

FOREWORD





Pedro Solbes Mira
Deputy Prime Minister and Minister of Economy and Finance

THE SPANISH ECONOMY AND FINANCIAL MARKETS IN 2007

2007 was a positive year for the Spanish economy. Average growth stood at 3.8%, with another strong performance from investment (up by more than 6%) and, especially, its equipment component, which managed an annual average advance of over 10%. This robust growth was compatible with a less negative contribution from net exports, which look set to detract around 0.7 percentage points compared to the -1.2 outcome of 2006. The year also closed with a solid progression in job creation (around 500,000 more people employed than at end 2006) and unemployment rate moving near their record best (8.6%).

However, our economy had to confront an increasingly adverse environment in the closing months of the year, caused by the downturn in the real estate cycle and the financial market tensions born in the United States. Although the Spanish financial system has no significant exposure to the US mortgage market, the uncertainty generated there by the subprime lending crisis finally spread to the international financial system, seriously hampering the worldwide saving-investment flows.

2007 was also a successful year from the standpoint of Spain's General and Central Government finances. The budget surplus widened by 0.5 points to approximately 2.3% of gross domestic product, while the Public Debt/GDP ratio came down by almost 3.5 percentage points. Both improvements drew strongly on the year-long performance of the Central Government sector, whose surplus expanded 0.7 points of GDP, while its debt/GDP ratio decreased by a little over three percentage points.

It is at less settled times like these that we can appreciate the benefits of Spain's intense fiscal consolidation effort during the last few years, which has notably improved the budget position in both general and structural terms. In the financial sphere, the year's lower issuing requirements meant less dependence on the markets, allowing the Treasury to be more selective in its issuance, while reducing our country's vulnerability to the complex international situation. Economically, the healthy state of Spain's public accounts will give scope for the free play of automatic stabilisers and other fiscal measures.





INTRODUCTION



Soledad Núñez Ramos
Director General of the Treasury and Financial Policy

The Directorate-General of the Treasury and Financial Policy is pleased to again offer its Annual Report on Financial Markets and Public Debt. 2007, finally, was something of a record-breaking year: the euro climbed to an all-time high against the US dollar while the yen sank to new lows against the European currency; oil prices soared higher than ever; and a number of world stock markets posted month after month of record gains. But the fact is that 2007 will be better remembered for other events that stirred up the turbulent waters of financial markets. Against this troubled backdrop, worldwide growth experienced a fairly gentle deceleration, due in part to the resilience shown by the emerging economies.

The causes of the financial turmoil lay in the US mortgage crisis, which later spread to international financial markets through new and complex financial products that disseminated the risk among agents everywhere. The fact no one could be sure about the extent and location of subprime losses prompted a crisis of confidence that pushed up risk premia and caused major distortions in money and credit markets. The accompanying upswing in volatility and dearth of liquidity weighed on financial sector performance in the second half of the year and rekindled fears of a negative impact on economic growth. Central banks, faced with the monetary policy dilemma posed by slowing output growth and resurgent inflation on both sides of the Atlantic, took firm action to calm the turbulence by injecting abundant liquidity into the markets and adapting their policy stances to seek the least costly exit from the present conjuncture.

Market turmoil also affected government bond markets. Treasury securities, especially US and German, took on the mantle of safe-haven assets, sending yields heading sharply lower in the second half of the year. The result was a pronounced steepening in government yield curves, particularly in the US market.

Central Government financing requirements were revised down in 2007 on the strength of a higher-than-expected budget surplus. The Treasury's outright issuance was accordingly less than both National Budget projections (authorising growth in the Debt outstanding amount of up to €12 billion) and the amount pre-announced by the Treasury in December 2006 (entailing an increase in the Debt of around one billion).

The result was a contraction of approximately €5 billion that left the year-end Debt stock at €307 billion. This alone was enough to take 0.5% off the Debt/GDP ratio, before considering GDP growth or the Debt purchases made by the Social Security Reserve Fund.

The year's keynote issuance was the syndicated placement of a new 30-year benchmark, enabling the enlargement and diversification of the geographical investor base. A number of changes were also made in the issuance schedules of Letras del Tesoro. The market now operates on the basis of monthly sales of 12-month bills with monthly (previously two-monthly) maturities. Accordingly, as of January 2007, the Treasury ceased to issue 18-month Letras. In their stead, it auctioned 6 and 7 month bills between August and January 2008, as a transition to a market characterised by monthly auctions coinciding with maturities.

The secondary market turnover of Spanish Debt expanded in 2007, with keen trading of Bonos and Obligaciones offsetting the contraction experienced in the Letras market. The year's dominant trend, carried forward from previous years, was the strong advance in account holders' activity with clients.

The distribution of held-to-maturity Debt portfolios underwent few changes in the year. The largest owner group was again non residents, with around 50%, followed by Spanish credit institutions, which regained some ground versus the previous year. Non resident investment originated mainly in Europe while, individually, France, Japan and Italy were the top three holder countries.

In the financial policy sphere, the Report describes the year's intense legislative output, aimed at guaranteeing financial stability and the competitiveness of the financial sector, while ensuring the adequate protection of investors. In this respect, the new activities and innovative products emerging day by day call for a finely tuned regulatory effort.

The Spanish legislation approved in 2007 was informed by European guidelines, as contained in the White Paper on Financial Services Policy. The triple task of transposing EU Directives into national law, negotiating new pan-European instruments and introducing properly aligned national measures is itself a reflection of our increasingly global, interdependent financial sector.

Among the important texts implemented in Spanish law we can single out the Directive on Markets in Financial Instruments (MiFID), aimed at strengthening investor protection while modernising markets to adapt them to today's needs, and the Capital Requirements Directive, in answer to Basle II solvency requirements. The reform of mortgage market legislation has also to be stressed, which provides a new regime for reverse mortgages and dependency insurance.

Takeover bids were the object of renewed attention in the year, to deal with certain shortcomings detected in the past. The new law addresses the twin goals of an efficient corporate sector and protection for stockholders.

Other regulatory novelties touched on diverse topics such as issuer disclosure and the cross-border financial services commercialization.

The process of improving Spain's financial sector legislation will continue in 2008 through projects like the recasting of the Securities Market Law, confirming financial policy measures as agile instruments alert to the challenges of a fast-changing system.

The fight against money laundering is another important objective of the Directorate-General of the Treasury and Financial Policy. In accordance with the Regulations to Law 19/1993 on the prevention of money laundering, Order EHA/2444/2007 of 31 July establishes implementing measures for the expert report on the internal control and reporting procedures and bodies of obligated parties with regard to their responsibilities in money laundering prevention.

Finally, we welcome with satisfaction the start-up of the twinning project with Morocco, led by this Directorate-General, whose aim is to assist the neighbour country in establishing an institutional and procedural framework to efficiently combat money laundering and terrorist financing.

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MACROECONOMIC DEVELOPMENTS
AND FINANCIAL MARKETS



1.1. MACROECONOMIC DEVELOPMENTS

After world growth of 5.4% in 2006 and 2.9% for the advanced economies, 2007 got off to a promising start. Forecasts for the year pointed to similar if rather more moderate rates of 4.9% and 2.5% respectively.

Although these projections were generally borne out, the real estate and subprime lending crises in the United States enlarged the downside risk for the whole world economy in the second half of the year. At the same time, oil prices escalated to record levels, just short of \$100 a barrel, sowing serious doubts about the future of the expansionary cycle and putting pressure on inflation; the more so when price hikes did not stop at oil but spread to a whole range of commodities (precious metals, base metals, food produce...).

Growth rates hold up well in 2007...

... despite the mortgage crisis in the United States and escalating oil prices

Figure 1.1.A OIL PRICES IN 2007 (dated Brent)



Source: Reuters.

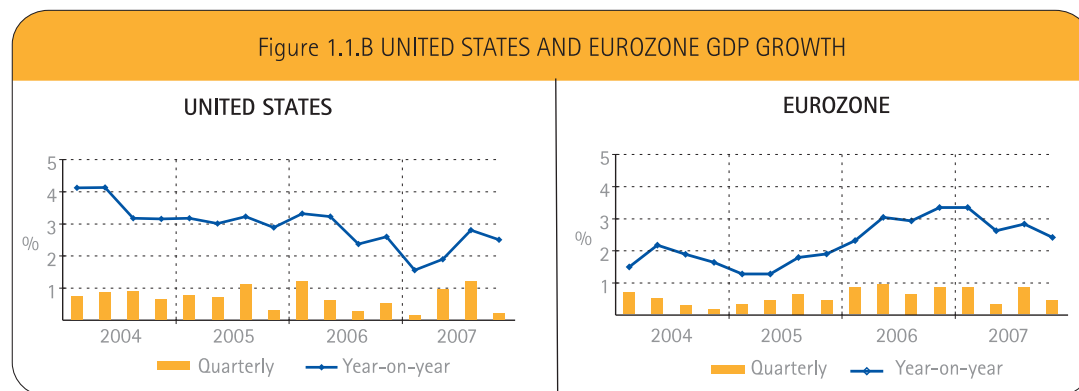
The slowdown in the US housing market intensified in 2007, with sales down by 25% and prices falling around 5%. In the mortgage market, the cumulative run-up in interest rates and the lending laxity that had characterised the previous years sent non-performing loan ratios rising sharply, especially in the lower credit quality segment known as subprime. This slump in the US mortgage market was the spark that ignited the financial market turmoil evident from summer on, which, in turn, was largely responsible for the slower growth of the year's closing months.

However, growth kept a solid pace in the United States economy, despite the real estate crisis, enabling it to close the year with an average rate of 2.2%. The drain effect of real estate investment was effectively compensated by robust consumer spending and by a strong contribution from net exports on the back of persisting dollar weakness. In the Eurozone, investment was again the main growth driver, with consumption also coming up strongly. The external sector, conversely, lowered its contribution as the euro continued to appreciate. The result was a full-year growth rate of 2.7%. In Japan, growth of 2.1% was again achieved on the strength of domestic demand, especially investment, with consumption still lagging some way behind.

The crisis in US real estate detracts from growth in the year's second half...

... but consumption and net exports carry the economy to a final 2.2%

GDP expands 2.7% in the Eurozone and 2.1% in Japan

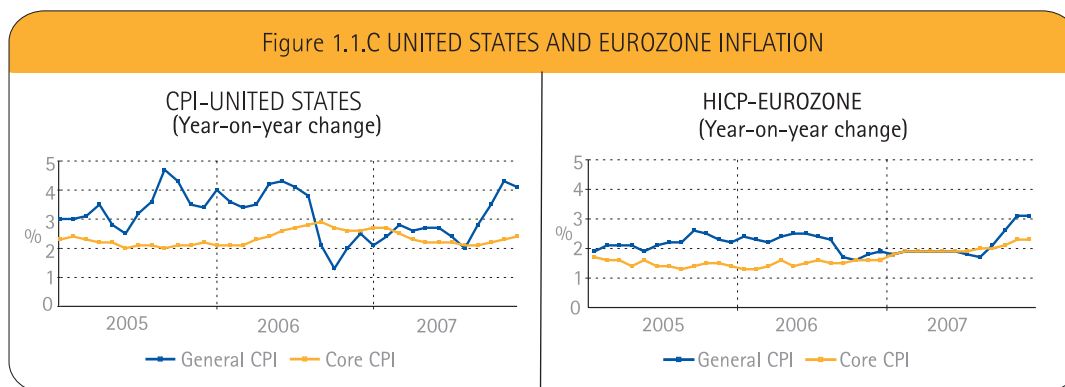


Sources: Bureau of Economic Analysis and Eurostat.

Headline inflation moved to the tune of energy prices, with a run-up in the closing months in which food price increases also played a part. In contrast, core inflation remained moderate for yet another year. In the United States, inflation closed at 4.1% (2.4% the core rate) ahead of the 3.1% of the Eurozone (2.3% the core rate). In Japan, the economy balanced on the verge of deflation for most of 2007, but closed with a positive variation of 0.6% (0.4% the core inflation).

Headline inflation quickens but the core rate stays tame

Figure 1.1.C UNITED STATES AND EUROZONE INFLATION



Source: Bureau of Economic Analysis and Eurostat.

The labour market stayed notably dynamic in 2007, in consonance with output growth. In the Eurozone, brisk job creation kept unemployment rates stable in the neighbourhood of 7% (7.2% in December). US unemployment rates began turning up towards the end of the year after a long period of stability reaching 5% at the year's end, while the Japanese rate moved within a narrow band to close at 3.8%.

This time round, the slowdown in the industrialised economies had less of a frontal impact on emerging markets. The increased decoupling of both groups owes to the improved fundamentals of the emerging countries, aided by the high prices of commodities. The average 2007 growth rate of the emerging contingent promises to stand at around 7.8%, maintaining the pace of the previous year. The Chinese economy, finally, shows no sign of slowing, and has continued to build its weight in the world economy, where it is now the number-one contributor to global growth.

The labour market remains dynamic though with unemployment rates straining higher

Emerging economies gain in resilience

1.2. FINANCIAL MARKETS

The subprime mortgage crisis in the United States eventually spread to international financial markets. The contagion route was banks' direct and indirect exposure to the sector, primarily through asset-backed securities, and the existence of highly structured and relatively opaque financial instruments, like conduits, which made it hard to tell where the losses were being taken. The result was a slump in investor confidence that sent risk premiums climbing and caused significant restrictions on money

The subprime crisis affects international financial markets...

... sparking a crisis of confidence that pushes up risk premiums and leaves certain segments dry of cash

markets. Hardest hit were segments like mortgage-backed commercial paper or interbank markets which suffered a real liquidity drought as a result of the turmoil.

Problems at certain European financial institutions and the losses that began to show up in banks third-quarter releases, compounded by the further buffeting of the US subprime market as volatility and risk premiums started to rise, stoked fears of a knock-on effect on other asset categories of higher credit quality and a possible impact on the real economy in both America and Europe. Indeed financial markets as a whole were shaken by the changed scenario of the second-half of 2007.

Financial turbulence and the ensuing liquidity crunch in the banking system called for a firm and unanimous response from leading central banks. And this was forthcoming. Despite the differing stances of their respective monetary policies, all the major banks took action to restore confidence in the markets, injecting sufficient liquidity to normalise the situation.

Money markets reacted in similar fashion in most developed countries. The crisis of confidence that gripped financial institutions led to a sharp contraction in interbank volumes and prices, with a slump in transactions in certain segments and sharply widening spreads on central bank base interest rates. These tensions became more pronounced in late November as banks cast around for funds to meet their annual close and, in the end, five of the world's top central banks had to take coordinated action to alleviate the lack of short-term credit.

These circumstances were to dictate the course of monetary policy decisions in main economic areas. First of all, the Federal Reserve had to end one of its longest ever periods of rate stability and bring forward monetary easing, on the evidence that the US economy was heading for slowdown. The ECB, which before the summer had been sending out signals of renewed rate rises to stave off inflationary pressures, had to switch to a wait-and-see policy, for the moment "sine die". And the story was similar, allowing for local idiosyncrasies, in Japan and the United Kingdom.

Growing concerns about the impact on the real economy

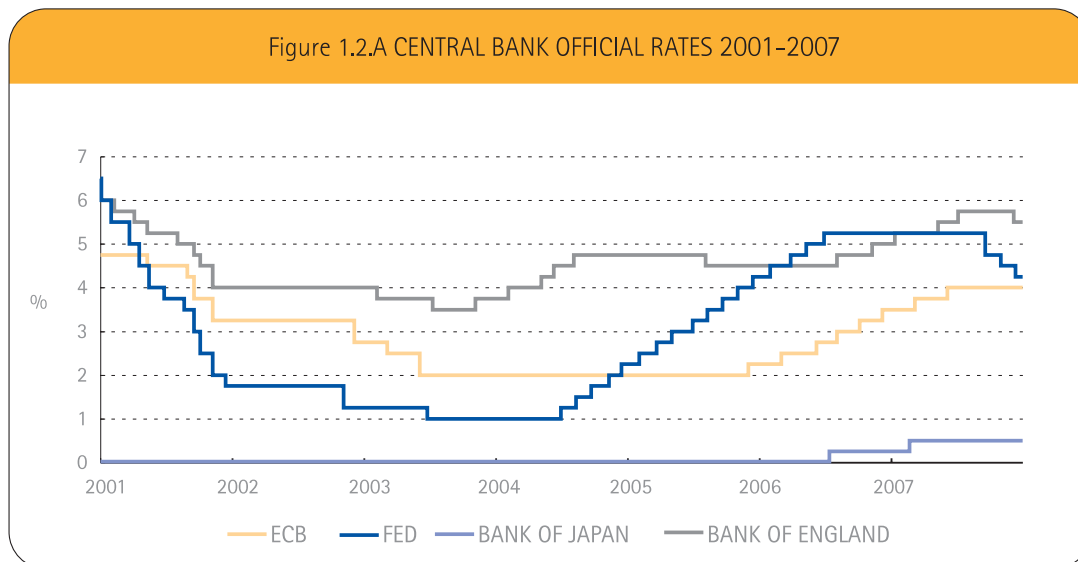
Central banks unanimously respond to the financial turmoil

The crisis of confidence is acutely felt on interbank markets

Concerted action by five leading central banks

Impact on monetary policy management: the Federal Reserve and Bank of England lower rates while the ECB and Bank of Japan call a halt to their respective upcycles

Figure 1.2.A CENTRAL BANK OFFICIAL RATES 2001-2007



Sources: ECB; Federal Reserve, Bank of Japan and Bank of England.

In 2007 the ECB raised its main interest rate by 50 basis points to 4.0%. Despite the euro zone good economic performance and the persistence of inflationary pressures, the uncertainties hanging over the financial system from summer onwards urged the bank to caution before moving interest rates.

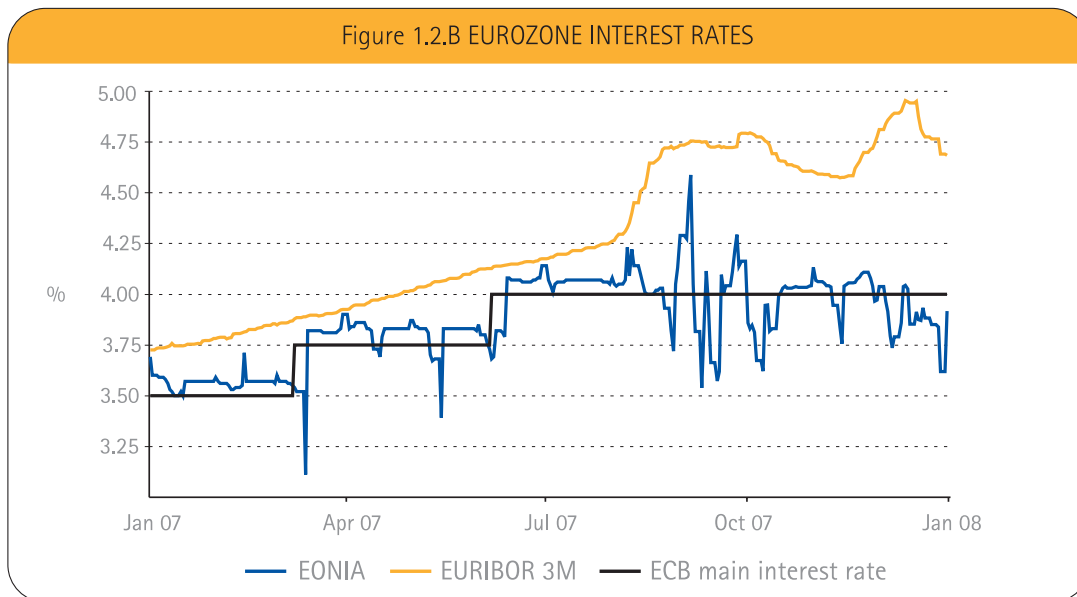
Growing tensions on the interbank market made for atypical times in money markets. From the end of August, both the Eonia (overnight interbank rate) and Euribor began to pull away from the path being traced by the ECB rate. In order to normalise money market conditions the ECB resorted to extraordinary cash injections, both through its regular auctions and by fine-tuning operations, invariably accepting a wide range of eligible collateral. Although risk premia at the shortest terms had been brought down by the end of the year, spreads to the official rate remain wide and the situation is not wholly back to normal.

The ECB raises its main refinancing rate by 50 basis points to 4% ...

... but puts the brakes on after summer

Extraordinary liquidity injections to restrain spot rates

Figure 1.2.B EUROZONE INTEREST RATES

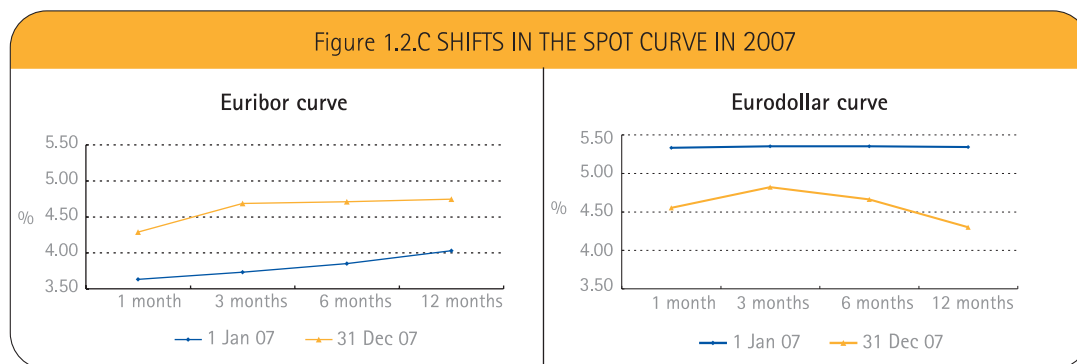


Source: Bloomberg.

Interest rate expectations were especially volatile in such a rarefied environment. The euro zone spot curve shifted upwards by between 65 and 95 basis points, depending on the maturity, while flattening out in the 3-12 month segment. These movements owed, firstly, to the ECB's rate hikes in the first half of 2007, secondly, to expectations that the central bank would hold its main interest rate around 4% for most of 2008 and, finally, to the tensions emerging in interbank markets.

The flattening of the euro spot curve reflects stable expectations for ECB base rates in 2008

Figure 1.2.C SHIFTS IN THE SPOT CURVE IN 2007



Source: Reuters.

In the United States, Ben Bernanke faced his first trial by fire at the head of the Federal Reserve. From the year's outset, fears that a deceleration phase, provoked mainly by the real estate downturn, might be punctuated by inflationary pressures, seemed set to test the Fed's resistance to move interest rates. However the turbulence of the summer months dispelled any doubts; the downside risks to growth became the main enemy to combat, inflation eased in the third quarter of the year and the financial crisis threatened to bite deeper than expected. The Federal Reserve's response was to slash the federal funds rate by 100 basis points in a bare three months, to a year-end level of 4.25%. The markets ended the year with the hope of further benefits from the "*Bernanke put*" in the shape of renewed rate cuts in 2008.

