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Spain: The Reform of Spanish Savings Banks Technical Notes

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FINANCIAL SECTOR ASSESSMENT PROGRAM UPDATE

SPAIN

THE REFORM OF SPANISH SAVINGS BANKS

TECHNICAL NOTE

MAY 2012

INTERNATIONAL MONETARY FUND
MONETARY AND CAPITAL MARKETS DEPARTMENT

Contents Page

GLOSSARY

ACs	Autonomous Communities
BdE	Banco de España
CNMV	Comisiòn Nacional del Mercado de Valores
FROB	Fondo de Reestructuracion Ordenada Bancaria
LDI	Law 26/1988, on Discipline and intervention of credit institutions
MoE	Ministerio de Economía y Competitividad
NPLs	Non-performing Loans
RDL	Royal Decree Law
SIP	Sistema Institucional de Protección
SSBs	Spanish Savings Banks

EXECUTIVE SUMMARY

The crisis revealed several weaknesses in the Spanish savings banks (SSBs) framework. Having become universal banks, they expanded their activities across Spain, contributing to the build-up of excess capacity and risk concentration in the system. This might have reflected the representation of a broad variety of stakeholders' interests, including political constituencies, in their decision-making bodies. Being unable to raise capital in the absence of a traditional shareholding structure, SSBs were not subject to typical market discipline mechanisms, and blurred competences between the central government and the autonomous communities (ACs), slowed the intervention process.

Albeit gradually, the authorities took remarkable steps to reform savings banks, accomplishing major progress. A consolidation strategy, aimed at rationalizing the capacity of the SSB system, was pursued initially through the so called "institutional protection schemes", which was designed to provide for mutual solvency and liquidity support among participating entities. Increased capital requirements prompted SSBs to spin-off their banking business into newly created commercial banks that operate under the exclusive supervision of the Banco de España (BdE). Fit and proper requirements and conflict-of-interest rules for SSBs governing bodies were strengthened. Lastly, several SSBs have been intervened and resolved, and the consolidation process reduced the number of institutions from 45 to 11, which is likely to decline even further.

While the emerged institutional framework presents some advantages, further improvements can be identified. Although SSBs no longer perform a banking activity, they retain their legal status as banks. This is a peculiar arrangement, but offers oversight advantages, tighter than for normal shareholders. In this new set-up, however, the financial soundness of SSBs as bank shareholders, which is an important element in assessing the financial soundness of the controlled commercial bank itself, remains unaddressed. Rules may be revisited and adapted to different circumstances and SSBs models. Since SSBs, with their wide range of stakeholders' interests, may continue to exercise dominant or significant influence over commercial banks, governance arrangements could be further improved through a number of measures, aimed at better shielding the ownership function from the management of commercial banks, mitigating conflicts of interest and enhancing transparency and accountability mechanism.

Despite major reforms, the overall strategy for the role of SSBs in the future banking sector may still need to be well thought through. In a systemic crisis environment the reform of the SSBs framework is a moving target. There are, therefore, merits in preserving a well-defined regulatory and oversight framework. The law envisages that SSBs losing their control over banks, or lowering their participation below a certain threshold, would be transformed into foundations. However, complex legal and institutional issues related to the competences of the State and ACs would need to be addressed in such an event. Despite this friction, the need for designing a comprehensive framework for SSB as major or significant shareholders arises. Leaving to the market to decide the faith of the controlled bank and of the shareholder-SSBs through the progressive dilution might not be a smooth and linear process, also taking into account significant resistances from stakeholders which may emerge in such a process. There is the need to govern this transformation process to provide for a sound and reliable framework for the ownership structure of the SSB groups.

In the context of such strategy, consideration could also be given to spelling out certain sound features of SSBs that transform into foundations. The legal framework for "special foundations", although they are mentioned in the recent reforms, has not been developed. Having a comprehensive framework that anticipates the main features regarding a (transformed) foundation still holding significant shares in a bank may enhance preparedness and stability should such a transformation occur. This would also provide sound and coherent principles governing the role of those "special foundations" in the governance of banks. Given the current institutional division of competence between the State and the AC over foundations, the authorities could consider whether financial stability could be the legal basis for providing harmonized principles of such framework at the State level.

Table 1. Spain FSAP Update: Main Recommendations

Recommendations and Authority Responsible for Implementation	Priority	Timeframe
Further improve the SSBs framework to enhance rules on financial strength of SSBs as shareholders, governance arrangements, and transparency and accountability mechanisms, in particular by: • Improving clarity and disclosure toward third parties about the financial regulatory requirements applying to SSBs. • Streamlining the governance structure of SSBs. • Introducing incompatibility requirements regarding SSBs and commercial banks' governing bodies. • Tightening conflict-of-interest rules for representatives in SSBs governing bodies. • Enhancing fit and proper requirements for SSBs governing bodies. • Introducing independent members in SSBs governing bodies. • Revisiting rules on the appointment process to mitigate undue political interference in SSBs governing bodies. • Requiring disclosure of Sistema Institucional de Protección (SIPs) among SSBs. • Updating required contents of corporate governance report to take into account the new role of SSBs as major shareholders.	Medium	12 months
Devise a law for SSBs as a major or significant shareholder, providing for basic features at the State level that include: • Governance rules on the foundations' governing bodies and on the relationship between foundations as significant shareholders and commercial banks. • Investment criteria and related disclosure and monitoring mechanisms. • A tailored supervisory framework.	Medium	12/18 months

THE REFORM OF THE SPANISH SAVINGS BANKS[1]

1. **In the last two years the landscape of the SSB has been fundamentally reshaped.** The number of institutions has been reduced through mergers, acquisitions, and interventions. With the exception of two small institutions, the SSBs have transferred their banking business to newly formed commercial banks, in exchange for controlling shares in such banks and thus separating the banking business from their social activities.

2. **This technical note is organized as follows.** Section I provides a brief overview of the SSB institutional framework before the reform. Section II describes the main factors that led to the financial distress, albeit uneven, of the SSB sector. Section III outlines major regulatory and institutional reforms of SSBs. While Section IV evaluates the main achievements of the reforms to date. Section V consider improvements to the current framework and potential developments in the SSB institutional framework.

I. SPANISH SAVINGS BANKS BEFORE THE REFORM: A BRIEF OVERVIEW

3. **Historically, savings banks (or *cajas de ahorros*) have represented a fundamental pillar of the Spanish banking system.** The origin of savings banks can be found in the old thrift institutions (*Montes de Piedad*) from the 18th century, whose main objective was to channel people's savings toward investments and to perform a social task in their respective territories.

4. **The SSBs evolved into financial institutions that do not distribute profits, with no formal owner and pursuing a wide array of competing (if not conflicting) goals, including the fulfillment of social functions**. By law, SSBs must pursue a wide array of goals:[2]

- Promote savings among the popular classes and prevent their exclusion from the financial system.
- Maximize the value of the institution and strengthen its financial soundness.
- Enhance competition and avoid abuse of monopoly, that is, obtain better conditions and lower prices for customers (a modernized version of the traditional objective of fighting usury which was at the core of savings banks' origins).
- Provide services with a charitable or social-cultural character to the community.
- Contribute to regional development, that is, generate social externalities that the private sector does not provide.

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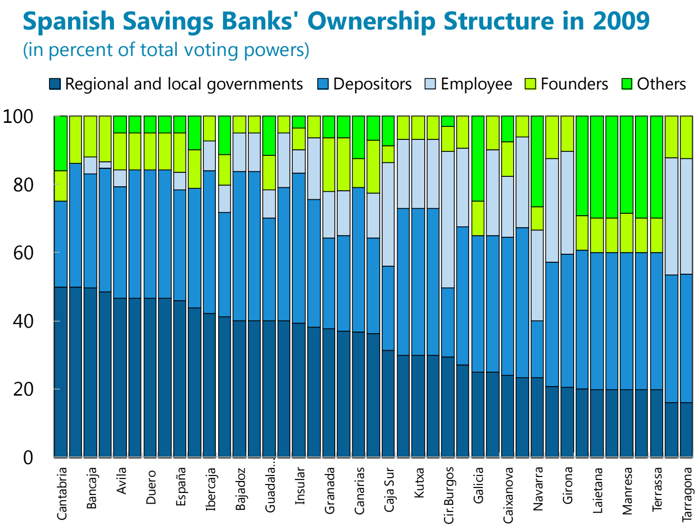
[1] Prepared by A. Giustiniani, and A. Gullo (LEG).

[2] See, García-Cestona and Surroca (2008).

