

**Spain: Financial System Stability Assessment,  
including Reports on the Observance of Standards and Codes on  
the following topics: Banking Supervision, Insurance Supervision,  
Securities Supervision, Payment Systems, Securities Settlement Systems, and  
Financial Policy Transparency**

This Financial System Stability Assessment on Spain was prepared by a staff team of the International Monetary Fund and the World Bank as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on June 12, 2006. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Spain or the Executive Board of the IMF.

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## SPAIN

### **Financial System Stability Assessment**

Prepared by the Monetary and Financial Systems and European Departments

Approved by Ulrich Baumgartner and Alessandro Leipold

May 23, 2006

This report is based primarily on work undertaken during two visits to Spain in June-July and October-November 2005, as part of the Financial Sector Assessment Program (FSAP). The FSAP findings and recommendations were discussed with the authorities during the Article IV Consultation mission in March 2006.

The FSAP team comprised Tomás J. Baliño (Mission Chief); Patricia Brenner (Deputy Mission Chief), Renzo Avesani, Jorge Cayazzo, Antonio García Pascual, Silvia Ramírez, Juan Solé, and Francisco Vázquez (all MFD); Mario Catalán (EUR); Manuel Aguilera Verduzco (IAIS expert, Comisión Nacional de Seguros y Finanzas, Mexico); Marilyn Choy Chong (CPSS expert, Banco Central de Reserva del Perú); Camilla Ferenius (transparency expert, Riksbank, Sweden); Saul Carpio (BCP expert, Office of the Comptroller of the Currency, United States); Larry Bergmann (CPSS/IOSCO expert, Securities and Exchange Commission, United States); and Mohamed Ben Salem (IOSCO expert, Autorité des Marchés Financiers, France). The main findings of the FSAP are:

- Spain has been enjoying a period of strong economic growth, well-supported by credit to the private sector, partly financed by large capital inflows to the financial system. However, the continued rapid growth of credit is a concern.
- Strong domestic demand has been associated with a boom in the housing market and house prices. Staff attaches high priority to moderating housing credit expansion and mitigating credit risk, including by strengthening prudential requirements on non-traditional mortgages.
- Credit institutions are highly competitive, well-capitalized and profitable. Stress tests showed they would be able to absorb the losses from large adverse shocks without systemic distress.
- Financial sector supervision shows a high degree of observance of international financial standards. Nevertheless, staff makes several recommendations to strengthen the independence of the supervisors, especially the insurance supervisor.
- Notwithstanding their overall strong performance, savings banks' special ownership features make rigorous governance particularly important. Staff makes several recommendations in this direction.
- Supervision of nonfinancial equity investments of large credit institutions should follow the most conservative approaches for mitigating the associated risks.

The main authors of this report are Tomás J. Baliño and Patricia Brenner, with contributions from the rest of the FSAP team.

*FSAPs are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAPs do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.*

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## GLOSSARY

AC	Autonomous Community ( <i>Comunidad Autónoma</i> )
AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
ASCRI	<i>Asociación Española de Entidades de Capital Riesgo</i>
BCP(s)	Basel Core Principle(s) for Effective Banking Supervision
BE	Bank of Spain
BME	<i>Bolsas y Mercados Españoles</i>
CADE	<i>Central de Anotaciones de Deuda del Estado</i>
CECA	Spanish Confederation of Savings Banks
CI(s)	Credit institutions
CII(s)	Collective investment institution(s)
CNMV	National Securities Market Commission
CPSIPS	Core Principles for Systemically Important Payment Systems
CPSS	Committee on Payment and Settlement Systems
DGSFP	Directorate General of Insurance and Pension Funds
EC	European Commission
ECB	European Central Bank
EMU	European Monetary Union
ESCB	European System of Central Banks
EU	European Union
FGD(s)	Deposit Guarantee Fund(s)
Iberclear	National central securities depository
IAIS	International Association of Insurance Supervisors
IFRS	International Financial Reporting Standards
IOSCO	International Organization of Securities Commissions
IRB	Internal ratings-based approach
ISCs	Investment service companies
LGD	Loss given default
LMV	<i>Ley del Mercado de Valores</i>
ME	Ministry of Economy and Finance
MEFF	Market for Financial Futures and Options
MFAO	Market for Futures on Olive Oil
MFP	Monetary and Financial Policies
OECD	Organization for Economic Cooperation and Development
PD	Probability of default
RCC	Risk Capital Companies
RTGS	Real-Time Gross Settlement System
SCLV	<i>Servicio de Compensación y Liquidación de Valores</i>
SENAF	Electronic platform for trading Spanish government bonds, TNs, and repos
SGCs	Portfolio management companies
SLBE	Spain's Real-Time Gross Settlement System
SNCE	National Electronic Clearing System
TARGET	Trans-European Automated Real-Time Gross Settlement Express Transfer

## EXECUTIVE SUMMARY

**Overall Spain's financial sector is vibrant, resilient, highly competitive, and well-supervised and regulated.** The sector's strengths are evident: a high degree of financial intermediation that contributes to the efficient mobilization and allocation of savings; low intermediation margins; well-capitalized and professionally managed financial institutions; and a prudential framework at the cutting edge of innovation. The expansion of Spain's financial system accelerated since the country joined the euro area, in the context of a long period of strong economic growth and rising employment. Private sector lending has grown even faster than deposits, owing to strong credit demand, especially for housing loans, in an environment of very low interest rates (short-term rates are negative in real terms).

**Real GDP growth has averaged 3.6 percent a year since 1996, sustained by domestic demand, particularly consumption and construction.** Thus, the external current account deficit has widened, reflecting a persistent inflation differential with the euro area and eroding competitiveness. Foreign saving, at 7.4 percent of GDP in 2005, has been filling the gap between domestic savings and investment. Net foreign direct investment, however, was negative in 2005, reflecting a trend in Spain, as in the euro area generally.

**Buoyant domestic demand has been associated with a boom in the housing market.** House prices rose by 104 percent in real terms between end-1997 and end-2005. A substantial part of this increase can be explained by fundamentals, including the low interest rate environment and rising employment, household income, and the number of households. Nevertheless, despite some signs of a slowdown in the rise in house prices, private and official analysts now estimate overvaluation on the order of 25 to 35 percent, relative to end-2005 levels.

**Credit has grown much faster than GDP and credit institutions have been relying heavily on cross-border capital flows.** Increased credit to the corporate and household sectors has more than offset a decline in credit to the public sector. Portfolio flows were the primary external financing source in 2005, amounting to €40 billion (4.5 percent of GDP). Financial institutions attracted large amounts of funds, mainly by issuing fixed-income instruments.

**Household debt rose from 45 percent of disposable income in 1993 to 112 percent of disposable income in 2005, above the average for the euro area, but below that of Germany, the United Kingdom, and the United States.** Although households maintain strong net wealth positions, a large share of their assets is in real estate, which has benefited from the surge in prices. Mortgage credit—almost exclusively at variable rates—has grown rapidly in recent years, partly fueled by the longer maturities offered by financial institutions and the low real interest rates. Credit to real estate developers and construction companies has also grown rapidly.

**Stress tests showed credit institutions and insurers to be highly resilient to a variety of shocks,** including rising interest rates, a fall in house prices, a drop in equity prices, and a

sharp depreciation of the U.S. dollar against other currencies. The results suggest that credit institutions would be able to absorb the losses associated with large adverse shocks without systemic distress. This reflects multiple factors, including the strong capitalization of the systemically important credit institutions, their sizeable loan-loss provisions as required under Spain's rigorous provisioning framework, their overall sound risk management practices, and the fact that Spain has been enjoying an extended period of strong growth.

**Nevertheless, an adverse macroeconomic scenario would intensify the risks associated with the housing boom.** A slowdown of domestic demand for housing would affect output and consumption, and eventually lead to higher unemployment—construction itself accounts for 14 percent of employment—that would weaken household debt-servicing capacity. It could also dampen market appetite for credit institution debt.

**The double-digit growth of credit over the last five years, led by housing-related credit, is cause for concern.** Thus, the FSAP attaches high priority to moderating credit expansion and mitigating credit risk. On the monetary side, the projected gradual cooling off of the housing market and domestic demand depend on rising interest rates, as tighter prudential rules alone are unlikely to be sufficient. A gradual increase in euro-area interest rates—if decided by the ECB—would help in dampening both house price increases and credit demand in Spain. In addition, staff supports the concerns expressed in the Bank of Spain's (BE) 2005 Financial Stability Report about non-traditional mortgage products. Additional prudential measures with respect to these mortgages are recommended.

**Some of the larger credit institutions have relatively large equity investments in nonfinancial companies** (these holdings are called “industrial participations” in Spain). To mitigate the risks inherent in equity investments, and considering the substantial changes that are taking place within the regulatory framework (capital adequacy and accounting rules) the BE should implement additional regulatory measures to reduce the incentive for industrial participations, such as adopting the most conservative approaches under Basel II.

**Notwithstanding the overall strengths of financial system supervision, the FSAP makes several recommendations applicable to all three supervisors:**

- Further strengthening the independence of the three financial sector regulators by delegating the authority to issue norms and sanction violations from the Ministry of Economy and the Council of Ministers to the respective agencies. This would help minimize any chance of political interference in the future—although the mission found no instances of this—or undue self-restraint of the supervisors.
- Create an institutional mechanism for regular and continuous high-level coordination among the Bank of Spain, the National Securities Commission (CNMV), and the Insurance and Pensions supervisor.



- Ongoing reforms of the Statutes of the regional governments (Autonomous Communities) should clearly maintain the State-level supervisors' sole responsibility and powers regarding prudential supervision and regulation.

**Notwithstanding savings banks' overall strong performance and growing market share, structural features (they are similar to foundations and do not have private owners) make strong governance particularly important.** Several actions could help in maintaining the savings banks' strong market orientation:

- Ensuring that initiatives to improve corporate governance of all credit institutions are fully implemented, strengthening them if needed.
- Promoting new means to raise high-quality (Tier 1) capital, such as issuing *cuotas participativas*<sup>1</sup> to the market.
- Allowing savings banks to merge freely within and across Autonomous Communities.
- Reducing over time the public sector representation ceiling on savings bank boards, currently at 50 percent.

**Box 1 presents these and other main FSAP recommendations.**

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<sup>1</sup> Marketable capital shares without voting rights.

### **Box 1. Main FSAP Recommendations**

#### **A. Macro-relevant Recommendations**

- To discourage excessive risk-taking, the Bank of Spain should tighten provisioning or capital requirements for non-traditional housing and construction loans. *ST*
- Implement additional regulatory measures aimed at reducing the risks of nonfinancial equity investments (industrial participations) of credit institutions, such as the most conservative approaches considered in Basel II for such participations. *ST*

#### **B. Financial Sector Supervision**

- Strengthen the independence of financial sector supervisors by delegating more broadly the authority to issue norms and sanction violations from the Ministry of Economy and the Council of Ministers to the respective agencies. *ST 1/*
- Create an institutional mechanism for permanent and continuous coordination among the Bank of Spain, the securities market supervisor (CNMV), and the insurance supervisor. *ST*
- Ongoing reforms of the Statutes of the Autonomous Communities should clearly maintain the State-level supervisors' sole responsibility and powers regarding prudential supervision and regulation. *ST*
- Separate insurance supervision from the Ministry of Economy to achieve greater operational, institutional, and budgetary independence. *MT*
- Appoint members of the CNMV's board to longer, non-renewable terms. *MT*
- Introduce regulations to prevent a credit institution representative serving on the board of a nonfinancial company from taking part in the institution's decisions regarding that company. *MT*

#### **C. Issues Related to Savings Banks**

- Monitor the results of the 2002 and 2003 regulations on the governance of savings banks, particularly as regards outside influence on the decisions of savings banks, strengthening them if required. *MT 2/*
- Allow savings banks to merge freely within and across Autonomous Communities provided the Bank of Spain has ruled favorably on the suitability of the merged institution. *MT*
- Promote new means to raise high-quality capital from private sources, such as the issue of *cuotas participativas*. *MT*
- Reduce over time the public sector representation ceiling on savings bank boards—currently at 50 percent. *MT*

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<sup>1</sup>*ST* (short term), or within 12 months.

<sup>2</sup>*MT* (medium term), or 1–3 years.

## I. ECONOMIC AND FINANCIAL BACKGROUND

### A. Macroeconomic Background

1. **Spain has enjoyed a sustained period of economic growth and rising employment.** Real GDP growth has averaged 3.6 percent a year since 1996, outstripping the euro-area average. In recent years, growth has been sustained by domestic demand, particularly private consumption and construction. The composition of growth has become increasingly unbalanced, however, with net exports making a large negative contribution since 2002.
2. **The widening current account deficit reflects the persistent inflation differential with the euro area and an erosion of competitiveness.** The cumulative headline inflation differential since European Monetary Union (EMU) qualification in 1997 amounts to about 9.5 percentage points and the productivity gap has widened.
3. **Strong domestic demand has helped fuel a rise in house prices, which more than doubled in real terms between end-1997 and end-2005.** To a considerable degree, the level of house prices can be explained by fundamentals, including low interest rates and rising employment, household income, and the number of households. Private and official analysts now suggest an overvaluation on the order of 25 to 35 percent. Nonetheless, the Bank of Spain thinks that the most likely scenario is one in which house price overvaluation is corrected gradually.<sup>2</sup> Some signs of deceleration have appeared (the 12-month increase in house prices decelerated from 18.5 percent at end-2003 to 12 percent at end-2006Q1).
4. **Monetary policy conditions in the euro area have been accommodative from Spain's perspective, contributing to negative short-term real interest rates in Spain for the past three years.** Despite relatively tight fiscal policy, Spanish inflation increased to 3.4 percent in 2005 (against a euro-area average of 2.2 percent).
5. **Credit institutions have provided ample credit to the private sector in the past five years.** Household (largely mortgage), construction, and real estate credit have expanded from about 40 percent to 53 percent of domestic credit between 2000 and 2005, more than offsetting a decline in credit to the public sector (Figure 1). Credit institutions' exposure to the corporate sector includes equity participations as well as lending.

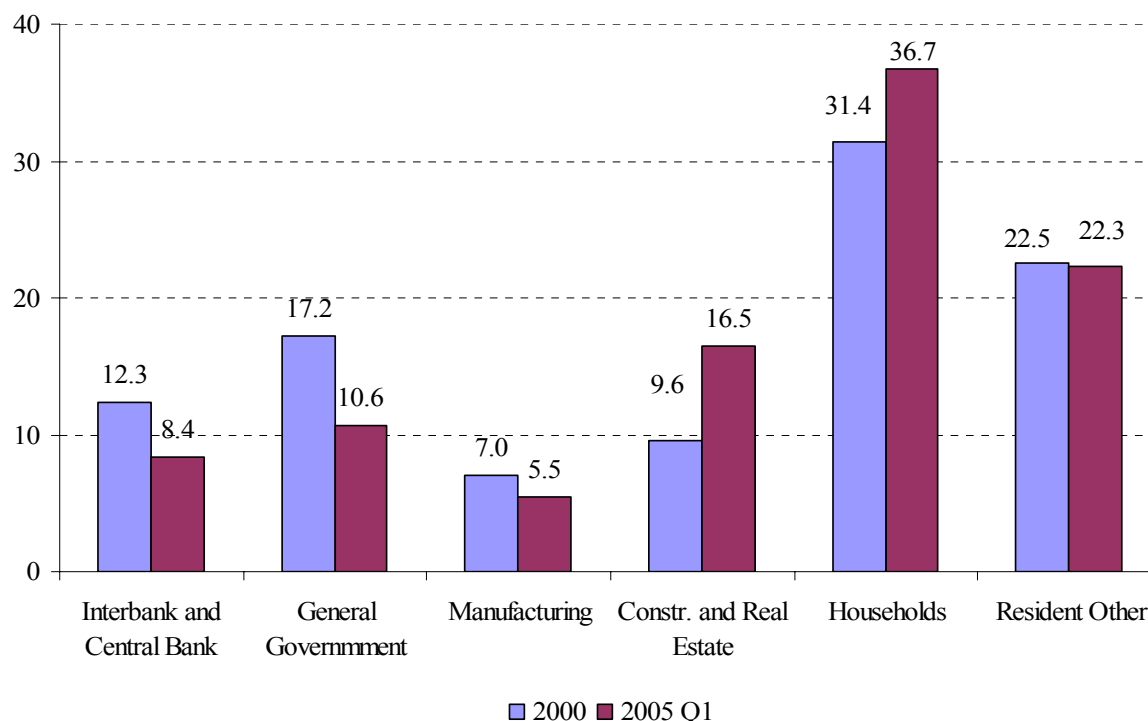
### B. Macroeconomic Risks

6. **The erosion of competitiveness poses a risk of slower growth in the years ahead.** Although short-term growth prospects remain strong, the external sector drag is around 2 percentage points.

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<sup>2</sup> The BE has expressed its views on the housing market in various publications, including in its 2004 Annual Report and in its December 2005 Financial Stability Report.

Figure 1. Spain: Distribution of Domestic Credit, 2000-05



Source: Bank of Spain

7. **Spain's increasing reliance on external savings reflects the gap between rising investment and, in the past two years, declining domestic savings.** Total investment rose from 21 percent of GDP in 1996 to 29.7 percent of GDP in 2005, among the highest rates of EU countries (Table 1). Construction has been the most rapidly growing component of investment, while consumption has also grown rapidly. Domestic saving was equivalent to 22.3 percent of GDP in 2005, resulting in an external current account deficit of 7.4 percent of GDP. Net portfolio flows were the primary external financing source in 2005, amounting to €40 billion (4.5 percent of GDP).

8. **The rapid growth of credit to the housing and construction sectors raises some macroeconomic concerns.** It feeds the house price boom and overall household debt, thus increasing credit institutions' vulnerability in case of a sharp downturn in the housing market. Moreover, such a downturn would affect output and consumption, and could result in important second-round effects, such as increasing unemployment. All this could weaken households' debt-servicing capacity, and dampen market appetite for credit institutions' debt.

## II. FINANCIAL SYSTEM INSTITUTIONS AND MARKETS

9. **Overall, the FSAP found the financial sector to be vibrant, resilient, highly competitive, and well-supervised and regulated.** The strengths of the system are evident: a high degree of financial intermediation; the efficient allocation of savings; wide access to financial services; low intermediation margins; well-capitalized and professionally managed

financial institutions; and a prudential supervisory framework that has been at the cutting edge of innovation,<sup>3</sup> e.g., by the dynamic loan-loss provisioning system put in place in 1999 (Appendix I). The payment and securities' settlement systems are robust and well-integrated internationally. All this has allowed the financial system to develop and withstand substantial shocks, such as the financial disruption in Latin America of a few years ago.

#### A. Credit Institutions<sup>4</sup>

10. **Following deregulation in the late 1970s, and Spain's joining the euro area, financial services have expanded rapidly and the system is highly competitive** (Figure 2). Following consolidation, the five largest credit institutions account for just under half of system assets. Credit institutions compete fiercely and offer a wide range of financial products. Efficiency indicators of Spanish credit institutions rank among the best, reflecting competition and a combination of strong volume growth and cost containment. At end-2005, the average cost-to-income ratio was below 57 percent, compared with 60 percent in the U.S. and an average of more than 63 percent in major EU countries.

11. **Along with commercial banks, the savings banks (*cajas*) have been a major force in extending services and in creating a highly competitive environment.** Savings banks are subject to the same supervisory and prudential regime applied to all credit institutions. They have close ties with the communities and support social, cultural, and educational projects. They also have a large network of branches and a strong regional identity, and have increased their share of customer deposits from one-third in 1980 to more than one-half in 2005. Savings banks' share in total credit to the private sector has also been increasing and is concentrated in lending to individuals and to small- and medium-size enterprises. Commercial banks dominate the investment and pension fund businesses, and have a larger portfolio of corporate loans.

12. **The ownership structure of savings banks differs from that of commercial banks.** Savings banks operate with no share capital and must allocate nonretained profits to social and welfare projects. (In recent years, about thirty percent of profits have been devoted to social projects.) Thus they are more reliant than commercial banks on retained earnings to meet their Tier 1 capital needs. Owing to their ownership structure, they cannot be bought by banks, though they can sell branches or other assets. They can merge with one another subject to approval of the Autonomous Communities, and can also buy other financial institutions including banks.

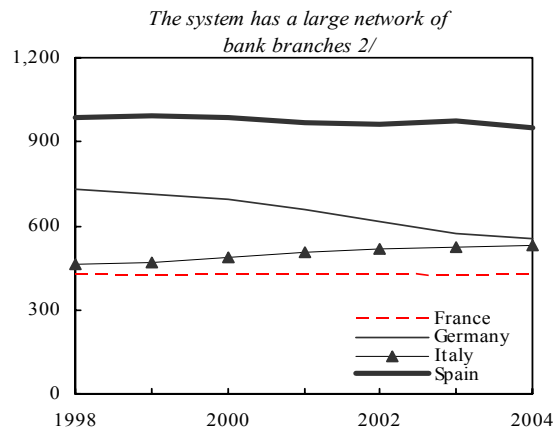
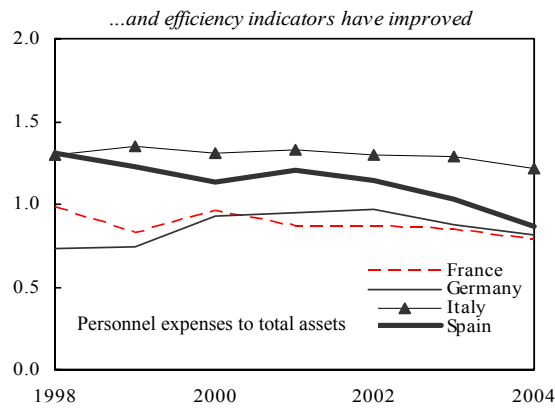
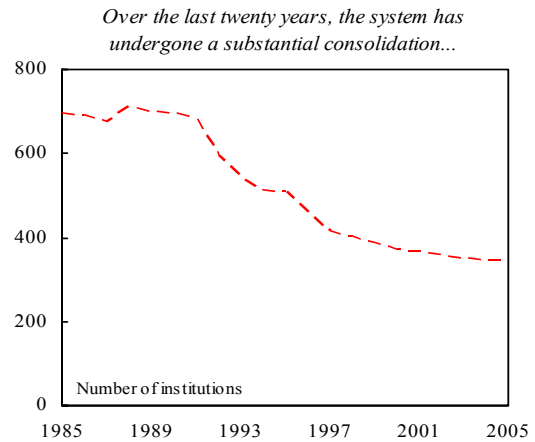
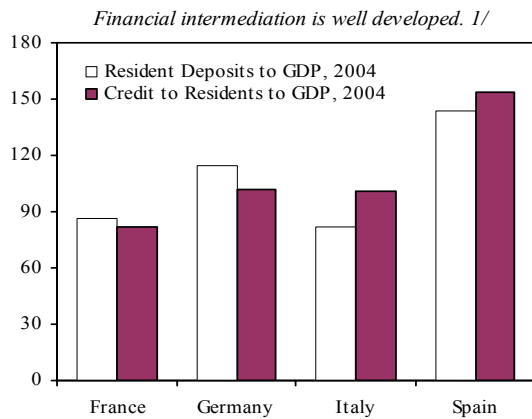
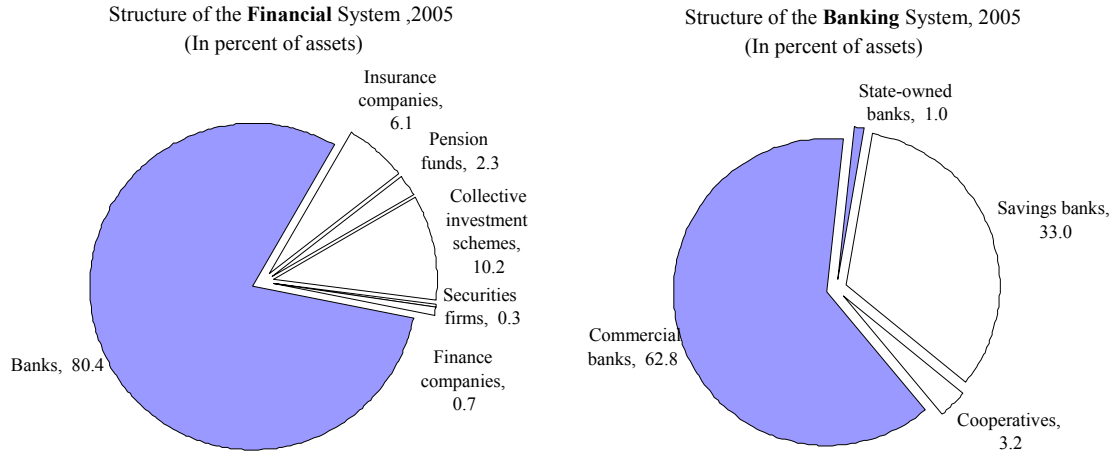
13. **Commercial banks and savings banks also have different business strategies and risk profiles.** In recent years, the larger banks have been expanding overseas, while the larger savings banks have been increasing their industrial participations. Nonetheless, all credit institutions have been aggressively expanding their mortgage portfolios.

