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Spain: Financial Sector Assessment Program—Detailed Assessment of Compliance with the Basel Core Principles for Effective Banking Supervision

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FINANCIAL SECTOR ASSESSMENT PROGRAM

SPAIN

DETAILED ASSESSMENT OF COMPLIANCE WITH THE BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

MAY 2006

INTERNATIONAL MONETARY FUND
Monetary and Financial Systems Department

Contents

GLOSSARY

AML	Anti-Money laundering
BCPs	Basel Core Principles for Effective Banking Supervision
BE	Bank of Spain (*Banco de España*)
CAs	Autonomous Communities (*Comunidades Autónomas*)
cajas	Savings Banks (C*ajas de Ahorro*)
CBE	Bank of Spain Circular
CECA	Spanish Confederation of Savings Banks (*Confederación Española de Cajas de Ahorro*)
CIR	Central Credit Register
CNMV	National Securities Market Commission (*Comisión Nacional del Mercado de Valores*)
DGS	General Directorate of Supervision (*Dirección General de Supervisión*)
EMU	European Monetary Union
FGDs	Deposit Guarantee Funds (*Fondos de Garantía de Depósitos*)
FSAP	Financial Sector Assessment Program
CI	Credit Institution
ICAC	Institute of Accounting and Auditing
ICO	Official Institute of Credit (*Instituto de Crédito Oficial*)
IFRS	International Financial Reporting Standards
LABE	Law on the Autonomy of the Bank of Spain
LDI	Law of Discipline and Intervention
LMV	Securities Market Law
LOB	Banking Law
LRP	Law on Capital Adequacy
ME	Ministry of Economy and Finance
OM	Ministerial Order
RD	Royal Decree
SEPBLAC	*Servicio Ejecutivo de la Comisión de Prevención del Blanqueo de Capitales e Infracciones Monetarias*

I. Introduction

1. This assessment of Spain's implementation of the Basel Core Principles for Effective Banking Supervision (BCPs) was undertaken, in the context of a wider Financial Sector Assessment Program (FSAP), by a team from the International Monetary Fund (IMF), using the methodology recommended by the Basel Committee on Banking Supervision.[1] The assessment was carried out on the basis of a review of the legal and regulatory framework and intensive discussions with representatives from the Bank of Spain (BE), the *Dirección General de Supervisión* (DGS within the BE), the bankers' association, management and staff of large commercial and savings banks *(cajas),* and analysts from credit rating firms. The BE was especially well prepared for the assessment and the team received excellent cooperation from all those it met. The documents examined included the BE's self-assessment of compliance with the BCPs, regulations, and financial stability reports.

II. Market Structure and Trends

2. **The Spanish financial sector is characterized by a dominant banking system[2] and sizeable insurance and capital markets**. Financial sector assets are estimated at about twice nominal GDP. About 80 percent of these assets are accounted for by banks and 15 percent by insurance companies.

3. At end-2004, credit institutions were 346 and comprised 136 commercial banks, 47 saving banks (*cajas)*, 83 cooperatives, 79 specialized credit institutions, and the state-owned *Instituto de Crédito Oficial* (ICO). The system is well intermediated by international standards, with total loans and deposits of the resident private sector roughly equivalent to 115 and 75 percent of GDP, respectively, in 2004. Commercial banks and *cajas* are the most important players, jointly accounting for more than 90 percent of system assets. The system has experienced widespread liberalization and consolidation over the past 20 years, including the formation of the two largest Spanish banks, BSCH and BBVA after a series of mergers.[3] The elimination of geographical restrictions on the operations of the *cajas* in 1988 triggered their expansion within the same and to other regions.

4. **The savings banks *(cajas)* have been a major force in the extension of services and in creating a highly competitive environment.** They have close ties with the communities and they support social, cultural, and educational projects. The savings banks 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 2004. On the

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[1] The BCP assessment was conducted by Messrs. Jorge Cayazzo (MFD) and Saul Carpio (U.S. Office of the Comptroller of the Currency). The assessment took place from June 22 to July 1, 2005.

[2] For purposes of this report the term *banking system* is generally used to denote commercial banks, saving banks (*cajas*), and credit cooperatives.

[3] BSCH is the result of the 1999 merger of Banco Santander and Banco Central Hispanoamericano, while BBVA, is the result of the merger between Banco Bilbao Vizcaya and Argentaria Caja Postal, in 2000.

asset side, the share of savings banks 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.

5. **Savings banks operate as non-profit entities with no share capital.** They rely on retained profits to meet their capital needs, though they can borrow from the market on the same footing as banks. Their ownership structure also means that they cannot be bought by banks, though they can sell branches or other assets. They can merge with one another upon approval by the autonomous communities and can also buy other financial institutions including banks.

6. **The banking system continues to display a strong financial position, supported by the favorable macroeconomic environment**. The quality of bank assets improved further in 2004, with NPLs reaching 0.8 percent of gross loans—an historic low. Profit margins, while satisfactory, are compressed by high competition and the steady increase in loan provisions since the introduction of statistical (dynamic) provisioning in July 2000.[4] Banks are overall well capitalized, with Basel ratios surpassing 12 percent for both commercial banks and *cajas*. In the face of the strong expansion of credit, banks have increasingly resorted to the domestic and international capital markets for alternative sources of funding, notably through asset securitization and the issuance of medium- and long-term debt.

7. **On the international front, the large Spanish banks have reduced exposure to Latin America, and their international strategy appears more focused on EU countries recently.** Following the 2002 Argentine crisis, the Spanish banks reduced their risk exposures to Latin America to about one-quarter of overseas assets. Nevertheless, the region is considered a strategic business segment given close cultural ties and the recent rebound in local economic conditions. Business expansion in Europe has focused primarily on Germany, Portugal, and, more recently, the United Kingdom, which now accounts for one-third of overseas assets.[5]

8. **Spain is scheduled to adopt Basel II by 2007.** This is inducing progress in risk-management practices among banks and *cajas*. The majority of large Spanish banks which make up the bulk of the system's assets are expected to use the internal ratings based approach. Among *cajas*, there is an ongoing project to implement a common risk management tool developed by the Spanish Confederation of Savings Banks (CECA), so as to facilitate cost sharing. In most cases, models are suggesting large excesses of current capital and loan loss provisions. This has presented the authorities with the challenge of

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[4] Under statistical provisioning, a provision for loan loss coverage of credit risk is required in addition to other loan provisions to mitigate risks that may be expected to accompany the next economic downturn.

[5] This reflects BSCH acquisition of Abbey National in 2004, thereby becoming the eighth largest financial institution in the world (fourth in Europe) by market capitalization.

ensuring that models are thoroughly evaluated and validated to ensure capital positions supporting risk profiles are not weakened in the implementation of Basel II. Some large banks and cajas have already validating their models.

III. General Preconditions for Effective Banking Supervision

A. Macroeconomic Soundness and Stability

9. **The Spanish economy has experienced steady economic growth, outstripping that of the euro zone in the past five years**. Real GDP growth was 3.1 percent in 2004, sustained by strong domestic demand—particularly private consumption and construction. The composition of growth has become increasingly unbalanced, however, with the external sector deducting 1.9 percentage points from growth in 2004.

10. **Buoyant domestic demand has been associated with a boom in house prices and a sharp increase in household indebtedness.** House prices have virtually doubled in real terms since 1997. Private and official analysts now acknowledge overvaluation on the order of 25 to 35 percent. Mortgage credit has grown at a rapid pace in recent years, partly fueled by the longer maturities offered by financial institutions and the low real interest rates recorded since Spain's adoption of the euro.

11. **A persistent inflation differential relative to the euro area has eroded competitiveness.** The cumulative headline (core) inflation differential since EMU qualification in 1997 amounts to about 7 percentage points, outstripping relative productivity gains. Although there is no clear consensus on the causes of the inflation differential, contributing factors include: the international convergence of nontraded goods prices as income levels converge; the high sensitivity of the Spanish price index to oil price shocks; wage indexation; and the elimination of credit constraints. The inflation differential has also contributed to the compression of export margins, and to the widening of the external current account deficit to 5.3 percent of GDP in 2004. To address the loss of competitiveness, the government has recently launched a package of measures aimed at boosting productivity through increasing labor market productivity, greater competition in industry, and the adoption of advanced technologies.

12. **Monetary policy conditions in the euro area have been accommodative, from Spain's perspective, contributing to negative short-term real interest rates in Spain the past three years.** In these circumstances, relatively tight fiscal policy (a small general government surplus in 2004) has helped contain inflation to around 3 percent in 2004 (against a euro-area average of 2.4 percent).

B. Public Infrastructure and Institutional Arrangements for Regulation and Supervision

13. **The regulation and supervision of financial institutions and securities markets is performed by three main agencies**. Oversight of credit institutions is the responsibility of the Bank of Spain, although regional governments retain some regulatory and supervisory

powers over the *cajas* operating in their jurisdictions; securities markets are supervised by the *Comisión Nacional del Mercado de Valores* (CNMV);[6] supervision of insurance companies is under the mandate of the *Dirección General de Seguros* within the Ministry of Economy and Finance (ME). As many nonbank financial intermediaries are owned by banks, however, the Bank of Spain plays an indirect supervisory role at the consolidated group level.

14. **At the national level the legal framework for regulation and supervision of credit institutions (CIs) involves the Ministry of Economy and Finance (ME) and the Bank of Spain (BE)**. **In addition, the Autonomous Communities have some regulatory and supervisory powers over saving banks and credit cooperatives that do not include solvency or financial stability issues, in line with rulings by the *Tribunal Constitucional* handed down over many years.** 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 CIs. Additionally, each CA operates under its own legal framework. In general, these frameworks provide CAs 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*).

15. **The Bank of Spain oversees the banking system**. Its main responsibilities include (a) defining prudential and accounting regulations; (b) evaluating risks in the banking system as well as in individual institutions (c) enforcing the legal and prudential framework; and (d) implementing bank resolutions. The BE carries out these responsibilities through periodic onsite inspections, offsite review of the financial information submitted by credit institutions, and regular communication with bank management. Commercial bank licenses are granted and removed by the Ministry of Economy and Finance upon the recommendation of the Bank of Spain.

C. Market Discipline and Governance

16. **The legal and regulatory framework for transparency and governance of publicly traded institutions has improved significantly in recent years.** Following the recommendations of the *Comisión Aldama* and EU directives on transparency and corporate governance,[7] the Spanish authorities issued a number of laws and regulations between 2002 and 2004. The new regulatory framework details the fiduciary duties of managers of firms with publicly traded financial instruments, and includes specific aspects related to the

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[6] The Bank of Spain retains supervision of the book-entry public debt market.

[7] The Special Commission to Foster Transparency and Security in the Markets and in Listed Companies (Aldama Commission) was established in June 2002 and issued its recommendations in January 2003. The Commission's report emphasizes the need to balance increased self-regulation of issuers with greater transparency, notably through requiring regular reporting on corporate governance structures. The first set of reports were published on July 1, 2005.

governance of the *cajas*, notably with a view to shielding these institutions from unwarranted political interference.

17. **Recent regulatory initiatives include accounting and reporting norms consistent with International Financial Reporting Standards (IFRS) and the adoption of Basel II guidelines.** IFRS came into effect in Spain in June 2005 following the decision of the European Commission to adopt them.[8] Implementation of Basel II is expected by 2007; preparations in Spain are well under way.

18. **The BE is taking a conservative, comprehensive, and measured approach to the implementation of international standards to minimize the potential for undue reduction of current capital or provisioning requirements**. Potential reductions in required capital could result from the application of less strict accounting rules. Moreover the new accounting principles required adapting the former statistical provisioning requirements, which resulted in less demanding generic provisions. Within the framework of Basel II, the BE has been using various tools to smooth implementation, including applying minimum risk parameters for specific asset portfolios, running of models in parallel with current regulations for a two-year period, and practical use tests for risk management and capital allocation.

D. Problem Credit Institution Resolution

19. **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 effect 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.

20. **In addition to sanctions, the law establishes an extraordinary resolution mechanism, which may be activated in concert or apart from the 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.

21. **In addition to its standing facilities, the BE can provide emergency liquidity assistance to financial institutions, within the operational framework of the European System of Central Banks (ESCB)**. In the ESCB's operational framework, the European Central Bank (ECB) lacks an explicit mandate to provide discretionary liquidity support to solvent institutions if their collateral is ineligible for open market operations and overnight

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[8] 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.

standing facilities. Rather, national central banks are responsible for financial stability, including providing 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.