Market turbulences push the Federal Reserve into cutting rates by 100 basis points to 4.25%

The new "Bernanke put"

The Federal Reserve too had to inject emergency liquidity to restore normality on interbank markets, with results similar to those garnered by the ECB. Money market rates had a notable correction, though in the opposite direction to the euro curve. Specifically, the spot curve, after opening at a near flat 5.35%, shifted downwards by between 50 and 100 basis points, to close the year inverted, in consonance with the easing expectations for 2008.

Expectations for US rates turn sharply downwards ...

... with more easing on the cards for 2008

The Bank of England was also in the headlines in 2007. The high inflation of the opening months of the year obliged the central bank governor, Mervyn King, to write an open letter to the Chancellor of the Exchequer explaining why the official inflation target of 2% had been overshoot by more than 1% and what corrective measures he proposed to take. Among those cited was the upkeep of a restrictive monetary policy stance.

The Bank of England, in the eye of the hurricane:

first inflation, ...

However, the summer turmoil ended up rocking the foundations of the British financial system. The Bank of England was heavily criticised for its handling of the crisis, with accusations of a lack of flexibility in its emergency liquidity injections and being over fussy about the choice of assets eligible as collateral. The problems were compounded by the Northern Rock crisis and the steadily deteriorating financial positions of certain leading banks. Indeed, the Bank admitted at the end of the year that, even with inflation under tighter control, the crisis was going to have a serious impact on the UK economy. The result was a radical about-turn in monetary policy and a 25 bp cut in rates to a year-end of 5.50%. A sign in itself of the gravity of the situation.

... then its handling of the crisis ...

... and, finally, Northern Rock

Fears that the crisis could undermine the economy accelerated rates easing

In Japan, 2007 was less eventful than expected in the monetary policy field. After the abandonment of quantitative easing in 2006 and its first hike in rates, to 0.25%, the Bank of Japan had its sights firmly set on the progressive normalisation of interest rates, with the aid of the hoped-for inflation. In February 2007, the Bank of Japan raised its base rate once more, to 0.50%, in the face of external pressures from the government and doubts about the health of the economy and whether the days of deflation were truly over.

But then came summer. Expectations of new tightening movements subsided, while the uncertainty surrounding the real impact of the financial turmoil and the US slowdown put paid to the desires of the central bank. 2007 closed, finally, with a sizeable revise-down in rate expectations and the feeling that the long awaited normalisation of monetary policy would have to wait until the new year.

In currency markets, the euro continued the upward climb against the dollar initiated at end 2005, reaching a lifetime high in the last four months of 1,4968 \$/€. The European currency's annual gain of 10.54% rested basically on the weakness of the US housing market and the cooling of activity that led the Federal Reserve to lower its interest rates, narrowing the spread vs. the Eurozone. The persistent imbalances of the US economy also did little to help the dollar. Note, though, that its external imbalance has shown signs of correction thanks to the export dividend of a cheap dollar, which reduced the current account deficit to 5.1% of GDP in the third quarter of 2007.

The yen too remained at lows against the euro. Among the factors pressuring the Japanese currency were the firming recovery of the Eurozone economy and the behaviour of domestic prices, which suggested the economy was still far from sound enough to dispel doubts about monetary policy normalisation. Another downside influence was the yen's status, alongside the Swiss franc, as the financing currency of choice in carry trade activity. The result was a sustained descent, interrupted only by episodes of volatility from the third quarter onwards in the wake of the financial market turbulence. Finally, the yen sank to 25 year lows in real effective exchange rate terms, and lost 3.34% against the euro in nominal terms, touching its lowest historical level against the European currency. Conversely, symptoms of economic weakness in the United States and the repatriation of financial flows secured it a 6.88% gain against the dollar.

The Bank of Japan tries to progress with its interest rate normalisation ...

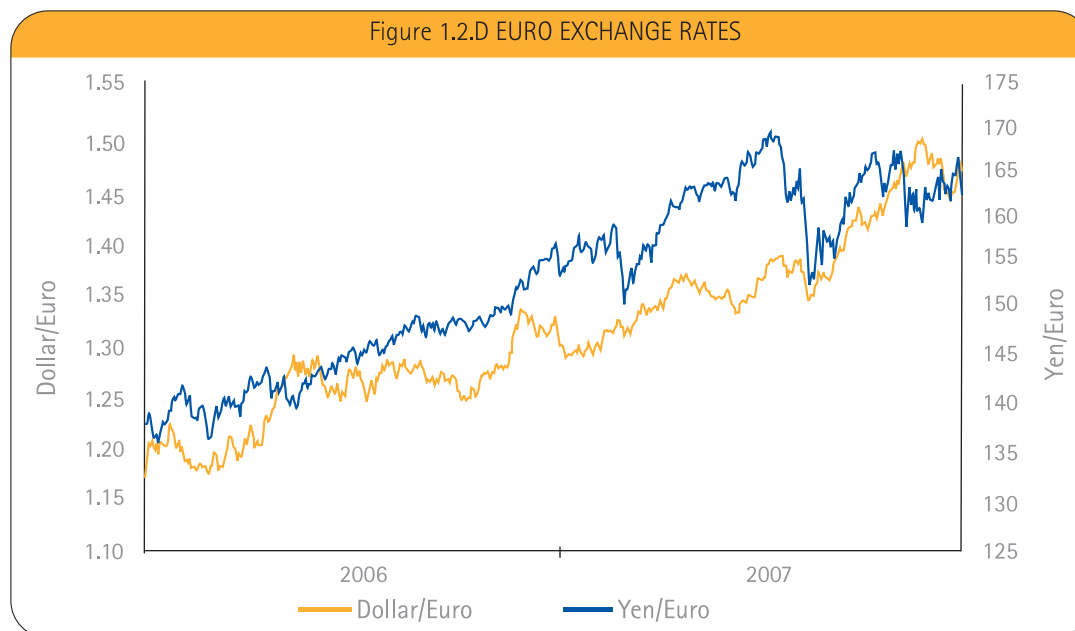
... but events go against it

More moves will have to wait until 2008

The euro's strength rests on the symptoms of weakness in the US economy and narrowing interest rate spreads

The yen continues at lows against the euro

But the weakening US economy allows it to gain ground against the dollar



Source: Reuters and authors.

Debate rumbled on with a little less intensity about the sustainability of global external imbalances, 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 \$1.4 trillion at the 2007 close. In view of the greenback's steep descent, several central banks have talked about a change in their reserve mix, where the dollar still dominates, and the creation of funds, investing under private management criteria, with a growing proportion of euros, sterling pounds and yens.

As to the yuan, the Chinese authorities have pressed on with the soft adjustment against the dollar that began in July 2005 with a revaluation of 2.1%. The yuan's 2007 appreciation against the US currency was finally 7.01%, equating to 11.26% since revaluation. The slow pace of progress has brought renewed calls for the authorities to let the currency appreciate as a way to help right global imbalances.

In equities, instability was without question the year's dominant note. After four years of a more or less continuous bull run, the markets turned down in 2007 though with most indices managing to close the year in positive territory. Here too the causes were the credit market turbulences of the second half.

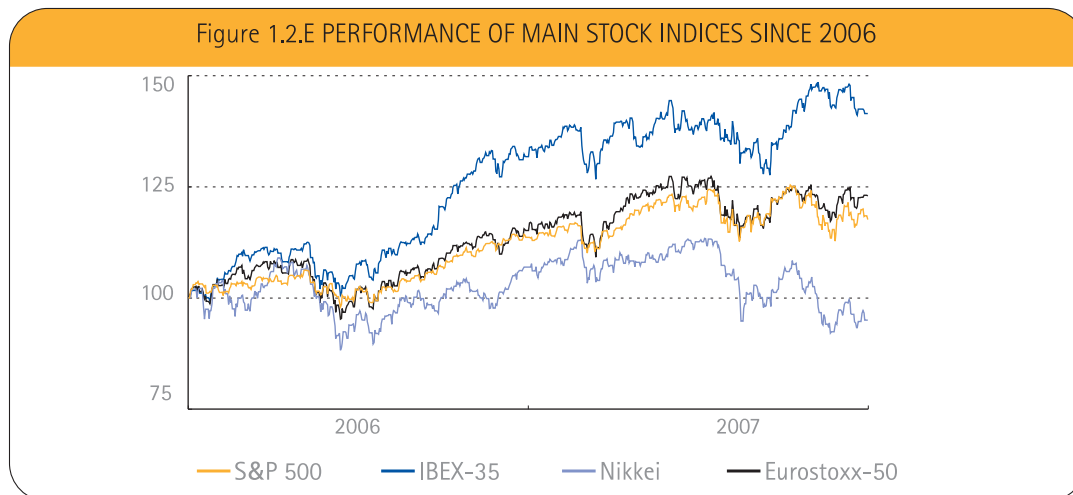
The financial crisis has diverted attention from the debate on the sustainability of external deficits

Yuan adjustment continues to take its time

The bull run in equity markets hits a wall in 2007

The correction left main market indices with the following annual scores: 3.5% for the S&P, 6.8% for the Eurostoxx, 7.3% for the Ibox-35 and, finally, -11.1% for the Nikkei. Curiously, despite the crisis having its epicentre in the United States, it was European markets that came out worse. Tail-ender Japan, meantime, was further penalised by the weaknesses of its own economy. At the opposite extreme, the Spanish market stands out for the strength of its annual gains.

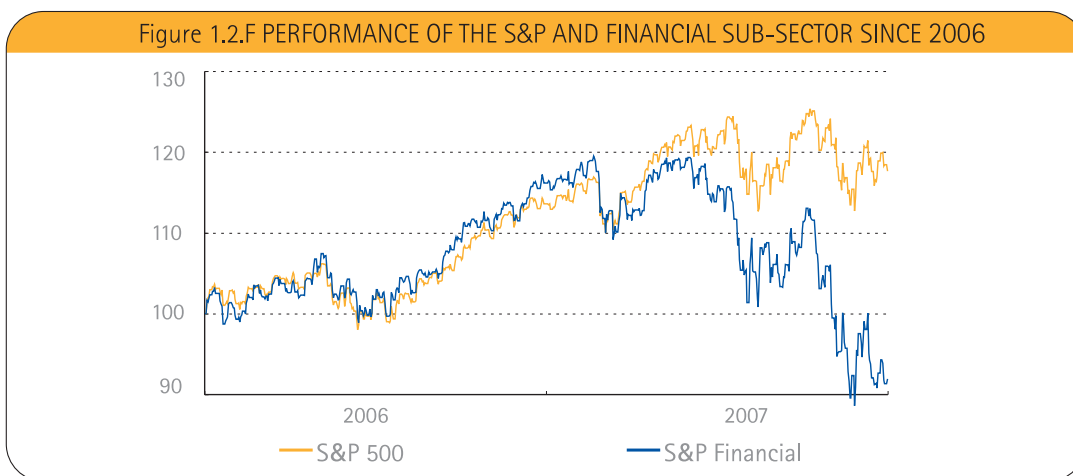
Financial turmoil takes its toll on US and European markets



Source: Bloomberg.

The financial sector was at the centre of the credit crisis. And its eminently "global" nature meant the correction originating in the United States spread almost instantaneously to Europe. Our next figure shows how after a long run of outperformance, the financial subsector began to exert a drag effect from mid 2007 onwards.

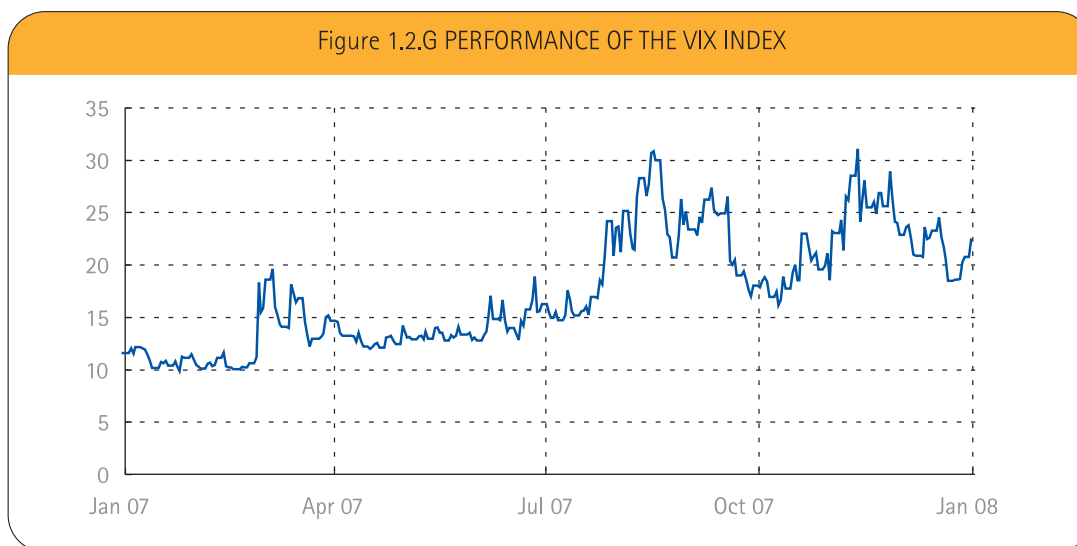
The financial sector is among the first sufferers



Source: Bloomberg.

The instability dominating stock markets was evidenced by a pick-up in both historical and implied volatility. The VIX index of the Chicago Board Options Exchange, which measures implied volatility via the price of options on the S&P, has climbed to highs not seen since 2003 after moving consistently near historic lows throughout 2006.

Volatility picks up sharply



Source: Bloomberg.

The PER (price earnings ratio) of US stocks held relatively flat over 2007, reflecting cooler expectations for corporate earnings. In effect, the companies making up the S&P 500 suffered a 1.9% decline in earnings per share (February 2008 estimates) against the 14.8% growth of 2006.

PER holds stable in the United States

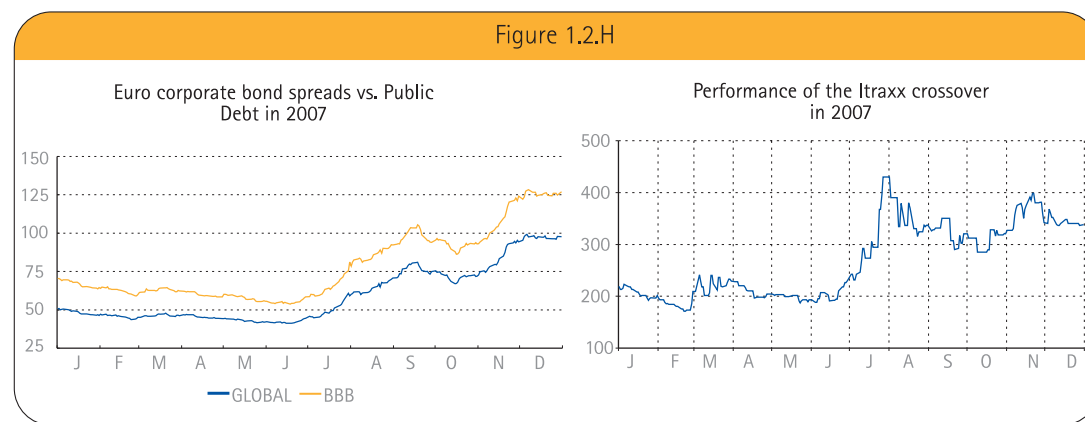
The first thing to say about the Spanish market (see figure 1.2.E) is that it outperformed both European and US peers, with the Ibex-35 index chalking up an annual gain of 7.3% (10.7% if we factor dividend payments into the equation). The main growth driver for Spanish equities has been the strength of corporate earnings. Moreover, Spain's financial sector has come out relatively unscathed versus its European counterparts thanks to its near zero exposure to subprime loans and the stability conferred by its diversified interests in areas like Latin America. Market P/Es dropped back slightly on the strength of the 15.5% profits growth posted to the 2007 close.

Spanish markets outperform their peers

Equity trading volumes went from strength to strength, with turnover climbing 45% with respect to 2006. Market capitalisation, meantime, moved up 22.1%.

In fixed income, the robust performance of emerging market debt delivered a 6.5% increase in the EMBI+ index. Though spreads widened 70 basis points to 239, this is still a historically subdued level. The US credit market turmoil has affected emerging market debt, but in smaller measure than other asset classes. The resilience gained in the last few years thanks to emerging countries' improved fundamentals, less issues and the enlargement of their investor base has given emerging market paper safe-haven status compared to other assets buffeted by the junk mortgage crisis.

Corporate bonds too felt the impact of the subprime crisis. For higher rated issuers (investment grade), the run-up in risk premia was a manageable 47 basis points as far as a 98 bp spread over risk-free assets. But lower quality bonds fared a lot worse. Heightened perceptions of risk in the European private fixed-income market and the cost of its avoidance can be tracked using the *Itraxx crossover*, which measures the spread in rates for insuring risky euro corporate debt against default and which, as we can see below, has been trading sharply higher since the turbulences of summer.



Source: Reuters.

The securitisation market has been one of the main contagion channels for financial turmoil. And it is important to pause here to look at the specifics of the Spanish market, which in recent years has grown into the second largest in Europe after only the United Kingdom.

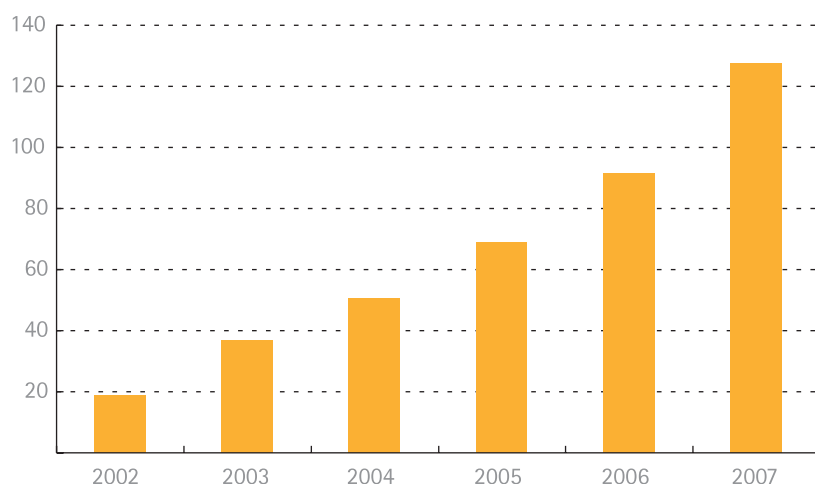
Trading volumes on the rise

Emerging market debt fares relatively well

Euro corporate bond spreads head higher, but distinguishing by quality

Spain ranks second in Europe by securitisation issuance

Figure 1.2.I ASSET-BACKED SECURITIES IN SPAIN
(issues filed with the CNMV, in billion euros)



Source: Authors (data to November 2007).

The rise of the Spanish securitisation market owes to the intense growth of lending in the Spanish financial system which has not been matched by the growth in customer deposits. Spanish institutions, in consequence, have turned increasingly to wholesale markets in order to bridge this funding gap. This model bears no relation whatsoever to the "originate to distribute" practices of certain foreign institutions which are at the root of uncertainties about the location of US subprime losses. Other distinguishing features of the Spanish market are the relative simplicity of the securitisation structures in use, and the high quality of the underlying assets (94% of asset-backed securities hold a top credit rating from international agencies).

As regards the distribution of risk, it bears mention that an overwhelming majority of Spanish asset-backed securities are in the hands of national or foreign financial institutions, so are less exposed to financial turmoil. Further, the riskiest tranches tend to be held by Spanish credit institutions. Most of this risk is accordingly carried on the balance sheet, so banks have every incentive to manage it prudently.

The Spanish securitisation model corresponds to the funding of lending activity and stands out for the quality of underlying assets ...

... with reduced exposure to market turmoil



GOVERNMENT BOND
MARKETS IN 2007

2



2.1. MAIN INTERNATIONAL TRENDS

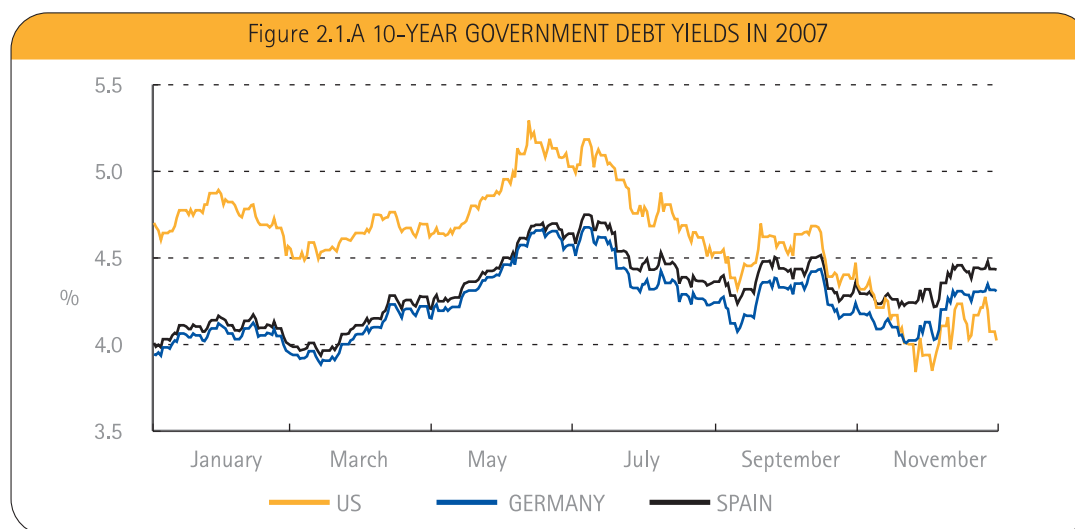
The long-term yields of government bonds performed divergently on the two sides of the Atlantic. This was not so much in the pattern as in the intensity of their movements, which translated as an annual change in opposite directions, as shown in figure 2.1.A below. In effect, the 10-year US government bond yield took a considerable tumble (-67 bp) as far as a year-end yield of 4.023%. In the Eurozone, meantime, yields edged gradually higher (+36 bp) with the 10-year Bund yield closing at 4.307%.

The reasons for the uneven second-half performance of developed country sovereign paper lie in the knock-on effects of the financial turmoil unleashed in July, which was felt most acutely in the United States as the epicentre of the storm. Differences, however, also reflect the divergent stance of monetary policy and the fact that both economies find themselves at different stages of the cycle.

In the United States, the downtrend in long-term government yields reflected the deceleration of economic activity. Eurozone yields, however, picked up slightly on the strength of a recovery trend that by the end of the year was only just beginning to lose steam. It bears mention that 10-year US bond yields closed below their German counterparts for the first time since 2004. The year-end picture, then, was one of long government yields moving at fairly low levels in a context of subdued economic growth and mounting inflationary pressures, as oil prices exerted their pull. This was reflected in a jump in the inflation breakeven in both geographical zones.

A fall in US government yields contrasting with a moderate upturn in the Eurozone

Long-term sovereign bond yields move at historic lows



Source: Bloomberg.

