FINANCIAL REGULATION: 2008 Q2

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Introduction

In 2008 Q2 relatively few new financial provisions were enacted in comparison with previous periods.

In the field of credit institutions, the Spanish government enacted the final implementing regulations on own funds and supervision on a consolidated basis in line with the solvency guidelines set by the Basel Committee on Banking Supervision in 2004 and written into subsequent Community directives, which, after various pieces of implementing legislation, have now been transposed in full into Spanish law.

In the area of securities markets, two provisions have been enacted: first, the scope of operations of collective investment institutions (CIIs) has been made more flexible in regard to operations in derivative financial instruments and certain concepts have been adapted to Community law; and second, the law on the appraisal of real estate held by real estate investment companies and funds has been amended, among other reasons, to permit appraisal certificates to be sent electronically. Lastly, a number of fiscal and economic measures have been promulgated to spur economic activity and combat the slowdown of the Spanish economy.

Amendment of regulations on the determination and control of minimum own funds of credit institutions

The 2004 Basel II Capital Accord issued by the Basel Committee on Banking Supervision on 26 June 2004 (known as Basel II) established a set of structured measures based on three mutually reinforcing pillars: the adoption of uniform rules to determine minimum capital requirements on the basis of the risks assumed (Pillar 1); supervisory review to foster improved internal risk management by institutions (Pillar 2); and market disclosure of the key features of their business profile, risk exposure and risk management practices (Pillar 3). These measures must be taken into account simultaneously so that the level of own funds held by institutions is in keeping with their overall risk profile.

Subsequently, in the EU this Accord was adopted in two 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) and Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast).[1] These two directives were partially included in Spanish law through two different laws: Law 36/2007 of 16 November 2007[2] amending Law 13/1985 of 25 May 1985 on the investment ratios, own funds and reporting obligations of financial intermediaries and other financial system rules, in the area of credit institutions, and Law 47/2007 of 19 December 2007[3] amending Law 24/1988 of 28 July 1988 on the securities market, in the area of investment firms. In this broad setting, subsequently Royal Decree 216/2008 of 15 February 2008[4] on the own funds of financial institutions was published. It undertook the further partial transposition of the above-mentioned directives, which made it necessary to complete the process of transposition in lower ranking provisions containing the technical specifications provided in said directives.

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1. For more information on these two directives, see "Financial regulation: 2006 Q2", *Economic Bulletin*, July 2006, Banco de España, pp. 142-146. **2.** See "Financial regulation: 2007 Q4", *Economic Bulletin*, January 2008, Banco de España, pp. 174-176. 3**.** See "Financial regulation: 2007 Q4", *Economic Bulletin*, January 2008, Banco de España, pp. 182-189. **4.** See "Financial regulation: 2008 Q1", *Economic Bulletin*, April 2008, Banco de España, pp. 159-163.

For this purpose, *Circular CBE 3/2008 of 22 May 2008* of the Banco de España (BOE of 10 June 2008) on the determination and control of minimum own funds was published. It constitutes the final implementation, in the field of credit institutions, of the legislation on own funds and supervision of financial institutions on a consolidated basis (hereafter "the Circular"). This Circular replaces CBE 5/1993 of 26 March 1993 on the determination and control of minimum own funds.[5]

The Circular makes significant changes, since it not only replaces the old system of determination of minimum own funds with a more complex one more sensitive to actual banking risks, but also, as a result of implementation of pillars 2 and 3, introduces new features in other respects, such as those relating to the function of the supervisor, whose responsibility in the process of control in this area is broadened, and to mandatory reporting by credit institutions.

Outlined below are the main new features of the Circular, which came into force on 11 June 2008. Table 1 compares, in summary form, the main elements of the Circular with their treatment in CBE 5/1993 and subsequent updates.

SCOPE OF APPLICATION

Like its predecessor, the Circular applies to groups and sub-groups of credit institutions, as well as to individual credit institutions of Spanish nationality regardless of whether or not they form part of a group or sub-group of credit institutions.[6] In contrast, co-ordination groups controlled by a foreign financial institution with registered office outside the European Union shall not be subject to supervision in Spain provided they are subject to supervision on a consolidated basis by the competent authority of a third country equivalent to that provided for in Spanish law. Otherwise, the consolidated supervision regime provided for in this Circular within the framework of Directive 2006/48/EC shall be applicable to such group.

GENERAL MINIMUM OWN FUNDS REQUIREMENTS

In regard to minimum own funds requirements, an institution shall hold a sufficient volume of regulatory own funds to cover the sum of: a) the requirement for *credit risk and dilution risk* in respect of all its activities with the exception of its trading book business; b) the requirement for *counter-party risk* and for *position and settlement risk* in respect of its trading book; c) the requirement, in respect of all its activities, for *foreign-exchange and gold-position risk*, based on its overall net foreign-exchange position and its net gold position; and d) the requirement for operational risk determined in respect of all its activities.

The new features included in the Circular, in addition to the limits on large exposures, consist of obligations relating to *corporate governance*, *capital assessment*, *interest rate risk measurement* and *market disclosure*.

Moreover, the Circular sets out the requirements to be complied with at consolidated level and at individual level, by both parents and Spanish subsidiaries. However, the Banco de España may exempt them from this obligation in response to an application submitted jointly by the subsidiary and its parent if certain conditions are met that ensure a suitable allocation of the own funds and risks within the group and the non-existence of any obstacle to the transfer of own funds and the repayment of liabilities.