22. **Like other central banks, the BE has deliberately kept some ambiguity about its emergency lending policies.** It has not provided general guidance on the conditions and circumstances under which decisions to extend discretionary liquidity support are made. Presumably, this ambiguity aims at limiting moral hazard. It is recommended, however, that the BE set clear internal objectives, criteria, and rules to guide such operations—even if they are not publicly disclosed—so as to avoid potential sources of inefficiencies, such as intervention delays, pressures from interest groups, procedural ambiguities, and lack of accountability. Since joining the euro system, Spain has not undertaken any emergency liquidity operations.

23. **The deposit insurance framework follows EU standards.** The system comprises three funds operating under the same rules and procedures—for commercial banks, savings banks, and credit cooperatives—covering up to €20,000 per depositor. An umbrella agency administers the investment and use of the funds in accordance with statutory rules. The funds are governed by a board whose eight members are selected by the ME, four in representation of the BE, and four of the respective member institutions. The Deposit Guarantee Fund (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.

24. **The application of the current deposit insurance framework has been limited, but effective, in practice.** In the last 15 years, it has been used in cases affecting six banks and seven savings banks. In the case of banks, various resolution mechanisms have been applied. In the case of 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.

25. **The ownership structure of *cajas* presents additional challenges in applying recapitalization mechanisms.** This is because—under least-cost resolution rules—it may not be effective for the FGD to recapitalize a *caja,* under circumstances where the investment does not legally entail any participation in the ownership of the recapitalized institution.

E. Main Findings

26. **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 its 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.

27. **The dual legal framework governing *cajas* poses the risk of potential conflicts in the exercise of supervisory and sanctioning authority.** The laws articulate the responsibilities among the BE and the ME with respect to the regulation and supervision of the solvency, performance, and compliance with specific regulations governing credit institutions. At the same time, each CA operates under its own legal framework, which generally provides for licensing, supervisory and sanctioning authority to oversee the activities of saving banks *(cajas)* and cooperatives headquartered in their respective jurisdictions, particularly with regards to corporate governance, consumer protection, transparency and dividend policies supporting social contributions (*obra social*). Nonetheless, there are circumstances where -due to legal ambiguity- overlapping national and regional legal frameworks may cause conflicts, particularly in the application of supervisory authority on prudential issues. 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**.**

28. **The BE's limited regulatory powers should be expanded**. 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.

29. **The Law of Discipline and Intervention (LDI) assigns sanction authority to the ME and BE on the basis of the severity of infractions:** the 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 is recommended to consider providing increased sanctioning power to the BE to bolster its effectiveness in promoting safe and sound practices. This may be of particular importance when addressing serious infractions that require the suspension of executives and directors from serving in leadership positions of credit institutions. For instance, while current law appears to allow the BE to suspend or remove bank officers responsible for serious violations for one year, the BE may

only propose more severe sanctions (suspensions or removals greater than one year) to the ME.

30. **There is room to strengthen supervisory tools**. Given the BE's limited regulatory and sanctioning authority, it would be desirable to further strengthen moral suasion. One alternative is to issue additional BE 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 by making supervisory expectations on sound bank practices more explicit and transparent to the industry. Explicit standards would help reinforce communication between the BE and supervised institutions, particularly when the BE is proposing prompt corrective measures.

F. Core Principles Assessment

31. This assessment of compliance with the Basel Core Principles has been made on a qualitative basis using the methodology prescribed by the Basel Committee. A five-part assessment system has been used: compliant; largely compliant; materially noncompliant; noncompliant; and not applicable. To achieve a **compliant** assessment with a principle, all "essential"criteria generally must be met without any significant deficiencies. A **largely compliant** assessment is given if only minor shortcomings are observed and these are not seen as sufficient to raise serious doubts about the authority's ability to achieve the objective of that principle. A **materially noncompliant** assessment is given when the shortcomings are sufficient to raise doubts about the authority's ability to achieve compliance, but substantive progress had been made. A **noncompliant** assessment is given when no substantive progress towards compliance has been achieved, or if insufficient information was available to allow a reliable determination that substantive progress had been made towards compliance. An assessment of **not applicable** is rendered for a principle deemed by the assessors to not have relevance.

Table 1. Detailed Assessment of Compliance with the Basel Core Principles

Principle 1.	**Objectives, autonomy, powers, and resources** An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to the authorization of banking establishments and their ongoing supervision; powers to address compliance with laws, as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Description	
Assessment	
Comments	
Principle 1(1).	An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks.
Description	At the national level the legal framework for regulation and supervision of credit institutions (CIs). involves the Ministry of Economy and Finance (ME) and the Bank of Spain (BE). In addition, each Autonomous Community (CA) is vested with some regulatory and supervisory powers over saving banks and credit cooperatives that do not include solvency or financial stability issues, in line with rulings by the *Tribunal Constitucional* handed down over many years. 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 CIs. Additionally, each CA operates under its own legal framework. In general, these frameworks provide CAs 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*). The most relevant elements delineating the above description of this framework are embodied in: Law 26/1988 on the discipline and intervention of credit institutions (LDI), Law 13/1994 on the autonomy of the BE (LABE), regulations governing CAs, LABE Art. 7.6, and LDI Art. 43 bis. A legal mechanism is in place to coordinate the activities of the various supervisory agencies (i.e., the BE and the respective CA agencies). Since all agencies responsible for banking supervision are part of the Public Administration, they must observe the constitutional coordination principle and the administrative regulations governing cooperation and collaboration (Art. 4 of Law 30/1992). In general, relations with CA financial sector authorities are considered adequate: statistical data are exchanged, visits are conducted, there is joint training for inspectors, joint operations are carried out, etc. In terms of cooperation arrangements among the various functional supervisory agencies, on March 12, 2004, a "Cooperation Protocol between the BE and the Ministry of Economy Directorate General of Insurance and Pension Funds on their respective supervisory responsibilities" was signed addressing, inter alia, the principles on which this type of cooperation must be based, the scope of respective responsibilities and functions, and the general regime governing the exchange of information and the systems agreed for technical cooperation between both institutions. In addition, a "Cooperation Protocol between the BE and the CNMV on their respective supervisory responsibilities" was signed on June 9, 2004 with the same tenor as the Protocol signed with the Directorate General of Insurance. Finally, pursuant to the regulations in force, the BE is empowered and actively participates in cases involving the resolution of problem banks, through: (a) LABE Art. 23.1 f): Formulating requirements and recommendations for credit institutions. (b) Article 34 of RD 1343/1992: Measures to ensure compliance with the solvency coefficient and solvency standards. (c) LDI Title III: Intervention or provisional substitution of a CI's management or board in exceptionally serious circumstances that jeopardize the institution's stability. (d) LDI Title I: Initiation and implementation of sanctioning proceedings that could lead to the closure of the institution.

	(e) Articles 10 and 11 of RD 2606/1996 on credit institution Deposit Guarantee Funds: Intervention of Deposit Guarantee Funds (in which four of the eight members of the executive committee are BE officials) when proposing restructuring plans subject to BE approval. A credit institution bankruptcy trustee panel shall be composed of one Deposit Guarantee Fund representative and an attorney and an auditor appointed by the judge from those proposed by the Deposit Guarantee Fund pursuant to Article 27 of Bankruptcy Law 22/03.
Assessment	Largely compliant.
Comments	While in practice the cooperation between the BE and the CAs appears to be effective, the dual legal framework governing *cajas* 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.
Principle 1(2).	Each such agency should possess operational independence and adequate resources.
Description	The BE is fully autonomous and has sufficient resources to supervise the CIs effectively. LABE Art. 1.1: In pursuing its activities and fulfilling its objectives, the BE acts with full autonomy from the Central Administration. LABE Art. 1.2: The BE is not governed by Law 6/1997 on the Organization and Functioning of the Central Administration. LABE Art. 4.1: The BE enjoys full operational and financial autonomy. The laws governing the budget, property, and procurement regimes for public agencies depending on or related to the Administration shall not apply. To ensure the autonomous and independent functioning of the BE, its staff is bound by a Code of Conduct (Internal Circular 10/2002) and selection and training procedures are governed by professional and ethical criteria (LABE Articles 18 and 24.1). The governor, the highest representative of the BE, is appointed by the king following a proposal by the head (president) of government for a non-renewable terms of six years. Nominees shall be Spanish and have acknowledged proficiency in monetary and/or banking affairs. The minister of economy must submit a report to the relevant parliamentary committee on the candidate before he/she is appointed. The deputy governor has to meet the same requirements as the governor. The BE has the capacity and sufficient financial resources—coming from ordinary operating income—to ensure appropriate compliance with its responsibilities independently and autonomously and has put in place the means to carry out its supervisory duties efficiently. In addition, the BE has the resources and procedures to hire the outside experts as necessary to meet its responsibilities. According to LABE Art. 4, the BE has its own operating expenses and investment budget approved by its Governing Council. This prospective budget is forwarded to the government, which then submits it to the National Legislative Assembly for approval. This budget is not consolidated with any other public sector budgets. On budget execution completion, the government approves the accounts, the balance sheet, and the closure of the financial year and forwards same to the National Legislative Assembly for information.
Assessment	Compliant.
Comments	The BE enjoys sufficient financial revenues to ensure the adequacy of resources to properly cover its operating expenses, including those required to fulfill supervisory and regulatory responsibilities.
Principle 1(3).	A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision.
Description	LDI Art. 43.1: AUTHORIZATION: In general, the authority responsible is the minister of economy subject to a prior report from the BE. For certain types of credit institutions (savings banks), the responsible authority is appointed for this purpose by the CA (a territorial division for which provision is made in the Spanish Constitution) in which the savings banks intend to locate. The prior report from the BE is mandatory in all cases. Article 57 bis of the Banking Law (LOB): REVOCATION: The authority responsible for revocation is the Council of Ministers, at the suggestion of the minister of economy, in the case of the LDI being applied for very serious infringements. In the event of revocation for exclusion from the guarantee system or for revoking a foreign branch's authorization for having had its license revoked by its supervisory authority, the revocatory power lies directly with the minister of economy. Revoking licenses for savings banks is governed by the responsible authority appointed by the CA. LABE Art. 3: The BE may issue specific regulations, known as "Circulars," by implementing higher-

	level regulations empowering it to do so. Specifically, the BE is expressly empowered by the government to issue via Circulars regulations on: - Accounting standards and financial statements (OM 31/3/1989 Art.1º); - Certain solvency standards that are already largely specified in Laws, Royal Decrees, and OMs; - Transparency with customers (OM 12/12/1989, final provision 1ª) The legal framework enables the BE to request and have access to all economic-financial and organizational information required to allow it to carry out its supervisory responsibilities. LDI Art. 48.1 and Order 31-3-1989: The BE is empowered to establish and modify credit institution accounting standards and specify the form, frequency, and detail of how these data must be submitted. LDI Art. 43 bis: The BE is authorized to conduct inspections and this implies having access to all information of whatever kind held by credit institutions. In addition, the BE may request local branches to provide any information it may require to carry out its responsibilities appropriately. LABE Art. 7 sections 6 and 7: The BE is empowered to request all information it requires from each individual institution.
Assessment	Largely compliant.
Comments	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.
Principle 1(4).	A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws, as well as safety and soundness concerns.
Description	LABE Art. 7.6 and LDI Art. 43 bis: The BE shall supervise the solvency, operations, and compliance with specific regulations of credit institutions and any other financial institution or market it has been called upon to oversee, without prejudice to the prudential supervision carried out by the CAs in their areas of responsibility and in cooperation with the BE. LABE Art. 7.7: The BE may engage in the necessary activities, to perform these functions correctly. LABE Articles 7.5 b and 3.1: The BE's purpose is to ensure the smooth operation and stability of the financial system and it has full autonomy to select the appropriate supervisory instruments and carry out specific activities which do not exclude applying certain qualitative criteria. LABE Articles 7.6 and 7.7 and LDI Art. 43 bis: Within the framework of the provisions in force, the BE supervises credit institutions' solvency, operations, and compliance with specific regulations. The BE conducts inspections and requests the information and documentation required to carry out its responsibilities. The law empowers the BE to adopt early prevention measures if a credit institution: (i) fails to comply with regulations (measures include: suspension of dividend distribution, limitation of branch office expansion, adherence to a capitalization plan, suspension of voting rights, subjection to sanctions for infringing rules); or if it (ii) engages in unsound practices (measures may include: requirements and recommendations; intervention and management substitution in exceptional circumstances). The prudential supervision of credit institutions is based on: LABE Art. 23.1 (f) and Art. 47 of the Banking Law: The formulation of specific recommendations and requirements is the responsibility of the BE Executive Commission. Approval of restructuring plans for credit institutions in crisis also falls to the BE, although they may also be supported by the corresponding Deposit Guarantee Fund (FGD). LDI Title I contains sanctions that could result in the revoking of authorization (also see Banking Law Art. 57 bis 1.g). Pursuant to LDI Art. 18, the initiation and processing of sanctioning proceedings and imposing mild and severe sanctions rests with the BE, while the imposition of sanctions for very severe infringements shall rest with the ME at the proposal of the BE. Revoking authorization is the responsibility of the Council of Ministers (Banking Law Art. 57 bis.2). LDI Title III: The BE determines the intervention and substitution of administrators in cases in which an institution is in an exceptionally serious situation that jeopardizes the adequacy of its own funds,

