

Spain: Report on the Observance of Standards and Codes – Summary Assessment

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FINANCIAL SECTOR ASSESSMENT PROGRAM UPDATE

SPAIN

REPORT ON THE OBSERVANCE
OF STANDARDS AND CODES
(ROSCs)—SUMMARY
ASSESSMENTS

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GLOSSARY

AC	Additional Criteria
AGROSEGURO	Spanish Association of Insurers for Combined Crop Insurance
AIAF	Asociación de Intermediarios de Activos Financieros
AMA	Advanced Measurement Approach (operational risk)
AML/TF	Anti-Money Laundering and Terrorist Financing
BCP	Basel Core Principles for Effective Banking Supervision
BdE	Banco de España
BME	Bolsas y Mercados Españoles
CBE	Circular de Banco de España
CCAA	Autonomous Communities
CCP	Central Clearing Counterparty
CCS	Insurance Compensation Consortium
CDD	Customer Due Diligence
CESFI	Committee for Financial Stability
CIR	Central de Información de Riesgos
CIS	Collective Investment Schemes
CNMV	National Markets and Securities Commission
CRAs	Credit Rating Agencies
DGSFP	General Directorate of Insurance and Pension Funds
EBA	European Banking Authority
EC	Essential Criteria
EIOPA	European Insurance and Occupational Pensions Authority
ELA	Emergency Liquidity Assistance
ESMA	European Securities Markets Authority
EU	European Union
FIU	Financial Intelligence Unit
FGD	Fondo de Garantía de Depósitos
FROB	Fondo de Reestructuración Ordenada Bancaria
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
HF's	Hedge Funds
IAC	Informe de Autoevaluación de Capital
IAIS	International Association of Insurance Supervisors
ICAAP	Internal Capital Adequacy Assessment Program
ICAC	Instituto de Contabilidad y Auditoría de Cuentas
ICEA	Insurance Entities Cooperative Research
ICP	Insurance Core Principles
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions

IRB	Internal Ratings Based Approach
ISPs	Investment Services Providers
LABE	Law 13/1994 on the Autonomy of BdE
LCS	Insurance Contract Law
LMV	Ley del Mercado de Valores
MAB	Mercado Alternativo Bursátil
MEC	Ministry of Economy and Competitiveness
MFAO	Mercado de Futuros del Aceite de Oliva
ML	Money Laundering
MMoU	Multilateral Memorandum of Understanding
MoE	Ministry of Economy
MoU	Memorandum of Understanding
MTFs	Multilateral Trading Facilities
PIEs	Public Interest Entities
RMs	Regulated Markets
ROSSP	Private Insurance Organization and Supervision Code
SABER	Supervision of the Banking Activity By Risk Approach
SEPBLAC	Servicio Ejecutivo de la Comisión de Prevención del Blanqueo de Capitales
SIA	System of Information on Borrowers
SICAV	Sociedad de Inversión de Capital Variable
SIFIs	Systemically Important Financial Institutions
SROs	Self-Regulatory Organizations
TRLOSSP	Private Insurance Organization and Supervision Law
UNESPA	Spanish Association of Insurance and Reinsurance Institutions

I. BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

A. Introduction

1. **This assessment of the current state of the implementation of the Basel Core Principles for Effective Banking Supervision (BCP) in Spain has been completed as part of a Financial Sector Assessment Program (FSAP) update undertaken by the International Monetary Fund (IMF) during February 2012.** It reflects the regulatory and supervisory framework in place as of the date of the completion of the assessment. It is not intended to assess the merits of policy and implementation issues regarding European Union (EU) regulatory framework. In addition, it is not intended to represent an analysis of the restructuring processes of the savings banks sector, which is addressed in the broader FSAP exercise.
2. **An assessment of the effectiveness of banking supervision requires a review of the legal framework, and detailed examination of the policies and practices of the institutions responsible for banking regulation and supervision.** In line with the BCP methodology, the assessment focused on the Banco de España (BdE) as the main supervisor of the banking system, and did not cover the specificities of regulation and supervision of savings banks, which is a shared responsibility with the Autonomous Communities¹ (CCAA) and would have needed to involve the analysis of local authorities' legislation and supervisory practices. Insofar as prudential regulation of the banking sector and supervisory processes of the BdE are also applied to the Caja segment, this assessment is also applicable to the prudential supervision of Cajas, which is conducted by the BdE. It must be noted that as of the date of this BCP assessment, almost all the Cajas, with two small exceptions, had transferred their banking activities to commercial banks (although the ownership structure of the new banks may still retain some characteristics of the Caja governance), therefore the role of CCAA supervision in the financial sector could at this point be considered reduced, and this assessment should provide a clear picture of the current supervisory process applicable to the whole banking sector.

B. Information and Methodology Used for Assessment

3. **The Spanish authorities agreed to be assessed according to the Core Principles Methodology issued by the Basel Committee on Banking Supervision (BCBS) in October 2006.** The current assessment was thus performed according to a revised content and methodological basis as compared with the previous BCP assessment carried out in 2006.

¹ An **autonomous community** (*comunidad autónoma*) is the first-level political division in the country. The second Article of the 1978 Constitution recognizes the rights of "nationalities and regions" to self-government and declares the "indissoluble unity of the Spanish nation" (such level of decentralization was particularly relevant in the Spanish transition to democracy at the time). There are currently 17 autonomous communities.

It is important to note, for completeness' sake, that the two assessments will not be directly comparable, as the revised BCP have a heightened focus on risk management and its practice by supervised institutions and its assessment by the supervisory authority, raising the bar to measure the effectiveness of a supervisory framework.

4. **The assessment team² reviewed the framework of laws, rules, and guidance and held extensive meetings with officials of the BdE, and additional meetings with the Ministry of Economy (MoE), rating agencies, auditing firms, and banking sector participants.** The authorities provided a self-assessment of the Core Principles rich in quality and comprehensiveness, as well as detailed responses to additional questionnaires, and facilitated access to supervisory documents and files, staff and systems.

5. **The team appreciated the very high quality of cooperation received from the authorities.** The team extends its thanks to staff of the authorities who provided excellent cooperation, including extensive provision of documentation and access, at a time when staff was burdened by many initiatives related to the domestic situation, as well as European and global regulatory initiatives which are in progress.

C. Institutional and Macroeconomic Setting and Market Structure—Overview³

6. **Spain is experiencing the bursting of a real estate bubble after a decade of economic expansion.** Construction and real estate loans grew from 10 percent of GDP in 1992 to 43 percent in 2009, and amounted to about 37 percent of GDP at end-2011. Spanish banks funded their increasing exposures largely in capital markets and abroad. Banks play a pivotal role in the Spanish financial system. The total assets of the Spanish banking sector amount to about 320 percent of GDP, with the largest five banks accounting for more than 70 percent of total assets. Nonbank financial entities represent a small share of the financial sector (less than 5 percent of total assets).

7. **Significant consolidation has taken place in the savings bank sector.** The reforms to the legal framework together with financial support from the state-owned recapitalization vehicle, the Fondo de Reestructuración Ordenada Bancaria (FROB), were instrumental in reform process. At the time of this assessment, the number of institutions had been reduced from 45 to 18, through intervention, mergers, or takeovers. Tighter capital requirements led many savings bank groups to spin off their banking activities into newly created commercial banks. The FROB had taken over five institutions (8 percent of the system); one intervened bank had been recently auctioned off, another was in the pipeline, and the takeover of a small, ailing bank was underway.

² The assessment team comprised Fabiana Melo and José Tuya.

³This section draws from the Financial System Stability Assessment (FSSA).

8. **The sector was under severe pressure at the time of the assessment.** Spanish banks had been able to raise capital from private sources in response to the requirements of the European Banking Authority (EBA), but profitability had deteriorated. The uncertainty surrounding the valuation of real estate collateral had led the government to issue a new set of measures in February, while the mission was in the field, requiring additional capital and provisioning for problematic exposures to real estate and new measures to encourage further consolidation in the financial sector.

D. Preconditions for Effective Banking Supervision⁴

9. **In Spain, 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 BdE (although regional governments retain some regulatory and supervisory powers over the savings banks operating in their jurisdictions); securities markets are supervised by the Comisión Nacional del Mercado de Valores (CNMV); supervision of insurance companies and pension funds is under the mandate of the Dirección General de Seguros y Fondos de Pensiones (DGSFP) within the Ministry of Economy and Finance (MoE). Oversight and supervisory responsibilities regarding payments and settlements systems are the purview of the BdE and the CNMV, respectively.

10. **The legal and regulatory framework for transparency and governance of publicly traded institutions has improved significantly in recent years.** In particular, since 2006, for traded companies and issuers whose securities are traded on an official secondary market, financial statements must be prepared in accordance with International Financial Reporting Standards (IFRS) for consolidated statements and domestic Spanish standards for individual financial statements. Domestic Spanish standards are almost fully assimilated to IFRS, with differences only in that Spanish standards allow capitalizing research expenses and do not provide options available under IFRS, in connection with the valuation of certain assets (mainly real state and intangible assets).

11. **Instituto de Contabilidad y Auditoría de Cuentas (ICAC) is the body responsible for setting Spanish accounting standards and providing interpretation and guidance on their use.** It is a government entity, attached to the MoE. Any proposal to change the accounting standards must be subject to consultation with the Consultative Committee on Accounting Standards of ICAC, where the CNMV, the BdE, the DGSFP participate along with representatives from the professional bodies, issuers and investors. BdE has the

⁴ Full International Organization of Securities Commissions (IOSCO) and International Association of Insurance Supervisors (IAIS) Insurance Core Principles (ICP) assessments were conducted during the FSAP, as well as a review of the crisis management and resolution framework and financial markets infrastructure, therefore these topics will not be detailed in this document.

delegated authority from the MoE to establish accounting standards for banks, in which they coordinate with ICAC.

12. The BdE as a member of the Eurosystem may provide Emergency Liquidity Assistance (ELA) within the restrictions of the System. The financial safety net institutional framework is complemented by two other agencies, Fondo de Garantía de Depósitos (Depositor Guarantee Fund - FGD) and the FROB.

13. The FGD is a private legal entity wholly prefunded by the member credit institutions. The FGD does not act as a mere pay-box but it has, in conjunction with the BdE, a wide range of intervention powers and it had been the main crisis management “instrument” until the creation of the FROB. Originally, there were three FGDs; one for each sector of the banking industry (commercial banks, savings banks, and credit cooperatives). With the Royal Decree-Law 16/2011 of October 14, 2011, the three sectoral funds were merged. The FGD resources may be used for preventive measures and bank reorganization under specific safeguards.

14. The explicit objective of the FROB is to assist and foster the reorganization of the Spanish banking industry (Royal Decree Law 9/2009). The FROB received its initial capital from FGD and from the state, it can issue securities guaranteed by the state (and/or it can seek other funding) up to three times its capital, but it can leverage up to six times with ministerial approval. The FROB is administered by a governing committee named by the MoE, formed by nine members: four are proposed by the BdE, including the deputy governor who acts as chairperson, two members are from the MoE; and three members representing the FGDs.

15. The resolution and intervention framework is shared among these authorities. BdE is the triggering authority, determining that the solvency and liquidity of a bank is jeopardized, and activating intervention. FROB is then appointed as administrator, with managerial powers over the entity. FROB makes an inventory of the bank’s condition, prepares and submits to the BdE a restructuring plan, spelling out all the possible measures to restore the viability of the institution or to resolve it. At any point in time, the FROB may provide financial support to the problem bank (the same could be done by the FGD once the restructuring plan has been approved). At the same time that the FROB submits to the BdE the restructuring plan, it provides also a report to the MoE and the Minister of Finance and Public Administrations analyzing the impact of the plan on the public finances. If the restructuring plan is not successful, the alternative would be the revocation of the bank license (by the Council of Ministers) and, in case of insolvency of the entity, the initiation of a court-driven bankruptcy process.⁵ The resolution authorities, in principle, BdE, FROB, and

⁵ The revocation of the license based on its insolvency triggers a court administered process. If the institution is not insolvent (voluntary liquidation) there is no need to involve court proceedings.

MoE, cannot fully allocate losses to shareholders and creditors, or revoke a license (except the MoE in specific cases provided in law), which makes the resolution process somewhat convoluted.

E. Main Findings

16. **Significant changes have occurred in Spain since the last FSAP.** The most serious has been the deterioration of the economy and the real estate sector leading to a major decline in land values and the financial condition of developers impacting loan quality. The current crisis impacted the savings banks more severely due to their high concentrations in loans to finance land development and construction and highlighted a serious weakness in their risk management, leading to a complete restructuring of the sector and converting their vast majority into commercial banks. The commercial banks, with more diversified loan portfolios and bolstered by high levels of loan loss provisions, fared better through the initial phase but are under increasing pressure as provisioning and capital requirements continue to increase. On the regulatory side, the period was framed by the implementation of Basel II.

17. **The core supervisory process at the BdE is strong and is supported by qualified staff and an experienced cadre of inspectors, but there are areas of concern.** The authorities have made progress in addressing the recommendations of the 2006 FSAP as regulatory capital and loan-loss provisioning requirements for real estate exposures have been tightened and further guidance on best practices for lending in this area has been provided. The authorities have also implemented measures to reduce incentives for equity investments in nonfinancial companies by banks and to manage related conflicts of interest; introduced reforms to strengthen corporate governance and the ability to raise capital from external sources for savings banks; enhanced coordination and cooperation between financial sector regulators; adopted additional requirements on internal controls, investment, and adequate verification of the risk management processes of insurers; and improved the functioning of securities settlement systems. However, in spite of the high technical quality of the supervisory process, the closure of the supervisory work does not seem to be sufficiently timely or effective for bank resolution. There are areas requiring attention such as timeliness of remedial action, operational independence concerning issuance of regulations and enforcement, and oversight of concentration risk and related party transactions.

18. **A review of examples of inspection activities and reports revealed the thoroughness of the supervisory process and the identification of key risks and their communication to bank management, however, the process for requiring corrective action is lengthy and corrective action tools were not timely applied.** The BdE identified at a very early stage the need for provisions and recommended corrective action, but the formal decisions were only adopted after following the deliberate BdE process and not fully employing all its available enforcement tools as it focused on broader systemic responses. This resulted in the continued accumulation of problems and losses as the bank or savings bank continued operating without major restrictions during the process. Discussions with the

authorities provided context to their process and the timeliness issue. According to the authorities, the deterioration in the economy was more protracted than initially anticipated as was the deterioration in the financing of land and real estate development. As weak institutions were identified and it became apparent that a broader fix would be required rather than dealing with individual institutions, the BdE started to encourage mergers and did not close banks waiting for a market solution to achieve the lower cost option⁶. As the BdE reviewed the broader solution options, the use of enforcement tools to protect bank capital and avoid asset dissipation was not widely used (for example, implementing cease and desist orders to limit or eliminate dividends, putting in place strict review requirements before continuing to fund existing projects and severely curtailing new projects). Further, these decisions took into account the information available at the time, the legal framework currently in force, the cost to the public purse, and the implications for financial stability. BdE was of the view that since the troubled institutions had significantly curtailed lending to the troubled sectors; the level of bad assets would not increase.