A more detailed analysis of yield performance in the year reveals two differentiated periods:

The year began in a climate of indecision, with yields moving sideways. Then sovereign bond yields began to head higher on the prospect of a soft landing for the US economy, despite warning signs like a sharper housing market contraction and the first episode of what would later become the subprime mortgage crisis. This tentative movement strengthened into a rally that lasted till the month of June. Among the factors behind the large-scale sale of government bonds we can cite the optimistic bent of economic indicators, technical sales for hedging purposes by the managers of securitised mortgages, portfolio diversification by Asian central banks, the "crowding-out" effect that rising equity markets tend to exercise on bonds and the entry to what was then assumed to be a new rates upcycle at international level. At this point, developed country central banks still had inflation as their main worry.

The year opens with sideways movements followed by a yield rally to the month of June

Then came the dual crisis of liquidity and confidence. During this time of strong turbulence and heightened volatility, government debt acted as a safe haven for an increasingly risk averse investor public. Growing demand for sovereign bonds, in what was clearly a flight to quality, triggered a sharp run-down in yields (in other words, a run-up in Debt prices, remembering that price and yield move inversely). Attempts to normalise rates made little headway against the evidence of a continuing downturn in US real estate, accompanied by mounting financial instability that was making inroads into bank sector earnings.

The credit and liquidity crunch prompt a flight to the quality of government paper

This new scenario was quickly embedded into yield curve slopes in both the US and Eurozone. The dynamics of the Public Debt market launched the curve into a strong steepening trend, after the flattening that had predominated over 2006 and the first months of 2007. In fact, the slope of the US curve between 2 and 10 years was testing 100 basis points by the end of the year. This is because the decline in yields that accompanied the summer's financial turmoil was sharper at the short end (2 years) than in longer maturities (10 years). A number of factors explain this behaviour.

Sharp curve steepening in the year's second half...

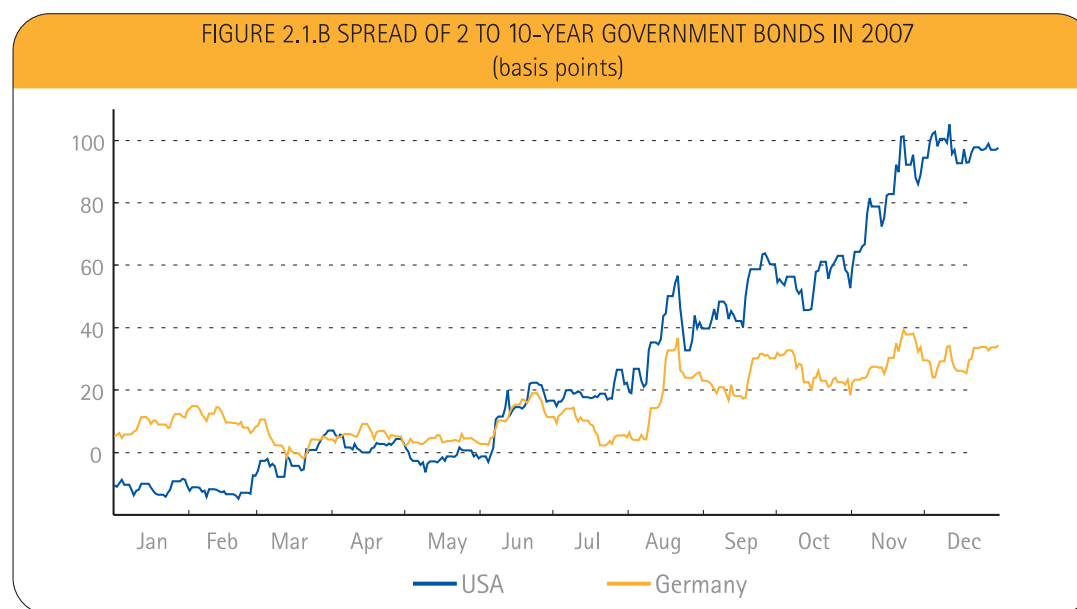
Firstly, the dearth of liquidity sent investors rushing for more liquid short-term paper. The rise in demand was therefore in inverse proportion to the instrument's maturity.

... as demand is keenest for shorter-dated bonds...

Secondly, the yields of short-term governments are more sensitive to expectations for interest rates and monetary policy. As such, monetary easing in the United States exerted a proportionally greater impact, as did the June decision to call a halt to the rates upcycle in the Eurozone.

... and because short-term yields are more sensitive to interest rate expectations

In figure 2.1.B we can observe the sharp curve steepening that took place in both the US and the Eurozone. The steeper angle of the US curve reflects the differing stance of monetary policy and the market's expectations of more rate cuts to come.



Source: Bloomberg.

2.2. SPANISH PUBLIC DEBT YIELDS

The Spanish economy again gave proof of the healthy state of its public finances. A strong growth performance, together with a budget surplus and further reduction in the debt/GDP ratio, conserved Kingdom of Spain Debt its maximum credit ratings (AAA) from the top world agencies (Standard & Poor's, Moody's and Fitch).

Spanish Government Debt keeps its AAA rating

The yield spread between the Spanish and German 10-year bond held more or less flat in the first half of the year. However, the more unsettled and volatile scenario following the outbreak of financial turmoil

The spread vs. Germany widens in the year

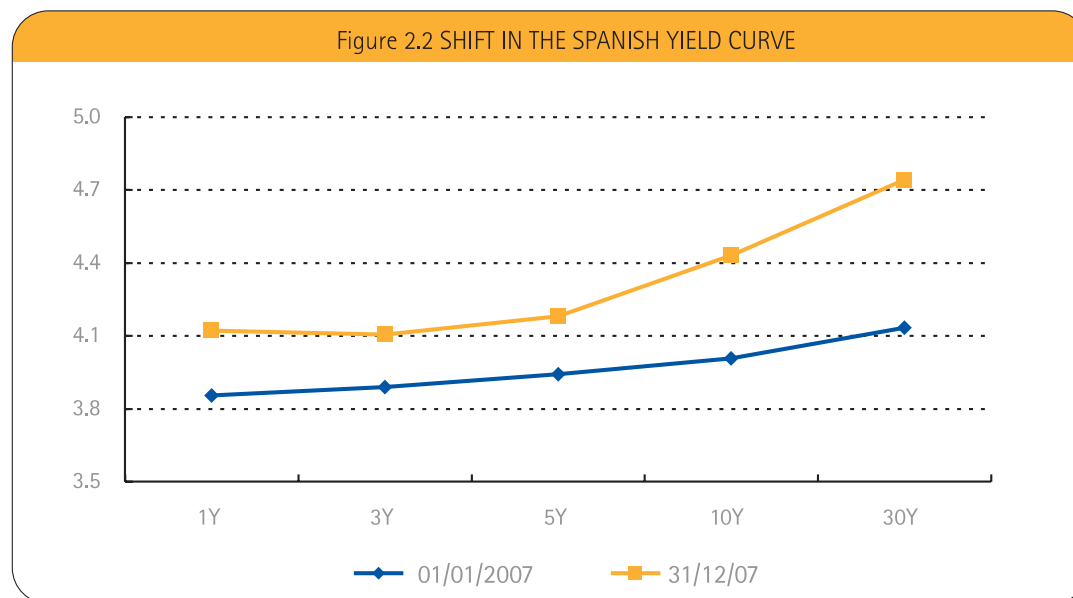
caused a flight to the quality of German debt that sent the spread heading considerably wider. It should be stressed that this is not a case of investors penalising Spanish Debt, which in fact fared better than that of other EU Member States, but simply testifies to the refuge status of the German economy.

Spanish government bond yields traced a similar course to that of Eurozone partners, within the same differentiated periods described in our previous section.

The full-year outcome was an upward shift from the short to the long end of the Spanish curve, as depicted in figure 2.2 below. We can also see that yields rose more steeply in the longer maturities. Hence the one- to three-year band registered the lowest increases, from the 26 basis points of 12-month Letras (closing yield 4.12%) to the 22 basis points of 3-year Bonos (closing yield 4.10%). Further along, the yields of 5-year Bonos rose by 24 basis points to 4.18%, and those of the 10- and 30-year Obligaciones by 42 and 60 basis points respectively to 4.43% and 4.74%.

Spanish government yields move in line with the rest of Europe

Rising yields cause an upward shift in the Spanish curve



Source: Bloomberg.



CENTRAL GOVERNMENT
FINANCING POLICY





3.1. CENTRAL GOVERNMENT DEBT ISSUANCE IN 2007

3.1.1. Overview

As in previous years, Tesoro Público issuance was sizeably less than first forecast thanks to the robust 2007 performance of public accounts.

Tesoro Público reins back issuance

CENTRAL GOVERNMENT DEBT OUTSTANDING(*)				
Year	Letras	Bonos and Obligaciones	Other	Total
1995	70,6	116,6	42,1	229,4
<i>%s/total</i>	<i>30,8</i>	<i>50,8</i>	<i>18,4</i>	<i>100,0</i>
1999	53,1	205,3	36,3	294,7
2002	35,8	247,1	29,0	312,0
2003	38,8	246,0	24,4	309,1
2004	37,0	255,9	26,3	319,2
2005	33,3	264,7	21,2	319,2
2006	31,3	264,1	17,1	312,5
2007	32,4	260,9	13,8	307,2
<i>%s/total</i>	<i>10,6</i>	<i>84,9</i>	<i>4,5</i>	<i>100,0</i>

Source: Directorate General of the Treasury and Financial Policy. Ministry of Economy and Finance.

(*)Central Government Debt in gross nominal terms at the end of each year.

Without deducting either Central Government Debt held by public authorities or the balance of the Treasury's account at Banco de España.

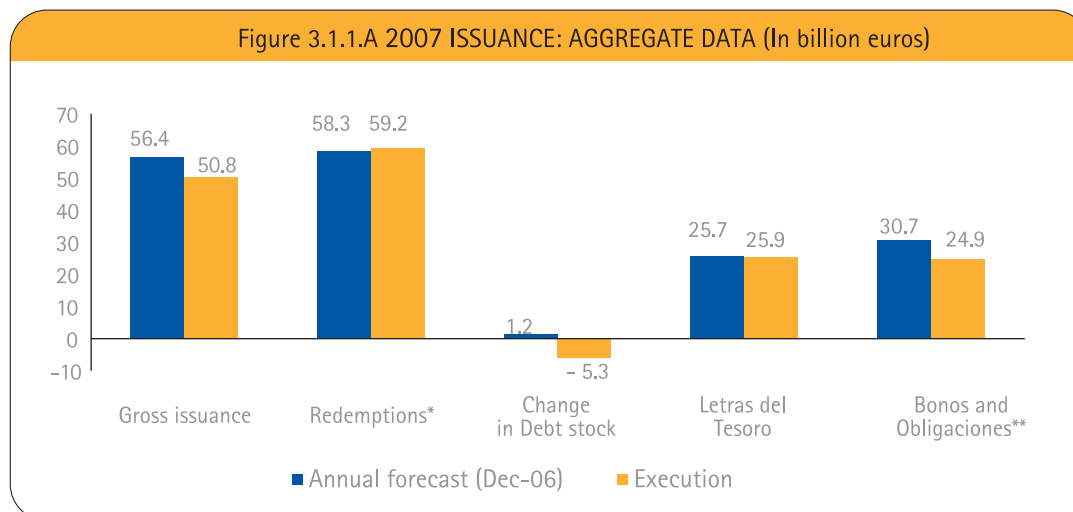
Specifically, gross issuance was cut back by over €6,000 million with respect to the level announced in December 2006, from €56,400 to €50,800 million. The revise-down mainly affected Bonos and Obligaciones, where issuance was almost €5,800 million below forecast. Meanwhile, Letras sales were increased by €240 million.

Outright issuance falls most sharply in Bonos and Obligaciones

The following chart sets issuance targets against the actual figures for the year. Since Tesoro Público Debt redemptions were also slightly higher than announced, the result is a negative net financing of -€8,400 million against the -€1,900 million projected at end 2006. Summing these issuance data with the debt taken on from Radiotelevisión Española, currently in liquidation, we arrive at an overall €5,300 million reduction in the nominal Debt stock.

The year ends with a €4,500 million decrease in the Debt stock

Figure 3.1.1.A 2007 ISSUANCE: AGGREGATE DATA (In billion euros)



Source: Directorate-General of the Treasury and Financial Policy. Issuance figures on a budget basis and change in the Debt stock in nominal terms.

* Including redemptions of Bonos and Obligaciones, Letras, Foreign-Currency debt, assumed debt and other debt.

** Including gross issuance in Foreign Currency.

Figure 3.1.1.B below offers the same information with a breakdown by market instrument. We can see that the issuance adjustment in Bonos and Obligaciones del Estado fell heaviest on the 10-year followed by the 30-year maturity.

Table 3.1.1.B 2007 ISSUANCE (In billion euros)

	December 2006 forecast	2007 close
Gross bond issuance	30.7	24.9
- 3 and 5 year Bonos	12.2	11.9
- 10 year Obligaciones	10.0	7.0
- > 10 years Obligaciones	7.5	6.0
- Other long term issuance	1.0	0.0
Bonos redemptions	28.5	28.4
Net financing in Bonos	2.2	-3.5
Net financing in Letras	0.7	1.1
Change in other debt outstanding	-1.6	-2.8
Change in debt stock	1.2	-5.3
Pro-memoria		
Total Debt en stock at 31-Dec*		307

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

Source: Directorate-General of the Treasury and Financial Policy.

The issuance policy of Tesoro Público was guided by the same concerns as in previous years; namely, to provide investors with a stable, predictable framework and a choice of highly liquid securities.

Auctions retained their primacy as an issuance instrument, channelling around 84% of annual sales. 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 price, and at the price actually bid in the case of all other accepted bids. Their dates adhered to a pre-set annual calendar: namely Letras auctions on the third Wednesday of each month and auctions of Bonos and Obligaciones on the first and third Thursday respectively. The specific references to be sold are announced ten days before the start of each quarter, with target placement volumes announced the Monday before the auction in question.

Auctions are still the favoured means of placement

Tesoro Público again reduced the number of its annual auctions. However the sharp contraction in borrowing requirements has ruled out further increases in average auction size. In the sections that follow we analyse the progress of auctions over 2007.

However we should pause first to consider some aspects of the 2007 redemptions schedule. Redemptions of Bonos and Obligaciones del Estado summed €28,300 million, plus another €147 million corresponding to debt in foreign currencies, giving a total in line with December 2006 forecasts. The Treasury decided not to buy back Debt on the secondary market, despite its more subdued financing needs, in a break with its policy of the last few years. The reason was to avoid a liquidity drain at the short end of the Spanish curve, in the virtual absence of Treasury issues of 18-month Letras and 3-year Bonos. Instead, Tesoro Público opted for the early repayment of certain non negotiable loans in its portfolio, granted by Banco de España and another supranational financial institution. The exhibit that follows describes the procedure followed with these loans and also with the assumed debt of state corporation Radiotelevisión Española, currently in liquidation.

Tesoro Público makes no buy-backs in 2007, the goal being to prevent any drain on liquidity at the short end of the Spanish curve

EXHIBIT: CHANGE IN THE REPAYMENT SCHEDULE OF SPECIAL LOANS FROM BANCO DE ESPAÑA TO THE STATE

The start of the third phase of Economic and Monetary Union on 1 January 1994 meant Treasury departments could no longer raise additional finance from central banks; a prohibition written into the

Law of Autonomy of the Banco de España. However, they were allowed to consolidate any loans granted beforehand, though the relevant Community text urged converting non negotiable borrowings into negotiable securities maturing no later than the formers' repayment date, and extended an authorisation to this effect.

In Spain's case, this preferred financing was consolidated into three special loans from Banco de España to the State, with zero interest, annual repayment instalments and due dates between 2018 and 2024. The financial conditions of these loans are described below, along with the enabling legislation:

- Law 3/1983 of 29 June on loans to the State.

- Article 2 of Law 3/1983 authorising loans to regularise fund advances and cover budget shortfalls in years prior to 1983 stipulates that the loans enabled therein shall be repayable to Banco de España in forty years, shall be free of interest and shall be repaid in annual instalments of an equal amount starting in 1984. The total loan came to 649,741,798,698 pesetas (3,905,026,857.42 euros) and its outstanding balance at 1 January 2007 was 1,757,262,085.92 euros, with final maturity in 2024 and annual repayments of 97,625,671.44 euros.

- Loan for the payment of contributions to International Organisations.

Granted by Banco de España to the State by virtue of the Laws regulating such payments. The repayment terms and conditions were established in Law 21/1993 of 29 December on the State budget for 1994, whose seventh transitional provision stipulates that Banco de España shall keep the loans granted to the State recorded in its assets, and that these loans shall conserve their repayment terms and conditions and, failing this, should be repaid in twenty-five years in equal instalments falling due as of the fifth year. The amount of this loan at 31 December 1993 was 135,827,051,595 pesetas (816,337,021.11 euros), and its outstanding balance at 1 January 2007 was 489,802,212.63 euros, with final maturity in 2018 and annual repayments of 40,816,851.06 euros.

- Law 4/1990 of 29 June on the State budget for 1990.

Article 48 of Law 4/1990 consolidated the State's net indebtedness with Banco de España as at 31 December 1989 into a special loan, though without establishing a schedule for its repayment. The loan was accordingly subject to the repayment terms and conditions set by Law 21/1993 for cases where no such schedule was stipulated. The starting balance of the said loan was 1,156,045,738,621 pesetas (6,947,974,821.33 euros), and its outstanding balance at 1 January 2007 was 4,168,784,892.77 euros, with final maturity in 2018 and annual repayments of 347,398,741.07 euros.

In 2007, both Banco de España and the General State Administration expressed an interest in bringing forward the original repayment terms with the idea of having all loans paid in full by 2015 at the latest. They also agreed to establish more flexible conditions, providing an express procedure in the corresponding regulation that allows the borrower to bring forward both maturity dates and instalments. The transaction was posed in terms of financial neutrality, meaning all repayments would be at their present value on the payment date, whatever the amount stated in the initial calendar. These changes were formally executed by the parties in an Agreement of 26 March 2007 and Order EHA/1019/2007 of 30 March.

Under the revised repayment schedule for the three special loans, the State will pay two instalments of the Law 3/1983 loan every year between 2007 and 2012 and two instalments of all three loans each year from 2013 to 2015, by which point they will be paid off in full. The instalments payable will be those corresponding to the current year plus the last outstanding from the original schedule, with the annual payment date brought forward to 30 April or the previous business day if it falls on a public holiday. Repayments will be made at their present value on the due date using the zero coupon interest rates of the Debt traded on the secondary market. The operation is accordingly neutral for both parties, while bringing the Treasury an added reduction in outstanding debt by way of the difference between the nominal value being redeemed and the updated cash amount payable.

As such, it fulfils the objectives proposed and will proceed to the benefit of both parties: Banco de España can speed up the redemption of the non negotiable loans on its balance sheet and replace them

with more liquid negotiable assets, while Tesoro Público gets to bring forward annual repayments to the month of April, avoiding the redemptions cluster that occurs around December. Also, the Treasury has the option, under the terms of the agreement, to pay all or part of any instalment earlier than the specified date with a minimum of ten days notice.

Set out below are the original and modified loan repayment schedules with amounts expressed in nominal terms:

YEAR	ORIGINAL SCHEDULE			ACTUAL SCHEDULE		
	Law 31/1983 loan (Due 15.12)	Int. Org. loan (Due 30.12)	Law 4/1990 loan (Due 30.12)	Law 31/1983 loan (Due 30.04)	Int. Org. loan (Due 30.04)	Law 4/1990 loan (Due 30.04)
2007	97,625,671.44	40,816,851.06	347,398,741.07	195,251,342.88	40,816,851.06	347,398,741.07
2008	97,625,671.44	40,816,851.06	347,398,741.07	195,251,342.88	40,816,851.06	347,398,741.07
2009	97,625,671.44	40,816,851.06	347,398,741.07	195,251,342.88	40,816,851.06	347,398,741.07
2010	97,625,671.44	40,816,851.06	347,398,741.07	195,251,342.88	40,816,851.06	347,398,741.07
2011	97,625,671.44	40,816,851.06	347,398,741.07	195,251,342.88	40,816,851.06	347,398,741.07
2012	97,625,671.44	40,816,851.06	347,398,741.07	195,251,342.88	40,816,851.06	347,398,741.07
2013	97,625,671.44	40,816,851.06	347,398,741.07	195,251,342.88	81,633,702.03	694,797,482.07
2014	97,625,671.44	40,816,851.06	347,398,741.07	195,251,342.88	81,633,702.12	694,97,482.14
2015	97,625,671.44	40,816,851.06	347,398,741.07	195,251,342.88	81,633,702.12	694,797,482.14
2016	97,625,671.44	40,816,851.06	347,398,741.07			
2017	97,625,671.44	40,816,851.06	347,398,741.07			
2018	97,625,671.44	40,816,850.97	347,398,741.00			
2019	97,625,671.44					
2020	97,625,671.44					
2021	97,625,671.44					
2022	97,625,671.44					
2023	97,625,671.44					
2024	97,625,671.44					
TOTAL	1,757,262,085.92	489,802,212.63	4,168,784,892.77	1,757,262,085.92	489,802,212.63	4,168,784,892.77

In accordance with the revised schedule, the instalments corresponding to 2007 were met on 30 April, at a price of 72.109126 percent for the Law 3/1983 loan and 97.364927 percent for the other two. The nominal amount repaid came to 583,466,935.01 euros with a redemption value of 518,779,866.92 euros, saving Tesoro Público the 64,687,068.09 euros difference thanks to the advancement of the due date.

EXHIBIT: ASSUMPTION OF THE DEBT OF STATE-OWNED RADIOTELEVISIÓN ESPAÑOLA, CURRENTLY IN LIQUIDATION

The fifth transitional provision of Law 17/2006 of 5 June on state-owned public radio and television stipulates that the Government should provide the former body Radiotelevisión Española (now in liquidation) and its companies with the necessary funding and economic resources to conclude its liquidation process in an orderly fashion and meet all claims on its assets. The debt of RTVE was 7,811,821,811 euros as at 31 December 2006. Of this total, some 40% or 3,180.91 million euros fell due or was otherwise callable in 2007, with another 20% approximately maturing each year from 2008 to 2010.

This being so, article 50.1 of Law 42/2006 of 28 December on the State budget for 2007 provides that the Central Government will assume the nominal amount of the debt repayments of this public corporation on their respective due dates up to a maximum amount of 3,180,910.91 thousand euros. Section two of the same article envisages that the Central Government will assume the rest of RTVE's cumulative debt in the years 2008 to 2010. Although this will foreseeably happen on the corresponding dates, the specific undertaking to this effect must figure in each year's annual budget law.

3.1.2. Bonos and Obligaciones del Estado

Tesoro Público had no recourse to foreign-currency issuance in 2007 in view of its scant borrowing requirements and the prevailing market conditions. As such, our analysis of medium- and long-term issues will be confined to Bonos del Estado and Obligaciones del Estado, whose 2007 sales amounted to €24,900 million.

