The Banking Regulation Review

Third Edition

Editor
Jan Putnis

Law Business Research

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THE BANKING REGULATION REVIEW

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Jan Putnis

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EDITOR'S PREFACE

Jan Putnis

When the first edition of this book was published in mid-2010, banking regulation seemed to be undergoing a transformation driven by a reasonably coherent international agenda. There were questions about how long it would be before nationalist and protectionist tendencies fractured the broad consensus that seemed to have built up on such issues as the need for more and better quality capital resources, liquidity requirements and the strengthening and reform of vital market infrastructure. However, there appeared to be a reasonable degree of certainty about the direction and speed of reform, at least among the G20 countries.

Events, as they always do, have since conspired to make the position considerably more complicated, in two separate ways. First, achieving many of the regulatory reforms agreed in principle at the meeting of G20 leaders in London in 2009 has proved to be a far more complex and difficult task than even those expert in the field of banking regulation had expected. Secondly, as concerns about solvency have spread to governments, sovereign debt has assumed centre stage. The eurozone crisis, as it has come to be known, rumbles on with no obvious short-term solution that would avoid significant economic and social upheaval in parts of the European Union. There is also the potential existential threat that sovereign defaults of eurozone countries would pose to banks that are either established in those countries or have significant exposure to banks or assets in those countries. Events in the eurozone have given the frenetic activity in the area of financial regulatory reform in the European Union a slightly surreal quality against the backdrop of the consequences of potential economic and financial upheaval in one or more eurozone countries. Meanwhile, in the United States, the rule-making process under the Dodd-Frank Act has continued, behind its original schedule, and banks continue to digest the consequences of the Volcker rule.

On both sides of the Atlantic the volume and complexity of new and proposed rules has continued to be a cause of criticism and frustration. A banking sector that was roundly blamed for creating the complexity in products, markets and business structures that exacerbated aspects of the financial crisis is facing the irony of a wall of new regulation of such complexity that the complexity itself might end up being the main reason that the new regulation fails to achieve its objectives.

Separately, in many Asian financial centres reforms are underway but are, in general, far behind those proposed and enacted in the United States and the European Union. Many governments, regulators and bankers in Asia saw (and continue to see) the western financial crisis of 2007–2009 as exactly that, a western financial crisis, and view the gradual liberalisation of the Chinese banking system and greater convertibility of the renminbi as the greater challenge and opportunity.

If we set ourselves the task of summarising the positive things that have emerged for banking regulation from that western financial crisis, what would we say now, three years on? There is little doubt that there is now much greater awareness among policymakers and regulators in all major jurisdictions of two important factors that will probably dominate any future international banking crisis:

a Banks, however well capitalised, risk collapse in sufficiently extreme circumstances and the crisis demonstrated that those circumstances should never be regarded as too extreme to contemplate. Assumptions about the credit quality and liquidity of assets, and about withdrawal of sources of funding (including deposits), may cease to apply in stressed market conditions. That means that the maturity transformation role of banks ('borrowing short term and lending long term', as it is often simplistically described) makes them subject to existential threats that are, by their very nature, difficult to anticipate and address accurately.

b Contagion can spread through financial systems in unexpected ways, or at least in ways that are unexpected by governments and regulators. Studying the potential routes of contagion and considering whether there are ways of closing down those routes without adverse unintended consequences for economies that are recovering from recession is therefore an important aspect of regulatory endeavour.

It might seem incredible now that these points were not appreciated sufficiently by governments and regulators before the financial crisis first erupted in the United States in 2007 and then spread to Europe in the following year. But that was undoubtedly the case.

The past year has seen international banking groups grappling with the practical realities of regulatory reform. Doubts about the ability of some banks to raise the additional capital (particularly Tier I capital) that they will require in order to meet the gradually increasing capital requirements set out in the Basel III agreement are feeding concerns about the long-term viability of some banks' business models and, more generally, about previously long-held expectations as to returns on equity of banking groups. Banks have begun to respond to actual and prospective higher capital requirements, in some cases by raising equity with varying degrees of success (which has been difficult in the market conditions prevailing in most of the world in the past year) and in other cases by selling or preparing to sell assets and business units, or simply by closing down business lines.

Politics have intervened in banking in the past year in ways that have made the debate about the direction of regulatory reform in the banking sector more complicated. In some countries, concern about the remuneration of senior management of banking groups has reached fever pitch in the media while, at the same time, a less emotive and generally more thoughtful debate has continued on the need for more financing for businesses, particularly small and medium-sized enterprises.

The apparent shortage of finance for businesses in many economies, coupled with expected further pressure on the ability of banks to provide that finance as their capital requirements continue to increase, has led to concerns about the development of other sources of finance. Is credit risk, and the contagion to which it can give rise if borrowers default, shifting in dangerous ways out of the banking sector into the so-called 'shadow banking sector'? The European Commission looks set to start investigating this topic in earnest in 2012. The consequences of regulatory intervention in this area are currently very difficult to predict, not least because any attempt to regulate non-bank sources of finance more heavily is bound to attract criticism from those who claim that it will only reduce further the sources of finance available to the 'real' economy.

Another area of regulatory reform that banking groups continue to grapple with in 2012 is transparency with regulators. There are various examples of the ways in which this is starting to affect the sector. The most immediate and relevant example concerns the work that many of the largest banking groups in the United States and Europe are currently involved in to draw up 'recovery plans' and to draw up, or to assist their regulators in drawing up, 'resolution plans', those plans being collectively (and somewhat misleadingly) referred to as 'living wills'. The phrase of the moment is 'barriers to resolution', describing factors that would prevent or inhibit the orderly resolution of a bank at or close to its collapse. Plenty of barriers to resolution are being identified as recovery and resolution plans are prepared. The second half of 2012 and 2013 will likely be an interesting period in which regulators ponder these barriers and deepen their discussions with banking groups as to what might be done about them.

Fears of enforced structural reorganisations and changes to business models have led some banking groups to spend considerable amounts of time and resources developing their own solutions to perceived barriers to resolution. More immediately, the process of preparing recovery and resolution plans has proved difficult, the main challenges including how to reconcile differences between the statutory resolution and insolvency procedures for banks in different jurisdictions and to understand the cross-border elements of those procedures. Fundamental questions about the availability of cross-border services to banking operations in a crisis, the treatment of banks' global hedging arrangements, and ultimately the resolvability of banking groups, are at stake. It seems likely that we are many years away from having recovery and resolution plans that carry the benefit of clarity around how regulators would operate them on a cross-border basis in a crisis. It also remains to be seen whether cross-border cooperation between regulators would work in such circumstances given the significant differences between national resolution and insolvency procedures and the desire in many jurisdictions to protect local depositors. Another major area of uncertainty concerns the proposals by some regulators that debt issued by banking groups be 'bailed in' (i.e., written off or converted into equity) in a crisis and how that could happen without spreading contagion through the banking system and the wider economy via the holders of that debt.

Meanwhile, scrutiny of the structure of banks themselves has continued in some countries. The likely implementation in the United Kingdom of proposals to require the 'ring-fencing' of retail banking activities within banking groups may be the start of a trend that spreads to other countries. Despite the prevalence of 'universal' banks, combining retail and investment banking activities in single legal entities in many of the other Member States of the European Union, the European Commissioner for the Internal Market has commissioned a study into the structure of banks with a remit to consider ring-fencing of retail banking.

Liquidity has remained a central concern for many banking groups in the past year. Short-term liquidity problems at banks (arising, in particular, from concerns about the strength of some banks as counterparties) have resulted in an increase in the range of funding for which banks generally are now expected to provide collateral. This trend is expected to be exacerbated by longer-term developments such as the Basel III requirements on liquidity and the proposed introduction of depositor preference in some countries for the first time. Liquidity pressures have led to many banks engaging in new types of transactions, such as so-called 'liquidity swaps', to increase the amount of high-quality collateral that they have available for their funding operations. This ongoing search for liquidity, and for the collateral required to obtain liquidity, has made some financial regulators concerned about the potential spread of contagion within the banking sector and from the banking sector to other sectors. For example, some liquidity swap transactions have involved banks receiving liquid assets from insurers in return for assets that are less liquid.

