



EUROPEAN COMMISSION

Brussels, 28.1.2010
C(2010)504 final

Subject: State aid N 28/2010 - Spain
Recapitalisation measures in favour of the banking sector in Spain.

Sir,

I. PROCEDURE

1. On 19 January 2010, Spain notified a recapitalisation scheme in order to carry out the restructuring of the Spanish banking system by maintaining confidence in the national financial system and enhancing its strength and solvency so that the credit institutions are sound and able to provide credit to the real economy normally ("**the Scheme**").
2. The legal basis for the Scheme is the Royal Decree-Law 9/2009 of 26 June, *sobre reestructuración bancaria y reforzamiento de los recursos propios de las entidades de crédito* and a draft Resolution of the *Fondo de Reestructuración Ordenada Bancaria* ("**the FROB**") implementing Article 9 of the Royal Decree-Law.

II. DESCRIPTION

II.1.Objectives and beneficiaries

3. The FROB was established, in the context of the financial crisis, to provide public support for the consolidation of the Spanish banking sector by, inter alia, strengthening the capital buffers of credit institutions. The Scheme allows the FROB to acquire convertible preference shares to be issued by credit institutions ("**the FROB Securities**").
4. The beneficiaries of the Scheme are credit institutions established in Spain ("**the Beneficiaries**").
5. Spain indicated that both fundamentally and non-fundamentally sound credit institutions are eligible under the Scheme.

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6. For the purpose of the Scheme, the FROB considers Beneficiaries to be fundamentally sound when the following cumulative conditions are met:
 - i) According to Bank of Spain the Beneficiary does not present any weakness that can affect its viability in the light of the evolution of financial markets;
 - ii) the result of dividing the sum of "capital social" (for commercial banks), or "fondos fundacionales" and "cuotas participativas" (for saving banks) or "aportaciones al capital social" (for cooperative banks) plus reserves and generic provision by the risk weighted assets ("**RWA**") must be at least 6%; and
 - iii) the amount of the capital injection by the FROB does not exceed 2% of the RWA. However, in some circumstances this threshold can be exceeded if the additional amount of the capital is linked to the costs of the integration between banks to achieve higher efficiency¹. In addition, where a Beneficiary has a rating at least of "single A" with a "positive" or "stable" outlook granted by an external rating credit agency² this will be considered as an indicator of the Beneficiary's lower risk profile without, however, being a requirement for a Beneficiary to be considered as fundamentally sound.
7. Special behavioural safeguards described below in Section II.4 will apply to Beneficiaries which meet conditions i) and ii) above but need a recapitalisation in excess of 2% RWA if, according to **the Recapitalisation Communication**³, they are to be considered non-fundamentally sound.
8. In order to benefit from the Scheme, Beneficiaries will need to draw up a plan, setting out the specific measures and commitments to be implemented in order to achieve increased efficiency and solvability. This plan will have to be approved by the Bank of Spain.
9. Before each recapitalisation takes place the Bank of Spain will assess the risk profile of the Beneficiary. The FROB will communicate to the Commission the results of that assessment so that the Commission can also assess the situation and draw the necessary consequences, such as the needs to provide a restructuring plan, to pay an adequate remuneration on the FROB Securities or to respect a ban on coupon payments on hybrid instruments.
10. For Beneficiaries needing a second recapitalisation, the Spanish authorities have committed to notify each additional measure individually.
11. In addition, in cases where the FROB intends to subscribe for FROB Securities in excess of 2% RWA in Beneficiaries which are non-fundamentally sound, Spain commits to

¹ As set out in paragraph 2 c) of the *Norma Segunda* of the draft Resolution of the FROB these exceptional circumstances are: a) the downgrading of the rating and the consequent increase in the cost of funding, b) divestiture costs associated with the duplication of facilities and/or the redesign of business models and c) inefficiencies due to the restructuring process. Normally, costs of integrations are due to: IT infrastructure, reorganization of processes, reorganization of branches network, etc.

