FINANCIAL STABILITY BOARD

Peer Review of Spain

Review Report

27 January 2011

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Foreword

The peer review of Spain is the second country peer review under the FSB *Framework for Strengthening Adherence to International Standards*.[1] FSB member jurisdictions have committed to undergo periodic peer reviews focused on the implementation of financial sector standards and policies agreed within the FSB, as well as their effectiveness in achieving the desired outcomes. As part of this commitment, Spain volunteered to undertake a country peer review in 2010.

This report describes the findings and conclusions of the Spain peer review, including the key elements of the discussion in the FSB Standing Committee on Standards Implementation (SCSI) on 13 December 2010. The draft report for discussion was prepared by a team chaired by Alexander Karrer (Federal Department of Finance, Switzerland) and comprising Francisco José Barbosa da Silveira (Central Bank of Brazil), Robert M. Schenck (Federal Reserve Bank of Atlanta, USA), Arun Pasricha (Reserve Bank of India), Constant Verkoren (DNB, Netherlands), and Mike Chee Cheong Wong (Monetary Authority of Singapore). Costas Stephanou (FSB Secretariat) provided support to the team and contributed to the preparation of the peer review report.

The analysis and conclusions of the peer review are largely based on the Spanish financial authorities' responses to a questionnaire designed to gather information about the initiatives undertaken in response to the relevant FSAP recommendations.[2] The review has benefited from dialogue with the Spanish authorities as well as discussion in the FSB SCSI and in the FSB Plenary.

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[1] A note describing the framework is at http://www.financialstabilityboard.org/publications/r_100109a.pdf.

[2] The FSAP report for Spain is available at http://www.imf.org/external/pubs/ft/scr/2006/cr06212.pdf.

Glossary

BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principle
CADE	Central Public Registry for public debt
CCP	Central Clearing Counterparty
CESFI	Financial Stability Committee
CNMV	National Securities Markets Commission
CPSS	Committee on Payment and Settlement Systems
CRD	Capital Requirements Directive
CRE	Commercial Real Estate
DGSFP	Directorate General of Insurance and Pension Funds
EC	European Commission
ECB	European Central Bank
EU	European Union
FAAF	Financial Assets Acquisition Fund
FSAP	Financial Sector Assessment Program
FROB	Fund for the Orderly Restructuring of the Banking Sector
IAIS	International Association of Insurance Supervisors
ICP	Insurance Core Principle
IFRS	International Financial Reporting Standards
IOSCO	International Organization of Securities Commissions
IRB	Internal Ratings-Based approach (Basel II)
LTV	Loan-to-Value (ratio)
MEF	Ministry of Economy and Finance
MiFID	Markets in Financial Instruments (EU Directive)
MoU	Memorandum of Understanding
NPL	Non-Performing Loan
OTC	Over-the-Counter
RRE	Residential Real Estate
SCLV	Securities Clearance and Settlement Service
SIP	Institutional System of Protection
SME	Small and Medium-sized Enterprise
TAC	Technical Advisory Committee (Iberclear)
TRMC	Technical Risk Management Committee (Iberclear)

FSB country peer reviews

The FSB has established a regular programme of country peer reviews of its member jurisdictions. The objective of the reviews is to examine the steps taken or planned by national authorities to address IMF-World Bank Financial Sector Assessment Program (FSAP) recommendations concerning financial regulation and supervision as well as institutional and market infrastructure. FSB member jurisdictions have committed to undergo an FSAP assessment every 5 years, and peer reviews taking place typically around 2-3 years following an FSAP will complement that cycle.

A country peer review evaluates the progress made by the jurisdiction in implementing FSAP recommendations against the background of subsequent developments that may have influenced the policy reform agenda. It provides an opportunity for FSB members to engage in dialogue with their peers and to share lessons and experiences. Unlike the FSAP, a peer review does not comprehensively analyse a jurisdiction's financial system structure or policies, nor does it provide an assessment of its conjunctural vulnerabilities or its compliance with international financial standards.

Executive summary

Spain underwent an FSAP in 2006, in which the IMF assessment team concluded that "*Spain's financial sector is vibrant, resilient, highly competitive, and well-supervised and regulated.*" The main challenges in the areas of financial regulation and supervision were related to the need to address the risks posed by rapid credit growth, especially in the housing sector; address the risks associated with banks' large equity investments in nonfinancial firms; enhance the regulation, supervision and governance of savings banks (cajas); and improve inter-agency coordination and supervisory autonomy. The FSAP also identified steps to further strengthen insurance supervision and securities settlement systems.

The Spanish financial system weathered the initial brunt of the financial crisis relatively well compared to other advanced countries, primarily due to a strong regulatory stance and sound supervision, as well as an efficient, retail-oriented bank business model (see section 1). The strong regulatory framework was effective in cushioning the financial system, thereby allowing the authorities and financial institutions more time to plan appropriate responses. The successful use of dynamic provisions during the crisis to cover the credit losses that built up in bank loan portfolios is particularly relevant given ongoing discussions at the international level about moving towards an expected loan loss provisioning regime.

The financial crisis had significant after-effects since it led to the bursting of the real estate bubble that had built up prior to the crisis. In that context, the risks identified in the FSAP relating to rapid credit growth in the housing sector and to the regulation, supervision and governance of the cajas have materialised. Credit institutions were over-exposed to the construction and property development sectors and experienced a sharp decline in credit growth and increase in non-performing loans. Savings banks have been particularly hit and are undergoing significant restructuring and downsizing. The business outlook is tempered by compressed net interest margins and higher loan losses, against a backdrop of a multi-year fiscal adjustment process, continued deleveraging by households, high unemployment, and subdued economic growth. Identifying future sources of growth for Spain and its financial system will be especially important following the severe contraction of the real estate sector.

FSB members welcome the strong actions taken to date by the Spanish authorities to address financial system vulnerabilities and urge them to continue on this path, especially in view of recent market developments. In particular, the tightening of prudential regulations, the stricter and more transparent approach employed by Spain compared to other countries in the 2010 EU stress tests, as well as the interventions by the Bank of Spain in two credit institutions, sent a strong signal to market participants and may thus have facilitated the restructuring process. Enhanced disclosures in perceived problem areas can play a valuable role, and the FSB commends the Spanish authorities for the importance they have given to transparency.

The authorities have made good progress in addressing several FSAP recommendations. They have tightened regulatory capital and loan loss provisioning requirements for real estate exposures, and provided further guidance on best practices for lending in this area; implemented measures to reduce incentives for equity investments in nonfinancial companies by banks and manage related conflicts of interest; introduced reforms to strengthen corporate governance and the ability to raise capital from external sources for savings banks; enhanced coordination and cooperation between financial sector regulators; adopted additional requirements on internal controls, investment, and adequate verification of the risk management processes of insurers; and improved the functioning of securities settlement systems. However, such determined actions became necessary partly because of the delay in addressing earlier the structural weaknesses of savings banks highlighted in the FSAP. A key lesson from the Spanish experience therefore is the importance of responding promptly to FSAP recommendations to ensure financial stability.

Spain's experience has brought to the forefront the high loan exposures to real estate and construction, which were created in response to an economy-wide boom in that sector (see section 2). Many credit institutions adopted similar business strategies during the boom by aggressively expanding their activities in this area, resulting in system-wide overcapacity and asset concentrations. Micro-prudential measures were an important, albeit insufficient, buffer against the risks emanating from such activities. A variety of micro- and macro-prudential policy measures are needed to address the build-up by banks of real estate exposures, coupled with sufficient supervisory independence and powers to be able to calibrate them appropriately. Different jurisdictions have addressed this issue using both demand and supply side measures that have varied widely in their scope and intensity. These often extend beyond prudential measures, depending on national circumstances and political economy trade-offs, and can include monetary policy and fiscal reform among others.

The equity investments of large Spanish banks in nonfinancial companies ("industrial participations") have dropped in relative terms, although they remain high compared to other developed countries (see section 3). These participations are often intrinsically linked to, and supportive of, nonfinancial companies' business models and strategies, making them difficult to untangle. The FSB is of the view that large industrial participations by banks not only create potential conflicts of interest, but may also pose concentration, reputational and systemic risks. Further regulatory efforts may therefore be necessary to ensure that industrial participations do not generate such risks, and that exposures continue to decrease in an orderly fashion. The authorities agree that proper monitoring and supervision of these participations is required, although they believe that there exist few alternative domestic sources of equity finance and that such investments have had clear benefits in terms of the growth and competitiveness (including internationally) of the private sector.

The comprehensive reform of cajas introduced in 2010 addresses FSAP recommendations related to strengthening corporate governance and their ability to raise capital from external sources (see section 4). However, it is too early to judge its effectiveness since most integration processes were only recently initiated. Savings banks have traditionally played an important role in several European countries. Although the forms such institutions take vary considerably from one country to another, they are often characterised by distinct business models (in terms of lending and/or funding) compared to commercial banks and by unique challenges with respect to governance and their ability to raise capital from external sources. One key lesson from Spain's experience is that such institutions should follow very conservative risk-taking policies when they lack access to external capital sources.

The FSAP recommendations on strengthening the autonomy of financial regulators (particularly on insurance) and delegating to them the authority to issue norms and to sanction violations have not been taken up by the authorities (see section 5). While it is understood that further delegation of relevant powers to regulators raises some difficulties under Spanish law, the observations made by the FSAP - regarding the risks of political interference in the future or undue self-restraint of supervisors in the presence of insufficient independence - remain valid. Similar issues essentially apply to the appointment of CNMV board members for longer, non-renewable terms. In this context, it is worth noting that the authorities were considering prior to the crisis the possibility of modifying the structure for financial supervision in Spain in order to create a so-called "twin peaks" system (i.e. separate institutions responsible for prudential supervision and for market conduct). This reform was put on hold as a result of the financial crisis and pending changes in the EU-wide supervisory architecture. It is recommended that, when markets are less volatile, the authorities reconsider the current institutional framework taking into account the relevant FSAP recommendations.

There is a wide range of practices and views across FSB jurisdictions regarding the optimal structure of supervisory arrangements. While the financial crisis highlighted some important lessons on financial supervision, it did not resolve the debate on the appropriate institutional design of the supervisory structure. Moreover, the need to extend the regulatory perimeter and to develop macro-prudential policy frameworks has complicated this debate. Although there is no single optimal structure and different organisational models have their own pros and cons, it is essential that the relevant authorities be able to work together and exchange information. Organisational structures are secondary to ensuring that these agencies have the tools and powers to intervene when necessary, and the willingness and independence to do so. In addition, the respective responsibilities of authorities need to be clear; in particular, it is critical to have clarity on who among the authorities is in charge in the event of a crisis.

With regard to insurance, the forthcoming implementation of Solvency II will likely address FSAP recommendations on fit and proper requirements, risk management systems, and the actuarial function (see section 6). In the meantime, the DGSFP could consider establishing general requirements on corporate governance that are comprehensive and applicable to all insurers, including non-listed ones, and additional specific requirements on boards of directors regarding their understanding of the use of derivatives. There may also be a need for the authorities to consider whether the resourcing of DGSFP is sufficient to carry out its ambitious mandate going forward, particularly once Solvency II is implemented.

