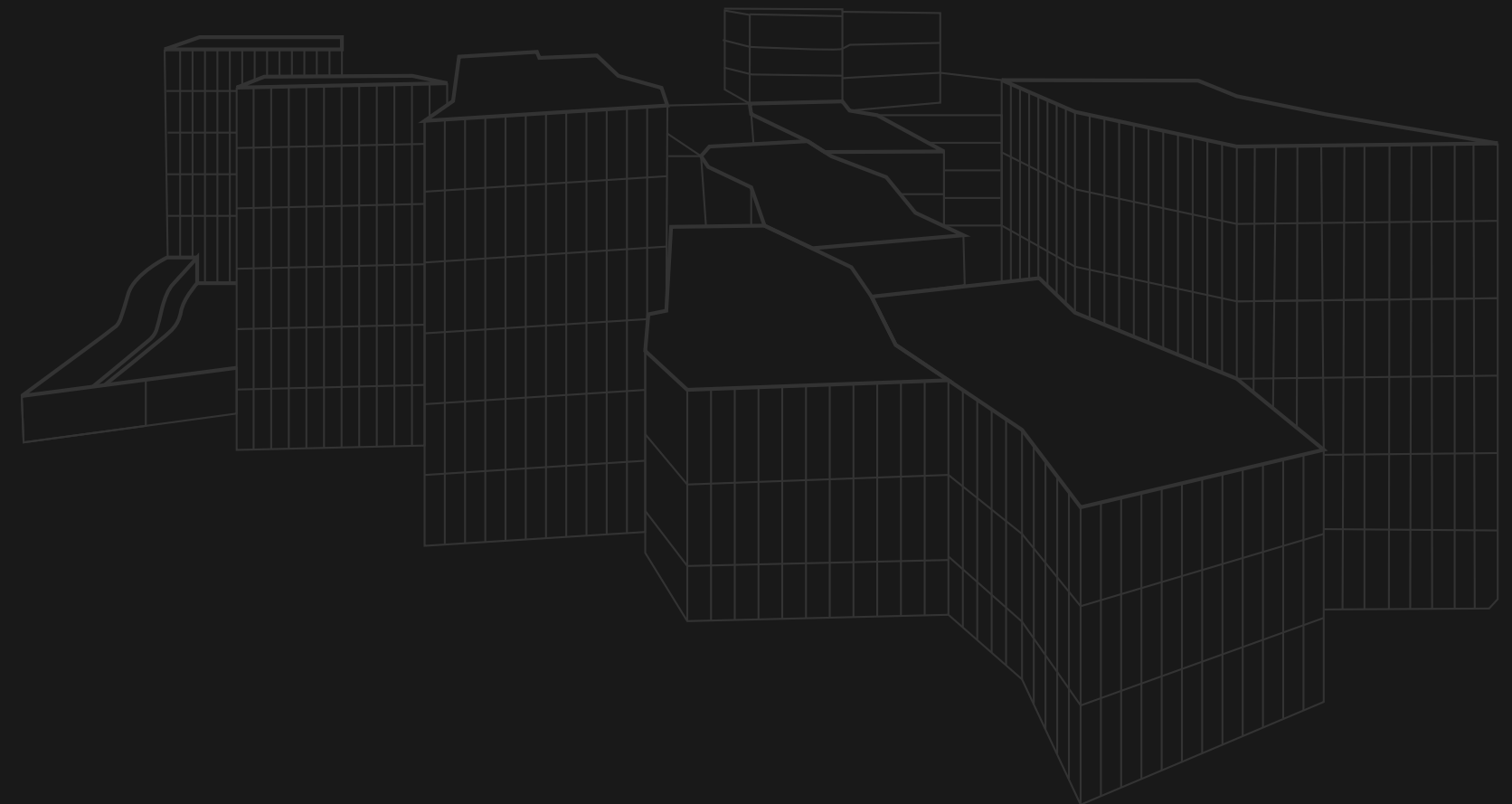


ANNUAL REPORT
2006
FINANCIAL MARKETS
AND PUBLIC DEBT

[Contemporary Art Museum of Castilla y León
(MUSAC). León]

FOREWORD





For Spain, 2006 was a very successful economic year. Our country's output expanded 3.9% within the gently accelerating curve that has characterised the past four years. This gathering momentum was also apparent over the four quarters of 2006. Intense economic growth has been accompanied, moreover, by a progressive correction of the country's macroeconomic imbalances, as evidenced by the year's lower inflation and more closely contained external deficit.

At the same time, investment continued to surge forward at rates of 6%, rising to 10% in the case of the equipment component. This points to an upswing in productivity going forward that will add further solidity to Spain's economic growth. The labour market has also picked up on the healthy state of the economy, with employment registering sustained growth upwards of 3% and the unemployment rate trending steadily downwards to the region of 8%.

As in previous years, the country's good economic performance has been both a cause and a consequence of fiscal restraint. A restraint manifest in the prudence and discipline exercised throughout the budgetary process and, ultimately, in the budget outcome, which in 2006 was again highly satisfactory. Central government closed the year with a surplus amounting to 0.8% of GDP, while the general government account recorded a positive balance of 1.8%. Both these results improve significantly on the surpluses of 2005 (0.4% and 1.1% respectively). A similar picture emerges with Spain's Public Debt, which has dropped below 40% of GDP for the first time in twenty years.

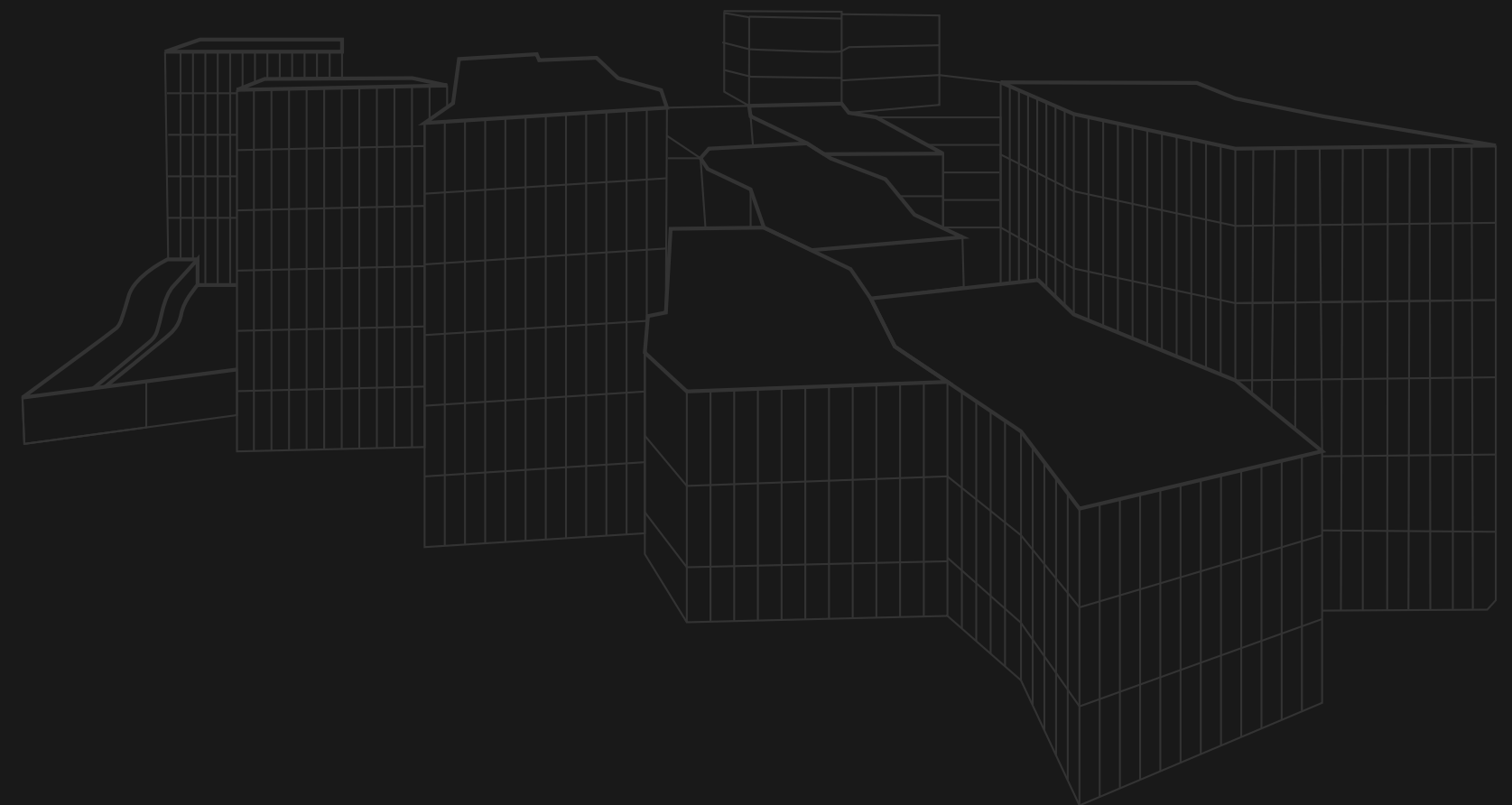
Budgetary policy is thus not only fulfilling the counter-cyclical role counselled by Spain's economic expansion, it is also strengthening our ability to cope in future with the budgetary implications of population ageing. This is a welcome development, which must be pursued further in the coming years to stop demographic change from harming the economy.

The Spanish Treasury's credit rating continues to reflect the strong performance and outlook of the national economy and the credibility of budgetary policy. Spain has conserved its top rating from all the leading international agencies and the Treasury's good standing was reflected once more in the next to negligible spreads of Spanish Debt against that of main European sovereign borrowers.

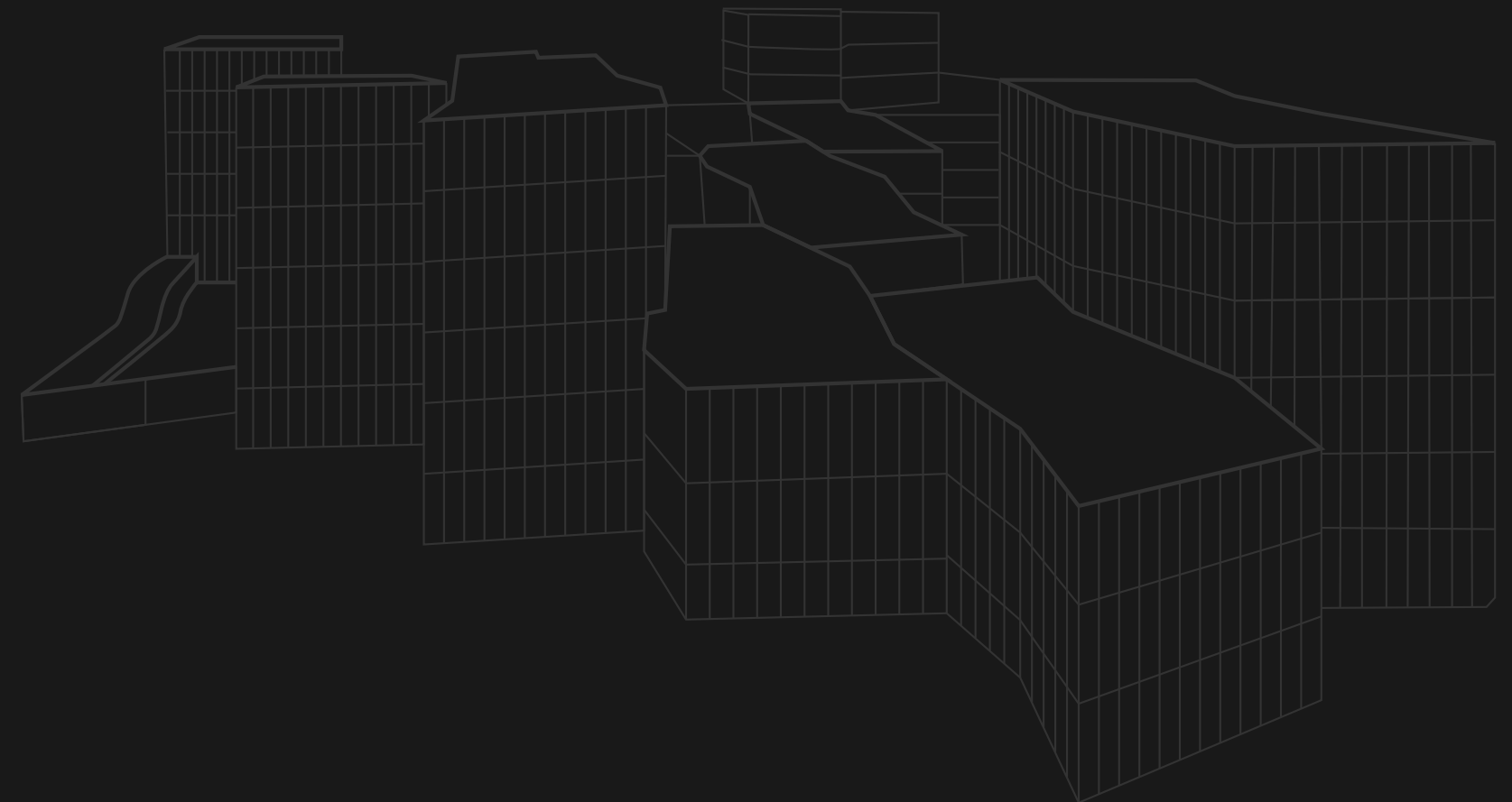
This economic and budgetary success has facilitated coverage of the country's increasingly subdued financial needs. But it also poses new and exacting challenges for Central Government Debt policy, which must work to fulfil its liquidity commitments in a context of lower net issuance.

These challenges will undoubtedly loom larger in future given the favourable mid-term outlook for the Spanish economy and the need to further reduce the Debt/GDP ratio to meet the budgetary pressures resulting from population ageing. The years ahead, then, will be an interesting time for Spanish Debt, as it explores the road taken by other countries with a sustained public accounts surplus.

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INTRODUCTION





The General Directorate of the Treasury and Financial Policy is pleased to again offer its Annual Report on Financial Markets and Public Debt, setting out the trends and characteristics defining Central Government Debt management in the past year along with the main developments in financial sector legislation.

The macroeconomic setting remained firmly supportive in 2006, with the world economy expanding slightly ahead of 5% despite the oil price highs of late summer and the persistence of inflationary pressures in the United States. In this context, the monetary policy of main economic areas turned simultaneously more restrictive, though the Federal Reserve opted to pause its tightening campaign around mid-year. The subsequent narrowing of the interest rate gap between the Fed and the ECB was one of the main forces driving the euro's appreciation against the dollar, by over 11%, and the yen, which sank to historic lows.

Equity markets registered widespread gains on the strength of this positive macro scenario and the excellent progress of corporate earnings, in a context marked by low volatility and moderate P/E ratios. Spain's Ibex-35 index, in particular, powered 35% higher to close the year at record highs. Meantime, bond markets stood out once more for the strong performance of emerging and corporate debt, which kept up historically narrow spreads versus public debt. The slope of the government yield curve continued flattening in Europe over 2006, while the US curve remained inverted. The good showing of Spanish Debt, anchored on the strength of our economy and an efficiently performing market, allowed it to conserve its maximum credit ratings and minimum yield spread versus Germany.

In Public Debt management, the 2006 highlight was the reduction in gross issuance facilitated by the positive evolution of public accounts. This reduction extended to both Letras del Tesoro and Bonos and Obligaciones del Estado and brought down the outstanding stock by almost 7 billion. Special mention should also go to the syndicated placement of the new 10-year benchmark which amply achieved the objectives set, including the enlargement of our investor base and a highly advantageous financing cost. The year brought two novelties in financial management. On the one hand, the Treasury bought back and redeemed a number of its bonds, the goal being to smooth out the Public Debt redemptions profile and facilitate cash management by reducing the volatility of its current account at Banco de España. On the other, changes were made in the cash management system so as to optimise Central Government returns on liquidity transfers while minimising possible distortions in the secondary market. Another welcome development was the reduction in the Central Government Debt/GDP ratio, accompanied by a declining weight of debt servicing charges. Finally, refinancing risk held to the downtrend of previous years while exchange-rate risk was almost completely eliminated.

Total turnover in Spanish Debt moved sharply higher in 2006, with keen trading in Bonos and Obligaciones offsetting the lower-key performance of the Letras market. The year's dominant trend, carried forward from previous years, was the strong advance in account holders' activity with their clients, leading to a steady rise in the relative weight of third-party trades.

Regarding the distribution of held-to-maturity portfolios, the salient trend was the declining share of credit institutions in contrast primarily to non resident investors. This was true of both non stripped Debt and stripped Debt and Letras del Tesoro. By country, 79% of non resident investment had its provenance in the European Union, with France, Japan and Germany accounting for the majority of non resident holders. By investor group, over 50% of non resident ownership corresponds to mutual and pension funds and financial entities.

In the financial policy sphere, the Report describes the year's legislative output and the main projects in the pipeline for 2007. Again, the measures adopted sought to strike a balance between the competitive demands of today's international markets and the upkeep of financial stability and the protection of investor interests. It is here that the European Union has come into its own as a source of legislative novelties which, combined with national laws, respond ably to the new challenges of the international economy and the financial system in particular.

The year brought fresh strides towards completion of a European financial services market along the lines mapped out by the European Commission's White Paper on Financial Services Policy. To this same end, the work of the General Directorate of the Treasury and Financial Policy followed a dual focus, combining the preparation of national legislation to implement Community directives with the negotiation of new Pan-European instruments to more closely harmonise the legislations of the 27 Member States. Transposing provisions touched on such varied subject matter as the distance marketing of financial services, capital adequacy, takeover bids, transparency or markets in financial instruments, and will continue their progress through the legislative pipeline. In parallel, negotiations on new directives concerning payment services and shareholders' rights are already well advanced and the final texts will foreseeably see the light some time in 2007.

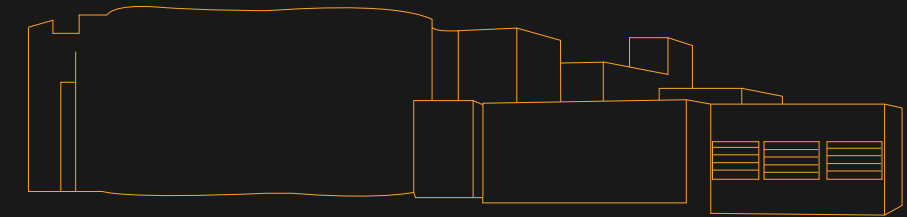
The Directorate also kept up work on draft provisions to perfect the Spanish financial system, including the finishing touches to the new regime of Bolsas y Mercados Españoles, the development of framework regulations for official secondary markets in energy futures and options, and the filling-out of the legal regime to govern hedge funds and funds of hedge funds. This activity will continue through 2007, addressing needed reforms in areas like the mortgage market.

In short, financial policy measures have continued to prove their worth as agile instruments for responding at national and, especially, European level to the challenges of an interlocking international financial system, in which the importance and prospects of the different actors hinge on their ability to embrace change.

Finally, we cannot neglect to mention the advances in the fight against the menace that is money laundering; another prize objective of this General Directorate of the Treasury and Financial Policy. In accordance with the Regulations to Law 19/1993 on the prevention of money laundering, new provisions were issued concerning the prior declaration of cash movements and the preventive obligations of establishments engaging in the management of money transfers and foreign currency exchange. A further two Orders now nearing approval regulate the mandatory external expert's report described in article 11.7 of the Regulations and the specific anti-money laundering duties of notaries public. Internationally, mention must go to the favourable conclusions of the Financial Action Task Force report on the Spanish laundering prevention system, as approved in June 2006. And, more recently, the award to Spain of a twinning project with Morocco, to be headed by the General Directorate of the Treasury and Financial Policy, whose aim is to help with the construction of the institutions and standards needed to combat money laundering and terrorist financing.

FINANCIAL MARKETS AND PUBLIC DEBT

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MACROECONOMIC DEVELOPMENTS AND FINANCIAL MARKETS

[Beulas Foundation Art and Nature Centre. Huesca]



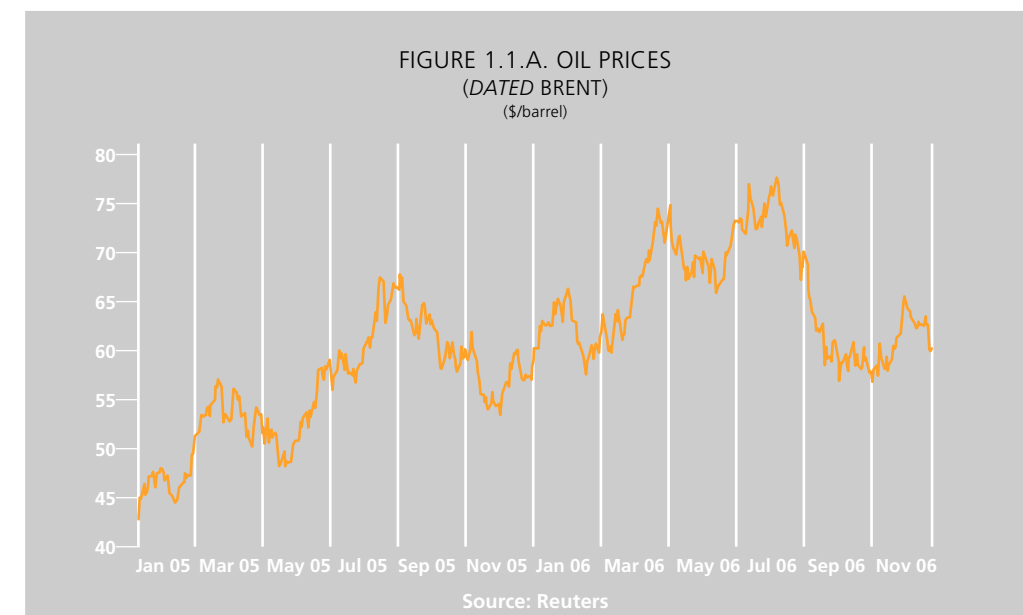
1.1. MACROECONOMIC DEVELOPMENTS

The world economy kept up its solid expansion for a fourth year running, with forecasts pointing to a final growth rate of 5.1%. The landscape, however, was not without its shadows, including a certain intensification of inflationary pressures, the more restrictive conditions prevailing in financial markets and the oil price highs of the year's middle months. An additional risk is that the stall in US housing demand during the year's second half could exert a drag effect on the rest of the economy.

In 2006, the world economy lived through its fourth year of expansion, though with certain risks

The continuing problems of producer countries and geopolitical tensions conspired to keep oil prices running at highs, with the peak reached in late August at over \$78 per barrel of Brent. Prices subsequently settled in the \$55-\$60 range for an annual average of \$65.22/barrel compared to the \$54.31/barrel of the previous year.

Oil prices touched new highs before settling back to more reasonable levels

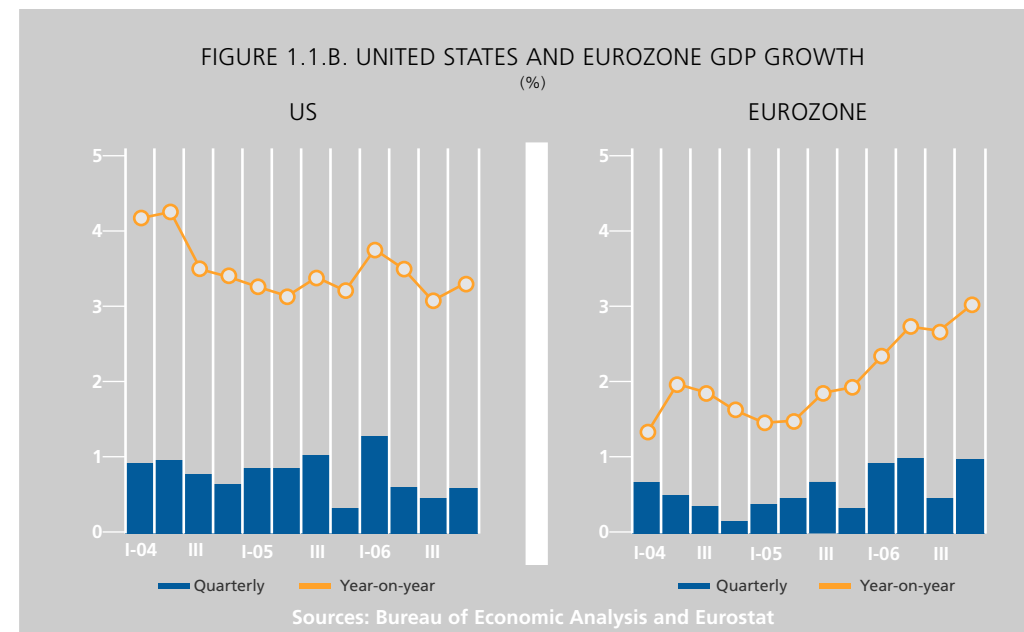


Economic expansion becomes broader based

Although the United States economy remained the main motor of worldwide growth, China and India, along with other major developing economies, continued to come through strongly. Expansion also gathered pace in the Eurozone, where the forecasts augur full-year growth rate slightly above the potential rate, though with the output gap still negative.

The United States closes the year with growth of 3.3%, against the 2.7% of the Eurozone and the 2.2% of Japan

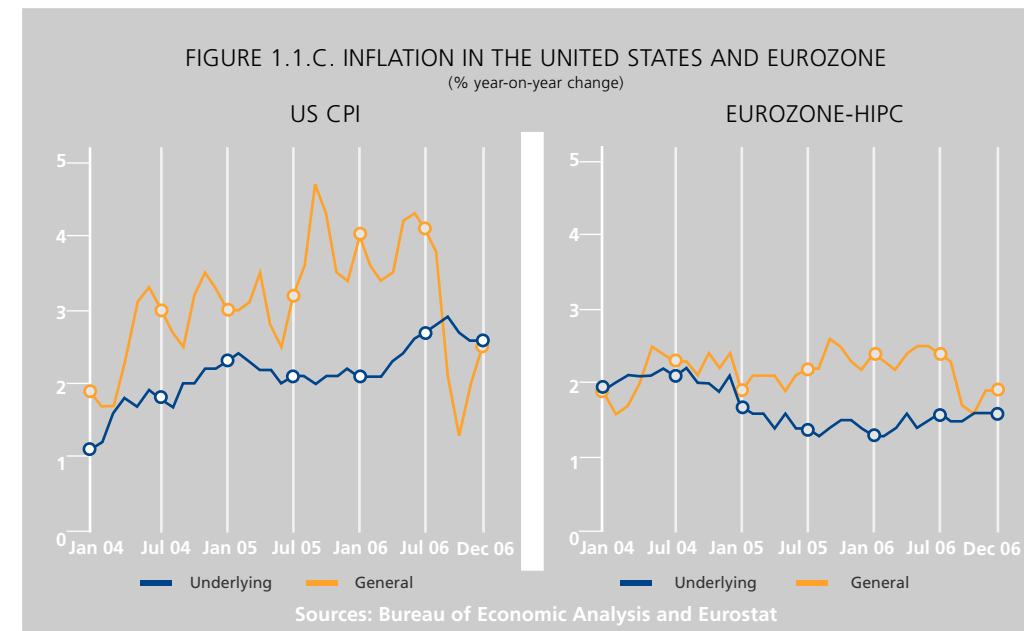
Growth rates generally held up strongly. In the United States, despite a progressive levelling-off due to the slowdown of the real estate market, average growth quickened to 3.3% from the 3.2% of 2005. Consumer spending was again the main motor force, contrasting with the negative pull of real estate investment. In the Eurozone, the year's growth spurt to 2.7% was mainly driven by domestic demand, with investment especially buoyant. In Japan, economic recovery continued to firm throughout 2006, which ended with growth of 2.2% and domestic demand increasingly to the fore.



