ANNEX 9 CREDIT RISK ANALYSIS, ALLOWANCES AND PROVISIONS

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INTRODUCTION

I. GENERAL CREDIT-RISK-MANAGEMENT FRAMEWORK

A) GRANTING OF TRANSACTIONS

B) MODIFICATION OF CONDITIONS

C) ASSESSMENT, MONITORING AND CONTROL OF CREDIT RISK

1. General principles for the assessment, monitoring and control of credit risk

2. General principles for estimating allowances and provisions for credit risk losses

2.1. Governance and integration in management

2.2. Simplicity and effectiveness

2.3. Documentation and traceability

3. Requirements for individualised estimation of allowances and provisions

4. Requirements for collective estimation of allowances and provisions

4.1. Common requirements for collective estimation of allowances and provisions

4.2. Internal methods for collective estimation of allowances and provisions

5. The Banco de España’s benchmarking exercises

D) COLLATERAL/GUARANTEES AND APPRAISALS

1. Definition and types of effective collateral/guarantees

2. Valuation of collateral

2.1. General collateral valuation policies and procedures

2.2. Procedures for and minimum frequencies of appraisal of real estate collateral

2.2.1. General real estate collateral appraisal procedures

2.2.2. Real estate collateral in transactions classified as performing exposures or performing exposures under special monitoring

2.2.3. Real estate collateral in transactions classified as non-performing exposures

II. CLASSIFICATION OF TRANSACTIONS ON THE BASIS OF CREDIT RISK ATTRIBUTABLE TO INSOLVENCY

A) PERFORMING EXPOSURES

B) PERFORMING EXPOSURES UNDER SPECIAL MONITORING

1. General criteria for the classification of transactions as performing exposures under special monitoring
2. Forborne exposures classified as performing under special monitoring

C) NON-PERFORMING EXPOSURES

1. General criteria for the classification of transactions as non-performing exposures
2. Non-performing exposures for reasons other than arrears
3. Non-performing exposures due to arrears
4. Forborne exposures classified as non-performing
5. Accrual of interest on transactions classified as non-performing

D) TOTAL WRITE-OFF

III. ALLOWANCES AND PROVISIONS FOR CREDIT RISK ATTRIBUTABLE TO INSOLVENCY

A) ALLOWANCES AND PROVISIONS FOR NON-PERFORMING EXPOSURES

B) ALLOWANCES AND PROVISIONS FOR PERFORMING EXPOSURES AND FOR PERFORMING EXPOSURES UNDER SPECIAL MONITORING

IV. CREDIT RISK ATTRIBUTABLE TO COUNTRY RISK

A) SCOPE

B) CLASSIFICATION OF TRANSACTIONS ON THE BASIS OF CREDIT RISK ATTRIBUTABLE TO COUNTRY RISK

C) ALLOWANCES AND PROVISIONS FOR CREDIT RISK ATTRIBUTABLE TO COUNTRY RISK

V. REAL ESTATE ASSETS FORECLOSED OR RECEIVED IN PAYMENT OF DEBT

INTRODUCTION

1. The annex has a dual goal:

   a) To establish a general framework for credit risk management, serving as the basis for the criteria with which the various transactions may be classified according to credit risk, and so enable the prudent estimation of levels of provisions and allowances for credit risk losses.

   b) To establish benchmarks facilitating the uniform application of these classification and provisioning criteria, and to enhance the comparability of institutions' financial statements.

2. Transactions ("exposures") shall be understood here to mean:

   a) debt instruments: loans, advances other than loans, and debt securities, as defined in paragraph 1 of rule 52, and

   b) other credit exposures ("off-balance sheet exposures"): loan commitments, financial guarantees and other commitments given, as defined in rule 25.

   For the purpose of estimating allowances and provisions in accordance with this annex, for debt instruments, the amount of the exposure shall be the gross carrying amount, and for off-balance sheet exposures, it shall be the estimate of the amount of the expected disbursement.

3. The general credit-risk management framework, the criteria for the classification of transactions according to their credit risk, and the valuation criteria for real estate assets foreclosed or received in settlement of debt provided for herein shall apply to all the institution's transactions, regardless of whether they are classed as business in Spain or abroad, pursuant to paragraph two of rule 64.

4. Where institutions make use of the alternative solutions for estimating credit-risk allowances or provisions and of the benchmarks for valuing foreclosed assets or those received in payment of debt envisaged herein, they shall apply them to the transactions classified as business in Spain, i.e. transactions recognised in the accounting records of Spanish institutions, with the exception of those recorded in the books of foreign branches.

5. Parent credit institutions of groups of credit institutions or consolidated groups of credit institutions, with foreign subsidiaries, and institutions with foreign branches, shall implement policies, methods and procedures to estimate the allowances or provisions for transactions recorded at these institutions or branches, and therefore classified as foreign operations, that are similar to those deriving from the criteria envisaged herein, but adapted to the particular circumstances of the country in which the subsidiaries or branches operate.

6. In the preparation of consolidated financial statements, the credit risk allowances and provisions of foreign subsidiaries shall be calculated according to criteria uniform with those applied at group level. In this process of measurement harmonisation, institutions shall analyse the allowances and provisions in their individual financial statements, estimated according to the applicable accounting standards, and shall maintain them unless they conclude that said allowances and provisions are not consistent with the criteria, policies and accounting standards applicable in the consolidated statements.

7. Without prejudice to the provisions of this annex, Royal Decree-Law 2/2012 of 3 February 2012 on balance sheet clean-up of the financial sector shall be applicable

to financing and foreclosed assets or those received in payment of debt relating to the Spanish real estate sector, including both those existing at 31 December 2011 and those arising from granting forbearance measures thereof at a later date.

I. GENERAL CREDIT-RISK-MANAGEMENT FRAMEWORK

8. Credit-risk management policies must be approved by the board of directors, or equivalent body, which shall be responsible for their periodic review.

   These policies shall be implemented in methods, procedures and practices for: i) the granting of transactions; ii) changes to their terms and conditions; iii) the assessment, monitoring and control of credit risk, including the classification of transactions and estimation of allowances and provisions; and iv) the definition and valuation of effective guarantees/collateral. These must allow early identification of transaction impairment and a reasonable estimate of credit-risk allowances and provisions.

9. The policies and their implementation must be consistent with the institution's risk appetite. The policies, and their updates, must be properly documented and substantiated; the necessary documentation shall include the proposals and opinions of the institution's relevant internal departments. In particular, institutions must keep adequate control over the policies applicable at all times, such that no doubts arise as to which are in force at a particular date.

   Among other points, the following should be specified:

   a) The responsibilities and powers delegated by the various bodies and persons entrusted with granting, amending, assessing, monitoring and controlling transactions.

   b) The requirements to be met in the analyses and the assessments of the transactions before they are granted and while they are current.

   c) The minimum documentation required in the different types of transactions for the granting thereof and while they are current.

   d) The actions the institution should take when payments are not made under the terms laid down in the contract.

10. The board of directors and the internal audit department shall ensure that the policies, methods, procedures and practices are appropriate, effectively in place and regularly reviewed.

A) GRANTING OF TRANSACTIONS

11. Policies for the granting of transactions must include the pricing policy, which should at least aim to cover the funding, overhead and credit risk costs of each class of transaction.

The institution shall calculate the credit risk cost for the various homogeneous risk groups in which transactions are categorised in a manner that is consistent with its historical experience of recognition of allowances and provisions, total write-offs, amounts partially written off in exposures which remain on the balance sheet and recoveries, as well as with the expected progress of the economy. For the purposes of this calculation, income or savings in expenses from other cross transactions with the borrower shall not be included.

The periodic review of the pricing policy must be responsive to the changes taking place in the cost structure and the risks of each class of transaction.

The granting of a transaction at an interest rate below its cost is a case in which the transaction price may not be representative of its fair value. When this occurs, the institution shall estimate the fair value of the transaction at the initial recognition date so as to compare it with the transaction price. If the transaction price differs from the estimated fair value, the transaction granted must be recorded initially at fair value. The difference between the fair value and the amount drawn down shall be recognised as an expense on the statement of profit or loss, either immediately or on a deferred basis as an adjustment to fair value, as applicable under paragraph 29 of rule 22.

B) MODIFICATION OF CONDITIONS

18. For the purposes of this annex, the following definitions shall apply:

    a) Refinancing transaction: a transaction which, irrespective of the borrower or collateral/guarantees, is granted or used for economic or legal reasons relating to the borrower's/s' current or foreseeable financial difficulties, either to repay one or several transactions granted by the institution itself or by others in its group to the borrower/s or to one or more other companies in its/their group, or to bring these transactions wholly or partially up to date in payment, in order to facilitate debt payments by borrowers whose transactions are repaid or refinanced (principal and interest) because they are, or will foreseeably become, unable to comply with the terms and conditions on time and in due form.

    b) Refinanced transaction: a transaction which is brought wholly or partially up to date in payment as a result of a refinancing transaction carried out by the institution itself or by another institution in its group.

    c) Restructured transaction: a transaction in which, for economic or legal reasons relating to the borrower's/s' current or foreseeable financial difficulties, the financial terms and conditions are changed in order to facilitate payment of the debt (principal and interest) because the borrower is or will foreseeably become unable to comply with those terms and conditions on time and in due form, even if that change was envisaged in the contract. In any event, transactions are considered to be restructured when a debt reduction takes place, assets are received to reduce the debt or their terms and conditions are changed to extend their maturity, change the repayment table to reduce instalments in the short term or reduce their frequency, or establish or extend the principal repayment and/or interest grace period, except when it can be demonstrated that the terms and conditions were changed for reasons other than the borrowers' financial difficulties and are similar to those applying in the market on the date of change on transactions with borrowers of a similar risk profile.

    d) Rollover transaction: a transaction executed to replace another previously granted by the institution itself without the borrower having any financial difficulties or foreseeably having any in the future, i.e. the transaction takes place for reasons other than refinancing.

e) Renegotiated transaction: a transaction whose financial terms and conditions are changed without the borrower having any financial difficulties or foreseeably having any in the future, i.e. the terms and conditions are changed for reasons other than restructuring.

19. Transactions shall be deemed to be a restructuring or refinancing ("forbearance measures") at least in the following circumstances:

    a) When the classification of the modified transaction was non-performing just before the modification, or it would be classified as non-performing in the absence of such modification.

    b) When the modification involves partial derecognition of the debt for reasons such as the recording of debt reductions or write-offs.

    c) When, simultaneously with or close in time to the granting of additional financing by the institution, the borrower made payments of principal or interest on another transaction with the institution that was classified as non-performing or would in the absence of refinancing be classified as non-performing.

    d) When the institution approves the use of embedded modification clauses in relation to transactions classified as non-performing or which would be so classified without the use of those clauses. For the purpose of this annex, embedded modification clauses shall mean those contractual clauses which allow the schedule or amount of a transaction's cash flows to be modified without the need to enter into a new contract because the original contract provided for such modifications.

20. Unless there is evidence to the contrary, transactions shall be deemed to be a restructuring or refinancing ("forbearance measures") in the following circumstances:

    a) When, without the transaction subject to modification being classified as non-performing, some or all of the payments of the transaction were past due by more than thirty days at least once in the three months preceding its modification, or would be more than thirty days past due without said modification.

    b) When, simultaneously or nearly simultaneously with the granting of additional financing by the institution, the borrower made payments of principal or interest on another transaction with it not classified as non-performing, on which some or all of the payments were past due by more than thirty days at least once in the three months prior to the refinancing.

    c) When the institution approves the use of embedded modification clauses in relation to transactions not classified as non-performing with outstanding amounts thirty days past due or that would be thirty days past due had such clauses not been exercised.

21. The policies for the modification of transaction conditions shall address the refinancing, restructuring, rollover or renegotiation of transactions bearing in mind that they are legitimate credit-risk management instruments and should be used appropriately and prudently, without their use undermining the proper accounting classification of risk or the timely recognition of its impairment.

    To this end, these policies should require appropriate identification of the nature of the transactions by means of an up-to-date analysis of the economic and financial situation of the borrower and guarantors, of their ability to pay under the new financial conditions, and of the effectiveness of the (new and original) collateral/guarantees provided.

    Policies for the modification of transactions shall specify the modification criteria,

including aspects such as the minimum experience with the borrower, the existence of a sufficiently extensive borrower compliance record, and the existence of new collateral/guarantees. They should also set a minimum validity period without modifications and a time limit on the frequency of changes in transaction conditions.

22. Rollover or renegotiation policies shall envisage that to classify a transaction as a rollover or renegotiation the borrowers must be able to obtain transactions on the market for an amount and under financial conditions analogous to those applied by the institution at the time of the rollover or renegotiation. These conditions must also be in line with those granted at the time to other borrowers with a similar risk profile.

23. Moreover, forbearance policies shall focus on the collection of recoverable amounts, which implies the need for immediate derecognition of amounts that are deemed irrecoverable without extinguishment of the related claims, where applicable. In the case of partial derecognition, the remaining amount of transactions shall, in accordance with paragraph 127, be classified in full in the appropriate category on the basis of the credit risk of the transaction.

    The use of forbearance measures for other purposes, such as delaying the immediate recognition of losses, is contrary to good management practices and must not hinder the proper classification and provisioning of these transactions.

    Therefore, forbearance decisions must be based on individual analysis of the transaction at an appropriate level of the organisation, other than the level which originally granted it, or, if on the same level, reviewed by a higher decision-making level or body.

24. Forbearance policies shall ensure that the institution has an internal reporting system with mechanisms allowing proper identification and monitoring of refinancing, refinanced and restructured transactions ("forborne exposures"), and their appropriate accounting classification according to their credit risk. The decisions taken shall be regularly reviewed to check proper compliance with forbearance policies.

    Transactions shall cease to be identified as forborne exposures if the requirements of paragraph 100 are met. However, in accordance with the principle of traceability set out in paragraph 45, an institution's internal information system must retain such information on the change made as is necessary to ensure at all times the proper monitoring, assessment and control of the transaction.

25. Institutions shall, in all cases, adhere to the criteria set out in Sections II, "Classification of transactions on the basis of credit risk attributable to insolvency", and IV.B, "Classification of transactions on the basis of credit risk attributable to country risk", for the classification of transactions according to their credit risk.

C) ASSESSMENT, MONITORING AND CONTROL OF CREDIT RISK

1. General principles for the assessment, monitoring and control of credit risk

26. Institutions shall have policies for the assessment, monitoring and control of credit risk, that require:

    a) The utmost care and diligence in the rigorous study and assessment of the credit risk associated with their transactions, not only at the time of their being granted but also throughout the period during which they are current.

    b) Databases of transactions enabling proper assessment, monitoring and control of credit risk, and the preparation of reports and other timely and

comprehensive documentation both for management and to inform third parties or respond to requests from the supervisor.

c) The reclassification and corresponding provisioning of transactions as soon as an abnormal situation or the deterioration of credit risk becomes apparent.

d) An adequate line of communication to the board of directors.

27. These policies will be implemented in methodologies, procedures and practices that specify, among other things, the characteristics these databases shall have. In any event, institutions must have databases complying with the following requirements:

a) Depth and breadth, in that they cover all the significant risk factors. This should allow, inter alia, exposures to be grouped together in terms of common factors, such as the institutional sector to which the borrower belongs, the purpose of the transaction and geographical location of the borrower, so as to enable aggregate analysis allowing identification of the institution's exposure to these significant risk factors.

b) Accuracy, integrity, reliability and timeliness of data.

c) Consistency, such that they are based on common sources of information and uniform definitions of the concepts used for credit-risk management.

d) Traceability, such that the source of information can be identified.