Bono issuance, at €11,870 million, represented 48% of this total and was only slightly down on the target announced in December 2006. The main novelty was that Tesoro Público opted to concentrate liquidity at a single point in this curve segment. In effect, only one new Bono was launched in the year: a 5-year bond, coupon 3.90%, issued in January and maturing in October 2012, which was auctioned four times bringing its outstanding balance to around €8,800 million. In the 3-year term, Bono 2.90%

Sales of Bonos and Obligaciones del Estado sum €24,900 million

Issuance of Bonos (48% of the total) is concentrated in the five-year term

maturing October 2008 had its last auction in the month of February, closing with an outstanding balance of €11,600 million. The Treasury also provided more liquidity to this maturity band by reopening an old bond in the month of December (4%, January 2010).

The issuance of 10-year Obligaciones was cut back sharply, with no new bonds placed in this term. The year's four auctions of the Obligación 3.80%, January 2017 lifted its outstanding volume to nearly €12 billion.

The long end of the curve was perhaps the most visible, thanks to the Treasury's June launch of a new 30-year benchmark (4.90%, July 2040) for the sum of €4 billion. The bond's sale was handled by a syndicate, which 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. Finally, one auction of the Obligación 2037 and another of the new 2040 maturity takes total ultralong issuance to around €6,000 million, likewise lower than the pre-announced amount.

Figure 3.1.2 shows the volumes sold at each auction and the associated bid-to-cover ratio. This ratio reflects the relationship between the bids made at each auction and the final amount issued by the Treasury. It accordingly stands as a demand indicator for each maturity band. The fact the bid-to-cover ratio has held consistently above 2 denotes the strong demand existing for Spanish paper.

We can also see the amounts allotted in non competitive bidding and second rounds. The former refers to bids that are filled at the weighted average price of the auction in question. They tend to trace back to smaller investors, who use them to ensure their bids will be accepted. The ceiling amount of non competitive bids was raised in 2006 (from one hundred thousand to a million euros) to deter competitive bidding at inflated prices with its distorting effect on auction outcomes. Such bids are especially relevant in the case of Letras del Tesoro, as we will later discuss.

Second rounds are an option reserved for Primary Dealers who meet the minimum Debt quotation requirements set in their regulations. Those entering the second round have their bids allotted at the weighted average price of the competitive auction. As such, their use by Primary Dealers depends on

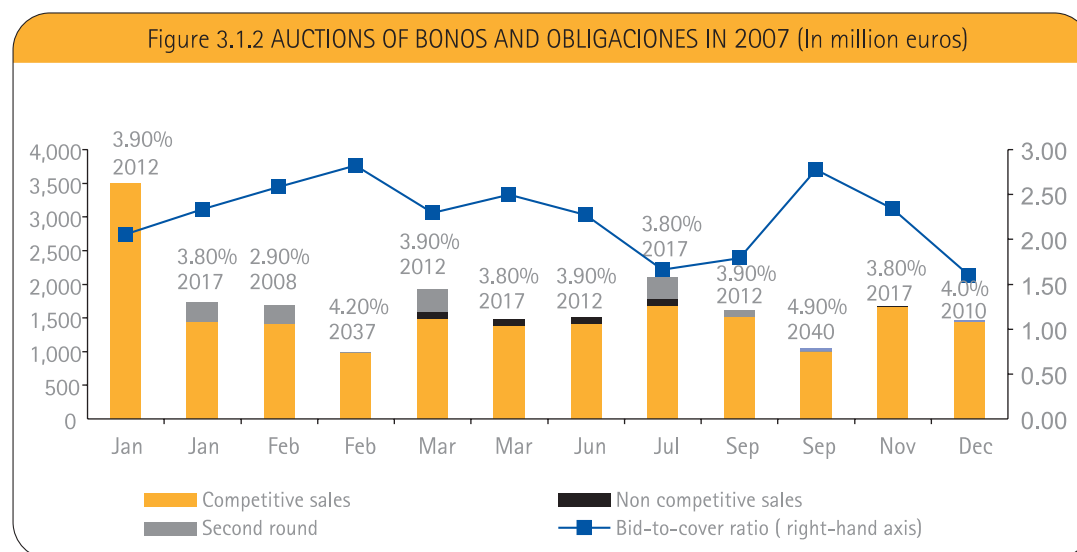
Meanwhile, 10-year issuance drops back sharply

The transaction attaining most market visibility was the syndicated placement of a new 30-year Obligación with €4 billion euros allocated

A bid-to-cover ratio of over 2 evidences the strength of demand for Spanish paper

Second round issuance of €1,372 million

the market conditions prevailing. Basically, they will only be interested if the market price on the date in question (two business days after the auction, almost always a Monday) is higher than the auction average. In 2007, the total issued in second rounds came to €1,372 million.



Source: Directorate-General of the Treasury and Financial Policy.

EXHIBIT

SYNDICATED ISSUE OF THE 30Y BENCHMARK

In June 2007, Tesoro Público issued €4,000 million of a new 30-year Obligación. This bond, which is the benchmark in its term (replacing the now closed 4.20%, July 2037), has a 4.90% coupon and matures on 30 July 2040.

Tesoro Público markets a new 30-year benchmark in June 2007

Tesoro Público decided to again use a bank syndicate for the placement of the opening tranche. Syndication is regarded as a good option for placing large volumes of bonds dated 10 years and more, as it helps to get the outstanding balance rapidly up to strength. It also improves distribution among end investors thereby favouring the bond's secondary market performance.

This particular syndicate had a two-tier structure made up of leads and co-leads. The leads on this

occasion were Barclays Capital, BBVA, Calyon, Citigroup, SCH and Société Générale CIB with almost all remaining Primary Dealers making up the second tier of co-leads.

Almost all Primary Dealers entered the syndicate, with a two-tier structure

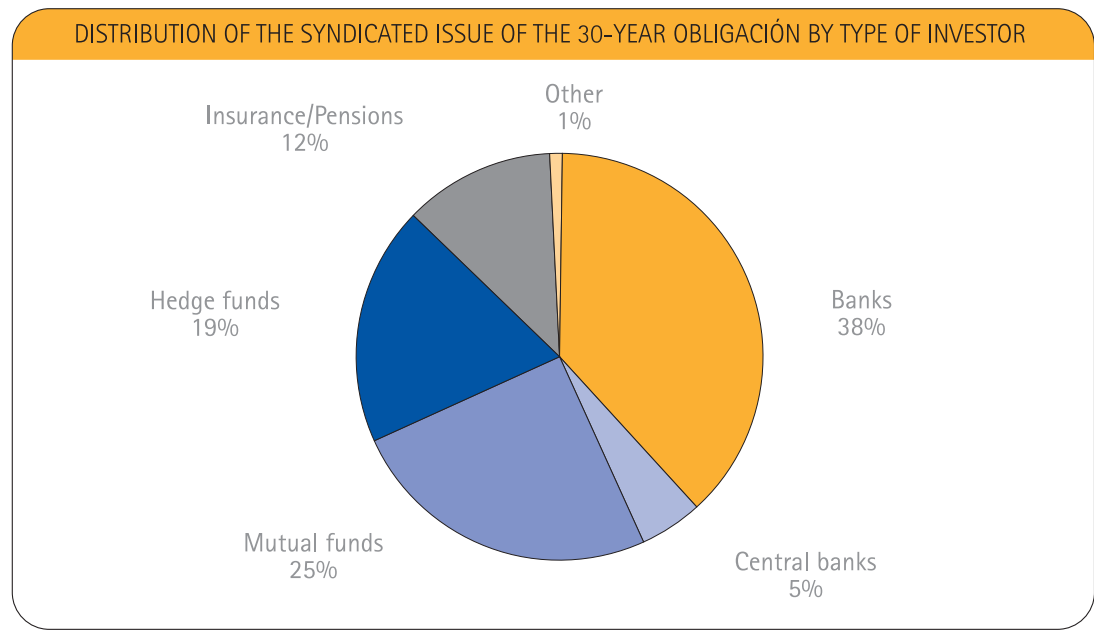
Despite the volatile markets of the time, the Treasury managed to place the Obligación at a spread of +7 basis points to the German benchmark (4%, January 2037). This was also the lowest price on the indicative range, which ran from +7 to +9.

The order book, finally, summed over €11,000 million, spread across 119 accounts. This time round, the Treasury issued only €4,000 million euros, in view of the healthy state of Spain's public finances. It was accordingly possible to allocate to the highest quality investors. Over 42%, finally, went to end investors (mutual and pension funds, insurers and central banks), 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.

The issue is 2.75 times overbidded

With more than 42% going to end investors

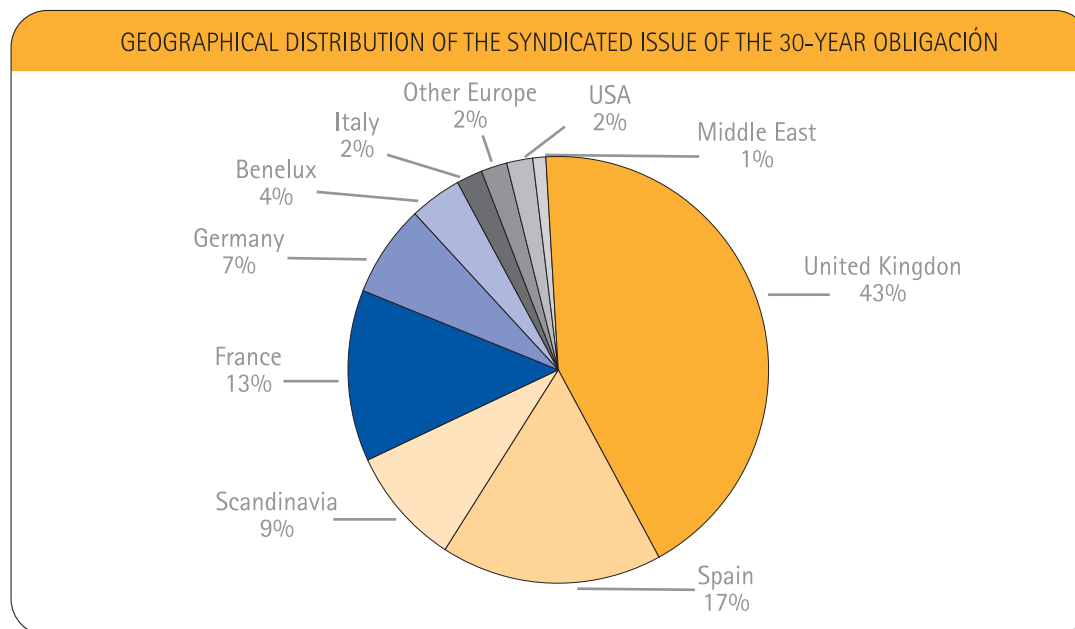
The operation also fulfilled its mission of diversifying the investor base, with more than 80% of sales to



Source: Directorate-General of the Treasury and Financial Policy.

institutional investors. By country, 43% found its way to the United Kingdom, followed by France with 13% and the Scandinavian countries with 9%.

80% of sales are to international investors



Source: Directorate-General of the Treasury and Financial Policy.

3.1.3. Letras del Tesoro

One of the big novelties in 2007 was the reform of the Letras del Tesoro market. The reasons for this reform were essentially two:

The 2007 reform of the Letras market streamlines issuance in the one-year term

- Firstly, the gradual but sustained decrease in Letras market size. This has certainly reduced the refinancing risk that invariably looms over the short curve segment, but at the cost of liquidity, which tends to be a sticky point with bills in general. The solution sought was along the same lines as with Bonos del Estado; namely, to concentrate liquidity in a single maturity. The term chosen was in this case 12 months, with the Treasury ceasing to issue 18-month bills.

- The Treasury also judged it wise to switch to a scheme of monthly auctions and maturities (against the monthly auctions and two-monthly maturities that had characterised the market in previous years). The goal here was to prevent market operation from causing constant fluctuations in the Central Government cash position. Investors, meantime, would enjoy the advantage of a considerably denser short-term curve. Another problems arising with the previous system was that investors wishing to roll over their Letras holdings invariably did so in even months (the only one with maturities), with a distorting impact on the corresponding auctions. Our next graph clearly shows the large number of non competitive bids submitted in even months.

These considerations led the Treasury to streamline Letras issuance in the 12-month maturity. It accordingly suspended sales of 18-month Letras, calling a last auction in this term for January 2007, but as part of its issuance schedule for the year 2006. 12-month auctions were then held monthly, with maturities in every month of 2008 except January (whereas 2007 maturities were confined to even months). In order to provide liquidity to the new 12-month Letras issued in odd months, i.e., which are not re-openings of old 18-month bills, a series of six- and seven-month auctions were organised in the second half of 2007:

- in August and September the bill maturing in March 2008 was auctioned (at 7 and 6 months) for €570 and €590 million respectively.

- followed in October and November by auctions of bills maturing in May 2008 for €634 and €582 million in each auction.

- and in December by the bill maturing in July 2008 for upwards of 700 million euros.

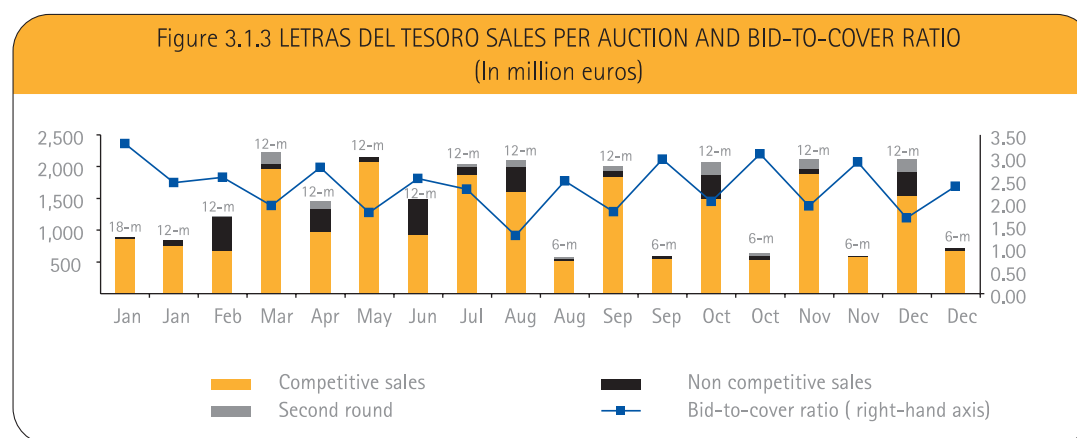
As well as putting more liquidity behind the new Letras, these shorter-term issues add flexibility to Central Government cash management by bringing in short-term funds in the year's closing months when there tend to be more payments and, generally, fewer long-term issues.

The reform will be rounded off in 2008 with the redeeming of all remaining 18-month Letras (the last in June). The market will thereafter have 12 bills outstanding with monthly redemptions coinciding with the value date of each auction.

As to Letras issuance volumes, the €26,000 million raised at 2007 auctions was broadly in line with initial forecasts. So in contrast to the shrinkage experienced in preceding years, the size of the Letras market remained practically unchanged at around €32,500 million (nominal) or 10% of the Debt stock.

After years of shrinkage, Letras market size stabilises at 26,000 million

Our next figure gives the results of Letras auctions in the year. Like the equivalent table for bonds it include non competitive bids (more frequent in this market) and the second round offered to Primary Dealers (generally organised for the day after the auction with sales of up to 10% of the auction allocation at the corresponding stop-out price).



Source: Directorate-General of the Treasury and Financial Policy

EXHIBIT

Bank credit lines arranged in 2007

Tesoro Público has seldom turned to bank finance in the recent past. Its portfolio accordingly contains only a few loans from public entities, notably the European Investment Bank (EIB), earmarked for the funding of specific projects. In 2007, however, the Treasury negotiated two types of credit instruments with prime international banks which, though not entirely novel, serve to enlarge and strengthen its arsenal of finance sources.

In January it arranged three credit lines with Barclays Bank, Société Générale and ABN AMRO, for a combined amount of €2,500 million drawable against the issue of Letras. The Treasury had made a similar

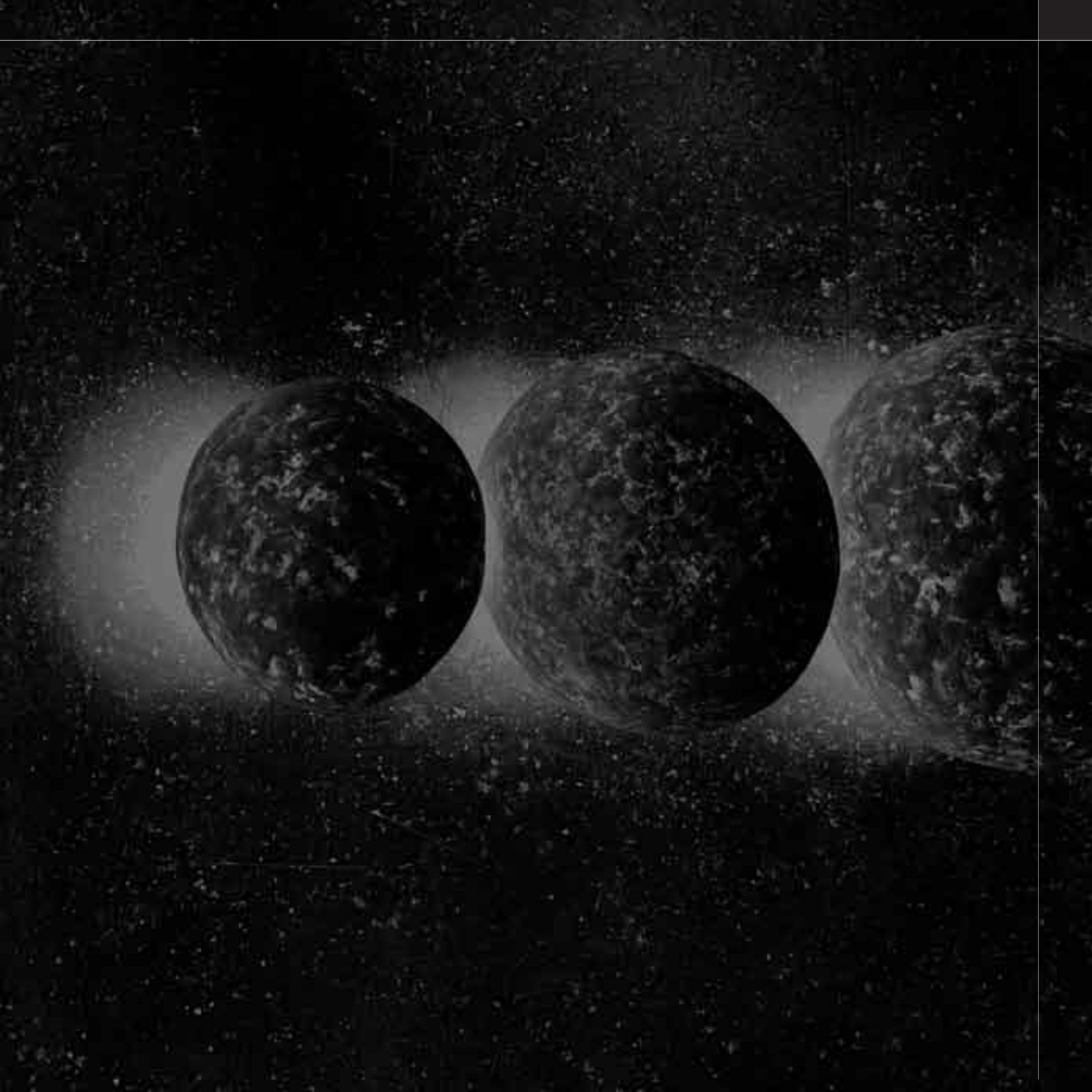
arrangement for the first time in 1997 and thereafter in 2000 and 2003. Rather than a credit line *per se*, it stands as a guarantee of Letras subscription under set conditions (Euribor-0.04/0.05%), whatever the circumstances of the market. This new facility has been taken out for a period of four years.

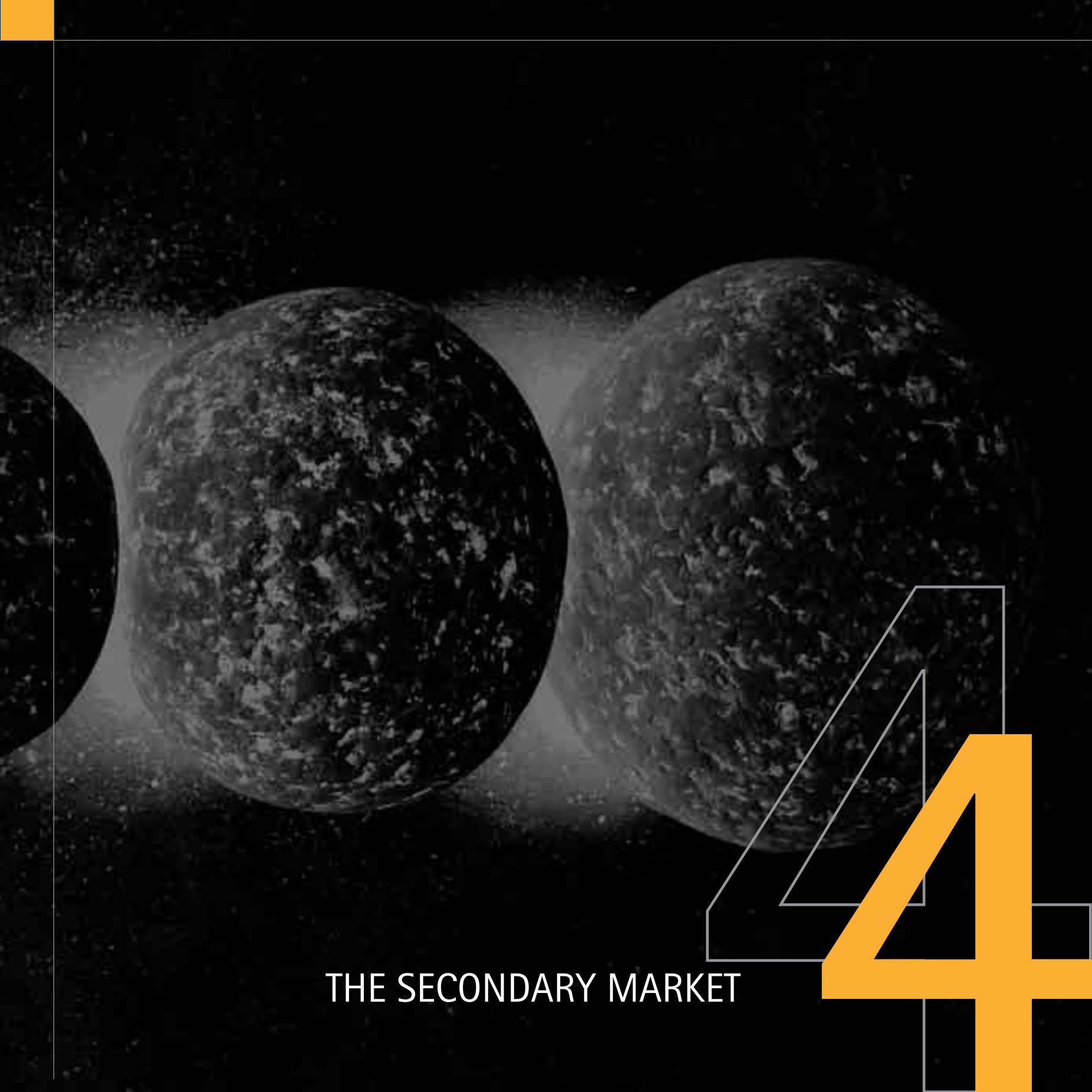
This was followed in July by the arrangement of a syndicated short-term credit line for a period of three years, in this case neither collateralised nor backed by the simultaneous issue of Letras or any other debt instrument. The bank syndicate behind this new line, also for the sum of €2,500 million, comprises Citibank, HSBC, NATIXIS, Dresdner Bank and Credit Suisse, with La Caixa de Ahorros y Pensiones as agent bank. In this case, the credit quality of the lending banks was a key selection factor, while the cost of drawing on the line has been set at Euribor minus 0.04 %.