Headline inflation moves to the tune of energy prices;...

Inflation in the year mirrored the progress of energy prices. In the United States, the pattern was one of sharp monthly fluctuations giving way to a marked downward movement in the closing months, while Eurozone inflation held to a more even course. However, underlying inflation in the United States crept inexorably higher to a closing rate of 2.6%, in contrast to Eurozone rates settling below 2%. The Japanese economy, meantime, pulled out of its deflationary phase in 2006, though inflation rates remain subdued.

... underlying rates strain higher in the US and stabilise in the Eurozone



The labour market continued its recovery in 2006 in keeping with the year's robust economic growth. In the Eurozone, quickening activity and the effects of past labour-market reforms made further inroads into unemployment, as far as a closing rate of 7.6%. The United States unemployment rate also moved down gradually to 4.5%, while the Japanese rate continued its retreat from highs to close the year at 4.2%.

Unemployment rates come down

For the emerging economies, 2006 was another year of strong economic expansion that kept growth running upwards of 7%, on a par with the previous year. This growth was not only broad-based geographically, but also conformed to the pattern of recent years, i.e., drawing both on external demand, the original driver of the current cycle, and an increasing contribution from the domestic demand side. The mild slowdown of the Chinese economy did not detract from its growing influence in the global economy, above all in the Asian continent.

The emerging economies flex their growth muscles

1.2. FINANCIAL MARKETS

Restrictive monetary policies all round

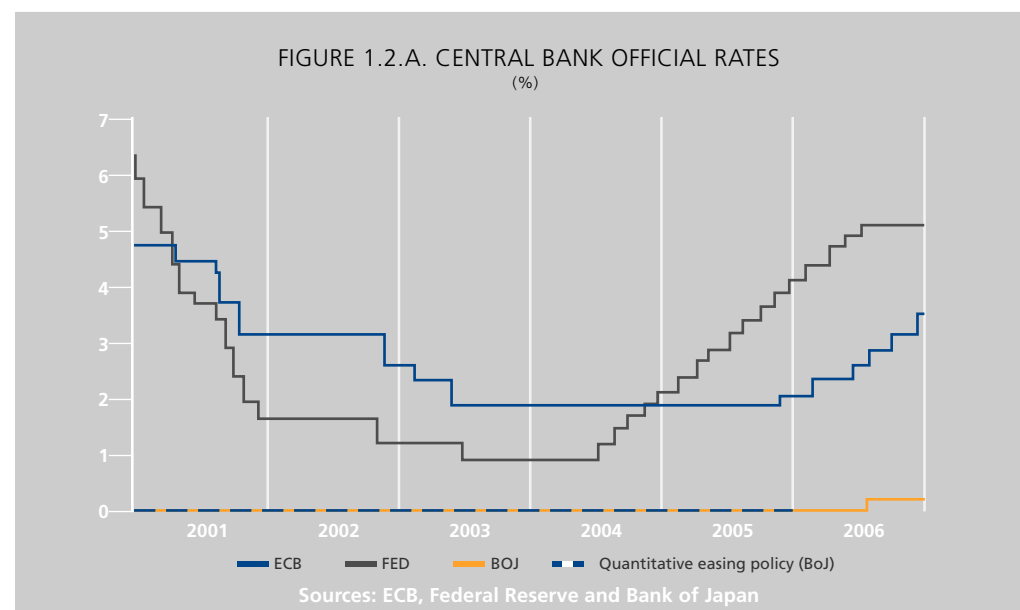
All three of the world's main economic blocs tightened their monetary policies in 2006, albeit from different points in their respective business cycles.

Ongoing monetary tightening at the ECB and the halt called by the Federal Reserve narrow the gap between their reference rates

The Federal Reserve called a halt to its rate upcycle around mid year, pending better perspective on whether its economy was heading for a soft or a hard landing and confirmation of the persistence of inflationary pressures. The ECB, meantime, progressively tightened its official rate in view of renewed signs of economic recovery. These movements reduced the gap between US and Eurozone interest rates to 175 bp at the end of the year.

Japan finally normalises its monetary policy

Finally, the Bank of Japan consolidated the normalisation process of its monetary policy, after the end of its quantitative easing policy in the early months of 2006 and the country's apparent escape from deflation.

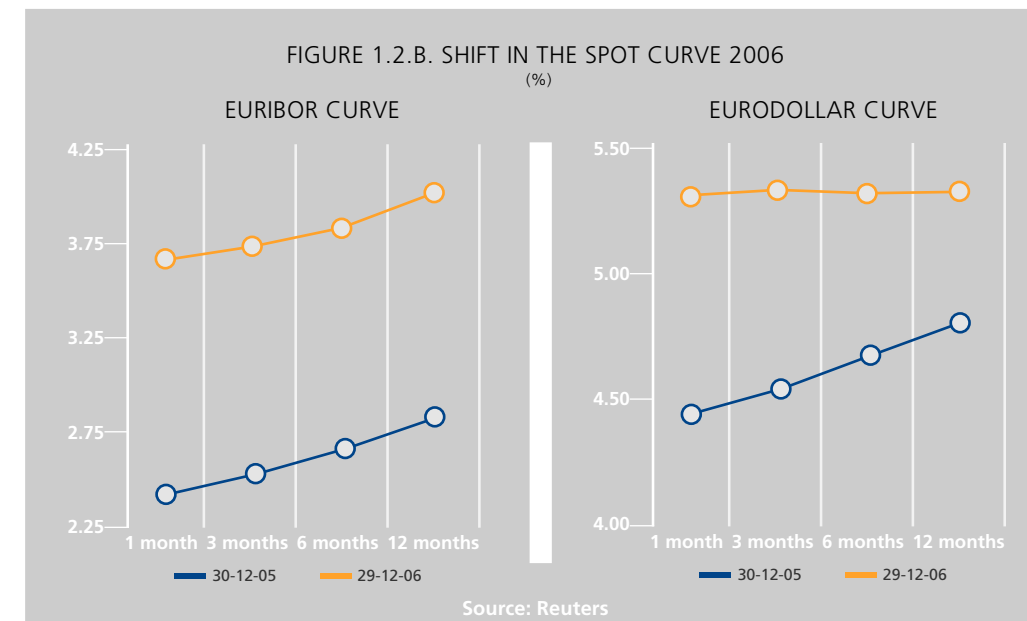


The ECB raised its main refinancing rate on five occasions during 2006, from 2.25% to 3.50%. The monetary authority rested its decisions on the sound Eurozone growth and the persistent inflationary pressures projected in its mid-term forecasts. Hence hikes continued through the closing quarter despite the area's tamer inflation readings, as ECB forecasts placed the 2007 rate above 2%.

The ECB hikes its rate 125 basis points to 3.50% despite the easing of inflation

The ECB's rate hikes and further tightening expectations for 2007 caused an upward shift in the euribor curve, with 1-month and 12-month rates rising in parallel by approximately 120 bp. The result was that the curve slope between 1 and 12 months closed at 40 basis points against the 44 basis points of end 2005, showing that money markets anticipate further tightening in 2007 to the region of 3.75%-4%.

A parallel upward shift in the European spot curve



In the United States, the Federal Reserve, chaired by Ben Bernanke since January 2006, broke off its monetary tightening cycle in the month of June. Accordingly, the federal funds target rate stood at 5.25% in December 2006, one percentage point higher than at the year's outset. Monetary policy statements ceased to talk about economic vigour and began to express fears of resurgent inflation and a future slowdown in US growth in the slipstream of the housing market. The question remains then as to how long the Federal Reserve will keep up its wait-and-see attitude.

Federal Reserve rate hikes pause in June

Since then, it has been wait-and-see

The performance of the US money market reflected both the Federal Reserve's decisions and expectations on interest rates. The result was that the spot curve progressively flattened leaving no slope at all by the end of the year, after one-month rates rose 93 bp and 12-month rates by 50 bp only. Consequently the market is discounting a stable federal funds rate over most of 2007 followed by possible monetary easing in the closing months.

The US interest rate curve flattens in 2006...
...hinting at a possible monetary easing towards the end of 2007

The Bank of Japan dropped qualitative easing in March and switched the focus to an interest rate target

In Japan, 2006 marked the end of an anomalous economic cycle characterised by deflation and a liquidity trap, after the Bank of Japan's abandonment of a no less singular monetary policy. In March, with slightly positive inflation rates, the monetary authority announced a change in its policy framework, switching from a bank-reserves focus to an interest rate target, initially set at 0%. In this new framework, the Bank of Japan also publicly clarified its conception of medium to long-term price stability as a 0%-2% variation in the consumer price index.

In July, the bank raised its main interest rate to 0.25%

Since then, the Bank of Japan has changed its official rate once only, in July, raising it to 0.25%. This mild tightening was a response to the moderate expansion of the Japanese economy and the prospect that inflation would remain above the line. Its insistence on these projections and, possibly, the optimism of economic agents, led the markets to initially discount various hikes in the course of the year. However, the sluggish progress of prices restrained the Bank from any further move and successively cooled agent expectations.

A tentative rise in prices fuels expectations of a gradual rates upcycle

Caution until the deflation threat is over

All this suggests that the Bank of Japan will opt for a gradual and measured tightening, preferring not to rush into a restrictive monetary stance until it is sure that deflation is safely over and that economic growth will be sustained.

The euro gains strength as US growth shows signs of faltering

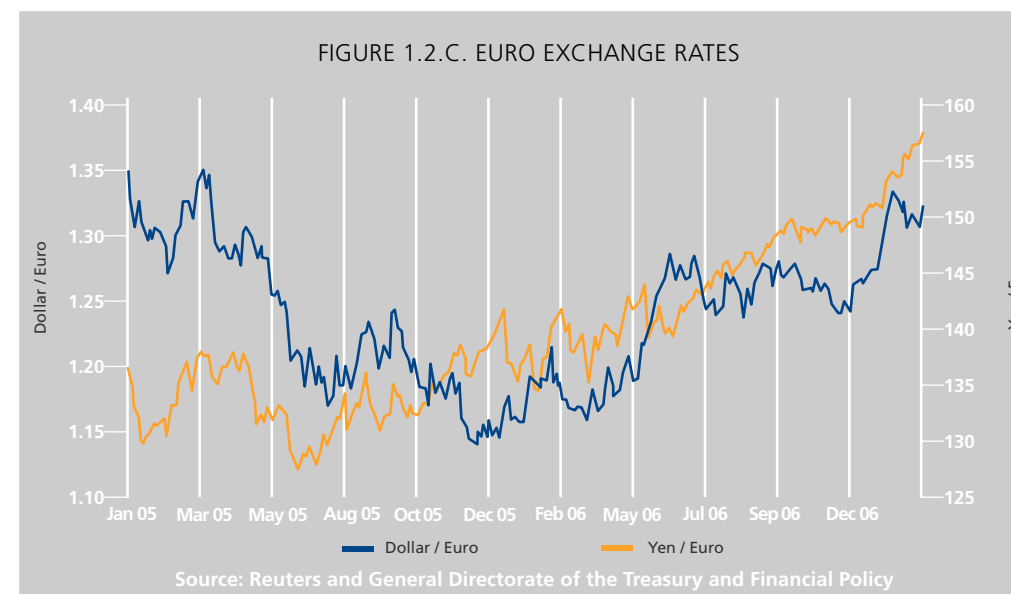
In currency markets, the euro pulled out of its decline against the dollar towards the end of 2005, initiating an appreciation trend to around mid year and, from there, staying more or less flat until practically the 2006 close. In all, the European currency notched up an 11.45% gain driven mainly by expectations of a narrowing spread between ECB and Federal Reserve rates, joined later by symptoms of weakness in the United States economy.

Dollar depreciation owes to the reduction of interest rate spreads and the persistence of fundamental imbalances

Dollar exchange rates were also affected by the US external imbalance. By the 2006 close, its current account deficit was 6.2% of GDP, absorbing 75% of net world savings. We can say, then, that the greenback's performance has depended at times on macro fundamentals (current account deficit, domestic savings, budget deficit) and at others on conjunctural factors like the outlook for interest rates.

The yen sinks to all-time lows against the euro

The yen's 2006 performance was paradoxical, at least against the euro. For just as Japan was confirming its economic recovery and visibly extricating itself from deflation, its currency entered a downward spiral that took it to a 20-year low in real effective exchange rate terms and lost it 12.47% in nominal terms, to its lowest ever level since the creation of the European currency. Elsewhere, the yen was hurt by carry trade activity which tended, conversely, to support the dollar, securing it a year-long gain of 0.89% vs. the Japanese currency.



The debate over the sustainability of external deficits remains very much alive, above all in the case of the United States as a result of Asian economies accumulating foreign reserves in the form of dollar-denominated assets. China stands out in this respect, with known reserves topping one trillion dollars at the 2006 close. In the midst of this debate, several central banks have hinted at a change in their reserve mix, with the dollar still dominant but an increased share falling to euros and yens.

Doubts remain about the sustainability, and financing, of the US external deficit

The IMF has gone more hands-on in its attempts to correct the US external deficit, by pushing for coordinated policies of dollar depreciation against the Asian currencies in general and the yuan in particular. A first move in this soft adjustment was China's decision to revalue the yuan 2.1% vs. the dollar in July 2005, which was read at the time as its first step on the road of currency liberalisation. However, progress has been slight with the yuan's 2006 appreciation against the dollar confined to 3.85%.

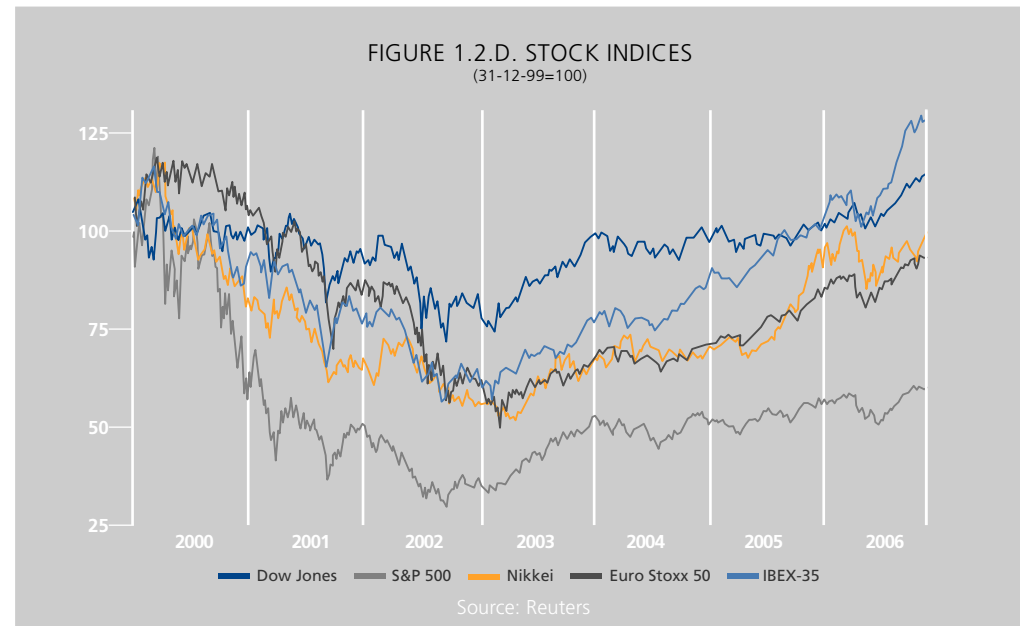
Yuan adjustment is taking its time

For equity markets, 2006 marked the consolidation of the recovery building since the dotcom slump of 2000 to 2002.

A year of rising equity markets

The trend however was not a straight one. The first months were clearly bullish with stocks buoyed up by the strength of company earnings and a wave of corporate transactions, against a backdrop of generally upbeat expectations regarding the United States economy. Gains extended to all world markets despite rising interest rates in both the United States and Europe and the high prices of crude. The month of May, however, brought a sharp correction as fears spread that the Federal Reserve would tighten the screws of monetary policy due to an inflation uptick in the United States. But this turned out to be a temporary crisis and from summer on the markets rallied once more. The pause in the Federal Reserve's rates upcycle, falling oil prices and a growing consensus around the soft landing scenario for the US economy aligned with strong corporate profitability to power many market indices to record highs.

A bullish start to the year, followed by correction in May then resumption of gains



Another difference with respect to the earlier bull period is that the P/E of main world indices decreased in the year to what we can consider extremely low levels. The cause in this case was the scale of company earnings, which went from strength to strength in 2006. Other support factors included the large sums mobilised on both sides of the Atlantic by corporate transactions like mergers, acquisitions and takeovers.

P/E ratios are held down by the strength of company earnings

Mention apart must go to the Spanish market, where the Ibex-35 recorded an annual gain of 31.8% (against the 13.6% of S&P and the 15.1% of Eurostoxx-50). Dividend payments overtook 2005 levels, lifting the index yield to 36%, while the vigour of company earnings, up by 31% year-on-year, kept P/E ratios running at lows (an average of 13.4 times). Corporate movements were the order of the day, above all in the energy and construction industries. The result was that the capitalisation of the Spanish stock market topped one trillion euros for the first time ever after an increase of 26%, while turnover expanded 36% to 1,150,547 million. One of the year's main events was the initial public offering of BME (Bolsas y Mercados Españoles), the last of Europe's big exchange owners to float its shares.

The Ibex-35 powers to highs with an annual increase of 31.8%

Asian markets traced a divergent course in the second half of the year. So while Hong Kong, India, Singapore and Indonesia all reported all-time highs, Tokyo failed to recoup its May levels due to doubts about the durability of the country's economic recovery.

Gains are the order of the day in Asia, with Japan as exception

This positive performance by Asian emerging equity markets set the pace for the remainder of the emerging group, which rallied strongly after the May correction to close the year substantially ahead. Gains were supported on countries' improved economic fundamentals and, in fact, the laggards tended to be those with their economic indicators in worse shape, such as Turkey and its large current account deficit.

The strong 2006 performance of emerging debt delivered a 10.5% increase in the EMBI+ index, bringing spreads down 76 basis points to 169. Although US rate expectations and fears of a slowdown in the American economy are inevitably conditioning factors, emerging debt has grown more resistant to the fluctuations of financial markets. Hence prices recovered rapidly after the mid-May correction, which impacted lightly on emerging bonds in comparison to other assets. Factors in favour included an abundance of global liquidity, the improved fundamentals of emerging economies, a broader investor base, high commodity prices, a reduction in new paper reaching the markets and the year's numerous buy-back operations.

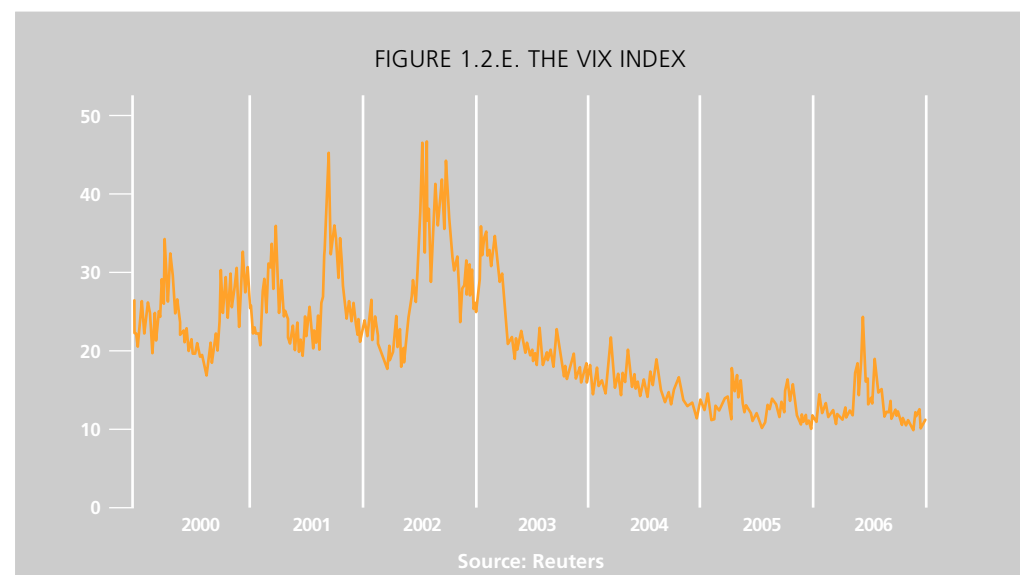
A positive year for emerging debt

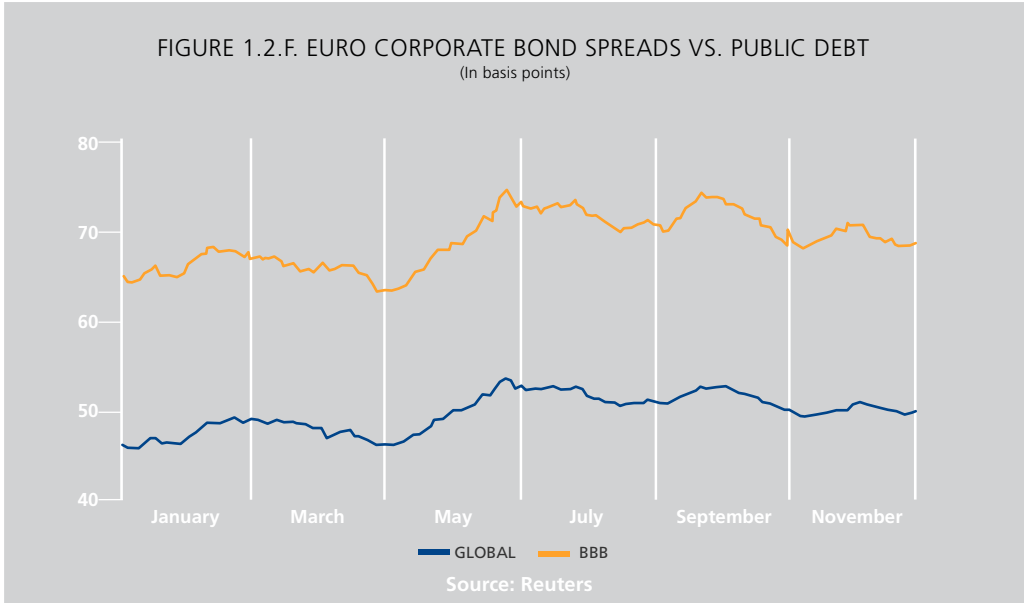
Finally, investors reaffirmed their confidence in corporate bonds. Despite starting out at historical lows, the May correction in financial markets provoked only a small upturn in corporate bond spreads, which subsequently exhibited downside resistance due to oil price escalation and increased corporate borrowings. By the close of the year, spreads had widened 5 basis points to a modest 51 basis points.

Corporate bond spreads stay at lows

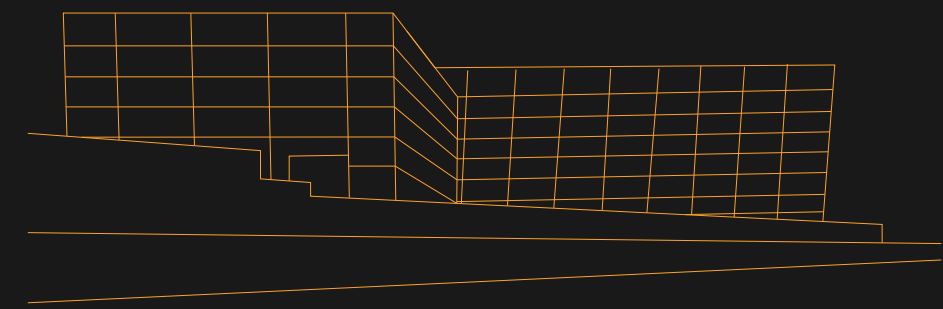
High share prices hand in hand with low volatility

The subdued volatility and earnings multiples of leading world indices corroborate the strong performance of equity markets. Specifically, market volatility as measured by the VIX index of options on the S&P 500 held at very low levels for most of 2006 (save for the peak coinciding with the instability episode of May-June). This also stands in contrast to the previous run-up of 1995-2000, when the VIX index trended higher.

