3 Regulatory changes in prudential supervision

This chapter includes the most significant legal changes which, from a prudential supervision standpoint, were made in 2008 in the regulation of the activity of CIs and other financial intermediaries and auxiliaries subject to supervision by the Banco de España. This chapter is devoted to organisational and disciplinary rules and omits other regulatory changes of a more technical and operational nature which do not address the solvency of institutions or their interaction with markets or customers.

3.1 Community provisions

Despite the intense regulatory debate at international level in general and in the EU in particular, in 2008 there was only one new piece of EU legislation in the field with which we are concerned.

Directive 2008/48/EC of the European Parliament and of the Council of 23 April 2008 on credit agreements for consumers and repealing Council Directive 87/102/EEC

The purpose of this Directive is to reduce the differences between the laws of the various Member States in the field of consumer credit in order to create a genuine internal market in consumer credit. It therefore determines first the information which the creditor and, where applicable, the credit intermediary (although not suppliers of goods and services that act only as credit intermediaries in a secondary capacity) must provide to consumers before the credit agreement is concluded. This information is provided in the so-called Standard European Consumer Credit Information, although there are specific provisions on distance marketing. The Directive also regulates how this information must be reflected in the contractual documents.

The Directive grants certain rights to consumers: (i) right to be informed of any change in the borrowing rate before the change enters into force, (ii) right to make full or partial early repayment of credit, for which the creditor is entitled to receive compensation which may not exceed 1% of the amount of credit repaid early (0.5% if the credit is repaid no more than one year early), (iii) right to withdraw from the credit agreement, which, except in certain circumstances, may be exercised within a period of 14 calendar days without giving any reason, (iv) right to be informed of any assignment of rights under a credit agreement, retaining vis-à-vis the assignee the same exemptions and defences as with the original lender.

In regard to linked credit,[1] the Directive provides that, in the event of withdrawal from a contract for the supply of goods or services, the consumer shall no longer be bound by the linked credit agreement. Also, in the event of breach of contract by the supplier, the consumer shall have the secondary right to pursue remedies against the creditor.

The Directive devotes particular attention to the calculation of the annual percentage rate of the transaction and introduces the obligation to assess the credit status of the consumer using either the information furnished by him or the relevant databases. As a corollary to this obligation, it requires the Member States to ensure that creditors have access to these databases regardless of their nationality.

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1. That which serves exclusively to finance an agreement for the supply of specific goods or the provision of a specific service, such that the two agreements form, from an objective point of view, a commercial unit.

The Directive excludes the following credit agreements, among others, from its scope of application: (i) those secured either by a mortgage on immovable property or by delivery of an asset to the creditor, (ii) those relating to deferred debit cards under the terms of which the credit is repayable within three months free of interest, (iii) those in which the total amount of credit is less than €200 or more than €75,000 and (iv) those in the form of an overdraft facility and where the credit has to be repaid within one month (those in which the credit has to be repaid within three months have to meet only certain information requirements).

3.2 National provisions

3.2.1 PRUDENTIAL REGULATION

Royal Decree 216/2008 of 15 February 2008 on the own funds of financial institutions

The Basel II Capital Accord was written into Community law in the form of two directives, both dated 14 June 2006: Directive 2006/48/EC on the taking up and pursuit of the business of credit institutions and Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions. These two directives were partially included in Spanish law through Law 36/2007 of 16 November 2007 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, and through Law 47/2007 of 19 December 2007 amending Law 24/1988 of 28 July 1988 on the securities market. Royal Decree 216/2008 continues this process of transposition. Set forth below are the main aspects of this process affecting the institutions supervised by the Banco de España.

The definition of the components of CIs' own funds includes, along with other minor changes in the conditions for their eligibility and in the items deducted in calculating them, such notable new features as the introduction of so-called ancillary capital and the setting of new limits for traditional categories.