Finally, with respect to securities settlement systems (see section 7), the proximity of Iberclear's backup site to the main site may need to be re-examined for operational risk purposes. Iberclear may also need to ensure that its participants have access to backup systems and that these are regularly tested both with its main data site and with its backup site. The intention by the authorities to shift finality towards time of settlement and to establish a CCP for stock exchange clearing and settlement is welcome and would bring Iberclear's post-trade practices in line with EU common standards and practices.

1. Recent market developments and regulatory issues

Financial system structure

Spain's financial system is primarily bank-based, with 87% of system assets belonging to credit institutions. As of year-end 2009, there were 353 credit institutions comprised primarily of commercial banks, savings banks ("*cajas de ahorros*"), and cooperatives. The total assets of those institutions were about €3.7 trillion (351% of Spain's GDP), of which 61% and 35% were held by commercial banks and cajas respectively. All credit institutions are subject to the same supervisory and prudential regime.

Commercial banks follow the universal banking model and provide traditional banking services and products, as well as pension and mutual funds management, insurance, private equity and venture capital services, factoring, and leasing. Domestic banks are generally listed on the domestic capital markets and are engaged heavily in retail banking. The degree of sector concentration has remained relatively unchanged in recent years, with the top 5 banks accounting for 44% of total domestic sector assets in 2009. Despite the entry of European banks after Spain joined the European Union (EU) in the 1980s, foreign banks remain minor players representing around 7% of system assets. Conversely, the foreign operations (primarily in the form of subsidiaries) of Spanish banks account for around 24% of their total consolidated assets, and are located mostly in Latin America and the UK.

Savings banks are nonprofit credit institutions that play a significant social welfare role in their respective home regions and supply nearly half of the credit issued to the country's private sector. Although they are allowed to pursue the same range of activities as commercial banks, they do not have shareholders. There are different groups of stakeholders to whom the law provides representation in the savings banks' governing bodies, including regional governments ("autonomous communities"), depositors, founders, and employees. While cajas are allowed to be shareholders in banks, the banks traditionally could not purchase capital participations of cajas. The savings banks sector, which is quite heterogeneous in terms of the size and activity of different entities, is currently changing dramatically as a result of restructuring and consolidation efforts that are actively supported by the authorities (see section 4).

Spain has relatively developed capital markets, with financial instruments traded in a variety of platforms and settlement infrastructures (see section 7). Debt securities markets have traditionally played a relatively small role in the financing of domestic corporations as these entities have preferred to use bank loans and/or internally generated funds. The Spanish stock exchanges' market capitalization (almost €1 trillion at end-2009, or 95% of GDP) is concentrated in a small number of stocks, with institutional investors playing a dominant role in the market for fixed income securities.

The Spanish insurance market is the eleventh largest in the world and the sixth largest in Europe by net premium income. It is also very competitive with relatively low levels of concentration. The assets managed by the insurance sector were €243 billion at the end of March 2010, dominated by life insurers. The industry is characterized by a well-developed infrastructure and a generally high quality regulatory and supervisory regime (see section 6). Private pension funds have also started to develop in recent years, albeit from a low base.

Regulatory framework and crisis response

The regulatory framework changes since the FSAP, and the Spanish authorities' response to its recommendations, need to be considered in conjunction with the global financial crisis that began in the second half of 2007. As in many countries, the crisis highlighted policy and structural weaknesses that are currently leading to the restructuring of parts of the Spanish financial system and to the reform of financial regulation and market practices.

The Spanish financial system weathered the initial brunt of the financial crisis relatively well compared to other advanced countries, primarily due to the Bank of Spain's strong regulatory stance and sound supervision, as well as an efficient, retail-oriented bank business model that is based on proximity to customers (as opposed to "originate-to-distribute"). Spanish banks entered the crisis with robust capital and strong counter-cyclical loan loss provisioning buffers.[3] They were largely shielded from the subprime mortgage crisis due to low exposure to complex structured products as the Bank of Spain's regulations discouraged investments in such products and the creation of off-balance structured investment vehicles and conduits.

The Financial Stability Committee, which was established in 2006, proved to be a useful means of coordination and decision making among the various regulatory agencies during the crisis (see section 5). As part of their early crisis response, the Spanish authorities adopted the following main measures:

- Creation of the Financial Assets Acquisition Fund (FAAF) in October 2008 to purchase high quality assets from credit institutions operating domestically as a way of providing liquidity for their activities and fostering credit to the private sector. The FAAF, which stopped operating in early 2009, purchased around €19 billion of assets via four market auctions.
- Approval of a series of government guarantees by the Spanish government, starting in early 2009, for new senior debt issuance by domestic credit institutions to help boost liquidity and jump start lending. While the maturity of these instruments generally ranges between three months and three years, guarantees could be extended to instruments with a maturity of up to five years. The total amount of guaranteed issues up to July 2010 had reached €56 billion, and the European Commission (EC) authorised the extension of the scheme at least until end-2010.
- Provision of financial support to small and medium-sized enterprises and the self-employed via the *Instituto de Credito Oficial*, a public financial agency.
- Introduction of more stringent loan loss provisioning requirements for credit institutions (see section 2).

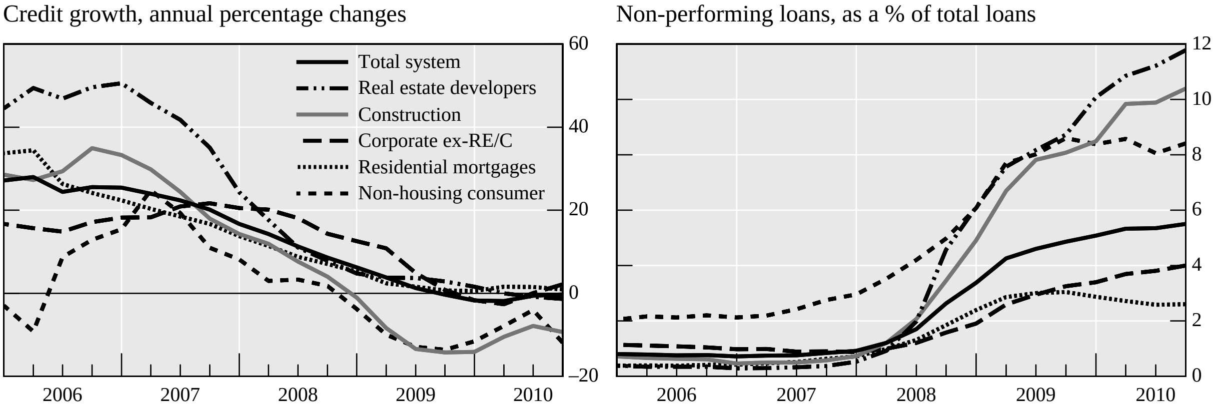
[3] Dynamic, or so-called statistical, loan loss provisions were introduced in Spain in 2000 and revised in 2004. In contrast to specific provisions based on incurred losses, dynamic provisions are based on estimated credit losses at portfolio level and have the effect of building a buffer of extra provisions in good times, based on the buildup of credit risk over this period, which can be used to cover credit losses during bad times. See "Dynamic Provisioning: The Experience of Spain" by Saurina (World Bank Group Crisis Response Note 7, July 2009, available at http://rru.worldbank.org/documents/CrisisResponse/Note7.pdf) for details.

- Increase in the deposit insurance guarantee threshold in October 2008, in accordance with EU decisions, from €20,000 to €100,000 per depositor. [4]

However, the financial crisis had significant after-effects since it led to the bursting of the construction and property development boom that had been the primary driver of growth to the Spanish economy in recent years. As property prices began declining and unemployment rose to 20%, the banking sector experienced a material worsening in asset quality due to the high concentration of lending to residential real-estate construction and development (see section 2). According to Bank of Spain data, construction and real estate lending as a share of total domestic private sector loans soared from around 9% and 18% for commercial banks and cajas respectively in 1983, to around 22% and 26% respectively in 2009. Lending to these sectors had increased sharply in response to a sustained demand for housing supported by tourism (seasonal homes) and strong demographics, low interest rates, the easy availability of credit, and a buoyant economy. With the severe contraction of the real estate market and the decline in overall credit growth, credit institutions experienced a sharp increase in their non-performing loans (NPLs), particularly to construction and property development, with the average system-wide NPL rate exceeding 5% (see Figure 1). In addition to reported NPLs, banks have made extensive use of loan restructurings, and have engaged in debt-for-equity swaps with property developers and real estate repossessions. While reporting of such figures at system-wide level by the Bank of Spain is comprehensive and granular[5], there is scope for improved and more consistent disclosure practices on loan restructurings, debt-for-equity swaps, and real estate repossessions by individual banks.

Figure 1: Evolution of credit growth and of non-performing loan rate in Spain

All credit institutions



Source: Bank of Spain.

Note: The above NPL figures exclude loan restructurings, debt-for-equity swaps, and real estate repossessions.

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[4] The deposit guarantee program is comprised of three separate funds for commercial banks, savings banks, and cooperatives. In addition to guaranteeing deposits in the event of failure of an institution, the funds also contribute to the restructuring of an institution under certain circumstances. Their available financial assets are currently around €5 billion.

[5] See, for example, "The Spanish banking sector: outlook and perspectives" by the Bank of Spain (December 2010, at http://www.bde.es/webbde/es/secciones/prensa/situacion/updatespanishbankingsector122010.pdf).

Dynamic provisions helped the banking sector absorb credit losses that had built up in loan portfolios at the beginning of the crisis; it is estimated that €19 billion of these provisions were used by banks from early 2008 to June 2010. This cushion has been steadily depleted, resulting in lower loan loss reserve coverage ratios and diminished profitability by Spanish banks recently. Spanish banks' ability to continue generating profits during this period (particularly for the largest banks) has allowed them to absorb asset write-downs of €47 billion between 2008 and June 2010, compared to €14.6 billion for 2006-07.

The performance and volumes of domestic equity and fixed income markets have also mirrored the difficulties of the financial system and the general downturn in economic activity. The assets of collective investment schemes shrank by 38% since the start of the crisis, primarily due to redemptions in favour of higher-yielding bank deposits, and amounted to only €171 billion as of end-2009. By contrast, insurance companies were not as impacted because of their relatively low exposure to real estate and equity securities.

The deteriorating performance of the economy in general, and of credit institutions in particular, also had knock-on effects on the risk perceptions of debt investors. Many Spanish institutions, particularly the cajas, had become highly dependent on medium- to long-term wholesale funding to finance the real estate boom. Such funding mainly took the form of covered bonds ("*cedulas hipotecarias*")[6], resulting in loan-to-deposit ratios for these institutions significantly in excess of 100%. In an environment where only the largest Spanish banks had access to capital markets, smaller credit institutions started funding their liquidity needs through a combination of short-term collateralized loans from the European Central Bank (ECB), government guarantees to issue senior debt, and increased efforts to attract and retain retail deposits.