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5. With the wording given by the following circulars: CBE 12/1993 of 17 December 1993, CBE 2/1994 of 4 April 1994, CBE 6/1994 of 26 September 1994, CBE 12/1996 of 29 November 1996, CBE 3/1997 of 29 April 1997, CBE 5/1998 of 29 May 1998, CBE 10/1999 of 17 December 1999, CBE 4/2001 of 24 September 2001, CBE 3/2003 of 24 June 2003, CBE 3/2004 of 23 July 2004, CBE 3/2005 of 30 June 2005, CBE 2/2006 of 30 June 2006 and CBE 2/2008 of 25 January 2008. **6.** For simplicity, from now on the term "institution" will be used to refer collectively to groups of credit institutions, sub-groups of credit institutions and credit institutions not forming part of such groups or sub-groups, including the branches in Spain of credit institutions with head office in third countries.

DETERMINATION AND CONTROL OF MINIMUM OWN FUNDS OF CREDIT INSTITUTIONS

TABLE 1

CBE 5/1993 of 26 March 1993	CBE 3/2008 of 22 May 2008
Scope of application	
Groups and sub-groups of credit institutions, as well as individual credit institutions of Spanish nationality regardless of whether or not they form part of a group or sub-group of credit institutions	No significant changes
General minimum own funds requirements	
Institutions shall at all times hold a sufficient volume of regulatory own funds to cover certain risks (credit, foreign-exchange and gold position, trading book and commodity). They must comply with limits on risk concentration and tangible fixed assets, and comply individually with limits on foreign-exchange position risks. They must also have administrative and accounting procedures, risk management systems and internal control mechanisms appropriate to their size and to the diversity and complexity of their activities.	An institution shall at all times hold a sufficient volume of regulatory own funds to cover risks similar to those established in CBE 5/1993 (plus operational risk and dilution risk). Also, institutions must comply with the obligations relating to limits on large exposures, internal risk management, corporate governance, capital assessment, interest rate risk measurement and market disclosure.
Components of own funds	
Tier 1 capital	Tier 1 capital
Share capital of public limited companies, initial capital and non-voting equity units of savings banks, capital contributions of credit co-operatives and assigned capital of branches	No significant changes
Disclosed reserves, and funds similar to or reclassified as reserves	
Preference shares and non-voting shares not carrying cumulative dividend collection rights	Preference shares and non-voting shares ear-marked for the coverage of risks and losses in the event of general write-down, with undefined term, and which do not carry cumulative dividend collection rights. Limits are set on what can form part of tier 1 capital, unless there are clauses to ensure they can be converted into capital, and in the case of general
Tier 2 capital	Tier 2 capital
Asset regularisation, adjustment and revaluation reserves	
The book value of the general loan loss provisions.	No significant changes
Other non-voting shares and redeemable shares with a maturity of not less than five years	
Subordinated debt with a maturity of not less than five years	No significant changes (now known as "standard")
Subordinated debt with undefined maturity.	No significant changes
Not envisaged	Short-term subordinated debt: its original maturity must be no less than two years from the effective disbursement date and it may not contain rescue, repayment or early redemption clauses.
Not envisaged	Ancillary capital: for the coverage of position and foreign-exchange risk only
Solvency ratio	
Credit risk: the minimum capital requirements will be 8% of the result of the weightings of the various risk components.	Credit risk: The minimum capital requirements are 8% of the institution's total risk-weighted assets calculated by the standardised approach or, if authorised by the Banco de España, the internal ratings based (IRB) Included in credit risk is dilution risk, which arises from the possibility that an amount receivable acquired by a credit institution is reduced through credits to the obligor for reasons such as the commercial relationship between the obligor and the seller of the receivables.
Counterparty risk: the risk of counterparty default in derivatives transactions. Two valuation systems are established: at market prices and by the original exposure method.	Counterparty risk: The value of counterparty risk exposure can be calculated by various methods: original exposure method, mark-to-market method, standardised approach and internal model method.
Foreign-exchange and gold-position risk: not less than the sum of 8% of the net overall foreign-exchange position and 8% of the net gold position. However a ratio below 8% may be set in certain cases. Subject to certain requirements, institutions may use internal risk management models to determine the foreign-exchange and gold-position risk.	Foreign-exchange and gold-position risk: calculated under the standardised approach by multiplying by 8% the sum of the net overall positions in currencies, gold and reporting currencies. A minimum threshold is set equal to 2% of total regulatory own funds, below which these requirements are zero. For all or for a pool of foreign-exchange positions, this method may be replaced by internal models.
Trading book risk: in calculating capital requirements, regard shall be had to both the credit risk and the market risk on trading book business. Position risk shall be divided into a general risk and a specific risk. Thresholds shall be set below which the minimum requirement shall not apply. If certain requirements are met, internal risk management models may be used to determine the trading book and commodity position risks.	Trading book risk: the capital requirements shall be determined by the sum of the following requirements: that for price risk of fixed-income positions; that for price risk of commodities positions; that for price risk on positions in shares and other equity, including those in collective investment institutions; that for credit and counterparty risk linked to the trading book; that for clearing and delivery risk; and that for foreign-exchange and gold position risks. Position risk shall be broken down into a general risk and a specific risk. Credit institutions with a significant level of activity they may use their own internal risk management models to calculate their capital requirements. The exemption thresholds for little activity have undergone only small changes.