	stability, liquidity, or solvency.
Assessment	Compliant.
Comments	The Law of Discipline and Intervention assigns sanction authority to the ME and BE on the basis of severity of infractions: the 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. This may be of particular importance when addressing serious infractions that require the suspension of executives and directors from serving in leadership positions of credit institutions. For instance, while current law appears to allow BE to suspend or remove bank officers responsible for serious violations for one year, BE may only *propose* to the ME more severe sanctions (suspensions or removals greater than one year) for graver infractions.
Principle 1(5).	A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors.
Description	Articles 106.2 CE and 139 of Law 30/1992: Public Administrations (including the BE) only respond financially to administrative tribunals when certain legally established conditions are met. This procedure refers to the assumption of the financial liability of the BE or any of its employees pursuant to Article 139 and following of Law 30/1992. Articles 25 and 26 of BE Internal Rules: The BE must directly compensate individuals for any loss suffered to the assets and rights caused by the authorities and staff in the exercise of their legally bestowed duties and functions pursuant to Article 139 of Law 30/1992. In addition, the BE provides direct compensation for claims for damage or loss caused by the authorities and staff of said BE in the performance of their professional or other public duties (Art. 25.2). In such cases, the BE assumes responsibility for the legal management, defense, and legal advice of its staff and governing bodies, even if the interested party's working relationship or connection with said BE no longer exists at the point at which the claim or procedure is initiated, except in cases in which the BE acts as the complainant or accuser by decision of its governing council. This legal defense is available to the assignees of parties facing claims from third parties in cases in which these claims have been transferred to them. LABE Art. 6 and Art. 6 of Royal Legislative Decree 1298/1986: Binds the members of the governing bodies of the BE and its staff to secrecy with respect to any confidential information they may receive while discharging their duties. Article 25 of BE Internal Rules: In addition to legal management, defense, and legal advice, the BE assumes all financial and compensatory liability resulting from offenses or omissions committed by the authorities or its staff in the performance of their duties, including posting guarantees or sureties in civil or criminal claims, except in cases in which the BE acts as the complainant or accuser by decision of its governing council. Although the BE directly compensates injured parties, following initiation of the corresponding proceedings, it must, of its own accord, claim from its directors and employees any liability they may have incurred as a result of fraud, negligence, or gross negligence (Art. 25.5 of BE Internal Rules).
Assessment	Compliant.
Comments	Current legal protection for supervisors provides an effective tool to shield supervisors from legal actions taken while carrying out their duties in good faith.
Principle 1(6).	Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Description	Cooperation between banking, securities, and insurance supervisors, aimed at harmonizing supervisory criteria, practices, and techniques and sharing the information these supervisors required to carry out their duties, is mandated in current legislation (additional provision 2 of Law 44/2002). Article 17 of the Securities Market Law (LMV) and LABE Art. 20: Cooperation between the BE (banking supervisor) and the CNMV (securities supervisor) is primarily based on the composition of their respective governing bodies which include a highly-qualified representative from the other supervisory body. - LMV Art. 88: Operations must be coordinated in the event of overlapping responsibilities. For this purpose, agreements must be signed defining the respective responsibilities. - LMV Art. 90.6: Without prejudice to the secrecy obligation, the BE and the CNMV must provide each other with all information required to ensure that each can appropriately carry out the supervisory

	activities for which they are ultimately individually responsible. - LMV Art. 97: The CNMV must obtain a report from the BE prior to initiating credit institution sanctioning proceedings. - Article 12.3 of Law 13/1992: Cooperation between the banking supervisor (BE) and the insurance supervisor (ME) mainly relates to the supervision of financial conglomerates. The respective law has been implemented by RD 1343/1992, on own funds and the consolidated supervision of financial institutions. - Article 4 of Law 30/1992: All relations between national supervisors and CAs with supervisory responsibilities are based on the general principle of cooperation and mutual assistance among public administrations. Article 6.4 of RD 1298/1986: Expressly releases the BE from its confidentiality obligation with regard to providing other supervisors with information to assist them in carrying out their responsibilities. The BE has signed various cooperation protocols with authorities in European Union member states, as well as with authorities in third countries, especially those in Latin America. LABE Art. 7.8 and Art. 23 of BE Internal Rules: The BE may establish relationships with other central banks and financial supervisory authorities in other countries. Art. 6.1 of RD 1298/1986: Cooperation with authorities with supervisory functions in other countries is foreseen. LDI Articles 43 and 58.2 and Art. 7 of RD 1245/1995: Express provision is made for consultation with the competent European Community authorities when setting up Spanish institutions or taking a considerable share of existing institutions when the supervision of these institutions is to be carried out by entities domiciled in these European Community member states. LDI Art. 23 bis: The supervisory authority of branches of credit institutions authorized in another European Community member state must be notified of the initiation of sanctioning proceedings affecting these branches. Furthermore, said supervisory authority and the European Commission must also be informed of the decision taken when sanctions are imposed as a result of serious or very serious infringements. Article 6.4 of RD 1298/1986: Releases the BE from its confidentiality obligation when providing other financial sector supervisors with information. Information may also be provided to other persons or agencies to assist them in carrying out their responsibilities (e.g., deposit guarantee systems, the ECB, authorities responsible for combating money laundering, parliamentary investigation commissions, etc.) and all such persons or agencies are, in turn, bound by confidentiality obligations. Article 6.5 of RD 1298/1986: This law requires parties receiving this information to take steps to ensure that the information will be treated as confidential, binds them to professional secrecy, and stipulates that the information must only be used for the legal purposes established. Article. 6.1 of RD 1298/1986: As local supervisors and supervisors from other EU member states are bound by national or harmonized regulations, the obligation to take steps to ensure confidentiality is stricter for supervisors from third countries. Consequently, prior to providing the information requested, it must be verified that these supervisors are bound to professional secrecy at a level at least equal to that required by Spanish law. Article 6, sections 2 and 4 of RD 1298/1986: The general rule states that all information in a supervisor's possession is confidential. Exceptions to this rule are restricted to a specific list of cases (criminal court judges, authorities responsible for preventing money laundering, etc.). Consequently, information must be denied to any person or authority not included in this list. LABE Art. 6.3: When reporting to the National Legislative Assembly on matters legally subject to confidentiality, the governor may request a closed session or implementation of the established procedure for access to classified material.
Assessment	Compliant.
Comments	The assessors encourage the authorities to continue to deepen the cooperation among ME and bank, securities, and insurance supervisors with respect to the regulation of financial products that foster the development of capital markets.
Principle 2.	**Permissible activities** The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word "bank" in names should be controlled as far as possible.
Description	Art. 1 of RD 1298/1986: A generic definition of credit institution is established as a parallel definition to that provided in EU regulations. LOB Art. 38 of 1946 (banks); Art. 21 of RD of 21.11.29 (savings banks); Art. 3 of Law 13/1989 (credit cooperatives); Art. 1.3 of RD 692/1996 (financial credit entities): The specific terminology for each of these credit institution types is clearly defined in law or regulations. The authorization procedure involves analyzing the institution's plan of activities to verify viability. The CNMV is informed if the plan of activities contains activities related to investment and securities markets

	services. LDI Art. 52 (in line with the list included in Directive 2000/12/CE Annex I). Authorization to operate as a bank in Spain is universal and comprises all activities carried out by banking institutions. LDI Articles 28, 29, and 30: The word "bank" and any other term that might cause confusion with respect to its interpretation (pursuant to the rules indicated above in which the restricted terms are defined) is reserved and any infringement of this restriction may be prosecuted and sanctioned by the BE. Public registries must refrain from registering such names for companies not authorized as credit institutions and any such registration shall be null and void and may be canceled *sua sponte* or at the supervisor's request. LDI Articles 28 and 29 and Art. 1 of RD 1298/1986: Reimbursable deposit-taking from the public is reserved for credit institutions, for whatever purpose, in the form of deposits, loans, repurchase agreements or other similar purposes not subject to the regulations governing the securities market, as well as the issuing of electronic money. The BE may prosecute and sanction any infringement of this restriction.
Assessment	Compliant.
Comments	During the last five years the BE has initiated 14 sanctioning proceedings against non-authorized deposit-taking institutions.
Principle 3.	**Licensing criteria** The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organization's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.
Description	There is in place a set of regulations specifying the requirements for engaging in banking activities, application requirements, and applicable criteria for denying authorization. Articles 30.4 and 43 of Law 26/1988 on the discipline and intervention of credit institutions and Articles. 1–4 and 9 of RD 1245/1995 on the establishment of banks, transborder activities, and other matters relating to the legal regime governing credit institutions. Art. 2.4 of RD 1245/1995: Banks must satisfy the requirements for their establishment at all times and have minimum own funds of at least the minimum capital requirement. LDI Art. 43.5 and Art. 4 of RD 1245/1995: The ME shall deny authorization to set up a bank for failure to meet the requirements of Arts. 2 and 3 and, in particular, when the suitability of the shareholders who would have a significant holding in the institution is not deemed appropriate in view of the need to guarantee sound and prudent management of the institution. LDI Art. 43.5 and Art. 4 of RD 1245/1995: Assessing shareholders' suitability shall, inter alia, involve an assessment of transparency in the group to which the institution may eventually belong and, in general, if there are any serious difficulties in inspecting and obtaining the necessary information on its activities and the possibility that effective supervision might be hampered by the close ties the institution has with other natural persons or legal entities, by laws, regulations, or administrative provisions in the country to which any of said natural persons or legal entities is subject, or by problems related to applying such provisions. The process also involves assessing the assets shareholders have at their disposal to meet the obligations assumed. Article 2.1.(b) of RD 1245/1995: Minimum equity capital must total at least 3 billion pesetas (€18 million). Article 2 of RD 1245/1995: The credit institution shall have a Board of Directors with at least five members. All the directors shall be persons of good business and professional repute and at least the majority shall possess the appropriate knowledge and experience to perform their duties. Such repute, knowledge, and experience shall also apply to general managers or similar executives of the entity, as well as the individuals, who are directors, and represent any legal persons. Business and professional repute shall be deemed enjoyed by those persons who have a personal background of respect for the commercial and other laws that regulate economic and business activity, as well as good commercial, financial, and banking practices. In any event, the following persons shall be considered to lack such repute: those with a criminal record or subject to criminal charges or those, who in the proceedings referred to in Title III of book IV of the Criminal Procedure Law are subject to an order for oral proceedings in respect of offenses of defrauding the tax authorities, breach of trust in the custody of documents, money laundering, breach of secrets, misappropriation of public funds, disclosure and divulging of secrets or crimes against property, persons disqualified from holding public office, financial

	institution administration or management positions, persons who filed bankruptcy, and undischarged bankruptcy filers. Articles 2.1.(g) and 3.(b) of RD 1245/1995: The credit institution shall have sound administrative and accounting procedures, as well as adequate internal control procedures to ensure sound and prudent management of the entity. In particular, the Board of Directors shall establish adequate operating standards and procedures to ensure that all its members may comply at all times with their obligations and to assume the responsibilities that are theirs according to the rules of supervision and discipline of credit institutions, the Public Limited Companies Law, and any other provisions that may be applicable, and the operating plan that must specifically contain the type of operations in which they aim to engage, the administrative and accounting structure, and internal control procedures. Articles 3 and 4 of RD 1245/1995: The credit institution shall submit an operating plan that must specifically contain the type of operations in which it aims to engage the administrative and accounting structure, and internal control procedures. It shall also provide a list of shareholders who are to incorporate the company, specifying their holdings in its capital. In the case of shareholders who are legal persons, any capital holdings they may have in excess of five percent of capital shall be detailed. Shareholders who have significant holdings must, if they are natural persons, submit information on their professional career and activity and their financial position and, if they are legal entities, their annual accounts and Director's report, together with the auditor's report, if any, for the last two financial years, the composition of their governing bodies and the detailed structure of any group to which they may belong. Shareholders' suitability is assessed on the basis of the assets they have at their disposal to meet the obligations they have assumed. Article 1.1 of RD 1245/1995: The Minister of Economy is responsible for authorizing the setting up of credit institutions, following a report from the BE. Articles 7 and 9 of RD 1245/1995: In the case of branches of CIs established abroad, there is a legal obligation to consult the corresponding supervisory authorities. It must be verified that institutions from third countries wishing to open branches have obtained authorization from their country of origin to do so, if required, or that this certification is not required. LOB Art. 57 bis 1.(c): Establishes that a license obtained on the basis of false information or by other irregular means may be revoked.
Assessment	Compliant.
Comments	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.
Principle 4.	**Ownership** Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.
Description	LDI Art. 56.1 (Law 26/1988 on the Discipline and Intervention of Credit Institutions): For the purposes of this law, a significant holding in a credit institution shall mean a holding that reaches, directly or indirectly, at least five percent of the capital or voting rights in the institution. Holdings that do not reach this percentage but allow the holder to exercise notable influence in the credit institution shall also be considered significant. Article 18 of RD 1245/1995 (on the creation of banks, cross-border activity, and other matters relating to the legal regime of credit institutions): the shares, contributions to capital, and voting rights that make up a significant holding shall include: - Those acquired directly by a natural person or legal entity. - Those acquired through companies that a natural person controls or has a relevant holding in. - Those acquired by companies forming part of the same group as a legal person, or in which entities of the group have holdings. - Those acquired by other persons acting on behalf or in concert with the acquirer or with companies belonging to the same group. LDI Articles 57 and 58: Any natural person or legal entity intending to acquire a significant holding must inform the BE prior to doing so. Prior notification is also required if an increase in holdings reaches thresholds of 10, 15, 20, 25, 33, 40, 50, 66, and 75 percent or, in general, if this implies a change in controlling interest in the institution.

