3 REGULATORY CHANGES IN PRUDENTIAL SUPERVISION

3 Regulatory changes in prudential supervision

This chapter describes the most significant legal changes made, from a prudential supervision standpoint, in 2009 in regulation of the activity of CIs and other financial intermediaries and auxiliaries subject to supervision by the Banco de España. It deals with organisational and disciplinary rules, omitting other regulatory changes of a more technical or operational nature that do not address the solvency of institutions or their interaction with markets or customers.

3.1 Community provisions

3.1.1 LEGAL REGIME OF SUPERVISED INSTITUTIONS

Directive 2009/110/EC[1] was published in September 2009, culminating the implementing regulations on the provision of payment services in the European Union. This Directive, which amends the taking up and pursuit of the business of electronic money institutions (ELMIs), has two basic objectives.

First, it adapts the legal regime applicable to these institutions to the fact that they are now classed as payment service providers (recognised in Directive 2007/64/EC), as well as electronic money issuers. Thus, ELMIs are financial institutions that can both provide payment services (see Section 3.2.3.2 below)[2] and issue electronic money, subject to the specific regulations applicable to electronic money issuance and, in part, to the regulations on payment institutions (PIs). In consequence, ELMIs are subject to the prudential requirements applicable to PIs, and to those corresponding to the activity of electronic money issuance which, as in the previous Directive, relate to electronic money in circulation. In turn, the safeguarding regime for the funds received, which was previously based on a limitation of the investment regime, is now equivalent to that envisaged for PIs.

The Directive's second basic objective was to promote the development of ELMIs by making it easier for them to be created, since the European Commission considered that the previous regulations placed undue hindrance on the creation of a genuine single market in electronic money services. To this end, ELMIs cease to be CIs under Community law and the requirements for creation thereof are brought more in line with those applicable to PIs. In fact these requirements are identical, save in respect of their share capital, which stands at €350,000, in comparison with a maximum of €125,000 for PIs (and much lower, in any case, than the previous minimum of €1,000,000).

As in the previous Directive, exemptions from certain obligations are envisaged for ELMIs with low activity levels, although these imply non-recognition of the Community passport.

3.1.2 SOLVENCY OF CREDIT INSTITUTIONS

The European Commission published two Directives on the solvency of CIs, Directives 2009/27/EC and 2009/83/EC,[3] amending certain Annexes to Directives 2006/49/EC and 2006/48/EC[4] as regards technical provisions, aimed at ensuring convergent application of

1. Directive 2009/110/EC of the European Parliament and of the Council of 16 September 2009 on the taking up, pursuit and prudential supervision of the business of electronic money institutions, amending Directives 2005/60/EC and 2006/48/EC and repealing Directive 2000/46/EC (OJ L of 10 October 2009). **2.** See also Section 3.1 of the *Report on Banking Supervision in Spain, 2007.* **3.** Commission Directive 2009/27/EC of 7 April 2009 amending certain Annexes to Directive 2006/49/EC of the European Parliament and of the Council as regards technical provisions concerning risk management (OJ L of 8 April 2009) and Commission Directive 2009/83/EC of 27 July 2009 amending certain Annexes to Directive 2006/48/EC of the European Parliament and of the Council as regards technical provisions concerning risk management (OJ L of 28 July 2009). **4.** 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).

various technical aspects and, above all, at promoting sounder risk management practices. The changes introduced include, notably, definition of the cases in which it may be considered that CIs transfer a significant portion of credit risk, both in traditional and synthetic securitisations, and the increase in the credit conversion factor for liquidity facilities.

Moreover, with the dual aim of strengthening the solvency situation of CIs, against a background of economic and financial crisis, and of enhancing the management of those elements most directly affected by the crisis, at the end of 2009 Directive 2009/111/EC[5] was published, also amending the 2006 Directives cited above.

In particular, and with a view to helping CIs achieve a sufficiently diversified capital structure, the Directive aims to harmonise the hybrid and ordinary capital instruments that are eligible as original own funds. To this end, the CEBS is assigned an important role, to make supervisory practices in this area more uniform, and criteria are established on the eligibility of hybrid capital instruments within original own funds.

The Directive also introduces rules on the setting-up of liquidity buffers, stress tests and contingency plans, with a view to enhancing liquidity management at CIs, a factor that is determinant in their financial soundness.

In addition, it amends the existing regime on large exposures, which dated back to 1992, requiring that exposures vis-à-vis CIs or investment firms be subject to the same limits as other exposures (25% of own funds), since the potential losses stemming from such exposures rule out a preferential regime. Nonetheless, to mitigate the impact of the new limit on small institutions, the Directive introduces an alternative quantitative limit (€150 million).