SOURCE: BOE and Banco de España

DETERMINATION AND CONTROL OF MINIMUM OWN FUNDS OF CREDIT INSTITUTIONS (cont'd) TABLE 1

CBE 5/1993 of 26 March 1993	CBE 3/2008 of 22 May 2008
Solvency ratio (cont'd)	
Not envisaged	Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, and includes legal risk. The methods for calculating capital requirements for operational risk are the basic indicator approach, the standardised approach and its variant the alternative standardised approach, and the advanced measurement approaches based on each institution's own measurement systems.
Limits on large exposures: an exposure is considered to be large if its value exceeds 10% of the credit insitution's own funds. The value of all the exposures of a credit institution to one individual, institution or external economic group shall not exceed 25% of its own funds. The total large exposures shall not exceed 800% of the credit institution's own funds.	No significant changes.
Adoption of measures to return to compliance with solvency regulations: if a regulatory capital shortfall exceeds 20% of the minimum requirement, all net profit or surplus must be allocated in full to reserves. If the capital shortfall is 20% or less, a proposed distribution of profits shall be submitted for authorisation to the Banco de España, which shall set the minimum percentage to be allocated to reserves, although it may never be less than 50% of profits.	Adoption of measures to return to compliance with solvency regulations: if a regulatory capital shortfall exceeds 20% of the minimum requirement or tier 1 capital falls below 50% of that minimum requirement, all net profit or surplus must be allocated in full to reserves, although the Banco de España is empowered to authorise other action in the event that the programme submitted by the institution for restoring compliance with capital requirements is approved. If the capital shortfall is 20% or less of the minimum requirement, a proposed distribution of profits shall be submitted for authorisation to the Banco de España, which shall set the minimum percentage to be allocated to reserves (the limit of 50% of profits no longer applies).
Governance, organisational structure, risk management and internal control procedures	
Institutions must have an organisational structure commensurate with the volume of the risks managed by them. In particular, they must have a risk control department or unit which is independent from the operating units, and their staff must be competent in using risk control models.	Organisational structure. Institutions must have: an organisational structure appropriate to the nature of their activities, with well defined, transparent and consistent lines of responsibility; an internal audit function which oversees the smooth working of the information and internal control systems; a unit to carry out the regulatory compliance function; and adequate internal control mechanisms, including sound administrative and accounting procedures.
Not envisaged	Assessment of on-balance-sheet interest rate risk: establishment of specific procedures to assess and manage this risk. Institutions shall, among other things, analyse the effect that interest rate risk may have on their future solvency and stability when the potential impact of that risk is negative and exceeds certain thresholds.
Not envisaged	Internal capital adequacy assessment process: institutions shall specifically have sound, effective and exhaustive strategies and procedures to assess and maintain on an ongoing basis the amounts, types and distribution of internal capital and own funds that they consider adequate to cover the nature and level of the risks to which they are or might be exposed. A yearly internal capital adequacy assessment report shall be sent to the Banco de España.
Not envisaged	Review and assessment by the Banco de España: if a supervised credit institution or group or sub-group of credit institutions does not have adequate corporate governance procedures or if its internal capital adequacy assessment process is inadequate, it has to prepare a compliance and capital adequacy programme which shall be submitted to the approval of the Banco de España.
Disclosure	
Not envisaged	Obligation to publish the document "Prudential information". The Circular stipulates the minimum content of this document to ensure that the disclosures made by institutions are comparable and establish the principles on which an institution's disclosure policy should be based. This document must be made public at least annually, at the same time the annual accounts are issued. However, depending on the circumstances, the Banco de España may require more frequent disclosure and stipulate deadlines. The institutions themselves may also increase the frequency of such public disclosures if considered appropriate in view of the characteristics of their business. The disclosures to be made in this document centre on key aspects of an institution's business profile, risk exposure and means of managing risk. In particular, disclosure should be made of risk management objectives, the institution's strategies and processes to manage those risks, the scope and nature of risk reporting and measurement systems, and the policies for hedging and mitigating risk

SOURCES: BOE and Banco de España.

COMPONENTS OF OWN FUNDS

Within the elements composing the own funds of credit institutions, the Circular, like its predecessor, distinguishes tier 1 capital from tier 2 capital and introduces the new concept of ancillary capital. Regarding the former, which consists of capital, effective reserves, preference shares and non-voting shares, few changes have been made with respect to the previous rules, save the quantitative limitations which will be described later on.

Tier 2 capital consists of the other elements specified in Circular CBE 5/1993 and of the excesses over the limits established for certain elements in tier 1 capital.

Ancillary capital represents a significant new feature in Spanish prudential regulation, as an alternative definition of own funds, for the coverage of position and foreign-exchange risk only. Apart from the excesses over the limits established for tier 2 capital, the most significant development is the inclusion of a new type of *short-term subordinated debt* within regulatory own funds, for which the following conditions, among others, must be met: its original maturity must be no less than two years from the effective disbursement date and it may not contain rescue, repayment or early redemption clauses, although the Banco de España may authorize the debtor to make early repayment at any time if this does not affect the institution's solvency.

The method of calculating the regulatory own funds of a group or sub-group does not differ significantly from that under the previous rules.

Among the limitations on what can be included as own funds, mention may be made of certain new ones in regard to tier 1 capital.

Included as such are preference shares and non-voting shares not exceeding 30% of tier 1 capital, unless there are clauses to ensure they can be converted into short- or long-term ordinary capital, and in the case of general write-down of the institution. If the non-voting shares include early-redemption incentives but meet certain conditions,[7] this limit is reduced to 15%.

The new Circular limits the inclusion as group own funds of the minority interests in subsidiaries, provided they meet certain thresholds of materiality and come from individually over-capitalised subsidiaries. Specifically, tier 1 capital shall exclude the portion of the aggregate excess amount of minority interests held as ordinary shares that exceeds 10% of the group or subgroup's total tier 1 capital. The way in which that excess is determined is specified.

Another new feature is that ordinary capital, reserves and minority interests (less losses and own shares) must in any event exceed 50% of tier 1 capital.

