Financial regulation: 2005 Q3

Introduction

In 2005 Q3 relatively few financial provisions were published.

First, the law on the minimum own funds of credit institutions has been amended to adapt it to the new accounting environment arising from the adoption by the European Union of the International Financial Reporting Standards (IFRS). However, the substance of the current definition of eligible own funds and the accounting basis for calculating exposures have been left unchanged.

In the area of public debt, the legal regime for market makers has been updated, in order to facilitate its adaptation to the changes that have occurred in public debt markets in the last two years.

Meanwhile, as anticipated in the 2005 State Budget, Sociedad Española de Sistemas de Pago (SESP) has been authorised to manage the National Electronic Clearing System (SNCE) from 1 July 2005.

In the area of taxation, the Corporate Income Tax regulations have been revised to adapt them to the new accounting rules on credit risk allowances and provisions in financial institutions, in particular, taking into account the new circumstances determining the tax deduction for such allowances and provisions.

Finally, certain clarifications have been made to the law on the reporting obligations for preference shares and other debt instruments and for certain income obtained by individuals resident in the European Union.

Modification of the law on the determination and control of minimum own funds

Law 13/1992 of 1 June 1992[1] on own funds and supervision on a consolidated basis, Royal Decree 1343/1992 of 6 November 1992 and the Order of 30 December 1992 incorporated into Spanish law a large part of the Community legislation regulating the solvency of credit institutions. The Banco de España, in the exercise of its powers, developed and applied such law by means of CBE 5/1993 of 26 March 1993[2] on the determination and control of minimum own funds. Specifically, CBE 5/1993 defined the accounting items that have to be computed for the purposes of calculating the solvency of credit institutions and their consolidable groups, on the basis of the rules for the measurement and presentation of financial statements contained in Circular 4/1991 of 14 June 1991[3] on accounting rules and financial statement formats for credit institutions.

Subsequently, CBE 4/2004 of 22 December 2004[4] on public and confidential financial reporting rules and formats repealed CBE 4/1991 and made significant changes to the accounting rules for Spanish credit institutions to adapt them to the new accounting environment arising from the adoption by the European Union of IFRS. This important reform necessitated the revision of Circular 5/1993, which has been carried out by means of *CBE 3/2005 of 30 June 2005* (BOE of 13 July 2005) on the determination and control of minimum

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1. See "Regulación financiera: cuarto trimestre de 1992", *Boletín Económico,* January 1993, Banco de España, pp. 65-71. **2.** See "Regulación financiera: primer trimestre de 1993", *Boletín Económico,* April 1993, Banco de España, pp. 88-89. **3.** See "Regulación financiera: segundo trimestre de 1991", *Boletín Económico,* July-August 1991, Banco de España, pp. 58-60. **4.** See "Financial regulation: 2004 Q4", *Economic Bulletin,* January 2005, Banco de España.

own funds. However, it should be noted that there has been no change in the substance of either the current definition of eligible capital or the accounting basis for the calculation of risk exposures.

With regard to *own funds,* irrespective of their accounting classification as a financial liability or as equity, the Circular specifies the instruments eligible as own funds and sets out adjustments to be applied to accounting equity to adapt it to the definition of regulatory capital, thereby avoiding the computation of elements that do not fulfil the requirements of complete availability to absorb losses and permanence laid down by the applicable legislation.

As regards the elements that make up own funds, *preference shares*[5], which are regulated in Law 19/2003 of 4 July 2003 on capital movements, cross-border financial transactions and measures to prevent money laundering, are included, whether or not they are recorded as a financial liability.

In the section on *deductions from own funds,* some of the items are revised, such as the prior years' losses, and the current year's loss. Specifically, the Circular establishes that the debit balance (losses) of each of the equity accounts that reflect valuation adjustments of available-for-sale financial assets, whether debt or equity securities, or non-current assets for sale, and of the valuation adjustments attributable to exchange differences that arise from the application of CBE 4/2004, shall be added to the loss for the year. Any debit balance in the asset revaluation reserve, in consequence of the application of CBE 4/2004, shall also be added to the losses.

On the *exposures* side, most of the sections are amended to adjust them to the new nomenclature of CBE 4/2004. Also, the Circular specifies their valuation and the adjustments necessary to go, where applicable, from the amounts contained in the confidential individual or consolidated financial statements to the calculation basis of the own funds requirements. The purpose of this is to avoid modifying the level of the requirements, either because the new risk exposures reflected in the accounts should not be subject to additional capital requirements, or because the new valuation rules increase or decrease their book amount.