The Spanish government responded to increasing system strains with additional measures to provide a liquidity and capital backstop and to support the restructuring process for the financial system, particularly for cajas. It established a Fund for the Orderly Restructuring of the Banking Sector (FROB) under Royal Decree Law 9/2009, which is managed by 8 individuals appointed by the Ministry of Economy and Finance (MEF). The FROB is financed by €9 billion in capital (75% provided by the government and 25% provided by the deposit guarantee funds) and its maximum borrowing capacity can reach up to 10 times that amount (i.e. €90 billion, or 8.5% of GDP). It has the twin objectives of:

- supporting mergers and equity strengthening, by extending funds to viable credit institutions in the form of 5-year (or 7-year in exceptional circumstances) convertible preference shares that at the end of the period are either redeemed or converted into equity at nominal value. These instruments currently qualify as Tier 1 regulatory capital; and
- facilitating crisis resolution for non-viable institutions by, in addition to the pre-existing framework for dealing with troubled credit institutions, authorizing the FROB to intervene and restructure non-viable entities.

[6] Covered bonds, or securities issued by financial institutions that are secured by dedicated collateral, have become one of the largest asset classes in the European bond market in recent years, and are an important source of finance for mortgage lending. The collateral is usually structured so as to obtain a triple-A credit rating, making them attractive to bond investors interested in only the most highly rated securities.

Moreover, the authorities reformed in July 2010 the legal framework for savings banks in order to support their restructuring. The reforms give greater capital-raising flexibility to cajas and reduce the influence of regional governments in their management and governance (see section 4).

Table 1: Restructuring Process of Spanish Savings Banks

	Institutions	Type	Total assets (€bn)	% of sector assets	FROB aid (€bn)	Inter-Regional
Approved by the Bank of Spain, with FROB aid						
1	Catalunya/Tarragona/Manresa	Merger	79	6.1%	1.25	No
2	Sabadell/Terrasa/Manlleu	Merger	29	2.2%	0.38	No
3	España/Duero	Merger	46	3.7%	0.53	No
4	CAM/Cajastur+CCM/Cantabria/ Extremadura	SIP	127	9.9%	1.49	Yes
5	Caixanova+Banco Gallego/Galicia	Merger	78	6.0%	1.16	No
6	Madrid/Bancaja+Banco de Valencia/ Laietana/Insular de Canarias/Ávila/ Segovia/Rioja	SIP	337	26.3%	4.46	Yes
7	Murcia/Penedés/Sa Nostra/Granada	SIP	72	5.6%	0.92	Yes
Approved by the Bank of Spain without financial aid						
8	Navarra/General de Canarias/ Municipal de Burgos	SIP	46	3.6%		Yes
9	Unicaja/Jaén	Merger	35	2.8%		No
Authorisation in process, without financial aid						
10	La Caixa/Girona	Merger	261	20.3%		No
11	Cajasol/Guadalajara	Merger	31	2.4%		Yes
12	CAI/CC Burgos/Badajoz	SIP	21	1.6%		Yes

Source: Bank of Spain.
Note: SIP refers to the Institutional System of Protection, which is a contractual agreement that brings together a group of credit institutions in order to pool their solvency and develop risk sharing strategies (see section 4).

The biggest restructuring process of the banking sector, involving institutions accounting for almost 40% of total sector assets, is under way (see Table 1). It is expected to significantly reduce the number of cajas from 45 to 17 entities or groups, and result in 6 of them ranking among the top 10 credit institutions in Spain. It will also reduce the number of employees and branches of cajas by an average of 15% and 20% respectively. Currently, 13 mergers are in process involving 38 cajas totalling around €1.2 trillion in assets, 8 of which have required FROB funds of around €10.6 billion. *Caja Castilla-La Mancha* was intervened by the Bank of Spain in March 2009, and received €4.1 billion of aid from the deposit guarantee fund before being integrated in *Caja Asturias*. The Bank of Spain also intervened in a small savings bank (*Cajasur*) in May 2010 to ensure its orderly restructuring under the FROB; its restructuring plan includes the full transfer of its assets and liabilities to another savings bank, *Bilbao Bizkaia Kutxa*, with a maximum financial support from the FROB of €0.4 billion. Merger initiatives are also underway for a few small banks and cooperatives without FROB aid. While short-term capital needs will likely be met from the FROB, the authorities expect additional funds to come over time from the private sector. As the process is ongoing and involves difficult and politically sensitive consolidation and rationalization efforts, including mergers of entities across regions, the final shape and size of the sector is not yet clear.

Since the time of the FSAP, and in addition to their participation in international and European financial reform initiatives, the Spanish authorities have undertaken a range of additional policy initiatives, including: strengthened legal measures, regulatory guidance, and supervisory actions to assure fair treatment of investors in collective investment schemes; new disclosure requirements on short-selling positions, securitization structures, and regulations on the advertisement of investment products; updated existing disclosure requirements for credit institutions and investment firms; and measures to identify, monitor and stress test potential systemic risk exposures by insurance companies.

In the first half of 2010, the loss of market confidence on Greek sovereign bonds spread out to a number of other European countries, including Spain. As a result, Spanish banks were shunned from international markets amid counterparty credit risk fears and they resorted to increased borrowing from the ECB (see Figure 2), while the cost of insuring against losses on Spanish sovereign debt rose to historically high levels. Market confidence was subsequently restored to a degree, due to the austerity measures passed by the Spanish government, the release of the results of the EU stress tests in July 2010, and to financial sector policy actions. In particular, the approach employed by the Spanish authorities in the EU stress tests was relatively stricter and more transparent than in the case of other EU countries, while the results were considered to be broadly reasonable. Spain subjected 95% of its banking sector (8 listed commercial banks and 41 cajas) to the stress tests, the highest percentage among all the European countries involved, thereby providing a measure of clarity as to the size of the sector's capital needs and some comfort that these needs are likely to be manageable.[7] The fact that four small groups of cajas failed the 6% Tier 1 capital ratio threshold of the stress test was not unexpected, and the FROB's deadline was extended to end-2010 to cover the additional recapitalization needs (€1.8 billion) that were identified.

Access to wholesale markets was restored for the larger Spanish banks in the autumn of 2010, albeit at relatively high spreads. These institutions issued preferred shares and senior debt without government guarantees recently, and have benefited since early August from the acceptance of Spanish sovereign debt for repo operations in the LCH Clearnet (Europe's largest independent clearing house). A two-tier market, however, has emerged since funding for smaller credit institutions is primarily through covered bonds and pricing is expensive in spite of relatively short tenors. Cajas, in particular, continue to remain dependent on cheap short-term financing from the ECB. Financial market conditions remain fragile because of lingering market concerns that link Spain with problems experienced by other European countries, while the spreads on sovereign bonds have increased recently (see Figure 3).

The Spanish authorities have recently announced a plan for further strengthening the financial sector in response to market uncertainty.[8] The plan, which will be implemented through a legal reform, increases core capital requirements for all credit institutions, with even higher requirements for those that are not publicly listed, have few private investors, and are heavily

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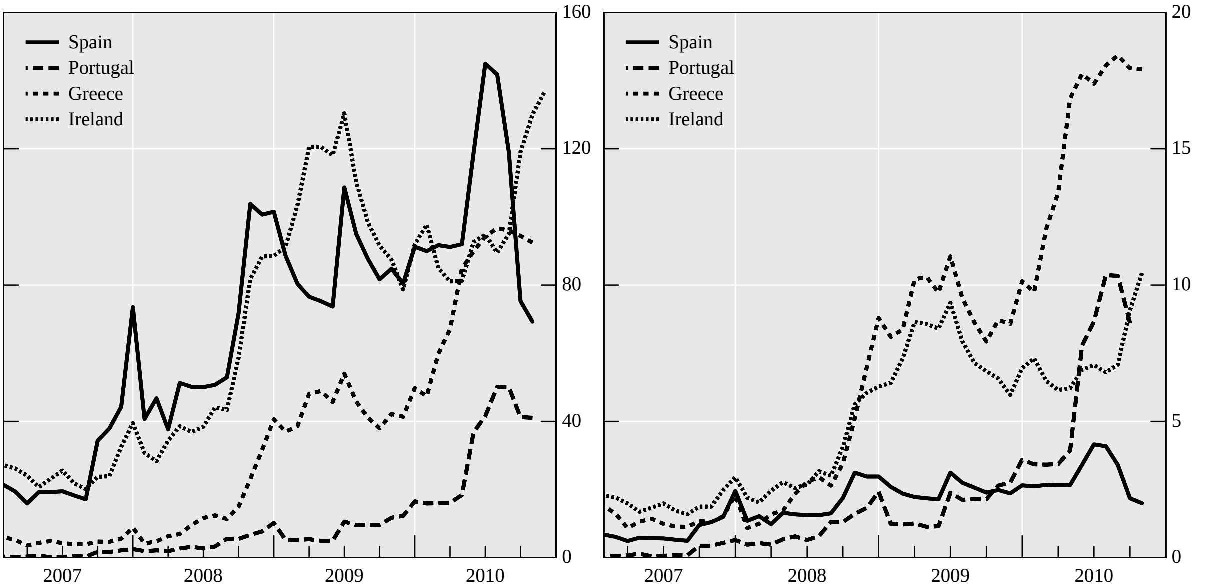
7 See the Bank of Spain (http://www.bde.es/prensa/test_cebs/resultados_cebse.htm) and the European Banking Authority (http://www.eba.europa.eu/EuWideStressTesting.aspx) for more information on the methodology and results of the stress tests.

8 See the announcement by the MEF for details (http://www.thespanisheconomy.com/pdf/110125%20Spanish%20Plan%20for%20Strengthening%20the%20Financial%20Sector.pdf).

dependent on wholesale funding markets. The main goal is that recapitalisation is mostly done through the market, although the FROB will be available to act as a backstop if needed.

Figure 2: Central bank funding of banks in Portugal, Ireland, Greece and Spain

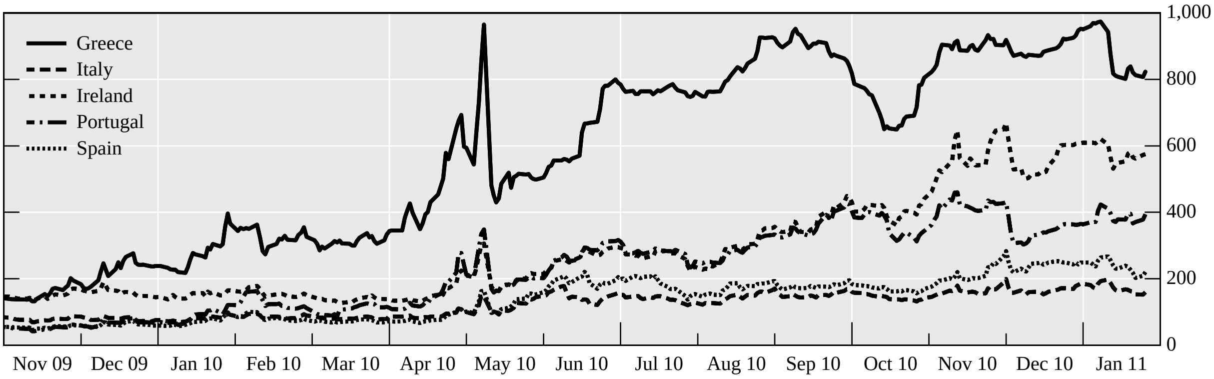
In billions of Euros — As a percentage of total banking sector assets



Sources: ECB; national data.