19. **A review of the legal framework identified areas where the BdE authority can be increased to expedite corrective action.** The BdE lacks authority to issue prudential regulations, except in areas specifically delegated by law or the Ministry of Economy. Having the authority to issue prudential regulations would enable the BdE to address at an earlier stage developments of a systemic nature. In addition, enforcement action is shared with the MoE, with the BdE having to send to the Ministry the more grave issues for enforcement. Having a flexible enforcement regime enables the supervisor to quickly adjust a course of action should original assumptions prove incorrect, and a more intense use of sanctions should work as deterrent to imprudent risk management.

20. **The regulatory framework and oversight over concentration risk and related party transactions were not sufficient to address significant build-up of weaknesses in the system, some of them derived from the peculiar corporate governance structure for savings banks.** In the case of savings banks, the issue may have been aggravated by the division of responsibilities with the CCAA. Although the number of savings banks has been drastically reduced and their banking business transferred to commercial banks, the shareholder and corporate structure of the new banks is complex and the BdE will need to apply particular attention to make sure deficiencies in the previously existing structures do not contaminate the banking organizations

⁶ The restructuring of the saving banks sector and the crisis management framework in Spain are not object of this assessment, and were covered by separate Technical Notes during the FSAP.

The BCP

21. For simplification, the Core Principles (CPs) may be grouped into seven major categories: (i) objectives, independence, transparency, powers and cooperation (CP 1); (ii) licensing and structure (CPs 2–5); (iii) prudential regulations and requirements (CP 6–18); (iv) methods of ongoing supervision (CP 19–22); (v) accounting and disclosure (CP 23); (vi) corrective and remedial powers of supervisors (CP 23); and (vii) consolidated and cross-border banking supervision. (CP 24–25)

Objectives, independence, powers, transparency, and cooperation (CP 1)

22. **As noted in the previous FSAP, the dual legal framework governing Cajas poses the risk of potential conflicts in the exercise of supervisory and sanctioning authority.**

Some areas where responsibilities overlap between BdE and CCAA—for instance, governance and sanctioning, are directly related to reputational risk and risk management, which affect solvency. The fragmentation of CCAA supervision over such issues may have played a role in the deterioration of the situation of saving banks sector. The lack of clarity brings reputational risk to the BdE, and the 2006 FSAP recommendation that the legal regime be reinforced is still valid. It must be noted that since all but two Cajas have transferred their banking activities to commercial banks, the issue will become less relevant as the governance of the new institutions become closer to that of listed commercial banks and CCAA role in the supervision of banking activities diminishes.

23. **Other 2006 FSAP recommendations have been magnified with the perspective given by the events from 2007 to 2011.** Since the last FSAP, and given the saving banks restructuring process in Spain, some market participants have expressed concerns about BdE's independence, particularly due to the apparent delays in implementation of corrective actions and sanction. This concern is triggered as the market is well aware of the thoroughness of BdE's supervision—while the sanctioning proposals are made by the Governing Council of BdE to the Minister of Economy, who has sanctioning power for very serious infractions and resolution capacity. The legal framework also establishes the MoE as the principal agency charged with issuing financial regulation. Assessors have not seen any evidence of government or industry interference in the operation of supervision and budget of supervision in BdE. However, the presence of a government member in the governance structure of the BdE, combined with the legal framework for sanctions and regulation powers, does not create an environment conducive to independence. It is striking that the law clearly distinguishes the independence and regulatory capacity of BdE in its monetary operations role from its supervisory role. As prudential regulation in Spain depends on governmental action, changes in the regulatory framework tend to follow the political cycle and may result in delays in the issuance of critical regulations. The broad presence of the MoE in the supervisory and regulatory hierarchy clouds the independence of a well conducted and highly technical supervisory body, and ultimately undermines the credibility and effectiveness of the supervision.

Licensing and structure (CPs 2–5)

24. **The ongoing restructuring process in the financial sector will bring challenges to supervision with respect to structure and governance of banks.** The MoE is the licensing authority, based on an analysis by BdE of the compliance with the licensing criteria established in law. The BdE is then responsible for supervising the ongoing compliance with the licensing criteria in the life of the institution. On the other hand, BdE is the authority responsible authorizing and monitoring significant transfers of ownership and major acquisitions. The framework has improved since the last FSAP and a closer monitoring of the structure of banks is carried out, in particular given the expansion of *seguimiento continuado* approach to more financial institutions. In that sense, the peculiar situation of new commercial banks created as the result of the reform of the Cajas should be carefully followed by authorities, insofar as the new shareholder entities (no longer conducting banking business) have no identifiable ownership and frequently have close links to the local industrial and political environment given their social services objectives. This situation has the potential to create detrimental influence over the bank's operations and soundness. Supervision of such institutions needs to be tailored to these special characteristics.

Prudential regulation and requirements (CPs 6–18)

25. **Pillar 2 implementation has been a significant focus for the BdE.** A standard format was designed for the banks to report on their Internal Capital Adequacy Assessment Program (ICAAP). The reporting was initiated in 2008 and has been revised to capture additional information and provide further guidance to the banks. The BdE staff meets with the banks annually to discuss the report. The results of the report are used in evaluating the banks' risk profile. There has been significant consolidation in the financial system creating challenges for banks to integrate risk management systems.

26. **Concentration risk and related party lending played a significant role in recent cases of distressed financial institutions, in particular Cajas de Ahorros.** These Cajas, given their local characteristics and business nature, presented both high sectoral (real estate) and geographical concentration, but economic sector concentration also affected many banks. In addition, in Spain many linkages between industrial companies and banks remain, and the organizational structures are often complex and related parties difficult to detect. Related party lending was an important source of lower quality credit that played a role in the savings banks crisis, due to both exposures to non-consolidated real estate enterprises and in certain cases, exposures to public entities or organizations linked to members of governance bodies of the Cajas. The application of an enhanced regulatory framework within Pillar II and more intensive monitoring and control of such risks under *seguimiento continuado* is recent, and is not yet fully applied to all institutions in the system. Going forward, the complex organizational and governance structures of the new commercial banks presents particular challenges to supervision of these risks.

27. **Loan loss provisioning has been robust but had to be supplemented in February 2012 due to the continued economic decline.** At the start of the crisis existing provisions, built through the dynamic provisioning framework, enabled banks to meet the increased specific provisions required by a deteriorating loan portfolio but the continued crisis has prompted additional provisioning. The decline in real estate prices and the dearth of transactions highlighted weaknesses in the real estate appraisal methodology, which becomes very difficult in the absence of market transactions, resulting in valuations that were based in too optimistic discount rates and execution periods. To address these issues a Royal Decree Law was issued imposing extraordinary provisioning levels on substandard and doubtful loans secured by land of by real estate developments.

28. **A new law on anti-money laundering and combating terrorism (AML/CFT) was adopted in 2010.** The responsibility for enforcing and monitoring compliance with AML/CFT regulation rests with SEPBLAC. However, the BdE also plays an important role as in its compliance inspections; it also reviews the banks' systems for AML/CFT and follows up on deficiencies. The BdE and SEPBLAC collaborate closely and perform joint inspections when warranted.

Methods of ongoing banking supervision (CPs 19–21)

29. **The BdE has a risk-based supervisory model supported by a strong technical staff and a well-developed information technology system.** Onsite and offsite staff is integrated and both participate in onsite inspections. The primary supervisory instruments are the onsite inspection and permanent onsite presence at many of the banks (at the time of the assessment, there was permanent onsite presence at 16 of the banks)

30. **A risk-based matrix is developed for each bank.** The supervisory team assigned to a bank develops a risk matrix by rating the level of risk in a number of categories of banking activity. The matrix also includes elements of corporate governance, concentrations risk and operational risk. The matrix also describes the risk direction as stable, increasing or declining. Based on the results, the annual supervisory plan is developed.

31. **The informational technology infrastructure greatly enhances supervisory efficiency and risk monitoring.** The supervisory staff has access to a vast amount of information with systems that facilitate the manipulation of the data. In addition to financial information, there is an electronic file system where an audit trail is available of all the supervisory reports, activities and issues related to a bank, including all inputs by inspectors.

Accounting and disclosure (CP 22)

32. **The BdE is the body responsible for issuing accounting standards and has a working relationship with the audit industry.** The BdE meets annually with auditors and discusses issues of concern and audit scopes. The annual audit produces a report for the BdE addressing the banks' compliance with BdE requirements and an evaluation of the loan

portfolio. Disclosure in Spain is extensive and in recent stress tests there has been transparency in result reporting, accounting and disclosure

Corrective and remedial powers of supervisors (CP 23)

33. **The BdE has a broad range of supervisory enforcement authority. However, the adoption of new regulations to implement Pillar 2, the current crisis and the pace at which deterioration can occur in the integrated global market indicate the need for flexible actions that can be applied at an earlier stage to effect corrective action.** The enforcement practice employed by the BdE follows a deliberate, well-documented approach that has reduced the need for sanctions. In the current environment, it is unclear whether implementation of all the enforcement tools available to the BdE while it searched for a systemic solution, was held in abeyance in expectation of a quick resolution of the weak banks or underestimation of the duration and depth of the economic crisis.

Consolidated and cross-border banking supervision (CPs 24–25)

34. **The BdE has broad authority to conduct consolidated supervision.** BdE is empowered to supervise banks on a solo and consolidated basis, including all the offices or entities within the group, irrespective of their location or legal structure.

35. **Consolidated supervision is primarily based on the information compiled by the parent bank in order to manage the risks and controls of the group as a whole.** Parent banks are subject to mandatory detailed regular reporting to the BdE, which also covers internal global risk management and information on internal controls. Additionally, the BdE coordinates and exchanges information with domestic and foreign supervisors to accomplish a full view of risk.

36. **Through supervisory colleges and on a bilateral basis, the BdE collaborates with home-host supervisors.** The BdE conducts supervisory colleges for its two largest banks and for a medium-sized bank and has signed Memoranda of Understanding (MoUs) with relevant supervisors. The BdE coordinates the supervisory activities of these three banking groups with host supervisors and relies on their reports.

Table 1. Spain: Summary Compliance with the Basel Core Principles—ROSCs

Core Principle	Comments
1. Objectives, independence, powers, transparency, and cooperation	
1.1 Responsibilities and objectives	<p>In spite of court decisions on the distribution of supervisory responsibilities between BdE and CCAA with respect to Cajas, there is still some overlap of responsibilities. For instance, governance and sanctioning, which are under CCAA supervision, are directly related to reputational risk and risk management, which affect solvency - which would fall under BdE's supervisory realm. The fragmentation of CCAA supervision over such issues may have played a role in the deterioration of the situation of saving banks sector. The lack of clarity brings reputational risk to the BdE, to the extent that the oversight of deep problems in institutions under co-supervision, and the continuing condition concerns facing the banks resulting from the Cajas' restructuring process, may be publicly attributed to failures in BdE's supervisory action even when there were supposed to be responsibilities shared with or of exclusive competence of the CCAA. The issue may become less relevant as the supervisory role of CCAA over banking activities diminishes with the restructuring of the sector</p>
1.2 Independence, accountability and transparency	<p>Some market participants have expressed concerns about BdE's independence, particularly due to the apparent delays in implementation of corrective actions and sanction. This concern is triggered as the market is well aware of the thoroughness of BdE's supervision—while the sanctioning proposals are made by the Governing Council of BdE to the Minister of Economy, who has sanctioning power for very serious infractions and resolution capacity. Assessors have not seen any evidence of government and industry interference in the operation of supervision and budget of supervision in BdE. However, the involvement of political bodies such as the CCAAs and the MoE in licensing, sanctioning and resolution does create an environment for potential influence. In addition, the presence of the Secretary General of the Treasury in the Board of BdE, with voting capacity in what concerns issuance of prudential regulation, nomination of senior supervisory staff and allocation of supervisory budget (LBE Arts 20 and 21), as well as on the sanctions with fall under the capacity of the BdE (less serious and serious infractions) is not conducive to independence.</p>
1.3 Legal framework	<p>The supervisory authority cannot update prudential rules without changing laws. It is striking that the law clearly distinguishes the regulatory capacity of BdE in its</p>

	<p>monetary policy role from its supervisory role. As already stated in the 2006 FSAP, “there is a risk that the BdE may be unable to respond adequately should there be conflicting interests between the institutional goals of the BdE and the government, which could undermine BdE’s supervisory independence.” Changes in the prudential framework follow the political cycle, because prudential regulation is done through laws (approved by the legislative body) or the government. This may have allowed for the accumulation of problems, and created an environment of regulatory uncertainty.</p>
1.4 Legal powers	<p>On the powers to require prompt remedial action and impose sanctions, there are material deficiencies. While the supervisors can and—as the assessors were shown evidence—do send recommendations and requirements to banks, sanctioning powers are lacking. This had already been raised in the previous FSAP, which recommended transferring sanctioning powers currently under the MoE to BdE. While authorities have informed there has never been a case of a sanction that, once recommended by BdE, has failed to be imposed by MoE, the fact that the Secretary General of the Treasury is a voting member of the Governing Council on the proposals of sanctions that are to be raised to the MoE for decision, diminishes the significance of the prior argument. According to the 2010 Supervision Report (Memoria de Supervision), from 2007 to 2010 only one sanctioning procedure was initiated against banks, and two against saving banks, although several of these institutions had serious deficiencies in management and solvency in the period.</p> <p>The lack of coercive powers taints the results of a well conducted and highly technical supervisory body, and may ultimately undermine the credibility and effectiveness of the supervision. Also see CP 23—enforcement tools to protect bank capital and avoid asset dissipation were not widely used.</p>
3. Licensing criteria	<p>The licensing authority is the MoE, and the reasons for the denial of licenses, based on BdE’s report, are clearly stated in Law. There is no provision in the Law, however, that prevents the MoE from providing a license over the contrary opinion of BdE. There is, therefore, no certainty that MoE’s understanding of fit and proper, adequacy of controls, and organizational structure, will coincide with the supervisory authority and therefore not hinder effective supervision. The authorities report that this has <u>never been the case in practice</u>, and the level of prescriptiveness in the legislation makes this result unlikely. The assessors did review complete cases and it seems all due diligence has been taken by the authorities.</p>