It should be said that both lines differ from the standard bank loan in that they do not envisage the immediate withdrawal of the total amount. Rather they offer the guarantee of near-instantaneous access to credit – 48 hours in the first case, on the same day in the second. They therefore fall within the category of standby credit lines.

The first time the Treasury designed such a standby facility was in 1993 on the eve of the entry to force of the Law of Autonomy of the Banco de España, which barred its access to central bank finance in line with the requirements of the Maastricht Treaty. To address what was then a new situation, it was judged advisable to arrange a standby line with international banks of strong credit standing, which could be called on in the event of an unforeseeable cash shortage. This line, which was barely drawn, provided the Treasury with an invaluable fall-back in what were financially troubled years both inside and outside Spain.

Its modern-day equivalents will serve, in a far more buoyant financial setting, as a finance source of last resort in the unlikely but not altogether impossible event of some operational risk materialising, and as part of the increasingly sophisticated armoury at the disposal of Central Government liquidity management.





THE SECONDARY MARKET



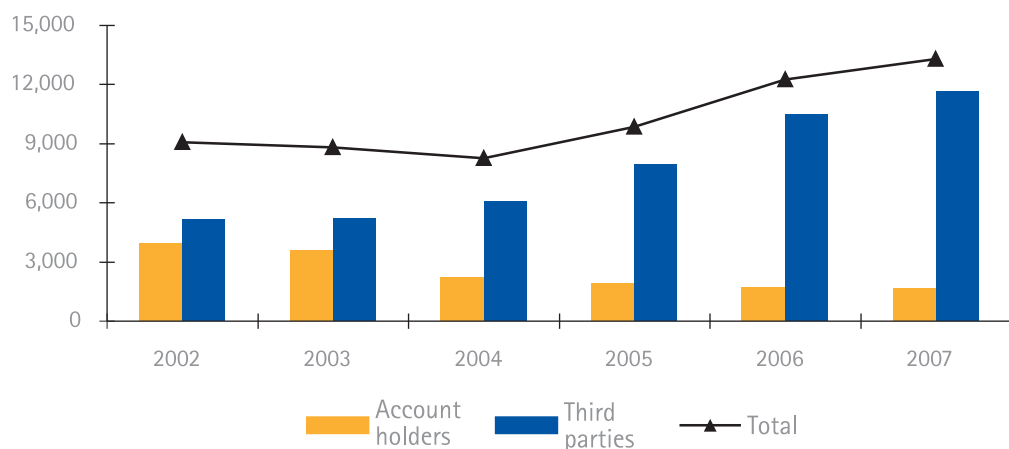


4.1. OUTRIGHT TRADES IN BONOS AND OBLIGACIONES DEL ESTADO

Outright transactions in Bonos del Estado and Obligaciones del Estado (spot and forward) grew their average daily volumes by 8.7% to €13,290 million. Third-party trades accounted for 88% of this total after climbing 11% vs. 2006 to an average daily volume of €11,650 million. This marks the continuation of the vigorous uptrend in place since 2003. Meantime, account-holder trades recorded an average daily volume of €1,640 million, 5.4% less than the year before.

Average daily volumes in outright trades in Bonos and Obligaciones move up 8.7% with respect to 2006

Figure 4.1.A OUTRIGHT TRADES IN BONOS DEL ESTADO AND OBLIGACIONES DEL ESTADO BETWEEN ACCOUNT HOLDERS AND THIRD PARTIES (In million euros)

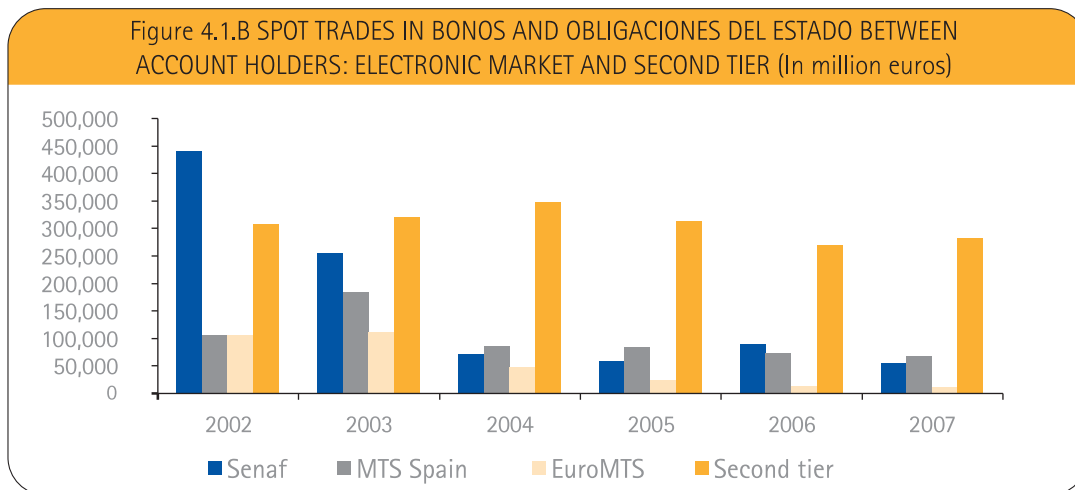


Source: Banco de España.

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 2007 turnover is down by 6% vs. 2006, the reason being a sharp contraction in electronic trading, insufficiently compensated by a small upturn in the second tier.

Spot trades between account holders fall away as turnover contracts on electronic markets

Figure 4.1.B SPOT TRADES IN BONOS AND OBLIGACIONES DEL ESTADO BETWEEN ACCOUNT HOLDERS: ELECTRONIC MARKET AND SECOND TIER (In million euros)

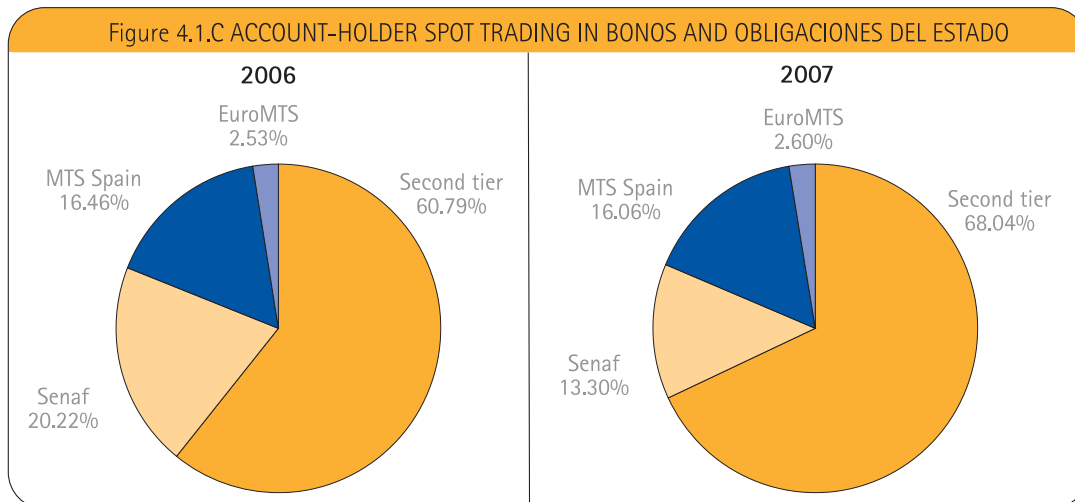


Source: Iberclear.

These developments served to push up the share of second-tier trading, primarily at the cost of the Senaf platform. The share per platform also varied in the year, with MTS Spain pulling slightly ahead of Senaf. Activity on EuroMTS stayed more or less flat in relative terms.

The second tier gains ground

Figure 4.1.C ACCOUNT-HOLDER SPOT TRADING IN BONOS AND OBLIGACIONES DEL ESTADO



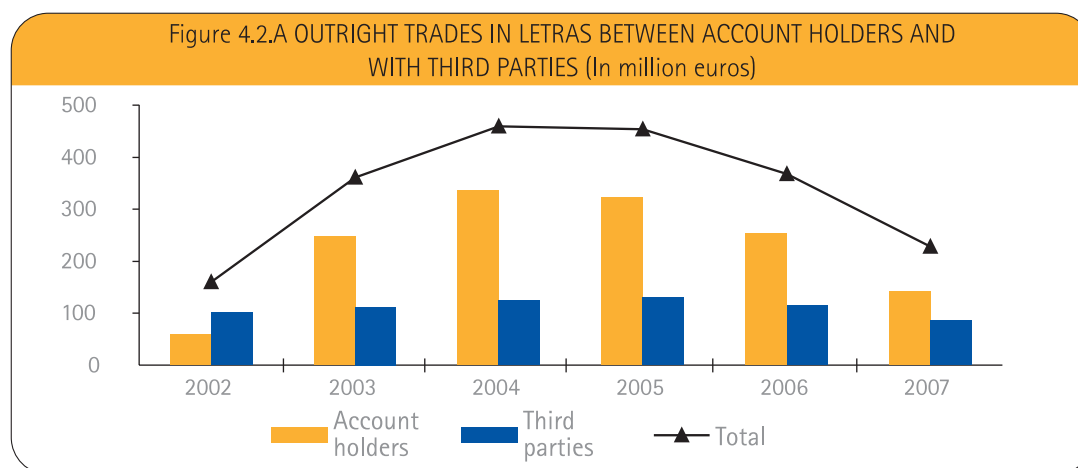
Source: Iberclear.

The bond most keenly traded in the wholesale market in 2007 was the 10-year Obligación (coupon 3.80%, maturing January 2017), which accounted for 17.91% of total spot trading on the electronic market and second tier, followed by the 5-year Bono (coupon 3.90%, maturing October 2012) with 9.40%, and the 10-year Obligación (coupon 3.15%, January 2016) with a share of 7.55%.

4.2. OUTRIGHT TRADES IN LETRAS DEL TESORO

The Letras market experienced a lull in its activity, with average daily turnover dropping back 37.8% to 228 million. This decline extended to both wholesale trading, down by 44%, and business-to-consumer volumes, which fell by 25% with respect to the previous year.

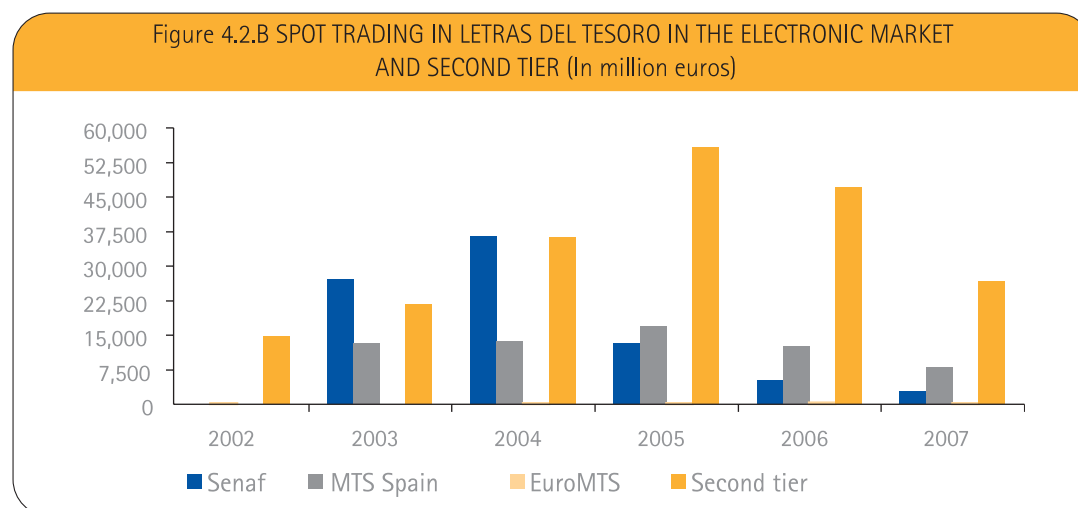
Outright trading in Letras recedes in the year



Source: Banco de España.

The trading contraction in the account-holder segment traced to both the second tier and electronic platforms.

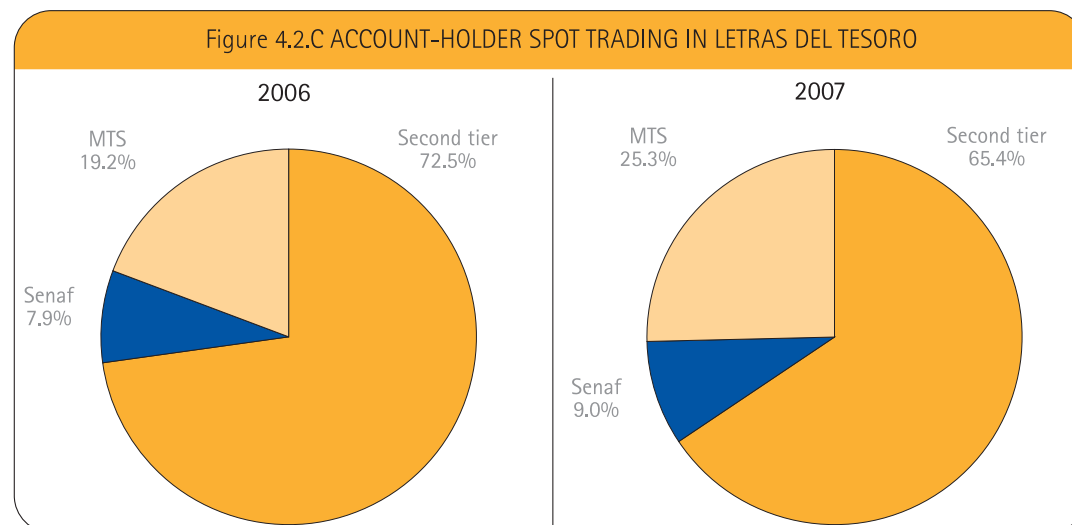
A general decline in account-holder trading



Source: Iberclear.

The decline was rather more acute in second-tier trading, which accordingly dropped back in terms of market share.

The second tier reduces its lead



Source: Banco de España.

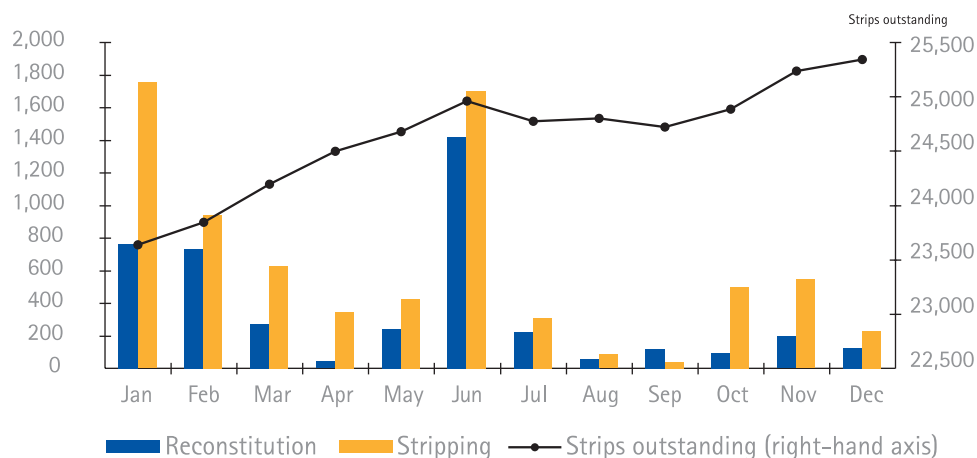
4.3. STRIPS MARKET TURNOVER

The strips market in Spanish debt commenced in 1998 with the first-time authorisation of bond stripping and reconstitution. Three new bonds were declared strippable in 2007 (4.90% July, 2040; 3.90%, October 2012; and 3.80%, January 2017) while another two were redeemed in the year (3.00%, July 2007 and 4.25%, October 2007). This left an end-2007 total of 21 principle strips with their respective coupon strips, covering a spectrum of maturities from 2008 to 2040, and with a total strippable volume of €360,990.25 million, between principle (€255,336.27 million) and coupons (€105,653.98 million). As at 31 December stripped debt outstanding came to €25,339.07 million.

21 strippable bonds with a maximum strippable volume of almost €361 billion between principle and coupons

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

Figure 4.3.A STRIPPING AND RECONSTITUTION
(In million euros)

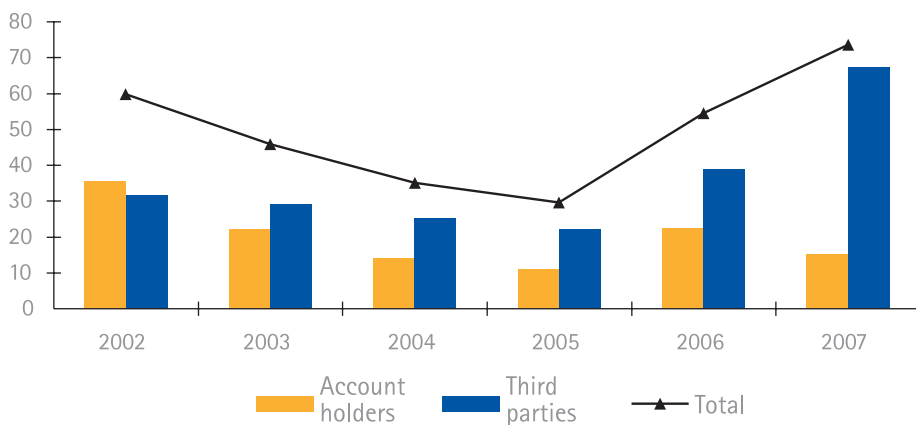


Source: Banco de España.

The strips market continued its come-back through 2007, albeit with third-party trades as the sole driver. Turnover in this segment was around 73% higher in year-on-year terms, amply compensating the 31.1% decline in wholesale trading.

Stripped debt trading moves up strongly with third parties but declines among account holders

Figure 4.3.B OUTRIGHT TRADES IN STRIPPED DEBT BETWEEN ACCOUNT HOLDERS AND WITH THIRD PARTIES (In million euros)



Source: Banco de España and Iberclear.

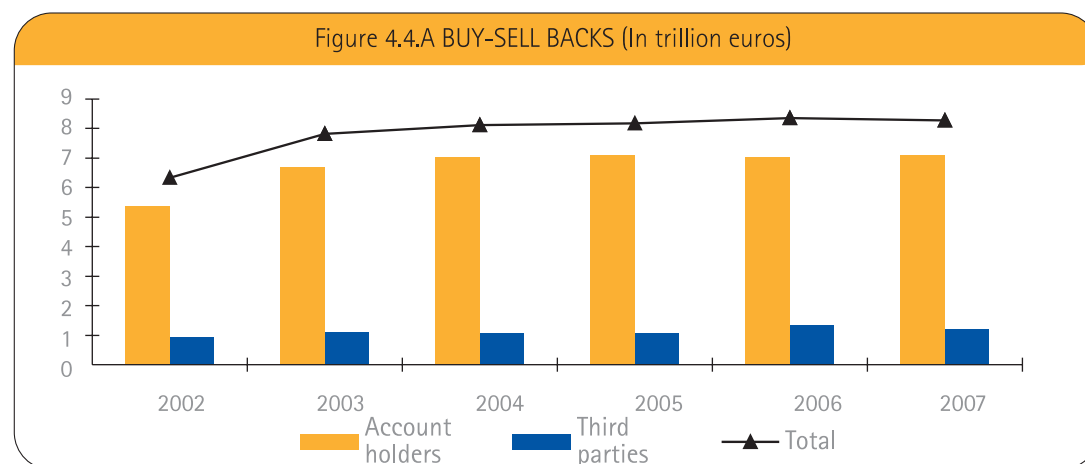
By reference, the most actively traded was the principal component (PO) of the Obligación 6.00%, January 2029, which accounted for 15.15% of all strips traded in the account-holder segment. Next in line, with a share of 10.08%, was the PO of the Bono 5.35%, maturing October 2011.

4.4. 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 account-holder to client trades, since there is no risk of the third party failing to return the security on the preset date.

Turnover in buy-sell backs was slightly down in comparison to 2006. Of the total, 85.5% corresponded to account-holder trades and the rest to third parties. Bonos and Obligaciones were by far the most popular underlying asset, accounting for 96% of buy-sell back transactions against the 3.7% of Letras and the residual share of strips; these percentages, logically enough, square with the size of the respective markets. Terms again tended to the shortest end, with overnight transactions dominating strongly.

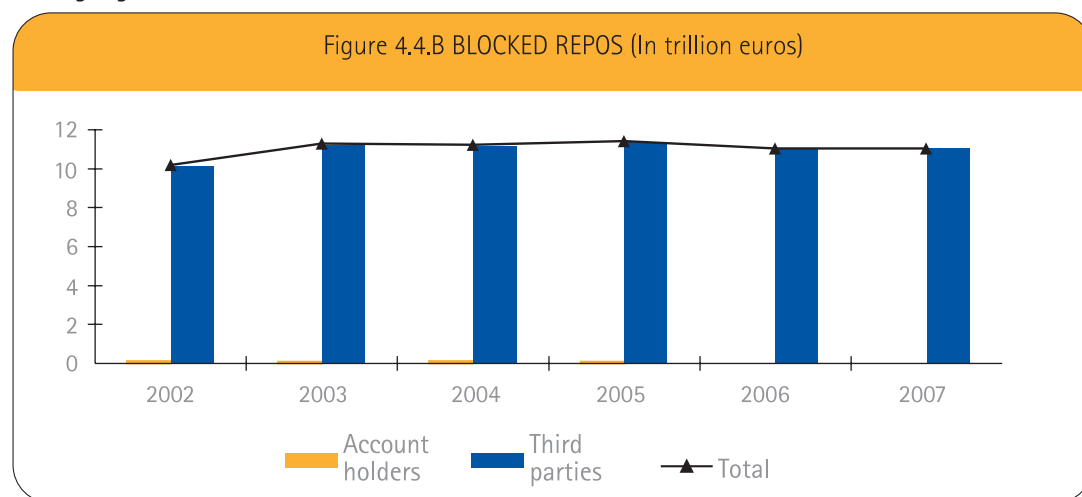
Buy-sell back trading drops slightly in year-on-year terms



Source: Banco de España.

Blocked repo trading was closely in line with the previous year. Transactions, moreover, were confined exclusively to third parties. In effect, the scant wholesale activity in repos apparent since 2006 urged the Banco de España in its Circular 2/2007 of 26 January to prohibit this trading modality among account holders. Demand was again strongest for transactions based on Bonos and Obligaciones, which accounted for 86% of total trading against the 11% of Letras and 3% of strips, though note that these last instruments have gained considerably in popularity. Short terms were also the most prevalent in this trading segment.