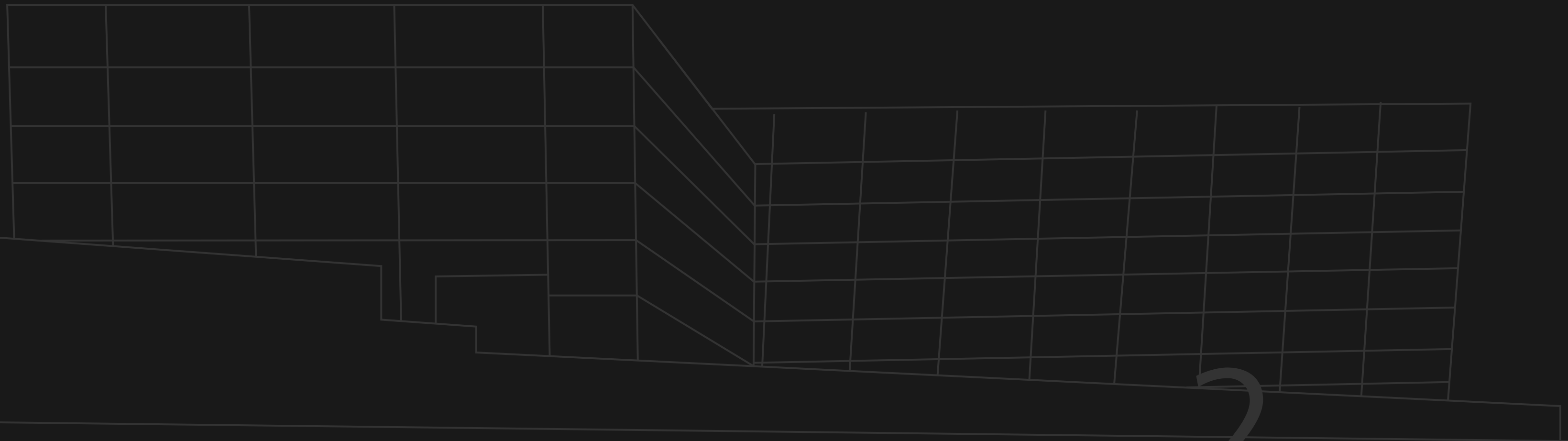




[Kursaal Centre. Donostia / San Sebastián]



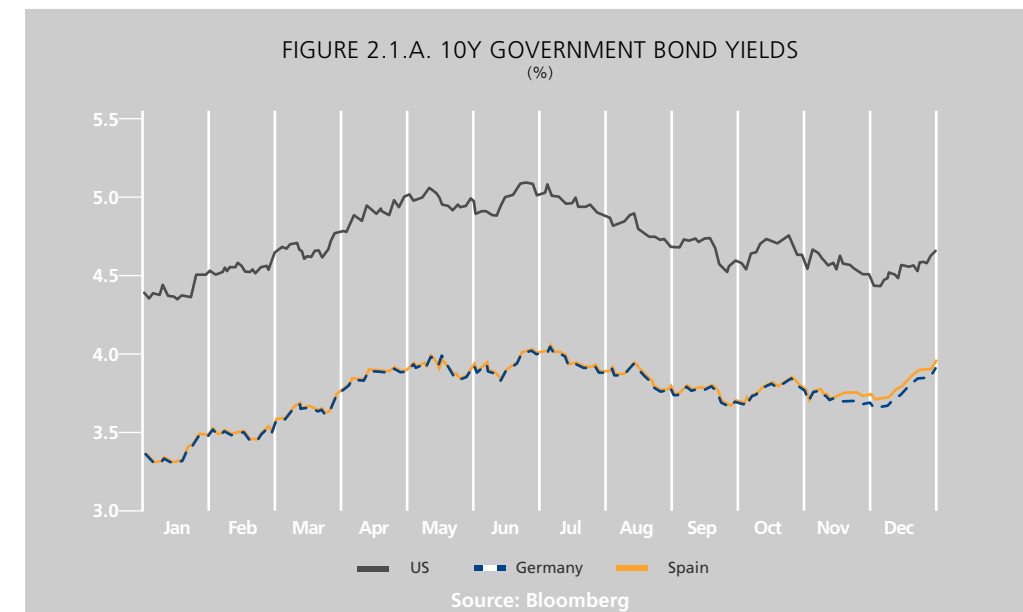
GOVERNMENT BOND MARKETS IN 2006



2.1. MAIN INTERNATIONAL TRENDS

Long-term government bond yields remained comparatively low over 2006, with only a small increase versus 2005. This was so despite a supportive international juncture in terms of economic growth and, in some areas, the persistence of inflationary tensions. The general pattern was fairly homogeneous in the main developed economies – though with differences in the scale of fluctuations – and, as our next figure shows, divides more or less neatly into three periods.

Long-term government bond yields stayed low...



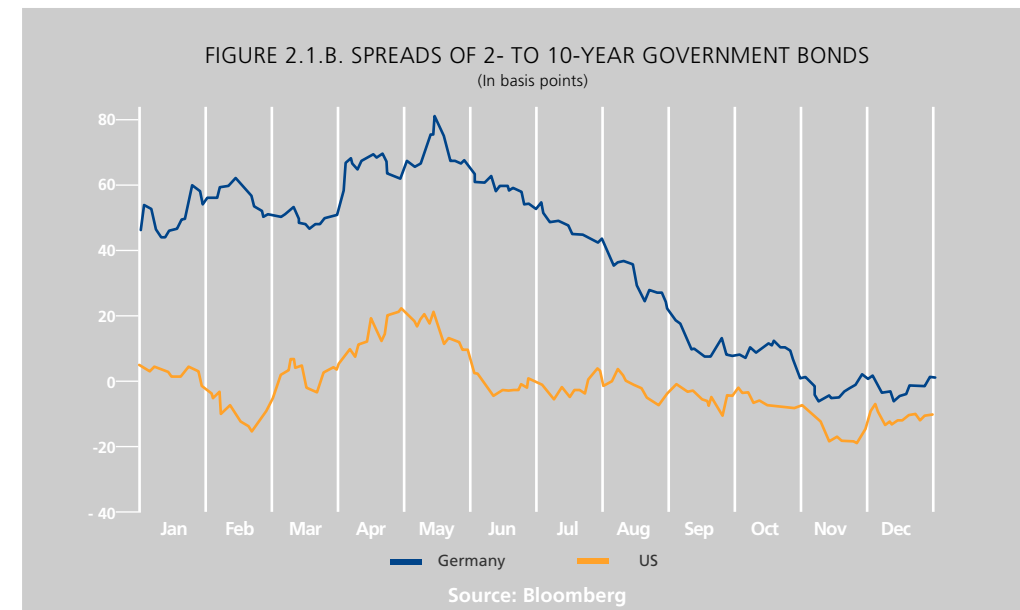
...despite the run-up to end June ... During the first period, from January to June, government bond yields moved significantly higher in the US, the Eurozone and Japan on the spur of a favourable growth outlook and the tightening of monetary policies. Especially striking was the rally that followed the end of the Bank of Japan's quantitative easing programme, confirming the economy's emergence from deflation.

.. which then partly was offset by the run-down in yields to October The second period, marked by an increase in debt prices, stretched from June to October. The turning point came around the end of this first month after the financial market turbulence unleashed in mid May. In a context of greater risk aversion and more volatility, bond markets served as a safe haven for the funds flowing out of suddenly bearish equity markets, causing the appreciation of government bonds and a demand-induced fall in yields. This run-down continued even after the turbulence was safely over, in response to the deceleration of economic growth. Other factors at work were the Federal Reserve's decision to call a halt to its rates upcycle, lower heading oil prices, the reserve mix of Asian monetary authorities, with dollar assets still dominant, and carry trade activity.

Uncertainty rules in the closing quarter The third period, from October to year end, was characterised by sideways moving yields, with no clear trend, in tune with the uncertain outlook for the US economy. The Federal Reserve showed itself more concerned about inflationary pressures than the faltering of growth and decided to stick with its tightening stance, pushing back the downside expectations being priced in by the market and breaking off the decline in yields that had dominated from mid-year on.

Yield curves flatten Yield curves, meantime, continued to flatten in both the United States and Eurozone, with rates straining higher at the short (2 years) than the long end (10 years). Generally speaking, short-term yields are more sensitive to interest rate and monetary policy expectations, while longer-term yields are influenced additionally by growth and inflation prospects. Accordingly, yields were reacting to the monetary tightening applied to June in the United States and to October in the EMU.

Inversion in the slope of the US yield curve in the 2-10 year interval The case of the US market bears particular mention for the negative spreads recorded by government bonds in the 2- to 10-year maturity band, reopening the debate about the predictive power of an inverted yield curve as the prelude to slowdown/recession. At the same time, the conundrum of low yields of long-term government bonds referred to by Alan Greenspan in February 2005 showed no signs of changing. One possible explanation is that structural factors might be distorting the bond market and, therefore, our interpretation of the curve: chief among them, the surplus of savings over planned investment at worldwide level, the pension fund industry's keen demand for long-term government bonds and the Chinese authorities' fondness for dollar-denominated assets.



2.2. SPANISH SOVEREIGN BOND YIELDS

A good showing by Spanish Public Debt, which conserves its AAA rating and its minimum yield spread vs. the German bund

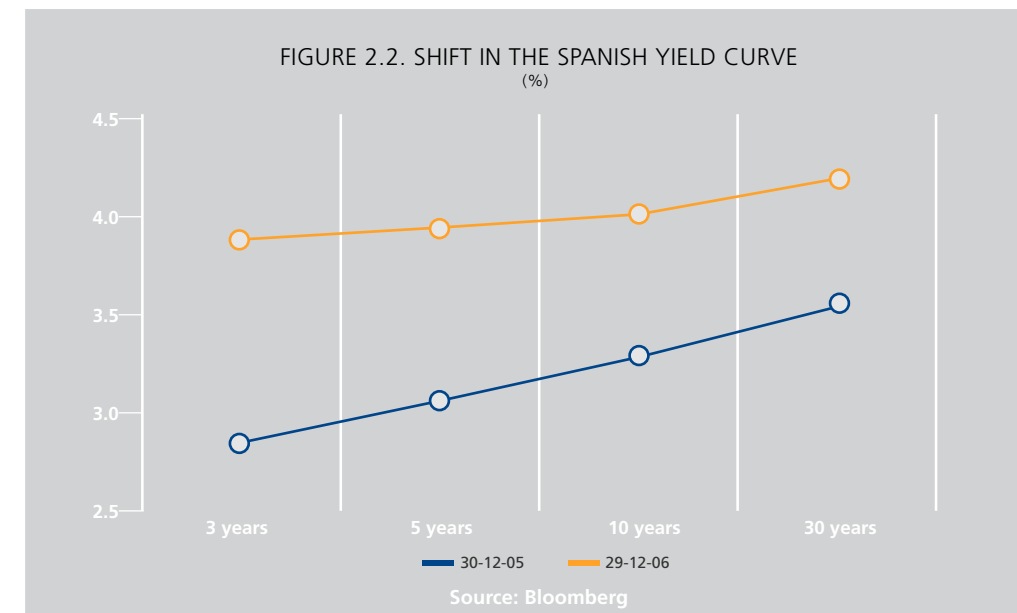
The growth vigour of the Spanish economy and the upkeep of a contractionary fiscal policy have permitted further progress in consolidating the public finances. The result has been a budget surplus and a reduction in the Debt/GDP ratio which have favoured the market performance of Spanish government bond, conserving it its top credit ratings (AAA) from the main international agencies (Standard & Poor's, Moody's and Fitch). Also, 10-year spreads versus Germany held consistently near historical lows, consolidating the convergence in long-term interest rates.

Spanish bond yields move parallel to Europe's

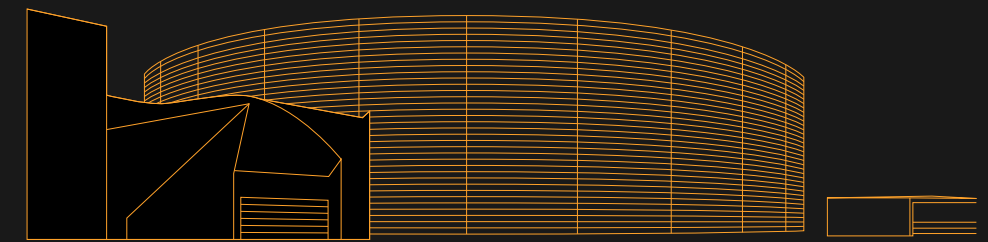
The 2006 yields of Spanish government fixed income securities mirrored those of remaining Eurozone countries, with a similar distribution in time: a first period to June, with bond prices falling, followed from June to October by falling yields, then a less defined period to the end of the year characterised by mainly sideways movements.

Higher yields in 2006 cause an upward shift accompanied by curve flattening

Overall, Spanish bond yields trended higher in 2006 though with increases inversely proportional to maturities. The result was an upward shift in the yield curve accompanied by a flattening movement. Yields rose highest in the 1- to 3-year maturity band, between the 114 basis points of 12-month Letras (which closed the year yielding 3.86%) and the 103 basis points of 3-year Bonos (to a year-end yield of 3.89%). As regards longer-dated securities, 5-year Bonos saw yields climb 89 basis points to 3.94%, while 10- and 30-year Obligaciones recorded more modest increases of 69 and 52 basis points to 4.00% and 4.11% respectively.



["Manuel Rojas" Conference Centre. Badajoz]



CENTRAL GOVERNMENT FINANCING POLICY



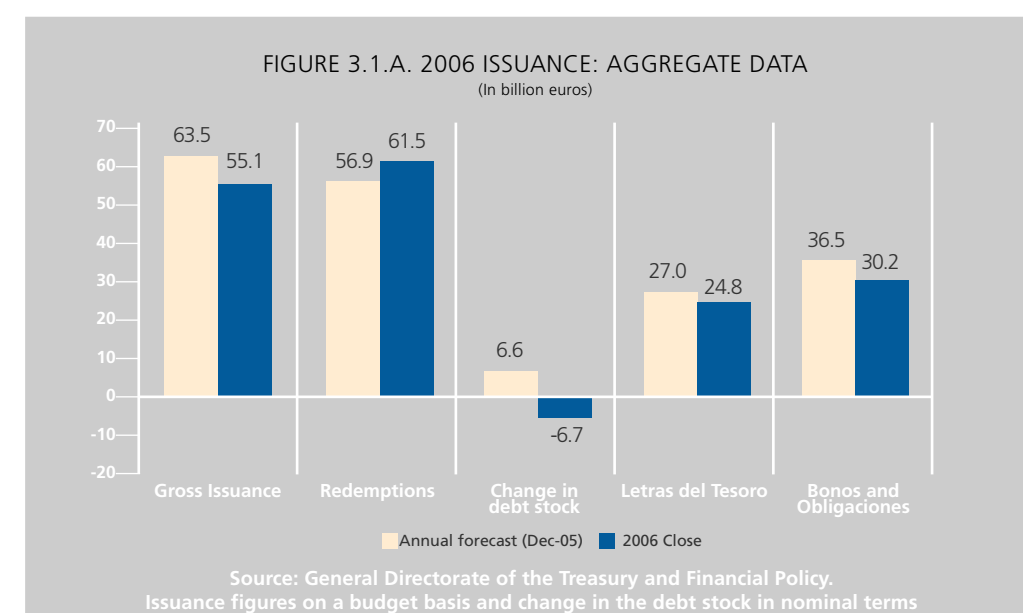
3.1. CENTRAL GOVERNMENT DEBT ISSUANCE

As in previous years, Tesoro Público issuance was considerably below initial targets. The reduction in this case was done in two stages: the gross issuance projected at the presentation of the Treasury's annual financing strategy (in December 2005) was already less than the amount stated in the "Yellow Book" of the 2006 National Budget; then, as the year advanced, issuance was cut back to considerably below this revised-down level.

Tesoro Público raises negative net finance of 6.40 billion as the good 2006 outlook for public finances frees it to again reduce its gross Debt issuance

Specifically, the "Yellow Book" (published at end September 2005) projected gross sales of 75.30 billion and net sales of 14.20 billion. However, by the December presentation, the figures had been heavily adjusted to 63.50 billion outright and a bare 6.60 billion net.

From the figure below, we can see that the year's execution surpassed even these more optimistic forecasts: gross issuance came down sharply (from 63.50 to 55.00 billion) while redemptions increased (from 56.90 to 61.50 billion) on account of the year's buy-back programme, resulting in negative net sales of - 6.40 billion vs. the positive 6.60 billion forecast in December and an approximately 6.70 billion reduction in the nominal Debt stock. The difference between the net financing figure and the Debt stock reduction is because the former is stated on a budget rather than nominal basis.



The adjustment in gross issuance embraced bonds and bills, both of which contributed to the negative net financing

This same information is presented below from another angle, but with identical conclusions: the reduction in gross sales of bonds and bills was such that both these instruments contributed to the negative net financing of the Spanish Treasury.

TABLE 3.1.B. 2006 ISSUANCE
(In million euros)

	December 2005 Forecast	2006 Close
Gross bond Issuance	36.5	30.2
• 3-and 5-year Bonos	15.0	15.2
• 10-year Obligaciones	14.5	11.4
• Over 10-year Obligaciones	6.0	3.7
• Other long-term issuance	1.0	0.0
Bond redemptions	27.8	32.0
Net financing in bonds	8.7	-1.7
Net financing in bills	0.2	-2.3
Change in other Debt outstanding	-2.4	-2.4
Change in Debt stock*	6.6	-6.7

* Data on a budget basis, except Debt stock (nominal).

Source: General Directorate of the Treasury and Financial Policy

The main characteristics of the Treasury's 2006 financing policy can be summed up as follows:

Letras issuance is scaled back

- Letras del Tesoro sales were around 2.00 billion down with respect to the December target, reducing market size by the same amount. Letras issuance in the year was confined to 18- and 12-month terms.

Long-term issuance reduced in the year

- Issuance of Bonos and Obligaciones came to 30.20 billion, 17% down on the 36.50 billion forecast. In this case, the adjustment fell heaviest on longer sectors of the curve.

Conversely, 3-and 5-year sales exceeded pre-announced targets due to liquidity commitments behind this curve segment

- The only sales to exceed forecasts were those of 3- and 5-year Bonos del Estado, reflecting liquidity commitments behind the 3-year benchmark (2.90%, October 2008), launched in January, and the need to give the 5-year bond (3.25%, July 2010) a sufficient outstanding balance before proceeding to its closure.
- Sales of 10-year Obligaciones del Estado came out some 3.00 million below forecast. Despite this adjustment, the Treasury launched a new 5.00 billion reference (3.80%, January 2017) in the month of October. This bond's sale was handled by a syndicate, which again secured an efficient placement as regards both interest rates and investor diversification. This operation, the year's biggest in terms of market visibility, is described more fully in a later section.
- Long term issuance also came down sharply (from 6.00 billion to 3.70 billion in the 30-year sector). The outstanding balance of the bond 4.20%, January 2037 closed in consequence at around 12.00 billion.

- Tesoro Público made no foreign-currency issues in 2006, judging that neither market conditions nor budgetary implementation warranted such a move.

- Bond redemptions closed the year around 32.00 billion, substantially ahead of the 27.80 billion figure first managed. This deviation owes to the year's debt buy-back programme, which we will discuss more fully later in this chapter.

Increase in redemptions due to the buy-back programme

Issuance procedures were very much as in previous years. Despite the higher profile syndication provides, auctions retained their primacy as an issuance instrument, channelling around 90% of annual sales.

Auctions are still the favoured means of placement

- Auctions were resolved by the "modified Dutch" or "Spanish" procedure meaning sales went through at the average price in the case of bids above this average, and at the price actually stated in the case of all other accepted bids.

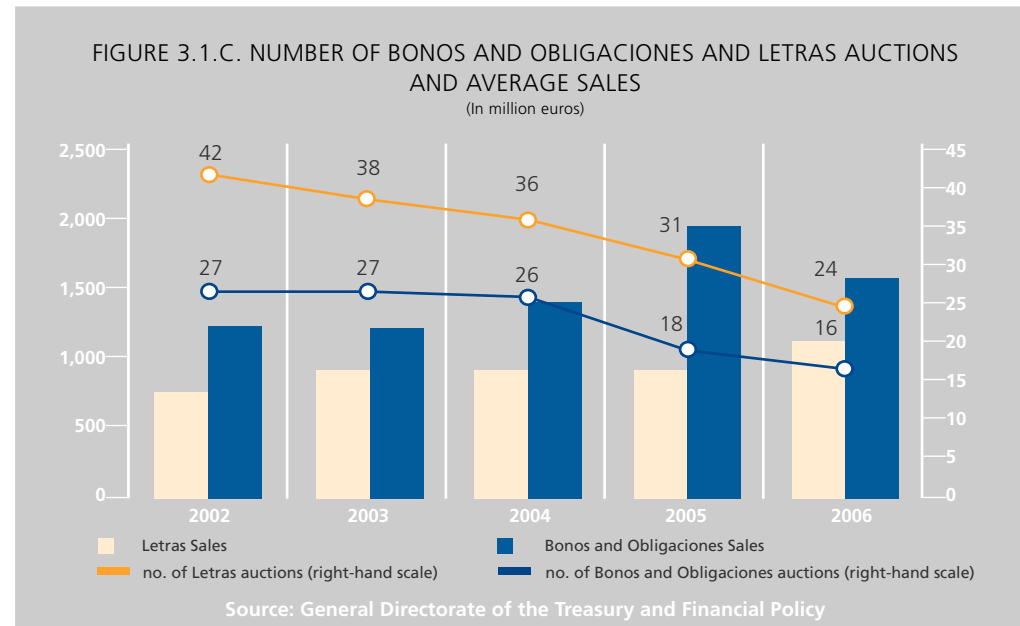
- The ceiling for non competitive bids was raised in the year from one hundred thousand to one million euros. The aim here was to discourage competitive bidding at inflated prices and its distorting effect on auction results. It is preferable for small investors wishing to secure paper at auction to subscribe non competitively, so their bids do not compute towards the average price or interest rate.

- Auction dates adhered to a pre-set annual calendar: namely Letras auctions on the third Wednesday each month and auctions of Bonos and Obligaciones on the first and third Thursday respectively. The specific references to be auctioned are announced ten days before the start of each quarter, in furtherance of Tesoro Público's commitment to maximum issuance transparency.

- The volume of Bonos and Obligaciones placed in each term is informed by the recommendations of the Primary Dealer group.

- In 2006, the Treasury pressed on with its policy of holding fewer auctions but with higher volumes, as a means to boost primary market liquidity. This meant, for instance, not holding bond auctions in either August or October (to leave room for the syndicated placement of the new 10-year Obligación). The figure below tracks the progress of these two variables. We can see that Letras and Bonos and Obligaciones auctions have reduced their frequency though with the latter showing some decline in the average amounts allotted. In effect, the sharp contraction in borrowing requirements has ruled out any further increase in the size of Bonos and Obligaciones auctions.

Fewer auctions with larger volumes in order to boost primary market liquidity



The Treasury comes under new rules concerning the arrangement of credit lines and extends the term of a 2.5 billion line drawable against Letras

Another 2006 novelty relates to credit facilities. After the ban on borrowing from the Banco de España, the Treasury arranged a series of credit lines to cover for potential cash shortages. Since 1999, these lines have been drawable against the issue of Letras del Tesoro. The rules governing these arrangements were modified in 2006 (Order EHA/2393/2006 of 14 July) and one 2.50 billion facility had its term extended.

The above Order regulates all the short-term financing options potentially open to Tesoro Público. Credit lines, for instance, can be of any kind (in euros or currencies, backed by Letras...) with two arrangement modalities:

- A public tender call directed at all financial institutions and published in the Official State Gazette (BOE): the procedure that Tesoro Público has been using in these past years.
- A restricted tender for Primary Dealers only.

In both cases, the Director General of the Treasury and Financial Policy makes the award decision at the proposal of a Committee with its members drawn from Tesoro Público and the Departmental Controller's Office.

A new, non collateralised vehicle will be introduced in 2007

The Treasury's 2007 plans are to renew the credit lines drawable against Letras and negotiate a new, non collateralised vehicle to cover risks in extreme situations or address possible operational risks.

SYNDICATED ISSUE OF THE 10-YEAR OBLIGACIÓN

In October 2006, Tesoro Público issued a new 10-year Obligación for an amount of 5.00 billion. This new bond, which has since become the benchmark in its term, has a 3.80% coupon and matures on 31 January 2017.

Syndication pursued the twin opportunity of improving the bond's distribution among end investors and getting the outstanding balance rapidly up to strength in order to secure its liquidity and entry to international trading platforms. The bookrunners for the issue were ABN AMRO, Barclays Capital, BBVA, Deutsche Bank and Société Générale CIB, with the majority of other Primary Dealers acting as co-leads.

The issue of the new Obligación was a notable success. In price terms, the bond was placed at a return to the investor of 3.856%, equating to a -20 bp spread to the swap curve and +5 bp to the German bond. This difference is partly because the new Spanish bond matures later than the German benchmark (due date July 2016). Adjusting for this factor, the spread vs. Germany narrows to 3 basis points, the lowest ever achieved by the Spanish Treasury in a syndicated issue. This is comparable to what the markets are asking from issuers like France or the Netherlands, confirming the favour won by the quality of Spain's public finances.

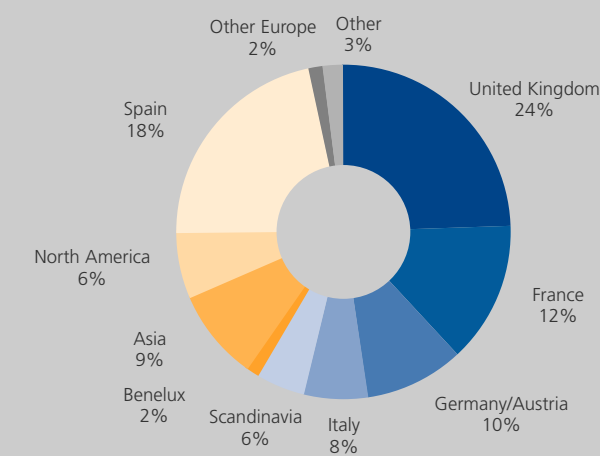
The vigour of the Spanish economy and healthy state of the country's accounts were also reflected in the issue's outright demand: 7.50 billion worth of orders from a varied base of around 118 investors. By geographical distribution, almost half the issue found its way outside the Eurozone, with Asian and North American investors particularly prominent (these two nationalities together acquired 15% of the total issue). Spanish investors ended up with 18% of the new Obligación, in tune with the Treasury's goal of steadily enlarging the international reach of Spanish Debt:

In October 2006, Tesoro Público completed the syndicated placement of a new 10-year Obligación, currently the benchmark in its term

The issue was a solid success in price terms: enabling the Treasury to borrow at a 3-point spread to Germany

The deal also met its goal of diversifying the investor base, with Asian and American investors to the fore

FIGURE 3.1.D. GEOGRAPHICAL DISTRIBUTION OF THE 10-YEAR OBLIGACIÓN (%)

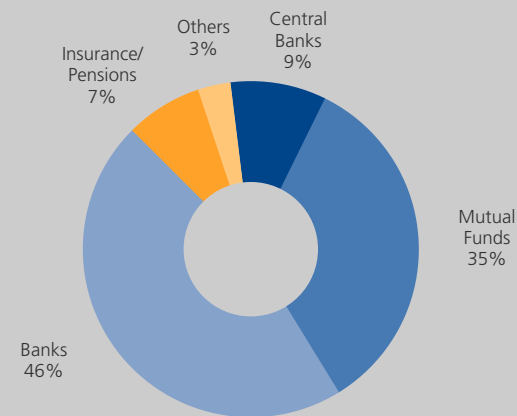


Source: General Directorate of the Treasury and Financial Policy

The fact 54% of sales went to end investors will help the new benchmark's secondary market performance

By demand sector, 54% of sales went to end investors (mutual funds, insurance firms and pension funds). Placement was thus centred successfully on high-quality clients, ensuring the bond a good secondary market performance. This is important because it will help bring down the financing costs of successive tranches placed by the traditional auction route.

FIGURE 3.1.E. DISTRIBUTION OF THE 10-YEAR OBLIGACIÓN BY TYPE OF INVESTOR (%)



Source: General Directorate of the Treasury and Financial Policy

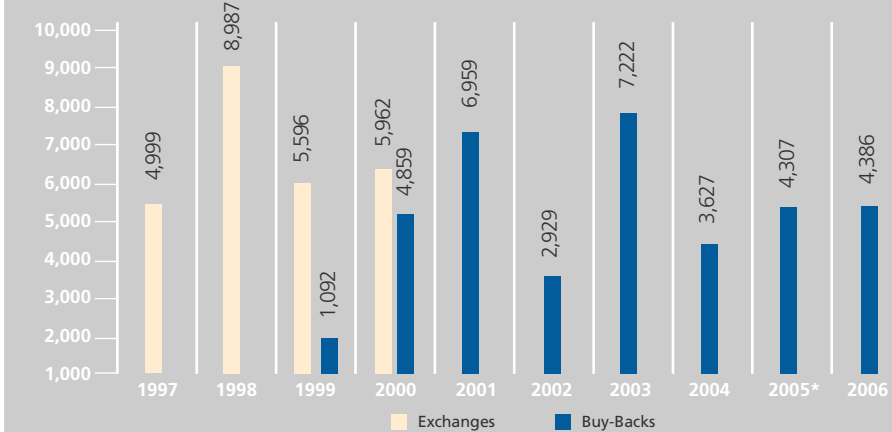
3.2. FINANCIAL MANAGEMENT: BUY-BACKS AND LIQUIDITY AUCTIONS

Issuance policy is of necessity closely tied in with the Treasury's buy-back programme and cash management operations.