This third edition of *The Banking Regulation Review* updates the position on important aspects of banking regulation in the countries covered, in most cases to February 2012. While the book is aimed principally at staff in the legal and compliance departments of banks, it is to be hoped that senior management also find it helpful. The book focuses most closely on the deposit-taking activities of banks. The constraints of space and time mean that it will never be possible to do full justice to all of the subjects covered in each chapter, but readers are of course welcome to contact me if they have any suggestions for future editions.

Preparing successive editions of this book continues to be an onerous task for the busy lawyers who contribute the chapters and who are otherwise much in demand. My thanks go to them for their dedication to the task. Significant changes to a book such as this also mean much more work than would otherwise be the case for the publisher. I am therefore very grateful to the publisher's team for their understanding, hard work and patience with a group of authors who often have many other commitments.

Finally, I would like to thank the partners and staff of the financial regulation group at Slaughter and May for appreciating this book's value and for encouraging our involvement in it for a third successive year.

Jan Putnis
Slaughter and May
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Chapter 48

SPAIN

Juan Carlos Machuca[1]

I INTRODUCTION

The Spanish banking regulator, Banco de España, joined the European System of Central Banks ('the ESCB') on 1 January 1999. As a result, the definition and implementation of the country's monetary and exchange rate policy, the management of official currency reserves, the efficiency of the payment systems and the issuing of banknotes are now controlled by the ESCB.

The Spanish regulatory system governing credit institutions largely mirrors the legal framework in other EU Member States. As such credit institutions from other EU Member States may provide banking services in Spain, and vice versa, without the need to establish a branch or a subsidiary. There has also been intense regulatory activity relating to equity ratios and risk management and control, in line with other Member States. In the past few years, changes of note include the incorporation of IFRS into the Spanish banking accountancy rules, the transposition of the Basel II Accord establishing requirements on investment ratios, own funds and reporting obligations of the Spanish institutions and measures relating to the marketing and execution of the business of credit institutions supervised by Banco de España.

The Spanish financial system has been sound and stable for the past 30 years. Spain boasts a diversified modern financial system that is fully integrated with international and European financial markets. However, as we will describe in this chapter, since our last edition, the most significant overhaul of the legal framework for banks and savings banks, the latter principally, in decades, has been approved in the past months. In particular, there were some positive regulatory factors. In 2000 the government had established a counter-cyclical provisioning backed by Banco de España during the boom times forcing Spanish credit institutions to build buffers. Spanish banks were not largely exposed to American sub-prime debt and hybrid securities (contrary to other European

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entities), partly because of the attitude of Banco de España (the Spanish regulator turned down many initiatives by the Spanish banks because of risk-assessment concerns).

Banco de España conscious that debt default increases in economic downturns, realised that if provisions were made only in a downturn, in upturn years the impact of loan loss provisions in P&L accounts would be low, and financial institutions' financial statements would appear deceptively strong, leading to greater dividends being distributed than if a conservative approach had been adopted. In contrast, in downturn years the impact of loan loss provisions was significantly higher. Banco de España concluded that failing to consider latent losses caused cyclical movements in financial institutions' results. This, in turn, generated cyclical movements in interest rates, therefore increasing the impact and depth of economic cycles through the lending market. To mitigate these risks, in 2000 Banco de España introduced a counter-cyclical buffer, the 'statistical provisions'.

However, certain Spanish financial institutions are struggling to cope with the depth of the crisis, mainly given their exposure to the Spanish real estate market, whose collapse is well known. Having urged several savings banks in severe financial difficulties to merge to strengthen their balance sheets, in April 2009 the regulator intervened in the case of the medium-sized savings bank Caja Castilla La Mancha (accounting for less than 1 per cent of the local banking market), given its lack of liquidity. A similar process happened in May 2010, with another medium-sized savings bank, CajaSur, followed by the intervention in 2011 of Banco de Valencia and the savings banks UNNIM, NovaCaixa Galicia, Catalunya Caixa and Banco CAM, some of which are in the process of being sold in auctions. In July 2011, Banco de España replaced the directors of Banco CAM and initiated a sale under a competitive procedure, which integrated Banco CAM into Spanish bank Banco Sabadell. Also, on 7 March 2012, Banco de España attributed nationalised savings bank UNNIM to Spanish bank BBVA in a competitive sale procedure.

In the past three years, among other measures adopted due to the economic and financial crisis, the Spanish government established a Fund for the Acquisition of Financial Assets issued by credit institutions and special purpose vehicles, which has been partially used by certain entities.

According to the most recent Report on Banking Supervision in Spain issued by Banco de España, at the end of 2010, 339 credit institutions were registered with the Spanish regulator, of which only 53 were domestic banks and 17 savings banks. The number of savings banks was reduced from 45 to 15 institutions subsequently due to the merger and concentration processes carried out in 2010 and 2011. A total of 40 institutions, with assets accounting for 95 per cent of the savings bank sector, participated in 12 concentration processes that took place. In addition, five banks that are holding entities of Institutional Protection Scheme ('IPS') savings banks have been created. These processes of concentration continued in 2011 and there will be even more downsizing in 2012. The number of operational offices of credit institutions active in 2010 was 43,303, although Spanish banks have substantially reduced their operating network in the past three years. The savings bank sector has suffered a complete reduction of its branch offices by 15 per cent and its staff by 12.54 per cent with respect to 2009 according to the Spanish association of savings banks. The number of employees at credit institutions has also fallen, with cuts concentrated in office network staff, agents and point-of-sale terminals. Banco de España estimates that after the 2011 and 2012 restructuring the employee headcount will be reduced between 9 and 23 per cent and the number of offices between 10 and 30 per cent. The number of credit and debt cards issued by Spanish banks decreased to 93.8 million, equivalent to 2.4 cards per inhabitant over 16 years old.

At the end of 2010, there were 71 consolidated groups, 28 less than in 2009 (those that include, in addition to the parent, one or more other fully or proportionally consolidated financial institutions), of which there were three financial conglomerates (Santander, BBVA, and la Caixa) and five holding entities of IPS for savings banks.

In July 2010, Banco de España carried out extensive and detailed stress tests over 90 per cent of the total system, including all listed banks and savings banks, exceeding the 50 per cent requested at EU level. A similar strict stress test was performed in 2011 over 114 entities, which substantiate the solvency of Spanish institutions. All Spanish financial institutions will meet the new solvency ratio according to the latest report of Banco de España.

However, although the effects of the first wave of the financial crisis were avoided, following the sovereign debt crisis in May and November 2010, Spain tightened provisions requirements, encouraged a process of restructuring of its financial system, the largest banking concentration and reform of the regulatory framework. From 45 savings banks in early 2010 to the currently 15 savings banks or groups though institutional protection schemes and through the undertaking of severe balance write-downs to readdress the imbalances built up during the real estate boom years, the image of the Spanish banking sector has substantially changed since the first and second editions of this chapter.

In February 2011, Royal Decree-law 2/2011 of 18 February, on the strengthening of the banking system was approved by the Council of Ministers, accelerating and completing the restructuring of the Spanish banking system. The purpose of this Royal Decree-law was twofold:

a to strengthen the solvency of Spanish banking entities; and

b to speed up the restructuring process initiated by saving banks.

The objective was to dissipate the fears that had arisen in the markets concerning the capacity of the Spanish banking system to absorb the potential losses associated with the deterioration of assets and to envisage a recapitalisation process of the Spanish financial system.