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<sup>3</sup> Financial soundness indicators are shown in Table 2. Low NPLs, capital well above the statutory minimum, and adequate profits are evident for the system as a whole.

<sup>4</sup> Comprises commercial banks, savings banks, cooperatives, and a small state-owned bank.

Figure 2. Spain: Financial and Banking System Structure and Trends  
(In percent, unless otherwise indicated)



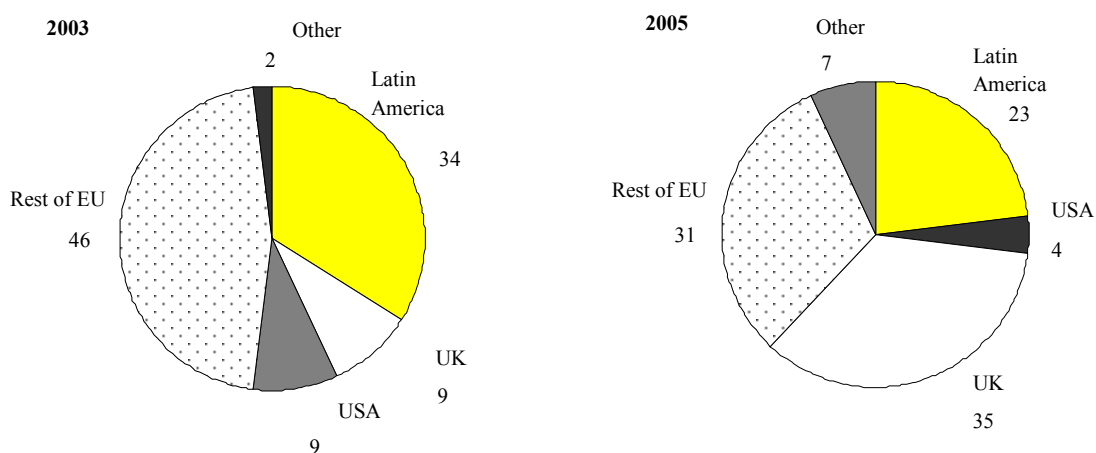
Sources: Bankscope, Bank of Spain, and ECB.

1/ Deposit-taking institutions comprise commercial, savings and cooperative banks.  
2/ Number of branches per million inhabitants.

14. **Credit institutions have become highly integrated in international capital markets, as reflected in substantial cross-border financial flows.** Their net debt with the rest of the world was €214 billion at end-2005. Cross-border inflows in 2005 were almost equally divided between portfolio flows (€15.5 billion) and foreign deposits plus interbank loans (€12 billion). The high degree of international integration of major Spanish credit institutions, especially with the EU and Latin America has led to close coordination between supervisors in the countries involved. Moreover, Spanish supervisors have been actively involved in ongoing EU efforts to strengthen arrangements dealing with crisis management and monitoring of risks in a cross-border context.

15. **Spanish banks have expanded their assets abroad in two stages.** Initially, they acquired large amounts of assets in emerging economies, especially in Latin America. In recent years, however, they have also increased their presence in other European countries, most notably the United Kingdom (Figure 3). (The increase in the share of the U.K. mainly reflects the acquisition of Abbey Bank by the Santander group in 2004.)

Figure 3. Credit Institutions' Distribution of Foreign Assets by Geographic Areas, 2003 and 2005 1/ (In percent)



Source: Bank of Spain.  
1/ Data as of March 2005.

16. **The banking system's exposure to loss of assets abroad has been declining since 2000.**<sup>5</sup> Exposure to loss was close to 5 percent of capital at end-March 2005, compared with 11.2 percent in December 2003. This reduction is partly due to much-improved economic conditions in Latin America. Furthermore, banks have taken measures to mitigate the risks of adverse events in Latin America, including by shifting their investments overseas from emerging markets toward more developed markets and hedging their exposures to currency

<sup>5</sup> The Bank of Spain computes the measure *exposure to loss* as the product of the value of assets abroad times an estimated default probability, which may vary across sectors and countries. This measure may be interpreted as an upper bound to the expected loss of assets abroad. See *Revista de Estabilidad Financiera del Banco de España*, no. 7, for details on the construction of this measure.

movements. Banks weathered well the losses on their Latin American exposure in the late 1990s especially because these losses were well-provisioned, as required by Spain's strict regulations.

17. **Reflecting their strong retail orientation, deposits accounted for three-quarters of credit institutions' total liabilities at end-2005, 55 percent of liabilities in resident deposits and 20 percent in non-resident deposits** (Figure 4). Domestic credit has expanded even faster than deposits, increasing from 57 percent of assets in 2000 to about two-thirds of assets in 2005.

18. **The rapid development of the securitization market has also facilitated the access of credit institutions to foreign savings.** Credit institutions have established securitization funds, which in turn have issued their own securitization bonds, mostly held abroad. At end-2004, of the €122.5 billion of outstanding securitized bonds, 62 percent were held by foreigners, 34 percent by domestic financial institutions, and the remaining 4 percent by the nonfinancial resident sector.

### **Housing prices, household debt, and mortgage loans**

19. **As indicated above, in a context of declining interest rates and rising employment, mortgage loans have been growing rapidly for several years, accompanying a housing boom.** Strong housing demand stemmed from the favorable macroeconomic environment and from immigration, the increased number of incomes per household, and a decline in the average household size (Figure 5).

20. **Stress tests (see below) suggest that the financial system as a whole is well positioned to absorb a significant fall in housing prices.** The resilience of credit institutions is underpinned by: (a) high loan provisioning and a good level of capitalization; (b) relatively low loan-to-value ratios on the outstanding loan portfolio (an average LTV ratio of 65 percent at end-2004); and (c) a moderate debt-to-income (DTI) ratio for the average household.

21. **Nevertheless, LTV and DTI ratios have been rising, and the concentration of credit in the housing and construction sectors raises some concerns.** DTI rose from 77 percent of disposable income in 2001 to 112 percent in 2005. Credit to housing and construction represented about half of private credit portfolios for banks and two-thirds for savings banks at end-June 2005.<sup>6</sup> Despite recent rapid growth of mortgage securitization, most (80 percent) of the credit risk remains with the originating institution.<sup>7</sup> Moreover, some institutions are likely to have additional risk arising from geographical loan concentration, such as second residences on the coast.

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<sup>6</sup> *Informe de Estabilidad Financiera 2005*, Bank of Spain.

<sup>7</sup> As of end-June 2005, credit institutions had securitized around 20 percent of their mortgage assets.

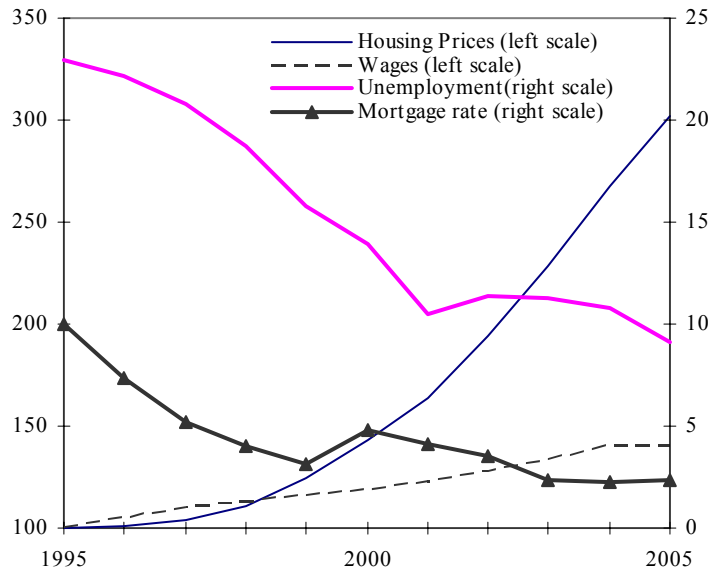


Figure 4. Credit Institutions: Composition of Assets and Liabilities, 2000 and 2005 1/



Source: Bank of Spain.  
1/ Based on non-consolidated data.

Figure 5. Spain: Mortgage Rate, Unemployment Rate, Housing Price, and Wage Indexes



Source: Bank of Spain.

22. **Strong competition has led banks and savings banks to aggressively market mortgage loans.** The prevalence of mortgage loans at floating rates (over 95 percent of outstanding mortgage loans) means that households are already absorbing most of the interest rate risk. More recently, the maturity of mortgage products offered has increased markedly from a maximum of 10 years by 1985 to maturities currently offered of up to 50 years in a few cases. (The average duration of outstanding mortgage loans is 25 years.) New products, including interest-only mortgages, or long grace periods for payment of principal are increasing the riskiness of such loans. To discourage excessive risk-taking, the staff recommends tightening provisioning or capital requirements for non-traditional housing loans.

23. **Many of the factors affecting house prices and the most effective measures that could be taken to dampen the rise in the medium term lie outside the purview of the FSAP.** These include elements such as fiscal incentives that favor home ownership, and land policy, which creates perverse incentives to limit the supply of residential and commercial land. Moreover, renting is further constrained by legal difficulties to evict problem tenants and by the de facto minimum length of rental contracts (five years). The government has adopted several measures intended to boost the rental market and address the issue of land use.

24. **The authorities are preparing a draft reform of the mortgage market that could help in making the market more flexible to changing price conditions.** These include regulatory changes to streamline commissions for early amortization; a reduction and streamlining of legally established fees incurred when modifying a mortgage contract; and enhanced information requirements from credit institutions to their clients. The reform also

aims at lowering the legal costs involved in mortgage refinancing, enhancing the repayment capacity of issuers of mortgage-backed securities, and reinforcing the independence of the appraisal companies.

25. **While house price increases have slowed somewhat, the pace of mortgage and real estate lending has accelerated in the past two years to more than 20 percent a year.** If this were to continue, a soft landing for the economy could be put in jeopardy. The increase in euro-area interest rates in recent months, if sustained, would help dampen both house price increases and credit demand in Spain. In this context, it would be helpful for the BE to complement its moral suasion by further tightening provisioning or capital requirements on housing and construction loans, especially non-traditional mortgages. While by itself this may have limited impact on credit growth, it would have a positive prudential effect.

#### **Nonfinancial equity investments of credit institutions**

26. **Nonfinancial equity investments of credit institutions (industrial participations) represent a significant proportion of Spanish credit institutions' activities.** At end-2004, the value of the participations in listed and nonlisted companies by a group of 19 credit institutions—which held approximately 80 percent of CI assets—totaled more than €48 billion, equivalent to about half of those credit institutions' regulatory capital.<sup>8</sup> More than 80 percent of the participations are in listed companies, concentrated in utilities, energy, and telecommunications.

27. **Industrial participations raise two concerns.** First, returns on equity are relatively risky and volatile. While rising equity prices and dividends have made industrial participations a significant source of profits for credit institutions, a decline in equity prices would reverse these gains. Moreover, concentration in a few sectors or companies could add further volatility. Second, major participations in a single company raise the possibility of conflicts of interest and informational asymmetries for credit institutions relative to other investors. They could also lead to suboptimal lending by the credit institution to the company.

28. **The BE is well aware of the risks stemming from CIs' industrial participations and has required credit institutions to enhance the monitoring of these investments.** The staff favors adopting the most conservative approaches to the treatment of industrial participations under Basel II.

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<sup>8</sup> Spain fully adheres to the limits set by the European Directive for equity holdings: a limit of 15 percent of the institution's capital for any individual company and a limit of 60 percent of the institution's capital for the entire portfolio of equity holdings.

29. **Conflicts of interest can arise when CI directors or decision-making officers also serve as directors in an industrial company in which the CI has ownership.** Limiting the possibility of CIs to hold controlling equity positions in nonfinancial companies should be considered, as well as introducing regulations to prevent a credit institution representative serving on the board of a nonfinancial company from taking part in the institution's decisions vis-à-vis that company.

#### **Vulnerabilities and stress test results**

30. **Spanish credit institutions show strong results overall, with low NPLs, comfortable provisioning and capital well above statutory minimums** (Table 2). Reflecting the rapid expansion of credit, the capital adequacy ratio (CAR) for credit institutions fell slightly from 12.3 percent at end-2004 to 12.2 percent at end-2005. At the same time, NPLs, at 0.6 percent of total gross credit, are very low by international standards. NPLs are low for all categories of loans, ranging from 0.2 percent for mortgage loans to around 2 percent for consumer loans. Earnings are also at a comfortable level for both banks and savings banks.

31. **Core stress tests examined the impact of a variety of shocks on the seven largest financial groups, accounting for about two-thirds of system assets, and on credit institutions as a group.**<sup>9</sup> The stress tests were carried out jointly by the FSAP team, the BE and the group of systemically important credit institutions. The methodologies were agreed between the FSAP team and the BE; the BE and credit institutions provided all the data needed to carry out the analysis. The size of the shocks to market risks, interest rate risk, credit risk, and liquidity risk were calibrated on historical experience in Spain and were in line with those applied in FSAPs for other Euro area countries. In addition, the stress tests assessed the impact of several adverse macroeconomic scenarios on credit institutions: a drop in house prices in Spain and the UK; an increase in oil prices; a depreciation of the U.S. dollar against other currencies; and a crisis in Latin America, simulated by turmoil in capital markets in the region.

32. **Overall, the system was found to be resilient and well-prepared to absorb the losses associated with large adverse single-factor shocks, as well as multiple shocks resulting from the adverse macroeconomic scenarios.** This reflects a combination of factors, including the strong asset quality and capitalization of the systemically important credit institutions, their comfortable loan-loss cushion induced by the rigorous provisioning system, their sound risk management practices, and the fact that Spain has been enjoying an extended period of strong growth. The low loan-to-value ratio for housing loans and the large unrealized capital gains in the equity participations provide a substantial buffer for credit institutions against potential declines in housing and equity prices, respectively.

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<sup>9</sup> Appendix II contains a more complete summary of the stress test methodology and results.

33. **Stress tests indicated that credit risk is important for some credit institutions, but does not seem to pose a threat to capital adequacy.** The most severe scenario of sustained deterioration in credit quality during a three-year window resulted in average losses equivalent to 13 percent of Basel regulatory capital. Similarly, liquidity risk was found to be small and large credit institutions were found to have a well-diversified pool of funding sources.

34. **The savings banks generally showed greater sensitivity to adverse shocks and scenarios.** This reflects their larger holdings of industrial participations relative to assets and regulatory capital, larger exposures to mortgage loans and real estate developers, and the slightly lower quality of their loan portfolios relative to banks (see Appendix II, Table 15).

35. **The relatively low impact of stress tests under adverse scenarios reflects the soundness of the system, but also the relatively mild intermediate macroeconomic effects in terms of the decline in GDP growth and rise in unemployment that resulted from applying the shocks to the BE's macroeconomic model.** To explore further the resilience of the system, the staff carried out an illustrative exercise in which employment and growth are assumed to decline in line with what was observed in the 1992-93 downturn (when housing prices also declined). This exercise resulted in average losses of 16 percent of regulatory capital, and for the 12 most affected institutions (holding about 12 percent of system assets), the Basel CAR fell to a range between 4 and 8 percent.

## **B. Insurance and Private Pension Funds**

36. **The Spanish insurance market is the tenth largest in the world and the sixth largest in Europe by net premium income.** It is also very competitive with relatively low levels of concentration. Assets managed by the insurance sector amounted to €192 billion at end-2005 (Table 3), of which 61 percent corresponded to life insurers. The industry is characterized by a well-developed infrastructure, and a sound regulatory and supervisory regime.

37. **The insurance industry is solvent and profitable (Table 4) with assets covering technical provisions some 15 percent above the statutory level, and a surplus of 158 percent in its solvency margin.** Stress tests for the insurance sector (Appendix II) generally indicate that the system would be resilient to a wide range of shocks. Besides a favorable macroeconomic performance, several factors have contributed to the sound growth and resilience of the sector: (a) the strengthening of asset-liability management techniques; (b) the industry's conservative investment portfolio; (c) the limited credit risk transfer from the banking to the insurance sector; and (d) a public insurance consortium (*Consortio de Compensación de Seguros*), which has helped private insurers to deal effectively with extraordinary and catastrophic risk and facilitated the orderly exit of weak insurers.

38. **The high quality of insurance supervision by the DGSFP has contributed to the stability and growth of the sector.** The regulatory framework has provided appropriate

mechanisms for insurers to calculate both the technical provisions and capital requirements linked to the solvency margin. These standards have been strongly enforced by the DGSFP.

39. **Parallel to the development of the insurance sector as an asset class, private pension funds have emerged as an investment option for households.** Between 1995 and 2005, the value of private pension funds' portfolios increased from a small base, €13 billion, to €73 billion at end-2005 (8.1 percent of 2005 GDP). Over the same period, the number of fund participants rose from 1.8 million to 9.3 million. The growth in contributions has been helped by demographics, including immigration and rising labor force participation and employment. Further development of private pensions appears to be limited by the large compulsory public pension system and the life insurance sector, which provide alternative sources of income to retirees. Reflecting the conservative nature of their investor base, pension funds appear to have followed relatively risk-averse investment strategies, and therefore do not present a systemic risk.

### C. Capital Markets<sup>10</sup>

40. **Spain has a well-developed and rapidly growing capital market, comprising a full range of institutions and markets.** The most important vehicles are collective investment institutions (CIIs), which managed assets valued at €323 billion at end-2005 (Table 3), comprising securities and money market mutual funds. In recent years, the assets managed by small investment service firms and individual brokers have been declining in importance owing to increased competition from credit institutions and CIIs. The growth of CIIs can be attributed to the promotion of these schemes by credit institutions as they compete for clients; the further liberalization and integration of Spanish capital markets into the international economy; and the recent global environment of low interest rates, which has pushed investors to seek alternative products that offer higher returns. In the past five years, 12 to 14 percent of household savings have been placed in investment funds.

41. **Several markets and trading platforms deal with financial instruments.** Variable-income instruments are traded in the four stock exchanges (Madrid, Barcelona, Bilbao, and Valencia). *AIAF Mercado de Renta Fija*, is the market for private fixed-income. Government debt is traded in the *Mercado de Deuda Pública en Anotaciones* (Annotated Public Debt Market) and the electronic platforms MTS and SENAF. The Market for Financial Futures and Options (MEFF) trades futures and options on bonds, interest rates, the equity index IBEX-35, and equities.

## III. FINANCIAL SECTOR SUPERVISION<sup>11</sup>

42. **Overall, the FSAP found a high degree of observance of the principles dealing with effective supervision** by the three regulatory authorities—the Bank of Spain, National

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<sup>10</sup> Appendix III contains detailed information on the main equity markets and instruments.

<sup>11</sup> The Annex contains summary reports of the assessment under financial sector standards and codes (ROSCs).

Securities Market Commission, and the Directorate General of Insurance and Pension Funds (DGSFP). The main recommendations for strengthening the frameworks even further include:

- a. **While the FSAP did not find any instances of interference, the need to strengthen the independence of financial sector supervisors emerged as a common theme.** Presently, all the regulators require specific delegation of authority to issue norms, and major violations must be formally sanctioned by the Ministry of Economy and Finance (ME) and the Council of Ministers. Going through the chain of norms (law, royal decree, ministerial order, circular) delays action. Thus, strengthening the powers of the supervisors in those two aspects would enhance their independence, improving observance of international standards. This would also be in line with ongoing EU initiatives to expedite passage of financial sector regulations.
- b. **Formal independence of the DGSFP is particularly constrained because it is directly part of the ME.** The FSAP team has provided a note on several alternative institutional arrangements for a more independent insurance supervisory authority.
- c. **Delegate regulatory and sanctioning powers over credit institutions on prudential matters, including licensing and delicensing, from the ME and the Council of Ministers to the BE.**
- d. **The assessment also found room for improving cooperation and coordination among regulatory agencies.**<sup>12</sup> While there is high-level cross-membership on the Boards of the BE and CNMV, this should be complemented by a fully fledged cooperation arrangement that provides permanent and continuous high-level coordination among the heads of the three supervisors.
- e. **The 17 Autonomous Communities (regional governments) have some regulatory and supervisory powers over saving banks.** The BE in practice has all necessary prudential authority over credit institutions (as ruled over the years by the Constitutional Tribunal). Given the ongoing reforms of Autonomous Communities' Statutes, it is important that these unambiguously preserve the current sole responsibility and powers of State-level supervisors regarding prudential supervision and regulation of financial institutions. This would also help ensure consistency with the present trend in European and international markets towards avoiding fragmentation and enhancing harmonization.

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<sup>12</sup> Toward this end, in February 2006 the ME, the BE, and the CNMV signed a cooperation agreement on financial stability and prevention and management of crises, pursuant to an ECOFIN MOU on the topic.

