

**REPORT ON BANKING
SUPERVISION IN SPAIN**

2016

BANCO DE ESPAÑA
Eurosystem



REPORT ON BANKING SUPERVISION IN SPAIN 2016

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ABBREVIATIONS

AEG	Accounting Expert Group of the Basel Committee on Banking Supervision
ASBA	Association of Supervisors of Banks of the Americas
ATM	Automated Teller Machine
AVM	Automated Valuation Models
BCBS	Basel Committee on Banking Supervision
BdE	Banco de España
BRRD	Bank Recovery and Resolution Directive
CET1	Common Equity Tier-1
CCyB	Countercyclical Capital Buffer
CCF	Credit Conversion Factor
CCP	Central Counterparty
CGP	Code of Good Practices
CNMV	National Securities Market Commission
CRD IV	Capital Requirements Directive IV
CRR	Capital Requirements Regulation
DCMR	Market Conduct and Claims Department
DGS	Deposit Guarantee Scheme
DGBS	Directorate General Banking Supervision
EBA	European Banking Authority
ECB	European Central Bank
ESRB	European Systemic Risk Board
EU	European Union
FINREP	Consolidated financial reporting
Fintech	Financial Technology
FROB	Fund for the Orderly Restructuring of the Banking Sector
FSB	Financial Stability Board
GDP	Gross domestic product
GL	Guideline
G-SII	Global Systemically Important Institution
ICAAP	Internal Capital Adequacy Assessment Process
ICO	Official Credit Institute
IFRSs	International Financial Reporting Standards
ILAAP	Internal Liquidity Adequacy Assessment Process
IMF	International Monetary Fund
IRB	Internal Ratings Based Approach
JST	Joint Supervisory Team
LGD	Loss Given Default
LSI	Less significant institution
MDA	Maximum Distributable Amount
MREL	Minimum requirement eligible liabilities
NCA	National competent authority
OND	Options and National Discretions
O-SII	Other systemically important institution
P2G	Pillar 2 Guidance
PD	Probability of Default
RDL	Royal Decree-Law
RWA	Risk-weighted assets
Sareb	Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria (asset management company for assets arising from bank restructuring)
SEP	Supervisory Examination Program
SEPBLAC	Commission for the Prevention of Money Laundering and Monetary Offences
SI	Significant institution
SMA	Standardised Measurement Approach

SPE	Single Point of Entry
SQA	Supervisory Quality Assurance
SRB	Single Resolution Board
SREP	Supervisory Review and Examination Process
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
TLAC	Total Loss Absorbing Capacity
TRIM	Targeted Review of Internal Models

* * *

€m	Millions of euro
€bn	Billions of euro
P	Placed after a date [Jan (P)], indicates that all the related figures are provisional. Placed after a figure, indicates that this and only this figure is provisional
bp	Basis points
pp	Percentage points
...	Not available
—	Nil, non-existence of the event considered or insignificance of changes when expressed as rates of growth

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GOVERNOR'S INTRODUCTORY LETTER



2016 was the second full year in which the Banco de España performed its supervisory functions within the framework of the Single Supervisory Mechanism (SSM) for European credit institutions. The Banco de España is working with the European Central Bank (ECB) and the other central banks and national supervisors of the euro area countries within this framework to firmly establish uniform, high-quality European supervision.

In particular, progress continued to be made in 2016 in establishing supervisory procedures and practices. Advances were made in the uniform application of the process of supervisory review and evaluation of the solvency and liquidity situation of institutions, as well as in the cross-functional review of the internal models used by institutions to calculate their capital requirements. Experience shows that, in addition to having a common regulatory framework, its application and subsequent supervisory review also need to follow common guidelines to ensure that institutions compete on a level playing field.

The importance of making progress towards the convergence of supervisory practices obviously applies to all areas of banking activity and regulation. Consequently, although important steps have been taken within the SSM to establish common supervisory procedures in the prudential area, it should not be forgotten that there are other important spheres, closely related to the latter, which need to be explored in order for progress to be made in entrenching a genuine, effective and uniform European banking supervision system. I am referring here to the sphere of financial data, the raw material for all supervisory analysis of the financial and solvency position of credit institutions. In 2016 a major effort was made to address the problem how the non-performing loans on bank balance sheets should be managed, and I trust that progress will continue to be made in this respect.

Apart from SSM-related tasks, in 2016 the Banco de España carried out important work in other areas related to the supervision of financial institutions. In particular, macroprudential tools began to be applied from 1 January 2016 and greater efforts were made in relation to the supervision of institutions' conduct, with the aim of improving customer confidence in the banking system.

All in all, the balance of supervisory activity in 2016 was positive. That said, given the important challenges posed by the demanding macroeconomic, regulatory and technological environment in which Spanish credit institutions operate, the Banco de España will continue to endeavour to achieve increasingly efficient supervision with the ultimate aim of promoting a stable Spanish banking system capable of effectively channelling the economy's financial flows and of contributing to the welfare of the general public.

INTERVIEW WITH THE DEPUTY GOVERNOR



Until his recent appointment as Deputy Governor he performed various functions in the Banco de España, basically in the area of central banking. He is now embarking on a new phase in which he will also address supervisory tasks. To what extent does this new phase involve change or continuity with respect to your previous experience?

It certainly involves a change as I have been working for many years in central banking-related areas and now I am focusing to a greater extent on supervision-related functions, as required by my new position. However I think that these duties have important aspects in common. Specifically, both are pursued in markedly European environments; the Eurosystem and the Single Supervisory Mechanism (SSM).

These two frameworks are at different phases of development. While the Eurosystem is fully formed, since it has been in operation since January 1999, when the euro area was created and monetary policy competence was transferred from the then 11 national central banks (now 19) to the ECB, the SSM had been in existence for little more than two years. I recall how the establishment of the euro area and the creation of the ECB were an important landmark in the long and complex process of European integration. We now face the challenge of entrenching the SSM. I believe that the experience of the Eurosystem – of working jointly with the other central banks and the ECB – is proving key to the development of a common European system of supervision today.

Is there any particular lesson for the SSM that stands out from the Eurosystem experience?

The Eurosystem experience showed us that procedures and instruments need to be extensively harmonised for the system to work properly. All parts play an important role in achieving the common purpose, namely an appropriate definition for and smooth implementation of European monetary policy, but this requires uniform procedures. I believe that this insight is directly extendable to the SSM, and that we now need to press ahead with the harmonisation of supervisory practices.

Have all the Banco de España's supervisory powers been transferred to the ECB?

Not exactly. Not all the Banco de España's supervisory powers have been transferred to the ECB. The Banco de España has transferred to the SSM the direct supervision of significant credit institutions, but retains that of less significant institutions, in respect of which the SSM exercises indirect supervisory functions. In addition, even in those cases in which the SSM is directly responsible for supervision, the Banco de España participates actively in the supervision of Spanish institutions, and in the supervision of the institutions of other SSM Member States.

For the exercise of its functions, the SSM is set up as an integrated system, made up of the ECB and the national competent authorities, including the Banco de España. Membership of the SSM involves participation by the Banco de España in decision-making in relation to all euro area credit institutions, through its representation on the SSM's Supervisory Board and on the ECB's Governing Council.

At the same time, we should not forget that the supervisory powers over credit institutions in areas other than microprudential supervision, such as the protection of bank customers and the application of macroprudential tools, remain at the Banco de España. In addition, the latter continues to supervise entities, other than credit institutions, engaged in activities relating to the financial sector, such as specialised lending institutions, mutual guarantee companies and payment institutions. All these functions contribute to the objective of the Banco de España of preserving the stability of the Spanish financial system.

Further to your comment regarding the SSM as a milestone in the European integration process, what do you think its main achievements have been during its first two years of operation and what have been its main challenges?

Nobody doubts now that the SSM is the most important step in European financial integration since the introduction of the euro. Among its achievements, I would point to the various different initiatives to harmonise the supervisory practices applicable to European significant institutions in the prudential sphere. For example, the SSM has defined a single methodology for the supervisory review and evaluation process and has managed to harmonise supervisory options and discretions through a regulation and guidelines issued by the ECB.

Despite these notable efforts, there is still a long way to go in harmonising supervisory practices. This is not surprising, given that the SSM brings together supervisors with varied approaches and cultures. This diversity has been apparent, for example, in the differences of scope and depth of the criteria followed by national supervisors when authorising and reviewing internal models used to calculate capital requirements. To address this lack of supervisory uniformity, a cross-functional analysis of these models is currently being performed.

Also with the objective of achieving greater convergence of supervisory practices within the SSM, another area in which it is worth making further progress, closely linked to the purely prudential sphere, is that relating to the review of accounting information. This is the starting point for supervisory analysis of the situation of institutions, so that reviewing its reliability and quality, beyond mere formal compliance with the applicable accounting framework, is essential.

Focusing a little more on the challenges you mentioned to harmonise supervisory practices for the review of institutions' internal models, both the prudential (to calculate capital requirements) and the accounting ones (to calculate provisions), do you think there are any differences in the degree of progress made in this harmonisation?

The truth is that, so far, the concern and action to harmonise supervisory practices has mainly been focused on prudential aspects, rather than on financial aspects; we have already mentioned the harmonisation of options and national discretions, the supervisory review and evaluation process, and capital models. It is true that capital is a key element in the event of unexpected losses, and its appropriate calculation, in accordance with the risk of each institution, is fundamental when assessing the solvency of each institution and of the financial system as a whole. However, at least as important as the appropriate calculation of capital is the appropriate calculation of provisions to cover credit losses, the main banking risk.

The experience and conclusions obtained from the cross-functional review of capital models currently in progress may be useful to explore the harmonisation of the supervisory review of institutions' accounting methodologies.

Returning to the common methodologies being developed by the ECB to supervise significant institutions, like the one relating to the supervisory review and evaluation process, what are their implications for the direct supervision of less significant institutions by the Banco de España?

The subject of alignment of the supervision of significant institutions, carried out by joint supervisory teams from the SSM, with the supervision of less significant institutions, carried out directly by the Banco de España, is being addressed from two standpoints.

First, within the SSM work is being carried out to adapt the binding criteria applied to significant institutions to the specific circumstances of less significant institutions, through guidelines addressed to national authorities. The Banco de España actively participates in the preparation of these harmonised supervisory criteria both on the ECB's supervisory board and in the various technical level working groups.

Second, the Banco de España endeavours generally to align supervisory practices for less significant institutions with those agreed within the framework of the SSM for significant institutions. Thus, when supervisory criteria are defined or the options and discretions envisaged in the regulations for Spanish less significant institutions are exercised, it very much takes into account the criteria adopted by the ECB. In fact, we are working to adapt Circular 2/2014 to the exercise of options and discretions by the ECB. To apply different rules to different Spanish institutions may result in unwarranted competitive differences.

Let's talk about Spanish credit institutions. What is the current situation of the banking sector in Spain?

Spanish institutions' solvency situation is adequate. This was reflected, for example, in the results of the European Banking Authority (EBA) stress tests, according to which the participating Spanish institutions' capital exceeded the requirements used as a reference in previous stress tests.

From this starting point, institutions have to deal with an environment that remains difficult, characterised by increasing competition and falling profitability. The current low level of interest rates and, to a lesser extent, the accumulation of unproductive assets threaten their profitability. Assessing these risks is a current supervisory priority, and managing them appropriately is a priority for directors.

How can a credit institutions deal with the current economic environment of low interest rates, and what is the role of the supervisor in this area?

As a general rule, supervisors should not interfere in the strategic decisions of institutions, which are responsible for taking such measures as they deem appropriate from time to time, with the objective of protecting their value and better serving their shareholders and customers. However, I believe that supervisors should monitor such strategies, share their analysis with the institutions concerned and support decisions that promote financial stability.

In this respect, the current environment of low interest rates requires, in my opinion, very high levels of efficiency, with appropriate diversification of revenues, in terms of location and the range of financial services provided. Accordingly, further bank consolidation, which would result in a banking sector with fewer, better capitalised, more profitable and more efficient competitors, with a more diversified business model, cannot ultimately be ruled out.

The regulations applicable to credit institutions have undergone far-reaching amendments in recent years. What challenges does this pose to institutions and supervisors?

The regulations applicable to credit institutions have indeed undergone significant changes in recent years. These include, notably the new crisis management framework for credit institutions and, in particular, the new eligible liabilities requirement (MREL). Institutions will have to make changes to their financing structure in order to meet these new requirements. In addition capital buffers began to be required in 2016, one of their objectives being to address systemic risks.

In the accounting sphere, the transition from the incurred loss to the expected loss model will come into effect in January 2018, which involves a significant challenge for institutions in terms of databases and effective integration of accounting methodologies into credit risk management.

All these regulatory changes involve a challenge not only for institutions, but also for supervisors, as we have to adapt our procedures to the new requirements.

You mentioned, in relation to the initial application of macroprudential instruments, that 2016 was the first year in which capital buffers were required. What do you think will be the future impact of these measures?

The last crisis showed that the work of financial supervisors needs to address not only the individual situation of each institution (“microprudential supervision”), but also developments in the financial sector as a whole, from a macroprudential viewpoint. The various macroprudential tools now provided for in the regulations, including notably capital buffers, are the fruit of this lesson.

Specifically, buffers for institutions designated as systematically important are intended to address the negative externalities that these institutions pose for financial stability as a consequence of their size, activity and interconnectedness with other institutions. The countercyclical capital buffer, on the other hand, is intended to strengthen bank solvency and to smooth the credit cycle, forcing institutions to build up capital buffers during upswings, so that they can be used subsequently in an adverse macroeconomic environment.

One of the consequences of the recent crisis was the deterioration in the confidence of bank customers in credit institutions. How is the Banco de España addressing this situation?

The lack of good customer practices has undoubtedly generated significant reputational damage for the whole banking sector. For this reason the Banco de España has redoubled its efforts in the area of supervision of the conduct of institutions, allocating greater resources to these tasks, separating them from prudential supervision and setting up new procedures. This is an activity that will be intensified even further in future.

These actions are included in the process of continuous improvement of supervisory organisation and procedures, with the aim of adapting the tasks performed by the Banco de España to the various risks and threats to financial stability.

To finish, what are the main challenges of your term of office as deputy governor?

I believe that my main challenges relate to adaptation to change. That is to say, regulatory changes, changes in supervisory procedures and changes in the environment in which credit institutions operate. For example, the impact of new technologies and the entry into the financial market of so-called FinTech companies. Financial risks are constantly evolving, and this requires an appropriate response from institutions, regulators and supervisors. As a result of the work carried out in recent years, Spanish institutions are in a favourable position to confront these challenges.

I also consider it a priority to continue building a common supervisory culture in the euro area, in the EU as a whole and worldwide. As regards the euro area, notable efforts have been made in recent years by the ECB and by the national supervisors. However, building a supervisory model that combines the best of the various traditions existing in each participating State is an ambitious task that will take time.

1 ORGANISATION OF BANKING SUPERVISION IN SPAIN

1.1 Supervisory functions of the Banco de España

Financial supervision in Spain is based on a sectoral model, with three separate supervisors for each of the main financial sectors. The Banco de España has supervisory powers over the solvency and conduct of credit institutions and other financial auxiliaries, which it exercises, either independently or as part of the Single Supervisory Mechanism (SSM) in the euro area, cooperating with other national supervisors in the area of their respective powers.

A distinction may be drawn between the following types of supervisory functions:

- 1 **Microprudential supervision of credit institutions**, focused on monitoring the solvency of credit institutions, aiming to reduce to a minimum the likelihood of crises at individual institutions and the effects of such crises. These powers are exercised within the framework of the SSM in force in the euro area.

The Banco de España has formed part of the SSM from the outset. Since 4 November 2014 the SSM carries out the prudential supervision of the more than 4,200 credit institutions operating in the 19 euro area countries. For the exercise of its functions, the SSM is organised as a system comprising the ECB and the national competent authorities (hereafter, NCAs), among which, the Banco de España. The NCAs play a key part in the operation of the SSM, to which they dedicate a very significant portion of their resources, in addition to their experience in supervisory matters and their superior knowledge of their home country banking systems and institutions.

As a member of the SSM, the Banco de España is present on its governing bodies, the Supervisory Board and the ECB Governing Council. The Banco de España is, therefore, involved in decision-making relating not only to Spanish credit institutions but also to credit institutions from all the euro area countries.

In the framework of the SSM a distinction is drawn between two types of institutions: significant and less significant institutions. This distinction is based on criteria of size, economic significance and cross-border activity that must be reviewed at least once a year (in 2016 the number of significant institutions rose by six in net terms). The ECB is responsible for the direct supervision of significant institutions, while the NCAs are responsible for the direct supervision of less significant institutions. However, even in cases where they are not directly responsible, both the ECB and the relevant NCAs participate in the supervision of all institutions.

JSTs made up of ECB and Banco de España staff conduct ongoing monitoring of Spanish institutions

Ongoing monitoring of significant institutions is performed through Joint Supervisory Teams (JSTs). The JSTs of the Spanish significant institutions are made up of ECB and Banco de España staff, headed by an ECB coordinator who is assisted by a sub-coordinator from the Banco de España. In the case of groups of Spanish institutions with a presence in other SSM countries and of Spanish subsidiaries of groups of institutions of other SSM countries, the

JSTs also include staff from other NCAs and a sub-coordinator from each of the countries concerned.

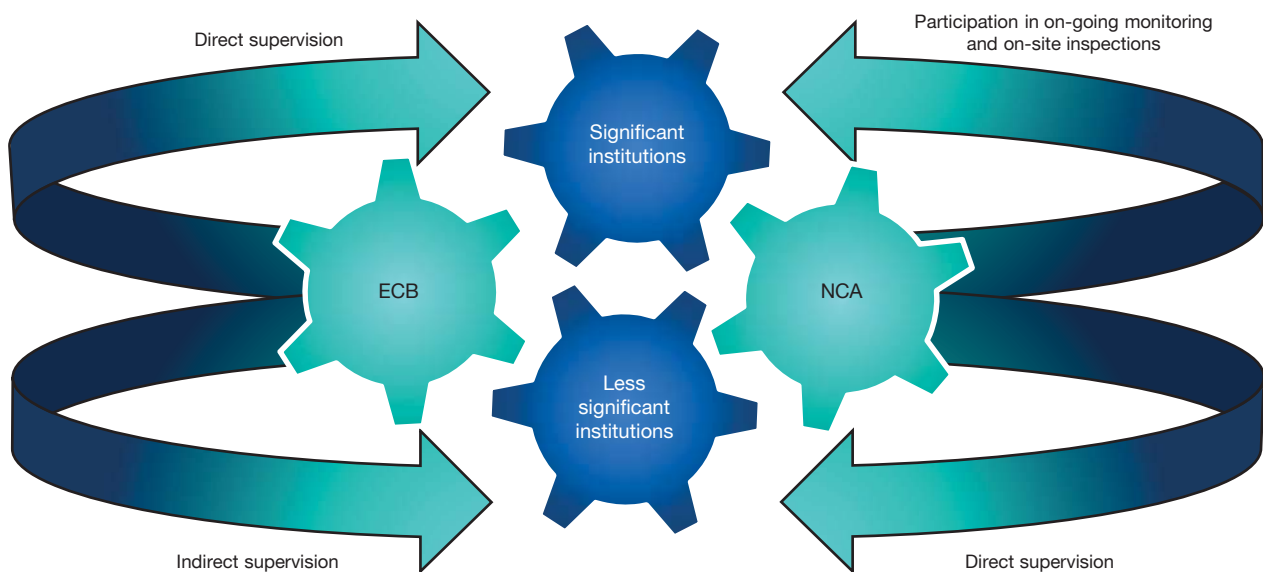
The Banco de España plays an important part in the performance of on-site inspections and reviews of internal models of the Spanish significant institutions, having led approximately 70% of the operations conducted in 2016. Nevertheless, it is important to underline that, within the framework of the SSM, staff from the ECB and from other NCAs also participate in this work, either as team leaders or members, contributing to the development of a common supervisory culture within the SSM that will help standardise the different supervisory practices.

The Banco de España led approximately 70% of the operations conducted in 2016

Also, the Banco de España cooperates with the ECB in the handling of the “common procedures” relating to all institutions included in the scope of the SSM, whether significant or less significant. The common procedures are those relating to the granting and withdrawal of banking licences and the authorisation of qualifying holdings. The Banco de España receives the requests from institutions, performs the first analysis and approves proposals for decisions to be conveyed to the ECB. Subsequently, on the basis of those proposals and other actions it may deem relevant, the ECB makes the final decisions.

Throughout 2016 further moves were made to delimit the distribution of supervisory powers between the ECB and the NCAs. On the indications of the European Commission, the Supervisory Board stipulated that the exercise of supervisory powers granted under national law falls within the direct competence of the ECB if such powers refer to its supervisory tasks and contribute to the performance of its supervisory functions. Specifically it was determined that, from 1 January 2017, the ECB will directly exercise the following powers: authorisation of acquisitions of qualifying holdings in companies that are not credit institutions or in institutions of non-EU countries; approval of mergers and divisions of significant institutions; approval of articles of association of significant institutions; and approval of the appointment of key function holders and of limits on the extension of credit to related persons. NCAs will have powers only over those matters that are not included in the scope of the work of the ECB or do not support its supervisory functions. In those cases, the ECB may exercise its power to provide guidelines to the NCAs in accordance with the SSM Regulation.