A year later, on 4 February 2012, a new government approved Royal Decree-law 2/2012 of 3 February on the banking sector reform, which entered into force the day after it was published in Spain's state official gazette. The purpose of the new 2012 Royal Decree-law is to strengthen the balance sheets of credit institutions to increase confidence and reliability, and to reinforce the Spanish financial system, with a view to allowing access to capital markets and restoring their main role of channelling savings into the real economy. The main changes introduced by the new 2012 Royal Decree-law are the following:

a increased coverage requirements for real state assets in the balance sheets of credit institutions, to be implemented through:
   - specific provisions for real state assets classified as substandard or doubtful;

- general provisions (7 per cent coverage on real state assets classified as normal); and
- principal capital requirements;

b novelties in the Fund for Ordered Bank Restructuring ('FROB'), aid system, reinstating 'FROB I', consisting in the subscription of instruments convertible into capital of any credit institution that is about to integrate and needs to reinforce its solvency;

c changes in the corporate structure of savings banks to make more flexible its functioning; and

d restrictions relating to the remuneration of directors of entities that receive government financial support.

II THE REGULATORY REGIME APPLICABLE TO BANKS

The Spanish regulatory regime for credit institutions is set out in a number of laws and regulations establishing the rules aimed at providing supervisory authorities with full information on the state of Spanish financial institutions, as well as rules to restrict or prohibit practices or operations that increase the risk of insolvency or lack of liquidity, and to strengthen the capital requirements with which the institutions can manage those risks without causing harm to depositors and the wider Spanish economy.

Certain matters and rules, principally related to savings banks and credit cooperatives, are also regulated at regional level. Therefore, together with the basic organisation of the Spanish financial system at a state level under the direction of the Ministry of Economy and Competitiveness and the supervision of Banco de España (with the issuance of circulars, rules and guidelines), the regional authorities have enacted a number of pieces of legislation.

A credit institution is defined under Spanish law as a company engaging in any activity consisting of the solicitation of repayable funds from the public in the form of deposits or other borrowings, and the application of such funds to grant credits or carrying out similar transactions for its own account. Spanish credit institutions may therefore engage in a number of retail banking services, but may also offer securities and financial advisory services.

Credit institutions must be recorded in a register maintained by Banco de España before they commence banking activities.

i The credit banking market

Credit entities: banks and savings banks

Credit entities in the Spanish financial system basically consist of banks and savings banks, together with credit cooperatives and the Official Credit Institute, which is the country's financial agency. The raising of funds from the general public, except through activities subject to the securities markets regulations, is reserved for credit entities.

Banks and savings banks are a central part of the financial system because of the sheer volume of their business and their involvement in every segment of the Spanish economy. Most Spanish banks provide a full range of services for corporate and private customers, including collection and payment services outside Spain through foreign branches. Savings banks attract a substantial portion of private savings in Spain and tend to loan funds to private customers (mortgages, etc.). Moreover, they are closely involved in financing major public and private projects by subscribing to and purchasing fixed-interest debt securities.

Both banks and savings banks render universal banking services and may act as operators in the securities markets.

Banks have the legal form of companies, and are therefore subject to general principles of company law as well as to banking regulations.

Savings banks are a specific type of credit entity that account for nearly half the Spanish financial sector. Savings banks have tended to be locally oriented entities of variable (but generally limited) size (this has recently changed due to the integration process undergone by several savings banks in 2011 and 2012), with strong economic and social ties to their home region. Although savings banks fully participate in the market, they are a special category within the financial services industry, as they are structured as foundations rather than companies. As a result, they are governed by representatives of collective shareholders: mainly depositors, employees and local authorities. Any positive result is allocated to social welfare and cultural projects. However, after the publication of the stress tests in 2010 and 2011, a substantial and complete reform of the savings banks' legal framework was approved in July 2010, has been deepened in 2011 and in 2012. As a consequence, most of the Spanish savings banks have transformed themselves into banks through different integration processes. The corporate model of savings banks have been completely changed in the past two years. Some of them requested funds from the FROB, transferring its financial activity to a bank, with the savings bank coming to perform its business activity indirectly or become a foundation. The same requirement applied to savings banks affiliated to an IPS in the event the assistance is requested by the IPS central entity. Moreover, if the FROB had previously subscribed preference shares convertible into common shares of the requesting entity, the latter may carry out its conversion immediately, after a request by the FROB and by joint agreement.

Financial credit establishments

Financial credit establishments are those companies which are not in the strictest sense credit entities and typically perform one or more of the following activities:

a granting of loans, credits and facilities, including consumer credit, mortgages and commercial transaction financing;

b factoring;

c leasing;

d issuing and managing credit cards; and

e granting bonds and sureties.

They are also formed as companies. They are, however, precluded from receiving repayable funds from the public in the form of deposits, loans and temporary assignment of financial assets or other comparable instruments. Regarding the differences between financial credit establishments and banks – mainly in relation to their financing structure – the requirements placed on the former for pursuing their activities are more flexible in comparison with those demanded of the latter.

Electronic money entities ('EDEs')
EDEs are recognised as a special type of credit institution that issues electronic money. Its legal regime was established in 2008 and amended in 2011 by a law regulating the issuing of electronic money and the legal regime of EDEs, partially implementing EU Directive 2009/110/CE. In addition to meeting all the requirements applicable to credit institutions, EDEs are subject to investment requirements whereby, to safeguard the funds received from customers for the issuance of the e-money, an amount not less than the outstanding e-money must be invested by them in certain liquid, low-risk assets.

Payment services entities
In 2009 Spain regulated a new type of credit institution, those entities rendering, in a professional manner, payment services that coincide with those set out in the Annex of Directive 2007/64, of the European Parliament and of the Council, of 13 November 2007. Secondary legislation was approved in May and June 2010 establishing the conditions and requirements for the rendering of these activities.

ii Securities markets

The functioning of the securities markets has also been modernised and a new framework for the incorporation and activities of investment services entities has been set out: namely in regard to, *inter alia*, transparency requirements in relation to issuers whose securities are traded on a regulated market, and on takeover bids. The Spanish government also implemented, although later on, the EU Markets in Financial Instruments Directive 39/2004 ('MiFID') with further measures regarding organisational requirements and operating conditions for investment firms. In addition, new rules of internal organisation and of conduct applicable to institutions providing investment services, among which credit institutions predominate; other provisions on the solvency and supervision of investment services companies; and requirements of the regulated markets where they operate have been amended introducing major changes to the Spanish securities market.

The Law on Securities Markets defines investment services mainly as the reception, transmission or execution of orders for trading financial instruments on behalf of third parties, the performance of transactions on one's own account and the individual management of investment portfolios. These activities are reserved to investment services companies and credit entities.

The former may be securities agencies, which may only carry out transactions on behalf of third parties; securities companies, which are also entitled to act on their own account; or portfolio management companies, which may not receive, transmit or execute orders in the securities markets, but only manage investment portfolios. All three require prior authorisation from the Ministry of the Economy and Competitiveness, and are subject to supervision and control by the National Securities Market Commission ('the CNMV'). Credit entities, as previously indicated, may also carry out investment services and those activities will be supervised by the CNMV.

Banco de España will also ensure that credit institutions providing securities services have in place suitable administrative and accounting procedures, effective internal control mechanisms and risk-assessment techniques and appropriate measures for protecting customers' funds when rendering investment services.

Foreign investors wishing to do business in Spain may also open branches to provide banking and investment services, which have no separate legal personality. Notwithstanding, for certain administrative, tax and other purposes the branch is treated as if it were separate. The establishment or attribution of capital to a branch of a foreign company in Spain is considered a foreign investment, although an actual attribution of capital is not necessary (except in the case of some types of branches, such as those of non-EU banks).

The establishment of a branch requires the execution of a public deed that must be registered with the Commercial Registry. Certain key company documents and powers of attorney governing the establishment of the branch (which must be translated by an official translator if they are not in Spanish) are also required.