In 2006, the Treasury continued its policy of Public Debt buy-backs and early redemptions. The goal, as always, was to smooth out the profile of Debt redemptions and facilitate cash management by reducing the volatility of Tesoro Público's current account at Banco de España. Buy-backs are also liquidity-enhancing in both the primary market (redemptions are financed by means of new sales) and the secondary market (new on-the-run bonds tend to be more keenly traded than the bonds withdrawn). Tesoro Público has been applying this policy since 1997, in which time over 60 billion have been redeemed ahead of time, equating to 9% of the gross issuance in the period.

Buy-backs continued through 2006 and extend to 9% of the gross amount issued since the programme's launch in 1997

FIGURE 3.2.A. DEBT EXCHANGES AND BUY-BACKS (In million euros)



*Including the early redemption of RENFE debt.

Source: General Directorate of the Treasury and Financial Policy

4,386 million bought back in Bonos and Obligaciones del Estado

A face value of 4,386 million was repurchased in 2006. Buy-backs mainly targeted bonds dated up to 2011, with a preference for those maturing earliest (2006 and 2007 maturities together summed 2,011 million or 46% of the total). The biggest single target was the Bono del Estado 3% maturing July 2007, with a repurchased face value of 1,080 million. Remaining buy-backs were spread over various off-the-run strippable bonds.

TABLE 3.2.B. 2006 BUY-BACKS
(Face value, in million euros)

Bond Repurchased		Amount Repurchased			
Coupon	Maturity	Cash Amount	%Total	Face value	%Total
4.80	31/10/2006	305	6.6	295	6.7
7.35	31/03/2007	79	1.7	76	1.7
3.00	30/07/2007	1,103	23.8	1,080	24.6
4.25	31/10/2007	581	12.5	560	12.8
6.00	31/01/2008	572	12.3	540	12.3
3.60	31/01/2009	407	8.8	400	9.1
5.15	30/07/2009	643	13.9	590	13.5
5.40	30/07/2011	603	13.0	540	12.3
5.35	31/10/2011	340	7.3	305	7.0
Total		4,633	100.0	4,386	100.0

Source: General Directorate of the Treasury and Financial Policy

The system of liquidity auctions is retained but with adjustments to improve its functioning

Cash management also underwent some minor changes. Since February 2001, Tesoro Público has been assigning the daily balance in its Banco de España account to the highest bidding credit institutions in the corresponding monthly auctions. Transfers take place daily at 14:30 instrumented on Debt buy-sell backs maturing at 07:00 the following morning. This not only earns the Treasury a return on its current account, but furthers the purposes of European Central Bank (ECB) monetary policy by reducing the variability of one of the main autonomous factors in the monetary base.

Changes to auctions in 2006 sought to boost the return to the government of providing this liquidity and to minimise their potentially distorting effects on secondary Debt markets:

A lower minimum bid

- Firstly, the minimum bid at tenders was lowered from 2% to 1% of the daily balance, and each institution allowed to make up to 5 bids against 3 previously. The idea in this case was to encourage take-up by smaller banks.

Greater auction transparency: the Treasury offers bidders projections of its daily balance

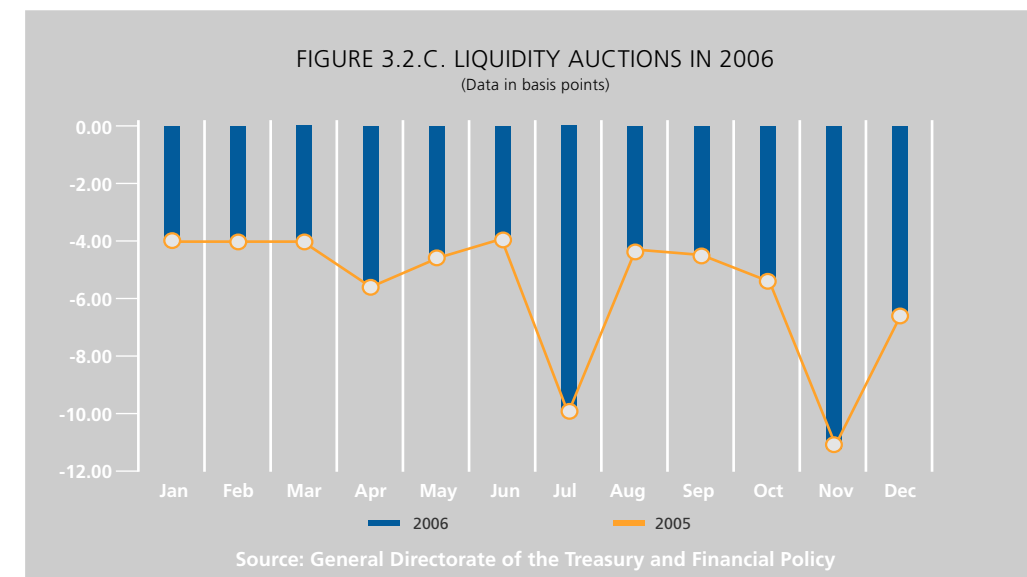
- In the interest of greater transparency, the Treasury now informs bidders before each auction of its projected account balance each day in the month; providing updates on this forecast during the first working days of each week. Previously the only information given out was a prospective minimum, maximum and average balance, so this 2006 measure is a substantive step forward in transparency to the market.

- Finally, the choice of collateral deliverable for buy-sell backs has been widened on certain days. Since 2001, only Spanish Debt securities had been accepted as collateral, with the risk that the secondary market could run short of paper on days when the Treasury's account recorded peak balances. To forestall such distortions, the Treasury now announces before each auction whether it will accept other securities and on which days. These securities must in all events be denominated in euros, registered on Iberclear and have good credit quality (issued by EU countries, Spanish autonomous communities or other borrowers rated AAA/Aaa). At 2006 auctions the decision was to accept only EU sovereign debt securities and those of Spanish regions, and then only during certain months. When given the opportunity to deliver non Spanish securities, entities opted for German, French and Italian Debt.

The range of collateral deliverable for buy-sell backs is widened on certain days

The average daily balance transferred in 2006 was 14.00 billion, just slightly ahead of the figure for the previous year. The spread to the EONIA also edged higher in the year, as we can see from the graph below.

The average balance transferred moved up slightly in 2006 as did the spread vs. the EONIA



3.3. CENTRAL GOVERNMENT DEBT AND ITS COST

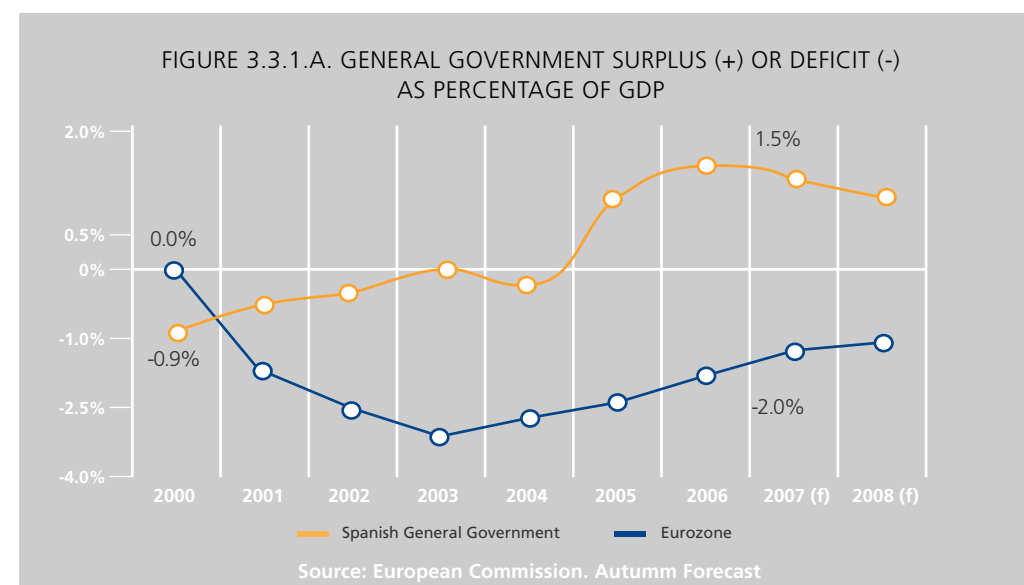
3.3.1 THE FISCAL BALANCE AND DEBT/GDP

Both Debt/GDP and Debt interest rates head lower in the year

A renewed fiscal surplus in 2006

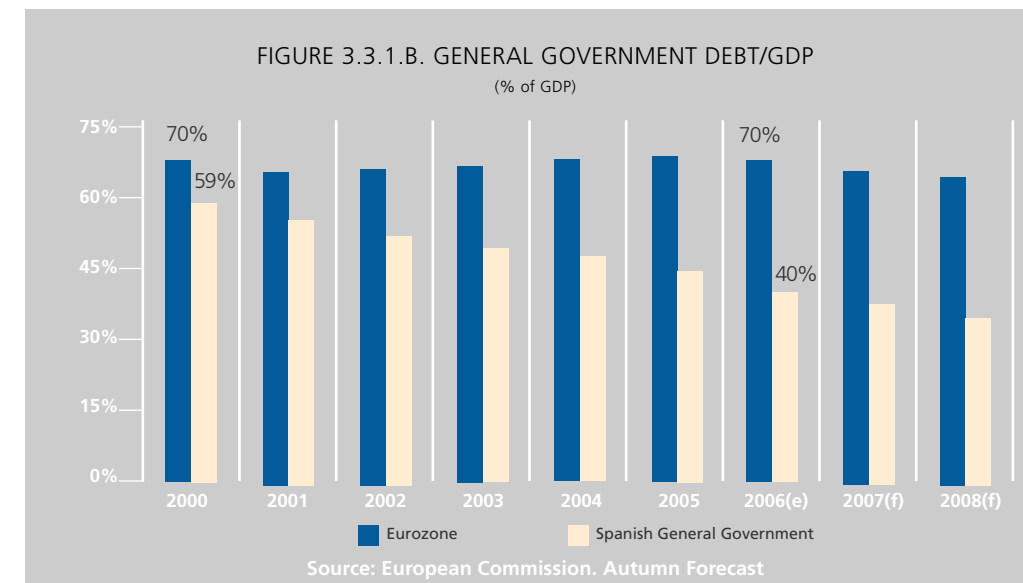
Budgetary stability is now firmly entrenched as a cornerstone of Spanish economic policy. And the 2006 performance was again positive both fiscally and in terms of the Public Debt ratio. Specifically, the weight of public indebtedness in GDP and the average interest rates of the Debt portfolio continued to trend downwards, providing a store of benefits for future years.

Firstly, the Government's budget forecasts were surpassed in the year, which ended with a surplus higher than in 2005. The European Commission's autumn 2006 forecasts put the general government surplus at 1.5% of GDP against the 2% deficit projected for the Eurozone as a whole. This surplus draws on the Central Government account (which consolidated the surplus position attained in 2005), the Social Security (allowing more funds to be transferred to the Reserve Fund) and the accounts of both autonomous communities and local corporations.



The robust growth of nominal GDP combined with the reduction in the Spanish Debt stock to deliver further improvement in the Debt/GDP ratio. This performance looks stronger still set against the same aggregates for the Eurozone. As we can see from the following graph, the weight of General Government Debt in Spanish GDP receded from 59.2% in 2000 to 39.7% in 2006, a reduction of over 20 percentage points. This contrasts with the flat evolution of the Eurozone ratio – from 69.5% to 69.8% – in the same six-year period. And European Commission estimates suggest this divergent trend will persist in the next few years.

The General Government Debt/GDP ratio drops to 39.7%



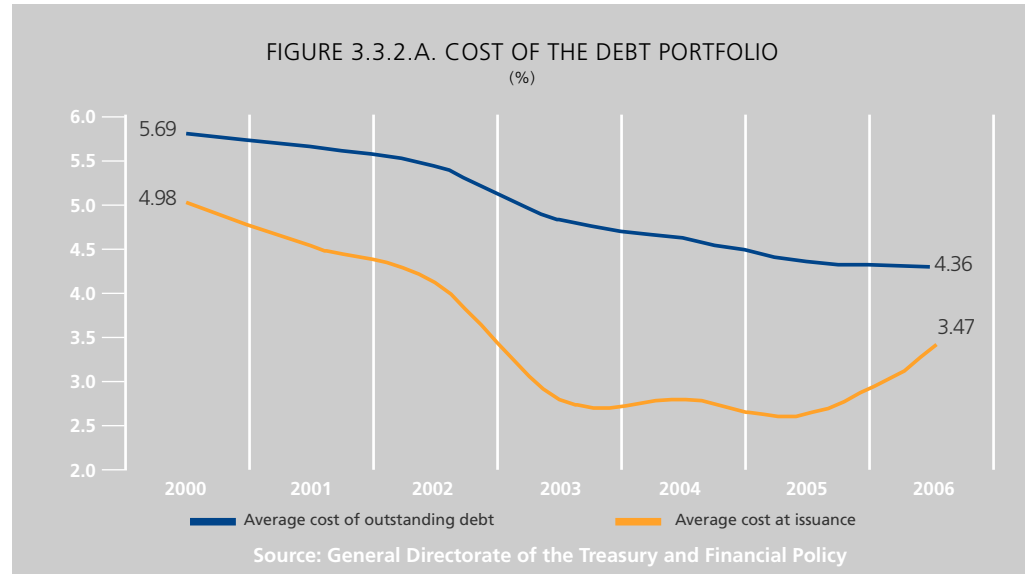
3.3.2 COST AT ISSUANCE AND AVERAGE COST OF CENTRAL GOVERNMENT DEBT

The downtrend in Debt costs at issuance came to an end in 2006, with an average cost of 3.47% practically 0.7% up on the prior-year rate. This increase traces mainly to the rising yields of Letras del Tesoro, which accounted for 45% of the year's total sales.

A cost at issuance of 3.47%

That said, the average cost of the Central Government Debt portfolio (taken as the weighted average of the issuance costs of all its component securities) continued to head lower throughout 2006. This outcome is explained, in average terms, by the replacement of Debt redeemed in the year by new, less expensive references. Specifically, the average cost of the outstanding Debt closed the year at 4.36%, a little below the level of end 2005.

The average cost of the Debt portfolio continues to trend lower



3.3.3 SECONDARY MARKET PRICES OF SPANISH DEBT

The Treasury, like other market participants, keeps a keen eye on secondary market Debt prices. The following chart tracks the yield spreads of the Spanish 10-year bond vs. German and French equivalents, based on the corresponding generic bonds¹. The performance of Spanish bonds was adverse as whole, particularly in the closing months, with the 10-year spread vs. Germany widening from 1.5 basis points at the outset to 5 basis points at the close of the year. The spread vs. the French bond augmented by around 4 basis points in the period from a negative to a positive 2 basis points.

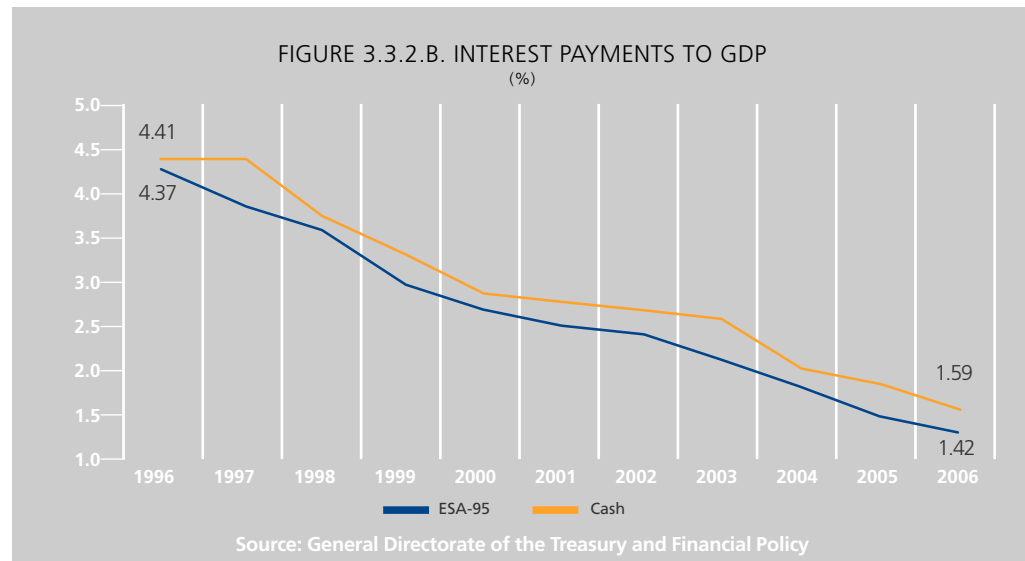
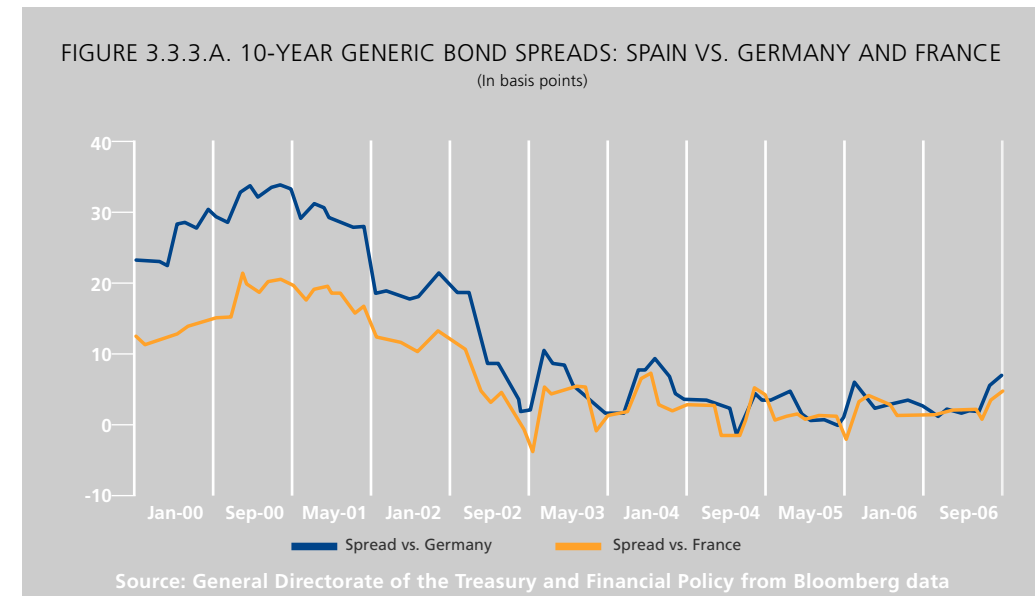
Spreads vs. Germany and France turn more adverse in the year

Most of this spread slippage vs Germany and France owes to the greatly improved state of both countries' public finances. What we have, then, is a relative loss due to the better economic and financial prospects of Germany and France rather than any deterioration in Spain's economic indicators.

The reason being these two countries' improved macro and financial outlook

Interest charges drop back as a percentage of GDP: 1.59% in cash terms and 1.42% on a National Accounts basis

Lower average costs, the moderate growth of the nominal stock and the vigour of the Spanish economy combined to lighten the debt servicing bill as a percentage of GDP. Specifically, interest payments/GDP reduced in cash terms from 4.41% of GDP in 1998 to 1.59% in 2006 and, in National Accounts terms (ESA-95), from 4.37% to 1.42% respectively. This trend reflects the dividend for Spanish society of the budgetary discipline being exercised.



1. The spread is calculated using the generic bonds published by Bloomberg, corresponding to the benchmark in each market. The jumps in the spread are explained by changes in the benchmark used.

3.4. STRUCTURE AND RISK PROFILE OF THE CENTRAL GOVERNMENT DEBT

The Spanish Debt stock sees its largest contraction in recent years

Lower stocks of Letras del Tesoro and "Other Instruments"

The year 2006 witnessed the largest reduction in recent years of the Spanish Debt stock, which fell by 6.70 billion or 2% to a closing figure of 312.5 billion.

This decrease will not harm the liquidity of the main Debt market (Bonos and Obligaciones del Estado), since its outstanding balance remains practically unaltered at 264 billion. Conversely, the size of the Letras del Tesoro market has reduced by 2 billion (almost 6%). However, the biggest contraction was reserved for the "Other Instruments" caption, relating to lower issuance in foreign currencies and the redemption of non marketable debt in the Tesoro Público portfolio.

TABLE 3.4.A. GOVERNMENT DEBT OUTSTANDING
(In billion euros and nominal terms)

Year	Letras	Bonos and Obligaciones	Other	Total
1995	70.61	116.33	42.12	229.36
% total	30.80	50.80	18.40	100.00
1999	53.14	205.33	36.27	294.74
2002	35.83	247.11	29.02	311.96
2003	38.76	245.97	24.40	309.13
2004	36.99	255.88	26.29	319.15
2005	33.29	264.66	21.21	319.16
2006 (f)	31.30	264.07	17.09	312.46
% total	10.00	84.50	5.50	100.00

Source: General Directorate of the Treasury and Financial Policy

We can see from the preceding table that Bonos and Obligaciones del Estado again made up the largest group with 84% of the total. The weight of Letras del Tesoro held practically flat at around 10% while remaining portfolio items continued to lose ground. Specifically, Debt denominated in foreign currencies fell back to 1.32% of the total portfolio, with dollars and yens both raising their share. Exchange-rate risk, concentrated mainly in the yen, was practically eliminated through swaps.

Foreign-currency Debt is no more than 1.32% of the total portfolio against the 84% of Bonos and Obligaciones

TABLE 3.4.B. MAIN TESORO PÚBLICO FOREIGN CURRENCY ISSUES
(Data at 31 December 2006)

	Currency	Amount	Coupon %	Maturity
Notes	JPY ^(*)	20,000	0.950	06/11/07
Notes	JPY ^(*)	30,000	1.000	30/10/08
Notes	JPY ^(*)	20,000	1.000	06/11/08
Notes	JPY	20,000	3.133	17/04/17
Notes	JPY ^(*)	20,000	3.100	21/04/17
Eurobond	USD ^(*)	1,500	5.875	28/07/08
Notes	USD ^(*)	1,500	3.375	28/10/09
Notes	USD ^(*)	1,000	4.125	20/07/10
Bulldog Bonds	GBP	60	11.750	24/03/10
Notas	GBP	200	5.250	06/04/29

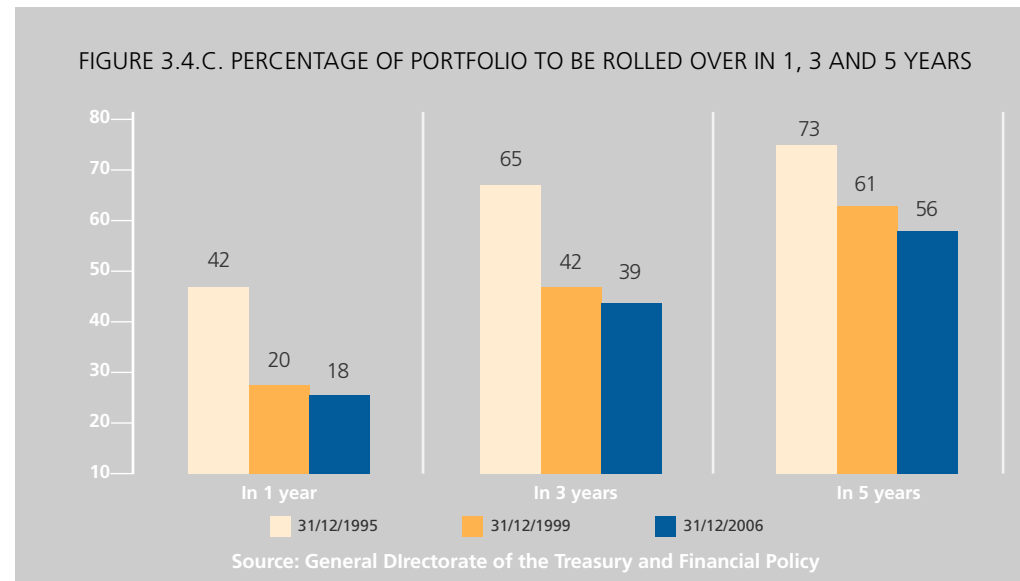
* Swapped at floating Euribor.

"Notes" correspond to Eurobonds issues under the Medium-Term Notes facility.

Source: General Directorate of the Treasury and Financial Policy

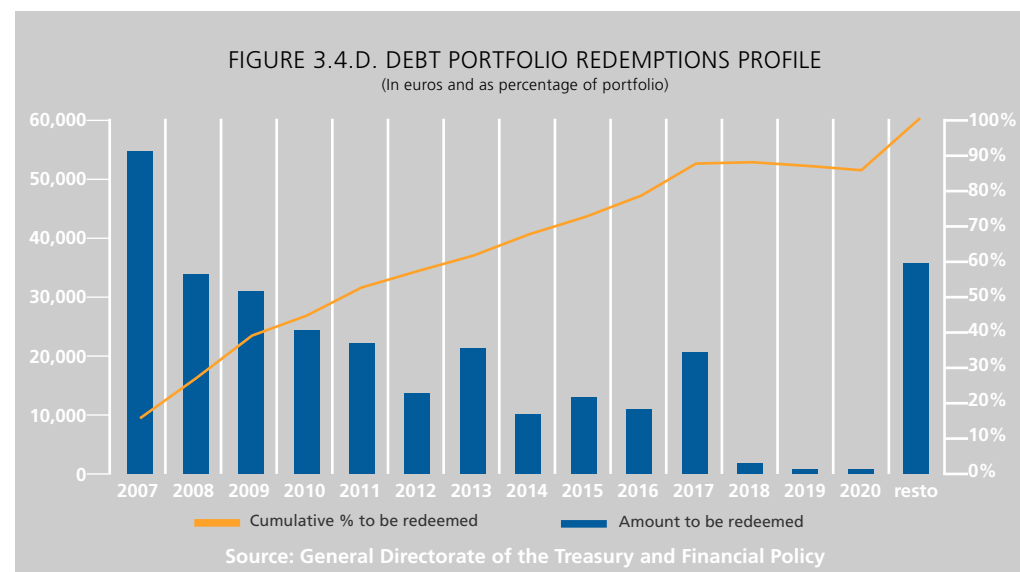
The Treasury's refinancing risk came down significantly in 2006. In the mid 1990s, as our next graph shows, over 40% of the outstanding Debt had to be rolled over every year, such that portfolio costs were acutely sensitive to interest rate movements. This picture has since changed out of all recognition, with year-end rollover at just 18% in line with the gentle downtrend of previous years. The year also brought a significant decrease in the percentage of the portfolio to be refinanced in 3 and 5 years. These developments, together with a sharply falling Public Debt ratio, have delivered a two-way reduction in refinancing risk in terms of GDP.