	<p>However, it seems that, in the ongoing reorganization process of the Caja sector, suitability of shareholders and senior management has been assumed, as the shareholders were authorized entities under CCAA suitability criteria.</p>
4. Transfer of significant ownership	<p>122 requests for transferring significant participation have been received in the past five years, all but one have been approved. Each application may involve one or more interested parties. Some of these are reorganization within the entity, including creation of SPVs and the segregation of financial activities of Cajas into Banks. The rejected application was related to anti-money laundering and terrorist financing (AML/FT) restrictions and structural hindrance to consolidated supervision concerns. The assessors were given access to one complete case and also viewed the database derived from the supervisory returns. Although the ultimate ownership is defined, the chain stops at shareholders which are listed and/or disperse shareholder ownership entities themselves. The peculiar situation of new commercial banks created as the result of the reform of the Cajas should be carefully monitored by authorities, insofar as the new shareholder entities have no identifiable ownership and frequently have close links to the local political environment given their social services objectives. This situation has the potential to create detrimental influence over the bank's operations and soundness.</p>
7. Risk management process	<p>The LC grading in 2006 was based on the lack of ability to issue guidance on best practices and to require correction. The implementation of EU Directive 48/2006 on Pillar 2 has addressed the 2006 deficiency. The steps taken to implement Pillar 2 compliance and monitoring are well-defined and the IAC report implemented is comprehensive and provides guidance to banks for benchmarking. The report was designed to fit well into supervision by risk and feeding SABER and the supervisory risk matrix. However, the Informe de Autoevaluación de Capital (IAC) implementation has been difficult for some institutions and continues to be adjusted since initiated in 2008, the current version appears to be very workable. The wave of mergers and the need for crisis management has slowed the ICA implementation and bank-by-bank evaluation, therefore, effective implementation of this CP in the system, in particular the new banks, cannot be fully assessed at this point</p>
9. Problem assets, provisions, and reserves	<p>The BdE approach to provisioning is conservative and the use of a dynamic provisioning element provided an additional cushion to support the initial effects of the crisis. As the market conditions deteriorated in the prolonged crisis, however, it was clear that the conservativeness of banks' provisioning was not homogeneous, in particular</p>

	<p>with regards to the valuation of real estate collateral. Therefore, although the BdE has established detailed loan classification and provisioning requirements and its supervisory efforts focus on the review of the loan portfolio, the system results have had to be supplemented by broader government action. The requirement for a one-off large catch-up provision for the system and the large amounts of provisioning and capital support required in the conglomeration of savings into commercial banks indicates that the process of provisioning did not lead to prompt adjustments in light of the crisis. BdE is currently analyzing the framework for the valuation of real estate collateral in order to promote a legal revision, and its implementation should be an important element for the full compliance with this CP. Additionally, as it is expected that dynamic/generic provisioning will fade from use as a supervisory tool in the new EU common regulatory framework, provisioning levels on an ongoing basis will need to be adjusted to ensure adequacy of credit loss estimation.</p>
10. Large exposure limits	<p>BdE has extensive information on large exposures and concentration, provided by both the quarterly information and the powerful Central de Información de Riesgos (CIR) database. Information obtained is input into the System of Information on Borrowers (SIA), which analyses the economic and financial situation of the largest borrowers (on an individual and consolidated basis) in the system grades such borrowers for the exclusive use of the supervision. External auditors are also required to verify compliance with large exposures and concentration rules (long report). The BdE has been strengthening its monitoring and control of concentration risk, and the ICAAP process has included concentration risk in the determination of additional Pillar 2 capital. The importance of concentration risk has been made all the more relevant given the entrance, in the banking sector, of banks derived from the consolidation of Cajas de Ahorros. These Cajas, given their local characteristics and business nature, presented both high sectoral (real estate) and geographical concentration. Economic sector concentration, in particular, was a significant factor in recent distressed bank cases. The application of Pillar 2 and the ICCAP process, incorporating sector concentration, is recent. As discussed during the meetings, banks have two options to calculate additional capital to cover sector concentration risk, the simplified (ICS—indice de concentracion setorial) and the internal methodology under Internal Ratings Based Approach (IRB). Given the high sector (and geographical) concentration of the banking system, in particular the newly formed banks resulting from the restructuring of the</p>

	Cajas segment, the assessors are not confident that the current framework (ICAAP + internal controls) is sufficient to cover concentration risk.
11. Exposure to related parties	The definition seems to be broad enough in the sense that relationship can be established indirectly through one or more “interposed” persons. However, not all requirements and guidance are based on the broad definition of related party, and many focus instead on the “altos cargos” (senior management). Although BdE does have information from which supervision can and does verify, on onsite inspections, if such exposures are treated in no more favorable terms than regulation or market conditions allow, the framework does not seem to cover adequately conflicts of interest in related party lending. As in Spain many linkages between industrial companies and banks remain, and the organizational structures are often complex and related parties difficult to detect, this aspect should deserve additional attention. Related party lending was an important source of lower quality credit that played a role in the savings banks crisis, due to both exposures to non-consolidated real estate enterprises and exposures to public entities or organizations linked to members of the governance bodies of the Cajas.
23. Corrective and remedial powers of supervisors	The BdE has a broad range of supervisory enforcement authority. The process has worked well for the BdE and the deliberate approach has reduced the need for sanctions. The BdE preventive powers have been enhanced by the adoption of new regulations to implement Pillar 2, the current crisis and the pace at which deterioration can occur in the integrated global market indicate the need for flexible actions that can be applied at an earlier stage to effect not only corrective action but preventive. The current crisis has highlighted the need for prompt corrective action to resolve weak banks and conserve assets and capital. The BdE should review of enforcement procedures, including expediting the process to take earlier actions such as adding more weight to a written communication from the inspector at the conclusion of an inspection or supervisory activity at banks with ongoing supervision. Other possible options may include linking the issuance of letters of requirement to risk-based benchmarks such as the risk matrix measurements of trends and the risk rating assigned to the bank. The paper issued by the BCBS entitled “Supervisory Guidance on Dealing with Weak Banks” provides a number of options for preventive and corrective action tools.

F. Recommended Actions

Table 2. Spain: Recommended Actions

Reference Principle	Recommended Action
1.1 Responsibilities and objectives	Change the legal regime to clearly preserve the sole and exclusive roles of the BdE in prudential oversight of financial institutions, avoiding any possible inconsistency in the division of responsibilities.
1.2 Independence, accountability and transparency	<p>It is recommended that the LBE is amended to give BdE operational independence in its supervisory function in line with its independence as a Euro system central bank.</p> <p>In addition, internal governance structures, such as selection, nomination and responsibility processes for supervision could be clear and publicly available, so that the independence of supervisory processes is assured and understood by external parties.</p>
1.3 Legal framework	Introduce changes to the current legal framework for banking supervision in order to transfer most regulatory powers currently under the MoE to enable BdE to promulgate prudential rules.
1.4 Legal powers	<p>Introduce changes to the current legal framework for banking supervision in order to transfer most sanctioning powers currently under the MoE to the BdE.</p> <p>Consider granting the BE licensing revocation authority in appropriate circumstances.</p>
3. Licensing criteria	As the restructuring process continues, ensure that licensing criteria, in particular fit and proper requirements for senior management are fully applied.
4. Transfer of significant ownership	As the restructuring process continues, ensure that the governance of the new institutions, fully complies with the requirements of this CP.
7. Risk management process	Ensure that IAC (ICAAP) implementation continues and it is fully integrated into the BdE's matrix for the whole system.
9. Problem assets, provisions, and reserves	<p>Ensure completion and implementation of the reforms to the collateral appraisal requirements.</p> <p>As dynamic provisioning fades from use as a supervisory tool, review provisioning requirements to ensure adequacy of loss protection.</p>

Reference Principle	Recommended Action
10. Large exposure limits	<p>Improve tools and controls for the effectiveness of supervision regarding economic sector concentration, in addition to and within the existing ICAAP and internal controls framework. In particular, it is recommended that BdE issues guidance/regulation specific to sector concentration (similar to what exist regarding large exposures). These could include more detailed requirements in the management of sector concentration in Circular de Banco de España (CBE) 3/2008 (Capítulo noveno), and internal controls (capital decimo). Going forward, banks should be required to pursue adequate diversification, and include the impact of stress tests in their management of concentration risk (factoring in effects of economic downturn in specific sectors, major decline in values of assets and collateral, etc). Enhanced requirements for banks could include the identification, monitoring and management of exposures where apparently un-correlated borrowers are exposed to a secondary common risk factor (for instance, where a bank has granted a large number of loans to different employees of a company, sector or local government). Going forward, reporting and disclosure of concentration by region and sector can be improved. While prudential exposure limits to sector concentration may not be appropriate in all cases, supervisors should be able to require limits on a case by case basis, culminating in a monitorable plan where the bank commits to reduce its concentration risk to an acceptable level. The supervisor needs to be satisfied that the concentration risk is not a cause of prudential concern. The SREP guidance can be strengthened in what regards concentration risk, so that a deeper understanding of the adequacy of the ICAAP capital coverage for concentration risk is sufficient.</p>
11. Exposure to related parties	<p>Ensure conflict of interest rules are enforced and related party lending monitored and control tools are updated, given the new organizational structure of banking institutions derived from the restructuring process.</p>

Reference Principle	Recommended Action
23. Corrective and remedial powers of supervisors	<p>Review enforcement procedures, to include:</p> <ul style="list-style-type: none"> • Implementation of earlier notification to the bank, of areas for improvement; such as a required written communication from the inspector at the conclusion of a supervisory activity. • Raise the expectation of supervisory required action and enforcement based risk-based benchmarks from the risk matrix and capital levels. • In addition to the linear approach to heightening supervisory pressure on individual banks also adopt parallel actions to address individual unsound practices to protect assets and capital. This was particularly important in the current crisis as systemic and individual bank issues needed attention.

G. Authorities' Response to the Assessment⁷

37. The Spanish authorities (Spanish Treasury and Banco de España) want to express their appreciation to the IMF and its assessment team for this comprehensive assessment of Spain's compliance with the Basel Core Principles for Effective Banking Supervision. The Spanish authorities strongly support the FSAP as a means of promoting the soundness of financial systems as well as of improving supervisory and regulatory practices all over the world. For this reason the authorities welcome this opportunity to comment on the important regulatory reforms Spain is undertaking to improve the soundness of its financial system.

38. The authorities share the main views of the assessment team and appreciate its recommendations. The strength of the Spanish regulatory and supervisory framework was subject to stress during the crisis. The IMF broadly recognizes the determination and effort of the Spanish authorities to address the challenges posed by the crisis. Spain is committed to continue its effort to respond to the crisis and to overcome it successfully. Spain has a long tradition of adherence to the highest international regulatory and supervisory standards and works to improve compliance with the Basel Core Principles on an ongoing basis.

39. Some of the regulatory and supervisory practices commented in this report have actually been improved in parallel to the development of the FSAP missions. The financial

⁷ If no such response is provided within a reasonable time frame, the assessors should note this explicitly and provide a brief summary of the authorities' initial response provided during the discussion between the authorities and the assessors at the end of the assessment mission ("wrap-up meeting").

reform has been accelerated recently. As a consequence improvements are only partially reflected in the final draft of the assessment. A deep and unprecedented process of restructuring of savings banks is on its way. Professional management teams have been ensured and transparency has been improved. Spain is fully involved in the international efforts to reinforce bank resolution regimes through the implementation of the Financial Stability Board *Key Attributes for Effective Resolution Regimes* and of the European Commission proposals on crisis management and bank resolution. The Spanish response to the crisis is active, constant and multi-dimensional. At the same time it is adapted to the special features of the Spanish banking system.

40. The Spanish authorities look forward to continuing their dialogue with the IMF beyond the FSAP exercise. An important experience in the field of cooperation, transparency and best practices has been acquired and must be now appropriately cherished. Spanish authorities are aware of their role in the promotion of international financial stability and declare their willingness to continue working with international counterparts in order to grant it.

41. In addition, the Banco de España would like to add that although it recognizes that the restructuring process has not been sufficiently timely, as is suggested both in the assessment of some of the principles and -more significantly- in the section “*Summary, key findings, and recommendations*” there are several factors responsible for this, which the Banco de España considers need to be explained in order for the recent restructuring process to be understood:

- First, it is important to take into account that adequate instruments for resolution were not introduced until 2009.
- Second, it is only now with hindsight that we know that the deterioration in the economy was more protracted than initially anticipated by all national and international institutions.
- Third, the successive Spanish governments in power over the period decided and re-confirmed that only limited public funds should be used to rescue banks, thus discarding the ‘bad bank’-type alternatives. Other options were considered more appropriate, in part taking into account that the large Spanish banks were not affected, unlike large banks in other countries. This decision was taken not only due to the need to contain the public deficit, but also—and especially—due to the fact that a huge increase in the deficit could lead to an acute sovereign crisis, as has already happened in other countries. The decision to implement the restructuring through private solutions has many advantages but is inevitably slower and much more complex and cumbersome to implement than those that—however being more expeditious—involve huge amounts of public resources.

- Fourth, the implementation of a private solution has proven particularly difficult and slow during this crisis because the large international institutions that could have participated in mergers and acquisitions of Spanish institutions were not in a position to do so. For this reason, the private solution was constrained to the domestic level.
- Fifth, during this systemic crisis it was not possible to use the traditional resolution tool of winding-down a bank with write-downs for bondholders. If Spain had been the only country to impose losses on bond holders of medium-sized institutions, the funding for other healthy Spanish institutions would have been seriously impaired. Therefore, the benefits derived from the liquidation of a good number of credit institutions would not have compensated the potential damage to the banking system as a whole and especially to healthier institutions.
- Sixth, the governance of the Cajas also added to the complexity of the restructuring process and affected its speed, due to the strong presence of political and trade union interests in their boards of directors and general meetings. This problem has been mitigated with the transformation of Cajas into banks, but will only disappear if the Cajas lose control over their participated banks.
- Seventh, the fact that the Comunidades Autonomas exercised their power to approve the mergers of Cajas during the restructuring process significantly slowed down the process, given the need to hold long, complex and difficult negotiations with regional governments to reach adequate agreements. This problem has already disappeared thanks to the transformation of Cajas into banks.

42. These are some of the factors that explain why the whole restructuring process was slow and why, against this complex backdrop, the Banco de España had to conduct a large amount of work and was able to take actions only after following a very laborious and cumbersome process.

II. ASSESSMENT OF INSURANCE CORE PRINCIPLES

A. Introduction and Scope

43. **This assessment provides an update on the significant regulatory and supervisory development in the Spanish insurance sector since 2006.** Spain undertook an initial FSAP in 2006, which included a formal assessment of Spain's observance with the ICPs issued by the IAIS in 2003. Spain also volunteered to undertake a country peer review under the Financial Stability Board (FSB) Framework for Strengthening Adherence to International Standards in 2010.