	LDI Art. 61: Credit institutions must notify BE as soon as they become aware of acquisitions that exceed the established limits. Article 19 of RD 1245/1995 (regulated in CBE 6/1995): Regulates the information CIs must submit to the BE on their capital structure. In particular, as soon as a credit institution becomes aware of such information, it must notify the BE of transfers of shares that involve the acquisition by a person or group of one or more percent. LDI Articles 58 and 59 establish that the BE shall have three months, if required, to oppose the proposed acquisition based on the same requirements in place for authorizing new institutions. The BE must consult the competent authority if, as a result of the acquisition, the CI becomes subject to supervision by an EU institution. If the acquisition is made without notifying or obtaining authorization from the BE, the following shall apply: - Voting rights may not be exercised. - Where necessary, the intervention of the institution or substitution of its directors shall be decreed. - Sanctions may be imposed. LDI Art. 62 establishes that where there are well-founded reasons indicating that the influence exercised by persons with significant holdings could be seriously detrimental to the institution's financial position, following a proposal from the BE, the ME may adopt the following measures: - The above-mentioned measures provided in Art. 59. - In exceptional circumstances, the authorization for an acquisition may be revoked. - Sanctions may be imposed.
Assessment	Compliant.
Comments	While there appears to be effective cooperation between the BE and ME, greater delegation of authority from the ME to the BE should be considered pursuant to LDI Art. 62, particularly in circumstances where the soundness of the institution may be harmed by the influence of the acquiring shareholder.
Principle 5.	**Investment criteria** Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.
Description	LDI Articles 57 and 58: Purchases of significant holdings in Spanish credit institutions (CIs) must be approved by the BE. LDI Articles 30.bis.3 and 4: Setting up branches abroad must be authorized by the BE. LDI Art. 30.bis.5: A Spanish CI or group of CIs must obtain BE authorization when setting up a CI or directly or indirectly acquiring a significant holding in an already existing institution when the foreign CI is to be incorporated or has its office in a state that is not a member of the EU. When setting up banks in EU member states, the supervisor for these states must consult the BE before issuing the corresponding report, pursuant to the Second Banking Coordination Directive. In addition, Spanish regulations have established limits on and deductions from eligible own funds for specific investments, as follows: LRP Art. 6.3 (Law 13/1985 on Capital Adequacy): This Article allows for the possibility of establishing ceilings on investments in real property, shares and holdings, assets, liabilities, or positions denominated in foreign currency, risks with the same person, institution, or economic group and, in general, all transactions or positions that imply high risks to the solvency of the respective institutions. This Article is implemented through: - Art. 30 of RD 1343/1992 and Rules 25-28 of CBE 5/93 on limits on high risks:[9] this may not exceed 25percent of own funds (20 percent for risks with non-consolidated institutions in an institution's own economic group). Total high risks may not exceed 800 percent of own funds. - Art. 31 of RD 1343/1992 and Rule 29 of CBE 5/93 on limits on tangible fixed assets: these items may not exceed 70 percent of own funds. LRP Art. 10, Art. 21.1.h) of RD 1343/1992, and Rule 10 of CBE 5/93 on the deduction from eligible own

[9] A high risk is defined as a risk that exceeds 10 percent of own funds.

	funds of qualifying holdings in companies not listed as finance companies: The higher of the following amounts shall be deducted: (a) the total amount of qualifying holdings[10] in non-finance companies for the part that it exceeds 60 percent of the institution or group's own funds; (b) the sum of qualifying holdings in each non-finance company for the part of each holding that exceeds 15 percent of the institution's own funds. Article 21.1.e) g) of RD 1343/1992 and Rule 9.e) g) of CBE 5/93: The following items shall be deducted from own funds: Holdings in financial institutions that are consolidatable on the basis of their activity but are not integrated into the consolidatable group and not listed as insurance companies, when the holding exceeds 10 percent of the capital of the respective institution or group, or the sum of all holdings that are equal to or less than 10 percent of the capital of said institutions, for the part that exceeds 10 percent of the holder's or its group's own funds. LDI Art. 30 bis.5 on a Spanish credit institution operating in a non-EU country through another credit institution. This Article stipulates possible reasons for denying authorization, on the basis that, due to the credit institution's financial position or management capacity, the project could have a negative effect on said institution, that the BE cannot ensure effective supervision of the group on a consolidated basis, or when the activity of said institution is not subject to effective supervision by the national supervisory authority. Article 4 of RD 1245/1995: All requirements stipulated for conducting banking activities (Art. 2) must be observed at all times. This includes having sufficient organizational resources and internal controls to ensure the sound and prudent management of the institution.
Assessment	Compliant.
Comments	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.
Principle 6.	**Capital adequacy** Banking supervisors must set minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. For internationally active banks, these requirements must not be less than those established in the Basel Capital Accord.
Description	Solvency regulation in Spain adheres to the principles and definitions laid down in European Union regulations in this area, which, in turn, incorporate the criteria adopted in the 1988 Basel Committee Accord on Minimum Capital Requirements. The current differences result in Spanish regulation being stricter in certain areas, particularly with regard to the definition of own funds: it excludes own funds eligible under EU and Basel (general provisions, surplus for the year at the half-year mark), and it introduces additional own funds deductions (indirect financing of own funds and certain excess holdings). Basic solvency regulation for consolidatable credit institution groups is established in Law 13/1992 on own funds and consolidated supervision of financial institutions. This amounted to a redrafting of Law 13/1985, which had already introduced own funds requirements sensitive to the level of risk of assets and memorandum accounts in anticipation of what would subsequently become the new international practices. Furthermore, since 1993, Spanish regulation (Law 13/1992, Chapter V) includes the own funds requirements for financial conglomerates. This regulation comprises a non-accounting-based own funds consolidation procedure and requirements to verify the overall solvency of the financial group. Article 6 of Law 13/1985 stipulates that "consolidatable groups of credit institutions, as well as credit institutions not integrated into a credit institution consolidatable group must, at all times, maintain sufficient own funds in relation to their investments and risks assumed …." Article 25 of RD 1343/1992 stipulates the level of the solvency ratio requirement: "Consolidatable groups of credit institutions, as well as credit institutions not integrated into one of these groups must, at all times, maintain a solvency ratio of not less than 8:100." Article 13 of Law 13/1985: this obligation also applies to non-exempt Spanish branches of foreign credit institutions.

[10] A qualifying holding is defined as the direct or indirect possession of at least 10 percent of capital or voting rights in a company or the possibility of exerting a marked influence on the management of the company (at least 20 percent of the directors may be appointed by the institution in possession of the holding—Rule 10.2b of CBE 5/1993).

Article 26 of RD 1343/1992: the capital ratio reflects the consolidatable group's risk profile based on the differentiated weighting of assets and memorandum accounts according to the level of risk: "capital accounts, commitments, and other memorandum accounts representing a credit risk, excluding items deducted from own funds shall be classified and weighted to calculate the solvency ratio in risk groups, with the weighting factors and surcharges that …," pursuant to European Union regulations that, in turn, adhere to the Basel Accord.

Article 6 of Law 13/1985 and Art. 30 ff. of RD 1343/92: the solvency ratio is reinforced by a number of provisions limiting the negative effects of risks to which credit institutions are exposed, particularly in terms of credit risk:

- Limits major risks with an individual or economic group representing more than 10 percent of the own funds of the consolidatable group. Individually limited to 25 percent of own funds (20 percent for own group) and globally limited to a total of 800 percent of own funds.
- Limits tangible fixed assets to 70 percent of own funds.
- Penalties, via deduction from own funds, of excess qualifying holdings in nonfinancial institutions

In addition, institutions are required to control interest and liquidity risks and these controls must be verifiable by and available to BE staff.

Article 7 of Law 13/1985 stipulates that "Own funds of CIs and consolidatable CI groups shall comprise capital stock, the initial fund (*fondo fundacional*), reserves, generic banking provisions, credit cooperative training and promotion funds, subordinated financing and all other receivable or non-receivable items to be used to cover losses. All losses and any assets that may reduce the effectiveness of said resources in covering losses shall be deducted from these resources."

Article 9.4 of Law 13/1985: The BE must monitor credit institutions' individual solvency status, irrespective of consolidated own funds. Pursuant to this provision, the BE has stipulated lower individual ratios for Spanish CIs that form part of consolidated groups (Rule 5 of CBE 5/1993). These requirement reductions could total as much as 50 percent based on the group's holdings in these Spanish CI affiliates (see additional criterion 5).

Article 10 of Law 3/1992 and LDI Articles 4–5: Pursuant to these Articles, reducing own funds below 80 percent of the minimum requirement for more than 6 months is considered a very serious infringement, while the infringement would be categorized as serious if this situation were to remain for 2 to 6 months. LDI, Chapter III establishes the respective sanctions for the infringements committed.

Article 11.1 of Law 13/1992: In addition to the applicable sanctions, when a CI or a consolidatable group of credit institutions fails to achieve the stipulated minimum own funds requirement, the institution, or each and every consolidatable institution must restore the reserves by allocating their liquid profits or surpluses as prescribed in the regulations and only distribute these funds following prior authorization by the BE.

Article 35 of RD 1343/1992: If the own funds deficit is more than 20 percent of the minimum requirement, the institution, or each and every institution belonging to the consolidatable group must allocate to reserves all their net profits or surpluses, with due consideration of the stipulated exceptions. If the deficit is below 20 percent, the distribution of profits is submitted to the BE and at least 50 percent of this amount must be allocated to reserves.

Rule 30 of CBE 5/1993: In addition to the corresponding sanctions, in the event of noncompliance with the minimum own funds requirement, the respective institution must immediately inform the BE to this effect. In addition, within one month, said institution must submit a solvency recovery plan to the BE and said BE shall approve this plan if deemed appropriate. Moreover, the BE may stipulate additional measures to those proposed by the institution.

DF 2 RD 1343/1992: The BE is legally empowered to "stipulate the frequency and form of own funds declarations and compliance with the required limits".