Within the *risk groups* and asset *weightings*, the Circular lists new assets that shall not be subject to the weightings established in CBE 5/1993. These are as follows: a) hedging derivatives; b) capital calls made to shareholders; c) fees and commissions for financial guarantees; d) changes in the fair value of the hedged items in portfolio hedges of interest rate risk; e) tax assets, provided that the foreseeable recovery period does not exceed 10 years, and f) insurance contracts linked to pensions which meet the other conditions to be considered scheme assets and, in accordance with the provisions of CBE 4/2004, have been included in the assets of the institution simply because their counterparty is an insurance company that is a related party.

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5. Preference shares must comply, inter alia, with the following requirements: a) they shall be issued by a credit institution or by an entity resident in Spain or in a European Union territory that is not a tax haven, whose voting rights correspond entirely, directly or indirectly, to a parent credit institution of a consolidable group or sub-group of credit institutions, and whose sole activity or object is the issuance of preference shares; b) their holders shall be entitled to receive a non-cumulative pre-set dividend. The accrual of this dividend shall be conditional upon the existence of distributable earnings at the parent credit institution or at the consolidable group or sub-group; c) they shall not give their holders voting rights, except in exceptional cases established in the relevant terms of issuance; d) they shall not give their holders pre-emptive rights in respect of future new issues; e) they shall be non-redeemable, although early redemption may be agreed from the fifth year after the share payment date, following authorisation from the Banco de España, and f) they shall be listed on organised secondary markets.

Another amendment of the Circular refers to the *calculation of the solvency ratio*. Assets and off-balance sheet items shall be computed at their book value, as defined in CBE 4/2004 (they were previously computed at their book value net of the corresponding specific provisions), based in each case on the amounts included in the individual and consolidated confidential statements, without taking into account certain valuation adjustments relating to micro-hedges reflected in equity and to assets measured at fair value, except those for any type of asset when the adjustments have been recognised through the income statement.

As regards the own funds requirements for *portfolio risk,* it should be noted that the Circular establishes that, securities used to collateralise transfers to financial accounts and securities given as collateral for a period of more than six months, provided that they are not directly related to other elements in the portfolio, cannot be included in the held-for-trading portfolio, or, where applicable, shall be excluded from it.

Finally, most of the statements in the annexes of the Circular are revised in order to adapt them to the new accounting rules.

Credit institutions had until 1 October 2005 to send to the Banco de España statements relating to the first half of 2005, in line with the new formats and criteria established in the Circular.

New regulations for State debt market makers

The Ministerial Order of 10 February 1999[6], implemented by the Resolution of 11 February 1999 of the Directorate General of the Treasury and Financial Policy (the Treasury), established the basic principles for the regulation of "Kingdom of Spain public debt market makers[7]". Subsequently, the Resolution of 20 February 2002[8] redefined the terms on which these institutions collaborate with the Treasury as regards the placement of public debt securities on the primary market and their trading on the secondary market. Later, the Treasury Resolution of 5 March 2003 repealed the previous resolution in order to broaden the scope of market makers' collaboration so as to include not only the State bond market, but also the Treasury bill market, and thus to guarantee market liquidity and maintain competitiveness with other institutional issuers in the euro area.

Treasury *Resolution of 20 July 2005* (BOE of 28 July 2005) has recently been published. This updates the regime for market makers to facilitate its adaptation to the changes that have occurred in public debt markets over the last two years. In addition, it seeks to promote the market for strips and to cover the agreement reached by the euro area Treasuries represented on the European Commission's Economic and Financial Committee (EFC) Sub-Committee on EU Government Bills and Bonds Markets with regard to the harmonised format for primary dealers to report on their activity. This resolution repeals and replaces that of 5 March 2003.

