BRRD transposition in Spain: a milestone in implementing an effective resolution regime

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Today it has been published in the BOE the transposition of the Bank Recovery and Resolution Directive (BRRD) in Spain (*Ley 11/2015 de recuperación y resolución de entidades de crédito y empresas de servicios de inversión*) approved by the Spanish Parliament last 11 June. It will enter into forceon 20 June.

This is the last step on the implementation of a resolution framework which sets out the responsibilities, instruments and powers to enable Spanish authorities (the Bank of Spain and the FROB) to resolve failing banks in an orderly manner, by protecting critical functions and without exposing the taxpayer to the risk of loss.

The newly implemented law substitutes the former Spanish resolution framework (Ley 9/2012) implemented in the context of the Financial Assistance Program led by the Troika in 2012. The new resolution powers and tools are based on four main pillars:

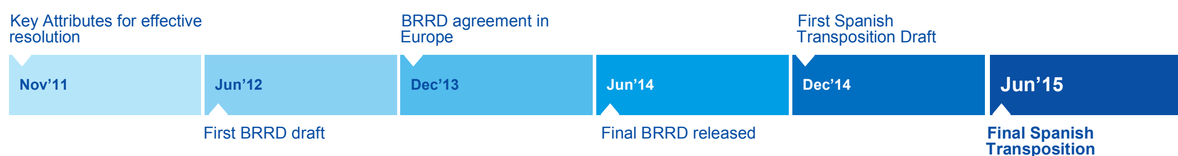
- The new law sets a two-tier institutional framework. On the one hand, the Bank of Spain would be responsible for pre-resolution tasks organized under two different units: i) the supervisor will assess the recovery plan and ii) the new resolution unit will develop de resolution plan. On the other hand, an independent institution (the *Fondo de Restructuración Ordenada Bancaria* – FROB) will be responsible for all resolution functions on the execution phase.
- The new resolution tools provide a wide range of options to deal with banks in troubles. Particular attention should be paid to the new hierarchy of claims in the insolvency law providing a maximum degree of protection for retail deposits.
- Spain shall establish a Resolution Fund for the purpose of ensuring the effective application of the resolution tools which will gradually be merged at the eurozone level between 2016 and 2024. This fund will be constituted by annual contributions from credit institutions with a target level of at least 1 percent of the covered deposits of all entities. The resolution fund may assume losses only after shareholders and debt holders have assumed losses up to at least an 8% of the liabilities. This constitutes an additional cushion for retail deposits, even for those not covered by the deposit guarantee scheme
- On the subordination issue Spain follows a contractual approach. In fact it changes the Spanish Insolvency law making tier 3 debt feasible and credible. Whether or not other European countries will implement a contractual or statutory approach is not clear yet. However, it is worth to emphasize that a harmonized subordination scheme across Europe is highly desirable.

The BRRD transposition process in Spain

Last 11 June the Spanish Parliament approved the transposition of the Bank Recovery and Resolution Directive (BRRD) in Spain (*Ley de recuperación y resolución de entidades de crédito y empresas de servicios de inversión*. (Law 11/2015, of 18 June)[1] and it will enter into force on 20 June. This step constitutes a key milestone in the new regulatory framework that surged in the onset of the crisis. **In 2011, in Cannes (France), the G20 members reached a commitment** to implement in their local jurisdictions a new resolution framework which should set out the responsibilities, instruments and powers to enable authorities to resolve failing financial firms in an orderly manner, by protecting critical functions and without exposing the taxpayer to the risk of loss.

Figure 1

Main milestones in the BRRD implementation process



Source: BBVA Research

Two years later, on 12 December 2013, the European leaders reached a final agreement on the BRRD after several months of negotiations between the European Commission, the European Council and the European Parliament. Note that the first BRRD draft was launched for consultation by the European Commission in June 2012. The enforcement of BRRD was scheduled for two dates: i) 1 January 2015 with 12 months for transposition, and ii) the bail-in regime to impose losses on senior debt will be introduced from 2016 onwards. Finally, on 12 June 2014, the BRRD was published in the Official Journal of the European Union.[2]

In parallel, the euro area leaders reached an agreement to implement a **Single Resolution Mechanism** (SRM) for all the institutions located in the eurozone.[3] In fact, it constitutes the third big step towards a credible Banking Union. A centralised power of resolution is entrusted to the Single Resolution Board (SRB) and to the national resolution authorities, and complemented with the Single Resolution Fund (SRF). The SRM is interwoven with the process of harmonisation in the single rulebook and the establishment of the Single Supervisory Mechanism (SSM) to which the application of Union prudential supervision rules is entrusted. Supervision and resolution are two complementary aspects which are mutually dependent. It is worth mentioning that the SRM becomes fully operative from January 2016.