A further objective is to strengthen the supervision of cross-border banking groups. To this end: all decisions on risk assessment and additional capital requirements must be coordinated between the supervisor of the parent institutions and that of their subsidiaries; all reporting requirements will be fully harmonised across Europe by 2012; colleges of supervisors chaired by the supervisor of the parent institutions are established, to enable the competent authorities to reach agreements on essential supervisory tasks, and the role of the CEBS in this field is strengthened; and all the decisions of the competent authorities must take into account the effects these decisions may have on the stability of the financial systems of the Member States concerned.

Lastly, as a response to the “originate and distribute” model, the Directive introduces stricter due diligence and transparency obligations, both for the originators of securitisation transactions and for investors, and at the same time requires that the originators retain 5% of the risk transferred to investors (“retention of net economic interest”).

3.1.3 OPERATIONAL FRAMEWORK

The main objective of Directive 14/2009/EC,[6] published In March 2009, within the framework of the measures taken by the Council of the European Union to mitigate the impact of the financial crisis, was to help restore confidence and the correct functioning of the financial sector, by converging the deposit-guarantee schemes.

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5. Directive 2009/111/EC of the European Parliament and of the Council of 16 September 2009 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements and crisis management (OJ L of 17 November 2009). **6.** Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009 amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay (OJ L of 13 March 2009).

The key changes centred on two aspects. First, the minimum coverage level granted by these schemes per depositor, which was initially raised from €20,000 to a minimum of €50,000, and must subsequently be raised, by no later than 31 December 2010, to €100,000. And second, the payout delay, which was reduced from three months to 20 working days (extendable by a further ten working days in wholly exceptional circumstances). This is the time limit within which deposit-guarantee schemes must meet legitimate claims by depositors, once the competent authorities have determined that the institution in question is unable to repay the deposits. In addition, the time limit for taking this decision was reduced from 21 to five working days.

3.2 National provisions

3.2.1 LEGAL REGIME OF CREDIT INSTITUTIONS

a. Structural changes

Regarding the legal framework of credit institutions (CIs), the first development to note was Law 3/2009[7] of 3 April 2009 on structural changes to commercial companies. The Law introduced various changes in the procedure for mergers, divisions and transformation of credit co-operatives, essentially establishing the need for a prior report from the Banco de España and determining the treatment to be given to the *Fondo de Reserva Obligatorio* (Compulsory Reserve Fund) in the event of transformation into another credit institution.

This Law was subsequently amended by Law 27/2009 of 30 December 2009, with a view to encouraging restructuring processes among CIs, making mergers, divisions and transfers, in full or in part, of assets and liabilities between CIs expressly subject to the general regime envisaged in Law 3/2009, whatever the specific legal status of the entities involved. The reason for this amendment was that there was no express mention of savings banks in the scope of the original Law, raising doubts as to whether or not it was applicable thereto. The amendment provided the necessary legal certainty for the aforesaid transactions, with no detriment to the rights of shareholders and creditors or to any exceptions that may derive from the specific legal status of the CIs concerned.

b. Qualifying holdings

Law 5/2009,[8] which transposed Directive 2007/44/EC[9] into Spanish law, reformed the regime for qualifying holdings in the financial sector, clarifying the procedures and evaluation criteria applicable for the prudential assessment of acquisitions and increases of such holdings. The aim was to enhance both the legal certainty and the practical effectiveness of the regime, making it more consistent with the ultimate aim, which is to ensure the stability of the financial institutions and of the markets in which they operate.

To this end, the Law envisages that a qualifying holding is held if it amounts to 10% (up from 5% previously) or more of the capital or voting rights of the institution acquired, or if there is a possibility of exerting notable influence in the institution (deemed to exist when there is a possibility of appointing or dismissing a Board member). Moreover, all holdings of 5% or more of the capital or voting rights, even if they are not considered qualifying holdings, must be notified to the supervisor.

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7. Law 3/2009 of 3 April 2009 on structural changes to commercial companies (BOE of 4 April 2009), subsequently amended by Law 27/2009 of 30 December 2009 on urgent measures to support and foment employment and unemployment protection (BOE of 31 December 2009) which, among other changes, added a new Additional Provision Three devoted to the regime applicable to mergers, divisions and transfers, in full or in part, of assets and liabilities between credit institutions. **8.** Law 5/2009 of 29 June 2009 amending the Securities Market Law 24/1988 of 28 July 1988, Law 26/1988 of 29 July 1988 on the discipline and intervention of credit institutions and the consolidated text of the Private Insurance Law, enacted in Legislative Royal Decree 6/2004 of 29 October 2004, for reform of the regime for qualifying holdings in investment services firms, credit institutions and insurance corporations (BOE of 30 June 2009). **9.** Directive 2007/44/EC of the European Parliament and of the Council of 5 September 2007 amending Council Directive 92/49/EEC and Directives 2002/83/EC, 2004/39/EC, 2005/68/EC and 2006/48/EC as regards procedural rules and evaluation criteria for the prudential assessment of acquisitions and increase of holdings in the financial sector (OJ L of 21 September 2007).