Figure 3: Peripheral Europe: Government bond spreads

In basis points, over 10 year German Bunds



Source: Bloomberg.

Lessons and issues going forward

The Spanish financial system has shown resilience to the initial phases of the financial crisis due to an efficient, retail-oriented bank business model and as a result of the strong regulatory and supervisory framework in place. The challenges confronting domestic financial institutions were brought about mostly by the subsequent bursting of the domestic real estate bubble, with banks over-exposed to the construction and property development sectors, and the related decline in credit growth and loan quality. Risks remain elevated in terms of asset quality and funding, and are unevenly distributed across credit institutions.[9] The savings banks sector has been particularly hit and it is undergoing significant restructuring and downsizing. The business outlook for most credit institutions is tempered by compressed net interest margins and higher loan losses, against a backdrop of a multi-year fiscal adjustment process, continued deleveraging by households, high unemployment, and subdued economic growth. Identifying future sources of growth for Spain in general, and for its financial system in particular, will be especially important following the severe contraction of the real estate sector and of related financial activities.

The authorities have taken strong actions to date to address financial system vulnerabilities, and need to continue doing so in view of recent market developments. Such determined actions became necessary partly because of the delay in addressing earlier the structural weaknesses of savings banks that were highlighted in the FSAP (see section 4). A key lesson from the Spanish experience therefore is the importance of responding promptly to FSAP recommendations to ensure financial stability.

As in other countries, the crisis has changed policy priorities, particularly in terms of focusing on strengthening bank capital, liquidity, and risk management; supporting the restructuring of financial institutions in response to a changed operating environment; and adopting a more macro-prudential orientation to financial oversight by concentrating on systemic risks. It has also highlighted important lessons that are of relevance for other countries, such as:

- The importance of a sound regulatory and supervisory framework. In particular, the actions taken by the Bank of Spain were effective in cushioning the system at the onset of the financial crisis, thereby allowing the authorities and financial institutions more time to plan appropriate responses. The successful use of dynamic provisions during the crisis to cover the credit losses that built up in bank loan portfolios is particularly relevant given ongoing discussions at the international level about moving towards an expected loan loss provisioning regime. The subsequent tightening of prudential regulations, as well as the interventions by the Bank of Spain in two credit institutions, also sent a strong signal to market participants and may thus have facilitated the restructuring process.
- The need for enhanced transparency during periods of market turbulence. As previously mentioned, the relatively more transparent approach employed by the authorities in the EU stress tests helped to allay some of the concerns by market participants at the time. Spanish banks have subsequently committed to disclose in their quarterly accounts the same granular information on their loan portfolios that was provided in the stress tests. However, while reporting of NPL figures at system-wide level by the Bank of Spain is comprehensive and granular, disclosure practices by individual banks on loan restructurings, debt-for-equity swaps, and real estate repossessions vary in scope and quality. Promoting transparency and consistency of such practices helps to provide confidence and to address any market concerns.[10]

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[9] For more details, see the latest Article IV report (IMF Country Report No. 10/254, July 2010, available at http://www.imf.org/external/pubs/ft/scr/2010/cr10254.pdf).

[10] See also the “Principles for disclosures in times of stress (Lessons learnt from the financial crisis)” by the Committee of European Banking Supervisors (April 2010, available at http://www.c-

2. Real estate markets and financial stability

The FSAP noted that rapid growth in bank lending, notably to the real estate sector, posed a risk to the quality of bank loans and to financial stability. Buoyant domestic demand had been associated with a housing boom and an increase in household indebtedness. A decline in house prices – as observed following the FSAP – could leave households with negative home equity, especially on mortgages originated at high loan-to-value ratios. Falling housing prices would impact consumer confidence, economic activity and employment, especially in the construction sector. Localized risks could also emerge among regional banks with high exposure to overvalued real estate markets, such as second residences and real estate developments.

In terms of product features, most mortgage loans at the time were carrying floating rates, meaning that the interest rate volatility risk was assumed by the borrowers. New fixed-rate or quasi fixed-rate products, and some riskier hybrid-rate mortgages - such as adjustable rate, constant payment and interest only mortgages - were beginning to be offered, but they represented a very small percentage of outstanding mortgage loans.[11]

The FSAP recommended that provisioning or capital requirements on housing and construction loans, especially non-traditional ones, be tightened, in order to address the trends in household indebtedness, real estate lending and house prices. Guidelines could also be issued to credit institutions on best practices in mortgage lending and credit to real estate developers, adding detail to existing general guidance. While mortgage lending by large credit institutions appeared aligned with international best practices, such guidance could still be useful for small or less sophisticated institutions that might not have access to the resources and expertise of larger ones.

The FSAP also recommended that steps be taken to reduce commissions and fees for changes in mortgage terms, and to remove the caps on credit institutions' commissions for early mortgage repayments. The former would improve the ability of renegotiation of a mortgage in case of household debt servicing problems, while the latter would better align commissions with the risks incurred by credit institutions and would ensure that only those borrowers repaying early the mortgage would have to pay for it.

Steps taken and actions planned

With respect to capital requirements on housing and construction loans, Spain introduced in 2008 a more stringent treatment for commercial real estate (CRE) and residential (RRE)

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ebs.org/documents/Publications/Standards---Guidelines/2010/Disclosure-guidelines/Disclosure-principles.aspx).

[11] Adjustable rate mortgages are priced at (relatively low) fixed rates for the first few years, and then convert to floating rate for the rest of the mortgage life. Constant payment mortgages are variable rate mortgages with equal payments throughout the length of the contract, where ups/downs in interest rates extend/reduce the maturity of the mortgage but leave constant service payments. Interest-only mortgages push bank repayment of the principal to the final maturity.

exposures than the one envisaged in the Capital Requirements Directive (CRD) of the EU. This was done in order to penalize non-traditional riskier mortgages with higher capital requirements. More specifically, the portion of such mortgages that exceeds pre-defined loan-to-value (LTV) thresholds is penalized with progressively higher risk weights.[12]

The Bank of Spain reformed its specific provisioning guidelines in 2010 (while keeping dynamic provisioning rules unchanged) in two ways. First, the presence of real estate collateral was recognized for the purposes of reducing provisions set aside for NPLs. This approach of collateral recognition is based on valuation haircuts of 20%-50% depending on the type of real estate collateral. The collateral valuation is also conservative, being the lower of the cost stated in the deeds or the appraised value for ongoing contracts, and the lower of carrying amount or appraisal value for repossessed real estate.[13] Second, the specific provisioning calendar was accelerated for the unsecured part of loans such that it has to be fully provisioned within 12 months from default. This represents a considerable acceleration of provisioning compared to the range of 24-72 months in the past. In addition, tighter rules on provisioning for repossessed real estate were introduced to account for the possibility of further deterioration in the market value of the repossessed property.[14]

As a result of recent experience in assessing loan portfolios of supervised institutions, pre-existing regulations on credit risk policy and risk management practices have been enhanced. More recently, the regulation on good practices in mortgage lending and credit to real estate developers was also revised in light of the lessons from the crisis. Both of these regulations focus on ensuring adequate assessment of the capacity of borrowers to repay loans, the role of collateral in underwriting and risk management practices, as well as conditions that must be considered when restructuring loans. In addition, Spain is involved in EU-wide efforts to better regulate responsible lending practices. The result of such work will be an EC Directive at the beginning of next year, which should include norms on publicity, pre-contractual information, measures to correctly assess creditworthiness, and requirements for the pursuit of the mortgage lending business.

With regard to the final set of FSAP recommendations in this area, the fees for changes in the conditions of a mortgage contract ("*novación modificativa*") were significantly reduced in 2007, particularly the registration costs ("*aranceles registrales*"). In addition, and to facilitate the restructuring of mortgage contracts over this period, the government introduced a temporary measure for April 2008-2010 that eliminates mortgage modification fees.

The regime on commissions for early mortgage repayments and for conversions from fixed to variable-rate mortgages was also modified in 2007. Banks can no longer charge such

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[12] In particular, standard risk weights (35% for RRE and 50% for CRE) are applied only to the part of the mortgage that does not exceed an LTV ratio of 80% for RRE and 60% for CRE exposures. The portion of a mortgage with an LTV range of 80%-95% for RRE and 60%-80% for CRE exposures is charged with a 100% risk weight, while anything above those LTV thresholds is penalized with a 150% risk weight. Compared to the CRD, more stringent risk weights are applied in Spain to RRE and CRE exposures with an LTV ratio above 95% and 80% respectively.

[13] Spanish law establishes authorization parameters for real estate appraisal firms, including fit-and-proper rules, independence requirements, valuation conditions, and a sanctioning regime.

[14] The minimum impairment to be applied is 10% in the event of foreclosure or payment in-kind, 20% after 12 months, and 30% after 24 months.

commissions for contracts with individuals and small businesses, although the reform introduced compensations in order to reimburse banks for the assumed prepayment and interest rate risks. Such compensations need to be anticipated in the contract and are subject to caps in order to guarantee a certain degree of consumer protection and avoid any possible position abuse.

Lessons and issues going forward

While FSAP recommendations were primarily aimed at non-traditional mortgage loans, Spain has linked capital requirements to risk in a more comprehensive fashion by using LTV ratios as a parameter for determining regulatory capital charges. The change in loan loss provisioning rules is also an improvement, especially with regard to the acceleration of the provisioning calendar for the unsecured part of the loan and for the stricter treatment of repossessed real estate. Although the change in provisioning rules is quite recent, evidence to date (impact assessment by the Bank of Spain and quarterly result announcements by some Spanish banks) suggests that it will increase banks' specific provisions in 2010 and beyond.

The improvements made in the guidelines to credit institutions on best practices in mortgage lending are generally in line with FSAP recommendations. The efforts carried out at EU level to develop new policies concerning responsible lending and best practices on mortgage credit are expected to lead to further improvements in this area. It is worth noting that conservative residential mortgage lending regulations and market practices have prevented an even worse NPL performance given the severe contraction of the real estate market.[15] However, the fact that the vast majority of mortgages in Spain are indexed to floating rates (Euribor) raises the risk of additional NPLs being created when rates rise.

Spain has also taken steps to meet the FSAP recommendations of trimming legally established fees for changes in mortgage contracts. The temporary elimination of mortgage modification fees by the government indicates its resolve to be flexible in order to facilitate mortgage modifications and restructurings under a difficult economic environment. However, in contrast to the relevant FSAP recommendation, credit institutions' commissions for early mortgage repayments and for conversions from fixed to variable-rate mortgages are now forbidden in contracts with individuals and small businesses. Although such commissions have been replaced by compensations to reimburse banks for the assumed prepayment and interest rate risks, they remain subject to caps for consumer protection purposes.