44. **The current assessment is benchmarked against the revised ICPs issued by the IAIS in October 2011.** It takes into account laws, regulations and other supervisory requirements and practices that are in place at the time of the assessment, as well as market

data provided by the authorities in the FSAP self-assessment questionnaire. Ongoing regulatory initiatives are noted by way of additional comments, in particular, the pending legislative amendments to implement Solvency II.

45. **Spanish financial markets are supervised by three separate sectoral supervisors:** banking by the BdE, securities by the CNMV and insurance by DGSFP. The Ministry of Economy and Competitiveness (MEC) is the agency empowered by the Private Insurance Organization and Supervision Law (TRLOSSP) to supervise insurance activities, with the exception of mutual insurers that operate solely within an CCAA⁸ where the CCAA has agreed to assume their supervision. By regulation, MEC has delegated the insurance supervisory responsibility to DGSFP, a department within MEC. DGSFP supervises only private insurance; social insurances are not subject to DGSFP supervision.

46. **The assessors are grateful to the authorities for their full cooperation, thoughtful logistical arrangements and coordination of various meetings with industry participants.** In-depth discussions with and briefings by officials from the DGSFP facilitated a robust and meaningful assessment of the Spanish regulatory and supervisory regime for the insurance sector. The assessors also met a number of Spanish insurers, reinsurers, industry and professional associations, audit firms and rating agencies, who provided valuable input and insight to the assessment. The assessment was conducted by Dr. Rodolfo Wehrhahn, Technical assistance Advisor in the Financial Sector Oversight Division, a part of the Monetary and Capital Markets Department, IMF and Mimi Ho, insurance supervision advisor during February 1–21, 2012.

B. Executive Summary

47. **Spanish insurance market is well developed, with a comprehensive range of products offered by domestic and foreign insurers.** Life insurers accounted for about half of total gross premium written in 2010, and held approximately 80 percent of total industry assets. The majority of life products (including annuities) sold are guaranteed products. The main lines of non-life business are motor and property. The reinsurance market is relatively undeveloped in Spain for certain risks, due to the existence of the Insurance Compensation Consortium (CCS), which provides coverage for extraordinary natural and social-political perils through a compulsory surcharge based on sum insured. Thus, there is little need for insurers to seek catastrophic reinsurance.

⁸ By law, these CCAA should consult DGSFP before granting a license. However, it is not always done in practice. As at the end of 2010, there were 159 such entities in seven CCAA with gross written premium of EUR 1.6 billion, or 2.7 percent of total Spanish insurance market in 2010. 87 percent of such entities by number (82 percent by premium volume) were in the Autonomous Community of the Basque Country.

48. **The Spanish insurers have weathered the financial crisis well.** Total written premiums increased in each of the past five years, except for a decline of 6 percent in 2010. Insurers remain profitable. The industry has maintained combined ratios below 100 percent in the last three years and the 2011 first nine months' ROE is over 15 percent in non life and 13.5 in life. Under Solvency I the industry show on average a sound solvency margin of around 200 percent above the required capital in the life sector and 350 percent in the nonlife sector.

49. **The insurance sector is supervised under a sound regulatory framework.** Supervision is carried out by competent supervisors, adhering to the EU directives that are consistent with international standards. The Spanish authorities have made progress in addressing several recommendations arising from the previous FSAP in 2006, while recommendations on strengthening the autonomy of financial supervisors have not yet been taken up.

50. **The main vulnerabilities of the Spanish insurance supervisory framework are:**

- **Lack of sufficient resources to effectively carry out its supervisory objectives.** The State budget is likely to remain stagnant if not shrinking in the near future given the economic forecast. DGSFP's share of the State budget is not likely to increase. On the other hand, it is facing increasing demand on resources to implement new international prudential standards, and to provide ongoing cooperation and coordination in supervising cross-border insurance groups and financial conglomerates. The effectiveness of its supervision may be adversely affected given the competing demands on limited resources.
- **A third of the life insurance business carries guarantees backed by sovereign and corporate bonds.** While regulatory capital of life insurers appears sufficient under existing Solvency I methodology, adoption of Solvency II could result in additional capital requirements for some insurers. As the QIS 5 exercise showed a breadth of results, further calibration is needed. To this end, DGSFP has been working closely with the European Commission Working Groups and the European Insurance and Occupational Pensions Authority (EIOPA) on the advanced design of Pillar 1 of Solvency II.
- **Product disclosure requirements for life insurance should be improved.** The Spanish Association of Insurance and Reinsurance Institutions (UNESPA) has issued voluntary guidelines on disclosure to customers. To promote fair treatment of customers, DGSFP should be empowered to standardize and formalize the disclosure requirements at the point of sale to ensure customers receive adequate and non-misleading information, as well as requiring ongoing disclosures to customers to keep them abreast of changes to policy values. DGSFP's cooperation with the Ministry of Justice in revamping the insurance contract law is a step in the positive direction.

C. Main Findings

51. **Despite the lack of independence in the regulatory structure, there is no evidence to suggest that DGSFP is not independent in carrying out its duties.** However, the budgetary dependency appears to have limited DGSFP's ability to expand its resources to match its expanded responsibility, particularly in the area of group-wide supervision. The competing demands on limited resources have resulted in a "fire-fighting" modus operandi. Current urgencies (such as implementation of Solvency II and participation in supervisory colleges) are managed at the expense of less visible but equally important tasks such as ongoing supervision.

52. **DGSFP is solely dependent on State budget.** Unlike CNMV, it does not collect any fees from market participants, other than the one-time registration fee from intermediaries. In 2011, it collected about EUR 700,000 of registration fees (which were turned over to the Treasury) as compared to its operating budget of EUR 12.8 million. As DGSFP is unlikely to receive more allocation from the State budget in the foreseeable future, it should explore other funding models to reduce its reliance on State budget.

53. **In the absence of additional budget, DGSFP should review its scope of work.** With limited resources, DGSFP should consider delegating important but less critical areas of supervision like complaint handling to have a stronger focus on offsite supervision and inspection. DGSFP currently deploys 31 staff to handle a large number of complaints from the public against insurers and insurance intermediaries. The public trusts DGSFP to be impartial in resolving their disputes with insurers. While handling public complaint is an important function to promote fair-dealing with customers and is one of the early indications of emerging trend of poor business results, DGSFP may not be best placed to resolve disputes. DGSFP could explore other methods, such as an independent industry-wide ombudsman. The brunt of the cost should be borne by the insurers, although the complainant should bear some cost to discourage frivolous complaints.

54. **Supervision is handicapped by the lack of resources.** Six analysts are responsible for the off-site monitoring of 280 insurers. As a result, there is a high dependency on system-generated ratios and ranking based on quantitative financial information. As a result, analysis of internal control systems relies on insurer's own disclosure on an annual basis in an internal control report and on on-site inspection. But, the resources for on-site supervision only allow an inspection cycle of 4 to 5 years.

55. **A third of the life insurance business carries guarantees backed by sovereign and corporate bonds.** While capital appears sufficient under existing Solvency I methodology, adoption of Solvency II could result in additional capital requirements for some insurers. As QIS 5 exercise showed a breadth of results, further calibration is needed. To this end, DGSFP has been working closely with European Commission Working Groups and the EIOPA on the advanced design of Pillar 1 of Solvency II.

56. **Requirements on disclosures to customers should be strengthened to provide greater consumer protection.** Investment products with guarantees are one of the key life insurance products sold in Spain. Point-of-sale disclosure should include investment strategies so that customers may form an informed opinion on the security of the guarantee. On an ongoing basis, policyholders should be provided with information on the changes to the policy values at least annually.

57. **Shortcomings in suitability of persons, corporate governance, risk management and internal control will be addressed when Solvency II is implemented.** In the meantime, DGSFP should work with the industry on its preparedness. In the area of corporate governance, DGSFP should consider issuing a Code of Corporate Governance in line with the Unified Good Governance Code issued by the CNMV for the listed companies. Should Solvency II be further delayed DGSFP should address these deficiencies with high priority.

58. **Some of the largest insurers operating in Spain are insurance groups or belong to financial conglomerates.** To enhance collaboration among supervisory authorities, both domestically and internationally, DGSFP has signed Memorandum of Understanding (MoU) with BdE, CNMV, the Swiss Federal Office of Private Insurance, and three South American insurance supervisors to exchange information on issues relating to prudential supervision, market development, and technical cooperation. DGSFP participates in 23 supervisory colleges and is the group supervisor for two international groups.

59. **Insurance premium written has been relatively stable over the past three years.** A mature and saturated market coupled with recent economic difficulties are key challenges for industry growth. There is a wide variety of life insurance products, distributed fairly evenly across participating, non-participating (including term), investment-linked and annuities. Annuity is the only clear growth product, with premium growth rate of 48 percent from 2008 to 2010. Majority of the annuities and unit-linked business sold are guaranteed investment products with little mortality or longevity risk to the insurers. The major non-life products are motor and property (about one-third each) and A&H (20 percent).

60. **The reinsurance market in Spain is shaped by the participation of the CCS⁹ in catastrophic insurance.** The number of reinsurers remains at 2 in the past five years. A

⁹ CCS is a public institution but not part of the government. It has its own legal status and full capacity to act. It is not supervised by the DGSFP, although it must comply with the requirements in insurance laws and regulations. It is funded through mandatory surcharges on each insurance policy issued. At the end of 2011, it has a reserve fund of EUR 7.8 billion. It has a staff strength of 353.

The Director General of DGSFP is the chairman of CCS. Besides the chairman, there are 14 board members appointed by the Minister for MEC: 7 members from the insurance sector and 7 members from the public sector. CCS has three main functions:

1. Permanent insurance functions—providing coverage for (a) extraordinary risks for natural (floods, storms, earthquakes and tsunamis, volcanic eruptions and falling of meteorites) and social-political

(continued)

unique feature of the Spanish market is the protection offered by the CCS on catastrophic risks, funded by compulsory premium surcharges on every policy issued. CCS has acted in situations where the private sector capacity is severely impaired, such as credit insurance during the recent crisis, after special authorization by the Parliament. On an ongoing basis, the CCS provides capacity to the multi-peril crop insurance sector through a reinsurance arrangement with the Spanish Association for Combined Insurers for Crop Insurance (AGROSEGURO).¹⁰

61. Assets held by insurers as at end of 2010 totaled EUR 242.3 billion, or 22.8 percent of GDP. The 27 composite insurers accounted for 53 percent of total industry assets. Investment of insurance assets is predominantly in fixed income instruments, while exposure to real estate is low. Holdings in sovereign debts are around a quarter of the investment assets and around thirty percent in corporate debt. This investment strategy is aligned with the required matching of the long term liabilities that insurers, life and composite, have in their books. Exposure to sovereign debt and corporate debt is thus a significant risk for the industry through the credit risk.

62. Related party investments may also be an important source of risk to the life industry, particularly composite insurers. While for capital requirements double counting and intra-group transactions are disallowed, the total intra-group and related company receivables are around five percent of the investments supporting the technical provisions. Furthermore, some insurers use deposits placed with their parent banks to provide the capital guarantee under the unit-linked business, thus, intra-group exposure may be even higher.

63. Despite the stagnation of premium income, insurers remain profitable. For the non-life business, catastrophic risks are covered by the CCS resulting in high retention of premium. For the life business, about 80 percent of life insurance (by new premium) is guaranteed return investment products with little mortality or longevity risks. Life insurers typically use asset/liability matching to manage interest rate risk. Nonetheless, the portfolio is subject to credit risks. The industry has maintained combined ratios below 100 percent in the last three years. The Institute of Insurance Entities Cooperation and Research (ICEA) data

(terrorism, rebellion, insurrection, riots and civil commotion, and actions of armed forces in peacetime) perils; (b) compulsory motor insurance for unaccepted or uninsured private vehicles and all official vehicles of government and public agencies; and (c) multi-peril crop insurance, working through AGROSEGURO.

2. Other insurance functions—as and when required by public interest and market circumstances. A 2/3 majority of board approval is needed for CCS to take on additional insurance functions.
3. Non-insurance functions—winding-up of insurers.

¹⁰ AGROSEGURO manages the agricultural insurance system under a co-insurance arrangement private insurers in which CCS takes up 10 percent.

showed that the industry profitability as measured by return on equities has further improved in the first nine months of 2011.

D. Summary of Observance of the Insurance Core Principles

Table 3. Spain—Summary of Observance of the Insurance Core Principles

Insurance Core Principle	Overall Comments
1. Objectives, Powers and Responsibilities of the Supervisor	<p>The primary insurance legislation clearly defines the objectives of insurance supervision and designates MEC as the insurance supervisor, who in turn delegates the day-to-day supervisory responsibility to DGSFP by regulation (<i>decreto real</i>). The Minister for MEC is the ultimate decision-maker in the areas of market access and sanctions on very serious legal infringements. Legislation provides sufficient mandate and power to the authorities to fulfill their responsibilities.</p> <p>Autonomous Communities are in charge of the licensing and supervision of regional mutual insurers operating solely in their respective communities. In 2010, there were 159 such entities with gross written premium of EUR 1.6 billion (2.7 percent of Spanish insurance market). As the national insurance supervisor, DGSFP should monitor the development of these entities.</p>
2. Supervisor	<p>DGSFP is a department within MEC, and is funded by the State budget. While it does not have administrative independence, it has clear objectives and operates in a transparent manner. There is no evidence to suggest that it suffers from undue political interference.</p> <p>DGSFP has full operational independence except in the areas of market access and administrative sanctions on very serious legal infringements where the Minister for MEC is the approving authority at the recommendation of the Director General of DGSFP. In practice, the prescriptive approach embedded in the insurance law makes it difficult for the Minister to deviate from legal provisions. Nonetheless, to enhance operational independence, such powers should be delegated to DGSFP.</p> <p>The increase in size and complexity of the supervised market demands new knowledge and skills for appropriate supervision and cross-border coordination, in particular with the eminent Solvency II preparedness. DGSFP did not have the additional resources needed for a more risk-focused supervisory approach. Furthermore, the lack of staff retention policy and succession planning exposes DGSFP to the risk of loss of critical staff when economy recovers and unemployment improves.</p> <p>DGSFP staff members are competent and qualified, but the headcount assigned to core supervisory functions needs to be increased to avoid supervisory gaps.</p> <p>There are no policies in place to guide DGSFP staff in conflict of interest situations. Such situations include family members working in supervised entities, or trading of securities of supervised entities.</p>
3. Information	The regulatory framework enables DGSFP to exchange confidential