In regard to capital requirements, the Royal Decree stipulates different treatment according to the type of risk. Thus, for credit and counterparty risk it holds unchanged the coverage of 8% of risk-weighted exposures, although the coverage of credit risk may now be calculated either by the so-called standardised approach or by the internal ratings-based (IRB) approach. Under the standardised approach, the risk weights are calculated, as before, on the basis of predetermined categories, although now in many cases credit ratings by eligible external ratings agencies or, in certain cases, by export credit agencies, may be used in this calculation. Under the IRB approach, the use of which requires prior authorisation from the Banco de España, the weightings are carried out using internal risk models based on the institutions' experience. Also, the Royal Decree continues to allow the value of exposures to be reduced through the use of collateral or guarantees, the latter being understood to include credit derivatives, and devotes particular attention to the calculation of exposures in securitisation transactions from the standpoints of both the originator and the investor.

Other types of risk addressed in the Royal Decree are: (i) those relating to possible unfavourable changes in exchange rates and in gold and commodity prices (for which internal calculation models may be used); (ii) those deriving from price changes affecting positions in the financial assets comprising CIs' trading portfolios and (iii) risk of loss due to events which might occur in an institution's internal processes (operational risk). To calculate the latter, which is the only new risk, three possible approaches are established: the basic indicator approach, the standardised approach (along with the variant which gives rise to the alternative standardised approach) and the advanced approach, based on an institution's own prediction systems.

The Royal Decree holds unchanged the existing regulation of limits on large exposures and eliminates the previous limit on property, plant and equipment, which had no equivalent in Community legislation.

The Royal Decree also introduces a series of organisational requirements which include: (i) a suitable organisational structure, (ii) compliance and internal audit functions, (iii) an internal capital adequacy assessment process (see Section 2.4.1 of both this and the 2007 Report) and (iv) definition of the policies for assuming, controlling, managing and mitigating risks, including interest rate and liquidity risk. Also specified are the general requirements and conditions under which credit institutions may delegate the provision of services or the exercise of functions forming part of their activity, thereby ensuring the consistent treatment of such delegation by credit institutions and investment firms.

Turning to market disclosure by credit institutions (Pillar 3), these are required to publish so-called "information of prudential significance" at least once a year as soon as it is feasible to do so. Where information is omitted because it is confidential, this must be stated and the reasons doing so must be given.

Lastly, the Royal Decree stipulates the measures to be taken by groups of credit institutions or by credit institutions individually should they fail to meet the requirements or limits in place. Accordingly, within one month the institution must submit for approval by the Banco de España a programme setting out the plans for returning to compliance.

In any event, a substantial part, if not all, of the technical matters relating to the own funds of financial institutions is delegated to the Banco de España or the CNMV, since the directives contain detailed provisions on them.

Other supervised institutions

The Royal Decree establishes specific own funds and risk diversification requirements for mutual guarantee and reguarantee companies (the previous ones were established by reference to those of credit institutions) and recognises that, under certain conditions, reguarantees are an instrument that reduces credit risk and should therefore entail the consequent reduction of capital requirements for commitments backed by reguarantees.

Banco de España Circular 3/2008 of 22 May 2008 to credit institutions on determination and control of minimum own funds

This Circular culminates the process of transposition of Community solvency legislation by establishing the technical specifications applicable to consolidable groups and sub-groups of credit institutions and to individual credit institutions of Spanish nationality. As a general obligation, the Circular mandates compliance with requirements and limits at both individual and consolidated level, although it provides that the Banco de España may grant certain individual exemptions provided that an adequate allocation of own funds and of risks within the group is assured and the inexistence of obstacles to the transfer of own funds or the repayment of liabilities between the parent and its subsidiaries is accredited. The Circular also applies to coordination groups controlled by a financial institution with registered office outside the EU that are not subject to equivalent consolidated supervision.

Eligible elements

A major new development in this respect is the limits set for the calculation of certain financial instruments as tier 1 capital of CIs. Thus preference shares and non-voting shares may not exceed 30% of tier 1 capital (15% including early redemption incentives). Also excluded is the aggregate amount of minority interests held as ordinary shares that exceeds 10% of the group

or sub-group's total tier 1 capital. In any event, ordinary capital, reserves and minority interests (less losses and own shares) must exceed 50% of tier 1 capital. The excesses resulting from the application of these limits shall be included in tier 2 capital.

The most significant new feature in the definition of eligible elements is, however, the ability to calculate, subject to certain conditions, the provisional profit as it is accrued during the year. Also, the scope of the so-called ancillary capital, valid only to cover position and foreign-exchange risk, is specified.

