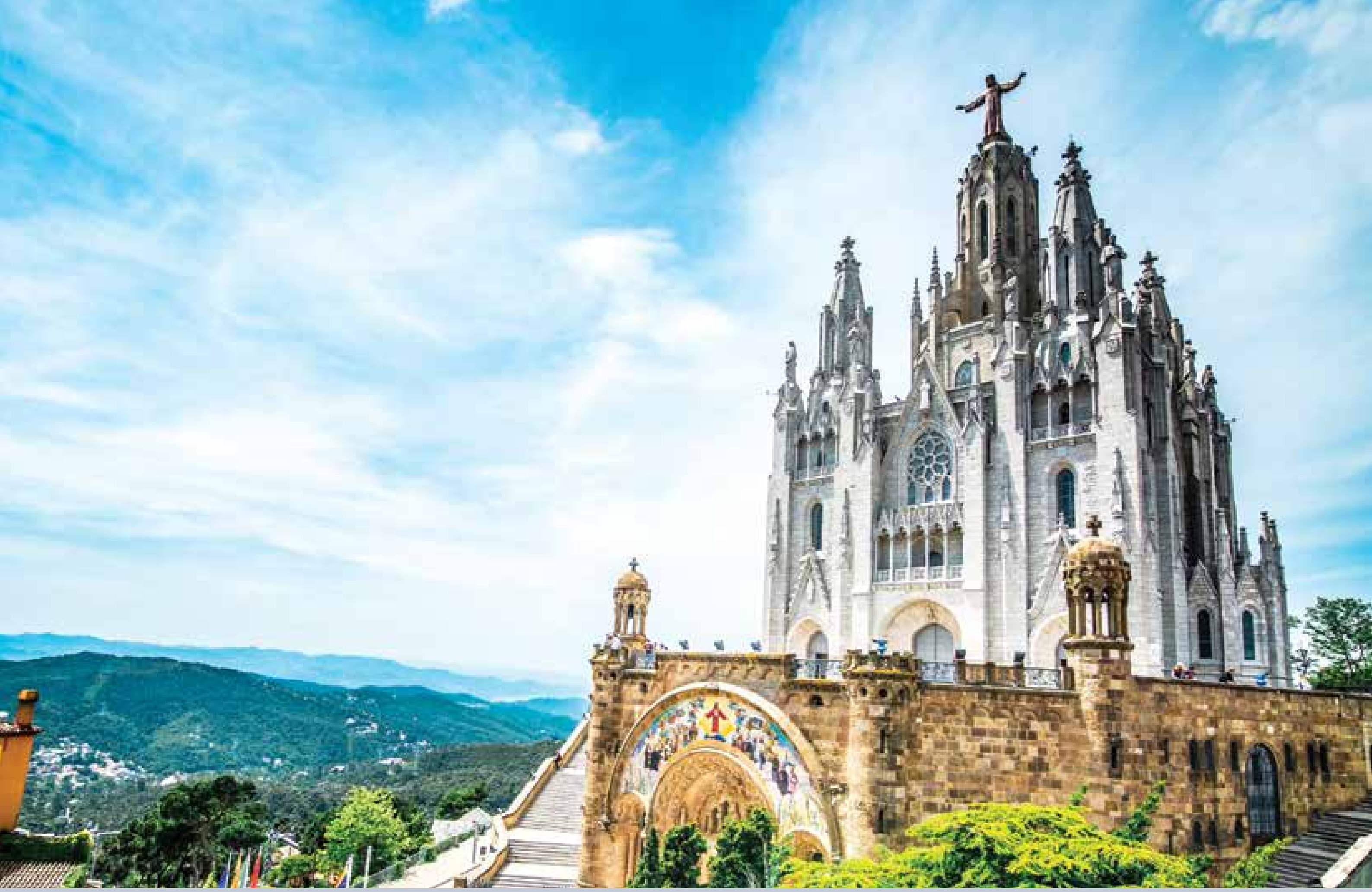

Sale of Business
Banco Popular Español (2017)

Background and context

The resolution of Banco Popular Español, S.A. (Banco Popular) represents a key milestone in relation to the bank resolution framework within the European Banking Union (Single Resolution Mechanism).[48] This case was the first time the SRB had used its powers to write down the liabilities of a bank. Banco Popular was resolved through the write-down and conversion of its capital instruments, and subsequent transfer to Banco Santander S.A. (Santander).

Banco Popular was formed in 1926 as a local bank servicing Spanish customer. Historically, Banco Popular's core business consisted of a strong Spanish retail franchise, with a focus on lending to SMEs. Its lending included mortgages and other home loans to retail customers. As at December 2016, Banco Popular was Spain's sixth largest bank, with a market share of 17.7%. It had total assets of approximately €148 billion ($156 billion), 1,739 branches worldwide, and was supported by a workforce of 10,671 employees. Banco Popular was listed on the Spanish Stock Exchange, and formed part of the IBEX35 (consisting of the 35 companies with the highest market capitalisation in Spain). It was an active participant in both Spanish and European capital markets.