Rules 33 and 37 of CBE 5/1993 stipulate the information to be reported by CIs, consolidated groups, and non-consolidatable mixed groups under BE supervision semi-annually (in some cases, quarterly). Statements are compiled in annexes to CBE 5/1993 and refer to:

- Compliance with minimum own funds requirements
- Eligible own funds
- Own funds requirements according to credit and counterparty risk
- Own funds requirements according to exchange rate and gold position risk

	- Own funds requirements according to business portfolio risk - Non-consolidatable mixed group compliance with minimum own funds requirements - Limits for major risks and fixed assets - Own funds requirements calculated using internal models
Assessment	Compliant.
Comments	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.
Principle 7.	**Credit policies** An essential part of any supervisory system is the independent evaluation of a bank's policies, practices, and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.
Description	Article 2 of RD 1245/1995: Credit institutions must have a sound administrative and accounting organization at all times, as well as determine internal control procedures that guarantee sound and prudent management. The Board of Directors must establish appropriate operational and procedural rules to ensure that all members fulfill their obligations at all times and assume their respective responsibilities. Article 32 of RD 1343/1992; Rule 4.4 of CBE 5/93: Institutions must clearly establish interest and liquidity risk policy and its supervision, approved by the governing body, as well as how often this policy is analyzed and reviewed by said governing body and the BE must be able to verify this policy. Institutions must also identify the management body or manager directly responsible for information and risk management and specify the scope of these responsibilities. Rule 10.1 of CBE 4/1991: Credit institutions must exercise utmost care and diligence in the rigorous and individualized analysis of the credit risk inherent in their credits, not only when these credits are granted but also throughout the entire duration of said credits. In addition, Annex IX of CBE 4/2004 on credit risk clearly requires that institutions determine appropriate policies, methods, and procedures for granting, analyzing, and documenting credit risk and these must be approved by the Board of Directors. The Audit Committee and the Internal Audit Department shall ensure that these policies, methods, and procedures are appropriate, implemented effectively, and regularly reviewed. Rule 25.7 of CBE 5/93: Institutions shall have sufficient internal information, monitor their risk concentrations in the various economic sectors, and ensure sufficient diversification, corporate purpose and market conditions permitting. Rules 10.2 and 10.3 of CBE 4/1991: These rules establish accounting classification criteria for doubtful items (including contingent liabilities). The remainder of above-cited Rule 10 establishes a further series of criteria and considerations for doubtful credit investments (extensions, redocumentation, accrual of interest, etc.). Rule 11.4.d) of CBE 4/1991 on "credit risk coverage" penalizes credits in excess of €25,000 that are not adequately documented with minimum provisioning of 10 percent. If the holders are companies, documentation must include timely updated financial statements to enable the economic and financial analysis of said companies. The content of the two references to CBE 4/91 cited above has been enlarged in CBE 4/2004 Annex IX, section II (classification of operations in terms of credit risk) and III (cover for losses as a result of heightened credit risk). CBE 3/95 Central Credit Register (CIR) establishes the obligation to report, on a monthly basis, the amount and holder(s) of practically all risks equal to or exceeding certain minimum thresholds (€6,000 for business conducted in Spain with residents) granted by Spanish credit institutions (and foreign CIs in their operations in Spain), together with other data describing these risks. Reporting institutions have access to aggregate information on all risks reported by risk holders in the system or of potential clients who have expressly granted access to their data. Rule 28.7 of CBE 4/1991: Credit institutions shall ensure that their profits are not affected by granting credits at abnormally low interest rates. Rule 72 and CBE 4/2004 stipulate adequate internal accounting, management control, and internal control on policy implementation, including pricing policy, approved by the Board of the respective institution. Verification and analysis of the aforementioned aspects is ultimately one of the main aims of on-site visits. When weaknesses in risk management policies and practices are identified in these inspections, the

	BE issues the corresponding requirements to the respective institutions (letter to the Board of Directors).
Assessment	Compliant.
Comments	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.
Principle 8.	**Loan evaluation and loan-loss provisioning** Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices, and procedures for evaluating the quality of assets and the adequacy of loan-loss provisions and reserves.
Description	Rule 10.1 of CBE 4/1991: Credit institutions must exercise utmost care and diligence in the rigorous and individualized analysis of the credit risk inherent in their credits, not only when these credits are granted but also throughout the entire duration of credits, and shall not delay in reclassifying credits as doubtful assets and covering these assets with special funds. Rule 10 of CBE 4/1991: Establishes the criteria for classifying an investment as doubtful, both objectively (arrears) and subjectively (deteriorated financial position). Rule 11 of CBE 4/91: Establishes the criteria for the following three types of minimum provisioning: - Specific: covers losses for transactions or customers classified as doubtful. - Generic: 1 percent of risks without specific cover or 0.5 percent in some cases (mortgages on completed housing). - Statistical: covers estimated latent overall insolvency in the various risk portfolios.[11] Annex IX of CBE 4/2004 on analysis and coverage of credit risk establishes the criteria institutions must apply in their credit risk management policies, methods, and procedures and, in particular, includes specific rules for classifying transactions in terms of credit risk and for covering this risk with provisioning (specific and generic coverage). Additional Provision 1 of Law 19/1988 on the Auditing of Accounts: All Spanish financial institutions are obliged to audit their annual accounts. The accounting standards contained in BE circulars are mandatory standards from the commercial viewpoint and, consequently, external auditors issue their opinions on annual accounts on the basis of these provisions. Technical Standards approved by Institute of Accounting and Auditing (ICAC) Resolutions issued on December 1, 1994 and December 15, 1995: External auditors also prepare a supplementary report for the supervisor and this report must provide information on loan-loss provisions. Rule 11.4.b) and c) of CBE 4/1991 establishes the provisioning criteria for contingent assets and liabilities. Annex IX of CBE 4/2004 on analysis and coverage of credit risk establishes the specific rules for classifying contingent risks and liabilities in terms of credit risk and for the purpose of covering this risk with provisioning. Rules 10 and 11 of CBE 4/1991 establish criteria for classifying doubtful investments and making minimum provisioning. CBE 4/2004 updates accounting rules formerly contained in CBE 4/1991 adapting them to the IFRS. Specifically: - Rule 10.2.b) states that transactions, matured or otherwise, in which there is reasonable doubt with regard to total reimbursement at the time and in the form contractually agreed must be classified as doubtful, whether this involves the holder experiencing circumstances that imply a deterioration of his/her solvency, such as negative net worth, continuous losses, generalized payment arrears, an inadequate economic or financial structure, or other reasons. - Rule 10.5: Extending or redocumenting transactions where reimbursement is problematic neither affects payment arrears nor results in reclassification as regular transactions unless it is reasonably certain that the customer can meet his payments within the foreseen schedule or effective new guarantees are forthcoming and, in both cases, at least the pending ordinary interest is paid without taking the arrears interest into account. - Rule 11.4.b)c): Provisioning shall be made for guarantees and other pledges given and classified as doubtful, and contingent assets and other contingent liabilities classified as doubtful for reasons other

[11] The current generic provision includes the former anti-cyclical provision, which was reformed to comply with the principles of the international accounting standards recently adopted in Spain.

	than arrears in an amount equal to the estimated unrecoverable amount based on the strictest valuation criteria and respecting the minimum percentages stipulated in the above-mentioned circular. Rule 41.1 of CBE 4/1991: Spanish CIs and branches of foreign institutions must submit a quarterly statement (T-10) of transactions classified as doubtful and grouped according to various characteristics and the respective provisioning. CBE 3/1995: Monthly individualized information is available on risks reported to the credit register (CIR) by Spanish CIs and branches of foreign institutions operating in Spain, as well as information on evolution of the total amount of doubtful credits and respective provisioning included in balance sheets. Rule 29.7 12.b of CBE 4/2004 on loss in value of financial assets requires the updated value of real guarantees to estimate future cash flows for debt instruments valued at amortized cost. Rule 29.22 of CBE 4/2004 on methods to estimate loan losses: among other factors, institutions' calculation models must take account of guarantees made on the basis of the information available on the date on which the estimate is calculated.
Assessment	Compliant.
Comments	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, seeking to preserve as much as possible the traditionally strong credit risk control framework.
Principle 9.	**Large exposure limits** Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.
Description	Spanish regulations assume a very generic and broad definition of "group" and this allows the supervisor to exert a fair degree of discretion if there is some indication of " close relation." Article 42.1 of the Commercial Code (RD 22 of August 1885): a "group" is said to exist when several companies form a decision-making unit. LMV Art. 4: Institutions constituting a decision-making unit, in that one of said institutions directly or indirectly holds or may hold control of the others, or in that this control is held by one or several natural persons acting systematically in concert, shall be deemed to belong to the same group for large exposure limits purposes. Article 5 of RD 1343/1992: Irrespective of their activity or corporate purpose, a group of companies or institutions constituting a decision-making unit shall be deemed an economic group pursuant to Article 4 of the Securities Market Law (LMV). Rule 25 of CBE 5/93 on risk aggregation for the calculation of concentration limits: All risks held with (a) a person, (b) another economic group (Art. 5 of RD 1343/1992), and (c) non-consolidated companies belonging to the same economic group, shall be aggregated. Article 30.4 of RD 1343/1992; Rule 25.2 of CBE 5/93: The BE may stipulate that specific groups of customers be considered as a single unit, even though they do not belong to the same economic group and this status shall apply from that point onward. Rule 26 of CBE 5/1993: Definition of major risk: Any risk exceeding 10 percent of own funds. Risks assumed with an individual or group not belonging to the risk-bearer's group may not exceed 25 percent of own funds. Risks with non-consolidated companies belonging to the CI's own group are limited to 20 percent of own funds. Total major risks are limited to 800 percent of own funds. Rule 25.5 of CBE 5/93: Risks shall be calculated by aggregating transactions posted as assets in the balance sheet with sureties, guarantees, and all other obligations listed in memorandums accounts for the same person or group. Article 30.4 of RD 1343/1992: CIs shall ensure that their risk concentration is appropriately monitored via suitable administrative and accounting procedures and internal control mechanisms, with special emphasis on identifying holdings and cross-guarantee relationships and interdependent business relationships among their customers. Rule 6.3 of CBE 4/1991: Institutions shall monitor the various types of risk to which their financial activity is exposed with the utmost care. In particular, they must be in possession of the information required to assess the concentration risk. Rule 33.1 of CBE 5/1993: Institutions must provide the BE with periodic information on major risks and compliance with limits. Rule 41.1 of CBE 4/1991 establishes two further statements that institutions must submit periodically to ensure that geographical and sectoral concentration are reviewed.

Assessment	Compliant.
Comments	In practice, a wide range of concentrations that may be present in institutions' credit portfolios are analyzed at both individual and group level, using both the information regularly received by the BE and the information requested from institutions during on-site inspections.
Principle 10.	**Connected lending** In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.
Description	The legal and regulatory framework establishes a comprehensive definition of "connected or related parties" (see description of BCP 9). Rule 62 of CBE 4/2004 provides a detailed definition of "related parties" and establishes specific information requirements for them. As mentioned in BCP 9, Art. 30.4 of RD 1343/1992 allows the BE to stipulate that specific groups of customers be considered as a single unit, even though they do not belong to the same economic group and this status shall apply from that point onward. LRP Art. 9.4: Empowers the BE to require information and carry out on-site examinations of non-financial CI-related parties in order to assess the legal and financial influence resulting from such a relationship on CIs. Article 5.1 of Law 31/1968 and Art. 2 of Decree 702/1969 on credits to "directors" or companies they control: Persons who must be recorded in the Senior Bank Officials Register *(Registro de Altos Cargos de los Bancos)* may not obtain loans, sureties, or guarantees from the institution in which they are managers or directors, unless expressly authorized by the BE. Rule 32 of CBE 5/1993: This rule stipulates the criteria and terms for the respective authorization and states that the decision must be adopted by the Board of Directors without the involvement of the director concerned. On a quarterly basis, the BE receives a list of credits granted to persons holding management positions in the respective institution or in other institutions in the same group and of companies in which 'such persons have a majority capital stake or hold the position of general manager or a similar position. Annex IX of CBE 4/2004 on credit risk explicitly requires that institutions establish appropriate policies, methods, and procedures for granting, analyzing, and documenting credit risk and that these must be approved by the Board of Directors. The Audit Committee and the Internal Audit Department shall ensure that these policies, methods, and procedures are appropriate, implemented effectively, and regularly reviewed. Credits to directors, companies linked to directors, the bank's own group, etc. are monitored on the basis of monthly information from the credit register and the quarterly report on risks with related persons and connected companies (Rule 32.2 CBE 5/93). On-site inspections include verifying that board of directors minutes include credits granted to directors and companies in which they have holdings and that the person concerned does not participate in approving these credits. Rule 26.3 of CBE 5/1993: Definition of major risk: Risks assumed with 'respect to the risk-bearer's non-consolidatable group may not exceed 20 percent of own funds. Risks held with directors of companies belonging to the CI's own group shall be aggregated in the calculation.
Assessment	Compliant.
Comments	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.
Principle 11.	**Country risk** Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring, and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.
Description	Regulations and supervisory activities enable BE to have a clear understanding of country risk management in supervised institutions and country risks in the banking sector in general. CBE 4/1991 defines country and transfer risk, outlines requirements that banks must undertake to review and manage such risks, and establishes detailed quarterly reporting requirements. The Circular also establishes criteria to categorize countries into six distinct groups (ranging from least to highest risks) to facilitate risk classification. Annex IX of CBE 4/2004 articulates requirements for establishing country risk management policies and