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

Many Spanish financial institutions have attributed their solid financial position to their long-standing strategy of prudence and foresight. However, Banco de España, an institution under public law with its own legal personality and capacity, which pursues its financial supervisory activities and objectives with full autonomy, also deserves part of the credit.

As previously noted, Banco de España no longer sets the country's monetary and exchange rate policy, except in its role as a member of the ESCB. However, it remains in control of, *inter alia*, the following functions:

- *a* management of currency and precious metal reserves not transferred to the European Central Bank;
- *b* supervision of the solvency and the behaviour of credit institutions;
- *c* promotion of the stability of the financial system and of national payment systems, without prejudice to the functions of the European Central Bank; and
- *d* mintage and circulation of coins and other types of legal tender.

Banco de España carries out continuous monitoring and analysis of the Spanish credit entities monitoring reports and regular information received from the credit institutions, and conducting on-site inspections. There is close interaction between Banco de España and the entities subject to its supervision. There is a permanent presence at the two large Spanish banking groups and other institutions whose size and complexity call for regular monitoring of inspection staff from Banco de España combining analysis and verification tasks and for a proper assessment of the position of the Spanish credit institutions, their liquidity risk, capacity to generate earnings and their solvency.

In Spain, provisioning rules are straightforward and transparent and verified by Banco de España, while in other countries provisions generally decided by the banks with the approval of their external auditors.

In the past two years Banco de España amended, *inter alia*, rules on financial reporting rules and formats, the accounting regulations on loan write-downs (loan loss provisions) to improve transparency and recognise the value of the different real estate collateral and minimum provisions. New rules introduced in February 2012 guide credit institutions to set aside minimum specific provisions for non-performing loans, how to value the reposed assets and the minimum impairment estimate when, after a period of time, these assets are kept in the balance sheet for long periods, which is considered to be a sign of deterioration.

The responsibilities of Banco de España include the checking and verification of maximum prices and fees for banking services rendered by the credit institutions. The regulator will therefore review compliance with rules prices of bank services, charges, valuation conditions, interests, expenses and advertising campaigns and projects of the credit entities (i.e., to ensure the features of financial offers, returns offered and competition). Banco de España also verifies the customer protection rules and keeps several registries of public banking information, including the register of institutions, register of senior officers, the register of shareholders, reporting of agents or a special registry of articles of association of the supervised institutions. Banco de España also receives the confidential information from the institutions on their financial situation and their shareholders.

During such continuous supervision from Banco de España, the regulator may issue general or specific recommendations and requirements from the entities (i.e., requiring adequate provisioning for the less solvent obligors and improvements in the quality control over assets) and approve restructuring plans. The regulator may also initiate disciplinary proceedings against the institutions and their board of directors or managers or even their intervention (and replacement of directors to remedy observed deficiencies or non-compliance with the prudential rules.

The Spanish banking regulator has powers to enforce compliance with the organisational and disciplinary regulations applicable to credit institutions operating in the Spanish financial sector. Such powers are exercised not only on credit institutions and any other financial institutions subject to its oversight, but also to their directors and managers, who can be penalised for very serious or serious infringements when they are attributable to wilful misconduct or negligence. Sanctions can also be imposed on the owners of significant shareholdings in credit institutions and on Spanish nationals that control a credit institution in an EU Member State. Sanctions can be a public reprimand, disqualification from serving as a senior officer and even revocation of the banking authorisation. Such withdrawal of authorisation to operate as a credit institution is a competence that lies with the Spanish Council of Ministers. Banco de España's disciplinary powers are, however, geared not so much towards the punishment of unauthorised conduct as towards the protection of the financial stability system, the prevention of future non-compliance and the reinstatement of legal order.

The 2012 Royal Decree-law provides that the state will supervise special foundations of saving banks through the Protectorate of the Ministry of Economy and Competitiveness, provided that the main scope of action of the bank through which the financial activity is carried out covers more than one autonomous region. This confirms the inclusion of these special foundations in the framework of the distribution of functions between the state and the autonomous regions, as provided under Law 50/2002 on foundations.

Finally, Banco de España has a special duty of confidentiality and secrecy in respect of any information and documentation obtained in the course of its prudential supervisory role on credit institutions. The same obligation applies to any officials that perform or have carried out activities in Banco de España. These individuals are precluded from making any declaration, testifying, publishing or exhibiting any data or reserved document, even after leaving their position with Banco de España.

ii Management of banks

The board of directors of a credit institution (of at least five members) has exclusive powers to administer and manage the operations and financial matters of the entity. Members of the board and senior management must have commercial and professional experience (a minimum of five years' experience in a bank of similar size and type), be trustworthy and of good reputation; they must not have been convicted of offences or declared bankrupt.

As previously mentioned, credit entities (other than credit cooperatives and savings banks) are incorporated as companies and general corporate rules will fully apply (i.e., they must have a suitable structural organisation, compliance and internal audit functions and risk assessments, certain separate and delegated committees within the board, including an internal audit). The board must design the internal policies for assuming, controlling, managing and mitigating risks, including interest rate and liquidity risk. Also it must establish rules for the delegation of the provision of services or the exercise of functions forming part of their activity. Generally, however, the board of directors of a Spanish credit entity cannot subject its decision-making powers or its liability to the approval of a parent company.

The board of directors must set up the strategies and procedures to evaluate and maintain the necessary capital and solvency of the institution, establishing the necessary risk management, risk measurement and internal rules of governance. The board of directors must approve an annual report to be sent to Banco de España on the capital adequacy assessment and capital planning of the entity, including own funds return at the year-end.

Among its responsibilities, the board of directors, which must meet regularly, must establish the management measures to improve the organisation and the internal procedural and control systems of the credit institution. These processes must represent oversight of efficiency, rational management, administration, oversight of investment and size of the relevant entity capacity, all intended to maintain the entity's solvency and prospects.

The autonomous regions have their own regulations affecting savings banks, providing for, *inter alia*, the appropriate representation of stakeholders' interests on the governing bodies and management.

Since February 2011, FROB is authorised to buy ordinary shares or to make capital contributions to the entities that so request. The subscription of these instruments will cause the immediate inclusion of the FROB in the entity's board of directors and will be subject to the assumption by the entity of the following undertakings:

a at the request of the FROB, to reduce overheads;

b to arrange its corporate governance in line with the standards applicable to listed companies; and

c to increase financing to small and medium-sized companies.

The 2012 Royal Decree-law also amends Law 31/1985 and Royal Decree-law 11/2010 concerning the governing bodies of savings banks to lighten their structure and make the operation of savings banks conducting business indirectly more flexible. The most significant novelties are as follows:

a the obligation that savings banks implement the same structure as that of their management bodies in the banks in which they have contributed their financial activity is removed;

b the savings banks' discretion to make disbursements (including ordinary expenses) unrelated to the community welfare project is limited; and

c from now on, savings banks must become special foundations not only when they lose control of the bank in which they have contributed their financial activity, but also when, even though they still hold control, they have less than 25 per cent of the voting rights in the new bank.

Also in 2011, Law 2/2011 of 11 March introduced an amendment to the banking and securities market laws by establishing rules that the entities must have internal policies and practices for remuneration that balance risk-taking and variable income, stressing that such remuneration should be linked to factors that represent real growth of the credit entity and real wealth creation for the banks' shareholders. Over recent years, Banco de España has already recommended that entities under its supervision follow the remuneration policies principles and measures approved by the European Banking Federation. Banco de España imposed specific restrictions on bonus payment to management and employees of banking and securities groups when they are incoherent with the maintenance of a solid core capital base. General corporate rules also require that stock options and share remuneration schemes for directors and managers must be contemplated expressly in the entities' by-laws and be annually approved by the general shareholders' meeting. Further, annually, banking groups and savings banks will need to approved a report of the annual remuneration of their board members for the relevant years and the future years on an individual basis.