Lower refinancing risk of the Debt portfolio



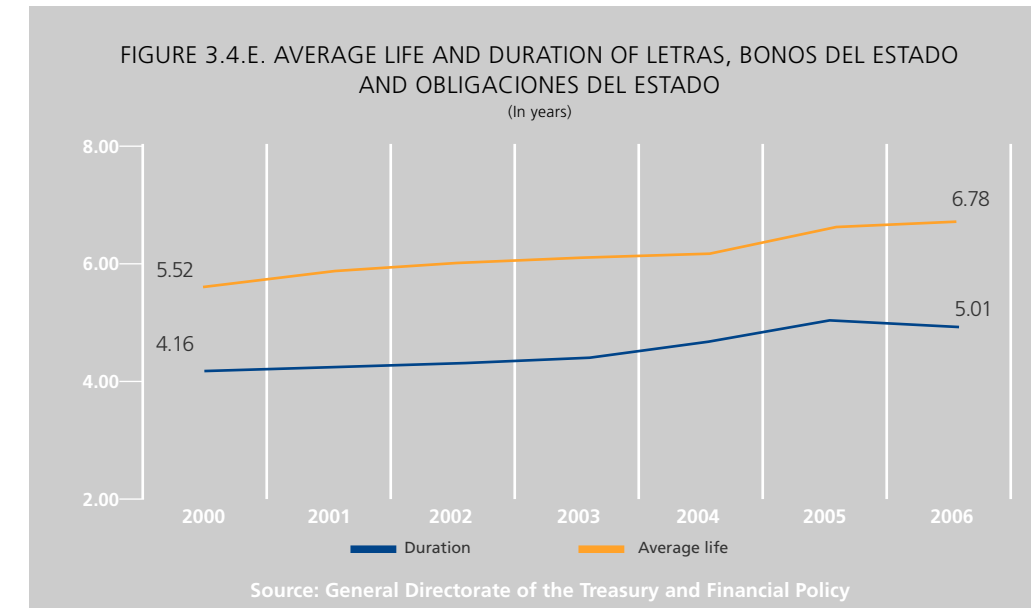
A smooth redemptions profile testifies to the portfolio's subdued refinancing risk

The portfolio's smooth redemptions profile stands as another indicator of reduced refinancing risk. As our next graph shows, only 18% of the outstanding stock will need refinancing in 2007, and it is not until 2010 that the amount rolled over will sum even 48%.



Tesoro Público's issuance programme in the last few years has tended to push up average life. Hence the average life of the portfolio of Letras, Bonos del Estado and Obligaciones del Estado was 6.78 years at the 2006 close. Duration, however, has come down slightly to the current 5.01 years.

Average life rises slightly (6.78) while duration moves down (5.01)





THE SECONDARY MARKET

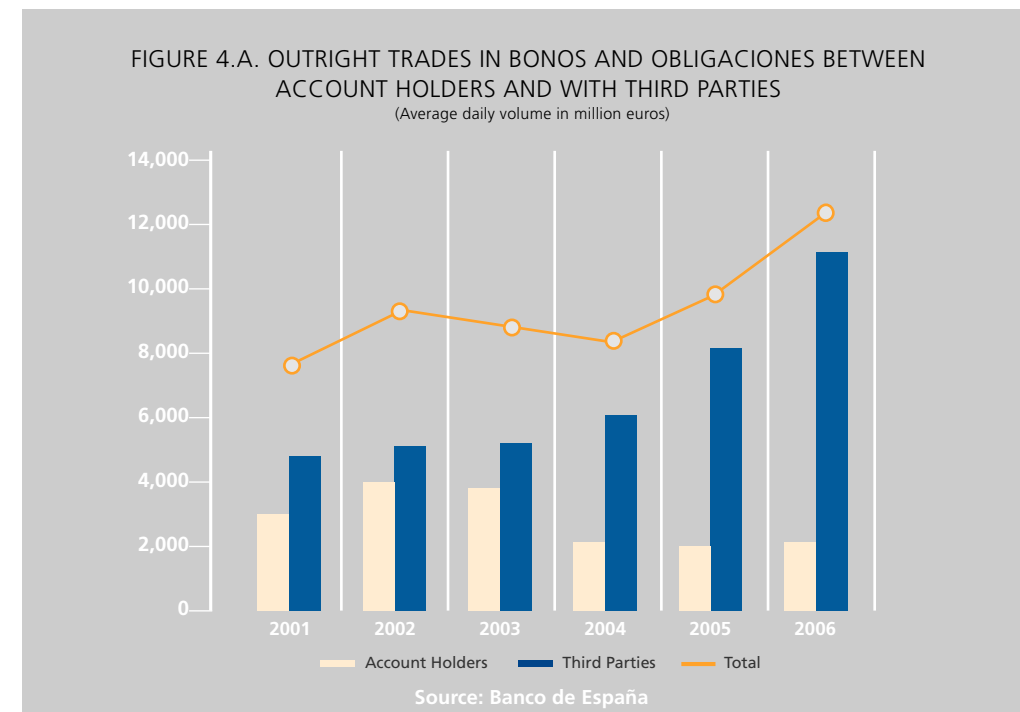
[Santa Caterina Market. Barcelona]



OUTRIGHT TRADES IN BONOS DEL ESTADO AND OBLIGACIONES DEL ESTADO

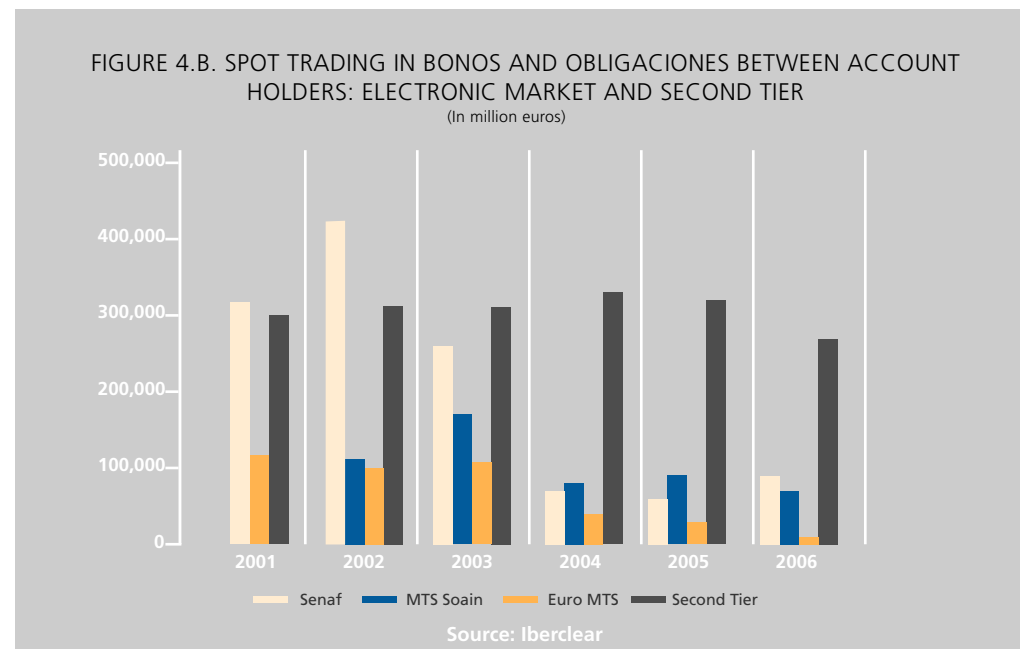
Outright transactions in Bonos and Obligaciones (spot and forward) grew their average daily volumes 24.41% with respect to 2005. Third-party trades accounted for a notable 86% of the total amount, up from 80.5% one year before, with account-holder trades accounting for the other 14%. This marks a continuation of the downtrend in wholesale activity dating back to 2003 and ascribable probably to the persistence of low interest rates and subdued volatility. Conversely, the volumes of account-holder trading with their clients moved steadily higher in the period, demonstrating that the decline in “first tier” trades has not robbed Spanish debt of its attractiveness for end investors.

Average daily volumes in outright trades in Bonos and Obligaciones move up 24.41% with respect to 2005



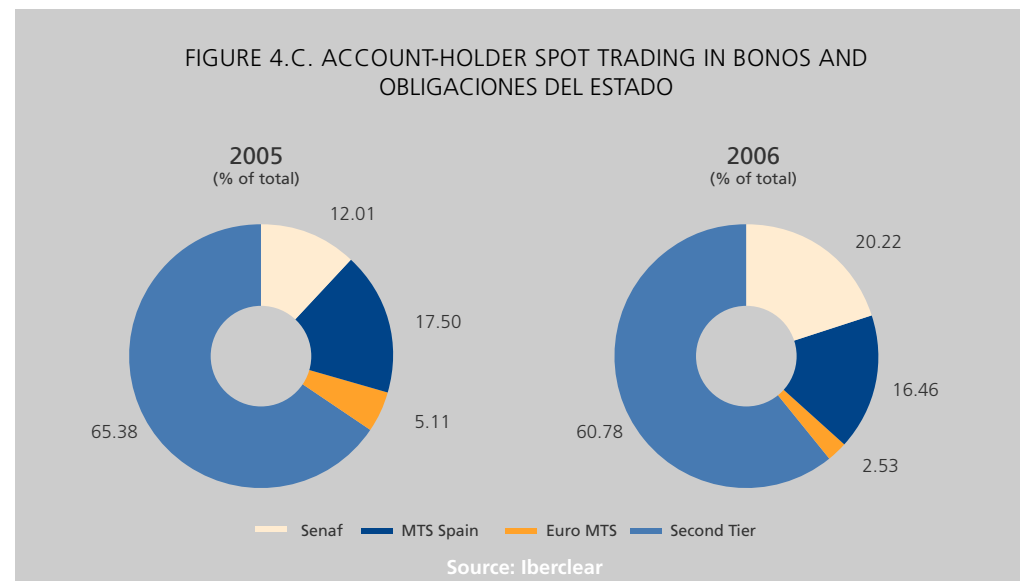
Zeroing in on spot trades between account holders (the sum of first-tier trades on electronic platforms and bilateral second-tier or OTC transactions), we find that total turnover has dropped by 8%, the reasons being a sharp contraction in second-tier volumes and low-key trading on MTS Spain and EuroMTS. In contrast, trading on local platform Senaf advanced strongly in the year.

Spot trades between account holders fall away, especially on the second tier



Senaf takes up the turnover lead

These developments have translated as a steady drain in the trading share of the second tier, with Senaf picking up the slack to become top electronic platform by the measure of turnover. The share of MTS Spain has held more or less flat, while that of EuroMTS has dropped to about half.

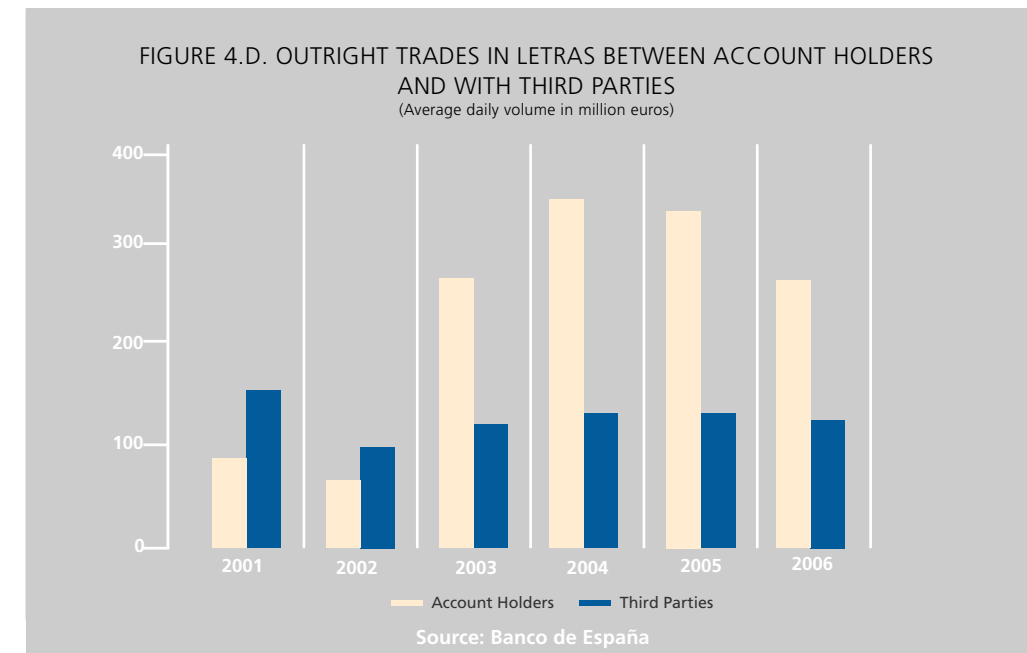


The bond most keenly traded on electronic platforms was the 10-year Obligación (coupon 3.15%, maturing January 2016), which accounted for 17.87% of spot trading volumes in the electronic market and second tier, followed by the 3-year Bono (2.90%, October 2008) with 12.47% and the Obligación 4.40%, January 2015, with a share in the year of 7.56%.

OUTRIGHT TRADES IN LETRAS DEL TESORO

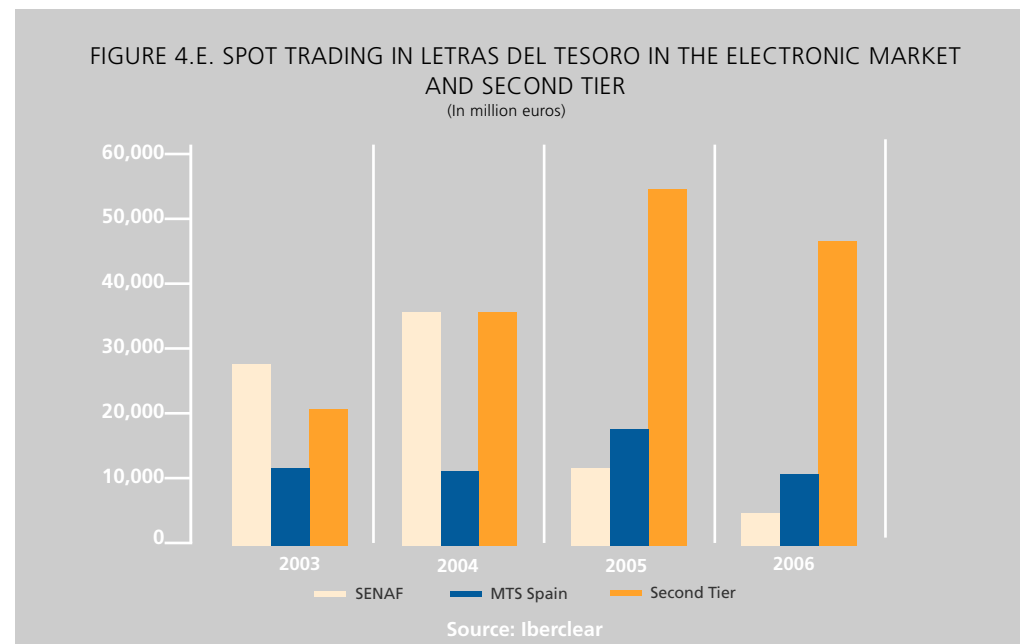
Letras del Tesoro turnover in this modality dropped back 19% with respect to the previous year. The decline extended to the trading between account-holders, and, in a lesser extent, to the trading with third parties. Note, however, that the size of the Letras market reduced by 2.00 billion in the year, so the difference is smaller in portfolio rotation terms. Specifically, portfolio rotation (annual turnover divided by the average Letras balance) was 2.89, just slightly lower than in 2005 (3.28).

Outright trading in Letras recedes in the year

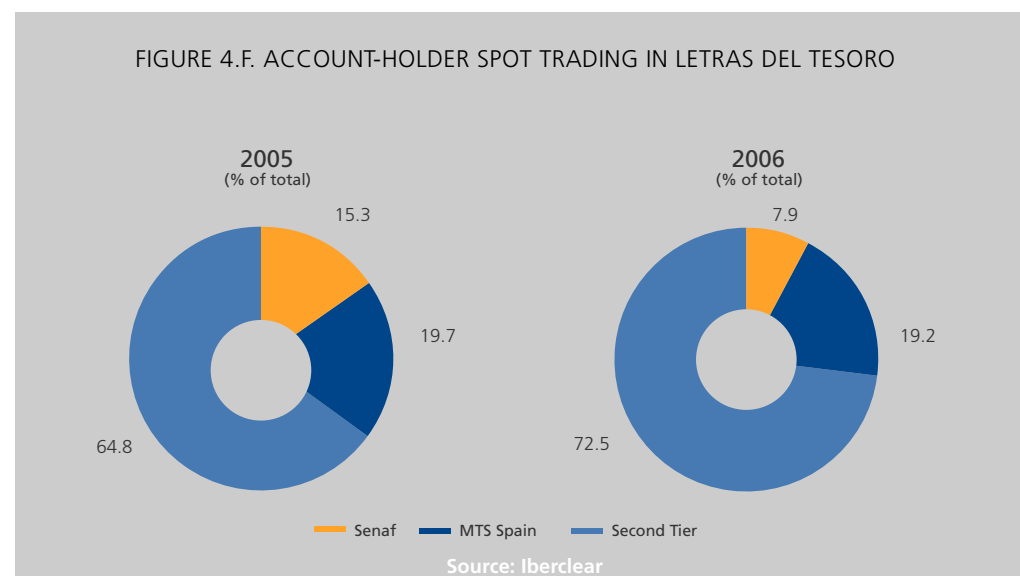


The trading decline in the account-holder segment extended to both the second tier and local electronic platforms, with activity on Senaf falling most steeply. Trading volumes on EuroMTS (not shown on the graph) remain strictly testimonial.

An across-the-board decline in account-holder trading



One result is that the second tier has gained market strength, mainly at the expense of Senaf, and now accounts for almost three-quarters of spot trading volumes in the account-holder segment. The share of MTS Spain, meantime, has barely varied.



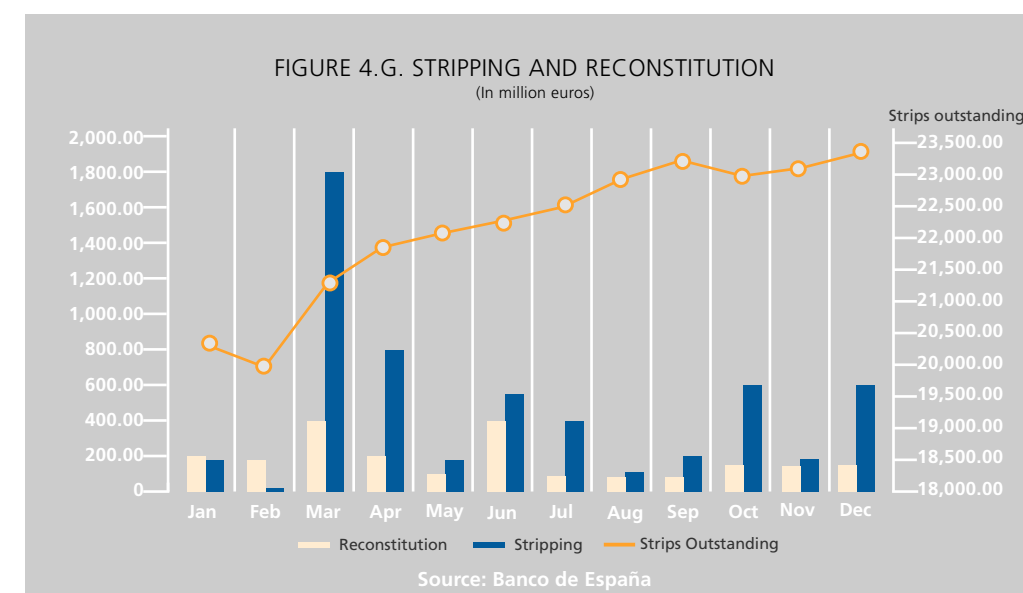
STRIPS MARKET TURNOVER

The strips market in Spanish Debt commenced in 1998 with the first-time authorisation of bond stripping and reconstitution.

Two new strippable bonds were authorised in 2006 (3.15%, January 2006 and 2.90%, October 2006) while another two were redeemed in the year (3.20%, January 2006 and 4.80%, October 2006). This left an end-2006 total of 20 principle strips with their respective coupon strips, covering a spectrum of maturities from 2007 to 2037, and with a maximum strippable volume of 351.26 billion.

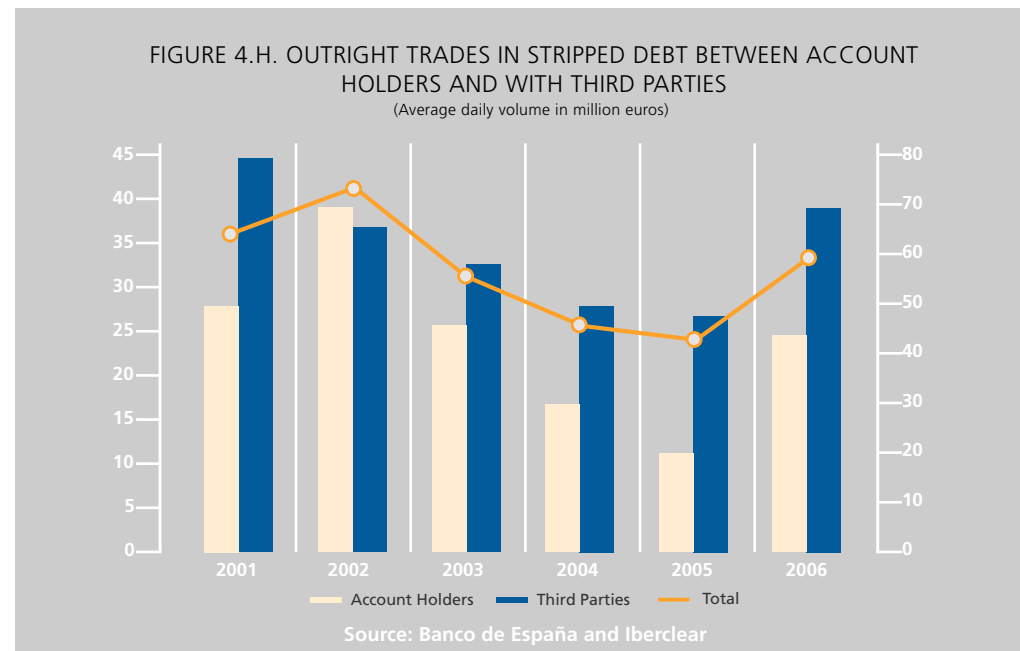
20 strippable bonds with over 351 billion

Gross monthly stripping fluctuated widely in the year as our next figure shows.



Outright account-holder trades in stripped Debt securities surged to an average daily volume almost doubling the figure for 2005, while third-party trades moved up 79%. The strips market has thus come back strongly after the lull of the previous years. One factor at work was the reform of the market making system, under which each Primary Dealer is obliged to quote at least four separate strips.

Stripped debt trading powers ahead in both account-holder and third-party segments



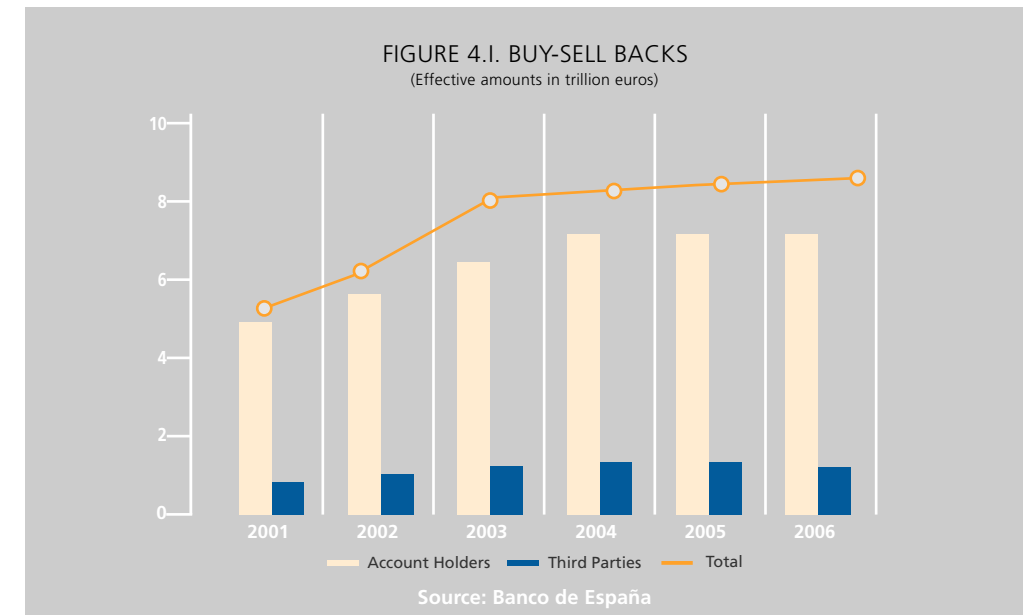
By reference, the most keenly traded was the principal component (PO) of the Obligación 5.75%, July 2032, which accounted for 16% of all strips traded in the account-holder segment. Next in line, with a share of 12%, was the PO of the Obligación 4.20% maturing January 2037.

REPO TRANSACTIONS

Before looking at the performance of the repos market we must distinguish between two types of admissible transactions, that is, buy-sell backs and blocked repos. Buy-sell backs are more liquid and, as such, have traditionally featured larger in account-holder trading: the security acquired can be sold at any time, while blocked repos can only be sold up to the repurchase date set in the original transaction. This makes them more suited for retail trades, since there is no risk of the third party failing to return the security on the preset date.