The final step in the legislative process in Europe is to transpose the BRRD and SRM powers into the national laws. In Spain, the BRRD's transposition began in December 2014, when the Spanish Treasury published a consultative draft law. After a long legislative procedure and several months of discussions, **the Spanish Parliament approved the new resolution law in Spain on 11 June.**

Although the BRRD transposition is something new in most of the European countries, Spain did already implement some elements of the resolution regime in the context of the Financial Assistance Programme led by the Troika. In particular, in November 2012, **the Spanish government implemented a new resolution law, *Ley 9/2012***, which included a new resolution authority in Spain, the *Fondo de Restructuración Ordenada Bancaria* (FROB), and provided it with a series of tools and powers to tackle banks in crisis. This law was used by the Spanish authorities to carry out successfully the resolution of several institutions (such

1Law 11/2015, of 18 June 2015: http://www.boe.es/boe/dias/2015/06/19/pdfs/BOE-A-2015-6789.pdf
[2]Directive 2014/59/EU of 12 June 2014
[3]Regulation 806/2014 of 15 July 2014

as Bankia or CantalunyaCaixa). Despite its robustness and effectiveness dealing with ailed Spanish banks, the *Ley 9/2012* does not include all the tools and powers of the BRRD. As shown in Table1, the new resolution law clarifies the institutional framework and includes the transposition of those aspects of BRRD pending implementation..

Table 1
New resolution law versus the existing Ley 9/2012

	Ley 9/2012	BRRD Transposition (Law 11/2015, of 18 June)
Resolution Authority	✓	✓(clarifying the Bank of Spain, FROB and SRB roles)
Resolution Plan	X	✓
Recovery Plan	X	✓
Early Intervention measures	✓	✓
Resolution tools:		
Sale of business tool	✓	✓
Bridge institutions	✓	✓
Asset separation	✓	✓
Bail-in	≈ (only junior debt)	✓
Resolution Fund	X	✓

Source: BBVA Research

The new resolution institutional framework in Spain

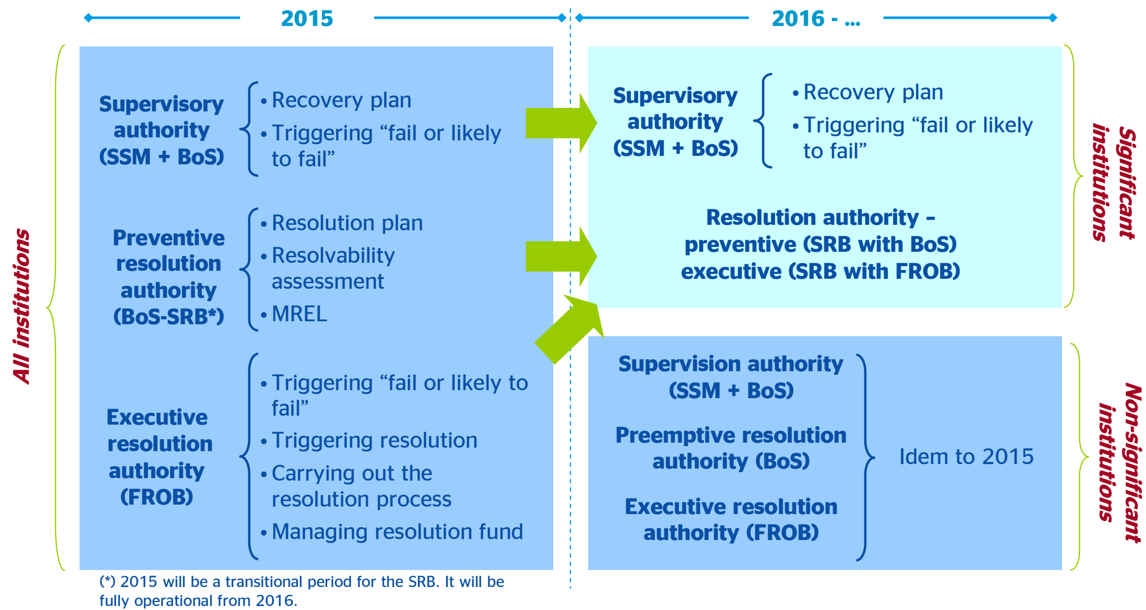
One of the main cornerstones of the BRRD is the creation of a new authority responsible for carrying out the pre-emptive and resolution task. Although the BRRD recommends the establishment of an unique resolution authority, article 3 allows that on exceptional basis, more than one resolution authority may coexist even allowing that the supervision authority assume resolution functions as long as there are arrangements to ensure operational independence between both functions.