43. **Despite their overall good performance and strong market orientation, savings banks occasionally have had to deal with outside attempts to influence their commercial operations.** Moreover, their structure limits their capacity to raise capital. Though they issue financial instruments, which both provide finance and a measure of how markets evaluate their performance, they lack the additional market signal that the price of a share (or *cuota participativa*) would provide. Therefore, it is crucial to ensure that they benefit from strong governance and market discipline. Some important steps, such as reducing the ceiling on public sector representation on boards, have been taken to improve corporate governance of savings banks since 2002, but it is still too early to see their full effects.<sup>13</sup> In this connection, staff welcomes the current work that the government is undertaking to improve corporate governance, which will include both banks and savings banks.

44. **The following recommendations would further improve the competitiveness and governance of the savings banks:**

- Ensure that the regulations issued since 2002 on corporate governance are fully implemented, strengthening them if required.
- Over time, promote new means to raise high-quality capital in case of need, such as the issuance of *cuotas participativas* to the market.
- Allow savings banks to merge freely within and across Autonomous Communities, provided the BE has ruled favorably on the viability of the merged institution.
- Reduce over time the public sector representation ceiling, currently at 50 percent.

### **Insurance supervision**

45. **Notwithstanding the generally high quality of insurance regulation and supervision,** the following recommendations would strengthen it further:

- **Separate the insurance supervisor from the ME.** Experience worldwide suggests that a separate independent agency (i) has greater operational flexibility to develop, implement, and enforce regulatory policy; (ii) is better ring-fenced against outside interference—conditional on an adequate structure and accountability of the agency's

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<sup>13</sup> Other measures adopted since 2002 include: (a) the mandate of public sector representatives in the governing body of the savings banks is made irrevocable for the duration of the appointment (to reduce political interference during the representative's mandate); (b) all savings banks issuing securities admitted to trading in official markets must publish an annual Report on Corporate Governance (this report should contain detailed information on the decisions adopted by the governing bodies of the savings banks including lending to political parties); and (c) all savings banks must have a *Comisión de Retribuciones* and a *Comisión de Inversiones* (the first commission has the mandate to inform regarding the compensation of Board members and other high-ranking personnel; and the second informs on the strategic investment decisions of the savings banks).



governing board; and (iii) by providing budgetary independence, would have better and more flexible access to highly skilled experts than a government department.

- **Establish clear responsibilities and minimum expertise for the boards of directors** and senior management of insurance companies, including in the use and risks of derivatives.

### **Securities market supervision**

46. **As per the main securities law (*Ley del Mercado de Valores—LMV*), securities markets are supervised by the CNMV, an autonomous public entity.** It has responsibility for supervising the conduct of business of investment service providers and market operators, the clearinghouse and its members, and for licensing and prudentially supervising asset managers and collective investment institutions. Its main aims are to ensure the transparency of markets and to protect investors.

47. **The CNMV conducts off-site and on-site inspections on a well-planned basis and has also developed a system for real-time monitoring of trading on regulated markets to detect possible abuses.** Off-site inspections analyze the periodic reports required of regulated entities. On-site inspections are conducted according to an annual plan focused on areas of potential risks in the sector. They include verification of the entity's compliance with prudential requirements.

48. **The assessment under the IOSCO principles for securities' market supervision found that securities' market regulation and supervision by CNMV is generally sound and of a high standard.** Nonetheless, additional attention in some areas is recommended, including:

- To make them less vulnerable to outside influence, appoint members of the CNMV board to longer, non-renewable terms. Presently board members are appointed for four-year terms, renewable once.
- To ensure consistency of requirements and ongoing oversight, the BE should routinely consult with the CNMV whenever a credit institution applying for a license intends to provide investment services.

## **IV. INFRASTRUCTURE**

### **A. The Payment and Securities Settlement Systems**

49. **The Spanish payment system is fully integrated into the EU system.** The single large-value interbank payment system—the Real-Time Gross Settlement System (*Servicio de Liquidación del Banco de España—SLBE*)—is connected to TARGET and is owned, operated, and controlled by the BE. A small-value payment system—the National Electronic

Clearing System (*Sistema Nacional de Compensación Electrónica—SNCE*)—is operated by a private company (*Sociedad Española de Sistemas de Pago*) and overseen by the BE.

50. **The assessment under the CPSS Core Principles found that all principles are observed by the SLBE.** Nevertheless, a few recommendations have been made to improve the system further. In particular, the BE is encouraged to improve public accessibility to payment system information and the readability and transparency of its circulars. The SLBE procedures manual should give clearer guidance on the expected behavior of participants in emergencies—such as platform failures. Finally, statistics and reports on the BE’s oversight activities should be published periodically.

51. **Securities transactions clear and settle through a national central securities depository and local securities settlement systems.** The national central securities depository (known as Iberclear) consists of the *Servicio de Compensación y Liquidación de Valores (SCLV)* for securities other than public debt, and the *Central de Anotaciones de Deuda del Estado (CADE)* for public debt securities. Also, local securities settlement systems in Barcelona, Bilbao, and Valencia process transactions in securities listed only on the corresponding stock exchanges—mainly public debt of the Autonomous Communities.

52. **The assessment of observance of the CPSS/IOSCO Recommendations for Securities Settlement Systems found that risks in the Iberclear securities settlement system are negligible, albeit minor improvements are feasible.** There are still instances where the SCLV will credit securities to a buyer’s account even though the seller has failed to deliver the securities. (The authorities intend to correct this anomaly by mid-2006.) In addition, Iberclear should test its contingency plans and backup facility, as well as the participants’ backup sites, more frequently. Iberclear’s backup facility is 20 km from the main site and appears to rely on many of the same resources, which may represent a risk.

## **B. Dealing with Problem Financial Institutions**

53. **Current arrangements provide an effective framework for timely and orderly resolution of problem credit institutions.** The BE relies mostly on moral suasion and the legal sanctions’ regime to elicit prompt corrective actions when problems emerge. The sanctions’ regime qualifies legal infractions as light, serious, and very serious. Penalties are tailored to the severity of infractions and range from private warnings to the revocation of banking licenses. The BE may impose sanctions to address light and serious infractions and recommend penalties to the ME in the case of very serious infractions. The revocation of a license rests with the Council of Ministers.

54. **The law also establishes an extraordinary resolution mechanism, which may be activated with or without sanctions.** In exceptionally grave cases, this mechanism enables the BE to appoint an official with veto powers over all the institutions’ operations (“interventor”) or to replace management and the board of directors.

## **Systemic liquidity and emergency liquidity support**

55. **In addition to standing facilities, the BE can provide emergency liquidity assistance to financial institutions, separately from the Eurosystem framework for monetary policy operations.**<sup>14</sup> When conducting monetary policy operations, the Eurosystem can only provide liquidity support to eligible counterparties whose financial soundness is one eligibility criterion, and the counterparty must provide adequate collateral. Rather, national central banks are responsible for financial stability, including providing emergency liquidity assistance to the credit institutions operating in their jurisdiction. If such assistance were to have significant euro area-wide implications the ECB's Governing Council is to be consulted.

56. **Like other central banks, the BE has deliberately kept some ambiguity about its emergency lending policies.** It has provided general internal guidance on the conditions and circumstances under which decisions to extend discretionary liquidity support are made.<sup>15</sup> However, this has not been disclosed.

## **Deposit insurance**

57. **The deposit insurance framework comprises three funds—for commercial banks, savings banks, and credit cooperatives—all operating under the same rules and procedures.** Each fund covers up to €20,000 per depositor, the minimum threshold set by the EU. An umbrella agency administers the investment and use of the funds in accordance with statutory rules. The funds are governed by a board of eight members selected by the ME, four in representation of the BE, and four of the member institutions. The Deposit Guarantee Funds (FGDs) have a broad mandate; in addition to paying off insured deposits in failed institutions, they can contribute to the recapitalization of distressed banks under exceptional circumstances—under least-cost resolution rules—and at the direction of the BE.

58. **In the few cases that the current deposit insurance framework had to be activated, it was effective.** In the last 15 years, it has been used in cases affecting six banks and seven savings banks. For banks, various resolution mechanisms have been applied. For savings banks, deposit insurance operations have been exclusively to provide support to the institutions in the form of long-term low-interest loans; no payouts to depositors were necessary. For cooperatives, there are no reported cases of rescue operations by their FGD.

## **C. Accounting Standards and the Adoption of Basel II**

59. **Recent regulatory initiatives include accounting and reporting norms consistent with International Financial Reporting Standards (IFRS) and the adoption of Basel II**

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<sup>14</sup> See the ECB Annual Report 1999, p. 109.

<sup>15</sup> The Bank of Spain agreed on such norms in November 2005.

**guidelines.** IFRS came into effect in Spain in June 2005 following the decision of the EC to adopt them.<sup>16</sup> Implementation of Basel II is expected by 2007.

60. **The larger Spanish credit institutions and the BE seem well prepared for the adoption of the Basel II credit and market risk framework.** Much work has been done to collect the data and develop the models necessary for adopting the advanced internal ratings-based (IRB) approach. The Spanish Confederation of Savings Banks (CECA) is developing a common risk management tool to facilitate cost sharing among its members. In most cases, models appear to be suggesting excesses of current capital, mainly because of lesser credit portfolio risks.<sup>17</sup> This presents the authorities with the challenge of ensuring that models are thoroughly evaluated and validated. The BE is taking a conservative and measured approach to the implementation of international standards, to minimize the potential for undue reduction of capital or provisioning.

#### **D. Transparency of Financial Policies**

61. **The evaluation of transparency of financial policies found a high degree of observance of the principles.** Nevertheless, the assessment recommended a few improvements, including providing more extensive explanations on the objectives and operating procedures for banking supervision and making existing information on banking supervision more easily accessible on the BE's website.

62. **The Bank of Spain has already initiated an action plan to address the transparency recommendations.** In the first phase, they will include:

- Improving consistency between the Spanish and English versions of their web page.
- Adding institutional information, such as the internal code of conduct for employees of the BE and the members of the Governing Council (*Consejo de Gobierno*) including their CVs.
- Reorganizing and developing the website contents under bank supervision.

#### **E. AML/CFT**

63. **An anti-money laundering and combating the financing of terrorism (AML/CFT) assessment was conducted by the Financial Action Task Force on Money Laundering (FATF) in September 2005.** A draft mutual evaluation report will be

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<sup>16</sup> In November 2004 the European Commission endorsed IAS 39 with the exception of certain provisions on the use of the full fair value option and on hedge fund accounting.

<sup>17</sup> BE supervisors noted that banks' internal models for credit risk may reduce capital requirements, but observed that this may be compensated by additional capital requirements for operational risk.

considered for adoption by the FATF Plenary in June 2006. Once the report is adopted, FATF will forward a ROSC to the Fund which will subsequently be circulated to the Board for information.

#### **F. Other Issues**

64. **A pyramid scheme scandal outside the financial sector was discovered in early May.** Two firms encouraged small savers to purchase collectible stamps, promising them a better return than traditional investments. The stamps remained on deposit with the firm, which regularly paid the investor a guaranteed minimum return, apparently using the funds of new investors. Media reports put the number of affected small investors at more than 300,000 and the amounts involved at about €4–5 billion (0.4–0.5 percent of GDP). The activities of these firms are subject to consumer protection provisions included as clarified in the legislation on collective investments in tangible assets. Ongoing investigations also concern alleged money laundering. The authorities intend to review the operations and regulation of such firms, which fall outside the scope of financial sector regulators and supervisors.

Table 1. Spain: Main Economic Indicators, 2001–05  
(In percentage change, unless otherwise indicated)

	2001	2002	2003	2004	2005
Demand and supply in constant prices (growth rates, in percent)					
Gross domestic product	3.5	2.7	3.0	3.1	3.4
Private consumption	3.2	2.9	2.6	4.4	4.4
Public consumption	3.9	4.5	4.8	6.0	4.5
Gross fixed investment	4.5	3.3	5.6	4.9	7.3
Construction investment	6.8	6.2	6.3	5.5	6.1
Total domestic demand	3.6	3.3	3.8	5.0	5.3
Net exports (contribution to growth)	-0.2	-0.7	-0.9	-2.2	-2.2
Exports of goods and services	4.0	1.8	3.6	3.3	1.0
Imports of goods and services	4.2	3.9	6.0	9.3	7.1
Potential output growth	3.9	3.6	3.4	3.2	3.2
Gross national saving (in percent of GDP)	22.5	23.3	23.9	23.0	22.3
Gross domestic investment (in percent of GDP)	26.3	26.6	27.5	28.3	29.7
Growth of deposits 1/	13.7	7.0	7.1	8.3	8.4
Private credit growth	11.8	12.3	14.2	17.9	27.2
Prices					
GDP deflator	4.2	4.4	4.0	4.1	4.4
HICP (average)	2.8	3.6	3.1	3.1	3.4
Differential with euro area average	0.5	1.3	1.0	0.9	1.2
Employment and wages					
Unemployment rate (in percent)	10.6	11.5	11.5	11.0	9.2
Unit labor cost in manufacturing (growth rate)	4.1	2.9	0.9	0.6	0.5
Wage growth	3.7	3.9	3.7	3.6	2.9
Employment growth	3.2	2.4	2.6	2.6	3.6
Labor participation rate (in percent) 2/					
Total	53.0	54.3	55.5	56.4	57.2
Male	66.2	67.0	67.7	68.1	68.7
Female	40.4	42.2	43.8	45.2	46.2
Balance of payments (in percent of GDP)					
Trade balance 3/	-5.7	-5.0	-5.1	-6.4	-7.6
Current account balance	-3.9	-3.3	-3.6	-5.3	-7.4
Official reserves excl. gold (in billions of US dollars)	30.3	35.3	20.7	13.3	7.7
Nominal effective rate (1990=100)	72.5	74.2	76.8	77.6	76.3
Real effective rate (1990=100)	85.2	88.8	92.6	94.4	94.3
Public finance (in percent of GDP)					
General government balance	-0.5	-0.3	0.0	-0.1	1.1
Primary balance	2.1	2.1	2.1	1.7	2.7
General government debt	55.6	52.7	49.1	46.6	43.1

Sources: IMF, *World Economic Outlook* and *Information Notice System*; and Fund staff estimates.

1/ Figure for 2005 refers to y-o-y growth rate for March of 2005.

2/ Based on national definition (i.e., the labor force is defined as people older than 16).

3/ Excludes nonfactor services.

Table 2. Spain: Financial Soundness Indicators, 2001–05 1/  
(In percentage change, unless otherwise indicated)

	Dec-01	Dec-02	Dec-03	Dec-04	Dec-05
<b>Capital Adequacy 2/</b>					
Regulatory capital to risk-weighted assets	12.9	12.5	12.6	12.3	12.2
<i>Of which:</i>					
Regulatory Tier 1 capital to risk-weighted assets	9.0	8.6	8.5	8.1	8.1
Regulatory Tier 1 capital to assets	5.9	5.8	5.8	5.1	4.9
<b>Asset Quality</b>					
Credit to residents to total credit	68.3	73.6	75.9	67.6	65.8
Credit to nonresidents to total credit	31.7	26.4	24.1	32.4	34.2
<i>Of which (by region of residence):</i>					
European Union (except Spain)	11.2	11.4	11.9	21.2	21.7
Latin America and the Caribbean	15.9	11.5	9.2	7.5	8.2
FX assets to total assets	26.3	21.5	12.8	21.2	22.0
Nonperforming credit to total gross credit	0.9	1.0	0.9	0.7	0.6
Nonperforming credit net of provisions to capital 3/	0.2	1.6	0.5	-1.0	...
Provisions to nonperforming assets	204.0	185.2	214.1	253.4	...
Large exposures to capital 4/	78.9	77.3	61.0	47.2	52.6
<b>Earnings and Profitability 2/</b>					
ROA	0.9	0.9	0.9	0.9	0.9
ROE	13.5	12.1	13.2	14.1	16.9
Interest margin to gross income	70.1	70.8	68.8	68.6	58.9
Noninterest expenses to gross income 5/	61.0	59.8	58.0	57.1	53.7
Personnel expenses to noninterest expenses 5/	56.8	57.0	58.0	57.4	56.9
Trading and fee income to total income	29.9	29.2	31.3	31.4	35.7
Spread between reference loan and deposit rates	3.8	3.6	3.2	2.8	2.3
Spread between highest and lowest interbank rates	1.7	1.0	1.6	0.8	1.0
<b>Liquidity</b>					
Liquid assets to total assets 6/	33.2	30.9	30.3	30.4	34.3
Broad liquid assets to total short-term liabilities 7/	74.8	70.2	67.9	66.7	75.6
Customer deposits to total (noninterbank) loans	104.8	100.5	93.1	87.0	79.0
FX liabilities to total liabilities	27.9	22.8	15.1	23.2	23.8
Average daily turnover ratio in the securities market	24.1	27.8	30.8	33.2	...
<b>Sensitivity to market risk</b>					
Net open positions in FX to Tier 1 capital	24.0	13.5	8.6	11.5	11.4
Net open positions in equities to Tier 1 capital	0.7	5.6	1.9	1.4	6.5
<b>Housing sector</b>					
Household debt to gross disposable income	72.1	79.1	88.6	99.5	111.9
Household savings (in percent of disposable income)	12.3	12.5	12.8	12.7	11.0
<b>Corporate sector</b>					
Debt to equity	97.0	103.9	100.1	103.3	...

Sources: Bank of Spain, and CNMV.

1/ Deposit-taking institutions comprise commercial, savings and cooperative banks.

2/ Based on consolidated data.

3/ Nonperforming credit net of specific provisions and those general and statistical provisions not included in Tier 2 capital to total regulatory capital.

4/ Large exposures as defined by EU Directive 2000/12, Article 48.

5/ Data for December 2005 reflect the implementation of the new accounting rules (IFRS).

6/ Liquid assets exclude equity investments and fixed income portfolio instruments.

7/ Broad liquid assets include fixed and variable income portfolio instruments.

Table 3. Spain: Financial System Structure, 2000-05

	Dec-00			Dec-02			Dec-04			Dec-05		
	Number	Assets (In billions of euros)	Percent of total assets	Number	Assets (In billions of euros)	Percent of total assets	Number	Assets (In billions of euros)	Percent of total assets	Number	Assets (In billions of euros)	Percent of total assets
Deposit-taking institutions	285	1,376	77.9	278	1,483	77.8	267	2,031	78.8	269	2,540	80.4
Commercial banks	142	877	49.6	143	878	46.0	136	1,269	49.3	138	1,594	50.4
Domestic	64	781	44.2	60	752	39.4	52	1,084	42.1	52	1,366	43.2
Foreign	77	96	5.4	83	126	6.6	84	185	7.2	86	228	7.2
State-owned banks	1	26	1.5	1	26	1.4	1	26	1.0	1	26	0.8
Savings banks	48	434	24.6	47	529	27.7	47	671	26.0	47	839	26.5
Cooperatives	94	40	2.2	87	51	2.6	83	65	2.5	83	81	2.6
Five largest banks	5	855	48.4	5	842	44.1	5	1,194	46.3	5	1,501	47.5
Institutional investors	5,395	367	20.8	6,806	399	20.9	7,451	520	20.2	7,673	588	18.6
Insurance companies 1/ Life	377	118	6.7	358	150	7.8	332	177	6.9	317	192	6.1
Nonlife	127	77	4.4	123	107	5.6	111	109	4.2	107	117	3.7
Pension funds	250	41	2.3	235	43	2.2	221	69	2.7	210	75	2.4
Collective investment schemes	711	39	2.2	917	50	2.6	1,163	63	2.4	1,255	73	2.3
Money market mutual funds	4,307	210	11.9	5,531	200	10.5	5,956	279	10.8	6,101	323	10.2
Other financial intermediaries	201	33	1.9	165	53	2.8	165	58	2.2	154	55	1.7
Securities firms	191	23	1.3	193	25	1.3	181	26	1.0	179	32	1.0
Finance companies	105	12	0.7	110	12	0.6	103	11	0.4	102	11	0.4
Finance companies	86	11	0.6	83	13	0.7	78	16	0.6	77	21	0.7
Total financial system	5,871	1,766	100.0	7,277	1,907	100.0	7,899	2,577	100.0	8,121	3,160	100.0

Sources: Bank of Spain, CNMV, and DGSFP at the Ministry of Economy and Finance.



Table 4. Spain: Insurance Sector Financial Soundness Indicators, 2001-05

	2001	2002	2003	2004	2005
Life insurance					
Capital adequacy					
Capital / total assets	8.0	8.7	9.9	9.7	8.2
Capital / technical reserves	9.5	9.1	9.7	10.8	10.5
Asset quality					
(Real estate + unquoted equities + debtors) / total assets	7.1	7.1	6.8	5.7	6.0
Debtors / (gross premium + reinsurance recoveries)	1.6	1.4	1.2	1.1	0.6
Equities / total assets	4.1	4.4	4.5	3.7	4.5
Reinsurance					
Risk retention ratio (net premium / gross premium)	98.7	98.6	98.3	98.2	98.2
Net technical reserves / avg. net premiums received (3 yrs)	261.3	304.3	421.5	537.5	515.3
Management soundness					
Gross premium per employee (in euro thousands)	3,190	2,911	1,430	3,628	1,796
Total assets per employee (in euro thousands)	13,085	15,176	8,798	22,560	10,552
Earning and profitability					
Expense ratio (expenses / net premium)	4.3	5.5	6.3	6.2	5.6
Investment income / investment assets	4.5	3.6	5.9	5.2	5.8
ROE	16.3	6.7	10.6	7.1	8.5
Mixed					
Capital adequacy					
Capital / total assets	7.4	7.3	7.7	8.5	8.0
Capital / technical reserves	9.5	9.1	9.7	10.8	10.0
Asset quality					
(Real estate + unquoted equities + debtors) / total assets	13.2	12.5	11.5	11.4	9.3
Debtors / (gross premium + reinsurance recoveries)	5.1	5.3	4.4	3.5	2.8
Equities / Total assets	5.0	4.5	4.3	5.0	4.1
Reinsurance					
Risk retention ratio (net premium / gross premium)	94.5	94.6	93.0	92.8	94.0
Net technical reserves / avg. net premiums received (3 yrs)	284.5	314.4	328.6	335.2	381.0
Management soundness					
Gross premium per employee (in thousands of euros)	1,087	1,360	1,059	1,067	1,250
Total assets per employee (in thousands of euros)	3,577	4,246	4,580	4,476	5,646
Earning and profitability					
Expense ratio (expenses / net premium)	10.1	8.8	12.6	13.1	13.2
Investment income / investment assets	4.0	3.3	5.6	5.3	5.5
ROE	12.0	13.4	19.0	25.8	27.5
Nonlife					
Capital adequacy					
Net capital / premium (net)	38.5	35.4	37.1	38.4	47.0
Capital / total assets	22.0	20.2	20.6	20.8	23.6
Asset quality					
(Real estate + unquoted equities + debtors) / total assets	28.7	28.0	26.7	24.3	30.2
Debtors / (gross premium + reinsurance recoveries)	11.5	12.1	11.6	10.8	11.1
Equities / total assets	10.3	9.5	9.1	7.6	12.1
Reinsurance					
Risk retention ratio (net premium / gross premium)	86.7	84.4	83.3	83.5	84.9
Net technical reserves / avg. net claims paid (3 yrs)	148.2	159.1	154.0	152.7	189.7
Net technical reserves / avg. net premiums received (3 yrs)*	97.1	103.8	99.7	96.8	118.5
Management soundness					
Gross premium per employee (in thousands of euros)	308	408	570	636	647
Total assets per employee (in thousands of euros)	468	602	853	981	1,095
Earning and profitability					
Loss ratio	77.2	75.7	74.9	71.8	72.4
Expense ratio (expenses / net premium)	18.2	17.3	16.4	16.2	15.5
Combined ratio	100.7	98.7	96.6	93.5	93.1
Investment income / net premium	4.4	2.3	4.4	3.6	4.5
ROE	8.0	6.3	18.4	24.6	23.8

Source: Ministry of Economy and Finance.