MINIMUM CAPITAL REQUIREMENTS FOR CREDIT RISK

The minimum capital requirements for credit risk remain at 8% of risk-weighted assets, including the off-balance-sheet items that entail credit risk and have not been deducted from own funds. The main new features of the Circular arise from the implementation of Royal Decree 216/2008. In particular, to calculate credit risk, institutions may choose between the standardised approach or, if authorised by the Banco de España, the internal ratings based approach.

For the standardised approach,[8] the Circular determines the weights applicable to the various risk exposures and sets the requirements to be met by external credit assessment institutions.

7. These conditions are: availability to cover risks and losses of the issuing company in the event of general write-down and of its liquidation; undefined duration, and no granting of cumulative receivables. **8.** Under the standardised approach, the own funds requirements for credit risk are determined by applying the weights assigned to the different risk exposures.

There are some new developments in regard to the weights of the various risk exposures. Those to general governments and central banks of the European Economic Area generally retain a weight of 0%, and the others are set a weight of 100% which can be changed depending on the external rating. Two new categories are established: that of *retail*, with a weight of 75%, and that of corporate, with a weight equal to the higher of 100% or that assigned to the central government of the jurisdiction in which it is domiciled, which may be replaced by the firm's external credit rating, if any. Other new developments are that risk exposures secured on residential real estate collateral will receive a weight of 35%, provided they meet certain conditions, including, among others, that the loan value does not exceed 80% of the collateral value. If the loan is more than this percentage but not more than 95% of the collateral, it shall be weighted at 100%. Loans over 95% shall receive a weight of 150%.[9] Also new is the inclusion of risk exposures secured by commercial real estate collateral, which have a weight of 50% provided they meet certain conditions, including that the loan value may not exceed 60% of the collateral value. If the loan is more than this percentage but not more than 80% of the collateral, it shall be weighted at 100%. Loans over 80% shall receive a weight of 150%. Other exposures worthy of note are: those in default (more than 90 days past-due), which shall receive a weight of up to 150%, equal to that of regulatory high-risk categories.[10]

External credit assessment institutions (ECAIs) may only be used to determine the risk weight if they have been recognised by the Banco de España. An ECAI will be recognised if its rating methodology meets the requirements of objectivity, independence, ongoing review of the methodology applied and transparency established in detail in the Circular. Also noteworthy is the recognition of the credit assessments issued by export credit agencies for determining the risk weight of an exposure to a central government or central bank, when they emanate from Compañía Española de Seguros de Crédito a la Exportación (CESCE) or when they are recognised by the Banco de España, provided they meet certain conditions.

The second method for calculating risk exposures, i.e. the internal ratings based approach (IRB approach), is subject to the express authorisation of the Banco de España. Authorisation can also be requested to use own estimates of loss in the event of default (LGD[11]), of conversion factors or both. Credit institutions which request authorisation to use the IRB approach or the LGD approach must provide evidence that, prior to obtainment of the authorisation, they have been using, for at least three years, assessment systems that are consistent for the purposes of measurement and internal risk management. Also, a set of prudential and technical minimum requirements, relating basically to risk management and the soundness of the credit institution's internal controls for the use of the IRB approach, is established. Thus, institutions must have suitable internal ratings systems for measuring the credit risk and, where applicable, the dilution risk, of their exposures. These systems should include all the methods, processes, controls and data collection and IT systems needed to appropriately assess the nature of debtors and of transactions, to differentiate between risks through the assignment of exposures to grades or pools of exposures, and to quantify, reasonably accurately and consistently, the default and loss estimates for a certain type of exposure. Once authorisation has been obtained for use of the IRB approach, credit institutions shall not return to using the standardised approach, save for justified reasons and with authorisation from the Banco de España.

Turning to credit risk, the Circular contains, as a new feature, the treatment of *dilution risk*, which is the risk that an amount receivable acquired by a credit institution is reduced through

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9. Under the previous rules, loans secured by house mortgages had a weight of 50% if the risk exposure was less than 80% of the house appraisal value; any excess was weighted at 100%. **10.** Such as investments in venture capital firms and private equity investments of a non-permanent nature. **11.** Loss given default.

cash or non-cash credits to the obligor for reasons such as the commercial relationship between the obligor and the seller of the receivables. To calculate it, the Circular establishes in detail how to estimate the risk parameters and the expected loss. However, these calculations will not be necessary where a credit institution has full recourse in respect of all purchased receivables for default risk and for dilution risk, to the seller of the purchased receivables, or where such risk is immaterial.

A new feature of the Circular relates to the techniques allowed for credit risk mitigation and the requirements for applying them. There are three such requirements: first, protection based on collateral or similar instruments, such as on-balance-sheet netting of mutual claims between counterparties or master netting agreements relating to repurchase transactions, securities or commodities lending transactions or other transactions linked to the capital market or other assets or claims used as collateral in the terms specified by the Circular; second, protection based on guarantees, including those derived from credit insurance, provided by certain protection providers, which must be sufficiently solvent; and, finally, protection based on credit derivatives, whether they be simple derivatives (credit default swaps, total return swaps and credit-linked notes) or basket derivatives. In addition, the Circular allows combinations of these techniques (for which purpose, the institutions must identify which part of the exposure is protected by each of these techniques) and, as a new feature, imperfect cover.

Within credit risk, a major new feature introduced by the Circular is the treatment of capital requirements for securitisation exposures,[12] both for the originator institution and for the holder or any other participant in the process. The new system is much more risk sensitive and establishes the criterion that, for the purpose of calculating own funds for these transactions, it much be taken into account whether there has been a significant transfer of credit risk, which is considered to take place when a significant portion of the tranches where the risk of first loss is concentrated has been transferred to third parties.

