The Banking Regulation Review

Second Edition

Editor

Jan Putnis

Law Business Research

THE BANKING REGULATION REVIEW

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Second Edition

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SPAIN

*Juan Carlos Machuca**

I INTRODUCTION

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

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

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

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

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

Certain Spanish financial institutions, particularly savings banks, might be struggling to cope with the crisis, mainly given their exposure to the Spanish real estate market, whose collapse is well known. Having urged several savings banks in severe financial difficulties to merge to strengthen their balance sheets, in April 2009 the regulator intervened in the case of the medium-sized savings bank Caja Castilla La Mancha (accounting for less than 1 per cent of the local banking market), given its lack of liquidity. A similar process happened in May 2010, with another medium-sized savings bank, CajaSur.

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

According to the most recent Report on Banking Supervision in Spain issued by Banco de España, at the end of 2009, 353 credit institutions were registered with the Spanish regulator, of which only 48 were domestic banks and 45 savings banks. There was a stable number of branches from other EU countries being registered. The number of operational offices of credit institutions active in 2009 was 44,532, although Spanish banks have substantially reduced their operating network in the past two years. Savings banks sector has reduced its branch offices by 5 per cent and its staff by 4 per cent with respect to 2008 according to Banco e España. The number of employees at credit institutions has also fallen, with cuts concentrated in office network staff, agents and point-of-sale terminals. The number of credit and debt cards issued by Spanish banks decreased to 96.3 million, equivalent to 2.5 cards per inhabitant over 16 years old.

At the end of 2010, there were 99 consolidated groups (those that include, in addition to the parent, one or more other fully or proportionally consolidated financial institutions), of which there were three financial conglomerates (Santander, BBVA, and, la Caixa).

In July 2010, Banco de España carried out extensive and detailed stress tests over 90 per cent of the total system, including all listes banks and savings banks, exceeding the 50 per cent requested at EU level.

However, although the effects of the first wave of the financial crisis were avoided, following the sovereign debt crisis in May and November 2010, Spain tightened provisions requirements, encouraged a process of restructuring of its financial system, the largest

banking concentration and reform of the regulatory framework. From 45 savings banks in early 2010 to the currently 17 savings banks or groups though institutional protection schemes and through the undertaking of severe balance write-downs to re-address the imbalances built up during the real estate boom years, the image of the Spanish banking sector has substantially changed since the first edition of this chapter.

In February 2011, Royal Decree-law 2/2011 of 18 February, on the strengthening of the banking system was approved by the Council of Ministers and entered into force on 20 February 2011 accelerating and completing the restructuring of the Spanish banking system. The purpose of this new Royal Decree-law is twofold:

a to strengthen the solvency of Spanish banking entities; and

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

The objective is to dissipate the fears that have arisen in the markets in the last few months concerning the capacity of the Spanish banking system to absorb the potential losses associated with the deterioration of assets.

II THE REGULATORY REGIME APPLICABLE TO BANKS

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

Certain matters and rules, principally related to savings banks and credit cooperatives, are 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 Finance and the supervision of Banco de España (with the issuance of circulars, rules and guidelines), the regional authorities have enacted a number of pieces of legislation.

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

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

i The credit banking market

Credit entities: banks and savings banks

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

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

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

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

Savings banks are a specific type of credit entity accounting for nearly half the Spanish financial sector. Savings banks have tended to be locally oriented entities of variable (but generally limited) size, with strong economic and social ties to their home region. Although savings banks fully participate in the market, they are a special category within the financial services industry, as they are structured as foundations rather than companies. As a result, they are governed by representatives of collective stakeholders: mainly depositors, employees and local authorities. Any positive result is allocated to social welfare and cultural projects. However, after the publication of the stress tests in July 2010, a substantial reform of the savings banks legal framework was approved in July 2010 and has been deepened in 2011. As a consequence, many saving banks will transform themselves. In the event, they request funds from the Fund for Ordered Bank Restructuring (Fondo de Reestructuración Ordenada Bancaria or 'FROB'), saving banks must transfer its financial activity to a bank, with the savings bank coming to perform its business activity indirectly or become a foundation. The same requirement will apply to savings banks affiliated to an Institutional Protection Scheme (IPS) in the event the assistance is requested by the IPS central entity. Moreover, if the FROB had previously subscribed preference shares convertible into common shares of the requesting entity, the latter may carry out its conversion immediately, after a request by the FROB and by joint agreement.