Further, the 2012 Royal Decree-law establishes significant restrictions to the remuneration of directors, general directors and senior executives in institutions receiving public aid, by imposing more stringent requirements for institutions in which the FROB has a majority stake. These restrictions apply to fixed and variable remuneration, and may even affect certain pension benefits.

In the case of integration processes in the context of the 2012 Royal Decree-law, the latter provides that these restrictions will apply only to directors of the institution giving rise to the need to seek public aid, and that the Minister of Economy and Competitiveness may modify the limits applicable to the directors of such institution.

iii Regulatory capital and liquidity

Spain's legislation has incorporated capital adequacy requirements in line with the risk-based capital provisions of the Basel II Accord, therefore requiring an appropriate level of solvency and capital in accordance with risk management principles. A banking group should be adequately capitalised overall (in terms of both volume and quality of capital) and there should be an adequate distribution of the capital and the allocation of risk with sufficient buffers to allow ordinary growth.

Several laws, decrees and regulations on own funds and capital requirements of individual credit institutions and consolidable groups have been approved in the past four years, followed by specific circulars and guidelines issued by Banco de España determining the technical specifications and control of minimum funds. Banco de España guidelines require from credit institutions an appropriate capital strategy, based on maintaining a sufficient buffer in excess of the regulatory minimum requirement, to enable credit institutions to overcome difficult situations and fulfil their strategic business plans. Banco de España, in assessing an institution's capital target, will particularly take into account that this target should be commensurate with the institution's risk profile.

The solvency requirements of banking consolidated groups, and banks, savings banks and credit cooperatives that do not form part of a consolidated group, have been made more stringent with new rules approved in February 2011 and February 2012. On a general basis the 2011 Royal Decree-law required 'capital principal' (that will be referred for the purposes of this chapter as 'core capital') equal to or above 8 per cent of their risk-weighted assets.

For credit entities that are highly dependent on wholesale markets (in other words, a wholesale funding coefficient – to be set by Banco de España – above 20 per cent), the core capital ratio is increased by the new rules to 10 per cent. As an exception, the 8 per cent ratio is maintained when the relevant entity has 20 per cent or more of its capital or voting rights placed among third parties, either in the stock market or among private investors. The ratio may also be increased for entities that do not pass the stress tests carried out by the Bank of Spain.

The concept of core capital ratio is new, not only in connection with the levels required, but also as regards quality. Core capital is formed of: (1) common shares; (2) retained earnings (including share premiums of capital instruments); (3) other comprehensive income; (4) minority interests; and (5) instruments subscribed by the FROB, all of which minus treasury stock, cumulative losses, unrealised losses recognised in other comprehensive income and intangible assets (including goodwill).

For a transitional period, subordinated debt instruments mandatory convertible into common shares will be included in the core capital, provided that conversion takes place before 31 December 2014. This includes instruments issued before the entry into force of the 2011 Royal Decree-law and those issued subsequently (in the latter case, the conversion ratio must be predeterminated). In any event, these instruments must not represent more than 25 per cent of the core capital.

Although the new capital requirements are in line with Basel III standards, they are specific to the Spanish banking system. From a quality point of view, the core capital ratio is less stringent than Basel III's core capital. Certain deductions, such as deferred tax assets and investments in the capital of financial and insurance entities are not included, and certain convertible instruments are. From a quantitative point of view, however, the level required is higher than Basel III (8 per cent or 10 per cent as opposed to 7 per cent – including the capital conservation buffer – of Basel III).

A significant feature in the definition of eligible elements is, however, the ability to calculate, subject to certain conditions, the provisional profit as it accrues during the year. Also, the scope of the ancillary capital, valid only to cover position and foreign exchange risk, is now specified.

The capital requirements for credit risk includes the credit risk associated with off-balance-sheet items and not yet deducted from own funds. Such coverage of credit risk can be calculated either following the standardised approach (i.e., on the basis of predetermined categories and with the assistance of credit ratings agencies) or subject to specific authorisation from Banco de España, through an internal ratings-based approach using internal risk models tailored to the institution in question.

According the 2012 Royal Decree-law, credit institutions may seek permission from Banco de España to defer, for a term not exceeding 12 months, interest payment of preferred shares and mandatory convertible bonds into shares issued before the entry into force of the Royal Decree-law in the event they do not have enough distributable profits or reserves, or there is a shortfall of equity as a consequence of the implementation of the reinforcement measures. This possibility should be carefully assessed by institutions with issues subject to different laws, or that are ranked differently, as the deferment could enter into conflict with the holders of other issues or capital instruments.

Spanish capital adequacy regulations allow the value of exposures to be reduced through collateral and guarantees, the latter includes credit derivatives and devotes particular attention to the calculation of exposure in securitisation transactions from both the originator and the investor standpoint. In 2010 Banco de España tightened provisioning rules establishing realistic haircuts to value the collateral taken by the credit institutions and established incentives for banks to take foreclosed assets off the balance sheet.

Generally, the weighting applicable to the different risk exposures contain two categories: retail, which has a weighting of 75 per cent and corporate, which will be weighted at 100 per cent, or a weighting assigned by central government of the jurisdiction in which the company is incorporated, whichever is higher. Exposures secured by residential mortgages have a low weighting provided that they meet certain conditions, including the requirement that the loan amount does not exceed 80 per cent of the collateral value (if it is more that 80 per cent but not more that 95 per cent, it is weighted at 100 per cent; and if it is more than 95 per cent of the collateral value, it is weighted at 150 per cent), and exposures secured by commercial mortgages are reduced to 50 per cent under certain conditions. Doubtful loans (more than 90 days overdue) shall receive a weighting of up to 150 per cent, as shall regulatory high-risk categories (including non-permanent variable-rate exposures).

The amount of all the exposures of a credit institution to a single third-party client or economic group may not exceed 25 per cent of its own funds; if the risk exposure is to unconsolidated institutions of the relevant reporting entity's own economic group, the limit is set at 20 per cent. Additionally, the overall large exposures may not exceed eight times its own funds. However, for the purposes of calculating these limits, the Spanish rules include a wide variety of exposures.

To calculate credit risk-weighted exposures, the system for calculating the counterparty default risk before final settlement of the agreed floors is present in certain off-balance sheet transactions.

By virtue of Royal Decree-law 2/2012, the government increased the coverage requirements for certain real estate assets in the balance sheets of Spanish credit institutions as of 31 December 2011. In particular, the new reinforcement measures introduced in February 2012 affect financings and asset foreclosures or assets received as payment of debts from the real estate sector in Spain. The requirements are to be implemented by combining three regulatory techniques; two are accounting-related (general and specific provisions) and one relates to equity (capital buffers):

a Specific provisions: the specific coverage is increased for those assets mentioned above that are classified as substandard or doubtful, above the thresholds established in Annex IX of the Circular of the Bank of Spain 4/2004 as amended by Circular 2/2012 of 29 February. Therefore, two different provisioning mechanisms will coexist: one for the mentioned assets, and another one for all other assets (including real estate loans granted since 1 January 2012 and pre-existing unimpaired loans).

b 'General' provision: a new one-off 7 per cent coverage is created to be applied on the outstanding balance of real estate financings classified as normal. If they are reclassified as substandard or doubtful, any impairments can be allocated to the general provision.

c Capital buffer: specific provisions for problematic credit assets and asset foreclosures are supplemented with additional principal capital requirements.

In sum, for troubled assets, combining the specific provisions and the capital buffer coverage for land would increase from 31 per cent to 80 per cent and for ongoing developments coverage increases from 27 per cent to 65 per cent. Coverage of the remaining troubled assets in the real estate development and construction sector (finished properties and housing) would increase to 35 per cent.