Insurance Core Principle	Overall Comments
Exchange and Confidentiality Requirements	information with supervisors. In the case of non-EU supervisors, legislation also establishes the conditions for collaboration and exchange of information on the condition of reciprocity and confidentiality.
4. Licensing	The legislation clearly defines the activities that require licensing, and the process and criteria to obtain a licence. There are inadequacies in the assessment of (a) key individuals in control positions and (b) corporate framework during the licensing process. These are separately discussed and assessed under ICPs 5 and 7.
5. Suitability of Persons	<p>The suitability test is applied to “effective managers,” defined as board members, senior management and significant owners.</p> <p>The ongoing monitoring of the fitness and propriety of effective managers is indirect as it relies on the insurer’s initiative to report new appointments and removal of such individuals. In the absence of reporting requirements, DGSFP may not be aware of situations where an individual previously assessed to be fit-and-proper becomes unsuitable due to changes in circumstances.</p>
6. Changes in Control and Portfolio Transfers	<p>The Minister for MEC has the approving authority for changes in control, portfolio transfer and changes in legal structure of an insurer. The Minister must take into account policyholders’ interest and prudential considerations in granting approval.</p> <p>Acquisition of 10, 20, 30, or 50 percent or more of voting share or capital of an insurer is subject to DGSFP’s specific indication of no-objection. Additionally, there is a notification threshold at 5percent ownership of an insurer.</p>
7. Corporate Governance	The corporate governance requirement for insurers is limited to the requirement for the Board to be responsible for establishing adequate internal control processes including independent internal audit function and risk management systems consistent with the insurer’s risk management strategies. There are no comprehensive requirements on the role and accountability of the Board and Senior Management.
8. Risk Management and Internal Controls	DGSFP has made important progress in the last few years with the introduction of the mandatory reporting of internal controls deficiencies, and the guidance on the checks of internal control in the inspection manual. However, more specific details on the scope of such internal controls and reporting duties should be provided.
9. Supervisory Review and Reporting	<p>Due to limited resources, off-site monitoring is heavily dependent on system-generated ratios and warning flags based primarily on financial information. The off-site analytical reports focus on worst-performing insurers in terms of financial results. The qualitative review of internal control deficiencies basically relies on the insurer’s disclosure. There is a lack of a full integration of quantitative business results with qualitative indication of management of business to form a comprehensive view of the insurer’s operation, or a risk-ranking based on impact/probability analysis.</p> <p>DGSFP conducts both full scale and focused on-site inspections. Its current</p>

Insurance Core Principle	Overall Comments
	<p>resources only allow a 4- to 5-year inspection cycle, excluding 66 small insurers (ERD). The off-site supervisors visit the ERDs periodically for a day or two. The target is to cover all ERDs over a two- to three-year period. DGSFP conducted only 18 on-site inspections in 2011 (two thirds of which were full scale), compared to 48 in 2010, due to re-allocation of resources to Solvency II implementation.</p> <p>Some key elements of insurance operations are only reviewed during on-site inspections.</p>
10. Preventive and Corrective Measures	<p>DGSFP may require an insurer to put in place a financial recovery plan when it determines that the insurer's solvency position is in jeopardy or that policyholder's interest may be compromised. The financial recovery plan must, at a minimum, include a 3-year projection of (a) estimates of management expenses, (b) detailed estimates of revenues and expenses relating to direct business, reinsurance acceptances and cessions, (c) the balance sheet, (d) estimates of financial resources intended to cover the liabilities and the solvency margin, and (e) the overall reinsurance policy. DGSFP may also require the insurer to maintain a higher solvency margin, or engage a special audit of its accounts.</p> <p>If an insurer's situation worsens further, DGSFP may adopt one or more of the following escalating measures:</p> <ul style="list-style-type: none"> • restriction of asset transfers, • short term financing, • injection of additional capital, • suspension of dividend payment to shareholders, • restriction to write new policies or to renew existing policies, • convening special board meetings, • temporarily replacing the board of directors, and • taking control of the insurer's operation. <p>If special control measures fail to restore the insurer's financial standing, DGSFP may commence winding-up procedures.</p>
11. Enforcement	<p>Spanish insurance law adopts a prescriptive approach to supervisor's enforcement power. The situations under which sanctions may be imposed and the types of sanctions to be applied for each situation are clearly defined in the law. While this prescriptive approach at first glance restricts the supervisor's ability to take action, Article 38 of the law provides the supervisor a broad power to take action when a circumstance arises that jeopardizes the insurer's solvency or policyholders' interest. As such, DGSFP is not constrained in taking corrective action in situations not prescribed in law. (See also ICP 10.)</p>
12. Winding-up and Exit from the Market	<p>Policyholders and beneficiaries have priority rights to the assets covering insurers' technical provisions in the event of winding-up CCS is not a guarantee fund but manages winding-up and bankruptcy cases to ensure orderly exit from the market and timely payments to policyholders. Out of the 19 winding-up cases between 2007 and 2011, policyholders were paid</p>

Insurance Core Principle	Overall Comments
	100 percent on all cases except two, where they were paid 52.4 percent and 84.1 percent, respectively.
13. Reinsurance and Other Forms of Risk Transfer	<p>The reinsurance regulation follows current EU Directives on reinsurance that requires insurers to adequately control and to transparently report their risk transfer programmes.</p> <p>Through the offsite reporting, the DGSFP has an indication of the level of risks reinsured. The onsite inspection reviews the sufficiency of risk transfer of the reinsurance contracts as well as their completeness and timely execution. However, there are no formal requirements to finalise the reinsurance contract in a timely fashion, nor a prohibition against reinsurance side letters that would add transparency to the contracts.</p> <p>Liquidity in general is supervised through the statutory reporting process, but there is no requirement to consider the payment pattern of reinsurance claims for the purpose of liquidity management of the insurer.</p>
14. Valuation	<p>The current method of valuation follows the Solvency I rules. The valuation of assets and liabilities is undertaken on consistent bases in the general regime (Article 33.1) and for the immunized policies through the accounting mismatch reserve. However, for the business portfolios underwritten before 1999, assets are valued at fair value and liabilities at historical value, the latter of which is not an economic valuation. Furthermore, for non-life business, most future cash flows are not discounted. The pending adoption of Solvency II will address these discrepancies.</p> <p>Revaluation of real estate is every three years.</p> <p>The current method does not explicitly recognize best estimate of future cash flows, and a specific margin for adverse experience fluctuation. There is some conservatism implicitly incorporated in the technical provisions by under-estimating future cash inflows through the use of risk premiums instead of gross premium. On the other hand, the estimate of future cash outflows may be less conservative in some cases, in particular in the disregard of embedded options and for the legacy business issued prior to 1999.</p>
15. Investment	The investment limits stated under current regulation do not hinder the ability of insurers to invest in a prudent and efficient way.
16. Enterprise Risk Management for Solvency Purposes	While some insurers have adopted their groups' ERM systems, there is no regulatory requirement to adhere to comprehensive ERM systems other than the general requirement to have internal controls under Articles 110 and 110A of the Private Insurance Organization and Supervision Code (ROSSP).
17. Capital Adequacy	<p>Spain is on the Solvency I regime. While waiting for the implementation of Solvency II, Spain has not established any enhancements to make the solvency regime more risk sensitive with the exception of detailed asset/liability matching requirements.</p> <p>Thus, shortcomings of the current solvency regime are hindering the compliance with this ICP as a total balance sheet approach and a risk-</p>

Insurance Core Principle	Overall Comments
	based assessment of the capital requirements is not incorporated into the legislation in force.
18. Intermediaries	<p>DGSFP registers insurance agents and brokers at both legal entity and natural person levels. In registering an intermediary, DGSFP takes into account the applicant's integrity, competence, and financial standing. DGSFP has the power to supervise and sanction intermediaries. However, in practice, due to limitation of resources, the supervision of exclusive agents is left to the insurers, and the level of supervision of multi-tied agents and brokers is inadequate with only 20 inspections of brokers and bank assurance operators in 2011.</p> <p>Bank assurance is a major distribution channel for life insurance. 75 percent of individual life and 45 percent of group life business were sold through banks in 2010.</p> <p>DGSFP maintains on its website a register of intermediaries, which is a mix of natural persons and legal entities. Sales staff (not inclusive of management board) of legal entity intermediaries are not individually registered, nor listed in the register.</p> <p>Intermediaries are required to disclose to customers their identity, licensed status, their relationship with the insurer, procedures to lodge complaints, and legal protection of confidential client data. The disclosure of remuneration is limited. A broker is only required to disclose his commission when he is paid both a fee by his client and a commission by the insurer.</p> <p>Multi-tied agents and brokers are required to carry professional liability insurance with coverage of up to EUR 1.68 million per year.</p>
19. Conduct of Business	<p>The insurance laws and regulations establish requirements on disclosure to customers at the point of sale. In particular, in the case of life insurance where the policyholder bears the investment risk, a clear and precise statement about the fact that policy values is subject to market fluctuation, beyond the control of the insurer and that historical results do not indicate future results. However, investment strategies and policies are not part of the required disclosure.</p> <p>On an ongoing basis, insurers must inform the policyholder of any changes to the policy terms and conditions, and also on the status of their participation in profits. For investment products, there is no requirement to inform policyholders on the value of their policies.</p> <p>Life policies (except those where the policyholder bears the investment risk) may be cancelled within 30 days after receipt of policy document.</p> <p>DGSFP handles a high volume of customers' complaints against insurers and intermediaries.</p>
20. Public Disclosure	DGSFP publishes a substantial amount of financial information about insurers, the basis for the preparation of annual statements, distribution of benefits and profits, asset and liability valuation methods and assumptions, information on different sections of the financial statements, specific technical information on the life and non-life segment of the business,

Insurance Core Principle	Overall Comments
	coverage of technical provisions and solvency margin. While the disclosure requirements are comprehensive, the financial data can be very out-dated by the time the database is updated. The highly technical nature of the disclosures also makes it difficult for a member of the general public to comprehend the inherent risks.
21. Countering Fraud in Insurance	Insurance frauds are criminal offences under the general criminal law. DGSFP does not explicitly require insurers to have in place procedures to deter, detect, prevent and remedy frauds. Nor does it monitor or analyze the overall market vulnerabilities to frauds. Counter-fraud measures are implemented voluntarily at the industry level, although it is limited by the legal protection of client data.
22. Anti-Money Laundering and Combating the Financing of Terrorism	DGSFP supports SEBLAC, the designated Financial Intelligence Unit (FIU), in collecting data during on-site inspections. It understands the ML/TF risks in insurance business, and collaborates with other agencies in imposing sanctions on ML/TF offences.
23. Group-wide Supervision	<p>DGSFP's supervision of an insurance group extends to all legal entities within the group, including non-regulated entities and any entity that DGSFP has good reasons to believe to be part of the insurance group.</p> <p>An insurance group is required to notify DGSFP of any change in its structure in a timely manner. DGSFP may deny or withdraw the insurance group's licence if the organization or group structure hinders effective supervision.</p> <p>DGSFP adopts the three levels of group wide supervision framework, which is in line with current EU Directives.</p>
24. Macroprudential Surveillance and Insurance Supervision	<p>DGSFP collects and publishes a high volume of market statistics that are widely used by industry and academia for research purposes. However, it appears that DGSFP does not use the wealth of statistics for qualitative analysis beyond the generation of ratios. DGSFP is advised to develop a macroprudential surveillance system, including mandatory industry-wide stress tests to identify trends, potential risks and plausible future unfavourable scenarios, so that it may take early action to reduce the likelihood of systemic risk. The current 3-year projection of individual insurer's solvency position is a good start. DGSFP should include sensitivity and scenario testing to identify vulnerabilities at the insurer level and at the industry level.</p> <p>The Spanish insurance market has high participation by foreign insurers. Some of its insurers also have operations in other countries. DGSFP should also consider regional and global market development in its macroprudential analysis.</p> <p>It is noted that DGSFP is developing a new analytical tool with a view to build an early warning system. Through coordination by EIOPA, DGSFP contributes to and receives information from other supervisors on market conditions.</p>
25. Supervisory	The engagement at EU and international level with relevant supervisors is

Insurance Core Principle	Overall Comments
Cooperation and Coordination	high and collaborative. Supervisory colleges for the two international groups (where DGSFP is the designated group supervisor) have been established by the DGSFP and are under continuous improvement. DGSFP participates in another 21 Colleges as host supervisors.
26. Cross-border Cooperation and Coordination on Crisis Management	<p>DGSFP follows EIOPA and IAIS protocols on cooperation and coordination in cross-border crisis management. However, the colleges have not tested crisis simulations beyond EU. There are no resolution plans among cross-border supervisors. Work on determining Systemically Important Financial Institutions (SIFIs) is in early stages.</p> <p>A relatively minor weakness is that it does not require insurers to regularly test their contingency plans. It is advised that DGSFP should require it.</p>

E. Recommendations and the Authorities' Responses

Table 4. Spain—Recommendations to Improve Observance of ICPs

Insurance Core Principle	Recommendations
1. Objectives, Powers and Responsibilities of the Supervisor	DGSFP is advised to maintain updated information from the Autonomous Communities on the number and the size of the mutual insurers they license and supervise, consistent with its role as the national insurance supervisor.
2. Supervisor	<p>a. Enhance operational independence, the power to control market access (licensing and mergers and acquisitions) and administrative sanctions on very serious legal infringements should be delegated to DGSFP.</p> <p>b. Increase resources to keep pace with rapid industry developments. The ideal outcome is for DGSFP to gain financial and human resource policy independence so that it may explore alternative funding models. In the absence of financial independence, DGSFP needs to review its workload to focus on its core functions and delegate certain important but less critical functions to entities that may perform such duties more competently and efficiently. For example,</p> <ul style="list-style-type: none"> • The handling of public complaints consumes 31 of DGSFP's headcount. This function may be more competently carried out by an industry-wide independent ombudsman. • The implementation of Solvency II requires intense and highly technical attention. DGSFP could explore other avenues for resources, such as the CCS. <p>c. Issue conflict of interest policies to complement the general Public Employees Code of Conduct.</p> <p>d. Update the Insurance Contract Law (LCS) without delay.</p>

Insurance Core Principle	Recommendations
3. Information Exchange and Confidentiality Requirements	Spain is not yet a signatory to the IAIS Multilateral Memorandum of Understanding (MMoU). It should reconsider its accession to the MMoU.
4. Licensing	Expand the fitness and propriety assessment to include key individuals in control positions (see ICP 5), and (b) assess an applicant's corporate governance framework (see ICP 7).
5. Suitability of Persons	<p>a. Amend the definition of "effective manager" to include key individuals in control positions, with an attendant definition of "control positions." (See also ICP 8.)</p> <p>b. Improve the ongoing monitoring of the fitness and propriety of effective managers by requiring insurers to report any changes in circumstances affecting their fitness and propriety.</p>
6. Changes in Control and Portfolio Transfers	None
7. Corporate Governance	DGSFP should establish a comprehensive Code of Corporate Governance for insurers domiciled in Spain, in line with the Unified Good Governance Code issued by the CNMV for listed companies. The Code should contain specific requirements on: (a) the board structure, governance, and assessment of the effectiveness of the board; (b) roles and accountability of board members, senior management and key personas in control functions; (c) remuneration of board members and senior management; (d) timely and reliable financial reporting to the public; and (e) timely and effective communication with DGSFP and relevant stakeholders (including policyholders) on the governance structure of the insurer.
8. Risk Management and Internal Controls	<p>a. DGSFP is advised to strengthen the existing regulation in the following areas:</p> <ul style="list-style-type: none"> • Scope of internal controls—To be effective, internal controls should be comprehensive, covering the insurer's key business, IT and financial processes. Key control functions must minimally include internal audit, risk management and actuarial. Each key control function should (a) be led by a person suitable for the position, (b) have sufficient independence from business units and adequate resources, (c) have sufficient resources, and (d) have access to the board and provide regular reports to the board. • Duties of key control functions: <ul style="list-style-type: none"> (a) Risk management should assess risks on an enterprise-wide basis. There should be defined risk appetite, documented approval process and authorities, established risk strategy, and escalation and reporting procedures. (b) Internal audit should assess the adequacy and effectiveness of the insurer's policies and procedures, and the documentation and controls of these. It should also evaluate the reliability and integrity of management information.