² As defined in directive 2006/48/ec of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) OJ L 177, 30.6.2006

³ Communication from the Commission - The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition, OJ C 10, 15.1.2009, p. 2.

notify the conditions of the recapitalisation as well as the restructuring plan for the Beneficiary in line with **the Restructuring Communication**⁴.

12. The subscription of the FROB Securities by the FROB will be capped as a maximum to the amount necessary for the Beneficiary to reach a Tier 1 ratio of 8% taking into account the potential economic losses in a two-year time horizon.

II.2. Temporal and material scope of the Scheme

13. The Scheme is valid until 30 June 2010.
14. The FROB has legal personality and full public and private capacity to implement its objectives. The FROB is funded by the State Budget and by the Deposit Guarantee Funds of commercial banks, savings banks and credit cooperatives.
15. The FROB has an established original funding of EUR 9 billion, of which EUR 6.75 billion is contributed by the State Budget and the rest (EUR 2.25 billion) has been contributed by the Deposit Guarantee Funds. In addition, the FROB may resort to outside funding to finance its activities; however, outside funding may never exceed 10 times its original funding.

II.3. THE FROB SECURITIES

16. The FROB Securities constitute perpetual convertible preference shares and are part of the non-core Tier 1 capital of the Beneficiary.
17. Interest paid on the FROB Securities is not cumulative and will be paid whenever and to the extent that the Beneficiary⁵ has distributable profits.
18. The remuneration of the FROB Securities is equal to the minimum of:
 - a) 7.75% annual yield; or
 - b) 5Y Treasury bonds issued by the Kingdom of Spain plus 500 basis points ("**bp**").

In both a) and b) an additional 15 bp will be added annually as a step-up clause as from the first year of issuance until the fifth year. For the FROB Securities outstanding after the fifth year, an additional step-up clause of 100 bp per year will apply in the sixth and seventh years respectively.

19. Should the Beneficiary breach the behavioural safeguards described in Section II.4 below, the remuneration on the FROB Securities will be increased by 200 bp.
20. As from the date of issuance, the Beneficiaries commit to repurchase the FROB Securities as soon as they are in a position to do so. At the end of the fifth year, the

⁴ Commission Communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under State aid rules, OJ C 195, 19.8.2009, p. 9.

⁵ According to Norma Sexta of the draft Resolution of the FROB, this includes the banking group or the sub-consolidated banking group of the Beneficiary as defined by the Spanish Law.

- FROB Securities will have to be bought back or converted⁶ into ordinary shares (or its equivalent items⁷) of the Beneficiary.
21. In exceptional circumstances⁸ and with the prior authorisation of the Bank of Spain, the FROB may extend the five-year period for an additional two years. If, after this additional period, the Beneficiary is not able to buy back the FROB Securities, the FROB may convert the FROB Securities into ordinary shares (or equivalent items).
 22. In addition, should the Bank of Spain consider the buy-back to be unlikely in view of the situation of the Beneficiary (or its group), the FROB may convert the FROB Securities into ordinary shares (or its equivalent item) of the Beneficiary at any time.
 23. Upon conversion, should the Beneficiary find itself in a weak position the restructuring process described in Article 7 of the Royal Decree-Law 9/2009 will be applied. In those cases, the FROB will be appointed as the Beneficiary's interim administrator and, within one month, it will submit a plan to Bank of Spain specifying the proposed course of action for the Beneficiary, which would imply its merger or absorption by another credit institution and/or the full or partial transfer of its business to other credit institutions.
 24. The conversion of the FROB Securities into ordinary shares (or its equivalent item), will be notified by the FROB to the Commission, including all relevant information regarding the situation of the Beneficiary at the time of the conversion and the FROB's intentions as regards the ordinary shares (or equivalent items) subscribed for in the Beneficiary.