Spain has already a resolution authority, the FROB, which was launched in 2012. Therefore, aimed at fulfilling the BRRD' goals while not affecting the on-going restructuring and resolution processes (the FROB is still carrying out the restructuring process of a few banks such as Bankia), the **new Spanish resolution Law sets up a two-tier approach**:

- **The Bank of Spain** will be responsible for pre-resolution tasks organized under two different units:[4]
    - First, the Directorate General of Banking Supervision together with the Single Supervisory Mechanism (SSM) will be responsible, among others, for assessing the recovery plan developed by each bank.
    - Second, the Bank of Spain has launched a new resolution unit which will be responsible for developing the resolution plan and analyzing how to deal with the resolvability barriers.
- **The FROB** will be responsible for all resolution functions on the execution phase.

[4] See the Bank of Spain organizational chart http://www.bde.es/bde/en/secciones/sobreelbanco/organizacion/Organigrama/

Figure 2
New institutional powers in Spain from June 2015



Source: BBVA Research

In this vein, on 11 June 2015, the **ECB has published an opinion**[5] on the separation of the resolution powers between Bank of Spain and FROB. It welcomes the fact that the Spanish law, particularly on Chapter VII art.57 and 58,has specific provisions on the cooperation and coordination between both Spanish authorities and other European authorities (the SRB and the ECB).Additionally, the ECB also welcomes the provisions on functional and hierarchical separation between the supervision duties and recovery and preparatory resolution powers,

Nevertheless, this scheme is transitional. It **will substantially be modified when the SRM will fully enter into force in 2016**. From that date on, the SRB in cooperation with the national authorities (the Bank of Spain and the FROB) will assume at the same time the preventive and executive resolution powers for all significant entities which account around 90 per cent of the total Spanish banking sector.

Finally it is worth mentioning that the institutional framework adopted in other EU countries, with the exception of Finland, have opted to place the resolution authority under the same roof as the supervisory authority.[6] Nevertheless, as mentioned above, the matter is not where the functions are located but how the organisational and coordination measures have been adopted to clearly define the roles and responsibilities to ensure operational independence and avoiding conflicts of interest while ensuring the higher degree of cooperation and coordination between the supervisory and resolution functions.

[5]Opinion of the ECB of 10 June 2015 on the recovery and resolution of credit institutions and invest firms: http://www.ecb.europa.eu/ecb/legal/pdf/en_con_2015_19_f_signed.pdf
[6] See Box 4.1of the Bank of Spain Financial Stability Report (November 2014). http://www.bde.es/f/webbde/Secciones/Publicaciones/InformesBoletinesRevistas/InformesEstabilidadFinancera/14/FSR-November2014.pdf

The resolution tools in the Spanish context

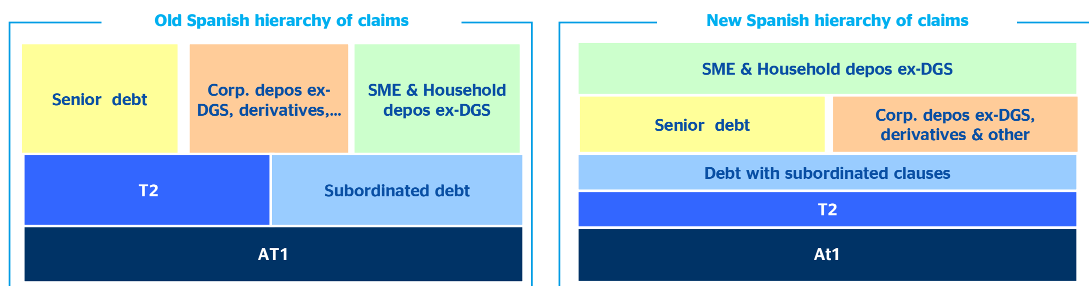
The new Spanish resolution regime, which aims at transposing the BRRD and completing the existing resolution law (Ley 9/2012), is based on four main pillars reflecting the different stages of the recovery and resolution planning and execution:

- **Preparation and prevention**: all banks must annually draw up recovery plans which will be assessed by the supervisory functions. In parallel, resolution authorities must prepare resolution plans that ensure the continuity of critical functions. A key element when developing the resolution plan is the identification of the obstacles to resolvability and which measures may be imposed to reduce or remove such impediments to resolvability.
- **Early intervention measures**: the supervisor may activate the early intervention process if a bank does not meet regulatory capital requirements or is likely to breach them. The institution must restore its financial situation by implementing recovery measures, and/or adopting key reforms or restructuring its debt with creditors, among other measures.
- **Resolution powers and tools**: the resolution phases are activated only if the recovery or the early intervention measures fails. Authorities would take control of the institution and activate any of the following resolution tools: i) sale of business; ii) bridge bank; iii) asset separation, and iv) debt conversion or write down (bail-in, the main novelty).

  The bail-in tool is one of the cornerstones of the resolution process. The Ley 9/2012 already provides bail-in powers to the Spanish resolution authority (the FROB) but only limited to junior debt. The **new law extends the bail-in powers to all types of unsecured liabilities**.

  Moreover, the new resolution law introduces a **new hierarchy of claims in the insolvency law providing a maximum degree of protection for retail deposits, even for those not covered by the deposit guarantee scheme** as shown in Figure 3. Although the introduction of the bail-in radically changes the fundamentals of the unsecured creditors, the introduction of a super-seniority feature for retail deposits versus the senior debt and corporate deposits provides them with an enormous cushion against losses.

  Figure 3
  New hierarchy of claims in the Spanish insolvency law



Source: BBVA Research

- **Resolution Fund**: European countries shall establish one or more financing arrangements for the purpose of ensuring the effective application of the resolution tools. This fund will be funded by the financial sector. In fact, it will be constituted by **annual contributions from credit institutions** with a target level of at least 1 percent of the covered deposits of all entities to be reached in 2024.

From 2016 onwards, when the SRM will be fully operational, the national fund will gradually be merged with other national funds from Member States of the eurozone in a **Single European Resolution Fund** (SRF). Thereafter, the national resolution fund will only be operational for investment services firms.

To sum up and from an operational standpoint, the key of the new law is that, in case an entity enters into resolution, shareholders and debt-holders (junior and senior) will have to **assume losses up to at least 8% of the liabilities before having recourse to the private resolution fund**, orany kind of public aid. After the bail-in, the Resolution Fund (national or European) can be tapped, up to a limit of 5% of the bank's liabilities as well.

How do Spanish authorities solve the subordination issue?

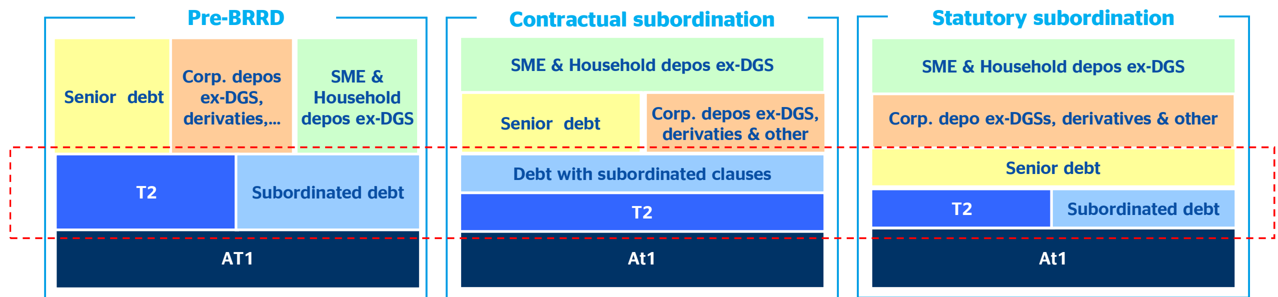
The new resolution framework seeks to avoid bail-outs with bail-in. In order for this new philosophy to be credible, banks must have enough liabilities with loss-absorbency capacity without facing any sort of legal challenge. In this vein, authorities would require banks to have a minimum amount of instruments that can be legally, feasibly, effectively and operationally written down or converted into equity in case of resolution. This is the aim of the FSB's TLAC and the BRRD's MREL. Based on those principles, capital instruments (CET1, AdT1 and T2), together with long-term subordinated unsecured debt – contractually or statutorily – will be fully eligible to comply with this new requirements.