Spain's experience has brought to the forefront the high loan exposures to real estate and construction, which were created in response to an economy-wide boom in that sector. Many credit institutions adopted similar business strategies during the good times and aggressively expanded their activities in this area without apparently adopting any sectoral exposure limits, resulting in system-wide overcapacity and asset concentrations that now need to be

[15] These include mandatory insurance for all mortgages with an LTV ratio above 80%; the right for banks to seize other obligor assets in case of mortgage default; and the requirement that an LTV ratio must be below 80% for a mortgage to be eligible as collateral for covered bonds. According to the Bank of Spain's latest Financial Stability Report (October 2010, at http://www.bde.es/informes/be/estfin/completo/estfin19e.pdf), the average LTV ratio for Spanish RRE mortgages is 62%, and it is relatively homogeneous across deposit institutions; less than 20% of all RRE mortgages had an LTV ratio above 80%. These help explain why the NPL rate for residential mortgages (around 3%) is lower than for loans to property developers (over 10%).

addressed. Micro-prudential measures, such as the ones mentioned above, were an important, albeit insufficient, buffer against the risks emanating from such activities. While supervision is not a substitute for effective risk management by the financial institutions themselves, there are lessons about the degree of intrusiveness and the questioning of firms' business strategies by supervisors going forward.[16]

Many countries around the world have experienced a real estate boom whose aftermath has, given rise to, or exacerbated, financial instability. While there are a variety of micro- and macro-prudential policy measures that can help to address the build-up by banks of real estate exposures, sufficient supervisory independence and powers is needed to be able to calibrate them appropriately. Different jurisdictions have addressed this issue using both demand side measures (e.g. LTV caps, affordability requirements, elimination of tax benefits for home purchases[17]) and supply side measures (risk management guidelines, capital and loan loss provisioning requirements, property valuation rules, portfolio and leverage limits) that have varied widely in their scope and intensity.[18] Such measures often extend beyond prudential regulation and supervision depending on particular national circumstances and political economy trade-offs, and can include monetary policy and fiscal reform among others.

3. Regulatory framework for industrial participations

The significant equity investments of large Spanish banks in nonfinancial companies (notably in utilities, energy and telecommunications) were a cause of concern that was highlighted in the 2006 FSAP. Sizeable industrial participations made banks vulnerable to declines in equity prices, with concentration in a few sectors or companies potentially adding to volatility in returns. Furthermore, the significant size of these positions may result in illiquidity, hampering a wind down of participations by those credit institutions that may want to limit their exposure to individual companies and/or industry segments during adverse economic conditions. Under such conditions, contagion effects may also be visible as deteriorating confidence in individual companies may spread to others in the same industry, thus putting pressure on investments made and loans held by credit institutions in these companies.

Another source of concern that was mentioned in the FSAP was the possibility of conflicts of interest and information asymmetries arising from major participations by banks in a single company relative to other investors. The FSAP encouraged the authorities to consider

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[16] This issue is addressed in the November 2010 report by the FSB, prepared in consultation with the IMF, on supervisory intensity and effectiveness for systemically important financial institutions (available at http://www.financialstabilityboard.org/publications/r_101101.pdf). See also "The Making of Good Supervision: Learning to Say No" by Viñals et al. (IMF Staff Position Note 10/08, May 201, available at http://www.imf.org/external/pubs/ft/spn/2010/spn1008.pdf) and "Trust Less, Verify More: Financial Supervision in the Wake of the Crisis" by Briault (World Bank Group Crisis Response Note 5, July 2009, at http://rru.worldbank.org/documents/CrisisResponse/Note5.pdf).

[17] Spain is, in fact, eliminating interest tax deduction on mortgages (except for low-income households) starting in 2011.

[18] See the FSB thematic peer review report on residential mortgage underwriting and origination practices (available at http://www.financialstabilityboard.org/).

whether the conflict of interest guidelines in place adequately address potential conflicts. In particular, conflicts of interest could stem from the possibility that bank directors or officers also serve as directors in an industrial company in which the bank has ownership and to which the bank, at the same time, also extends credit or provides other financial services.

To mitigate the risks inherent to equity investments, the FSAP recommended that authorities take additional regulatory measures to reduce the incentive for industrial participations, such as adopting the most conservative approaches under Basel II. To limit conflicts of interest, it also recommended that regulations be introduced to prevent bank employees serving on the board of a nonfinancial company from taking part in the bank's decisions regarding that company - for example, with respect to lending.

Steps taken and actions planned

The Spanish authorities have taken some steps in response to the FSAP recommendations. First, Spain adopted the more conservative Basel II regulatory capital approaches for nonfinancial equity investments as part of its transposition of the CRD in 2008. The Spanish legislation already had, prior to the 2006 FSAP, established limits for equity participations in accordance with the relevant EU legislation[19] and required credit institutions to deduct industrial participations that exceed certain thresholds from their own funds when calculating solvency requirements.

Second, the Spanish Corporate Governance Unified Code, which was published shortly after the completion of the FSAP in 2006, contains various recommendations related to conflicts of interest and the independence of the decision taking process in quoted companies. The Code follows a "comply or explain" approach, meaning that listed banks and all savings banks should explain, in their annual public report, their level of compliance with all of the Code's recommendations. An assessment of corporate governance related issues is also a key component of ongoing supervision of credit institutions by the Bank of Spain.[20]

In addition, it is worth noting that the Bank of Spain had established, even prior to the FSAP, prudential controls aimed at preserving the independence of the decision taking processes in credit institutions.[21] Through these requirements, the authorities intend to ensure that non-financial equity investments are undertaken at arm's length conditions and are appropriate for the sound management of the credit institution.

Lessons and issues going forward

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[19] Article 120 of Directive 2006/48/EC sets a limit of 15% of the credit institution's regulatory capital for any individual participation in nonfinancial entities, and a limit of 60% for the entire portfolio of equity holdings.

[20] The supervisory approach of the Bank of Spain is described in more detail in the publication "The *Banco de España* Supervisory Model" that is published on its website (www.bde.es).

[21] For example, authorization by the Bank of Spain, in addition to review and formal agreement of the institution's board of directors (without participation of the relevant manager or director), is required before granting any borrowing facilities to the directors and managers of credit institutions, as well as to legal entities that they are involved with. Credit institutions are also required to report semi-annually to the Bank of Spain all persons classified as related parties to whom credit facilities have been granted.

The Spanish authorities have made some progress to date in addressing the relevant FSAP recommendations on industrial participations, specifically via the implementation of the Basel II framework and additional regulations addressing conflicts of interest issues. Recent data indicates that the size of participations relative to regulatory capital has decreased from approximately 60% in December 2005 to 47% in December 2009.

While the above actions have contributed to credit institutions holding more capital as a result of their industrial participations, the Basel II (or indeed, the forthcoming Basel III) framework does not specifically address all related types of risks. These participations are often intrinsically linked to, and supportive of, nonfinancial companies' business models and strategies, making them difficult to untangle. The FSB is of the view that large industrial participations by banks not only create potential conflicts of interest, but may also pose concentration, reputational and systemic risks. Further regulatory efforts may therefore be necessary to ensure that the overall exposure of Spanish banks to such participations does not generate important vulnerabilities and continues to decrease in an orderly fashion. The Spanish authorities agree that proper monitoring and supervision of these participations is required, although they believe that such investments reflect the traditional banking business model in Spain and that they have had clear benefits in terms of the growth and competitiveness (including internationally) of the private sector. They also point out that, given the small size of the domestic institutional investor base, there exist few alternative sources of equity finance.

More broadly, significant equity investments by banks in non-financial companies have been a structural feature of many countries' financial systems in the past. These participations have been reduced in recent decades as a result of policy measures to address connected lending problems in mixed-activity conglomerates (including in Spain), and as capital markets develop and firms are better able to raise funds from institutional and foreign investors. Long-term industrial participations by banks may continue to be a viable business model in certain occasions, although prudential measures are necessary to mitigate related risks.

4. Regulation, supervision, and governance of savings banks

The FSAP found that structural features of cajas limited their capacity to raise capital and could make them potentially subject to outside pressure to influence their commercial operations. Because the cajas can issue debt but not equity, additional mechanisms to ensure strong governance and market discipline would be particularly important. Some key steps, such as reducing the ceiling on public sector representation on boards, had been taken to improve their corporate governance since 2002, but it was too early to see their full effects.

The FSAP recommended several actions to maintain the cajas' strong market orientation:

- Ensuring that initiatives since 2002 to improve corporate governance of all credit institutions have been fully implemented, and strengthening them if required;
- Allowing the cajas to merge freely (with the consent of the Bank of Spain) within and across autonomous communities;

- Promoting over time new means to raise high-quality (Tier 1) regulatory capital from private sources, such as the issue of *cuotas participativas*; and
- Reducing over time the public sector representation ceiling on savings banks boards (50 percent at the time of the FSAP).

Steps taken and actions planned

Royal Decree-Law 11/2010 introduces substantial changes to the legal regime of savings banks in order to promote their access to capital markets, to raise high-quality capital, and to enhance the fitness and propriety of their managers and directors by reducing the public sector representation ceiling and tightening suitability requirements.

One of the main objectives of the reform was to make the corporate governance of cajas more professional and transparent in line with the principles underlying corporate governance of commercial banks. Adopted measures include: reducing the ceiling on the voting rights of public entities within savings banks from 50% to 40%; establishing fit and proper requirements for representatives of regional governments to ensure good repute and sufficient expertise to perform their duties; prohibiting elected officials from serving in their governing bodies; including dispositions on conflicts of interest for different categories of staff; introducing new requirements on knowledge and expertise for staff in control functions, directors and managers[22]; strengthening criteria on reputation and experience through the establishment of a new Appointment and Remuneration Committee for each caja; and requiring the annual publication of a report on corporate governance.

Another important change relates to the need for cajas to obtain autonomous communities' authorization in the case of inter-regional mergers. The conditions for denying such an authorization have been restricted to cases in which some objective legal requirement is not met.[23] In addition, the need for authorizations has been removed in the case of restructuring plans involving the FROB, which only require authorization by the Bank of Spain.

The reform also addresses the inability of cajas to raise equity from external sources under conditions equivalent to those of commercial banks, which was one of the main flaws highlighted by the crisis. Savings banks have four options in that respect[24]:

- Maintain their existing structure, but with increased ability to issue *cuotas participativas*. The objective is to make this equity instrument more attractive for private investors and to ensure that it is treated as high quality capital. Savings banks now have the possibility to incorporate voting rights to *cuotas participativas* up to an overall limit of 50% of total equity. The new regime also eliminates the 5% limit on *cuotas* that an individual or group of individuals can hold, and removes the need for any administrative authorization other than fit-and-proper requirements that are applicable to all credit institutions.

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[22] These include a requirement that at least half of Board members have relevant experience.

[23] Examples of such requirements, which differ across autonomous communities, include the preservation of stakeholders' rights and the continuity of social functions.

[24] In order to avoid the actual choice between these four options being based on fiscal considerations, the tax treatment has also been adapted to guarantee that all types of structures are treated symmetrically.