5. **As SSBs do not have any share capital, their ability to raise external equity capital has been limited.** Their equity consists mainly of reserves generated through retained earnings. Until recent reforms, SSBs were required to allocate at least half of their profits to reserves, while the remainder was channeled back into the community toward projects that fall under their social mandate (*obra social*). The capital instruments available to savings banks were the *cuotas participativas* (in essence non-voting equity securities), the *participación preferente*, and subordinated debt. Although the difference between the first two instruments was somewhat blurred, there have been very few issues of *cuotas participativas* due to a number of constraints on the holding and issuance of such securities that reduced the attractiveness for external investors.[3]

6. **In the absence of shareholders, control exercised over SSBs is not coupled by legal ownership of shares, and therefore SSBs' corporate governance model differs considerably from that of a commercial bank.** The SSBs' governing bodies consisted of a General Assembly, a Board of Directors and a Control Committee—the latter having to report to the General Assembly and not to the Board of Directors—whose members were representatives of the different stakeholders, which could be classified in two broad categories: "insiders" (employees, depositors, and private founders) and "outsiders" (local and regional governments and public founders). The relative voting powers of the different stakeholders varied depending on the specific regional law, but the national law spelled out certain general principles.[4] Further to legal changes made in the early 2000s, the representation of the founding entities and public entities was capped at 50 percent of the voting rights in each of the bodies; the deposit-holders' representation could range between



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[3] See, IMF (2006). SSBs could not issue *cuotas participativas* in excess of 50 percent of the value of their equity capital, and no individual investor could acquire more than 5 percent of the securities issued, thereby limiting external investors to holding no more than 2.5 percent of a SSB's equity. These limits and the absence of voting rights for holders of *cuotas participativas* did not allow investors to have a say on the governance of the institutions, and prevented their take-over.

[4] The Spanish Constitutional Court declared unconstitutional the distribution of voting rights that was established in the national law passed in 1985. This gave rise to specific regional laws that introduced greater heterogeneity across regions.

25 and 50 percent, whereas between 5 and 15 percent of the voting rights of each body were reserved to the employees.

7. **The allocation of responsibilities in the regulation and supervision of SSBs was grounded on a delicate balance between central and local powers.** Within the general principles dictated at the State level, the central government and the BdE, on one hand, and by the local governments (or ACs), on the other hand, shared, regulatory and supervisory powers over SSBs. In broad terms, the BdE, as banking supervisor, retained the exercise of powers over financial stability aspects related to solvency, liquidity, risk limits, provisions, and accounting, while the ACs exercised their competence rather on corporate governance, consumer protection issues, and reporting requirements. Mergers among SSBs also needed to be approved by the ACs. The central government had responsibilities in the issuance of sanctions such as revocations of licenses, performed in cooperation with the BdE

II. From Boom to Crisis

8. **The deregulation of Spanish financial markets started in mid-1970s, which changed the business model of SSBs.** SSBs were allowed to carry out universal banking activities, compulsory direct lending coefficients were gradually lifted (although not fully abolished until 1992), and branching barriers were removed in steps until they were completely eliminated in 1988.

9. **SSBs gradually reduced their regional specificity, expanded their range of activities, and became solid competitors to commercial banks.** Many SSBs strengthened their national presence, as illustrated by the increasing trend in the number of employees and branches. The market share of SSBs, measured in terms of total assets, steadily increased; from around 20 percent in 1980s to 40 percent in 2010. This aggressive expansion went hand in hand with growing lending to construction companies, real estate developers, and to households for mortgages, which was increasingly financed by tapping the wholesale market. As a result, SSBs' share of total assets funded by domestic deposits (public and private sector, excluding credit institutions) trended downward from over 80 percent in the early 1980s to 64 percent in 2010.

10. **The other side of the coin has been the build-up of excess capacity in the system.** As of end-2009, there was almost one branch for every 1,000 inhabitants in Spain, almost twice the density of the euro-area average. The extreme capillary of the branch network was reflected by the low number of employees per branch compared with other European banking systems (Figure 1). In particular, SSBs—which from the '80s were allowed to expand beyond their home regions—did not compare favorably in terms of assets-per-employee with euro-area average.[5]

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[5] See IMF (2011).

11. **Some institutional features of SSBs may have had a bearing on the SSB's business activity.** For instance:

- The relative importance of "insiders" or "outsiders" in the stakeholders-model may have affected the SSBs' objectives. In theory, while the insiders would tend to focus on growth and value maximization in order to preserve their jobs, the outsiders would be more concerned to achieve the social-oriented goals (universal access to financial services, contribution to regional development, competition enhancement and avoidance of monopoly abuse). Empirical evidence shows that when SSBs increased their size, the economic goals (profit maximization) gained in importance (particularly for those SSBs in which "insider" stakeholders had more relevance).[6]
- Political influence may have affected performance.[7] SSBs are characterized by a significant involvement of local governments and political parties. An inherent conflict exists between the public sector as regulator and the presence of public stakeholders in SSB model. This may have had a bearing on several aspects of SSB's business activity, for instance geographic expansion – SSBs were more likely to open new branches and extend new loans in provinces that were politically "close."[8] SSB mergers across regions have proved to be quite difficult since they ought to be approved by the respective ACs, which need to agree on the distribution of the public sector representatives in the governing bodies of the new entity. Empirical evidence shows that SSBs whose chairman was previously a political appointee and, in many cases, lacking proper banking experience, have had significantly worse performance.[9]

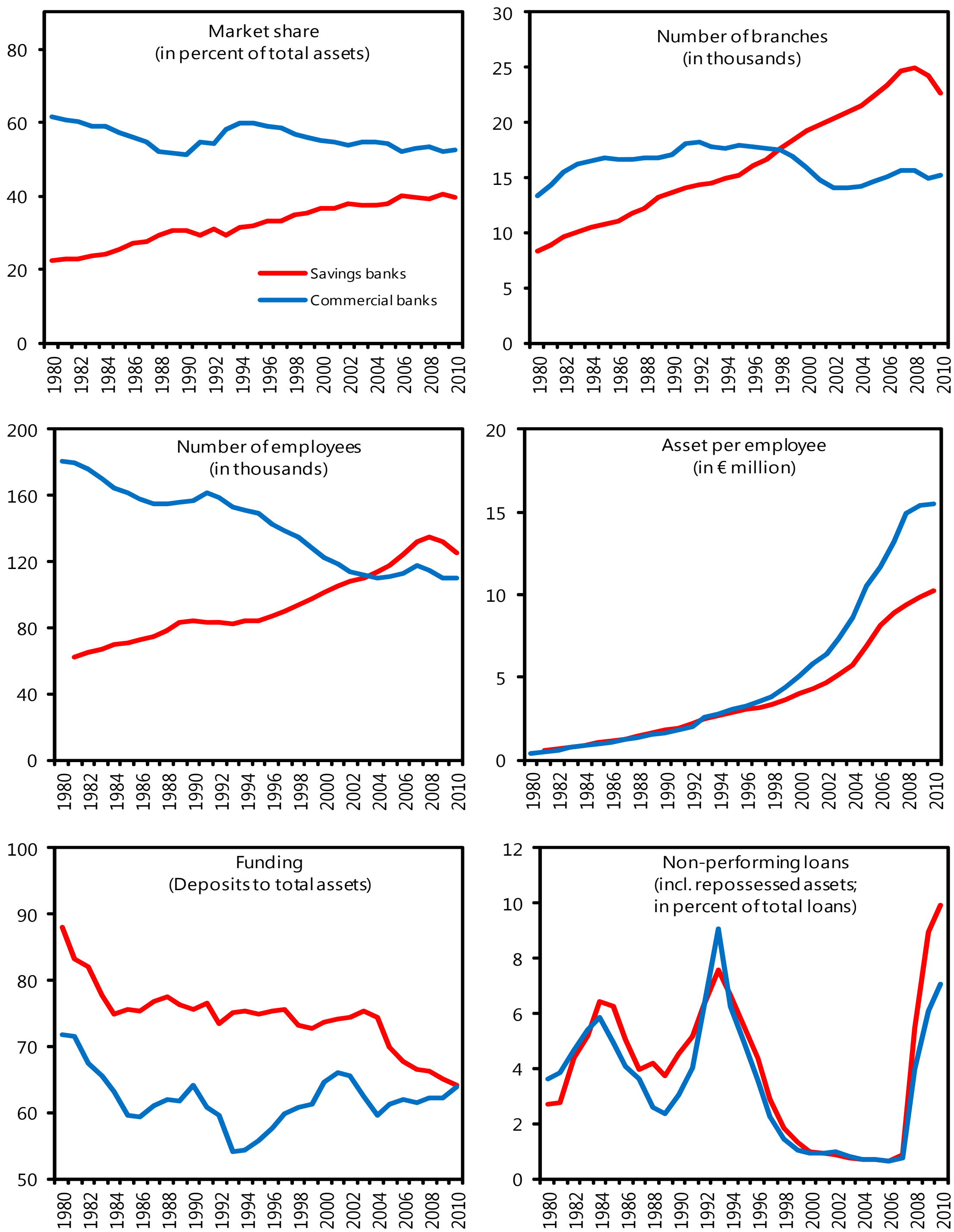
[6] See, García-Cestona and Surroca (2008).

[7] The literature that compared Spanish commercial and savings banks' behavior did not find robust evidence to corroborate the view that the peculiar ownership and corporate governance structure of the latter institution affected their business and risk-taking decisions as well as performance. Strong competition in the Spanish banking system was considered a crucial disciplinary device. See, for instance, Pastor (1995), Grifell-Tatjé and Lovell (1997), Lozano (1988), Salas and Saurina (2002) Crespí, García-Cestona, and Salas (2004), García-Marco and Robles-Fernández (2007).

[8] See, Illueca, Norden, and Udell (2008).

[9] See, Cuñat and Garicano (2009).

Figure 1. Spain: Savings vs. Commercial Banks, 1980-2010



Sources: Banco de España; and IMF staff estimates.