II.4.BEHAVIOURAL SAFEGUARDS

25. In order to benefit from the Scheme the Beneficiaries must agree:
 - a) to refrain from non-organic growth;
 - b) not to use the fact that they benefit from the Scheme for advertising or marketing purposes or carry out aggressive commercial strategies;
 - c) to accommodate the remuneration of senior management to the applicable Union rules and to the criteria laid down in the Commission Recommendation of 30 April 2009, *on the remuneration policies in the financial services sector*⁹; and
 - d) to cap dividend payment to 30% of annual profits or, in the case of savings banks, to limit distribution to "*obra benefico-social*" up to 30% of annual profits, unless a higher percentage is necessary to honour existing commitments.

⁶ In that case, FROB would receive ordinary shares of the Beneficiary (or equivalent items) with voting power in the highest governance board equal to the percentage of nominal value of the FROB Shares by total equity of the total voting rights, as of the conversion date.

⁷ Cajas de ahorro are a type of credit institutions in the Spanish legislation. They do not issue shares, which is a concept that applies to common joint stock companies ("sociedades anonimas"). However, the "cuotas participativas" are securities issued by cajas de ahorro equivalent to ordinary shares, since they provide equivalent voting rights and participation in results to ordinary shares.

⁸ According to Article 9, paragraph 7, of the Royal Decree Law 9/2009 "If a consequence of the development of the economic-financial situation of the institution resulting from the integration process or from the evolution of market conditions, it becomes apparent that the plan cannot be complied with in the terms in which it was approved, the institution may ask the FROB for an amendments of these terms, which may include, amongst other matters, an extension for the period to repurchases the securities subscribed by FROB for a further two years".

⁹ OJ L 120, 15.5.2009

26. In cases where the FROB has subscribed for the FROB Securities in excess of 2% RWA of a Beneficiary which is nevertheless considered to be fundamentally sound, the following additional commitments will be required:
- a) to divest at least 10% of the installed capacity;
 - b) to refrain from increasing the number of branches in Spain;
 - c) not to pay dividends or, in the case of savings banks, not to distribute any amount to the "obra benefico-social" for new projects; and
 - d) to maintain the staff productivity ratio between the revamped branch network and the central services during the next five years.
27. In cases where the FROB subscribes for the FROB Securities in Beneficiaries which are non-fundamentally sound as described in paragraph 7 above, the following additional commitments are required:
- a) a reduction of 20% of the installed capacity;
 - b) after three years from the subscription of the FROB Securities, the aggregate total assets of the Beneficiary may not exceed 95% of the sum of the total assets of the credit institutions involved in the merger; and
 - c) not to remunerate any outstanding hybrid instruments unless this obligation stems from legal obligation.
28. Finally, according to Norma Novena of the draft Resolution of the FROB, upon the buy-back by a Beneficiary of the FROB Securities, the FROB may gradually (depending on the size of the buy-back), exonerate that Beneficiary from the behavioural commitments describe in paragraphs 25 a) and d) and 26 c) above.

III. REVIEW

29. Every six months, from the date of this Decision, the FROB will submit a report to the European Commission containing the information specified in paragraph 40 of the Recapitalisation Communication.
30. The Spanish authorities have committed to notify to the European Commission the prolongation of the Scheme after 30 June 2010, if such an extension proves to be necessary.

IV. ASSESSMENT

IV.1. State aid character of scheme

31. As set out in Article 107(1) TFEU, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.

32. The Scheme enables the Beneficiaries to secure capital on more favourable terms than would otherwise be possible in the light of the prevailing conditions in the financial markets. This gives an economic advantage to the Beneficiaries and strengthens their position compared to that of their competitors in Spain and in other Member States and must therefore be regarded as distorting competition and affecting trade between Member States. The advantage is selective since it only benefits the Beneficiaries, and it is provided through State resources.
33. In the current circumstances of financial crisis, capital injections would in all likelihood not be provided by market economy investors to the Beneficiaries on a comparable scale and on similar terms. As a consequence, the Scheme constitutes aid to the Beneficiaries within the meaning of Article 107(1) TFEU.