28. The institution's internal control functions must verify that its databases comply at all times with the characteristics required by its internal policies, and in particular, the requirements set out above.

Institutions must have procedures ensuring that the information collected in their databases is integrated in management, such that timely, complete and consistent information is included in reports and other documentation (whether recurrent or ad hoc) of relevance to decision-making at the various management levels, including the board of directors.

29. Furthermore, the methods, procedures and practices in which the policies are implemented shall specify how transactions are to be classified according to their credit risk, distinguishing between performing exposures, performing exposures under special monitoring, non-performing exposures and total write-offs, and how individual and collective estimates of credit-risk losses are quantified and covered.

These criteria shall not allow any delay in a transaction's reclassification for accounting purposes into a worse category due a deterioration in credit quality, nor in the setting aside of adequate allowances and provisions, for which purposes the stipulations of this annex shall be observed.

30. The methods, procedures and criteria for the accounting classification of transactions shall be integrated in the credit-risk management system. They shall take past experience into account together with all relevant risk factors, including those listed in Sections II, "Classification of transactions on the basis of credit risk attributable to insolvency", and IV.B, "Classification of transactions on the basis of credit risk attributable to country risk", for the classification of transactions according to their credit risk.

31. Allowances and provisions for transactions classified as performing exposures shall be associated with a group of transactions with shared risk characteristics ("homogeneous risk group") and thus shall always be estimated collectively, taking into account the credit losses on transactions with shared risk characteristics.

Allowances and provisions for transactions classified as performing exposures under special monitoring may be associated with a homogeneous risk group or a

transaction. When they are associated with a homogeneous risk group, they shall be estimated collectively. When they are associated with specific transactions, they shall be estimated as appropriate in accordance with paragraphs 48, 58(c) and 58(d), either individually based on the credit losses on the transaction in question, or collectively taking into account the credit losses on transactions with shared risk characteristics.

Finally, allowances and provisions for transactions classified as non-performing shall be associated with specific transactions and estimated either individually or collectively as appropriate in accordance with paragraphs 47, 58(a) and 58(b).

2 General principles for estimating allowances and provisions for credit risk losses

32. When estimating allowances and provisions, institutions shall be guided by the following principles:

    a) Governance and integration in management, which entail approval by the board of directors of the policies for estimating allowances and provisions and their periodic monitoring, and their continuous integration in the various credit-risk management processes.

    b) Effectiveness and simplicity, avoiding the inclusion of elements that add complexity without bringing clear and demonstrable improvements to the logical coherence, consistency and quality of the results obtained.

    c) Documentation and traceability.

    These principles are set out in more detail in paragraphs 33 to 45 below.

2.1. Governance and integration in management

33. The board of directors shall:

    a) Approve written policies and ensure the adequacy of written methods and procedures describing:

        i) The type and sources of the minimum information necessary for the analysis and assessment of transactions.

        ii) The main assumptions and hypotheses on which the identification and assessment of credit risk rests.

        iii) The factors and parameters used in estimating allowances and provisions.

        iv) The monitoring of the results of the methodologies used to estimate allowances and provisions.

        v) Processes for the internal verification of estimates.

        vi) The periodicity of updates to estimates, including a review of the data and parameters used.

    b) Have an up-to-date knowledge of the relevant information on the credit risk assumed by the institution. In relation to the methods implemented, it should be familiar with their assumptions and most significant limitations, including those regarding the databases on which they rely, and the impact on the resulting allowance and provision figures.

34. The methods and procedures for estimating allowances and provisions must be integrated in the institution’s credit-risk management system and form part of its processes; in particular, pricing and transaction-granting processes, risk monitoring and control, and stress-test processes.

35. The institution’s various internal control functions shall review the methods and procedures for estimating allowances and provisions in the light of the principles set out in paragraph 32, seeking at all times to ensure they are observed and periodically reporting on such observance to the board of directors at least yearly.

36. The review mentioned in paragraph 35 above must cover at least the information systems used, analysing the suitability of the databases for the allowance and provision estimation principles defined, and their integration in risk management, as regards aspects such as the consistency of the concepts used for internal purposes and those defined herein.

2.2. Simplicity and effectiveness

37. The methods and processes for monitoring and updating estimates of allowances and provisions must ensure at all times that the results obtained are attuned to the reality of the transactions, the prevailing economic climate, and the forward-looking information available.

38. Estimates must have a quantitative basis. Greater prudence must be applied in the case of estimates made without an adequate quantitative basis. In any event, estimates must be based on adequately substantiated assumptions that are consistent over time.

39. The methods for estimating allowances and provisions should be comprehensible to users and, in any event, ensure that the results obtained do not contradict the underlying economic and financial logic of the various risk factors. Any complexity deriving from methods, procedures and collective calculations that does not significantly improve the results obtained, while making them harder to understand, must be avoided. In short, the calculation should explain and reflect the best estimation of the loss.

40. The institution shall ensure consistent treatment of the different categories into which transactions may be classified such that the level of allowances and provisions estimated for a transaction should be higher than the level of allowances and provisions that would apply to it if it were classified in another category with lower credit risk.

41. The institution shall establish and document the periodic procedures for checking the reliability and consistency of its transaction classifications and its estimates of allowances and provisions over the course of the various stages of the credit-risk management cycle. The periodic check of its allowance and provision estimates shall be performed regularly throughout the year by means of backtesting whereby it assesses their accuracy by comparing a posteriori the estimated credit losses with the actual losses effectively observed on transactions. For performing exposures and performing exposures under special monitoring, it shall also carry out backtesting separately to compare the estimated probabilities of default with the observed frequencies of default.

42. As an additional support, the institution shall periodically undertake:

    a) Benchmarking exercises, using all the significant information available both internally and externally; and

b) Analysis of sensitivity to changes in the methods, assumptions, factors and parameters used to estimate allowances and provisions. These analyses must consider different time horizons and scenarios, both plausible and extreme.

43. The methods and assumptions used for estimating allowances and provisions are to be reviewed regularly so as to:

a) reduce any differences between credit loss estimates and the actual loss experience, and

b) introduce the improvements needed to correct the weaknesses detected in benchmarking exercises, in backtesting and in sensitivity analyses.

Significant changes in the institution's methodologies for estimating allowances and provisions shall be communicated by it to the Banco de España after they are approved but before they are implemented. The institution's board of directors shall be responsible for approving the procedures needed to decide whether said significant changes are to be made and for ensuring that the Banco de España is informed of these changes in a timely fashion. To this end, the institution's policies shall include a definition of what constitutes significant change, in absolute and relative terms, at the homogeneous-group or credit-risk-segment level and at the total risk level.

Non-significant changes shall be communicated annually on an overall basis to the Banco de España by the institution. The board of directors of the institution shall be responsible for ensuring that these changes are communicated to the Banco de España on a timely basis.

The institution shall also inform the Banco de España of the results of periodic backtesting, containing the measures adopted to correct any significant deviations observed, and of the results of periodic benchmarking exercises, together with the causes of any significant deviation brought to light. The institution's board of directors must also approve the necessary procedures, including the time period, for communicating this information to the Banco de España.

2.3. Documentation and traceability

44. The institution must have detailed and up-to-date documentation on all its methods, procedures and criteria for the assessment, monitoring and control of credit risk, including those relating to estimates of allowances and provisions, such that a third party could understand and replicate the calculations made.

Its transactions must also be properly documented and identified in the institution's accounts in accordance with rule 70. In particular, all the information needed to know the origin and course of transactions must be conserved.

45. The information must be traceable, so that its source and different stages can be identified at all times.

3. Requirements for individualised estimation of allowances and provisions

46. Institutions must develop methodologies for the estimation of all allowances and provisions for non-performing or performing-under-special-monitoring transactions subject to individual estimation. These individual estimation methods must comply with the general principles for estimating allowances and provisions set out in paragraphs 32 to 45, which are common for individual and collective estimation, and with all the specific requirements for individual estimations set out in paragraphs 47 to 57.

The specific requirements for individual estimations are based on the premise that such estimations should be made when expert judgement is needed to identify a significant increase in credit risk since initial recognition or credit impairment, and to assess the impact of such events on the cash flows of transactions.

47. The allowances and provisions for the following non-performing transactions must be estimated individually:

a) Allowances and provisions for transactions that are non-performing as a result of arrears and that the institution considers to be significant.

For this purpose, institutions must have duly documented policies, procedures and practices which specify, inter alia, the absolute and relative quantitative thresholds for considering a transaction to be significant.

As a reference, a transaction is considered to be significant if its gross carrying amount is more than either of the following thresholds:

i) Three million euro, or

ii) 5% of the institution's own funds, as defined in Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

Nevertheless, institutions may establish thresholds different from those stated above when necessary for individualised estimates to comply with the general principles for estimating allowances and provisions set out in paragraphs 32 to 45. Institutions may consider all transactions with a borrower to be significant when the sum of all transactions with that borrower exceeds the aforementioned thresholds.

b) Allowances and provisions for transactions considered non-performing for reasons other than arrears. As an exception, allowances and provisions for transactions, other than those that were identified as having low credit risk, that are classified as non-performing for reasons other than arrears solely on the basis of automatic classification factors, such as the transactions listed in paragraph 58(b) below, shall be subject to collective estimation.

c) Allowances and provisions for non-performing transactions, whether due to arrears or for reasons other than arrears, that were identified as having low credit risk in accordance with paragraphs 88 and 89.

d) Allowances and provisions for non-performing transactions not belonging to a homogeneous risk group, and, therefore, for which the institution cannot develop internal methods for collective estimation of the credit losses on these transactions.

48. The allowances and provisions for the following performing transactions under special monitoring must be estimated individually:

a) Allowances and provisions for performing transactions under special monitoring transactions that the institution considers to be significant. For this purpose, institutions must have duly documented policies, procedures and practices which specify, inter alia, the absolute and relative quantitative thresholds for considering a transaction to be significant. The thresholds set for performing exposures under special monitoring may be higher than those set for non-performing transactions.

As a reference, a transaction shall be considered significant if its gross carrying amount exceeds any of the thresholds in the third subparagraph of paragraph 47(a) above. However, institutions may set thresholds other than those stated above when necessary for individualised estimates to comply

with the general principles for estimating the allowances and provisions described in paragraphs 32 to 45.

Institutions may consider all transactions with a borrower to be significant when the sum of all transactions with that borrower exceeds the aforementioned thresholds.

b) Allowances and provisions for transactions classified as performing under special monitoring as a result of individual analysis of a transaction in which some factor other than automatic ones has had a decisive influence. For this purpose, taking into account the principle of proportionality, institutions must have policies, procedures and practices specifying the qualitative criteria for a transaction to be subject to individual analysis for its classification as performing under special monitoring, the factors to be considered in such analysis and their importance in determining the classification.

c) Allowances and provisions for performing transactions under special monitoring not belonging to a homogeneous risk group, and, therefore, for which the institution cannot develop internal methods for collective estimation of the credit losses on these transactions.

49. Institutions may extend individual estimation of allowances and provisions to non-performing and performing-under-special-monitoring transactions with (full or partial) effective personal guarantees by guarantors of low credit risk, and to transactions with (full) effective personal guarantees by guarantors with significant transactions or with other transactions whose allowances or provisions are estimated individually, within the meaning of paragraphs 47 and 48.

50. The allowances and provisions shall be equal to the difference between the gross carrying amount of the transaction and the present value of the estimated cash flows expected to be collected, discounted, as specified in paragraph 9 of rule 29, using the original effective interest rate of the transaction or, in the case of purchased or originated credit-impaired financial assets, at the credit-adjusted effective interest rate. For this purpose, regard shall be had to the effective guarantees received in accordance with Sub-section I (D) “Collateral/guarantees and appraisals”.

In the case of transactions granted at below cost as indicated in paragraph 11(c), the institution shall take into account the original effective interest rate calculated using the initially recognised amount of the transaction.

51. Individual estimation of allowances and provisions shall be made using techniques for the discounting of future cash flows. To do so, the institution must have reliable up-to-date information on the solvency and ability to pay of borrowers or guarantors.

In the individual estimation of allowances and provisions for performing exposures under special monitoring, regard must be had not only to credit losses, as in the case of non-performing exposures, but also to the probability of default. To include default risk in the individual estimation of allowances and provisions for these exposures, the institution may opt to use the estimated probability of default, either for the specific exposure or for a group of exposures with similar characteristics.

52. When transactions are classified as non-performing, the institution must evaluate whether the estimation of contractual flows receivable from borrowers or guarantors is subject to high uncertainty and, if so, make the individual estimation of allowances and provisions as provided in the following paragraph.

In any event, the institution must consider that the estimation of contractual flows receivable from borrowers or guarantors is subject to high uncertainty in the case of transactions with amounts more than eighteen months past-due.

53. When the estimate of the contractual flows receivable from borrowers or guarantors is subject to high uncertainty, the individual estimation of allowances and provisions for non-performing transactions should be performed by estimating the recoverable amounts of the effective collateral received.

    The recoverable amount of effective collateral shall be estimated by applying to its reference value, determined as specified in paragraphs 72 to 85, the adjustments needed to capture adequately the uncertainty of the estimate and consequent possible falls in value up to the time of foreclosure and sale, plus foreclosure costs, maintenance costs and costs to sell.

54. In compliance with the principle of consistency described in paragraph 40, except in exceptional duly justified cases, the allowance/provision estimated on an individual basis for a performing exposure under special monitoring should be greater than the collective allowance/provision that would apply to the transaction if it were classified as a performing exposure. Similarly, the allowance or provision estimated on an individual basis for a non-performing exposure should be greater than the collective allowance or provision that would apply to the transaction if it were classified as a performing exposure under special monitoring.

    In any event, the allowance or provision estimated on an individual basis for a non-performing exposure must be greater than the individual allowance or provision that would apply to the transaction if it were classified as a performing exposure under special monitoring.

55. In compliance with the principle of documentation and traceability, described in paragraphs 44 and 45, institutions must include in the credit file of transactions the documentation needed so that a third party can replicate the calculation of individual estimates of allowances and provisions made over time. This documentation must include, inter alia, information on the approach used to estimate the cash flows it is expected to collect, their amount, maturity periods and the effective interest rate used for cash-flow discounting.

56. Institutions shall apply the alternative solutions for collective estimation set out in Section III "Allowances and provisions for credit risk attributable to insolvency" in their periodic benchmarking exercises on individualised estimates.

57. The institution shall change its individual estimation methods in the event of recurrent significant non-compliance with the requirements for the estimation of allowances and provisions set out in this section. In particular, the institution shall change these methods when periodic backtesting recurrently reveals significant differences between the estimated credit losses and the actual loss experience.

    In such cases, the institution shall draw up a plan specifying the measures it has to take to correct the differences or non-compliances, accompanied by an implementation timetable.

    The institution's internal audit department shall monitor implementation of this plan, verifying that the corrective measures are adopted, and that the timetable is followed correctly.

    The institution shall communicate to the Banco de España the start of the implementation period of the plan for changing its individual estimation methods. The institution's board of directors shall approve the procedures needed to decide and communicate to the Banco de España the start of said implementation period of said plan. While it is implementing this plan, the institution shall carry out its individual estimations by using the alternative solutions for collective estimates set out in Section III "Allowances and provisions for credit risk attributable to insolvency".