12. **Despite the traditional retail-oriented business model and forward-looking prudential regulation, the Spanish banking sector came under pressure with the unfolding of the crisis.** The dislocation of wholesale credit markets together with the burst of the real estate bubble and the sharp economic downturn triggered a rapid de-leveraging and risk re-pricing by Spanish banks. Credit growth collapsed. Given their large exposure to the real estate sector, SSB's nonperforming loans (NPLs) soared reaching almost 10 percent of gross loans as of end-2010,[10] compared to about 1 percent in 2007. SSB's loan-loss-provision buffers, although buttressed by counter-cyclical mechanisms, were rapidly eroded, declining from almost 100 percent in 2007 to about 40 percent in 2010.

13. **The limited ability to raise equity capital together with the prospect of more demanding Basel III capital requirements further complicated the situation for the SSBs**. The deterioration of the operating environment and the increasing losses on the real estate portfolio reduced the SSB's capital generation capacity. New international capital standards, which put greater emphasis on equity capital and tighten asset risk weighing, represented an additional challenge for the SSBs' model.

14. **Against this backdrop, the need to restructure the sector became evident.** The capacity of the SSB system, in terms of branches and employees, needed to be rationalized. Capital and provision buffers needed to be strengthened, and the SSBs had to adopt a corporate governance structure necessary to retain or attract the confidence of third-party investors.

III. From Savings Banks to (Indirect) Commercial Banks

15. **To restructure the SSB sector, the Spanish authorities followed a gradualist, step-wise approach.** The main objective of the reform has been to promote the consolidation of the SSB sector through mergers or other integration processes, and in case of non-viable institutions through their intervention and absorption by a stronger entity. In principle, the consolidation process was expected to generate economies of scale thereby improving SSBs' cost-efficiency and restoring their capital generation capacity. However, the strategy, at least in a first phase, did not aim at fundamentally changing the basic model of SSBs.[11]

16. **To support the necessary consolidation process, the authorities launched the *Fondo de Reestructuración Ordenada Bancaria* (FROB) in June 2009.**[12] One of the main goals of the FROB has been to encourage an orderly consolidation of the Spanish banking

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[10] The figure includes an estimate of repossessed real estate assets.

[11] Fernández Ordóñez (2012).

[12] Royal-Decree Law (RDL) 9/2009.

industry by, inter alia, strengthening the capital buffers of credit institution involved in the integration-cum-restructuring process.[13]

17. **With a view at pursuing such consolidation strategy, several SSBs entered into SIPs, governed by a June 2010 law.**[14] The SIP could be defined as a contractual agreement created with the aim of protecting and improving the liquidity and solvency of participating institutions, which remained separated legal entities. The SIP was structured on three basic pillars:[15]

- The relinquishing by all participants to the central body of the SIP (a newly established bank, controlled by the participant savings banks) of the capacity to determine and implement business strategies and internal risk control and management tools, in such a way that this central body was expected to become the core center of the group, also responsible for the fulfillment of the regulatory requirements on a consolidated basis.[16]
- The mutual liquidity and solvency pacts between the participating savings banks and the pooling of results, to an extent not lower than 40 percent of the respective resources.
- The commitment to stability of the agreements, which should last for a minimum term of 10 years, and which could not be broken without the BdE first analyzing the viability of the various institutions resulting from the fragmentation process.

18. **In July 2010 the SSBs' legal framework was fundamentally reformed, leaving to the SSB different options on how to carry out their business activity.**[17] In particular,

- The SSB's capacity to raise capital was improved by amending some features of *cuotas participativas* that had curbed investors' appetite. Voting rights were granted to this type of securities and the individual holding limit of 5 percent was removed,

[13] See, IMF (2012).

[14] RDL 6/2010.

[15] Aríztegui (2010).

[16] In practice, however, the SIP mechanism showed some important weaknesses. Although it was devised to avoid political resistance against cross-region mergers (since participating institutions would have remained separated legal entities), some ACs legislated so as to retain their veto powers on the participation of savings banks to SIPs. Furthermore, the organization of SIPs proved to be complicated particularly as far as the scope of functions and business activities to be transferred to the newly formed central entity of the group was concerned: in substance, such entity was acting as the parent company, directing the group, while remaining formally controlled by the SSBs. Uncertainties regarding consolidation perimeter and tax regime caused additional difficulties.

[17] RDL 11/2010.

while the overall issuance limit of 50 percent of a SSB's capital was retained. However, no significant issuances followed.

- The governing bodies of the SSBs were reformed and professionalized, in line with the principles underlying commercial banks' corporate governance. The ceiling on voting rights of public entities was reduced from 50 to 40 percent.[18] General fit and proper criteria for representatives of regional government were established. Elected political representatives were prohibited from serving in the governing bodies and a cooling-off period of two years was introduced in case the representative took decisions regarding SSBs while in his/her office. To enhance internal check-and-balance and risk management, other functions of the SSBs governance structure - the general manager, the investment committee, the compensation and appointment committee, and the welfare project committee, were reformed.[19] The required commercial and professional expertise and integrity of SSB's governing bodies were tightened, although this requirement did not apply to all the Board members but only to at least the majority of them.

- In addition to SIPs, two new corporate models for SSBs were introduced:

  - the indirect performance of financial activities through a commercial bank to which SSBs transfer all their financial operations (this option was open to individual SSBs or group of SSBs forming a SIP);

  - the transformation of a SSB into a "special foundation" by transferring its business to another credit institution. This transformation would be compulsory when a SSB ceases to have a significant stake, either alone or jointly with other SSBs under a SIP, in the entity through which it performs its banking activity or should it be intervened under the Law 26/1988 on Discipline and Intervention of Credit Institutions (LDI).[20]

19. **In February 2011, the introduction of new capital requirements and the reform of the FROB provided further impulse to the reshaping of the SSBs model.** Banks were required to comply, by end-September 2011, with a "principal capital" of at least 8 percent of total risk-weighted assets.[21] This minimum threshold was set equal to 10 percent for credit

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[18] The representation ranges for the other stakeholders remained unchanged.

[19] For SSBs performing their banking business indirectly through commercial banks, the governing body will be only the General Assembly, the Board of Directors and, optionally, the Control Committee.

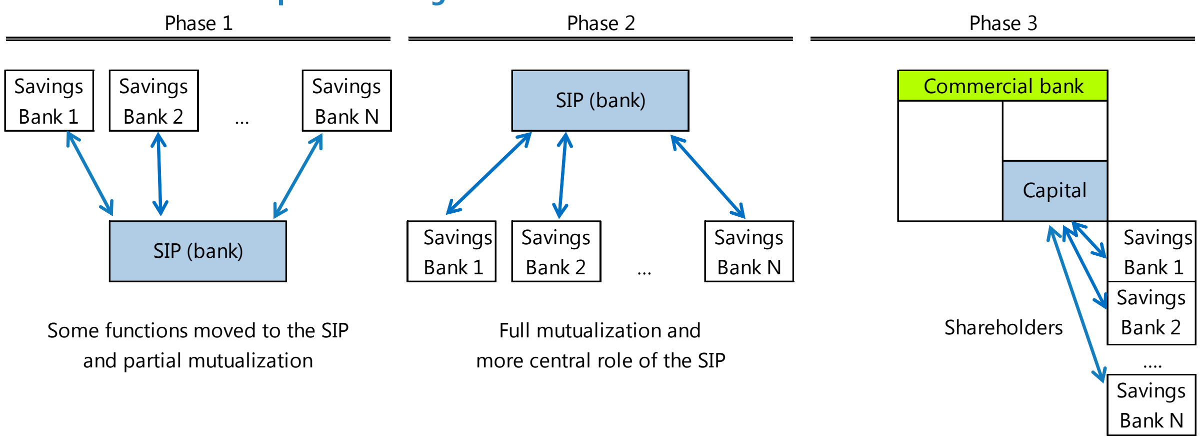
[20] Originally, the RDL set a threshold of 50 percent of the voting power, below which a SSB was supposed to be transformed into a "special foundation." Subsequently the law was amended to make specific reference to the concept of "control", as defined in the commercial law, and the threshold was lowered to 25 percent.

[21] RDL 2/2011. The "capital principal" is considered a step toward the Basel III Common Equity capital definition, but will need to be further adjusted when Basel III is implemented. Capital principal is similar to the capital predominante (common equity plus reserves, minus losses, intangibles and own shares), but includes the

(continued)

institutions excessively relying on wholesale funding (more than 20 percent of total funding) and with limited equity holding (less than 20 percent) by the private sector. If capital could not be raised through the market, the FROB would have acted as a backstop by purchasing equity share capital in the institutions requesting support. Both these measures prompted almost all the SSBs, acting alone or under SIPs, to spin off their banking into newly created commercial banks. Two of the new credit institutions (Banca Civica and Bankia) carried out their initial public offering in July 2011.

Spanish Savings Banks: From SIPs to Commercial Banks



20. **The legal framework for SSB was further modified by the decree on the cleaning up of banks' balance sheet in February 2012.**[22] In particular, the law reaffirmed that the governing bodies of SSBs carrying out their banking business indirectly are the General Assembly, the Executive Board and, on a voluntary basis, the Control Committee. The RDL 2/2012 encouraged AC to streamline the size of these bodies in line with the limited scope of activities of the SSBs, spelling out some rules of general applicability. It also established that the SSB cannot devote more than 10 percent of its profits to expenses other than social works. Finally, it was specified that an SSBs ought to be converted into a "special foundation" if it loses control of the commercial bank or in any event if its share of voting powers falls below 25 percent even though the application of the two criteria may not bring a coherent outcome, as control could exist even below the 25 percent threshold).

adjustments for gains and losses on the available-for-sale securities, and accepts up to 25 percent of mandatory convertible instruments (ManCos).