- 2 **Exercise of the functions conferred upon the supervisor by the regulations on recovery and resolution of credit institutions:** the Banco de España, as the supervisory authority, is assigned new functions (focused essentially on the pre-resolution phase) and is provided with new tools with which to meet the objectives of safeguarding financial stability and minimising the effects on the system of crises at individual institutions.
- 3 **Microprudential supervision of the Official Credit Institute (ICO, by its Spanish acronym) and other institutions other than credit institutions that provide services or perform activities related to the financial sector, within the scope envisaged in Spanish legislation:** specialised lending institutions, mutual

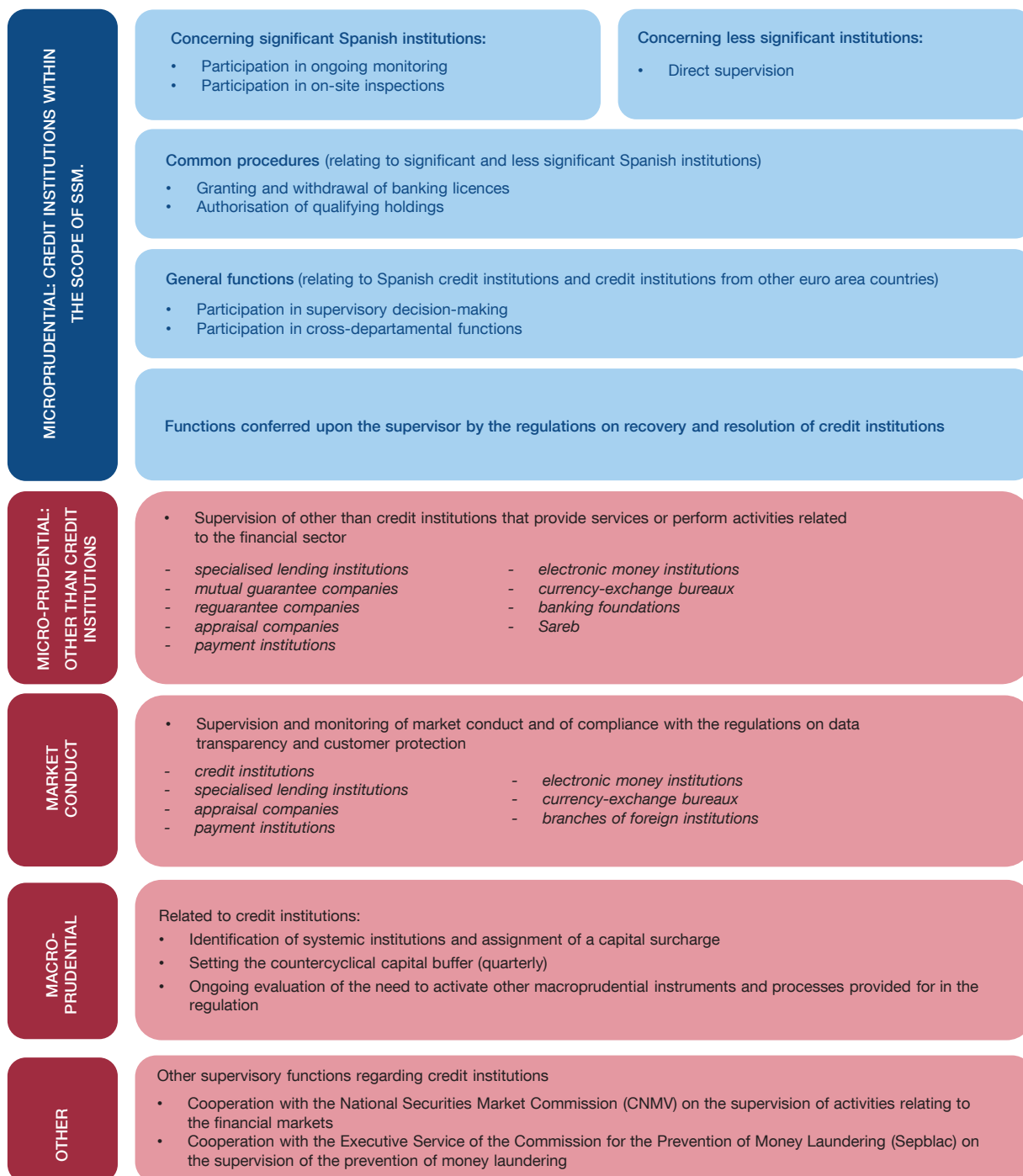


SOURCE: Banco de España.

guarantee companies, reguarantee companies, appraisal companies, payment institutions, electronic money institutions, currency-exchange bureaux, banking foundations and the asset management company for assets arising from bank restructuring (hereafter, Sareb).

- 4 **Macroprudential supervision**, focused on safeguarding the stability of the financial system overall. As part of this function, the Banco de España makes use of the macroprudential instruments provided for in the European legislation on capital requirements for the banking sector (established in the Capital Requirements Regulation (CRR) and the Fourth Capital Requirements Directive (CRD IV)) and the implementing Spanish legislation.
- 5 **Supervision and monitoring of market conduct** and of compliance with the regulations on data transparency and customer protection by the institutions registered in the Banco de España's official registers of institutions for which there are specific regulations on transparency and customer protection. These include, in their various forms, credit institutions, specialised lending institutions, payment institutions, electronic money institutions, appraisal companies, branches of foreign institutions and owners of currency-exchange bureaux.

It is important to note that, in addition to the institutions that operate in Spain through a permanent establishment, there are others that pursue their business under the freedom to provide services which, in accordance with Article 12(2) of Law 10/2014 of 26 June 2014 on the regulation, supervision and solvency of credit institutions, shall "observe, in the pursuit of their business in Spain, the regulatory and disciplinary provisions for credit institutions which, where appropriate, are applicable and whatsoever other



SOURCE: Banco de España.

provisions are issued for reasons of general interest”. In particular, these institutions are expressly included under the subjective scope of some of the precepts of Ministerial Order ECO/734/2004 of 11 March 2004 on customer care services and departments and the financial services ombudsman, and of Ministerial Order ECC/2316/2015 of 4 November 2015 on obligations relating to information on and classification of financial products. Accordingly, the Banco de España also exercises certain supervisory functions over these institutions.

6 Other supervisory functions, including in particular:

- Cooperation with the Executive Service of the Commission for the Prevention of Money Laundering (Sepblac) in the supervision of the prevention of money laundering.¹
- Cooperation with the National Securities Market Commission (CNMV) in the supervision of activities related to the financial markets.

Schema 1.2 summarises the Banco de España's various supervisory functions.

1.2 Organisation of banking supervision at the Banco de España

Schema 1.3 outlines how supervisory functions are distributed between the Banco de España's different directorates general and departments.

Regarding microprudential supervision, the entry into force of the SSM entailed a highly significant change in the European supervisory model. In view of this new scenario, the Banco de España adapted its organisational structure so as to participate in the most effective way possible in the SSM.

The Banco de España's organisational structure is tailored to the new microprudential supervisory framework

The present structure separates ongoing supervision of the significant institutions, undertaken by Supervision Departments I and II, from the on-site inspections and reviews of internal models conducted by divisions specialising in that work located in Supervision Department IV.

Supervision Department III performs ongoing supervision and on-site inspections of the less significant institutions.

1.3 Staff

The launch of the SSM had a significant impact on Directorate General Banking Supervision (DGBS) staff, as around 80 staff members who belonged to the DGBS are now working at the ECB within the SSM structure. This has posed a major challenge in terms of human resources, heightened by the necessary adaptation to new common procedures and methodologies, the need to work in English and the significant regulatory changes in the banking sector in recent years.

The Banco de España has an intensive on-the-job staff training programme

In this setting, the DGBS has followed a dual strategy. First, with a view to maintaining the high professional profile of its staff, numerous training activities are conducted, adapted to the new supervisory situation, both at the national and international level. Thus, the Banco de España offers DGBS staff an extensive annual internal training programme, aiming to disseminate and refresh the technical knowledge essential for supervisory work. Moreover, in cooperation with various international and European supervisory bodies and agencies (ECB, Basel Committee on Banking Supervision, EBA, etc.), the Banco de España also offers its staff a range of courses and workshops abroad, to achieve optimum completion and reinforcement of their training. Lastly, significant language training activities are conducted to maintain and, where necessary, improve the DGBS staff's command of English, which is essential in the new European supervisory framework.

¹ In Spain, the Executive Service of the Commission for the Prevention of Money Laundering and Monetary Offences (Sepblac) is the authority responsible for the supervision and inspection of compliance with prevention of money laundering obligations and for adoption of the measures necessary in the event of non-compliance. The Banco de España cooperates in the operations relating to these matters, in accordance with the cooperation regime established in Law 10/2010 of 28 April 2010 and in the agreement signed with Sepblac in 2013.

DIRECTORATE GENERAL BANKING SUPERVISION	Supervision Department I	– Ongoing or day-to-day supervision of the four major significant institutions through the JSTs.
	Supervision Department II	– Ongoing or day-to-day supervision of the other significant institutions (10) through the JSTs.
	Supervision Department III	– Ongoing supervision and on-site inspections of the: <ul style="list-style-type: none"> • Less significant institutions under the SSM • Significant Spanish institutions belonging to groups with non-Spanish parents • Other entities outside of the scope of the SSM
	Supervision Department IV	– Specialised or horizontal tasks that affect all institutions – On-site inspections of significant institutions and reviews of the internal capital models of Spanish institutions
	Regulation and Supervisory Policy Department	– Definition of supervisory and regulatory policies – Implementation and interpretation of banking accounting legislation and prudential legislation – Coordination of the Banco de España's participation in the European Banking Authority (EBA) and cooperation with Spanish and international bodies and forums
	SSM Coordination Service	– Supporting the participation of the Banco de España's representative on the SSM Supervisory Board – Internal organisation, distribution and monitoring of the information received at this level regarding the SSM
	Supervisory Planning Service	– Preparation and monitoring of the supervision framework and annual plan – Supervisory methodology and Pillar 2 – Quality control of supervisory actions – Hiring and training of DGS employees
	Centralised Lending Analysis Division	– Coordinated implantation of the new provisioning model contained in IFRS 9 and modifications introduced by Circular 4/2016
	Information and Analysis Group	– Computer processing of the financial information received from institutions – Specific analyses of the developments in the Spanish financial system and its main risks
GENERAL SECRETARIAT	Suitability Assessment and Individuals Register Division	– Assessing the compliance with the suitability requirements of board members, managing directors and similar officers – Maintaining the Senior Officer Register
	Authorisations and Institutions Register Division	– Participating in the granting and withdrawal of the authorisation of institutions – Maintaining the Institutions Register
	Division for Sanctioning Proceedings	– Instructing disciplinary proceedings – Collaboration with Jurisdictional Bodies
	Market Conduct and Claims Department	– Supervisory powers over the issue of banking transparency and the protection of institutions' customers – Definition of supervisory and regulatory policies related to market conduct
DIRECTORATE GENERAL FINANCIAL STABILITY AND RESOLUTION	Financial Stability Department	– Assessment of financial stability and drawing up proposals for macroprudential policies – Coordination with the European Systemic Risk Board (ESRB) and the Financial Stability Committee (FSC) of the ECB – Coordination with other international organisations, such as the BCBS and the FSB
	Financial Reporting and CCR Department	– Defines, receives, validates and acts as the custodian of the information submitted periodically to the Banco de España by the institutions subject to supervision by it or by the ECB – Management of the Central Credit Registry
	Resolution Department	– Functions related to Resolution

SOURCE: Banco de España.

Second, in recent years the number of positions advertised each year within the DGBS has risen significantly. Until the full complement of permanent staff is achieved, temporary staff are being hired. However, these measures are not yet reflected in a net increase in staff numbers in the DGBS.

BANKING SUPERVISION, FINANCIAL STABILITY AND RESOLUTION, AND MARKET CONDUCT AND CLAIMS DEPARTMENT STAFF IN 2016

TABLE 1.1

Number	Directorate General Banking Supervision (a)	Directorate General Financial Stability and Resolution	Market Conduct and Claims Department (b)	Deputy General Secretariat (c)
Directors and other managers	49	27	9	4
Bank examiners/Inspection auditors	243	9	6	
Senior analysts/lawyers/experts	26	39	23	6
IT auditors	46		2	
Junior analysts	69	73	38	13
Administrative staff	49	22	12	8
TOTAL	482	170	90	31

SOURCE: Banco de España.

- a** The staff of the Directorate General Banking Supervision have the following functions:
- 163 persons have functions relating to the ongoing supervision of significant institutions conducted through joint supervisory teams set up by the SSM.
 - 19 persons have functions relating to the ongoing supervision of less significant institutions supervised directly by the Banco de España and indirectly by the ECB.
 - 20 persons have functions relating to institutions whose supervision has not been taken on by the ECB.
 - 103 persons have functions relating to the performance of on-site inspections or the review of models.
 - 116 persons have cross-departmental functions.
 - 49 persons have administrative functions.
 - 2 persons are appointed as General Director and Deputy General Director.
 - 10 persons have other functions.
- b** Of the total staff in the Market Conduct and Claims Department, 33 employees (Director and 32 assigned to Conduct Oversight Division) have direct functions related to supervision.
- c** Only staff of the Suitability and Registration of Senior Officers, and Authorisations and Registration of institutions are included.

A further challenge for the Banco de España has been the need to provide the necessary human resources to assume the supervision of market conduct, since these powers were assigned to the General Secretariat in October 2014.

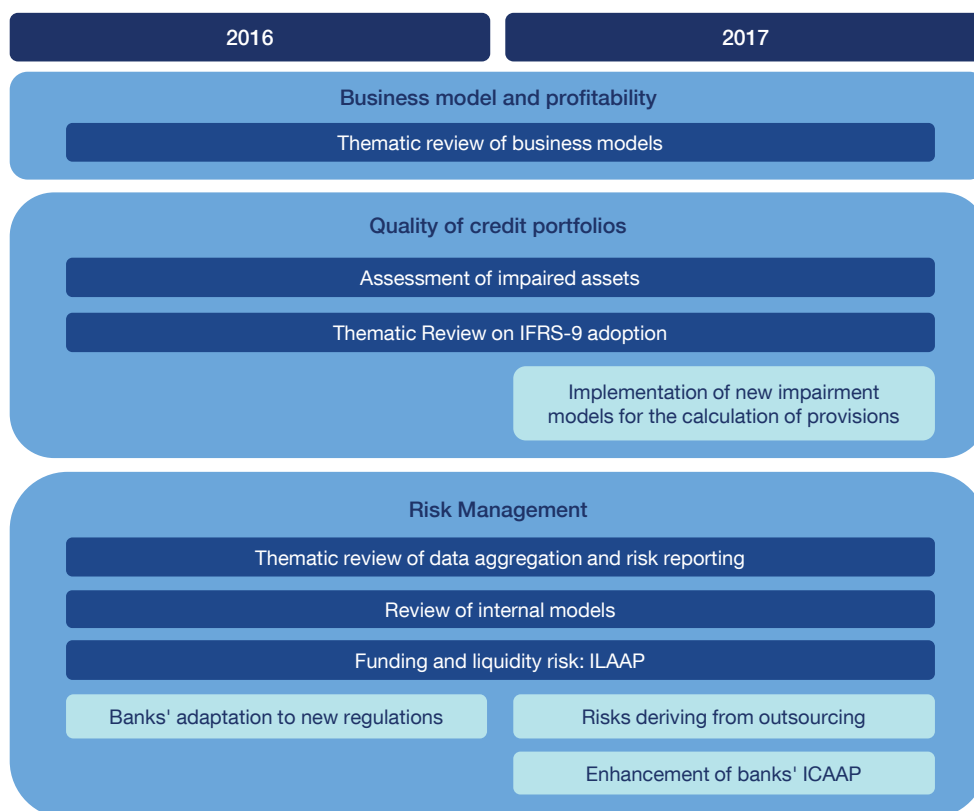
2 MICRO-PRUDENTIAL SUPERVISION

2.1 Supervisory priorities and strategies

As in 2015, the supervisory priorities for 2016 were established jointly under the SSM framework, with the active participation of the Banco de España. The main areas requiring special attention by the supervisor in 2016 and the priorities for 2017 are set out below and summarised in Schema 2.1.

SUPERVISORY PRIORITIES IN 2016 AND 2017

SCHEMA 2.1



SOURCE: Banco de España.

2.1.1 SUPERVISORY PRIORITIES IN 2016

- Adaptation to new regulatory developments:** the legal framework for credit institutions was developed further in 2016, requiring institutions to make a considerable effort to adapt to the new requirements. In particular, the new liquidity and liability requirements with loss absorbing capacity in the event of resolution pose a challenge both for institutions, which must adapt their structure and sources of financing to the new framework, and supervisors, who must ensure compliance with these regulations.
- Sustainability of the business models:** in 2016, credit institutions were faced with a complex economic environment, characterised by low interest rates and high levels of non-productive assets. This affected their profitability and the sustainability of their business models, placing them under the supervisory spotlight. In 2016, a thematic review of the business models was carried out for all the significant credit institutions in the SSM sphere. As indicated in the section below, this work will continue to be a supervisory priority in 2017 and will be based on the analysis already carried out.

- 3 **Quality of the loan portfolio:** as in previous years, particular attention was paid in 2016 to the quality of the loan portfolio. The Banco de España has participated in different areas of supervisory work within the SSM framework, on the one hand, to develop a common methodology for analysing impaired assets and, on the other, to promote the effective management of non-performing assets, to reduce their weight in banks' balance sheets, by ensuring proper identification and provisioning. The latter line of work resulted in the publication of the ECB's Guidance to Banks on Non-Performing Loans in March 2017, following a public consultation which took place from September to November 2016. The guidance document describes best practices to be adopted by credit institutions, relating both to the management of and proper accounting for non-performing loans, bearing in mind the growing importance of integrating credit risk accounting practices into credit risk management procedures. This guidance will serve as the basis for ongoing supervisory dialogue with institutions.

These issues, together with the monitoring of institutions' adaptation to the new International Financial Reporting Standard 9 on financial instruments, which began in 2016, will continue to be a priority in the coming years.

The main scope of around 75% of the 29 on-site inspections carried out in 2016, including significant and less significant Spanish credit institutions, was to review credit risk.

- 4 **Review of internal models:** An in-depth review of the internal capital models applied by institutions within the SSM commenced in 2016. The EBA, as part of its review on the consistency of risk weighted assets (RWAs), has revealed on several occasions that the characteristics of the internal models give rise to a high variability in the level of capital required, not warranted by the different risk profiles of institutions. The work under way will be essential to achieve greater consistency and comparability in the calculation of solvency ratios among the various institutions.
- 5 **Quality of information:** the Banco de España has participated in the thematic review of compliance with the Basel Principles for the effective aggregation of risk data and reports within the SSM, which will continue in 2017. Quality management information will enable institutions' governing bodies to properly assess the risks to which the institutions are exposed.
- 6 **Monitoring of financing and liquidity risk:** within the SSM, there have been efforts to make institutions aware of supervisory expectations regarding the internal liquidity adequacy assessment process (ILAAP), in order to address the weaknesses detected in previous years and promote the adoption of best practices by institutions.

The results obtained by Spanish credit institutions in the EBA stress test show a considerable degree of resilience, since they amply exceed the capital requirements

One of the supervisory instruments used in 2016 to address the aforementioned priorities was the performance of stress tests. Six significant Spanish institutions participated in an EU-wide stress test, based on the single methodology approved by the EBA to assess the resilience of the large European banks in the event of a hypothetical deterioration of the macroeconomic and market conditions. This exercise contributes to transparency, essential to foster market discipline. Box 2.1 describes the methodology used for the exercise and the main outcomes. The ECB has performed similar exercises for other institutions in the SSM.

The stress test included 51 institutions throughout the EU, representing approximately 70% of the EU banking sector assets.

In accordance with the methodology approved by the EBA, institutions made three-year projections of results and capital (from December 2016 to December 2018) under two different macroeconomic scenarios: a baseline scenario designed by the European Commission, and an adverse scenario, approved by the European Systemic Risk Board (ESRB)¹. The methodology establishes certain constraints, such as the assumption of a static balance sheet during the exercise, restrictions on the recognition of new deferred tax assets or the application of compulsory adjustments to the available for sale sovereign debt portfolio. Also, a change in relation to previous exercises is that the assessment of operational risk covers resilience to conduct risk events.

Chart 1 provides details of the results obtained for six Spanish institutions in the adverse scenario, in terms of the highest quality capital, calculated in accordance with the transitional arrangements laid down in solvency regulations (transitional CET1 ratio).

An important part of the estimated decline arises in most cases from the impact of the progressive elimination of the transitional arrangements from the solvency framework over the three-year duration of the exercise. If this effect is excluded, the impact of the exercise is significantly reduced, as seen in the development of the fully loaded ratio detailed in Chart 2.

The results of this exercise will be taken into account by supervisors when determining capital requirements within the framework of the supervisory review and evaluation process.

To conclude, the test results show an appreciable degree of resilience of Spanish institutions, close to the EU average.

¹ The baseline scenario was based on the European Commission's economic projections for the autumn of 2015. The adverse scenario was developed on the basis of assumptions of severe negative alterations in the principal macroeconomic variables (Gross Domestic Product [GDP], unemployment, inflation, interest rate and asset prices).