The Law outlines a new assessment procedure that is clearer and more transparent and has shorter time limits, and establishes the criteria on which financial supervisors should base their opposition to any acquisitions proposed (the standing and solvency of the acquirer, the standing of the future administrators of the institution and the capability and solvency of the institution). It also reinforces the collaboration between the supervisor of the acquiring institution and that of the institution acquired throughout the assessment process, and simplifies the limits determining the need to notify any increases or reductions in qualifying holdings, which are set at 20%, 30% and 50% of the capital or voting rights.

Royal Decree 1817/2009[10] complemented the above-mentioned Law, implementing its more technical aspects. Thus, the Banco de España will compile and publish a list specifying the information to be provided by a potential acquirer, on itself and on the reasons for the acquisition, for assessment of the transaction. Should the acquisition signify takeover of the institution, the information to be provided must also include matters connected with possible changes in the institution's structure and in its corporate governance, with the procedures envisaged relating to internal control and prevention of money laundering, and with the new business and strategic development plan.

3.2.2 SOLVENCY OF CREDIT INSTITUTIONS

Despite the proven soundness of the Spanish financial system, the continuation of the present international financial crisis could compromise the viability of some of the smaller CIs. Although none of these institutions alone signify a systemic risk, together they could do so, at least potentially. Hence Royal Decree Law 9/2009 (RDL),[11] which regulates restructuring processes at CIs and the strengthening of own funds at those institutions which, although not in difficulties, may be intent on ensuring their future viability, with the creation, to this effect, of the Fund for the Orderly Restructuring of the Banking Sector (FROB).

The bank restructuring model envisaged in the RDL is based on the Deposit Guarantee Funds (DGFs) and the FROB and may be broken down into three stages. The first (not regulated in the RDL) envisages a search for private-sector solutions for CIs. The second stage also envisages a search for private-sector solutions, but backed, with the participation of the DGFs, by an action plan that must be approved by the Banco de España and may include three types of measures: strengthening the solvency of CIs, merger or absorption thereof, or transfer in full or in part of their business. The third stage would involve the Banco de España replacing the governing bodies of the CIs concerned and appointment of the FROB as provisional administrator, which would have to submit to the Banco de España a restructuring plan for merger of the CI or transfer in full or in part of its business.

As regards the strengthening of own funds, the FROB's role is to support mergers between CIs that are fundamentally sound but that are having difficulties obtaining the funds necessary for merger. In these cases, following approval of the merger plans by the Banco de España, the FROB could acquire preference shares issued by the CIs, convertible into ordinary shares, *cuotas participativas* (non-voting equity units) or share capital injections. The CIs issuing these shares must undertake to buy them back from the FROB as soon as they are able; the FROB is entitled to request conversion of said shares if, after five years have elapsed, there has been no buyback or if, at an earlier date, the Banco de España believes that buyback within said period is unlikely. Sale of the shares to third parties, within the five

10. Royal Decree 1817/2009 of 27 November 2009, amending Royal Decree 1245/1995 of 14 July 1995 on the creation of banks, cross-border activity and other matters relating to the legal regime of credit institutions and Royal Decree 692/1996 of 26 April 1996 on the legal regime of specialised credit institutions (BOE of 7 December 2009). **11.** Royal Decree Law 9/2009 of 26 June 2009 on bank restructuring and strengthening of own funds of credit institutions (BOE of 27 June 2009).

years following compliance with the merger plans, is also envisaged, via competitive procedures.

One key aspect of the legal regime applicable to the FROB is that it is governed by a Steering Committee comprising eight members, all appointed by the Minister for Economy and Finance with a four-year renewable mandate (five members proposed by the Banco de España, one of whom will be the Deputy-Governor and will act as Chair, and the other three representing each of the three DGFs). The FROB has initial funding of €9 billion, 25% of which contributed by the DGFs and 75% charged to the State Budget. It may raise extra funds on the markets, with State guarantees, for up to ten times the initial amount assigned.

