The Banking Regulation Review

Fifth Edition

Editor
Jan Putnis

Law Business Research

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This article was first published in The Banking Regulation Review, 5th edition
(published in May 2014 – editor Jan Putnis).

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Published in the United Kingdom
by Law Business Research Ltd, London
87 Lancaster Road, London, W11 1QQ, UK
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Enquiries concerning reproduction should be sent to Law Business Research, at the address above. Enquiries concerning editorial content should be directed to the Publisher – gideon.roberton@lbresearch.com

ISBN 978-1-907606-96-0

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following law firms for their learned assistance throughout the preparation of this book:

ADVOKATFIRMAET BA-HR DA

AFRIDI & ANGELL

ALI BUDIARDJO, NUGROHO, REKSODIPUTRO

ALLEN & GLEDHILL LLP

AMARCHAND & MANGALDAS & SURESH A SHROFF & CO

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MIRANDA CORREIA AMENDOEIRA & ASSOCIADOS

MORATIS PASSAS LAW FIRM

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URÍA MENÉNDEZ ABOGADOS SLP

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EDITOR'S PREFACE

The past year has seen a number of critically important bank regulatory initiatives reach interim conclusions.

In the European Union we have seen the finalisation and coming into force of the primary measures that are required to implement Basel III, as well as – at long last – political agreement on the Recovery and Resolution Directive and the principal elements of the banking union proposals. We have also seen the first foray of the European Commission into bank structural reform, with its controversial proposal for EU legislation on that subject, after the enactment of detailed domestic bank structural reform measures in a number of member states.

In the United States, the past year has seen the culmination of a number of regulatory initiatives, including the issue of final rules implementing the Volcker Rule and the issue of rules that will require large foreign banking groups to establish intermediate holding companies for their US subsidiaries. Both of these sets of rules stem from the Dodd-Frank Act: predictions that numerous legal careers would be made by that legislation are so far proving to be accurate.

I refer to these developments above as 'interim conclusions' because, of course, even though a period of primary rule-making has reached a conclusion, the full implications are still emerging. That said, there are helpfully more certainties now about the future direction of banking regulation than was the case a year ago. The combination of that fact, generally improving western economies and shareholder pressure has made many banks take the plunge and start to reorganise and restructure.

Recovery and resolution planning work remains a powerful driver of structural reform. It does not, however, require a particularly sophisticated legal and regulatory view to conclude that the world remains far from a position where we can have confidence that a global systemically important bank could be resolved in an orderly manner today without significant disruption and damage to the world economy. The fact that some regulators occasionally argue to the contrary disregards the detailed work that still has to be done so that governments and regulators may have a good chance of attaining that confidence in the next few years. But that work is, in general, progressing and reassuringly

shows no real sign of faltering yet as memories begin to fade of just how close the world came to economic calamity during the financial crisis.

Divergent approaches to structural reform in different countries could, however, make group-wide resolution more difficult to achieve. Localism, in the form of requirements that banking subsidiaries hold additional, more loss-absorbent capital and additional pools of liquidity, and have boards of directors with a significant independent membership, all have the potential to threaten the concept of a global banking group unless careful thought is given in such groups to how to address these challenges. The ways in which banking groups can best coordinate their relationships with multiple regulators are high on this agenda.

Perhaps the most difficult challenge facing banks in their relationships with their regulators is that of how to reconcile the need for close and cooperative working relationships with those regulators against the backdrop of seemingly never-ending conduct-related investigations and enforcement action. This difficulty varies according to which regulator is carrying out the investigation and the extent to which the investigation relates to matters that are historic and which the banking group concerned has taken steps to address. The challenge is clearly greatest where a major investigation concerns recent conduct and is led by a regulator with which the relevant bank requires good relations in order to achieve its commercial objectives to the satisfaction of its customers and shareholders.

It will be increasingly important for banks to appreciate the capacity of the more material investigatory and enforcement activity to shape business structures as much as structural reform itself. The changes to the ways in which certain markets and trading operations will be organised in the future in response to enforcement activity will be at least as significant as the changes that are brought to those markets and operations by, for example, resolution planning.

The upheaval that all of this implies for some banks' corporate and business structures, as well as for their staff, is combining with changes to previously held assumptions about the profitability of certain activities as Basel III capital requirements bite. The result is uncertainty, but with some grounds for cautious optimism, at least for those banking groups that are less seriously affected by conduct investigations and are firmly on the road to developing simpler, more capital-efficient structures.

Banks that have adopted a properly integrated and global approach to structural reform will, in my view, reap the benefits. While, in the short term, that is likely to be more expensive from a resourcing perspective, in the long term it should achieve savings. It is all too easy to address each regulatory initiative as it comes along, not recognising that this reactive approach runs the risk of structural muddle and missing out on developing business models that address multiple regulatory concerns at the same time. It is to be hoped that more regulators start to recognise positive proactivity on the part of banks not just as commercial astuteness but as a contribution to the restoration of trust that is required to make bank regulatory reform a success.

One increasingly important aspect of reform in the banking sector concerns the capital structures of banking groups. The requirement for more and higher quality loss-absorbing capital under Basel III, coupled with the introduction of bail-in as a resolution tool in a number of important banking jurisdictions, means that banking groups are having to rethink which company or companies they will use to raise capital

and what form that capital will take. Particularly in Europe, the issue of additional Tier I capital and other contingent capital instruments has added complexity to banks' capital structures and a need for banks to engage with current and potential investors to explain those structures.

This fifth edition of *The Banking Regulation Review* contains submissions provided by authors in 56 jurisdictions between late February and mid-April 2014, as well as the chapters on 'International Initiatives' and the European Union. Preparing the chapters has been a particularly onerous task for the authors this year because many of their clients have now moved from observing the regulatory revolution that has taken place in the banking sector to taking tangible steps to reorganise in order to make themselves fit for the new world in which the sector finds itself. My thanks go to all of the authors for their dedication in completing their chapters.

Thank you also to Adam Myers, Shani Bans, Nick Barette and Gideon Roberton at Law Business Research Ltd for their patience, understanding and – above all – great effort in preparing this edition.

The partners and staff of Slaughter and May in London and Hong Kong also deserve more than the usual mention, above all for their continuing tolerance of my involvement in this project. Particular thanks go to Ben Kingsley, Peter Lake, Laurence Rudge, Nick Bonsall, Ben Hammond, Tolek Petch and Michael Sholem.

Jan Putnis
Slaughter and May
London
May 2014

Chapter 49

SPAIN

Juan Carlos Machuca and Tomás José Acosta[1]

I INTRODUCTION

Spain boasts a diversified modern financial system that is fully integrated with international and European financial markets. The Spanish banking regulator, Banco de España, joined the European System of Central Banks (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.

Also, as a consequence of such integration, 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.

It is fair to state that the Spanish financial system has been sound and stable for the past 30 years. There has, however, 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, significant changes include the incorporation of IFRS into the Spanish banking accountancy rules, the transposition of the Basel 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.

One of the most relevant outcomes of such an activity materialised in 2000, when the Spanish government 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

1 Juan Carlos Machuca is a partner and Tomás José Acosta is an associate at Uría Menéndez Abogados SLP in its London office.

securities (contrary to other European 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, 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'.