Virtually no change in blocked repo turnover



Source: Banco de España.



DISTRIBUTION OF THE CENTRAL
GOVERNMENT DEBT PORTFOLIO





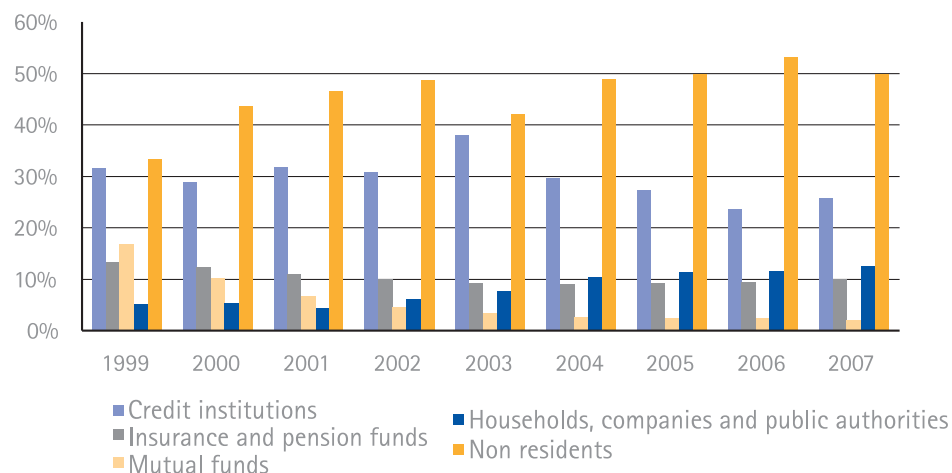
5.1. DISTRIBUTION OF UNSTRIPPED GOVERNMENT DEBT HOLDINGS

5.1.1. Distribution of Government Debt holdings

The distribution of unstripped Government Debt holdings by type of investor was more or less unchanged with respect to 2006. The largest owner groups were again non residents (up from 27% of the total in 1999 to 46% en 2007), followed by Spanish credit institutions (which regained some ground in 2007) and other resident segments. Among this last group, households, companies and the public authorities enlarged their portfolio share against the declining weight of mutual funds, pension funds and insurers. Note that the insurers group includes the Social Security Reserve Fund and the Wages Guarantee Fund, whose abundant surpluses of recent years have translated as a sizeable increase in their Debt holdings.

Since 1999 resident holders have been losing ground to non residents, who now represent 46% of Debt ownership

Figure 5.1.1.A DISTRIBUTION OF HELD-TO-MATURITY PORTFOLIOS OF SPANISH DEBT



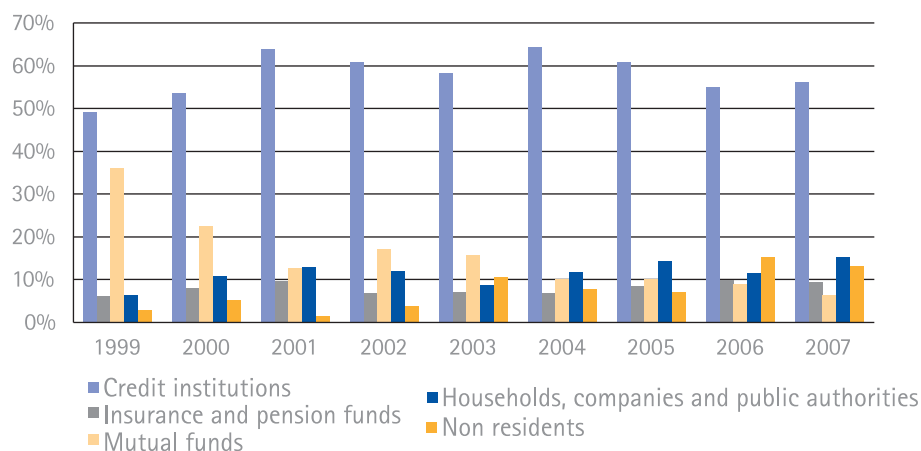
Source: Banco de España.

–Letras del Tesoro held to maturity.

At the short end of the maturities range, we observe that the credit institutions which hold more than 55% of Letras del Tesoro have been losing share in recent years. Likewise Spanish mutual funds, which in the 1990s accounted for 40% of Letras ownership. Non resident holdings have been gaining ground since 2003 and now stand at 13%.

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

Figure 5.1.1.B LETRAS DEL TESORO HELD TO MATURITY



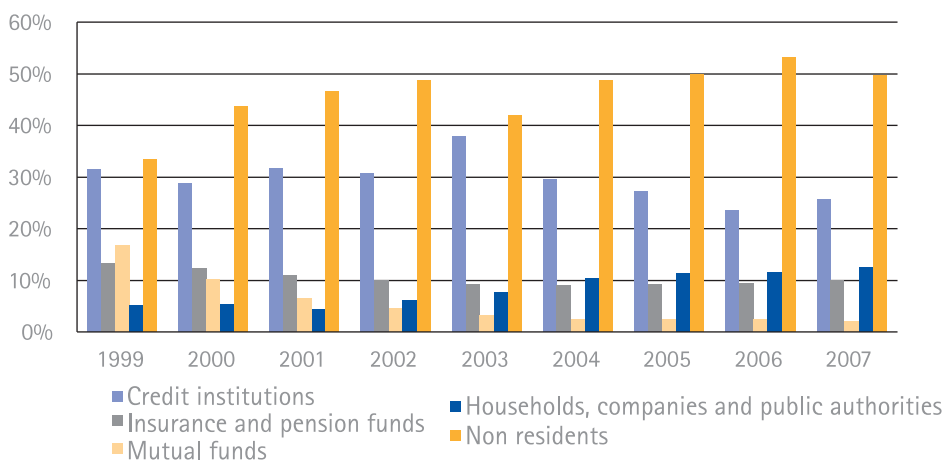
Source: Banco de España.

- Bonos and Obligaciones held to maturity.

Since 1999, non resident investors have headed the Bonos and Obligaciones ownership list. This group accounted for 50% of holdings at year-end 2007. Credit institutions, meantime, reduced their share to 26%, while mutual funds continued their retreat (settling since 2004 around the level of 2%). Spanish households, companies and public authorities, finally, worked their way up steadily to the 12% ownership of end 2007.

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

Figure 5.1.1.C BONOS AND OBLIGACIONES HELD TO MATURITY



Source: Banco de España.

– Stripped Debt held to maturity.

A look at the distribution of the stripped Debt portfolio (principal plus coupons) 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 45% in 2007), to take over as the single biggest group in this category.

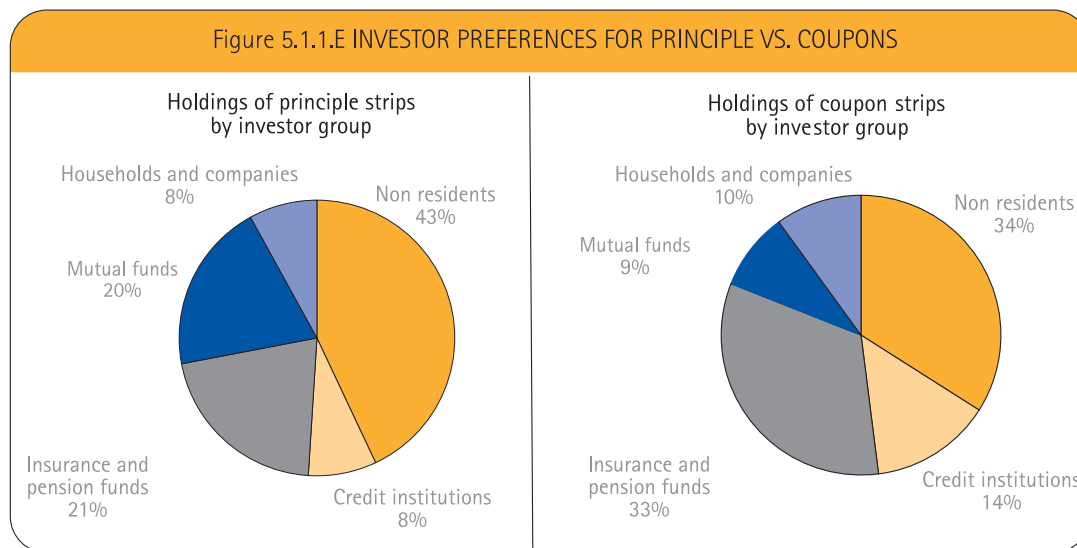
Strong progression of non residents in stripped debt ownership

Mutual funds, which until 2003 were the biggest 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 5.1.1.D DISTRIBUTION OF STRIPPED CENTRAL GOVERNMENT DEBT BY INVESTOR GROUP (% TOTAL)					
COUPON AND PRINCIPLE	2003	2004	2005	2006	2007
RESIDENTS	77%	72%	67%	59%	55%
Credit institutions	15%	14%	12%	10%	9%
Insurance and pension funds	25%	27%	28%	25%	25%
Mutual funds	27%	23%	18%	16%	14%
Households, companies and public authorities	10%	9%	9%	8%	8%
NON RESIDENTS	23%	28%	33%	41%	45%
TOTAL	100%	100%	100%	100%	100%

On a principle and coupon split, we find that non residents and mutual funds had a preference for principal-only strips, while insurers and pension funds invested primarily in coupons, driven, presumably, by the search for securities that more precisely match their liabilities.

Figure 5.1.1.E INVESTOR PREFERENCES FOR PRINCIPLE VS. COUPONS



Source: Banco de España.

5.1.2. Holdings of registered debt

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

And here we find that 82% of Letras holdings to maturity in credit institution portfolios and 2% in non resident hands have been ceded via repos or buy-sell backs, primarily to mutual funds, non financial companies and insurance and pension funds. Similarly, in Bonos and Obligaciones, 75% of credit entity holdings to maturity and 14% of those of non residents have been assigned via these same instruments to mutual funds, non financial companies and public authorities. In the case of stripped Debt, 88% and 75% respectively of the principle and coupon instruments held to maturity by credit institutions have been subject to repo or buy-sell back arrangements with mutual funds and, to a lesser extent, non financial companies. Non residents tend to either hold their Debt to maturity or refinance it somewhere other than Iberclear.

The conclusion, then, is that credit institutions maintain large held-to-maturity portfolios of Public Debt, which they refinance through repo arrangements with mutual funds, non financial companies, public authorities and households. In exchange, the latter get access to very short-term securities of maximum

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

credit quality. Non residents, in contrast, refinance only a small part of their Spanish Debt holdings via repo transactions registered with Iberclear.

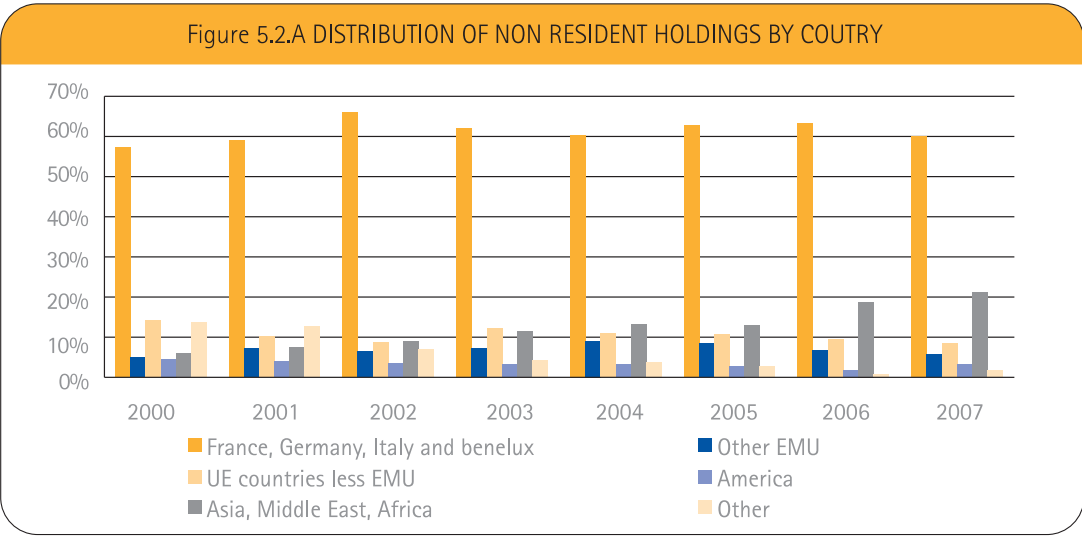
5.2. NON RESIDENT DEBT HOLDINGS: DISTRIBUTION BY COUNTRY

It is also interesting to consider the geographical distribution of Spanish Debt holdings. By individual country, first comes France, with 23% of non resident ownership, followed by Japan (11%) and then Italy (10%), which narrowly beats Germany (just under 10%) into third place. By area, 73% of non resident investment originates in the European Union, especially the Eurozone countries. The United Kingdom was the largest source of foreign ownership until 1999 but has since reduced its share dramatically, from 42% in 1998 to 7% at present.

73% of non resident investment is EU based

Outside the EU, after Japan (up from 7% in 2000 to almost 11% today), the big emerging force is China, which has climbed from just 1% in the year 2000 to 4% in 2007.

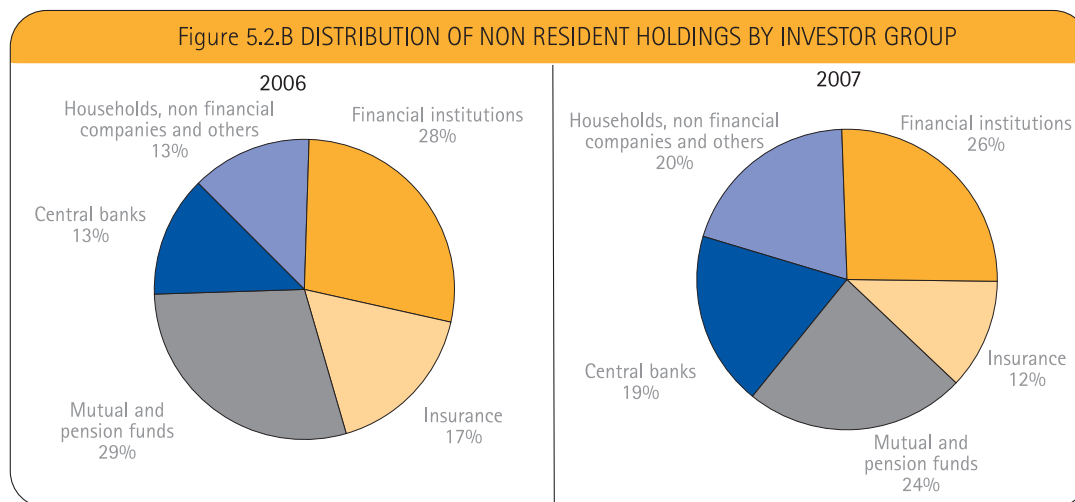
Japanese investors take a growing share, with China too starting to come up strongly



Source: Banco de España.

By investor category, 24% of non resident holdings were lodged with mutual and pension funds and 26% with other financial institutions. One recent development has been the growing share of central banks, from just 2.4% of non resident ownership in 2004 to 19% today. The top credit rating awarded to Spanish Debt has undoubtedly favoured this trend.

24% of non resident ownership falls to mutual and pension funds and 28% to financial institutions



Source: Banco de España.

EXHIBIT FONDTESORO

Fondtesoro are mutual funds holding most of their assets in Treasury Securities. They are run by management companies bound by a collaboration agreement with Tesoro Público to fulfill certain specifications.

Since their start-up in 1990, Fondtesoro have served as a demand source for Central Government Debt. They had something of a boom year in 1997 with 652,839 unitholders and €13,451 million in assets under management, but have tended to lose out since then to the strong competition from equity investment and rival products (primarily guaranteed funds and high-yield deposits).

Year	No. of unitholders			Assets under management					
	Long-term	Short-term	Total	Long-term	Market share (*)	Short-term	Market share (*)	Total	Market share (*)
1995	111,751	254,127	365,878	2,734	8.75	4,885	11.62	7,619	10.40
1996	197,485	345,876	543,361	4,585	8.28	6,794	11.90	11,379	10.12
1997	233,640	419,199	652,839	5,504	5.43	7,947	13.01	13,451	8.28
1998	253,630	391,011	644,641	6,277	4.10	7,022	13.87	13,299	6.53
1999	208,396	350,393	558,789	4,990	3.05	5,974	14.04	10,964	5.32
2000	122,542	283,461	406,003	3,171	2.08	4,652	13.94	7,824	4.20
2001	114,980	348,305	463,285	3,168	2.30	6,026	13.75	9,195	5.07
2002	110,419	393,474	503,893	3,179	2.62	8,082	15.14	11,261	6.44
2003	95,856	379,831	475,687	2,761	1.81	7,812	13.46	10,572	5.02
2004	82,906	325,534	408,440	2,561	1.44	6,409	11.05	8,971	3.80
2005	81,614	304,680	386,294	2,603	1.25	5,680	10.37	8,283	3.16
2006	70,245	288,941	359,186	1,996	1.25	5,507	5.91	7,503	2.96
Sept 2007	59,523	273,747	333,270	1,274	0.81	5,804	6.05	7,078	2.80

(*) Percentage invested in Fondtesoro out of total assets under management in mutual funds.

The regulations governing Fondtesoro have been modernised in recent years. The latest reform of agreements was instrumented through Order EHA/2688/2006 of 28 July 2006 in collaboration agreements with mutual funds specialising in Spanish Government Debt. This text reduces the Fondtesoro formats from five to three: short-term Fondtesoro, long-term Fondtesoro and Fondtesoro Plus, with their main features as shown below. Short-term Fondtesoro invest in money market products so their risk is near to zero. Long-term Fondtesoro can also invest in longer dated fixed-income securities, so tend to offer a higher return in exchange for the investor taking on rather more risk. Fondtesoro Plus are mixed funds that can be up to 30% invested in equity. They are accordingly a riskier product than the preceding two, but also offer higher returns. All of them must hold at least 70% of their assets in Central Government Debt, but are free to invest part of the remainder in other high quality fixed-income instruments. The fees fund managers can charge are also capped at a specified percentage.

Type	Minimum investment in Central Government Debt	Maximum investment in other fixed-income securities	Maximum investment in other fixed-income and equity	Maximum management and custody fees
Short-term Fondtesoro	70%	30%		1.05%
long-term Fondtesoro	70%	30%		1.25%
Fondtesoro Plus	70%		30%	1.35%

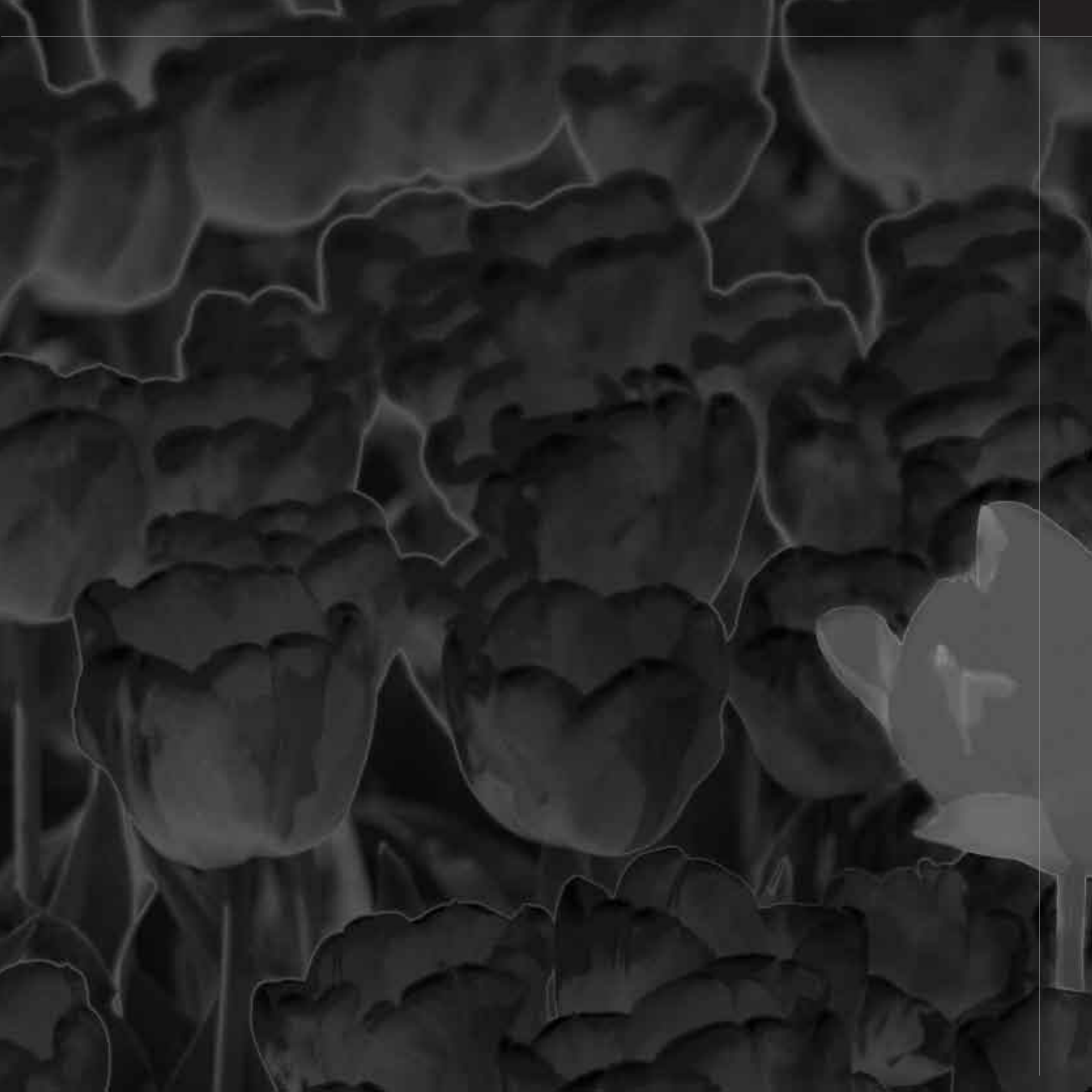
The current rules give Fondtesoro managers more leeway in deciding their investment policies. Our next table shows how this has translated as a decline in their Debt holdings, from 98% to just 64%. In contrast, they have increased their investment in asset-backed securities *FTPymes*, with a government guarantee, and other fixed-income products.

Fondtesoro investment in Central Government Debt (In million euros)			
Year	Fondtesoro assets	Investments in Debt holdings	% asset invested
2000	7,824	7,658	97.89%
2001	9,195	8,932	97.15%
2002	11,261	11,038	98.02%
2003	10,572	9,640	91.18%
2004	8,971	6,817	75.99%
2005	8,283	6,146	74.20%
2006	7,503	5,380	71.71%
sep 2007	7,078	4,539	64.13%

Another general trend has been towards greater use of Government Debt repos, with the corresponding reduction in held-to-maturity instruments. That said, the share of Debt repos receded in 2007 in favour of Letras del Tesoro.