Chart 1
EBA STRESS TEST RESULTS. CET1 "Phased in"
Adverse scenario results

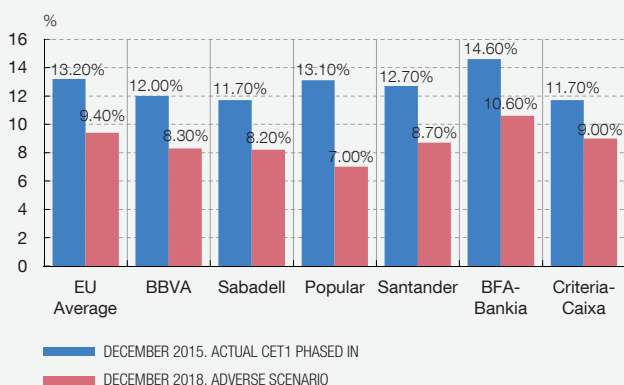
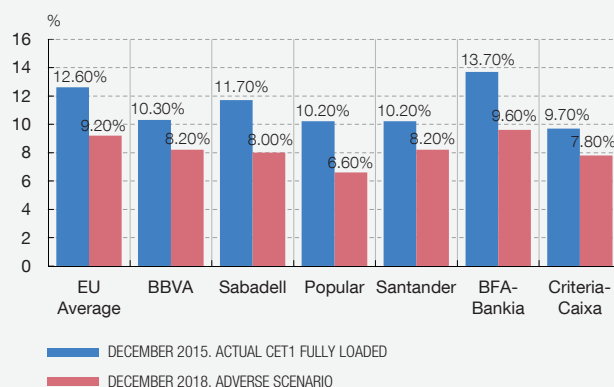


Chart 2
STRESS TEST RESULTS. CET1 «FULLY LOADED»
Adverse scenario results



SOURCES: EBA and Banco de España.

a Results do not include recapitalization measures adopted after December 31st, 2015, such as Banco Popular rights issue.

2.1.2 SUPERVISORY PRIORITIES IN 2017

Work will focus on three priority areas in 2017. The first two relate to business models and profitability factors, and credit risk, already identified as priorities in 2016. The third priority area for 2017, namely risk management, covers new aspects as well as areas which were previously included as independent priorities, but which are all closely related to the issue of risk management.

- 1 Business models and profitability.** Oversight of the business model and of the effects of low profitability continues to be a supervisory priority in 2017, especially in light of the historically low and even negative interest rates.

Given the challenges posed by the macroeconomic environment and regulatory developments, management of bank profitability remains complex. Moreover, the emergence of new non-banking competitors (Fintech) will contribute to banks having to continue to revise their business models in order to assess the extent to which they need to adapt to maintain a sustainable and profitable performance. The possible impact of Brexit on the business models of euro area banks will also be considered.

In this context, more in-depth work will be carried out on the thematic review of banks' business models initiated in 2016 spanning two years.

2 Quality of the loan portfolio:

- **Assessment of the impaired risks portfolio:** this will continue in 2017, since there are still institutions with high levels of impaired assets.
- **Review of adaptation to IFRS 9:** the thematic review initiated in 2016 to assess the potential impact on banks of the IFRS 9 and their level of preparedness will continue and conclude in 2017. This is an area of particular supervisory concern, since it is considered that the new standard will have an impact on the measurement of institutions' impaired assets and the valuation of financial instruments, and thus on own funds.
- **Implementation of new models to calculate provisions:** the recent amendment of Annex IX of Circular 4/2004 on the accounting of credit institutions has introduced new models for identifying loan losses, which will represent a significant challenge for credit institutions and the need to ensure that the models are properly implemented.

The individual review of loan files and the reconciliation of accounting and credit risk databases are indispensable supervision tools to ensure consistency of supervisory activities

- ## 3 Risk management.
- In a setting such as the present, with low interest rates and scant profitability, proper risk management becomes essential, and the review of this area is thus a supervisory priority in 2017. It will centre on three lines of supervisory action. First, the thematic review which commenced in 2016 to assess compliance with the Basel Principles for the effective aggregation of risk data and risk reporting will continue. This review pays special attention to the quality of risk data provided and suitability of the related technological infrastructure. Second, in order to restore the credibility and adequacy of the internal models approved under Pillar 1 and, therefore, of banks' risk management, work will continue on the specific review on internal models initiated in 2016, with on-site supervisory actions in the first half of 2017. Lastly, as regards banks' internal risk management activities and in keeping with the measures adopted in 2016, in 2017 supervisors will promote the continuous improvement of the internal capital adequacy (ICAAP) and liquidity (ILAAP) assessment processes and will examine how banks are managing the risks derived from outsourced activities.

Credit risk is the main risk arising from the financial intermediation of credit institutions. Essential to credit risk management is the identification and provisioning of non-performing loans. It is therefore no surprise that the review of credit risk, in general, and of non-performing loans, in particular, is a recurrent supervisory priority.

The first step in a supervisory review of non-performing loans is to identify and define a non-performing loan, so as to be able to draw consistent and comparable conclusions on the quality of the balance sheets of different institutions and, ultimately, on their solvency position. Annex IX of Circular 4/2004, recently updated by Circular 4/2016, defines non-performing loans as those with amounts more than 90 days past due or for which, although the loans are not doubtful due to borrower arrears, there are doubts as to the borrower's ability to repay as and when required.

This accounting definition of non-performing is fully aligned with that established by the EBA for the supervisory reporting (known as FINREP), and used in its stress tests and transparency exercises for the banking sector. Spanish credit institutions must therefore apply the same definition of non-performing loan when preparing financial statements and in their financial reporting to the supervisor. Although International Accounting Standard (IAS) 39 provides an ample margin for institutions to apply a definition of "non-performing" or "impaired" in their accounting policies, would it make sense to use different definitions?

The Banco de España, as the accounting regulator, has opted to align the accounting definition of "non-performing" with that which European credit institutions must use to report to the supervisor on their non-performing loans. This complies fully with the SSM guidance on non-performing loans, published in March 2017, which strongly recommends that credit institutions use the EBA's definition of "non-performing" when preparing their financial statements.

Once the non-performing loans have been identified using a uniform definition for all banks, another key aspect of the supervisory review of non-performing loans are the practices pursued by institutions for the adequate coverage of their credit risk losses. For this review to be consistent and comparable, it is essential that guidelines are applied in addition to the general principles established under the IFRS accounting framework adopted by the EU, especially when expert judgement plays such an important role in the estimation of allowances and provisions to cover credit risk losses. In this connection, Annex IX of Circular 4/2004 contains principles and requirements for the estimation of allowances and provisions by institutions, thus specifying sound and consistent alternatives for applying the IFRS accounting framework. Moreover, having regard to the principle of proportionality, the aforementioned Annex IX offers solutions for estimating allowances and provisions in the IFRS framework for institutions or less complex portfolios.

Notwithstanding the foregoing, having accounting regulations containing a uniform definition of non-performing loans and consistent principles and requirements for the estimation of inherent losses is not enough: they must also be appropriately applied by institutions. That is why the supervisory review of their application is essential for supervisors to make their own diagnosis of the credit quality of bank balance sheets. A correct and updated diagnosis will depend on the supervisory review of institutions' accounting practices having sufficient scope, depth and frequency. This review is a necessary complement to the analysis of strategies, policies, procedures and controls designed by institutions to manage credit risk, since their effectiveness cannot be assessed without verifying their implementation in specific operations. In this sense, the individual review of loan files and the reconciliation of accounting and credit risk databases are very useful supervision tools, both in the course of on-site inspections and ongoing monitoring (offsite) of institutions.

At the end of 2016, the Banco de España approved the creation within the DG Banking Supervision of a new cross-departmental group for "Centralised lending analysis".

This new group seeks to provide support for other specialist and operational groups, both in the monitoring and on-site inspections of credit institutions, to coordinate the review of compliance with the new principles and requirements (introduced by Circular 4/2016), which must be met in institutions' methodologies for estimating provisions to cover credit losses.

The functions assigned to the new group most notably include:

- First, centralisation of databases relating to credit risk, such as those connected with the loan portfolio, appraisals and internal methodologies.
- Second, validation and verification of the information contained in the above.
- Third, comparative analyses or benchmarking exercises and creation of risk indicators and reports enabling comparison of institutions.

2.2 Supervision of credit institutions

As indicated above, credit institutions are subject to supervision within the framework of the SSM. At end-2016, the SSM framework covered 125 groups of significant institutions (a total of 955 individual institutions, including holding companies) and 3,304 individual less significant institutions. Of the 125 largest banking groups, 14 are headed by a Spanish institution¹. The 14 Spanish groups, which represent 15% of the total assets of significant institutions in the SSM, only behind Germany and France, comprise 78 individual institutions from euro area countries, 54 of them Spanish. The institutions directly supervised by the ECB account for around 94% of the Spanish banking system's assets. In addition, there are another eight significant foreign groups partly owned by Spanish subsidiaries. Spanish credit institutions also encompass 69 less significant groups or individual institutions, including branches directly supervised by the Banco de España within the SSM framework.

SPANISH CREDIT INSTITUTIONS

TABLE 2.1

Figures at December 2015 and 2016

	2015		2016	
	Groups	Assets	Groups	Assets
Spanish groups of significant institutions	14	94.4%	14	94.3%
Foreign groups of significant institutions in which Spanish subgroups participate	8	1.1%	8	1.2%
Groups of less significant institutions (a)	73	4.5%	69	4.5%
TOTAL	95		91	

SOURCES: European Central Bank and Banco de España.

a Including groups, individual institutions not belonging to a group and branches of EU banking groups outside the euro area (11 branches in 2015 and 10 branches in 2016).

Table 2.2 shows a breakdown of credit institutions operating in Spain by type of institution, and changes in their number over time.

OFFICIAL REGISTERS OF INSTITUTIONS

TABLE 2.2

Number. Year-end data (a)

	2013	2014	2015	2016		
				Registrations	Deregistrations	Final
Credit Institutions	244	227	220	5	17	208
Banks	72	70	67	0	7	60
Saving banks	18	5	2	0	0	2
Credit cooperatives	67	65	65	0	2	63
ICO	1	1	1	0	0	1
Branches of EU institutions	78	79	79	5	7	77
Branches of non-EU institutions	8	7	6	0	1	5
Controlling companies	1	3	3	1	0	4
TOTAL	245	230	223	6	17	212

SOURCE: Banco de España.

a The number of institutions also includes those that are non-operational and in the process of deregistering.

As already mentioned, although the ECB is responsible for the direct prudential supervision of significant Spanish credit institutions, the Banco de España participates both in the ongoing monitoring and on-site inspections of these institutions. Less significant

¹ Santander, BBVA, Critería (CaixaBank), BFA (Bankia), Sabadell, Popular, Unicaja, Bankinter, Kutxabank, Ibercaja, Abanca Holding (Abanca), Liberbank, BMN and Banco de Crédito Social Cooperativo.

institutions are directly supervised by the Banco de España, although the ECB exercises indirect supervisory powers over them.

The supervision of both significant and less significant institutions is performed by means of two procedures: ongoing supervision and on-site inspections.

- Ongoing supervision is based on supervisory activities aimed at thoroughly analysing and assessing institutions to establish their risk profile and viability, and to determine their specific capital and liquidity prudential requirements. It adopts a prospective risk-based approach that is intensive in terms of supervisory activities, scope and resources.

Although all credit institutions apply an ongoing supervision approach, the frequency and intensity varies applying the proportionality principle depending on the size, systemic importance, nature, complexity and risk profile of the institutions.

- These activities are complemented by the performance of on-site inspections focusing on the review of specific areas previously identified by the ongoing monitoring team, the conclusions of which feed back into the assessment of the institution.

Just over two years after the start-up of the SSM, the ongoing supervision model continues to develop and adapt to changes in the regulatory environment and banking system. In this respect, the SSM has developed a common methodology (known as the Supervisory Review and Evaluation Process or SREP), based on the guiding principles defined in the Capital Requirements Directive IV and the EBA guidelines, which is proportionally applied both to significant and less significant institutions.

2016 saw the consolidation of common supervisory and authorisation processes and the fine-tuning of the supervisory review and evaluation methodology applied in the SSM sphere. In particular, changes were made in the methodology, and the SSM Supervisory Manual was updated to expand upon certain areas, such as internal governance. In addition, in relation to liquidity, a stress test exercise was included. As regards the capital decision, the composition and calculation of capital requirements was modified, as explained in Section 2.2.5 below.

An assessment of all credit institutions is performed every year

An overall SREP assessment of all credit institutions is conducted every year. On the basis of the SREP conclusions, the institutions' risks, their capital adequacy and liquidity to cover such risks are assessed. Depending on the SREP assessment made, the level of capital and liquidity considered adequate by the supervisor for the institution's risk profile is determined, and additional capital and liquidity requirements are imposed, as well as any other supervisory measures deemed necessary. Lastly, any shortcomings detected and capital and liquidity decisions are notified to and discussed with the institution's managers.

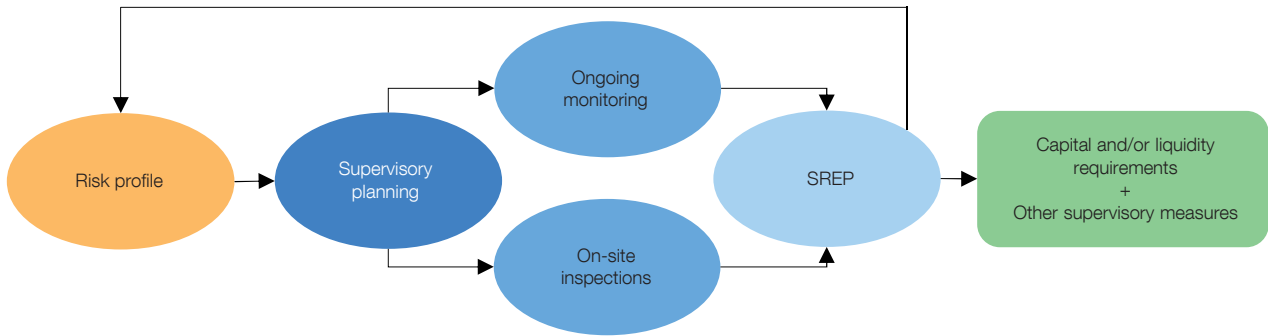
Establishing supervisory dialogue with the supervised institution is an essential feature of ongoing supervision

This approach enables the supervisory team to constantly update the institution's risk profile, to detect early potential areas of risk that may affect it and to identify factors which may trigger recovery and resolution measures envisaged in the legislation. Establishing a dialogue between the supervisor and the supervised institution is essential for the supervisory priorities and the weaknesses detected to be swiftly notified to the appropriate level, for the rapid and effective adoption of the corresponding preventive or remedial measures.

The intensity of the supervisory cycle depends on the supervisory priority assigned to the institution. This supervisory process is based on the institution's risk profile of the previous year, which is used to plan the intensity of supervisory actions, both relating to ongoing monitoring and to on-site inspections. The Supervisory Examination Programme (SEP) determines the supervisory tasks, their distribution, estimated timetable and frequency, and the necessary resources to carry them out.

SUPERVISORY CYCLE

SCHEMA 2.2



SOURCE: Banco de España.

The following sections discuss the main areas of supervision undertaken by the Banco de España in the framework of the SSM, both in relation to significant and less significant institutions, and the actions performed in 2016.

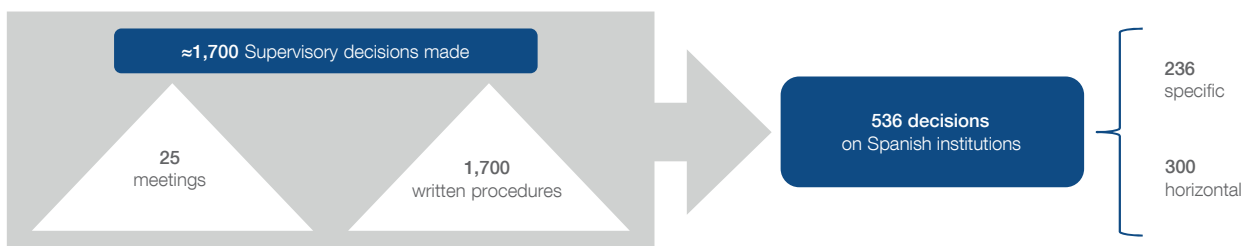
The Banco de España is actively involved in the SSM working groups.

Furthermore, the Banco de España participates in various working groups and numerous expert networks coordinated by the ECB or by one or several NCAs, for the discussion and proposal of supervisory policy and technical criteria relating to all the areas of work of the SSM. In 2016 the Banco de España participated actively in 63 of the approximately 80 horizontal groups organised within the SSM sphere.

Lastly, it should be mentioned that the Banco de España participates in decision-making in the framework of the SSM through its representation on the mechanism's Supervisory Board. Such decision-making is based on the outcome of the supervisory activities described above and is channelled via its governing bodies. In 2016, the Supervisory Board adopted (or proposed for final approval by the Governing Council under the so-called "non-objection procedure") a large number of supervisory decisions (see Schema 2.3). The bulk of those decisions have to date been adopted through written procedures, which supplement physical meetings of the governing bodies, enabling the decision making process to be expedited, particularly with respect to recurring or previously addressed matters.

DECISIONS MADE BY THE SUPERVISORY BOARD IN 2016

SCHEMA 2.3



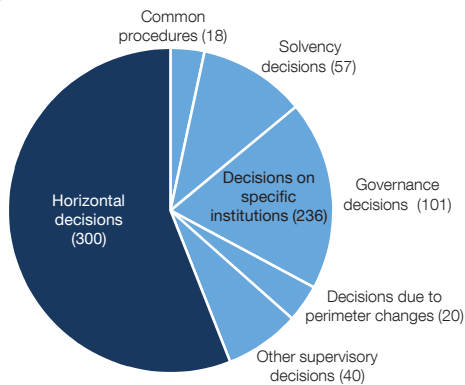
SOURCE: Banco de España.

The decisions adopted may either address specific credit institutions or be horizontal in nature, relating to organisational matters or supervisory policies and methodologies. Chart 2.1 shows the distribution of the 536 decisions adopted in 2016 affecting Spanish institutions in those categories. In addition, the chart illustrates how the bulk of the decisions affecting specific institutions relate to significant Spanish institutions, and only a small proportion to other types of institutions (less significant institutions and subsidiaries and branches of significant foreign banking groups established in Spain).

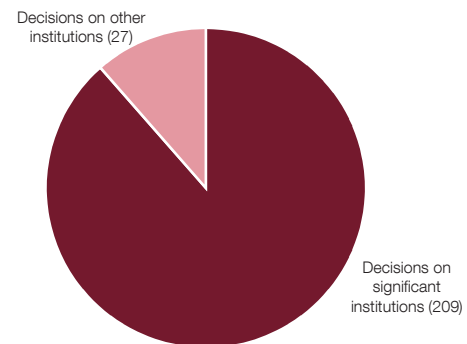
DISTRIBUTION OF DECISIONS

CHART 2.1

1 BY CATEGORY



2 BY TYPE OF INSTITUTION



SOURCE: Banco de España.

2.2.1 ONGOING SUPERVISION OF SIGNIFICANT SPANISH INSTITUTIONS

Since the start-up of the SSM in November 2014, the ECB exercises microprudential supervisory powers over significant institutions and performs supervisory tasks with the active participation of the Banco de España through the JSTs.

The Banco de España participates in the JSTs of the 14 groups of Spanish credit institutions classified as significant based on the SSM criteria and in the JSTs of 24 significant foreign banking groups established in Spain (8 subsidiaries and 16 branches). At 2016 year-end, the Banco de España contributed a total of 163 bank examiners and junior analysts to the JSTs of the Spanish banks.

Supervisory Review and Evaluation Process

As mentioned earlier, the SREP of significant institutions is carried out in accordance with the methodology defined by the SSM. The tasks are organised around four basic elements: analysis of the business model; evaluation of internal governance and global controls; assessment of the risks affecting capital and of capital adequacy to cover those risks; and assessment of the risks affecting liquidity and of the adequacy of liquidity sources to cover those risks.

The JSTs maintain ongoing and direct contact with credit institutions

In the performance of their supervisory functions, the JSTs periodically monitor risk indicators, with the frequency and intensity required by the supervisory significance assigned to the institutions. They also analyse regulatory reports, financial statements, management information, strategic and financial plans, frameworks, policies, manuals and procedures, the minutes of the institution's different decision-making and management bodies, and other relevant internal documentation. This wide range of documents most notably include the ICAAP and ILAAP, which are essential for determining the sufficiency and adequacy of capital and liquidity, together with the performance of stress tests.