Credit risk

The capital requirements for credit risk remain at 8% of risk-weighted assets, including the credit risk associated with off-balance-sheet items and not yet deducted from own funds. To calculate credit risk, institutions can use the standardised approach or, if authorised by the Banco de España, the internal ratings-based (IRB) approach.

Under the standardised approach, the Circular specifies[2] the weights applicable to the different risk exposures, although it permits the use of external ratings provided that certain requirements are met.[3] The main new developments in these risk weight specifications are the two new categories: that of retail, which will receive a weight of 75% and that of corporate, the weight of which will be 100% or that assigned by central government of the jurisdiction in which the company is incorporated, whichever is higher. Exposures secured by residential mortgages have a low weight provided they meet certain conditions, including the requisite that the loan amount does not exceed 80% of the collateral value (if it is more than 80% but not more than 95%, it is weighted at 100%, and if it is more than 95% of the collateral value, it is weighted at 150%), and exposures secured by commercial mortgages are reduced to 50% under certain conditions. Doubtful loans (more that 90 days past-due) shall receive a weight of up to 150%, as shall regulatory high-risk categories (including non-permanent variable-rate exposures).

Under the IRB approach, the use of which requires prior authorisation from the Banco de España, risk exposures are weighted using the institution's own risk models, which may also use own estimates of conversion factors of loss given default.

In any event, the Circular allows the calculation of credit risk-weighted exposures to be changed through the application, either separately or in combination, of so-called credit risk mitigation techniques, which may be based on collateral, on guarantees provided by protection providers or on single-name or basket credit derivatives. Certain general and specific requirements for each group have to be met before these techniques can be used.

The Circular also pays particular attention to exposures resulting from securitisation transactions[4] the calculation of which has to take into account, as a general principle, whether or not

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2. In the case of risk exposures to the public sector, this is done by Royal Decree 216/2008. **3.** External ratings can only be used to determine risk weights when the rating agency has been recognised by the Banco de España, for which purpose it must meet the requirements of objectivity, independence, continuous revision of the methodology applied and transparency. The credit ratings that may be recognised for the purpose of determining the risk weights of an exposure to central government or central banks also include those performed by Compañía Española de Seguros de Crédito a la Exportación (CESCE) and other export credit agencies recognised by the Banco de España. **4.** The Circular defines securitisation as a financial transaction or scheme whereby the credit risk associated with an exposure or pool of exposures is divided into two or more separately transferable tranches (in which the subordination of tranches determines the distribution of losses), the payments of which are dependent upon the return on the exposure or pool of securitised exposures. In addition to traditional securitisation (which entails the economic transfer of the securitised exposures), the Circular provides for synthetic securitisation (securitisation where the tranching of credit risk and its transfer are achieved by the purchase of credit protection for the securitised exposures) and multi-assignor securitisation (in which there is more than one originator credit institution).

there is significant credit risk transfer. Securitisation exposures are calculated as the sum of the products of the exposure value of each position by its respective risk weight.

Counterparty risk

In order to complete the calculation of credit risk-weighted exposures, the Circular holds virtually unchanged the systems previously established for calculating the counterparty default risk before final settlement of the agreed flows, which is present in certain off-balance-sheet transactions.

Foreign exchange risk

As has been the practice so far, capital requirements for foreign exchange risk shall be calculated by the standardised approach, linked to the overall foreign currency position, although, for the total position or for a pool of positions in foreign currencies, this approach may be replaced by internal models upon prior authorisation from the Banco de España. Nevertheless, a new development is that the Circular sets a minimum threshold below which there will be no requirement.

Trading book risk

The trading book is composed of all the positions in financial instruments and commodities held by the CI with the intention of trading or which serve as a hedge of other items in this portfolio. As a new development, hedges of non-trading book positions (internal hedges) to also be included under certain conditions.

The capital requirements for the trading book continue to be the sum of the position risk requirements[5] for positions in fixed-income securities, in shares and other equity (including holdings in collective investment institutions) and in commodities, as well as the credit and counterparty risk requirements linked to the trading book, those relating to settlement and delivery risk and to foreign exchange and gold position risk. If CIs have a significant level of trading book activity, they may, upon prior authorisation from the Banco de España, calculate their capital requirements using their own internal risk management models. As before, the treatment stipulated for risks of this type shall not apply if the trading book does not reach certain thresholds.