3.2.3 OPERATIONAL FRAMEWORK

a. Legal regime applicable to collateral pledged to the Banco de España, the European Central Bank or other EU national central banks

The legal regime applicable to collateral pledged to the Banco de España, the European Central Bank (ECB) or other national central banks (NCBs) of the European Union was amended, with effect as of 1 January 2010,[12] adding the possibility that the collateral may be realised, when agreed by the parties concerned, by means of appropriation by the beneficiary central bank of the collateral and the consequent application of its value to satisfy the collateralised obligations.

In accordance with Additional Provision One of Royal Decree Law 9/2009, this regime is also applicable to collateral pledged to the credit institution deposit guarantee funds (DGFs) or the FROB.

b. Payment services

In the area of Community regulations on payment instruments, Law 16/2009 on payment services[13] was published in November. The ultimate aim of this Law, which transposes Directive 2007/64/EC on payment services in the internal market into Spanish law, is to improve the efficiency of payments throughout the EU, via three basic objectives.

The first objective is to determine the institutions that can provide payment services. To this end, the Law establishes the legal regime applicable to payment institutions (PIs), a new type of institution which, together with CIs and ELMIs, are exclusively authorised to provide payment services (it should be noted, in this respect, that ELMIs will cease to be considered CIs in Spain once Directive 2009/110/EC has been transposed, by 30 April 2011 at the latest). These institutions have been regulated similarly to other financial institutions, and especially to credit institutions, meaning that there are very few differences between the respective regimes for authorisation and supervision of PIs and CIs, apart from the logical adaptation to the nature of the services provided.

Nevertheless, PIs present two clear differences vis-à-vis other financial institutions. The first is that they do not need to have a sole corporate purpose, meaning that, in addition to providing payment services, PIs may also engage in any other economic activity subject to applicable Community and national law. The second basic difference lies in the safeguarding requirements for funds received from payment service users. PIs may choose to hold these funds separately from any other funds (by depositing them in a separate account at a CI or by investing them in secure, liquid, low-risk assets), or to enter into an insurance policy or other comparable guarantee covering an amount equivalent to that which would have been set aside had there been no such policy or guarantee.

The second basic objective pursued by Law 16/2009 is to increase competition in the payment services market, through transparency, especially for the benefit of consumers, for whom

12. By virtue of Final Provision Two of Law 26/2009 of 23 December 2009 on the State Budget for 2010 (BOE of 24 December 2009). **13.** Law 16/2009 of 13 November 2009 on payment services (BOE of 14 November 2009).

a special safeguarding regime is established. However, this regime, which is organised (with the logical accommodations) for single payment transactions and for those conducted under framework contracts, is barely outlined in the Law, leaving the determination of its material aspects to subsequent implementing provisions. Nevertheless, the Law does establish that no charges may be applied for providing the information required thereunder, and it places the burden of proof of compliance with all information requirements on the payment services provider.

The third basic objective of the Law is to establish a common system of rights and obligations for providers and users of payment services, in connection with the provision of these services. This system is outlined in the Law with the same level of detail as in the Directive, meaning that the necessary elements for the correct provision of payment services are in place. One notable new feature in this respect is the principle of shared charges, which signifies that, when there is no currency exchange involved (and if there is, save otherwise agreed), each user, whether the payer or the payee, shall pay the charges levied by the payment services provider.

Two final points to note: the requirements envisaged in Law 16/2009 extend to the provision, in Spain, of any type of payment service (not limited, as under the Directive, to services provided within the EU denominated in euro or in any other EU Member State currency), provided in all cases they do not place Spanish payment services providers in a position of inferiority in comparison with their peers in other countries; and existing currency-exchange bureaux authorised to arrange cross-border money transfers that wish to continue to do so must become PIs by 30 April 2011.

c. Mortgage market

Royal Decree 716/2009 of 24 April 2009,[14] which replaced Royal Decree 685/1982, completed the modernisation and improvement of the mortgage market initiated by Law 41/2007,[15] essentially insofar as the refinancing mechanisms of CIs are concerned.

Thus, the Royal Decree implements the requirements that mortgage loans and credits must meet to serve as coverage for issues of mortgage securities or to serve as collateralised mortgage bonds. In particular, it specifies the conditions under which the LTV ratio of residential mortgages may be raised to 95%, from the general level of 80%. These conditions relate to the existence of bank guarantees or credit insurance (which will be paid, in all cases, by the CI), the legal strength of the guarantee and the credit quality of the guarantor. The Royal Decree also establishes the requirements that mortgages granted in other EU Member States must meet to be included in the credit collateral pool, and introduces special eligibility limits for mortgages on buildings under construction and land.