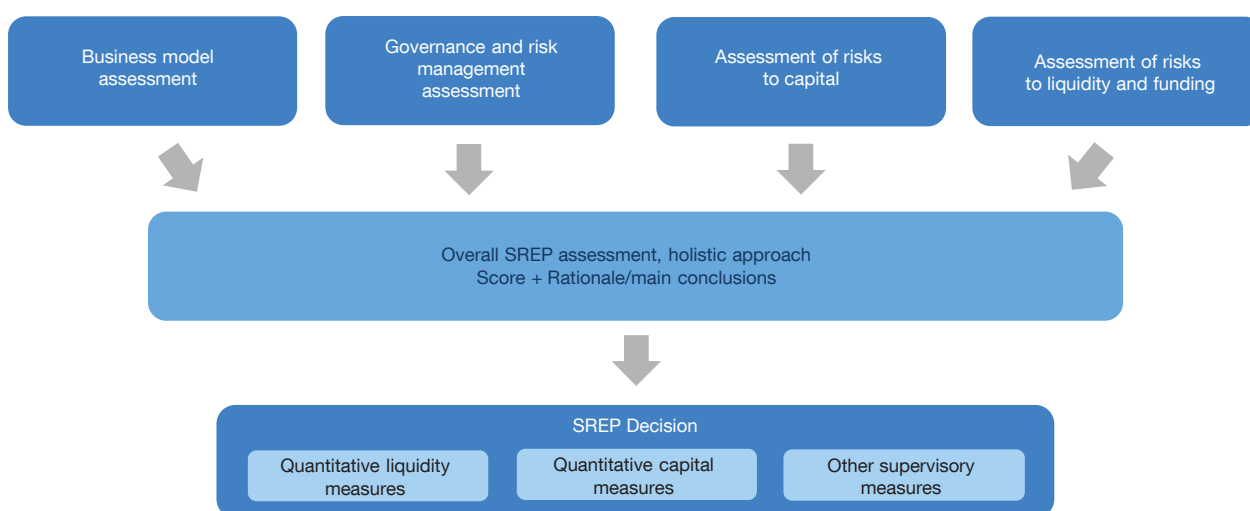
The JSTs maintain ongoing and direct contact with the institutions at different hierarchical levels. The heads of the JSTs attend board meetings or meet with independent directors

who chair control committees, as well as with executive directors and senior managers of institutions. The JSTs also hold regular and one-off meetings with management at different hierarchical levels. In the case of large Spanish significant institutions, the JSTs are based at their premises, and provide access to management and information. This communication is vital for conveying the identified shortcomings, the assessment of the institution and the supervisory priorities, and any other information relevant to the supervisor-supervised institution relationship, and favours the exchange of opinions and debate about the main supervisory areas.

SINGLE SUPERVISORY MECHANISM

SCHEMA 2.4

SUPERVISORY REVIEW AND EVALUATION PROCESS (SREP). 2016 METHODOLOGY



SOURCE: Banco de España.

Also, the JSTs participate in the significant institutions' supervisory colleges present in countries outside the SSM context. In the case of Spanish institutions, these colleges are presided over by the ECB and the Banco de España participates as an observer.

The programme of supervisory activities at significant institutions in 2016 included both the tasks relating to the SREP and other tasks in line with the supervisory priorities defined by the SSM and the Banco de España, mentioned in section 2.1, or by the JST, based on the supervised institution's risk profile. The plans also encompassed the monitoring of the shortcomings detected by on-site inspections, the reviews of internal models used for calculating capital or the previous year's thematic reviews, such as that relating to internal governance and risk appetite.

Participating in the EBA and ECB stress tests has used up a significant portion of supervisory resources. These exercises have revealed the loss-absorbing capacity and resilience of the capital of European institutions to stress events. Moreover, in 2016, the results of the stress tests were, for the first time, taken into account in the capital decision, together with other considerations, specifically to define the Pillar 2 guidance (P2G).

Also, a review of management practices for non-performing exposures and foreclosed assets was conducted at institutions with high levels of problem assets, which has resulted in the drafting of guidelines for supervisors and supervised institutions. Finally, the scheduled

activities included the review of the recovery plans and cooperation with the Single Resolution Board (SRB) in the review of the resolution plans of significant institutions.

Thematic and specific reviews

As mentioned earlier, the SEP's tasks include thematic reviews and other, specific cross-sectional reviews. These reviews focus on the SSM's supervisory concerns which are to be addressed in greater depth. As well as serving to assess and compare practices in the system, they are also used to identify best practices and to convey supervisory messages and expectations and their conclusions feed back into the SREP assessment.

In 2016, in line with the strategic priorities detailed in section 2.1.1, the JSTs participated in various thematic reviews, some of which will extend into 2017.

In 2016, the thematic reviews covered the business model, implementation of IFRS 9, internal capital models and data aggregation

- Review of business model and profitability risk. This is a two-year project, centred on the analysis of the profitability levers both at institution level and by business model segment, in a setting of low interest rates. This review aims to verify whether institutions are assuming greater risks to compensate for the decline in profitability. During 2016, it involved preparatory work, such as the design of tools and preparation of guidelines, and in 2017, the JSTs will participate more actively, performing the field work.
- Review of IFRS 9 on Financial Instruments. The purpose of this review is to assess the potential impact on the provisioning policies of credit institutions of applying the new accounting standard, and the preparatory measures for its entry into force in 2018. As with the previous review, it will be conducted over two years, with greater intensity in 2017.
- Review of internal capital models (Targeted Review of Internal Models, TRIM). This review addresses the supervisory concern relating to the quality and composition of banks' own funds, and also seeks to harmonise national options and discretions (OND). The primary objective is to assess the adequacy of the Pillar 1 internal models to measure risks. The multi-year review commenced in the second quarter of 2016.
- Review of compliance with the Basel Committee principles for effective risk data aggregation and risk reporting. This review focuses on global systemically important institutions.

Following the thematic reviews of 2015, the SSM issued a statement in June on governance and risk appetite, with reference to the main conclusions of the thematic review and the supervisory expectations in these areas. Also, in November 2016, it published draft guidelines on leveraged finance for consultation, providing guidance on the subject for credit institutions. The definitive version shall be published in 2017.

Other tasks

The JSTs also participate in authorisation processes initiated by the supervised institutions, preparing assessment reports for the adoption of resolutions in the SSM sphere. Some examples of such processes are issues, amortisations and repurchase of capital items, changes to internal capital models, exclusion of identified staff, payment of variable remuneration, corporate operations, and outsourcing processes.

It should be noted that the JSTs can perform specific tasks and activities on top of those in the supervisory plan, especially in order to swiftly address possible emerging risks or circumstances that might affect the institution.

The JSTs also cooperate with various European and international authorities and bodies, conducting surveys or impact studies, either by mediating between these authorities and the participating institutions, or responding to them.

Lastly, the Banco de España also participates, together with the ECB, in the supervision of foreign banking groups with a presence in Spain, eight of them with subsidiaries, the parents of which are classified as significant.

2.2.2 ONGOING SUPERVISION OF LESS SIGNIFICANT SPANISH INSTITUTIONS

As mentioned above, the Banco de España is responsible for the direct supervision of less significant institutions (LSIs), which account for around 6% of the Spanish banking system's assets, while their indirect supervision falls to the ECB.

Supervisory processes at less significant institutions observe the principle of proportionality

In the exercise of its supervisory tasks, the Banco de España performs quarterly or half-yearly general monitoring actions of less significant Spanish credit institutions, covering, inter alia, the areas of financial monitoring, credit risk and liquidity

PERCENTAGE OF THE DIFFERENT TYPES OF LESS SIGNIFICANT INSTITUTIONS TABLE 2.3

	% total assets/sector	
	December 2015	December 2016
Domestic Banks	33.94	31.50
Subsidiaries of Foreign Banks	3.83	4.30
Credit Cooperatives	57.25	59.50
Saving Banks	1.23	1.18
Foreign Branches	3.75	3.48
TOTAL	100.00	100.00

SOURCE: Banco de España.

The objective of those actions is to update the institution's risk profile, identify weaknesses and detect areas or matters which should be explored in greater depth. All these actions follow the principle of proportionality, so smaller institutions, with an insignificant volume of deposits raised on the retail market, are subject to simplified remote monitoring in the form of quarterly alerts based on information from confidential financial statements and the Central Credit Register. The purpose of that remote monitoring is to detect potential future liquidity, solvency or profitability problems. In 2016, there was comprehensive ongoing monitoring of 19 of the 69 groups of LSIs that were under the supervision of the Banco de España (around two thirds of LSIs total assets), and the simplified remote monitoring of the remaining 50 groups.

Also, more than 450 detailed actions were performed, including reviews of audit reports and reviews of internal capital adequacy assessment reports and capital decisions. In addition, regular meetings were held with persons in positions of responsibility at the institutions.

The Banco de España continued to cooperate with other NCAs in the area of colleges of supervisors of foreign banking groups with LSI parents, participating in three colleges² in 2016.

² A&G Banca Privada, Banco Finantia Sofinloc and Banco Mediolanum.

Such direct supervision of the LSIs by the Banco de España is supplemented by the indirect supervision by the ECB, which consists of:

- overseeing the functioning of the LSI sector, and
- ensuring the application of high and harmonised supervisory standards by the NCAs.

The ECB's performance of those two functions benefited from the cooperation by the Banco de España, which contributed its staff's experience and knowledge of the characteristics of the less significant Spanish institutions. In particular, the Banco de España cooperates with the ECB by submitting regular and ad hoc information on the manner in which the supervisory activity is performed and its results, following the procedures laid down by the ECB.

The Banco de España cooperates with the ECB and the other NCAs in defining high supervisory standards which, once approved in the form of guidelines or recommendations, must be applied or taken into consideration by all the SSM countries in the supervision of their LSIs. That cooperation will be maintained in the coming years, since ensuring that the supervisory standards are consistent and effective and that there is an appropriate level of consistency within the SSM is deemed a priority, without prejudice to the fact that the characteristics of the LSIs of each country must be taken into account.

Lastly, given that the branches of institutions with head offices in European Union Member States that are not under the supervision of the SSM are not subject to prudential or liquidity requirements at the branch level, the supervision of the Banco de España is based on simplified remote monitoring and on the regular exchange of information with the authorities of the home country of the branch, under the terms established in Commission Implementing Regulation (EU) 620/2014.

2.2.3 COMMON PROCEDURES

The common procedures, established in Regulation (EU) 468/2014 of the ECB, are those relating to authorisations to take up the business of a credit institution, withdrawals of such authorisations and the acquisitions of qualifying holdings. Among these procedures, the Banco de España is responsible for making an initial assessment and submitting a draft decision on each specific case. Subsequently, on the basis of this proposal and other additional tasks that it might deem appropriate, the ECB must adopt a final decision.

In 2016, five common procedures were performed relating to the acquisition of significant holdings and five to withdrawals of authorisations.

2.2.4 ON-SITE INSPECTIONS

As regards both significant and less significant credit institutions, the on-site inspection function is separate from ongoing monitoring for the purpose of reinforcing the independence and objectivity of the conclusions obtained from those tasks. Table 2.3 details the on-site actions performed on credit institutions in 2016.

ON-SITE SUPERVISORY ACTIVITY AT CREDIT INSTITUTIONS. ACTIONS

TABLE 2.4

	2016		TOTAL
	Significant institutions	Less significant institutions	
On-site inspections	16 (a)	13	29
Internal risk-model reviews	14	—	14
Anti-money laundering inspections	3	—	3
TOTAL	33	13	46

SOURCE: Banco de España.

a Of which, 12 were led by Banco de España.

On-site actions
for significant institutions

On-site inspection actions for significant institutions are planned as part of the SEP. Apart from the three inspections on the prevention of money laundering mentioned below, in 2016, 28 on-site inspections of significant Spanish institutions were performed. The Banco de España played a major role in those supervision tasks:

- Of the 30 on-site inspections, 24 were led by Banco de España staff, 3 by ECB staff and 3 by staff from another SSM Member State.
- A significant proportion of the personnel who participated in the aforementioned inspection visits were from the Banco de España.

In 2016, Banco de España staff participated for the first time in inspections of institutions from other SSM Member States

In addition, Banco de España staff participated for the first time in inspections of two financial groups from other SSM Member States.

In 2016, work continued to improve on-site inspections, particularly to boost their efficiency by developing mechanisms and routines to reduce inspection turnaround times.

As part of the aforementioned significant and active participation of the Banco de España in the many working groups set up in the SSM framework, it participated intensively in the development of the most appropriate techniques for the on-site inspection of different risks (credit, technological, market...). In this respect, to continue uniformly applying on-site inspections in all SSM countries, in 2016 the ECB Centralised On-Site Inspection Division organised a series of working meetings between the ECB and the various national supervisors.

In the last quarter of 2016, the Banco de España participated actively in the preparation of the 2017 SEP, which established the on-site inspections to be performed throughout the year. The main new features should be noted:

- An increase in the number of joint inspections (performed by staff from different countries), including some headed by Banco de España staff in institutions in other SSM countries.
- There will be an ambitious programme of reviews of internal models in 2017, which will cover a total of 19 Spanish institutions and will notably include an in-depth review of the internal capital models in force within the SSM (Targeted Review of Internal Models, TRIM).

A substantial increase in supervisory actions by multinational teams is expected in 2017

The Banco de España will continue cooperating with SEPBLAC, which is responsible for the supervision of the prevention of money laundering

Since the supervision of the prevention of money laundering and terrorist financing has been excluded from the SSM's supervisory action, the Banco de España continues to cooperate with SEPBLAC in the supervision of this area. In 2016, three inspections were carried out at significant institutions, and the Banco de España continued to take part in various international working and cooperation groups on this issue.

On-site actions for less
significant institutions

A supervisory action plan is prepared every year for less significant institutions, which, together with monitoring actions, makes up the plan of on-site actions for less significant institutions, taking into consideration the supervisory risk profile of the various institutions and the years elapsed since the last action. This plan is approved by the Banco de España's Executive Commission. A total of 13 actions were performed in the year.

The supervisory assessment of each credit institution contains the conclusions of the remote and on-site reviews and determines the annual capital decision (known as “Pillar 2”) which is notified in December each year and which institutions must comply with the following year.

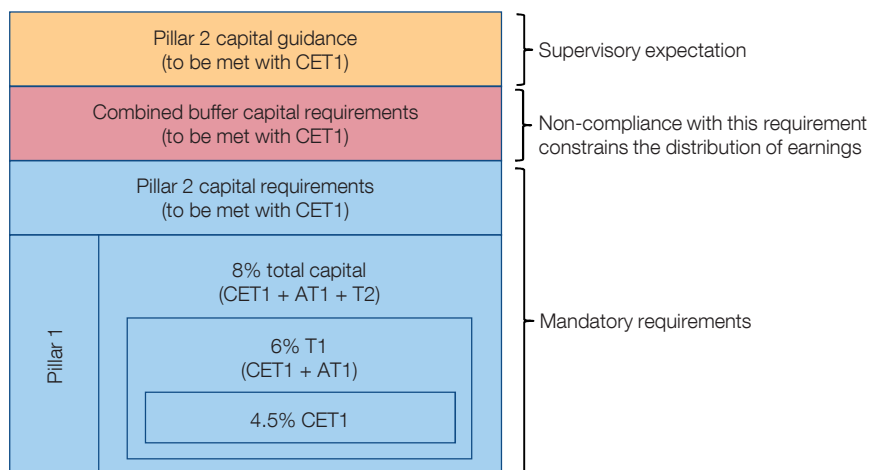
The supervisor adopts this decision essentially on the basis of the SREP, which includes the examination of the institution’s risks, controls and governance. The SREP also takes into account the supervisory review of the assessment that the institution itself makes of its risks and its capital base in accordance with its internal processes, in a process called “Internal Capital Adequacy Assessment Process” (ICAAP).

It should be taken into consideration that the guidelines prepared by the EBA in relation to the SREP, which were published in December 2014 (EBA/GL/2014/13), have been in force since 2015. Also, at the end of 2016, the EBA published guidelines on the ICAAP and ILAAP (EBA/GL/2016/10), which will be formally implemented following the adoption by the Banco de España of the definitive version of the guidelines translated into Spanish.

The formal structure of the 2016 capital decision has changed substantially with respect to that of 2015, in the terms set out below. In principle, this change affects both significant institutions supervised by the SSM and less significant institutions.

- The first change is a formal one: the 2015 capital decision indicated the total level of CET1 which institutions must have at all times and which covered both the minimum regulatory requirement (Pillar 1) and Pillar 2 risks (basically business risk, balance sheet interest rate and exchange rate risk, concentration risk and reputational risk). However, the 2016 capital decisions only include the amount of CET1 required to cover Pillar 2 risks.
- The 2015 capital decision required institutions to cover, in relation to Pillar 2, the portion of the capital conservation buffer not yet directly enforceable at the time, in application of the transitory adjustment regulations (that is, the equivalent of a 2.5% buffer was required). The 2016 capital decision only refers to the combined buffer requirement enforceable at institutions in accordance with the phasing-in period envisaged in the regulations, by virtue of which Spanish banks need to cover 1.25% in 2017.
- The capital decisions issued by the SSM in 2016 introduced a new element, the so-called “Pillar 2 guidance” or P2G. This supervisory tool sets capital expectations above the level of overall capital requirements, which are not binding and supplement the Pillar 2 requirements. This guidance relies on the outcome of the stress test exercises conducted during the year and is expressed in terms of CET1. The SSM expects banks to comply with P2G, on top of the minimum regulatory requirements (Pillar 1), the Pillar 2 requirement and the combined buffer requirement. If a bank fails to comply with this expectation, there will be no automatic supervisory actions. Instead, supervisors will consider adopting supervisory measures on a case by case basis, with the approval of the Supervisory Board of the SSM. Such measures may include the transformation of this capital expectation into a Pillar 2 capital requirement, which the bank in question would be obliged to comply with.

The SSM’s capital decision for significant institutions in 2016 includes a capital requirement and recommendation for the first time



SOURCE: Banco de España.

Capital decision of significant institutions

With regard to significant institutions, 2016 saw for the second time the application of the methodology implemented within the SSM for determining the capital decision, which guarantees that all significant European institutions are assessed on a uniform basis. This common framework covers:

The level of capital communicated to significant institutions by the SSM in 2016 remained stable in overall terms.

- a) a system for risk assessment of credit institutions' risks;
- b) a review of the ICAAP and ILAAP applied by the institutions; and
- c) a methodology for calculating the capital and liquidity needs on the basis of the assessment of their risks.

In material terms, the inclusion of the capital expectation (P2G) in the capital decision has been a particularly significant factor in the overall reduction of the Pillar 2 capital requirement with respect to that of the 2015 capital decision. However, if the capital expectation and capital conservation buffer are included, the total capital requirement notified by the supervisor to institutions does not change overall.

Once the period granted to institutions for making representations has expired, the 2016 SREP capital decisions approved by the SSM Supervisory Board will be in force until the next capital decision, which will foreseeably be adopted in December 2017.

Capital decisions of less significant institutions

With respect to less significant institutions under the direct supervision of the Banco de España, a similar, though simpler, arrangement was applied in 2016, taking into account the SREP methodology already developed by the SSM for LSIs and the Banco de España's guidelines on the ICAAP and the capital review process.

Once the corresponding 2016 SREPs had concluded, the Banco de España adopted capital decisions for the less significant institutions by means of a procedure that included the consideration of institutions' representations.

The supervisory practices of the Banco de España are adapted, in all material respects, to the current framework established by international agreements, European legislation, the EBA guidelines adopted by the Banco de España as at 31 December 2016, and the SSM

cooperation framework. Given that the SREP methodology for LSIs is currently under preparation, in 2017 the SREP will need to be adapted and brought into line with the guidelines issued by the SSM for LSIs, although entry into force will not be mandatory until 2018.

2.2.6 INFORMATION SUBMITTED PERIODICALLY TO THE EXECUTIVE COMMISSION

Although supervisory decisions relating to significant credit institutions are adopted by the Governing Council of the ECB, supported by the Supervisory Board, the Directorate General Banking Supervision informs the Executive Commission of the Banco de España about these decisions and other relevant SSM matters. The director general of Banking Supervision reports to the Executive Commission on:

- The supervisory decisions regarding significant Spanish institutions, including capital decisions.
- The supervisory priorities and the supervision plan for the coming year.
- General SSM matters which may be of particular interest.
- Relevant decisions relating to foreign SSM institutions.
- Periodically, on the situation of Spanish institutions.

2.2.7 THE QUALITY FUNCTION

The quality function seeks to ensure that banking supervision is consistent and applies the best supervisory practices

The quality function seeks to ensure that banking supervision is consistent and applies the best supervisory practices. Before the SSM was created, the Banco de España's quality function centred on providing support to operational groups, with the aim of standardising supervisory practices. As an example, this standardisation was achieved by unifying technical supervisory criteria, establishing common supervisory procedures and methodologies, using the analytical ratios of similar institutions, ensuring that information was properly filed and assessing the degree of compliance with the action plan.

Following the entry into operation of the SSM, and without abandoning its supportive role, the quality function has been strengthened and geared towards specific ex-post quality reviews, in line with the SSM's approach. In this respect, responsibilities between the SQA (Supervisory Quality Assurance) Division of the ECB and the quality function at the Banco de España (as the Spanish NCA) have been allocated as follows:

- The SQA Division is responsible for exercising the quality function over institutions which are directly supervised by the ECB, that is, significant institutions.
- The Banco de España's quality function is responsible for assuring the quality of supervision of less significant Spanish institutions, and that of all other functions of local institutions. In addition, it may cooperate with the SQA Division in the reviews of significant institutions.

2.2.8 SUITABILITY

The applicable legislation establishes certain suitability requirements for board members and...

The purpose of the supervision of the suitability regime for senior officers is to assess compliance with the requirements that the persons appointed to occupy the positions of board members, managing directors or similar officers must fulfil in accordance with the applicable legislation: commercial and professional repute, appropriate knowledge and experience to exercise their functions, compliance with the incompatibilities and limitations regime (where applicable) and, in the case of board members, willingness to exercise good governance. The suitability assessment by the supervisor is conducted mainly upon the

**...managing directors
of credit institutions**

appointment of the senior officer, but also in an ongoing manner, when there are significant events or changes which might affect it.

Competence in the case of significant institutions corresponds to the ECB, in close cooperation with the NCAs, whereas competence in the case of less significant institutions corresponds to the Banco de España.