	procedures, and sets specific country risk classification criteria and minimum provision requirements. A long-standing specialized unit of the BE continues to carry out ongoing monitoring of country risks, particularly in Latin America (where the bulk of overseas exposures have been lodged) to support bank supervision. Discussions with BE inspectors as well as the two largest internationally active Spanish banks indicate that comprehensive country risk information is reported and evaluated by BE supervisors on a frequent basis. Compliance with prudential requirements as well as country risk-management practices is evaluated as part of on-site inspections.
Assessment	Compliant.
Comments	Given Spanish banks' substantial growth in exposures to European countries, the assessors encouraged the authorities to consider reviewing, and if necessary, making appropriate adjustments in supervision practices with respect to country risk monitoring and assessment.
Principle 12.	**Market risks** Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor, and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposure, if warranted.
Description	Regulatory and accounting rules underpin the BE's ability to evaluate CI market risk identification and control. Article 2, Royal Decree 1245/1995 requires institutions to have sound internal controls and risk management systems. CBE 4/1991 (updated by CBE 4/2002) generally requires CIs to evaluate and monitor a variety of risks, including market risk, and make available the information necessary to support BE supervisors' market risk assessment. Further, the CBE sets out accounting rules for some fixed or variable rate trading portfolios for which there is intent to profit from price volatility in the short term. A breach of market risk regulatory requirements may subject the institution to the sanctions regime under which a range of penalties and restrictions may be imposed. CBE 5/1993 also requires that CIs have sufficient resources to cover positions in foreign exchange, gold, trading portfolios, and commodity price risks. Requirements for approval of market risk models and the minimum capital charges and fixed daily VaR limitations to be maintained are also outlined. The BE and banking associations collaborated to produce a set of guidelines addressing internal controls in Treasury activities in 1997. During onsite inspections, BE uses this guidance, as well as other internal updated guidelines and supervisory tools, to evaluate treasury and market risk activities. There are two teams of inspectors specialized in treasury and internal models and custody, respectively, for this purpose. The BE expects supervised institutions to have well-documented policies and procedures approved by the Board of Directors and being in fact applied by affected employees. On-site inspections cover adequacy of contingency plans, stress-testing, simulation methodology and back-testing.
Assessment	Compliant.
Comments	The assessors took note of BE supervisors' measures to evaluate market risks and encouraged the authorities to review and update, as needed, the 1997 public guidance on treasury activities.
Principle 13.	**Other risks** Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor, and control all other material risks and, where appropriate, to hold capital against these risks.
Description	CBEs 4/1991 and 5/1993 supported by Arts. 2, RD 1245/1995 and 32 RD 1343/1992 emphasize: the need for maintenance of controls that foster sound risk management processes, scope of responsibilities of Boards of Directors to maintain effective internal controls, and adequate CI reporting to evaluate liquidity, market risk, foreign exchange risks, concentrations, and operational risks among others. This framework allows BE a wide scope for assessing whether CIs are operating with adequate risk management systems and controls. BE supervisors evaluate the state of CI risk management functions largely through risk-based onsite inspections where they can more closely evaluate whether bankers are building effective risk management processes and are complying with capital and liquidity requirements. Discussions with Spanish banks and BE supervisors indicate that the risk management function is a pivotal component of onsite examinations. BE supervisors convey concerns and seek corrective measures through formal or informal communications with management and board of directors. BE does not routinely issue prudential guidelines on different kinds of risk. However, it fosters the

	dissemination of sound practices through periodic publications, public speeches by BE's representatives in different financial fora, participation with professional banking associations, and through its leadership in the Basel Committee on Banking Supervision.
Assessment	Largely Compliant.
Comments	While the BE encourages the diffusion of best risk management practices in such areas as liquidity risk, as a general rule the BE does not issue prudential standards. The lack of regulatory authority hampers BE's scope of action in this area. Therefore, 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.
Principle 14.	**Internal control and audit** Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls, as well as applicable laws and regulations.
Description	The legal framework underpinning corporate governance in financial institutions includes: Article 133, *Ley de Sociedades Anónimas* and Art. 2.1 g) RD 1245/1995 addresses responsibilities of boards of directors in establishing appropriate operating policies and procedures *Ley 44/2002 de Reformas del Sistema Financiero* requires board audit committees with majority non-executive directors for large publicly traded companies; and *Ley de Transparencia* 26/2003 requires corporate governance reports annually containing information on risk management systems. It also requires *cajas* to establish within the board both an investment and a compensation committee. These legal foundations have also been supplemented with codes produced by professional groupings that voluntarily adopt corporate governance best practices as in *El Código Olivencia* (Feb 1998) and more recently, *El Informe Aldama* (Jan 2003). Furthermore, Art. 62, LDI allows the ME, at the request of the BE, to suspend voting rights of major shareholders and revoke previously approved significant ownership stakes in circumstances where the influence of major shareholders can gravely damage the institution's financial health. Deficiencies in internal control procedures, including those related to risk management, are defined as infractions subject to sanctions under the aforementioned LDI. The BE has instituted detailed procedures to evaluate internal controls at supervised institutions. In discussions with BE inspectors and banks, it was noted that emphasis is placed on evaluating internal audit functions to assess adequacy of technical and human resources, independence, scope and frequency of audits, and reporting and recommendations to management and the board of directors.
Assessment	Compliant.
Comments	BE supervisors place considerable emphasis on evaluating CIs' adequacy of internal controls.
Principle 15.	**Money laundering** Banking supervisors must determine that banks have adequate policies, practices, and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.
Description	Ley 19/1993 on the prevention of laundering of capital, modified by Ley 19/2003 , provides a legal framework governing capital movements, foreign economic transactions and measures to prevent money laundering. The law requires credit institutions to implement internal controls, communication policies and employee training to prevent money laundering. The law also requires the identification of clients and ultimate beneficiaries, the retention of customer records a minimum of 5 years, and the reporting of suspicious transactions to SEPBLAC *(Servicio Ejecutivo de la Comisión de Prevención del Blanqueo de Capitales e Infracciones Monetarias)*, a unit within the ME. . Movement of cash and Cashier's checks over 80.500 euros subject CIs to reporting and other obligations under the law, while transactions

	involving currency and travelers' checks over 30.050 euros must be disclosed to SEPBLAC. Under the law, SEPBLAC has the legal authority and responsibility for supervising and enforcing CIs' compliance with AML rules. The BE does not supervise anti-money laundering compliance but provides the human and financial resources to assist SEPBLAC to carry out supervision and inspections. Further, BE supervisors review the effectiveness of CIs' internal controls to help detect and prevent money laundering and fraud. Discussions with SEPBLAC officials and review of documents disclosed that SEPBLAC is led by experienced management, has procedural manuals to guide offsite and onsite activities and to monitor implementation of recommendations made to CIs.. SEPLAC has issued rules to foster anti-money laundering compliance in areas such as reporting requirements and "Know Your Customer" policies. In particular, it is apparent that SEPBLAC's reporting system requirements for suspicious transaction are applied by the major credit institutions. . In recent years, SEPBLAC's principal efforts have been focused on reviewing compliance with anti-money laundering rules in the largest commercial and savings banks *(cajas)* and their affiliates. The scope of such reviews appear to include determinations over the adequacy of CIs' anti-money laundering policies and procedures, appointment of compliance officers, suspicious transaction reporting , internal lines of communication and controls for preventing money laundering. Discussion with SEPBLAC officials indicates that inspection reports provide recommendations to improve anti-money laundering compliance programs and follow-up procedures to monitor implementation of recommendations. Under the law, the BE and SEPBLAC are required to cooperate with one another. A BE Director is required to serve as a SEPBLAC commissioner. In June 2005, the BE and SEPBLAC entered into a cooperation agreement that, in part, calls for the BE to provide SEPBLAC with information related to any activity in a CI that may involve money laundering or represent a breach of AML laws. The BE is also required to convey pertinent information from foreign supervisors to SEPBLAC. SEPBLAC in turn, agrees to transmit its recommendations and requirements imposed on CIs to the BE. BE supervisors assured the assessors that there is now, in practice, a systematic sharing of information between the two institutions. The agreement also calls for the BE and SEPBLAC to perform simultaneous inspections to evaluate CIs' compliance with AML rules in the future. The BE and SEPBLAC are to share responsibility for planning the inspections and formulating requirements and corrective measures on CIs as a result of inspection findings. Collaboration and consultations on technical training are also part of the agreement. The BE participates in national initiatives to combat money laundering and in international fora where the issue is discussed. .
Assessment	Largely Compliant. The Financial Action Task Force (FATF) expects to complete a mutual evaluation of Spain's framework for combatting money laundering and the financing of terrorism in June 2006.
Comments	Given the size and complexity of the CIs sector and the relatively small number of inspectors, some doubts remain on whether the current inspector force can implement a risk-based inspection program with sufficient depth and frequency, especially when considering the need to also inspect medium and smaller-sized CIs. The authorities are encouraged to review the adequacy of resources on hand and determine any adjustments necessary to make the risk-based inspection program as effective as possible. The assessors also encourage that BE and SEPBLAC take swift steps to fully implement the June 2005 collaboration agreement, including joint inspections to the extent practical.
Principle 16.	**On-site and off-site supervision** An effective banking supervisory system should consist of some form of both on-site and off-site supervision.
Description	The BE has developed an effective risk-based supervisory program that integrates onsite inspections, offsite monitoring and analysis of individual banks and the banking sector, as well as communication with institutions' management and directors. The supervisory program is particularly underpinned by Art. 7.6 of the Autonomy Law of the Bank of Spain and Art. 43 of the Disciplinary and Intervention Law. These laws place the responsibility for supervising financial institutions' solvency and adherence to prudential rules on the BE. They also empower it to conduct onsite inspections, and extend its range of competence to examine cross-border operations of Spanish CIs. Functionally, BE supervision is largely carried out through teams organized taking into account the size and complexity of financial institutions. To maintain a high degree of contact with management and current knowledge of individual institutions, BE supervisors have a permanent presence at the two largest

	banks and *cajas*, conducting activities in accordance with pre-established examination plans. Supervisory plans are developed taking into account bank risk profiles, using a consistent set of defined risks. Based on discussions with inspectors, the risk profiles, particularly for the larger banks and *cajas*, force them to a disciplined and systematic risk assessment for each bank. This has proven helpful in better understanding banks' risks and as a tool to help prioritize allocation of resources. On-site inspections are led by an examiner-in-charge, are preceded by detailed scoping of the areas to be reviewed and communication with bankers over material to be prepared ahead of the team's arriving onsite. There is ongoing dialogue with bank management during the course of the inspection, and there is a meeting with management at the end of the exercise to go over corrective actions. A written report outlining areas reviewed and specific corrective measures is sent to bank management and the board of directors. There is a series of CBEs outlining prudential information requirements (including consolidated statements evidencing compliance with solvency rules) that supervised institutions must periodically submit to the BE. This requirement supports offsite supervision, which also serves to follow up on deficiencies identified during on-site inspections. The compulsory external audit of CIs' individual and consolidated annual accounts further underpins off-site supervision.
Assessment	Compliant.
Comments	The banks' risk matrix , by-product of the supervisory process, is a powerful tool to categorize risk and marshal appropriate resources to evaluate and mitigate them. The assessors encouraged BE supervisors to continue to strengthen the use of the banks' risk matrix as a tool to prioritize risks and allocate supervisory resources.
Principle 17.	**Bank management contact** Banking supervisors must have regular contact with bank management and a thorough understanding of the institution's operations.
Description	The BE's supervisory process emphasizes contact with officers of supervised institutions both during offsite monitoring and in the course of on-site inspections to deepen understanding of the condition and risks facing the institution. Such contacts coupled with regulatory notification requirements provide the BE with the ability to remain adequately apprised of matters affecting individual banks. CBE 5/1993 obligates banks and financial groups to notify the BE promptly when concentration risk limits are exceeded or capital requirements breached. Further, under Article 6.3. RD 1254/1995 during the first three years, new CIs are required to notify the BE of significant changes to their operating strategy as compared to the strategy submitted when approval was received. Contact among BE supervisors and supervised institutions is routine and aimed at evaluating prospective risks and progress of corrective measures. BE supervisors have access to high-level bank officials and members of the board of directors where warranted. At the largest banks, and particularly in the two banks where examination teams have permanent residency, communication is fluid with senior management, board of directors' committees and individual board members. A lead examiner-in-charge serves as a focal point between BE supervisors and senior management. Contact with smaller supervised institutions may be less frequent by virtue of their risk profile and examination priority (an onsite inspection may occur within a 3-year window) but BE supervisors indicate that offsite monitoring can include direct contact with management and meetings where warranted. The quality of bank management is considered as part of the fit-and-proper assessment during licensing as well as evaluated in the context of onsite inspections and follow-up corrective actions.
Assessment	Compliant.
Comments	On the whole, BE's supervisory process enables maintenance of effective contact with management of credit institutions, particularly the major ones in the sector. Based on discussions of examination plans with BE supervisors, the assessors encouraged them to consider whether more frequent management contact is advisable in smaller to mid-sized institutions where the interval between on-site inspections may be relatively lengthier.
Principle 18.	**Off-site supervision** Banking supervisors must have a means of collecting, reviewing, and analyzing prudential reports and statistical returns from banks on a solo and consolidated basis.
Description	LABE and LDI enable BE to establish and modify accounting rules and public and reserved financial reports and adapt them to EU and international standards. CBE 4/2004 updates and aligns existing