- Integrate part of their operating structure (at least 40% in terms of capital and profits) in a group of cajas using the so-called Institutional System of Protection (SIP). The SIP, which was established by Royal Decree-Law 6/2010, is a contractual agreement that brings together a group of credit institutions in order to pool their solvency and develop risk sharing strategies. In the special case of savings banks, this system is organized around a central entity, a commercial bank, which will be able to raise equity in capital markets. The obligation to remain in a SIP lasts for at least 10 years, while the total capital participation of all credit entities in the SIP must not fall below 50% in order to avoid the loss of control over the central entity. This system therefore attempts to resolve the problem of raising capital while preserving the special nature of cajas. In cases where the group of cajas does not meet this requirement, they will have to transform themselves into foundations and transfer their financial activity to the commercial bank acting as the central entity.
- Retain their legal nature, but transfer their financial activities to a subsidiary commercial bank that can also raise external equity. In order to safeguard the special nature of a caja, its capital participation in the bank should not fall below 50%.
- Transform themselves into foundations and transfer their financial activity to a commercial bank, in which they will have a stake that can be below 50%.

Lessons and issues going forward

The deficiencies in corporate governance and external capital-raising ability of savings banks were exposed in the aftermath of the crisis, forcing the authorities to take corrective actions. The above measures, some of which received financial support from the FROB, have allowed 38 out of 45 savings banks to embark on a restructuring and consolidation process that will result in a substantial reduction of their number, employees, and branches (see section 1).[25]

The comprehensive reform introduced in 2010 addresses most FSAP recommendations, particularly those related to strengthening corporate governance and the ability to raise capital from external sources. Some of the changes bring cajas closer to the prudential framework of commercial banks, especially those concerning the professionalization of the management via additional corporate governance requirements. Other changes, such as those addressing the ability to raise external capital and to facilitate mergers across communities, are very creative and adapted to the Spanish legal framework and context.

The reform represents an important step forward but it is too early to judge its effectiveness, particularly because most integration processes were only recently initiated. The results - in terms of operational integration and the ability to raise external capital - can only be seen in the medium term, and continued decisive action by the authorities may be needed to address any impediments in the execution of the reform plan that may arise.

Savings banks have traditionally played an important role in several European countries (e.g. Italy, Germany, Netherlands, Austria, United Kingdom, and Norway). Even though the term "savings bank" can refer to different types of institutions across countries, these are typically

[25] For more information, see "Restructuring of Spanish Savings Banks" note by the Bank of Spain (June 2010, at http://www.bde.es/webbde/GAP/Secciones/SalaPrensa/NotasInformativas/10/Arc/Fic/presbe22_en.pdf).

characterised by distinct business models compared to commercial banks but also by unique challenges with respect to governance and their ability to raise capital from external sources. Reforms of savings banks have been initiated in several jurisdictions in recent decades to preserve them as a useful pillar of the financial system that diversifies risk and enhances competition. One key lesson from Spain's experience is that such institutions should follow very conservative risk-taking policies (in terms of both lending and funding) when they lack access to external sources of capital.

5. Inter-agency coordination and supervisory autonomy

While the FSAP recognized the overall strength of the Spanish financial sector and found a high degree of observance of principles dealing with effective supervision, it made several recommendations applicable to the three regulatory authorities - namely, the Bank of Spain, the National Securities Markets Commission (CNMV), and the Directorate General of Insurance and Pension Funds (DGSFP) of the MEF. The most important ones were:

- Further strengthening the autonomy of the three financial regulators by delegating the authority to issue norms and sanction violations from the MEF and from the Council of Ministers to the respective agencies. This would help minimize any chance of political interference in the future (although the FSAP found no instances of this) or undue self-restraint of the supervisors. In that regard, the FSAP recommended the separation of insurance supervision from the MEF to achieve greater operational, institutional, and budgetary independence, and the appointment of members of the CNMV board for longer, non-renewable terms;
- Creating an institutional mechanism for regular and continuous high-level coordination among the three financial regulators; and
- Ensuring that reforms in the statutes of regional governments (Autonomous Communities) unambiguously maintained the national supervisors' sole responsibility and powers regarding prudential supervision and regulation.

Steps taken and actions planned

Consistent with their response at the time of the FSAP recommendations, the Spanish authorities are of the opinion that further delegation of regulatory and sanctioning powers from the MEF to financial sector regulators is neither practicable under Spanish law nor desirable from a policy perspective. For example, the authorities assert that delegating more sanctioning powers to supervisors may create potential conflicts of interest with their supervisory responsibilities. Although there have been specific normative delegations to the regulators when the degree of technicality of the relevant norms justified it, the overall distribution of supervisory and regulatory powers that existed at the time of the FSAP has not essentially changed. The authorities point out that the FSAP had found no instance of political interference in sanctioning powers over credit institutions on prudential matters, and that the recently created European Supervisory Authorities reproduced a similar structure to the Spanish framework for financial regulation at EU level.

With regard to insurance, in particular, the authorities note that insurance supervision in Spain has traditionally been a function allocated to the MEF, and that the FSAP highlighted that the quality of insurance supervision was generally high. They emphasize that, while DGSFP still forms part of the MEF, it carries out its duties in accordance with national regulations based on international standards (Insurance Core Principles or ICPs), and is represented in relevant EU oversight bodies. As such, they conclude that DGSFP is capable of safeguarding an efficient, fair, safe and stable insurance market in Spain.

On the issue of the appointment of CNMV board members for longer, non-renewable terms, the authorities have not undertaken steps to address the relevant FSAP recommendation. They note that such appointments are currently renewable only once, thereby allowing for a maximum term of no more than eight years. In addition, since a renewal of the entire board is unlikely to take place in practice, there is likely to be sufficient diversity of members.

With regard to the recommendation to create an institutional mechanism for regular and continuous high-level coordination, the authorities established the Financial Stability Committee (CESFI) in 2006. The three financial sector regulators are represented on this Committee, together with the State Secretary for Economic Affairs (acting as Chair) and the Director General on Treasury and Financial Policy (in charge of the Secretariat of CESFI). The Committee, created through a Memorandum of Understanding (MoU) signed by its members, offers a forum for information exchange on potential systemic financial stability issues. While CESFI does not have any decision making powers of its own, it is expected that the exchange of relevant information will lead to duly coordinated actions by its members. The Spanish authorities are of the view that CESFI has proven a useful tool during the financial crisis, since it met every 1-2 months and developed several working groups for information exchange on market developments and for the analysis of instruments to address financial stability. In addition to CESFI, coordination and cooperation between the Bank of Spain and the CNMV has strengthened via the amendment in 2008 of their MOU. The DGSFP has also signed an MOU in 2004 with the Bank of Spain and CNMV aimed at improving coordination and exchange of information.

Finally, with regard to reforms in the statutes of Autonomous Communities, the Spanish Constitutional Court has confirmed in Judgement 31/2010 the role of national supervisory authorities in the prudential oversight of financial institutions.[26] This judgement has preserved the traditional concept and scope of basic national regulations regarding national regulatory powers and executing functions, as recommended in the FSAP.

With regard to the insurance market in particular, and as part of the broad reform of the Statutes of Autonomy of the regional governments that started in 2004, some Autonomous Communities obtained competences in supervising insurance cooperatives (*"mutualidades de previsión social"*). In those cases, the role and responsibilities of the Autonomous Communities have remained within the limitations stemming from the Constitution and the

[26] The Judgment followed a reform of the Statute of Autonomy by the Autonomous Community of Cataluña, which raised doubts on the allocation of some responsibilities, including in financial supervision. In determining its constitutionality, the Constitutional Court confirmed the allocation of competences in the Constitution. According to this allocation, all financial solvency competences in regulation and enforcement accrue to national authorities (i.e. the Bank of Spain for credit entities), while Autonomous Communities are responsible for certain corporate governance, consumer protection, and social welfare issues.

Statutes of Autonomy. The reforms have therefore kept the existing balance regarding allocation of supervisory responsibilities - namely, that DGSFP is responsible for supervising insurance companies with the exception of smaller mutualised undertakings.

Lessons and issues going forward

The Spanish authorities have addressed the FSAP recommendations on enhancing coordination and cooperation between financial sector regulators and on ensuring that national supervisors' prerogatives in prudential matters have been unambiguously retained in the reforms of the statutes of Autonomous Communities. However, other recommendations, such as strengthening the autonomy of financial regulators (particularly on insurance) and delegating to them the authority to issue norms and to sanction violations, have not been taken up. While it is understood that further delegation of relevant powers from the MEF to regulators raises difficulties under Spanish law, the observations made by the FSAP - regarding the risks of political interference in the future or undue self-restraint of supervisors in the presence of insufficient independence - remain valid. Similar issues essentially apply to the appointment of CNMV board members for longer, non-renewable terms.

In this context, it is worth noting that the authorities were considering prior to the crisis the possibility of modifying the structure for financial supervision in Spain in order to create a so-called "twin peaks" system. Under this arrangement, the Bank of Spain would be responsible for prudential supervision of financial institutions (including insurance), while the regulation of market conduct would be the responsibility of an independent agency that would be set up from the current CNMV. This reform was put on hold for two reasons. First, the authorities concluded that a significant modification of the institutional framework was not advisable during the financial crisis. Second, it was felt that it would be better to defer such changes until the new EU-wide supervisory architecture is in place, as will be the case in 2011. It is recommended that, when markets are less volatile, the authorities reconsider the current institutional framework taking into account the relevant FSAP recommendations.

While there is broad agreement on the need for supervisory independence, there is a wide range of practices and views across countries regarding the optimal structure of supervisory arrangements.[27] The trend towards having an integrated financial supervisor (typically outside the central bank), which was increasingly prevalent in some jurisdictions prior to the crisis, has not proven superior in achieving all regulatory objectives. While the financial crisis highlighted some useful lessons on financial supervision, it did not conclusively resolve the debate on the supervisory structure. Moreover, the need to extend the regulatory perimeter and to develop macro-prudential policy frameworks has complicated this debate.

Although there is no single optimal structure and different organisational models have their own pros and cons, the relevant authorities need to be able to work together and exchange information. Organisational structures are secondary to ensuring that these agencies have the tools to intervene when necessary, and the willingness and independence to do so. In addition, the respective responsibilities of authorities need to be clear; in particular, it is critical to have clarity on who among the authorities is in charge in the event of a crisis. If the

[27] See "The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace" by the Group of Thirty (October 2008, available at http://www.group30.org/100608release.pdf).

organisational structure is to be revised, it would be better to do so during a period of financial stability in order to ensure that the pros and cons can be carefully considered and that resources are available to implement the changes.

