Towards a new Banking Code in Spain

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The crisis has facilitated progress on Basel III rules related to key standards under the Basel III initiative. Next steps entail their transposition into European and Spanish legislation, in an overall context of the construction of the European Banking Union.

The financial crisis has brought about significant changes in global financial regulation. Such changes aim at preventing, to the extent possible, the recurrence of a crisis of such magnitude in the future, rather than resolving the negative effects already incurred. In the areas of bank solvency and liquidity, at the international level, these efforts have been addressed through Basel III. The majority of these regulatory changes introduced in response to the crisis have yet to be implemented in many countries throughout 2014 in order for their effects to be fully felt in their respective financial systems. In fact, regulatory adaptation to Basel III has just began with the implementation of a number of standards. In Spain, this implementation process will lead to a new Banking Code, which will systematize and unify Spain´s overarching legislation on credit institutions, simplifying regulations and helping to enhance compliance and enforcement.

Introduction

Basel III has been introduced into European Union (EU) legislation through two basic documents, added to which will be the developing regulations envisaged therein,[3] the vast majority of which must be prepared by the European Banking Authority (EBA):

- Directive 2013/36/EU of the European Parliament and of the Council, of June 26th, 2013, on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, known as the Capital Requirements Directive (CRD) IV, an expression that applies to both documents as a whole, as all previous documents on this matter were directives.

- Regulation (EU) No 575/2013 of the European Parliament and of the Council, of June 26th, 2013, on prudential requirements for credit institutions and investment firms, known as the Capital Requirements Regulation (CRR).

The CRR is directly applicable and need not be transposed to Spanish law. However, the CRD IV

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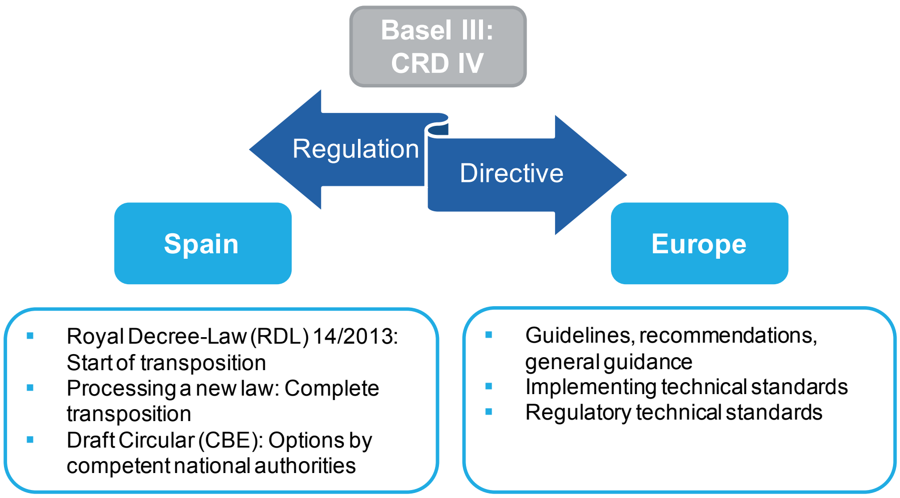
[3] The first has already been published in the Official Journal of the European Union (OJEU): L 355, of 31-12-2013: Commission Implementing Regulation (EU) No 1423/2013, of December 20th, 2013, establishing implementing technical standards with regard to disclosure of own funds requirements for institutions.

Exhibit 1

Incorporation of Basel III into Spanish law



Source: Own elaboration.

must be transposed, which has taken place through the approval of Royal Decree-Law (RDL) on urgent measures,[4] and, secondly, through the processing of a new law, which too has already begun. Exhibit 1 summarizes the entire process.

As in the past, Spain is lagging behind in transposing important financial services policy. However, in this case, this is of little significance, since the polices are, in part, directly applicable from EU Regulation.

Given that Basel III and its aforementioned basic documents generally come into force on January 1^{st}, 2014, this again means that there will be a delay in Spain in the transposition of an important directive in the field of financial services. Nevertheless, the delay is not of great importance owing to the following:

✓ As noted, the regulation, which contains the majority of Basel III, is directly applicable.

✓ Only the new features of Basel III need to be transposed, as those inherited from Basel I and II have already been incorporated into Spanish law.

Start of transposition

The RDL partially incorporates, in its most urgent aspects, the aforementioned Directive 2013/36/EU, a process that will be completed once the law under processing is approved, which is expected to occur in the first quarter of 2014.

Although, as noted above, the CRR is directly applicable, this does not mean that the RDL does not seek its incorporation into Spanish banking legislation, which it does on three complementary levels:

[4] Royal Decree-Law (RDL) 14/2013, of November 29^{th}, on urgent measures for the adaptation of Spanish law to European Union law on the supervision and solvency of credit institutions.

- By directly incorporating it into Spanish legislation on banking organization and discipline where applicable in existing law, which shall be mentioned below.