4. Requirements for collective estimation of allowances and provisions

4.1. Common requirements for collective estimation of allowances and provisions

58. Collective estimation shall be applied to calculate the allowances and provisions for all transactions for which an individualised estimate does not have to be made. Allowances and provisions for the following transactions shall therefore be calculated by collective estimation:

   a) Those classified as non-performing owing to arrears (other than those that were identified as having low credit risk) that are not considered significant, including those classified as non-performing due to arrears because of an accumulation of past-due amounts on other transactions with the same borrower.

   b) Transactions classified as non-performing for reasons other than arrears (other than those that were identified as having low credit risk), solely on the basis of automatic classification factors, such as:

      i) Forborne exposures that do not have amounts more than ninety days past due but remain classified as non-performing exposures because the other requirements for reclassification out of that category have not been met, in accordance with paragraph 120.

      ii) Forborne exposures in the probation period reclassified as non-performing exposures because they have been subject to a second or subsequent forbearance measures, or because they have amounts more than thirty days past due, in accordance with paragraph 102.

   c) Those classified as performing exposures under special monitoring that are not considered significant.

   d) Those classified as performing exposures under special monitoring as a result of an individual analysis of the transaction in which only automatic classification factors were considered or in which no factor other than automatic ones had a decisive influence. This is the case, inter alia, of transactions classified in this category because the borrower has amounts more than thirty days past due, in accordance with paragraph 95.

   e) Those classified as performing exposures under special monitoring because they belong to a group of transactions with shared risk characteristics ("homogeneous risk group"). This is the case, inter alia, of groups of transactions classified in this category because the borrower belongs to segments (such as geographical areas or economic sectors) where there are weaknesses.

   f) Those classified as performing exposures.

59. Institutions which have not developed internal methods for complying with the requirements of paragraphs 60 to 67 below shall make their collective estimations of allowances and provisions according to the alternative solutions given in Section III "Allowances and provisions for credit risk attributable to insolvency".

   The Banco de España shall regularly update these alternative solutions to reflect changes in the data for the sector and in the forecasts of future conditions.

4.2. Internal methods for collective estimation of allowances and provisions

60. Internal methods must comply with the general principles set out in paragraphs 32 to 45, which are common to all individualised and collective estimations, and with all the specific requirements for collective estimates set out below:

    a) The institution must have a record of reliability and consistency in the estimation of individualised allowances and provisions, as demonstrated by the periodic comparison of its results by means of backtesting.

    b) The institution is to have written procedures describing the criteria used to identify and group transactions with shared risk characteristics (such that collective estimates can be made for these groups) and the factors and parameters that, in each case, determine this estimation. The institution must document how it reconciles these homogeneous risk groups and the risk segments in Section III "Allowances and provisions for credit risk attributable to insolvency", in terms of transactions and allowances and provisions. The institution shall periodically review how well the homogeneous risk groups used match the reality of its operations and the economic climate.

    c) In accordance with paragraph 40, internal methods must be consistent with one another and with the classification of transactions according to their credit risk. In any event, the allowances and provisions estimated collectively for a non-performing exposure must be higher than the collectively estimated allowances and provisions that would apply to the transaction if it were classified as a performing exposure under special monitoring. Similarly, the allowance or provision estimated collectively for a performing exposure under special monitoring must be higher than the collectively estimated allowance or provision that would be applicable to the transaction if it were classified as performing.

    d) Estimates must be based on each institution's historical experience of observed losses, which, if necessary, will be adjusted to take the prevailing economic conditions and other current circumstances known at the time of the estimate into account. Historical experience of losses shall be adjusted, based on observable data, to reflect the effect of current conditions that did not affect the historical reference period, eliminate the effect of past conditions no longer prevailing, incorporate possible differences in the composition and quality of the current portfolio with respect to the historical reference period, and reflect the effect of forecasts of future conditions. The institution must have duly documented policies, procedures and practices on the use of forecasts of future conditions in which it defines, inter alia, the variables to be taken into account (such as indicators of the behaviour of the economy) and the prediction time horizon (which must be limited to those future periods that can be predicted without a high level of uncertainty).

    e) For transactions classified as performing, an estimate must be made of the expected credit losses in twelve months, as defined in paragraph 4(b)(ii) of rule 29, and for transactions classified as performing under special monitoring, an estimate must be made of the expected credit losses over the life of the transaction as defined in paragraph 4(b)(i) of rule 29.

    f) For transactions classified as non-performing, an estimate shall be made of the credit losses, defined as the difference between the amount of the exposure and the present value of the estimated future cash flows. Estimates of changes in future cash flows consistently reflect any signs of losses deriving from any changes, period to period, in the observable data; in particular, these estimates shall take into account the progress of payments and other factors indicating the existence and scale of losses incurred in the homogeneous risk group, for example, changes in unemployment rates or in

the prices of real estate collateral. In these flows, both estimated future recoveries and possible increments in the drawn-down principal and expenses associated with the process of recovering each transaction are to be considered.

g) Institutions shall have methods enabling them to analyse the effectiveness of the collateral/guarantees and estimate the discounts necessary to estimate the recoverable amount for the purposes of calculating allowances and provisions. The recoverable amount of effective collateral shall be estimated from the applicable reference value, as specified in paragraphs 72 to 85, subtracting the adjustments needed to reflect adequately the uncertainty of the estimate and how it affects the potential fall in value up to the time of foreclosure and sale, plus foreclosure costs, maintenance costs and costs to sell, in accordance with paragraph 138. When estimating the recoverable amount of the collateral, the institution's ability to realise the collateral, once foreclosed, must be taken into account.

h) Institutions may use internal methods for estimating allowances and provisions even though they have not developed internal models for determining the capital requirements. If an institution has developed internal models for determining the capital requirements, and without prejudice to the differences between internal methods for estimating allowances and provisions and those used in said internal models, the key elements of both systems must be closely aligned:

   i) Both systems must be based, on the one hand, on estimated inflows into non-performing exposures (based on estimates of the probability of default) and, on the other, on estimates of recovery flows (by considering possible outcomes of recovery processes and estimates of the losses produced in each of them).

   ii) All other key elements of the systems, related to their practical implementation, must be aligned. These other elements include, inter alia, the definition of homogeneous risk groups, the databases used, relevant risk factors, and controls.

   iii) Institutions must be able to explain and justify the differences existing between the two systems of calculation.

i) Institutions which use estimated probabilities of default employing internal methods to classify transactions as performing exposures under special monitoring must have duly documented policies, procedures and practices in which they define, inter alia, the quantitative thresholds of change in the probabilities of default at which an increase in credit risk is considered to be significant.

61. Institutions using internal methods for collective estimation of allowances and provisions shall have their own methods enabling them to estimate the fair value and costs to sell of assets foreclosed or received in payment of debt. Institutions' own methods for estimating the fair value of assets foreclosed or received in payment of debt shall comply with the stipulations of paragraphs 166 to 173.

62. Institutions that intend to use internal methods for collective estimation of allowances and provisions must carry out a prior validation to demonstrate that these comply with the principles and requirements set out in paragraphs 60 and 61. For this purpose, before starting to use these internal methods in the calculation of allowances and provisions, for a period of at least six months, institutions shall:

a) Compare the allowances and provisions obtained with the alternative solutions in Section III "Allowances and provisions for credit risk attributable

to insolvency" with those obtained by applying their internal methods and with those in the comparative information published by the Banco de España, as indicated in paragraph 68. The institution must analyse the possible reasons for any significant deviations resulting from this comparison.

b) Use backtesting to show that the credit losses that would be obtained using internal methods compare satisfactorily with actual observed losses.

63. The institution shall notify the Banco de España of the start of the comparison and backtesting period described in the preceding paragraph, and inform it of the causes of any significant deviation observed in the benchmarking exercises and of the results of backtesting. The institution's board of directors shall approve the procedures necessary to decide and notify the Banco de España of the start of the backtesting period described above and to inform it of the results of the benchmarking exercises and of backtesting.

64. For the periodic benchmarking of the allowances and provisions estimated using internal methodologies, institutions shall use the alternative solutions set out in Section III "Allowances and provisions for credit risk attributable to insolvency" for collective estimation and the comparative information published by the Banco de España as indicated in paragraph 68. Reasons must be given for deviations in comparable portfolios.

65. Institutions using internal methods for collective estimates must submit the individual confidential report FI 131-5 "Comparativa de las estimaciones con metodologías internas y con soluciones alternativas (negocios en España)" [Comparison of estimates made using internal methods and alternative solutions (business in Spain)] for each of the risk segments in Section III "Allowances and provisions for credit risk attributable to insolvency". This report is to state the differences between the results obtained using internal collective estimates (and with individualised estimation methods) and those that would be obtained by applying the aforementioned alternative solutions.

66. Institutions which have developed internal methods complying with paragraph 60 shall apply them to all transactions subject to collective estimation of allowances and provisions. Notwithstanding this, these institutions may continue to use the alternative solutions set out in Section III "Allowances and provisions for credit risk attributable to insolvency" for:

a) Collective estimates of allowances and provisions for exposures classified as performing relating to credit risk segments which do not have sufficient transactions to be considered a homogeneous risk group and, therefore, for which the institution cannot develop internal methods.

b) Collective estimates of allowances and provisions for exposures relating to homogeneous risk groups in which, in application of the principle of simplicity stated in paragraph 39, the increase in complexity and costs derived from developing and using internal methods substantially outweighs the improvements which would be obtained in the estimates.

The justification for using alternative solutions in the cases described in subparagraphs a) and b) above must be adequately documented. If an institution has developed internal models to calculate capital requirements, the accommodative treatment in the cases described in the preceding subparagraphs would not be justified for portfolios subject to these capital models and, consequently, the institution will have to be able to develop internal methods to estimate allowances and provisions for the transactions in these portfolios.

67. The institution must modify its internal methods for collective estimates if the results of the periodic backtesting, performed as established in paragraph 41,

recurrently reveal significant differences between the estimated credit losses and the actual losses experienced, or if there are any significant non-compliances with the principles and requirements in this section for the estimation of allowances and provisions.

In such cases, the institution shall draw up a plan specifying the measures that it has to take to correct the differences or non-compliances, accompanied by an implementation timetable.

The institution's internal audit department shall monitor implementation of this plan, verifying that the corrective measures are adopted, and that the timetable is followed correctly.

The institution shall communicate to the Banco de España the start of the implementation period of the plan for changing its collective estimation methods. The institution's board of directors shall approve the procedures needed to decide and communicate to the Banco de España the start of the implementation period of said plan. While it is implementing this plan, the institution shall carry out its collective estimations by using the alternative solutions for collective estimates set out in Section III "Allowances and provisions for credit risk attributable to insolvency".

5. The Banco de España's benchmarking exercises

68. The Banco de España shall publish annually a report comparing, in aggregate terms at overall banking sector level, credit risk allowances and provisions for credit institutions' business in Spain, in order to facilitate the homogeneous and consistent application of this annex.

D) COLLATERAL/GUARANTEES AND APPRAISALS

1. Definition and types of effective collateral/guarantees

69. For the purposes of this annex, collateral and personal guarantees an institution is able to show are valid as a means of mitigating credit risk, and which are valued in accordance with the policies and procedures laid down in paragraphs 72 to 85, shall be considered effective collateral/guarantees.

    The analysis of effectiveness of collateral/guarantees shall take into account, *inter alia*, the time needed to realise them and the entity's ability and past experience to do so. This analysis must be more rigorous in the case of the provision of new collateral/guarantees in performing exposures under special monitoring and non-performing exposures, for which there is a greater likelihood that their foreclosure may become the main means of recovering the credit.

70. Under no circumstances shall collateral/guarantees whose effectiveness depends substantially upon the credit quality of the debtor, or of any group to which the debtor may belong, be admissible as effective collateral/guarantees for the purposes of this annex. An adverse correlation exists for the institution between the effectiveness of the collateral/guarantees and the credit quality of the debtor in at least the following cases:

    a) When shares or other negotiable securities in the borrower, or in any group to which it may belong, are pledged.

b) When the value of the collateral is highly conditional upon the continued operation of the party giving the guarantee, as in the case of some industrial buildings or non-multi-purpose elements.

c) The case of cross guarantees, in which the guarantor in one transaction is, in turn, guaranteed by the borrower in another transaction.

71. In accordance with the foregoing, the following types of collateral/guarantees may be considered effective, defined according to the instructions for the completion of the data for the Banco de España's central credit register set out in Annex 2 of Banco de España Circular 1/2013 of 24 May 2013:

a) Real estate mortgages, provided they are the first mortgage and duly constituted and registered in favour of the institution; real estate includes:

i) Completed buildings and parts thereof, distinguishing between:

– Housing;

– Offices and commercial premises and multi-purpose industrial buildings;

– Other buildings, such as non-multi-purpose industrial buildings and hotels.

ii) Urban land and regulated building land; i.e. level I land under Ministerial Order ECO/805/2003 of 27 March 2003 on rules for the appraisal of real estate and of certain rights for financial purposes.

iii) Other real estate, which will include, *inter alia*, buildings and parts of buildings under construction, such as property development in progress or halted, and other land, such as rural properties.

b) Collateral in the form of pledged financial instruments such as cash deposits and debt securities or equity instruments issued by creditworthy issuers.

c) Other collateral, including personal property received as collateral and second and subsequent mortgages on properties, provided the institution demonstrates their effectiveness. The institution shall apply particularly restrictive criteria when assessing the effectiveness of second and subsequent mortgages on real estate. It shall take into account, inter alia, whether the previous encumbrances are in favour of the institution or not, and the ratio between the exposure secured and the value of the property.

d) Personal guarantees and the inclusion of new borrowers covering the total amount of the transaction such that direct and joint liability to the institution falls on persons or institutions whose solvency is sufficiently verified to ensure the reimbursement of the transaction under the established terms. In addition, partial personal guarantees, i.e. those covering only part of the amount of the transaction, shall be considered to be effective when they entail the direct and joint and several liability of the guarantors identified as low credit risk, in accordance with paragraphs 88 and 89. Personal guarantees, such as guarantees, credit or suretyship insurance, are defined in paragraph 16(b) of rule 64.

For the purposes of estimating allowances or provisions in accordance with this annex, finance leases shall be treated in the same way as mortgage collateral, sale and leaseback transactions where the seller-lessee retains control of the underlying asset shall also be treated in the same way as mortgage collateral, and reverse repo loans shall be treated in the same way as collateral in the form of pledged financial instruments.

2. Valuation of collateral

2.1. General collateral valuation policies and procedures

72. The institution must have written policies and procedures approved by the board of directors on the valuation of collateral complying with the criteria established herein. These policies and procedures shall include:

    a) procedures, to be applied with a defined frequency, to verify the existence of signs of any significant decline in value and to update the value of collateral;

    b) the criteria for determining that a significant decline in value has taken place. These shall include quantitative thresholds for each type of collateral established based on the institution's experience and bearing in mind relevant factors such as market price trends or the opinion of independent appraisers; and

    c) the criteria for selecting appraisers.

73. The institution shall have databases with all the relevant information on properties and other collateral for its transactions and on the links between collateral and specific transactions. These databases must comply with the requirements of paragraph 27 in order to be able to adequately support an analysis of the effectiveness of the collateral.

    The institution shall keep a register with all valuations, including full individual appraisals, of effective collateral and of real estate assets foreclosed or received in payment of debt, in which it records, in chronological order, all requested or commissioned appraisals and the appraisals and valuations carried out as a result of such requests or commissions, so as to ensure that all appraisals and valuations made are included in the institution's databases or data systems.

74. The institution shall apply criteria for the selection and contracting of appraisers that are geared towards assuring the independence of the appraisers and the quality of the appraisals. To this end, these criteria will include, at least, factors such as the suitability of the human and technical resources, in terms of experience and knowledge of the markets for the assets subject to appraisal; the soundness of the methods used; and the depth, relevance, and quality of the databases used. The institution must also monitor the appraisals given by these service providers. The institution's risk control function shall verify compliance with the above selection criteria.

75. The internal audit department shall regularly review the application of the policies and procedures for the appraisal of collateral. In particular, it shall subject the databases of collateral and their appraisals to periodic audits on their consistency and quality.