DISTRIBUTION OF FONDTESORO DEBT HOLDINGS			
Year	Letras del Tesoro	Bonos and Obligaciones	Repos
2000	18.96	34.01	47.03
2001	21.12	26.73	52.14
2002	24.46	19.17	56.38
2003	25.66	16.45	57.90
2004	17.59	24.87	57.54
2005	16.03	28.05	55.92
2006	13.24	26.98	59.78
Sept 2007	16.08	25.95	57.97

Finally, it bears mention that Fondtesoro managers have recently been restructuring their portfolios via fund mergers in order to coax out more efficiency. Specifically, three Fondtesoro absorbed other (non Fondtesoro) funds in 2007, while another non Fondtesoro was switched to the Fondtesoro category. The conclusion of this process will foreseeably prompt a renewed increase in Fondtesoro assets and unitholder numbers.





FINANCIAL POLICIES





A financial system is a dynamic mechanism in constant flux. The new activities and innovative products emerging day by day call for a finely tuned regulatory effort, at both national and European level, that lets the system evolve while at the same ensuring financial stability and the adequate protection of investors. The Sub-Directorate-General of Legislation and Financial Policy has been assigned competences in five major areas:

1. The design, development and implementation of financial policy.
2. The drafting and processing of legal provisions governing credit institutions, securities markets, exchange controls and listed companies.
3. The delegated management of the official registers of financial institutions, entities and markets, the processing of authorisation procedures for entry to these registers, management and vetting functions in specified financial market activities, and the analysis and monitoring of financial institutions and markets with a view to future regulatory changes.
4. The exercise of the financial inspection functions entrusted to the Directorate-General of the Treasury and Financial Policy.
5. Representation on European Union Technical Committees dealing with credit institutions, financial markets, collective investment schemes and other financial matters within the scope of this Directorate-General, as well as on the Financial Markets Committee and the Corporate Governance Steering Group of the Organisation for Economic Cooperation and Development.

Regulatory output in 2007 was informed by the content of European Directives in the financial sphere, as reflected in the White Paper on Financial Services Policy 2005-2010, which urges stakeholders to drive on with the implementation of the Financial Services Action Plan.

Spain continues work on perfecting its financial regulation in line with the European framework

Finally, the healthy state of Spain's economy was evidenced once again 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.

6.1. SPANISH FINANCIAL LEGISLATION

6.1.1. Laws and regulations approved in 2007

Law 6/2007 of 12 April reforming Securities Market Law 24/1988 of 28 July to modify the regime governing takeover bids and issuer transparency.

This text partially transposes two Community Directives into Spanish legislation: the Takeover Directive (Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids) and the Transparency Directive (Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, amending Directive 2001/34/EC).

It also alters certain aspects of the current regime to ensure that takeover bids are conducted in a comprehensive legal framework and with full legal certainty.

TAKEOVER BIDS:

The Takeover Directive is the result of a lengthy and complex drafting process that extended over nearly fifteen years. Its purpose is to establish minimum common guidelines for the conduct of takeover bids affecting companies with at least some of their shares admitted to trading on regulated markets. It accordingly starts from the need to "protect the interests of holders of the securities of companies when they are the subject of takeover bids or of changes of control". To this end, it sets out a series of principles that have been respected in its transposition: all holders of securities must be afforded equivalent treatment and have sufficient time and information to enable them to reach a properly informed decision on the bid; the board of an offeree company must act in the interests of the company as a whole; false markets must not be created in the securities of the offeree company, of the offeror company or of any other company affected by the bid; an offeror must announce a bid only after ensuring that he/she can fulfil in full any cash consideration, if such is offered; and the offeree company must not be hindered in the conduct of its affairs for longer than is reasonable.

The Spanish law embraces the goal of protecting the holders of securities in companies facing a takeover bid or change of control. It accordingly makes a takeover bid mandatory whenever one owner holds 30% or more of a company's voting rights. Takeover bids must address all the holders of the company's securities, i.e., 100% of its capital. This ensures that minority shareholders too get the chance to sell at the offer price, which is normally higher than the going market price.

The law also stipulates what actions a board of directors can take in order to stave off a hostile bid.

Among its novelties is the concept of the squeeze-out or mandatory sale/purchase of securities. The idea here is to allow a majority shareholder who has bid successfully for a high percentage of the offeree's capital to gain 100% ownership control and, with it, the sole power of decision, by obliging the rest of the shareholders to sell their securities. For the sake of fairness, the law also allows minority shareholders the chance to withdraw by requiring the majority shareholder to buy their securities.

Finally a new **special regime** is contemplated for persons holding from 30 to 50 percent of a company's voting rights prior to the law's enactment.

TRANSPARENCY:

The goal of issuer transparency is to ensure that investors and the market in general have sufficient information regarding the companies whose securities are admitted to market trading. The two disclosure pillars on which the text is based are the preparation of annual, half-yearly and quarterly financial reports, and the notification of significant holdings.

The first point to make is that Spanish transparency rules were already very tough, so in contrast to the novelties introduced by the transposition of the Takeover Directive, the implementing regime for the Transparency Directive implies few material changes.

The law requires issuing companies to draw up periodic financial reports (annual, half-yearly and quarterly) depending on the kind of securities they have admitted to trading.

They must also notify the market and securities regulator Comisión Nacional del Mercado de Valores of the proportion of their voting rights held by significant shareholders. The law's most novel aspect is that the calculation base for ownership interests changes from the company's total capital to its total voting rights.

Finally, it lays down a series of conditions for the way in which this information is to be disseminated to the market: a vital factor as disclosure is pointless unless the facts being disclosed are readily available to all investors.

Law 22/2007 of 11 July on the distance marketing of consumer financial services.

This law transposes into Spanish legislation 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 same text was already transposed in Law 4/2003 of 4 November amending private insurance legislation and adapting it to European Union rules. The above Directive lays down a minimum framework for distance financial services contracts, harmonising basic rules with regard to the offer, negotiation and conclusion of contracts, and ensuring consumers are adequately informed both before and after entering into a service agreement.

It accordingly reflects the EU's commitment to achieve the effective integration of European financial services markets as one of the most tangible expressions of the Internal Market. The text also supplements the more blanket provisions of Law 34/2002 of 11 July on information society and e-commerce services. Spanish legislation thus gains a specific financial services norm that extends beyond electronic contracts to encompass all distance services without face-to-face contact between the parties, whether the medium be telephone, fax or some other form of mass communication.

Among its core concerns is to maximise consumer protection, given the particular nature of the financial services industry, while respecting, as is mandatory, the freedom of choice enshrined in the Rome Convention of 1980 on the law applicable to contractual obligations.

Law 36/2007 of 16 November amending Law 13/1985 of 25 May on the investment ratios, equity and reporting obligations of financial intermediaries and other financial system regulations.

The prudential supervision of credit institutions is a means to guarantee the stability of the Spanish financial system and avert possible crises among the entities that make up its fabric. The ultimate reason for this precautionary approach is the role of the banking sector as the prize vehicle for channelling savings to investment.

So whatever other instruments may be employed, their capital adequacy, that is, the requirement of a minimum level of equity adjusted technically for their real needs and risks is seen as a vital means to control credit institution solvency.

In today's increasingly international markets, matters of bank solvency cannot be left exclusively to the national legislator, because differences in regulation will create artificial advantages and disadvantages and thereby distort competition between entities from different countries. Hence the harmonising measures launched in respect of the prudential criteria to apply to financial intermediary capital adequacy.

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: the first emphasises the adoption of uniform rules and lays down minimum capital requirements; the second introduces a system of supervisory review aimed at improving firms' internal risk management; finally, the third 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.

This law is the first transposing measure for one of the above directives: Directive 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 (recast). Its text gives legal recognition to the regulatory developments required until such time as the directives are transposed in full.

With respect to the first pillar, it enumerates the risks that institutions carry which are subject to minimum capital requirements: namely, credit, market, exchange rate, commodity and operational risks. Institutions will have a choice of methods for measuring at least some of these risks, depending on their size and the degree of sophistication and/or complexity of their operations.

The text also establishes the supervisory review process as a second pillar. This process involves an active dialogue between credit institutions and Banco de España, as well as guaranteeing a sound internal process for assessing the capital requirements banks themselves have calculated from an analysis of the group's risk profile. The goal of this pillar is to strengthen the connection between entities' risk management strategies and their systems, and to ensure they are integrated in capital planning.

As the last pillar of capital adequacy regulation, the law requires credit institutions to disclose to the market key aspects of their business mix, risk exposure and risk management systems. This third pillar, which goes by the name of "market discipline", reasons that public disclosure and competitive pressure will spur the adoption of best practices while serving to build up investor confidence. To this end, entities must bring out an annual publication titled "Information of Prudential Relevance". The minimum contents of this document will be laid down by the Banco de España in the interests of bank-to-bank comparability, but each one should also draw up a formal policy for the dissemination of information on its capital adequacy. Banco de España will advise credit institutions regarding their compliance with these disclosure obligations.

Law 41/2007 of 7 December, amending Law 2/1981 of 25 March on the regulation of the mortgage market and other financial and mortgage system provisions with regard to the regulation of reverse mortgages and dependency insurance, and introducing new tax provisions.

The Spanish mortgage market is among 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 this legal norm is to modernise our mortgage market and bring in a greater degree of financial sophistication. Its main improvement measures are:

- Improved safeguards for consumers, by requiring financial institutions to be more transparent and precise in the information they give out.
- Removal of obstacles and a more flexible framework for the mortgage market.
- Abolition of early repayment penalties and their replacement by breakage costs.
- Regulation of reverse mortgages for homeowners aged over 65 or in a state of dependency, and of dependency insurance.
- Promotion of a more independent, professional appraisal sector.
- A more flexible legal regime for refinancing mechanisms.
- A reduction in notarial and registry expenses.

Law 47/2007 of 19 December amending Securities Market Law 24/1988 of 28 July.

This text is a vehicle for transposing various directives into Spanish law: Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments (MiFID); Commission Directive 2006/73/EC implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (this directive implements the MiFID and is transposed into the law in limited terms only, the rest being left to regulatory development); and Directive 2006/49/EC of the European Parliament and the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (CAD).

The goals it addresses are as follows:

- Improve investor safeguards so the firms providing investment services operate more transparently and match their investment offers to the profile of the customer. The law lays down a catalogue of rules which are binding on investment service providers, who are required to ensure that customers are fully cognizant with the nature and risks of the services they are being offered. Investment Service Companies must keep a record of all contracts signed with clients. They must also operate

- an order management policy that ensures the timely, fair and swift execution of customer orders.
- Modernise financial markets to adapt them to new and emerging needs. The range of investment services is broadened with financial advisory firms joining the three existing categories of Investment Service Companies, namely securities brokers, securities dealers and portfolio management firms. Attention goes also to investment guidance, understood as the presentation to clients of personalised recommendations either at their request or on the initiative of the service provider. The law enlarges the number of venues for the execution of trades on financial instruments, with regulated markets now joined by multilateral trading facilities (MTFs) and systematic internalisers. New marketable financial instruments are added to the traditional range, including all types of derivatives, whether based on financial or non financial instruments.
 - Adapt investment firms' organisational requirements to new rules regarding solvency and internal operation. A new solvency regime is established pursuant to the norms of the Capital Requirements Directive. This effectively means bringing investment firms within the perimeter of Basel II.
 - Strengthen the supervisory powers of the Comisión Nacional del Mercado de Valores and foster cooperation between national supervisors.

Royal Decree 1066/2007 of 27 July on the legal regime for takeover bids.

This new regulation of takeover bids supplements the amendments introduced by Law 6/2007 with two aims in view: firstly, to introduce the changes required by Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004, with regard to takeover bids; and, secondly, to amend certain points of the regulations to ensure the conduct of takeover bids enjoys full legal coverage and certainty. Its text makes exhaustive provision for all the steps involved in the lodging of a takeover bid for the shares of a listed company.

Royal Decree 1362/2007 of 19 October implementing Securities Market Law 24/1988 of 28 July on transparency requirements regarding information on issuers with securities admitted to trading on an official secondary market or another regulated market of the European Union.

This royal decree completes the implementation in Spanish law of EU transparency requirements with regard to issuers whose securities are traded on an official Spanish secondary market or some other regulated market in the European Union. It starts from the conviction that efficient, transparent and integrated securities markets are a vital means to complete the EU single market and to boost growth and employment creation by enabling a better distribution of capital at a lower cost.

The disclosure of accurate, complete and timely information on securities issuers is a permanent stimulus to investor confidence, allowing them to reach an informed judgement about companies' earnings performance and assets. The result is to strengthen investor protection while enhancing market efficiency.

The text sets out the information that securities issuers must disclose to the market on a periodic basis (annual and half-yearly reports, interim statements) or event driven (change in number of voting rights, treasury stock transactions). It also lays down reporting obligations with respect to major holdings in the voting rights of listed companies.

Royal Decree 361/2007 of 16 March implementing Securities Market Law 24/1988 of 28 July with regard to ownership stakes in companies which manage secondary markets or securities registration, clearing and settlement systems.

The ground covered divides more or less into two parts. Firstly, it lays down special rules for all those holding a significant or controlling interest in companies managing secondary markets and/or securities registration, clearing and settlement systems. According to the seventeenth additional provision of the Securities Market Law, the acquisition or disposal of controlling stakes in this kind of entity must have government approval. The royal decree clarifies the information to be furnished when applying for such authorisation.

Secondly, it introduces a series of obligations for entities that own controlling stakes in this kind of company. Such entities must abide by certain conditions when introducing limits on the rights conferred by holdings in their capital.

Royal Decree 362/2007 of 16 March amending the Regulation implementing Law 35/2003 of 4 November on collective investment undertakings, as approved by Royal Decree 1309/2005 of 4 November.

The purpose of this text is to amend the legal regime for hedge funds and funds of hedge funds established in the Regulation on collective investment schemes, allowing them a more flexible framework with regard to redemptions in particular. This reform addresses the need to give these funds sufficient scope to deploy their particular investment strategies. In other words, the Spanish legal regime for collective investment must be flexible and accommodating enough to allow hedge funds to operate effectively.

Royal Decree 363/2007 of 16 March amending Royal Decree 726/1989 of 23 June on the governing council and members of stock exchanges and stock exchange companies, Royal Decree 1814/1991 of 20 December regulating official futures and options markets and Royal Decree 116/1992 of 14 February on the representation of securities by book entries and the clearing and settlement of stock exchange transactions.

The aim of this royal decree is to introduce needed amendments in a number of financial sector regulations. These amendments serve a variety of purposes: to remove obsolete references, to clarify certain potentially misleading points, to give more flexibility where required and to repeal regulations that are no longer pertinent.

Royal Decree 364/2007 of 16 March amending Royal Decree 685/1982, Royal Decree 1343/1992, Royal Decree 867/2001 and Royal Decree 1333/2005.

This norm makes minor amendments in four financial sector royal decrees. It abolishes the cap on interest rate fluctuations in the case of floating-rate bonds. It clarifies the scope of a recent change in the list of assets classifiable for capital purposes by credit institutions and their consolidated groups. The solvency rules for portfolio managers are also retouched to align them with those of remaining investment firms. Finally, new categories are added to the list of director and senior manager related parties who are obliged to disclose transactions in the shares of the listed company.

Order EHA/3011/2007 of 4 October 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 order was judged necessary to align property appraisal regulations with the changed nature of real estate business, and to address the enforcement problems of the current rules as reported by both supervisors and appraisal firms and services. The order accordingly sets forth the following amendments:

a) Include the property registry number in property appraisal reports as a means to prevent and combat real estate fraud.

b) Adapt the contents of the said Order to Royal Decree 1332/2005 of 11 November implementing Law 5/2005 of 22 April on the supervision of financial conglomerates, which in turn amends the regulations on private insurance and its supervision approved by Royal Decree 2486/1998 of 20 November.

c) Implement the technical and formal improvements called for in practice from the standpoint of both supervisory agencies and appraisal firms and services.

Resolution of 20 December 2007 of the Directorate-General of the Treasury and Financial Policy to amend the Resolution of 9 July 1996 implementing articles 4, 5, 7 and 10 of the Ministry of Economy and Finance Order of 27 December 1991 on cross-border economic transactions.

Raising the declaration threshold for collections and payments between residents and non residents and cross-border transfers ordered through registered entities. Spanish residents engaging in such transactions must now make an official declaration in their respect when the amount is equal to or greater than 50,000 euros. The aim is to bring down the costs of cross-border payments, thereby facilitating capital movements.

6.1.2. Legislative projects in the pipeline

Draft Royal Decree on the capital adequacy of financial institutions.

Law 36/2007 of 16 November amending Law 13/1985 of 25 May concerning the investment ratios, equity and reporting obligations of financial intermediaries and other financial sector regulations, is in need of extensive regulatory development covering in detail how capital requirements are to be worked out for credit institutions and investment firms. The resulting regulation should be ready for approval in early 2008. The current draft faithfully transposes Directives 2006/48/EC and 2006/49/EC containing the translation of the Basel II accords. This is, however, a partial transposition, since the technical specifications making up much of the Community text are better left for provisions of a lower rank.

Draft Royal Decree on the legal regime for investment firms and other entities providing investment services.

The draft transposes the implementing measures to the Directive on markets in financial instruments (MiFID). The text is basically to update the rules of conduct governing investment firm dealings with their clients, and the conditions they must meet in order to operate in securities markets. The specific instrument transposed will be Directive 2006/73/EC implementing Directive 2004/39/EC on markets in financial instruments.

Draft Royal Decree implementing article 21 of Law 44/2002 of 22 November on financial system reform measures with regard to electronic money institutions.

This draft royal decree will open the door to electronic money institutions setting up in Spain. The material legislation configuring these firms as a new type of credit institution is contained in Directive 2000/12/EC and in article 21 of the above Law 44/2002 of 22 November. The royal decree's provisions, as such, are mainly procedural in nature, laying down the steps for the entities envisaged in the directive and the above law to be legally incorporated in Spain.

This procedural content covers the following main elements:

- Regime for the authorisation and registration of electronic money institutions.
- Authorisation of electronic money institutions under foreign control.
- Operational requirements and application conditions.
- Grounds for refusal of applications.
- Exemptions.
- Revoking of authorisation.

Draft Order implementing the provisions of the Regulation to the Law on collective investment undertakings with regard to the transactions of financial collective investment schemes in derivative financial instruments.

This order will clarify and enlarge the range of assets in which collective investment schemes can invest. It will also transpose Directive 2007/16/EC implementing Directive 85/611/EEC on Undertakings for Collective Investment in Transferable Securities.

Draft Order implementing the provisions of the Regulation to the Law on collective investment undertakings with regard to depositories.

This order will specify the functions to be carried out by the depositories of collective investment scheme assets, with particular regard to their oversight and supervisory duties.

Draft Order implementing the provisions of the Regulation to the Law on collective investment undertakings with regard to securities loans.

This order will specify the legal regime to apply to securities lending by collective investment schemes.

Draft Order implementing provisions on the accounts, asset valuation, diversification coefficients and other aspects of collective investment undertakings whose investment policy is to reproduce,

replicate or take as benchmark a given stock or bond index, and empowering the Comisión Nacional del Mercado de Valores to draw up the appropriate implementing measures.

The purpose of this order is to elaborate on certain aspects of the legal regime for collective investment schemes set out in Law 35/2003 of 4 November on collective investment undertakings and its implementing regulations, as approved by Royal Decree 1309/2005 of 4 November. Specifically, it will regulate the accounts kept by collective investment schemes, the determination of their assets, the rules for calculating risk diversification ratios, collective investment schemes 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. Securities regulator Comisión Nacional del Mercado de Valores will also be empowered to fill out its contents in appropriate respects. The date set for its approval is January 2008.

6.1.3. Future legislative projects

Consolidated text of the Securities Market Law.

The Securities Market Law has undergone numerous and substantial reforms in the last few years. And its text is now in need of systematic recasting in the interests of clarity and legal certainty.

Adaptation of the implementing regulations to Law 2/1981 of 25 March regulating the mortgage market.

After the enactment of Law 41/2007 of 7 December, amending Law 2/1981 of 25 March on the regulation of the mortgage market and other financial and mortgage system provisions with regard to the regulation of reverse mortgages and dependency insurance, and introducing new tax provisions, the next step is to adapt the regulations of the present Royal Decree 685/1982 of 17 March implementing certain aspects of Law 2/1981 of 25 March regulating the mortgage market with regard to the refinancing of mortgage loans.

This should be followed up by the drafting of a ministerial order on the transparency of home purchase loans and credits, which deals in depth with the specifics of the reverse mortgage. Finally, the Ministry is empowered to specify the indices or rates to serve as benchmarks for calculating whether or not there has been a capital gain in cases of breakage charges.

Transposing of the Directive on payment services in the internal market.

This directive regulates the providers engaging in money remittances, transfers and payment services in general. To this end, it establishes harmonised reporting requirements for payments industry operators as well as the rights and obligations to apply to payment service providers and users. The deadline for transposing this norm has been set at 1 November 2009.

Transposing of the Directive on the prudential assessment of acquisitions and increase of holdings in the financial sector (Directive 2007/44/EC of 5 September 2007).

This directive establishes a checklist for supervisors to aid in their assessment of cross-border merger processes or acquisitions of significant stakes in credit institutions, investment firms and insurance undertakings. The transposition deadline is in this case March 2009.

Law amending the legal regime for securitisation.

The idea is to modernise the legal framework for securitisation in order to consolidate the market's rapid expansion and enable a greater degree of financial sophistication, while improving the legal certainty attached to these products.

6.2. EUROPEAN FINANCIAL LEGISLATION

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

The Financial Services Action Plan lives on in the guidelines of the White Paper on Financial Services Policy

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 underway.
- enhance supervisory cooperation and convergence.
- remove the last obstacles to integration.

6.2.1. Directives approved in 2007

Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies.

The purpose of this directive is to facilitate the cross-border exercise of shareholder rights as expressed in the following measures:

- 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).

Directive 2007/44/EC of the European Parliament and of the Council of 5 September 2007 amending Council Directive 92/49/EEC and Directives 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 holdings in the financial sector.

The goal is to improve the legal certainty, clarity and predictability of the regime governing the acquisition of significant shareholdings in financial institutions, reducing the latitude afforded to the supervisory authorities.

Directive 2007/64/EC of 13 November 2007 on payment services in the internal market amending Directives 97/7/EC, 2002/65/EC, 2005/60/EC and 2006/48/EC and repealing Directive 97/5/EC.

This 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).

6.2.2. Directives under negotiation

Proposal for a Directive on the harmonisation of Member States' legal, regulatory and administrative provisions concerning credit for consumers.

The proposal pursues three main 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).

The Council reached a common position in 2007 and the text has been sent to the European Parliament.

6.2.3. Discussions at Commission groups

The European Commission organises regular discussion groups to review the progress of EU legislation and identify where new initiatives are needed in financial policy matters. Among them:

- European Commission expert group on company law and corporate governance.
- European Commission expert group on electronic money.
- European Commission expert group on the mortgage market.
- European Commission expert group on retail banking.
- European Commission expert group on legal certainty in securities registration, clearing and settlement.