- By defining the competent authorities, for the purposes of the CRR, as the Bank of Spain and the National Securities Market Commission (CNMV),[5] in their respective fields of authority. In relation to this, the RDL empowers both to make use of the capacities assigned to competent national authorities in the CRR.

- By repealing all provisions of the law that are not compatible with the CRR, although without expressly naming any of them.

The RDL will also have significant quantifiable effects: allowing certain deferred tax assets (DTA) to continue to count as capital, as other EU States have done, which will amount to some 30 billion euros.

With a view to strengthening banking supervision, the Bank of Spain is assigned new powers, not only to impose obligations on institutions and, in the event of non-compliance, to impose the relevant sanctions, but also for the purpose of prevention, through the elaboration of technical guides or responses to binding consultations,

The Bank of Spain will strengthen both the punitive and preventive aspects of its oversight function.

which is quite common in tax matters. This is due to the growing complexity of regulation and financial supervision. A good example of such preventive measures is the stress test, by means of which the resilience of the banking system is to be assessed at least once a year.

The measures the Bank of Spain might adopt in case of non-compliance by credit institutions on capital requirements, deficiencies in organizational structure, or on internal control procedures and mechanisms include the following:

- Force institutions to maintain additional capital beyond the minimum requirement.

- Restrict or limit institutions' businesses, operations or networks or request the abandonment of activities that pose excessive risks to the institutions' soundness.

- Prohibit or restrict the institutions´ distribution of dividends or interest to shareholders, partners or holders of additional Tier 1 capital instruments.

- Require that credit institutions limit their variable remuneration when inconsistent with the maintenance of a solid capital base.

- Impose specific liquidity requirements, including restrictions on the maturity gap between assets and liabilities.

Corporate governance is also reinforced in the remuneration of key personnel (senior executives or employees who undertake risks or exercise control functions) not only for supervision, but also from the point of view of the procedures for setting variable remuneration above a certain limit (100% of fixed remuneration, without exceeding 200%), for which reinforced majorities are required in institutions' general meetings or assemblies.

In any event, the RDL does not take into account, except for a brief mention in the background presentation, the fact that the banking supervisor of the largest institutions in Spain will change in less than a year. At that time, it will be the single supervisory mechanism (SSM), with a central unit, namely the European Central Bank (ECB), and as many national units as countries become a part of it; in Spain, the Bank of Spain will be the banking supervisor, and not the central bank.

[5] The CRR also affects investment service enterprises, which explains the inclusion of the CNMV.

Although not required under the CRD IV, Spanish lawmakers have decided to simplify the set of Spanish credit institutions, excluding from the category of credit institutions, and consequently, from the EU regulations governing them, financial credit establishments, specialized institutions in some activities such as mortgage credit, leasing, financing of consumer goods and factoring, which will all continue to exist, but subject to Spanish regulation. Hence, the category of credit institutions shall now comprise deposit institutions (banks, credit cooperatives and savings banks) and the official institute of credit, the financial agent of the state, which is excluded from EU regulations on the single banking market. As a result, the degree of homogeneity of Spanish credit institutions increases.

The new Spanish Banking Code

At the end of last year, processing began of a new law that, when approved, will complete the transposition initiated by the RDL of Directive 2013/36/EU and which will represent a new Banking Code that will bring together in a single text all basic banking legislation, with all the advantages this entails for the dissemination and study of the regulation. The law is expected to be fast-tracked to enable it to come into force in the first quarter of 2014.

From our point of view, the law will be of major importance and have significant repercussions on Spanish banking regulations, as it will be an entirely new general regulation of Spanish credit institutions. Furthermore, this unification of banking legislation will help improve comprehension of a legal regime that has been profusely modified throughout history and with numerous regulatory texts, which hindered both compliance and enforcement.

In line with its scope, the law seeks to repeal a number of laws on banking, some of them quite significant in their content. Specifically, and firstly, it will repeal Law 13/1985, emerging after the crisis in the Spanish banking system between the years 1977-1985, that modernized Spanish regulations on bank solvency, establishing norms that would be similar to those adopted in 1988 by Basel I. Secondly, it will repeal Law 26/1988, which modernized regulations on the discipline and public takeover of credit institutions after Spain's accession to the European Community.

In the same way that the laws to be repealed once emerged, the future Banking Code has arisen from the need to overcome the shortcomings observed in the recent financial crisis and to adapt regulation to the new European banking regime. Hence, the law is not only a transposition of Basel II, but also the adoption of harmonized legislation within the European Union that will serve as the basis for implementation of the single supervisory and resolution mechanisms for credit institutions, once it has been enacted.