Operational risk

Three methods can be used to calculate the new capital requirements for operational risk: (i) basic indicator approach, which uses the main income items in the income statement; (ii) standardised approach, based on the main income items of certain lines of business defined in the Circular, although those of commercial and retail banking may be replaced by normalised relevant income (alternative standardised approach); and (iii) advanced approaches, based on the own measurement systems of each institution. The Circular permits CIs to use a combination of various methods in exceptional temporary circumstances, subject to prior authorisation from the Banco de España.

Limits on large exposures

The limits on large exposures (those exceeding 10% of a CI's own funds) do not undergo any significant changes. The amount of all the exposures of a CI to a single third-party client or economic group may not exceed 25% of its own funds; if the risk exposure is to unconsolidated institutions of the reporting institution's own economic group, this limit shall be 20%. Additionally, the overall large exposures may not exceed eight times its own funds. However, for the purposes of calculating these limits, the exceptions envisaged by the Circular include a wide variety of exposures.

Internal governance and internal capital adequacy assessment requirements

To implement the so-called Pillar 2 of the Basel Accord (internal capital adequacy assessment and supervisory review process), the Circular includes a wide range of measures designed to

5. Position risk can, in turn, be divided into a general risk, derived from a price change in trading book items due to general movments in markets, and a specific risk, due to factors related to the issuer of the security or of its underlying instrument.

improve the internal management of institutions and, in particular, of their risks. Thus credit institutions and consolidable groups and sub-groups of credit institutions should have a clear organisational structure with well-defined, transparent and consistent reporting lines. They should also have adequate internal control mechanisms and appropriate processes to prevent conflicts of interest and to identify, manage, monitor and report risks (including interest rate risk). These procedures should be reviewed regularly.

Additionally, both CIs and consolidable groups of CIs should carry out an internal capital adequacy assessment process. This process should enable institutions to assess and maintain on an ongoing basis the amounts, types and distribution of internal capital and of own funds they consider adequate to cover all risks, depending on their nature and level, to which they are or may 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 for this purpose. These strategies and procedures shall be summarised in a yearly internal capital adequacy assessment report to be sent on a confidential basis to the Banco de España for review in accordance with the provisions of Article 10.bis of Law 13/1985.

Market disclosure

To further define market disclosure requirements (Pillar 3), the Circular specifies the minimum content of the document entitled Information of prudential relevance in order that the disclosures are comparable from one institution to another. This document must be made public, at a minimum, when the financial statements are published, although the Banco de España may set a higher frequency or establish disclosure schedules.

Non-compliance with solvency requirements

The Circular, without prejudice to other measures that institutions may have to take, specifies the limitations on income distribution to which institutions are subject if they fail to comply with solvency requirements. Thus, if a CI or a consolidable group or sub-group of CIs has a regulatory capital shortfall exceeding 20% of the minimum requirement, or if its core capital falls below 50% of that minimum requirement, the institution or each and every member of the group or sub-group must allocate to reserves all its or their net profit or surplus, unless the Banco de España authorises some other course of action in the framework of a programme to return to compliance with the required levels. If the capital shortfall is equal to or more than 20%, the individual institution or each and every member of the group or sub-group shall submit to the Banco de España for authorisation an income distribution proposal setting out the minimum percentage to be allocated to reserves. Nevertheless, the limitations on the distribution of income shall not apply to certain subsidiaries.

Banco de España Circular CBE 5/2008 of 31 October 2008 to mutual guarantee companies on minimum own funds and other obligatory reporting

The purpose of this Circular is to define the new solvency regime applicable to mutual guarantee companies, which was incorporated in Royal Decree 2345/1996[6] by the aforementioned Royal Decree 216/2008. Thus the requirements to be met by these companies are equal to the sum of those established to cover the risks associated with their ordinary activities, whether arising from credit risk (8% of the outstanding exposure from credit guarantees and 4% of other commitments, without prejudice to possible reduction if backed by reguarantees) or operational risk (15% of annual net interest income).[7] The risks associated with non-habitual

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6. Royal Decree 2345/1996 of 8 November 1996 on the administrative authorisation rules and solvency requirements for mutual guarantee companies. **7.** Annual net interest income is defined as the sum of total interest income, fees for all guarantees provided, income from the provision of services or any other source and income from financial instruments net of expenses.

commitments or investments shall also be taken into account, this being done in accordance with the criteria set for CIs.