6. Insurance supervision

The FSAP noted the general high quality of insurance regulation and supervision and made a number of recommendations to further align the regulatory and supervisory framework to the ICPs. In addition to steps to enhance the autonomy of the insurance supervisor and inter-agency coordination (see section 5), these included measures to strengthen observance in areas where it had been found to be partial, such as:

- including specific suitability and fit and proper requirements for actuaries as part of the licensing process and on an on-going basis for insurance companies;
- establishing general corporate governance requirements for all insurers (irrespective of whether they are listed), including clear responsibilities for the boards of directors and senior management;
- considering a regulatory requirement for insurers to maintain a framework for internal control that includes internal auditing procedures, risk management systems, assessment of outsourced functions and clear responsibilities for the board of directors;
- incorporating explicit requirements for insurers to have an overall strategic investment policy approved and reviewed regularly by the board of directors, specific fit and proper requirements for staff involved in investment activities, and requirements for insurers to implement audit procedures with respect to investment operations;
- considering explicit regulatory requirements on the board of directors to ensure the necessary expertise related to the use of derivatives, to approve and review periodically a policy on their use, and to have in place risk management systems and audit procedures covering the risks from derivatives;
- including explicit requirements in the regulatory framework on policies and systems on risk assessment and management for insurers, which should be verified as part of the supervisory process;
- collecting relevant information from insurers and implementing regular analysis of market conditions, including the identification of trends and scenarios that could impact future developments; and
- providing the necessary resources to DGSFP so that it can participate effectively in group-wide supervision.

Steps taken and actions planned

The DGSFP is in the process of transposing EU Directive 2009/138/EC (Solvency II). Article 42 of this Directive states the general fit and proper requirements for persons who manage the insurer or have other key functions, and Article 48 includes more specific requirements on the actuarial function. The DGSFP will also include the actuarial function as one of the key functions in the new regulatory framework in Spain, and it intends to implement the new framework by 31 October 2012 in order to coincide with the target date set by the EC on Member States.

With regard to corporate governance requirements for insurers, existing legislation already includes certain responsibilities imposed on the board of directors and senior management, such as on internal controls, winding up, and breach of regulations by the insurer. However, no additional steps have been undertaken to establish general requirements or guidance on corporate governance for all insurers that would include clear and comprehensive responsibilities for the board of directors and senior management. For example, there are currently no regulatory requirements for non-listed insurers[28] with respect to the structure and membership of their board of directors to ensure independence and effectiveness.

Regarding internal controls and investment policies of insurers, the relevant regulation was amended in 2007 to enhance relevant requirements (particularly for boards of directors and senior management) and to cover investment activities (including the use of derivatives). Along with the implementation of Solvency II, the fit and proper requirements would apply on the relevant persons in the investment functions of insurers.

On risk assessment and management, an asset-liability management system is already included in prudential regulation for life insurance policies. Article 44 of Solvency II will introduce additional requirements with respect to risk management systems for insurance and reinsurance undertakings. DGSFP staff already verifies during on-site inspections the existence and adequate operation of risk management systems by insurers.

The DGSFP also analyses the insurance and pension funds sector, and publishes an annual report that is made available on its website. This analysis is both quantitative and qualitative in nature, and covers areas like market structure, market development, identification of domestic and international trends, developments in the supervisory and regulatory framework, and the claims servicing activities of the DGSFP. In the conduct of the analysis, the DGSFP makes use of information submitted by the insurers (on a solo and group level) on a quarterly and yearly basis. The insurers have been submitting such information through a new reporting template introduced in 2008/2009. The new template includes information on, among others, gross and net insurance premiums, claims, balance sheet and profit and loss items, technical provisions, investments, expenses, and calculations on compliance with solvency requirements.

The total number of staff in the DGSFP since the FSAP has remained almost unchanged. However, the number of staff involved with group-wide supervision has increased steadily and has actually doubled since 2006 (albeit from a low level). The DGSFP has also implemented certain processes and tasks related to group-wide supervision, including the conduct of on-site inspections at a consolidated level, more interactions with other regulators, and the organisation and attendance of supervisory colleges.

Lessons and issues going forward

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[28] Corporate governance requirements currently apply only to the two insurers (with a combined market share of around 18%), out of 290 insurers supervised by DGSFP, that are listed on the Spanish stock exchange.

The regulatory reform enacted in 2007 and operational changes by the DGSFP appear to have already addressed FSAP recommendations regarding internal controls, investment requirements, and adequate verification of the risk management processes of insurers. The annual market analysis, its publication, and the implementation of new reporting templates also indicate that the DGSFP has made progress in this area. The implementation of Solvency II will likely address other relevant FSAP recommendations, particularly fit and proper requirements, risk management systems, and the actuarial function. Although the DGSFP is making progress in the transposition of this Directive, it will take another two years before the entire new regulatory framework can be implemented.

As mentioned in the FSAP recommendation, the DGSFP could also consider establishing general requirements on corporate governance that are comprehensive and applicable to all insurers, given its critical role in ensuring that the board of directors and senior management oversee and manage the insurer prudently. These could include general requirements on non-listed insurers with respect to the structure and membership of their board of directors, and responsibilities for the board of directors and senior management similar to those listed in the ICPs. Moreover, there may be a need to introduce additional specific requirements on boards of directors regarding their understanding of the use of derivatives. These requirements would need to go beyond general fit-and-proper rules of Solvency II, and would be motivated by the special concerns that these types of instruments raise as outlined in the relevant ICP.

Finally, the big increase in the number of staff involved in group-wide supervision, as well as better group-wide analysis, are evidence of greater attention given to this issue. However, the total number of staff in the DGSFP has remained almost unchanged since 2006, which implies that the increased intensity on group-wide supervision may have been achieved at the expense of other functions. There may therefore be a need for the authorities to consider whether the resourcing of DGSFP is sufficient to carry out its ambitious mandate going forward, particularly once Solvency II is implemented.

7. Securities settlement systems

The FSAP had assessed the observance of the CPSS-IOSCO standards by Spanish securities settlement systems, and found that they were in full compliance with most of them. It made a number of recommendations to further strengthen the national central securities depository (Iberclear), in particular in areas of broad or partial observance of the relevant standards:

- improve risk controls by prohibiting debit balances in a participant's securities account in the Securities Clearance and Settlement Service (SCLV) platform;
- test its backup facility with its members more frequently and evaluate the actual independence of critical services, such as telecommunication facilities;
- implement an effective process to obtain the views of its participants on the efficiency and costs of its services and operations, or regularly survey its participants on these matters; and
- implement international communication standards for all participant communications.

Steps taken and actions planned

Regarding the first recommendation, the clearing and settlement regulation prohibits debit balances in a participant's securities account in the SCLV platform. A potential exceptional short position in a client's securities account should be distinguished from an overdraft in the Iberclear member's omnibus securities account in the SCLV platform. An overdraft in the securities account of an Iberclear participant has, in fact, never occurred.

The Spanish authorities have taken additional steps to minimise potential short positions in the securities accounts of the clients of Iberclear participants. These included:

- Increasing the number of daily multilateral settlement cycles in the SCLV platform in order to speed up the settlement process, reduce settlement failures, increase intraday finality capabilities, and enhance the volume of securities valid for delivery. Presently the Iberclear-SCLV platform operates three multilateral settlement batches and two bilateral batches during the day.
- Undertaking an on-site inspection by the CNMV of Iberclear in 2006 in order to check Iberclear's compliance with post-trade regulation, particularly whether the prohibition of a debit balance in participants' securities account was being observed. The inspection did not reveal any instance of violation of this regulation.
- Continuously monitoring failed transactions in the SCLV and the public debt Central Public Registry (CADE) settlement platforms of Iberclear. Between January and August 2010 the daily average of failed transactions was between 0.12% and 0.20% of the total number of settled trades, which is very low compared with other main EU post-trading infrastructures.

As regards the second recommendation, Iberclear has developed a contingency plan and backup facilities to assure that all critical business functions will continue running and to mitigate the impact on participants. The contingency plan is managed by a group of specialists who have remote access to the system even when access to the main site is not available. Iberclear systems are in a secure, underground environment, with the back-up centre located 23 km away from the main site. The backup site receives simultaneous mirror data from the main site, and was operated by a vendor until 2006 based on Service Level Agreements and subject to regular review by the holding company that manages the different securities markets and financial systems (BME). Iberclear has taken up the operations of the backup site since 2007. The BME carries out external audits of Iberclear's information technology systems on an annual basis, while the CNMV undertakes ad hoc reviews in the case of major events, such as migration to a new or upgraded system.

Regarding the third recommendation, all Iberclear members have two separate connections: one with the Iberclear's main facility and another one with the backup/contingency site located in a separate data centre. Data from the main facility is replicated synchronously at the backup/contingency site. With regard to the reliability of Iberclear's business contingency plan, the backup/contingency system and facilities are based on totally separated and duplicated equipments and data centre infrastructures using different resources. Testing of the contingency system takes place regularly, with the last one undertaken in June 2010. In these cases, and for one whole day, the contingency system is used in real production environment switching back and forth from the main data site to the backup site.

21 out of 199 participants of Iberclear, representing almost 50% of the total value of securities in this depository, are represented in the Technical Advisory Committee (TAC). The Spanish Banking Association, Confederation of Savings Banks, and the Spanish stock exchanges are also represented in the TAC, which is responsible for monitoring and examining Iberclear's operational systems and advising the Board on matters such as efficiency, security and other technical matters. It meets regularly to discuss operations, projects, fees and participants demands for new services. In addition, Iberclear established a Technical Risk Management Committee (TRMC) in 2007 to obtain the views of its participants about potential improvements and developments in the services provided and fees charged; participants in the TRMC hold almost 45% of the total value of the Iberclear system. Any developments and changes affecting the efficiency, the procedures, and the costs of the system for participants are submitted to these two Committees in order to reach consensus. CNMV is monitoring the functioning of these mechanisms to analyse if further actions are needed to increase the users' say in matters of general interest.

In response to the last FSAP recommendation, Iberclear has made substantial improvements in the standardization of flows and messages for communication with its participants. Currently all bilateral communications between participants are fully standardised and ISO 15022-compliant, with the exception of the transactions executed at the Spanish stock exchanges given their multilateral settlement procedure.[29] Iberclear also intends to implement ISO 15022 messages in the short term for reconciliation and in the medium term for corporate actions.

Lessons and issues going forward

The Spanish authorities have improved their securities settlement systems in response to the FSAP, and continue their efforts to bring more safety and efficiency in securities settlement. Since 2007, the CNMV and the Bank of Spain have been studying the clearing, settlement and registry procedures of Iberclear's equity settlement platform, identifying several aspects that could be improved so as to bring its post-trade practices in line with EU common standards and practices. Two main issues identified were the possibility of shifting finality towards time of settlement and establishing a CCP for stock exchange clearing and settlement.

In early 2010, the CNMV launched an initiative for reshaping post-trading systems and developed a process to prepare a document for public consultation on potential reforms. The proposed reforms seek to bring an element of flexibility in the finality of transactions. Iberclear has a system of guaranteed settlement. Finality (irrevocability and unconditionality) currently takes place immediately after trading in the equity markets. However, in practice, it is not always possible to settle all transactions on the value date, resulting in transient mismatches in balances of securities with Iberclear. In effect, the proposed change seeks to shift finality from time of trade to the time of actual settlement. This entails introducing different deadlines and procedures for settling the same securities, and changes in settlement cycles (instead of the present uniform T+3) to bring them in line with the type of product and

[29] Since there is no Central Clearing Counterparty (CCP) for equities market settlement, the multilateral links between the trading platform and the Central Securities Depository do not permit the Spanish stock exchange to be ISO 15022-compliant.

nature of settlement (bilateral or multilateral). This change will allow cancellation of settlement instructions and even the delay of settlement in order to prevent or reduce the number of failures. It will also bring uniformity between finality in the equity transactions and fixed income transactions, and intends to address some of the settlement risk-related issues that were raised by the FSAP.