Financial credit establishments

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

a granting of loans, credits and facilities, including consumer credit, mortgages and commercial transaction financing;
b factoring;
c leasing;
d issuing and managing credit cards; and
e granting bonds and sureties.

They are also formed as companies. They are, however, precluded from receiving repayable funds from the public in the form of deposits, loans and temporary assignment of financial assets or other comparable instruments. Regarding the differences between financial credit establishments and banks – mainly in relation to their financing structure

– the requirements placed on the former for pursuing their activities are more flexible in comparison with those demanded of the latter. At the end of 2008, there were 75 financial credit establishments, with a decrease and deregistration in the past year.

Electronic money entities ('EDEs')

EDEs are recognised as a special type of credit institution that consists of issuing electronic money. Its legal regime was established in 2008 and in addition to meeting all the requirements applicable to credit institutions they are subject to investment requirements whereby, to safeguard the funds received from customers for the issuance of the e-money, an amount not less than the outstanding e-money must be invested by them in certain liquid, low-risk assets.

Payment services entities

Spain has recently started to regulate a new type of credit institution, those entities rendering, in a professional manner, payment services that coincide with those set out in the Annex of Directive 2007/64, of the European Parliament and of the Council, of 13 November 2007. Secondary legislation was approved in May 2010 establising the conditions and requirements for the rendering of these activities.

ii Securities markets

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

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

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

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

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

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

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

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

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

a management of currency and precious metal reserves not transferred to the European Central Bank;

b supervision of the solvency and the behaviour of credit institutions;

c promotion of the stability of the financial system and of national payment systems, without prejudice to the functions of the European Central Bank; and

d mintage and circulation of coins and other types of legal tender.

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

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

In 2010 Banco de España amended, *inter alia*, rules on financial reporting rules and formats, the accounting regulations on loan write-downs (loan loss provisions) to improve transparency and recognise the value of the different real estate collateral and minimum provisions. The new rules guide credit institutions to set aside minimum specific provisions for non-performing loans, how to value the reposed assets and the minimum impairment estimate when, after a period of time, these assets are kept in the balance sheet for long periods, which is considered to be a sign of deterioration.

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

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

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

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

ii Management of banks

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

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

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

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

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

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

a at the request of the FROB, to reduce overheads;
b to arrange its corporate governance in line with the standards applicable to listed companies; and
c to increase financing to small and medium-sized companies.

Also in March 2011, Law 2/2011, of 11 March, introduced an amendment to the banking and securities market laws by establishing rules that the entities must have internal policies and practices for remuneration that balance risk-taking and variable income,

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

iii Regulatory capital and liquidity

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

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

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

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

The concept of core capital ratio is new, not only in connection with the levels required, but also as regards quality. Core capital is formed of (1) common shares, (2) retained earnings (including share premiums of capital instruments), (3) other

comprehensive income, (4) minority interests and (5) instruments subscribed by the FROB; all of which minus treasury stock, cumulative losses, unrealised losses recognised in other comprehensive income and intangible assets (including goodwill).

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

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

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

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

Spanish capital adequacy regulations allow the value of exposures to be reduced through collateral and guarantees, the latter includes credit derivatives and devotes particular attention to the calculation of exposure in securitisation transactions from both the originator and the investor standpoint. The regulations address other types of risk, such as: risks relating to unfavourable changes in exchange rates or commodity prices; risks deriving from price changes to the financial assets comprising the institution's trading portfolios; or operational risks. The new rules have not changed the existing limits on large exposures (those exceeding 10 per cent of the credit institution's own funds) and eliminate the previous limits on property, plant and equipment, which had no equivalent in EU legislation.