[22] RDL 2/2012.

IV. Reforms Achievements

21. **The reform of the SSBs has accomplished major achievements.** The measures adopted by the authorities have brought clarity and can contribute in the longer term to financial stability. In particular:

- Ability to raise external equity capital and market discipline. The separation between social and commercial banking activities of SSBs has remarkable benefits: now the financial activities of SSBs are carried out by "ordinary" commercial banks. These banks have the capacity to access markets to raise equity capital, if needed. In so doing, they will be subject to the daily monitoring of their investment decisions by external investors. Market discipline is therefore enhanced for the commercial banks resulting from the spin-off as for any other institution active in the market. Moreover, the application of minority shareholders safeguards would hinder behaviors of SSBs as controlling shareholders that act to their exclusive benefit.

- Supervisory framework. As commercial banks are under the exclusive supervision of the BdE in all respects, issues of blurred competences or uncertainty in the allocation of competences between the ACs and the BdE no longer exist. Regarding the commercial banks resulting for the spin-off, the BdE is the authority responsible for the prudential supervision and for taking early intervention and resolution measures when appropriate.[23] Importantly, moreover, in the current circumstances the BdE maintains intervention powers also at the "holding" level, as SSBs can be intervened by the BdE, which can take control over troubled institutions, impose the recognition of losses, and write down equity.[24] The BdE also retains over SSBs the same supervisory powers previously existing, and therefore can monitor their solvency or leverage, unlike for other shareholders of banks.

- Professionalism of management. Fit and proper criteria for SSB themselves have been strengthened. Members of the board of directors of SSBs are now subject to the same general duties applying to directors of commercial companies, particularly with respect to the obligation to act with due diligence and to disclose conflicts of interests. Moreover, at least the majority of the board of directors of SSBs needs to

[23] In the Spanish supervisory framework, such competence is shared with the Ministerio de Economía y Competitividad (MoE) who is responsible for certain sanctions and for withdrawing the license upon certain circumstances (See Basel Core Principles for Effective Banking Supervision, Detailed Assessment of Compliance, Financial Sector Assessment Program Update, Spain).

[24] The absence of shareholders in SSBs—that do not qualify as ordinary commercial companies—avoids encountering certain property rights issues—currently being addressed at the EU and the international level—that emerge when banks are resolved and shareholders' rights are overridden.

comply with specific professionalism criteria relating to expertise on the banking business.

- Independent directors. The presence of independent directors in the board of the commercial banks resulting from the spin-off is a positive development as it allows having an external view on the governance and operations of a bank. Indeed, commercial banks resulting from the spin-off and that are listed have to comply with corporate governance rules applying to listed companies, which entail that, among other things, at least 1/3 of its directors ought to be independent. The same percentage applies when FROB recapitalizes weak but viable institutions, such as those undergoing a merger process; in this case, in addition, the majority of the board has to be composed by non-executives. Following a non-binding recommendation by the Comisiòn Nacional del Mercado de Valores (CNMV), non-listed commercial banks to which the banking business have been transferred by an individual or group of SSBs (SIP) tend to have at least two independent directors in their Boards.

- Governance and conflict-of-interest rules. Recent reforms have significantly improved the governance of SSBs. The RDL 11/2010 has introduced limits on the maximum size of representatives in the governing bodies of SSBs, which were overburdened with a massive number of stakeholders. These limits can increase the operational efficiency in the functioning of SSBs.[25] Moreover, the composition of the governing bodies of the controlled commercial bank does no longer have to mirror the percentages of stakeholders present in the governing bodies of the SSBs. For listed entities intra-group transaction are subject to a closer scrutiny. Lastly, and importantly, clear incompatibility requirements have been established for politically elected officials.[26]

22. **Furthermore, the reform process has prompted a staggering consolidation of the SSB sector and a progressive reduction in its excessive capacity.** Through mergers and acquisitions, the number of institutions has declined from 45 to 11 and it is bounded to fall to 9 with the auctions of the two weak institutions (Catalunya Banc and NCG Banco) currently under FROB management (Figure 2). Since mid-2008, the number of branches has been reduced by 17 percent and the number of employees by 14.3 percent. The average size

[25] It will have to be seen how these requirements will be implemented in the legislation of the various ACs, as such limits on the representation in SSBs' governing bodies are not "basic rules" under the Constitution, and the ACs have therefore a higher degree of autonomy.

[26] The SSB system has radically transformed and only two small SSBs have retained their status without spinning-off their commercial banking business. It is unlikely that the problems emerged in the recent past will rematerialize, and the recent reforms have also improved the regime of SSBs as such, whether they exercise their banking business directly or indirectly. In any event, consideration could be given to introducing a rule that SSBs of a certain size (e.g., based on assets) would be required to transfer their banking business and/or to be transformed into foundations.

in terms of assets of a "new" SSB has increased from €29.4 billion to €99.2 billion (Figure 3). However, compared to the situation before the reform, the market-share distribution of SSBs has remained, probably inevitably, skewed with two large players (La Caixa and BFA-Bankia) and a smaller number of somewhat bigger institutions.

23. **However, the emerging corporate structure whereby SSBs are holding companies of commercial banks still deserves some additional thoughts (Figure 4).** It is not a common practice that entities that do not perform any banking activity any longer, but merely act as holding company, retain a banking license. The anomaly is particularly evident for those smaller institutions that have a minor stake in a commercial bank but still, due to acting in concert under a SIP, maintain their legal status as SSBs. Although the main objective of such approach is to preserve a well-defined regulatory framework—and this may be particularly important in the current crisis circumstances—a number of issues remain.

24. **The spin-off of the banking activity raises the issue of the financial strength of SSBs as controlling shareholders.** As a consequence of the reforms adopted by the authorities, the predominant source of income for most SSBs as holding companies derives from their controlling stakes in the commercial banks, and with such income SSBs finance the social work. This leads to question the SSBs' ability to backstop the capital needs of the controlled institutions. From a financial stability perspective, this is an important element in assessing the financial soundness of the controlled commercial bank itself.[27] Indeed, as SSBs do not have in turn shareholders behind themselves, their financial strength needs to be ensured through an appropriate, self-contained regime. A counter-argument would be that the same situation applies generally, since shareholders of a commercial bank may not be able to provide capital when it is needed. It is certainly a key consideration that now banks resulting from the spin-off would be able, if efficiently managed, to attract investors, with the consequent dilution of SSBs as controlling shareholder. However, especially in a distressed environment, recourse to the market may not be straightforward.

- *It may be important from a financial stability perspective to have in place a framework ensuring the financial strength of controlling shareholders and their ability to backstop banks as needed*.[28]

[27] See for instance Basel Core Principle 3, Core Principles Methodology. The US for instance has a special regime for bank holding companies, subject to a number of prudential requirements. In other words, while prior to the reforms the limited capacity of SSBs to raise external capital was noted as a significant weakness of those institutions, the problem has been now resolved for the controlled banks, but remains in the control chain for their shareholders.

[28] A SSB can be de-consolidated from the banking group, on a *ad hoc* basis by the BdE, if its financial position is not particularly relevant for the group. As a consequence of such consolidation, losses borne by the SSB need to be consolidated within the group, and discrepancies between the nominal value of the shares of the