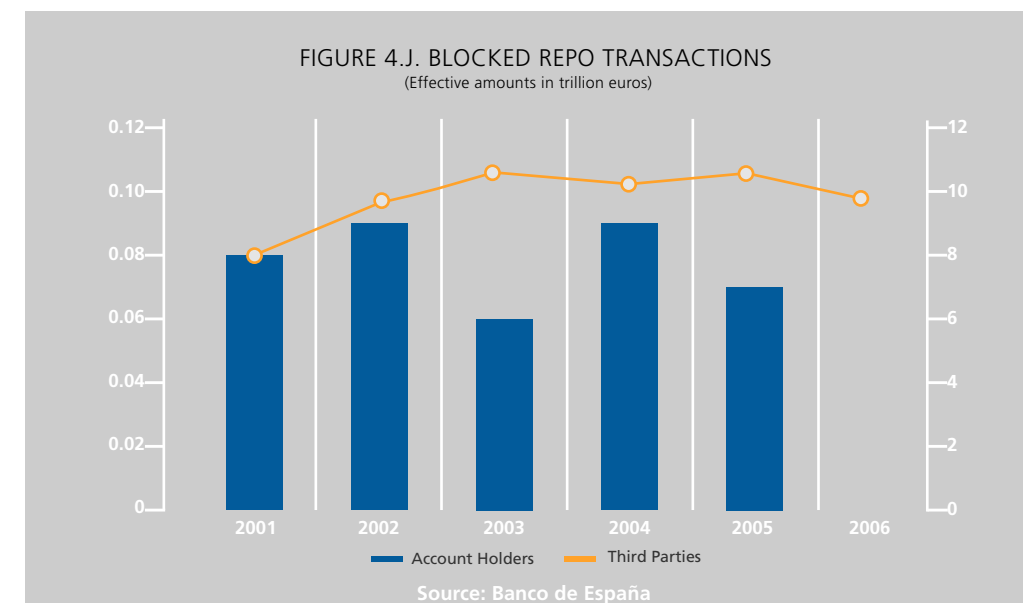
A small year-on-year increase in buy-sell back trading

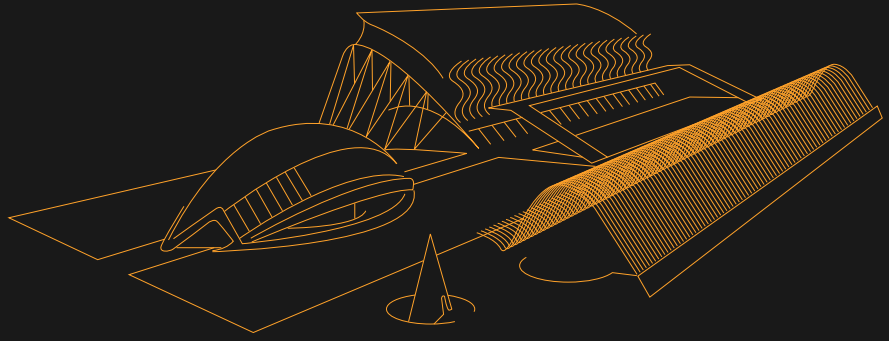
Turnover in buy-sell backs rose by 2.34% in 2006. Of the total, 84% fell to account-holder and the remainder to third-party trades. Bonos and Obligaciones were by far the most popular underlying asset, accounting for 95% of buy-sell back transactions against the almost 5% of Letras and the residual share of strips; percentages which, logically enough, square with the size of their respective markets. Terms again tended to the shortest end, with overnight transactions dominating strongly.



Blocked repo trades dropped back 3.25% with respect to the previous year. Trading, moreover, was almost wholly with third parties. Here too demand was strongest for transactions based on Bonos and Obligaciones, which accounted for 87% of the annual total against the 11% of Letras and the 2% of strips. Short terms were also the most popular in this trading segment.

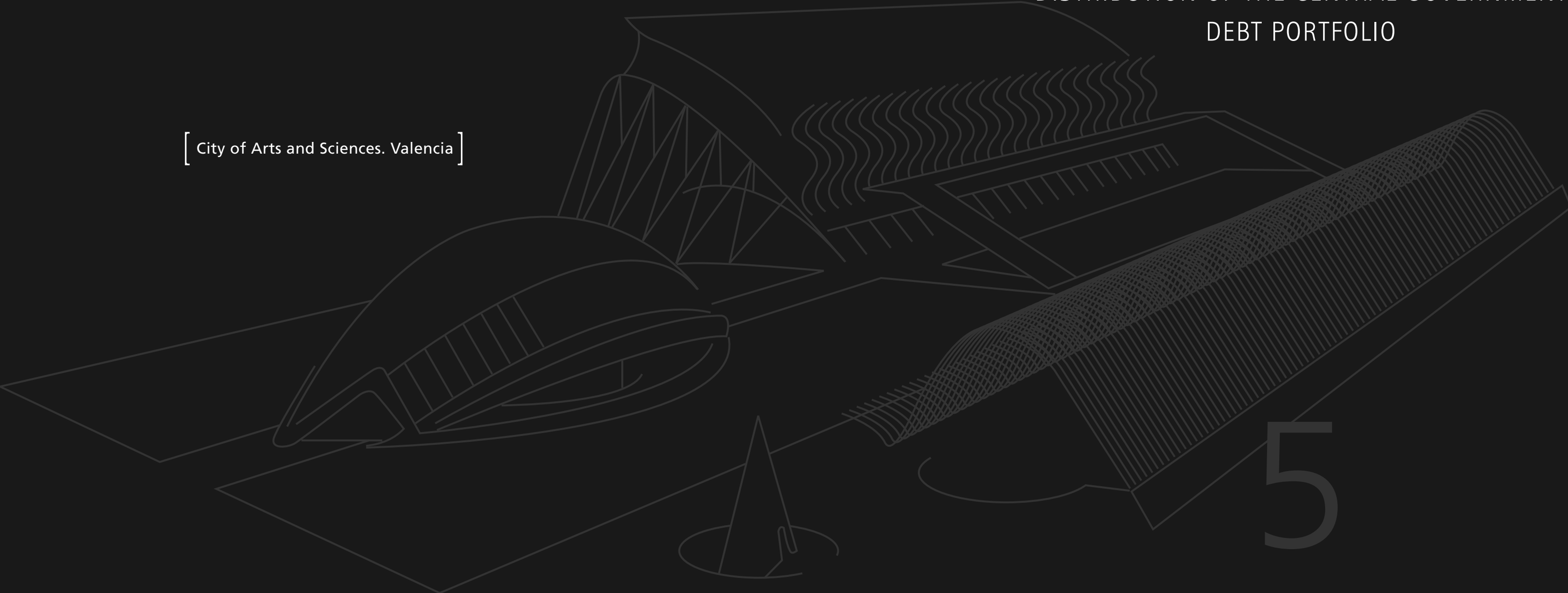
Blocked repo turnover falls by 3.25%





DISTRIBUTION OF THE CENTRAL GOVERNMENT
DEBT PORTFOLIO

[City of Arts and Sciences. Valencia]



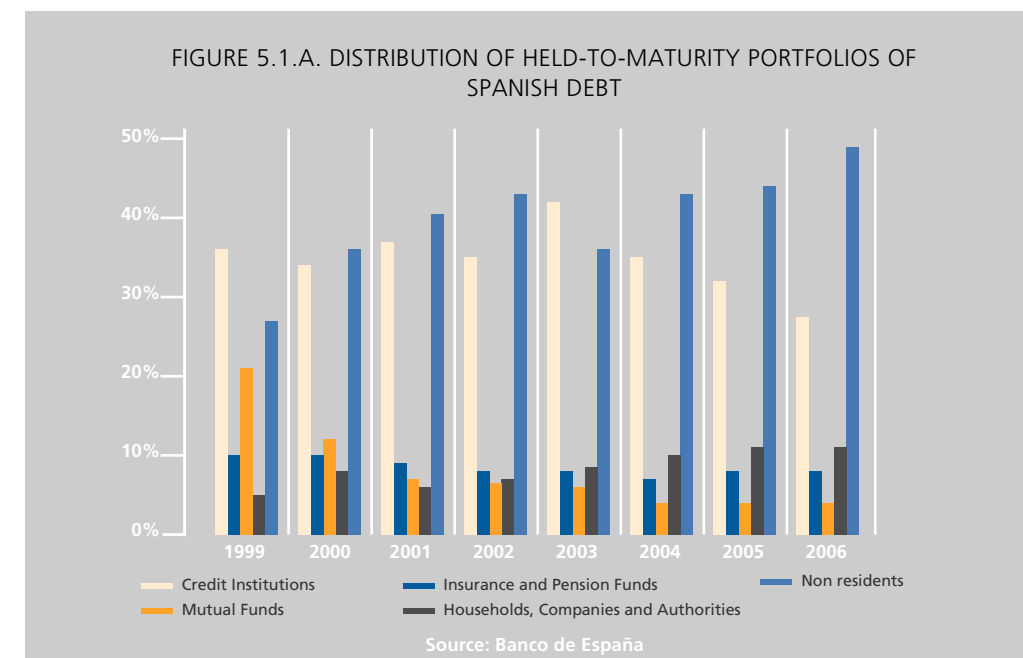
5.1. DISTRIBUTION OF UNSTRIPPED GOVERNMENT DEBT HOLDINGS

DISTRIBUTION OF HELD-TO-MATURITY PORTFOLIOS

The distribution of unstripped Government Debt held to maturity has undergone major changes in the past few years. Spanish credit institutions have lost ground to non resident investors, who raised their share of Debt outstanding from 27% in 1999 to 49% in 2006. This process has gained fresh momentum since 2003, when the award of a top credit rating by the three leading agencies served to heighten the Debt's international appeal. On the other hand, households, companies and public authorities also took a larger portfolio share against the declining weight of mutual funds, pension funds and insurers. Among leading public authority investors is the Social Security Reserve Fund, though note that the Wages Guarantee Fund, a major Debt holder, is classed in the non financial companies category.

Credit institutions lose ground while non resident investors come up strongly

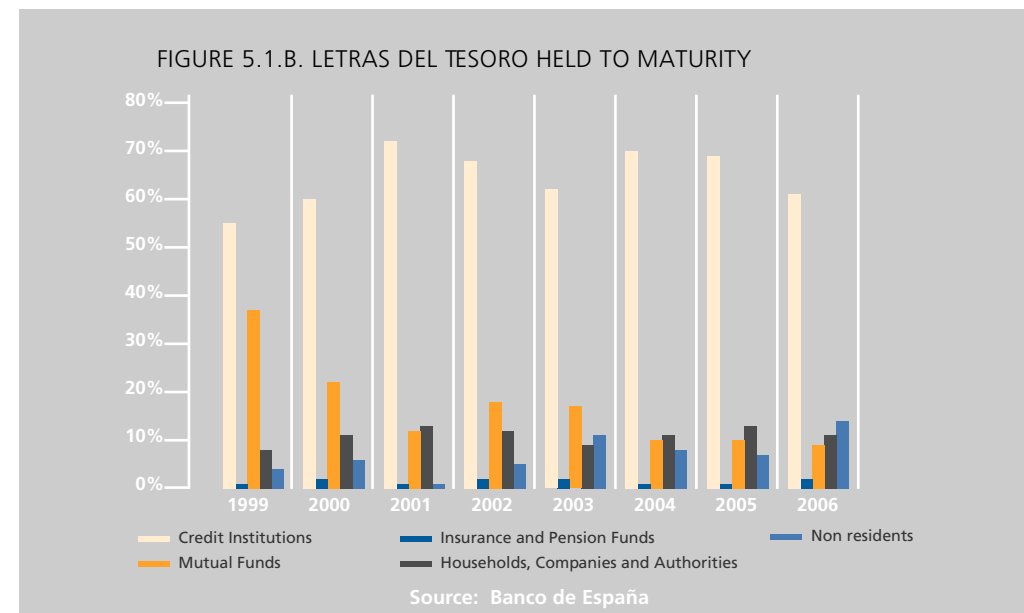
Non residents now represent 49% of Debt ownership



LETRAS DEL TESORO HELD TO MATURITY

Credit institutions are the single biggest group of Letras investors, though with non residents rising fast

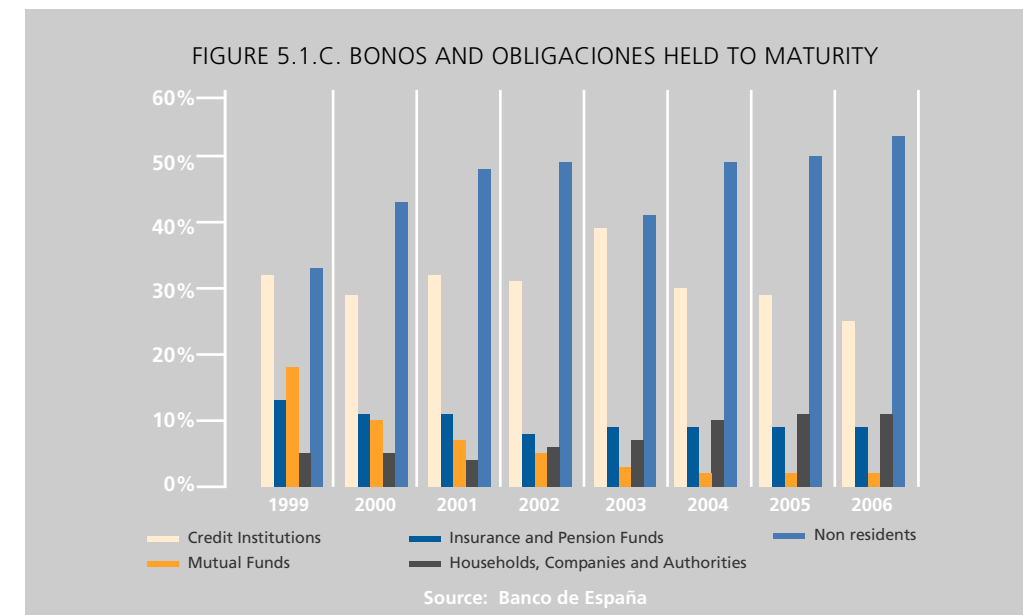
At the short end of the maturities range, we observe that credit institutions closed the year with more than 61% of the bills in issue despite losing share in recent years. Likewise Spanish mutual funds, which in the 1990s accounted for 40% of Letras ownership have lost ground. Other trends of note are the advance of non resident holdings as of 2003, motivated no doubt by the launch of a Primary Dealers group committed to providing liquidity to Letras del Tesoro and promoting their wider ownership. By end 2006, specifically, non resident holdings were 15% of the total against just 3.8% in the year 2002.



BONOS AND OBLIGACIONES HELD TO MATURITY

Non residents take the biggest cut of the Bonos and Obligaciones portfolio

Since 1999, non resident investors have headed the Bonos and Obligaciones ownership list. This group accounted for 53% of holdings at year-end 2006, while credit entities had fallen back to 25%. Mutual funds too have been in steady retreat (settling since 2004 around the level of 2% of total holdings), in contrast to households, companies and public authorities which have worked their way up to nearly 12% (as stated earlier, this trend is largely explained by the Social Security Reserve Fund and the Wages Guarantee Fund).



HOLDINGS OF REGISTERED DEBT

The foregoing analysis refers to Debt holdings to maturity. But it is also worth looking at developments in registered Debt (the held-to-maturity portfolio minus repo sales plus repo purchases).

And here we find that 73% of Letras holdings to maturity in credit institution portfolios and 17% in non resident hands have been assigned via repos or buy-sell backs, primarily to mutual funds and non financial companies. Similarly, in Bonos and Obligaciones, 81% of credit entity holdings to maturity and 16% of those of non residents have been assigned via these same instruments to mutual funds, non financial companies and public authorities.

The conclusion, then, is that credit institutions maintain large held-to-maturity portfolios of Letras, Bonos and Obligaciones, which they refinance through repo arrangements with mutual funds, households, non financial companies and public authorities. In exchange, the latter get access to very short-term securities of maximum credit quality. Non residents, in contrast, refinance only a small part of their Spanish Debt holdings via repo transactions registered with Iberclear.

Credit institutions refinance their portfolios via repo transactions with mutual funds, households, non financial companies and public authorities

5.2. DISTRIBUTION OF STRIPPED GOVERNMENT DEBT HOLDINGS

Strong progression of non residents in stripped debt ownership

A look at the distribution of the stripped Debt portfolio (POs plus IOs) reveals some slight slippage since 2003 in the percentage share of credit institutions. Non residents, conversely, went on enlarging their share in both straight and percentage terms (from 23% in 2003 to 41% in 2006) to become the single biggest investor group in this category.

Mutual funds, which until 2003 were the main investors in stripped debt, have since dropped from 27% to 16%, due almost certainly to their lesser use of strips in making up guaranteed structures. All remaining groups kept up a similar level of investment, with insurance companies and pensions funds (25%) as the largest contingent after non residents.

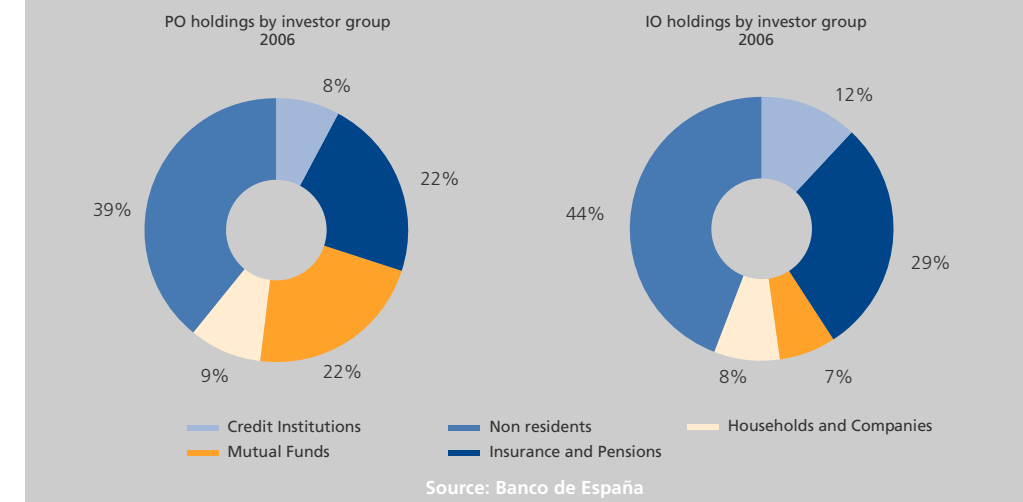
TABLE 5.2.A. DISTRIBUTION OF STRIPPED DEBT BY INVESTOR GROUP

INTEREST AND PRINCIPLES	2003		2004		2005		2006	
	AMOUNT	% of TOTAL	AMOUNT	% of TOTAL	AMOUNT	% of TOTAL	AMOUNT	% of TOTAL
RESIDENTS	16,486	77%	15,882	72%	13,901	67%	13,669	59%
Credit institutions	3,315	15%	3,057	14%	2,576	12%	2,266	10%
Insurance and pension funds	5,339	25%	5,910	27%	5,806	28%	5,823	25%
Mutual funds	5,763	27%	4,985	23%	3,748	18%	3,624	16%
Households and companies	2,069	10%	1,930	9%	1,771	9%	1,956	8%
NON RESIDENTS	5,035	23%	6,174	28%	6,797	33%	9,450	41%
TOTAL	21,521	100%	22,056	100%	20,698	100%	23,119	100%

Source: Banco de España

On a PO and IO split, we find that mutual funds retained their preference for principal only strips, while insurers and pension funds invested primarily in interest, driven, presumably, by the search for securities that more precisely match their liabilities.

FIGURE 5.2.B. INVESTOR PREFERENCES: PRINCIPLE (PO) VS. INTEREST (IO)



Counting in both held-to-maturity and registered portfolios, we find that 86% of POs and 77% of held-to-maturity IOs in credit institution portfolios have been assigned via repos or buy-sell backs to mutual funds and, to a lesser extent, households. Non residents, conversely, tend to hold their Debt investments to maturity.

5.3. NON RESIDENT DEBT HOLDINGS: DISTRIBUTION BY COUNTRY

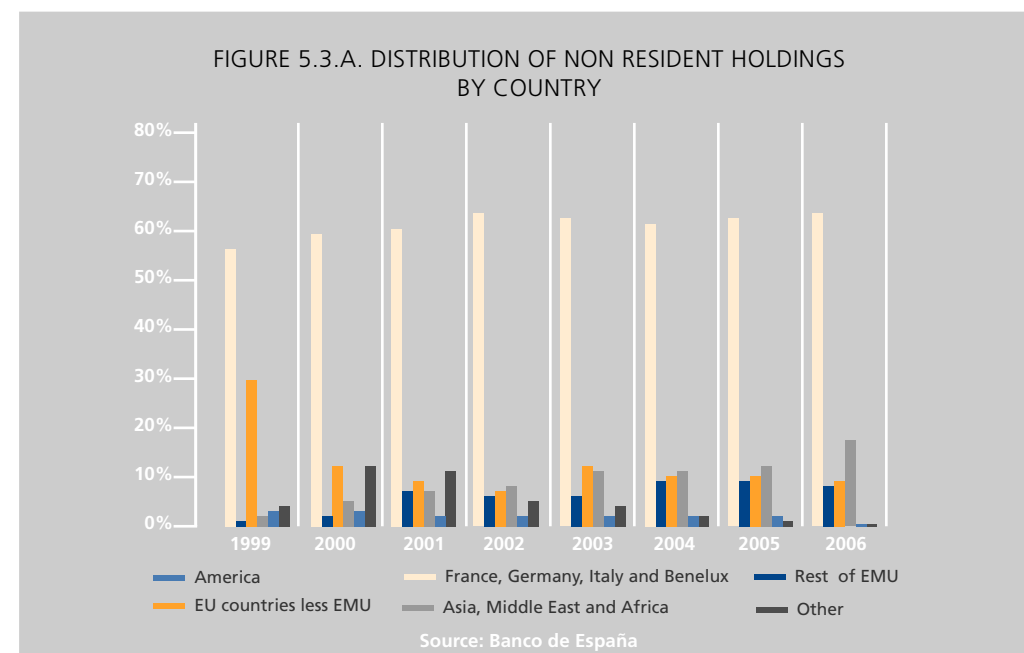
Regarding the ownership split by country of Spanish Debt holdings, the end 2006 data show as follows:

France tops the list of non resident investors, followed by Japan and Germany.

79% of non resident investment is EU based

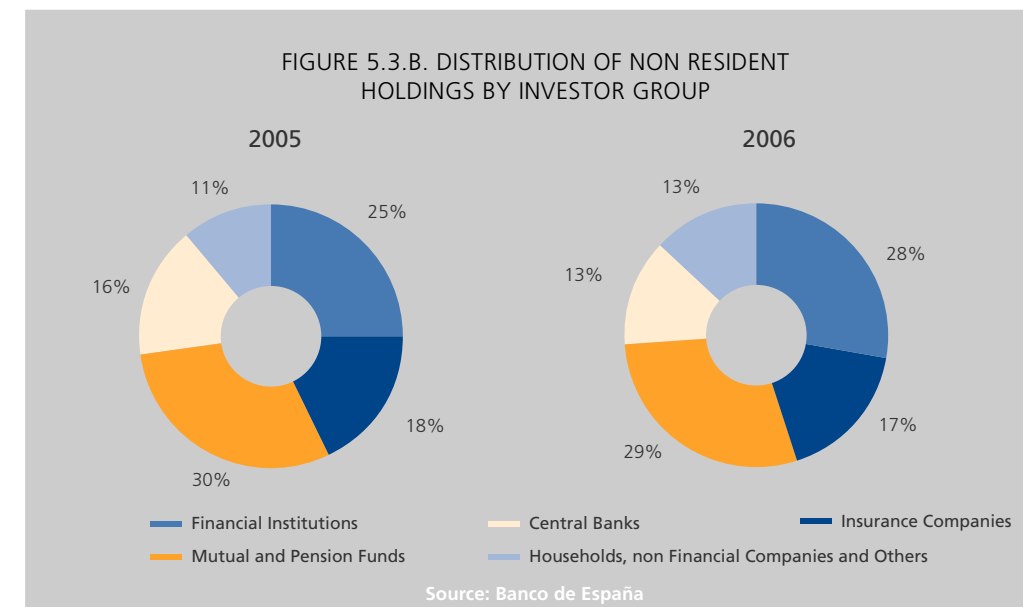
Japanese investors take a growing share

- The main country of origin is France, with 23% of the non resident total, followed by Japan with 11% and Germany with 10%. The United Kingdom was the largest source of foreign ownership until 1999 but has since reduced its share dramatically, from 42% in 1998 to 8% at present.
- As much as 79% of non resident investment originates in the European Union (EU). The relative share of EU member countries has varied little since 2005, though note that Italy came up three points in 2006 primarily at the expense of Germany.
- Outside the EU, Japanese investors increased their holdings from 7% in 2005 to almost 11% one year later, while the share of US investors receded slightly to just over 1%.



- By investor category, 29% of non resident holdings were lodged with mutual funds and another 28% with other financial institutions. A salient 2006 development was the growing share of central banks, from a bare 2.4% of non resident ownership to 13% today. The top credit rating awarded to Spain has undoubtedly favoured this trend.

29% of non resident ownership falls to mutual and pension funds, 28% to financial institutions and 13% to central banks



REGULATORY FRAMEWORK OF THE BOOK-ENTRY DEBT MARKET AND BUDGET LEGISLATION

BASIC LEGAL FRAMEWORK

- **General Budget Law 47/2003** of 26 November (BOE [Spanish Official Bulletin], 27 November 2003).
- **Budgetary Stability Law 18/2001** of 12 December. (BOE, 13 December 2001).
- **Law 15/2006** of 26 May amending Budgetary Stability Law 18/2001 of 12 December (BOE, 27 May 2006).
- **National Budget Law 30/2005** of 29 December approving the 2006 Budget (BOE, 30 December 2005).
- **Royal Decree** providing for Public Debt creation on an annual basis (repealed on the entry to force of General Budget Law 47/2003).

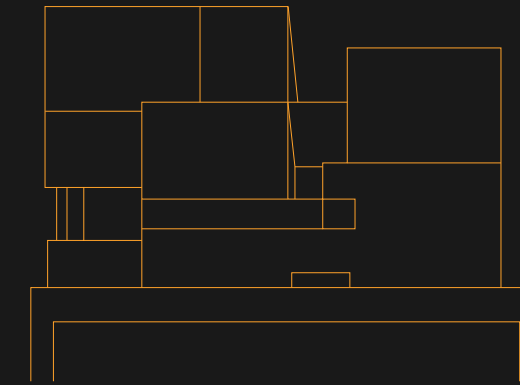
- **Order EHA/4247/2005** of 30 December providing for Central Government Debt creation in 2006 and January 2007, and delegating certain powers to the Director General of the Treasury and Financial Policy (BOE, 16 January 2006).
- **Royal Decrees 553/2004** of 17 April (BOE, 18 April 2004) and **562/2004** of 19 April (BOE, 20 April 2004) on the reorganisation of ministerial departments.
- **Royal Decree 1552/2004** of 25 June regulating the organic structure of the Ministry of Economy and Finance (BOE, 26 June 2004).
- **Orders EHA/1112/2004** of 28 April (BOE, 29 April 2004), **3057/2004** of 21 September (BOE, 27 September 2004) and **3923/2004** (BOE, 30 November 2004) on the ratification and delegation of powers.
- **Securities Market Law 24/1988** of 28 July (BOE, 29 July 1988) and successive amendments.
- **Law 37/1998** of 16 November amending Securities Market Law 24/1988 of 28 July (BOE, 17 November 1998).
- **Law 41/1999** of 12 November on securities payment and settlement systems (BOE, 13 November 1999).
- **Royal Decree-Law 5/2005** of 11 March on urgent measures to enhance productivity and improve public procurement (BOE, 14 March 2005).
- **Royal Decree 1310/2005** of 4 November implementing the provisions of Securities Market Law 24/1988 of 28 July with regard to admission of securities to trading on regulated secondary markets, public share and rights offerings and their corresponding prospectuses (BOE, 16 November 2005).
- **Royal Decree 505/1987** of 3 April providing for the creation of a book-entry system for Central Government Debt (BOE, 14 April 1987).
- **Royal Decree 116/1992** of 14 February, on the representation of securities by book entries and the clearing and settlement of stock market transactions (BOE, 20 February 1992).
- **Financial Law 44/2002** of 22 November (BOE, 23 November 2002), whose first transitional provision establishes the Sociedad de Sistemas de Registro, Compensación y Liquidación de Valores, merging the registration systems of the Servicio de Compensación y Liquidación de Valores and those of the Banco de España book-entry system, to manage the registration, clearing and settlement of Book-Entry Public Debt.
- **Order of the Ministry of Economy and Finance of 10 February 1999** regulating the office of Primary Dealer in Kingdom of Spain Debt. (BOE, 13 February 1999). Specific implementing provisions are contained in a Resolution of the General Directorate of the Treasury and Financial Policy, dated 20 July 2005, in respect of Kingdom of Spain Primary Dealers (BOE, 28 July 2005).