In 2010 Banco de España tightened provisioning rules establishing realistic haircuts to value the collateral taken by the credit institutions and established incentives for banks to take foreclosed assets off the balance sheet.

Generally, the weighting applicable to the different risk exposures contain two categories: retail, which has a weighting of 75 per cent and corporate, which will be weighted at 100 per cent, or a weighting assigned by central government of the jurisdiction in which the company is incorporated, whichever is higher. Exposures secured by residential mortgages have a low weighting provided that they meet certain conditions, including the requirement that the loan amount does not exceed 80 per cent of the collateral value (if it is more that 80 per cent but not more that 95 per cent, it is

weighted at 100 per cent; and if it is more than 95 per cent of the collateral value, it is weighted at 150 per cent), and exposures secured by commercial mortgages are reduced to 50 per cent under certain conditions. Doubtful loans (more than 90 days overdue) shall receive a weighting of up to 150 per cent, as shall regulatory high-risk categories (including non-permanent variable-rate exposures).

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

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

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

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

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

IV CONDUCT OF BUSINESS

i Conduct of business rules

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

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

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

Further, credit entities must make certain information available to customers including (1) the existence of the customer service department and of the customer ombudsman, as the case may be, including postal and e-mail addresses; (2) its obligation to serve and resolve customers' complaints within two months; (3) the existence and contact information of Banco de España Complaints Service (which is in charge of resolving customers' complaints when they are not satisfied with the answer or solution provided by the credit entity); (4) the internal customer service regulations approved by the entity; and (5) references to the legislation in force on transparency and protection of financial services customers. Further, there are rules on the delivery of the contract and a number of specific provisions regarding the valid incorporation of terms into consumer contracts (some of which are currently the subject of legal debate after several Supreme Court decisions recently declaring null and void certain terms traditionally used by Spanish banks).

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

Finally, after the implementation of MiFID in Spain, a number of rules were introduced for effective protection of consumers of investment services that apply to credit entities (i.e., categorisation of investors, delivery of appropriate and comprehensible information on the financial instruments and investment strategies offered to the

customer, etc.) and include a number of rules to check that the conduct of the credit entities is sufficiently diligent.

ii Spanish banking secrecy

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

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

V FUNDING

The main funding for Spanish credit institutions has obviously been based on deposits made by their customers. According to Banco de España, credit institutions have increased the deposits taken from the private sector, which in December 2009 grew year-on-year by 6 per cent, although the pace has slowed in recent months. As of February 2011, according to Banco de España savings banks had an aggregate principal capital ratio of 8.3 per cent.

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

In the past two years Spanish credit institutions have needed to issue euro-denominated subordinated debt and borrow from the Eurosystem liquidity facilities against bonds and collateral. The number and volume issued has fallen recently and the average amount of each issue in recent times has also decreased.

In 2010, the mistrust in the Spanish public finances and its financial system derived in a substantial increase in funding costs and difficulties in gaining access to wholesale markets. The data provided by Banco de España in January 2011 reflect a further reduction in applications for Eurosystem lending.

With respect to savings banks, a special funding instrument was used for the first time recently with the issuance of non-voting equity units or 'participating quotas',

which are equity securities available only to Spanish savings banks that do not provide the owner with the right to vote on corporate matters, such as the election of the members of the relevant entity's board. From an economic standpoint, participating quotas allow supervision by the market of the management and business of the savings bank issuing the quotas, just as with listed banks. This market supervision provides the issuer with more national and international visibility and grants coverage to the growth of the business together with flexibility for the raising of funds. These securities also allow Spanish savings banks to make use of a fund-raising mechanism that was already available for banks. From a legal standpoint, participating quotas are defined as registered negotiable instruments issued by savings banks, representing indefinite cash contributions, which may be applied to the same aims as the rest of the assets of the issuer. The reforms in 2010 and 2011 to the legal framework of the Spanish savings banks now allow them to raise capital and improve savings banks' capacity to raise funds in the markets. There are now a new range of alternatives for savings banks to raise tier 1 capital and the pursuing of banking activities through a bank to which they shall transfer their financial business. Saving banks can now transfer voting stock, either directly or through a bank.