The content of the new code may be summarized in three main points:

- **Legal regime of credit institutions**: Requirements are laid down for the functioning of credit institutions with regard to the procedure for authorization, suitability and honorability and corporate governance. Specifically, and with respect to establishing efficient corporate governance systems and a remuneration policy that is more aligned with the medium-term risks of an institution:

  - Limits are placed on the number of boards on which a director may serve.
  - Limits are placed on the simultaneous exercise of the post of chair of the board of directors and chief executive officer.
  - Limits are placed on variable remuneration.
  - It will be mandatory for institutions to have a remuneration committee and an appointments committee.

- Institutions are required to publish the total compensation received annually by all the members of the board of directors.

- The requirement of reaching binding decisions on remuneration policy is now extended to all credit institutions.

- **Prudential supervision and solvency of credit institutions:**

The basic norm governing solvency will be the CRR, although provisions as regards matter exist that are to be maintained in national law, such as the evaluation of the capital adequacy of institutions for the risk they undertake (Pillar II of Basel).

The law also contains the criteria to be followed by the Bank of Spain for setting any liquidity requirements, as a complement for those to be required from 2016 under Basel III.

In addition, a series of ordinary Tier 1 capital requirements are set out as a complement to those envisaged in the CRR, such as capital buffers, which are regulated in the CRD IV Directive and whose non-compliance does not carry consequences as severe as the solvency coefficient, as it would mainly affect the freedom of distribution of institutions net earnings.

In supervision, as a consolidation of the present situation, the Bank of Spain is designated as the supervisor of credit institutions and it is granted the power and authority necessary to carry out this function. The scope of supervision is defined, in a context where account must be taken of its relations with other supervisory authorities and, specifically, with the EBA. Among other measures, the Bank of Spain must elaborate stress tests at least once a year.

Further, institutions must publish an Annual Banking Report, which will disclose information on their staff headcounts, taxes payable and the public aid they have received.

- Sanction regime: The amounts of penalties are increased, and the formula for calculating them is modified.

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Once the law is approved, basic Spanish banking law will be comprised solely by this law and another two laws governing sectors of institutions with particular features with regard to their legal configuration. The first is to be modified by the new law in only one detail, but the detail is highly significant with regard to how equity is calculated, while the second has recently been approved:

- ✓ Law 13/1989, of May 26th, **on credit cooperatives.**[6]

- ✓ Law 26/2013, of December 27th, **on savings banks** and bank foundations.

National options

Although the CRR is directly applicable and needs no law to transpose it in Spain, it may contain –and, in fact, does contain– provisions that require subsequent national implementation, apart from the necessary implementation at the EU level. Some of these national options are of a

[6] The planned modification means that partner contributions will be reimbursed to the latter under the conditions set out in the regulation and provided it is authorized by the Governing Board. In any event, such a reimbursement may not be approved if it causes insufficient capital coverage of mandatory share capital, reserves and the solvency coefficient. At the same time, no contributions may be privileged over others in their seniority in the event of insolvency or liquidation of the cooperative.

permanent nature and others are transitional, as many provisions would be brought into force on a rolling basis during a transitional period in order to gradually achieve convergence.

Towards this end, and taking account what we have noted above with regard to the RDL, the Bank of Spain opened a consultation period on a draft circular it completed on December 20th.

We emphasize that, within this process, no new circular should be expected to fully replace the circular in force to date on equity, namely CBE 3/2008, which is not expressly repealed. Among other reasons, it will remain applicable to financial credit establishments, at least during a transitional period, that will no longer have the status of credit institutions and that will, therefore, not be affected by the new law on credit institutions, as noted above.

For credit institutions, CBE 3/2008 is replaced by the CRR and its implementing regulation. Accordingly, for these institutions, provisions of CBE 3/2008 that are incompatible with the CRR are repealed, although the provisions that are affected are not specified. CBE 7/2012, on principal capital is repealed, as this concept is not contained in the CRR.

Concerning transitional options, the general criteria of the draft project, in the case of capital deductions, for example, is based on adopting the longest periods allowed by the CRR, and on use of less stringent correction coefficients. In matters where the CBE 3/2008 is less strict than the CRR, the latter is viewed as a floor in terms of exercise of the option.

Further, the draft circular establishes the provisional treatment to be applied in certain matters until the entry into force of the technical regulations to complement the CRR, and which are currently being processed.

Conclusion

For the reasons noted herein, 2014 presents itself as a particularly intense year as regards novelties in banking regulations, both in Spain and in Europe.

For Europe and for Spain, the adaptation of current regulations to Basel III, which will take place through the laws and draft laws discussed in this article, as well as the start-up of the SSM and, if approved, the single resolution mechanism, as well as the new directives on bailouts and restructuring of credit institutions, shall be the most significant matters on which to focus attention.

Technically, the Spanish economy came out of recession in the third quarter of 2013, with reported growth of 0.1%.

However, this does not mean that the crisis is over. As is clear from the current low inflation rate, continuing fall in real estate asset values and wages, credit squeeze, and faster generation of financial surpluses by households and firms to pay down their debts, the adjustment process is still on-going. Similarly, the general government also has yet to complete the major budgetary adjustment it has embarked upon.

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