Ongoing development
of the Banco de España's
supervisory practices

The supervision of the suitability regime for senior officers is constantly being adapted to the new criteria published by regulatory bodies, and to both national and international best practices. In the case of institutions forming part of significant groups, the ECB endeavours to harmonise supervisory criteria among all the SSM countries, always observing the limits established under national legislations.

The Banco de España has not only participated actively in the drafting of criteria and practices which began to be defined in the previous year and which, as discussed below, have culminated in the publication of the ECB and EBA guidelines on suitability assessments, but has also worked to improve the coordination of the ongoing supervision of institutions' corporate governance, and the suitability regime for senior officers, both as individuals and as a group.

In 2016, the collective suitability of the board of directors was further analysed, bearing in mind, for the purpose of taking decisions on suitability, the supervisory teams' conclusions on the corporate governance of some institutions, mainly those forming part of significant groups, when such conclusions are related to the collective suitability requirement of the board. For example, the decisions refer to the level of skills and experience expected by the supervisor in any future appointments made by the institution.

Accordingly, the focus has shifted to ongoing supervision of compliance with the suitability regime, attempting to relate findings or new facts detected, either externally or internally, during the mandate of the senior officers. The circumstances analysed in each specific case may give rise to a suitability reassessment procedure, if it is determined that the new facts are sufficiently relevant (with a positive or negative outcome) or, otherwise, to a supervisory judgement on the lack of relevance of such facts regarding suitability.

The Banco de España has consolidated the practice of i) incorporating into the suitability decisions for significant and less significant institutions conditions, recommendations, requirements or obligations, in line with the measures taken the previous year for institutions forming part of major groups, and ii) interviewing the chair, chief executive officer or, depending on the case, newly appointed independent directors of credit institutions belonging to major groups, consolidated at the highest level within the group or, if this is a corporation, of the credit institution with the highest volume of assets.

**Institutions must
continually improve and
adapt their suitability
assessment procedures
and duly reflect the
outcomes in their reports**

Also, work is under way to systemise the information required by the competent authorities for the suitability assessment files, so as to ensure that the suitability assessment requests submitted by institutions are as detailed as possible and can be dealt with by the competent authority quickly, especially taking into account that, in the case of credit institutions, the exercise of functions by the appointed person is conditional upon registration in the Senior Officers Register, and that the suitability assessment must be performed by the competent authority prior to registration. The ECB, jointly with all the NCAs, has prepared a suitability questionnaire intended to systematise the required information and prevent the competent authorities from having to make additional information requests during the processing of

the files. The Banco de España is expected to implement this questionnaire in the coming year. The Banco de España's Virtual Office is proving to be an essential tool for sharing information about these new developments.

In this respect, the guidelines published by the EBA and the SSM and referred to below provide guidance on the information that institutions must take into consideration when assessing whether each of the suitability requirements has been met. Both sets of guidelines emphasise that the credit institutions themselves have the primary responsibility for selecting and appointing senior officers and ensuring that they adequately comply with the suitability requirements at all times. It is therefore particularly important that they continuously improve and adapt their suitability assessment procedures, duly reporting on the results.

Finally, in early 2016, the Banco de España approved Circular 2/2016, relating to important aspects such as: i) the incompatibilities regime; ii) the possibility, during the processing of the files, of consulting other supervisors, conducting interviews or requesting additional information or documentation, or iii) the adoption of a negative decision, among other reasons, if false or misleading information is provided or relevant information is omitted during the assessment process, or if the shortcomings detected in the process are not remedied. Furthermore, in compliance with the third transitional provision of this circular, information has been provided about board members, managing directors and similar officers of credit institutions, with a view to updating the Register of Senior Officers.

Harmonisation of supervisory practices among the SSM countries

As mentioned above, the ECB has published a Draft guide to fit and proper assessment, the main objective of which is to inform credit institutions under its direct supervision of the supervisory criteria used when assessing the suitability of senior officers. This guide has been submitted for public consultation and will foreseeably be approved by June 2017.

European Banking Authority Guidelines

Also noteworthy is the publication of the *Joint ESMA and EBA Guidelines on the assessment of the suitability of the management body and key function holders under Directive 2013/36/EU and Directive 2014/65/EU*, which have been put to public consultation and whose final version is pending approval. Once these guidelines have been approved, the competent supervisory authorities must inform the EBA of the level of compliance with the guidelines and provide justification in the event of non-compliance.

2.2.9 OTHER ACTIONS

In addition to the tasks described above, the Banco de España's supervisory tasks also include, both for significant and less significant institutions, the microprudential supervisory tasks not transferred to the SSM and the handling of certain procedures envisaged in the applicable legislation.

Other supervisory tasks of the Banco de España

Noteworthy among the microprudential supervision tasks not transferred to the SSM which were performed by the Banco de España in 2016 are the following:

- The Banco de España is the competent body to authorise the opening of third-country branches in Spain. In 2016 no new authorisations were granted.
- As indicated in the Chapter 1, the supervision of the prevention of money laundering and terrorist financing at credit institutions in Spain is the competence of the Executive Service of the Commission for the Prevention of Money Laundering and Monetary Offences (SEPBLAC by its Spanish abbreviation) and the Banco de España participates in the supervision of those procedures under the special cooperation arrangements provided.

As mentioned earlier, the division of certain competences between the ECB and the NCAs, not arising from EU legislation, has recently been clarified in the framework of the SSM. Accordingly, the Banco de España assumes supervisory powers which do not correspond to the ECB or which do not support its supervisory functions.

Specifically, the Banco de España pays ongoing attention to developments and changes in the banking activity and to new trends, for example, the emergence of Fintech firms.

Procedures performed

Also, in 2016 the Banco de España, both as a member of the SSM and in the exercise of its exclusive supervisory powers, performed the procedures summarised in Table 2.5 below.

PROCEDURES IN RESPECT OF CREDIT INSTITUTIONS INVOLVING THE BANCO DE ESPAÑA

TABLE 2.5

	Total number
Cross-border activity of Spanish credit institutions	47
Branches in the European Union (a)	11
Branches in third countries	2
Freedom to provide services	34
Suitability	294
Loans to senior officers	68
Other procedures relating to own funds (b)	21
Reports to Ministry of Economy on structural changes	13
Acquisition of credit institutions in third countries	4
Amendments of articles of association	55
Issuance of reports for other Spanish authorities	16
Other procedures	26
TOTAL	544

SOURCE: Banco de España.

a The amount includes one closure and ten modifications of the branches initial notifications.

b Including exemptions from deductions provided for in Regulation (EU) 575/2013, authorisations relating to the scope of that regulation and joint decisions on capital.

2.2.10 LETTERS

In the performance of its supervisory tasks, the Banco de España sent 150 letters to credit institutions containing requirements and recommendations, as detailed in Table 2.6. Of these, 57 related to capital decisions, 54 to recovery plans, 19 to the outcome of the comprehensive annual monitoring and 20 to on-site inspections.

SUPERVISORY ACTIVITY. LETTERS ADDRESSED TO CREDIT INSTITUTIONS

TABLE 2.6

Number	
Credit institutions (a)	Total number
Banks	43
Savings banks	6
Credit cooperatives	99
Foreign branches	2
TOTAL	150

SOURCE: Banco de España.

a Of these letters, 3 relate to SIs arising from competencies not assumed by the SSM and the rest relate to LSIs.

The regulation assigns a major role to the supervisor in the recovery and resolution of credit institutions

2014 saw the publication of the Banking Recovery and Resolution Directive (BRRD), which guarantees a harmonised resolution framework in the EU with a view to ensuring that taxpayers do not have to bear the costs of failing banks, and that the shareholders and creditors assume the mistakes of inappropriate private action. The BRRD was transposed into Spanish legislation through the approval of Law 11/2015 and Royal Decree 1012/2015 in June and November, respectively.

On the one hand, a new institutional framework for resolution is defined, drawing a distinction between: i) preventive resolution functions, assigned to the Banco de España (which performs that task independently from its supervisory functions), and ii) executive resolution functions, assigned to the FROB. These functions will be performed bearing in mind the competence structure attributed to the ECB in the framework of the SSM and to the SRB as the single resolution authority in the framework of the Single Resolution Mechanism (SRM)³.

On the other, three key phases are established for the new resolution framework: i) a preventive phase, in which institutions and authorities must plan how to handle a critical situation or a potential resolution; ii) an early intervention phase, in which the supervisor is granted powers that supplement the other supervisory measures available to it to take action in relation to institutions when they start to show weakness but are still viable and, iii) a resolution phase. In addition, under this new crisis management framework, supervisors and resolution authorities are subject to an obligation to cooperate and work closely in the different phases mentioned above.

Preventive phase

In the preventive phase, in its normal course of business, it is particularly important for an institution to ensure that it is prepared to deal with a crisis situation (in the case of institutions, in order to “survive”, and in that of the resolution authorities, in order to “take swift action” to ensure the continuity of critical functions and stave off adverse effects for the economy).

This phase consists of the following key elements: i) the preparation of recovery plans by institutions, defining measures they would adopt to restore their position in times of crisis, and ii) the design of resolution plans by the resolution authority, establishing the roadmap to be followed to resolve the institution, if necessary. Also, under the regulations, as an integral part of the resolution plan, the resolution authority must perform two key tasks: a “resolvability analysis” (to identify and remove, if necessary, any possible obstacles to the swift execution of a potential resolution) and the determination of the “minimum requirement for own funds and eligible liabilities (MREL)” to be met by institutions to guarantee loss-absorbing capacity and, if necessary, the recapitalisation of the institution.

Early intervention phase

The early intervention would be activated at the request of the competent supervisor before the institution’s resolution becomes necessary and with a view to avoiding it. There are some thresholds, which are not automatic, allowing for early intervention, defined by the EBA guidelines and adopted by the Banco de España. Those thresholds are linked to the institution’s SREP, to significant events or to the outcomes of the monitoring of the institution’s financial situation. The supervisor may adopt different measures, from forcing through the adoption of measures included in the recovery plan or requiring the removal of directors, for example, to deciding on the intervention of the institution if the other measures prove to be insufficient. Identifying the time at which early intervention should be triggered

³ The SRB (the single resolution authority in the euro area) has powers over the institutions supervised directly by the ECB in the framework of the SSM and other cross-border groups of less significant institutions.

is essential to prevent the institution from becoming non-viable. In that connection, the Banco de España has adopted the guidelines issued by the EBA on the thresholds for triggering early intervention, on which it bases its analysis to decide on this matter.

Schema 2.6 summarises the main tasks assigned to the supervisory and resolution authorities (prevention and execution) in these two phases of the resolution framework, taking into account the competences attributed to the ECB and the SRB in the framework of the SSM and the SRM, respectively.

MAIN TASKS OF THE SUPERVISOR AND THE RESOLUTION AUTHORITIES DURING THE PREVENTIVE PHASE AND DURING EARLY INTERVENTION

SCHEMA 2.6



SOURCE: Banco de España.

Resolution phase

In order to commence the resolution phase, the following must be determined: i) whether the institution is non-viable; ii) that there are no private alternatives or other supervisory measures that might prevent failure; and iii) whether it is in the public interest. In Spain, it is the supervisor that determines the first premise⁴. Verification of the second premise

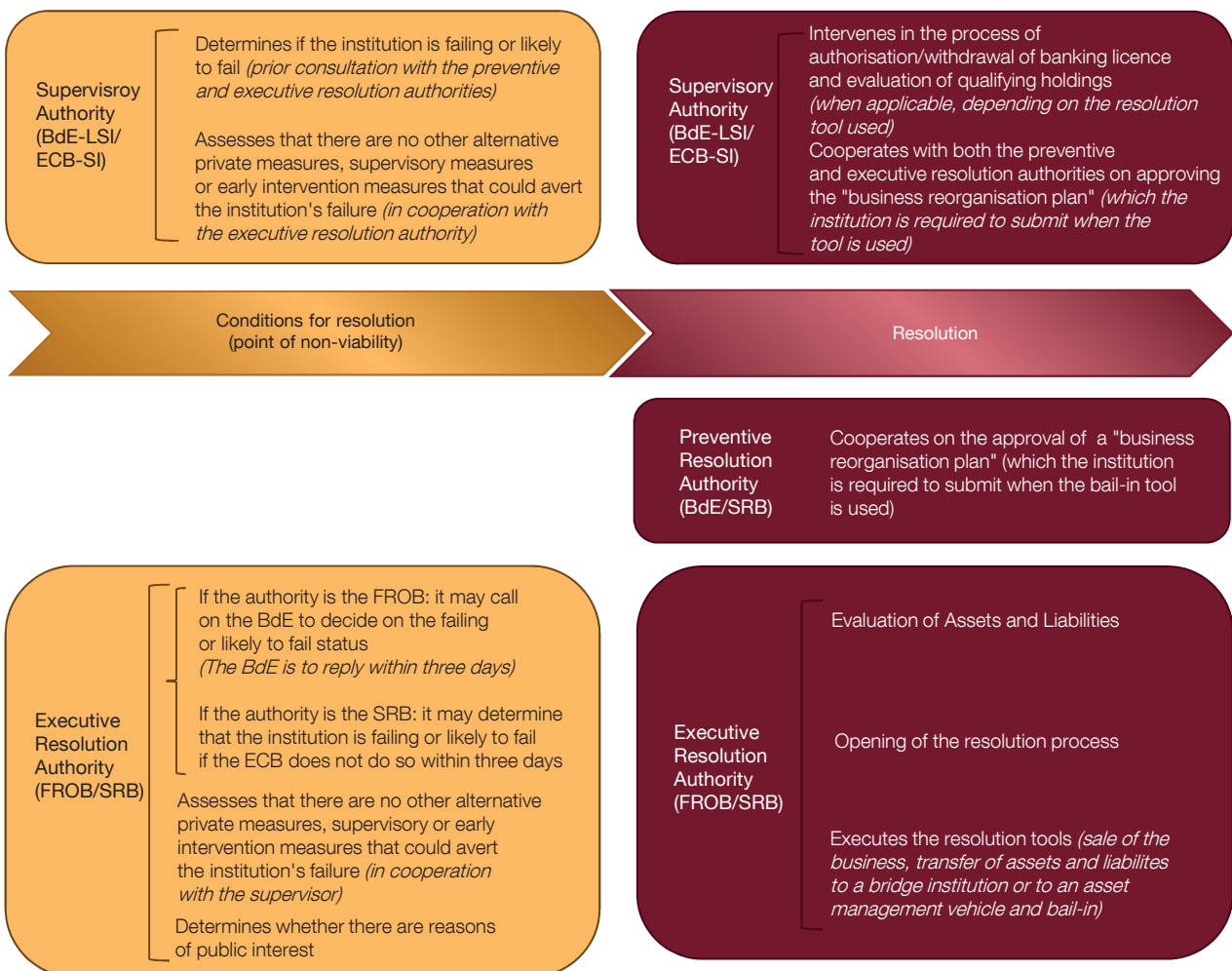
⁴ Although the FROB may urge the supervisor to make such a determination if it considers there are reasons to do so, the supervisor must give a justified response within three days.

(alternatives to prevent failure) is the joint responsibility of the supervisor and the executive resolution authority. Lastly, the assessment of public interest falls to the executive resolution authority. If the resolution cannot be justified for reasons of public interest, the institution would be wound up under normal insolvency proceedings.

Schema 2.7 summarises the main tasks assigned to the supervisory and resolution authorities (prevention and execution) when the institution becomes non-viable and a decision is taken to proceed with the resolution, taking into account the competences attributed to the ECB and the SRB in the framework of the SSM and the SRM, respectively.

MAIN TASKS OF THE SUPERVISOR AND THE RESOLUTION AUTHORITIES WHEN THE INSTITUTION REACHES THE POINT OF NON-VIABILITY AND DURING THE RESOLUTION PHASE

SCHEMA 2.7



SOURCE: Banco de España.

Main supervisory activities of the Banco de España in the resolution framework in 2016

With respect to the groups of significant institutions, the JSTs performed the following activities in the area of recovery and resolution:

- They completed the reviews of the first recovery plans submitted by these institutions in the final quarter of 2015. Institutions were informed of the outcome of the reviews in letters in which they were advised of the aspects to be improved before submitting their plans for 2016.

The recovery plans of significant credit institutions were reviewed for the first time

- They participated in the resolution plan review process, in the legally established prior consultation phase between the resolution authority and the competent supervisory authority (SRB and ECB, respectively). This review was particularly relevant for the analysis of the implications of the resolution strategy adopted by the resolution authority for the different groups, and the measures required for reducing or removing any identified impediments to resolvability. No formal decision was taken in 2016 as regards determining the minimum requirement for own funds and eligible liabilities (MREL).

With regard to less significant institutions, the Banco de España:

- Completed the definition of the institutions which may be subject to simplified obligations, taking into account the framework established in the EBA guidelines on this issue (EBA/GL/2015/16). In fact, these institutions submitted their resolutions plans to the Banco de España for the first time in 2016, by the 30 September deadline. The supervisor reviewed these plans in the first quarter of 2017.
- Has also participated actively with other NCAs and the ECB in the process of harmonising crisis management schemes for less significant institutions in order to ensure consistent procedures and tools in the SSM framework for sound and effective crisis management at these institutions.

2.3 Supervision of institutions other than credit institutions

The Banco de España has exclusive microprudential supervisory powers over the following institutions other than credit institutions that provide services or perform functions related to the financial sector: specialised lending institutions, mutual guarantee and reguarantee companies, appraisal companies, payment institutions, electronic money institutions, currency-exchange bureaux, banking foundations and Sareb. Table 2.7 contains the detail of those institutions.

OTHER INSTITUTIONS

TABLE 2.7

Number. Year-end data (a)

	2013	2014	2015	2016
Specialised lending institutions (b)	48	47	44	43
Mutual guarantee companies	24	24	21	21
Reguarantee companies	1	1	1	1
Appraisal companies	46	40	36	37
Currency-exchange bureaux (c)	9	10	13	12
Payment institutions	48	45	43	41
Hybrid payment institutions	—	—	2	3
Branches of EU payment institutions	6	8	12	15
Agent networks of EU payment institutions	2	3	3	3
Electronic money institutions	3	4	3	4
Branches of EU electronic money institutions	1	2	2	2
Banking foundations	—	13	14	14
Sareb	1	1	1	1
TOTAL	189	198	195	197

SOURCE: Banco de España.

a The number of institutions also includes those that are non-operational and in the process of deregistering.

b Of the total, there are 21 specialised lending institutions that are subsidiaries of banking groups and are supervised through these groups. Also included are the specialised lending institutions that have proven their status as hybrids, in application of Law 5/2015, to promote business financing (0 in 2013, 0 in 2014, 5 in 2015, and 8 in 2016).

c Not including establishments only authorised to purchase foreign currency with payment in euro.

Institution type	Activities conducted	Supervisory powers of the Banco de España	
		Legal basis	Main activities
Specialised lending institutions	Various types of credit transactions and granting of guarantees. They cannot take deposits from the public, however.	Article 12.1 of Law 5/2015, on the promotion of business financing.	Review of credit portfolio quality, profitability, solvency and internal controls. Carried out via monitoring activities or on-site inspections.
Mutual guarantee companies	These act as a means of business promotion, granting guarantees to SMEs to allow them to access bank finance, and providing other complementary services, such as advice on negotiating better borrowing conditions with credit institutions and evaluating investment projects.	Article 66 of Law 1/1994 on the Legal Regime for Mutual Guarantee Companies.	Analysis of the the quality of the portfolio of guarantees, their liquidity, profitability and solvency. Carried out via monitoring activities and on-site inspections, where applicable.
Appraisal companies	Appraisal of assets used as collateral for credit institutions' mortgage exposures in general.	Article 15 of Royal Decree 775/1997 on the rules governing the approval of appraisal services and companies.	Analysis of the procedures used to perform the appraisal of real-estate assets taken as mortgage collateral by credit institutions. This analysis is carried out using a tool based on statistical methods to review the appraisals performed by these companies, and by on-site inspections, where applicable.
Payment institutions	Providers of services and means of payment, performing an important role in the functioning of an effective, efficient and secure payments system, which is in turn crucial to the correct functioning of economic and commercial relations.	Article 15 of Law 16/2009 of 13 November 2009 on payment services.	The work of supervising these institutions focuses on reviewing the adequacy of the safeguards protecting funds received from customers, institutions' solvency and internal control, and their correct identification.
Electronic money institutions		Article 20 of Law 21/2011 of 26 July 2011 on electronic money.	
Currency-exchange bureaux	Two types of establishment exist: those authorised only to buy foreign currency and travellers' cheques against payment in euros, and those authorised to sell foreign banknotes and travellers' cheques against payment in euros or banknotes in other currencies. These range from seasonal tourism establishments licensed to change foreign currency as an extra service for their customers, to joint-stock companies with significant volumes of own funds and turnover, solely engaged in money changing on a professional basis.	Article 6 of Royal Decree 2660/1998 of 14 December 1998 on the changing of foreign currency in establishments open to the public other than credit institutions.	Analysis of a series of alerts (negative margins, significant changes in activity, etc.), the most significant being those affecting compliance with own funds requirements. Generally carried out through monitoring activities, although they may be subject to on-site inspections.
Banking foundations	Foundations with a direct or indirect shareholding in a credit institution accounting for at least 10% of its capital or voting rights, or which entitles it to appoint or dismiss a member of its governing body. It must have social goals as its purpose, and its main focus should be managing and developing its community welfare activities and the appropriate administration of its shareholding in a credit institution.	Article 46 of Law 26/2013 of 27 December 2013 on savings banks and banking foundations.	Analysis and evaluation of banking foundations' influence on the sound and prudent management of those credit institutions in which they have an interest. The Banco de España therefore has powers conferred upon it to: a) carry out inspections and make any checks it deems necessary in the exercise of its functions; b) require that the banking foundation provide it with all such information as is necessary for the performance of its functions. In the implementation of the foregoing, management protocols and annual financial plans were received for approval from the banking foundations subject to this requirement for the first time.
Sareb	Created in November 2012 to assist the Spanish financial sector, and in particular, institutions in difficulties as a result of their excessive exposures to the real-estate sector. 55% of its capital is private, with the remaining 45% being held by the FROB.	Seventh additional provision of Law 9/2012 of 14 November 2012 on credit institution restructuring and resolution.	Verification of the proper application of the procedures applied for the disposal of assets received, and their appropriate valuation. Carried out via monitoring activities and on-site inspections, where applicable.