Finally, in the past three years, among other measures adopted due to the economic and financial crisis, the Spanish government established a Fund for the Acquisition of Financial Assets issued by credit institutions and special purpose vehicles, which has been partially used by certain entities. Also, the provision of state guarantees to new funding transactions launched by Spanish-resident entities with a maximum maturity of seven years was approved. The amount and period in which guarantees are effective has been extended on several occasions and is currently under review, while remaining open until June 2010. Neither secured issues nor arranged loans and credits shall include options, nor any derivative instruments, nor any other element that might hinder the evaluation of the risk assumed by the guarantor.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

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

Spain incorporated the essential terms set out by the Acquisition Directive, mainly, the guidelines for the no-opposition procedure that shall be submitted by the potential acquirer with Banco de España, and the criteria that Banco de España should take into consideration when evaluating the proposed shareholding's increase. Furthermore, the rules, *inter alia*, set out how to calculate the shares to be taken into account or excluded and to determine whether a qualifying shareholding has been triggered. They also provide a detailed list of information to be submitted to Banco de España to request Banco de España's non-opposition to the potential acquisition, and define the meaning of

significant influence. This pre-acquisition approval from Banco de España is mandatory either where as a consequence of the acquisition the acquirer would hold (taking into account certain conditions regarding aggregation laid down in the Spanish regulations), either directly or indirectly, a qualifying shareholding, that is over the 10 per cent of the issued share capital or voting rights of a Spanish bank, or the amount held would rise to or above 20 per cent, 30 per cent or 50 per cent of the issued share capital or voting rights of a Spanish bank (instead of the prior 10 per cent, 15 per cent, 20 per cent, 25 per cent, 33 per cent, 40 per cent, 50 per cent, 66 per cent or 75 per cent). Such pre-acquisition approval also arises where the direct or indirect holding in a Spanish bank enables the exercise of a significant influence on the management of the said Spanish bank. In this sense 'significant influence' exists where the proposed acquirer is able to appoint or dismiss a member of the board of directors of a Spanish bank.

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

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

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

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

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

ii Transfers of banking business

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

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

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

b a directors' report; and

c a public deed.

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

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

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

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

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

FROB is now authorised to buy ordinary shares or to make capital contributions (in the case of credit cooperatives) to the entities that so request.

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

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

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

VII THE YEAR IN REVIEW

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

During the past year, the Spanish banking system has made a sharp adjustment with a restructuring, merger and concentration process, as well as a reduction in capacity and presence in the market.

According to Banco de España, the tier 1 ratio increased to 9.5 per cent in December 2010, which represents capital equivalent to 3.7 per cent of GDP. The sum of provisions and capital accumulated amounts to around 12.5 per cent of GDP.

In addition, a piece of legislation was enacted in 2009 with the setting up of the FROB as an entity with a legal personality and an initial allocation of a €9 billion equity commitment by the Spanish Treasury and the Bank Deposit Guarantee Fund for banking rescue and restructuring. The FROB is chaired by Banco de España and has a debt capacity of three times the initial allocation with the explicit, unconditional and irrevocable guarantee of the Kingdom of Spain. Its functioning was substantially amended in 2010 and more recently in February 2011. The FROB has provided financing in the case of one of the troubled saving banks, CajaSur, but principally contributed to provide temporary financing to eight merger processes of savings banks. As of February 2011, FROB has provided aid of €11.56 billion, little more that 1 per cent of Spanish GDP.

In 2010 and 2011, a number of laws and rules have also been approved to establish an efficient system for bank restructuring and credit institutions' equity reinforcement and to facilitate the speed and legal safety for the restructuring of the Spanish banking sector. Provisions regarding the financial sector restructuring and necessary to strengthen the solvency and equity of the Spanish credit institutions have been implemented.