Insurance Core Principle	Recommendations
	<p>(c) Actuarial function is to advise on matters relating to technical provisions, pricing, investment policies, solvency position, reinsurance, recommendation of dividends to policyholders on participating policies, and risk modelling.</p> <p>(d) Compliance function is to advise on compliance with laws, regulations and internal policies and procedures. Compliance procedures should be integrated in work processes.</p> <p>b. Many insurers have started to outsource high technical functions (such as IT and risk modelling). The existing regulation on outsourcing should be expanded to require: (i) board approval of outsourcing of material functions or activities, (ii) due care and diligence in selecting the outsourcing providers, (iii) written documentation of the outsourcing arrangements, and (iv) periodic review of such arrangements.</p>
9. Supervisory Review and Reporting	DGSFP is advised to review the adequacy of resources for both on- and off-site supervision, and formulate a more robust risk-based supervision approach.
10. Preventive and Corrective Measures	See ICP 17.
11. Enforcement	None.
12. Winding-up and Exit from the Market	None.
13. Reinsurance and Other Forms of Risk Transfer	<p>DGSFP should require insurers to:</p> <p>a) finalize the reinsurance contract in a timely fashion, and prohibit the use of reinsurance side letters.</p> <p>b) consider the payment pattern of reinsurance claims for the purpose of liquidity management.</p>
14. Valuation	<p>DGSFP should address a number of deficiencies in the current Solvency I methodology. For instance by implementation of the Solvency II regime.</p> <p>Specifically, the valuation of liabilities should explicitly recognize best estimate of future cash flows, and a specific margin for adverse experience fluctuation.</p> <p>Real estate should be re-valued every year.</p>
15. Investment	None.
16. Enterprise Risk Management for Solvency Purposes	There is an urgent need to develop a comprehensive enterprise risk management regulatory framework.
17. Capital Adequacy	Pending Solvency II adoption, the DGSFP is advised to introduce regular scenario testing to determine the impact on insurer's solvency position. DGSFP should also formalize its practice of commencing discussions with an insurer at risk of breaching its solvency margin so that there is sufficient time to take preventive measures.

Insurance Core Principle	Recommendations
18. Intermediaries	<p>DGSFP is advised to:</p> <ul style="list-style-type: none"> • Improve the register of intermediaries to include all persons allowed to sell, for greater public disclosure and protection. • Require intermediaries to disclose their financial interest in the sale of the products. For instance, an intermediary should point out which of the policies presented to the client bears the higher commission. Also the commission should be disclosed at least upon request. • Require intermediaries to put in place additional safeguards to protect client's money. For example, the use of bank accounts separate from the intermediaries' own accounts to hold client's money. • Increase frequency of on-site inspections.
19. Conduct of Business	<p>a. DGSFP is advised to improve the disclosure requirements to include:</p> <ul style="list-style-type: none"> • At the point of sale: description of investment strategies used to provide policy guarantee, so that the customers may form an informed conclusion on the security of the guarantee. • Intermediaries selling products invested in complex investment instruments (e.g., derivatives, structured products) should have special training so that they can explain the risk, costs and benefits of the investments to customers clearly. • On an ongoing basis: statements to customers of life insurance with investment elements at least annually, to inform them of the changes in policy values during the year. <p>b. DGSFP is advised to consider setting up an industry-wide independent ombudsman to handle public complaints.</p> <p>c. Banks often offer packaged products for compulsory insurance. In such cases, the bank assurance operator should inform the customers that he is free to choose the product from another insurer. Furthermore, the cost for each component of the packaged product should be clearly identified.</p> <p>TRLOSSP should give DGSFP the proper power to improve public disclosure.</p>
20. Public Disclosure	<p>DGSFP is advised to (a) improve the timeliness of public disclosure by using quarterly information submitted by insurers, and (b) require insurers to disclose their risk management and internal controls in a manner that can be understood by the public. (See also ICP 7 on corporate governance.) TRLOSSP empower DGSFP to improve public disclosure.</p>
21. Countering Fraud in Insurance	<p>Regulation should explicitly require insurers and intermediaries to have effective policies and procedures to deter, prevent, detect, report and remedy fraud as part of their internal control processes.</p>
22. Anti-Money Laundering	<p>DGSFP should consider, in supporting Servicio Ejecutivo de la</p>

Insurance Core Principle	Recommendations
and Combating the Financing of Terrorism	Comisión de Prevención del Blanqueo de Capitales (SEPBLAC) to further facilitate the industry's compliance with AML/CFT law, issuing guidelines on risk-based customer due diligence (CDD) procedures.
23. Group-wide Supervision	<p>DGSFP is advised to consider the following improvements to its group-wide supervision framework:</p> <ol style="list-style-type: none"> a. Given the large number of insurance groups in Spain, review its capacity (under level 1) to carry out effective group-wide supervision. b. In light of the recent financial crisis, consider improving the level 3 reporting requirements to include off-balance exposures, liquidity risks and possible contagion and reputation risks.
24. Macroprudential Surveillance and Insurance Supervision	<p>DGSFP is advised to:</p> <ol style="list-style-type: none"> a. Provide context to the comprehensive market statistics it publishes, by including more macroeconomic factors, such as level of interest rates, financial market indices, inflation, interconnectedness with other financial market participants, catastrophes and pandemics that may impact insurers and insurance markets. b. Develop a macroprudential surveillance system, including mandatory industry-wide stress tests to identify trends, potential risks and plausible future unfavourable scenarios, so that it may take early action to reduce the likelihood of systemic risk. DGSFP should include sensitivity and scenario testing to identify vulnerabilities at the insurer level and at the industry level as well as to assess the potential systemic importance of insurers. c. Consider regional and global market development in its macroprudential analysis, recognizing the international dimension of its insurance market.
25. Supervisory Cooperation and Coordination	<p>Due to the international operations of some Spanish insurance (groups), the degree of cross-border cooperation is highly intensive, and necessary. DGSFP is advised to allocate sufficient resources to the supervision of international groups to meet the growing requirements arising from its participation in 23 supervisory colleges.</p>
26. Cross-border Cooperation and Coordination on Crisis Management	<p>As part of its involvement in supervisory colleges, DGSFP should work with other group/involved supervisors to:</p> <ul style="list-style-type: none"> • test the crisis simulations beyond EU; • establish resolution plans among cross-border supervisors; • identify SIFIs; • institute action plans in respect of SIFIs in case of a crisis; and • require insurers to regularly test their contingency plans.

F. Authorities' Response to the Assessment

64. The Spanish authorities want to express their gratitude towards the huge and valuable work developed by the IMF to assess the implementation of the supervisory and regulatory competences. The Financial Sector Assessment Program has been extremely useful in a critical moment where the experience and know-how of the IMF is received as precious benchmark to inspire and implement the improvements to come.

65. The assessment concludes that the sector is supervised under a sound regulatory framework. Notwithstanding this good evaluation, the Spanish authorities have an ambitious agenda to introduce new regulation and tools to keep improving the supervisory action, making it more efficient and adapted to the current economic environment.

66. As the FSAP rightfully points out, the main vulnerability of the supervisory framework is the lack of sufficient resources. The Spanish authorities are well aware of this weakness and will take measures to make the system cope with its demands. The Spanish insurance industry has repeatedly expressed their willingness to financially support the supervisor.

67. The FSAP recognizes that the strengthening of the autonomy of the supervisor is a pending issue. This statement, together with the previously mentioned assessment, is one of the issues that will be dealt by the Spanish authorities as soon as the economic crisis allows it.

68. The Spanish authorities have already taken steps to address a number of shortcomings identified in the FSAP. Furthermore, the ongoing works to transpose Solvency II will duly tackle some of the concerns raised in the assessment regarding product disclosure for life insurance and capital requirements linked to the risk taken by the insurance companies.

III. IOSCO OBJECTIVES AND PRINCIPLES FOR SECURITIES REGULATION

A. Summary

69. **Spain exhibits a high level of implementation of the IOSCO principles.** The legal framework is robust and provides the CNMV with broad supervisory, investigative and enforcement powers. Arrangements for off-site monitoring of regulated entities are robust. Thematic reviews in selected areas have complemented such monitoring, allowing the CNMV to take a “full industry” perspective on key issues. The CNMV has also developed robust arrangements for market surveillance. A new committee (*the Grupo de Estabilidad Financiera*), biweekly meetings by a management committee and annual strategic reviews allow the CNMV to contribute to the identification and monitoring of emerging and systemic risk and the review of the perimeter of regulation.

70. **Some areas of supervision and enforcement require strengthening.** In particular, the CNMV should make more use of on-site inspections for all types of investment service providers, but in particular in connection with credit institutions given their dominant role in the securities markets and the inherent conflicts of interest that arise from their dual role as issuers and distributors of products. This could be done via spot checks on particular issues, and does not imply the need for full scale inspections. In tandem, the CNMV should continue to use more proactively its sanctioning powers in connection with breaches by regulated entities, in addition to other enforcement mechanisms such as remedial agreements. Successful criminal prosecution of market abuse is a challenge, but positive steps have been taken as the CNMV has become more active in the referral of cases to the criminal authorities.

71. **Certain aspects of the current governance structure of the CNMV raise concerns vis-à-vis independence, although the assessors saw no evidence of interference with day-to-day operations.** The participation of a representative of the MEC in the board of the CNMV; the fact that certain key decisions (authorizations and the imposition of sanctions for the most serious breaches) are still a responsibility of the MEC; and the requirement of governmental approval to hire additional personnel are threats to CNMV independence. In practice the collegial nature of the board and the “regulated” nature of the authorization and sanctioning processes—which require a recommendation from the CNMV—have acted as mitigating factors.

B. Introduction

72. **An assessment of the level of implementation of the IOSCO Principles in the Spanish securities market was conducted** from February 1 to 21, 2012 as part of the FSAP by Ana Carvajal, Monetary and Capital Markets Department (MCM) and Malcolm Rodgers, MCM expert. An initial IOSCO assessment was conducted in 2006. Since then significant changes have taken place in the Spanish market, in terms of market development and upgrading of the regulatory framework. In addition IOSCO approved a new set of Principles in 2010 and a revised Methodology in 2011.

C. Information and Methodology Used for the Assessment

73. **The assessment was conducted based on the IOSCO Objectives and Principles of Securities Regulation approved in 2010 and the Methodology adopted in 2011.** As has been the standard practice, Principle 38 is not assessed due to the existence of a separate standard for securities settlement systems. A technical note on the oversight framework for clearing and settlement of securities markets was delivered during this mission.

74. **The IOSCO methodology requires that assessors not only look at the legal and regulatory framework in place, but also at how it has been implemented in practice.** The recent global financial crisis has reinforced the need for assessors to take a critical look at supervisory practices, to determine whether they are effective enough. Among other things,

such judgment involves a review of the inspection programs for different types of intermediaries, the cycle, scope and quality of inspections as well as how the agency follows-up on findings, including the use of enforcement actions.

75. **The assessors relied on:** (i) a self-assessment prepared by the CNMV; (ii) the review of relevant laws and reports; (iii) review of supervisory files; (iii) meetings with staff from the CNMV, the BdE; the ICAC; the MEC; and prosecutorial authorities; as well as (iv) meetings with market participants, including issuers, securities firms, fund managers, exchanges, external auditors, credit rating agencies and law firms.

76. **The assessors want to thank the CNMV for its full cooperation** as well as its willingness to engage in very candid conversations regarding the regulatory and supervisory framework in Spain. The assessors also want to extend their appreciation to all other public authorities and market participants with whom they met.

D. Institutional Structure

77. **The regulation and supervision of securities markets in Spain is a responsibility of the CNMV.** The CNMV is responsible for the supervision of both securities and derivatives markets. In particular, it has responsibility for the supervision of primary securities markets (issuance); secondary markets (for both securities and derivatives); the disclosure obligations of issuers; the provision of investment services by market intermediaries; and collective investment schemes (mutual funds and investment companies). The authorization of all intermediaries, except financial advisors, to provide services in the Spanish market as well as the authorization of all market infrastructure providers (exchanges and central clearing counterparties) is a responsibility of the MEC, based on a recommendation of the CNMV. Regulations can only be issued by the Government or the MEC, but the CNMV can issue binding rules (*Circulares*) where expressly permitted to do so by the relevant Royal Decree or MEC order.

78. **The CNMV is a public law entity with legal personality.** The CNMV is governed by a board (the *Consejo*), composed of seven members, including a President and a Vice President appointed by the government on a recommendation of the MEC, three members with experience in securities markets, and two ex-officio members, the *Secretary General of the Treasury and Financial Policy* and the Deputy Governor of the BdE. The board has delegated its day to day functions to an Executive Committee which is composed of all but the ex-officio members. Decisions that must be taken at the board level are, among others: the approval of *Circulares* and the imposition of sanctions, as well as the approval of the annual report and the annual plan of activities of the CNMV. While self-funded the CNMV requires government approval to hire additional staff.