IV.2. Compatibility

Application of Article 107(3)(b) TFEU

34. In line with the **Banking Communication**¹⁰ and given the present circumstances in the financial market, the Commission considers that it may be acceptable to examine this measure under Article 107(3)(b) TFEU.
35. Article 107(3)(b) TFEU enables the Commission to declare aid compatible with the internal market if it has the effect "*to remedy a serious disturbance in the economy of a Member State*". It is clear that this provision needs to be applied restrictively and must tackle a disturbance in the entire economy of a Member State¹¹.
36. The Commission considers that the Scheme applies to the entire Spanish banking industry. Furthermore, the Commission believes that due to the role of the banking sector in providing funds to other sectors, the financial crisis is having a systemic effect on other economic sectors and thus the entire Spanish economy. Hence, it finds that the Scheme is apt to remedy a serious disturbance in the Spanish economy.
37. The Commission notes that the Spanish Ministry of Economy has consulted with the Bank of Spain on the design and implementation of the Scheme. The Bank of Spain will continue to play a major role in the implementation of the Scheme, and notably in the monitoring of the Beneficiaries.

Conditions for compatibility under Article 107(3)(b) TFEU

38. In line with the Banking Communication, in order for the Scheme to be compatible under Article 107(3)(b) TFEU, it must be appropriate, necessary and proportional.
39. With the Recapitalisation Communication, the Commission further refined its assessment criteria for State recapitalisation of financial institutions. The Communication acknowledges the appropriateness of capital support to financial institutions, notably to strengthen financial stability, to sustain lending to the entire economy and to deal with the risk of insolvency. It recalls three main goals of the Commission's control: ensuring fair

¹⁰ Communication from the Commission – The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, OJ C 270, 25.10.2008, p. 8.

¹¹ Cf. in principle Joined Cases T-132/96 and T-143/96 *Freistaat Sachsen and Volkswagen AG Commission* [1999] ECR II-3663, para. 167. Applied in Commission Decision in case C 47/1996, *Crédit Lyonnais*, OJ 1998 L 221, 8.8.1998, p. 28, section 10.1; Commission Decision in Case C28/2002 *Bankgesellschaft Berlin*, OJ L 116, 4.5.2005, p. 1, recitals 153 *et seq.*; and Commission Decision 2008/628/EC of 27 June 2007 in case State aid C 50/2006 implemented by Austria for BAWAG P.S.K., OJ L 83, 26.3.2008, p. 7, recital 166. See also Commission Decision of 5 December 2007 in case NN 70/2007, *Northern Rock*, OJ C 43, 16.2.2008, p. 1; Commission Decision of 30 April 2008 in case NN 25/2008, *Rescue aid to WestLB*, OJ C 189, 26.7.2008, p. 3; and Commission Decision of 4 June 2008 in Case C9/2008 *SachsenLB*, OJ L 104, 24.4.2009, p. 34.

competition between Member States, ensuring fair competition between credit institutions and ensuring a return to normal market functioning. The Recapitalisation Communication distinguishes between *fundamentally sound* and *distressed* credit institutions. In the case of temporary recapitalisations of the fundamentally sound banks, the Commission accepts a minimum remuneration based on the Eurosystem methodology of 20 November 2008. That methodology defines a pricing formula consisting of several components: i) the risk-free rate as of the date of the recapitalisation; ii) the average pre-crisis sovereign risk spread over the risk-free rate; and iii) a risk premium reflecting the degree of subordination of the securities in question. In addition, the Commission requests sufficient incentives to redeem the State participation when the market will so allow. Furthermore, competition safeguards have to be introduced to prevent the use of State funds for anti-competitive goals. Moreover, a regular review, every six months, has to take place on the basis of a report from the Member State. Finally, paragraph 46 of the Recapitalisation Communication takes into account the possibility that credit institutions' participation in recapitalisation operations is open to all or a good portion of credit institutions in a given Member State, also on a less differentiated basis, and aimed at achieving an appropriate overall return over time.