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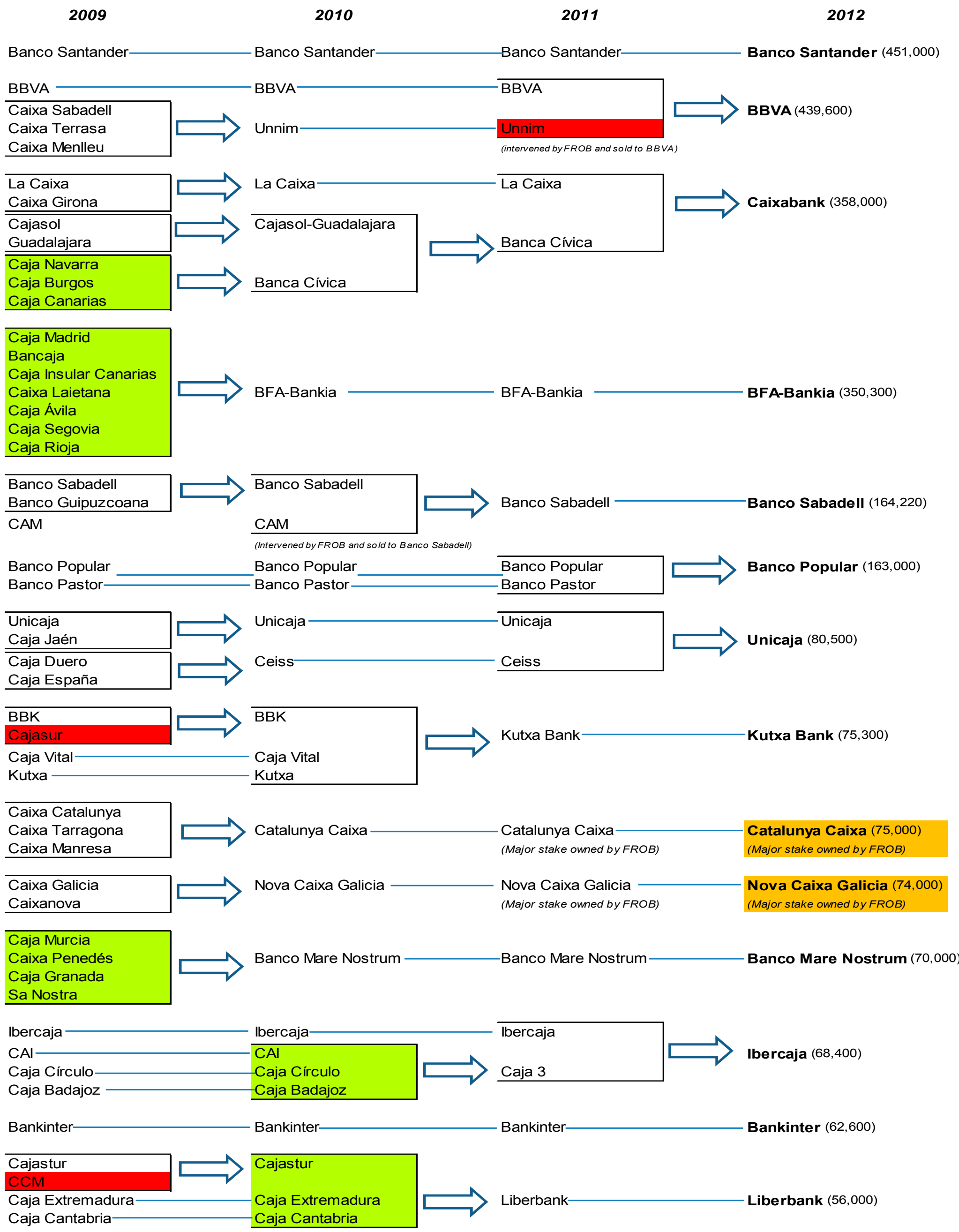
Figure 2. Spanish Savings Banks' Integration Process



Sources: Data from the authorities; and IMF staff estimates.
Note: Assets for each bank are reported in millions of euro and only correspond to assets in Spain in 2011. Banks coded in red were intervened; banks coded in green were part of the institutional protection scheme; banks coded in orange have been intervened and will be auctioned.

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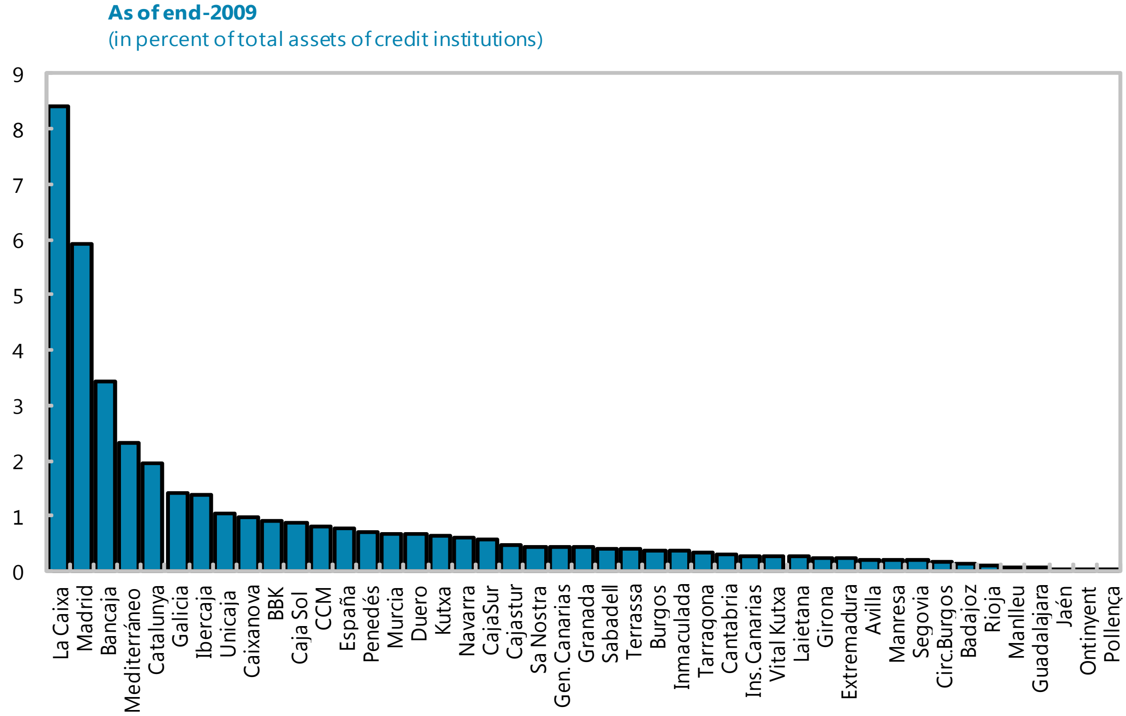
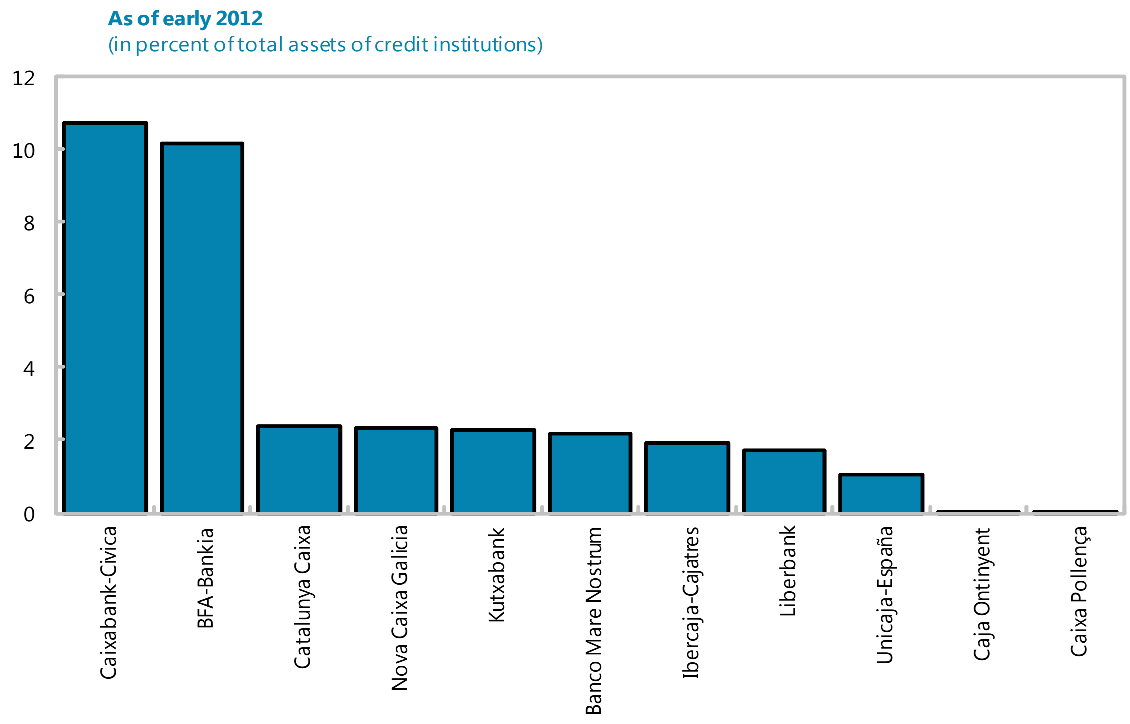
commercial bank attributed by the shareholders SSBs and the market value would lead to the recognition of the relevant losses.