79. **There are no self-regulatory organizations in Spain.** Exchanges (in the context of Spain the four exchanges operated by the *Bolsas y Mercados Espanoles* (BME) are the front line supervisor for the purpose of ensuring orderly trading, but they only have a

complementary role to that of the CNMV in what concerns market abuse. The exchanges do not have either a role in securities intermediaries' supervision (beyond ensuring that the rules of the market are being complied with), nor in monitoring compliance of issuers with their disclosure obligations. In connection with multilateral trading facilities (MTFs) (in the context of Spain: Latibex and *Mercado Alternativo Bursátil* (MAB)) the MTF operator (BME) has a more direct role in monitoring the market for purposes of detecting market abuse, and it is also in charge of monitoring compliance by issuers with their disclosure obligations. However at present these markets are not of material importance.

E. Market Structure

80. **At 30 September 2011, Spanish savings and investments totalled approximately 1,758 billion Euros.** 57 percent are held in deposits with credit institutions, but 26 percent are held in mutual funds or direct market investments:

Table 5. Spain: Non-Financial Corporations and Households Financial Assets

3Q11, EUR billion				
	Non-financial corporations	Households	TOTAL	% of TOTAL
Deposits	240	769	1,010	57
Mutual funds	12	111	123	7
Pension funds	0	104	104	6
Savings insurance	26	162	188	11
Direct investments	192	142	334	19
Fixed income	42	50	92	5
Equities ¹	150	92	242	14
TOTAL	470	1,288	1,758	100

Source: BdE (Financial Accounts).

¹ Listed equities and investment companies shares.

Issuers

81. **At December 2011, 130 companies were listed on the main (electronic) Spanish equities market operated by the BME Group.** In addition, there were 7 issuers on the second market and 28 issuers listed on the small cap open outcry market. Total market capitalisation was € 421 billion (or approximately 39 of Spain's GDP). Stocks in financial companies account for almost 31 percent of total market capitalization, with banks accounting for over 90 percent of this figure. The market is concentrated, with the top ten companies representing over 60 percent of total market capitalization. The rate of new listings has slowed markedly since the financial crisis, and there were only six new listings in 2011 (and five de-listings). A small number of companies are listed on other markets, including the BME MAB market (18 companies), and regional exchanges.

82. **At December 2011 there were 611 issuers of fixed interest products and a total of 4,382 issues available for trading on the BME's fixed interest market, Asociación de Intermediarios de Activos Financieros (AIAF).** Total outstanding on these issues was € 882.4 billion.

Intermediaries

83. **At December 2011, 94 investment firms (49 broker dealers and 45 brokers) and 187 banks and other credit institutions were authorized to carry out investment services in Spain.** In addition, 2,377 European firms have notified the CNMV of their intention to provide investment services in Spain. Of these 36 operate through branches and the remainder through the free provision of services (passport) arrangements. There are also six authorized portfolio management firms and 82 authorized financial advisors (60 firms and 22 individuals).

84. **Banks dominate the investment services industry, and account for 72 percent of commissions earned from investment services activities.** They account for over 96 percent of placement and underwriting activity, 95 percent of administration and custody, and 92 percent of mutual fund marketing.

85. **As of December 2011, 114 firms were authorized to manage Collective Investment Schemes (CIS).** In addition, 94 firms were authorized to provide depository (custodial) services, although in practice 56 do so, and a small number of banks account for most of the business.

Collective investment schemes

86. **At December 2011, there were 5,460 CIS vehicles registered with the CNMV,** comprising 2,341 investment funds, 3,056 investment companies (Sociedad de Inversión de Capital Variable (SICAVs)), 36 hedge funds, and 27 fund of hedge funds. In addition, there were 14 real estate funds (6 investment funds and 8 SICAVs). There are almost 5 million investors in CIS in Spain.

87. **Total assets under management at November 2011 were € 156 billion, with € 132.4 in investment funds and € 23.6 in SICAVs.** Banks and other credit institutions manage more than 90 percent of the total assets under management. Asset allocation is heavily weighted toward fixed income, with over 60 percent of fund assets in fixed income or guaranteed fixed income funds; and a further 4 percent in mixed fixed interest funds. Guaranteed equity funds account for almost 14 percent of total funds under management. Investment in real estate funds was € 4.8 billion, or about 3 percent of all funds under management.

Markets

88. **The BME Group operates all regulated markets in Spain, except for an olive oil futures market and the Spanish Public Debt Market.** BME group equity markets use the same electronic trading platform. They are order driven markets, and market makers are used by Latibex and MAB to provide liquidity. BME also operates a centralised securities depository, IBERCLEAR, and a Central Clearing Counterparty (CCP) for repos on Spanish public debt transactions, MEFFCLEAR. The markets the BME group operates are listed in Table 6.

89. **Spain has not yet seen the emergence of trading venues competing for trading in BME listed products.** Some BME listed stocks are traded on venues located elsewhere in Europe, such as Chi-X, but overall non-BME trading is estimated at less than 2 percent.

90. **There is also a specialized olive oil futures market authorized as an official secondary market.** Trading volumes are small and appear to be in decline.

Table 6. Spain: Spanish Regulated Markets: BME Group

Market	Regulated as:	Products traded	Listed entities	Comment
BME [comprising the stock exchanges of Barcelona, Bilbao, Madrid and Valencia]	Official secondary market	Spanish equities, ETFs, warrants and certificates	130	Market capitalization: € 492 billion [November 2011]
MAB	MTF	Small cap stocks; SICAVs	18 [3,056 SICAVs]	Market capitalization: € 444 million (small cap stocks) [December 2011]
Latibex	MTF	Latin American equities (euro denominated)	34	
AIAF	Official secondary market	Corporate debt	608 debt issuers	Total outstandings: € 868 billion [November 2011]
SENAF	MTF	Public debt	-	
MEFF Equities	Official secondary market	Equity derivatives		
MEFF Fixed Income	Official secondary market	Fixed income derivatives		No activity in 2012

91. **The Official Secondary Market for Book-Entry Public Debt is run by the Bank of Spain which is in charge of its supervision and oversight.**

F. Preconditions for Effective Securities Regulation

92. **The preconditions for effective regulation and supervision of securities markets appear to be in place.** Foreign issuers can tap the markets under similar conditions to domestic issuers. The same authorization requirements apply to both domestic and foreign corporations that want to provide investment services, including CIS management, or to operate an regulated markets (RM) or an MTF in Spain. In practice, however operational barriers have prevented the establishment of multilateral trading facilities outside of those

managed by the BME. The company law is modern, and the insolvency framework includes restructuring procedures. The judiciary system is perceived as impartial. Accounting and auditing standards do not have major differences with international standards.

G. Main Findings

93. **Principles for the regulator:** The CNMV has a clear mandate imbedded in the LMV. The organizational structure does not guarantee the CNMV full independence. Authorization requirements in connection with the provision of regulated activities are clear and interested parties can access them through CNMV's website. In addition, the CNMV has developed manuals to support consistent decision making. The development of regulations by both the CNMV and the MEC is subject to public consultation. CNMV staff is subject to robust rules in connection with conflicts of interest, including a detailed framework for securities transactions. The CNMV has established processes to identify and monitor systemic risk, perimeter of regulation and conflict of interest.

94. **Principles for enforcement:** The CNMV has broad powers to request information and inspect regulated entities. It also has broad powers to request information and testimony from third parties. The CNMV has a wide set of enforcement tools at its disposal, including the imposition of money penalties for breaches to the LMV and secondary legislation. Until recently the majority of enforcement cases concern issuers' violations. Since the last three years the CNMV has been more active in investigating compliance by investment firms and credit institutions that provide investment services with their conduct obligations.

95. **Principles for issuers:** Issuers of public offerings and products admitted to trading on an RM are subject to robust disclosure obligations at the moment of registration and on a periodic and on-going basis. In addition, the CNMV has developed a robust program to monitor issuers' compliance with their disclosure obligations. Basic rights of shareholders are imbedded in company law, and additional protections exist in connection with issuers listed in an RM, including the obligation to launch a mandatory tender offer under certain conditions. There are notification obligations for substantial and insider holdings. Different provisions apply to MAB and Latibex however at this time those markets are not material.

96. **Principles for auditors, credit rating agencies (CRAs) and other information service providers:** The ICAC, is in the process of implementing a system of quality control review for auditors of public interest entities (PIEs), which include firms that audit issuers listed in a RM, whereby such auditors would be subject to inspections by ICAC on a three year cycle. CRAs that provide services in Spain have been subject to a thorough registration process by cross-European colleges of supervisors. European Securities Markets Authority (ESMA) is currently in the process of developing its supervisory program for CRAs. There is a framework in place for sell-side analysts to address potential conflict of interests, which is based on disclosure obligations; and additional disclosure obligations have been imposed in other entities that provide evaluative services

97. **Principles for collective investment schemes:** CIS operators and distributors of CIS are subject to authorization requirements, which include financial, fit and proper, and organizational requirements. The process to review applications is thorough. The supervisory program for CIS relies on off-site monitoring and thematic reviews. On-site inspections are conducted on a limited number of operators, which are selected under a risk-based approach. CIS that are offered to the public are subject to similar disclosure obligations as an issuer. Assets must be entrusted to a depository (custodian). Depositories can be (and in practice are) of the same group, but there are legal and regulatory arrangements in place that provide additional safeguards. In particular special reports are required from the compliance unit of the CIS as well as from the external auditors. Assets must be valued at fair value. The CNMV has developed guidance on valuation of illiquid assets. Conditions of suspensions of redemptions must be disclosed in the offering documents. Suspensions must be notified to the CNMV.

98. **Principles for securities intermediaries:** Investment Services Providers (ISPs) are subject to authorization requirements. Such requirements include financial resources, fit and proper, and organizational requirements. The process to review applications is thorough. The supervisory program for ISPs relies on off-site monitoring, and thematic/horizontal reviews. On-site inspections are conducted on a limited number of operators, which are selected under a risk-based approach. Minimum and ongoing capital requirements apply to ISPs. ISPs must submit monthly and quarterly reporting of their capital adequacy as well as annual audited financial statements. The CNMV uses an estimate of five month losses as an early warning indicator that triggers more intense monitoring. The CNMV has developed manuals to facilitate the process of dealing with the failure of an ISP.

99. **Principles for secondary markets:** RMs and MTFs operators are subject to authorization requirements, which include financial, fit and proper, and organizational requirements. The CNMV has developed robust arrangements for market surveillance. The CNMV has also developed both formal and informal arrangements to oversee BME and Mercado de Futuros del Aceite de Oliva (MFAO). MEFF and MFAO monitor clearing members' exposures on a daily basis and each has powers to request members to post additional margin. Default procedures are transparent. There are reporting obligations in connection with short selling, as well as in connection with failed settlements.

Table 7. Spain: Summary Implementation of the IOSCO Principles

Principle	Findings
Principle 1. The responsibilities of the Regulator should be clear and objectively stated.	The CNMV has a clear mandate stemming from the LMV. The CNMV has established formal and informal cooperation arrangements with the BdE and the DGSP. There appear to be material differences in the regulation of like products, in particular unit-linked insurance

	products vis-à-vis securities products; and additional cooperation in this area appears to also be needed.
Principle 2. The Regulator should be operationally independent and accountable in the exercise of its functions and powers.	The legal framework does not provide the CNMV with full independence. In particular, the Ministry of Essential Criteria (EC) is part of CNMV's board, certain key decisions are still a responsibility of the MEC and the CNMV requires governmental approval to hire additional resources. In the current environment, where a freeze of resources has been decreed for the whole public sector, this is a source of concern. There are clear mechanisms of accountability of the CNMV to the government and the public, including an annual report and the review of its accounts.
Principle 3. The Regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.	The CNMV has adequate powers; however authorization of ISPs and RMs is still a responsibility of the MEC. While not yet at optimal level, the level of resources of the CNMV has increased in recent years. Governance arrangements to ensure that the CNMV carries its functions effectively are robust.
Principle 4. The Regulator should adopt clear and consistent regulatory processes.	The CNMV has adopted a public consultation process for the development of <i>circulares</i> . Requirements for authorization of regulated entities and public offerings are clear and can be accessed through CNMV's website. The CNMV has developed manuals that seek to ensure consistency in its decisions. Enforcement sanctions are disclosed once they are final—except for minor infractions. Due process obligations exist in connection with acts that affect third parties. Individuals can seek redress in the judicial courts against acts of the CNMV, and the MEC (in connection with authorization and sanctioning procedures).
Principle 5. The staff of the Regulator should observe the highest professional standards, including appropriate standards of confidentiality.	The CNMV staff is subject to the duties of loyalty, fairness and confidentiality. The CNMV has issued detailed guidance in connection with personal securities transactions. The Internal Control Department is in charge of monitoring compliance. Cooling off periods exist.

<p>Principle 6. The Regulator should have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate.</p>	<p>Through the <i>Grupo Interno de Estabilidad Financiera</i>, the CNMV is able to identify and monitor potential sources of systemic risk consistent with the scope of its mandate , and to contribute to Committee for Financial Stability (CESFI)'s discussions on financial stability.</p>
<p>Principle 7. The Regulator should have or contribute to a process to review the perimeter of regulation regularly.</p>	<p>Front-line supervisors have a responsibility to identify potential gaps in the perimeter of regulation within the areas of their responsibilities. Such bottom—up approach is supported by biweekly meetings at the management committee, which allows for an interdepartmental analysis. Findings are reasonably linked to a top down exercise of definition of priorities that the CNMV conducts on an annual basis.</p>
<p>Principle 8. The Regulator should seek to ensure that conflicts of interest and misalignment of incentives are avoided, eliminated, disclosed or otherwise managed.</p>	<p>Regulated entities are required to have in place internal controls and risk management procedures to identify, monitor and address conflicts of interest. Misalignment of incentives affecting issuers are tackled through disclosure obligations. In the area of securitization, retention requirements have also been imposed. All such obligations are monitored via the supervisory programs established by the CNMV for each category of regulated entity.</p>
<p>Principle 9. Where the regulatory system makes use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, such SROs should be subject to the oversight of the Regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.</p>	<p>There are no SROs in Spain.</p>
<p>Principle 10. The Regulator should have comprehensive inspection, investigation and surveillance powers.</p>	<p>The CNMV has comprehensive powers to request information and conduct inspections on regulated entities.</p>
<p>Principle 11. The Regulator should have comprehensive enforcement powers.</p>	<p>The CNMV has broad powers to request information and testimony from third parties, including bank, records. The CNMV can use a wide set of enforcement tools, including the imposition of money penalties for breaches on the LMV and secondary legislation.</p>

