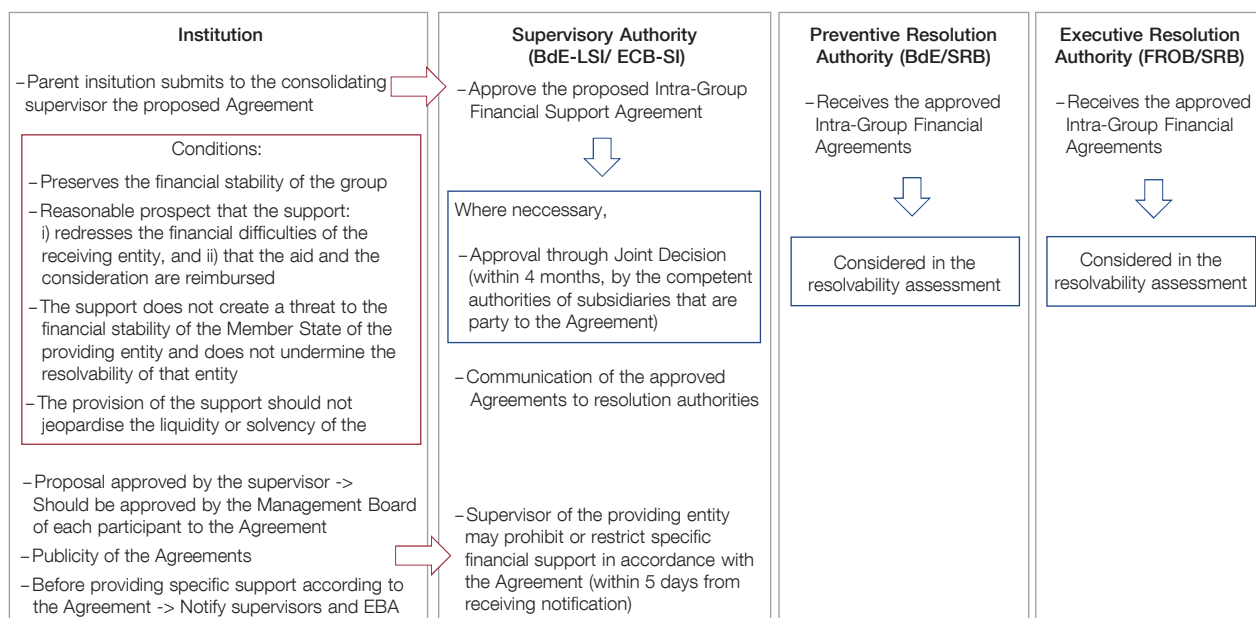
<sup>4</sup> However, exceptions are permitted in the individual requirement if certain requirements are met.

<sup>5</sup> The first element is linked to the current capital requirement applicable to the institution. The second element is determined by the capital requirements needed to meet the authorisation conditions once the resolution tool has been applied and taking into account the optimum level of capital needed to restore market confidence.

support in the event that an institution enters into an early intervention situation.<sup>6</sup> Those agreements must be authorised by the consolidating supervisor in a joint decision-making process with the supervisors of each subsidiary party to the agreement. As an additional precaution, before lending support in the framework of those agreements, the lender's supervisor may prohibit or restrict the granting of such support if it considers that certain premises of the legislation have been breached.

## INTRA-GROUP FINANCIAL SUPPORT AGREEMENT

SCHEMA 5.4



SOURCE: Banco de España.

Early intervention phase  
(significant deterioration  
of the institution)

Early intervention is activated at the request of the competent authority when the institution breaches or it likely that it will breach the solvency regulations but it is considered that it may comply with them once again by its own means. It is activated before the institution's resolution becomes necessary and with a view to avoiding it. From the start of the early intervention process (and the resolution process described below), the judges must not give an institution's petitions for insolvency leave to proceed; therefore, from that moment, actions are conducted in the administrative sphere.