Like CIs, mutual guarantee companies have to establish internal procedures, proportionate to the nature, scale and complexity of their activities, to control and manage the risks arising in their operations. If the Banco de España perceives significant deficiencies, it may, after consulting the interested party, require a remediation plan to be set in place and, until that plan has been effectively implemented, require additional capital to be held, up to a maximum of 25% of the minimum capital requirement.

Mutual guarantee companies shall continue to comply with the limits on large exposures, on property, plant and equipment, on shares and other equity and on investment of own funds, which were already included in the aforementioned Royal Decree 2345/1996.

3.2.2 PURSUIT OF ACTIVITY

Royal Decree 217/2008 of 15 February 2008 on the legal regime of investment firms and of other investment services entities

Insofar as the areas of relevance to this chapter are concerned, this Royal Decree sets out rules of internal organisation and of conduct applicable to institutions providing investment services, among which credit institutions predominate. Thus, in regard to general organisational requirements, the Royal Decree stipulates that institutions providing investment services must employ sufficiently qualified staff, keep orderly and appropriate records, ensure functions are properly carried out and safeguard business continuity in the event of systems interruption. They also have to set up a separate unit responsible for regulatory compliance and establish risk management procedures and policies. They must regularly assess the internal control mechanisms in place.

The Royal Decree systematises the measures to be taken to prevent and manage conflicts of interest, for which purpose it uses the concept of competent persons for whom it establishes a list of prohibited activities. Additionally, it regulates the outsourcing of services, paying particular attention to essential functions, to delegation to service providers located in third countries, to the custody of financial instruments and to the deposit of customer funds.

In regard to rules of conduct, the Royal Decree specifies that permitted incentives shall be those delivered to, or offered by, customers or persons that act on their own behalf, provided that they are communicated to customers in a clear, complete, precise and understandable manner and their payment increases the quality of the service provided. Also considered to be permitted incentives are the appropriate fees that are necessary and that, by their nature, cannot conflict with the optimum interest of customers.

In addition, the Royal Decree sets out the conditions to be met by information directed at customers, including advertising, for it to be considered impartial, clear and not misleading. Also addressed is the content of the information and the manner in which it must be presented to customers. Moreover, the Royal Decree specifies which information must be obligatorily provided and when this is to be done, paying particular attention to the contractual conditions and to the provision of portfolio management services.

Lastly, the Royal Decree specifies various matters relating to the provision of investment services: assessment of the suitability of the recommended transaction when financial advisory services are provided, how appropriate the offered service or product is for the customer profile, the “best execution” criteria and the general principles to be observed in processing or-

ders. Additionally, it regulates, at all times in conformity with the principle of free market pricing, the regime applicable to fee and commission charges.

Royal Decree 322/2008 of 29 February 2008 on the legal regime of electronic money institutions

This Royal Decree completes the transposition into Spanish law of Directive 2000/46/EC of the European Parliament and of the Council of 18 September 2000, establishing the legal regime governing a new type of entity called electronic money institutions (ELMIs). The main activity of ELMIs, which currently have the status of credit institutions, consists of issuing electronic money, defined as the monetary value accepted as a means of payment by undertakings other than the issuer, stored on an electronic device, issued on receipt of funds not less in value than the monetary value issued.

ELMIs are authorised by the Ministry of Economic Affairs and Finance upon a prior report from the Banco de España and from the Commission for the Prevention of Money Laundering and Monetary Offences. To obtain this authorisation, ELMIs must meet all the requirements applicable to CIs, particularly those relating to their corporate form, the suitability of significant shareholders, the integrity and experience of Board members and the existence of an appropriate administrative organisation and means of internal control. Their capital stock may not be less than €1 million and their own funds (in the form defined for other CIs) must not be less than 2% of the current amount or the average of the preceding six month's total amount of their financial liabilities related to outstanding e-money.

Also, they are subject to investment requirements whereby, in order to safeguard the funds received from customers for the issuance of e-money,[8] an amount not less than the outstanding e-money must be invested by them in certain liquid, low-risk assets specified in the Royal Decree. In any event, the disciplinary regime applicable to ELMIs is that established in Law 26/1988 of 29 July 1988 on the discipline and intervention of credit institutions.