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, and a similar strict stress test was performed in 2011 over 114 entities, which substantiated, in theory, the solvency of Spanish institutions.

Although the effects of the first wave of the financial crisis were avoided, following the sovereign debt crisis in summer 2011, Spain tightened provision requirements, raised the Tier I ratio to 9 per cent, and encouraged a process of restructuring of its financial system. As a result of the introduction of this new ratio, transitional regulations were introduced, granting a reasonable compliance period to the banking groups that failed to meet this requirement when it was approved. For this purpose, the institutions with initial shortfalls submitted recapitalisation plans that were approved by Banco de España.

In 2011, a new regulation was approved in order to strengthen the banking system[2] with a dual purpose: (1) to strengthen the solvency of Spanish banking entities; and (2) to speed up the restructuring process initiated by the saving banks. Part of this regulation has already been repealed by means of the Royal-Decree 14/2013 referred to below. However, 2012 would prove to be the year of revolution of the Spanish banking system.

On 4 February 2012, a new government approved Royal Decree-law 2/2012 of 3 February on banking sector reform. The purpose of this law was 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 2/2012 Royal Decree-law were:

a an increase of the coverage requirements for real estate assets in the balance sheets of credit institutions;

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

2 Royal Decree-law 2/2011 of 18 February.

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

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

In May 2012, the government adopted Royal Decree-law 18/2012, now Law 8/2012 of 30 October (Law 8/2012), which regulated the obligations of credit entities to take their foreclosed assets or those received in payment of debts linked to the real estate sector to an asset management company other than the entities themselves. At the same time, the government entrusted two independent appraisers with the duty of carrying out an analysis of the Spanish banking system's balance sheets to determine what the capital needs of each Spanish credit institution would be in a stress scenario.

In that very same month, the conversion of preferred shares held by FROB in Bankia, the fourth-largest Spanish banking institution, and its public statement of needing up to €17 billion to restore its regulatory capital, resulted in its nationalisation by the Spanish government and, subsequently, the request to the European Union for financial assistance for the recapitalisation of Spanish financial institutions that was concluded upon the signing of the memorandum of understanding (MoU) of 20 July 2012 between the Spanish and European authorities, with the participation of the International Monetary Fund.

Nonetheless, FROB sold, as recently as in February 2014, 7.5 per cent of Bankia's share capital to institutional investors, as a consequence of which its interest in this institution was reduced to 60.89 per cent. Given the conditions under which the transaction was carried out, the fact that FROB made a profit was welcomed by the market as a sign of recovery.

According to the MoU, the Spanish banking sector would be provided up to €100 billion in financial assistance under a programme that would cover a period of 18 months. Major changes to the Spanish banks have taken place since then.

The MoU comprised several specific conditions based on the following elements:

a the identification of the individual needs of capital after complete bank-by-bank stress tests;

b recapitalisation, restructuring or resolution of weak banks by means of the implementation of plans to address any capital shortfalls identified in the stress tests;

c segregation of problematic assets by those banks receiving public support into the external Asset Management Company for Assets Arising from the Bank Restructuring (SAREB),[3] applicable to assets related to real estate development and foreclosed assets;

---

3 SAREB's own funds amount to 8 per cent of its total assets, split between equity (25 per cent) and subordinated debt (75 per cent). Its share capital is privately owned in a 55 per cent, while 45 per cent is owned by public authorities. Private investors, mainly banks from Group 0 and insurance companies (domestic and foreign) have signed shareholders' agreements and disbursed two tranches of capital related to the transfers of assets from Group 1 (circa €36

d resolution and burden-sharing legislation to provide the legal framework for a swift and orderly restructuring of the banking sector with minimum costs to the taxpayers; and

e reform of the regulatory and supervisory framework of the financial sector.

As part of the MoU obligations, as a road map of the Spanish banks' restructuring, the viability of Spanish banks was assessed by Spain and the European Commission on the basis of the results of complete stress tests that were carried out during the summer of 2012 by independent experts Oliver Wyman and ended in September 2012. Banks were evaluated on a consolidated basis against a post-stress core Tier I ratio of 9 and 6 per cent in the base and adverse scenarios. Spanish banks were divided into four categories:

a Group 0 banks: those in relation to which no further measures were needed after the stress tests as there was no capital shortfall.

b Group 1 banks: those in which FROB, already has a stake, which prepared recapitalisation plans in the autumn of 2012, which were approved by the European Commission in November 2012, and received state aid and funds. These banks were Bankia-BFA, NCG Banco SA, Catalunya Banc and Banco de Valencia.

c Group 2 banks: those in which stress tests detected a shortfall capital and needed state aid, which also prepared recapitalisation plans in the autumn of 2012, approved by the European Commission in December 2012, and which eventually received state aid and funds in early 2013. The banks that fell under this category were Banco Mare Nostrum, Banco Caja 3, Liberbank and Banco CEISS.

d Group 3 banks: those in which the stress tests detected a shortfall capital and will be able to cover their capital needs without public aid, either by means of issuing contingent convertible securities (CoCos), under a recapitalisation scheme, by repurchasing own subordinated debt and divesting assets. These banks were given until 30 June 2013 to apply for any of the referred measures. Ibercaja and Banco Popular were in this group.

This process was overseen by a Strategic Coordination Committee composed of Spanish authorities, the European Commission, ECB, EBA, ESM and IMF staff.

Overall, the final capital needs of the Spanish banks proved to be lower than those initially identified. Out of the original €56 billion of capital needs identified by the stress tests, approximately €41 billion were disbursed.

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billion) and 2 (circa €14 billion) banks. Please see below for a description of Group 0, 1 and 2 entities. It has the mandate to divest the assets over 15 years, optimising levels of recovery and value preservation, minimising negative impacts on the real estate market and economy and the costs to the taxpayers.

It is facing operational challenges, transfer pricing issues (the price being determined by Banco de España) and the need to adopt a sound business plan, as well as unforeseen changes in some of its senior offices; however, the balance of the first fiscal year of activity of SAREB is moderately positive and it can be reasonably expected that it will meets it divestment deadline.

The clean-up process of the Spanish banking system included the transfers of assets from banks in Groups 1 and 2 to SAREB. Established by Law 9/2012 as a majority private-owned company, although its top management was appointed by FROB (which has a 45 per cent shareholding), it was set up at the end of 2012 and has already received real estate development-related exposures and foreclosed on assets from participating banks, and have been involved in a number of sales of assets worth several billion euros.

A number of Spanish financial institutions are still struggling to cope with the depth of the crisis, mainly given their exposure to the Spanish real estate market, the collapse of which 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 regulatory intervention in 2011 in Banco de Valencia and the savings banks UNNIM, NovaCaixa Galicia, Catalunya Caixa and Banco CAM, some of which were sold at auction during the past year. 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 after a competitive sale procedure. Likewise, a number of savings banks adhered to one of the Institutional Protection Schemes (IPSs) that have been created during the crisis.