IV.3. Assessment of the conditions for compatibility under Article 107(3)(b) TFEU

a) Appropriateness and necessity

40. The Scheme is appropriate and necessary to achieve the goal of strengthening credit institutions and reorganizing some segments of the Spanish credit system.
41. The financial crisis and the fall of the real estate market in Spain have affected the Spanish credit market in two different ways:
 - Credit growth has slowed down. The volume of new lending has decreased significantly in recent months and it is not expected to recover in the near future. As a result of substantial past growth, some parts of the Spanish credit system are oversized, hence decreasing its efficiency. Consequently, a number of credit institutions need to revamp their business and recover their historically high efficiency levels.
 - Performance of outstanding credit has deteriorated and delinquency rates have risen sharply from very low levels. Those conditions are harming credit institutions by weakening their financial strength and hindering some of them from access the capital markets.
42. The strong link between credit activity and economic growth makes an overhaul of some parts of the Spanish credit system necessary, allowing fundamentally sound credit institutions to overcome their weaknesses and facilitating a return to normal lending conditions, which in turn will foster economic recovery¹².
43. According to the Spanish authorities there is an excess of capacity in the Spanish banking sector. The FROB is intended to provide the Beneficiaries with the means necessary to undertake the reorganization process leading to an adjustment of their size in order to be

¹² See Commission decisions in cases N507/08 Financial support measures to the Banking Industry in UK; N512/08 Rescue package for the financial institutions in Germany; N 560/2008, Support Measures for the Credit Institutions in Greece; and N 613/2008, Bank recapitalisation scheme in France, on: <http://ec.europa.eu/competition/elojade/isef/index.cfm>.

able to continue the lending to the real economy taking into account the change in the market. The Spanish authorities consider that the adjustment can be done through integration and rationalization of the credit institutions. In addition, by strengthening their capital position, access to capital markets will be eased.

44. The Scheme is appropriate and necessary to overcome the aforementioned drawbacks and improve the overall situation of the Spanish credit institutions, weakened by the current exceptional market circumstances.

c) Proportionality

45. In order to evaluate the proportionality of the Scheme, the Commission must check that distortions of competition resulting from this intervention are kept to a minimum, having regard to the risk of serious disturbances to the economy. According to the Recapitalisation Communication, for aid to be compatible with the internal market, a good balance must be achieved between the pursuit of common objectives and the distortion of competition between Member States and between credit institutions. Furthermore, recapitalisation schemes must also ensure that normal market operating conditions are restored as swiftly as possible. In this regard, the distortions of competition caused by the Scheme are minimised by various safeguards.

46. Above all, the amount of aid is minimised through a price that reflects current market conditions. This safeguard is proportionate and consistent with the Recapitalisation Communication and with the practice of the Commission for the following reasons:

- The overall remuneration of the FROB Securities adequately factors in: a) the specific features of those securities; b) the incentives for an early redemption by way of annual step-up clause; c) an appropriate risk-free rate of interest; and d) the average pre-crisis sovereign risk spread;
- The Spanish authorities have relied on a methodology which is in accordance with the Recapitalisation Communication. The remuneration formula has an appropriate structure in that it takes account of a risk-free interest rate as well as an additional spread. The additional spread is intended to minimise the financial advantage that this intervention entails, as well as to encourage the Beneficiaries to buy back the FROB Securities.

47. The Commission notes that the FROB Securities constitute a hybrid instrument, which, while qualifying as Tier I, offers the FROB more security than other Tier I instruments. According to paragraph 28 of the Recapitalisation Communication, this factor justifies lower remuneration.

48. Security enhancement is offered by the following features of the FROB Securities:

- The expected maturity of the FROB securities is most likely to be five years.
- The possibility to hold the FROB securities for two more years would only be available under exceptional circumstances. That is subject to a number of conditions, namely, i) the FROB has the power to decide whether to extend the period; ii) the extension has to be authorised by Bank of Spain; iii) it involves a significant increase of the remuneration (100 bp per year).
- The variable conversion option set out in paragraphs 20 and 22 is intended to preserve the value of the FROB Securities in case of the non-performance of the Beneficiary. Should the option be exercised, the FROB would receive ordinary

shares (or equivalent items) with the same nominal value as the FROB Securities. Consequently, the Beneficiary's equity prior to recapitalisation by the FROB constitutes a first layer of protection against losses. While losses of the Beneficiaries would suspend payments of coupons on the FROB Securities those losses would not affect their value until the amount of equity in place prior to the recapitalisation had been exhausted.