The Royal Decree provides for a regime of partial exemption for those ELMIs issuing e-money which is accepted as means of payment only by entities of the group to which the ELMI belongs.

3.2.3 URGENT MEASURES

Various legal measures were adopted in late 2008 for the dual purpose of increasing financial system stability through enhanced investor and deposit confidence and of palliating the growing difficulties encountered by CIs as they seek to raise funds on capital markets strongly distorted by notable uncertainties over credit and counterparty risk. These include the following:

Royal Decree 1642/2008 of 10 October 2008 setting the guaranteed amounts referred to in Royal Decree 2606/1996 of 20 December 1996 on the deposit guarantee fund of credit institutions and Royal Decree 948/2001 of 3 August 2001 on investor compensation schemes

Within the framework of the initiatives undertaken by other Member States and of the EU Economic and Financial Committee resolution to raise the minimum coverage threshold of deposit guarantee schemes to €50,000, this Royal Decree increased to €100,000 the amount insured by Spanish deposit and investment guarantee system, which until then had been €20,000.

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8. Note that ELMIs are not covered by any deposit guarantee fund.

Royal Decree-Law 6/2008 of 10 October 2008 creating the Fund for the Acquisition of Financial Assets

This Royal Decree-Law creates a Fund for the Acquisition of Financial Assets of €30 billion, extendable to €50 billion, to enhance the capacity of CIs to increase the supply of credit to firms and individuals. The Banco de España will act as the agent and depository of this Fund, which is financed out of the State budget, is attached to the Ministry of Economic Affairs and Finance and is only temporary. It will invest, by voluntary competitive selection procedures (consisting of auctions conducted in accordance with Ministerial Order EHA/3118/2008 of 31 October 2008 implementing the Royal Decree), in high quality financial instruments issued by CIs and special purpose entities, giving priority to those backed by new loans to individuals and non-financial corporations. The Fund will function according to the principles of objectivity, security, transparency, efficiency, profitability and diversification.

Royal Decree-Law 7/2008 of 13 October 2008 on urgent economic and financial measures in relation to the concerted action plan of the euro area countries

The heads of state and government of the euro area decided in October 2008 that governments could, temporarily and under market conditions, provide guarantees, insurance or similar instruments to underwrite new issues of medium-term bank debt. Royal Decree-Law 7/2008 is the means by which this decision has been implemented in Spain, since it authorises the State to guarantee new funding transactions (comprising, among other instruments, issues of notes and bonds admitted to trading on Spanish official secondary markets) launched by CIs resident in Spain with a maximum maturity of five years. The period in which guarantees may be granted ends on 31 December 2009 and the maximum amount to be guaranteed in 2008 is set at €100 billion.

Additionally, the Ministry of Economic Affairs and Finance is authorised to acquire, exceptionally and upon a prior report from the Banco de España, securities issued by CIs resident in Spain to bolster their own funds.

Royal Decree 1975/2008 of 28 November 2008 addressing the urgent adoption of economic, fiscal, employment and housing-access measures (BOE of 2 December 2009)

Against the background of unfavourable performance of the Spanish economy at end-2008, this Royal Decree introduced a number of labour, financial and fiscal measures aimed primarily at curbing job destruction and protecting those in danger of losing their job. For the purposes of this chapter, mention need only be made here of the moratorium introduced by the Royal Decree on payments of mortgages taken out prior to 1 September 2008 for an amount less than €170,000 solely for the purpose of purchasing a principal residence, provided they meet certain requirements relating mainly to the employment status of the debtor.

These measures envisage a moratorium, which is temporary (from 1 March 2009 to 28 February 2011)[9] and partial (up to a maximum of 50%, with an upper limit of €500 per month), on the monthly instalments payable in that period. These amounts will be offset by prorating them

9. Following the enactment of Royal Decree 97/2009 of 6 February 2009 amending Royal Decree 1975/2008. Initially the deferral period was going to be from 1 January 2009 to 31 December 2010 and the offset period was going to start in January 2011 with a limit of 10 years.

from 1 March 2012 among the monthly instalments remaining for total repayment of the mortgage loan with an upper limit of 15 years.