Finally, as a consequence of the subscription of the MoU, Spain, in consultation with the Strategic Coordination Committee, established a number of comprehensive and legislative framework of utmost relevance, specifically with the approval on 31 August of Royal Decree-law 24/2012, now Law 9/2012 of 14 November, on the framework for the restructuring and resolutions of financial institutions (Law 9/2012). It lays down the procedures and functions of the agencies involved in the process of preparation, approval and monitoring of the restructuring plans and resolutions of credit institutions.

Law 9/2012 was a major achievement and incorporates international best practices. Furthermore, it included three major reforms:

a it designated FROB – acting in coordination with Banco de España – as the authority in charge of restructuring and resolving credit institutions;

b it empowered FROB and Banco de España to take more wide-ranging actions towards banks at the different stages of financial distress – early intervention, restructuring and resolution, including imposing losses on shareholders and creditors; and

c it lays down the legal bases on which SAREB was set up in November 2012 to manage and divest in an orderly manner the asset portfolio or real estate loans and assets received from participating banks and therefore segregate the bank's impaired assets.

2013 has been a year during which this overhaul of the Spanish legal and regulatory framework for banks, savings banks and other financial institutions has been deepened by means of the approval of a number of regulatory changes, not only at a national, but also at EU level. Some relevant changes have taken place during the past year.

First, there has been the implementation in Spain of the 'CRR/CRD IV package'. A number of initiatives have been taken to adapt the Spanish regulatory environment to the new EU standards on regulation, supervision and solvency of credit institutions established by means of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (applicable since 1 January 2014) (CRR); and Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (CRD IV).

The initiatives that have been taken so far are:

a Royal Decree-Law 14/2013, of 30 November 2013, on urgent measures to adapt Spanish legislation to European regulation on the supervision and solvency of financial institutions, which incorporated, on an urgent basis, the most pressing legal changes required to enable supervisors and financial institutions to operate from 1 January in the new EU legal environment arising from the CRR/CRD IV package;

b a draft bill on regulation, supervision and solvency of credit institutions the main purpose of which is to implement CRD IV into Spanish legislation and consolidate into one single instrument the main provisions on the regulation and discipline of credit institutions that hitherto have regulated such area in a rather dispersed manner (the Draft Banking Bill) which is currently being discussed in the Parliament and

c Circular 2/2014, of 31 January 2014, issued by Banco de España, by means of which a number of regulatory options, as set out in CRR, are exercised by Banco de España in its capacity as competent national authority.

The Draft Banking Bill is expected to be a major achievement, as it is expected to repeal the laws that have traditionally laid out the core regulation of credit institutions in Spain.[4]

There has also been approval of the new law on saving banks – the Law 26/2013, of 28 December 2013, on Savings Banks and Banking Foundations (the Savings Banks Law) – whose purpose is to set out the new legal framework for the saving banks and the new regulation on banking foundations.

Law 19/2013, of 10 December 2013, on transparency, public access to information and good governance was also approved, the purpose of which is to improve transparency in public life. Its main impact on the banking sector derives from the improvement of the anti money-laundering regime and the broadening of the concept of 'persons with public responsibilities'.

Although not yet enacted, it is worth noting now that on 5 March 2014, the Spanish government submitted a preliminary draft law for public consultation, which

4 Most notably the Banking Regulation Law of 31 December 1946, Law 13/1985 of 25 May 1985 on investment ratios, own funds and reporting requirements for financial intermediaries and Law 26/1988 of 29 July 1988 on Discipline and Intervention of Credit Institutions.

intends to ease the access of Spanish companies (primarily, SMEs) to financing by means of a number of measures, by also promoting alternative non-banking financing sources (the Draft Company Financing Bill). Within the latter, the Draft Company Financing Bill has, according to its present wording, a multiple purposes:

a amending and updating the regime of financial credit establishments;

b amending the regime for securitisations (a market in which Spain became one of the most relevant players during the upturn of the last economic cycle);

c easing the access of Spanish companies to the capital markets (including, in particular, a much-awaited amendment in the regime for bond issues); and

d regulating for the first time crowdfunding in Spain (further details are likely to come in the next year).

Finally, the EU programme that orchestrated assistance for the Spanish financial institutions through the MoU was finalised on 23 January 2014, leading in to a new post-supervision programme that will be in place until Spain repays at least 75 per cent of the funds provided, which is expected to take place no earlier than in 2026.

In sum, a new institutional and legal framework for the Spanish banking system is in process of being established in Spain by a multistage procedure that commenced in 2012, deepened in 2013 and is likely to continue in the coming years. Within this process, a number of measures are being taken with the goal of enhancing the recapitalisation and restructuring of banks, and improving bank transparency, regulation and supervision.

II THE REGULATORY REGIME APPLICABLE TO BANKS

The Spanish regulatory regime for credit institutions is currently 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. Once, however, the Draft Banking Bill is enacted, such regime (or at least the bulk of it) will be contemplated only therein, in the Savings Banks Law and in Law 13/1989, of 26 May 1989, and on credit cooperatives (as amended by the Draft Banking Bill).

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), as well as the regime applicable to the FROB, 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; reference to credit cooperatives

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, to a far lesser extent, 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 attracted a substantial portion of private savings in Spain and tended to loan funds to private customers (mortgages, etc.). Moreover, all 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 accounted, until two years ago, for nearly half of the Spanish financial sector. Savings banks tended to be locally oriented entities of variable (but generally limited) size (this has recently changed due to the integration, auctions and restructuring processes undergone by several savings banks in 2011 and 2012), with strong economic and social ties to their home region. Although savings banks fully participated in the market, they were a special category within the financial services industry, as they were structured as foundations rather than companies and governed by representatives of collective shareholders: mainly depositors, employees and local authorities. Any positive result is allocated to social welfare and cultural projects.

The corporate model of savings banks has completely changed in recent years. After a number or partial reforms during 2011 and 2012 (as a consequence of which most of the Spanish savings banks were transformed into banks through different integration processes), a comprehensive overhaul of their legal regime was put in place in December 2013 when the Savings Banks Law was passed following the conditions set out in the MoU.

In light of the radical changes in the savings banks sector,[5] the Savings Banks Law aims to clarify the role of savings banks in their capacity as shareholders of credit institutions and to strengthen incompatibility requirements regarding the governing

5 Since 2010, 43 out of 45 of them have taken part in a consolidation process, which has resulted in a total of 12 groups operating at the of writing; the number of branches has been reduced in 33.9 per cent and the workforce in a 29.5 per cent).

bodies of the former savings banks and the commercial banks controlled by them. Some of the main features of the new regime are as follows:

a Savings banks will only be entitled to engage in the solicitation of repayable deposits from the public and the granting of credit within the territory of one autonomous region or a maximum of 10 neighbouring provinces.

b Savings banks must engage mainly in deposit taking and lending.

c Any person holding an executive position in a political party, trade union or professional association, as well as elected representatives in the public administration, senior officers in such public administrations and those that have held any of the foregoing positions during the past two years will not be allowed to be a member of the management bodies of savings banks. This is a change to the prior regime that aims to avoid the previous failures in the savings banks' management.