Securitisation exposures shall be calculated as the sum of the products of the exposure value of each position by its respective risk weight. To calculate the exposure value and the risk weight of each of the positions held in a securitisation, institutions can use the standardised approach for securitisation or the IRB approach. Also, both methods may be used for the various securitised exposures composing the underlying portfolio ("mixed" portfolios), provided that the institution meets certain conditions.

MINIMUM CAPITAL REQUIREMENTS FOR COUNTERPARTY CREDIT RISK

Like CBE 5/1993, the Circular regulates the own funds requirements for counterparty credit risk, which is the risk that the counterparty to a transaction involving derivatives[13] could default before the final settlement of the transaction's cash flows. The value of counterparty risk exposure can be calculated by various methods: original exposure method, mark-to-market method, standardised method and internal model method. The latter may be used with prior authorisation from the Banco de España. Once authorisation has been obtained, neither the standardised method nor the mark-to-market method may be used

12. The Circular defines securitisation as a financial transaction or scheme in which the credit risk associated with an exposure or pool of exposures is divided into two or more separately transferable tranches and which has the following characteristics: payments in the transaction or scheme are dependent on the performance of the securitised exposure or pool of exposures, and the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme. In addition to traditional securitisation (which involves the economic transfer of the exposures being securitised), it provides for synthetic securitisation (in which the division of credit risk into tranches and their transfer is achieved through the purchase of credit protection for the securitised exposures) and multiple-transferor securitisation (in which there is more than one originator institution). **13.** Also included, in addition to the types of derivatives (swaps, futures and options), are repurchase transactions, securities or commodities loans, long settlement transactions and margin lending transactions.

again, except for justified causes and subject to prior authorisation from the Banco de España. Credit institutions may use counterparty risk mitigation techniques such as contractual netting agreements, bilateral contracts for novation between a credit institution and its counterparty, and contractual cross product netting agreements, provided they meet certain requirements set out in the Circular. Netting transactions between institutions forming part of a group shall not be taken into account for the purpose of calculating own funds requirements.

MINIMUM CAPITAL REQUIREMENTS FOR FOREIGN-EXCHANGE RISK

As above, the capital requirements for foreign-exchange risk shall be calculated under the standardised method by multiplying by 8% the sum of the net overall positions in currencies, gold and reporting currencies , without taking into account their sign. However, as a new feature, a minimum threshold equal to 2% of total own funds is set.

Capital requirements for foreign-exchange risk shall be calculated by the standardised method, although, for all or for a pool of foreign-exchange positions, this method may be replaced by internal models, subject to prior authorisation from the Banco de España.

MINIMUM CAPITAL REQUIREMENTS FOR TRADING BOOK RISK

There are no major changes with respect to the previous rules. The trading book shall consist of all positions in financial instruments and commodities held by the credit institution for trading or used to hedge other items of that portfolio. As a new feature, the trading book may include internal hedges which significantly offset the risk associated with a non-trading book position or set of positions. The positions arising from internal hedges may form part of the trading book provided they meet certain conditions.

The capital requirements for trading book business shall be determined by the sum of the following requirements: that for position risk on fixed income, including convertible instruments; that for position risk on shares and other equity; that for position risk on shares and other equity in collective investment institutions; that for price risk of commodities positions; that for credit and counterparty risk linked to the trading book; that for clearing and delivery risk; and that for foreign-exchange and gold position risks.

Position risk shall be broken down into a general risk, arising from a change in the price of trading book components due to general movements in markets, and a specific risk, arising from a price change in the instrument concerned due to factors related to its issuer or, in the case of a derivative, the issuer of the underlying instrument. The position in a commodity shall include the holdings of that commodity and the derivatives in which it is the underlying, such as, among others, financial futures and warrants.

As under the previous circular, the treatment of risks of this type shall not apply when a credit institution's average trading book is lower, during the immediately preceding six months, than the lower of 5% of its total activity and €15 million, and does not at any time in that period exceed 6% of its total activity or €20 million. A new feature is that they can also be exempt if they temporarily exceed these thresholds, provided that in the observation period of six months immediately preceding the request for exemption they have not, on 75% of the days, exceeded the thresholds of 5% of total activity or €15 million.

Another new development in the Circular is that credit institutions with a significant level of activity in regard to their trading book positions may, upon prior authorisation from the Banco de España, use their own internal risk management models to calculate their capital requirements for position risk, including that of commodities, and for foreign-exchange and gold position risks. To do so, credit institutions must, among other conditions, have a risk management

system that is adequate for the volume of risk under management, conceptually sound and implemented with integrity.

MINIMUM CAPITAL REQUIREMENTS FOR OPERATIONAL RISK

As required by Directive 2006/49/EC, and incorporated in Law 13/1985 with the wording given by Law 36/2007, the Circular introduces, as a new feature, the capital requirements for operational risk. The methods that can be used are the basic indicator approach,[14] the standardised approach[15] and, where applicable, the alternative standardised approach,[16] and the advanced measurement approaches based on each institution's own measurement systems. The Circular sets out in detail the characteristics of each of the systems and the requirements to be met by institutions to obtain authorisation to apply the alternative standardised approach and the advanced measurement approaches. Institutions may also use a combination of various methods in exceptional, temporary circumstances, such as the recent acquisition of a new business, albeit always subject to authorisation from the Banco de España.

LIMITS ON LARGE EXPOSURES

There are no significant changes in respect of large exposures. As in the previous circular, a large exposure is defined as one whose value exceeds 10% of a credit institution's own funds. The value of all the exposures of a credit institution to a third-party person or economic group may not exceed 25% of its own funds. Where the exposures are to non-consolidated entities of a credit institution's economic group, this limit shall be reduced to 20%. Finally, the total large exposures may not exceed eight times a credit institution's own funds.