The most important changes are as follows:

MARKET MAKER ELIGIBILITY REQUIREMENTS

The eligibility requirements for market makers are similar to those set out in the previous Resolution. Notable, among others, are being the holder of an Iberclear securities account in one's own name; meeting the technical and human resources requirements that may be es-

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6. See "Financial regulation: first quarter 1999", *Economic Bulletin,* April 1999, Banco de España, pp. 60-62. **7.** Kingdom of Spain public debt market makers are those financial institutions belonging to the Book-Entry Public Debt Market whose function is to boost liquidity and the smooth and orderly operation of the Spanish public debt market and to cooperate with the Treasury in the placement and promotion in and outside Spain of State debt. **8.** See "Financial regulation: 2002 Q1", *Economic Bulletin,* April 2002, Banco de España, pp. 70-72.

tablished; meeting certain financial and legal conditions that are necessary to be considered a member with full powers of at least one of the organised electronic dealing systems determined by the Treasury; and demonstrating for at least one month, through activities in the primary and secondary Treasury bill markets, a commitment similar to that required by market makers as a whole.

RIGHTS AND OBLIGATIONS OF STATE BOND MARKET MAKERS

Similar rights to those in the previous Resolution are maintained, including the following: participation in State bond auctions; exclusive access to the second rounds of State bond auctions; stripping and reconstituting State debt securities; debt management and placement operations that can be performed by the Treasury, such as syndicated issues in euro, swap transactions and issues in foreign currency; receiving information on the Treasury's financing policy, and participation, where applicable, in the setting of targets for the issuance of medium and long-term Treasury instruments.

Likewise, the same obligations are maintained, with some changes. They continue participating in State bond auctions and guaranteeing liquidity in the secondary bond and strips markets, on the same conditions as in the previous Resolution.

Also, the Treasury may modify the trading terms set out above, and those appearing in paragraphs a) and b) below, after consulting the market makers:

a) Each market maker shall trade at least four benchmarks (previously 5), but there is no reference to the three additional bond baskets established in the previous Resolution.

b) Each market maker shall trade at least four main strips (previously two main ones and two extra benchmarks, which could be either strips or the two bonds replacing the strips) in accordance with certain maximum spread (expressed in basis points of yield) and volume (millions of euro) conditions.

Another change is that market makers may divide themselves up into groups for quoting the main strips. Thus, at meetings with the Treasury baskets may be designed containing the main strips, whose quotation shall be compulsory, with each basket assigned to a group of market makers. When making up the baskets the maturity of the benchmarks included shall be taken into account, so that their duration and liquidity is similar. The baskets may normally be modified every two months.

At the same time, they must provide the information that the Treasury may request on the debt market in general and on market making activity in particular. A new obligation is that if a market maker is allotted more than 40% of the volume issued in one bond auction, it shall notify the Treasury of any clients on whose behalf it was acting in the auction.

Finally, they shall continue to ensure the sound operation of the market, respecting the operational obligations that may be established and avoiding actions that may have an adverse effect on the market or on State debt.

RIGHTS AND OBLIGATIONS OF TREASURY BILL MARKET MAKERS

The same rights as in the previous Resolution are maintained: exclusive access to a second round of the Treasury bill tender; debt and treasury management operations that the Treasury may perform, such as auctions of Treasury liquidity; receipt of information regarding the Treasury's financing policy; participation, where applicable, in the setting of issuance targets for short-term Treasury instruments, and representation on the Public Debt Market Advisory Committee, along with the bond market makers.

As in the previous case, the same obligations are maintained, although with some changes: they shall participate in Treasury bill tenders and shall guarantee liquidity on the secondary Treasury bill market.

At meetings with the Treasury they shall define the bills deemed to be market benchmarks, but there is no reference to the two extra bill baskets and creation of the corresponding groups.

Finally, they shall provide the information that the Treasury may request on the debt market in general and on market making activity in particular, and they shall ensure the sound operation of the market, respecting the operational obligations that may be established and avoiding actions that may have an adverse effect on the market or on State debt.

ASSESSMENT OF MARKET MAKERS

As under the previous Resolution, the Treasury shall assess each month, and independently, the activity of market makers in different areas specified in the Resolution. There are five new areas of assessment:

1. Degree of participation in the monthly dealing in public debt by market makers with entities that do not hold Iberclear accounts.

2. Stripping and reconstitution of strippable securities, and dealing therein.

3. Degree of participation in operations to promote State debt in and outside Spain.

4. Degree of distribution of State debt in countries or strategic areas calculated on the basis of the monthly reports the market makers send to the Treasury.