However, doubts arise on how unsecured debt will absorb losses. As shown in Figure 3, unsecured senior debt ranks *pari-passu* to instruments which are less credibly bailed out, or for where the feasibility to absorb losses is less clear. These implies that unsecured senior debt needs to be subordinated to these instruments to the extent that the authorities want to avoid legal challenges (and not putting at risk the principle of No Creditor Worse Off than in Liquidation which is at the center of the resolution framework). How to structure this subordination is a challenging question. Three different options can be used:

- Structural: senior debt is subordinated by being issued from a pure holding company above the operating bank.
- Contractual: senior debt is subordinated by including contractual clauses which specifically state this particular feature.
- Statutory: all senior debt is subordinated by law and therefore traditional senior debt is totally replaced by subordinated senior debt.

Structural subordination is not applicable in Spain, since Spanish banks are not structured with pure (non-operating) holding companies. There are therefore **two options left – contractual or statutory –** as shown in Figure 4.

Figure 4
Contractual subordination versus statutory subordination



Source: BBVA Research

The path followed in Spain to overcome the subordination issue has been the contractual one. Aimed at easing this type of subordination, the BRRD transposition in Spain incorporates an amendment to the national insolvency law, which provides legal certainty to the issuances of senior debt with subordination clauses embedded (known as subordinated senior debt or Tier 3).

Particularly, the new resolution law has included an additional provision[7] which changes Article 92 of the Spanish Insolvency Law. By virtue of this amendment, there are two main characteristics:

- The new hierarchy of claims is:
    - Any contractually subordinated debt which does not qualify as Tier 2 or Additional Tier 1 (the so called Tier 3)
    - Subordinated debt qualifying as Tier 2.
    - Subordinated debt qualifying as Additional Tier 1.
    - Equity instruments (CET1)
- This loss-absorbing liabilities scheme is the same for insolvency than for resolution and therefore it minimizes the risk of breaching the “No Creditor Worse Off than in Liquidation” principle.

The only question which may remain open with the Spanish approach and that should be carefully analyzed is regarding the subordination language used in the prospectus of the outstanding Tier 2 debt, which may not allow issuing other subordinated debt ranking above them.

This approach is different from the one currently being considered in Germany. On 10 March 2015, the **German Government** launched for consultation its draft BRRD transposition, being the first European country to propose the **introduction of a statutory subordination of senior debt** amending the insolvency law.

It is true that the statutory subordination increases confidence in the effectiveness of senior debt bail-in, helps banks to comply with the new TLAC/MREL ratio, and enhances the credibility and feasibility of the new resolution principle “more bail-in & less bail-out.” However, this type of subordination has also some weaknesses in terms of less financing instruments available from an issuer's perspective (probably worse), has an unfair treatment for current investors, and would have procyclical effects as long-term funding would be jeopardized in stressed periods.

[7] Chapter VI, Section 5, Article 48

It is worth to emphasize that it is important to achieve a **homogeneous and credible resolution framework at EU level (or at least at the eurozone level)**, not only in terms of MREL ratio's features but also in terms of hierarchy of claims, for several reasons:

- The common resolution authority (SRB) fully enters into force on 1 January 2016. It is difficult to envisage a single authority having to deal with different hierarchies of creditors.
- A homogenous subordination approach at EU level is critical in order to reinforce the standardization achieved through the Bank Recovery and Resolution Directive (BRRD).
- Divergent senior debt treatment across Member States would create distortions in the way that entities comply with TLAC/MREL requirements.
- Markets and creditors require upfront clarity and predictability about the treatment of the instruments they have invested in. In this vein, the lack of consistency at EU level will reduce this market attractiveness.
- Heterogeneous creditor hierarchies will distort the banking sector by making fund raising more complex and therefore unnecessarily impacting competitiveness of the EU financial services sector.

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