	accounting and reporting requirements included in CBE 4/91 to the new European framework. Along with inspection powers and financial resources, BE is able to access accounting, statistical, prudential and other information necessary to carry out its supervisory responsibilities. Financial institutions are required to provide statistical information in the following areas: on- and off-balance sheet assets, liabilities, losses and gains, own capital resources, liquidity, large exposures, provisions for insolvencies, market risks and deposit originations on a solo and a consolidated basis. After the data are subjected to quality controls and corrections are made, they are aggregated and made available both on a solo and consolidated basis to the supervisory function and all interested parties within the BE, for analysis and reporting. Article 47 and LDI Art. 9 and Ley 3/85 modified by Ley 13/92 and CBE 5/93 require the periodic (at least semi-annual) remittance to the BE of financial statements which must reflect in detail the capital and financial condition of credit institutions. Non-compliance with accurate and timely reporting requirements is a serious infraction subject to sanctions, which serves as deterrent to misreporting, persistent errors or providing misleading information (see BCP 22 for discussion of infractions and enforcement actions.) Internal management information is analyzed during on-site visits. In the case of large banks, the presence of inspection teams in their premises, makes access to internal management information continuous. The BE has an extensive analytical framework to monitor the condition of the financial sector using bank provided data. For example,. the BE is responsible for the development and maintenance of the large Central Risk Data Base (*Central de Información de Riesgos del BE*). This is an extensive pool of credit information (transactions greater than €6,000) for the entire financial sector, which is routinely used by bankers and supervisors for statistical and supervisory analysis.
Assessment	Compliant.
Comment	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.
Principle 19.	**Validation of supervisory information** Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.
Description	See BCPs 16-17 also. The BE has put in place a program of supervision that takes into account individual banks’ risk profiles and factors of systemic importance (such as large size) to produce a flexible plan that guides the conduct of offsite and onsite activities over the course of the year. BE supervisors use in-house resources for the vast majority of their work with very limited instances where external auditors conduct operational tasks of a supervisory nature. BE supervisors view the external audit of CIs’ annual accounts as an additional e tool to support supervisory activities. Meetings with external auditors are conducted as needed, and at least annually. BE supervisors routinely receive and review external audit reports accompanied with a complementary report that describes technical aspects of the review. BE supervisors analyze the consistency of the periodic information received from financial institutions, which permits an initial filter to identify and remove errors, prior to the in-depth assessment which may require contacting the CI itself. As a result of monitoring the information regularly submitted by CIs, inspection teams prepare various updates, including bank performance and trend analysis on a quarterly basis. The on-site inspections serve to verify the reliability of data reported. While the BE does not have direct authority to oppose the appointment of an external auditor, it may use its moral suasion over supervised institutions and influence through its membership in ICAC (a commission charged with oversight of the auditing profession) to prevent the engagement of unfit external auditors. BE inspectors are organized into three groups each with a few teams ranging from 7-10 individuals; a fourth group provides analysis support to the rest. One of the groups focuses on cajas, another on the smaller-to mid-sized banks and other financial entities, while a group with the most experienced staff supervises the two largest banks in the system. Discussions with inspectors and bankers indicated that on-site inspections receive significant planning, the scope of work is detailed and communicated to the supervised institution, interaction during the onsite inspections between examiners and bankers are fluid, and conclusions are discussed with high-level management and reported to the Board of Directors. BE inspectors enjoy the professional respect of bankers. BE inspectors, backed by legal authority under Art. 45 LDI have wide access to bank information to

	carry out supervision.
Assessment	Compliant.
Comments	The BE's on-site activities, particularly in the largest institutions, provide an effective means of validating supervisory information.
Principle 20.	**Consolidated supervision** An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.
Description	Legal and accounting framework requirements, the scope of BE supervisory authority, collection and off-site review of consolidated information, and on-site inspection activities enable the BE to supervise banking groups on a consolidated basis. CBE 5/1993 defines a consolidatable group or subgroup of a CI, which includes all relevant financial companies. The exclusion of any entity holding a 20 percent or more participation or voting rights from group consolidation requirements must be justified to BE. CBE 4/1991 requires that consolidatable groups of a CI submit the C-5 quarterly statement, "Relations of entities belonging to economic groups or other participated companies." This report includes information for each company including, capital, business activity codes, percentage of participation in the parent company (direct or indirect) and consolidating method (proportional, global etc.). The CBE also requires from groups subject to consolidation the following information on a quarterly basis: - Consolidated balances - Detail and amortization of differences in capital consolidation - Accounting for loss and earnings - Details on minority interests - Relationship among entities belonging to economic group and entities connected but not belonging to the economic group - Direct participations (including voting rights) - Relationships among credit entities and foreign financial companies where there is an investment or controlling interest - Collective investment firms managed by consolidated group - Summary of consolidation process - Consolidated activity categorized by country - Relationships among shareholders and senior managers of banks and foreign financial firms where there is an investment or a controlling interest (annual) The submission and review of the above data along with on-site inspections where the consolidation process is evaluated enable BE supervisors to gain a good degree of understanding of banking group structures, activities and material parts. As a consequence, impediments to consolidated supervision where they arise can be identified and may be mitigated. Further, Article 9.3, Ley 13/1985 enables the BE to inspect non-financial entities with whom there is a controlling relationship to determine legal, financial and economic impacts on the bank, banking group and groups subject to consolidation. To mitigate potentially adverse effects emanating from investments in non-banking companies, Article 24, Ley 13/1985 requires CIs to reduce from capital accounts the larger of (a) the part of total investments in qualified participations in non-financial companies exceeding 60 percent of the credit entity or the group's capital, or (b) the sum of each non-financial qualified participations exceeding 15 percent of the credit entity or group capital. Under Articles 9.2 and 9.3, Ley 13/1985, the BE has authority to require the collection, submission and on-site verification of data to achieve a comprehensive and consolidated view of the institution, group or entities constituting the group under supervision. Article 43, LDI extends the BE's power to inspect offices and pertinent units of the supervised institution and of entities constituting the group domestically and abroad Further, under CBE 4/91, the consolidation of consolidatable entities, must be carried out even when participation among them takes place through entities within an economic group not subject to consolidation. Over the past year, the BE has entered into bilateral collaboration agreements with the supervisors of the Insurance and Pension Funds (under the ME) and the CNMV. The agreements have as an important aim

	the fostering of information exchange on firms under supervision given the mix of insurance, banking and securities activities conducted in Spanish financial markets. Internationally, Article 6, RD 1298/1986 allows for the BE to enter into collaboration agreements with foreign supervisors provided there is reciprocity and the ability to maintain confidentiality of information comparable to Spanish laws. A number of agreements with EU and non-EU countries have been in place for a number of years. As provided in Article 6, Ley 13/1985, prudential standards apply on a consolidated basis, including capital adequacy, risk concentrations and other operational limits. On-site inspections serve to verify compliance with such prudential requirements. The BE also has authority to limit the cross-border activities Spanish banks can undertake. Article 30 LDI requires prior BE authorization to establish branches or acquire ownership of a credit entity in countries not members of the European Union. Article 4 LDI considers as a very serious infraction the establishment of unauthorized offices outside Spain.
Assessment	Compliant.
Comments	The framework of legal, accounting, collection and supervisory methods fosters the BE's ability to conduct consolidated supervision.
Principle 21.	**Accounting standards** Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.
Description	The BE plays a pivotal role in fostering the development and application of prudent accounting standards and the financial sectors' transparency both of which are helpful to fairly assess the financial condition of CIs. Ley 26/1988 underpinned the BE's faculties to establish and modify accounting rules and financial statement modalities in Spain. The most recent use of this authority is CBE 4/2004 which adapts the accounting regime of Spanish firms to the new international accounting modality derived from EU adoption of *Normas Interncionales de Información Financiera* of IASB. Spain's Commercial Code, and fundamental laws (*Ley de Sociedades Anónimas* (RD 1564/1989), LDI (L.26/1988), and *Ley de Auditoria de Cuentas* (L.19/1988) support holding managers and administrators responsible for accurate and timely financial records and public disclosure of company accounts. Consistent with that principle, the BE expects bank managers and boards of directors to ensure the institution produces and releases timely and accurate information to supervisors and the public. Specifically, CBE 4/91 (updated by CBE 4/2004) requires that annual bank account balances and complementing financial statement data provide a fair image of the institution's capital position, financial risks and condition, as well as accurate reflection of its operations on a timely basis. Further, Ley 19/1988 Audit of Accounts, requires that all CIs be subjected to an external audit of annual accounts. Article 4.g) LDI makes it a very serious infraction not to comply with this requirement. Discussions with BE supervisors indicated that as part of off-site and on-site inspection procedures the consistency of information received from supervised institutions is analyzed, data errors are detected and further verifications are performed. The BE does not use external auditors for supervisory purposes. The BE holds annual meetings periodically with the major external audit firms, mostly to discuss results of identified deficiencies. External auditors are required to provide the BE with information at their disposal on potential serious violations of law, developments that could have serious adverse effects on solvency of the institution, and an unfavorable or qualified opinion. The BE does not have direct authority to revoke appointment of a bank's auditor. Since external auditors are not generally used for supervisory tasks, the issue is of less importance. However, as a member of ICAC, the commission setting professional auditing standards, the BE can exercise influence in investigating and limiting the ability of unfit external auditors to participate in audits of institutions under BE supervision. Furthermore, the BE may use its moral suasion, backed by legal authority to prevent the engagement of an external auditor who could be of harm to a supervised institution.
Assessment	Compliant.
Comments	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.

Principle 22.	**Remedial measures** Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking license or recommend its revocation.
Description	Under Article 23 f) LABE, the BE has the authority to recommend or require supervised institutions to undertake remedial measures to correct deficiencies. "Moral suasion," the most heavily used supervisory tool to achieve corrective actions, is backed by a legal sanctions regime with sanctioning authority shared by the BE and the ME as outlined below. According to Art. 4.6 LDI, there are light, serious, and very serious infractions depending on the facts of the case. These infractions constitute a breach of prudential requirements, and can result in a range of penalties tailored to the gravity of the infraction. Accordingly, under Art. 18 LDI, the BE starts the sanctioning process with an "*expediente*," a factual document prepared on the basis of inspection findings which is activated with the agreement of the BE's executive committee and the naming of an "instructor" who will guide the BE's legal effort. These initial proceedings are transmitted to the offending institution. The BE then prepares a notice of charges which is also transmitted to the institution; the institution may present its views on the matter. After evidence is gathered and on the basis of documentation presented, a solution is proposed and the BE's executive committee drafts a resolution when dealing with light and serious infractions. The most serious infractions are resolved by the minister of economy upon consultation with the BE. The revocation of a license is by decision of the Council of Ministers. In the case of *cajas*, as a practical matter, the authority to revoke a license rests with the Council of Ministers , although CAs can also revoke the licensee under their own statutes. Sanctions may be imposed on individual officers and directors of the institution as well as on the institution itself. Under Chapter 3 of Title I LDI, the sanctions against institutions include: • For the commission of very serious infractions, one or more of these sanctions will be imposed on the offending credit institution: a fine up to €300,000 or 1 percent of own capital funds whichever is higher; revocation of license; a public warning • For the commission of serious infractions, one or more of these sanctions will be imposed: a fine of up to €150,000 or half of 1 percent of own capital funds whichever is higher, and/or a public warning. • For the commission of a light infraction there will be either a public warning and/or up to a €60,000 fine. In addition, there are other supervisory measures available to BE supervisors in certain circumstances independent of the sanctions regime procedure and authority. For instance, Art. 34 RD 1343/1992 provides that when an institution falls below required capital levels, it must present to BE a plan of capital restoration and restrict its regular operations as approved by the BE. Failure to restore the institution to required minimum solvency levels, may trigger the BE's intervention. Under Title III, LDI, the law establishes a mechanism that enables the BE to intervene an institution by placing an "interventor" to ensure the institution does not engage in unsound practices or by replacing management and the board of directors. Such measures are exceptional and considered only when the institution's liquidity or capital are in severe peril. Under this intervention, the institution remains open while its longer-term financial viability and operation are determined. Furthermore, in the case of new banks, there are dividend payment restrictions during the first three years and other financial limitations up to the first five years of operation.
Assessment	Compliant.
Comments	The authorities should consider whether delegating further authority to bring about timely corrective action to the BE would effectively bolster its moral suasion and enforcement effectiveness as further outlined in BCP 1 (4) enforcement powers.