PROFIT APPROPRIATION IN THE EVENT OF NON-COMPLIANCE WITH SOLVENCY REGULATIONS

The Circular makes some changes to the measures in place to return to compliance with solvency regulations. Thus it equates a shortfall of 20% of minimum own funds with a shortfall of 50% in tier 1 capital, so that where a credit institution or group or sub-group of credit institutions has a regulatory capital shortfall exceeding 20% of the minimum requirement, or its tier 1 capital falls below 50% of that minimum requirement, the individual institution or each and every institution in the group or sub-group must allocate its net profit or surplus in full to reserves. However, as a new feature, and as required by Royal Decree 216/2008, the Banco de España is empowered to authorise other action in the event that the programme submitted by the institution for restoring compliance with capital requirements is approved.

If the capital shortfall is 20% or less of the minimum requirement, the individual institution or each and every institution in the group or sub-group shall submit a proposed distribution of its profits, and of those of each of the institutions in the group or sub-group, to the Banco de España for authorisation. The Banco de España will set the minimum percentage to be allocated to reserves, taking into account the programme submitted to restore the required levels. In this case, the limit of 50% which the previous circular set on the profits allocated to reserves no longer applies.

The limitations on the distribution of dividends do not apply to the subsidiaries in which consolidated group entities hold at least 80% (previously 90%) of the voting rights and of the capital, provided that, in the case of credit institutions, they individually meet the general own funds requirements.

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14. The capital requirements for operational risk shall be determined as 15% of the average of the relevant income over the last three financial years as per the profit and loss account, provided it is positive. **15.** The capital requirements for operational risk shall be determined as the simple average over the last three years of the aggregation, for each year, of the higher of zero and the sum of the relevant income of each line of business defined in the Circular multiplied by its respective risk weight. **16.** For the commercial banking and retail banking lines of business, the capital requirements formula is similar to that under the standardised approach, but the relevant income is replaced by normalised relevant income, which is determined as the book amount of the financial assets assigned to the respective business line multiplied by 0.035.

Finally, as under the previous circular, if one of the credit institutions belonging to a group or sub-group has a capital shortfall at individual level but its group or sub-group does not, the limitations on dividend distribution shall apply only to the results of that institution.

INTERNAL ORGANISATION, RISK MANAGEMENT AND INTERNAL CONTROL

In conformity with Pillar 2 of Directive 2006/48/EC, which has been partially implemented in Law 36/2007 and in Royal Decree 216/2008, and which aims to foster internal risk management in credit institutions, the Circular includes a large number of measures designed to develop and improve their internal risk management. The previous circular, although requiring internal control and risk management systems, did not address this matter so exhaustively and completely.

Thus the Circular requires both credit institutions and consolidated groups and sub-groups of credit institutions to have robust governance arrangements, and, in particular, a clear organisational structure with well defined, transparent and consistent lines of responsibility, adequate internal control mechanisms, including sound administrative and accounting procedures, and effective processes to identify, manage, monitor and report the risks it is or might be exposed to. Compliance with these obligations will require, at a minimum, the observance of certain requirements, such as the segregation of duties, the criteria for the prevention of conflicts of interest, the periodic review of the strategies and policies for taking up, managing, monitoring and mitigating risks, the establishment of appropriate internal control systems in all areas of activity and of sound and adequate internal audit procedures which ensure that the policies, procedures and systems established to assess, manage and report risks are observed and are consistent and appropriate.

The new risk management system includes two notable new features: express assessment of *on-balance-sheet interest rate risk* and *internal capital adequacy assessment*.

Regarding the first, to assess and manage risk derived from possible changes in interest rates, institutions must have in place specific procedures conforming to certain rules set out in the Circular. Institutions shall, among other things, analyse the effect that interest rate risk can have on their future solvency and stability when the potential impact of that risk is negative and exceeds certain thresholds (decrease of more than 20% in the economic value of the institution or of its own funds or a decrease of more than 50% in the interest-rate-sensitive net interest income in one year).

Regarding the second, both credit institutions and groups of credit institutions shall carry out a process of internal capital adequacy assessment. This process shall include exhaustive strategies and procedures to assess and maintain on an ongoing basis the amounts, types and distribution of internal capital and own funds that they consider adequate to cover the nature and level of the risks to which they are or might be exposed. In order to measure them, institutions may use their own methodologies or, alternatively, the criteria provided for this purpose by the Banco de España in its guidelines on the internal capital adequacy assessment process at credit institutions. These strategies and procedures shall be summarised in a yearly internal capital adequacy assessment report to be sent to the Banco de España at the same time as the own funds reporting relating to the end of the year.

If a credit institution or group or sub-group of credit institutions does not have adequate corporate governance procedures or if its internal capital adequacy assessment process is inadequate, it has to prepare a compliance and capital adequacy programme which shall be submitted to the approval of the Banco de España.

Lastly, the circular provides that credit institutions may delegate to a third party the provision of services or the exercise of functions forming part of their ordinary activities, provided that certain conditions are met. Thus such delegation may not apply to the activities restricted to credit institutions alone (receiving deposits from the public and granting loans), nor may it leave an institution bereft of its general activity or reduce its internal control or the Banco de España's supervisory capabilities.

MARKET DISCLOSURE OBLIGATIONS

Under Pillar 3 of Directive 2006/48/EC, and partially implemented by Law 36/2007 and Royal Decree 216/2008 regulating and promoting the public disclosure of relevant information, the Circular stipulates the minimum content of the document entitled "Prudential information" to ensure that the disclosures made by institutions are comparable and establish the principles on which an institution's disclosure policy should be based. This document must be made public at least annually, at the same time the annual accounts are issued. However, depending on the circumstances, the Banco de España may require more frequent disclosure and stipulate deadlines. The institutions themselves may also increase the frequency of such public disclosures if considered appropriate in view of the characteristics of their business.