The second issue identified for change is establishing a CCP for stock exchange trades. The present system of the guarantee fund does not adequately address the issues relating to counterparty risk and revocation of settlement instructions. The introduction of a CCP will not only bring the Spanish stock exchange clearing and settlement system in line with common practices in Europe, but will also improve post-trading systems by mitigating counterparty risk, and reduce liquidity requirements since netting will diminish the number of transactions that need to be settled. These benefits were also highlighted in the financial crisis. The issue of the CCP having a banking license (as in other EU countries) is also being examined so that it is able to access liquidity in times of need.

With respect to operational risk issues, as described in the FSAP, the proximity of the backup site to the main site may need to be re-examined. In particular, the advantages and costs of having the backup site in a different seismic zone or geographical area need to be carefully assessed. Iberclear may also need to ensure that its individual participants have access to backup/contingency systems and that these are regularly tested, both with its main data site and with its backup/contingency site.

Finally, Iberclear has made good progress in obtaining periodic feedback from a large number of its participants on the quality and costs of its services via the two technical committees that it has established for this purpose. Going forward, Iberclear may also want to consider setting up a customer (user) facilitation/call centre to obtain more immediate feedback from all participants - including those not represented in the technical committees - about these issues.

Annex: Spain peer review – Selected FSAP recommendations

a. Real estate markets and financial stability

Relevant FSAP Recommendations	• To discourage excessive risk-taking, the Bank of Spain should tighten provisioning or capital requirements for non-traditional housing and construction loans. • The Bank of Spain should issue guidelines to credit institutions on best practices in mortgage lending. The guidelines could provide detailed recommendations in areas such as risk management, risk policy, and information systems on mortgage lending, in general, and credit to developers, in particular. They could expand upon the general recommendations by the Bank of Spain in the *2003 Memoria de Supervisión Bancaria*. • The authorities could trim legally established fees for changes in mortgage contracts considered "*novación modificativa*" that are subject to "*aranceles notariales y registrales*." In general, lower fees would facilitate changes in mortgage contracts, such as extending their maturity, which could be helpful in an eventual cyclical downturn that would reduce households' debt servicing capacity. • The authorities could remove the caps on credit institutions' commissions for early mortgage repayment and for changes from fixed- to variable-rate mortgages. This measure is intended to allow the market to determine these commissions in order to (i) align them better with the risks incurred by credit institutions and (ii) avoid that banks cover these risks through higher lending rates, so that only those borrowers exercising the option of changing the terms of the mortgage contract have to pay for it.

b. Regulatory framework for industrial participations

Relevant FSAP Recommendations	• Implement additional regulatory measures aimed at reducing the risks of nonfinancial equity investments (industrial participations) of credit institutions, such as the most conservative approaches considered in Basel II for such participations. • Introduce regulations to prevent a credit institution representative serving on the board of a nonfinancial company from taking part in the institution's decisions regarding that company. • Limiting the possibility of CIs [credit institutions] to hold controlling equity positions in nonfinancial companies should be considered.
Relevant Basel Core Principles (BCP) Assessment Recommendations	• Principle 10 (Connected Lending): The assessors encouraged the authorities to consider whether current conflict of interest policy guidelines adequately address potential conflicts. In particular, conflicts of interest stemming from the possibility that bank directors or officers could also serve as directors in an industrial company in which the bank has ownership and to which the bank extends credit or provides other financial services may warrant further consideration.

c. Regulation, supervision, and governance of the cajas

Relevant FSAP Recommendations	• Monitor the results of the 2002 and 2003 regulations on the governance of savings banks, particularly as regards outside influence on the decisions of savings banks, strengthening them if required. • Allow savings banks to merge freely within and across Autonomous Communities provided the Bank of Spain has ruled favourably on the suitability of the merged institution. • Promote new means to raise high-quality capital from private sources, such as the

	issue of *cuotas participativas*. • Reduce over time the public sector representation ceiling on savings bank boards—currently at 50 percent.

d. *Inter-agency coordination and supervisory autonomy*

Relevant FSAP Recommendations	• Strengthen the independence of financial sector supervisors by delegating more broadly the authority to issue norms and sanction violations from the Ministry of Economy and the Council of Ministers to the respective agencies. • Create an institutional mechanism for permanent and continuous coordination among the Bank of Spain, the securities market supervisor (CNMV), and the insurance supervisor. • Ongoing reforms of the Statutes of the Autonomous Communities should clearly maintain the State-level supervisors' sole responsibility and powers regarding prudential supervision and regulation. • Separate insurance supervision from the Ministry of Economy to achieve greater operational, institutional, and budgetary independence. • Appoint members of the CNMV's board to longer, non-renewable terms.
Relevant BCP Assessment Recommendations	• Principle 1.1 (Legal Framework – Responsibilities and Objectives): Looking to the future, eventual changes in the legal regime [of the Autonomous Communities] should clearly preserve the sole and exclusive roles of the BE [Bank of Spain] in prudential oversight of financial institutions, avoid any possible inconsistency in the division of responsibilities, and enhance coordination of the supervisory bodies. • Principle 1.3 (Legal Framework – Regulatory Powers): Introduce changes to the current legal framework for banking supervision in order to transfer most regulatory powers currently under the ME [Ministry of Economy and Finance] to the BE to enable promulgation of prudential rules. Consider granting the BE licensing revocation authority in appropriate circumstances. • Principle 22 (Remedial Measures): Consider delegating from the ME to the BE further sanctioning authority for the gravest infractions, particularly those calling for suspension of bank officers.
Relevant Insurance Core Principles (ICP) Assessment Recommendations	• Principle 3 (Supervisory Authority): Implement an institutional arrangement for insurance supervision that enables: (i) strengthening of regulatory governance in terms of independence of the supervisory body (i.e., the establishment of procedures regarding the appointment and dismissal of the head of the supervisory authority and members of the governing body); (ii) the supervisory authority to issue secondary regulation by administrative means that is binding to the insurance industry; and (iii) a budgetary scheme that could allocate more financial resources to insurance supervision and a more flexible scheme for the allocation of resources; increase supervisory authority's staff and attract and retain highly skilled personnel; and provide the necessary resources to enhance supervisory infrastructure and tools. • Principle 17 (Group-wide supervision): Strengthen the coordination and collaboration framework between the insurance supervisory authority and the BE and the CNMV, in order to create and implement effective mechanisms for group-wide analysis and effective group-wide supervision of financial conglomerates.
Relevant Securities Objectives and Principles Assessment Recommendations	• Principle 1 (Clarity of responsibilities of the regulator): Cooperation between the Bank of Spain and the CNMV in the discharge of their respective functions could be further enhanced by including CNMV's assessment of the program of activity of credit institutions that intend to provide investment services. • Principles 2 (Independence and accountability of the regulator) and 3 (Adequate powers and resources of the regulator): To enhance independence, appointments to CNMV's board should be for a longer term than the present four years, and should

	be non-renewable. Also, it is recommended that the appointment of at least some non-executive members of the Board be made, drawing from varied constituencies, for example, academia or the private sector. With regard to operational independence, although the current framework does not result in gaps in oversight or regulation, compliance with international standards would be enhanced by vesting the CNMV with the power to design and adopt secondary legislation which would then be promulgated by the executive authorities; the capacity to grant and withdraw licenses to regulated entities and products; and with the power to sanction on administrative grounds any infractions of the securities law and regulations.

e. Insurance supervision

Relevant ICP Recommendations	• Principle 6 (Licensing): Include, as part of the licensing process for insurance companies, specific suitability requirements for the actuaries that will participate in the technical management of the company. • Principle 7 (Suitability of persons): Consider, as an additional element for the fit and proper scheme applicable to key functionaries, specific fit and proper requirements for actuaries. Introduce the obligation for insurers to inform the supervisory authority, in a timely manner, of circumstances that may affect the fitness and propriety of its key functionaries. • Principles 9 (Corporate governance): Establish general requirements on corporate governance applicable to insurers in which clear responsibilities for the board of directors and senior management are included. • Principle 10 (Internal control): Explicitly consider in regulation the requirement for insurers to maintain a framework for internal control that includes internal auditing procedures, risk management systems, assessment of outsourced functions and clear responsibilities for the board of directors. • Principle 11 (Market analysis): Implement regular analysis of the conditions of the market, not only in terms of the past developments and present situation, but also to identify trends, scenarios and issues that could have an impact on future development, financial position and/or financial stability of the market. (ii) Include as part of the systematic financial and statistical information required of insurers for supervision purposes, the information required to conduct regular analysis of market conditions. • Principle 17 (Group-wide supervision): Provide the necessary resources to the insurance supervisory authority so it can participate effectively on group-wide supervision. • Principle 18 (Risk assessment and management): Include explicitly in the regulatory framework specific requirements on risk assessment and management for insurers, in order to recognize the wide range of risks that they face and to assess and manage them in a comprehensive and effective manner. Include, as part of the supervisory process, the verification of the existence and adequate operation of policies and systems on risk assessment and management by insurers. • Principle 21 (Investments): Incorporate in the insurance regulatory framework explicit requirements for insurers to have in place an overall strategic investment policy approved and reviewed regularly by the board of directors, that addresses the different aspects linked to investment risks. (ii) Include in the regulation specific fit and proper requirements for staff involved with investment activities, in terms of appropriate levels of skills, experience and integrity. (iii) Consider within the regulatory framework requirements for insurers to implement audit procedures to ensure the timely identification of internal control weaknesses and operating system deficiencies on investment operations that include contingency plans. • Principle 22 (Derivatives and similar commitments): Consider in the regulatory framework explicit requirements on the board of directors to satisfy itself that it has

	the necessary expertise to understand the important issues related to the use of derivatives; to approve and review periodically a policy on their use; and to have in place risk management systems and audit procedures covering the risks from derivatives.

f. Securities settlement systems

Relevant Securities Settlement Systems Assessment Recommendations	• Principle 9 (Settlement risk): Iberclear should improve risk controls by prohibiting debit balances in a participant's securities account in the SCLV platform (to balance credits in other participants' accounts). • Principle 11 (Operational risk): Iberclear should test its backup facility with its members more frequently. Its backup facility is 20 km from the main site and appears to rely on many of the same resources, which represents a risk. The actual independence of critical services, such as telecommunications facilities, should also be evaluated. • Principle 15 (Cost-effectiveness): Iberclear should implement an effective process to obtain the views of its participants on the efficiency and costs of its services and operations, or it should regularly survey its participants on these matters. • Principle 16 (International communication standards): Iberclear should implement international communication standards for all participant communications.