EUROPEAN COMMISSION
Brussels, 16.7.2012

Proposal for a
COUNCIL DECISION
addressed to Spain on specific measures to reinforce financial stability

EXPLANATORY MEMORANDUM
CONTEXT OF THE PROPOSAL

Spain has recently come under increasing pressure in financial markets. Market uncertainty has centred on the situation of the banking sector, which has been adversely affected by the burst of the real estate and construction bubble and the economic recession that followed. As a result, several Spanish banks have accumulated large stocks of problematic assets raising concerns about viability of some of these banks.
On 9 June, the Eurogroup was informed about Spanish authorities' intention to apply for financial assistance to recapitalize its banking sector. The Eurogroup stated that it was willing to respond favourably to such a request and committed to granting Spain financial assistance, covering estimated capital requirements with an additional safety margin, estimated as summing up to EUR 100 billion in total.
On 25 June 2012, the Spanish Government requested external financial assistance in the context of the ongoing restructuring and recapitalisation of the Spanish banking sector. A formal request was submitted following the publication on 21 June 2012 of the results of the first stage of the independent evaluation of the balance sheets of banks. The assistance is sought under the terms of the Financial Assistance for the Recapitalisation of Financial Institutions by the EFSF.
Following this request, the European Commission in liaison with the ECB, the European Banking Authority (EBA) and the IMF conducted an independent assessment of the eligibility of Spain's request for such assistance. This assessment concluded that Spain fulfils the eligibility conditions.
The Heads of State and Government at the Euro Area Summit of 29 June 2012 specified that the assistance will subsequently be taken over by the ESM, once this institution is fully operational, without gaining seniority status. When a single supervisory mechanism for banks in the euro area, involving the ECB, is established, the ESM could have the possibility to recapitalise the banks directly via a new instrument.

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THE COUNCIL OF THE EUROPEAN UNION,
Having regard to the Treaty on the Functioning of the European Union (TFEU), and in particular Article 136(1)(a) in accordance with the procedure of Article 126(6) thereof,
Having regard to the proposal from the European Commission,
Whereas:
(1) Article 136(1)(a) TFEU foresees the possibility of adopting measures specific to the Member States whose currency is the euro with a view to strengthening the coordination and surveillance of their budgetary discipline.
(2) Abundant availability of external financing at low cost in the 2000s fuelled a credit-driven domestic demand and asset boom in Spain, concentrated in particular in real estate The burst

of the real estate and construction bubble and the economic recession that followed has adversely affected the Spanish banking sector. As a result, with the exception of a few large and internationally diversified credit institutions, Spanish banks have largely lost access to wholesale funding markets on affordable terms and, thus, have become highly dependent on Eurosystem refinancing. In addition, their borrowing capacity has been severely limited by the impact of rating downgrades on collateral availability.

(3) The sizeable contraction of the economy in recent years, which is affecting employment and unemployment in a very negative way, has deteriorated substantially the budgetary position in Spain. According to a Commission services' update of the 2012 Spring Forecast, the general government deficit is projected at 6.3% of GDP in 2012, which compares to an expected deficit of 5.3% of GDP in the 2012 stability programme and the draft 2012 budget law. Gross public debt rose to 68.5% of GDP in 2011, and according to the Commission services' update of the 2012 Spring Forecast it is expected to surge to 80.9% of GDP in 2012 and to 86.8% in 2013, based on a no-policy-change scenario, thus exceeding the Treaty reference value in all years. Risks related to the macroeconomic scenario and the budgetary targets, as well as to additional financial rescue measures, may contribute to a further increase in public debt. In view of these developments, on 10 July 2012 the Council issued a recommendation to Spain under Article 126(7) TFEU to put an end to the present excessive deficit situation by 2014.

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

(5) In February 2011, the Spanish authorities raised the minimum capital ratio requirement ("capital principal") to 8% of banks' risk weighted assets and gave banks until September 2011 to comply with this new regulation. For banks more dependent on wholesale funding and characterized by a limited market access the minimum capital ratio was increased to 10%. In February and May 2012, new legislation required banks to build higher provisions and capital buffers against possible losses on both performing and non-performing loans on the legacy stock of construction and real estate assets. The expected overall volume of these new provisioning requirements amounted to approximately EUR 84 billion.

(6) As of April 2012, the total gross financial contribution by the Spanish State (excluding bond issuance guarantees) amounted to about EUR 34 billion (3.2% of GDP). The capital support was provided via the Fund for Orderly Bank Restructuring (FROB) endowed with a capital of EUR 15 billion, of which EUR 9 billion were already paid in. The State has also provided guarantees to bank senior bond issues amounting to about EUR 86 billion (out of this total, about EUR 58 billion guarantees are outstanding). Although the FROB still had a remaining funding capacity of about EUR 27 billion (as of April 2012), available domestic public sector support will not be sufficient to provide a sufficiently large backstop for conducting the required system-wide clean-up of the banking sector.

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

(8) On 25 June 2012, the Spanish authorities officially requested financial assistance in the context of the ongoing restructuring and recapitalisation of the Spanish banking sector. The assistance is sought under the terms of the Financial Assistance for the Recapitalisation of

Financial Institutions by the EFSF. The assistance provided is subject to specific financial sector conditionality. This conditionality should be fully consistent with the coordination measures adopted within the framework of the EU Treaties, in particular those contained in this Decision.

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

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

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

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

HAS ADOPTED THIS DECISION:

Article 1

1. Spain shall adequately recapitalise and thoroughly restructure its banking system. In that regard, Spain shall develop in coordination with the European Commission and in consultation with the ECB a strategy for the future structure, functioning and viability of the Spanish banks which will identify how to ensure that they are able to operate without further state support.

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

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

(a) identification of individual bank capital needs through a comprehensive asset quality review of the banking sector and a bank-by-bank stress test, based on that asset quality review;

(b) recapitalization, restructuring and/or resolution in an orderly way of weak banks, based on plans to address any capital shortfalls identified in the stress test;

(c) segregation of assets in those banks receiving public support in their recapitalization effort and their transfer of the impaired assets to an external Asset Management Company (AMC).

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

(a) Spanish credit institutions shall be required to increase their Common Equity Tier (CET) 1 ratio to at least 9%;

(b) From 1 January 2013, Spanish credit institutions shall be required to apply the definition of capital established in the Capital Requirements Regulation (CRR);

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

(d) The operational independence of the Banco de España shall be further strengthened; the sanctioning and licensing powers of the Ministry of Economy with respect to the banking sector shall be transferred to the Banco de España;

(e) The supervisory procedures of Banco de España shall be further enhanced based on an internal audit;

(f) The governance arrangements of the financial safety net agencies (FROB and FGD) shall be reviewed to avoid potential conflicts of interest;

(g) The rules on the governance of the savings bank sector and of the banks owned by savings banks shall be strengthened;

(h) Consumer protection and securities legislation, and compliance monitoring by the authorities, shall be strengthened.

Article 2

This Decision is addressed to the Spain.

Article 3

This Decision shall be published in the *Official Journal of the European Union*.

Done at Brussels,

For the Council
The President