<p>Principle 12. The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.</p>	<p>The CNMV makes limited use of on-site inspections. The CNMV should intensify the use of on-site inspections, in particular in connection with banks due to their dominant role in the Spanish securities market. The CNMV has been active in investigating market abuse and some sanctions have been imposed mainly in connection with insider trading, but cases on market abuse are also in the pipeline. In recent years the CNMV has also become more active in referring market abuse cases to the criminal prosecutors, but only one conviction has been secured. The CNMV has also more actively opened sanctioning procedures against regulated entities, however cases are still in the pipeline.</p>
<p>Principle 13. The Regulator should have authority to share both public and non-public information with domestic and foreign counterparts.</p>	<p>The CNMV is empowered by the LMV to share information with domestic and foreign regulators.</p>
<p>Principle 14. Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.</p>	<p>The CNMV has developed formal and informal cooperation arrangements with the BdE and the DGSP. The CNMV is signatory of the IOSCO MMoU.</p>
<p>Principle 15. The regulatory system should allow for assistance to be provided to foreign Regulators who need to make inquiries in the discharge of their functions and exercise of their powers.</p>	<p>The CNMV regularly collects information on behalf of foreign regulators. Under the IOSCO MMoU no request for assistance has been refused.</p>
<p>Principle 16. There should be full, accurate and timely disclosure of financial results, risk and other information that is material to investors' decisions.</p>	<p>Issuers of public offerings must submit a prospectus to the CNMV. Robust periodic and ongoing disclosure requirements apply to issuers admitted to trading on a RM. The CNMV has implemented a robust program to monitor compliance by issuers with their reporting obligations. While less stringent than for RMs, disclosure requirements in MAB are broadly in line with the IOSCO Principles. For Latibex, disclosure requirements of the home country apply, but the BME must verify whether they provide equivalent protection. In any case the size of these venues is not material.</p>

<p>Principle 17. Holders of securities in a company should be treated in a fair and equitable manner.</p>	<p>The Company Act provides a general framework for shareholders' rights. Additional protections exist in connection with issuers admitted to trading in a RM, including the obligation to launch a mandatory tender offer under certain conditions. Substantial and insider holdings must be disclosed. Notification of substantial and insider holdings apply also to issuers admitted to trading in MAB, although the thresholds are different; but tender offer obligations do not apply to MAB. For Latibex, the protections of the home country apply.</p>
<p>Principle 18. Accounting standards used by issuers to prepare financial statements should be of a high and internationally acceptable quality.</p>	<p>Issuers admitted to trading in an RM must submit their consolidated statements according to IFRS. Other issuers can use Spanish GAAP (or national accounting standards of an EEA or U.S. GAAP). Spanish GAAP are largely in line with IFRS. The CNMV monitors compliance with accounting standards through its program of review of issuers' periodic information.</p>
<p>Principle 19. Auditors should be subject to adequate levels of oversight.</p>	<p>ICAC is in the process of implementing a system for auditors' oversight of PIE firms, whereby such firms will be subject to direct inspections by ICAC on a three year cycle. Additional resources will be key to achieving such objective.</p>
<p>Principle 20. Auditors should be independent of the issuing entity that they audit.</p>	<p>Auditors are subject to strong independence provisions. They must provide an annual report, which among other things provide information on the fees receive for different services. The audit committees of issuers listed in a RM must in turn provide an opinion on such report.</p>
<p>Principle 21. Audit standards should be of a high and internationally acceptable quality.</p>	<p>Audits must be conducted based on local auditing standards. These standards are developed by the professional bodies and must be approved ("homologated") by the ICAC. There are no material differences between local standards and IAS.</p>
<p>Principle 22. Credit rating agencies should be subject to adequate levels of oversight. The regulatory system should ensure that credit rating agencies whose ratings are used for regulatory purposes are subject to registration and ongoing supervision.</p>	<p>All CRAs that provide services in Spain were subject to a thorough registration process, through colleges of European regulators, including the CNMV. ESMA has already conducted on-site inspections on CRAs and has recently released to the public a report with general findings. Adding the staff already approved will be key to the effectiveness of the supervisory program.</p>

<p>Principle 23. Other entities that offer investors analytical or evaluative services should be subject to oversight and regulation appropriate to the impact their activities have on the market or the degree to which the regulatory system relies on them.</p>	<p>The LMV and secondary legislation contain a specific framework in connection with sell side analysts, which is based on disclosure in the corresponding research of potential conflict of interests. Additional disclosure obligations are in place for other evaluative services, including entities that provide valuation services of real estate (<i>sociedades tasadoras</i>).</p>
<p>Principle 24. The regulatory system should set standards for the eligibility, governance, organization and operational conduct of those who wish to market or operate a collective investment scheme.</p>	<p>CIS operators are subject to authorization requirements which include financial resources, fit and proper and organizational requirements. The authorization process is thorough. There is active use of thematic reviews, although only limited use of on-site inspections is made.</p>
<p>Principle 25. The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.</p>	<p>CIS prospectuses contain detailed information on the legal form adopted by the CIS and the rights of investors. The LMV requires that CIS assets be entrusted to a depository. There is no requirement that the depository be of a different group, however information barriers must be developed and specific reports on the robustness of segregation arrangements are required from the compliance unit of the CIS operator and the external auditors.</p>
<p>Principle 26. Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.</p>	<p>CIS that are publicly offered must submit a prospectus for the approval of the CNMV. Secondary legislation contains detailed rules concerning the content of the prospectus which are aimed to ensure the comparability of information available to investors. Periodic disclosure obligations also apply. Material changes must be approved by the CNMV and informed to investors</p>
<p>Principle 27. Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.</p>	<p>CIS must be valued at fair value. There is guidance in connection with valuation of illiquid assets. Suspensions of redemptions must be notified to the CNMV.</p>
<p>Principle 28. Regulation should ensure that hedge funds and/or hedge funds managers/advisers are subject to appropriate oversight.</p>	<p>Hedge Funds (HF) operators are subject to the same authorization requirements as any other CIS operator. HFs themselves are subject to a process of authorization. HF operators must submit to the CNMV a confidential report on the HFs they operate on a monthly basis. Vis-a-vis investors, HFs are subject to the obligation to prepare a prospectus, and periodic information.</p>

<p>Principle 29. Regulation should provide for minimum entry standards for market intermediaries.</p>	<p>ISPs are subject to authorization requirements that include financial resources, fit and proper and organizational requirements. The authorization process is thorough.</p>
<p>Principle 30. There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.</p>	<p>ISPs are subject to minimum and ongoing capital requirements that are adjusted by risk. They have to submit monthly and quarterly reports of their capital adequacy, as well as annual audited financial statements.</p>
<p>Principle 31. Market intermediaries should be required to establish an internal function that delivers compliance with standards for internal organization and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk, through which management of the intermediary accepts primary responsibility for these matters.</p>	<p>ISPs are required to put in place robust internal controls and risk management mechanisms and an annual report must be prepared and submitted to the CNMV. They are also subject to robust information disclosure obligations vis-à-vis clients, as well as to suitability obligations in connection with investment advice. The CNMV makes limited use of on-site inspections. Thematic reviews take place but only in a limited number of topics.</p>
<p>Principle 32. There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.</p>	<p>The CNMV uses a calculation of estimated losses over a period of five months as an early warning mechanism. An investor compensation scheme is in place. Resolution of ISPs is governed by the general regime for corporations. The CNMV has developed guidance (a manual) to facilitate dealing with the failure of an ISP. In any case, the business model of investment firms is simple, and in practice banks dominate the market.</p>
<p>Principle 33. The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.</p>	<p>RMs and MTFs are subject to authorization requirements, which include financial resources, fit and proper and organizational requirements. IT incidents must be reported immediately. Their regulations are subject to approval by the CNMV.</p>
<p>Principle 34. There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.</p>	<p>The CNMV is the front line supervisor for purposes of detecting market abuse. To this end it has developed an automated system of alerts. The CNMV has developed a set of arrangements to oversee the BME and MFAO.</p>
<p>Principle 35. Regulation should promote transparency of trading.</p>	<p>Pre and post trade transparency requirements apply to all markets, equity, debt and derivatives markets managed by the BME and MFAO. In comparison to other European markets, the Spanish market has not faced challenges related to market fragmentation.</p>

<p>Principle 36. Regulation should be designed to detect and deter manipulation and other unfair trading practices.</p>	<p>Insider trading (including front -running) and market manipulation constitute both an administrative infraction and a criminal offense. The CNMV is active in investigating these practices, and sanctions have been imposed mainly in connection with insider trading, and cases on market manipulation are in the pipeline. Recently the CNMV has become active in referring cases to the criminal authorities, but there has only been one conviction.</p>
<p>Principle 37. Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.</p>	<p>MEFF monitors clearing members' positions in the derivatives markets on a daily basis. MEFF has also set up position limits for members' clients. Members are required to notify any breach to such limits by their clients. If a clearing members' exposure becomes a concern, MEFF and MFAO have the power to request additional collateral. There are clear procedures in the event of default which are available to members. Naked short selling is prohibited. Notification of failed settlements to the CNMV is required. Iberclear is empowered to order replacement purchases in the market at the expense of the seller.</p>
<p>Principle 38. Securities settlement systems and central counterparties should be subject to regulatory and supervisory requirements that are designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.</p>	<p>Not assessed</p>

Table 8. Recommended Action Plan to Improve Implementation of the IOSCO Principles

Principle	Recommended Action
Principle 1	A legal reform should be sought to ensure consistent regulation between unit-linked insurance products and securities. In the short term, the CNMV should consider forming a working group with the DGSFP to coordinate approaches to the regulation and supervision of lookalike products.

Principle	Recommended Action
Principle 2	Strengthen the independence of the CNMV by: (i) providing it with the authority to grant and revoke authorizations and to impose sanctions for the most serious violations; (ii) providing it with stronger financial autonomy given its self funded status, and (iii) considering removal of MEC representation on its board.
Principle 3	A legal reform should be pursued to provide the CNMV with broader rulemaking powers. The authorities should explore mechanisms to ensure that CNMV can acquire and retain needed expertise, including salaries that are comparable with financial sector.
Principle 4	The CNMV should consider making public the comments received during the consultation process for circulars.
Principle 6	Broader integration of the top down analysis with findings from the bottom up analysis is encouraged.
Principles 7	The CNMV should consider more systematic review of the perimeter of regulation.
Principle 8	The CNMV should continue to monitor actively conflicts of interest that arise from dominance of banks in securities markets.
Principle 11	A legal reform could be pursued to provide the CNMV with the power to access telephone and internet service providers data.
Principle 12	The CNMV should review and expand the coverage of the inspection program. A legal reform should be sought to introduce a more streamlined procedure for “objective” breaches of the law, such as late filing.
Principle 16	The CNMV should continue to actively monitor disclosure by banks in the issuance of financial products in particular when placed to retail investors.
Principle 17	The CNMV should continue to monitor the growth of MAB to determine whether further enhancement to investors’ rights is required.
Principle 19	The ICAC should continue implementation of the new approach to PIEs oversight, including by hiring additional expert staff as envisioned.
Principle 24	The CNMV should keep under review the balance between off-site, thematic and on-site inspections to ensure sufficient presence in the market place. The CNMV should consider enhancing the authorization process by conducting on-site inspections of newly authorized firms.
Principle 29	The authorities should consider extending competence requirements to all directors, as is the case of integrity requirements.

Principle	Recommended Action
Principle 31	The CNMV should review the coverage of the inspection program for credit institutions and investment firms. The CNMV should also consider incorporating more systematically investment advisors into its on-site inspection program.
Principle 32	The CNMV should consider implementing an early warning system more directly connected to the solvency requirement.
Principle 36	The CNMV should complete as planned the implementation of its cross market surveillance system.

H. Authorities' Response

100. The Spanish Authorities broadly agree with the IOSCO Principles assessment and would like to praise the IMF FSAP team for the excellent work done. The authorities believe the FSAP is an extremely useful instrument for markets and regulators since it provides a transparent picture of how the financial sector does work while at the same time, encourages ways to ameliorate its functioning.

101. Nevertheless the Spanish Authorities do not fully share the IMF's views on the presence of the Ministry in the Board of the CNMV (Principle 2. The Regulator should be operationally independent and accountable in the exercise of its functions and powers). The distribution of regulatory competences between the Ministry and the CNMV cannot be interpreted as breaches against the independence principle. Besides, the presence in the Board is of just one vote, provides the best possible channel of communication between the CNMV and the Ministry and enriches the Board's debates bringing points of view of all regulatory bodies just as the Bank of Spain is also member of the CNMV Board. Finally and crucially, day-to-day technical matters are not referred to the Board and therefore the Ministry, as a member of the Board, cannot cast a vote, and legislation is clear about the scope of regulatory measures that the CNMV and the Ministry have to take.

102. Regarding principle 3, it is worth noting that the IMF considers the current framework –whereby the CNMV only has rulemaking powers in the cases that the law expressly authorize it- may constrain its ability to respond quickly. The Spanish authorities believe this is a natural consequence of our distribution of power and the checks and balances system that is applied in Spain. In addition to this, there are mechanisms that allow for swift reactions to any emerging problem in the market. Besides, the fact that authorisation of financial entities and the imposition of sanctions is responsibility of the MEC, having taken into account the compulsory report of the CNMV is also a consequence of the Spanish administrative system, which is based on these checks and balances. The implication of two different authorities aims at preventing any kind of discretionary decision against the interest of the entity and at promoting financial stability.

103. With regard to Principle 1, the authorities agree about the need to avoid regulatory gaps between products with potential substitutability properties and commit themselves to make all the necessary efforts to improve the cooperation between the competent domestic supervisory authorities in this area. The authorities would like to stress that they support the current European Commission's Packaged Retail Investment Products (PRIP) initiative, which is expected to produce harmonized legislation at European level on investment-like products sold to retail investors in the near future. Also, it is worth noting that the material relevance of the particular issue raised by the assessors is limited in practice, given the small size of the market for the relevant unit-linked insurance products in comparison with the segment of the securities markets that would be a close substitute for them (insurance technical reserves associated to unit-linked products and invested in CIS roughly amount to 3 percent of total CIS assets).

104. With regard to principles 12, 24, and 31, the authorities observe that these principles have been assigned a lower grade in comparison with the equivalent principles in the 2006 FSAP. The authorities would like to clarify that the current assessment is based on a change of the required standards. It should therefore not be interpreted as an indication that the supervisory framework exhibits a lower level of observance compared to the 2006 FSAP. On the contrary, supervision has been strengthened over the last years. In particular, in the area of supervision of entities, the CNMV has carried out new relevant supervisory tasks from 2006 on, mainly in connection with the activities performed by credit institutions.

105. Regarding the supervision of investment services providers and concerning the conduct of business rules applied by the credit institutions, the IMF recommends the use of more on-site inspections. Nevertheless, the authorities want to emphasize, firstly, that the approach for the supervision of the business rules requires a different balance between on-site inspections and off-site reviews than prudential supervision. Moreover, it is important to stress that on-site inspections carried out by the CNMV have reached 75 percent of the total number of clients in the last three years (considering as inspected, in equivalent terms, one big credit institution which has been subject to three thorough and specific off-site reviews).