Figure 3. Spanish Savings Banks' Market Shares

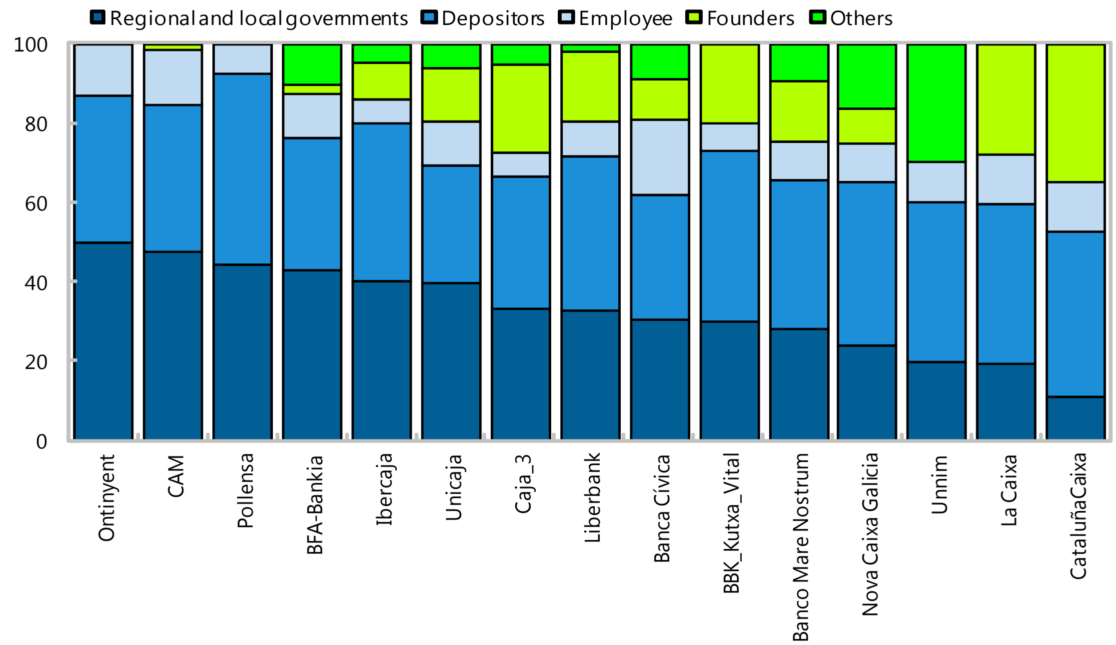




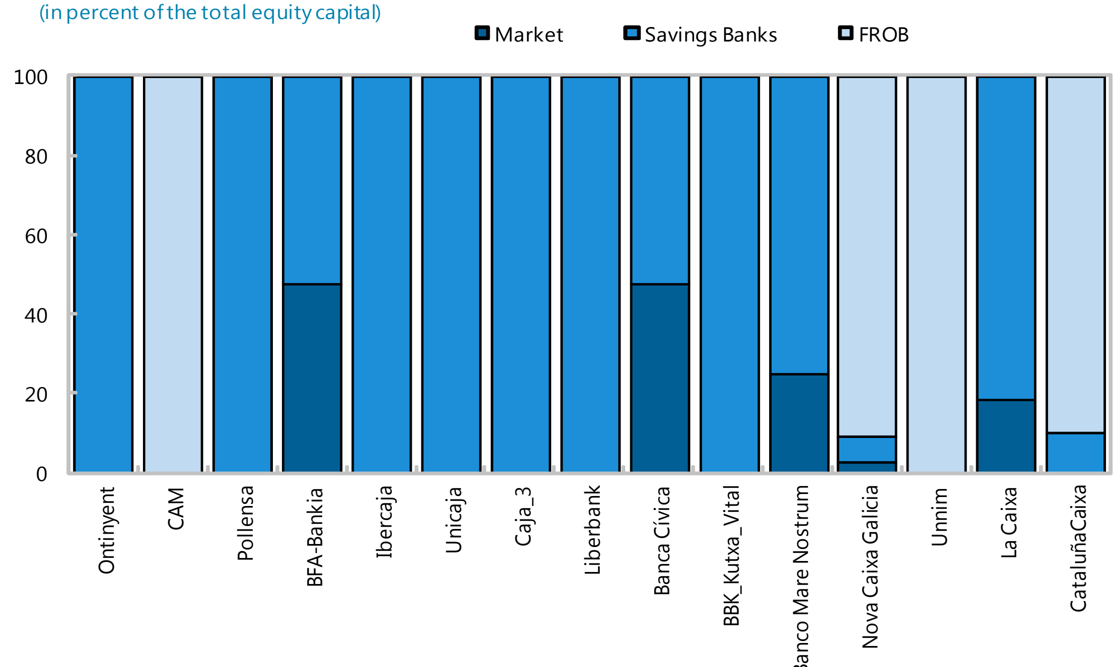
Sources: Banco de España; CECA; and IMF staff estimates.

Figure 4. Spanish Savings Banks: Ownership Structure and Participation in Newly Created Commercial Banks

Ownership structure
(in percent of voting powers)



Participations in Newly Created Commercial Banks
(in percent of the total equity capital)



Sources: Banco de España; and IMF staff estimates.

25. **The reform of SSB's corporate governance does not fully address the issue of SSBs as shareholder.** In particular, no specific criteria have been established to guide SSBs in the exercise of their shareholding rights over commercial banks, so as to preserve the arms' length independence of the management in the day-to-day operations. While shareholders may pursue a broad and diversified range of objectives in their ownership policies, it is important in the case of the SSBs to ensure transparency and accountability mechanisms with respect to their objectives. In this respect, the fact that SSBs continue to be subject to two tiers of regulation, at the State and at the ACs level, could also create some room for ambiguity. For instance when two commercial banks controlled by SSBs intend to merger, the approval will ultimately be taken by the General Assembly of the SSBs; in this case, the merger may or may not go through based, rather than on their business viability, on different stakeholders' interests. Furthermore, it is unclear whether the approval of the ACs is also needed since a merger would imply the integration of institutions through which SSBs indirectly carry out their banking activity. Since some ACs have retained their right to vet SIP agreements, by extension one could envisage that also mergers of controlled banks may require their approval, especially in the case a new SIP or shareholders' agreement might be created so as to maintain the legal status of "savings bank."[29]

- *The new role assumed by SSBs as major shareholders may require some further refinements in order to ensure transparency and accountability of the SSBs in the exercise of their shareholding rights over commercial banks*.

26. **Certain potential overlaps in competences between BdE and ACs may persist.** As credit institutions, SSBs will continue to be regulated and supervised at the State and ACs level, while, as major shareholders of commercial banks, they will be subject to certain requirements by the BdE as prudential supervisor. Therefore, it might be possible that these two tiers of regulation, for instance on corporate governance rules, may overlap or be inconsistent, and actions may be therefore hindered. Moreover, the BdE, as only responsible for the prudential supervision of commercial banks, can take action vis-à-vis SSBs as major shareholders as for any other shareholder. For instance, when it is judged that the influence of a significant shareholder may be detrimental to the sound and prudent management of a credit institution, the MoE, upon proposal of the BdE, may suspend the "political rights" (i.e., voting and other governance rights) of such shareholder.

- *A clearer separation of oversight competences between the State and ACs is warranted.*

V. Toward a New Role for Spanish Savings Banks

27. **In light of the concerns illustrated in the preceding Section, further improvements to the current framework might be considered.** The ongoing consolidation process of the Spanish banking system may lead to a configuration of the system with fewer

[29] It is important to note that in such case the BdE could exercise, as appropriate, its intervention powers.

and larger banks, in which a SSB act alone or in concert with other SSBs, to control those institutions. Even if diluted, SSBs can still play a relevant role, and not all may undergo a listing process prompting a more transparent behavior. In addition, there is the need to govern the whole transformation process to provide a sound and reliable framework for the ownership structure of the Spanish banking system, thus accompanying the transition toward a more market-driven environment.

28. **The issue of SSBs' financial strength as shareholder needs to be addressed.** If the intention is to preserve the possibility that SSBs may remain controlling shareholders, some thinking is warranted on their financial requirements, and a number of clarifications seem necessary. For instance, now, SSBs cannot devote more than 10 percent of their profits to expenses other than social works, subject to their compliance with capital requirements. The scope of this rule is not clear, and its application may not allow SSBs to perform a role as holding companies, and to backstop banks as needed. At the same time, it should be clarified how the said rule interacts with the limits so far in force—which broadly required SSBs to invest 50 percent of their retained earnings in reserves, and the other 50 percent in social work—and whether such limits are still valid[30].

29. **Corporate governance arrangements could be further streamlined and strengthened**. Given that the role of SSBs has radically changed, it seems appropriate that the size of SSBs governing bodies be further streamlined. In certain cases, however, maintaining the Control Commission, which SSBs now are not bound to have, could be useful, in light of the check-and-balance function performed by it. A legally binding requirement to have a certain number of independent directors—hich would be enforced by the CNMV—could be introduced for those non-listed commercial banks formed under a SIP. Likewise, a similar requirement could be introduced for the board of directors of SSBs themselves, even in the absence of a capital support by the FROB. The law distinguishes the roles of the President and of the Chief Executive Officer for SSBs: this distinction could be further elaborated by requiring that their responsibilities be always performed by different persons. Lastly, fit and proper criteria should be extended to—not just, at least, the majority but—all members of the SSBs' Board of Directors: these enhanced professionalism requirements could accompany the approach, supported by the recent legislation, that the General Assembly be in charge of the general ownership policies and objectives, while the Board would be more involved in the relationships with the commercial banks.[31]

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[30] While in theory the SSBs may still issue *cuotas participativas* to finance themselves on the market, such possibility is unlikely given the current structure.

[31] These change would follow the example of a recent amendment introduced by the RDL 2/2012 , providing that entities undergoing a merger process to comply with increased provisioning and capital requirements shall comply with the unified code of good corporate governance applicable to listed companies (including a requirement to have independent directors).

(continued)

30. **Incompatibility requirements need to be tightened.** Currently, it is possible for persons having an executive post in the board of a SSB to serve, as non-executive, in the board of the commercial bank controlled by the former.[32] The opportunity to further shield and distinguish the ownership function from the management of the commercial bank could be considered, especially when the appointment process of SSB governing bodies is more politically-driven and/or may favor a less dispersed group of stakeholders. Therefore, a more stringent incompatibility requirement may operate, so that anyone being in the governing body of a SSB—regardless of being executive or not—or having a senior management position shall not perform any equivalent function neither in the controlled commercial bank nor in other entities controlled by the banking group. This could also prompt changes in the governance of the commercial banks that have originated from the spin-off of SSBs, and would clarify the respective responsibilities of the directors of SSBs and of the commercial banks, whose interests and objectives may indeed differ. The two-year cool-off period for political representatives could be applied regardless of whether a person has participated in the adoption of any deliberation regarding a SSB. Consideration could be given to regulate cases in which persons having certain executive roles in a political party or trade union would serve in the governing bodies of commercial banks controlled by SSBs.