Beginning in 2007, Spain suffered one of the most severe financial crises amongst the EU member states, with unemployment peaking at 26.1% in 2013. In 2014, public debt stood at a record high of 100.4% of GDP. The crisis heavily impacted the financial industry, which had over-invested in the real estate sector during the years leading up to 2008. By November 2012, bad debts in the banking sector had reached a record high of €197 billion ($255.8 billion) – more than 10 times higher than the €17 billion ($25 billion) recorded in December 2007. During this period, numerous

[48] The Single Resolution Mechanism is second of three pillars of the European Banking Union. The first pillar is the Single Supervisory Mechanism which has been setup under the ECB, and the third pillar is the European Deposit Insurance Scheme which is still being discussed

Spanish banks experienced solvency and liquidity problems, aggravated by increasing difficulties in accessing wholesale funding and the drying up of short-term interbank liquidity. In contrast to most other Spanish banks, Banco Popular emerged from the 2008 financial crisis independently without requesting or receiving any state aid in the form of capital injections or asset transfers.

Like many other European banks, Banco Popular was saddled with NPLs. From 2008, it implemented a number of significant asset write-downs. In 2016, Banco Popular reported losses of €3.5 billion ($3.69 billion), followed by a first-quarter 2017 loss of €137 million ($146.5 million) with NPLs representing 15% of the loan book. In the first week of June 2017, Banco Popular experienced a bank run of approximately €6 billion ($6.7 billion) of deposits being withdrawn. It was noted that many state- owned entities were quick to withdraw deposits. On 5 and 6 June 2017, Banco Popular requested and received consecutive Emergency Liquidity Assistance (ELA) of €1.9 billion and €1.6 billion ($2.17 billion and $1.82 billion) from Banco de Espana (the Spanish Central Bank). It was reported that discussions on Banco Popular's eligible collaterals had already taken place since March 2017.[49] However, the ELA proved to be inadequate and the severity of this liquidity crisis led the ECB to decide that Banco Popular was Failing Or Likely To Fail (FOLTF)[50] on 7 June 2017.

> ***We believe it (the Banco Popular resolution) was a successful example of the first use of the single resolution mechanism***
>
> Valdis Dombrovskis, former European Commissioner for Financial Stability, Financial Services and the Capital Markets Union

Resolution actions

Bank run preceding resolution[51]

Investor confidence in Banco Popular began to wane due to concerns of the bank's inability to clean up its balance sheet and to strengthen its capital position.

Resolution of Banco Popular – Timeline of Key Events

- **End-2016** Banco Popular reported losses of €3.5 billion ($3.69 billion).
- **Feb 2017** Banco Popular sought liquidity assistance from Banco de Espana, backed by eligible collaterals.
- **3 Apr 2017** Chief Executive Officer (CEO) of Banco Popular resigned after audit revealed inadequate provisioning of bad loans.
- **11 May 2017** The press published an article on the possibility of Banco Popular bankruptcy.
- **18 May 2017** Banco Popular requested for access to ELA for the second time from Banco de Espana.
- **31 May 2017** Banco Popular stock price plummeted more than 50%.
- **1-6 Jun 2017** Banco Popular suffered deposit withdrawals of approximately €6 billion and its LCR fell to 24%, below the minimum regulatory requirement of 80%. Banco de Espana provided ELA of €1.9 billion (5 Jun) and €1.6 billion (6 Jun) to Banco Popular.
- **6 Jun 2017** Banco Popular President informed ECB that it was running out of cash and therefore "likely to fail".
- **7 Jun 2017** Upon the declaration of Banco Popular as FOLTF by ECB – Santander and BBVA were invited to submit binding offers. Only one bid was received from Santander for €1.
- **Aug 2018** SRB opened up a 'right to be heard' proceeding for investors affected by the resolution of Banco Popular.
- **Mar 2020** SRB decides no compensation is due to Banco Popular shareholders and creditors, as insolvency would have been more costly.

[49] In mid-May 2017, Banco Popular had presented a collateral portfolio of at least €22 billion ($24.7 billion) to Banco de Espana and were informed of possible ELA provision of €700 million ($787 million) (about 3% of total value of collaterals). The significant haircuts of 97% were unprecedented given that a maximum rate of 65% would be applied under normal circumstances

[50] FOLTF is a classification used by supervisors from the ECB. It covers aspects of troubled institutions relating to the withdrawal of authorisation, liabilities of the institution exceeding its assets, inability to pay debts as they fall due, or the need for extraordinary financial public support. FOLTF is determined by the ECB after consultation with the SRB. The SRB may also determine that a bank is considered FOLTF, if it has informed the ECB of its intention to do so and the ECB has not reacted within three days

> ***The decision taken today safeguards the depositors and critical functions of Banco Popular. This shows that the tools given to resolution authorities after the crisis are effective to protect taxpayers' money from bailing out banks.***
>
> Elke König, former Chair of the SRB

The purchase of Banco Popular was a strategic move that would propel Santander ahead of rivals BBVA and La Caixa in the domestic banking market, giving it an additional 18% market share, adding important SME clients and boosting its presence in important regions. In the weeks prior to Banco Popular's collapse, Santander had considered acquiring it for up to €1.6 billion ($1.8 billion)[52] but had held off making an offer because of concerns that shareholders would reject the proposal.

