

Basel II

APPLICATION IN SPAIN



CARLOS COLAO OSARIO
Avocat
Salans Madrid

As is well known, the Basel Committee on Banking Supervision adopted, in June 2004, a not binding framework agreement on the international convergence of capital measurement and capital standards (“Basel II”). This new framework agreement came to substitute the old 1988 Basel accord. Basel II is divided in three essential Pillars: Pillar 1, minimum capital requirements; Pillar 2, supervisory review process; and Pillar 3, market discipline.



FRANCISCO APARICIO
Avocat of
Counsel
Salans Madrid

The implementation of this new capital framework agreement in the European Union was made through the signing, in June 14, 2006, by the Council and the European Parliament, of the Capital Requirements Directive for credit institutions and investment firms (“CRD”). CRD comprises Directives: 2006/48 of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of the credit institutions (“Directive 2006/48”); and 2006/49 of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (“Directive 2006/49”). Although European Directives 2006/48 and 2006/49 implement Basel II, their content is much larger. Indeed, these two new Directives have a wider scope of application (i.e. CRD will apply to all credit institutions and investment firms), and they recast and substitute European Directive 2000/12 of March 2000, relating to the taking up and pursuit of the business of credit

institutions, and Directive 1993/6 of 15 March, on the capital adequacy of investments firms and credit institutions. Due to this reason, in this brief note, we will focus only on the changes that were introduced in the above mentioned Directives, exclusively, as a result of the incorporation of Basel II agreement. Since part of these two new Directives is a recast of abrogative Directives 2000/12 and 1993/6, European countries will have to implement only those changes arising out of Basel II.

SPANISH APPLICATION OF BASEL II

Spanish application of Basel II is the result of the transposition in our legal system of the European Directives 2006/48 and 2006/49. Although these two Directives were supposed to be transposed by December 31, 2006¹, Spain has not yet put them into effect.

However, Spain has already walked a long trend for this implementation. In this respect, and with the aim to achieve this objective, a working group, led by the Economy Ministry and with the participation of the Bank of Spain and the Securities Market Commission, was set up. In this implementation process, one of the main tasks that Spain has to face, is the legal structure in which the above mentioned Directives would need to be transposed. Indeed, under Spanish laws, there are some subjects of the mentioned European Directives that need to be approved and enacted by a Law, while some other subjects do not need to meet this latter requirement². This aspect makes necessary to implement the changes of the new regulations through two

1. In accordance with article 157 of Directive 2006/48.

2. Spanish Constitution establishes the obligation to regulate by law some specific subjects. Since the main object of the mentioned Directives is the regulation of State intervention in companies (i.e. credit institutions and investment firms) as well as the administrative sanctions, they should be covered by Law (articles 128 and 25 of the Spanish Constitution).

different legal vehicles; by enacting a new Law and by issuing administrative regulations (i.e. Royal Decree and Circulars of the Bank of Spain)³. Obviously, the Bank of Spain, as the main supervisory authority of credit institutions, plays one of the most important roles in this implementation. As a matter of fact, the transposition of the Directives 2006/48 and 2006/49, with the exception of the content of the Directives which

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needs to be enforced by a Law, and those other contents that would be implemented through administrative regulations, will be implemented through dispositions issued by the Bank of Spain (“Circulares”). To this respect, it should be mentioned, that the Bank of Spain issued, at the end of 2006, a Circular Proposal for the implementation of the above mentioned Directives, which will substitute the currently in force Circular 5/1993⁴. Nevertheless, this

referred Circular Proposal is still provisional since, as mentioned above, some of their subjects will need to be regulated by Law. Additionally, there is currently a Law Proposal at the Spanish Parliament to transpose European Directive 2006/48 into the Spanish Legal framework⁵. The main purpose of this Law Proposal is to introduce the core principles of Directive 2006/48 that need to be regulated by a formal Law into the Spanish legal framework.

Based on all the above, at this stage, we can only analyse the effects of the Spanish implementation of Basel II, by analyzing the content of the transposition of European Directive 2006/48 through the above mentioned Spanish Proposal Law. At this point, it is very important to bear in mind that European Directive 2006/49 is not transposed yet and therefore, our present analysis does not cover the changes that need to be made in our legal system once European Directive 2006/49 is transposed. Taking all the foregoing into consideration, the most relevant changes that the Proposal Law will introduce in the Spanish legal system can be summarised as follows.

Minimum own funds requirements (Pillar I)⁶

In accordance to the European Directive, the Spanish Law proposal sets forth the own funds that credit

institutions in an individual basis and group of credit institutions in a consolidated basis will have to provide for the different kinds of risks (i.e. credit risk, operational risk, and market risks). The transposition of the different methods to calculate the minimum own funds, will be made through administrative rules, as well as the different techniques to calculate the credit risk mitigation. The Law Proposal establishes the possibility for credit institutions in an individual basis and group of credit institutions in a consolidated basis to use either, external or internal ratings to calculate the minimum own funds that they have to provide for credit risks. If these credit institutions choose an external rating, these companies will have to be recognised by the Bank of Spain, in accordance with the criteria that the Bank of Spain sets forth, and always taking into consideration that their assessment methodology complies with the requirements of objectivity, independence, ongoing review and transparency, and that the resulting credit assessment meets the requirements of credibility and transparency.