## OBSERVANCE OF FINANCIAL SECTOR STANDARDS AND CODES—SUMMARY ASSESSMENTS

This annex contains summary assessments of five international standards and codes relevant for the financial sector. Given the size and importance of the financial sector in Spain, it was appropriate to assess observance of the main standards. The assessments have helped to identify the extent to which the supervisory and regulatory framework is adequate to address the potential risks in the financial system. The following detailed assessments of financial sector standards were undertaken.

- The Basel Core Principles for Effective Banking Supervision (BCP), by Jorge Cayazzo (MFD) and Saul Carpio (U.S. Office of the Comptroller of the Currency);
- The IAIS Insurance Core Principles (ICP), by Manuel Aguilera-Verduzco (Comisión Nacional de Seguros y Fianzas, Mexico);
- The IOSCO Objectives and Principles for Securities Regulation, by Mohamed Ben Salem (Autorité des Marchés Financiers, France);
- The Core Principles for Systemically Important Payment Systems (CPSIPS), by Marilyn Choy (Central Bank of Peru); and the Securities Clearance and Settlement Payment System (CPSS-IOSCO—RSSS), by Larry Bergmann (U.S. Securities and Exchange Commission); and
- The IMF Code of Good Practices on Transparency in Monetary and Financial Policies—Financial Policies, by Camilla Ferenius (Bank of Sweden).

In addition, FATF carried out an assessment of the AML/CFT standard.

The assessments relied on several sources including:

- Self-assessments by the supervisory authorities;
- Reviews of the relevant legislation, regulations, policy statements, and other documentation;
- Detailed interviews with the supervisory authorities;
- Meetings with the Bank of Spain, CNMV, DGSFP, Ministry of Economy and Finance, and other authorities; and
- Meetings with financial sector firms and associations, and academics and constitutional lawyers.

**SUMMARY ASSESSMENT OF COMPLIANCE WITH THE BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION AND TRANSPARENCY OF BANKING SUPERVISION**

**General**

65. **This section summarizes the assessment of the implementation by the BE of the Basel Core Principles as of November 2005.** The assessment was conducted as part of IMF FSAP by a team that visited Spain during July and November 2005. It follows the Basel Committee's methodology, and has been made on a qualitative basis using the assessors' opinion as one of the main inputs. Evidence of supervisory practices and enforcement ability was based on an examination of key documents and discussions with BE senior staff. In addition, discussions were held with relevant government agencies as well as financial sector participants. The assessment team benefited from the full cooperation of its counterparts.

**Main findings—summary**

66. **Bank supervision is effectively carried out by the BE and there is a high degree of compliance with the Basel Core Principles.** The BE has developed an effective risk-based supervisory prudential framework. This framework is underpinned by the BE's long-standing professional credibility, recognized technical expertise and operational independence. These attributes enable the BE to have experienced supervisory personnel who maintain close supervision and effective communication with the industry. However, enhancements in some specific areas would be advisable.

67. **The main findings of the detailed assessment of observance of the Core Principles (CPs) are stated under the following seven main groupings:** (a) objectives, autonomy, powers, and resources; (b) licensing and structure; (c) prudential regulations and requirements; (d) methods of ongoing supervision; (e) accounting standards; (f) remedial measures; and (g) cross-border banking. Table 5 summarizes main recommendations to improve compliance with the Basel Core Principles.

***Objectives, autonomy, powers, and resources (CP 1)***

68. At the national level the legal framework for regulation and supervision of credit institutions involves the Ministry of Economy and Finance (ME) and the Bank of Spain. In addition, each Autonomous Community is vested with legal authority to regulate and supervise CIs' activities. The laws clearly articulate the responsibilities among the BE and the ME with respect to the supervision of the solvency, performance, and compliance with specific regulations governing CI. Additionally, each AC operates under its own legal framework, which in general provides ACs with licensing and sanctioning authority and power to oversee the activities of saving banks (*cajas*) and cooperatives headquartered in their respective jurisdiction, particularly with regards to corporate governance, consumer protection, transparency and dividend policies supporting social contributions (*obra social*).

69. In practice, coordination between the BE and the Autonomous Communities supervisory bodies appears to have worked smoothly overall. Looking to the future, eventual changes in the legal regime should clearly preserve the sole and exclusive roles of the BE in prudential oversight of financial institutions, avoid any possible inconsistency in the division of responsibilities, and enhance coordination of the supervisory bodies. This would help ensure that Spanish financial supervision is consistent with the present trend observed in European and international markets towards avoiding fragmentation and enhancing harmonization.

70. The BE has sufficient financial revenues to ensure the adequacy of resources to properly cover its operating expenses, including those required to fulfill supervisory and regulatory responsibilities. At the same time, current legal protection for supervisors provides an effective tool to shield supervisors from legal actions taken while carrying out their duties in good faith.

71. The current legal framework establishes the ME as the principal agency charged with issuing financial regulatory rules. The ME has delegated to BE the authority to issue regulations on specific areas, such as accounting standards and financial statements, certain solvency standards that are already largely specified in laws, and financial disclosure. Notwithstanding this delegation and the good cooperation among the agencies, there is a risk that the BE may be unable to respond adequately should there be conflicting interests between the institutional goals of the BE and the government, which could undermine BE's supervisory independence. Consequently, the authorities should introduce changes to the current legal framework for banking supervision in order to transfer most regulatory powers currently under the ME to enable BE to promulgate prudential rules. Further, the authorities should consider granting the BE license revocation authority in appropriate circumstances.

#### ***Licensing and structure (CP 2–5)***

72. The definition of banking activities and the proper use of the name “bank” are clearly established in the law. In addition, the requirements regarding licensing are complied with. Both the supervisory approach and the regulations in place ensure ongoing monitoring and foster proper control of CIs' strategies and investment decisions. On-site examinations are designed to verify that regulatory limits are not exceeded and that the data submitted to the BE are accurate.

73. Given the ability that CIs headquartered in European Union members have to set up branches in other European Union members, the assessors encourage the BE to maintain a close relationship and coordination with other European supervisory agencies so as to ensure *fit and proper* test compliance when authorizing the entry of new CIs.

#### ***Prudential regulations and requirements (CP 6–15)***

74. Prudential regulations and requirements are considered adequate and the BE is legally empowered to enforce them. Capital adequacy regulations in place provide a comprehensive

prudential framework that not only adheres to international standards but also includes specifications that make it stricter in terms of capital composition vis-à-vis other developed countries.

75. Spain traditionally has applied very strong loan classification and provisioning rules, as well as strong compliance procedures. This is done through both off-site credit risk follow up, mainly by way of a comprehensive credit risk register system, and significant presence in banks through on-site examinations. In adopting both international accounting standards and Basel II guidelines the BE is following a measured approach to minimize the potential for undue reduction of capital and provisioning.

76. The assessors encouraged the authorities to consider whether current conflict of interest policy guidelines adequately address potential conflicts. In particular, conflicts of interest stemming from the possibility that bank directors or officers could also serve as directors in an industrial company in which the bank has ownership and to which the bank extends credit or provides other financial services may warrant further consideration.

77. Supervisory tools to secure CIs' prompt corrective actions rely mostly on moral suasion. In this context, there is a need to further buttress moral suasion by making supervisory expectations on best banking practices more explicit. One alternative is for the BE to issue guidelines on best banking practices, particularly those that foster effective risk management. Such guidelines may help strengthen the effectiveness of the BE's moral suasion since the industry will have greater appreciation of the BE's expectations and supervisory judgments will be more transparent. Standards may help reinforce communication between the BE and supervised institutions, particularly when discussing the need for corrective measures to achieve sound practices.

#### ***Methods of ongoing supervision (CP 16–20)***

78. The Spanish supervision system is intense in terms of ongoing monitoring of CI policies, practices, and risk control management. This is reinforced with regular on-site inspection. The BE's off-site supervision activities effectively complement on-site examinations, through the preparation and dissemination of a comprehensive risk analysis that guides on-site examinations. The BE's on-site activities, particularly in the largest institutions, provide an effective means of validating supervisory information.

#### ***Accounting standards (CP 21)***

79. While BE can use its influence and sanctioning authority to cause the removal of unfit external bank auditors, the assessors encouraged the authorities to consider seeking direct BE authority to remove external auditors.

**Remedial measures (CP 22)**

80. The Law of Discipline and Intervention assigns sanction authority to the ME and BE on the basis of severity of infractions: ME imposes sanctions on the gravest offenses at the proposal of the BE, and the BE imposes sanctions in less severe cases. While the current framework appears to be working well, it would be advisable for the authorities to consider delegating further sanction power to the BE to bolster moral suasion and enhance its effectiveness in enforcing safe and sound practices.

**Cross-border banking (CP 23–25)**

81. The BE has adequate systems in place to collect information from home country supervisors and parent bank organizations and should continue to evaluate the effectiveness and quality of information obtained to support supervisory efforts.

Table 5. Recommended Action Plan to Improve Compliance with the Basel Core Principles

Reference Principle	Recommended Action
Legal Framework—Responsibilities and Objectives (BCP 1(1))	While in practice the cooperation between the BE and the ACs appears to be effective, the dual legal framework governing <i>cajas</i> poses the risk of potential conflicts in the exercise of supervisory and sanctioning authority. Looking to the future, eventual changes in the legal regime should clearly preserve the sole and exclusive roles of the BE in prudential oversight of financial institutions, avoid any possible inconsistency in the division of responsibilities, and enhance coordination of the supervisory bodies. This would help ensure that Spanish financial supervision is consistent with the present trend observed in European and international markets towards avoiding fragmentation and enhancing harmonization.
Legal Framework—Regulatory Powers (BCP 1(3))	Introduce changes to the current legal framework for banking supervision in order to transfer most regulatory powers currently under the ME to the BE to enable promulgation of prudential rules. Consider granting the BE licensing revocation authority in appropriate circumstances.
Connected Lending (BCP 10)	The assessors encouraged the authorities to consider whether current conflict of interest policy guidelines adequately address potential conflicts. In particular, conflicts of interest stemming from the possibility that bank directors or officers could also serve as directors in an industrial company in which the bank has ownership and to which the bank extends credit or provides other financial services may warrant further consideration.

Reference Principle	Recommended Action
Other Risks (BCP 13)	Issue guidelines on best banking practices, particularly those that foster effective risk management.
Money Laundering (BCP 15)	Fully implement the June 15, 2005 BE/SEPBLAC collaboration agreement.
Accounting Standards (BCP 21)	While BE can use its influence and sanctioning authority to cause the removal of unfit external bank auditors, the assessors encouraged the authorities to consider seeking direct BE authority to remove external auditors.
Remedial Measures (BCP 22)	Consider delegating from the ME to the BE further sanctioning authority for the gravest infractions, particularly those calling for suspension of bank officers.

### Authorities' response to the assessment

82. The Spanish authorities wish to thank the members of the IMF assessment team for all their work to produce this report. They welcome the assessment recognizes that the Spanish supervisory system has a high degree of compliance with the Basel Core Principles and that Bank supervision is effectively carried out by the BE.

83. On a number of issues, however, the Spanish Authorities wish to qualify the IMF experts' view, in particular regarding the recommendation to change the current division of competences between the Ministry of Economy and Finance and the Bank of Spain to strengthen the supervisory tools of the Bank of Spain; and the observations and recommendations on the role of the Autonomous Communities in the supervision of the Cajas.

84. On BCP 1(3), the Spanish authorities wish to comment the IMF assessment. The Spanish authorities consider, first, that the current legal framework has demonstrated its efficacy along the years due to the good cooperation between the ME and the BE and, second, that it is better suited to achieve the goal of effective banking supervision. Currently, the competences of the ME and the BE are clearly delimited: the Ministry of Economy and Finance elaborates prudential rules and the BE enforces those rules. Therefore, it is the government through the ME who creates the legal framework for banking supervision and there are good reasons for that. Firstly, as there is no single financial supervisor (like the FSA or BaFin) in Spain, the ME is the only institution which has a global view of the three financial sub-sectors: banking, insurance and securities, whose regulations are closely interlocked. Secondly, the ME is also the institution responsible for negotiating the EU legislation for financial services through its presence in Council discussions of Level 1 Directives and Regulations, and its presence in the level 2 Committees (Banking Advisory Committee, European Securities Committee and the European Insurance and Occupational Pensions Committee). Finally, it is justified that the ME is in charge of issuing financial regulation because it can balance the need for an efficient supervision of credit institutions and the economic needs of the market, so as to avoid overregulation. Therefore, the Spanish authorities consider that the institutional framework does comply fully with BCP 1(3).

85. Further on BCP 1(3) and also on BCP 22, the Spanish authorities wish to comment on the assessors' recommendation to grant the BE license revocation authority and delegate from the ME to the BE further sanctioning authority for the gravest infractions. According to the Spanish legal system, the power to license and sanction credit institutions belongs to the public administration. Those duties are determined by law and have to be exercised by the public administration in conformity with legal provisions and public interest. The Bank of Spain does not belong to the Spanish public administration. The Spanish legal system allows the delegation of public duties to non public bodies, such as the Bank. As a result, the Bank of Spain has been vested with the power to impose sanctions for light and serious infringements, while the power to impose sanctions for very serious infringements is the Ministry of Finance's remit. Even in those cases the role of the Bank is of paramount importance since it proposes the actual sanction that will be imposed by the Minister. The system just described, where the Ministry of Finance grants licenses to credit institutions and imposes very serious sanctions does not prevent the Bank of Spain from acting independently when supervising credit institutions. Therefore, the current state of affairs does not demand any change in the system to better serve the principles included in the Constitution and the efficient supervision of credit institutions thereof.

86. On the assessment of BCP 1(1), the Spanish authorities wish to comment on the notion put forward by the assessors that there is a risk of overlapping in the exercise of supervisory and sanctioning authority between the BE and the CAs. There, in our view, no possibility of overlapping of the national and regional legal frameworks. The basic national regulation obliges all the Cajas and the first final disposition of the LORCA (ley 31/1985) defines what is basic in the field of prudential supervision and direction of the activity of the Cajas. The ME and the BE are thereby entrusted with the functions of discipline, inspection and sanctioning of the cajas on matters of their competence and, in particular, those regarding monetary and financial policy, solvency and safety.

87. Other aspects of the supervision of the cajas are also considered basic as long as (1) they are needed to ensure the effectiveness of the state competences, (2) they are connected with the State's general economic policy, (3) they have an effect in the monetary sector, or (4) they are of a nature that requires the existence of only one decision center.

88. CAs can only establish additional measures in matters of their competence, i.e, those that are not reserved to the State. There is therefore no possibility of conflict as the supervision and sanction on solvency matters belongs exclusively to the State. Therefore, the Spanish authorities believe that Spain complies with BCP1(1).

89. On BCP 13, the Spanish authorities consider that, inside the current regulation, there already are criteria that define what the entities must do to identify, measure, monitor, and control "Other risks." Regarding credit risk in particular, these criteria are extremely detailed in Annex IX of Circular 4/2004. That is, Spain does not rely on "best practices" guidelines, since those "best practices" have been elevated to a normative rank. Regardless of that, the BE, through its different publications and public interventions, has made recommendations in this field, including the ones attached to the requests made to the entities.



90. On BCP 24, the practice of the BE relies on parent credit institutions providing information on its subsidiaries, thereby allowing for remote inspections. However, this does not rule out direct contact and the exchange of information with other supervisors.

## SUMMARY ASSESSMENT OF OBSERVANCE OF IAIS INSURANCE CORE PRINCIPLES

### General

91. The assessment of observance of the International Association of Insurance Supervisors' Insurance Core Principles (ICP) took into account the review of the following aspects: (a) an extensive self-assessment prepared by the *Dirección General de Seguros y Fondos de Pensiones* (General Directorate of Insurance and Pension Funds, DGSFP) based on the new version of the IAIS Insurance Core Principles and Methodology; (b) the *Comentarios a la Autovaloración de la Dirección General de Seguros y Fondos de Pensiones sobre los "Insurance Core Principles" de la IAIS* (Comments to the Self-Assessment of the General Directorate of Insurance and Pension Funds on the IAIS Insurance Core Principles); (c) *Ley de Ordenación y Supervisión de los Seguros Privados* (Private Insurance Organization and Supervision Law, LOSSP); (d) *Reglamento de Ordenación y Supervisión de los Seguros Privados* (Private Insurance Organization and Supervision Code, ROSSP); (e) *Ley de Mediación de los Seguros Privados* (Private Insurance Intermediation Law, LMSP); (f) *Ley de Contrato de Seguro* (Insurance Contract Law, LCS); and (g) relevant secondary regulations (*Real Decreto, Órdenes Ministeriales, Consultas, Criterios and Instrucciones*) on the insurance activity issued by the Ministers Council (*Consejo de Ministros*), Ministry of Economy and Finance (ME), and the DGSFP.

92. The assessment process was conducted from June 22 to July 1, 2005. It evaluated the observance of the insurance regulatory framework with respect to the IAIS ICP. It also included a revision of the effectiveness of the insurance supervisory agency (DGSFP), which is part of the ME. The assessment process involved discussions with officers of the ME and the DGSFP, and meetings with private sector representatives from both industry associations and insurance companies.

### Institutional and macro prudential setting—overview

93. With net premium income in 2004 of €45.5 billion, the Spanish insurance market is the tenth largest in the world and the sixth largest in Europe. Its importance is higher in the non-life sector in which is the eighth largest market globally and the fifth in Europe, while in the life sector it ranks sixteenth internationally and eighth in the European area. In terms of penetration and density, Spain ranks relatively low compared to the premium income analysis. Spain presents a penetration index of 5.77 percent of GDP, being ranked twenty-seventh globally and fourteenth in Europe. With respect to density (€1,080 per capita), it ranks twenty-fourth internationally and fifteenth in Europe.

94. The Spanish insurance market is innovative and increasingly competitive, with important participation of banks and *cajas* in the distribution of life products. At the end of 2004, the insurance sector comprised 330 insurance entities: 227 insurance companies that accounted for 81 percent of total premiums written; 44 mutual societies, 18.5 percent; and 59 social mutual societies, with only 0.2 percent market share. Overall, the Spanish insurance industry is solvent and profitable. By the end of 2004, assets covering technical provisions exceeded by 15 percent the statutory level and the solvency margin surplus was 158 percent.

95. The Spanish market has developed a strong infrastructure to enhance its functioning. From the private side, several organizations have been created to support market development. And from the government side, the *Consortio de Compensación de Seguros* has helped private insurers to deal with extraordinary and catastrophic risks, and has facilitated the orderly exit of troubled insurers.

96. Looking at the shocks that the international insurance industry has faced in the past years, the Spanish insurance sector has demonstrated its resilience. The effect of the reduction of interest rates and the adverse movement in the equity markets have been absorbed smoothly. Additionally, since 2000 the non-life sector has maintained a clear growth path. In the case of the life sector, after a slowdown in 2003, the market has also resumed growth. Besides the positive effect of macroeconomic fundamentals, there seem to be several factors that could contribute to a stable and sound growth of the market: (a) the strengthening of asset-liability management techniques as part of the regulatory requirements and market practices; (b) the limited impact of interest rate guaranteed life products; (c) the conservative structure of the investment portfolio of the industry; (d) the limited credit risk transfer activity from the banking to the insurance sector; and (e) the effective functioning of a compensation mechanism to deal with catastrophic and extraordinary risks.

97. In the years to come, authorities will face the challenge to implement the outcome of the EU Solvency II Project, specifically on risk management and stress testing. In addition, insurance regulatory and supervisory authorities will face the challenge of implementing new international accounting standards on insurance that will be produced as part of the project conducted by the International Accounting Standard Board.

### **Main findings**

98. The regulatory and supervisory scheme on insurance is comprehensive and has demonstrated to be effective. The evaluation shows that the majority of principles are assessed as observed or largely observed.

99. Overall, insurance regulation and supervision in Spain relies on a clear legal framework which already considers the implementation of most of the EU Directives on insurance. Spain has a professional and reliable judicial system. Additionally, alternative mechanisms for the resolution of conflicts, such as private arbitration, are usually used. The accounting and auditing professions are well-developed in the country. In general,

accounting and auditing rules are in line with internationally accepted practices. There is also an organized actuarial profession.

### ***Supervisory authority***

100. The insurance supervisory authority (the DGSFP, which is part of the ME) has no legal powers to issue secondary regulation that are binding on the industry. As the DGSFP is not an independent agency, there is no regulatory governance scheme in place. Among others, there are no explicit procedures regarding the appointment and dismissal of the head of the supervisory body.

101. The current institutional arrangement for insurance supervisions seems to create obstacles to allocate enough resources and in a timely manner, in accordance with the risks the supervisory authority perceives. For the same reason, the institutional arrangement under which insurance supervision is conducted does not provide the required resources to attract and retain highly skilled personnel and to develop all the necessary supervisory infrastructure and tools.

### ***Corporate governance, internal control and risk management***

102. In general, neither general Law nor Insurance Law establishes requirements on corporate governance for insurance companies. The existing regulation is applicable only to a limited number of insurers listed in the Spanish stock exchange.

103. The regulatory framework does not establish specific requirements on risk assessment and management for insurers to recognize the wide range of risks that they face and to assess and manage them in an appropriate manner.

104. In addition, the insurance regulatory framework does not require explicitly that insurers be required to have an internal control framework that includes internal auditing, risk management systems, assessment of outsourced functions and a clear responsibility of the board of directors. The insurance supervisory authority has a limited capacity to conduct on-site processes with respect to the existence and adequate operation of this kind of policies and systems.

### ***Group-wide supervision***

105. Even though the insurance supervisory authority has established formal mechanisms with the banking and securities supervisors to create a general framework for coordination and collaboration on financial conglomerates supervision, in practice these agreements are limited to exchange of information on a case-by-case basis. There is no evidence of group-wide analysis or group-wide supervision of financial conglomerates from the insurance standpoint.

***Market analysis***

106. The insurance supervisory authority does not conduct regular analysis of market conditions to identify main trends, scenarios and issues that could have an impact on the development and financial position and stability of the market. In this sense, the supervisory authority does not require insurers to engage in market-wide systematic reporting, or to analyze and monitor particular market-wide events of importance for the financial stability of the insurance market.

***Investments and use of derivatives***

107. The current regulatory framework does not include the obligation for insurers to have in place an overall strategic investment policy approved and reviewed regularly by the board of directors. In the same sense, the regulatory framework does not require that oversight of, and clear management accountability for, insurer's investment policies and procedures remain ultimately with the board of directors.