- **Order EHA/2688/2006** of 28 July on partnership agreements relative to mutual funds specialising in Central Government Debt (BOE, 19 August 2006).
- **Auction calendars, the characteristics of the Letras, Bonos and Obligaciones** to be issued and the volume of placements are set by Resolution of the General Directorate of the Treasury and Financial Policy. In 2006: Resolution of 17 January 2006 of the General Directorate of the Treasury and Financial Policy specifying determined issues of Bonos del Estado and Obligaciones del Estado and publishing the auction calendar for 2006 and January 2007 (BOE, 24 January 2006); and Resolution of 17 January 2006 of the General Directorate of the Treasury and Financial Policy specifying determined issues of Letras del Tesoro at three, six, twelve and eighteen months during 2006 and January 2007 and calling the corresponding auctions (BOE, 27 January 2006).

OTHER PROVISIONS

- **Order ECO/689/2003** of 27 March approving the Regulations of the Sociedad de Sistemas de Registro, Compensación y Liquidación de Valores (BOE, 28 March 2003).
- **Order EHA/2393/2006** of 14 July regulating the arrangement by the General Directorate of the Treasury and Financial Policy of credit lines and other short-term financing instruments, as well as the taking out of medium- and long-term loans.
- **Order ECO/1860/2003** of 30 June for the arrangement of credit lines in euros to be drawn on via Letras del Tesoro issues, and calling a tender to select the financial institutions with which agreements will be concluded (BOE, 5 July 2003). Credit lines open to 28 July 2006.
- **Resolution of 17 July 2003 of the General Directorate of the Treasury and Financial Policy** publicising the results of the selection process for the arrangement of the above credit lines in euros (BOE, 23 July 2003). Credit lines open to 28 July 2007.
- **Resolution of 20 December 2005 of the General Directorate of the Treasury and Financial Policy** calling the next liquidity auctions and amending the Resolution of 26 January 2001 regulating Treasury liquidity auction procedures (BOE, 27 December 2005).

[Museum of Almería]



FINANCIAL POLICIES

The financial sector landscape is an increasingly international one, whose distinguishing features are its growing competitiveness and the difficulty of controlling the immense variety of new activities and products emerging in our global markets. This situation calls for a finely balanced regulatory effort at European level and within Member States that allows new activities and products to be brought to market while guaranteeing financial stability and investor protection. The General Directorate of the Treasury and Financial Policy is the Ministry of Economy and Finance department responsible for directing, developing and regulating financial policy, and to this end has been assigned a series of competences in three major areas:

- The drafting and processing of legal provisions governing financial and credit institutions, securities markets, payment systems and instruments, the legal framework for listed companies and corporate governance, and capital movements and cross-border transactions.
- Representation on European Union Technical Committees dealing with credit institutions, financial markets, collective investment undertakings and other financial matters, as well as on the Financial Markets Committee and the Corporate Governance Steering Group of the Organisation for Economic Cooperation and Development.
- The reception and processing of authorisation applications from financial entities.

Its work in these three areas throughout 2006 was informed by the guidelines of the Financial Services Action Plan of the European Union, which provided a comprehensive strategy framework for an intense national and EU legislative programme. The year was also a busy one in terms of preparing and negotiating new draft provisions that will foreseeably see the light in 2007. Finally, the healthy state of Spain's economy was evidenced by numerous applications to create financial entities or amend the bylaws of existing ones, either to adapt them to new regulations or with a view to improving their internal management.

Spanish financial regulation keeps pace with the European framework

6.1. SPANISH FINANCIAL LEGISLATION

6.1.1. LAWS AND REGULATIONS APPROVED IN 2006

Law 12/2006 of 16 May amending the consolidated text of the Statute of the Insurance Compensation Pool, approved by Legislative Royal Decree 7/2004 of 29 October, and Securities Market Law 24/1988 of 28 July.

This legal text transposes articles 6.9 of Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation, and articles 7 to 11 of Commission Directive 2004/72/EC of 29 April 2004. To this end, it inserts a new article into the Securities Market Law requiring certain obligated parties to report any transactions to the securities regulator (Comisión Nacional del Mercado de Valores, CNMV) which they suspect may involve the use of inside information or constitute an attempt to manipulate prices. It also completes the regulation of Bolsas y Mercados Españoles, Sociedad Holding de Mercados y Sistemas Financieros, S.A. or any future securities exchange management entity to provide it with a more flexible operational structure. Finally, the law clarifies and standardises significant shareholding rules with regard to the management companies of registration, clearing and settlement systems for Spanish securities and secondary markets.

Order EHA/1094/2006 of 6 April implementing the conditions to apply to official secondary markets in energy derivatives.

Financial derivatives markets are joined by other futures and options markets dealing in non financial goods or underliers, along the lines of the “commodity markets” that enjoy such a long tradition in the United States. Specifically, it was there, back in 1848, that the first ever futures market on agricultural produce was founded, the Chicago Board of Trade. Futures markets on non financial underliers have seen something of a boom in Europe since the end of the last century, with the result that contracts can now be arranged on over one hundred commodities worldwide. In Spain, immediate forerunners are the citrus fruit futures and options market created in 1995 and the olive oil futures and options market that followed in 2003.

In furtherance of the “Plan to Dynamise the Economy and Enhance Productivity”, the Council of Ministers resolved at its meeting of 25 February 2005 to charge the Ministry of Economy and Finance with preparing the regulatory ground for the creation of official secondary markets in energy futures and options. Getting the right legal framework for these markets to operate is particularly crucial following the entry to force of the agreement between Spain and Portugal to create an Iberian Electricity Market.

The Order sets out the specific rules to apply to official secondary markets in energy futures and options relative to financial futures and options markets. It stipulates which financial instruments will be admissible for trading, and defines the involvement of the different sector regulators in authorising the opening of such markets, the Regulations to govern their activities and the general conditions of the contracts to be traded. It also determines the minimum contents of market Regulations, the regime for approving and amending standard contract conditions and the way these are to be distributed to the investor public, and lays down rules for the suspension of market trading or the trading of a particular contract. Market management companies also have their role and structures defined and regulated, including equity requirements, qualifying conditions for board of director membership and the additional functions they may be called on to perform. Market membership will extend to brokers, broker-dealers and the group known as industrial members, for whom the Order sets a number of entry requirements with regard to equity, board membership and significant shareholdings. General conditions are also laid down for all market members, including application procedures and the rules of conduct and disclosure they must subsequently adhere to. Finally, the CNMV is empowered to issue any provisions necessary to implement the terms of the Order.

Additionally, a series of amendments to Order ECO/3235/2002 of 5 December define the conditions to apply to official olive oil futures and options markets, the idea being to attract in more members and boost their trading activity. Measures taken include a reduction in minimum equity requirements, a change of wording to replace “board of directors” with a more general reference to “governing body” and a special disclosure regime for industrial members.

Order EHA/1199/2006 of 25 April implementing certain provisions of the Regulations to Law 35/2003 of 4 November on collective investment schemes with regard to hedge funds and funds of hedge funds, and empowering the Comisión Nacional del Mercado de Valores to issue provisions in their respect.

Collective investment schemes (CIS) are now among the most popular savings vehicles in the Spanish financial system. Their success has called for changes in the regulatory framework to keep pace with sector expansion. This is one reason why the rules governing CIS have been overhauled in the last few years with the passage of two key pieces of legislation: Law 35/2003 of 4 November on collective investment schemes (hereafter, the CIS Law) and Royal Decree 1309/2005 of 4 November approving the Regulations to the said Law (hereafter, the Regulations). Order EHA/1199/2006 rounds off the regulatory cycle in the Spanish collective investment industry initiated with these two texts with regard to the globally important hedge fund market. Its purpose is to lay down the legal rules governing hedge funds and funds of hedge funds, with specific reference to their investment regime and leverage policies, addressing such vital questions as which items should and should not be factored into leverage limits. It also specifies the assets in which funds of hedge funds can invest the compulsory 60 percent ratio imposed by the CIS Regulations. General criteria are laid down for calculating the net asset value of hedge fund or fund of hedge fund units or shares, along with more detailed rules on redemption rights and the estimated NAV regime. Finally, the text elaborates on the regime applying to management companies and custodians and eligible collateral, and the procedures to be followed with investor consent forms. An additional provision empowers the CNMV to issue instructions for the calculation of performance-related management fees as regards not only hedge funds but all collective investment schemes.

Order EHA/2573/2006 of 12 July amending article 4.2 of the Regulations on MFAO, Sociedad Rectora del Mercado de Futuros del Aceite de Oliva, S.A.

In April 2005, MFAO, Sociedad Rectora del Mercado de Futuros del Aceite de Oliva, S. A., the management company of the olive oil futures market, approached the CNMV with a proposed amendment to article 4.2 of the Olive Oil Futures Market Regulations regarding the entry conditions

A comprehensive legal framework for hedge funds

New provisions regulate the establishment of official secondary markets in energy futures and options

for industrial market members. Order EHA/2573/2006 authorises the said amendment, in accordance with articles 4.1 and 2.1 of Royal Decree 1814/1991 of 20 December regulating official futures and options markets, which empowers the Minister of Economy and Finance to approve amendments to market Regulations at the proposal of the Comisión Nacional del Mercado de Valores.

6.1.2. LEGISLATIVE PROJECTS FOR 2007

The mortgage market, distance marketing of financial services, takeover bids, transparency, capital adequacy and markets in financial instruments make up the legislative agenda for 2007

The General Directorate of the Treasury and Financial Policy has worked throughout 2006 on preparing a diverse range of legal norms that should see the light in the coming year. The reform of the mortgage market and the transposition of EU Directives on the distance marketing of financial services, takeover bids and issuer transparency, capital adequacy and markets in financial instruments are all at an advanced stage in the national legislative pipeline, while a number of regulatory texts are awaiting their definitive approval and entry to force.

Draft Law on the distance marketing of consumer financial services.

This Draft has been prepared for the writing into Spanish law of Directive 2002/65/EC of the European Parliament and of the Council of 23 September 2002 concerning the distance marketing of consumer financial services. Part of this text has already been transposed via Law 4/2003 of 4 November amending private insurance legislation and adapting it to European Union rules.

The Distance Marketing Directive, which carries forward the EU's commitment to achieve the effective integration of European financial services markets by the year 2005, forms part of the Financial Services Action Plan (FSAP) launched as a vehicle for attaining this objective. Accordingly, its text prepares the ground for the distance selling of financial services to become one of the most tangible, visible expressions of internal market completion.

The Directive provides a minimum framework for distance financial services contracts, harmonising basic rules with regard to the offering, negotiation and conclusion of contracts, and ensuring consumers are adequately informed both before and after entering into a service agreement. It comes to supplement Directive 97/7/EC on the protection of consumers in respect of distance contracts, which established consumer safeguards for most goods and services other than financial services, due to the specific nature of the same. Its goal is therefore to fill this legal gap and establish a common set of rules to govern distance financial services contracts.

Draft Law amending Securities Market Law 24/1988 of 28 July with regard to the legal regime of takeover bids and issuer transparency.

This proposed amendment to the Securities Market Law will mark the partial transposition to Spanish law of EU Directives on takeover bids (Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids) and transparency (Directive 2004/109/EC of the European Parliament and of the Council on the harmonisation of transparency requirements in relation to information about issuers whose shares are admitted to trading on a regulated market, amending Directive 2001/34/EC). The full transposition of the Transparency Directive will also mean the amendment or, where appropriate, repeal of other provisions at regulatory level. In the paragraphs that follow we look at the main novelties introduced by the two Directives.

The Takeover Bids Directive forms part of the Financial Services Action Plan unveiled by the Commission in its Communication of 11 May 1999. The European Council of Lisbon also considered it a priority measure for the integration of financial markets. The Directive provides the legal framework for compulsory takeover bids targeting 100% of the capital of a listed company.

The Directive's objectives are expressed in the following general principles, which should be respected at all times:

- Principle of equivalent treatment: all holders of the securities of an offeree company of the same class must be afforded equivalent treatment.
- Protection of minority shareholders: if a person acquires control of a company, the other holders of securities must be protected.
- All takeover bids must take care to ensure that the holder of the securities of the offeree company have sufficient time and information to reach a properly informed decision on the bid.
- The board of an offeree company must treat all holders of securities equally and act in the interests of the company as a whole.
- Offerors must ensure that they can meet in full any cash consideration placed on the table when the bid was launched.
- A bid must not hinder an offeree company in the conduct of its business for longer than is reasonable.

The Transparency Directive is another of the Financial Services Action Plan measures adopted by the European Commission in 1999. Specifically, it forms a package of FSAP measures with the Regulation on International Accounting Standards (IAS) and the Market Abuse and Prospectuses Directives whose object is to establish a regime of disclosure common to all issuers of securities admitted to trading in EU markets.

The text aims to enhance the transparency of financial markets by improving the quantity and quality of the information provided to investors by the issuers of securities traded on regulated markets. Its main requirements relate to periodic financial reporting on an annual, half yearly and quarterly basis and the disclosure of significant shareholdings in the capital of listed companies. Rules are also laid down for the information issuers must give their share or bondholders with regard, primarily, to shareholders' or bondholders' meetings. The fact it is a minimum harmonisation Directive means Member States can choose to impose greater requirements on home market issuers.

Preliminary Draft on the modernisation of the mortgage market, regulating reverse mortgages and dependency insurance.

The Spanish mortgage market is one of the most efficient and competitive in Europe. However most of its core laws and regulations were passed some years ago, in 1981 and 1994, in a market setting very different from today's. It is therefore time to adapt its regulatory framework to new instruments and widen the choice available to families and businesses. The underlying aim of the reform process is to help the market stay efficient, competitive and accessible in these changed conditions. Measures include:

- Improved safeguards for consumers, by requiring financial institutions to be more transparent and precise in the information they give out.
- Removal of obstacles in the way of institutions offering interest rate protection under attractive conditions, so consumers have a wider choice of product.

- Change and reduction in early repayment penalties with or without subrogation.
- Lower notarial expenses for changing or cancelling a mortgage loan.
- Regulation of reverse mortgages for homeowners aged over 65 or in a state of dependency, and of dependency insurance.
- Promotion of a more independent appraisal sector.
- A more flexible legal regime for refinancing mechanisms.

Preliminary Draft amending Law 13/1985 of 25 May on the investment ratios, equity and reporting obligations of financial intermediaries.

National supervisory authorities can do little on their own in today's increasingly transnational financial markets, which are also in need of harmonising measures in respect of the prudential criteria for financial intermediary capital adequacy. Hence a series of harmonisation projects have been set in train to address the varied problems, among them of competitiveness and financial stability, deriving from the regulatory differences that separate states.

The Basel II Capital Accord of 2004 and, in the European Union, Directives 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions and 2006/49/EC of the European Parliament and of the Council, dated 14 June 2006, on the capital adequacy of investment firms and credit institutions, have deployed a battery of measures structured around three mutually supporting Pillars. Each of these Pillars represents a different approach to supervision: Pillar One emphasises the adoption of uniform rules and lays down minimum capital requirements; Pillar Two introduces a system of supervisory review aimed at improving firms' internal risk management; and, finally, Pillar Three seeks to maximise the disciplinary force of market scrutiny, by obliging firms to disclose key aspects of their business mix, risk exposure and risk management policy.

Directive 2006/48/EC establishes a set of prudential supervision rules to foster closer convergence in the regulatory and supervisory practices of the competent authorities in Member States, with the Basel II Accord as the guiding light.

The Draft Law transposes the relevant Directive in strict but only partial terms, since the EU text's complex technical requirements will need to be phased in through a number of provisions of lower rank.

Preliminary Draft amending Law 24/1988 of 28 July in order to transpose the Directive on Markets in Financial Instruments.

Again in accordance with the Financial Services Action Plan, the EU approved Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments (MiFID), amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC. The new text is designed to strengthen the Community legislative framework for investment services and regulated markets with a view to furthering two major regulatory objectives:

- Protect investors and safeguard market integrity by establishing harmonised requirements for the activities of authorised intermediaries.
- Promote fair, transparent, efficient and integrated financial markets.

In 2006, work progressed on drafting the transposed text of the MiFID, including the necessary amendments to the current Securities Market Law.

Draft Royal Decree implementing articles 31, 44 bis and additional provision 17 of the Securities Market Law.

The Draft proposes a series of amendments to Securities Market Law 24/1988 of 28 July in response to the newly enacted Law 12/2006 of 16 May, which requires the recasting of its articles 31.6, 44 bis.3, 48.1 and its seventeenth additional provision, in order to provide a more flexible regime for the owners of the management companies of securities exchanges and registration, clearing and settlement systems. The changes introduced by Law 12/2006 facilitated the stock market flotation of the holding company "Bolsas y Mercados Españoles, Sociedad Holding de Mercados y Sistemas Financieros, S.A." (BME). Its text also clarified and standardised the rules governing significant shareholdings in the said management companies.

Draft amendments to diverse financial sector regulations.

A series of amendments are being prepared for eight financial sector regulations. Changes are designed to eliminate obsolete references, clarify certain ambiguities, add flexibility where needed and repeal provisions that are no longer relevant, and will act on the regime governing hedge funds and funds of hedge funds and that of exchange management companies. Also, portfolio management companies will be brought within the same regulatory regime as other investment firms.

Draft Order amending Order ECO/805/2003 of 27 March on rules for the appraisal of real estate assets and of certain rights for financial purposes.

This text's main purpose is to fight tax fraud by means of the compulsory inclusion in appraisal reports of a property registry number. Other provisions deal with real estate investment funds and appraisal services in insurance, or amend certain terms of the Order to improve their effectiveness and technical quality.

Draft Order establishing rules for the accounts, valuation, diversification ratios and other aspects of collective investment schemes whose investment policy is to reproduce, replicate or take as benchmark a given stock or bond index, and charging the CNMV with their implementation.

The Draft Order elaborates on a number of legal provisions contained in Law 35/2003 of 4 November concerning collective investment undertakings and its implementing Regulations as approved by Royal Decree 1309/2005 of 4 November. Aspects touched on include the accounts kept by collective investment schemes, the determination of their assets, the rules for calculating risk diversification ratios, collective investment undertakings whose investment policy is to reproduce, replicate or take as benchmark a given stock or bond index, and the standards required of the internal control and risk control and management systems of fund management companies. The Comisión Nacional del Mercado de Valores is empowered to fill out its contents in appropriate respects.

6.2. EUROPEAN FINANCIAL LEGISLATION

FSAP rollout continues under the guidelines set in the White Paper on Financial Services Policy

The completion of a single financial services market in Europe is at the hub of the economic reform drive known as the "Lisbon Strategy". The Financial Services Action Plan 1999-2005 (FSAP) did much to advance this cause by way of improvements in sector efficiency and increased financial stability. It was with the idea of expanding on these labours while retaining a Community focus on the regulation and control of financial services that the Commission published its White Paper on Financial Services Policy spelling out its guidelines for the next five years:

- Consolidate progress to date.
- Complete the initiatives under way.
- Enhance supervisory cooperation and convergence.
- Remove the last obstacles to integration.

These general guidelines are joined by a series of priorities; among them, to go on boosting the efficiency of pan-European markets in long-term savings products, to complete a single retail market and to secure a better functioning risk capital market.

Within this framework, legislative activity has proceeded on four main fronts: retail banking, Solvency II for the insurance industry, the review of qualifying shareholdings and clearing and settlement. The main 2006 milestones in Community financial legislation were the approval of the Capital Adequacy Directive, the publication of the White Paper on Investment Funds and the approval of technical measures implementing the MiFID. Significant progress can also be reported in clarifying supervisor authorisation procedures in respect of cross-border mergers and acquisitions, and the definition of the priority lines to be taken in reforming company law.

6.2.1. DIRECTIVES UNDER NEGOTIATION

Negotiations will continue in 2007 regarding new EU Directives on payment services, consumer credit, shareholder rights and the acquisition of significant shareholdings

Proposal for a Directive on payment services in the internal market.

The proposed Directive establishes a common framework for the Community payments market, creating the right conditions for integrating and rationalising national payment systems. This proposal stands alongside the industry-sponsored SEPA project (Single Euro Payment Area). Negotiations are already well advanced and the text should reach the statute books in 2007.

Proposal for a Directive on the harmonisation of the laws, regulations and administrative provisions of Member States concerning credit for consumers

The Council continued its deliberations on the amended proposal, looking for a text that would contribute value-added. The Ministry of Economy and Finance forms part of the Spanish delegation headed by the Ministry of Health and Consumer Affairs.

The proposal pursues three core objectives in the consumer lending sphere:

- Establish the conditions for a genuine internal market.
- Ensure a high level of consumer protection.
- Improve the clarity of Community legislation by consolidating the three current directives on consumer credit (87/102/EC, 90/88/EC and 98/7/EC).

Proposal for a Directive on the exercise of voting rights by the shareholders of companies having their registered office in a Member State and whose shares are admitted to trading on a regulated market.

This proposal is aimed at facilitating the cross-border exercise of shareholders' voting rights. The specific objectives sought are:

- Ensure that general shareholders meetings are convened with sufficient notice and that all documents are available in time.
- Abolish all forms of share blocking: to be replaced by a record date system to determine the entitlement of a shareholder to participate and vote in a general meeting.
- Remove legal obstacles to electronic participation in general meetings.
- Provide simple means of voting without attending the meeting (voting by proxy, postal vote, voting instructions).

The text has been readied for submission to the European Parliament and subsequent approval by the Council.

Proposal for a Directive amending directives 92/49/EEC, 2002/83/EC, 2004/39/EC, 2005/68/EC and 2006/48/EC as regards procedural rules and evaluation criteria for the prudential assessment of acquisitions and increase of shareholdings in the financial sector.

This proposal aims to improve legal certainty, clarity and transparency with regard to the acquisition of significant shareholdings in financial institutions, reducing the latitude afforded to the supervisory authorities.

6.2.2. DISCUSSIONS AT COMMISSION GROUPS

European Commission Group on company law and corporate governance.

The Group has been meeting regularly to examine possible legislative proposals in its subject areas.

European Commission Group on electronic money.

After the assessment carried out in 2006, the Group has gone on to discuss concrete ways to amend the Directive now in force.

European Commission Group on the mortgage market.

A White Paper is planned for 2007.

6.2.3. EUROPEAN COMMITTEES

European Securities Committee.

The Committee approved a long list of implementing rules in 2006, with particular regard to the MiFID and UCITS directives, and plans are for it to meet monthly in 2007 with a slightly lighter agenda.

European Banking Committee.

Sub-groups pressed on with their work in areas such as large exposures and deposit guarantee funds, and will go on meeting on a quarterly basis in 2007.

6.2.4. PARTICIPATION OF THE GENERAL DIRECTORATE OF THE TREASURY AND FINANCIAL POLICY IN OTHER INTERNATIONAL FORUMS ENGAGING WITH FINANCIAL POLICY

Negotiation of the Hague Convention.

This Convention regulates formal rights pertaining to securities held with financial intermediaries. So far, there is insufficient consensus for the Convention to be signed.

Negotiation of the Unidroit Convention.

This Convention regulates substantive matters on intermediated securities. It is substantially a parallel document to the Hague Convention, and an agreement may be forthcoming in the first half of 2007, after which a Diplomatic Conference will be called for its adoption.

Participation in OECD Groups.

The Corporate Governance Group has continued to meet regularly, as have cooperation forums with Latin America and Mediterranean and North African countries.

6.3. MANAGEMENT

6.3.1. INTRODUCTION

Financial legislation lays down a series of formalities to be observed by entities operating in securities markets and in the ambit of credit institutions. In most cases, these are authorisations firms must seek to carry out a determined operation: incorporation, change of bylaws, corporate transactions, etc. The law also provides for permits to be revoked or withdrawn.

The General Directorate of the Treasury and Financial Policy has a voice in these procedures, although its exact function varies with the area concerned. The following sections describe the main procedures in place and the applications made under each in 2006, summing one hundred and thirty-four.

6.3.2. PROCEDURES IN THE SECURITIES MARKET SPHERE

The securities market area includes three differentiated groups, each with its own regulatory framework and procedural rules: investment firms, venture capital management companies (SGECR) and fund managers (SGIIC).

Applications are submitted to the CNMV, which studies them then refers its proposal to the Minister of Economy and Finance. The General Directorate of the Treasury and Financial Policy examines the proposal then refers it in turn to the State Secretary for the Economy (to whom powers have been delegated by the Minister). The decision of the Secretary is then issued, as the case may be, in a Ministerial Order. The file is sent back to the CNMV which conveys the result to the interested parties.

Authorisation procedures for investment firms are regulated by Securities Market Law 24/1988 of 28 July and Royal Decree 867/2001 of 20 July, on the legal regime of investment firms. A total of 16 applications were studied in 2004. The average time elapsing from a file being received by the General Directorate of the Treasury and Financial Policy and its referral for signing to the Secretary of State was eleven calendar days. Procedural formats may be of various types:

- Authorisation of investment firm:
 - Securities broker: 2 applications
 - Securities broker-dealer: 2 applications
 - Portfolio management company: no applications
 - Authorisation for change to investment firm schedule of activities: 2 applications
 - Authorisation for change in bylaws: 2 applications
 - Authorisation for corporate transactions (change of form, merger, de-merger, spin-off, etc.):
 - Transformation from broker to broker-dealer: 2 applications
 - Takeover of one investment firm by another: no applications
 - Takeover of an investment firm by a credit institution: 4 applications
 - Global assignment of investment firm assets and liabilities to a credit institution: 1 application
 - Other corporate transactions: 1 application
- Total: 16 applications

Until December 2005, risk capital entities were governed by Law 1/1999 of 5 January regulating risk capital entities. As of the entry to force of Law 25/2005 of 24 November regulating venture capital entities and their management companies, all applications regarding venture capital funds and companies have been handled by the CNMV, with this Ministry's part confined to management companies (SGEGR). In this respect, the 13 applications received in 2006 were processed by the General Directorate of the Treasury and Financial Policy in an average of 15 days.