Further, new measures adopted last November by Banco de España requesting additional transparency from credit institutions with respect to their exposure to real

estate development and constructions to dispel doubts over the strength of the Spanish financial system.

Certainly, a significant issue that the Spanish credit institutions have been facing during the past year is their exposure to construction and property development activities, which is an undoubted risk due to the high volume of loans and the impact that such bad debts and loss of value in the collateral taken is having on own funds and provisions of Spanish credit institutions. According to Banco de España, the banking system's volume of exposure in this real estate sector (€445 billion in December 2009) is high. There has also been an increase in doubtful assets and the rate of lending has slowed.

Spanish institutions, in particular the largest ones, have been able to issue debt on international markets throughout the last two years. Debt issues backed by state guarantee totalled €2.8 billion in the opening months of 2010, although the rate of issuance has declined as the year has progressed.

During 2010 and the first months of 2011, most of the Spanish savings banks have been involved in merger or concentration process through SIPs involving assets representing 95 per cent of the Spanish savings bank sector. Some of these processes have given rise to the incorporation of new banks (Banco Financiero y de Ahorros, Banco Base, Banca Cívica or Mare Nostrum) having as their shareholders different savings banks. The main purposes of the amendment of the savings banks system have been to promote the access to capital markets as the traditional banks had and the professionalisation of the management bodies of the savings banks.

VIII OUTLOOK AND CONCLUSIONS

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

Nearly three-and-a-half years ago after the international crisis started, the resilience of the Spanish banking sector, historically subject to regulation and supervision based on prudent and stringent application of international standards, was outstanding until recently, certainly in comparison with certain other developed countries. However, to strengthen the solvency of the Spanish financial system and complete the sector restructuring further measures were adopted in 2010 and 2011. These measures require, *inter alia*, new levels of capital requirements and coverage for their risk exposure through new provisions and accounting rules. Entities whose size make them decisive for the health of the system maintain a solid position, which in turn enables them to continue their domestic and international expansion and to continue to deal with the crisis without requiring public support or intervention. However, the position of some medium-sized or small credit institutions and the economic conditions of the country could be jeopardised in coming months due to the persisting liquidity and financing difficulties, the impairment of certain assets, a notable loss of confidence among institutions and the reduction of their activities and business, as well as the consequences

of the duration, intensity and extension of the crisis, and the state of economic activity in Spain generally.

On 10 March 2011, Banco de España, on the basis of the risk-weighted assets of each entity as at 31 December 2010, announced a detailed assessment of how much capital each credit institution will need to reach the new solvency ratios. However, there is an adjustment period for entities that do not meet this deadline, which ends on 30 September 2011. On 14 April 2011, Banco de España approved the compliance plans, with their strategy and time frame, of 13 credit institutions or groups of credit institutions. Exceptionally, Banco de España may extend the compliance term up to 31 December 2011 and, for entities involved in listing procedures, until the first quarter of 2012.

There are some risks associated with the exposure of the savings banks to the real estate development and construction sector. According to Banco de España, with data to December 2010, such exposure amounted to €217 billion, which accounted for 46 per cent of the total exposure.

During 2011, a number of Spanish credit institutions will have wholesale funding schedules to mature in a perhaps adverse international markets unless the new measures cope with the current situation. Many of them have also announced their intention to launch IPOs or private placement of the shares of the banks already incorporated (or in process).

Certainly, the poor growth in real activity, with lower GDP, the continuous pressure on real estate values, high unemployment (above 20 per cent), the exponential increase of the state deficit, the labour market rigidities and the continued increase in defaults will put some Spanish institutions in a difficult position. It seems inevitable that the Spanish banking industry, and especially the weaker institutions, will have to become more streamlined to adapt to the new national and international market. There will be more bank consolidation and mergers, especially affecting savings banks, which will be adapting themselves to its new nature. In this respect, the coming months, the several projects regarding mergers or institutional protection schemes and their listing will continue and will be subject to a very challenging year.

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

Appendix 1

ABOUT THE AUTHORS

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

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

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

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