31. **The appointment process could be improved to filter undue political interference.** The threshold for the representation of public entities, now at 40 percent, could be further reduced, perhaps also by distinguishing among different local powers or public entities. Rules on the appointment process of SSBs' governing bodies could be further revisited to filter undue political interference and to favor a broad, but not concentrated, variety of stakeholders' interests.

32. **SIP agreements should be disclosed to the public.** An institutional protection scheme contains provisions relevant for the governance of a commercial bank: as such, they have a function similar to a shareholders' agreement. Indeed, SSBs, as shareholders, may agree among themselves on the appointment of directors or on certain major decisions (such as mergers, for instance providing that such decisions will be approved with a certain majority). Currently, SIPs regarding banks with listed equity are made public. Similar provision applies in case the bank, although unlisted, issues debt instruments, if the SIP agreement is qualified by the CNMV as being price-sensitive information.[33] It may be appropriate to broaden public disclosure requirements on the contents of SIPs, regardless of

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See also the recent European Banking Authority "Consultation on draft guidelines on the assessment of the suitability of members of the management body and key function holders", highlighting the need to extend suitability criteria to the management body of financial holding companies.

[32] There are limits in the total number of non-executive positions that a person can have in boards.

[33] Only certain provisions of the SIPs will be made public, such as those concerning the governance of the commercial bank.

the above-mentioned criteria, and to make this requirement legally mandatory. Indeed, having information on SIPs' agreements enhances transparency regarding the operations of the controlled bank. This could also help the entry of potential investors, enhance the accountability of its controlling shareholders, and provide a monitoring tool to any minority shareholder. Also the contents of SIPs may be revisited in light of the role that has to be assumed by a SSB as minority, passive shareholder.

33. **Corporate governance report should be adapted to reflect the new role of SSBs as major shareholders**. SSBs are required to publish and to submit to the CNMV a corporate governance code, including a number of useful information on the remuneration policies, related party lending, credit operations with political constituencies or other public institutions, risk control system, situations of conflicts of interest for members of SSBs' governing bodies. Failure to submit such corporate governance report, or the submission of false or misleading information, is sanctioned as a grave infraction under law 24/1988 on financial instruments (Ley del Mercado de Valores). The contents of this report could be supplemented taking into account the role of SSBs as controlling shareholders, and monitored by the CNMV. SSBs should be required to disclose their ownership policies as to the exercise of their voting rights in banks, including on the criteria guiding the selection of directors. Likewise, they could also elaborate and disclose detailed criteria for their investment strategies. These disclosure requirements would serve as benchmarks against which the performance of the SSBs' institutional purposes would be assessed. At the same time, the practice of having a framework agreement, regulating and ensuring arms length relationships between the SSB and the controlled bank, could be generalized, together with appropriate monitoring mechanisms on such relationships, such as through the Control Commission.

34. **Some of these additional requirements may entail a regime for SSBs that is more stringent than for other controlling shareholders, but this would be based on well-justified grounds.** SSBs serve a variety of interests in their stakeholders' representation, including political constituencies. While this is legitimate, certain safeguards need to be in place to ensure that such stakeholders' interests are channeled in the activity of the commercial banks owned by SSBs in a sound and transparent manner. Indeed, even though they are not public entities, they perform a social mandate and there is a broad public interest in verifying how they exercise their governance and economic rights over banks. Moreover, certain transparency measures may allow for an adequate monitoring of the banks' business value, and reinforce incentives for external investors to bring in new funds, thus favoring the entry of participants in the capital base of Spanish banks and the competitiveness of the system.

Box 1: Stakeholders' Complex Objectives in Corporate Governance: International Practices and Countries' Experiences

SSBs (or SSBs transformed into foundations) may not be qualified as governmental or public entities and as such they are not subject to the same transparency and accountability mechanisms governing such entities.[1/] Nor are they institutional investors (e.g., pension funds or asset management companies) owing a fiduciary responsibility toward their clients. However, the fact that they fulfill a social function and represent a broad variety of stakeholders, including political constituencies, gives rise, in broad terms, to a stronger public interest in ensuring that their institutional purposes be pursued. From a corporate governance perspective, such particular role of SSBs raises the question as to whether references can be drawn from other models of shareholders that do not only act for their own economic benefit but have to pursue a more complex array of interests.

A first area of reference relates to the role of the public sector in commercial companies. The OECD "Guidelines for Corporate Governance of State-owned Enterprises" is aimed at ensuring a proper balance between the role of the State as active shareholder and an independent, even-handed management function of the state-owned enterprise. The principles for enhancing corporate governance adopted by the Basel Committee for Banking Supervision apply also to state-owned banks, and further refer to the OECD Guidelines. Albeit in a more specific context, similar corporate governance issues may arise for sovereign wealth funds (SWF), as they are owned by the government or by a governmental entity, and indeed the so called Santiago Principles set out certain safeguards. Under such principles, the governance framework and objectives, and the safeguards for the operational independence of the SWF management vis-à-vis its owner, should be publicly disclosed; the SWF owner should set the objectives of the SWF, appoint the members of its governing body in accordance with clearly defined procedures, and exercise oversight over the SWF's operations. Disclosure duties apply also to the investment policy of the SWF—while assets and investment performance has to be reported according to clearly defined standards—and to the key factors guiding the SWFs exercise of ownership rights, such as voting rights.

The recent financial crisis offers another angle of analysis, given that governments have provided various forms of financial support to banks. While the fear of political interference or the aim to preserve a healthy private sector have often lead to make use of a variety of instruments (e.g., debt securities, non-voting shares, warrants), in many countries the governments have assumed full ownership rights in banks. For instance, in the United Kingdom (UK) a special company has been set up—the UK Financial Investment Ltd.(UKFI)—to manage the UK Treasury participations in several financial institutions. A framework agreement regulates the relationships between the Treasury and the UKFI with the goal of keeping the UKFI at an arm's-length relationship from the Treasury. The UKFI has to exercise shareholders rights in investee companies in an uncoordinated manner, not to distort competition. On the other hand, the Treasury retains a power of direction and can give general or specific instructions at any time.[2/] The United States (US) has followed a diversified stance in taking equity investments in its financial assistance program during the crisis, using common and preferred stock and including trust structures such as in the AIG case or direct Treasury ownership such as with Citigroup.

Box 1: Stakeholders' Complex Objectives in Corporate Governance: International Practices and Countries' Experiences (Concluded)

As a general matter, it should be noted that in a crisis, different and sometimes conflicting objectives pursued by governments' shareholdings come into relevance, together with social pressures: ownership is often time-limited so as to provide an exit strategy and allow a return to a market-driven environment and is aimed at preserving and maximizing value for taxpayers (which may not be always in line with an exit strategy that leads to a forced sale). At the same time, the preservation of lending activities has to be aligned with the maintenance of financial stability and of a strong financial condition of recapitalized banks.

A third area of reference turns to the private sector, and particularly to the role of institutional investors in corporate governance. In very broad terms, institutional investors can be defined as financial institutions that accept funds from third parties for investment often—but not necessarily—in their own name but on behalf of such parties. Such role draws the attention on possible "agency problems" in the activity of institutional investors. They typically have a diversified investment strategy, also because of prudential regulation and often on the basis of indexes that can also represent a benchmark for their remuneration. Their role in corporate governance of investee companies may vary, but often institutional investors act as passive shareholders and may intermediate the exercise of shareholders' rights through third parties, such as proxies advisors. The OECD Principles of Corporate Governance emphasize the role that institutional investors can play in ensuring good corporate governance and companies' oversight. Particular attention is given to the need for disclosure of their voting policies and for transparency as to how conflicts of interest are addressed, given that their investments and ownership structures may give rise to conflicts. These practices may be best achieved by legally binding requirements rather than by "comply or explain" rules. While mutual consultation on the exercise of shareholders' rights is not disfavored, care should be taken to prevent abuse of concerted action.[3/]

[1/] Particular issues may arise if a SSB is transformed into a public foundation, which may depend on the nature of their founders and of the original resources allocated to the SSB.

[2/] Apart from the UK and Spain itself, other examples of jurisdictions that have set up state-owned vehicles to foster financial stability are Denmark and Greece. Germany has established a special fund for financial market stabilization administered by a federal agency under the general oversight of the Ministry of Finance. In the Netherlands, a legislative proposal envisages the establishment of a holding company (a foundation) managing state participations in financial institutions. The Minister of Finance, in commenting on such proposal, communicated the intention to have a conflict-of-interest rule in the foundation's articles of association.

[3/] See "The Role of Institutional Investors in Promoting Good Corporate Governance Practices", OECD, 2011. In the UK, the Stewardship Code for Institutional Investors aims to enhance the engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities; UKFI adheres to such code.