The legal basis under which the Banco de España supervises those institutions and the approach behind the tasks differ from case to case. However, the supervisory concern is always the same: to contribute to the proper functioning of those institutions, considering the role they play, and customer protection.

Although the weighting of the institutions discussed in this section with respect to the financial system as a whole cannot be compared to that of credit institutions, their supervision is conducted by the Banco de España with the conviction that an effective regulatory and supervisory model for these institutions promotes the fluidity of financial intermediation mechanisms and generates a climate of confidence in financial institutions.

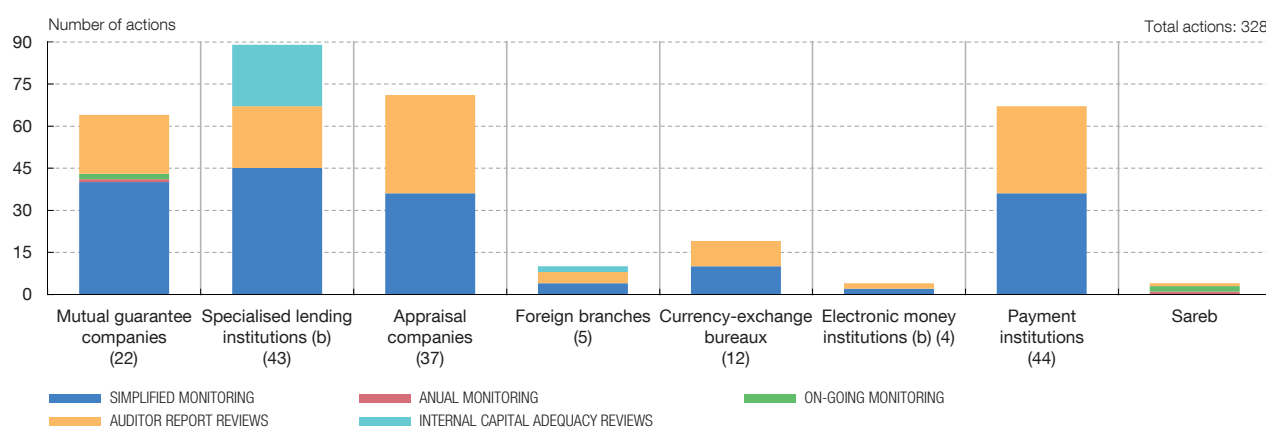
The following sections of this chapter refer, firstly, to the supervisory activity carried out in 2016 on the above-mentioned institutions. Secondly, mention is made of the authorisations and other procedures relating to the exercise of their activity. And thirdly, a description is given of the actions relating to the oversight of vetted access to activity.

2.3.1 SUPERVISORY ACTIVITY

In 2016, 328 remote monitoring actions were performed by various means: annual monitoring, periodic general monitoring, simplified monitoring, reviews of audit reports and reviews of internal capital adequacy assessment reports, as detailed in Chart 2.2.

SUPERVISORY ACTIONS (a)

CHART 2.2



SOURCE: Banco de España.

- a The number of institutions monitored in 2016 is shown on the label for each column.
b Supervisory actions are not included in the case of 21 specialised lending institutions and one electronic money institution belonging to a national banking group.

Also, a total of five inspections were performed in 2016, the detail of which is shown in Table 2.9.

ON-SITE INSPECTIONS AT OTHER INSTITUTIONS

TABLE 2.9

	2012	2013	2014	2015	2016 (a)
Specialised lending institutions	1	2	—	3	—
Appraisal companies	—	—	—	—	—
Mutual guarantee companies	1	—	—	2	1
Payment institutions	3	3	5	3	1
Currency-exchange bureaux	—	—	—	—	2
Electronic money institutions	1	—	—	1	—
Sareb	—	—	1	1	1
TOTAL	6	5	6	10	5

SOURCE: Banco de España.

- a Of these inspections, 1 was in progress as at year-end.

2.3.2 AUTHORISATIONS AND
OTHER PROCEDURES

Granting and withdrawal
of licences

The Banco de España participates in the granting and withdrawal of licences to open those institutions and to perform other procedures relating to the exercise of their activities. However, the scope of its involvement is not the same for all types of institutions. The Banco de España is the competent authority for granting and withdrawing licences for currency exchange bureaux and officially recognises appraisal companies. However, it only has to issue a mandatory report on the authorisation of the following types of institutions, which is granted by the Ministry of Economy and Competitiveness:

- Specialised lending institutions
- Electronic money institutions or branches in Spain of non-EU electronic money institutions.
- Payment institutions or branches in Spain of non-EU payment institutions.
- Mutual guarantee companies.

In 2016, a total of 14 requests to open institutions and 10 deletions in the register were processed, according to the breakdown in Table 2.10.

REGISTRATIONS AND DEREGISTRATIONS OF OTHER INSTITUTIONS

TABLE 2.10

Number of registrations/deregistrations in 2016

	Registered on 31/12/2016	2016 registrations	2016 deregistrations	Variation 2015-2016
Specialised lending institutions	35	1	5	-4
Specialised lending institutions - hybrid payment institutions	8	3	0	3
Mutual guarantee and reguarantee companies	22	0	0	0
Appraisal companies	37	1	0	1
Currency-exchange bureaux	12	1	2	-1
Payment institutions	41	2	4	-2
Hybrid payment institutions	3	1	0	1
Electronic money institutions	4	1	0	1
Branches of EU payment institutions	15	4	-1	3
Branches of EU electronic money institutions	2	0	0	0
TOTAL	179	14	10	2

SOURCE: Banco de España.

Other procedures

As indicated earlier, the Banco de España holds various supervisory powers over those institutions. In 2016, a total of 404 procedures relating to those powers were performed, as detailed in Table 2.11. Additionally, two procedures were handled relating to consultations with other supervisors in the sphere of cross-border activity.

OTHER PROCEDURES PERFORMED BY THE BANCO DE ESPAÑA RELATING TO OTHER INSTITUTIONS

TABLE 2.11

Number of procedures in 2016

	Payment institutions	Electronic money institutions	Specialised lending institutions	Mutual guarantee companies	Appraisal companies	Currency-exchange bureaux	Sareb	Banking foundations	Total other institutions
Acquisition of qualifying holdings	1		4		6				11
Cross-border activity of Spanish credit institutions	59								59
Branches in the EU	4								4
Branches in third countries									0
Freedom to provide services	55								55
Suitability	64	5	54	129	34	3	0	0	289
Other procedures relating to own funds			2						2
Structural changes			2						2
Amendments of articles of association	11	4	7	10					32
Authorisation of management and financial protocols								16	16
Other procedures	2	0	3	2	0	0	1	0	8
TOTAL									419

SOURCE: Banco de España.

Letters

Following the supervisory actions, 9 letters were sent to those institutions containing 27 requirements and recommendations. The most significant subject matters related to organisation, general internal control and management policies (25.9%); accounting shortcomings and reporting to the Banco de España (22.2%), and liquidity and meeting debt commitments and obligations (18.5%).

LETTERS ADDRESSED TO OTHER INSTITUTIONS

TABLE 2.12

Number	2013	2014	2015	2016
Specialised lending institutions	1	1	3	—
Appraisal companies	—	—	—	1
Mutual guarantee companies	—	2	2	2
Payment institutions	5	5	5	2
Currency-exchange bureaux	—	—	—	2
Electronic money institutions	1	—	—	—
Sareb	—	2	—	2
TOTAL	7	10	10	9

SOURCE: Banco de España.

3.3.3 COMPLIANCE WITH VETTED ACCESS TO ACTIVITY

Spanish legislation establishes that several financial activities are subject to vetted access to activity, i.e. they can only be carried out by the institutions legally authorised to do so. The Banco de España's functions include overseeing compliance with this legislation, taking action on persons seeking to break into the financial market without meeting the

conditions of access, whether it be through the exercise of activities legally restricted to credit institutions, payment service providers or other types of supervised institutions, or through the use of generic names restricted to those institutions or any other name that may cause confusion with them.

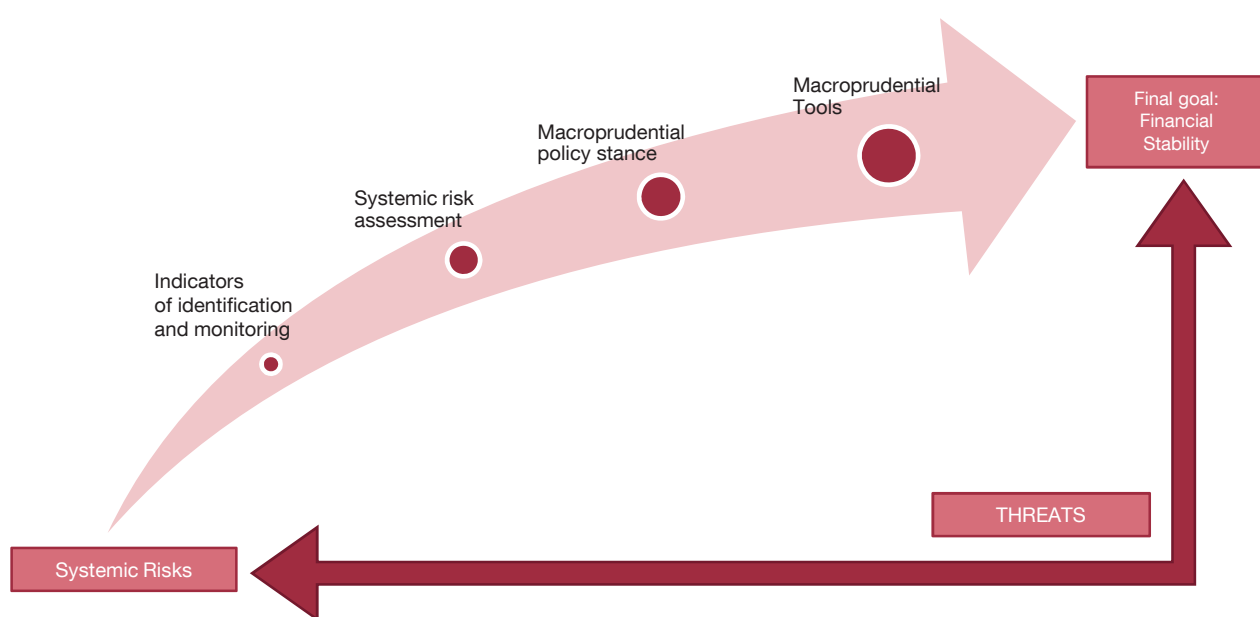
2016 saw the initiation of supervisory actions relating to 19 natural or legal persons who might be carrying out restricted activities without authorisation, the outcome of which might lead to the adoption of penalties.

3 MACROPRUDENTIAL SUPERVISION

The objective of macroprudential policy is to help safeguard the stability of the financial system by reinforcing its resilience and mitigating systemic risks, so as to ensure that the financial sector makes a sustainable contribution to economic growth. The steps followed in achieving this objective are shown in Schema 3.1. The first step is to identify and monitor systemic risks in the financial system through the use of a broad range of indicators. This information is analysed and assessed using tools and models developed by the Banco de España, which provide guidance in defining the macroprudential policy stance. Lastly, a series of macroprudential instruments available to the Banco de España are implemented to prevent and mitigate systemic risk and thus preserve stability.

MACROPRUDENTIAL POLICY AND ANALYSIS FRAMEWORK

SCHEMA 3.1



SOURCE: Banco de España.

3.1 Macroprudential instruments

The Banco de España has a number of macroprudential instruments provided for in European legislation, specifically in Directive 2013/36/EU (CRD IV) and Regulation (EU) No 575/2013 (CRR).¹ The main instruments include the so-called “capital buffers”, which are a set of CET1 requirements additional to the minimum levels set in the CRR and to the additional capital requirement set individually by the supervisor for the bank through the SREP. Unlike those compulsory capital requirements, capital buffers determined as a percentage of banks’ risk exposures consist of an additional CET1 capital requirement, which, if not fully met, entails limitations on the distribution of the bank’s profits (the greater the CET1 shortfall with respect to that required to cover the total buffers, the greater the limitation). At present the Banco de España sets two types of capital buffer to prevent and mitigate different facets of systemic risk: the countercyclical capital buffer (CCyB) and the buffers for systemically important institutions. The purpose of the CCyB is to ensure that

¹ Banco de España Circular 2/2016 sets out in more detail these powers, along with reporting transparency requirements and the relationship with the European authorities. A general description of Banco de España macroprudential policy objectives, instruments and indicators can be found in Occasional Paper 1601, Banco de España.

the banking sector as a whole has an additional capital buffer to help maintain the flow of credit to the economy without jeopardy to the solvency of the system in situations of financial system stress. For this reason, this buffer is designed to address the time dimension of systemic risks originated by excessive growth of aggregate credit. For their part, the buffers for systemically important institutions are intended to strengthen the solvency of institutions whose bankruptcy or poor functioning may seriously disrupt the financial system and the real economy. Also, these buffers act as capital surcharges which help to mitigate moral hazard for managers derived from the size and complexity of their banks. In this respect, these buffers seek to prevent and mitigate systemic risk in its transversal or structural dimension.

3.1.1 COUNTERCYCLICAL CAPITAL BUFFER

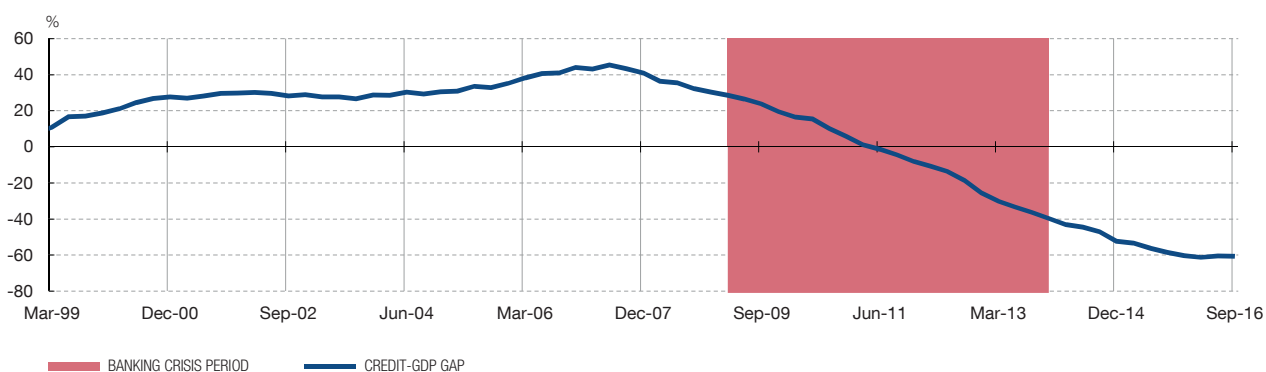
From 1 January 2016 the Banco de España determines quarterly the CCyB required of credit institutions. In 2016 the percentage of CCyB applicable to credit exposures in Spain remained steady at 0%. This periodic decision is based on technical analysis of specific quantitative indicators, on qualitative information and on expert judgement.

The CCyB required of banks remained at 0% in 2016

Within the quantitative indicators, the initial reference indicator is the so-called “credit-to-GDP gap”. This indicator is intended to measure the excess credit in terms of GDP with respect to its long-term or equilibrium level. The value of this indicator at September 2016 was near –61 pp (see Chart 3.1). This value is clearly far from the activation threshold (2 pp), per the suggestion by the Basel Committee for Banking Supervision.

CREDIT-GDP GAP

CHART 3.1



SOURCE: Banco de España.

3.1.2 CAPITAL BUFFERS FOR SYSTEMICALLY IMPORTANT INSTITUTIONS

The Banco de España identifies annually the global systemically important institutions (G-SISs) and the national systemically important institutions, also called “other systemically important institutions” (O-SISs). To identify G-SISs, the Banco de España uses the methodology developed by the Basel Committee and accepted by the financial stability (FSB), which has been endorsed by European and Spanish legislation. This methodology establishes the assignment of a capital buffer requirement in accordance with objective criteria.

To identify O-SISs, the Banco de España applies the guidelines developed by the EBA, also from the Basel Committee’s framework, based on quantitative criteria. For the institutions identified as O-SISs, the Banco de España determines the required capital buffers on the basis of a methodology of thresholds and intervals consistent with those set by the ECB. Under the applicable legislation, when the same institution is classified as both a G-SIS and an O-SIS, the higher of the two associated buffers is applied.

For 2017, six national systemically important institutions have been identified, of which one is also a global systemically important institution

At the end of 2016 the Banco de España published the lists of institutions identified as G-SIIs and O-SIIs for 2017 and their capital requirements. These requirements are introduced gradually, the required coverage being 50% in 2017, 75% in 2018 and 100% in 2019. The Banco de España reviews annually the institutions classified as G-SIIs and O-SIIs, and their respective capital buffers (see Table 3.1).

COMBINED BUFFER REQUIREMENT FOR G-SIIs AND O-SIIs IN 2017

TABLE 3.1

Institution	Systemic importance	Capital buffer requirement in 2017 (%)
Santander	G-SII and O-SII	0.500
BBVA	O-SII	0.375
Caixabank	O-SII	0.125
Bankia	O-SII	0.125
Sabadell	O-SII	0.125
Popular	O-SII	0.125

SOURCE: Banco de España.

3.2 European framework for reciprocity of macroprudential measures

The package of macroprudential measures may prove to be insufficient to mitigate the build-up of risk in the system if a supervisor's action is limited to banks' domestic activity and, moreover, addresses only resident agents. In recent years national banks have had a significant volume of exposures to foreign agents, so it is necessary to consider the risks arising from this activity, which may differ in nature and intensity from those identified in the domestic arena. Further, macroprudential action must be able to reach all institutions operating in the national territory, including those supervised by non-resident authorities (as in the case, for example, of branches of non-resident banks).

Reciprocal application of measures by countries allows more uniform and effective treatment of risks

Recognising the existence of cross-border issues in macroprudential policy, in 2015 the ESRB approved a recommendation,² adopted by the Banco de España, which introduced rules to ensure the reciprocity of macroprudential measures in the EU. The recommendation is based on the idea that exposure to the same macroprudential risk should receive equivalent regulatory treatment regardless of the jurisdiction of the agents affected. Specifically, it is recommended³ that the macroprudential measures adopted in the various EU jurisdictions should be reciprocal provided that a Member State so requests, subject to certain conditions. Although the CRD IV and the CRR already include provisions establishing the duty of reciprocity for certain macroprudential instruments, the ESRB recommendation breaks new ground in that it establishes a general framework of application for all these instruments.

In 2016 there were two requests for reciprocity within the ESRB framework. The first consisted of a request by the Belgian authorities to raise mortgage exposure risk weights, measured by the internal-ratings based (IRB) approach at 5 pp. The second was a request from the Estonian authorities to introduce a systemic risk buffer of 1% applicable not only to banks supervised by the Estonian authority but also to the branches of non-resident banks and to cross-border activity in this market. The Banco de España decided, on the basis of criteria and exemptions agreed by the ESRB, that exposures of Spanish banks to

² Recommendation ESRB/2015/2 on the assessment of cross-border effects of and voluntary reciprocity for macroprudential policy measures.

³ As with all ESRB recommendations, compliance is not compulsory, although in this case the reasons for non-compliance have to be duly explained.

these two countries did not reach the materiality thresholds set for the adoption of reciprocal macroprudential action.

In the coming years, the Banco de España will continue analysing the reciprocity requests received from other countries and will also examine the impact of its own decisions when it considers the advisability of requesting reciprocity from other Member States. The ESRB reciprocity framework is a key pillar for ensuring the homogeneity and effectiveness of macroprudential policy in the EU.

4 SUPERVISION OF INSTITUTIONS' CONDUCT

This is the second full year of activity in this area following the conferring of powers relating to the oversight of credit institutions' conduct and, in general, that of other institutions registered with the Banco de España (which extends to some aspects of institutions operating in Spain without an establishment), upon the Market Conduct and Claims Department (DCMR) in October 2014. In 2016, the Banco de España continued to work on the main areas of its supervisory strategy adopted in 2015, while also opening up new priority areas of action.

The Banco de España analyses the risk associated with institutions' marketing of each product type

This supervisory activity underpins the Banco de España's strategic commitment to avoiding the systemic risk associated with inappropriate conduct by financial institutions, while safeguarding the protection of bank customers, so as to restore trust in the financial system. Along with its conduct supervision tasks, the Banco de España performs other closely related tasks, such as promoting good practice in the financial services market, responding to queries by banking services users on the applicable transparency and customer protection rules, financial education, and resolving complaints and claims submitted to the Banco de España by customers of supervised institutions.