Another novelty of Law 25/2005 is that these institutions must have internal control units and procedures in place for the prevention of money laundering. These preventive requirements have since been joined by others regarding tax fraud, enshrined in Law 36/2006 of 29 November, whose second final provision recasts article one of Law 19/1993 of 28 December to add venture capital management companies and venture capital firms acting without management companies to the list of obligated parties under anti laundering legislation.

- Authorisation of SGEGR: 10 applications
- Change in bylaws of SGEGR: 3 applications
- Revocation of authorisation of SGEGR: no applications

Total: 13 applications

Finally, currently legislation on collective investment undertakings (Law 35/2003 of 4 November) establishes the following procedures. A total of 7 applications were studied in 2006 with regard to fund management companies (SGIIC), with an average of around 40 days processing time in the General Directorate of the Treasury and Financial Policy, including scrutiny of the mandatory report from the Executive Service of the Commission for the Prevention of Money Laundering and Monetary Offences (SEPBLAC).

- Authorisation for the setup of SGIIC: 7 applications
- Change in bylaws of SGIIC: no applications
- Revocation of authorisation of SGIIC: no applications

Total: 7 applications

6.3.3. PROCEDURES IN THE CREDIT INSTITUTION SPHERE

Procedures for credit institutions vary with the type of institution involved (banks, financial credit establishments, credit cooperatives, etc.). They also take a different route depending on the type of operation (incorporation, change in bylaws, revocation of authorisation). The applications filed with the General Directorate of the Treasury and Financial Policy generally require a mandatory report from Banco de España. The proposal of the General Directorate is normally referred for decision to the Secretary of State for the Economy, who holds delegated powers of decision from the Minister of Economy and Finance. All the information legally required for the correct processing of the application is sought from the applicant, if it was not furnished on submission.

Listed below are the formal procedures applicable to the different types of credit entities along with the number of applications processed for each in 2006, summing 98. The average time elapsing from receipt of the application to the decision date was three months (this figure is orientative only as the time to decision varies widely from one process to another).

- Creation of credit institutions:

Banks: no applications

Financial credit establishments: 3 applications

Mutual guarantee companies: no applications

- Change in bylaws:

Banks: 30 applications

Savings banks: no applications

Credit cooperatives: 25 applications

Financial credit establishments: 6 applications

Mutual guarantee companies: 12 applications

Branches of non-EU institutions: no applications

- Revocation of authorisation due to discontinuation of business:

Banks: no applications

Financial credit establishments: 2 applications

Branches of non-EU institutions: 1 application

Branches of EU credit institutions: no applications

- Revocation of authorisation in cases of takeover:

Banks: 1 application

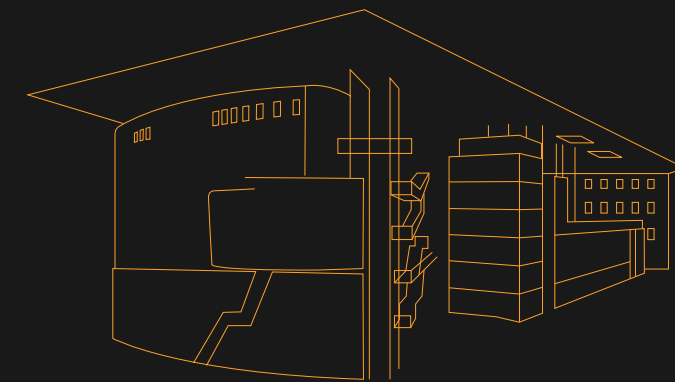
Credit cooperatives: no applications

Financial credit establishments: no applications

- Other applications: 18 applications

Total: 98 applications

[Reina Sofía Museum. Madrid]



PREVENTION OF MONEY LAUNDERING AND TERRORIST FINANCING

7

Our financial markets and institutions may at times be utilised to give an appearance of legitimacy to the proceeds of criminal activities or to channel funds to terrorist groups.

The public powers have responded to this threat by deploying a battery of measures to detect laundering offences and break up the organised networks that lie behind them. At the same time, preventive efforts have been redoubled to facilitate the identification of suspicious transactions and in this way hinder the progress of money laundering activities.

Prevention and control

In today's globalised economy, money launderers and terrorist financiers increasingly operate on a transnational scale as a means to evade detection. Hence the growing international movement to coordinate anti-laundering action through forums and organisations of which Spain is an active member.

A transnational crime

Another defining characteristic of modern-day society is the development and spread of new technologies and Internet use. In order to turn these instruments to best advantage, the Commission for the Prevention of Money Laundering and Monetary Offences has set up a dedicated website to help raise awareness around money laundering issues.

Commission website

7.1. SPANISH LEGISLATION

7.1.1. MINISTERIAL ORDER 1439/2006 OF 3 MAY REGULATING THE PRIOR DECLARATION OF CASH MOVEMENTS FOR THE PURPOSE OF MONEY LAUNDERING PREVENTION

This legal text reflects the new way of dealing with cash movements, which are now being addressed from a money laundering prevention rather an exchange control angle. This approach, followed for this first time in Law 19/2003, recognises the evidence compiled by the International Groups dealing in money laundering typologies about the growing use of large cash sums in criminal activities.

Novelties introduced by the Order

The main novelties introduced by the Ministerial Order are:

- Compulsory prior declaration of cash movements throughout national territory, to provide the competent authorities with background information of inestimable use in the fight against money laundering.
- Raising of declaration thresholds to 10,000 euros for cross-border movements and 100,000 euros for movements within national territory.
- The Order specifies the forms to be used for declarations and the place and manner of their presentation, seeking at all times to maximise compliance. Hence in certain cases, and with due precautions, declarants can present the forms in the offices of registered credit institutions.
- The seizure of the entire cash sum is provided for in cases of omissions or misrepresentations. The competent authorities may decide to award up to 1,000 euros as a minimum subsistence allowance depending on the circumstances.
- Obligated parties under anti money laundering legislation are obliged to list all transactions they channel that are subject to declaration in their monthly or systematic reporting to the Commission's Executive Service.
- Finally, the text stresses the importance of collaboration between government departments, with particular mention to the exchange of data between the Executive Service and the tax authorities.

In order to maximise enforcement of these provisions, a special working group has been set up bringing together members of all the administrative departments involved, with the remit to design specific implementing measures.

This group has already coordinated the deployment of a control operation on cross-border cash movements, including a greater number of routine checks at the country's busiest airports.

7.1.2. MINISTERIAL ORDER 2619/2006 OF 28 JULY IMPLEMENTING ANTI MONEY LAUNDERING RULES APPLICABLE TO OBLIGATED PARTIES ENGAGING IN CURRENCY EXCHANGE OR THE MANAGEMENT OF CROSS-BORDER MONEY TRANSFERS

All the international organisations and groups dealing with money laundering prevention concur that money transfers and currency and traveller's cheque exchange are among the activities most exposed to being utilised for money laundering or terrorist financing.

This kind of activity has multiplied its turnover in the past eight years, when the number of foreign nationals living in Spain has grown more than four times over. Business growth has attracted in new types of providers, such as credit institutions or postal services, and it is important that laundering prevention legislation dispenses an equal treatment to all, so no obligated party gains an unfair advantage. That said, there may be times when the nature of a business counsels added precautions.

With this reasoning, the main novelties introduced by the Order are:

Novelties introduced by the Order

- Clarification of the concept of non regular client with reference to the activities regulated.
- Customer identification requirements in the management of non face-to-face cross-border transfers.
- The requirement to have automated systems and control mechanisms for high-risk transactions, operating to a specified minimum standard.
- Specific information and other requisites to feature in the control procedures of the entities handling cross-border transfers, which they must notify, for supervisory purposes, to the Executive Service of the Commission for the Prevention of Money Laundering and Monetary Offences.

7.1.3. CATALOGUE OF RISK TRANSACTIONS

Government departments have been working with obligated sectors to draw up Catalogues of Risk Transactions, alerting them to the kinds of transactions susceptible of having a money laundering link. These are of an orientative rather than an exhaustive nature (they have no obligatory force) and are intended for use by entities in drawing up their own lists.

Alerting to transactions at risk of a laundering link

The list facilitates examples that can guide entities in evaluating their own risk positions, depending on the characteristics of their customers and the lines of business they engage in. This evaluation is the starting point for each entity to confect its own catalogue and ensure that it is properly distributed among employees, starting with senior management, and reviewed on a regular basis.

Transaction checklists to be drawn up for each type of obligated party

The transactions appearing must be automatically scrutinised by each institution, bearing in mind any added risk factors and/or their fit with the customer's normal transactional profile, in order to decide if there are grounds for suspicion of a money laundering link and, if so, to inform the Executive Service.

Catalogues approved in 2006 by the Commission for the Prevention of Money Laundering related to natural and legal persons dealing in jewellery, gems and precious metals, works of art and antiques or investments in stamps and coins. This kind of partnership effort between government and private sector can be an invaluable aid to obligated parties in refining their internal anti money laundering procedures.

7.1.4. DRAFT MINISTERIAL ORDER APPROVING THE MODEL OF EXTERNAL AUDIT REPORT REFERRED TO IN ARTICLE 11.7 OF THE REGULATIONS TO THE MONEY LAUNDERING PREVENTION LAW

One of the main legislative projects undertaken in 2006 was the drafting of a Ministerial Order to approve the model of report to be prepared by the external experts regularly called in to appraise the internal control and reporting procedures and units established by obligated parties.

This initiative addresses the felt need among external experts and the competent supervisor to procure a more standardised and rigorous report model detailing the money laundering prevention mechanisms set in train by obligated parties.

The latest wave of anti money laundering legislation attaches special importance to having internal control and reporting procedures and units subject to appraisal by an outside expert. This was patent in the rewording of article 3.7 of the Money Laundering Prevention Law given by Law 19/2003 on the legal regime for capital movements and cross-border transactions and specific measures to prevent money laundering.

Subsequently, Royal Decree 54/2005 amended the Regulations to the Money Laundering Prevention Law with particular reference to this obligation, specifying in its article 11.7 that the results of this audit should be written up in a confidential report which details the internal control measures in place, assesses their operational efficiency and proposes changes or improvements as required. The anti money laundering regime applicable depends on the sector of activity subjects engage in, and the text allowed subjects under the special regime to organise their external audits at three-year rather than annual intervals.

Two years on, the disparity of the reports submitted has led the Ministry to regulate their scope and content, laying down a standard structure and setting out point by point the minimum contents without which they will not be considered valid. This measure, it is hoped, will improve obligated parties' compliance with anti money laundering standards, favouring their voluntary adhesion to good practices and, indirectly, reducing the need for penalty proceedings.

By end 2006, the draft had been sent out for consultation to all anti money laundering legislation obligated parties, and the final document should have its official publication in the early months of 2007.

7.1.5. DRAFT MINISTERIAL ORDER CONCERNING THE OBLIGATIONS TO BE MET BY NOTARIES PUBLIC WITH REGARD TO MONEY LAUNDERING PREVENTION

Notaries, as public authenticating officers, are continually taking part in economic and financial transactions. Their status as government officials entails collaboration with the state administration which has proved a valuable anti money laundering tool.

The passage of Order EHA/2963/2005 of 20 September regulating the Centralised Laundering Prevention Unit of the General Council of Notaries has done much to improve the profession's commitment and effectiveness in combating money laundering.

The success of this experience urges the application of other anti money laundering obligations generically envisaged in Law 19/1993 of 28 December and Royal Decree 925/1995 of 9 June to the duties and day-to-day practices of notaries public.

Notaries are obliged, as public officials, to ensure the formal and material legality of the acts and transactions they authorise, and to render authentication services to any person so requiring, in accordance with articles 17 bis and 24 of the Notaries Law and 145 of its Regulations.

This function must be exercised in conformity with the current legal provisions on money laundering prevention that include notaries among their obligated parties. This is the case of Law 19/1993 of 28 December and Royal Decree 925/1995 of 9 June but also of Directive 2005/60/EC of 26 October of the European Parliament and of the Council, to be written into Spanish legislation.

Article 2 of Law 19/1993 of 28 December defines notaries public as obligated parties bound by the requirements of the law and the implementing measures contained in its regulations. These requirements may, however, be reinforced under two criteria: firstly, article 16 of Law 19/1993 lays down a special duty of collaboration when the obligated party is an authority or government employee. Secondly, article 16.1.b) of the Regulations contains an enabling provision such that persons not originally contemplated, as in the case of notaries, may be brought under reporting requirements vis à vis suspicious transactions or those involving capital movements. These obligations are also elaborated on for general purposes in Order EHA/1439/2006 of 3 May regulating declarations of cash movements. Accordingly, the new Order makes use of the enabling powers contained in the said article 16.1.b) of the Regulations approved by Royal Decree 925/1995.

Prevention obligations are spelled out more clearly

The obligation to have prevention systems examined by an outside expert

Towards a standard examination procedure

7.2. THE EUROPEAN UNION

As a member of the European Union, Spain takes part in initiatives and meetings concerned with the prevention of money laundering and the fight against terrorist financing.

Involvement in groups monitoring international financial sanctions

These include formations like COTER and RELEX/Sanctions with the remit to monitor international financial sanctions (freezing of terrorist assets, reporting to the EU on persons with funds frozen at credit institutions, bilateral contacts in anti terrorist matters...).

The Directorate is the 'competent national authority' in all matters concerning international financial sanctions, with specific responsibilities as follows:

- Notifying the Commission of any fund-freezing actions taken in Spain.
- Resolving on exemptions from fund freezing, at the petition of the interested party, with reference to the circumstances specified in the Regulations (need to defray essential expenses, professional fees, etc.).
- Handling enquiries in cases of coincidence in names (homonymy): if an entity detects that a client's name matches that of a person subject to a fund freezing order, it immediately freezes the funds and notifies the Directorate so it can verify whether the client in question is effectively the person subject to freezing measures.

Implementing Directive 2006/70/EC

The Directorate also represents Spain on the Prevention Committee, a first pillar group in charge of moving forward EU policy on the prevention of money laundering and terrorist financing. It is this Committee precisely that channelled the drafting and approval of Directive 2006/70/EC of 1 August laying down implementing measures for Directive 2005/60/EC of the European Parliament and Council as regards the definition of "politically exposed person" and the technical criteria for simplified customer due diligence procedures and for exemption on grounds of a financial activity conducted on an occasional or very limited basis.

7.3. MANAGEMENT

TABLE 7.3. INSTITUTIONAL FRAMEWORK

Institutional framework

INSTITUTIONAL FRAMEWORK

Before examining management milestones in 2006, we look briefly at the institutional framework for anti money laundering activity in Spain:

COMMISSION FOR THE PREVENTION OF MONEY LAUNDERING

An interdepartmental body chaired by the Secretary of State for the Economy and made up of units and departments having powers in money laundering related matters (in particular, the General Directorate of the Treasury and Financial Policy, Banco de España, the National Securities Markets Commission (CNMV), the Inland Revenue, the Special Public Prosecutor's Offices against drug trafficking and corruption, the General Directorates of the Police Force and Guardia Civil, the Police Committees of autonomous communities with their own law enforcement corps, etc.).

THE STANDING COMMITTEE

Chaired by the Director General of the Treasury and Financial Policy, it deals with all ordinary matters in the realm of money laundering prevention policy that cut across various units or require concerted action to reach their goals.

COMMISSION SUPPORT BODIES

1. Commission Secretariat

A role exercised by the Sub Directorate-General of Inspection and Control of Capital Movements of the General Directorate of the Treasury and Financial Policy. Responsible for promoting and coordinating Spain's participation in international forums, sponsoring regulatory changes and preparing sanction proceedings against obligated parties.

2. Executive Service

The Executive Service has the mission of receiving and analysing the reports submitted by obligated parties, and referring the results of its investigations to the competent legal and/or administrative authorities. It also has important inspection and support functions with obligated parties in respect of their reporting duties.

We now move on from legislative output to consider other means to carry forward the fight against money laundering and terrorist financing; namely, participation in international anti laundering organisations and control of legal compliance.

7.3.1. INTERNATIONAL COOPERATION AND COORDINATION

The transnational character of money laundering and terrorist financing transactions calls for closer cooperation at international level. One means to this end has been the creation of international forums where countries can exchange experiences and coordinate their action campaigns. The most important of these organisations are described in our next section:

The Financial Action Task Force (FATF)

International standards for the fight against money laundering and terrorist financing

The FATF is an intergovernmental organisation whose mission is to design and promote measures to combat money laundering and terrorist financing. This means, firstly, establishing international standards for the prevention of money laundering (the 40 Recommendations) and terrorist financing (the 9 Special Recommendations) and, secondly, examining their progress on the ground in different countries and territories by means of mutual evaluation exercises.

Spain exercises the joint chairmanship of the FATF Anti-Terrorism Group and is also an active presence in Plenary activities and in the working groups dealing with Implementation and Evaluation, Non Cooperative Countries and Territories (NCCTs), and Typologies.

Spain evaluated by the FATF

As part of the FATF's mutual evaluation round, the Plenary of June 2006 gave its final approval to the mutual evaluation report of Spain.

Evaluations of Greece and Portugal

Our country's commitment to maximising compliance with the FATF's international standards extends to proposing Spanish officials to form part of mutual evaluation teams. Hence in 2006 members of this General Directorate took part in the mutual assessments of Portugal and Greece.

FATF-style regional organisations engaged in the fight against money laundering and terrorist financing

GAFISUD

Spain's large economic and financial presence in South America gives it a special interest in the region. As well as participating in all GAFISUD Plenary sessions, Spain actively partners member countries in their efforts to comply with international anti money laundering standards, providing material and human resources to this end. It has observer status at GAFISUD meetings and is also the organisation's largest net contributor.

CFATF

Spain's involvement with CFATF (Central America and the Caribbean) is along broadly similar lines. As an observer, it participates in Plenary sessions and contributes funding and human resources in order to help strengthen regional compliance with international anti money laundering standards. Moreover, Spain has just taken on the presidency of the CFATF working group devoted to observer countries.

MONEYVAL

The third regional group of relevance, MONEYVAL, has the mission to improve the quality of the anti money laundering and terrorist financing systems deployed by Council of Europe countries who are not also FATF members (as well as Russia, which belongs to both).

Its Plenary meeting in Strasbourg in September 2006 approved the final text of the evaluation on Slovakia, drawn up by a team which included an officer from this Directorate.

Evaluation of Slovakia

In the cooperation sphere, the European Union has approved funds for a twinning project to set up a Financial Intelligence Unit in Morocco. This project will be rolled out in association with France but with Spain, specifically this General Directorate, taking on its leadership. The project, which is expected to last a year and a half, has been assigned a 1,400,000 budget.

Twinning with Morocco

7.3.2. CONTROL OF LEGAL COMPLIANCE

There are two aspects to consider as regards how anti money laundering rules are applied on the ground: firstly, the control and assessment of reporting parties' compliance with their preventive duties, and secondly, cooperation between them and the government authorities.

The first arm of anti money laundering action, that is, the control and assessment of compliance with preventive duties, has its main executive instrument in the inspections carried out by the Executive Service. The resulting reports are passed onto the Commission Secretariat, which examines them and decides whether there are grounds for instituting penalty proceedings. The following table sets out the number of money laundering reports examined in 2006, as received from the Executive Service and supervisory agencies, ordered by category of reporting party.

TABLE 7.3.2.A. INSPECTION REPORTS RECEIVED AND ANALYSED BY THE SECRETARIAT OF THE COMMISSION FOR THE PREVENTION OF MONEY LAUNDERING

Obligated party	Reports analysed
Banks	9
Savings banks	2
Exchange and remittance agencies	10
Real estate companies	2
Total	23

Source: Commission Secretariat

The cooperative duties imposed by Law 19/1993 are the second arm of anti money laundering action, consisting of the systematic reporting of certain predefined transactions by each kind of obligated party, and their analysis and notification of any suspicious transactions they encounter in the course of their business.

The number of transactions notified to the Executive Service under the systematic reporting schedule increased in the year. Especially encouraging was the rise in the total number of agents providing such reports, in line with the trend of previous years.

More private entities report suspicious transactions

Progress was also apparent in the notification of suspicious transactions. This closer collaboration was reflected not only in the number of reports received from obligated parties but in the quality of the information provided.

The following table sets out the 2006 statistics for penalty proceedings in respect of undeclared cross-border cash movements and movements of capital:

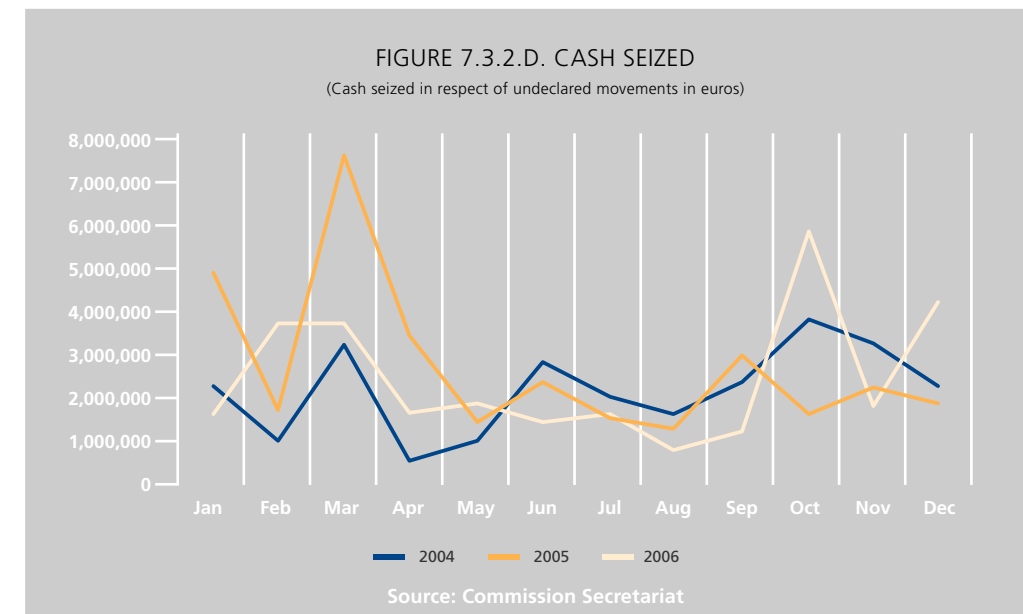
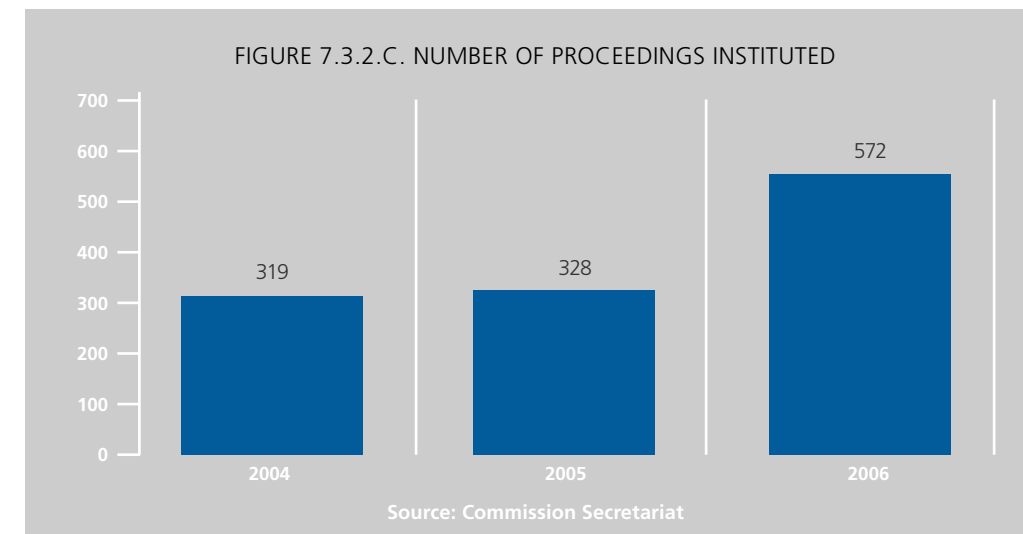
TABLE 7.3.2.B. PROCEEDINGS IN RESPECT OF UNDECLARED CROSS-BORDER CASH MOVEMENTS AND CAPITAL MOVEMENTS

Cause	Statistical information
Breach of obligations with regard to capital movements	Actions: 1,187
Failure to declare cash movements	Actions: 572 Cash seized: 27,871,598.34 euros
FINES IMPOSED	6,286,513 EUROS

Source: Commission Secretariat

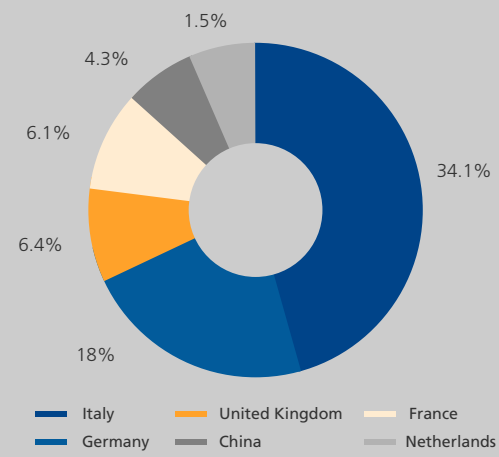
Proceedings for undeclared cash movements

A salient development in 2006 was the large incidence of proceedings for undeclared cash movements, which practically doubled the figure for the previous year. This is mainly due to the tighter controls in place at border crossings, where staff are increasingly on the lookout for undeclared cash movements.



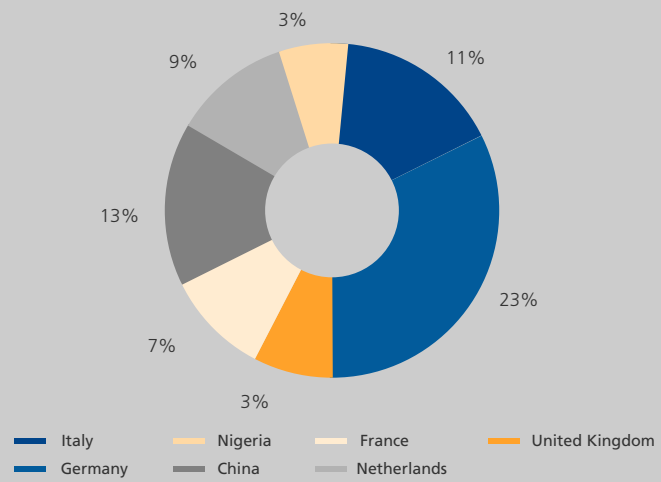
The figures below track changes in the direction of cash movements between 2005 and 2006, with Germany supplanting Italy as the biggest destination. Although the main countries involved remain the same, Nigeria came in strongly in 2006 with 3% of the total cash seized.

FIGURE 7.3.2.E. CASH SEIZED BY DESTINATION IN 2005



Source: Commission Secretariat

FIGURE 7.3.2.F. CASH SEIZED BY DESTINATION IN 2006



Source: Commission Secretariat

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