76. At the time of granting, institutions shall determine the reference value of the collateral received, and subsequently update this value at the minimum frequencies set, applying the procedures established by the institution. These reference valuations of collateral shall serve as the starting point for estimating its recoverable amount, as provided in paragraphs 53 and 138. In any event, institutions must observe the following criteria, depending on the type of collateral:

    a) For the appraisal of real estate collateral, the criteria in paragraphs 78 to 85 below shall be observed, depending upon the type of property and the accounting classification of the transactions according to their credit risk.

    b) Pledged financial instruments shall be appraised at least quarterly, for which purpose the reference value to be used shall be their fair value.

c) The reference valuation of other collateral shall be carried out by an independent appraiser, and the appraised value shall be updated at least annually.

77. Nevertheless, if a significant decline in the reference value of assets received as collateral is observed, institutions shall update these appraisals in order to reflect this decline, without waiting for the established updating period to elapse. Stricter procedures shall be applied to update appraised values in the case of transactions whose remaining amount of the exposure may exceed the value of the collateral following the loss of value of the latter.

2.2. Procedures for and minimum frequencies of appraisal of real estate collateral

2.2.1. General real estate collateral appraisal procedures

78. For the purposes of this annex, institutions shall use the following procedures to determine the reference value of real estate in Spain used as collateral for transactions:

a) Complete individual appraisals carried out by independent appraisal companies or approved appraisal services, registered in the Banco de España's Official Register of Appraisal Companies, applying the methods envisaged for this purpose, as established in Article 2(a) of Ministerial Order ECO/805/2003 of 27 March 2003.

For the purpose of this circular, an appraisal company or approved appraisal service shall be deemed to be independent if it is not a related party of the institution within the meaning of paragraph 1 of rule 62, and the requirements of the *Ley del Mercado Hipotecario* (mortgage market law) and the implementing rules and regulations applicable to appraisal companies are fulfilled.

To use these appraisals, the requirements are as follows:

i) The reference value shall be the mortgage value.

ii) If, upon performing the ocular inspection, it is not possible to visit the interior of the property, the collateral will not lose its effectiveness if the other requirements of said Ministerial Order are met. This exception will not apply to appraisal reports prepared for the granting of real estate mortgage loans, for which inspection of the interior as provided in said Ministerial Order is mandatory.

iii) The caveats and conditioning factors included by the appraiser in appraisal reports, particularly those derived from not having access to the interior of the property, shall be assessed by the institution in order to apply possible discounts to the reference value of collateral if the appraiser has not allowed for them.

b) Automated appraisal methods developed by approved appraisal companies or services registered in the Banco de España's Official Register of Appraisal Companies that are independent.

To use these appraisals, the following requirements must be met:

i) The properties to be appraised must have characteristics allowing their repeated production;

ii) The automated models must follow generally accepted appraisal practices; and

iii) The appraisers mentioned must compare the results obtained from the automated models with full individual appraisals, in accordance with Ministerial Order ECO/805/2003 of 27 March 2003, for a sample of appraised properties. The internal audit department shall review the quality of the databases of properties supplied to the appraisal companies or services mentioned so that they value these properties using mass models.

79. For real estate located in another European Union country, the criteria used shall be equivalent to those set out in Article 6 of Royal Decree 716/2009 of 24 April 2009 implementing certain aspects of Law 2/1981 of 25 March 1981. In the case of properties located in third countries not belonging to the European Union, institutions shall have a written procedure, approved by the most senior governing body, to seek to ensure that prudent and independent appraisals are carried out by professionals authorised in the country in which the property is located, or where applicable, by approved appraisal companies or services in Spain, and in accordance with the appraisal standards applicable in the country concerned, to the extent that they are compatible with generally accepted appraisal practices.

2.2.2. Real estate collateral in transactions classified as performing exposures or performing exposures under special monitoring

80. Institutions must have full individual appraisals at the time of granting the transaction. For these purposes, previous appraisals less than six months old at the time of granting the transaction shall be considered valid. When the appraised value is significantly higher than the value stated in the deeds, the institution must analyse the reasons for this difference and its possible impact on the value of the collateral and on its relationship with the borrower.

81. For transactions classified as performing exposures secured by real estate collateral, the institution must verify the existence of signs of significant falls in their reference values with a minimum frequency of one year.

    The verification of the existence of signs of significant falls in the value of real estate collateral, which must be properly documented, may be carried out by the institution itself taking into account the relevant factors, such as changes in published indices of real estate market prices or the opinion of an independent appraiser.

    If that verification evidences a significant fall in the reference value, it must be updated by approved independent appraisal companies or services applying the procedures described in the following two paragraphs. If there is evidence of a significant rise in collateral value, the institution may take this rise into account in the estimation of allowances or provisions provided that the reference value is updated by approved independent appraisal companies or services applying said procedures.

82. Appraisals of real estate collateral in the form of finished buildings and parts thereof may be updated by means of individual full appraisals or automated appraisal methods in those cases in which the requirements of paragraph 78(b) for the use of such mass models are met.

83. Appraisals of real estate collateral other than finished buildings or parts thereof and those that, irrespective of the type of real estate collateral, relate to transactions with a gross carrying amount of over €3 million or 5% of the institution's own funds, as defined in Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013, must be updated by means of a full individual appraisal if there is evidence of significant falls in appraisal value or, in any event, with a frequency of at least three years.

84. In the case of performing exposures under special monitoring, the verification of the presence of signs of significant declines in collateral reference values and the updating of these valuations shall be carried out in accordance with paragraphs 81 to 83 for transactions classified as performing exposures.

Notwithstanding the above, the reference value must be updated at least annually in the following cases:

a) When the total aggregate of transactions backed by collateral in the form of completed buildings or parts thereof identified as being under special monitoring has a gross carrying amount of over €300 million or 10% of the institution's own funds in any of the risk segments in Section III "Allowances and provisions for credit risk attributable to insolvency". This update may be carried out by means of full individual appraisal or automated appraisal methods in accordance with paragraph 78.

b) For transactions secured by collateral in the form of completed buildings or parts thereof with a gross carrying amount of over €1 million and a ratio of the transaction amount to the last available appraised value of the collateral of over 70%. This update must be performed as a full individual appraisal. Exceptionally, the update may be performed using automated valuation methods provided that institutions justify the suitability of the use of such mass models;

c) Transactions secured by real estate collateral other than completed buildings or parts thereof and transactions whose gross carrying amount exceeds €3 million or 5% of the institution's own funds. The collateral reference valuations must be updated by means of full individual appraisals.

2.2.3. Real estate collateral in transactions classified as non-performing exposure

85. The collateral reference valuation must be updated at the time the transaction is classified as non-performing exposure and at least annually while it continues to be classified as such.

As regards the admissible appraisal procedures for determining this valuation:

a) If the transaction is collateralised by completed buildings or parts thereof and its gross amount is less than or equal to €300,000, automated appraisal updating methods may be used provided the collateral may validly be valued by these mass models and the suitability of their use is documented by the institutions. Notwithstanding this, updating must be performed by means of a full individual appraisal if the transaction has been classified for more than three years as non-performing. Once this age in the category has been reached, a combination of automated appraisal methods and full individual appraisals may be used, such that the frequency of the latter is at least every three years.

b) A full individual valuation of the real estate collateral is required in cases other than those included in (a) above.

In any event, the appraisal company that updates the reference value by means of any of the admissible procedures, and the professional responsible for the update, must be changed after two sequential valuations by the same appraisal company.

II. CLASSIFICATION OF TRANSACTIONS ON THE BASIS OF CREDIT RISK ATTRIBUTABLE TO INSOLVENCY

86. Debt instruments other than financial assets held for trading and off-balance-sheet exposures shall be classified in terms of credit risk attributable to insolvency into one of the categories defined in the following sections.

    Bearing in mind the general credit-risk management framework set out in Section I "General credit-risk-management framework", institutions shall establish criteria for the analysis and classification of their transactions in their financial statements according to their credit risk, applying the provisions of this annex, without prejudice to greater detail being established for internal control purposes and, in the case of foreign subsidiary institutions, particular characteristics of the market in which they operate being taken into account.

87. As stipulated in paragraphs 13 to 16 of rule 29, for the classification of transactions on the basis of their credit risk, institutions shall assess whether credit risk has increased significantly since initial recognition.

    However, for transactions identified as having low credit risk at the reference date, the institution may consider that credit risk has not increased significantly. Under the principle of proportionality, an institution's use of this simplified approach to evaluate the significant increase in credit risk must be in consonance with the size and degree of sophistication of the line of business or homogenous group of transactions in which it is used.

88. To identify a transaction as low credit risk, an institution may use its internal credit risk ratings or other practices that are consistent with the habitual concept of low credit risk and that consider the risks and the type of financial instruments that are being assessed.

    An external rating of "investment grade" may be considered to indicate that a financial instrument has low credit risk, but not as automatically identifying it as such, since the other information available must also be assessed.

    Credit risk may not be considered to be low in any of the following circumstances:

    a) If the only reason for considering it to be such is the existence of collateral.

    b) If the transaction has a low credit risk only in relative terms, when it is compared with the risk of default of other transactions of the institution or of the country in which it operates.

89. When an institution uses the alternative solutions in Section III "Allowances and provisions for credit risk attributable to insolvency" to estimate allowances and provisions, the transactions identified as low credit risk at the reference date shall be those transactions with negligible risk not classifiable as non-performing.

    For the purpose of this annex, transactions with negligible risk are:

    a) transactions with central banks;

    b) transactions with governments of European Union countries, including those deriving from reverse repurchase agreements on government debt securities;

    c) transactions with general government of countries classified in group 1 for the purpose of country risk;

    d) transactions in the name of deposit guarantee funds and resolution funds, provided their credit quality is such that they are equivalent to those of the European Union;

e) transactions in the name of credit institutions and specialised lending institutions from countries of the European Union and, in general, from countries classified in group 1 for the purpose of country risk;

f) transactions with Spanish reciprocal guarantee companies and government agencies or enterprises from other countries classified in group 1 for the purpose of country risk whose main activity is credit insurance or guarantees;

g) transactions with non-financial corporations considered to belong to the public sector as referred to in rule 66, paragraph 5;

h) advances on the following month's pensions or wages, provided the paying entity is a government agency and the wage or pension is direct credited to the institution; and

i) advances other than loans.

90. Purchased or originated credit-impaired financial assets shall remain identified as such until removed from the balance sheet. Among others, debt instruments purchased at a significant discount reflecting credit losses shall be identified as purchased or originated credit-impaired financial assets.

A) PERFORMING EXPOSURES

91. This includes all transactions that do not meet the requirements for them to be classified in other categories.

B) PERFORMING EXPOSURES UNDER SPECIAL MONITORING

1. General criteria for the classification of transactions as performing exposures under special monitoring

92. This category includes all transactions that, while not meeting the criteria for individual classification as non-performing or total write-off, present significant increases in credit risk since initial recognition.

Transactions that are performing under special monitoring shall be so categorised for their entire amount.

93. To assess whether credit risk has increased significantly, the credit risk analysis shall be considered to be multi-factor and holistic. Whether or not a specific indicator is relevant, and its importance compared to other indicators, will depend on the type of product and the risk characteristics of the transactions and of the borrower. An institution shall consider reasonable and supportable information that is available without undue effort or cost and that is relevant to the specific financial instrument being assessed.

However, some indicators may not be analysable on an individual transaction level. In such a case, the indicators should be analysed for homogeneous groups of portfolios.

Institutions must have policies in which the indicators to be analysed are described according to the characteristics of the transaction or group of transactions.

94. To determine whether credit risk has increased significantly since initial recognition, institutions shall analyse at least whether any of the following indicators are perceptible:

a) Adverse changes in financial position, such as a significant increase in debt levels or significant increases in debt-service ratios, defined as the ratio of debt to operating cash flows;

b) A significant drop in turnover or, in general, in recurring cash flows;

c) A significant narrowing of operating margins or in disposable recurring income.

d) Significant changes in the cost of credit risk, estimated in accordance with the provisions of paragraph 11(c), as a result of a change in credit risk since inception, including, but not limited to, changes in the credit risk premium that would apply if a particular transaction or similar transaction with the same terms and the same counterparty were newly originated or issued at the reporting date.

e) Other changes in the credit risk of a transaction that would cause the terms and conditions to be significantly different if the transaction was newly originated or issued at the reporting date (such as increased amounts of required collateral or guarantees, or higher recurring income coverage ofthe borrower).

f) An actual or expected internal credit rating downgrade for the transaction or borrower or decrease in behavioural scoring used to assess credit risk internally.

g) An actual or expected significant decrease in the main transaction's external credit rating, or in other external market indicators of credit risk for a particular transaction or similar transaction with the same expected life.

h) Adverse changes in the economy or in market conditions, such as significant increases in interest rates or unemployment rates, which may cause a significant change in the ability of borrowers to meet their payment obligations.

i) Changes in the conditions of access to markets, or a worsening in financing conditions, or reductions in financial support provided by third parties to the borrower, which would be significantly different if the transaction were newly originated or issued.

j) A slowdown in the business or adverse tendencies in the operations of the borrower that may cause a significant change in the borrower's ability to meet its payment obligations.

k) Significant increase in economic or market volatility that may have a negative impact on the borrower.

l) For transactions secured with collateral, a significant worsening of the ratio of their amount to the value of the collateral, due to unfavourable developments in the value of the collateral, or no change or an increase in the outstanding amount due to the payment terms established (such as extended principal payment grace periods, rising or flexible instalments, extended terms).

m) Significant increases in credit risk on other transactions of the same borrower, or significant changes in the expected payment behaviour of the borrower.

n) Significant increase in credit risk due to an increase in the difficulties of the group to which the borrower belongs, such as residents of a specific geographical area at sub-country level, or significant unfavourable developments in the performance of the borrower’s sector of economic activity.

o) Significant increase in credit risk due to greater difficulties at entities related to the borrower, including entities in the same group as the borrower and those with which there is a relationship of economic or financial dependence.

p) Adverse changes in the regulatory or technological environment in which the borrower operates.

q) Pending legal action that may significantly affect the borrower's financial position.

95. In the absence of evidence to the contrary, transactions with amounts more than thirty days past-due shall be classified as performing exposures under special monitoring. Institutions may only apply a longer period if they demonstrate that the credit risk on the affected transactions has not significantly increased.

96. Transactions granted at below cost in accordance with paragraph 11(c) shall be subject to separate monitoring to identify significant increases in credit risk since initial recognition, and, if so, they shall be reclassified from the performing exposures category to that of performing exposures under special monitoring.

97. Transactions included in a special debt sustainability agreement shall be classified to performing under special monitoring, where this is understood to be an agreement between the debtor and a majority group of creditors with the goal and reasonably foreseeable effect of ensuring the viability of the corporation, and which fulfils all the following conditions:

a) That it is based on a viability plan for the corporation that has been endorsed as reasonable by an independent expert.

b) That it has been preceded by a prudent exercise of identification of the corporation's sustainable debt. For these purposes, sustainable debt shall be considered to be the amount that, according to the plan, is recoverable under the new conditions agreed. To determine recoverability, sufficient margin will be considered to absorb possible deviations in the estimates made.

c) That it is preceded by an analysis of the quality of the management of the corporation. If the difficulties affecting the corporation cannot reasonably be attributed to factors outside its ordinary management, it shall be necessary that the agreement include changes in the corporation's managers.

d) That it is preceded by an analysis of the possible existence of deficient business lines and, if any are identified, that the corporation undergoes a process of business reorganisation in which only the profitable businesses are retained.

e) That it entails the acceptance by the creditors of a full reduction of the unsustainable portion of the debt, or its conversion into equity.

f) That there are no clauses referring to the reimbursement of the sustainable debt that prevent the debtor's ability to pay from being verified over time.

g) That there are no other factors potentially detracting from the conclusion that the restructured corporation, under the conditions stated above, with new shareholders, and, where applicable, new managers, will be able to meet its obligations under the new conditions agreed.