The 2012 Royal Decree-law provides a deadline to comply with these requirements: 31 December 2012. However, it allows entities that undergo integration processes during 2012 to benefit from a 12-month extension from the date the transaction is authorised. Only integrations that require structural changes (e.g., mergers, demergers), or involve the acquisition of institutions in which the FROB,) currently has a majority stake, may benefit from such extension. In addition, among other requirements, the total balance sheet of the resulting entity must be at least 20 per cent (10 per cent in exceptional circumstances) higher than the total balance of the business in Spain of the largest institution in the integration.

Moreover, to benefit from the extension, the resulting institution must comply with the corporate governance rules established in Royal Decree-law 9/2009 for institutions receiving aid from the FROB.

The above should be considered in connection with the resolution of the Governing Committee of the FROB of 17 January 2012, which was published on 3 February 2012. The resolution states that institutions that receive aid (provided that it does not exceed 2 per cent of their risk-weighted assets) are now exempt from the prohibition to expand by acquiring other institutions.

As mentioned in Section I, *supra*, Banco de España introduced a counter-cyclical buffer, the 'statistical provisions'. These provisions aim at covering estimated losses of non-prejudiced asset portfolios during the whole economic cycle and, hence, counteracting the cyclical impact of other specific provisions (such as loan loss provisions). Statistical provisions and other specific provisions were conceived as complementary. At the high stage of the cycle, specific provisions are low and the statistical provision accumulates creating a buffer; on the low stage of the cycle, the increase of specific provisions may be covered with the fund created by the statistical provision, hence, not affecting the P&L account. Banco de España has recently softened the provisioning rules allowing provisioning for default loans only on the portion of the risk exceeding 70 per cent LTV, as opposed to considering the entire risk exposure as previously required.

Credit institutions should carry out stress capital tests to determine the impact in terms of the actual losses arising from a certain probability and for those purposes, credit institutions may use advanced regulatory methods for calculating own funds and, on this basis, estimate the losses that may arise within a certain period. Capital buffers over and above the regulatory minimum are held by credit institutions largely so that regulatory capital requirements continue to be met even in situations of stress, in which extraordinary losses appear.

Non-compliance with the capital adequacy and solvency requirements is subject to certain limitations and disciplinary measures. Banco de España has established limitations on income distributions to which credit institutions are subject if they fail to comply with the solvency requirements. If an entity has a regulatory capital shortfall exceeding 20 per cent of the minimum requirement, or if its core capital falls below 50 per cent of that minimum requirement, the credit institutions and each member of its group must allocate to reserves all its or their net profit or surplus, unless Banco de España authorises some other course of action in the framework of a programme to return to compliance with the required levels. If the capital shortfall is equal to or more than 20 per cent, the individual institution or each member of its group shall submit to Banco de España for authorisation an income distribution setting out the minimum percentage to be allocated to reserves.

IV CONDUCT OF BUSINESS

i Conduct of business rules

Spanish rules on discipline and intervention of credit institutions establish that credit institutions rendering services in Spain, whether domestic entities or foreign entities authorised in another Member State that open a branch or provide cross-border services in Spain, must observe the rules enacted in the interest of the general good or providing for disciplinary or regulatory standards, whether they are dictated by the state, the autonomous communities or local entities.

The 'general good' includes, *inter alia*, protection of the recipients of services, protection of workers, consumer protection, preservation of the good reputation of the national financial sector, prevention of fraud and protection of intellectual property.

Some conduct of business rules relate to compliance with regulations on advertising (i.e., prohibition of misleading or subliminal advertising, aggressive commercial practices) or conduct that may injure or is likely to injure a competitor; and also to consumer-related matters. Credit entities' are subject to Spanish regulations protecting financial services users and they must establish consumer services departments and a customer ombudsman to handle complaints of individuals or legal persons who are deemed as users of their financial services.

Further, credit entities must make certain information available to customers including:

a the existence of the customer service department and of the customer ombudsman, as the case may be, including postal and e-mail addresses;

b its obligation to serve and resolve customers' complaints within two months;

c the existence and contact information of Banco de España Complaints Service (which is in charge of resolving customers' complaints when they are not satisfied with the answer or solution provided by the credit entity);

d the internal customer service regulations approved by the entity; and

e references to the legislation in force on transparency and protection of financial services customers. Further, there are rules on the delivery of the contract and a number of specific provisions regarding the valid incorporation of terms into consumer contracts (some of which are currently the subject of legal debate after several Supreme Court decisions recently declaring null and void certain terms traditionally used by Spanish banks).

Anti-money laundering laws and regulations apply to credit institutions (including EU credit institutions rendering services in Spain on a cross-border basis). In April 2010, new legislation on anti-money laundering was passed setting forth certain particularities in relation to credit institutions' compliance with Spanish anti-money laundering rules including requirements of identification details, information on the purpose of banking transactions, the nature of the customers' activities, the obligation to analyse transactions and business relationships on a continuous basis, including for existing clients (in particular in relation to the contracting of new products or when significant or complicated transactions are carried out or special obligations in relation to 'politically exposed persons'), their close relatives and known related parties.

Finally, after the implementation of MiFID in Spain, a number of rules were introduced for effective protection of consumers of investment services that apply to credit entities (categorisation of investors, delivery of appropriate and comprehensible information on the financial instruments and investment strategies offered to the customer, etc.) and include a number of rules to check that the conduct of the credit entities is sufficiently diligent.

ii Spanish banking secrecy

The duty on credit institutions to maintain clients' information confidential from third parties other than the supervisory authorities has traditionally been a common feature of the Spanish banking system and is codified in law. Credit institutions, and their managers and directors, and significant shareholders of credit institutions and their managers and directors, must safeguard and keep strictly confidential without communication to third parties all information relating to balances, operations and any other customer's transactions. Disclosure will, however, be permitted if the entity is required to disclose by applicable law or there is an obligation to make disclosure to any supervisory authorities. In these exceptional cases, the delivery of confidential data must comply with the instructions of the client or with those provided by applicable law.

The delivery of confidential information among credit entities pertaining to the same consolidated group is not subject to these restrictions. Any breach of the aforementioned regulations will be deemed a serious offence, which may be punished according to the ordinary sanctions procedure provided under Spanish banking regulations.

V FUNDING

The main funding for Spanish credit institutions has obviously been based on deposits made by their customers. According to Banco de España, credit institutions have increased the deposits taken from the private sector.

In addition, both capital and debt issuance have also been sources of funding. These instruments include – in addition to common shares – perpetual subordinated debt, rights issues and preferred shares, in many cases issued by special purpose entities. Also in 2008, Banco de España approved Banco Santander's issue of mandatory convertibles. There are no restrictions on the issuance of such instruments but they are subject to the securities market regulations and must be verified by Banco de España to confirm they meet the conditions established by bank solvency regulations.

The requirements that necessarily turn convertible bonds into shares must comply with to be considered core capital have been amended by the 2012 Royal Decree-law. The 2012 reform: (1) extends the maximum conversion term until 2018; (2) allows for a variable conversion rate (although there is a limit to the number and face value of the shares to be delivered) and, consequently, no longer requires that they be accounted for as net equity; and (3) requires their conversion in the event of a solvency ratio deficit. In the past two years Spanish credit institutions have needed to issue euro-denominated subordinated debt and borrow from the Eurosystem liquidity facilities against bonds and collateral. The number and volume issued has fallen recently and the average amount of each issue in recent times has also decreased. The 2012 Royal Decree-law included rules for loans and credits other than mortgages to be considered as collateral in Central Bank operations to accomodate to the recognition announced by the ECB on 8 December 2011.