5. Regularity in the behaviour of market makers, to contribute to the stability of their efforts over time.

Unlike previously, the Resolution specifies those cases in which market makers shall be penalised:

a) When they fail to comply with a request for information or advice from the Treasury, when they fail to attend meetings with the Treasury, or when they carry out actions that may have an adverse effect on the operation of the market or that have as their single ultimate aim to improve the Treasury's assessment of them.

b) When the bids submitted at auctions differ substantially from the price or yield on the secondary market five minutes before the auction and thus distort its operation.

LOSS OF MARKET MAKER STATUS

Treasury bill market maker status may be lost for any of the following reasons, envisaged in the previous Resolution of 5 March 2003: renunciation by the entity itself notified to the Treasury; a decision of the Treasury, when it considers that the entity does not show sufficient commitment in the public debt market or that it has failed to comply with its obligations under the Resolution for three consecutive months; and a decision of the Treasury, when an entity fails to comply with the rules on withholding taxes in the current law applicable to it.

Also, a new case in which an entity may lose its market maker status is:

When the Treasury decides that it has performed actions that may have an adverse effect on the operation of the market or on State debt or that it considers its behaviour improper for a market maker, against the interests of the Treasury or contrary to the aim of sound operation of the debt market.

When the Treasury decides to rotate its group of market makers in order to give new entities access to the group, increasing their total number or not. The choice of the entity or entities who are to lose their market maker status shall be made on the basis of the assessment carried out in accordance with this Resolution and of the composition of the groups of bill and bond market makers.

Sociedad Española de Sistemas de Pago, SA: management of the National Electronic Clearing System

The 2005 State budget Law 2/2004 of 27 December 2004[9], in its additional provisions, amended Law 41/1999 of 12 November[10] on payment and securities settlement systems. Specifically, it regulated Sociedad Española de Sistemas de Pago, SA (SESP), which replaced Servicio de Pagos Interbancarios, SA. SESP has as its main object, to facilitate the exchange, clearing and settlement of orders for the transfer of funds between credit institutions, whatever the type of document, or of payment or fund transfer instrument from which such transfer orders arise; to facilitate for credit institutions the distribution, collection and processing of means of payment; and to provide technical and operational services that supplement or are ancillary to the above activities, and any others requested so that SESP collaborates and coordinates its activities in the payment systems area. It was also provided that SESP should take over the management of the National Electronic Clearing System (SNCE) before 1 July 2005.

For this reason, the Executive Commission of the Banco de España published a *Resolution of 30 June 2005* (BOE of 8 July 2005), authorising *SESP* to manage the SNCE with effect from 30 June 2005.

That said, the company will continue to be supervised by the Banco de España, which shall be responsible for authorising, prior to their adoption by the relevant bodies of the company, its articles of association and any amendments thereto, as well as the basic rules of operation of the systems and services that it manages. Also, the penalty regime of Law 26/1988 of 28 July 1988 on discipline and intervention of credit institutions, with such refinements as may be determined by law, shall be applicable to the company.

Revision of the Corporate Income Tax regulations to adapt them to the new accounting rules on the credit risk allowances and provisions of financial institutions

The consolidated text of the Corporate Income Tax Law approved by Legislative Royal Decree 4/2004 of 5 March 2004[11], implemented by the corporate income tax regulations, approved by Royal Decree 1777/2004 of 30 July 2004[12], provided for impairment allowances, and regulated the deductibility of the impairment charges to provide for the risk arising from the possible insolvency of debtors, establishing the rules relating to this risk in financial institutions and the amount of impairment charges to provide for such risk; all this in conformity with the rules in Circular 4/1991 of 14 June 1991 of the Banco de España, which regulated the accounting rules and financial statement formats for credit institutions.

This Circular was repealed by Circular 4/2004 of 22 December 2004 of the Banco de España on credit institutions' public and confidential financial reporting rules and formats, which came

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9. See "Financial regulation: 2004 Q4", *Economic Bulletin,* January 2005, Banco de España. **10.** See "Financial regulation: 1999 Q4", *Economic Bulletin*, January 2000, Banco de España, pp. 103-104. **11.** See "Financial regulation: 2004 Q1", *Economic Bulletin*, April 2004, Banco de España, pp. 99-100. **12.** See "Financial regulation: 2004 Q3", *Economic Bulletin*, October 2004, Banco de España.

into force on 30 June 2005 and amended the accounting regime for Spanish credit institutions in order to adapt it to the new accounting environment arising from the adoption by the European Union of IFRS, so that its application will affect tax periods from this year.