Any savings banks holding assets in excess of €10 billion, or with a market share in relation to the deposits in its autonomous regions of more than 35 per cent, must transfer its financial activity to a credit entity and become a 'banking foundation'.

d 'Banking foundations' hold a (direct or indirect) holding in a credit entity of at least 10 per cent of its share capital or voting rights or such other percentage allowing to appoint or remove at least one member of the board. These entities have the purpose of (1) managing the stakes in the relevant credit entities and (2) pursuing a social project or corporate responsibility programme. Depending on the stake of the banking foundation in the credit entity (the relevant thresholds being 10 per cent, 30 per cent and 50 per cent), a number of internal rules and protocols shall be in place. Further, the dividend distribution of credit entities controlled by banking foundations are subject to a minimum voting majority of two-thirds.

e Credit cooperatives are private institutions the corporate purpose of which is to attend the financial needs of its members and those of third parties by means of the development of those activities that are also carried out by credit institutions. Their current regime is contemplated in Law 13/1989, of 26 May 1989, on credit cooperatives, which will be amended by the Draft Banking Bill in relation to the calculation of their equity.

Electronic money entities

Electronic money entities (EDEs) are recognised as a special type of credit institution that issues electronic money. The legal regime for EDEs 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/EC. 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. Secondary legislation was approved by Royal Decree-law 778/2012 of 4 May developing the legal framework of EDEs, clarifying the definition of e-money and the scope of the applicable Spanish regulations, establishing the requirements for the setting up and running of EDEs, their supervision and sanction

regime being very similar to that applicable to credit entities. Royal Decree-law 778/2012 fully implemented EU Directive 2009/110/EC.

Payment services entities

In 2009 Spain made provision for a new type of credit institution that renders, 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 and further guidelines on transparency and customer protections were set out by Banco de España by virtue of Circular 5/2012 of 27 June.

Financial credit establishments

Financial credit establishments are those companies that 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.

It should be noted, however, that, as a consequence of the entry into force of the CRR/CRD IV package and the Royal Decree-Law 14/2013, these entities have lost their status as credit entities, but not their regulated nature. After this change in their nature, the regime is expected to be clarified by the enactment of the Draft Company's Financing Bill and the issuance of secondary regulation, which is expected to happen during 2014.

ii Securities markets

The functioning of the securities markets has also been modernised in recent years to set out a state-of-art framework with 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 implemented 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 may also 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 (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 a separate entity. 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.

Law 9/2012 also introduced disclosure and suitability requirements for securities service providers, including provisions on the additional information that must be given to investors in case of placements of securities other than shares in credit institutions and actions to be taken when providing investment advice and other services to clients and written records thereof.

One of the most relevant reforms of 2013 affecting Spanish securities markets was the creation, pursuant to one of the conditions set out in the MoU to establish new financing channels for Spanish companies, of the Alternative Fixed-Income Market (MARF), an unregulated multilateral trading facility the governing body of which is the AIAF Fixed-Income Market SA.

The following securities may be traded in this new market:

a fixed-income securities, such as promissory notes, bonds or other securities that create or recognise debt;

b securities that grant the right to acquire shares or equivalent securities to shares, by conversion of or by the exercise of the rights that grant such securities, provided that they are issued by the issuer of the underlying shares or by an entity of the group of the issuer;

c other trading securities based on the fixed-income securities referred to in (a) above, such as asset-backed securities; and

d units of collective investment schemes the investment policies of which include investment in securities issued by the companies that are listed on the MARF.

The issuance of the securities to be admitted onto the MARF should be exclusively aimed at qualified investors, be an issuance with a nominal value of at least €100,000, and be a security that is not admitted to trading in any of the markets operated by companies belonging to the stock exchange group BME.

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 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 of Banco de España inspectors at the two large Spanish banking groups and other institutions whose size and complexity call for regular monitoring to verify their liquidity risk, capacity to generate earnings and solvency. Notwithstanding this, as a condition of the MoU, a review of the supervisory procedures of Banco de España was carried out in 2012 identifying possibilities to strengthen Banco de España's power to issue binding guidelines or interpretations without regulatory empowerment and some other rules that were further implemented in 2013 to reform its regulatory framework. In Spain, provisioning rules are straightforward and transparent and verified by Banco de España, while in other countries provisions are generally decided by the banks with the approval of their external auditors.

In previous years Banco de España amended, *inter alia*, rules on financial reporting rules and formats, and the accounting regulations on loan write-downs (loan loss provisions) to improve transparency and recognise the value of real estate collateral and minimum provisions. New rules introduced in 2012 direct credit institutions to set aside minimum specific provisions for nonperforming loans, and give guidance on

how to value the repossessed assets and the minimum impairment estimate when, after a period of time, these assets are kept on the balance sheet for long periods, which is considered to be a sign of deterioration. Further, on 18 March 2014 Banco de España also issued guidelines for the accounting treatment of the outstanding debt after a financing agreement adopted pursuant to the rules of Spanish insolvency law, as it was amended in March 2014.

Banco de España's responsibilities include the verification of maximum rates and charges for banking services rendered by the credit institutions. 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, auditors' reports and a special registry of articles of association of the supervised institutions. Banco de España also receives confidential information from the institutions on their financial situation and their shareholders.

Banco de España may issue general or specific recommendations and requirements addressed to the entities (i.e., requiring adequate provisioning for the less solvent obligors and improvements in the quality control over assets) and approve restructuring plans. It may also initiate disciplinary proceedings against the institutions and their boards of directors or managers or may even intervene and replace directors to remedy deficiencies or non-compliance.

Banco de España 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 other financial institutions subject to its oversight, but also to 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 include 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. Further sanctioning and licensing powers for credit institutions have been transferred from the Ministry of Economy and Competitiveness to Banco de España by Law 9/2012.

Additionally, as a consequence of the CRR/CRD IV package and the entry into force of the Royal Decree-Law 14/2013, the supervisory powers of Banco de España and CNMV have been widened and strengthened in order to ensure appropriate enforcement of the new banking and supervisory discipline. Likewise, Royal Decree-law 14/2013 has amended Law 13/1994, of 1 June 1994 (the rule setting out the competences and regime applicable to Banco de España) to allow it to issue technical guidelines and answer binding questions on supervisory regulation.

Royal Decree-law 2/2012 provides that the state will supervise special foundations of saving banks through the Protectorate of the Ministry of Economy and Competitiveness, provided that the bank's main activities are carried out in 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.

Another relevant aspect of Law 9/2012 is the reform of FROB's governance. In compliance with the MoU, it was decided to separate FROB from credit entities, which were part of its management in representation of the Guarantee Depository Fund, in order to avoid potential conflicts of interest.

On the other hand, FROB has become the national resolution authority and, for these purposes, in 2012 it was given an unrivalled set of powers under Spanish law:

a Corporate faculties: apart from exercising the legal powers of the management body or the shareholders, FROB will exercise the powers of the general meeting in cases where the general meeting obstructs the restructuring or the resolution, or when necessary for urgent reasons.

b Administrative faculties: a broad list of administrative powers have been conferred, the most relevant of which are: (1) ordering the transfer of equity instruments or other instruments convertible into equity, whoever the owners may be, as well as the entity's assets and liabilities; (2) carrying out capital increases and reductions, and issuing and redeeming obligations, including the possibility of suppressing pre-emptive rights; and (3) ordering the transfer of securities deposited in one entity to another of the solvency and the behaviour of credit institutions.