108. Additionally, there is no explicit requirement for the board of directors to satisfy itself that it has the necessary expertise to understand the issues related to the use of derivatives, and to approve and review periodically a policy on their use. In addition, regulation does not require explicitly that insurers have in place risk management systems and audit procedures covering the risks from derivatives.

109. The regulatory framework does not require explicitly that insurance companies implement audit procedures to ensure the timely identification of internal control weaknesses and operating system deficiencies on investment operations, including contingency plans.

***Licensing and suitability of persons***

110. The regulatory framework does not include, neither for licensing nor for ongoing operation, specific fit and proper requirements for actuaries that will be in charge of the technical management of insurers, and for the staff involved with investment activities.

***Anti-money laundering, combating the financing of terrorism (AML/CFT)***

111. The supervisory authority undertakes examinations of insurers on the compliance with the AML/CFT requirements established in the Law. However, insurance agents and brokers are not required by regulation to adopt AML/CFT measures.

Table 6. Recommended Action Plan to Improve Observance of the IAIS Insurance Core Principles

Reference Principle	Recommended Action
<p><b>Principle 3.</b> Supervisory authority</p>	<ul style="list-style-type: none"> <li>▪ To implement an institutional arrangement for insurance supervision that enables:                             <ul style="list-style-type: none"> <li>(i) strengthening of regulatory governance in terms of independence of the supervisory body (<i>i.e.</i>, the establishment of procedures regarding the appointment and dismissal of the head of the supervisory authority and members of the governing body);</li> <li>(ii) the supervisory authority to issue secondary regulation by administrative means that is binding to the insurance industry; and</li> <li>(iii) a budgetary scheme that could allocate more financial resources to insurance supervision and a more flexible scheme for the allocation of resources; increase supervisory authority’s staff and attract and retain highly skilled personnel; and provide the necessary resources to enhance supervisory infrastructure and tools.</li> </ul> </li> </ul>
<p><b>Principle 6.</b> Licensing</p>	<ul style="list-style-type: none"> <li>▪ To include, as part of the licensing process for insurance companies, specific suitability requirements for the actuaries that will participate in the technical management of the company.</li> </ul>
<p><b>Principle 7.</b> Suitability of persons</p>	<ul style="list-style-type: none"> <li>▪ To consider, as an additional element for the fit and proper scheme applicable to key functionaries, specific fit and proper requirements for actuaries.</li> <li>▪ To introduce the obligation for insurers to inform the supervisory authority, in a timely manner, of circumstances that may affect the fitness and propriety of its key functionaries.</li> </ul>
<p><b>Principle 9.</b> Corporate governance</p>	<ul style="list-style-type: none"> <li>▪ To establish general requirements on corporate governance applicable to insurers in which clear responsibilities for the board of directors and senior management are included.</li> </ul>
<p><b>Principle 10.</b> Internal control</p>	<ul style="list-style-type: none"> <li>▪ To explicitly consider in regulation the requirement for insurers to maintain a framework for internal control that includes internal auditing procedures, risk management systems, assessment of outsourced functions and clear responsibilities for the board of directors.</li> </ul>

<p><b>Principle 11.</b> Market analysis</p>	<ul style="list-style-type: none"> <li>▪ To implement regular analysis of the conditions of the market, not only in terms of the past developments and present situation, but also to identify trends, scenarios and issues that could have an impact on future development, financial position and/or financial stability of the market.</li> <li>▪ To include as part of the systematic financial and statistical information required of insurers for supervision purposes, the information required to conduct regular analysis of market conditions.</li> </ul>
<p><b>Principle 17.</b> Group-wide supervision</p>	<ul style="list-style-type: none"> <li>▪ To strengthen the coordination and collaboration framework between the insurance supervisory authority and the BE and the CNMV, in order to create and implement effective mechanisms for group-wide analysis and effective group-wide supervision of financial conglomerates.</li> <li>▪ To provide the necessary resources to the insurance supervisory authority so it can participate effectively on group-wide supervision (<i>see</i> recommendation on ICP 3).</li> </ul>
<p><b>Principle 18.</b> Risk assessment and management</p>	<ul style="list-style-type: none"> <li>▪ To include explicitly in the regulatory framework specific requirements on risk assessment and management for insurers, in order to recognize the wide range of risks that they face and to assess and manage them in a comprehensive and effective manner.</li> <li>▪ To include, as part of the supervisory process, the verification of the existence and adequate operation of policies and systems on risk assessment and management by insurers.</li> </ul>
<p><b>Principle 21.</b> Investments</p>	<ul style="list-style-type: none"> <li>▪ To incorporate in the insurance regulatory framework explicit requirements for insurers to have in place an overall strategic investment policy approved and reviewed regularly by the board of directors, that addresses the different aspects linked to investment risks (<i>see</i> recommendation on ICP 9).</li> <li>▪ To include in the regulation specific fit and proper requirements for staff involved with investment activities, in terms of appropriate levels of skills, experience and integrity.</li> <li>▪ To consider within the regulatory framework requirements for insurers to implement audit procedures to ensure the timely identification of internal control weaknesses and operating system deficiencies on investment operations that include contingency plans (<i>see</i> recommendation on ICP 10).</li> </ul>
<p><b>Principle 22.</b> Derivatives and similar commitments</p>	<ul style="list-style-type: none"> <li>▪ To consider in the regulatory framework explicit requirements on the board of directors to satisfy itself that it has the necessary expertise to understand the important issues related to the use of derivatives; to approve and review periodically a policy on their use; and to have in place risk management systems and audit procedures covering the risks from derivatives (<i>see</i> recommendations on ICP 9, 10, and 18).</li> </ul>

<p><b>Principle 28.</b> Anti-money laundering, combating the financing of terrorism (AML/CFT)</p>	<ul style="list-style-type: none"> <li>▪ To provide the necessary resources to the insurance supervisory authority so it can maintain an effective supervision on AML/CFT requirements to insurers (<i>see</i> recommendation on ICP 3).</li> <li>▪ To draft legislation on AML/CFT requirements for insurance agents and brokers.</li> </ul>
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**Authorities’ response to the assessment**

112. The DGSFP appreciates the quality, precision and rigorous analysis carried out by the IMF mission and the assessor in connection with the IAIS Insurance Core Principles observance assessment. In general, the DGSFP shares the contents of the assessment. However, it considers necessary to comment on some specific aspects.

***Principle-by-principle assessment: Principle 18***

113. Regarding Principle 18 on risk assessment and management, it is stated that the DGSFP does not check, as part of its supervisory process, the existence and adequate operation of policies and systems on risk assessment and management. The above-mentioned statement does not take into consideration on-site inspections carried out, which include actions oriented to control and verify financial and non-financial risks. Inspection plans include specific references to that kind of evaluation. Moreover, the Inspection Manual, in its section on internal control and risk assessment, includes a questionnaire on risk assessment by insurers.

114. The responses given in the self-assessment questionnaire may have lead to confusion with respect to the absence of an analysis on risk aggregation and risk interrelation. When at the self-assessment it is stated that no checks are performed with respect to the effects of different risks aggregations, it aims to underline that, up to date, there is a lack of a system to weigh and quantify in a reliable manner the impact of diversification, aggregation and correlation of risks, in order to measure the effect of specific risks in the global risk position of an insurance entity. We understand that, in no way, does this situation imply that risk management systems of supervised insurers are not verified.

**The following regulatory initiatives already under way, or about to be launched, aim at bringing current regulations in line with IMF recommendations following the assessment of compliance with IAIS principles:**

***Principle 6. Licensing***

115. Among the requirements that insurance companies must meet in order to obtain licensing, the regulatory framework does not specifically require the appointment of an insurance actuary, nor does it specify the latter’s qualifications, because Spanish regulations assign responsibility for the management of an insurance company to its directors. Spanish

law, however, requires insurance companies to have an insurance actuary at their disposal. For instance, Article 29.1 of the Private Insurance Organization and Supervision Regulations (ROSSP) requires that the technical provisions be certified by an insurance actuary; the insurance company must therefore choose an insurance actuary and be accountable for the appointed actuary's actions.

***Principle 7. Suitability of persons***

116. With regard to the suitability of insurance actuaries and, in particular, the requirement concerning the fitness of these professionals, it should be noted that in Spain, insurance actuaries are university graduates; hence, their fitness is demonstrated by their possession of a bachelor's degree (*licenciatura*) in actuarial and financial sciences, issued by the Ministry of Education and Science. As to the requirement concerning the propriety of insurance actuaries, it is understood that insurance company managers are responsible for verifying compliance with this requirement, bearing in mind that the company is responsible for their actions. A forthcoming legislative amendment will include the requirement of propriety for insurance actuaries, although the insurance company that appointed the actuary remains accountable for noncompliance with this requirement.

***Principle 9. Corporate governance***

***Principle 10. Internal control***

117. Consideration is being given to a draft amendment to the ROSSP that provides for the establishment, documentation, and maintenance, at all times, of internal control procedures adapted to the company's organization. In line with the principle of proportionality, it is recognized that the procedures implemented must take into account the company's size and risk exposure; that notwithstanding, the application of the principle of proportionality can never lead to situations in which insured persons are unprotected. The draft amendment provides that ultimate responsibility for establishing the aforesaid procedures rests with the board of directors, and that the insurance company's management is responsible for implementing them. Internal control will include supervision of the procedures, to be exercised by independent expert staff from the supervised areas, and the assessment of internal and external risks to which the company is exposed. Contingency plans must be established in case circumstances arise that could jeopardize the company's viability. Lastly, the draft amendment provides that an annual report, containing an assessment by the board of directors of the effectiveness of the internal control procedures in place, identifying problems, and proposing solutions, is to be submitted by the company to the supervisory body.

***Principle 21. Investments***

***Principle 22. Derivatives and similar commitments***

118. With regard to investments (Principle 21) and financial derivatives (Principle 22), the text in preparation establishes clearly that responsibility for formulating and approving the investment policy rests with the insurance company's board of directors, which must ensure



the identification, follow-up, measurement, reporting, and management of risk. With regard to the use of financial derivatives and structured products, it will be necessary to provide clear, written rules on the usable categories, purpose, maximum positions, and authorized counterparties. The rules must provide for a sharing of the authorization, execution, and control functions, and for periodic documentation of all activities.

***Principle 28. Anti-money laundering, combating the financing of terrorism (AML/CFT)***

119. Article 2.1 of the Regulations contained in Law No. 19/1993, of December 28, 1993, on measures to prevent money laundering, approved by Royal Decree No. 925/1995, of June 9, 1995, provides that insurance companies are accountable for the actions of individuals and legal entities acting as dealers or intermediaries for them, an obligation that also applies to insurance brokers.

120. Since insurance brokers are independent from the insurance companies, a forthcoming legislative amendment will propose to maintain the aforesaid accountability of the companies for the actions of their agents, and will provide that insurance brokers remain directly bound by legal obligations with regard to specific measures to prevent money laundering, irrespective of the insurance companies for which they carry out trading activities. The latter provision will require the amendment of Article 2.1 of the aforesaid Law, which enumerates the parties required to comply with the provisions of that rule.

**SUMMARY ASSESSMENT OF IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION**

**General**

121. Spain has modernized the legal structure for financial services through several amendments to the main founding Law 24/1988 on the Securities Market known as the *Ley del Mercado de Valores* (LMV). As amended by these laws, the LMV simplifies and consolidates the laws affecting financial market institutions and related products.

122. The CNMV is the main regulator of all firms and individuals related to the securities market, notwithstanding the exclusive prudential oversight of the Bank of Spain (BE) over credits institutions involved in securities dealing and the role of the Ministry of Economy in licensing. Consultation with the CNMV occurs when the credit institution intends to dedicate a significant part of its business to the provision of investment services.

123. While generally reflecting the features of a sound financial market regulation, the Spanish regulatory framework could be further strengthened by granting the CNMV additional oversight and sanctioning responsibilities and by reinforcing the institutional and operational independence of the CNMV.

124. The president, vice president, and non-executive members of CNMV's Board are appointed for four-year terms, renewable once. To increase independence, appointments should be for a longer term than the present four years, and should be non-renewable. In addition, although no evidence was found of inappropriate political interference in the CNMV's decision-making process, it is recommended that the appointment of at least some non-executive members of the Board be made, drawing from varied constituencies, for example, academia or the private sector.

125. With regard to *operational independence*, important regulatory powers such as adopting new regulations in key operational areas of the securities field as well as the power to grant and withdraw licenses and to sanction very serious infractions to securities regulations remain the responsibility of the ME. Although the current framework does not result in gaps in oversight or regulation, compliance with international standards would be enhanced by vesting the CNMV with the power to design and adopt secondary legislation which would then be promulgated by the executive authorities, the capacity to grant and withdraw licenses to regulated entities and products; and with the power to sanction on administrative grounds any infractions of the securities law and regulations.

### **Information and methodology used for assessment**

126. Several sources were used in making this assessment: the *Principles* themselves, the *Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation (Assessment Methodology)*, the IMF Guidance Notes and Templates, and various IOSCO reports referenced in the Assessment Methodology and the Principles.

127. The assessment is based on meetings and discussions with the ME; senior CNMV staff responsible for each of the functional areas addressed by the Principles; staff of the BE (with respect to their roles in the securities framework); BME Spanish Exchanges (*Bolsas y Mercados Españoles*); and selected asset management and investment firms (and the related professional associations) representing different scales and complexity of financial services activity. Selected material was reviewed for the assessment, including the above institutions' annual reports; laws, regulations, and published guidance; statistics on operations; published information on issuers; official registries of licensed institutions; published information on regulatory actions; CNMV responses to the IOSCO questionnaires; and other material submitted by the CNMV during the course of the onsite portion of the assessment.

### **Description of regulatory structure and practices**

128. **CNMV's Board and Executive Committee.** The CNMV is an autonomous public authority governed by a seven-member board (*Consejo*)<sup>18</sup> chaired by a full-time president. A

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<sup>18</sup> The CNMV Board comprises seven members. Its president and vice president are appointed by the government, in consultation with the ME and experts in the securities field. Three other members are appointed by the ME, and the general director of the treasury and the deputy governor of the Bank of Spain are ex-officio

permanent Executive Committee (*Comité Ejecutivo*), comprising the president, vice president and the three full-time members of the Board, prepare the board agenda and exercise delegated powers.

129. **Consultative committee.** The CNMV also has a consultative committee chaired by the vice-president as a non-voting member. The committee is composed of 17 members representing secondary markets, issuers, investors and three Autonomous Communities. The committee must be consulted on CNMV's circulars, on the imposition of sanctions for very serious infringements, on the licensing, delicensing, mergers and takeovers of investment firms, and on the authorization and revocation of authorization of branches of investment of non-EU members states.

130. **Scope of competence.** The CNMV prudentially supervises investment services providers (ESIs), regulates public offerings and takeover bids, oversees the financial information related to securities and supervises the marketing and distribution of financial instruments. The CNMV has also responsibility for custodians of securities and of assets of collective investment schemes, for clearing and settlement systems and related custodians, without prejudice to the BE's functions and its specific role with respect to payment systems.

131. **Sanctioning powers.** The CNMV has somewhat restricted sanctioning powers, that have to be exercised after the non-binding advice of its consultative committee. The CNMV can only sanction *light* or *serious* breaches of relevant laws and regulations. With regard to *very serious* infringements, the CNMV prepares a report on the case and proposes a sanction for the ME to impose. Potentially criminal acts must be referred to the Public Prosecutor. The CNMV board must inform the BE of any sanction that it intends to apply to a credit institution.

132. **Licensing.** Licensing (and withdrawal of licenses) of ESIs is within the remit of the ME upon proposal of the CNMV. The ME will also retain licensing and delicensing powers over (a) insurance companies upon proposal of the DGFPS, and (b) credit institutions upon proposal of the BE.

133. **Coordination with the Bank of Spain.** Coordination with the BE and the CNMV is organized, in the case of day-to-day operations, through inter-staff contacts, information sharing, several coordinated data bases and regular monthly meetings. The CNMV maintains a registry of credit institutions involved in providing investment services that is publicly available on its website. The information on credit institutions is updated daily from a flow of information from the BE. The registry also includes the tariffs and the typical contractual documents as filed with the CNMV.

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members. All of them are subject to conflict-of-interest rules and, with the exception of the two ex-officio members, are full-time staff who may not engage in other professional activities.

134. **Cross-membership arrangements.** Cross-membership of the supervisory authorities also fosters cooperation and aims at reinforcing information-sharing mechanisms among financial regulators. Thus, the vice president of the CNMV is an ex-officio member of the board of the Bank of Spain, and reciprocally, the deputy governor of the Bank of Spain is a member of the CNMV Board. However, cross-membership on boards does not apply to the insurance supervisor. Regular meetings of the heads of the three financial sector supervisors could facilitate institutional links and add certainty to the information-sharing mechanism.

135. **Market operators and clearing and settlement systems** are monitored through protocols that are subject to review by the competent authority, and those protocols (and any powers or actions with respect to their infraction) are regarded as founded in contract law and not in public law. Power to impose penalties or fines, and to suspend or prohibit the participation of any participants in the markets is the responsibility of the CNMV and ME. Without prejudice to the disciplinary powers of the CNMV and ME, persons included within the scope of the BME regulations are also held liable for any infractions under the applicable employment or professional regime. The law applicable to securities is largely contained in the main LMV as subsequently amended by following laws and as further completed by a Royal Decree transposing both the market abuse and the prospectus directives in order to bring the Spanish framework fully in line with the European directives. Applicable law is also found in certain related legislation, such as company law, bankruptcy law, commercial law, property law, penal law, and administrative codes.

136. As a member of the European Community, Spain also recognizes credit institutions and investment firms that enter Spain from other European Economic Area jurisdictions in which they are authorized either by exercising a right of establishment or a right to provide cross-border services.

### **General preconditions for effective securities regulation**

137. Overall, Spain appears to meet the preconditions for an effective regulatory framework for capital markets and the provision of financial services. Such preconditions assume the existence of a legal framework that supports the integrity of contract and property rights, a legal structure that recognizes the instruments traded in the market and the rules that facilitate their trading, a commercial and insolvency regime that facilitates the taking of collateral, the use of clearing services, and the enforcement of guarantees, sound company law that protects investors, laws that support the ability to identify and protect client assets, reliable and consistent accounting standards, and the confidence of the marketplace that the rules will be consistently and equitably enforced and can be applied notwithstanding the bankruptcy of particular market participants. These assumptions are further premised on the assumption that the judicial, administrative, and regulatory authorities will reliably honor and equitably apply the rule of law. Certainty as to the application of the law, and confidence in its equity, is fundamental to the reliable functioning of markets and market confidence.

Table 7. Recommended Action Plan to Improve Implementation of the IOSCO Objectives and Principles of Securities Regulation

Reference principle	Recommended action
Principles Relating to the Regulator (P 1–5);	<p><i>Principle 1, clarity of responsibilities of the regulator.</i> While credit institutions are generally large companies or groups that are subject to more demanding prudential criteria than investment firms, it is important that the securities market activities of banking groups be supervised by the CNMV from inception (i.e., including in the licensing phase). Cooperation between the Bank of Spain and the CNMV in the discharge of their respective functions could be further enhanced by including CNMV’s assessment of the program of activity of credit institutions that intend to provide investment services.</p> <p>In making this recommendation, the assessor is fully aware that the IOSCO principles take no position on the desirable division of responsibilities among regulators in a particular legal framework, and that they only insist that this division be clearly set out, preferably in law, and that cooperation should be organized and reliable.</p> <p><i>Principle 2, independence and accountability of the regulator.</i> To enhance independence, appointments to CNMV’s board should be for a longer term than the present four years, and should be non-renewable. Also, although no evidence was found of inappropriate political interference in the CNMV’s decision-making process, it is recommended that the appointment of at least some non-executive members of the Board be made, drawing from varied constituencies, for example, academia or the private sector.</p> <p>With regard to <i>operational independence</i>, important regulatory powers such as adopting new regulations in key operational areas of the securities field as well as the power to grant and withdraw licenses and to sanction very serious infractions to securities regulations (<i>infracciones muy graves</i>) remain the responsibility of the Ministry of Economy and Finance. Although the current framework does not result in gaps in oversight or regulation, compliance with international standards would be enhanced by vesting the CNMV with the power to design and adopt secondary legislation which would then be promulgated by the executive authorities; the capacity to grant and withdraw licenses to regulated entities and products; and with the power to sanction on administrative grounds any infractions of the securities law and regulations.</p> <p><i>Principle 3, adequate powers and resources of the regulator.</i> As commented under Principle 2, the CNMV’s powers suffer from shortcomings in the areas of authorization of investment firms and credit institutions involved in securities dealings; in the adoption of secondary legislation, and in the limitation of sanctioning powers to mild and serious infractions (<i>infracciones leves y graves</i>) thus excluding from the Commission’s responsibility very serious infractions of the securities law (<i>infracciones muy graves</i>). As far as recruitment of staff is concerned, more flexibility is needed to hire specialized professionals in high demand by the private sector.</p>
Principles for the Enforcement of Securities Regulation (P 8–10)	<p>With respect to <i>Principle 8</i>, the right of the CNMV to inspect regulated entities on an unannounced basis is not <i>specifically</i> mentioned in the law. Although inspections are being carried out without prior notice, it is recommended to establish specifically in law that the CNMV may carry out inspections without prior notice.</p>

*Authorities' response to the assessment*

138. The authorities broadly agree with the assessment and welcome the fact that the Spanish regulatory system has a very high degree of compliance with the IOSCO Objectives and Principles. They have the following comments:

- Regarding Principle 1 (the responsibility of the regulator should be clear and objectively stated), measures will be taken in the near future to enhance the role of the CNMV when credit institutions intend to provide investment services.
- Regarding Principle 2 (the regulator should be operationally independent and accountable in the exercise of its functions and powers), the authorities are aware of the importance of the process of designation of the board members. Current legislation does not impede board candidates to be drawn from the private sector or the academia. The LMV only requires them to be experts in the field of the securities markets. Hence the recommended plan of action is not relevant in this regard. Measures will be taken to lengthen the current four-year term of appointment of board members and make the term non-renewable.

With respect to the possibility of adopting secondary legislation, the CNMV does in fact decide on the technical aspects of financial regulation. However, there are political decisions that can only be taken by the parliament and the government. In addition, there are advantages from the fact that the ME proposes financial regulation as it is the only institution that has an overview of the three financial sectors—banking, insurance, and investment services—whose regulations are closely interlocked. The ME is also the institution responsible for negotiating the EU norms for financial services through its presence in European Council discussions of Level 1 directives and regulations, and its presence in the Level 2 committees (European Banking Committee, European Securities Committee, and the European Insurance and Occupational Pensions Committee). Finally, it is justified that the ME is in charge of issuing financial regulation because it can balance the need for an efficient supervision of credit institutions and the economic needs of the market, so as to avoid overregulation.