6.2.4. European Committees

European Securities Committee.

The European Securities Committee (ESC) is a kind of think tank reporting directly to the European Commission. It has an advisory role with regard to the drafting and application of EC provisions in the securities markets sphere.

European Banking Committee.

The European Banking Committee assists the European Commission in its enforcement measures. This Committee continued to meet on a quarterly basis throughout 2007.

6.2.5. Participation of the Directorate-General of the Treasury and Financial Policy in other international fora engaging with financial policy.

Negotiation of the Unidroit Convention.

This Convention regulates substantive matters on intermediated securities. It is substantially a parallel document to the Hague Convention. As we write, talks are scheduled for completion in 2008.

Participation in OECD groups.

The corporate governance group continued to meet regularly, as did cooperation fora 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.

135 applications processed in 2007

The Directorate-General 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 2007.

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 (SGEGR) 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 Directorate-General of the Treasury and Financial Policy examines the proposal then refers it in turn to the Secretary of State 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 15 applications

were studied in 2007. The average time elapsing from a file being received by the Directorate-General of the Treasury and Financial Policy and its referral for signing to the Secretary of State was seventeen calendar days. Procedural formats may be of various types:

- Authorisation of investment firm:

Securities broker: 1 application

Securities dealers: 2 applications

Portfolio management company: no applications

- Authorisation for change to investment firm schedule of activities: 3 applications

- Authorisation for change in bylaws: no applications

- Authorisation for corporate transactions (change of form, merger, de-merger, spin-off, etc):

Transformation from broker to dealer: 2 applications

Takeover of one investment firm by another: 1 application

Takeover of an investment firm by a credit institution: no applications

Global assignment of investment firm assets and liabilities to a credit institution: no applications

Takeover of an investment firm by a fund manager: 2 applications

Other corporate transactions: 4 applications

Total: 15 applications

As regards venture capital entities, Law 25/2005 of 24 November regulating these entities and their management companies assigns the Ministry of Economy and Finance responsibility for all applications regarding management companies (SGECR). The 15 such applications received in 2007 were processed by the Directorate-General of the Treasury and Financial Policy in an average of 14 days.

- Authorisation of SGEER: 14 applications
- Change in bylaws of SGEER: no applications
- Revocation of authorisation of SGEER: 1 application

Total: 15 applications

Finally, the Directorate-General examined 7 applications relative to fund management companies (SGIIC), pursuant to its responsibilities under Law 35/2003 of 4 November, with an average processing time of 12 days.

- 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 Directorate-General of the Treasury and Financial Policy generally require a mandatory report from Banco de España. The proposal of the Directorate-General 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 2007, summing 98 in all. 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: 1 application

Financial credit establishments: 4 applications

Mutual guarantee companies: no applications

Branches of non-EU institutions: 1 application

- Change in bylaws:

Banks: 23 applications

Savings banks: no applications

Credit cooperatives: 13 applications

Financial credit establishments: 9 applications

Mutual guarantee companies: 8 applications

Branches of non-EU institutions: no applications

- Revocation of authorisation due to discontinuation of business:

Banks: no applications

Financial credit establishments: 5 applications

Branches of non-EU institutions: no applications

Branches of EU credit institutions: no applications

- Revocation of authorisation in cases of takeover:

Banks: 2 applications

Credit cooperatives: 1 application

Financial credit establishments: 2 applications

- Others: 29 applications

Total: 98 applications





PREVENTION OF MONEY LAUNDERING
AND TERRORIST FINANCING

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 laundering activities.

Prevention and control

In today's globalised economy, launderers and terrorist financiers increasingly operate on a transnational scale, in order to evade detection and prosecution. This calls for stronger international coordination through the anti money laundering forums and organisations.

Transnational crime

As part of its awareness raising mission, the Directorate-General of the Treasury has launched the website of the Commission for the Prevention of Money Laundering and Monetary Offences, which stands alongside the Tesoro Público site as an informative and training resource for the struggle against money laundering and terrorist financing.

Commission and Tesoro Público websites

7.1. SPANISH LEGISLATION

7.1.1. Order EHA/2444/2007 of 31 July implementing the Regulation to Law 19/1993 of 28 December on specific measures to prevent money laundering, approved by Royal Decree 925/1995 of 9 June, with regard to the external audit report to be prepared on internal control and reporting procedures and units for the prevention of money laundering.

The idea behind this norm is to detail the scope and content of the requirement that all obligated parties submit their internal control and reporting structure and procedures to the appraisal of an outside expert, and to lay down a standard format for the corresponding written report, specifying the minimum contents without which it will not be considered valid. In order to keep the system flexible for the diverse mix of obligated parties, it is envisaged that subjects under the special regime need not complete the whole report, provided they explain omissions.

The thinking behind the norm

The text also goes into considerably greater depth on the concept of "assess the operational effectiveness of procedures and units", hitherto only fuzzily defined. Now subjects have a mandatory checklist of points for analysis and must provide details of all the tests run.

This, it is hoped, will put an end to the abundance of reports with serious shortcomings in their scope, content and evaluative worth. Further ahead, the measure should also facilitate and expedite the supervision of obligated parties, with the collateral benefit of raising compliance standards.

Better quality reports with a wider content

It will also encourage the closer involvement of governing bodies, by stipulating that the main deficiencies detected should be reported to the Board of Directors or equivalent control body along with proposals for corrective or improvement measures. The result should be to give money laundering prevention policies a higher profile in corporate life.

Improved prevention procedures

7.1.2. Ministerial Order 114/2008 of 29 January on certain obligations to be met by notaries with regard to money laundering prevention.

Following the passage of Order EHA/2963/2005 of 20 September regulating the Centralised Laundering Prevention Unit of the General Council of Notaries, the next step has been to clarify the anti money laundering obligations of this group along with their application in day-to-day professional practice.

The new Ministerial Order seeks to do just this, laying down specific rules for the identification of natural and legal persons. These include the obligation to record the ownership structure of companies in transactions where a degree of risk is judged to be present or that involve some entity domiciled in a tax haven.

Disclosure of ownership structure

Notaries must also ask their clients to furnish a declaration of cash movements (form S1) when a transaction involves or is preceded by cash payments.

Demonstrating possession of form S1

Finally, the text will clarify the scope of remaining preventive obligations such as the record keeping, the establishment of internal control and reporting procedures, the duty to collaborate with the Executive Service and assessment of compliance with prevention regulations by means of procedural audits.

7.2. EUROPEAN UNION

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

Hence its involvement in groups like COTER and RELEX/Sanctions with the remit to follow up the progress of 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...).

Participation in groups monitoring international financial sanctions

The process of asset freezing is enshrined in EU legislation by Regulations 2580/2001 and 881/2002 (previously 467/2001), which have undergone over fifty amendments since their entry to force; basically to modify their lists and add new individuals and companies.

Regulation 881/2002 is specifically directed at the *Al-Qaeda* network (and its associates). It is the instrument whereby the Commission writes into EU law the guidelines of the U.N. Security Council's Sanctions Committee, established by Resolution 1267 (1999).

Regulation 2580/2001 is broader in scope, applying to all organisations and individuals whom the Council decides to include in its annexed lists.

Though differing in their perimeters, both Regulations take the same preventive approach expressed in broadly comparable measures. One of the most important for the financial sector is the *freezing or blocking of assets linked to terrorist organizations, meaning the prevention of any move, transfer, alteration, use of or dealing with funds in any way that would result in any change in their volume, amount, location, ownership, possession, character, destination or other change that would enable the funds to be used, including portfolio management.*

As Regulations, both instruments are immediately and directly applicable by all persons in the European Union, especially by financial institutions who must immediately freeze all kinds of assets in the property of the persons named.

The Directorate-General of the Treasury and Financial Policy, as the competent national authority related in the Annex to both Regulations, is there to assist and advise financial institutions (the direct obligated parties under the EU rules) on the practical application of freezing measures, whenever they approach it for information on some client appearing on international terrorist lists.

The European Commission and the European Banking Federation have created a centralised, downloadable database listing individuals and entities officially subject to freezing in order to aid financial institutions in their search.

When an obligated party discovers that a client's name matches that of a person subject to a freezing order, it must immediately immobilise his/her funds and notify the Directorate so it can check whether the client in question is the person listed.

The Directorate-General of the Treasury will then request additional information from the Civil Guard, the National Police and the Ministry for Foreign Affairs and Cooperation in order to confirm whether the two persons named are effectively one and the same.

In cases where confirmatory information is available, in one sense or another, the Directorate passes it on to the interested entity so it can decide whether or not to unfreeze the client's funds.

The Directorate-General of the Treasury is also empowered, on request from the interested entity, to authorise use of the frozen funds for the specific purposes stated in the Regulations (need to cover essential expenses, payment of professional fees, etc.).

As a final step in the process, the Directorate-General of the Treasury will inform the European Commission of all freezing measures taken in Spain (dates, amounts, persons implicated, etc.). The Commission will forward the data received from Member States to Committee 1267 of the United Nations for appropriate action to be taken.

The day-to-day management of international financial sanctions was joined in 2007 by a series of special measures against Iran, further to United Nations Resolution 1737 (2006). In particular, Council Regulation

Restrictive measures against Iran

423/2007 of 19 April concerning restrictive measures against Iran is intended to build confidence in the exclusively peaceful purposes of that country's nuclear programme. The Directorate-General of the Treasury figures in the Regulation's text as the competent national authority for ordering the release of frozen funds under the conditions specified in the said Regulation.

The Directorate also represents Spain on the Prevention Committee, a first pillar body with the remit to strengthen European Union policy in the fight against money laundering and terrorist financing.

Another legislative novelty was the entry to force, on 15 June 2007, of EU Regulation 1889/2005 of 26 October de 2005 on controls of cash entering or leaving the Community. Its provisions, however, have long formed part of Spanish legislation. Not only that, Law 19/1993, as reworded by the amendments of Law 19/2003, extends the obligation to declare cash movements into and out of Spain to all funds, whether or not they proceed from or are headed for non EU countries. In any event, Ministerial Order 1439/2006 of 3 May regulating declarations of cash movements for the purposes of money laundering prevention writes the European text into Spanish legislation.

Entry to force of EU Regulation 1889/2005

7.3. MANAGEMENT

INSTITUTIONAL FRAMEWORK

Before examining management milestones in 2007, we look briefly at the institutional framework for anti money laundering activity in Spain:

Institutional framework

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 Directorate-General of the Treasury and Financial Policy, Banco de España, securities regulator Comisión Nacional del Mercado de Valores (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, this collegiate body deals with all ordinary matters in the realm of money laundering prevention policy that cut across various administrative units or require concerted action to reach their goals.

COMMISSION SUPPORT BODIES

1. Secretariat

A role exercised by the Sub-Directorate-General of Inspection and Control of Capital Movements of the Directorate-General 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 Commission's 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.

Besides the legislative output described in the opening section, the fight against money laundering and terrorist financing is carried forward by means of participation in international anti money laundering organisations and control of legal compliance.

7.3.1. International cooperation and coordination

The transnational character of money laundering and terrorist financing schemes calls for closer cooperation at international level. For that purpose have been created different international forums where countries can exchange experiences and harmonise their action campaigns. The most important of these organisations are described below:

- The Financial Action Task Force (FATF)

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 countries and territories members of the organization by means of mutual evaluation exercises.

Standards for the fight against laundering and terrorist financing

Spain is currently co-chair of the FATF Anti Terrorism Group, as well as being an active presence in Plenary activities and in the working groups dealing with Implementation and Evaluation, International Cooperation and Money Laundering Typologies.

Our country is also actively engaged in furthering compliance with international standards and, to this end, has seconded Spanish government officers to participate in mutual evaluation rounds. Specifically, in 2007 officers from this Directorate took part in the mutual evaluations of Greece and Finland.

Evaluations of Greece and Finland

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

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. Spain has observer status within GAFISUD and is also its largest net economic contributor. It also helps out in mutual evaluation processes, and recently sent a government officer to the Ecuador exercise approved at last December's Plenary.

GAFISUD

Spain's involvement with CFATF (Central America and the Caribbean) is along broadly similar lines. An observer here too, it contributes funding and human resources to help strengthen regional compliance with international anti money laundering standards. Spain currently chairs one of the CFATF working groups, on observer countries.

CFATF

The third regional group of relevance, MONEYVAL, has the mission to improve the internal 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).

MONEYVAL

Still in the cooperation sphere, the European Union is funding a twinning project to set up a Financial Intelligence Unit in Morocco. The project is headed by a Resident Director based in Rabat and had its official presentation in the capital on 15 November 2007. Although conducted on a partnership basis with France, it is Spain, in particular this Directorate-General, that exercise global leadership of the project, to which end it has sent in a first expert mission to carry out a preliminary audit of the country's preventive and repressive measures.

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 obligated parties' compliance with their preventive duties, and secondly, cooperation between them and the government authorities, a task assigned to the Executive Service.

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 2007, as received from the Executive Service and supervisory agencies, ordered by category of reporting party.

Type of obligated party	Reports analysed
Banks	3
Savings banks	2
Insurance entities	2
Exchange and remittance agencies	2
Credit card issuers	1
Real estate firms	1
Cash transport firms	2
Total	13

Source: Commission Secretariat.

A total of € 2,595,000 in fines was imposed in 2007 for infringements of anti money laundering rules and regulations, in five separate penalty proceedings. A further five proceedings are open as we write and will be resolved upon in 2008.

The Directorate-General of the Treasury and Financial Policy also handles penalty proceedings for failure to declare cross-border cash and capital movements. The following table sets out the 2007 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 CASH AND MOVEMENTS	
Area	Statistical Information
Breach of obligations with regard to capital movements	Actions: 1328
Failure to declare cash movements	Actions: 456 Cash seized: €40,266,398
FINES IMPOSED	€14,167,455

Source: Commission Secretariat.

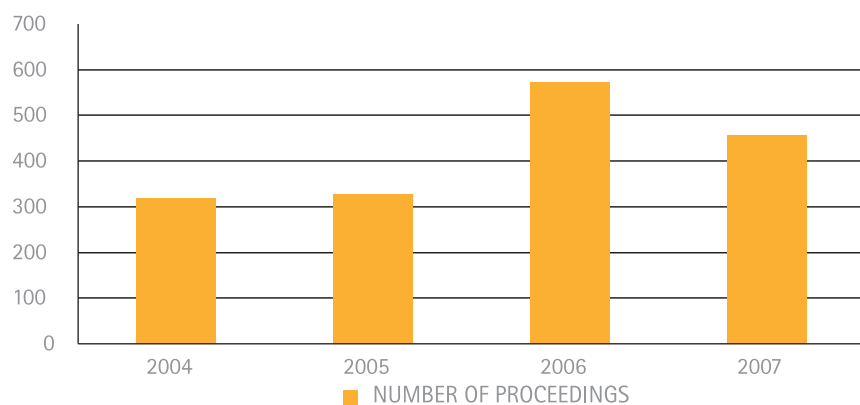
As regards cross-border cash movements, the trend in the year was towards fewer penalty proceedings in respect of failures to declare but with an increase in the sums seized. Note in this regard that Ministerial Order 1439/2006 on cash movements came into force on 14 February 2007. The text of this Order raises the minimum thresholds as of which declaration is mandatory, which now stand at €10,000 in cross-border movements and €100,000 inside the country. The publicity campaign that accompanied this change has helped bring down the number of infringements due to ignorance of the legal limits.

Proceedings for undeclared cash movements

Another salient outcome has been the steadily growing number of cash seizures for undeclared movements within the country (i.e., involving amounts upwards of €100,000).

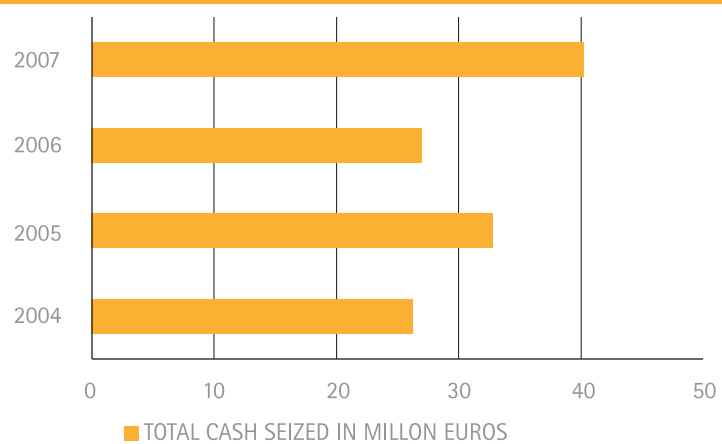
These trends are illustrated in the figures below, which show that, although fewer actual proceedings were brought in 2007, both the total cash seized and the fines imposed were higher than at any time in the immediate past.

Figure 7.3.2.C NUMBER OF PROCEEDINGS INSTITUTED



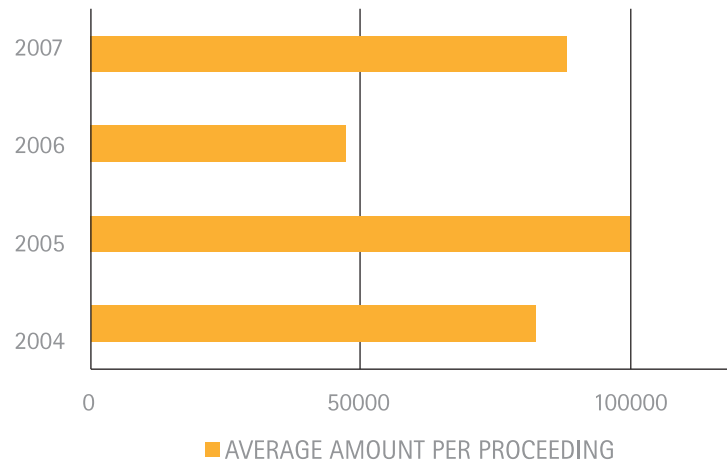
Source: Commission Secretariat.

Figure 7.3.2.D CASH SEIZED



Source: Commission Secretariat.

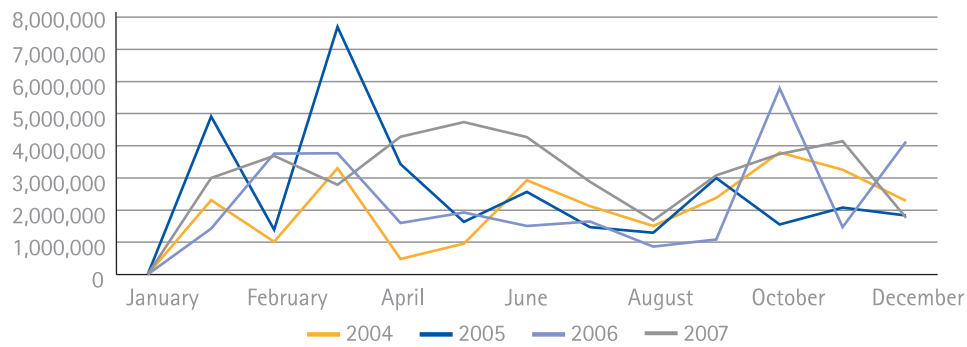
Figure 7.3.2.E AVERAGE CASH SEIZED PER PROCEEDING



Source: Commission Secretariat.

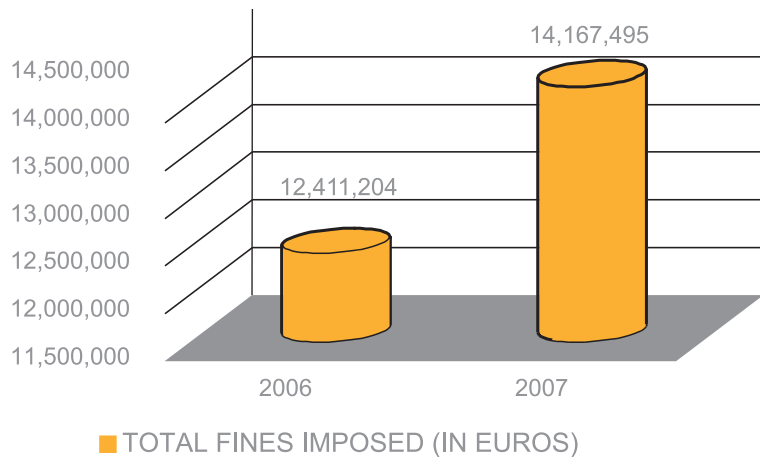
Figure 7.3.2.F CASH SEIZED

CASH SEIZED (in euros) IN RESPECT OF UNDECLARED MOVEMENTS



Source: Commission Secretariat.

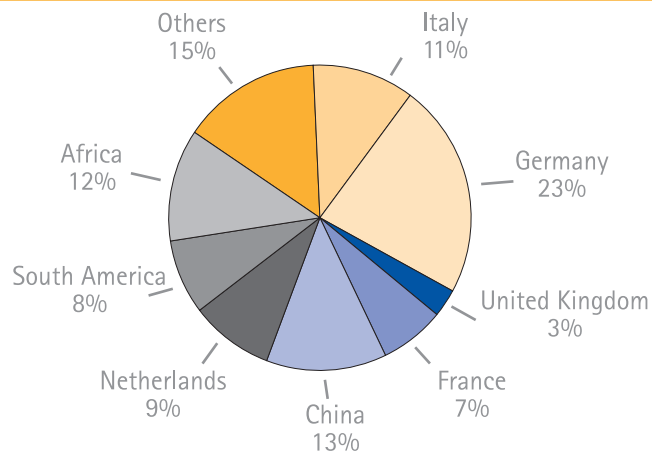
Figure 7.3.2.G TOTAL FINES IMPOSED



Source: Commission Secretariat.

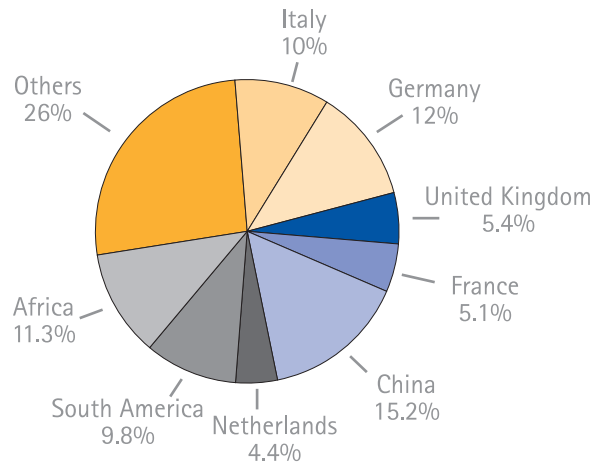
The figures below show the destinations of undeclared outgoing movements in the years 2006 and 2007. We can see that China is now the first placed destination by the measure of undeclared cash seized (15.2% of the total in 2007). Also noteworthy is that destinations were more evenly spread out than in 2006, with each country accounting for a similar share of the total.

Figure 7.3.2.H CASH SEIZED BY COUNTRY OF DESTINATION IN 2006



Source: Commission Secretariat.

Figure 7.3.2.I CASH SEIZED BY COUNTRY OF DESTINATION IN 2007



Source: Commission Secretariat.