To counterbalance these broad powers, various provisions have been created to protect the rights of shareholders and creditors. Accordingly, two basic principles have been established as regards resolution proceedings: losses must be allocated according to the insolvency ranking of credits; and no creditor may be paid less than the amount that they would have received had the entity been wound up under the framework of bankruptcy proceedings. It is also mandatory to carry out an economic assessment of the entity prior to the adoption of any resolution or restructuring measures.

It is worth noting that Royal Decree-law 14/2013 has amended Law 9/2012 to correct the unbalanced financial situation of FROB resulting from the losses suffered in its balance sheet as a consequence of its activity as the national restructuring and resolutions authority. FROB will be able to increase its net worth via the capitalisation of credits, loans and any other transactions in which the state stands as creditor.

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 past or present Banco de España officials. 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. These duties will also now apply to FROB with respect to its new authority on restructuring and resolutions.

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.

Further to the issuance on 22 November 2012 by the EBA of its guidelines on the assessment of the suitability of members of the management body and key function holders, the Spanish government passed Royal Decree 256/2013, of 12 April 2013, by means of which such guidelines are incorporated into the Spanish legal system. By means of such Royal Decree, Banco de España is entrusted with broader functions as to the assessment of the requirements that those roles need to meet: commercial good reputation, experience, and conflicts of interest. Additionally, credit entities are required to put in place departments and internal procedures to recruit directors and senior officers, as well as to appraise their performances. Additionally, Banco de España is given the faculty to authorise amendments to the credit entities' articles of association; all of it pursuant to the principles contemplated in Law 9/2012.

Additionally, the Draft Banking Bill is expected to introduce a number of changes at corporate governance level of credit entities, the most notable of them being (according to its current wording): (1) restrictions on being a director of a credit institution; (2) separation of the chairman's and CEO's roles (unless authorised by Banco de España); (3) obligation to have appointment, compensation and risk committees; (4) disclosure of directors' remuneration; and (5) issuance of an 'annual banking report'.

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 these functions. 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.

In December 2013 a draft bill was submitted for public consultation by the Spanish government for the amendment of general corporate rules applicable to Spanish companies generally (including credit entities). It is premature to make any analysis of the new regime that this bill – which is expected to enter into force during 2014 – will implement, but it seems that, according to its current wording, that its purpose is to incorporate the best practices into Spanish corporate governance. This bill is intended to cover a wide variety of aspects, including (1) directors' remuneration (which will likely need to be approved by the shareholders' meeting at least every three years), (2) the terms of directors' appointments (a maximum of four years, as opposed to the prior six years), (3) conflicts of interest, (4) diligence and fiduciary duties, and (5) shareholders' rights (lowering certain minority's rights from 5 to 3 per cent).

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.

Since February 2011, FROB may buy ordinary shares or make capital contributions to the entities that so request. The purchase of these instruments will cause the immediate inclusion of 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 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.

Significant attention has been devoted in Spain to remuneration policies in recent years in the same manner as it has been done at an European and international level. Various rules have been passed, including Law 2/2011, whereby it was established 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.

Additionally, Banco de España has already recommended in recent years that entities under its supervision follow the remuneration policies 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 incompatible with the maintenance of a solid core capital base.. Further, annually, banking groups and savings banks will need to approve a report of the annual remuneration of their board members for the relevant years and the future years on an individual basis.

Most recently, Royal Decree-law 14/2013 has introduced a number of innovations in relation to variable remuneration limits, the main of them being that variable remuneration of key personnel (i.e., senior executives or employees who undertake risk or exercise control functions) must be capped at 100 per cent of fixed remuneration, except if the general shareholders' meeting or equivalent governing body gives its approval to excess such a limit up to 200 per cent of the fixed remuneration.

Further, 2/2012 Royal Decree-law established significant restrictions on the remuneration of directors and senior executives in institutions receiving public aid, by imposing more stringent requirements for institutions in which FROB has a majority stake. These restrictions apply to fixed and variable remuneration, and may even affect certain pension benefits. These restrictions were clarified and tightened by Ministerial Order from the Ministry of Economy and Competitiveness ECC 1762 of 3 August 2012.

In the case of intervention mergers, 2/2012 Royal Decree-law provides that these restrictions will apply only to directors of the institution requiring public aid, and that the Ministry of Economy and Competitiveness may modify the limits applicable to the directors of such institution.

As a consequence of the foregoing, new forms of disclosure in relation to the compensation of directors of listed companies, savings banks and other issuers of securities admitted to trading in official securities markets were approved by Ministry of Economy and Competitiveness and the CNMV during 2013.

iii Regulatory capital and liquidity

Spain's legislation on capital and liquidity requirements has traditionally incorporated capital adequacy requirements in line with international standards as set out by the Basel Committee on Banking Supervision. According to such standards, 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, capital requirements and liquidity of individual credit institutions and consolidable groups have been approved in through the years, most of them in order to implement the Basel I and Basel II Accords in Spain. Such regulations have been followed by specific circulars and guidelines issued by Banco de España determining the technical specifications and control of minimum funds.

The regulations on capital and liquidity have been heavily affected by the MoU, one of the main purposes of which was to ensure adequate solvency of the entire Spanish banking system; to this end it was agreed to increase the amount of capital of banks and to align its definition with agreed internationally standards. As envisaged in the MoU, the additional capital to reach the 9 per cent ratio would be covered using the definition of capital approved by the EBA in its 2011 EU-wide recapitalisation plan. For this purpose, Law 9/2012 adopted this capital definition and this has been required since the beginning of 2013. The MoU's reforms of the regulatory framework were also met through Law 8/2012 establishing additional coverage reserves to those approved by Royal Decree-law 2/2012 with respect to deterioration of the financing link to real estate activities.

Additionally, a large amount of developing regulation has been issued by Spanish the authorities in recent years, contemplating, *inter alia*, provisions for:

a lending related to the acquisition of land for real estate developments, real estate developments and construction in Spain (real estate-linked lending);

b integration processes; promotion of loans to households and SMEs;

c technical details on the minimum capital requirements;

d assessment of loan-loss provisioning, credit concentration and related-party transaction (Banco de España Circular 7/2012), as well as a number or regulations on the transfer of real estate assets to asset management companies (e.g., Banco de España Circular 8/2012).

Nonetheless, the entry into force of the CRR/CRD IV package, as well as its incipient transposition into Spain, has led not only to a fundamental change (both at an European and Spanish level) in the regulation of solvency and liquidity of credit entities, but, more generally, is a step forward in the creation of Banking Union. Since 1 January 2014, the nuclear regime for credit entities solvency has been condensed in CRR (which is directly applicable in EU Member States). This Regulation is meant to replace all the currently

existing laws, decrees, regulations, circulars and guidelines that are inconsistent with its regime; thus, all such rules are formally in place, although it is expected that during the coming months new ones are issued by the Spanish authorities for the purpose of clarifying the applicable regime going forward.