With regard to sanctioning powers, it should be noted that under the Spanish legal system, the sanctioning power lies with the government, the only entity with democratic legitimacy to carry out that function. Therefore any delegation of this duty to non-governmental bodies, such as the CNMV, has to be carried out carefully. As a result, decisions on the most serious infractions are the responsibility of the ME. The CNMV retains a key role in those cases since it proposes the sanction.

- The same argument applies to Principle 3 (adequate powers and resources of the regulator) where it is recommended that the CNMV grant licenses to investment firms. The power to grant licenses is of a public nature and therefore has to be carried out by the public administration in conformity with legal provisions and the public

interest. In addition, it is the CNMV that proposes to the ME that a certain entity be licensed. Therefore, the present state of affairs does not pose any risk to the independence of the CNMV in the exercise of its duties nor to the adequate functioning of the system.

- The authorities disagree with the assessment that Principle 8 (the regulator should have comprehensive inspection, investigation and surveillance powers) is “broadly implemented” rather than “fully implemented.” The issue at stake is whether the CNMV can in practice inspect regulated entities on an unannounced basis, even if this power is not explicitly mentioned in our law. Article 85 of the LMV gives the CNMV sweeping inspection powers and does not impose any minimum prior notice to the regulated entities. Consequently, the CNMV is authorized to carry out inspections without prior notice, as indeed it has done over the years on several occasions.

## SUMMARY ASSESSMENT OF CORE PRINCIPLES FOR SYSTEMICALLY IMPORTANT PAYMENT SYSTEMS AND RECOMMENDATIONS FOR SECURITIES SETTLEMENT SYSTEMS

### A. Payment Systems

#### General

139. **The assessment of the Systemically Important Payment System (SIPS) in Spain against the Committee on Payment and Settlement Systems (CPSS) Core Principles covered one system: *Servicio de Liquidación del Banco de España*—SLBE (a Real-Time Gross Settlement System—RTGS).** It did not assess Spain’s link to the Trans-European Automated Real-Time Gross Settlement Express Transfer system (TARGET).<sup>19</sup>

140. **The methodology for the assessment was derived from the Guidance Note for Assessing Observance of Core Principles for Systemically Important Payment Systems (CPSIPS) of the IMF and the World Bank of August 2001.** The assessment involved discussions with members of the staff of the *Banco de España* (BE) and meetings with commercial banks. The assessment was conducted during the FSAP mission to Spain in June-July 2005.

141. **The assessment benefited from a self assessment by the BE and the assessment of the Euro Large-Value Payment System** against the core principles published by the European Central Bank. It was based also on relevant laws and regulations of the BE and on information available on the website of the BE.

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<sup>19</sup> The overall assessment of TARGET (Trans-European Automated Real-Time Gross Settlement Express Transfer) was part of the CPSS assessment for the Euro-area payment system conducted in November 2001 (see IMF Country Report No. 01/195); the assessment of transparency of monetary policy for the Euro area was completed at the same time.

### **Institutional and market structure**

142. **The SLBE is the only systemically important payment system.** The SLBE is a Real-Time Gross Settlement (RTGS) system owned, operated, and controlled by the BE. It is the Spanish component of the TARGET, and settles both domestic and cross-border operations.

143. **Law 41/1999 of November 12 (the Settlement Finality Law) provides the general legal framework for the payment and securities settlement system.** The law states the irrevocability and finality of payment orders and recognizes the legal validity of clearing agreements. It also establishes the procedures and consequences of legal insolvency, and covers clearing agreements, transfer orders, and the collateral deposited in the system. The law establishes expeditious proceedings for the execution of collateral in case of default. Insolvency proceedings do not have retroactive effects on payment orders or collateral that have been put through the payment system.

144. **The BE regulates the SLBE through circulars, technical applications (*aplicaciones técnicas*), and communications.** Circulars are published in the Official Gazette (*Boletín Oficial del Estado*) and at BE's website.

145. **The SLBE is an open system with participation of credit institutions established in any European Economic Area country, and investment service institutions that are subject to prudential supervision.** Treasury departments of central and regional governments and clearing houses such as the stock exchanges and IBERCLEAR, that are subject to oversight, also participate in this system.

146. **There are 184 direct participants (33 branches of foreign institutions) and 36 indirect participants in the system.** Direct participants have to open a centralized account on the books of the BE (RTGS account) for the settlement of transactions, and can act both on their own behalf and on behalf of their customers.

### **Main findings**

147. **The BE is an important player in the payment system and has a well-established and cooperative relationship with the financial sector.** Its role and responsibilities are clearly defined in the law, including the oversight function.

148. **The legal framework is sound: the Settlement Finality Law is fully enforceable.** Irrevocability and finality are clearly defined in the law and in the regulations of the system, and they are also ensured even in the event of insolvency of a participant. The relevant rules and regulations of the SLBE system are contained in a number of documents issued and modified by the BE. Although rules and regulations address all the relevant aspects of the system, they are contained in a number of circulars which are quite difficult to follow, so it is recommended that the BE consolidates its payment circulars to improve readability and



transparency for participants. BE staff has indicated that efforts in this direction are in progress.

149. **The infrastructure for clearing and settlement of payments is well-developed, modern, and functional.** The SLBE has systems that offer protection against liquidity and credit risks, such as queuing mechanisms, intraday credit and bilateral and multilateral algorithms. The needs of the users are accounted for in the development of the payment infrastructure. The introduction of the liquidity reservation facility is an example of requirements fulfilled by the BE. However, the BE should monitor the use of this facility to avoid possible discrimination against certain payments that may have to wait until the end of the day to be settled and to make sure that it does not unduly prevent the central bank from debiting accounts during the day.

150. **There are contingency plans to assure continuity in the SLBE.** However, the procedures in the manual of the SLBE should give clearer guidance on the expected behavior of participants in case of emergency situations. For instance, the procedures in case of failure of the platform of a participant or the SLBE should be clearly established. Although the BE conducts regular testing of the contingency plan with the cooperation of system participants, it is recommended to establish that participants have in place clear internal policies and procedures, and carry out operating audits. A periodic review of the IT infrastructure by participants to avoid operational risks is recommended. The distance of the external backup center from the main site should also be evaluated to make sure that it is sufficient in case of events such as natural disasters or terrorism.

151. **The BE complies with its oversight function to ensure the safety and efficiency of payment systems.** Oversight is based on data analysis, the analysis of payment instruments and new developments and self-assessment under international standards, among other aspects. As a result of its oversight activities the BE produces statistics and reports. It is recommended that this material be disseminated and published periodically.

Table 8. Recommended Action Plan to Improve Observance of the CPSS Core Principles 1/

Subject	Main Findings and Recommended Corrective Plan
Pre-settlement risk (Principles 2-5)	Revise the organization of BE’s circulars to improve readability and transparency. Ensure that the use of the liquidity reservation facility does not unduly prevent the debiting of accounts during the day.
Settlement Risk (Principles 6-10)	Revise the Manual of the SLBE to give clearer guidance on the expected behavior of the participants in case of emergency situations. The BE should require participants to put in place clear internal policies and procedures and to carry out operating audits. Conduct periodic reviews of the IT infrastructure of the participants to avoid operational risks.

	Evaluate the distance between the backup site and the main site to ensure that it is sufficient to guarantee the continuity of the system in case of events such as natural disasters or terrorist acts.
Responsibility C	Periodically publish and disseminate statistics and reports on oversight activities.

1/ All CPSS principles were rated as observed. The recommended actions are relatively minor measures that could be taken to make the SLBE even more robust

### **Authorities' response to the assessment**

152. The authorities thank the IMF team and the assessor for all the work undertaken and welcome its assessment, with which it is in broad agreement. The minor shortcomings pointed out in the assessment, that do not prevent the full observance of the Core Principles, have been addressed by the authorities and appropriate measures are being implemented to tackle the issue in the first half of 2006. Given BE's membership in the Eurosystem, some issues mainly to improve the payment system's business continuity, are being tackled collectively.

## **B. Securities Clearance and Settlement Systems**

### **General**

153. As part of the Financial Sector Assessment Program, an assessment was conducted of the observance of the CPSS/IOSCO *Recommendations for Securities Settlement Systems* by the securities clearance and settlement infrastructure in Spain.

154. Prior to the mission, the CNMV made a thorough self-assessment of the Iberclear system, which was used as the basis for this assessment.

### **Scope of the assessment**

155. The assessment covers Iberclear, the securities settlement system (CSD) for a broad range of securities, including public sector and corporate debt, and equities. Almost all securities (more than 99 percent) in Spain are dematerialized in Iberclear. The residual securities are immobilized in this CSD.

156. Iberclear operates two platforms for securities clearance and settlement:

- SCLV for securities other than public and private debt. It provides delivery versus payment on a gross-net basis (model 2 DVP). The multilateral net positions on the cash side are settled in accounts at BE.
- CADE for public and private debt securities. It provides trade-for-trade settlement (model 1 DVP). The cash leg is settled in accounts at BE.

### **Institutional and market structure**

157. Capital markets in Spain are large and sophisticated. In terms of stock market capitalization, the Spanish exchanges ranked fourth in Europe in 2004 (after London, Euronext, and Deutsche Boerse); in terms of the value of bond trading in 2004, the Spanish markets ranked first in Europe. (Data source: World Federation of Exchanges, *Annual Report and Statistics 2004*.)

158. BME is the holding company for all of the Spanish markets and securities settlement systems. As such Iberclear is a wholly owned subsidiary of BME.

159. All stock exchange transactions are submitted to Iberclear as “locked-in” trades and settled via Iberclear’s systems. Transactions in public and private debt are submitted to Iberclear through electronic trading platforms and as over-the-counter trades between participants. The total value of all trades settled in Iberclear systems in 2004 was €82,798 billion: €1,505 billion in equities, and €81,293 billion in debt.

### **Regulatory structure and practices**

160. The Securities Markets Act (*Ley del Mercado de Valores*—LMV) establishes the principles and contains the main provisions regarding clearance and settlement systems, including the creation of Iberclear. The regulation governing Iberclear was approved by the Ministry of Economy and Finance upon the advice of the CNMV. The CNMV is responsible for the supervision of Iberclear pursuant to Article 84 of the LMV. CNMV’s supervision over Iberclear and its participants includes oversight of their processes and activities, and review and approval of Iberclear’s bylaws and rules. Iberclear, in turn, supervises the activities of its participants. If Iberclear detects any circumstance that could indicate a violation of rules or deviation from the principles underlying securities market regulation, it will bring this immediately to the attention of the CNMV.

161. The BE also has a significant role in the oversight of the clearance and settlement system. This stems from its responsibility to prevent systemic risk in the financial system, and its responsibility for the payment system in which the cash portion of all securities transactions are settled. The BE is also a substantial user of Iberclear’s CADE system in conducting monetary operations and is the supervisor of credit institution participants in Iberclear.

162. The CNMV and the BE have cross-representation on each other’s board of directors, and the LMV directs CNMV and BE to coordinate their actions where their areas of authority overlap. In addition, the Director General of the Treasury General Directorate sits on the CNMV Board.

## **Information and methodology used for the assessment**

163. The assessment was based on the self-assessment conducted by the CNMV using the CPSS/IOSCO assessment methodology for *Recommendations for Securities Settlement Systems*. Discussions were held with the CNMV, Iberclear, BME, Treasury, and some market participants. Relevant statutes, rules, regulations, audit reports, and business plans were also reviewed and discussed.

164. Although the self-assessment by the CNMV contained a discussion of the systems of MEFFClear (the central counterparty for derivatives) in the context of Recommendation 4, it was decided to postpone the assessment of MEFFClear until later in the year after CNMV performs a self-assessment using the CPSS/IOSCO *Recommendations for central counterparties*.

## **Main findings**

### ***Legal risk (Recommendation 1)***

165. There is a consistent set of laws, regulations, and contracts that forms the legal foundation for clearance, settlement, and custody of securities. All relevant laws and regulations are publicly available. Customer assets are protected against the bankruptcy of Iberclear participants. Other key issues, such as dematerialization, netting, and securities lending arrangements are well regulated. All laws, regulations, and contractual arrangements are fully enforceable.

166. Transactions submitted to the Iberclear systems are deemed to be irrevocable, and are final when settled in the system. Cancellations on the ground of the zero hour rule in the bankruptcy law cannot be raised against them retroactively. The legal structure supports the validity of delivery versus payment.

167. Potential conflicts of law are reduced by requiring all settlement agents to be Spanish participants. With regard to assets that may be held in other CSDs, Iberclear requires legal opinions on foreign and domestic law to address potential conflicts.

### ***Pre-settlement risk (Recommendations 2-5)***

168. Matching and confirmation are well established on the stock exchanges and electronic markets, as are trades in the over-the-counter market. More than 99 percent of trades settle on a rolling basis by T+3. Incentives are in place to achieve timely settlement, and settlement failures are closely monitored. There is an active securities lending market.

### ***Settlement risk (Recommendations 6-10)***

169. More than 99 percent of securities in Spain are dematerialized. The other securities, mostly private debt, are immobilized in Iberclear.

170. Iberclear realizes delivery versus payment in both systems that it operates. SCLV is a model 2 DVP system for all securities other than public and private debt. CADE is a model 1 DVP system for debt.

171. Final settlement occurs before or at the end of the day in both systems. Real-time finality can be achieved in the CADE system during the day.

172. Trades are irrevocable and unconditional from the moment that they are reported to the Iberclear system. The settlements of the trades are final at the moment that the securities are transferred on Iberclear's books. All trades settle in central bank money.

173. Iberclear's financial resources are sufficient to complete settlements in the case of default by its participant with the largest settlement obligation. Its guarantee fund collects collateral on the assumption that all buyers and sellers default on a single settlement day, assuming normal market conditions. No participant has ever defaulted on the cash side.

174. Iberclear is never exposed to principal risk, with a minor exception. While the SCLV platform is designed to avoid overdrafts in securities accounts, there are instances where SCLV will credit securities to a buyer's account even though the selling participant has failed to deliver the securities. This creates a temporary short position in the selling participant's account. Because of Iberclear's risk control mechanisms, the potential loss has been negligible, however.

#### ***Operational risk (Recommendation 11)***

175. Iberclear systems function well (99+ percent uptime), and there is a backup site, and fold-over to the backup site takes two hours. However, Iberclear has not tested its contingency plans with participants in the past year. Iberclear should test its contingency plans more frequently, including with participants' backup sites. In addition, it should evaluate whether the 20 km proximity to the backup site is sufficient, and the actual independence of critical services (electricity, etc.) between the two sites.

#### ***Custody risk (Recommendation 12)***

176. Customers are legally protected against the insolvency of Iberclear and its participants. Customer securities are required to be segregated from participant securities on Iberclear's books, and these positions are reconciled daily. In the case of a participant's insolvency, a customer can request that its securities be transferred to another participant. An investment compensation scheme covers obligations to customers up to €20,000. The entities authorized to hold securities in custody are subject to the supervision of the CNMV or the BE.

#### ***Other issues (Recommendations 13-19)***

177. Iberclear is a wholly owned subsidiary of BME. However, processes are in place so that users are consulted and can make known their views about Iberclear policies and

operations. Iberclear has a board of directors that represents its users, and who must be approved by the CNMV. It is recommended, however, that CNMV review the participation of its representative on the Iberclear board. The BME is in the process of becoming totally demutualized, which may complicate the governance structure.

178. Iberclear’s access rules are disclosed to all potential applicants, and are objective, as are the rules for termination of membership. While membership is open to non-Spanish firms, a participant must have an account at BE to settle transactions. Iberclear’s fees and penalties are published to members.

179. Information exchanged with participants currently uses proprietary formats that are not translatable into international formats. Iberclear is in the process of providing a common communication protocol that will employ international standards.

180. Supervision of Iberclear is well-established and rigorous. There is close cooperation between CNMV and BE. It is recommended that the Memorandum of Understanding between CNMV and BE regarding coordination of activities be made public. CNMV is also able to cooperate with foreign authorities regarding the conduct of market participants.

181. Iberclear has a number of links with foreign CSDs. In all cases, Iberclear obtains opinions of counsel on the relevant Spanish and foreign laws. In all links, only free-of-payment transfers of securities are permitted, and no provisional transfers are allowed.

Table 9. Recommended Action Plan to Improve Implementation of the CPSS-IOSCO Recommendations for Securities Settlement Systems

<i>Reference principle</i>	<i>Recommended action</i>
Settlement risk <i>Recommendation 9</i>	Iberclear should improve risk controls by prohibiting debit balances in a participant’s securities account in the SCLV platform (to balance credits in other participants’ accounts).
Operational risk <i>Recommendation 11</i>	Iberclear should test its backup facility with its members more frequently. Its backup facility is 20 km from the main site and appears to rely on many of the same resources, which represents a risk. The actual independence of critical services, such as telecommunications facilities, should also be evaluated.
Other issues <i>Recommendation 15</i>  <i>Recommendation 16</i>	Iberclear should implement an effective process to obtain the views of its participants on the efficiency and costs of its services and operations, or it should regularly survey its participants on these matters.  Iberclear should implement international communication standards for all participant communications.

<i>Reference principle</i>	<i>Recommended action</i>
<i>Recommendation 18</i>	<p>CNMV should review the participation of its personnel on the Iberclear Board. While this practice has existed for some time without apparent adverse consequences, it apparently is unique in the Spanish regulatory system, and potentially complicates the governance of Iberclear. More importantly, it could present regulatory and reputational problems for CNMV if Iberclear should determine to adopt inappropriate measures (which then must be reviewed by CNMV), or if Iberclear should experience operational or other difficulties.</p> <p>In addition, the scope of oversight of the Iberclear system and its participants exercised by the CNMV and the Bank of Spain is complex, and may not be fully transparent to users and the public. The current environment is a dynamic one (considering, for example, the role of BE as a major user of the CADE platform, the recent transfer of the CADE platform to Iberclear, the BE's significant ownership of BME shares and substantial representation on the Iberclear Board, and the impending listing of the BME), and CNMV and the BE should continue to coordinate closely and clearly define their oversight roles.</p>

**Authorities' response to the assessment**

182. The Spanish authorities thank the assessor for his analysis and concur with his evaluation, but wish to make the following comments:

***Recommendation 9***

183. The rules of the clearing and settlement system prohibit participants from having debit balances and no participant has ever had a net overdraft. Bearing that in mind, possible, exceptional short positions that are temporarily held by **private customers** should not be confused with debit balances on the accounts of **participants** (namely, institutions participating in Iberclear), which are prohibited. In addition, it should be noted that the system does not recognize securities with economic and political rights in excess of the recorded totals for each issue.

184. Regarding the actions recommended for eliminating possible debit balances, it should be noted that the rules prohibit such balances on **participants'** accounts. With respect to temporary short **customer** positions, the Iberclear Strategic Plan includes the T+3 repurchase mechanism, anticipated for the second quarter of 2006, which will totally eliminate these positions.

***Recommendation 15***

185. The composition of the TAC and its regular meetings guarantee that all direct **participants** have detailed information on Iberclear activities and projects. With respect to

the **customers** of these participants, Iberclear is beginning to engage in more dissemination activity, in addition to the existing customer care procedures, whereby, on an ongoing basis, the different departments respond to inquiries by phone or through the mailbox on their website.

### ***Recommendation 16***

186. Since the IMF FSAP mission to Spain, there have been developments in at least partial compliance with the recommended actions. The “Unified Matching System” (SUC)—Transfers (03/07/05) and SUC—Loans (November 21, 2005), which use SWIFT communications based on ISO standard 15022, are already on stream. In addition, the third part of this project (SUC—Fixed Income), which is structured in three stages (the first of which was published on February 8, 2006), is scheduled to take effect over the first semester of 2006. Therefore, the requirement for using international communication standards is already over 75 percent implemented.

### ***Recommendation 18***

187. Since the IMF FSAP mission to Spain, there have been developments in at least partial compliance with the recommended actions. On September 22, 2005, the CNMV Executive Committee approved the work plan for conducting an on-site supervision mission to Iberclear, which began on October 19, 2005, with the collaboration of Banco de España. The basic purpose is to verify compliance with the functions assigned to Iberclear in the standards, including its supervisory functions.

## **SUMMARY ASSESSMENT OF OBSERVANCE OF THE CODE OF GOOD PRACTICES ON TRANSPARENCY IN MONETARY AND FINANCIAL POLICIES**

### **A. Transparency of Financial Policies: Banking Supervision**

#### **General**

188. The assessment of transparency in banking supervisory policies covers primarily the Bank of Spain (BE); other agencies with responsibilities in bank oversight (the Ministry of Economy and Finance—ME—and the Autonomous Communities—ACs) were also examined with a focus on transparency in the institutional framework.

#### **Main findings**

189. **Spain follows high standards of transparency in its banking supervisory policies.** The BE has taken several initiatives over the last five years to enhance transparency, leading to observance of almost all the practices of the *Code of Good Practices on Transparency in*



*Financial Policies.* While room for further refinement exists with regard to both clarity of objectives and public communication, these are improvements at the margin.

***Clarity of roles, responsibilities, and objectives***

190. **The legal and institutional framework for banking supervisory policy is defined in several legal texts, at both the national and regional level.** The law clearly articulates the responsibilities of the BE and the ME with respect to banking regulation and supervision; the ACs' role in the supervision of savings banks is defined under each Community's statute. There is some room to enhance transparency with respect to savings bank oversight, as overlapping national and regional legal frameworks can create uncertainty on the respective authority of the BE and the ACs.

***Open process for formulating and reporting policies***

191. **There is a high degree of openness in the process of formulating and reporting banking regulation and supervision policies.** The BE publicly announces and explains significant changes in financial policies through a variety of means, including the Annual Report, the web site, information notes, monthly publications and press releases. For proposed substantive technical changes to the structure of financial regulations, there is a presumption in favor of public consultations. The legislative framework requires processes of public debate and specific negotiations, with consultations with affected sectors.

192. **There is scope for strengthening transparency in the relationship between the BE and other financial agencies.** Bilateral memoranda of understanding on information sharing and consultation between the BE, the CNMV, and the DGSFP exist but only their existence, not their content, has been made public.

***Public availability of information***

193. **The BE maintains a comprehensive public information program.** It disseminates policy decisions and policy announcements, provides information on the operating framework and functions, publishes texts of major speeches by senior officials, data, and research reports, arranges seminars and maintains the contact with the media. Senior financial agency officials are ready to explain the objective(s) and performance to the public, and have a presumption in favor of releasing the text of their statements to the public. The BE website is available in both Spanish and English. The English version of the site, however, could be updated more regularly. General information on supervisory policies would also be more easily accessible if posted on the banking supervision section of the website.

***Accountability and assurances of integrity***

194. **Transparent mechanisms for accountability and assurances of integrity of the BE have been put in place.** These include regular appearances before Parliament and

parliamentary committees; attendance as required of cabinet meetings and meetings of the Council of Fiscal and Financial Policy of the Autonomous Communities (*Consejo de Política Fiscal y Financiera de las Comunidades Autónomas*); and regular reporting through the Annual Report. Internal governance procedures necessary to ensure the integrity of operations, including internal audit arrangements, as well information about legal protections for officials and staff of financial agencies in the conduct of their official duties, are publicly disclosed through the Annual Report and the website. The BE has a Code of Conduct, which should be made publicly available to ensure transparency.