Transactions included in a special debt-sustainability agreement that complies with the conditions described above are considered, for classification purposes, as refinancing, refinanced or restructured transactions, in accordance with paragraphs 18(a) to 18(c).

98. This category shall also include exposures to borrowers declared subject to bankruptcy proceedings that should be reclassified out of non-performing exposures in accordance with the first subparagraph of paragraph 110.

99. The exposures classified in this category may be reclassified to performing if the reasons for classifying them as performing under special monitoring cease to apply. As a general rule, the criteria for reclassification from performing under special monitoring to performing when there is a favourable change in credit risk must be consistent with those for the reverse reclassification when there is an unfavourable change. Notwithstanding, this consistency requirement shall apply only where the criterion analysed represents a reversal of the significant increase in credit risk.

The exposures to borrowers declared subject to bankruptcy proceedings that are classified as performing under special monitoring shall remain in this category so long as the borrower's status in bankruptcy proceedings remains unchanged.

In the case of purchased or originated credit-impaired transactions, exposures classified in this category cannot be reclassified to performing.

The transactions classified in this category and identified as forborne exposures may be reclassified to performing if the specific criteria set forth below are met.

2. Forborne exposures other than those classified as non-performing

100. Refinancing, refinanced or restructured transactions (transactions with "forbearance measures" or "forborne exposures") for which classification as non-performing is not applicable on the date of granting forbearance measures, in accordance with paragraphs 115 and 116, or owing to their reclassification from the category of non-performing exposures, on fulfilling the provisions in paragraph 120 for their reclassification, shall continue to be identified as such during a probation period until all the following requirements are met:

a) That it has been concluded, after an exhaustive review of the borrower's financial situation, that it is not likely that the borrower will experience financial difficulties.

b) That a minimum of two years has elapsed since the later of the date of entry into the forbearance measure and the date of reclassification from the category of non-performing exposures.

c) That the borrower has paid the accrued instalments of principal and interest since the later of the date of entry into the forbearance measure and the date of reclassification from the category of non-performing. Additionally, the following shall be necessary:

i) that the borrower has settled, by means of regular payments, an amount equal to all the amounts (principal and interest) that were past due at the time of the forbearance measure or that were derecognised as a result of it; or

ii) that there are other objective criteria evidencing the borrower's ability to pay, where more appropriate in view of the transaction characteristics.

Therefore, the existence of contract terms that extend the repayment period, such as grace periods for the principal, will mean that the transaction remains identified as a forborne exposure until the criteria set out in this subparagraph are met.

d) That the borrower does not have any other transactions with amounts more

than thirty days past due at the end of the probation period.

Accordingly, if all the foregoing requirements are met, the transactions shall cease to be identified in the financial statements as forborne, without prejudice to the requirement that information on changes made in transactions must be duly held in the institution's databases, as provided in paragraph 24 in application of the principle of traceability, and reported to the Banco de España's central credit register.

While they remain identified as such, forborne exposures for which classification as non-performing is not applicable shall be included in the category of performing exposures under special monitoring, unless the institution justifies that it has not identified any significant increase in their credit risk since initial recognition, in which case they shall be classified as performing exposures.

101. The analysis of the borrower's financial situation, as described in paragraph 100(a) above, shall be based on objective evidence, such as:

a) The existence of a payments plan attuned to the borrower's recurring cash flow.

b) The addition of new effective guarantors or new effective collateral.

102. During the probation period described, a new forbearance measure granted to forborne exposures, or the existence of amounts more than thirty days past due, shall entail the reclassification of these exposures to the category of non-performing for reasons other than arrears, provided that previous to the start of the probation period they were classified as non-performing. Pursuant to the provisions of paragraph 120(b), when the reclassification described is on account of the existence of amounts more than thirty days past due, the minimum period of one year established in paragraph 120(b) shall start to run from the date of reclassification to the category of non-performing exposures.

C) NON-PERFORMING EXPOSURES

1. General criteria for the classification of transactions as non-performing exposures

103. This category includes debt instruments, whether past due or not, which are not classifiable as total write-off, but for which there are reasonable doubts about their full repayment (principal and interest) by the borrower under the contractual terms. Also included are off-balance-sheet exposures whose payment by the institution is likely but whose recovery is doubtful.

104. Non-performing transactions shall be so categorised for their entire amount. To determine whether transactions are to be classified as non-performing, they shall be analysed without taking into account any collateral/guarantees associated with them.

105. Exposures which are non-performing due to arrears in which simultaneously there are other reasons for their classification as non-performing shall be classified as non-performing due to arrears.

2. Non-performing exposures for reasons other than arrears

106. This category shall include, inter alia, exposures whose full recovery is doubtful and that do not have any amount more than ninety days past due.

107. A transaction shall be included in this category when an event, or the combined effect of various events, has a detrimental impact on the estimated future cash flows of the transaction. The following, inter alia, shall be considered to be indicators that such event or events have occurred:

    a) Negative equity or drop, as a result of losses, in the borrower's net worth of at least 50% over the past financial year;

    b) Continuous losses or significant contraction in turnover or, in general, in recurring cash flows;

    c) Generalised delay in payments or insufficient cash flow to settle debts;

    d) Seriously inadequate economic or financial structure, or borrower's inability to obtain additional finance;

    e) Existence of an internal or external credit rating that shows the borrower to be in default;

    f) Existence of past-due commitments of the borrower for significant amounts to government agencies or employees;

    This category shall also include all the transactions of any borrower with one or more balances classified as non-performing due to arrears that do not reach the percentage indicated in the second subparagraph of paragraph 112 if, after individual analysis, it is concluded that there are reasonable doubts regarding full repayment (principal and interest).

    When the transactions of entities related to the borrower, including both entities of the same group and those with which there is a relationship of economic or financial dependence, enter the non-performing exposures category, the institution must analyse the transactions of the borrower and classify them also as non-performing if there is reason to doubt that they will be repaid in full.

108. Also, owing to the observation of one or more of the following automatic classification factors, the following shall necessarily be included in this category:

    a) Transactions with claimed balances and those the institution has decided to seek to recover via legal proceedings, although secured, and transactions where the debtor has undertaken litigation, such that collection depends upon the outcome;

    b) Transactions in which foreclosure on collateral has commenced, including finance lease transactions and sale and leaseback transactions where the seller-lessee retains control of the underlying asset, in which the institution has decided to terminate the contract in order to repossess the asset;

    c) Transactions of borrowers that have been or will foreseeably be declared bankrupt without an application for liquidation;

    d) Guarantees given to parties declared subject to bankruptcy proceedings with notice that the liquidation phase has been or is to be declared, or whose solvency has undergone a manifest and irreversible deterioration, even if the beneficiary of the guarantee has not demanded payment;

    e) Forborne exposures which in the probation period are granted forbearance measures or have amounts more than thirty days past due, in accordance with paragraph 102.

109. Purchased or originated credit-impaired transactions shall be classified upon initial recognition as non-performing for reasons other than arrears, unless they are forborne exposures that should be classified as non-performing due to arrears in accordance with the third subparagraph of paragraph 113.

110. The exposures of borrowers declared subject to bankruptcy proceedings without an application for liquidation shall be reclassified to the category of performing exposures under special monitoring if the borrower has paid at least 25% of the credit from the institution that is affected by the bankruptcy proceedings (once the agreed debt reduction, if any, has been deducted), or if two years have elapsed since the order approving the creditors' agreement was registered with the Mercantile Register, provided that this agreement is being faithfully performed and the financial situation of the corporation dispels any doubts regarding full repayment of its debts, provided that interest rates significantly below market rates have not been agreed.

Exposures incurred subsequent to the approval of the creditors' agreement need not be classified as non-performing as long as the agreement is being complied with and there are no reasonable doubts about collection.

111. Unless they are identified as forborne, the transactions classified in this category may be reclassified as performing or performing under special monitoring if, as a result of individual analysis, reasonable doubts regarding full repayment by the borrower under the contractually agreed terms are dispelled and there are no amounts more than ninety days past due at the date of reclassification to the category of performing exposures or to that of performing under special monitoring. Notwithstanding the above, if the general requirements established in this subparagraph are met, any purchased or originated credit-impaired exposures shall be reclassified as performing under special monitoring.

The transactions classified in this category (including purchased or originated credit-impaired exposures) and identified as forborne may be reclassified to performing under special monitoring if the general criteria established in the preceding subparagraph and the specific criteria set out in paragraph 120 are met.

3. Non-performing exposures due to arrears

112. These include the amount of debt instruments, whosoever the borrower and whatever the guarantee or collateral, any part of whose principal, interest or contractually agreed expenses is more than ninety days past due, unless such instruments should be classified as being written off. This category will also include financial guarantees given if the guaranteed party has fallen into arrears in the guaranteed transaction.

Non-performing transactions as a result of borrower arrears shall include the amounts of all a borrower's transactions if the transactions with amounts more than ninety days past due exceed 20% of outstandings. For the sole purposes of determining the indicated percentage, the gross carrying amount of the transactions with amounts more than ninety days past due shall form the numerator, and the gross carrying amount of all the debt instruments granted to the borrower shall form the denominator. If the percentage calculated thus exceeds 20%, both the debt instruments and the off-balance-sheet exposures entailing credit risk will be transferred to non-performing due to arrears.

113. In overdrafts and other demand debit balances without an agreed maturity, the age of the past-due amounts shall be counted from the start date of the debit balance.

In transactions with regular repayment instalments, the first due date for the purposes of classification of transactions in this category shall be that of the oldest instalment for which, as at the balance sheet date, any principal, interest or contractually agreed expense remains past due.

In the case of transactions forborne for the purpose of avoiding them being classified as non-performing due to arrears or remaining in this category, the date for the calculation of their age, for the purpose of determining whether they should be classified as non-performing due to arrears, shall be that of the oldest past-due amount that has been refinanced or restructured and remains outstanding, irrespective of the possibility that, as a result of the forbearance measures, the forborne exposures do not have past-due amounts. For these purposes, any amounts past due on the date of forbearance measures shall be considered past due, and the maturity date shall be the date on which they would have matured.

For transactions classified as non-performing due to arrears because the borrower exceeds the percentage of transactions with amounts more than ninety days past due specified in the preceding paragraph, their age as non-performing exposures due to arrears shall start to run from the date of their classification as non-performing, and it may not exceed that of the non-performing transaction due to arrears with the same borrower whose amounts have the highest number of days past due.

Institutions shall calculate the age of past-due transaction amounts in terms of number of days and shall classify transactions bearing in mind that, to convert into days the periods given in months in this annex, all months are deemed to have thirty days.

114. Unless they are identified as forborne, the transactions classified in this category may be reclassified as performing or performing under special monitoring if, as a result of the collection of a portion of the past-due amounts, the reasons for classifying them as non-performing due to arrears in accordance with the foregoing paragraphs cease to exist, and no reasonable doubts subsist for other reasons as to total repayment by the borrower at the date of reclassification to the category of performing or performing under special monitoring. Notwithstanding the above, if the general requirements established in this subparagraph are met, any purchased or originated credit-impaired exposures shall be reclassified as performing under special monitoring.

The transactions classified in this category (including purchased or originated credit-impaired exposures) and identified as forborne may be reclassified to performing under special monitoring if the general criteria established in the preceding subparagraph and the specific criteria set out in paragraph 120 are met.

4. Forborne exposures classified as non-performing

115. On the date of the refinancing or restructuring transaction, the refinancing, refinanced or restructured transactions (transactions with "forbearance measures" or "forborne exposures") classified as performing exposures or exposures under special monitoring shall be analysed to determine whether they should be reclassified to non-performing. This analysis shall take into account the general criteria determining the classification of transactions as non-performing and the specific criteria set out below.

116. Unless there is evidence to the contrary, forborne exposures meeting any of the following criteria shall be reclassified as non-performing:

a) They are supported by inadequate payment plans. The situations in which it will be considered that there is no adequate payment plan shall include, *inter alia*, the repeated failure to comply with the payment plan, its modification to avoid breaches, or its resting on expectations that are not supported by macroeconomic forecasts;

b) They include contract terms that extend the time for the regular repayment instalments on the transaction. Among others, grace periods of more than two years for the repayment of the principal shall be considered to be clauses with these characteristics;

c) They include amounts derecognised as being irrecoverable or due to extinguishment of the institution’s claims that exceed the allowances and provisions resulting from applying the percentages established for the corresponding risk segment in the alternative solutions in Section III “Allowances and provisions for credit risk attributable to insolvency”, for performing exposures under special monitoring.

Transactions included in a special debt sustainability agreement that fulfils the conditions described in paragraph 97 shall not be reclassified as non-performing.

117. When a transaction that was previously classified as performing or performing under special monitoring is forborne, institutions must carry out the analysis described in paragraphs 115 and 116 to determine whether the transaction should be reclassified as non-performing.

a) When the result of this analysis is that the transaction should not be reclassified to non-performing, institutions shall not derecognise the existing financial asset in its entirety, since there is no substantial change in the amounts it expects to recover before and after granting forbearance measures; it shall only record, where applicable, the partial recognition of the amounts no longer claimable or written off. The existing financial asset shall be classified in accordance with paragraph 99.

b) When the result of this analysis is that the transaction should be reclassified to non-performing, institutions shall determine whether or not to derecognise the existing financial asset in its entirety, following the policies established for this purpose. If removal from the balance sheet is required, the new financial asset recognised shall be a purchased or originated credit-impaired asset. If removal from the balance sheet is not warranted, the institution shall classify the existing financial asset as non-performing and record, where appropriate, the partial derecognition of the amounts no longer claimable or written off.

118. Granting forbearance measures to a transaction previously classified as non-performing shall not give rise to its reclassification to the category of performing or performing under special monitoring. For the credit quality of a transaction to be considered to have improved, the borrower has to consistently demonstrate over a period of time its ability to meet payments under the new contractual terms and conditions, as provided in paragraph 120.

Institutions shall determine whether to derecognise the existing financial asset in its entirety, following the policies established for this purpose. If removal from the balance sheet is required, the new financial asset recognised shall be a purchased or originated credit-impaired asset; if the asset is not removed from the balance sheet, the institution shall continue classifying it as non-performing and record, where appropriate, the partial derecognition of the amounts no longer claimable or written off.

119. When the borrower exercises embedded modification clauses, the institution must analyse the reasons why the borrower exercised those clauses and determine whether the transaction should be classified as non-performing.

120. For this reclassification out of non-performing to take place, all the general criteria for reclassifying transactions out of this category and the specific criteria set out below have to be met:

a) That it has been concluded, after an exhaustive review of the borrower’s financial situation, that it is not likely that the borrower will experience financial difficulties;

b) That at least one year has elapsed since the later of the date of the forbearance measures and the date of reclassification to the category of non-

performing exposures;

c) That the borrower has paid the accrued principal and interest instalments, reducing the renegotiated principal, since the later of the date of entry into the forbearance measure and the date of reclassification of the transaction as a non-performing exposure. Consequently, it is not possible for the transaction to present past-due amounts. Additionally, the borrower must have settled, by means of regular payments, an amount equivalent to all the amounts (including principal and interest) past due on the date of the forbearance measure, or which had been derecognised as a result of it.