3.2.4 SIGNIFICANT ACCOUNTING MATTERS

Banco de España Circular 6/2008 of 26 November 2008 to credit institutions amending Circular 4/2004 of 22 December 2004 on public and confidential financial reporting rules and formats

Spanish accounting rules

The changes in Spanish corporate law and international financing reporting standards, and the undertaking by the Banco de España to adapt the rules of the general regime set in place by the Spanish Accounting and Audit Institute, made it necessary to adapt CBE 4/2004. Summarised below are the main changes made to it via CBE 6/2008:

– Change in the definition of group. In line with the provisions of the Commercial Code, a group is only deemed to exist when an entity controls or can control another entity, the concept of a group as a decision-making unit being abandoned. An important implication of this change is the disappearance, for the purposes of accounting consolidation, of so-called coordination groups, which are those formed by various entities with a non-consolidable parent or those in which a decision-making unit exists for any other reason.

– Full application of the fair value option, as permitted by IAS 39. As a result of this change, the fair value option can be applied in the following situations: when accounting mismatches are eliminated, when financial instruments are managed on a fair value basis and in hybrid instruments where separation is not prohibited.

– Possibility of new reclassification of financial instruments. New reclassifications, consisting mainly of reclassification out of the trading book in rare and exceptional circumstances, are permitted when the asset ceases to be held for the purpose of sale or repurchase in the short term.

– Additional accounting treatments for actuarial gains and losses arising from defined benefit pension plans. To the existing option of taking actuarial gains and losses to the income statement, either in full or using a corridor, is added the possibility of recognising them in full against reserves.

– Regulation of new transactions in which payment is made with equity instruments, as in the case of payments to employees with own instruments of a group company and payments to third parties other than employees.

– New treatment of borrowing costs arising in the purchase of tangible assets. Instead of the immediate recognition in the income statement required under CBE 4/2004, it is now obligatory to capitalise these costs if certain requirements are met.

– Changes in financial statements. The formats of public financial statements are adjusted and a new statement of changes in equity is created. Also, new confidential returns are created.

– New approach to treatment of the tax effect. The recording of this effect is now based on the balance sheet, as distinct from the previous approach based mainly on the income statement.

– Change in the treatment of general provisions. The minimum floor of 33% of the general credit risk provision is eliminated and now institutions themselves determine the minimum provision based on their specific circumstances and characteristics.

Other Spanish initiatives

Royal Decree-Law 10/2008[10] amended Article 36.1.C) of the Spanish Commercial Code with a view to establishing the effectiveness for corporate-law purposes of the changes in value of hedging instruments used in cash flow hedges. This prevents fair value changes in cash flow hedges from being taken into account under corporate law for the purposes of capital reduction, profit distribution and situations of obligatory winding-up.

Additionally, the trend in international economic activity meant that the aforementioned Royal Decree-Law also amended the consolidated text of the Public Limited Companies Law and the Limited Liability Companies Law. Following this amendment, for a period of two years and solely for the purposes of determining losses for the mandatory reduction in capital stock, the impairment losses recognised in the annual accounts derived from property, plant and equipment, from investment property and from inventories will not be counted.

Lastly, the Spanish Accounting and Audit Institute decided to set up a working group to modernise and internationally harmonise the rules for preparing consolidated annual accounts set out in Royal Decree 1815/1991, applicable to corporate groups that do not use the international financial reporting standards adopted by the European Union. However, in January 2008 the IASB approved changes in international financial reporting standards regulating matters relating to business combination and to consolidated financial statements. Those changes in international financial reporting standards were not adopted by the European Union in 2008. Accordingly, the revision of the rules for preparing consolidated annual accounts was delayed and the only progress made was a memorandum[11] aimed at clarifying the criteria included in the rules for preparing consolidated annual accounts which are applicable under the current regulations, specifying the provisions tacitly repealed.

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10. Royal Decree-Law 10/2008 of 12 December 2008 adopting financial measures to improve the liquidity of small and medium-sized companies and other additional economic measures. **11.** Memorandum from the Spanish Accounting and Audit Institute published in BOICAC No. 75 relating to criteria applicable to the preparation of consolidated financial statements pursuant to the Commercial Code for years starting from 1 January 2008.