Table 10. Recommended Action Plan to Improve Observance of the IMF’s MFP Transparency Code—Banking Supervision

Reference Practice	Recommended Action
<b>V. Clarity of Roles, Responsibilities, and Objectives of Financial Agencies Responsible for Financial Policies</b>	
5.1.1 The broad objective(s) of financial agencies should be publicly disclosed and explained.	Disclosure of the objectives of the BE with regard to banking supervision could be more easily accessible.
5.2 The relationship between financial agencies should be publicly disclosed.	While the cooperation between the BE and the ACs appears to be effective, it is advisable to minimize those circumstances where overlapping national and regional legal frameworks may create uncertainty on the respective authority of the BE and the ACs.
<b>VI. Open Process for Formulating and Reporting of Financial Policies</b>	
6.1 The conduct of policies by financial agencies should be transparent.	Transparency would be enhanced if legislation and regulation relating to ACs were more easily accessible.
6.1.5 Where applicable, formal procedures for information sharing and consultation between financial agencies (including central banks), domestic and international, should be publicly disclosed.	The content of MoUs should be made public, not only the year they were signed.
<b>VII. Public Availability of Information on Financial Policies</b>	
7.4 Financial agencies should establish and maintain public information services.	General information on banking supervision could be more easily accessible. The English-language website for banking supervision should be updated regularly.
<b>VIII. Accountability and Assurance of Integrity by Financial Agencies</b>	
8.4 Standards for the conduct of personal financial affairs of officials and staff of financial agencies and rules to prevent exploitation of conflicts of interest, including any general fiduciary obligation, should be publicly disclosed.	Public disclosure of the Code of Conduct would strengthen transparency.

### *Authorities' response to the assessment*

195. The authorities are in broad agreement with the assessment. However, as regards cooperation with the ACs (point 5.2), they note that the State and the ACs have regulatory, supervisory and sanctioning powers within their corresponding areas of responsibilities, and no overlapping arises between the national and the regional legal framework. Each AC operates under its own legal framework. At the same time, the laws clearly articulate the responsibilities of the BE and ME with respect to the supervision of the solvency, performance, and compliance with specific regulations governing credit institutions.

## **B. Transparency of Financial Policies: Securities Markets Supervision**

### **General**

196. The assessment of transparency in securities markets oversight covers the National Securities Market Commission (*Comisión Nacional del Mercado de Valores—CNMV*).

### **Main findings**

197. **The transparency of the CNMV compares well with international standards.** The CNMV has taken several initiatives to enhance transparency. For instance, it publishes an Annual Report on the Securities Markets as well as a separate Annual Report on supervision activities. There remains some scope for enhancing its public communications program.

### *Clarity of roles, responsibilities, and objectives*

198. **The roles, responsibilities, and objectives of the CNMV are clearly defined in the Securities Market Law and discussed through various media.** The law also outlines the broad modalities of accountability; procedures for appointment, terms of office, and any general criteria for removal of the heads and members of the governing bodies; and the framework for the relationship with other financial agencies.

### *Open process for formulating and reporting policies*

199. **There is a high degree of openness in formulating and reporting securities markets policies.** The CNMV publicly announces and explains significant changes in financial policies through the Annual Report, the website, and press releases. The CNMV's Annual Report on Activities discusses its functions, activities, and procedures, and includes an internal audit report. For proposed substantive technical changes to financial regulations there is a presumption in favor of public consultations. Transparency could be enhanced in the procedures for information sharing and consultation with other Spanish financial agencies, as formal agreements exist but their text has not been released to the public.

***Public availability of information***

200. **The CNMV maintains an active public information program.** This includes a website in both Spanish and English, an Annual Report on Activities, an Annual Report on the securities market, market studies, statistical information on market entities, a weekly bulletin, public events such as seminars and conferences, relations with the press, an Investor Complaints Service, and an extensive program of investor education. CNMV officials are ready to explain their institution’s objective(s) and performance to the public, and do so in various speeches. However, there is no presumption in favor of releasing the text of their statements to the public.

***Accountability and assurances of integrity***

201. **Transparent mechanisms for accountability and assurances of integrity exist for the CNMV.** The CNMV is required by law to present a report on its activities and on the situation of the organized financial markets to the Parliamentary Committee on Economics, Trade and Finance, and the CNMV President to appear before such a committee to discuss the report. Internal governance procedures necessary to ensure the integrity of operations, including internal audit arrangements, as well as information about legal protections for officials and staff of financial agencies in the conduct of their official duties, are publicly disclosed through the annual report and the website.

Table 11. Recommended Action Plan to Improve Observance of the IMF’s MFP Transparency Code—Securities Market Supervision

Reference Practice	Recommended Action
<b>VI. Open Process for Formulating and Reporting of Financial Policies</b>	
6.1.5 Where applicable, formal procedures for information sharing and consultation between financial agencies (including central banks), domestic and international, should be publicly disclosed.	Existing MoUs with other national regulators should be made public.
<b>VII. Public Availability of Information on Financial Policies</b>	
7.4.2 Senior financial agency officials should be ready to explain their institution’s objective(s) and performance to the public, and have a presumption in favor of releasing the text of their statements to the public.	There should be a presumption in favor of releasing the text of senior officials’ statements to the public. The speeches before parliament should be posted on the website.

***Authorities’ response to the assessment***

202. The authorities are in broad agreement with the assessment, and a number of measures have already been adopted in line with the recommended plan of action:

- (6.1.3) Documents providing interpretation of CNMV rules have been posted on the website (*Criterios en el Ambito de la Autorización y Registro de los Fondos de Inversión* and *Criterios sobre la Aplicación de la Nueva Normativa de Mercados Primarios*).
- (6.3) A new section of CNMV's website (*comunicaciones*) is being set up which will contain, among other things, the speeches and statements of CNMV's senior officials.

203. The authorities are also considering options to publish the text of existing MoUs with other national authorities (6.1.5), CNMV's internal procedures (6.1.1), and the notes to the financial statements (8.2.1).

### C. Transparency of Financial Policies: Deposit Insurance

#### General

204. The assessment of transparency in deposit insurance policies covers Spain's three Deposit Insurance Funds (*Fondos de Garantía de Depósitos*—FGDs)—one for banks, one for savings banks, and one for credit cooperatives. The FGD Management Company (AIE) was established in 2000 to manage and administer the funds' capital.

#### Main findings

205. **Deposit insurance policies are broadly consistent with good transparency practices.** Annual reports are issued for each of the three funds as well as the Management Company. Transparency would benefit from a more proactive approach to public information, notably with regard to accountability and assurances of integrity.

#### *Clarity of roles, responsibilities, and objectives*

206. **The roles, responsibilities and objectives of the deposit insurance are clearly defined in the law and further described in the funds' annual reports and website.** The law also outlines the broad modalities of accountability; procedures for appointment, terms of office, and any general criteria for removal of the heads and members of the governing bodies and the framework for the relationship between financial agencies.

#### *Open process for formulating and reporting policies*

207. **FGD policies, including annual contributions by member institutions and bank resolution policies and procedures, are publicly available and well explained.** The system for the protection of deposits and other insured assets is disclosed in the relevant laws and regulations and on FGD's website. Formal procedures for information sharing and consultation with other financial agencies are also available on the website.

***Public availability of information***

208. Extensive information on deposit insurance is available through the website and the annual reports. In addition to the financial statements, the annual report includes an update on bank restructuring activities, payoffs, and other statistical data. The FGD website is available in both English and Spanish. The office responds via e-mail, fax or telephone to any question by the general public related to the mandate of the FGD. Senior officials of the FGD have the authority to explain their policies, objectives and performance to the public. This has not occurred in practice, however, other than through the website, because no perceived need for doing so has arisen.

***Accountability and assurances of integrity***

209. **A formal policy on public communications by senior FGD officials, including their appearance before parliament, would enhance transparency.** No specific rule requires the appearance of FGD officials before designated public authorities to report on the funds’ activities and performance. More transparent accountability rules would be especially relevant in the event of bank restructuring actions by the FGD.

210. **Information on FGDs’ internal governance procedures could also be enhanced.** Given the reduced size of their administrative units, the funds do not have an internal audit. Internal governance procedures are not made public, and information on standards of conduct of personal financial affairs is not publicly disclosed by means other than legislation. Better information on internal governance procedures would be particularly important due to potential conflicts of interest of financial institutions’ representatives in FGD’s management committees.

Table 12. Recommended Action Plan to Improve Observance of the IMF’s MFP Transparency Code—Deposit Insurance

Reference Practice	Recommended Action
<b>VII. Public Availability of Information on Financial Policies</b>	
7.4.2 Senior financial agency officials should be ready to explain their institution’s objective(s) and performance to the public, and have a presumption in favor of releasing the text of their statements to the public.	Transparency would be enhanced by a more proactive approach to public information. The FGD should develop a formal policy on public communications by senior FGD officials and on the release of the texts of public statements.
<b>VIII. Accountability and Assurance of Integrity by Financial Agencies</b>	
8.1 Officials of financial agencies should be available to appear before a designated public authority to report on the conduct of financial policies, explain the policy objective(s) of their institution, describe their performance in pursuing their objective(s), and, as appropriate,	A stated policy regarding the appearance of FGD officials before a designated public authority (e.g., parliament or a parliamentary committee) would enhance accountability. Such an arrangement would be especially relevant in case of FGD bank

Reference Practice	Recommended Action
exchange views on the state of the financial system.	restructuring actions.
8.2.2 Internal governance procedures necessary to ensure the integrity of operations, including internal audit arrangements, should be publicly disclosed.	The FGD should publish information on its internal governance procedures.
8.4 Standards for the conduct of personal financial affairs of officials and staff of financial agencies and rules to prevent exploitation of conflicts of interest, including any general fiduciary obligation, should be publicly disclosed.	Information (other than legislation) on standards of conduct of personal financial affairs should be disclosed to the general public.

### **Authorities’ response to the assessment**

211. The authorities are in broad agreement with the assessment but note that with reference to principle 7.4.2, they do not see a need to be more proactive in providing public information on deposit insurance because by law, the banks are obliged to do so. They point out that the cost of providing additional information to the public would be high in relation to its benefits. The authorities agree that in general, a well designed information program can enhance public confidence in credit institutions, but note that in the case of Spain, public confidence is already high and the launch of an information program on deposit insurance could have the opposite effect, that is, weaken confidence.

212. With regard to principle 8.1, the authorities are of the view that since the President of the FGD Management Company is the BE Deputy Governor, the BE has sufficient information about the funds that can be used as needed during appearances before parliament. The authorities consider the possibility of differences in opinion between the FGD and the BE on bank restructuring issues to be theoretical, as four of the eight members of the Management Committee are BE representatives, and the President, who is the BE Deputy Governor, has a deciding vote.

213. Regarding public disclosure of internal control regulations (8.2.2), the authorities are of the view that the composition of the governing bodies of both the funds and the Management Company ensure the transparency of, and control over, their actions.

## **D. Transparency of Financial Policies: Payment Systems Supervision**

### **General**

214. This assessment relates to the transparency of BE policies with respect to payment systems oversight. It encompasses Spain’s contribution to the oversight of pan-European systems such as TARGET, Clearnet, and Euroclear, as well as the oversight of purely domestic systems such as the SLBE for large-value payments and the SNCE for low-value payments for which the Bank of Spain bears sole responsibility.

## **Main findings**

215. **The BE adheres to almost all transparency practices with regard to payment systems oversight.** Several initiatives have been taken in the last five years to enhance transparency. For example, the BE issues occasional payment system articles in the biannual *Financial Stability Review* and has an informative and up-to-date payment systems section on its website. Some room for further refinement exists with regard to public communication.

### ***Clarity of roles, responsibilities, and objectives***

216. **The objectives, functions, and responsibilities of payment system oversight, as well as the authority to conduct financial policies, are detailed in the law.** The objective to promote the smooth functioning of the payment system through efficiency and security is recognized in both national and regional legislation. The law also outlines the broad modalities of accountability; procedures for appointment, terms of office, and any general criteria for removal of the heads and members of the governing bodies and the framework for the relationship between financial agencies.

### ***Open process for formulating and reporting policies***

217. **There is a high degree of openness in the process of formulating and reporting payment systems oversight policies.** The BE publicly announces and explains significant changes in financial policies through a variety of means, including the Annual Report, the web site, information notes, monthly publications, and press releases. For proposed substantive changes to relevant regulations there is a presumption in favor of public consultations. The legislative framework requires processes of public debate and specific negotiations, with consultations with affected sectors. In addition, the payment system decisions are discussed with the involved financial entities (about 20 member banks and the three associations) in a high level payment systems group, chaired by the BE Director General, that have met regularly (twice a year) for about three years.

### ***Public availability of information***

218. **The BE maintains a comprehensive public information program.** It disseminates policy decisions and policy announcements, provides information on the operating framework and functions, publishes texts of major speeches by senior officials, data, and research reports, arranges seminars and maintains the contact with the media. Reporting on major developments with regard to payment systems, however, is not on a regular basis. Senior financial agency officials are ready to explain the objective(s) and performance to the public, and have a presumption in favor of releasing the text of their statements to the public.

### ***Accountability and assurances of integrity***

219. **Transparent mechanisms for accountability and assurances of integrity of the BE have been put in place.** These include regular appearances before Parliament and



parliamentary committees; attendance as required of cabinet meetings and meetings of the *Consejo de Política Fiscal y Financiera de las Comunidades Autónomas*. There is no periodic reporting on payment systems oversight, however, since the Annual Report describes the operation of payment systems but not oversight activities. Internal governance procedures necessary to ensure the integrity of operations, including internal audit arrangements, as well as information about legal protections for officials and staff of financial agencies in the conduct of their official duties, are publicly disclosed through the Annual Report and the website. The BE has a Code of Conduct, which should be made publicly available to ensure transparency.

Table 13. Recommended Action Plan to Improve Observance of the IMF’s MFP Transparency Code—Payment System Supervision

Reference Practice	Recommended Action
<b>VI. Open Process for Formulating and Reporting of Financial Policies</b>	
6.1.5 Where applicable, formal procedures for information sharing and consultation between financial agencies (including central banks), domestic and international, should be publicly disclosed.	The content of the MoUs with other financial agencies should be made public.
6.3 Financial agencies should issue periodic public reports on how their overall policy objectives are being pursued.	Issuance of a periodic report on payment systems, including how oversight objectives are being pursued, would benefit transparency.
<b>VII. Public Availability of Information on Financial Policies</b>	
7.1 Financial agencies should issue a periodic public report on the major developments of the sector(s) of the financial system for which they carry designated responsibility.	The BE should issue a periodic report on payment systems.
7.4.1 Financial agencies should have a publications program, including a periodic public report on their principal activities issued at least annually.	Payment system oversight activities should be covered in a periodic report as well as be mentioned in BE’s Management Report.
<b>VIII. Accountability and Assurance of Integrity by Financial Agencies</b>	
8.4 Standards for the conduct of personal financial affairs of officials and staff of financial agencies and rules to prevent exploitation of conflicts of interest, including any general fiduciary obligation, should be publicly disclosed.	Public disclosure of the internal Code of Conduct would strengthen transparency.

**Authorities’ response to the assessment**

220. The authorities are in broad agreement with the assessment. Appropriate measures are being implemented to tackle the recommended action plan.

## LOAN-LOSS PROVISIONING<sup>20</sup>

221. Spain has been pioneering the use of dynamic provisions since 2000, with modifications after the adoption of IFRS in 2005. Dynamic provisioning is a prudential tool to address the credit risk that builds up during credit boom periods, helping smooth loan-loss provisioning over the economic cycle and to enhance financial stability. The mechanism draws from the observation that credit growth, and the quality of loan portfolios, exhibit strong cyclical fluctuations. During the upturn, credit tends to grow above trend and NPLs decline. During the downturn, these trends are reversed. Using historical experience, dynamic provisioning recognizes that credit losses can be properly accounted and provisioned in a statistical sense as soon as the risk (or the incurred loss) appears in the balance sheet.

222. Under the Spanish provisioning system, banks are required to register two types of loan-loss provisions: the generic,  $g$ , and the specific,  $s$ , whose effects can be proxied by the following formulas:  $g = \alpha\Delta L + \beta L - s$  and  $s = \gamma\Delta P$ ; where  $L$  is the total value of the loan portfolio,  $\Delta L$  is the change in total loans, and  $\Delta P$  is the change in problem loans. The generic provision is applied to homogeneous groups of risks. The vectors of the provisioning parameters  $\alpha$ ,  $\beta$ , and  $\gamma$ , are set by the Bank of Spain based on historical information on loan impairment and losses-given-default for specific loan categories (i.e., homogeneous groups of risks), albeit credit institutions are allowed to use their own estimates, subject to approval. Generic provisions accumulate in a generic fund  $G$ , which is required to remain within the following limits:  $0.33\alpha L \leq G \leq 1.25\alpha L$ .

223. In a given quarter, total required provisions,  $p$ , are the sum of the generic and the specific provisions:  $p = g + s = \alpha\Delta L + \beta L$ . The term  $\alpha\Delta L$  is common in traditional provisioning rules. The novelty of Spain's dynamic provisioning system is the addition of the second term ( $\beta L$ ), which captures the latent risk (inherent risk or incurred although not yet individually identified losses) of the loan portfolio and fluctuates with the business cycle. During the economic upturn, the latent risk of the loan portfolio tends to exceed the specific provision(s), causing an increase in the generic fund. A positive generic provision is considered a cost for the bank, and registered against income on a quarterly basis. During an economic downturn, the generic provision is negative and is registered as bank revenue (as long as it has a positive balance).

224. The more recent provisioning system is similar to the system associated with the initial regulation implemented in 2000, except for changes in the provisioning parameters (which are generally stricter under the new regulation) and the limits to the generic fund (which are lower under the new regime). The effects of the new regulation on provisioning levels of individual credit institutions will depend on the specific characteristics of their loan portfolios. On impact, however, the new regulation is expected to release provisions for the system as a whole, as a result of the combined effects of the reduction in the cap on the generic fund, and the large amount of provisions accumulated in the system.

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<sup>20</sup> Source: Bank of Spain Circulars 9/1999 and 4/2004.

## STRESS TESTS FOR CREDIT INSTITUTIONS AND THE INSURANCE SECTOR

### Credit Institutions

225. **In coordination with the FSAP team, the BE and a group of systemically important credit institutions carried out several stress test exercises.**<sup>21</sup> The stress tests were designed to assess the resilience of the banking system to key risk factors, and covered market risks, interest rate risk, credit risk, and liquidity risk.<sup>22</sup> A variety of techniques were used, including sensitivity analysis to single and combined risk factors, and scenario analysis. The scenario analysis considered four adverse cases: (a) an increase in oil prices to US\$80 per barrel; (b) a two-year cumulative drop in real house prices in Spain and the United Kingdom, by 21 and 28 percent, respectively; (c) a 30-percent depreciation of the U.S. dollar against other currencies; and (d) a crisis in Latin America, which entailed a political crisis in a key country, transmitted to other countries in the region (to which Spanish banks are exposed) via turmoil in capital markets and international contagion.<sup>23</sup> Cross-sector risks were assessed through parallel stress tests on a sample of insurance companies, and the results added to those of their related credit institutions.

226. **Core stress tests were conducted by a sample of systemically important credit institutions using their own internal models (bottom-up approach), while applying the same methods and shocks.** The sample covered the seven largest financial groups, comprising 37 institutions and roughly two-thirds of system assets. These banking groups have been identified as candidates for the implementation of IRB models under Basel II, and involve all the risks arising from the overseas exposures and the bulk of market risks in foreign currencies.

227. **Complementary stress tests on key sources of risk were conducted by the authorities and the FSAP team for credit institutions as a group (top-down approach).** These exercises covered credit risk, liquidity risk, and equity-price risk in the banking book. Emphasis was placed on the assessment of risks associated with credit institutions' exposures to the domestic housing market.

228. **Equity price risk from industrial participations held in not-for-sale portfolios by the larger credit institutions was found to be sizeable but not a threat to capital adequacy due to large unrealized capital gains.** An exercise based on a sample of 19 credit institutions representing roughly 80 percent of system assets, indicated that a 30-percent decline of equity prices would generate losses equivalent to 8.6 percent of regulatory capital (14.3 percent for the sampled savings banks). Large unrealized capital gains at current market prices in most systemically important credit institutions offer a margin against an

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<sup>21</sup> For comparability with other FSAPs, the impact of the stress tests on solvency was measured against the Basel definition of own resources, which includes the resources accumulated in the statistical fund (these resources do not count as own resources under Spanish solvency regulations). Similarly, the impact of the stress tests on after-tax profits does not take into account the buffer effect of the statistical provisions.

<sup>22</sup> Shocks to interest rates, exchange rates, and equity prices and those resulting from the adverse scenarios are shown in Table 14.

<sup>23</sup> A drop in house prices in the U.K. and a crisis in Latin America were chosen as adverse events that could affect Spanish banks, given their large presence in these markets.

eventual decline in equity prices. Nevertheless, six banks and four savings banks jointly accounting for 37 percent of assets in the sampled institutions would incur a net loss, even after taking into account unrealized gains, with an average impact of 5.4 percent of regulatory capital (13.3 percent in the worst case) (Table 6). Equity price risk in the trading portfolios was negligible because of their small size.

229. **Credit risk was found to be important for some credit institutions, but did not seem to pose a threat to capital adequacy.** Sensitivity analysis for credit risk based on an increase of the probabilities of default (PDs) of mortgage and commercial loans by 200 and 100 percent, respectively, from their end-2004 levels indicated that all of the systemically important credit institutions would be able to absorb the losses without falling below the required minimum 8 percent Basel CAR. A more severe scenario of sustained deterioration in credit quality during a three-year window was also considered, exploiting information on loan quality during the economic downturn of the early 1990s. Shocks to the PDs of specific portfolio categories were set to their average values during 1992-2004 plus two standard deviations, and losses given default (LGDs) were stressed to capture their typical deterioration during the downturn of the cycle.<sup>24</sup> resulted in average losses equivalent to 13 percent of Basel regulatory capital. Such a shock would result in a decline in the average CAR of a sample of the larger CIs, from 12.7 percent at end-2004 to 11.0 percent. Four credit institutions representing 5 percent of system assets would see their CARs drop to around 7 percent.

230. **Estimates of credit risk associated with the scenarios showed that the system would also be resilient to falling house prices, rising oil price, depreciation of the U.S. dollar and a crisis in Latin America.** Among these estimates, the largest effect would come from a drop in house prices in Spain, as assessed by the FSAP team using dynamic panel models. Average estimated losses would be equivalent to 11 percent of CAR with a maximum of 27.4 percent. The effects were generally larger for the savings banks, reflecting their relatively larger exposures to mortgages and construction loans. The losses associated with an oil price increase would average less than 7 percent of regulatory capital and those with a depreciation of the U.S. dollar 5 percent of regulatory capital. Losses estimated by the participating credit institutions and BE in the event of a crisis in Latin America were less than 1 percent of regulatory capital.