The Royal Decree also shapes the increased flexibility in the conditions of issue of mortgage securities, in terms of their financial characteristics and administrative requirements, envisaged in Law 41/2007. This greater flexibility is accompanied by new management features for their attendant risk, stricter limits on their issuance and mechanisms for their re-establishment in the event of default. To ensure the effectiveness of these measures, the Royal Decree regulates in great detail the special accounting register that must record not only mortgage loans and credits that serve as coverage for issues of mortgage securities (with express indication of whether or not they are eligible), but also the substitute assets backing these issues and the

14. Royal Decree 716/2009 of 24 April 2009 implementing several aspects of Law 2/1981 of 25 March 1981 on mortgage market regulation and other mortgage and financial system rules (BOE of 2 May 2009). **15.** Law 41/2007 of 7 December 2007, amending Law 2/1981 of 25 March 1981 on mortgage market regulation and other mortgage and financial system rules, regulating reverse mortgages and dependency insurance, and establishing a specific tax regulation (BOE of 8 December 2007).

LETTER FROM THE DIRECTOR GENERAL BANKING REGULATION ON ANNEX IX TO THE ACCOUNTING CIRCULAR

BOX 3.1

In July 2009, the Director General Banking Regulation wrote to associations of credit institutions to clarify certain aspects of Annex IX to the Banco de España Circular 4/2004.

The letter focused on three aspects:

i) A reminder that the allowance percentages applicable pursuant to the provisions of paragraph 17 of the Annex must be considered minimum values. Accordingly, it is essential to take into account the experience of each institution for recognition, in specific cases, of higher loss rates.

ii) Insistence on the need for institutions to make prudent assessments of the effectiveness of collateral, and, especially in the case of real estate, on the need for appraisals to be updated.

iii) Clarification, specifically regarding the allowance percentages for the secured transactions envisaged in point b) of paragraph 17 of Annex IX, that these percentages shall apply only to the amount of the loans over and above 70% of the appraised value, provided in all cases that the collateral is effective.

financial derivative instruments linked to each issue (whose conditions and requisites are also laid down in the RD).

In the specific case of collateralised mortgage bonds, the Royal Decree clarifies, definitively, that issues of these bonds, which must relate to a specific credit and not to a group of credits, signifies genuine transfer of the part of the mortgage credit in question, meaning that the issuer transfers all the attendant risk. In turn, mortgage transfer certificates are also classed as a transfer of credit, but with no guarantee of minimum quality, meaning they may only be issued for placement among professional investors or to be grouped in securitisation special purpose vehicles (SPVs).

Lastly, the Royal Decree sets out the tax and supervisory regimes applicable to mortgage securities. Notably, the tax regime considers these securities eligible for investment by certain regulated investment companies. The supervisory regime clarifies the previous regulations, expressly indicating the powers of the Banco de España (relating to control and supervision of the conditions to be met by the collateral pool and to issuance of single-certificate covered bonds) and of the CNMV (relating to public offerings of mortgage securities and trading thereof on official secondary markets).

d. Deposit guarantees

Ministerial Order EHA/3515/2009 of 29 December 2009[16] raised the calculation basis for the annual contributions to be made by the savings banks to their Guarantee Fund from 0.4 per mille to 1 per mille.

3.2.4 OTHER FINANCIAL INSTITUTIONS

The only noteworthy changes in 2009 in the regulations on other financial institutions other than CIs that are subject to supervision by the Banco de España are those introduced in Ministerial Order EHA 1327/2009[17] which, parallel to the contents of Banco de España Circular 6/2008 relating to CIs, adapts the accounting regulations applicable to mutual guarantee companies (MGCs) to the criteria and principles established in Royal Decree 1514/2007 approving the new General Chart of Accounts adapted to EU regulations.

The Ministerial Order establishes the special points to be borne in mind when preparing financial statements corresponding to the annual accounts of MGCs (balance sheet, income statement and notes to the financial statements). It determines the statistical data and breakdowns

16. (BOE of 31 December 2009). **17.** Ministerial Order EHA/1327/2009 of 26 May 2009 on the special rules for preparation, documentation and presentation of the accounting data of mutual guarantee companies (BOE of 28 May 2009).

to be included in the confidential financial statements and details the content of both the public and the confidential financial statements.

It also sets out the accounting rules and valuation criteria to be followed by MGCs relating to certain items, establishing specific rules for recording in the accounts of bank and other guarantees, technical provisions, contributions by members and reimbursable funds received for coverage of credit risk. And it determines that the same criteria as established in the accounting regulations relating to CIs shall apply for the calculation of specific coverage and the valuation of assets acquired in payment of debts.