Given that CRR is common to the EU, in order to avoid any potential overlap within this year's edition this section will be restricted to the Spanish implementation of the European regime.

Royal Decree 14/2013 includes the following points on capital requirements:

a The core capital requirement set out in Royal Decree-law 2/2011 has been eliminated so as to converge with the definition in CRR; however, in order to meet the MoU's requirement that a minimum capital of 9 per cent be kept until 31 December 2014, Banco de España may prevent or restrict any distribution of Tier I capital components that would have been eligible to comply with the minimum core capital requirements of such Royal Decree-law to the extent that, during 2014, these distributions exceed, in absolute terms, the excess capital with respect to the legally required minimum on 31 December 2013.

b Preference shares are eligible as own funds under the terms of the CRR (additional Tier I capital or common equity Tier I capital).

Even more interesting are the prospective changes that will be in place once the Draft Banking Bill is approved. The most relevant of them is the inclusion of 'capital buffers' (i.e., additional capital requirements to those envisaged under CRR). Failure to comply with capital buffers entails (1) restrictions on distributions and payments relating to components of common equity Tier I (such as shares) or additional Tier I capital (such as contingently convertible bonds), and on the payment of variable remuneration; and (2) the obligation to submit a capital conservation plan that must be approved by Banco de España.

In particular, the various capital buffers provided for in the Draft Banking Bill, in accordance with CRD IV, are as follows:

a a capital conservation buffer (2.5 per cent of the institution's risk exposure): a non-discretionary buffer, the application of which will be phased in from 2016;

b a countercyclical capital buffer (percentage to be set by Banco de España): a specific buffer for each institution, the application of which will be phased in from 2016. It is calculated as the weighted average of the countercyclical buffer percentages applicable in each of the territories in which an institution has exposures;

c buffers for global systemically important institutions (G-SIIs) and other systemically important institutions (O-SIIs): buffers specifically applicable to certain institutions by reason of their systemic importance. Banco de España will identify which institutions are to be considered GSIIs or O-SIIs and will set the buffer to be maintained by each of these types of institution, which, in the case of the G-SIIs, will range from 1 per cent to 3.5 per cent, and, in the case of O-SIIs many not exceed 2 per cent. These buffers will apply from 2016, although the application in the case of G-SIIs will be phased in; and

d a systemic risk buffer: a buffer that may be set by Banco de España to cover non-cyclical systemic or macroprudential risks, where there is a risk of disruption in

the financial system with the potential to have serious negative consequences for the financial system and the real economy.

Non-compliance with the capital adequacy and solvency requirements is subject to certain limitations and disciplinary measures. Banco de España has established the limitations on income distributions to which credit institutions are subject if they fail to comply with the solvency requirements. The Draft Banking Bill sets out the penalties that will be applicable in this case, which broadly coincide with those specified by the current Law 26/1988, of 29 July 1988 (which will be repealed by the Draft Banking Bill), albeit they are updated to include new penalties derived from CRD IV and from the new rules on fitness and transparency.

In terms of liquidity, the Draft Banking Bill sets out that Banco de España will assess the business model, corporate governance procedures and systems, supervision and evaluation findings, and all systemic risks.

Finally, at least once a year, Banco de España will subject credit institutions under its supervision to a stress test to facilitate the envisaged supervisory review and assessment process.

IV CONDUCT OF BUSINESS

i Conduct of business rules

Spanish rules on discipline and intervention of credit institutions (which will be amended during 2014 as a consequence of the enactment of the Draft Banking Bill) 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, a credit institution 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's Complaints Service;

d its internal customer service regulations; 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).

Since 2010, anti-money laundering laws and regulations applying to credit institutions (including EU credit institutions rendering services in Spain on a cross-border basis) set 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 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. This regime has been improved and further clarified by means of Law 19/2013, of 10 December 2013, on transparency, public access to information and good governance.

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 rules to check that the conduct of the credit entities is sufficiently diligent.

New consumer protection and new legislation on evictions in case of mortgage default were approved in 2012. The aim is to reinforce the protection of some vulnerable mortgage debtors by establishing a moratorium on evictions until 15 November 2014. It is in this context that Law 1/2013, of 14 May 2013, was passed in order to protect vulnerable mortgage debtors and provide a framework for the restructuring of debt and social renting.

Finally on 16 November 2012, a new Ministerial Order from the Ministry of Economy and Competitiveness ECC/2502/2012 was approved, establishing new claims and complaints procedures for customers of credit institutions, investment services companies and insurance companies before Banco de España, the CNMV and the insurance regulator.

Further, Banco de España approved Circular 6/2012, of 28 September 2012, on enhancing transparency of banks, further progress in establishing rules on public and reserved financing information and new financial statements forms and Circular 1/2013, of 24 May 2013, by means of which Circular 4/2004, of 22 December 2004, was amended in relation to reserved and public financial information, financial statements forms and the Central Credit Register, all of this within the context of the conditions set out in the MoU.

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, their managers and directors, and significant shareholders and their managers and directors must safeguard and keep strictly confidential all information relating to balances, operations and any other customer's transactions unless required to disclose by applicable law or the 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.

On 10 August 2012 the Spanish authorities on money laundering established the list of countries with equivalent banking secrecy and money laundering regulations to those established in Spain.

V FUNDING

The main funding for Spanish credit institutions has obviously been based on deposits made by their customers. However, according to Banco de España, the global amount of deposits taken from the private sector has decreased in recent years.

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. 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.

In recent years, the mistrust in the Spanish public finances and its financial system resulted in a substantial increase in funding costs and difficulties in gaining access to wholesale markets, which had a large effect on sovereign debt during the summer of 2012. 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 entitle the owner to vote on corporate matters. From an economic standpoint, participating quotas allowed supervision by the market of the management and business of the savings bank issuing the quotas, just as with listed banks. These securities also allowed 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.

Further, Law 9/2012 introduced hybrid instrument management measures that can be divided into two main groups: (1) voluntary management measures that credit entities must include in their restructuring and resolution plans to ensure fair burden sharing; and (2) measures that FROB may impose and that will be binding on the credit entity and the security holders. As a general principle, the exercise of these powers must respect the insolvency ranking of these instruments.

Voluntary measures may include: (1) exchange offers for equity instruments; (2) pure repurchase offers or for its reinvestment in equity instruments or other banking products; (3) reduction of the nominal value of the securities; or (4) early redemption below par value. These measures are subject to the voluntary acceptance by the holders of the securities and, in particular, those discussed in (3) and (4) require investors' prior consent to amend their terms.

On the other hand, to ensure more effective burden sharing of costs, or to preserve and restore the entity's financial position, since the 2012 reforms FROB may make arrangements for the entities involved in restructuring or resolution proceedings, including: (1) the postponement, suspension, resolution or amendment of certain rights, obligations, terms and conditions of all or some of the entity's securities; (2) the obligation of the entity to repurchase the affected securities, and of the investors to sell them, at the price determined by FROB, which may not exceed the market price (it may be stipulated that the price be reinvested in equity instruments); or (3) any other management action that the entity may have taken voluntarily.