   Therefore, the existence of contract terms that extend the repayment period, such as grace periods for the principal, will mean that the transaction remains identified as non-performing until the criteria set out in this subparagraph are met;

d) That the borrower does not have any other transactions with amounts more than ninety days past due at the date the forborne exposure was reclassified to the category of performing exposures under special monitoring.

5 Accrual of interest on transactions classified as non-performing

121. In non-performing exposures other than purchased or originated credit-impaired transactions, the interest to be recognised in the income statement shall be the result of applying the effective interest rate to the amortised cost, i.e. adjusted for any credit loss allowance.

122. If the institution calculates the interest income by applying the effective interest rate to the gross carrying amount and uses an adjustment item to adjust the excess over the amount to be recognised in the income statement, in accordance with the preceding paragraph, this adjustment item must be recorded against interest expenses. In this way, the transaction interest recognised in net interest income in the income statement will be equal to the result of applying the effective interest rate to the amortised cost.

123. In any event, the amortised cost of the transaction after recognition of interest in accordance with paragraph 121 may not exceed the present value of the effective flows the institution expects to receive, discounted at the original effective interest rate. If the former is higher, the excess shall be recognised as an impairment loss in the income statement by increasing the accumulated amount of the previously recorded credit loss allowances.

124. To calculate interest income from purchased or originated credit-impaired exposures, the credit-adjusted effective interest rate shall be applied to the amortised cost of the financial asset.

125. Late payment interest is not taken into account in calculating the effective interest rate or the credit-adjusted effective interest rate, so no interest income shall be recognised for late payment interest unless cash payments have been received from the borrower.

E) TOTAL WRITE-OFF

126. This category shall include debt instruments, whether due or not, for which the institution, after analysing them individually, considers the possibility of recovery to be remote due to manifest and irreversible deterioration of the solvency of the

transaction or borrower. Classification in this category entails the recognition in profit or loss of a loss equal to the carrying amount of the transaction and its total derecognition from assets.

127. The remaining amount of transactions with amounts derecognised (partial derecognition) because the institution's claims are extinguished (definitive loss) by, for example, debt forgiveness and debt reductions, or because they are deemed irrecoverable without extinguishment of the institution's claims (partial write-off), shall be classified in full in the category corresponding to it on the basis of the credit risk, which is frequently, but not exclusively, non-performing exposures. For transactions with partial derecognitions which remain in balance sheet assets, institutions must keep separate records of the amounts of definitive losses due to extinguishment of claims and of the amounts written off or deemed irrecoverable.

128. The possibility of recovery shall in any event be deemed remote in the following cases:

a) Transactions classified as non-performing due to arrears that have been in this category for more than four years or that, before reaching this age, have been covered by a credit risk allowance or provision of 100% for over two years, unless there is effective collateral covering at least 10% of the gross carrying amount of the transaction;

b) Transactions of borrowers declared to be in bankruptcy proceedings for which there is evidence that the liquidation phase has been or is due to be declared, except those with effective collateral covering at least 10% of the gross carrying amount of the transaction.

Classification in this category for the above reasons does not mean that the institution should cease negotiations and legal action to recover the amount.

Notwithstanding the foregoing, to classify transactions in this category before the periods indicated in (a) above elapse, it will be necessary for the institution to demonstrate in an individualised analysis that they have total write-off status.

An up-to-date appraisal of the collateral will be required in order to be able to apply the caveat regarding effective collateral covering at least 10% of the amount of the exposure indicated in (a) and (b) above. Updating must be carried out at least as frequently as required by paragraphs 76 and 77 for the category in which the transaction is classified, which is normally non-performing exposures.

129. Debt instruments, as established in paragraph 6(f) of rule 64, shall continue to be classified and reported as total write-offs until the extinguishment of all the institution's rights (by becoming time-barred, through debt forgiveness, or for other reasons) or until they are recovered.

130. Transactions classified as total write-off shall give rise to the recognition of income in the income statement only if the institution receives cash payments or collateral is enforced or received in payment.

III. ALLOWANCES AND PROVISIONS FOR CREDIT RISK ATTRIBUTABLE TO INSOLVENCY

131. Allowances and provisions shall be set aside for transactions not measured at fair value through profit or loss, including off-balance-sheet exposures, in accordance with the criteria indicated in this section.

132. In compliance with the general credit-risk-management framework and, in particular, with the principles and requirements for the estimation of allowances and provisions set out in Section I(C) "Assessment, monitoring and control of credit risk", institutions shall establish criteria for the calculation of the amounts necessary for credit risk allowances and provisions. In any event, they shall apply the following criteria:

    a) They shall calculate the amount of the allowance and provision needed for credit risk attributable to insolvency and also for country risk. The total allowances and provisions existing at any time shall be the sum of the allowances and provisions for credit risk attributable to insolvency, plus the allowances and provisions for country risk, as established in Section IV "Credit risk attributable to country risk".

    b) The allowances to be recorded for transferred financial assets that remain on the balance sheet because they do not meet the requirements laid down in rule 23 for their derecognition shall be those applicable to such assets, with a limit equal to the amount assumed by the institution as its maximum loss.

    c) The allowances and provisions for purchased or originated credit-impaired financial assets shall be for the cumulative amount of changes in expected credit losses since initial recognition, regardless of whether they are classified as non-performing exposures or whether, after initial recognition, they have been reclassified out of this category.

133. The amounts of off-balance-sheet exposures expected to be disbursed shall be estimated as the product of the nominal amount of the transaction and a conversion factor. As an alternative solution, these estimates will be calculated using the conversion factors in the standardised approach for the calculation of capital requirements stipulated in Article 111 of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013.

134. In finance lease transactions and in sale and leaseback transactions where the seller-lessee retains control of the underlying asset, instalments due and receivable shall, until the time of physical recovery of possession or use of the leased assets, follow the impairment treatment specified for the other transactions in this paragraph.

135. The allowances and provisions for non-performing exposures or performing exposures under special monitoring which would, in principle, be collectively estimated pursuant to paragraph 58, may be individually estimated when secured by effective personal guarantees, taking into account said guarantees, in the event of:

    a) full or partial effective personal guarantees given by guarantors identified as having low credit risk, or

    b) full effective personal guarantees given by guarantors with transactions subject to individual estimation in accordance with paragraphs 47 and 48.

    In the case of collectively estimated allowances and provisions for non-performing, performing-under-special-monitoring and performing exposures secured by full effective personal guarantees, the guaranteed amount may be attributed to the guarantor for the purpose of collective estimation of the allowance or provision for the transaction.

    Therefore, in these cases, the effective personal guarantees received allow the direct borrower to be replaced by the guarantor for the purpose of calculating the allowance or provision.

136. The basis of calculation for the allowances and provisions will be the amount of the exposure exceeding the recoverable amount of the effective collateral.

In the case of purchased or originated credit-impaired exposures, at initial recognition the discount due to credit risk at the purchase or origination date does not form part of the amount of the exposure (gross carrying amount) or of the amount of the allowance or provision. After initial recognition, the institution shall increase the gross carrying amount of the transaction and recognise a revenue in the statement of profit or loss for the present value of the increase in cash flows it expects to receive, where applicable, as a result of the favourable change in the credit quality of the exposure allowing it to recover a portion of the discount due to credit risk at the purchase or origination date.

The classification of exposures by institutional sector shall be carried out on the basis of that of the counterpart as stipulated in rule 66.

A) ALLOWANCES AND PROVISIONS FOR NON-PERFORMING EXPOSURES

137. Institutions shall evaluate assets classified as non-performing in order to estimate credit risk loss allowances and provisions, bearing in mind the age of the amounts past-due, the effective personal guarantees and collateral received, and the economic situation of the borrower and guarantors.

The allowances and provisions for non-performing transactions shall be calculated by individual or collective estimation in accordance with paragraphs 46 to 59.

138. When estimating allowances and provisions due to credit risk, the recoverable amount of effective collateral shall be estimated by applying to its reference value, determined as specified in paragraphs 72 to 85, the discounts needed to capture adequately the uncertainty of the estimate and consequent possible falls in value up to the time of foreclosure and sale, plus foreclosure costs, maintenance costs and costs to sell.

To determine these discounts, institutions shall apply their own professional judgement prudently, bearing in mind that the value of real estate collateral often deteriorates when it is most needed to protect the institution against impairment of the transactions it secures. In particular, institutions shall take into account the following: their prior experience of sales of similar assets in terms of time scales, prices and volumes; trends in the value of these assets, to avoid valuations reflecting temporary increases in prices; and the time taken for their foreclosure and realisation.

The recoverable amount of collateral in the form of pledged financial instruments shall be determined from its reference value as indicated in paragraphs 72 to 77, by subtracting an adjustment so as to factor in the uncertainty due to the variability of the market price of the asset, and adding the costs of foreclosure, maintenance and sale.

The recoverable amount of collateral other than real estate and of collateral in the form of pledged financial instruments shall be calculated taking into account the stipulations for real estate collateral set out in the first and second subparagraphs of this paragraph.

Institutions that have not developed internal methods for collective estimates of allowances and provisions complying with the requirements laid down in paragraphs 60 and 63 shall determine the recoverable amount of the effective collateral by applying to its reference value the percentage discounts shown in the following table as an alternative solution. These percentage discounts were estimated by the Banco de España based on its experience and the information it holds on the Spanish banking sector.

<table>
<tr><td colspan="5"></td><td>Discount on reference value (%)</td></tr>
<tr><td rowspan="10">Type of collateral</td><td rowspan="5">Real estate collateral (first mortgage)</td><td rowspan="3">Completed buildings and parts thereof</td><td colspan="2">Housing</td><td>30</td></tr>
<tr><td colspan="2">Offices, commercial premises and multi-purpose industrial buildings</td><td>40</td></tr>
<tr><td colspan="2">Other</td><td>45</td></tr>
<tr><td colspan="3">Urban land and regulated building land</td><td>40</td></tr>
<tr><td colspan="3">Other real estate</td><td>45</td></tr>
<tr><td rowspan="3">Financial instruments pledged as security</td><td colspan="3">Money deposits</td><td>0</td></tr>
<tr><td colspan="3">Other financial instruments with active market</td><td>10</td></tr>
<tr><td colspan="3">Other financial instruments with no active market</td><td>20</td></tr>
<tr><td colspan="4">Other collateral (e.g. second and subsequent real estate mortgages and collateral given in the form of movable property)</td><td>50</td></tr>
</table>

139. Due to the effect of the direct borrower being replaced by the guarantor providing an effective personal guarantee, the allowances and provisions for non-performing exposures which would, in principle, be collectively estimated by means of alternative solutions may be estimated individually if they have full or partial effective personal guarantees given by guarantors with negligible risk listed in paragraphs 89(a) to 89(d) and in (a) to (c) below:

a) Agencies backed by the unlimited guarantee of general governments of European Union countries and, in general, of central governments of countries classified in group 1 for the purposes of country risk;

b) The CESCE (Spain's official export credit company) or other government enterprises or agencies of countries classified in group 1 for the purposes of country risk whose main activity is credit insurance or guarantees;

c) Credit institutions, specialised lending institutions, and Spanish reciprocal guarantee companies, provided that the personal guarantees can be claimed on first demand.

140. Based on its experience, on the information it holds on the Spanish banking sector and on forecasts of future conditions, the Banco de España has estimated percentages for allowances and provisions that may be used as alternative solutions for collective estimates of allowances and provisions for transactions considered non-performing due to arrears, according to the segment of credit risk to which the transaction belongs and the age of the past-due amounts.

The following percentages are applicable to the amount of the exposure not covered by the amount recoverable from the effective collateral that may exist.

In the particular case of purchased or originated credit-impaired exposures classified as non-performing, the allowances and provisions shall also be determined by applying the relevant percentage to the amount of the exposure (of which the discount due to credit risk at the purchase or origination date does not form part) not covered by effective collateral.

Allowances and provisions for the amount not covered by effective collateral (%)		Age of past-due amounts						
		Over 90 days, but not exceeding 6 months	Over 6 months, but not exceeding 9 months	Over 9 months, but not exceeding 1 year	Over 1 year, but not exceeding 15 months	Over 15 months, but not exceeding 18 months	Over 18 months, but not exceeding 21 months	Over 21 months
Credit risk segment	A. Non-financial corporations and sole proprietorships							
	A.1 Specialised financing							
	A.1.1 For the financing of real estate construction and property development, including land	*70*	*75*	*85*	*90*	*95*	*100*	*100*
	A.1.2 For financing the construction of civil works	*55*	*65*	*70*	*80*	*95*	*100*	*100*
	A.1.3 Other specialised financing (a)	*55*	*65*	*75*	*90*	*95*	*100*	*100*
	A.2 Purposes other than specialised financing							
	A.2.1 Large corporations (b)	*55*	*65*	*75*	*90*	*95*	*100*	*100*
	A.2.2 SMEs	*65*	*70*	*75*	*85*	*90*	*95*	*100*
	A.2.3 Sole proprietorships	*35*	*45*	*60*	*65*	*80*	*95*	*100*
	B. Households (excluding sole proprietorships)							
	B.1 Housing purchases							
	B.1.1 For the purchase of the principal residence (amount not exceeding 80% of the collateral value) (c)	*45*	*50*	*65*	*70*	*85*	*95*	*100*
	B.1.2 For the purchase of the principal residence (amount exceeding 80% of the collateral value) (c)	*45*	*50*	*65*	*70*	*85*	*95*	*100*
	B.1.3 For the purchase of housing other than the principal residence (d)	*45*	*50*	*65*	*70*	*85*	*95*	*100*
	B.2 Consumer credit	55	65	80	85	95	100	100
	B.2.1 Of which: credit card debt	*55*	*65*	*80*	*85*	*95*	*100*	*100*
	B.3 Other purposes	55	65	80	85	95	100	100

(a) Other specialised financing consists of project finance loans for purposes other than the financing of real estate construction or development, including land, and other than the financing of construction of civil engineering works.

(b) In general, for transactions with general government and financial corporations, the percentages for large corporations shall be applied. In the case of specialised financing transactions, the percentages corresponding to the purpose shall apply.

(c) The principal residence is a completed dwelling with a current certificate of occupancy issued by the relevant administrative authority, in which the borrower customarily lives and to which he/she has the strongest personal ties.

(d) Housing other than a principal residence comprises completed dwellings with a current certificate of occupancy issued by the relevant administrative authority, but not classified in the preceding paragraph. This housing includes second homes and dwellings purchased for lease to third parties.

141. Allowances and provisions for non-performing exposures for reasons other than arrears must be determined by individual estimation, in accordance with paragraphs 46 to 57. However, if the classification has been carried out solely on the basis of automatic factors, the allowances and provisions for transactions classified as non-performing for reasons other than arrears shall be determined by collective estimation, as required by paragraph 58(b). As an alternative solution for these collective estimations of allowances and provisions, the percentages for allowances and provisions for exposures deemed non-performing due to arrears in the same risk segment and shorter age shall apply.

Also, the provisioning percentages for non-performing exposures due to arrears in the same risk segment but of lower age shall be used by institutions as an alternative solution for the allowances and provisions for those exposures classified as non-performing due to arrears because the percentage of past-due exposures to the borrower exceeds that specified in paragraph 112 for exposures whose age in the category, calculated in accordance with the fourth subparagraph of paragraph 113, is equal to or less than ninety days.

B) ALLOWANCES AND PROVISIONS FOR PERFORMING EXPOSURES AND FOR PERFORMING EXPOSURES UNDER SPECIAL MONITORING

142. Allowances and provisions for performing exposures shall be estimated collectively and those for performing exposures under special monitoring shall be estimated individually or collectively, as provided in paragraphs 46 to 59.

In the particular case of purchased or originated credit-impaired exposures classified as performing under special monitoring, the allowances and provisions shall be for the cumulative amount of the changes in the expected credit losses over the life of the exposures since initial recognition.