In the past two years, the mistrust in the Spanish public finances and its financial system derived in a substantial increase in funding costs and difficulties in gaining access to wholesale markets. With respect to savings banks, a special funding instrument was used for the first time a couple of years ago with the issuance of non-voting equity units or 'participating quotas', which are equity securities available only to Spanish savings banks that do not provide the owner with the right to vote on corporate matters, such as the election of the members of the relevant entity's board. From an economic standpoint, participating quotas allow supervision by the market of the management and business of the savings bank issuing the quotas, just as with listed banks. This market supervision provides the issuer with more national and international visibility and grants coverage to the growth of the business together with flexibility for the raising of funds. These securities also allow Spanish savings banks to make use of a fundraising mechanism that was already available for banks. From a legal standpoint, participating quotas are defined as registered negotiable instruments issued by savings banks, representing indefinite cash contributions, which may be applied to the same aims as the rest of the assets of the issuer. The reforms in 2010, 2011 and 2012 to the legal framework of the Spanish savings banks, and their transferring banking business to banks, now allow them to raise capital and improve savings banks' capacity to raise funds in the markets. There are now a new range of alternatives for savings banks to raise Tier I capital and the pursuing of banking activities through a bank to which they shall transfer their financial business. Saving banks can now transfer voting stock, either directly or through a bank.

Finally, in the past few years, among other measures adopted due to the economic and financial crisis, the Spanish government established a Fund for the Acquisition of Financial Assets issued by credit institutions and special purpose vehicles, which has been partially used by certain entities. Also, the provision of state guarantees to new funding transactions launched by Spanish-resident entities with a maximum maturity of seven years was approved. The amount and period in which guarantees are effective has been extended on several occasions. Neither secured issues nor arranged loans and credits shall include options, nor any derivative instruments, nor any other element that might hinder the evaluation of the risk assumed by the guarantor.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

The Acquisitions Directive was implemented in Spain in June 2009 establishing the new regime on the qualifying holding in an investment firm, a credit institution and an assurance, insurance or reinsurance undertaking. Following the main thread of the Acquisition Directive, the Spanish regime introduced identical rules and evaluation criteria for the prudential assessment of Banco de España regarding the acquisitions and increase of holdings in the Spanish credit institutions.

Spain incorporated the essential terms set out by the Acquisition Directive, mainly, the guidelines for the no-opposition procedure that shall be submitted by the potential acquirer with Banco de España, and the criteria that Banco de España should take into consideration when evaluating the proposed shareholding's increase. Furthermore, the rules, *inter alia*, set out how to calculate the shares to be taken into account or excluded and to determine whether a qualifying shareholding has been triggered. They also provide a detailed list of information to be submitted to Banco de España to request Banco de España's non-opposition to the potential acquisition, and define the meaning of significant influence. This pre-acquisition approval from Banco de España is mandatory either where as a consequence of the acquisition the acquirer would hold (taking into account certain conditions regarding aggregation laid down in the Spanish regulations), either directly or indirectly, a qualifying shareholding, that is over the 10 per cent of the issued share capital or voting rights of a Spanish bank, or the amount held would rise to or above 20 per cent, 30 per cent or 50 per cent of the issued share capital or voting rights of a Spanish bank (instead of the prior 10 per cent, 15 per cent, 20 per cent, 25 per cent, 33 per cent, 40 per cent, 50 per cent, 66 per cent or 75 per cent). Such pre-acquisition approval also arises where the direct or indirect holding in a Spanish bank enables the exercise of a significant influence on the management of the said Spanish bank. In this sense 'significant influence' exists where the proposed acquirer is able to appoint or dismiss a member of the board of directors of a Spanish bank.

The disposal of a qualifying shareholding in a Spanish bank triggers a requirement to notify Banco de España before making the disposal. Likewise, immediate written notification to Banco de España is required if, as a result of the acquisition, the acquirer would hold 5 per cent or more of the issued share capital or voting rights of a Spanish bank.

The obligation to seek approval for a proposed acquisition or increase of qualifying shareholding falls on the acquirer. However, the Spanish bank whose shareholding may be acquired must notify Banco de España as soon as it becomes aware of the proposed acquisition, and must provide Banco de España with specified information about the proposed controller or qualified holder.

Banco de España has a maximum of 60 working days to complete a prudential assessment of the proposed acquisition, though it may interrupt this period once to request additional information, after which it should, in any event, complete the assessment within the maximum assessment period. Such period may be extended if the proposed acquirer is either situated or regulated outside the European Community, or is a natural or legal person not subject to the supervision of Spain or of the European Community.

Acquisitions of control of listed banking entities arising in restructuring or integration processes in which the FROB or a Deposit Guarantee Fund takes part, shall not give rise to the obligation to launch a tender offer.

Finally, in respect of prudential assessment, this new regime sets forth that Banco de España must provide a report to the Commission for the Prevention of Money Laundering and Monetary Infractions, which, based on the information provided by the acquirer, should rule out any grounds to suspect that, in connection with the proposed acquisition, money laundering or terrorist financing is being or has been committed or attempted, or that the proposed acquisition could increase the risk thereof.

ii Transfers of banking business

Recently the Spanish financial system has moved towards greater consolidation, mainly for efficiency and profitability in an increasingly mature financial market. The issue of solvency is also a key driving factor behind this tendency. Naturally, the same factors also apply to the transfers of banking business, particularly considering the crucial importance of size in gaining access to wholesale capital markets.

The transfer of banking business, by virtue of mergers, total and partial spin-offs, segregation or subsidiarisation is subject to general corporate law. In this respect, in addition to regulatory approval, certain documents will be needed:

a the transfer plan, which must include the identification of the transferor and the transferee, the date of effect for accounting purposes, a valuation of the assets and liabilities for distribution among the transferees, the consideration to be given and the effects on employees;

b a directors' report; and

c a public deed.

In the case of an *en bloc* transfer to various beneficiaries, each portion of the assets and liabilities transferred must entail an economic unit.

Of particular relevance in Spain in the past year has been the mergers or integrations between savings banks instigated by the Banco de España. Few mergers have been carried out between savings banks other than in cases in which the financial issues facing one of the participants required immediate and drastic action. The distinctive qualities of savings banks, combined with the decision-making powers over them granted to local and regional authorities, account for this and explain the absence of merger activity until very recently between savings banks based in different regions. Regional laws require the consent of the regional governments for all mergers. There are, however, new structures of integration being discussed for savings banks, which include the transfers of savings banking business, through the above-mentioned IPS), which from a regulatory perspective is based on a rule issued by the Banco de España as a limited exception to delegate management capacities to entities created for enabling alliances between savings banks, and has been considered as a contractual structure for groups of credit entities.

The reform of savings banks allow, and instigate, the transfer of their banking business (and in which they shall hold at least 50 per cent of the voting rights, or else they will lose their status as a credit institution, and must turn themselves into foundations focusing on social projects).

In 2010, a new framework for the institutional protection schemes for the purposes of their consideration as consolidated groups of credit institutions and establishing new procedures involving bank restructuring was enacted. New provisions regarding the financial sector established requirements for an orderly restructuring of credit institutions, including facilitating mergers or absorption by another institution of recognised solvency or by the full or partial transfer of its banking business or business units to other credit institutions. It also contemplated the transfer, in full or in part, of deposits held in current or term accounts at an institution undergoing restructuring to another credit institution. This regime was further amended in February 2011 and 2012 and as a result a number of banking restructurings have been taking place.

FROB cannot, since the latest amendments, provide support through the subscription of convertible preference shares. This option is now restricted to credit cooperatives and, on a transitional basis, to entities involved in restructuring processes which, from 20 February 2011, had already started negotiations with the FROB.

FROB was authorised to buy ordinary shares or to make capital contributions (in the case of credit cooperatives) to the entities that so request. However, the 2012 Royal Decree-law further introduced minor changes to the subsidies system involving the acquisition of shares and to reinstate the so-called 'FROB I', which consists in the subscription of instruments convertible into capital of any credit institution (not only cooperatives) that is about to integrate and needs to reinforce its solvency.