In the supervisory sphere, a methodology is followed that assigns and updates a conduct risk rating for each institution associated with each of the products it markets. This is used to define supervisory priorities, on the basis of which the monitoring and inspection action plan is drawn up, in the light of the limited resources available. The IT application to support the management and control of the planning and implementation of supervisory activities was designed in 2016 and will come into operation in 2017.

4.1 Supervisory actions

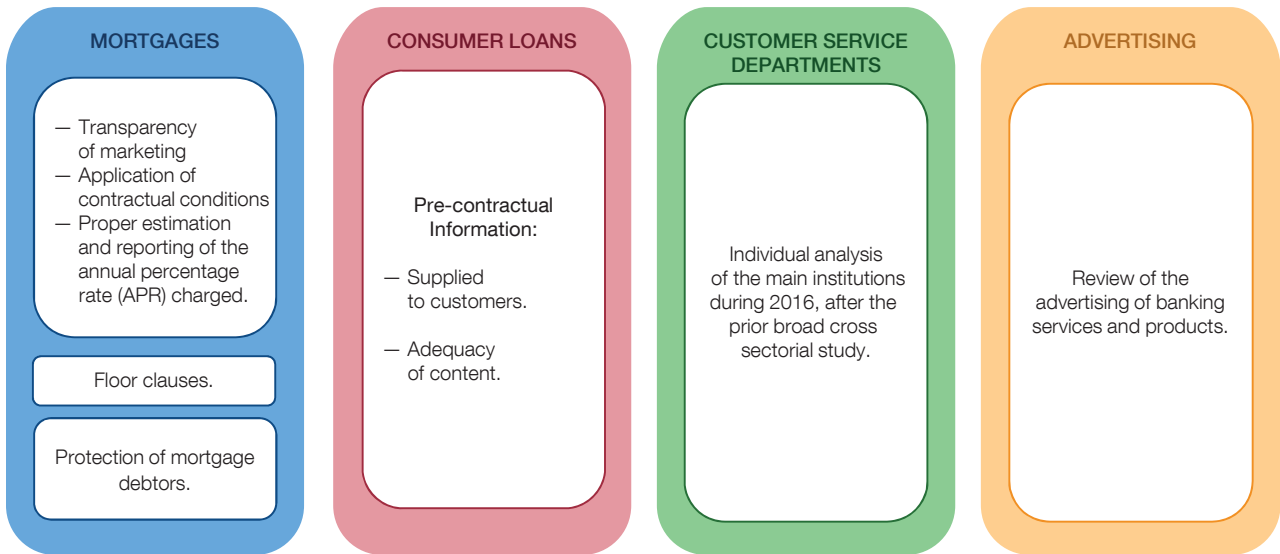
In the institutional conduct area, the actions carried out during the year included:

- those envisaged in the annual action plan (including both on-site visits to institutions and actions scheduled to be performed remotely), and
- unscheduled supervisory actions arising out of the need to respond to facts brought to the DCMR's attention over the course of the year, whether by other Banco de España departments, reports submitted by other public or private persons or institutions (regional authorities with competences for consumer affairs, for example), or following the observation of certain actions by supervised institutions in relation to which a specific supervisory action is deemed appropriate.

In 2016, it was necessary to launch 42 supervisory actions and 6 inspections that were not initially scheduled

In 2016, it was necessary to initiate a significant number of unscheduled on-site inspections and actions, accounting for a very significant percentage of the actions and inspections listed in Table 4.1. This consumed considerable resources.

The actions and inspections carried out, whether scheduled or not, are still concentrated in the three areas of activity identified back in 2015, to which have been added the review of the advertising of banking services and products by supervised institutions. These activities are summarised in Schema 4.1. Table 4.1 also summarises the supervisory actions undertaken in 2016.



SOURCE: Banco de España.

OVERSIGHT OF INSTITUTIONS' CONDUCT IN 2016

TABLE 4.1

Topic	Off-site monitoring (a)	Inspections (b)
Mortgages (Code of Good Conduct, floor clauses, transparency)	23	10
Customer service departments	31	0
Transparency (reporting, commissions and payments)	23	19
Advertising	2	0
Other	1	0
TOTAL	80	29

SOURCE: Banco de España.

- a Of these actions, 11 were begun in 2015.
- b Of these inspections, 11 were begun in 2015.

4.1.1 FUNCTIONING OF INSTITUTIONS' CUSTOMER SERVICE DEPARTMENTS

The proper functioning of customer service departments has an impact on consumer protection, in particular, as well as on institutions' reputations and the restoration and maintenance of trust in the financial system as a whole. The absence of a customer service department is therefore considered a serious infringement, as is the inadequate functioning of the department, unless the shortcomings detected by the Banco de España are rectified by the established deadline.

Following an aggregate analysis of the functioning of institutions' customer services the information available on the most significant institutions' customer services was reviewed in 2016

The second phase of an ambitious action begun the previous year was completed in 2016. In the first phase, which took place in 2015 and early 2016, an aggregate analysis was performed on the qualitative and quantitative information obtained from the responses to an exhaustive questionnaire sent to 266 institutions on various aspect of their customer service departments. This focused on three areas: i) the organisational set-up, objectives and resources of customer services; ii) criteria and procedures for receiving, handling and resolving complaints and claims; and iii) lines of communication and mechanisms for claim monitoring and control.

The results of this aggregate analysis were shared with institutions at a seminar held at the Banco de España on 12 April 2016. This aggregate and comparative analysis has made it possible to identify best practice in this field.

From the overall results of the exercise it may be concluded that, in general, there is considerable scope for improvement to the functioning of customer services, particularly as regards aspects where a significant number of institutions have (or will have) to redouble their efforts to address shortcomings or weaknesses in mechanisms to prevent or deal with conflict of interest; training plans; action plans or objectives; mechanisms for publicising their existence and how to contact them, procedures for receiving claims and complaints; access and information passed on to the board, and mechanisms for the control and monitoring of claims and complaints.

The volume and detail of the information analysed has also made it possible to identify weaknesses and shortcomings in various institution's customer services. Based on this information, a second phase was begun in 2016, in which 24 supervisory actions were conducted, aiming to evaluate, and where appropriate, rectify, the shortcomings detected in the set-up and functioning of the main institutions' customer service departments. At the same time, supervisory actions were also carried out with a view to rectifying omissions in the information detected in the context of the annual report each institution's customer service department is to prepare on the exercise of its tasks.

4.1.2 MORTGAGE LENDING

A mortgage is the contract with the biggest economic impact most people ever sign. The Banco de España's priority objective is to ensure they are marketed in a transparent way

Work in this area focused primarily on overseeing compliance with the transparency requirements laid down in Ministry of Economic Affairs and Finance Order EHA/2899/2011 of 28 October on transparency and customer protection in banking services, regarding loans to individuals resident in Spain secured by mortgages on homes located in the country. Given the high level of detail on the aspects examined and the broad scope of the portfolio reviewed (comprising 61.14% of mortgage lending to households in Spain for housing purchases) work continued in 2016 on the eight on-site inspections of credit institutions that were under way at the end of the previous year. These were due to be completed in the first half of 2017.

The reviews carried out focus on verifying proper compliance with the regulations on precontractual and contractual information, so the customer is aware at all times of the conditions and risks assumed. In particular, this information has made it possible to ascertain the effective cost of the transaction, which, along with the contractually determined interest rate, includes: i) fees, commission and other expenses the customer is required to pay; ii) taxes; (iii) other types of associated expenses known by the institution (except the notary public's fees); and iv) the cost of ancillary services relating to the loan contract (in particular, insurance premiums) if the conditions under which the loan is offered are subject to the provision of these services.

The review also includes verification of the correct application of the contract clauses and the regime for the substitution of official indices, the correct calculation of fees for early repayment, and the proper reporting to the Banco de España of the weighted APR on mortgage loans, verification of this latter aspect having been extended to a further 16 institutions.

Without prejudice to the conclusions each inspection may ultimately reach, while they were being conducted recommendation and requirement letters were sent to the inspected institutions in order to clarify and resolve some of the incidents that were detected.

4.1.3 FLOOR CLAUSES

It is for the judicial bodies to decide whether contract clauses are null and void, not the Banco de España. Thus, without prejudice to the Supreme Court judgment on 9 May 2013, the Banco de España, precisely because of the limitation on the scope of its powers, has

to restrict the checks that it performs to verifying formal compliance with the requirements of banking transparency and customer protection law.

Nevertheless, in 2016 the Banco de España continued to check that such clauses were included in contracts correctly. In this area, compliance with the requirements made of two institutions that they review all their variable rate loan and mortgage loan transactions to which floor clauses may have been applied in a way not in keeping with the agreed terms was verified. The review had to be extended in the case of one of these institutions as a result of extraordinary and unexpected circumstances in 2015 and 2016, culminating in the repayment of amounts corresponding to a significant number of customers affected by the incorrect application of floor clauses.

4.1.4 PROTECTION MEASURES FOR MORTGAGE DEBTORS WITHOUT RESOURCES

Numerous actions were performed with the aim of verifying the correct application of the Code of Good Practice (CGP) contained in the annex of Royal Decree-Law 6/2012 of 9 March 2012 on urgent measures to protect mortgage debtors without resources (RDL 6/2012) by its signatory institutions. Specifically, in these cases the correct application by institutions of the three obligations, non-compliance with which is classified as a serious infringement, was confirmed. These obligations are summarised in Schema 4.2.

LEGISLATION ON REGULATION AND DISCIPLINE

SCHEMA 4.2

OBLIGATION	Royal Decree-Law 6/2012
Effective implementation date	Art. 5.4 Institutions adhering to the Code of Good Practice (CGP) are required to apply the code whenever a customer is deemed to be on the exclusion threshold. This ultimately envisages possible loan restructuring, reduction or dation in payment measures.
Transparency and provision of information under the CGP	Art. 5.9 The participating institutions must provide their customers with the option of recourse to the CGP. The relevant information must be made available through the branch network, and, in particular, must be given in writing to customers who have failed to meet any mortgage repayments or who have otherwise shown themselves to be having difficulties repaying their mortgage. The information provided is to include a concrete description of the content of the CGP and the possibility of recourse to this code.
Information submitted to the Banco de España	Art. 6.5 The participating institutions are to send the information required by the CGP Compliance Monitoring Committee to the Banco de España on a monthly basis.

SOURCE: Banco de España.

The Banco de España is committed to verifying that signatory institutions of the CGP are genuinely proactive about informing customers and applying the code's measures as it requires

In 2016, work took place on 18 supervisory actions motivated either by evidence coming to light as a result of customer complaints to the Banco de España or reports submitted by various agents against credit institutions for alleged non-compliance with Royal Decree-Law 6/2012. In late 2016, these actions resulted in sanction proceedings being brought against one institution, and various institutions being sent requirements letters, one being sent a letter of observations and recommendations, and three being sent other types of letters.

Two on-site inspections on this matter took place in 2016. These were begun in late 2015 and concluded with the initiation of sanction proceedings against two institutions, and the sending of recommendation and requirement letters (see Section 4.2).

4.1.5 ADVERTISING

Advertising is the first contact between a bank and its customers, so it is essential that it be truthful, clear and concise

A large-scale supervisory action was begun in 2016 to obtain as much detail as possible about institutions' customary practices, procedures and internal controls in relation to their advertising and evaluate them appropriately. This had the aim of confirming whether these practices, procedures and internal controls comply with the current legislation and are, therefore, adequate to protect customers' legitimate interests and management the risks arising from their advertising activity.

This action, which will continue in 2017, reaches all the institutions within the scope of application of Ministerial Order EHA/1718/2010 of 11 June 2010, on regulation and control of the advertising of banking services and products. This Order modified the rules on advertising of banking products, replacing the previous system based on prior scrutiny of advertising, with a system of ex post checks combined with self-regulation by institutions. Since it came into force, the Banco de España does not authorise institutions' advertising campaigns in advance, but analyses a sample of them once they are in circulation. In 2016, this activity gave rise to 485 demands that advertising in various media (press, internet, etc.) be stopped or rectified.

4.1.6 CONSUMER LENDING

The Banco de España's website offers a simulator calculating the maturity date of the loan with the selected instalment payment

The focus of the Banco de España's activities and concerns remains the clarity, appropriateness and adequacy of the information provided to customers during the marketing of personal loans and credit cards.

As the regulations repeatedly state, it is particularly important in this connection that customers are aware of the consequences of the potential failure to pay their instalments, since this can trigger a spiral of late-payment interest and costs which end up pushing certain customers into economic and social exclusion. Similarly, in the case of revolving credit cards, the instalments paid may fail to cover the interest accruing. In this case, repayment may be postponed indefinitely, leading to the debt to grow to the point that it becomes difficult to pay off.

Accordingly, the supervisor's attention has focused on two on-site inspections verifying the precontractual information institutions are to provide to their customers in accordance with Law 16/2011 of 24 June 2011 on credit agreements for consumers, and in particular the adequacy of this information when revolving cards and insurance linked to personal loans are marketed. This need to strengthen transparency also arises in situations in which, in the event of default on payment of the monthly settlement of a credit card contracted for full payment at the end of the month, the institution automatically switches the unpaid amount to the revolving mode, without asking the customer for the requisite consent for this modification.

4.2 Adoption of supervisory measures

Supervisory activities may lead to, in rising order of importance, the sending of recommendations or observations to the institution, or possibly the initiation of sanction proceedings. Table 4.2 shows the type of measures in which the actions concluded in 2016 culminated.

SUPERVISORY MEASURES TAKEN IN 2016

TABLE 4.2

Number	Measures taken following off-site actions (a)	Measures taken following inspections (b)
Recommendation and observation letters	101	4
Letter of requirements	11	6
Initiation of penalty procedures	2	5
TOTAL	114	15

SOURCE: Banco de España.

a 11 requirement letters issued following verification actions, containing 38 specific requirements upon institutions.

b 6 requirement letters issued following inspections, containing 34 specific requirements upon institutions.

The Banco de España initiated seven sanction proceedings in 2016 in relation to conduct, five deriving from on-site inspections and two from customer complaints sent to the DCMR

Seven sanction proceedings were initiated in 2016: five as a result of inspections of institutions and two deriving from complaints received and dealt with by the Banco de España in which it was concluded that there had been a possible breach of the transparency and customer protection rules.

Of the five sanction proceedings initiated as a result of inspections, two concern the application of Royal Decree-Law 6/2012, and two the application of various aspects of the banking transparency and customer protection legislation. The fifth proceedings, begun against a currency-exchange bureaux, concerns the breach of the rules of organisation and discipline applicable to the operators of such establishments.

5 THE EXERCISE OF SANCTIONING POWERS

First proceedings in which the substantive rules applicable are those of Law 10/2014, which provides for much harsher penalties

From the standpoint of the applicable legislation, the first proceedings dealing with events entirely subsequent to 28 June 2014, when Law 10/2014 came into effect, were initiated in 2016. This is significant because this law generally provides for much harsher penalties than those in the previous legislation.

Central role of sanctioning in institutional conduct, transparency and customer protection

Part of the sanctioning activity in 2016 resulted from the exercise of the supervisory competences conferred upon the Banco de España in relation to institutions' conduct, transparency and customer protection. As mentioned in the preceding chapter, in 2016 seven proceedings were initiated in 2016 in this area (against four banks, one credit cooperative, one bureau de change and its managers and directors, and one specialised lending institution), and proceedings begun in 2015 against a specialised lending institution culminated in the imposition of penalties.

Additionally, in relation to the supervisory authority outside the scope of the SSM and therefore conferred upon the Banco de España, sanctioning activity concerning non-credit financial institutions stands out, in particular, in relation to payment institutions and the breach of the obligations upon them primarily as regards own funds coverage, book-keeping and safeguarding funds deposited by customers. In this regard, proceedings were brought in which the institution concerned's activity was temporarily suspended to safeguard the public interest, and two more sets of proceedings concluded with the imposing of penalties.

In the framework of the SSM, sanctioning powers are shared with the ECB

In relation to sanctioning activity aimed at significant credit institutions in the SSM framework, it should be recalled that as supervisory powers have been assumed by the ECB, Regulation (EU) No 1024/2013 of 15 October 2013 sets out a division of competences between the ECB and national competent authorities (NCAs) such as the Banco de España in order to maximise the system's coordination and consistency. Apart from the direct sanctioning powers of the ECB in certain cases envisaged in Article 18(1) of the Regulation, it is the ECB that, in general, in view of the facts coming to light during the inspection, instructs NCAs to initiate sanction proceedings, whether against the senior managers and directors of significant credit institutions, against credit institutions themselves in response to breaches of national legislation transposing directives, or finally, in those cases in which it sees fit to impose a non-financial penalty (Article 18(5) of the Regulation).

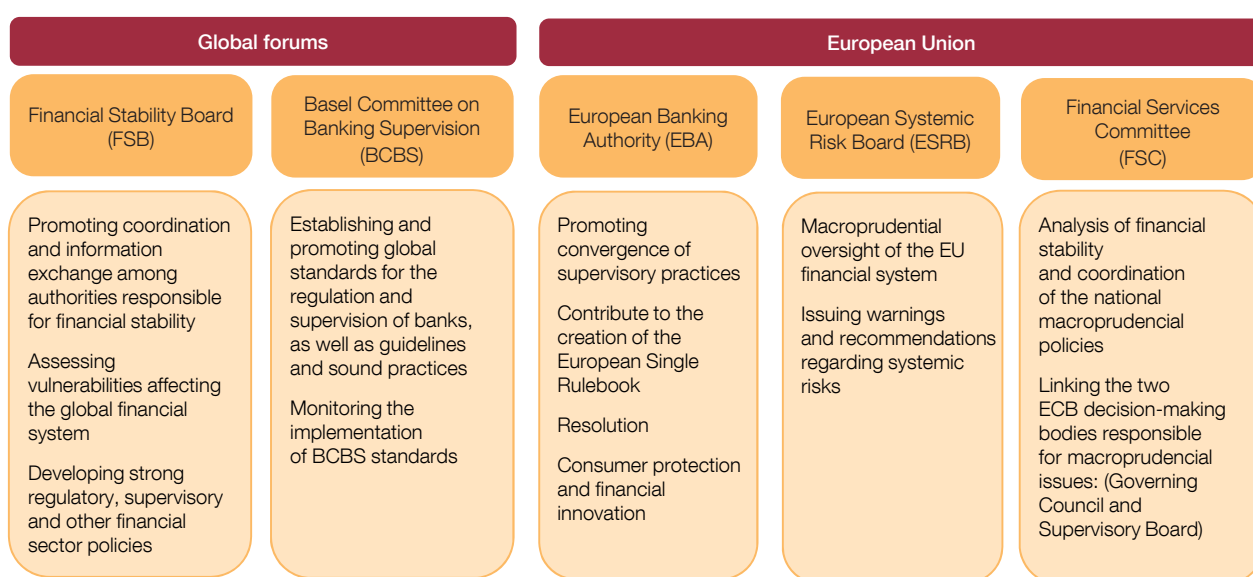
In this context, no specific proceedings were begun at the ECB's behest in 2016, but routine work has continued with the ECB aimed at achieving coordinated action and consensus on uniform criteria for action.

6 THE BANCO DE ESPAÑA'S PARTICIPATION IN INTERNATIONAL BANKING REGULATION AND SUPERVISION BODIES

The recent global financial crisis triggered a major overhaul of banking supervision and regulatory frameworks. As in previous years, in 2016 the Banco de España continued collaborating and making an active contribution to the development and implementation of new standards in the supervisory policy area, through its participation in various international and European bodies. These tasks are of particular significance for the Banco de España for two reasons: firstly, because they aim to contribute to financial stability through international coordination of the regulation of the various financial systems, and secondly, because the resulting standards are implemented and applied in Spain.

INTERNATIONAL REGULATORY AND SUPERVISORY BODIES AND COMMITTEES IN WHICH THE BANCO DE ESPAÑA PARTICIPATES

SCHEMA 6.1



SOURCE: Banco de España.

NOTE: This figure is not exhaustive. The Banco de España also participates in other international regulatory and supervisory bodies, in particular, the International Financial Consumer Protection Organisation (FinCoNet) and the Asociación de Supervisores Bancarios de las Américas (ASBA), are considered to be of Strategic importance for the Banco de España.

6.1 Global fora

6.1.1 FINANCIAL STABILITY BOARD

In November 2008, the G20 asked the Financial Stability Board (FSB) to lead financial regulatory reform in response to the crisis. With the publication of the requirement on total loss absorption capacity (TLAC) for G-SIIs in November 2015, and once developments regarding solvency, liquidity, and bank resolution frameworks are advanced or close to conclusion, the FSB will be able to conclude the main aspects of the reform of the banking regulations in response to the crisis.

In 2016, the FSB's attention mainly centred on promoting the consistent implementation of the agreed reforms, analysing their effects, and identifying risks and vulnerabilities in other sectors of the financial system.

The FSB is implementing a strategy that includes the monitoring and analysis of so-called "shadow banking",¹ and the development of possible regulatory measures where necessary.

¹ Credit intermediation not subject to the regulatory framework and safety nets applicable to banks.

In coordination with the National Securities Market Commission (CNMV) and the Directorate General of Insurance and Pension Funds, the Banco de España is taking part in the analysis of the risks arising from entities in the sector and in the exchange of information on measures to mitigate these risks.