143. The estimation of allowances and provisions for performing exposures and performing exposures under special monitoring shall be based on the recoverable amount of the effective collateral following application of the discounts estimated as established in paragraph 138 for allowances and provisions for non-performing exposures. Also, regard may also be had to the effect of effective personal guarantees, as provided in paragraph 135.

144. Based on its experience, on the information it holds on the Spanish banking sector and on forecasts of future conditions, the Banco de España has estimated the percentages institutions may use as an alternative solution for the calculation of allowances and provisions for transactions classified as performing exposures and performing exposures under special monitoring.

The percentages in the table below are applicable to the amount of the exposure not covered by the amount recoverable from the effective collateral.

In this alternative solution, a provisioning percentage of 0% shall be applied to the exposures identified as being of negligible risk in accordance with paragraph 89. This percentage may be applied to the total transactions with personal guarantees of guarantors of negligible risk listed in paragraph 139. If there are partial personal guarantees of guarantors of negligible risk, listed in paragraph 139, this percentage may be applied to the amount of the exposure covered by these personal guarantees.

Institutions which have developed internal methods to collectively estimate the allowances and provisions for all or, as applicable according to paragraph 66, a portion of their exposures must reserve the application of the provisioning percentage of 0% for exceptional cases in which its use is duly justified, in application of the principle of proportionality as provided in the second subparagraph of paragraph 87.

In the particular case of purchased or originated credit-impaired exposures classified as performing under special monitoring, the allowances and provisions shall be determined by applying the percentage for performing exposures under special monitoring to the amount of the exposure (of which the discount due to credit risk at the purchase or origination date does not form part) not covered by effective collateral.

The provisioning percentage for performing exposures shall be applied to trade receivables without a significant financing component, trade receivables maturing in less than one year initially measured at transaction price and goods-delivery or services-provision contract assets without a significant financing component, provided there is no doubt as to the borrower's or customer's ability to make payment of the full amount of the transaction or contract.

In accordance with paragraph 11 of rule 29, the provisioning percentage applied to goods-delivery or services-provision contract assets with a significant financing component shall be as follows: that for performing exposures when the cumulative impairment is calculated as the twelve-month expected credit losses; that for performing exposures under special monitoring when the cumulative impairment is calculated as the expected credit losses over the life of the transaction; and that for non-performing exposures when there is doubt as to the customer's ability to deliver the full amount of the consideration.

Allowances and provisions for the amount not covered by effective collateral (%)		Credit risk classification	
		Performing exposures	Performing exposures under special monitoring
Credit risk segment	A. Non-financial corporations and sole proprietorships		
	A.1 Specialised financing		
	A.1.1 For the financing of real estate construction and property development, including land	*1.9*	*30.0*
	A.1.2 For financing the construction of civil works	*2.0*	*18.8*
	A.1.3 Other specialised financing (a)	*0.6*	*9.6*
	A.2 Purposes other than specialised financing		
	A.2.1 Large corporations (b)	*0.6*	*9.6*
	A.2.2 SMEs	*1.1*	*17.8*
	A.2.3 Sole proprietorships	*1.4*	*13.9*
	B. Households (excluding sole proprietorships)		
	B.1 Housing purchases		
	B.1.1 For the purchase of the principal residence (amount not exceeding 80% of the collateral value) (c)	*0.7*	*18.0*
	B.1.2 For the purchase of the principal residence (amount exceeding 80% of the collateral value) (c)	*0.7*	*18.0*
	B.1.3 For the purchase of housing other than the principal residence (d)	*0.7*	*18.0*
	B.2 Consumer credit	1.8	20.2
	B.2.1 Of which: credit card debt	*1.0*	*11.6*
	B.3 Other purposes	1.8	20.2

(a) Other specialised financing consists of project finance loans for purposes other than the financing of real estate construction or development, including land, and other than the financing of construction of civil engineering works.

(b) In general, for transactions with general government and financial corporations other than those identified as being of negligible risk, the percentages for large corporations shall be applied. In the case of specialised financing transactions, the percentages corresponding to the purpose shall apply.

(c) The principal residence is a completed dwelling with a current certificate of occupancy issued by the relevant administrative authority, in which the borrower customarily lives and to which he/she has the strongest personal ties.

(d) Housing other than a principal residence comprises completed dwellings with a current certificate of occupancy issued by the relevant administrative authority, but not classified in the preceding paragraph. This housing includes second homes and dwellings purchased for lease to third parties.

IV. CREDIT RISK ATTRIBUTABLE TO COUNTRY RISK

A) SCOPE

145. Country risk is understood as the risk associated with the transactions of borrowers resident in a specific country due to circumstances other than normal commercial risk and other than insolvency risk. Country risk comprises sovereign risk, transfer risk and other risks arising from international financial activity, as defined below:

    a) Sovereign risk is that of the creditors of states or of state-guaranteed institutions insofar as legal action may be ineffective against the borrower or the ultimate obligor for reasons of sovereignty.

    b) Transfer risk is that of the foreign creditors of the residents of a country that experiences a general inability to meet its debts owing to a lack of the foreign currency or currencies in which they are denominated.

    c) Other risks arising from international financial activity are those resulting from one of the following situations: civil or international war, revolution, or any similar or catastrophic event; particularly serious political or economic events, such as balance of payments crises or significant exchange rate fluctuations giving rise to widespread insolvency; expropriation, nationalisation or seizure mandated by foreign authorities, and express or tacit measures adopted by a foreign government or by the Spanish authorities that result in a breach of contract.

146. The following shall be analysed to determine their allowances and provisions for credit risk attributable to country risk.

    a) The debt instruments of non-resident borrowers not designated at fair value through profit or loss.

    b) Off-balance-sheet exposures to non-resident borrowers.

    For this purpose, non-resident borrowers are defined as borrowers whose domicile is located in a country other than Spain.

147. The following transactions may be excluded from country-risk allowances and provisions, in view of where they are recorded.

    a) Exposures recorded at subsidiaries, joint ventures and associates located in the country of residence of the borrower, regardless of the currency in which they are denominated and of the institutional sector to which the borrower belongs.

    b) Exposures recorded at the parent, branches, subsidiaries, joint ventures and associates located in countries other than the country of residence of the borrower, provided they are denominated in the local currency of the borrower and are not to government.

    c) Exposures recorded at branches located in the country of residence of the borrower, provided they are denominated in the local currency of the borrower and regardless of the institutional sector to which it belongs.

148. The following transactions may be excluded from country-risk allowances and provisions, in view of their characteristics:

a) Monetary or non-monetary commercial credits, and the financial credits arising therefrom, with a maturity not exceeding one year from the date of utilisation of the initial credit.

b) Pre-financing credit with terms of six months or less for specific export contracts, provided that this credit matures on the date of export. For this purpose, pre-financing credit is defined as that granted for a commercial transaction, but prior to it, so as to, for example, finance the purchase or production of the good forming the subject-matter of the transaction.

c) Interbank transactions with the branches established in European Economic Area Member States of foreign credit institutions located in other countries.

d) Private-sector transactions of countries belonging to the monetary zone of a foreign currency issued by a country classified in group 1, as defined in paragraph 151(a), provided that the monetary authority of the group 1 country guarantees the convertibility of its currency.

e) Financial assets of whatsoever class acquired for placement with third parties as part of a portfolio separately managed for this purpose, that have been held by the institution for less than six months.

f) Advances other than loans.

B) CLASSIFICATION OF TRANSACTIONS ON THE BASIS OF CREDIT RISK ATTRIBUTABLE TO COUNTRY RISK

149. Transactions subject to country-risk provisioning shall be allocated to the borrower's country of residence as at the reference date.

Exposures to an institution's foreign branches shall be classified on the basis of the situation of the country of residence of the central headquarters of these branches.

150. Debt instruments and off-balance-sheet exposures shall be classified for country-risk purposes in groups 1 to 6 indicated in paragraph 151. To this end, institutions shall make an overall assessment of the exposure to the countries to which they allocate transactions on the basis of their economic performance, political situation, regulatory and institutional framework, and payment capacity and record. For these purposes, the following indicators regarding the country shall be taken into account:

a) Payment record, with particular attention, where appropriate, to compliance with renegotiation agreements and payments due to international financial institutions.

b) The external financial position, particularly taking into account the indicators of total external debt, short-term external debt, the ratio of debt service to GDP and to exports, and external reserves.

c) The situation of the public finances, particularly the budget balance, the public debt, the attendant interest burden and, in general, the sustainability of the government debt.

d) Other matters relating to the economic and financial situation, based essentially on:

i) Indicators relating to monetary and inflation aggregates.

ii) Indicators relating to the financial system and, in particular, its solvency and the contingent risks it entails for the country.

iii) Indicators relating to economic growth (level of income, savings or investment rates, GDP growth, etc.) and to vulnerability (strong economic dependence on a sector or trading partner, currency mismatches, etc.).

e) Market indicators; taking into account, in particular, secondary-market debt prices and the conditions of market access.

f) Credit ratings by reputable credit rating agencies and the country-risk classifications within the framework of the OECD arrangement on export credits.

151. Transactions shall be classified in the following groups:

a) Group 1. This group shall include transactions with ultimate obligors resident in:

i) European Economic Area countries.

ii) Switzerland, the United States, Canada, Japan, Australia, New Zealand and the United Kingdom, except if their country risk worsens significantly, in which case they would be classified accordingly.

b) Group 2. This group shall include transactions with ultimate obligors resident in low-risk countries, in terms of their high payment ability and commitment.

c) Group 3. This group shall include, at least, transactions with ultimate obligors resident in countries whose ability and willingness to pay may be affected by the economic and institutional situation of the country or by a foreseeable significant macroeconomic deterioration. This deterioration may manifest itself as: high budget deficits and growing government debt, significant and persistent current-account deficits, a high proportion of short-term debt in relation to total foreign debt or net external reserves, sharp depreciations of the currency or substantial changes in the exchange-rate regime (e.g. the abandonment or imminent risk of abandonment of monetary arrangements such as currency boards or managed float systems), higher political risk or eroded institutional strength that may affect commitment to pay, a slump in share prices, or external-debt and debt-service ratios far higher than those of the countries in groups 1 and 2 or those of neighbouring countries.

d) Group 4. This group shall at least include transactions with ultimate obligors resident in countries whose ability and willingness to pay may be highly affected by a weak level of economic and institutional development or by a foreseeable significant macroeconomic deterioration. Typically, transactions in countries with indicators showing a deeper weakness than that of countries classified in group 3 shall be included in this group.

e) Group 5. This group shall include transactions with ultimate obligors resident in countries that have had long-standing difficulties in servicing their debt, or whose payment ability or commitment causes the possibility of fully recovering such debt to be considered as doubtful.

f) Group 6. This category shall include transactions the recovery of which is considered a remote possibility due to circumstances attributable to the country's willingness to pay and its prolonged international isolation. In particular, this group shall include transactions with ultimate obligors resident in countries that have repudiated their debt or have not made repayments of principal and payments of interest for various consecutive years despite requests to do so.

Transactions with multilateral agencies whose member countries are classified in

groups 3, 4 and 5 shall be classified in the group to which the largest number of the participating countries belongs, with the exception of multilateral development banks that have a weight of 20% or less for the purposes of calculating own funds pursuant to Regulation (EU) 575/2013, of the Parliament and of the Council of 26 June 2013, which shall be classified in group 1. Where there are objective reasons for a better classification, a reasoned consultation shall be submitted to the Banco de España proposing the classification deemed appropriate.

152. To classify transactions by credit risk, institutions shall consider in their analysis both the credit risk attributable to insolvency and the country risk, if any, to which they are exposed. The transactions shall be classified in the category of the insolvency risk, unless a less favourable country risk applies.

In any event, debt instruments and off-balance-sheet exposures classified in groups 5 and 6 shall be classified in the following categories:

a) Non-performing: transactions classified in group 5 and off-balance-sheet exposures classified in group 6, unless the transactions should be classified as total write-off.

b) Total write-off: debt instruments classified in group 6 that will be removed from assets as provided in paragraphs 126 to 130.

A worsening in the country-risk classification from group 1 or 2 to group 3 or 4, or a worsening from group 3 to group 4 shall entail the classification of the transactions as performing under special monitoring, unless they should be assigned to a less favourable category for insolvency risk reasons. In any event, institutions must consider in their analysis other factors by means of which the transactions or groups of transactions that should be classified as performing under special monitoring can be identified before the aforementioned worsening in country-risk classification.

The exposures which, in accordance with paragraphs 147 and 148, have been excluded from country-risk allowances and provisions shall be classified in the category applicable to them on the basis of insolvency risk.

C) ALLOWANCES AND PROVISIONS FOR CREDIT RISK ATTRIBUTABLE TO COUNTRY RISK

153. Allowances and provisions for credit risk losses shall be estimated taking into account both insolvency risk and country risk. Country-risk allowances and provisions shall be estimated individually or collectively, as appropriate under the policies developed in accordance with paragraphs 46 to 59.

154. The methodologies for individual estimation of allowances and provisions for credit risk have to include country risk and comply with the general principles set out in paragraphs 32 to 45 and the specific requirements for these estimations set out in paragraphs 46 to 57.

155. Institutions using internal methodologies for collectively estimating credit risk allowances and provisions as provided in the general principles set out in paragraphs 32 to 45 and the specific requirements in paragraphs 60 to 67 must include in their methodologies the effect of the additional allowance/provision arising from country risk.

However, the cases specified in paragraphs 66(a) and 66(b) in which institutions with internal methodologies may use alternative solutions shall be taken into account.

In this respect, when their internal methodologies do not incorporate the effect of the additional country-risk allowance/provision, institutions must estimate said allowance/provision using alternative solutions. In this case, the total allowance/provision shall be the sum of the allowance/provision for credit risk attributable to insolvency, estimated by said internal methodologies, and the country-risk allowance/provision obtained by applying alternative solutions.

156. Institutions which have not developed internal methodologies meeting the requirements of paragraphs 60 to 67 shall use the alternative solutions provided by the Banco de España in this paragraph to make their collective estimations of country-risk allowances and provisions.

When alternative solutions are used, the estimation of allowances and provisions shall take place in two stages: first, the allowance/provision for credit risk attributable to insolvency shall be estimated, and then the additional allowance/provision for country risk shall be determined.

Accordingly, the amount of exposures not covered by the recoverable amount of effective collateral or by the amount of allowances/provisions for credit risk attributable to insolvency must be covered by the percentages set out in the following table, based on the country-risk group of the exposure and its accounting classification for credit risk:

Allowance/provision for the amount not covered by effective collateral or by allowances/provisions for credit risk attributable to insolvency (%)		Credit risk classification		
		Performing exposures	Performing exposures under special monitoring	Non-performing exposures
Country-risk group	Group 1	0	0	0
	Group 2	0	0	0
	Group 3	1.5	5	5
	Group 4	6	12	12
	Group 5			45
	Group 6			100

157. In both individual and collective estimations, the collateral/guarantees shall be effective when they meet the general criteria set out in paragraphs 69 to 85.

In collective estimations, the recoverable amount of collateral shall be calculated by applying to its reference value the discounts estimated using the institution's internal methodologies or the alternative solutions of paragraph 138, as appropriate.

158. The transactions covered in full by pledged financial instruments may be classified in the group of the country in which the instrument issuer is established. For this purpose, the transaction shall be deemed to be covered in full if the amount of the exposure is equal to or less than the recoverable amount of collateral, i.e. after deducting the adjustments to its reference value.

159. Additionally to the stipulations of the preceding paragraph, exposures secured by special bank accounts meeting the requirements of this paragraph may be classified in the group of the country of establishment of the credit institution at which said account is held.