The specific characteristics of the FROB's new convertible instruments are still to be developed by the FROB in 2012. This is a key issue especially after the new government announced that they will qualify as contingent capital.

Another novelty of the new FROB aid system introduced in 2012 is that the FROB may facilitate the subsequent sale of shares or convertible securities of credit institutions that have not been intervened before to third parties by providing support measures, such as asset protection schemes.

For the purposes of ensuring efficiency in the use of public resources, the FROB must divest through the relevant public auction within three years. In addition, the issue terms may state that, within a term of one year since the subscription of the shares, entities may repurchase its shares or designate a third party to buy them (this term may be extended to two years, making additional undertakings to those mentioned above).

The FROB's capital was increased by the 2012 Royal Decree-law in €6 billion, however, its leverage is reduced to six times its capital. The available funds are thus set at €90 billion.

Newly chartered banks are released from complying with the temporary limitations to carry out their activities provided that they are subsidiaries of credit entities or have been incorporated by one or more saving banks in the context of an IPS or by a total spin-off of their financial activities.

The requirements of the IPSs relating to pooling of results and joint solvency undertakings shall be construed as satisfied in those IPSs in which the financial activity of the participating savings banks has been contributed, as well as in those IPSs, in which various savings banks acting in concert carry out their corporate purpose as banking entities through the central entity.

VII THE YEAR IN REVIEW

New provisions have been enacted in the past three years, *inter alia*, to enhance the capacity of Spanish credit institutions to increase the supply of credit to firms and individuals, to authorise the Spanish state to guarantee new funding transactions of medium-term bank debt or to establish temporary and partial moratoria on the monthly instalments payable by unemployed debtors.

During 2011 and from the enactment of the 2012 reform last February, the Spanish banking system has made and will be subject to a sharp adjustment to the restructuring, merger and concentration process, as well as a reduction in capacity and presence in the market.

According to Banco de España, the Tier I ratio increased to 9.5 per cent in December 2010, which represents capital equivalent to 3.7 per cent of GDP. The sum of provisions and capital accumulated amounts to around 12.5 per cent of GDP.

A piece of legislation was enacted in 2009 by the Spanish Treasury and the Bank Deposit Guarantee Fund for banking rescue and restructuring, setting up the FROB as an entity with a legal personality and an initial allocation of a €9 billion equity commitment, recently increased by a further €6 billion. The FROB is chaired by Banco de España and has a debt capacity of three times the initial allocation with the explicit, unconditional and irrevocable guarantee of the Kingdom of Spain. Its functioning was substantially amended in 2010, 2011 and more recently in February 2012. The FROB has been very active in the intervention of several medium-sized saving banks SIPs groups and the auction process of them. Over the past three years, a number of laws and rules have also been approved to establish an efficient system for bank restructuring and credit institutions' equity reinforcement and to facilitate the speed and legal safety for the restructuring of the Spanish banking sector. Provisions regarding the financial sector restructuring and necessary to strengthen the solvency and equity of the Spanish credit institutions have been implemented. A variety of significant regulatory changes restructuring the Spanish banking system, the setting up of IPSs and conversation of saving banks into commercial banks have entailed complex and difficult processes.

A significant issue that the Spanish credit institutions are facing is their exposure to construction and property development activities, thus the 2012 reform implied a significant increase in bank asset write-downs of about €50 billion, both through provisioning and capital requirements as explained above.

During the year in review, significant incentives to consolidate the Spanish banking system have been introduced, which will imply a further concentration in 2012.

During 2010, 2011, and the first months of 2012, most of the Spanish savings banks have been involved in merger or concentration process. Some of these processes have given rise to the incorporation of five new banks (Banco Financiero y de Ahorros (and its subsidiary Bankia), Liberbank, Banca Cívica, Banco Mare Nostrum and KutxaBank) having as their shareholders different savings banks. The main purposes of the amendment of the savings banks system have been to promote the access to capital markets as the traditional banks had and the professionalisation of the management bodies of the savings banks.

VIII OUTLOOK AND CONCLUSIONS

The Spanish banking supervision model stems from two financial crises – the first resulting from the transition from dictatorship to democracy and the second undergone at the beginning of the 1990s – and the collapse of a number of entities. As a result, Banco de España had to forge a model that not only kept entities in good financial condition, but obliged them to save for a rainy day in booming times. This policy has proved extremely useful during the current economical crisis but it has not been enough.

Nearly five years ago after the international crisis started, the resilience of the Spanish banking sector, historically subject to regulation and supervision based on prudent and stringent application of international standards, was outstanding until recently, certainly in comparison with certain other developed countries. However, to strengthen the solvency of the Spanish financial system and complete restructuring of the sector, further measures were adopted in the past three years with three consecutive reforms. These measures require, *inter alia*, new levels of capital requirements, coverage for their risk exposure through new provisions, transparent process on write-downs and accounting rules. Entities whose size make them decisive for the health of the system maintain a solid position, which in turn enables them to continue their domestic and international expansion and to continue to deal with the crisis without requiring public support or intervention. However, the position of some medium-sized or small credit institutions and the economic conditions of the country could be jeopardised in coming months due to the persisting growth prospects deterioration, liquidity and financing difficulties, the impairment of certain assets, a notable loss of confidence among institutions and the reduction of their activities and business, as well as the consequences of the duration, intensity and extension of the crisis, and the state of economic activity in Spain generally.

The Spanish economy entered a recession during the last quarter of 2011. The new government resulting from the general elections on 20 November 2011 approved a set of budgetary adjustments measures on 30 December 2011. It also announced a deficit deviation of more than 8 per cent/GDP and the forecast for 2012 is even worse, with a very deteriorated labour market and an unemployment rate of almost 23 per cent evidencing a deteriorating economic outlook and making a financial sector reform even more necessary.

The cleanup of risks associated with the exposure to the real estate development and construction sector has been calculated by the new Spanish government to amount to €323 billion, of which €175 billion is considered troubled assets, hence the last February 2012 reform to dispel doubts about the valuation of real estate assents, to encourage the banking sector to place its real estate assets in the marker and to improve confidence, credibility and strength on the Spanish banking system.

During 2012, a number of Spanish credit institutions will have to comply with the new 2012 capital and provisions measures as well as face wholesale funding schedules to mature in perhaps adverse international markets unless the new measures cope with the current situation. In 2011, some of them (Bankia, Banca Cívica and Caixabank) became listed; others have also announced their intention to launch IPOs or integration plans which need to be submitted by 31 May 2012. Approval by the Ministry of Economy and Competitiveness should be obtained within a month and integration should occur within 12 months after the approval of the integration plan and the measures imposed by the Ministry.

There will be more bank consolidation and mergers, especially affecting savings banks, which will be adapting themselves to their new nature, greater market discipline and improved governance. In this respect, the coming months, the several projects regarding mergers or institutional protection schemes and their listing will continue and will be subject to a very challenging year.

In conclusion, the banking sector will continue to be subject to pressure insofar as investor confidence is not fully restored and growth does not resume in the Spanish economy. The difficult economic situation and the necessary adjustment of the Spanish financial market will continue in the coming months. Certain entities will further using the mechanisms set forth by the FROB to restructure their business under the strict and close supervision of Banco de España. In these circumstances, the Spanish credit institutions are embarked on the most extensive and challenging process of concentration and restructuring in the history of the Spanish banking system.

Appendix 1

ABOUT THE AUTHORS

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Juan Carlos Machuca joined Uría Menéndez in Madrid in 1996 and has worked out of the firm's London office since January 2000. He is the current resident partner in London.

Mr Machuca's practice focuses on corporate law, banking, finance, regulatory, investment funds, private equity and capital markets. He also advises clients on M&A transactions and on insolvency and restructuring proceedings.

In 2007, Mr Machuca was one of the winners of the Iberian Lawyer 40 Under Forty Awards, which recognise the achievements of the new generation of top lawyers in Spain and Portugal.

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