While, in the case that credit institutions choose for an internal rating, they will have to count with the previous authorisation of the Bank of Spain. Moreover and in compliance with the European Directive, the Law proposal authorises these mentioned credit institutions to use internal ratings to calculate the minimum own funds that they have to provide for market risks and for operational risks. Finally, the Law proposal entitles the implementation by administrative rules for the cases in which the Bank of Spain can release a credit institution that forms part of a group of credit institutions in a consolidated basis from the obligation of the requirements of minimum own funds in an individual basis.

3. As we mentioned before, since the main subjects of the European Directives is the regulation of credit institutions, and since the Bank of Spain is the main supervisory authority of credit institutions, this administrative body will have to implement the mentioned Directives. Nevertheless and since there are some subjects that need to be regulated by Law, the Bank of Spain needs to be entitled by Law. On the other hand, and in order to make the process more flexible and agile, it is necessary to be entitled by Law the Bank of Spain, so it can proceed to implement the above mentioned Directives through “Circulares”.

4. The proposal Circular is available at www.bde.es/regulacion/regulacion/enconsulta.htm

5. In particular, this Law Proposal contains one article that amends articles 6, 8, 9.4 and 11 of Law 13/1985; at the same time, and at the same time, modifies the Law text by adding new: articles 10 bis and 10 ter; one transitory provision, one abrogative provision and four final provisions. The complete text of the Law proposal is available in Spanish language at www.congreso.es/portal/page/portal/Congreso/Congreso/Iniciativas/IniTipo?_piref73_1335527_73_1335526_1335526_next_page=/wc/detalleDocumento&idIniciativa=121&numExpediente=137&numDocumento=0&paginaActualB=null/.

6. See, in the Proposal Law, article 6 of the amendment Law 13/1985, of May 25, and articles 75, 80, 81, 84.1 and 91 of European Directive 2006/48.

Credit institutions' assessment process⁷ (Pillar I)

In line with the European Directive 2006/48, the Law Proposal establishes that credit institutions must have in place sound, effective and complete strategies and processes to assess and maintain on an ongoing basis the amounts, types and distribution of internal capital that they consider adequate to cover the nature and level of the risks to which they are or might be exposed. These strategies and processes shall be subject

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to regular internal review to ensure they remain comprehensive and proportionate to the nature, scale and complexity of the activities of the credit institution concerned.

Credit institutions organisation and internal control⁸ (Pillar I)

Credit institutions must have robust governance arrangements which include a clear organisational structure with well defined transparent and consistent lines of responsibility, effective process to identify,

manage, monitor and report the risks it is or might be exposed to, and adequate internal control mechanisms, including sound administrative and accounting procedures. It is important to highlight that this provision is already covered in our legal system but it only applies to credit institutions in a consolidated basis⁹. Nevertheless, and since it does not mention credit institutions in an individual basis it is necessary to do so.

Disclosure by credit institutions¹⁰ (Pillar III)

The proposed Law establishes the information that credit institutions and groups of credit institutions in a consolidated basis will have to disclose. However, the Law Proposal also entitles the Bank of Spain to establish the disclosure requirements that the said credit entities should comply with.

Disclosure and obligation of the Bank of Spain as supervisory authority¹¹ (Pillar II)

In connection with European Directive 2006/48, the Law proposal establishes the information that the Bank of Spain will have to disclose, the obligations that the Bank of Spain are subject to, as well as the cooperation with other supervisory authorities from other Member States.

Transitional provisions¹²

The Law proposal, in connection with article 152 et subsequent of the

European Directives, establishes the amount of own funds that credit institutions and group of credit institutions in a consolidated basis will have to provide for credit risk-weighted exposure amounts during the first and second twelve months period after 31 December, 2007, if they decide to use the internal rating.

Finally, the Proposed Law entitles the Spanish government to enact all the administrative dispositions that may be necessary to implement the mentioned Law.

As a conclusion, taking into consideration the content of the Law Proposal, in our opinion it could be said that once this Law Proposal is enacted in January 2008 the requirements of the European Directive 2006/48 will be thoroughly transposed into the Spanish legal system, without prejudice of the amendments that could be introduced during its approval process in the Spanish Parliament. Nevertheless, the complete transposition of the aforementioned Directive will not be completed until the administrative rules that will have to implement the Proposal Law are not issued. Moreover, it is important to begin as soon as possible to the approval of these mentioned administrative rules, since, as it was already mentioned, the period of the transpositions of European Directive 2006/48 finalised, December 31, 2006. ■

9. Article 8.1 Law 13/1985 of May 25.

10. See, in the Proposal Law, article 10 ter of the amendment Law 13/1985, of May 25, and articles 145, 146, 147, 72 and 149 of the European Directive 2006/48.

11. See, in the Proposal Law, article 10 bis of the amendment Law 13/1985, of May 25, and articles 124, 129, 130, 132, 131 and 144 of the European Directive 2006/48.

12. See, in the Proposal Law, transitional provision of the amendment Law 13/1985, of May 25, and transitional provisions of European Directive 2006/48.

7. See, in the Proposal Law, article 6 of the amendment Law 13/1985, of May 25, and article 123 of the European Directive 2006/48.

8. See, in the Proposal Law, article 8 of the amendment Law 13/1985, of May 25, and articles 68.1, 22 and Annex V of the European Directive 2006/48.