For a bank account provided as collateral for a transaction to allow the reclassification of the collateralised transaction, the following requirements must be met:

a) The terms and conditions governing the funding and use of these accounts must clearly specify that the repayment of the collateralised transaction has absolute priority.

b) Institutions must verify the effectiveness of the legal framework regulating these accounts.

c) There must be an irrevocable instruction from the borrower for the cash flows assigned for repayment of the transaction to be deposited in this special bank account.

f) At all times the future revenue earmarked for repayment must exceed by more than 1.5 times the scheduled payments.

g) The future revenue according to the business plan must be in line with the scheduled payments.

h) The account balance must at all times be sufficient to meet the amount of the next maturities to fall due, such that cash withdrawals from the account do not endanger the next payment.

160. When there is effective collateral, institutions shall take into account the following specific requirements for individual or collective estimation of country-risk allowances and provisions in business in Spain with non-resident borrowers.

a) The recoverable amount of collateral in the form of pledged financial instruments shall reduce the amount of the exposure for the purpose of country risk, provided that the issuer resides in a group 1 to 4 country.

The recoverable amount of collateral in the form of pledged financial instruments issued by residents of group 3 or 4 countries shall be estimated by applying to its reference value an additional discount equivalent to the percentage of country-risk coverage corresponding to the country-risk group of the pledged financial instrument and to the credit risk classification of the collateralised transaction.

b) The recoverable amount of collateral other than pledged financial instruments shall reduce the amount of the exposure for the purpose of country risk, provided that the collateral is located and is realisable in Spain or another group 1 country.

161. Transactions with the effective full personal guarantee of residents of a more favourably classified country may be classified in the group in which the guarantor would be classified. Accordingly, the transactions guaranteed in full by the CESCE or other residents in Spain may be classified in group 1.

162. When there are effective personal guarantees, for collective estimation of the country-risk allowances and provisions in business in Spain with non-resident borrowers:

a) When institutions use their internal methodologies, they may apply the parameters of the guarantor to transactions with the full personal guarantee of borrowers with less country-risk coverage.

b) When institutions use their internal methodologies, they may apply the parameters of the guarantor to amounts guaranteed by the CESCE and other guarantors with low credit risk referred to in paragraph 88.

c) When institutions use alternative solutions, they may apply a provisioning percentage of 0% to the amounts guaranteed by the CESCE and other guarantors with negligible risk referred to in paragraph 139.

163. The country-risk allowances and provisions for transactions with subsidiaries, joint ventures and associates recorded in the individual statements of the institutions that grant said transactions shall be maintained in the consolidated statements, unless said transactions are financing assets for which country-risk allowances and provisions already exist.

V. REAL ESTATE ASSETS FORECLOSED OR RECEIVED IN PAYMENT OF DEBT

164. The value at which real estate assets foreclosed or received in payment of debt must be initially recognised, regardless of the legal form used, shall be the lower of:

a) The carrying amount of the financial assets applied, calculated as indicated in the following paragraph, and

b) The fair value at the date of foreclosure or receipt of the asset less the estimated costs to sell, as described in paragraphs 166 to 172.

The lesser of these two amounts shall be deemed to be the initial cost of the asset foreclosed or received in payment of debt.

165. For the purposes of calculating the carrying amount of the financial assets applied, at the date of initial recognition of the asset foreclosed or received in payment of debt the allowances or provisions for these financial assets shall be estimated on the basis of their accounting classification before the delivery, treating the asset foreclosed or received in payment of debt as collateral. This carrying amount shall be compared with the previous carrying amount and the difference shall be recognised as an addition to or release of allowances and provisions, as applicable.

To estimate the allowances and provisions for the financial assets applied, the recoverable amount of the collateral shall be taken as the fair value less the estimated costs to sell of the asset foreclosed or received in payment of debt, as indicated in paragraph 166, provided that the institution's experience of sales bears out its ability to realise said asset at its fair value. Otherwise, if the experience of sales does not corroborate this ability, the recoverable amount shall be estimated as specified in paragraph 138 for real estate collateral.

For the purposes of the preceding subparagraph, the institution's experience of sales shall be considered to bear out its ability to realise the asset at its fair value if the institution has a high rotation of its stock of similar assets, such that the average period they remain on its balance sheet is acceptable within the framework of the related asset disposal plans.

By way of a reference for assets located in Spain, an institution shall be considered to have a high rotation of its stock if it sells yearly the following minimum percentages of its annual average stock of similar real estate assets: 25% in the case of completed dwellings; 20% in the case of completed offices, commercial premises or multipurpose buildings; and 15% in the case of other real estate assets, including urban land and regulated building land.

166. The estimation of the fair value of real estate assets foreclosed or received in payment of debt at the time of foreclosure or receipt must be made taking as reference value the market value determined through a full individual appraisal, in accordance with the requirements set out in paragraphs 78 and 79.

After the time of foreclosure or receipt, the reference value, used as the starting point for the estimation of fair value, shall be updated at least annually. This reference value shall also be the market value determined in full individual appraisals. Nevertheless, if the fair value of the real estate is less than or equal to €300,000, automated valuation methods may be used provided the real estate may validly be valued by these mass models and the institutions substantiate the suitability of their use. In any event, once this real estate has been on the balance sheet for three years, its valuation shall be updated by means of the full individual appraisal. After that date, a combination of automated appraisal methods and full individual appraisals may be used, such that the frequency of the latter is at least every three years.

In the process of estimating the fair value of the asset foreclosed or received in payment of debt, the institution shall assess whether it is necessary to apply to the reference value a discount derived from the specific conditions of the assets, such as their location or state of conservation, or the markets for these assets, such as declines in the volume or level of activity. In this assessment, the institution shall take into account its experience of sales and the average time that similar assets remain on the balance sheet.

In any event, the adjustment described above will be necessary if the full individual appraisal includes warnings or conditioning factors, particularly those derived from the lack of access to the interior of the property the effect of which has not been included in the reference value.

In any event, the appraisal company that updates the reference value by means of any of the admissible procedures, and the professional responsible for the update, must be changed after two sequential valuations by the same appraisal company.

167. The estimated costs to sell shall be deducted from the fair value of the asset foreclosed or received in payment of debt. In accordance with paragraph 8 of rule 12, costs to sell include all essential incremental costs directly attributable to a sale which the institution would incur due to the occurrence of that sale.

168. All legal expenses shall be recognised immediately in the statement of profit or loss for the period in which they accrue. Settled registration and tax charges may be included in the value at initial recognition provided that the resulting amount does not exceed the fair value less estimated costs to sell.

All costs incurred between the date of foreclosure or receipt in payment and the sale date due to asset maintenance and protection, such as owners' association, tax, insurance or security service expenses, shall be recognised in the statement of profit or loss covering the period in which they accrue. Advertising costs do not form part of costs to sell and thus are also recognised in the statement of profit or loss covering the period in which they accrue.

169. The internal audit department shall regularly review the application of the policies and procedures for valuing the assets foreclosed or received in payment of debt as established in paragraph 75.

170. Institutions must develop their own methods to estimate the discounts applicable to the reference value and the costs to sell of the assets foreclosed or received in payment of debt, taking into account their experience of sales, in terms of time scales, prices and volumes, and the time they remain on the institution's balance sheet.

These methods must be developed within the framework of the internal methods for collective estimation of risk allowances and provisions should the institution have opted to develop the latter.

Institutions must develop their own methodologies for all the types of assets in which they have adequate sales experience. Institutions may only use the references given in paragraph 172 for those types of real estate in which they do not have adequate sales experience, and must use their own methodologies in all other cases.

By way of a reference for assets located in Spain, an institution is considered to have adequate sales experience for a type of real estate if sells yearly a minimum of 10% of its annual average stock and 75 units of that type.

171. Institutions must comply with the following principles and requirements in the development and use of their own methods for estimating the discounts applicable to the reference value and the costs to sell of assets foreclosed or received in payment of debt:

    a) Have databases of assets foreclosed or received in payment of debt which include all the information necessary for their proper traceability, including their links with the financial assets applied and their past record from the foreclosure date to the present. For these purposes, the information shall include the foreclosure date, foreclosure costs, carrying amount of the financial assets applied, reference value at the foreclosure date, any adjustments applied to obtain the fair value at that date and the estimated costs to sell. Also, for each of the years in which the asset is recognised on the balance sheet, the databases shall include at least the maintenance costs, the updated reference value, the adjustments made to obtain the fair value, the estimated costs to sell and the period the asset remains on the balance sheet. Finally, in the case of assets derecognised from the balance sheet, the information shall include at least the sale date, the sale price and the costs to sell.

    b) Carry out periodic backtesting to compare their credit loss estimates and the observed actual losses, as well as periodic benchmarking exercises on these estimates. Institutions must inform the Banco de España of the results of these tests and exercises and of any changes made in their methods, as described in paragraph 43.

    c) Submit individual confidential statement FI 131-5.4 "Comparison of fair value less costs to sell of real estate foreclosed or received in payment of debt", describing the differences between the results obtained with their own methods and those that would be obtained by applying the benchmarks in this section for each type of asset foreclosed or received in payment of debt. The various types of assets foreclosed or received in payment of debt used by the institution in its own methodologies may have a higher level of detail than that used in the references of this section; in any event, the institution must be able to reconcile the types of assets used in its own methodologies with those used in the references.

    d) Change their methods if the results of the periodic backtesting show recurrent significant differences or there are significant non-compliances with the principles and requirements referred to herein. In such cases, the institution must draw up a plan setting out the measures for correcting the differences or non-compliances and its implementation timetable. The internal audit department shall be responsible for monitoring this plan, as established in paragraph 67.

    e) Notify the Banco de España of the start of the implementation period of the plan for changing their methods described in (d) above or the impossibility of completing development of their own methods to meet the requirements of this paragraph because they do not have adequate sales experience for any of the asset types. While they are implementing the aforesaid plan or

completing the development of their methods, institutions shall use the discounts provided in the following paragraph for the types of assets in question.

172. The percentage discounts listed in the following table shall be applied to benchmarks by institutions in the benchmarking exercises and in the preparation of individual confidential statement FI 131-5.4 “Comparison of fair value less costs to sell of real estate foreclosed or received in payment of debt”. These percentage discounts were estimated by the Banco de España based on its experience and the information it has of the Spanish banking sector. The discounts in the following table include both the adjustments needed to obtain the fair value from the reference value and the costs to sell (both together, for practical reasons).

<table>
<tr><th colspan="3"></th><th>Discount on reference value (%)</th></tr>
<tr><td rowspan="5">Type of real estate asset foreclosed or received in payment of debt</td><td rowspan="3">Completed buildings and parts thereof</td><td>Housing</td><td>25</td></tr>
<tr><td>Offices, commercial premises and multi-purpose industrial buildings</td><td>30</td></tr>
<tr><td>Other</td><td>32</td></tr>
<tr><td colspan="2">Urban land and regulated building land</td><td>35</td></tr>
<tr><td colspan="2">Other real estate</td><td>40</td></tr>
</table>

Costs to sell vary depending on the type of real estate, although, as a reference, these costs should not be less than 5%.

173. In order to determine the amount of impairment at a time after the date of foreclosure or receipt in payment of debt, the institution shall calculate the difference between the carrying amount of the asset foreclosed or received in payment of debt and its fair value less costs to sell.

When the fair value less costs to sell exceeds the carrying amount, the difference may be recognised in the statement of profit or loss as income from reversal of impairment, up to the limit of the amount of the cumulative impairment since the initial recognition of the asset foreclosed or received in payment of debt.

The fair value shall be estimated as provided in paragraph 166 considering, additionally, that the time an asset foreclosed or received in payment of debt remains on the balance sheet in excess of the period initially envisaged in its disposal plan is an unequivocal sign that the institution is not able to realise this asset at its previously estimated fair value. Therefore, if the asset has exceeded the holding period of real estate with active sale policies, the institution must revise the procedure for determining the fair value of this asset by incorporating a discount based on the time it has remained on the balance sheet, additional to those described in paragraph 170, such that income from reversal of impairment is not recognised for this asset.

By way of a reference for assets located in Spain, assets foreclosed or received in payment of debt are considered to have exceeded the average holding period of real estate with active sale policies when they have remained on the balance sheet for more than three years.

174. Assets foreclosed or received in payment of debt as defined in paragraph 22 of rule 34 shall remain identified as such until removed from the individual and consolidated balance sheets, irrespective of the item in which they are classified in the balance sheet in accordance with rules 26, 27 and 34.

As provided in paragraph 25 of rule 34, generally real estate assets foreclosed or received in payment of debt are classified as non-current assets held for sale. If an institution demonstrates that a real estate asset foreclosed or received in payment of debt is held for a different use, its cost at initial recognition shall be determined also in accordance with paragraph 164(a).

175. In accordance with rule 26, real estate assets foreclosed or received in payment of debt shall be reclassified and valued as investment property, among others, if the real estate assets' intended use is leasing. In the process of estimating the related impairment losses, to determine the appropriate methodology for estimating the fair value of this investment property, the institution shall assess whether the lease transaction meets the following two requirements:

a) The lessee's ability to pay is considered sufficient to meet the contractual payments, and

b) The lease price evidences a market value of the asset above its carrying amount.

If the above two requirements are met, the fair value shall be estimated using methodologies compliant with paragraphs 36 and 38 of rule 14.

If either of the above two requirements is not met, fair value shall be estimated using the methodologies described in paragraphs 166 to 172.

176. The real estate assets obtained by foreclosure or receipt in payment of debt and which, at the reporting date, are classified as inventories at a real estate development subsidiary, in accordance with paragraph 3 of rule 27, shall be valued at the lower of cost and net realisable value.

a) For completed buildings and parts thereof, the net realisable value shall be their selling price less the sum of the costs to sell and a reasonable proportion of the gain remunerating the effort to make the sale, determined from gains on similar real estate assets. The selling price shall be estimated using the methodologies described in paragraphs 36 and 38 of rule 14 for estimating the fair value of real estate assets.

b) For real estate assets under construction, the net realisable value shall be the selling price of the finished real estate, estimated as specified in (a) above, less the sum of the cost of completing their construction, the costs to sell and a reasonable proportion of the gain remunerating the effort to make the sale, determined from gains on similar real estate assets. The selling price shall be estimated using the methodologies described in paragraphs 36 and 38 of rule 14 for estimating the fair value of real estate assets. When this price is obtained from a reference value in which all the aforementioned costs have been taken into account, as in a full individual appraisal meeting the requirements of paragraph 166, said costs need not be deducted again from the selling price.

177. To analyse whether there has been transfer of control of a real estate asset foreclosed or received in payment of debt, institutions shall consider the main indicator to be the substantial transfer of the risks and rewards of ownership of the asset, taking into account that physical possession of the asset by the other party may not coincide with transfer of control of the asset.

In sales of real estate assets foreclosed or received in payment of debt with financing by the institution itself, when making the analysis described in the

preceding subparagraph the institution shall examine whether the financing granted will be recovered purely through payments by the borrower or whether, on the contrary, the asset sold will have to be realised. In this second case, it is considered that there has not been substantial transfer of the risks and rewards of the real estate asset foreclosed or received in payment of debt.

In accordance with the second subparagraph of paragraph 1 of rule 15, institutions shall recognise a contract liability relating to the delivery of goods for the amount of the consideration received if the outcome of the analysis described in the preceding subparagraphs is that transfer of control of the real estate asset foreclosed or received in payment of debt did not take place. This liability shall remain on the balance sheet until the transfer of control of the asset takes place or, in accordance with paragraph 21 of rule 15, its amount is reduced against an account payable because the institution expects to reimburse the consideration received in part or in full.