The disclosures to be made in this document centre on key aspects of an institution's business profile, risk exposure and means of managing risk. In particular, disclosure should be made of risk management objectives, the institution's strategies and processes to manage those risks, the scope and nature of risk reporting and measurement systems, the policies for hedging and mitigating risk, and the strategies and processes for monitoring the continuing effectiveness of hedges and mitigants.

Lastly, the Circular specifies the confidential prudential information to be reported periodically to the Banco de España by supervised institutions and groups. This information is homogeneous with that required within the framework of the single market, since it reflects a process of convergence between the various countries of the European Union.

Financial collective investment institutions: transactions in derivative financial instruments and other matters

Ministerial Order of 10 June 1997[17] on the transactions of financial collective investment institutions (CIIs) in derivative financial instruments added flexibility to the operational framework of these institutions to enable more efficient management of their assets. Also, for the first time it enabled the use of derivative financial instruments not traded on secondary markets. Since then, the law in this respect has been updated in light of the new legal framework for these institutions,[18] in order to broaden the scope of their operations via financial instruments of this type. Specifically, the implementing regulations of Law 35/2003 on CIIs laid down the rules for investment in instruments of this type, included new underlyings among the assets considered suitable for investment and permitted the netting of positions in derivatives for the calculation of limits on investments in these instruments. Further, they empowered the minister of Economy and Finance and, with his express authorisation, the CNMV, to lay down provisions implementing this law.

In exercise of this power, *Ministerial Order EHA/888/2008 of 27 March 2008* (BOE of 2 April 2008) on transactions of financial CIIs in derivative financial instruments, clarifying certain concepts in the implementing regulations of Law 35/2003, was published.

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17. See *Regulación financiera: segundo trimestre de 1997* in Boletín económico, Banco de España, July-August 1997, pp. 111-113. **18.** See Law 35/2003 of 4 November 2003 on collective investment institutions and its implementing regulations in Royal Decree 1309/2005 of 4 November 2005 discussed, respectively, in "Financial regulation: 2003 Q4", *Economic Bulletin*, January 2004, Banco de España, pp. 84-87 and in "Financial regulation: 2005 Q4", *Economic Bulletin*, January 2006, pp. 112-116.

In general terms, the Ministerial Order has two aims: first, to add flexibility to the operational framework of CIIs in derivative financial instruments by, among other changes, enlarging the range of underlying assets deemed suitable for investments by financial CIIs, and, second, to update certain definitions under Community law.

Within its scope of application, the Ministerial Order clarifies that it does not apply to hedge funds, since the aforementioned regulations consider them to be institutions with a more flexible mandate and not subject to the general rules governing investments.

The derivatives suitable for investment are specified, as are the purposes for which they can be used: to ensure adequate hedging of the risks assumed in all or part of the portfolio, as an investment for more effective management, or to achieve a specific target rate of return. The Ministerial Order empowers the CNMV to authorise the use of other different derivative financial instruments, for which purpose regard shall be had to the specific characteristics of the instrument, its application and use in the financial markets and its impact on the risk and investment management policy of CIIs. Additional requirements are added where the underlying consists of certain assets (derivatives whose underlying asset consists of credit risk, a financial index or the volatility of another asset) or where the instrument is traded on an OTC market.

The Circular sets general limits for the use of market and counterparty risk derivatives and the way of valuing the positions in them. In the case of the former, the total exposure[19] to the market risk associated with derivative financial instruments may not exceed the equity of the CII. Regarding the latter, CIIs must have a reasonable policy of diversification of counterparty risk in transactions involving OTC derivative financial instruments that takes into account the situations of risk concentration that may arise in the future. CIIs must value positions in derivative financial instruments daily at market prices. When there is not a sufficiently liquid market to enable daily valuation, the management company or open-end investment company (SICAV) must, before carrying out the transaction, submit its elected valuation method to verification by the custodian.

The Ministerial Order includes certain internal control obligations which have to be observed to operate with derivatives, such as the disclosures to be made to the CNMV and to unit-holders and shareholders about the transactions carried out.

In regard to disclosures to shareholders and unit-holders, CIIs shall include in their (quarterly, half-yearly and annual) reports the extensive information spelt out by the CNMV on the derivatives transactions carried out in the relevant periods, including data on the risks taken on, the gains or losses resulting from those transactions and their purpose.

Lastly, the Circular specifies the provisions that will apply to financial CIIs wishing to market products of this type in other Member States of the European Union as permitted under Directive 85/611/EEC of the Council of the European Communities of 20 December 1985.

As regards the second aim, the Ministerial Order writes into Spanish law Commission Directive 2007/16/EC of 19 March 2007[20], particularly in regard to CII assets eligible for investment included in the regulations of Law 35/2003. This clarifies the references relating to transferable securities, to money market instruments, to institutions subject to prudential supervision and

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19. Total exposure is defined as any current or potential obligation that results from the use of derivative financial instruments, including short sales. **20.** The Directive seeks to ensure uniform application of Community law throughout the European Union and thus reduce the legal uncertainty of market players, by clarifying in greater detail the assets considered eligible.

to operations involving financial instruments, for the purpose of more effective portfolio management, and to financial CIIs which reproduce indices.

Finally, the sole additional provision of the Ministerial Order empowers the CNMV to establish and change the records that CIIs have to keep, the accounting rules and the public and confidential reporting formats to be employed in periodic financial statements and other statistical information of the official futures and options market operators.