Consequently, it was necessary to revise the corporate income tax regulations in order to adapt them to the new accounting rules on the credit risk allowances and provisions in financial institutions. This was achieved with the publication of *Royal Decree 1122/2005 of 26 September 2005* (BOE of 6 October 2005), which amended the corporate income tax regulations approved by Royal Decree 1777/2004 of 30 July 2004 in relation to credit risk allowances and provisions in financial institutions, and Royal Decree 1778/2004 of 30 July 2004, which laid down reporting obligations for preference shares and other debt instruments and certain income obtained by individuals resident in the European Union. The latter amendment will be discussed in the following section.

With regard to insolvency risk, Circular 4/1991 distinguished a specific provision, a general provision (insolvency fund to cover credit risk) and a statistical provision (fund to cover insolvencies statistically). Circular 4/2004 of 22 December 2004 makes a substantive change to the regulation of provisioning, while attempting to maintain a high degree of continuity with the previous regime, as regards both its accounting objectives (accurate valuation of losses in credit portfolios) and its supervisory and prudential aims. Thus Circular 4/2004 proposes two types of allowance or provision: a specific allowance or provision which reflects the deterioration in assets identified as impaired, and a general allowance or provision which turns on the entire credit portfolio.

Accordingly, Royal Decree 1112/2005 regulates the new circumstances that give rise to the tax deduction for credit risk allowances and provisions and its amount. In this respect, the general rule is still that all provisioning charges taken for credit risk, up to the level of the minimum amounts provided for in Circular 4/2004 of the Banco de España, are deductible, but some of the exceptions have been amended. Specifically, provisioning expense recorded in cases of loss or impairment of security and that recorded in accordance with the provisions of section 17.b) of Annex IX of Circular 4/2004 which refer to secured transactions is deductible. Also, a new category of risk is added, known as "substandard"[13]. This was introduced by Circular 4/2004, and the conditions for the related expense to be deductible are established.

Finally, a new criterion is added for the general allowance or provision to be tax deductible, subject to a quantitative limit. Thus, the amount of the general allowance or provision that does not correspond to contingent exposures shall be deductible, up to the limit of 1% of the overall positive change during the tax period in the debt instruments classified as standard risk referred to in Annex IX of Circular 4/2004 of 22 December 2004, excluding negligible-risk debt instruments, securities traded on organised secondary markets, secured credits and amounts not yet due on financial leases of property. That part of the general allowance or provision for contingent exposures that derives from the application of the alpha parameter referred to in section 29.b) of the aforementioned Annex IX shall be deductible[14].

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13. The substandard category includes all debt instruments and contingent exposures which, without qualifying individually for classification as doubtful or write-off, show weaknesses that may entail the entity assuming losses higher than the allowances and provisions for impairment of exposures under special monitoring. This category includes, inter alia, the transactions of customers who form part of groups in difficulty (such as the residents in a specific geographical area at sub-country level, or those belonging to a specific, ailing economic sector), for which overall losses higher than those in the foregoing category are estimated, and transactions that are not properly documented. **14.** The method of estimating the general allowance or provision in Annex IX of CBE 4/2004, so that the alpha parameter takes into account the historical inherent loss and the adjustments to adapt them to the current economic circumstances.

Modification of the law on reporting obligations for preference shares and other debt instruments and certain income obtained by individuals resident in the European Union

Royal Decree 1778/2004 of 30 July 2005[15], which establishes reporting obligations for preference shares and other debt instruments and certain income obtained by individuals resident in the European Union, incorporated into Spanish law Council Directive 2003/48/EC of 3 June 2003, on taxation of savings income in the form of interest payments. In this respect, it established that exchange of information would be applied to all relevant income paid as from 1 July 2005, whether or not it accrued after that date.

Subsequently, the ECOFIN Council resolved, at a meeting held on 12 April 2005, that the Directive would be applied to all interest payments accruing as from 1 July 2005. Royal Decree 1778/2004 has thus been amended by means of the above-mentioned *Royal Decree 1122/2005 of 26 September 2005*, which kept its date of entry into force as 1 July 2005, but made it applicable to all income subject to reporting requirements that is paid or received from that date, excluding the proportionate part accruing previously.

15. See "Financial regulation: 2004 Q3", *Economic Bulletin,* October 2004, Banco de España.