The adoption of these measures and their execution cannot be considered a breach of contract or early termination of any other obligations (cross-default clauses) that the entity has with third parties. The power to unilaterally impose losses on the creditors by an administrative authority outside the insolvency proceedings is one of the main novelties of Law 9/2012.

Depending on whether the proceedings involve a restructuring or resolution, FROB may take, *inter alia*, the following financial support measures in relation to the affected entity or its group, a third-party acquirer, a bridge bank or an asset management company: (1) the granting of guarantees; (2) the concession of financing; (3) the acquisition of assets or liabilities; or (4) recapitalisation measures.

Recapitalisation measures may consist of FROB purchasing equity instruments or convertible obligations in equity instruments which the entity must redeem or repurchase within a maximum of five years (instead of two, as in the early intervention phase).

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. Also, the provision of state guarantees to new funding transactions launched by Spanish-resident entities with a maximum maturity of seven years was approved.

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 investment firms, credit institutions and assurance, insurance or reinsurance undertakings. The Spanish regime introduced identical rules and evaluation criteria for the prudential assessment of Banco de España regarding the acquisitions of and increase of holdings in Spanish credit institutions. This regime is likely to be changed by the Draft Banking Bill. However, the changes will maintain the general framework depicted below.

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 consider when evaluating the proposed shareholding increase. Furthermore, the rules, *inter alia*, set out how to calculate the shares to be taken into account 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 its non-opposition to the potential acquisition, and define the meaning of significant influence. This pre-acquisition approval from Banco de España is mandatory where, as a consequence of the acquisition, the acquirer would hold (taking into account conditions regarding aggregation laid down in the Spanish regulations), 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. Such pre-acquisition approval also arises where the direct or indirect holding in a Spanish bank enables the exercise of a significant influence on its management. 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 requires prior notification to Banco de España. Likewise, immediate written notification 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 situated or regulated outside the European Union, or is a natural or legal person not subject to the supervision of Spain or of the European Union.

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

Finally, 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 and as a consequence of the restructuring of the Spanish banking system. 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 event 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 two years has been the mergers or integrations between savings banks instigated by Banco de España. Few mergers had been carried out between savings banks other than in cases of financial difficulty. The reform of savings banks allowed the transfer of their banking business (and in which they shall hold for the time being 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). The new proposal of the savings banks framework to be approved in 2013 will limit even more such shareholdings by savings banks in commercial banks.

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, Royal Decree-law 2/2012 further introduced minor changes to the subsidies system involving the acquisition of shares and reinstated 'FROB I', which consists in the purchase of instruments convertible into capital of any credit institution (not only cooperatives) that is about to integrate and needs to reinforce its solvency.

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

To ensure efficiency in the use of public resources, FROB must divest through a public auction within three years. In addition, the securities' terms may state that, within one year of the purchase of the shares, entities may repurchase their shares or designate a third party to buy them (this term may be extended to two years).

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

Law 9/2012 introduced three phases, each with its respective measures, depending on the entity's degree of deterioration that may affect the transfer of banking business.

Early intervention measures will apply when a credit entity breaches, or is likely to breach, solvency, liquidity, organisational structure or internal control requirements, provided that it is foreseeable that the entity will be able to overcome the situation by its own means (although, exceptionally, it may receive public financial support). The entity must prepare a recovery plan enabling it to achieve long-term viability without public financial support. In principle, the management of the entity remains in the hands of the entity's current management body during this phase.

The 'early intervention' measures set out in Law 9/2012 clearly fall under the scope of Banco de España's supervisory functions, which therefore plays a key role in this phase. Among the measures available, of particular importance are the traditional powers to temporarily and provisionally replace the management body of the entity and the capacity to exceptionally require the recapitalisation of the entity by issuing convertible instruments whose conversion or repurchase term does not exceed two years.

On the other hand, an entity will be restructured if it requires public financial support to ensure its viability but Banco de España considers that objective elements indicate that the entity will be able to repay the support within the terms granted. In addition, Banco de España may decide to restructure an unviable entity if its resolution may have systemic consequences.

Entities in this situation must prepare a restructuring plan, including measures to ensure their long-term viability. Such measures may include public financial support from FROB, as well as the transfer of assets and liabilities to an asset management company. In line with the new legal configuration of FROB as the Spanish resolution authority, FROB will be responsible for determining suitable measures to implement the restructuring plan, thus assuming, together with Banco de España, a key role in the procedure.

The resolution of an unviable entity will be carried out if its insolvency presents a concern as regards the general public interest. Resolution will also be carried out if it benefits the public interest and the restructuring phase is unsuccessful.

'Non-viability' is defined by Law 9/2012 for the first time under Spanish law, and generally mirrors European proposals. An entity is unviable if: (1) it fails to comply with the solvency ratios; its outstanding liabilities exceed its assets; or it does not meet, or will be unable to meet, its obligations as they fall due (illiquidity); and (2) it is not reasonably foreseeable that the entity will be able to overcome the situation by its own means.

Prior to the commencement of resolution proceedings, Banco de España may adopt certain measures to mitigate or eliminate obstacles that may arise during the resolution proceedings. Among other powers, Banco de España may, for the first time, require changes to the entity's legal or operational structure.

The power to initiate resolution proceedings is vested in Banco de España, which may exercise that power on its own initiative or at FROB's request. FROB will in turn draft a resolution plan or determine the need to commence insolvency proceedings. In addition, if FROB does not already control the entity's management body, the substitution of the management body will be agreed.

Law 9/2012 established that FROB may:

a sell the entity's business to a third party, by selling either its shares or all or part of its assets and liabilities, without requiring the prior consent of the entity's shareholders or any other party;

b transfer the asset and liabilities to a bridge bank, which will be a credit entity partly controlled by FROB and whose purpose is carrying out the activities of the entity under resolution and the management of all or part of its assets to sell them – or to sell the bridge bank's shares – to a third party within a maximum period of five years;

c transfer the assets and liabilities to an asset management company in which FROB holds a stake in order to maximise its value; or

d provide public financial support.

In contrast to the proposal for crisis directive, the use of the bail-in as a means of resolution is not envisaged. Nevertheless, it could be argued that the effect at least on the subordinated instruments is equivalent to that of the power to manage liabilities.

VII THE YEAR IN REVIEW

A number of new provisions have been enacted since the financial crisis arose in 2007 to, *inter alia*, 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. In recent years – and certainly in 2012 and 2013 – most of these provisions have been implemented as a consequence of the MoU signed in July 2012 with the European authorities, setting up a programme that has been in place since January 2014.

These regulatory changes were intended to establish an efficient system for bank restructuring and the reinforcement of credit institutions' equity. Additionally, new sources of financing have been promoted by Spanish government, leading to a number of initiatives that are meant to create new funding channels that would reduce the dependency of Spanish real economy from the banking sector.

During the year in review, significant changes included, during 2012, the regulatory landscape for financial institutions has been strengthened and further developed; 2013 has continued the trend of major reform in the Spanish banking system. The approval of the Savings Banks Law has been a major achievement, which has set out the grounds for a sounder banking sector with clearer roles among its participants. At the European level, the entry into force of the CRR/CRD IV package (following the framework set out in the Basel III Accord) and its implementation in each Member State is likely to have great effects on the regulation of banking institutions, not only in respect of capital and liquidity requirements, but also of the governance and remuneration fields affecting on Spanish entities.