Real estate investment funds: financial information

Circular 2/2008 of 26 March 2008 (BOE of 3 May 2008) of the Spanish National Securities Market Commission (CNMV), which partially amends Circular 4/1994 of 14 December 1994 on accounting rules, reporting obligations, determination of net asset value and investment and operating ratios, and operations in the appraisal of real estate held by real estate investment funds and companies, was published. The Circular stipulates that the management companies of collective investment institutions (CIIs) or the investment companies must send appraisal reports, now known as "extract of appraisal report", electronically via the new CIFRA-DOC/CNMV system approved by the CNMV board of directors on 15 September 2006 and discontinues the remittance of appraisal certificates on paper.

The Circular requires additional information to be sent to the CNMV, such as: the technical parameters used by the appraisal company to calculate the rates for adjusting cash flows from other rental property; an express, reasoned statement from the appraisal company when conditioning factors have been lifted, or from the management company when such conditioning factors exist but were unable to be lifted before the extract of appraisal report was sent; and the dates on which new real estate will be periodically appraised (appraisal schedule).

Lastly, the Circular specifies certain information concerning property appraisals, to be used to determine the assets of real estate CIIs or to be linked with the information sent by CIIs. A new development is the information relating to the percentage of completion of buildings under construction and to the percentage of occupation of the building, as well as that already indicated in Circular 4/1994, such as the sequential number assigned to the property by the manager or investment company to identify it in confidential reports to the CNMV, the functional units and the reason for the appraisal.

The Circular will come into force on 30 September 2008.

Measures to boost economic activity

Royal Decree-Law 2/2008 of 21 April 2008 (BOE of 22 April 2008) on measures to boost economic activity was enacted to combat the slowdown of the Spanish economy. The main measures taken are described below.

FISCAL MEASURES

The Royal Decree-Law contains a number of measures which affect, inter alia, personal income tax, corporate income tax, non-resident income tax and, among the indirect taxes, VAT and transfer tax.

Under personal income tax, a new tax credit with effect from 1 January 2008 has been added for the recipients of wage and business income, provided that certain limits are not exceeded.[21] Also, certain changes have been made to enable a new legal calculation procedure to be designed for the withholding and prepayment rate, with a view to gauging the impact of this tax credit for the 2008 tax year. Finally, it is stipulated that the new tax credit will not affect the

21. This amount may not exceed the result of applying the average tax rate to the total net wage and business income less the respective reductions established in Articles 20 and, where applicable, 32 of Law 35/2006 of 28 November 2006 on personal income tax and partially amending the corporate income tax, non-resident income tax and wealth tax laws.

determination of the personal income tax revenue assigned to regional and local governments, since the State bears the total cost of the measure.

In regard to corporate income tax, measures are defined to offset the tax effects derived from the application of the new general chart of accounts regulated by Royal Decree 1514/2007 of 16 November 2007[22] and the general chart of accounts for SMEs and specific accounting criteria for microenterprises, enacted by Royal Decree 1515/2007 of 16 November 2007[23] In this respect, Law 16/2007 of 4 July 2007[24] on reform and adaptation of accounting-related corporate law stipulated that, to prepare the financial statements of the first accounting period starting after 1 January 2008, companies must prepare an opening balance sheet as at the beginning of that accounting period. This opening balance sheet must apply the new accounting regulations, and this will entail adjustments as a result of the first-time application of the new chart of accounts, the balancing entries of which will generally be recorded in reserve accounts. These adjustments often affect the determination of the 2008 tax base. These tax effects would have immediate practical application, particularly when the advance payments for the tax periods starting in 2008 are made. To offset this, the Royal Decree-Law stipulates that the taxpayer can choose from two alternatives: use the tax payable for the previous tax period as the basis for calculating the advance payment, or take as a reference the portion of the tax base obtained in the first three, nine and eleven months of 2008, with the proviso that the effects of the adjustments derived from first-time application of the new general chart of accounts need not be included in this calculation.

The scope of the exemptions from non-resident income tax on public debt and other fixed-income instruments is widened for all non-residents, regardless of their place of residence.

Regarding VAT, the treatment of building refurbishment work[25] is amended. Now the proportional part relating to the land shall be subtracted when calculating 25% of the acquisition cost or market price of the building. In addition, the number of projects classed as refurbishment, and thus qualifying for the related advantageous tax regime with a tax rate of 7%, increases.

OTHER MEASURES

To help the economic situation of households, when loan holders arrange to lengthen the term of mortgage loans granted to purchase, build and refurbish a principal residence, they are not subject to stamp duty and notarial deeds may be executed on ordinary paper.

Also, the government receives a mandate to change the meaning of housing refurbishment[26] in the personal income tax regulations, in a similar way to the change in the VAT regulations.

Lastly, the upper limit set in the budget law for 2008 for the State to guarantee asset-backed securities within the framework of the FTPYME initiative is raised, the government is empowered to approve an extraordinary vocational guidance, training and integration plan and express provision is made for grants to assist job search processes and foment geographical mobility. These grants will be included in the plan together with the existing vocational guidance, training and integration measures, which will thus be strengthened.

7.7.2008.

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22. See “Financial Regulation: 2007 Q4”, *Economic Bulletin*, January 2008, Banco de España, pp. 196-198. **23.** See “Financial Regulation: 2007 Q4”, *Economic Bulletin*, January 2008, Banco de España, pp. 198-199. **24.** See “Financial Regulation: 2007 Q3”, *Economic Bulletin*, October 2007, Banco de España, pp. 149-151. **25.** Building refurbishment work aims mainly to reconstruct a building through the strengthening and treatment of the structure, facade, roof and other similar elements, provided that the total cost of the refurbishment work exceeds 25% of the acquisition cost or, where applicable, market price. **26.** When its main purpose is to reconstruct a building through the strengthening and treatment of the structure, facade, roof and other similar elements.