35. **Despite major reforms, the overall piecemeal strategy remains somewhat unclear and needs to be well thought through.** The authorities are facing the extremely

challenging task of devising a strategy in a systemic crisis environment, which makes the reform of SSBs a "moving target". Keeping the current legal status of SSBs allows relying on a well-established framework, and such legal certainty is very important in these circumstances. However, the risk is that leaving to the market to decide the faith of the controlled bank through the progressive divestment of the SSBs-shareholders might turn out not to be such a smooth and linear process, also taking into account significant resistances from stakeholders which may emerge in such process.

36. **In anticipation of the events, consideration should be given to further reflecting on the future role of SSBs, and to supporting such role with a coherent framework.** The circumstances may evolve in a way that some SSBs will be significantly diluted, which will also significantly reduce the resources through which they finance their social work.[34] Whether or not such institutions would then only act as minority, passive shareholders remains to be seen, and may vary according to the circumstances. Having a framework which anticipates the main features applying to a (transformed) foundation still holding significant shares in banks may enhance preparedness and stability should such a transformation occur, and may also provide sound and coherent principles governing the role of such foundation in the governance of banks. For instance, in anticipation of this possibility, the Generalitat de Catalunya is drafting some legislation on regional foundations holding shares in banks, providing a regime for the governance of the foundations and aimed at ensuring that resources flowing to them are properly channeled into social activities. In this transition process, the issue is not only one of form, i.e. as to whether the transformation of SSBs into foundations should not be already in place, and why instead varying thresholds for such transformation have been introduced. Indeed, also a substantive question arises, as to main features of this new role of SSBs and as to what extent a special framework supporting such role needs to be designed. [35]

37. **The legal framework for "special foundations", albeit they are mentioned in the recent reforms, has not been developed.** As indicated, the law envisages the transformation of SSBs into "special foundations" when they do not exercise "control" over the newly-established commercial bank or their share of voting rights falls below 25 percent. These double criteria may not, however, be fully coherent since a bank with less than 25 percent of voting rights may still exercise significant influence over a commercial bank. Furthermore,

[34] Indeed, one possible pattern is that the social work so far carried out by SSBs will be left to the corporate social responsibilities programs of commercial banks, according to their own, individual policies.

[35] The transformation into foundations may be seen as a natural development for SSBs, in light of their social mandate and of the absence of shareholders to which residual assets are distributed: this is indeed the legal consequence apparently provided by some by-laws of SSBs in case of their liquidation. The opportunity for this transformation could be evident particularly for those smaller institutions that maintain control over commercial banks through the concerted action agreed in a SIP, despite having a minor shareholding.

the legislator has not clarified yet what a "special foundation" would be and what regulation would be applied if this possibility materializes.

38. **Uncertainties exist as to whether SSBs may be transformed into foundations regulated at the State or at the AC level.** The current sparse regime provides that, if the main scope of activity of a foundation exceeds the territory of an AC, such foundation will be regulated at the State level.[36] It is not clear whether, to make this determination, it is sufficient or necessary to look only at where the social mandate is performed or whether the investment side is also relevant: in other words, the case would be that one of a foundation carrying out its *obra social* predominantly in a AC but investing in—and financing itself through—a bank operating throughout Spain. Another case would be that one of a foundation performing social work throughout the whole territory of Spain, with some predominance in some ACs. Even though what counts is probably the foundation's institutional objective (i.e., its social work), it may be advisable to provide more specific criteria.

39. **In Spain, foundations are governed by a specific legal regime and, like for SSBs, the State and the ACs share legislative and regulatory competence over them.** The right to establish a foundation for general interest purposes is protected by the Constitution. State-regulated foundations are governed by the *Ley de Fundaciones* 50/2002, applying to foundations that carry out their activities in more than one AC, or in one AC that does not have specific legislation.[37] Under the *Ley de Fundaciones*, foundations are subject to a series of provisions on the economic activity necessary for them to pursue their goals, on the composition and requisites of their governing bodies, and on the auditing of their accounts. Foundations are enrolled in a public register and overseen by a Protectorate, in charge of verifying that they act in accordance with the law and their regulations.

40. **Against this background, a possible approach would be to craft a special law for foundations as shareholders of banks and, possibly, transform SSBs into foundations.** Currently, the situation varies across institutions. Most of the "old" SSBs are not more than mere "shells" the activity of which focuses on "obras sociales." In other words, they are already de facto foundations. In this case, the main rationale for any regulation will be to ensure that the foundation model is sustainable and that their profits are channeled through their social activity to the community in a sound and transparent manner. But other "old" SSBs are still very much linked to the commercial bank that they own. Indeed, the case of a SSB transforming into a foundation may raise particular issues which may not be addressed

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[36] A previous version of the law provided that, in order to determine the sphere of competence of the State or of the ACs, reference had to be made to the bank in which the foundation invested. Such criteria have been eliminated, also due to a demand from the ACs to have control over the social activity exercised by foundations.

[37] Like for SSBs, the Constitution has intervened to interpret how the delimitation of competence between the State and the ACs to regulate foundations operates. Foundations may have the option to choose their regulatory framework (at the State or AC level.

by the existing general framework and which it may not be advisable to solve on a case-by-case basis.

41. **Indeed, even in the case SSBs were to be diluted in banks' capital and transformed into foundation, they could still play an important role as significant shareholders in banks.** In the absence of certain safeguards, their role in the governance of commercial banks may not be transparent or shielded from undue political interference, the management may not be professional or independent, nor, as significant shareholders, would they be able to financial buttress banks' capital. This may prompt special concerns that do not arise for an ordinary foundation. While overall well-designed, the *Ley de Fundaciones* might need to be adapted, as it does not address the specific issues arising when SSBs that are transformed into foundations maintain a significant shareholding in commercial banks. It must be stressed, however, that before making such step and adopting a special regime a rigorous analysis will be needed, especially as to if and how the balance in the allocation of powers between the State and the ACs would be altered.[38]

42. **Financial stability could be the legal underpinning for such special regime at the State level.** The shared competence between the State and the ACs over foundations could replicate the same issues faced for SSBs, and therefore harmonization may be advisable. Like for SSBs, the law enacted by the State would dictate some general principles, and the ACs would exercise their legislative powers in line with such principles. The authorities may consider drawing the legal basis of the suggested special regime at the State level on financial stability grounds – which is a responsibility of the State - as the role of foundations as significant shareholder is still relevant under such perspective.[39] At the same time, if a foundation, acting alone or in concert, lowers its participation under a certain threshold (or under other indicators, based on the assets and liabilities of the foundation or of the relevant commercial bank), it might fall within the remit of the ACs.[40] Such suggested regime could be devised along the following lines:

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[38] For instance, under the *Ley de Fundaciones* any sale of assets is now subject to the approval of the Protectorate, and at least 70 percent of the foundations' income must be allocated to pursue their institutional goals.

[39] Financial stability has an increasingly relevance in the adoption of financial sector laws, for instance constraining the autonomy of private parties (such as the area of bank resolution).

[40] In a scenario where the allocation of competences between the State and the ACs would be too problematic, an alternative might be to design a State-level framework for transforming SSBs into institutional investors (such unit trusts) holding and managing financial assets, including banks' shares, to the benefit of their stakeholders, while their social activity would be subject to the ordinary rules under the *ley de fundaciones*. In the design of these legal reforms, the challenge would be to transform a SSB into a company having shares: as the SSB does not have share capital, it would be difficult to determine the percentage of shares to be allocated to the various stakeholders.

- *Governance.* Similarly to the recommendations made for SSBs as controlling shareholders, special safeguards are needed to put in place a sound governance regime guiding the interaction between foundations as stable and significant shareholders and the commercial banks. Along the same lines, this would entail disclosure of shareholders' agreement, strengthening of incompatibility requirements, setting up and disclosing general ownership policies, enhancing the presence of independent directors in the board of commercial banks where foundations are significant shareholders. Moreover, rules on the composition of the foundations' management board should be devised, together with fit and proper criteria that would complement the requirements already imposed by the BdE on significant shareholders; at the same time, an oversight body could be established. Indeed, while many of these aspects have been addressed through recent reforms to the SSBs, the concerns raised in the past for SSBs governance would emerge again for SSBs that are transformed into foundations: for instance, it is unclear who would appoint the management of such foundations, and according to what criteria. The possibility of undue interference by the bank itself over the activity of the foundation could also be regulated[41].

- *Investment criteria*. Foundations could be designed in a way to resemble institutional investors that diversify their financial assets through a balanced portfolio of investments aimed at creating long-term value for the local community. According to their investment strategies, foundations would gradually divest their shares in banks or subscribe to capital increases in banks based on a viability plan of such bank. However, morphing foundations into institutional investors would require a significant change of their business model. Investment strategies should be verifiable against certain benchmarks, and transparency mechanisms should enable to evaluate such strategies: this should allow monitoring cases where investments are made in competing or related companies, and properly supervise cases of related-parties lending.

- *Supervisory framework.* The implementation of the above mentioned requirements could be overseen by a competent authority. For instance, this approach could build upon the functions currently performed by the Protectorate, provided that certain independence safeguards are put in place.

[41] The governance of foundations, if well designed, may actually bring the benefits of a strong and autonomous role played by management, because the founders— in the SSBs case, their stakeholders— typically have a less significant function once the foundation is established. This could contribute to separate more clearly the commercial banking operations from the stakeholders' interests represented by (SSBs transformed into) foundations. It is indeed in light of analogous concerns that the idea is often raised as to whether such type of investors should be entitled to have only non-voting shares.

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