231. **Liquidity risk was found to be small and the large credit institutions have a well-diversified pool of funding sources.** An exercise to assess liquidity risk at the system level indicated that all maturing liabilities within a month plus 20 percent of demand deposits can be covered by projected sources of funds and available fixed income securities, while

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<sup>24</sup> For mortgages, the exercise entailed an increase in the PDs from 0.5 percent (the point-in-time estimate in 2004) to 6.3 percent at the end of the three-year window. For commercial loans, it entailed an increase in the PDs from 1.8 to 8.9 percent over the same period. The stressed PDs were comparable to the levels observed in Spain in 1993, and below the peak levels used in a simulation exercise for an average EU bank, conducted by the ECB in 2004 (European Central Bank, Occasional Paper No. 13, April 2004). The exercise also used stressed LGDs of 10 and 45 percent for mortgage and commercial loans, respectively.

variable income securities provide an additional cushion. In addition, an innovative exercise designed by Bank of Spain indicated that the systemically important credit institutions have in place contingency liquidity plans that would allow them to cope with a withdrawal of 39 percent of their maturing time deposits and 10 percent of their demand deposits within a month, without cutting back their normal operations, even if they were to lose access to the interbank market. For some of those institutions, however, the contingency plans relied heavily on the issuance of covered bonds, a strategy that could entail risks should market sentiment or liquidity conditions deteriorate on a more systemic basis, especially given Spain's increasing dependence on capital inflows, the size of the current account deficit, and views about the behavior of the housing market in Spain.

**232. Market risks for the systemically important credit institutions were negligible, reflecting the small size of their trading portfolios and the active use of risk limits and controls by the large credit institutions.** (On average, the trading portfolios of the participating credit institutions amounted to about 6 percent of their assets.) Most credit institutions have hedged their interest rate and exchange rate risk. Interest rate risk in the entire positions of systemically important credit institutions was also found to be small, in part reflecting the predominance of loans at floating rates.

### **Insurance sector**

**233. Stress tests within the insurance sector, conducted by 27 insurers, covering 50 percent of the non-life market and 62 percent of the life market, showed that the system is resilient to a wide range of shocks.** Nevertheless, there were differences between life, non-life, and mixed insurers:<sup>25</sup>

- The first set of stress tests incorporated shocks similar to those applied to credit institutions. For the sector as a whole, the largest impact would come from a fall in real estate prices of 17 percent, which would reduce insurers' capital (i.e., shareholders' equity) by 5.6 percent. For life insurers, the largest impact would come from a downward parallel shift of the yield curve by 200 basis points, which would reduce capital by 25 percent. For non-life insurers, the largest impact would come from a parallel shift upward of 200 basis points in the yield curve, which would reduce capital by 10 percent (a large share of assets is in fixed-income securities, such as treasury bonds). For mixed insurance companies, the real estate shock would have the greatest impact on capital.

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<sup>25</sup> The stress testing followed an approach similar to that of the Preparatory Field Study (PFS) proposed by the Committee of European Insurance Supervisors (CEIOPS) in preparation of the new solvency standard for European insurance, "Solvency II." Prior to the stress test, a fair value estimation of assets and liabilities resulted in an increase of 82 percent in net assets for the whole industry, with individual institutions in the range of a 360-percent increase to an 8-percent increase. The revaluation of real estate assets had the largest impact on the increase of net assets.

- The second set of stress tests dealt with insurance-specific risk factors. For the sector as a whole, the largest impact on capital (a decrease of 4 percent) would come from underwriting risk (a 15-percent shock to mortality or survival rates). For life insurers, the largest impact on capital (a decrease of 18 percent) would result from an increase of 15 percent in the mortality rates. For non-life insurers, the largest impact on capital (a decrease of 7.3 percent) would result from a 10-percent increase in the average claim in the case of “mass events.”<sup>26</sup> For mixed insurance companies, the largest impact on capital (a decrease of 1.3 percent) would come from an increase in the average claim for peak events.

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<sup>26</sup> “Mass events” refer to those risks that are high-frequency but entail small claims.

Table 14. Spain: Stress Tests for Credit Institutions, Sizes of Shocks

Risk factors	Size of the shock
Market risks (applied to the trading portfolios only) 1/	
Interest rates (euro, U.S. dollar, and British pound exposures)	
Interest rate increase; negative tilt	short : 100 b.p.; long: 30 b.p.
Interest rate increase; positive tilt (*)	short : 30 b.p.; long: 100 b.p.
Interest rate decrease; negative tilt	short : -30 b.p.; long: -100 b.p.
Interest rate decrease; positive tilt	short : -100 b.p.; long: -30 b.p.
Increase in volatility of short-term interest rates	25 b.p.
Increase in volatility of long-term interest rates 2/	15 b.p.
Increase in corporate bond spreads 3/	15 b.p. to 300 b.p.
Equity price	
Across the board drop in equity prices (*)	-30 percent
Increase in the volatility of market indexes	200 b.p.
Exchange rate	
Appreciation 10 percent U.S. dollar/euro	-10 percent
Depreciation 10 percent U.S. dollar/euro	10 percent
Appreciation 7 percent British pound/euro	-7 percent
Depreciation 7 percent British pound/euro	7 percent
Increase in the volatility U.S. dollar/euro	170 b.p.
Increase in the volatility British pound/euro	120 b.p.
Interest rate risk (applied to all asset and liabilities) 4/	
Parallel increase in the euro yield curve	200 b.p.
Parallel decrease in the euro yield curve	-200 b.p.
Increase and positive tilt in the yield curve 5/	3 years: 50 b.p.; 10 years: 100 b.p.
Decrease and negative tilt in the yield curve 5/	3 years: -51 b.p.; 10 years: -100 b.p.
Credit risk	
Exercise 1: Increase in PDs	
Commercial loans (PDs; LGDs)	3.54; 25
Mortgage loans (PDs; LGDs)	1.77; 5
Exercise 2: increase in PDs and LGDs	
Commercial loans (PDs; LGDs)	3.54; 45
Mortgage loans (PDs; LGDs)	1.77; 10
Exercise 3: three-year deterioration in credit quality	
Commercial loans (PDs; LGDs)	8.86; 45
Mortgage loans (PDs; LGDs)	6.31; 10
Scenario analysis	
Dollar depreciation (permanent depreciation of the US dollar)	30 percent
Oil price increase (permanent increase in oil prices)	US\$80 per barrel
Drop in house prices (Two-year cumulative drop in real terms)	21 percent in Spain; 28 percent in the U.K.
Crisis in key Latin American countries (combination of:)	
Permanent increase in the country risk premium	400 b.p. to 800 b.p.
Depreciation of the equilibrium exchange rate	20 to 30 percent
Increase in the exchange rate risk premium	150 b.p. to 800 b.p.
Permanent drop in capital inflows	50 percent
Gradual reduction in external competitiveness	25 to 30 percent

Sources: Bank of Spain, and IMF staff estimates.

Sensitivity analysis to multiple risk factors was also considered, entailing a combination of the shocks marked with (\*).

1/ Applied to trading portfolios (i.e., actively traded assets and liabilities).

2/ For British pound exposures, the shock to volatility of long term interest rates was set to 25 b.p.

3/ The increase in corporate bond spreads was as follows: 15 b.p. for corporate bonds rated AAA through A; 100 for bonds rated BBB; and 300 b.p. for bonds rated below BBB.

Table 15. Spain: Summary of Stress Test Results for Credit Institutions 1/  
(In percent)

	Average CAR before shock 6/	Loss in percent of regulatory capital		CAR after shock		Loss in percent of after-tax profits 7/	
		Average	Worst	Average	Worst	Average	Worst
Equity risk in the banking book							
Drop in equity prices 30 percent 2/	12.3	-5.4	-13.3	11.6	10.1	-66.0	-379.3
Commercial banks	12.1	-4.6	-6.8	11.6	10.1	-31.7	-194.3
Savings banks	12.8	-9.4	-13.3	11.6	10.7	-235.6	-379.3
VaR approach 3/	12.7	-8.2	-24.1	11.7	8.2	-88.0	-250.4
Commercial banks	12.6	-5.6	-8.2	11.9	9.9	-57.1	-116.1
Savings banks	12.8	-13.3	-24.1	11.2	8.2	-147.2	-250.4
Credit risk: sensitivity analysis							
Exercise 1: stressed PDs							
Participating CIs	12.7	-1.5	-5.1	12.5	9.5	-17.4	-59.2
Entire system	11.6	-1.5	...	11.4	...	-16.1	...
Exercise 2: stressed PDs and LGDs							
Total sample	12.7	-4.1	-7.8	12.2	8.6	-53.0	-68.7
Commercial banks	12.6	-3.8	-7.8	12.2	8.6	-47.9	-7.4
Savings banks	12.8	-4.7	-6.5	12.2	9.0	-60.2	-80.1
Exercise 3: three-year deterioration in credit quality							
Total sample	12.7	-13.0	-26.5	11.0	7.1	-166.1	-273.0
Commercial banks	12.6	-11.8	-20.9	11.1	7.1	-150.0	-256.0
Savings banks	12.8	-14.8	-24.0	10.9	7.4	-190.2	-264.0
Scenario analysis							
Participating CIs 4/							
Dollar depreciation	12.7	-4.6	-24.5	12.1	9.6	-8.3	-41.8
Oil price increase	12.7	0.4	-5.3	12.8	12.0	1.0	-7.1
Drop in house prices	12.7	-2.3	-11.3	12.4	11.2	-4.9	-8.3
Crisis in Latin America	12.7	-0.7	...	12.6	...	-11.6	...
Total system 4/							
Dollar depreciation	11.6	-1.8	...	11.4	...	-14.2	...
Oil price increase	11.6	0.5	...	11.7	...	8.2	...
Drop in house prices	11.6	-0.6	...	11.5	...	-2.9	...
Crisis in Latin America	11.6	-0.4	...	11.5	...	-7.5	...
Total sample (based on dynamic panel models)							
Baseline	12.7	-1.9	-4.9	12.5	9.9	-12.1	-89.0
Dollar depreciation 4/	12.7	-3.0	-6.6	-0.4	-0.4	-19.1	-120.3
Oil price increase 4/	12.7	-4.7	-10.4	-0.6	-0.7	-29.8	-188.6
Drop in house prices 4/	12.7	-9.1	-22.4	-1.2	-1.4	-58.1	-370.5
Selected market risks (applied to trading portfolios only)							
Interest rate increase (euro) short: 100 b.p.; long: 30 b.p.	12.7	-0.1	-0.1	12.7	10.1	-0.5	-0.8
Increase in corporate bond spreads 15 b.p. to 300 b.p.	12.7	-0.1	-0.3	12.7	10.1	-0.6	-1.7
Multiple factors 5/	12.7	-0.1	-1.4	12.7	10.0	-0.8	-15.7
Interest rate risk (applied to all assets and liabilities)							
Parallel decrease in yield curve -200 b.p.	12.7	-2.8	-6.2	12.3	9.4	...	...
Decrease negative tilt: -50 b.p.; 10 yrs: -100 b.p.	12.7	-1.1	-3.1	12.5	9.8	...	...

Sources: Bank of Spain and staff estimates.

1/ Unless otherwise indicated, the stress tests were applied to a sample of seven banking groups covering 37 credit institutions and roughly two-thirds of system assets ("Participating CIs"), to the entire banking system using aggregate data ("Total system"), and to a sample of 86 credit institutions covering 94 percent of system assets ("Total system").

2/ Applied to 10 credit institutions (roughly one-third of system assets) with insufficient unrealized gains to cover the equity losses implied by the shock to equity prices. Losses are net of unrealized gains on equity investments not marked-to-market.

3/ Applied to the equity portfolios not marked-to-market of a sample of 19 credit institutions covering roughly 80 percent of system assets. Based on a three-month 99.5 percent VaR.

4/ Losses are in deviations from the baseline scenario.

5/ The multiple factor sensitivity included: an increase, positive tilt in interest rates in euro and U.S. dollars (30 b.p.; 100 b.p.), an increase, negative tilt in British pounds (100 b.p.; 30 b.p.), and a 30 percent across-the-board drop in equity prices.

6/ Based on the Basel CAR definition, which includes the statistical provision as part of own resources.

7/ For comparability with other FSAPs, the impact on after-tax profits does not take into account the available statistical provisioning fund, described in Appendix I. If the results took the fund into account, the effect on after-tax profits would be smaller.



Table 16. Spain: Summary of Stress Test Results for Insurance Firms  
(December 2004)  
(In percent)

	Total	Avg.	Std. Dev.	Max.	Min.
<b>All Institutions</b>					
Interest rate risk: Increase in slope	-0.5	-1.1	10.8	27.8	-30.2
Interest rate risk: Decrease in slope	0.7	0.7	13.7	26.1	-45.5
Interest rate risk: Parallel shift out	0.7	-3.2	30.5	79.2	-114.5
Interest rate risk: Parallel shift in	1.3	6.2	38.7	192.0	-115.2
Credit risk	3.0	3.8	7.6	24.6	-13.0
Real satate risk	5.6	3.9	7.5	26.0	-9.2
Underwriting risk	4.0	7.1	15.1	62.2	-14.0
Lapse risk / persistency risk	-1.2	-3.1	8.1	5.0	-27.1
Non life risk (group 1) 1/	0.5	0.1	7.0	11.5	-32.8
Non life risk (group 2, "mass" events ) 2/	1.0	1.2	3.2	11.4	-9.4
Non life risk (group 2, "peak" events ) 3/	1.7	1.6	2.1	6.7	0.0
<b>Life Institutions</b>					
Interest rate risk: Increase in slope	-2.8	-4.5	18.2	27.8	-30.2
Interest rate risk: Decrease in slope	2.7	2.5	23.6	26.1	-45.5
Interest rate risk: Parallel shift out	-8.1	-19.1	43.0	19.4	-114.5
Interest rate risk: Parallel shift in	24.8	32.5	46.3	122.0	-33.1
Credit risk	9.9	7.4	11.6	24.6	-13.0
Real satate risk	3.9	4.2	5.7	13.4	0.0
Underwriting risk	18.2	18.2	23.0	62.2	-14.0
Lapse risk / persistency risk	-3.5	-9.0	12.9	5.0	-27.1
Non life risk (group 1)	0.1	0.0	0.1	0.2	0.0
Non life risk (group 2, "mass" events )	0.0	0.0	0.0	0.0	0.0
Non life risk (group 2, "peak" events )	0.0	0.0	0.0	0.0	0.0
<b>Non life institutions</b>					
Interest rate risk: Increase in slope	4.7	1.3	3.2	7.9	0
Interest rate risk: Decrease in slope	-5.3	-1.5	3.7	0.0	-9.1
Interest rate risk: Parallel shift out	10.0	2.8	6.9	17.0	0.0
Interest rate risk: Parallel shift in	-13.0	-3.7	9.0	0.0	-22.0
Credit risk	1.0	0.6	4.3	6.6	-6.5
Real satate risk	7.1	-0.1	7.7	12.2	-9.2
Underwriting risk	0.0	0.0	0.0	0.0	0.0
Lapse risk / persistency risk	0.0	0.0	0.0	0.0	0.0
Non life risk (group 1)	7.3	3.6	4.1	11.5	0.0
Non life risk (group 2, "mass" events )	4.7	4.6	3.3	11.4	2.4
Non life risk (group 2, "peak" events )	4.6	3.2	2.0	5.7	0.7
<b>Mixed institutions</b>					
Interest rate risk: Increase in slope	-1.3	-0.2	6.7	11.7	-16.7
Interest rate risk: Decrease in slope	2.0	0.6	8.4	18.8	-14.4
Interest rate risk: Parallel shift out	0.5	3.8	26.0	79.2	-34.7
Interest rate risk: Parallel shift in	-1.5	-5.5	36.2	32.3	-115.2
Credit risk	1.5	3.1	5.0	11.8	-2.8
Real satate risk	5.6	5.5	8.1	26.0	0.0
Underwriting risk	0.9	3.5	8.0	15.1	-12.6
Lapse risk / persistency risk	-0.8	-0.8	3.1	4.3	-9.2
Non life risk (group 1)	-1.4	-1.6	9.4	2.8	-32.8
Non life risk (group 2, "mass" events )	0.2	0.3	3.1	3.5	-9.4
Non life risk (group 2, "peak" events )	1.3	1.8	2.2	6.7	0.0

Note: The results are presented in percent of insurer's capital (a positive number indicates a reduction in capital).

1/ Group 1 refers to those claims related to "mass events" (i.e. high frequency but low claims).

2/ Group 2 ("mass events") refers to those risks related to claims under €30,000. Group 2 correspond to marine, aviation and transport; fire; third party motor liability; third party liability; credit; surety; and industrial multi-risks (Group 1 risks are all the nonlife risks not included under Group 2.)

3/ Group 2 ("peak events") refers to those risks related to claims equal to or above €30,000.

### MAIN EQUITY MARKETS AND INSTRUMENTS

234. **Several legal initiatives promote and regulate the development of risk-capital companies (RCCs), but activity is small as yet.** Law 1/1999 established a framework for creation and registration of RCCs within the CNMV. Nevertheless due to fiscal incentives, as of end-2004, the capital managed by RCCs registered with the ASCRI (*Asociación Española de Entidades de Capital Riesgo*) amounted to €9.3 billion (0.1 percent of GDP), while the capital managed by RCCs registered with the CNMV was only €2.5 billion.

235. **Spain has recently approved a code (*reglamento*) complementing Law 35/2003 on Collective Investment Institutions that will allow them to expand their activities.**<sup>27</sup> The new code authorizes CIIs to invest in more financial assets (such as bank deposits or credit derivatives), allows new forms of CIIs to be created (e.g., hedge funds, funds of hedge funds), and puts in place new investor protection measures.

236. ***Bolsas y Mercados Españoles (BME)* is the holding company for the different corporations that run and manage the securities markets.** The BME encompasses the markets for variable-, fixed-income securities, and derivatives, as well as the clearing and settlement systems into a single entity. The BME group consists of the four stock exchanges (Madrid, Barcelona, Bilbao, and Valencia), *MF Mercados Financieros*, *Iberclear*, and *BME Consulting* (see figure below).

237. **By end-2004, BME had consolidated its position as an international financial center.** With a market capitalization of €855 billion at end-2005 (equivalent to 94 percent of Spain's GDP), BME remained Europe's fourth largest stock market, a position it had acquired in 2004. In total share value traded, it ranked seventh in the world (see table below). The Spanish stock market has yielded a return of 241 percent over the last ten years, the highest among the main stock markets in the world.<sup>28</sup> *Latibex* is the BME-owned trading platform for Latin American shares traded in euros. With total market value close to €200 billion, *Latibex* is the third largest stock exchange in Latin American shares, after Brazil and Mexico.

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<sup>27</sup> The code was approved on November 4, 2005. The CNMV published a *circular* on May 3, 2006, which regulates further the activities of hedge funds.

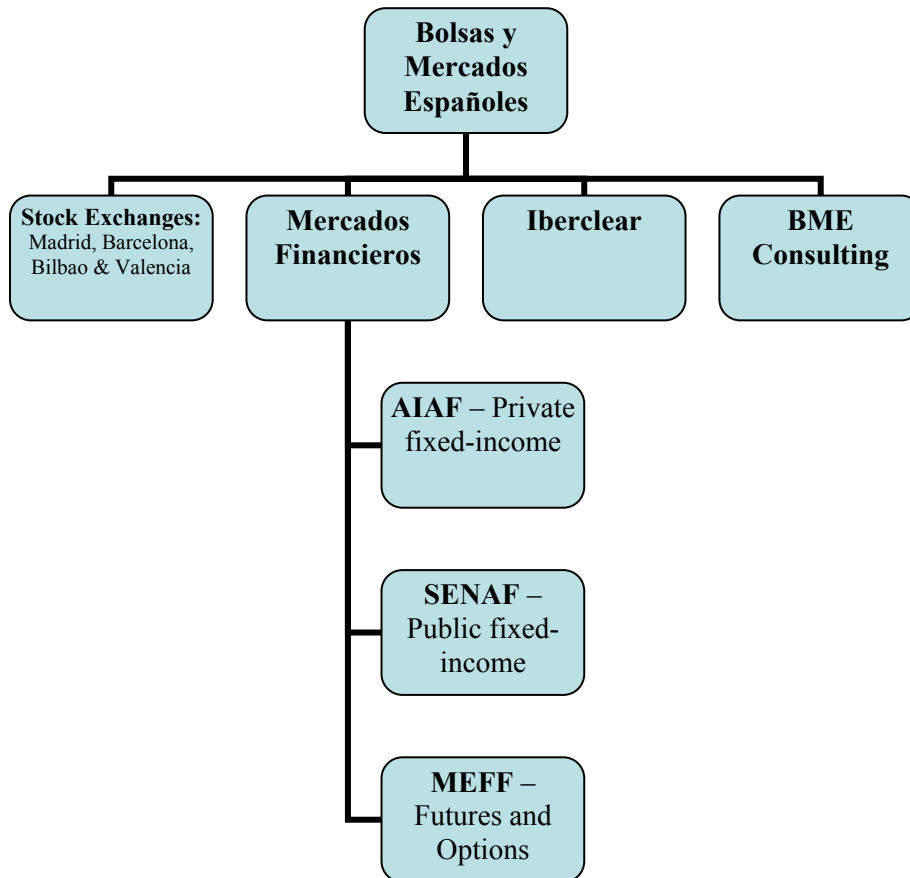
<sup>28</sup> Source: BME press release, September 13, 2005 (BME web site). Data are from Morgan Stanley Capital International.

Top 7 Exchanges by Total Value of Share Trading, 2005  
(In billions of U.S. dollars)

Exchange	Total Value
1. NYSE	14,125
2. Nasdaq Stock Market	10,087
3. London Stock Exchange	5,678
4. Tokyo Stock Exchange	4,482
5. Euronext	2,906
6. Deutsche Boerse	1,915
7. BME Spanish Exchanges	1,566

Source: World Federation of Exchanges.

Figure 6. Overview of BME Holdings



Source: BME.

238. **Several markets and trading platforms deal with non-equity instruments:** *AIAF Mercado de Renta Fija*, the market for private fixed-income instruments provided net financing in 2005 of €134 billion, compared with €9 billion in 2000. Government debt is traded in the *Mercado de Deuda Pública en Anotaciones* (Annotated Public Debt Market) and the electronic platforms MTS and SENAF. In 2004, SENAF created three new market segments: Swatches, Basis, and mortgage bonds. The Market for Financial Futures and Options (MEFF) trades futures and options on bonds, interest rates, the equity index IBEX-35, and equities. Contracts are settled through MEFF's own clearinghouse. MEFF is well established domestically and is expanding its international operations. The bulk of MEFF's activity is concentrated in futures and options on equity and on the IBEX-35 Index, with more than 40 million contracts negotiated during 2005, with total value close to €600 billion. In addition, a Market for Futures on Olive Oil (MFAO) was created in February 2004.