The new Banco Popular CEO had set up formal sales processes, with Santander, BBVA, Bankia and Sabadell taking part. However, none of the four banks were willing to make a bid by the closing date of 16 May 2017.

However, a week later, Santander decided to submit a bid to purchase Banco Popular through a resolution process under two conditions: (1) the offer price was to be €0, with a negotiation margin of up to €200 million ($225 million); and (2) a write down of Additional Tier 1 (AT1) and Tier 2 bonds (Tier 2) worth €2 billion ($2.25 billion). In addition, Santander would undertake a €7 billion ($7.9 billion) rights issue after the resolution.

On 3 June 2017, while Banco Popular and Banco de Espana were doing final checks on the ELA process, the resolution authorities[53] contacted Santander and BBVA, piggybacking on a failed sales process that Banco Popular had run earlier.

After signing non-disclosure agreements, the two bidders spent the next few days going over Banco Popular's books. On 7 June 2017 – upon the declaration of Banco Popular as FOLTF by the ECB – Santander and BBVA were invited to submit binding offers. Only one bid was received from Santander for €1 with the condition that shareholders, AT1 holders and Tier 2 holders were to be written down. The SRB accepted the offer, having concluded that a winding up of the bank under normal insolvency proceedings would pose risks to financial stability.

On 6 August 2018, the SRB opened up a 'right to be heard' proceeding for investors affected by the resolution of Banco Popular.[54] The SRB assessed 2,856 submissions from affected parties, including comments on the SRB's approach to the valuation of Banco Popular. On 18 March 2020, the SRB concluded that the resolution of Banco Popular by winding up would have been costlier than the approach taken, based on a post-resolution valuation undertaken by an independent valuer. Therefore, no compensation was due to the shareholders and creditors of Banco Popular.

[51] Summarised from the notice of arbitration between claimants and Kingdom of Spain for Banco Popular's resolution
[52] On 3 May 2017, the Santander bid team had proposed to its Board of Directors to make a €1.6 billion ($1.8 billion) offer for Banco Popular. They concluded that, even after a €6 billion ($6.4 billion) rights issue to clean up the bank, as well as litigation and restructuring costs, such an offer could still deliver an 11% return within three years
[53] Spain's Fund For Orderly Bank Restructuring (FROB) and the SRB
[54] The right to be heard process allows affected shareholders and creditors to explain why they consider that alternative approaches or assumptions for the normal insolvency proceedings should have been adopted and, if they had been, how in their view these would have affected the final outcome

Key takeaways

In the case of Banco Popular, the SRB and FROB (Spanish National Resolution Authority) were fortunate that efforts to identify a buyer and the sales process had already taken off prior to the actual resolution. The Chair of the SRB also noted that the structure of Banco Popular was relatively simple. While these factors facilitated swift resolution via immediate sale of Banco Popular to Santander, this case demonstrates that the volume of groundwork needed (identifying potential buyers, due diligence, negotiations, and others) for acquisitions of distressed banking institutions should not be underestimated.

The outcome of solvency stress test results may not guarantee the viability of a bank in the medium term. In similar vein, a run on deposits can quickly erode a high level of Liquidity Coverage Ratio (LCR). Striking a balance between solvency-based and liquidity-centric scenarios as part of the recovery and resolution planning process is critical to ensure that banks and regulators have more capacity and are more ready to face possible crisis situations.

Where banking institutions are faced with a liquidity crisis, clarity about conditions under which it may receive ELA from central banks become crucial. The provision of liquidity through ELA can also be affected by substantial haircuts on collateral posted, as the case of Banco Popular demonstrates.

The valuation process is another essential component supporting the execution of resolution actions. This can be highly challenging, given that the valuation of assets nose- dives once a bank is deemed non-viable. Additionally, in a situation of stress, the losses borne by Tier 2 bondholders may not be very different from those borne by holders of AT1 instruments. Experience has shown that losses imposed on investors have been considerably larger than market expectations (besides Banco Popular, another example is from the case of Portugal’s Novo Banco).

Post-resolution, authorities need to be prepared to contend with legal challenges from aggrieved parties. These could cover claims around the issues of transparency and reliance on disputed information that guided key decisions taken by authorities to resolve distressed institutions.

> ***When deciding upon resolution or insolvency for a failing bank, the SRB takes into account the idiosyncratic and systemic circumstances at the point of failure of a bank, which gives us the flexibility to properly account for the economic circumstances at that point in time***
>
> Elke König, former Chair of the SRB