Principle 23.	**Globally consolidated supervision** Banking supervisors must practice global consolidated supervision over their internationally active banking organizations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organizations worldwide, primarily at their foreign branches, joint ventures, and subsidiaries.
Description	As noted in BCP 20, legal and accounting framework requirements, the scope of BE supervisory authority, collection and offsite review of consolidated information are among key factors enabling the BE to supervise banking groups on a consolidated basis. These and other prudential factors are also pivotal to achieve global consolidated supervision. The BE draws its authority to supervise overseas activities of locally incorporated banks from Art. 43 26/1988 LD. Prudential requirements and supervisory policies and priorities give reasonable assurance that BE supervisors are encouraging proper oversight of Spanish banks' cross-border operations. BE supervisors routinely evaluate risk management and internal controls systems at the two largest and most internationally active Spanish banks. There is also a specialized supervisory team which monitors risks and trends in Latin America. In addition, regulations governing cross-border establishments also mitigate risks since they require BE authorization and regulatory information when opening foreign branches, creating affiliates or taking significant participations in credit entities, which are not EU members; these activities require submission of professional background data, and business and organizational structure plans. The BE can require additional facts or may deny authorizations to establish branches abroad when there are doubts over the administrative structure of the establishment, or the project lacks adequate management capacity. The BE has instituted a comprehensive system of reporting requirements which encompasses the activity of branches and affiliates abroad. Consequently, both the BE and head offices have access to considerable information on banks' international activities. The reporting requirements are enumerated in a series of CBEs issued over the past decade. Further, CBE 5/93 establishes capital and risk concentration limits at the consolidated group level and as a consequence head office management needs to maintain updated knowledge and ensure there are proper controls for the risks assumed by different entities within the group. In circumstances where overseas offices may make consolidated supervision unattainable, the BE may reject the acquisition or establishment request in a non-EU member state. Also, using Spain's' legal sanctioning process, the BE may close or limit banks' cross-border activities.
Assessment	Compliant.
Comments	From a practical standpoint, the BE's sanctioning authority appears to be effective in causing CIs to limit activities or operations of Spanish banks' overseas branches or affiliates when circumstances warrant it.
Principle 24.	**Host country supervision** A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.
Description	The BE is empowered to establish agreements with foreign central banks and supervisors under Art. 7.8 of the LABE 13/1994. Further, Art. 6.1 RD 1298/1986 also affirms the BE's attributes and notes that in cases where the supervisory authorities are non-EU members, arrangements for the exchange of information require reciprocity and comparable confidential protection from the collaborating foreign supervisor. The BE has entered into cooperating arrangements with European bank supervisors from Germany, Belgium, France, Holland, Italy, Luxembourg, United Kingdom, and Portugal. Additionally, the BE also established cooperating arrangements with Latin American bank supervisors as Spanish banks expanded substantially in the region last decade. Arrangements were signed with Colombia, Chile, Peru, Brazil, Argentina, and Venezuela. There are pending arrangements with Panama and Puerto Rico. In discussions with BE supervisors, it appears that on the whole, the arrangements have strengthened institutional relationships among the supervisors and also facilitated discussions and the sharing of supervisory information both as a home and a host supervisor. The BE evaluates the effectiveness of supervision when banks are applying to establish a new cross-border establishment or effecting an acquisition in non-EU countries. Further, under Art. 13.2 RD 1245/1995 and Art. 30 Ley 26/1988 LDI, the BE can deny such applications if obstacles in the structural organization of the entity impede effective consolidated supervision by BE.
Assessment	Compliant.

Comments	The assessors encouraged the authorities to review whether information exchange arrangements on hand remain current and update them where necessary. Also, the authorities should consider whether additional supervisory information exchange arrangements are needed with other foreign supervisors in countries hosting significant operations of Spanish credit institutions.
Principle 25.	**Supervision over foreign banks' establishments** Banking supervisors must require the local operations of foreign banks to be conducted with the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.
Description	Local branches and subsidiaries of foreign banks are subject to similar prudential requirements, offsite reviews and onsite inspections as domestic banks. BE supervisors do not single out foreign banks operating in Spain for different treatment. For licensing purposes, the BE is concerned about home country supervisory practices and reach, as well as the transparency of the individual or group forming the new establishment or proposing major acquisition. Consequently, BE supervisors will request information about partners (physical and legal) and their relations, group structure, and home country supervisors. In the case of affiliates domiciled in the European Economic Area and looking to create a new cross-border office in the host jurisdiction, it is obligatory to consult the appropriate supervisory authorities. If the request is from a non-European entity, the BE will contact the relevant supervisor. Cooperation agreements among the BE and counterparts in Europe and Latin America encourage on-site access to local offices and subsidiaries in order to foster safe and sound practices. Further, even apart from the cooperation agreements, it has been the practice to inform home authorities when there are deficiencies or serious infractions that carry the potential for fines and other penalties.
Assessment	Compliant.
Comments	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 2. Summary Compliance with the Basel Core Principles

Core Principle	C[1/]	LC[2/]	MNC[3/]	NC[4/]	NA[5/]
1. Objectives, autonomy, powers, and resources					
1.1 Objectives		X			
1.2 Independence	X				
1.3 Legal framework		X			
1.4 Enforcement powers	X				
1.5 Legal protection	X				
1.6 Information sharing	X				
2. Permissible activities	X				
3. Licensing criteria	X				
4. Ownership	X				
5. Investment criteria	X				
6. Capital adequacy	X				
7. Credit policies	X				
8. Loan evaluation and loan-loss provisioning	X				
9. Large exposure limits	X				
10. Connected lending	X				
11. Country risk	X				
12. Market risks	X				
13. Other Risks		X			
14. Internal control and audit	X				
15. Money laundering		X			
16. On-site and off-site supervision	X				
17. Bank management contact	X				
18. Off-site supervision	X				
19. Validation of supervisory information	X				
20. Consolidated supervision	X				
21. Accounting standards	X				
22. Remedial measures	X				
23. Globally consolidated supervision	X				
24. Host country supervision	X				
25. Supervision over foreign banks' establishments	X				

[1/] C: Compliant.
[2/] LC: Largely compliant.
[3/] MNC: Materially non-compliant.
[4/] NC: Non-compliant.
[5/] NA: Not applicable.

IV. Recommended Action Plan and Authorities' Response to the Assessment

A. Recommended Action Plan

32. The system in Spain for banking regulation and supervision is of high quality, and only three BCPs have been assessed "largely compliant" rather than "fully compliant." The authorities might usefully consider taking steps toward full observance of the BCPs.

Table 3. 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 CAs appears to be effective, the dual legal framework governing *cajas* 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.
Other Risks (BCP 13)	Along with strengthening BE's rule-making authority as outlined in BCP 1(3), 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 including joint BE/SEPBLAC inspections to the extent practical.
Accounting Standards (BCP21)	While the 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.

Reference Principle	Recommended Action
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.

B. Authorities' Response to the Assessment

33. 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.

34. On a number of issues, however, the Spanish Authorities do not agree with the 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, supposedly, 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.

35. On BCP 1(3) ("A suitable legal framework for banking supervision, including provisions relating to authorization of banking establishments and their ongoing supervision"), the Spanish authorities do not agree with the experts' view, which considers the current legal framework only "largely compliant" because, according to the experts' view, it leaves room for a possible conflict of interests between the institutional goals of the BE and the government. 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 which are then passed by parliament (laws) or approved by either the council of ministers (royal decrees) or the Minister himself (ministerial orders) depending on their normative rank. Therefore, it is the government through the ME who creates the legal framework for banking supervision and there are good reasons for that. Firstly, because the ME is the only institution which has an overview 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 normative 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. On the other hand, the role of the BE is to enforce those prudential rules and is completely independent on this matter. Its supervisory independence concerns, therefore, the

enforcement of the rules and is not at risk. To a limited extent, the BE can also issue prudential and accounting regulations through *Circulares* when explicitly empowered to do so by normative of higher rank (laws, royal decrees or ministerial orders). These *Circulares* usually cover the more technical details of the prudential and accounting regulation and allow the BE to respond to changes in the market through the adaptation of those technical details. Therefore, the Spanish authorities consider that the institutional framework does comply with BCP 1(3).

36. Further on BCP 1(3) and also on BCP 22, the Spanish authorities do not share the assessors' view that recommends granting the BE license revocation authority and delegating 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 is an independent body in charge of the supervision of credit institutions and the conduct of monetary policy within the framework of the Monetary Union. However it 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, when it helps to achieve more efficiently the principles and objectives established in the Constitution (ie, market freedom, economic stability).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. However, the role of the Bank in those cases 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 credits 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. Therefore, the Spanish authorities consider that the observance of BCP 1(3) should be considered as "compliant."

37. On the assessment of BCP 1(1) ("An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks"), the Spanish authorities do not agree with the notion put forward by the assessors that there is a risk of potential conflicts in the exercise of supervisory and sanctioning authority between the BE and the CAs. There is no possibility for overlapping of the national and regional legal frameworks. The basic national regulation obliges all the cajas. Sanctions, in particular, are regulated in the LORCA (ley 31/1985, de 2 de agosto, de regulación de las normas básicas sobre órganos rectores de las cajas de ahorro). The first final disposition of the LORCA 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. According to repeated rulings of the *Tribunal Constitucional* the following functions are considered "basic" and therefore reserved to the State: supervision of solvency and financial stability of

the Cajas. In particular, supervision of the following: the level of own resources, the solvency and liquidity ratios, insolvency provisions and the rules for risk concentration.

38. Other aspects of the supervision of the cajas should be 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.

39. Moreover, the supervision of the instrumental aspects related to the exam of the solvency of the Cajas is also considered basic; that is, rules on accounting (in order to have knowledge of their financial situation) and rules related to the compulsory provision of information to the relevant state agency.

40. 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 the observance of this criterion should be considered as "compliant".

41. The Spanish authorities also wish to refute the statement made by the assessors regarding the additional challenges that the ownership structure of the Cajas poses for the application of recapitalization mechanisms in times of trouble. The FGD (Fondo de Garantía de Depósitos), according to Articles 10 and 11 of Royal Decree 2606/1996, has many ways to take preventive and reorganization measures in case of crisis:

42. The FGD is able to recapitalize a *caja* through financial aid: concession of low interest, long-term loans; concession of non-refundable aid, subscription of subordinated debt or acquisition by the FGD of damaged or non profitable assets

43. The FGD can force a restructuring of the capital of the Caja: application of own resources to absorb losses, facilitating its merger with another, more solvent, *caja* or transferring its business to another credit institution.

44. The FGD can also subscribe *cuotas participativas*.

45. The fact that these preventive measures do not entail participation in the ownership of the recapitalized Caja does not pose a problem, given that the FGD can influence management actions through the action plan agreed between the Caja and the FGD and approved by the BE.

46. The fact that the Deposit Guarantee Scheme for Cajas (FGDCA) has historically had a better patrimonial situation compared to that of Banks is also noteworthy. The reason is the smaller incidence of crises in this group of credit institutions (only 14 interventions, all of them in the period comprised between 1983 and 1991). Along the years, the FGDCA has mostly taken preventive actions, focused on the monitoring of those Cajas with below average own resources or structural problems. The aid given to the Cajas has, in the majority

of cases, taken the form of zero interest loans or the subscription of perpetual subordinated debt. Also, most of the aid given was conditioned to the realization of a merger with another Caja which could help to overcome any deficiency. Taking all this into account, the Spanish authorities consider that the possible questions raised by the special ownership structure of the Cajas are adequately addressed by the current deposit insurance framework.

47. On BCP 13, the Spanish authorities consider that, inside the current normative, there already are criteria that define what the entities must do to identify, measure, monitor, and control "Other risks." credit risk in particular, these criteria are extremely detailed in Annex IX of Circular 4/2004. That is, in Spain there are more than "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. Therefore, the Spanish authorities consider the observance of this criterion should be considered as "compliant."

48. On BCP 17 and regarding the comment included that refers to the management contact with smaller to mid-sized institutions where the interval between on-site inspections may be relatively lengthier, the Spanish authorities wish to point out that the supervisory practice of the BE does not only rely on inspections and is characterized by continuous contact and very frequent meetings with the entities' managers.

49. 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.