- The variable conversion option entitles FROB, and not the Beneficiary, to trigger conversion, but that would only be exercised under exceptional circumstances.
 - Beneficiaries have the following incentives to buy back the FROB Securities in order to avoid the option being exercised: i) the conversion dilutes existing stakeholders and may lead to a merger or transfer of the Beneficiary's business to other credit institutions and ii) if upon conversion, a Beneficiary find itself in a weak position, then the conversion triggers a restructuring process. In any event, the conversion will have to be notified to the Commission, allowing it to determine the necessary course of action.
49. The Commission thus considers that the overall level of the remuneration, its evolution and the conditions attached to the FROB Securities are adequate and represent an appreciable incentive for the Beneficiary to exit the Scheme.
50. The Commission considers that the limits to the size of recapitalisations for fundamentally sound credit institutions (see paragraph 6 above) set by Spain also reduce distortions on competition.
51. Furthermore, the Commission notes that the Beneficiaries will abstain from unfair and/or aggressive commercial practices or expansion of their businesses. These conditions will also reduce the impact of the Scheme on competition.
52. The Commission recalls, once more, that the measures described can only be undertaken with regard to credit institutions which apply to the Scheme. The fact of making an application to the Scheme does not necessarily mean that the applying institution is in difficulty. In this context, the Commission notes positively that the Spanish authorities commit to distinguish between fundamentally sound institutions and those in difficulty according to the criteria set out in the Annex to the Recapitalisation Communication prior to granting any aid. To this end, the Commission will be provided with all information justifying the classification prior to any recapitalisation taking place. For fundamentally sound institutions, Spain will submit a viability plan proving its capability to conduct its business on a stand alone basis upon the redemption/exit of the State capital.
53. The pricing formula described in paragraph 18 above applies only to fundamentally sound institutions. For non-fundamentally sound institutions, Spain commits to notify the conditions of the recapitalisation as well as the restructuring plan. This will allow the Commission to determine, inter alia, the level of adequate remuneration on the FROB Securities¹³ and to ensure the presence of a ban on discretionary coupon payments on hybrid instruments.
54. The Commission notes positively that the Spanish authorities will present a report to the Commission every six months on the functioning of the Scheme in line with the Recapitalisation Communication.

¹³ In line with section 2.3 of the Recapitalisation Communication, the remuneration for banks which are not fundamentally sound should be higher than for fundamentally sound banks to reflect the risk profile of the Beneficiary. In footnote 1 to point 46 of the Communication, a total expected annualised return of at least 10% is mentioned for Tier 1 instruments.

55. Finally, the Scheme is limited in time until 30 June 2010, which is in line with the temporary scope of the recapitalisation scheme. Spain has committed to notify any prolongation which proves necessary.
56. On the basis of the above, the Scheme can be considered compatible with the internal market.

V. DECISION

The Commission concludes that the notified measures are compatible with the internal market on the basis of Article 107(3)(b) TFEU and has accordingly decided not to raise objections against the notified measure.

The Commission notes that for reason of urgency Spain exceptionally accepts the adoption of the Decision in the English language.

If this letter contains confidential information which should not be published, please inform the Commission within fifteen working days of the date of receipt. If the Commission does not receive a reasoned request by that deadline, you will be deemed to agree to publication of the full text of this letter in the authentic language on the Internet site:

http://ec.europa.eu/community_law/state_aids/state_aids_texts_en.htm.

Your request specifying the relevant information should be sent by registered letter or fax to:

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Yours faithfully,
For the Commission

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