The supervisor may, inter alia, force through the adoption of measures included in the recovery plan, require changes in the institution's strategy and the removal of directors and managers and, in extreme cases, decide on the intervention of the institution if the other measures prove to be insufficient.

The measures imposed are subject to monitoring to check the degree of compliance. The supervisor will inform the resolution authorities that the conditions for triggering early intervention are met<sup>7</sup> and of the measures imposed and their fulfilment.

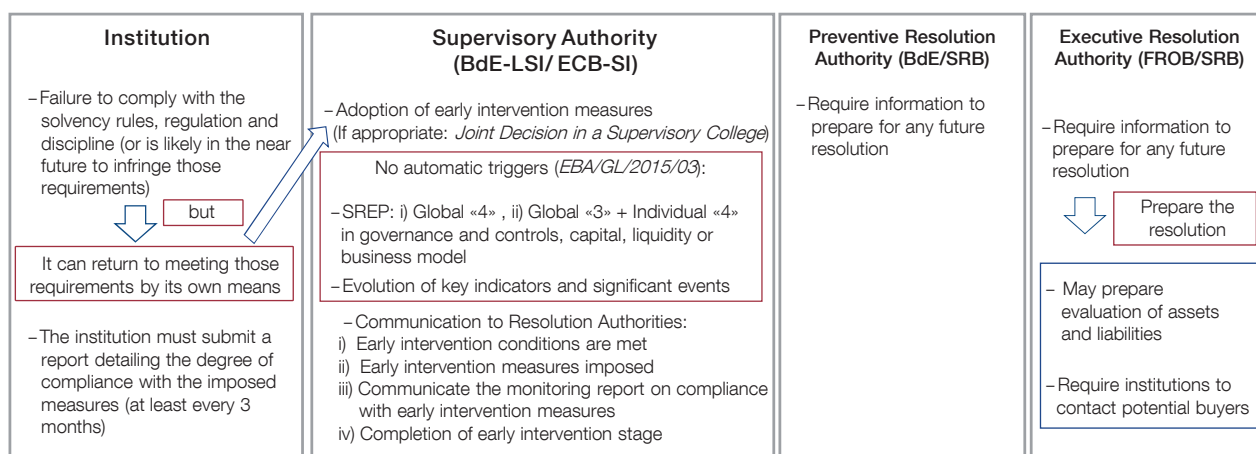
<sup>6</sup> Upon the entry into those agreements, none of the parties must be in a situation that activates early intervention..

<sup>7</sup> The resolution authority, in this phase, even has the power to require the institution to contact potential purchasers in order to prepare for resolution.

Identifying the time at which early intervention should be triggered is essential to avoid the institution's rapid deterioration and its failure. In that connection, the Banco de España has adopted the guidelines issued by the EBA on the thresholds for triggering early intervention (EBA/GL/2015/03). Those thresholds, which are not automatic, are linked to the outcomes of the institution's SREP, to significant events that may have an impact on the institution, and to the outcomes of the monitoring of key indicators of the institution's financial situation.

## EARLY INTERVENTION

SCHEMA 5.5



SOURCE: Banco de España.

Resolution phase  
(point of non-viability)

In order to commence the resolution process the following steps must be taken: i) determine the institution's failure; ii) verify that there are no private alternatives, supervisory or early intervention measures, or the write-down or conversion of capital instruments that might prevent failure; and iii) analyse whether it is in the public interest. If the last-mentioned premise is not met, the institution would be wound up under normal insolvency proceedings.

In Spain, it is the supervisor that determines an institution's failure, following consultation with the preventive resolution authority and the FROB. However, the FROB may urge the supervisor to make such a determination if it considers there are reasons to do so<sup>8</sup>, and the supervisor must give a justified response within three days.

In determining failure, expert opinion is essential. For these purposes, the Banco de España has adopted the guidelines published by the EBA on the circumstances that permit the determination of failure (EBA/GL/2015/07), as described in point 2 of Chapter 6.