According to the 2013 report issued by Spanish Savings Banks Foundation, that year was a turning point for Europe's economies, including Spain's. Spanish economy showed improvement in 2013 in key areas such as growth (the rate for 2013 is estimated to be -1.2 per cent compared with -1.6 per cent in 2012), employment (which stabilised

during the second half of 2013, outperforming the forecast) and private deleveraging. Progress in financial sector restructuring and the recapitalisation process has also paved the way for a potential reactivation in lending, although constrained domestic demand and continued private deleveraging will limit the potential upside in credit growth.

One of the most active players in the restructuring of the Spanish banking sector is FROB (set up in 2009, with a total allocation of €15 billion equity commitment and chaired by Banco de España), which has run a number of processes during the past year that is remarkable both in number and importance. In 2013, we have seen NCG Banco SA reduce its operative capacity by means of the sale of a substantial number of its offices, dispose of EVO Banco to the Apollo, and eventually itself be sold following a high-profile auction process to the Venezuelan bank Banesco. Other processes involved Banco Gallego SA, which was awarded to Banco Sabadell SA, and the consolidation of number of savings banks, which have given a new step towards a leaner financial sector on that end. Group 2 entities – such as Banco Mare Nostrum, Liberbank and Banco Grupo Caja 3 (which was acquired by Ibercaja)) – have received capital from FROB in a total amount of around €1.2 billion and one of the most relevant auctions processes (that concerning Catalunya Banc) was suspended in March 2013 in order to make sure that any sale was effected under optimal market conditions, and will be restarted in 2014. Other processes, such as the restructuring plan of Banco CEISS after its integration with Unicaja, have successfully gone forward during 2013.

The capital shortfalls identified during the 2012 stress tests (totalling €56 billion – 5.5 per cent of GDP) were filled, according to the Final Progress Report on Financial Sector Reform, issued in February 2014 by the International Monetary Fund, by public capital injections (approximately 70 per cent, 23 per cent by bailing-in junior debt, and 6 per cent by private capital injections).

Another heavyweight in the restructuring of the Spanish banking sector during 2013 has been SAREB (the 'bad bank'). During 2013, SAREB's commercial activity has made rapid progress with the sale of real estate and financial assets and retail sales through the commercial network of some of the banks that transferred their assets to it. In May 2012, SAREB's annual accounts were approved, covering the short period between 28 November and 31 December 2012, reporting a loss of €5.5 billion, as a consequence of external services and financial expenses. For 2013 it also registered a loss (basically, due to the costs associated with its start-up phase), albeit for 2014 SAREB expects to increase its sales volume, with profitability depending heavily on the level of house prices. Some of the factors supporting profitability include the recent acceleration of asset liquidation, plans to fully deploy commercial strategies developed in 2013, and lower debt-servicing costs as SAREB starts to repay its bonds and takes advantage of the improvement in Spain's sovereign spreads during the past year. SAREB is facing several logistical and financial challenges, albeit its commercial activity is already promising and allows for possibility that there are good chances that it will dispose of its portfolio within the 15-year term that it has been given.

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 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 was extremely useful during the current economic crisis but it has not been enough, as the request by the Spanish government for financial assistance from the banking sector in June 2012 proved.

More than five years 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 2012, certainly in comparison with many 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 few years with various consecutive reforms. The MoU imposed in 2012 the establishment and approval of new measures, *inter alia*, new levels of capital requirements, coverage for their risk exposure through new provisions, transparent process on write-downs and accounting rules, and a framework for the restructuring and resolution of banks. Systemically important banks 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 has been substantially jeopardised in recent years.

After the last joint review by the European Commission and the European Central Bank in December 2013 – conducted within the context of the fifth and final review of the Financial Assistance Programme for the Recapitalisation of Financial Institutions in Spain (report issued in January 2014) – it was concluded that Spain has pulled back from the severe problems in some parts of its banking sector, thanks to its reform and policy actions, with the support of the eurozone and broader European initiatives. Some of the most notable conclusions of such a report are as follows:

a Thanks to incipient positive economic news, the Spanish financial markets have started to stabilise.

b The solvency position of Spanish banks has remained broadly comfortable after the recapitalisation of parts of the banking sector, the transfer of assets to SAREB and overall positive earnings results over 2013.

c The process of restructuring banks, having received state aid, continues with the double objective of reaching a balanced and viable asset liability structure and providing credit to the real economy.

d Compliance with the horizontal policy requirements in the MoU is complete thanks to a thorough overhaul of the governance, regulatory and supervisory frameworks of the Spanish banking sector.

e The recent encouraging macroeconomic news bears witness to the rebalancing of the Spanish economy and corroborates the expectation of a gradual recovery in activity and of an approaching end to the fall in employment. According to the last IMF report, Spanish GDP growth for 2013 is forecast to stand at -1.3 per

cent (outperforming previous forecasts) and to go back to into the black at +0.2 per cent in 2014.

The Spanish authorities have also undertaken financial sector reforms and initiatives that were not explicit commitments under the MoU, such as Banco de España's recommendation for banks to limit cash dividends in 2013 to no more than 25 per cent of profits or its announcement to review cooling-off periods for director generals.

Once the programme has been terminated, the EC and the ECB will continue to monitor the Spanish financial sector and economy. This monitoring should allow (as per the financial sector) further progress in the stabilisation of the banking sector and the further effects of the horizontal policy measures taken under the terms of the MoU.

During 2014 – and probably also the coming years – a tight reform agenda will need to be implemented in order to consolidate the progress in the stabilisation of Spain's financial sector. Some of the key remaining tasks include:

a monitoring banks' efforts to maintain and further reinforce capital ratios, also in light of the forthcoming ECB comprehensive assessment with its Asset Quality Review and Stress Test;

b ensuring a smooth integration into the Single Supervisory Mechanism (SSM);

c the timely implementation of macroprudential supervision;

d monitoring of SAREB activity in order to ensure a timely asset disposal while minimising the cost to the taxpayer;

e monitoring the implementation of the law on evictions with a view to supporting financial stability;

f reviewing legislation on personal insolvency and consumer protection with due concern for balanced creditor or borrower rights, the stability of the financial sector and overall economic efficiency;

g completing the restructuring of state-owned savings banks in order to accelerate their full recovery; and

h further advances in fiscal consolidation and structural reforms.

In conclusion, the profound reforms put in place during 2012 and 2013, both as a consequence of the MoU and as a result of the overhaul of the capital and liquidity requirements, governance and compensation regimes at global, European and Spanish regime, will be developed, adapted and put to the test in the coming years. Spain's banking sector will be likely made up of fewer banks with adjusted risk profiles and improved corporate governance.

Additionally, a number of entities will be using the mechanisms set out by FROB to restructure their business under the strict supervision of Banco de España and FROB itself. Spanish credit institutions are still on course for the most extensive and challenging process of concentration and restructuring in the history of the Spanish banking system, but the light at the end of the tunnel is starting to becoming brighter.

Appendix 1

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