The verification that there are no private or supervisory measures or that the write-down or conversion of capital instruments might prevent failure is the joint responsibility of the supervisor and the executive resolution authority.

Lastly, the assessment of public interest falls to the executive resolution authority.

The range of instruments available to the executive resolution authority includes the sale of the business, the transfer of assets or liabilities to a bridge institution or to an asset management vehicle, and the bail-in.

<sup>8</sup> Based on the information provided by the supervisor.

The bail-in, which entered into force Europe-wide as from January 2016<sup>9</sup> and which extends to the bank's creditors the obligation to absorb losses, is one of the cornerstones of the resolution framework; however, deposits guaranteed under the Deposit Guarantee Fund legislation, inter alia, are exempt. A golden rule in the application of that measure is the no creditor worse off principle, which implies that no creditor will bear losses greater than the amount of losses it would have borne if it had been wound up under insolvency proceedings.

The application of the bail-in must be accompanied by a business reorganisation plan, prepared by the institution, which will include measures aimed at restoring long-term viability within a reasonable timescale. That plan must be assessed by the executive resolution authority in cooperation with the competent supervisor.

## RESOLUTION PHASE

SCHEMA 5.6

Conditions for resolution	Functions of the Authorities in the resolution phase	
<p>1 "Fail or likely to fail" determination.</p> <ul style="list-style-type: none"> <li>– Made by the supervisor (after consulting both the preventive resolution authority and the FROB)</li> <li>– The FROB may call on supervisor to determine "fail or likely to fail" status (the supervisor shall reply within 3 days)</li> </ul>	<p>Executive Resolution Authority</p> <ul style="list-style-type: none"> <li>– Evaluation of assets and liabilities</li> <li>– Opens the resolution (discloses it publicly)</li> <li>– May resolve to replace directors</li> <li>– Executes the resolution tools</li> </ul>	<p>Supervisor</p> <ul style="list-style-type: none"> <li>– Depending on the use of resolution tools: intervenes in the process of authorisation/withdrawal of banking licence and evaluation of qualifying holdings</li> <li>– Participate in the approval of the business reorganisation plan (in cooperation with the FROB and the preventive resolution authority)</li> </ul>
<p>2 There are no other private alternative measures, supervisory measures or early intervention measures to resolve the situation (under the judgment of the FROB in cooperation with the supervisor)</p>		
<p>3 There are reasons of public interest (assessment performed by the FROB)</p>		

SOURCE: Banco de España.

### 5.3 Supervisory activity in the resolution framework in 2015

In 2015, practically all the groups of significant Spanish institutions submitted their recovery plans in accordance with the BRRD requirements.<sup>10</sup> The Banco de España is currently assessing these plans in the context of the work performed by the JSTs.

Additionally, in the last quarter of the year meetings were held by the Crisis Management Groups<sup>11</sup> of the two largest Spanish groups (Santander and BBVA), aimed at preparing the coordinated management among authorities of the group's recovery and resolution plans should they have to be activated.

With regard to less significant institutions, the Banco de España, in cooperation with the ECB, is working on the definition of which LSIs will be subject to simplified obligations in the submission of their recovery plans.

<sup>9</sup> Previously, Chapter VII of Law 9/2012 of 14 November 2012 on credit institution restructuring and resolution (partially repealed) provided for the use of the bail-in tool, although it was limited to the sphere of hybrid and subordinated debt instruments. Therefore, unlike the current legislation, it did not provide for its application to senior debt issues, among other liabilities.

<sup>10</sup> The two largest Spanish groups (BBVA and Santander) have already been submitting recovery plans following the FSB guidelines for several years.

<sup>11</sup> The Crisis Management Groups, which were created under the principles and standards implemented by the FSB, are colleges in which various authorities participate with a view to planning and coordinating the crisis management of banking groups with cross-border activities. The participants in those groups are supervisory authorities, central banks, resolution authorities, finance ministries and authorities responsible for deposit guarantee schemes.