The FSB's areas of work in 2016 included, in particular, shadow banking, CCPs, and corporate governance and remuneration frameworks

Strengthening the soundness and resolution capacity of central counterparties (CCPs) is another key element following the increase in centralised clearing promoted by reforms in the OTC derivatives market. One area of analysis in this project is that of the interconnectedness of CCPs and their members, particularly banks.

Given their potential systemic impact, the FSB has promoted a review of the role played by corporate governance and remunerations frameworks in the prevention and mitigation of banking malpractice (for example, manipulation of benchmark indices). One of the main new areas of interest is the project on technological innovation in finance, which aims to identify key factors for financial stability.

Lastly, work under way to complete the bank resolution framework includes the publication of a consultative document on internal TLAC (i-TLAC) for groups that follow a single point of entry (SPE) strategy. The Banco de España has focused on defending the prepositioning of eligible instruments such as TLAC in each of the institutions that may prove to be critical in the event of non-viability, and has sought uniform treatment of the deductions necessary with regard to investments in this type of instrument. It has also advocated a position in favour of setting requirements by the host authority on an equal footing to other groups operating in its jurisdiction. This position aims to guarantee sufficient loss-absorbing and recapitalisation capacity for subsidiaries and equal treatment for all internationally active banking groups.

The rapid development of new technologies applied to the financial sector has led to the emergence of numerous initiatives under the generic name of FinTech, a portmanteau word combining “finance” and “technology”. There is no universally accepted definition of FinTech, but one of the most frequently used is that of the FSB, which defines FinTech “as technologically-enabled financial innovation that could result in new business models, applications, processes or products with an associated material effect on financial markets and institutions and the provision of financial services.” Obviously, technology has been used in the financial sector to enhance processes for long time and banks have been undergoing technology upgrades for many years. However, since the financial crisis, the sector has been buffeted by digital disruption from the unrelenting pace of new technology and the emergence of companies seeking to make inroads in the traditional banking business.

It should be borne in mind that these new business models are beyond the scope of regulated banking services and operate on the margins of – or even outside – the regulatory framework. It is therefore essential to identify the risks: increased operational risk

(obsolete IT systems, services outsourcing), profitability risk (increased disintermediation contributes to coordination of Bank activity in relation to the appearance of new, unregulated agents), liquidity risk (aggregator portals), cyber risk, etc. FinTechs represent a challenge for supervisors, who need to improve and update their knowledge in order to be able to adequately assess the risks associated with technological innovation and, of course, for regulators, who will have to redefine the scope of action to avoid the spread of shadow banking.

The Banco de España has therefore set up an in-house group entrusted with monitoring this phenomenon with a view to helping coordinate the Bank's activities in relation to it. In an initial phase, this group, known as the Financial Innovation Group, has focused its analysis on innovations in various financial processes (payment services and intermediation services) and in the technology tools that can be used to raise the efficiency of these processes or other financial or non-financial processes. This is currently at a second stage in which a more detailed impact analysis and list of possible actions that may be taken by the Banco de España will be drawn up.

In 2016, the Basel Committee continued working to complete the pending reforms to conclude the regulatory framework known as Basel III.² This work responds to the basic goal of helping reduce unjustified variability in RWAs, without this resulting in a significant increase in overall capital requirements.

Shortcomings identified

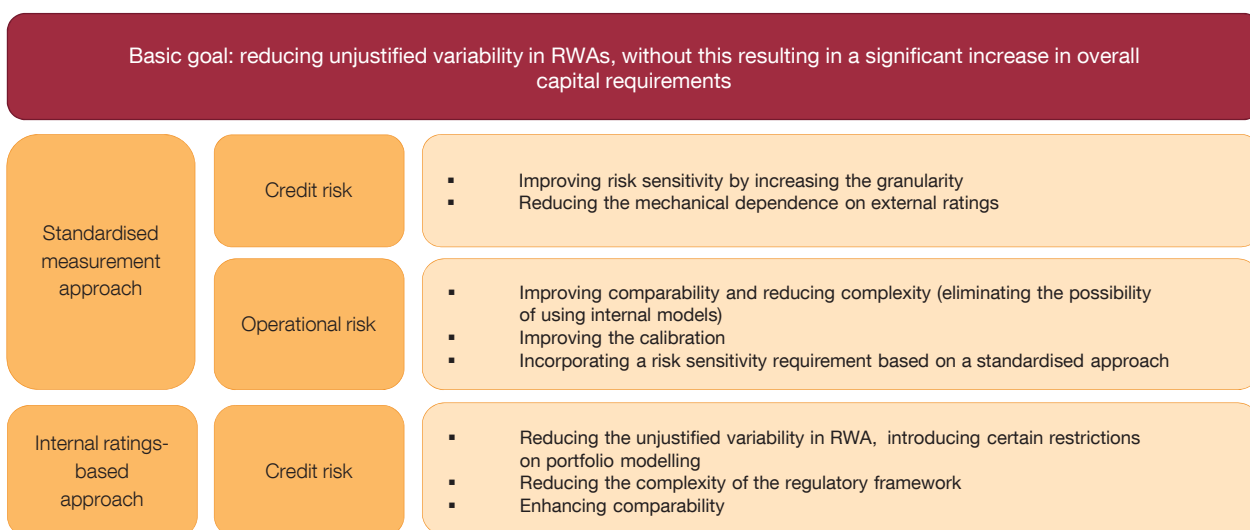
The international financial crisis revealed a high degree of variability in RWAs calculated by institutions using internal models and a lack of comparability between them, and this has not always been the result of differences in the risk of their respective portfolios. Moreover, limitations were also identified in the ability of the internal models used to measure certain types of risks correctly. These shortcomings have led to the validity of RWA-based capital ratios – and their comparability between institutions – being questioned.

Reforms worked on in the Basel regulatory framework

Figure 6.2 summarises the main objectives pursued by the Basel Committee to complete the pending Basel III reforms.³ The Banco de España has played an active role in these reforms with a view to contributing to reducing the unjustified variability of RWAs, simplifying the framework and improving the comparability of the ratios, while maintaining a risk-based approach.

MAIN OBJECTIVES PURSUED BY THE BASEL COMMITTEE TO COMPLETE THE PENDING BASEL III REFORMS

SCHEMA 6.2



SOURCE: Banco de España.

The Basel Committee has published consultative documents on internal model-based approaches and the standardised approach for credit risk, and on operational risk

In particular, in the case of credit risk and the standardised approach, consultations have been held on a series of changes aiming to make it more sensitive to risk by increasing the granularity of the weightings and reducing the mechanical dependence on external ratings. In relation to the IRB approach, the Basel Committee has published consultative documents about the introduction of certain restrictions on portfolio modelling, in those cases where the use of internal models is judged inappropriate.

2 The standards pending approval complement the reform adopted in December 2010. Both form part of the Basel III framework.

3 This section deals with the reforms concerning credit and operational risk. However, standardised approaches for market and counterparty risk have also been revised by the Committee with similar objectives. It is worth noting that in early 2016 the Committee published the revised framework for the treatment of market risk. Work is under way on the introduction of a surcharge in the leverage ratio for global systemically important banks (G-SIBs).

Consultations have also been held on the possibility of introducing floors in some of the parameters modelled (PD, LGD and CCF), referred to as “input floors”, and the use of floors on the capital requirements calculated using internal models (output floors). These have the purpose of ensuring minimum values with respect to the capital requirements resulting from internal models.

As regards operational risk, the Basel Committee has held consultations on the possibility of entities using the SMA (Standardised Measurement Approach), which would substitute the four currently existing approaches while eliminating the possibility of using internal models. In this way, the Committee aims to reduce the undesirable variability of RWAs and simplify the framework.

In parallel to the pending Basel III reforms, other prudential developments in progress that deserve mention include those relating to the prudential treatment of provisions, following the modifications that will be introduced by the adoption of IFRS-9 and the treatment of sovereign risk.

INTERVIEW WITH FERNANDO VARGAS, CHAIRMAN OF THE ACCOUNTING EXPERT GROUP
OF THE BASEL COMMITTEE

BOX 6.2

In April 2016, Fernando Vargas, director of the Regulation and Supervisory Policy Department, was appointed chairman of the Accounting Expert Group (AEG) of the Basel Committee, adding a new milestone to his extensive career leading international groups of banking supervisors and regulators.

He took over the chair at a time of transition between the incurred loss and expected loss accounting models, as IFRS 9 comes into effect in January 2018.

Numerous questions have arisen about the role the various agents involved should play, in particular, Fernando:

What impact will this change in accounting model have on prudential regulation?

We supervisors have always argued that banks’ accounting provisions should be calculated according to expected losses. This is therefore a very positive step by those in charge of setting international accounting standards. It leads us to revise certain aspects of the relationship between this accounting regulation and prudential regulation, particularly as regards the definition and calculation of expected loss in each case, and the impact of the new regulations on regulatory capital.

Given that the Basel Committee issues prudential rather than accounting standards, what role does a group of accountants like the AEG play within the committee?

Two comments. First, it is true that neither the Committee nor, therefore, the AEG, issue accounting standards. However, the

AEG’s mission is to promote high quality international accounting and audit standards promoting appropriate risk management by banks and contributing to financial stability, and it strives to encourage the consistent application of these standards. In particular, in relation to the transition towards an expected loss accounting model, in December 2015, the Committee published its «Guidance on credit risk and accounting for expected credit losses», and monitoring of compliance by banks and banking supervisors is envisaged.

Second, the members of the AEG are not accountants, but banking supervisors with expertise in accountancy. Banking supervisors have a legitimate interest in promoting the quality of credit institutions’ accounting. Accounting information is the raw material of supervisors’ analysis of the financial situation and institutions’ risk profile. The quality of supervisors’ diagnosis and the effectiveness of the measures they take largely depends on the quality of the information they have in general, and that of accounting information in particular. The supervisor needs to play a significant role in promoting the consistent application of accounting standards in a way that ensures comparability.

Are there any other international initiatives by prudential regulators in the accounting field?

Yes. Other international regulators, such as the EBA and banking supervisors, the ECB in its role in the SSM, and US supervision agencies, have published supervisory guidelines and opinions on the application of accounting criteria and, in particular, on the appropriate application by banks of IFRS 9 and its US equivalent.

International audit standards are an area of interest to the AEG. What is the relationship between the auditor and supervisor roles?

The external auditor's work is a valuable input for the supervisory process. It is an additional check, but it cannot replace the supervisor's role, as I do not believe that the supervisor's diagnosis of banks' financial position and risk profile is a delegable responsibility. Accounting standards are increasingly complex and they are based on general principles allowing different alternative

ways of putting them into practice, but not all of them are equally appropriate from the supervisory standpoint. Therefore, the fluid relationship that needs to exist between banking supervisors and banks' external auditors should be based on a shared understanding of the different responsibilities of each. Along these lines, in 2014 the Basel Committee prepared a set of guidelines on «The external audit of banks». Moreover, in practice, the AEG has fluid communications with major international audit firms and monitors international developments in this field.

6.2 European fora

6.2.1 EUROPEAN BANKING AUTHORITY (EBA)

Work relating to payment systems and FinTech is becoming more important

In 2016, the EBA remained focused on the traditional areas in which it has been working, mainly concerning prudential regulations, supervisory convergence, and resolution, and customer protection. Nevertheless, topics relating more closely to technological innovation in the financial sphere have become particularly important this year. Thus, the EBA focused its attention on work on payment systems, seeking to strike an appropriate balance between market development and the necessary security and customer protection. The EBA has also started work on identifying the risks and opportunities for the banking industry deriving from so-called FinTech companies, and has identified four areas for its work: i) authorisations; ii) prudential risks; iii) impact on the business model; and iv) impact on market conduct and consumers.

The EBA is working on a wide range of areas, including in particular:

Convergence on the application of supervisory reviews, evaluations and supervisory measures

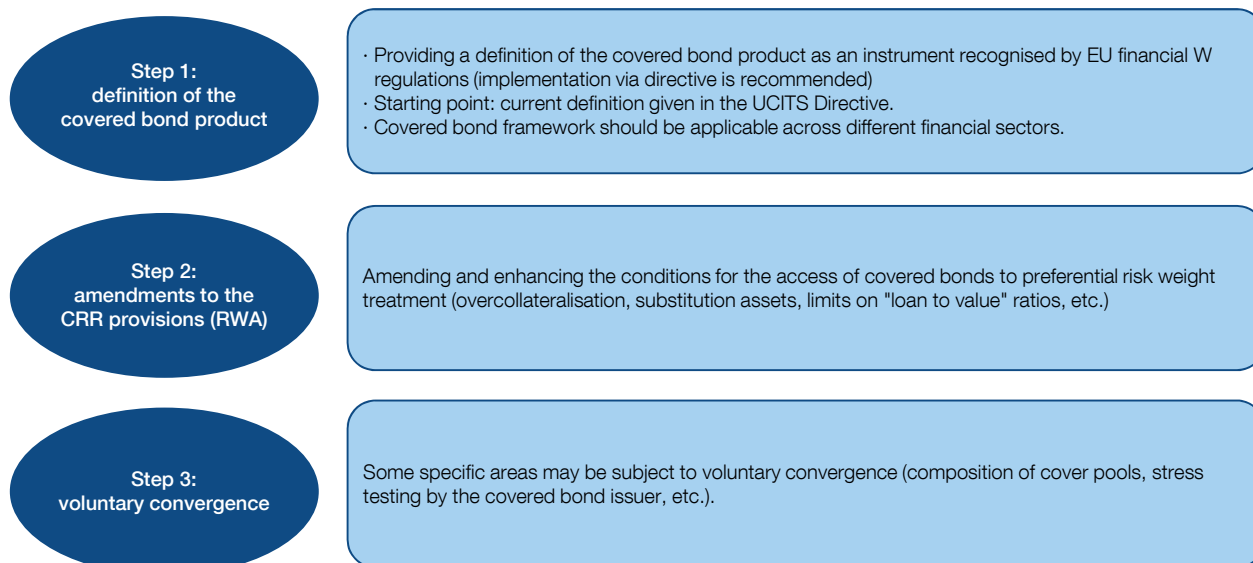
In relation to supervisory convergence, the main challenges of the Supervisory Committee, which has been chaired by the Banco de España since the EBA was set up in 2011, have been: i) strengthening the stacking order for the various types of capital requirements (pillar 1, pillar 2 and buffers); ii) ensuring a consistent application of the restrictions applicable to the distribution of earnings (or maximum distributable amount, MDA), and iii) achieving greater convergence on the use of stress tests to determine the so-called "Pillar 2 guidance".

The capital recommendation is a new supervisory tool in the stress-testing framework

The Banco de España has been working actively to build a consensus on the main defining features of this capital recommendation, while ensuring it has the flexibility required of all supervisory tools. In principle, this guidance will be determined based on the suitably adjusted quantitative findings of the supervisory stress test. It will be covered with common equity Tier 1 capital (CET1) instruments and will not be made public. For their part, institutions should include it in their capital planning and in their risk management and recovery plans.

Prudential regulation

From the Banco de España's viewpoint, one of the key areas of work in the prudential regulation field was the drafting of a report on covered bonds. This report analyses the features of the various bond markets that coexist in Europe, together with the degree of implementation of best practice, already set out in an EBA study in 2014. On the basis of this analysis, the EBA proposes a series of legislative measures to harmonise and strengthen current national frameworks, recommending that European institutions adopt a three-step approach, as outlined in Schema 6.3.



SOURCE: Banco de España.

The report on MREL contributes to the debate under way on the proposed amendment of the BRRD

The most significant area of work in relation to resolution was the report on minimum requirement for own funds and eligible liabilities (MREL) applicable to credit institutions and investment firms, so they have a liabilities structure that guarantees the institution's recapitalisation and its capacity to absorb possible losses. This report comprises a quantitative analysis (quantification of the potential financing needs, together with the possible costs and benefits at macroeconomic level), and various regulatory policy recommendations (which include the proposed change in the denominator of the requirements and integration in the European framework of international standards on TLAC).

Customer protection and financial innovation

In relation to institutions' market conduct and bank customer protection, the EBA has drawn up guidelines on policies for the remuneration of sales staff, with a view to safeguarding customers' interests. It has also drawn up rules to standardise the terminology for services offered on payment accounts and the format of information about them (prior information about fees and periodic information about fees and interest payments). Key areas of work on financial innovation include the Opinion on the European Commission proposal to include virtual currencies in the scope of the Directive on money laundering, and continuation of the analysis of the phenomenon of the innovative use of customer information and, broadly, the FinTech phenomenon alluded to above. The way in which the EBA can fulfil its financial education mandate has also been explored.

6.2.2 EUROPEAN SYSTEMIC RISK BOARD (ESRB)

In 2016, the ESRB finished two important studies in which the Banco de España played an active role on the expert working groups, general board and steering committee, of which the governor is a member.

The ESRB has warned of the vulnerabilities in the residential housing sector in various countries, but not Spain

First, it issued a series of alerts on the medium-term vulnerabilities of the residential housing sector, aimed at the authorities in Austria, Belgium, Denmark, Finland, Luxembourg, the Netherlands, Sweden and the United Kingdom. The main vulnerabilities, considered to be a source of long-term financial instability, were estimated. These were centred on rising debt levels and the capacity of households to repay their mortgages, and on the trends in residential property prices. Spain was not included on the list of countries with vulnerabilities relating to this sector.

A joint report by the ESRB and the ECB's Financial Sustainability Committee examining the macroprudential issues resulting from a prolonged period of low interest rates and structural changes affecting financial markets and the real economy also deserves to be highlighted. Three areas of financial stability risks were identified: i) sustainability of certain financial institutions' business models; ii) widespread risk taking; and iii) the trend towards a market-based financial system. Finally, recommendations were made to the macroprudential authorities, for instance, on monitoring credit standards, reviewing the risk-free interest rate in the Solvency II framework, and developing resolution procedures for insurance companies.

6.3 Other fora

The Banco de España is a member of the International Financial Consumer Protection Organisation (FinCoNet). FinCoNet is a global forum established in 2013 with the aim of promoting good market conduct and adequate protection of financial consumers through effective supervision of financial market agents' conduct. The forum, which mainly comprises financial sector supervisory authorities, enables an exchange of experience and practices relating to supervision of financial institutions' conduct.

FinCoNet is a global forum promoting sound market conduct and strong consumer protection

Issues such as online and mobile payments, sales incentives and responsible lending are among the key areas of its work. Over the coming years, FinCoNet will focus its attention on the impact of the digital world on safeguards for financial consumers. In this area, the Banco de España chairs one of the working groups on risk-based supervision practices in the digital age and the tools needed to support them.

ASBA is a regional forum aiming to strengthen banking regulation and supervision, and foster the stability of the financial system in the Americas

The Association of Supervisors of Banks of the Americas (ASBA), a high-level forum in which the banking supervision authorities of 33 countries in the Americas are represented. Its mission is to contribute to the strengthening of banking regulation and supervision, and to the stability of the region's financial system, by promoting the implementation of practices in line with international standards and using mechanisms of analysis, cooperation, capacity building and dialogue.

ASBA's 2016 work plan focused on two issues: reviewing and implementing sound and transparent corporate governance practices, and establishing itself as a prudential supervision agency that is committed to financial stability in the region.

The Banco de España has been a collaborator since 1999 and an associate member since 2006, and is the only non-regional associate authority and participates actively in the forum's activities. In 2016, along with attending the meetings of the ASBA governing bodies, it continued to support the ASBA Continental Training Plan through seminars in the region and in Spain.

7 REGULATORY CHANGES IN SUPERVISORY ISSUES IN SPAIN

7.1 Banco de España Circulars

Transposition of the European solvency framework into Spanish legislation was completed with Banco de España Circular 2/2016 of 2 February 2016 regulating outstanding matters arising from Law 10/2014 and Royal Decree 84/2015.

7.1.1 BANCO DE ESPAÑA CIRCULAR 2/2016 ON SOLVENCY

The main new developments introduced by the Circular with respect to higher-ranking legislation are: the use of the national option, whereby public-sector entities may receive the same weighting as the tier of government on which they rely; the mandatory characteristics of the supervisory review and evaluation process to be performed by the competent authority; and implementation of the regulation on capital buffers, internal governance and remuneration policy. The Circular also regulates certain aspects of the supervision of financial conglomerates.

The Circular regulates various aspects relating to the countercyclical buffer, the method for identifying global systemically important institutions (G-SIIs) and other systemically important institutions (O-SIIs), in this case, based on the EBA guidelines, and the rules for joint application of the G-SII, O-SII and other system risk buffers.

With regard to internal governance, the Circular establishes the procedure for fit and proper assessment of senior officers both by institutions and the supervisor, and certain criteria for assessing their capacity to exercise good governance. It also sets out the procedure for authorising and reporting loans, guarantees and other collateral to institutions' senior officers, the composition of the risk, appointments and remuneration committees, and the conditions permitting the creation of joint appointments and remuneration or risk and audit committees.

As to institutions' remuneration policy, the Circular specifies the applicable criteria for "identified staff", requiring institutions to prepare a report on their annual internal assessment programmes. Lastly, it details the information on corporate governance and the remuneration policy that should feature on institutions' websites.

7.1.2 BANCO DE ESPAÑA CIRCULAR 4/2016 AMENDING THE ACCOUNTING CIRCULAR

The accounting regime for Spanish credit institutions is regulated in Circular 4/2004 on public and confidential financial reporting rules and formats. Annex IX of Circular 4/2004, on credit risk analysis, allowances and provisions, establishes a general framework for credit risk management in accounting-related aspects, such as criteria for accounting classification and estimation of credit risk allowances and provisions.

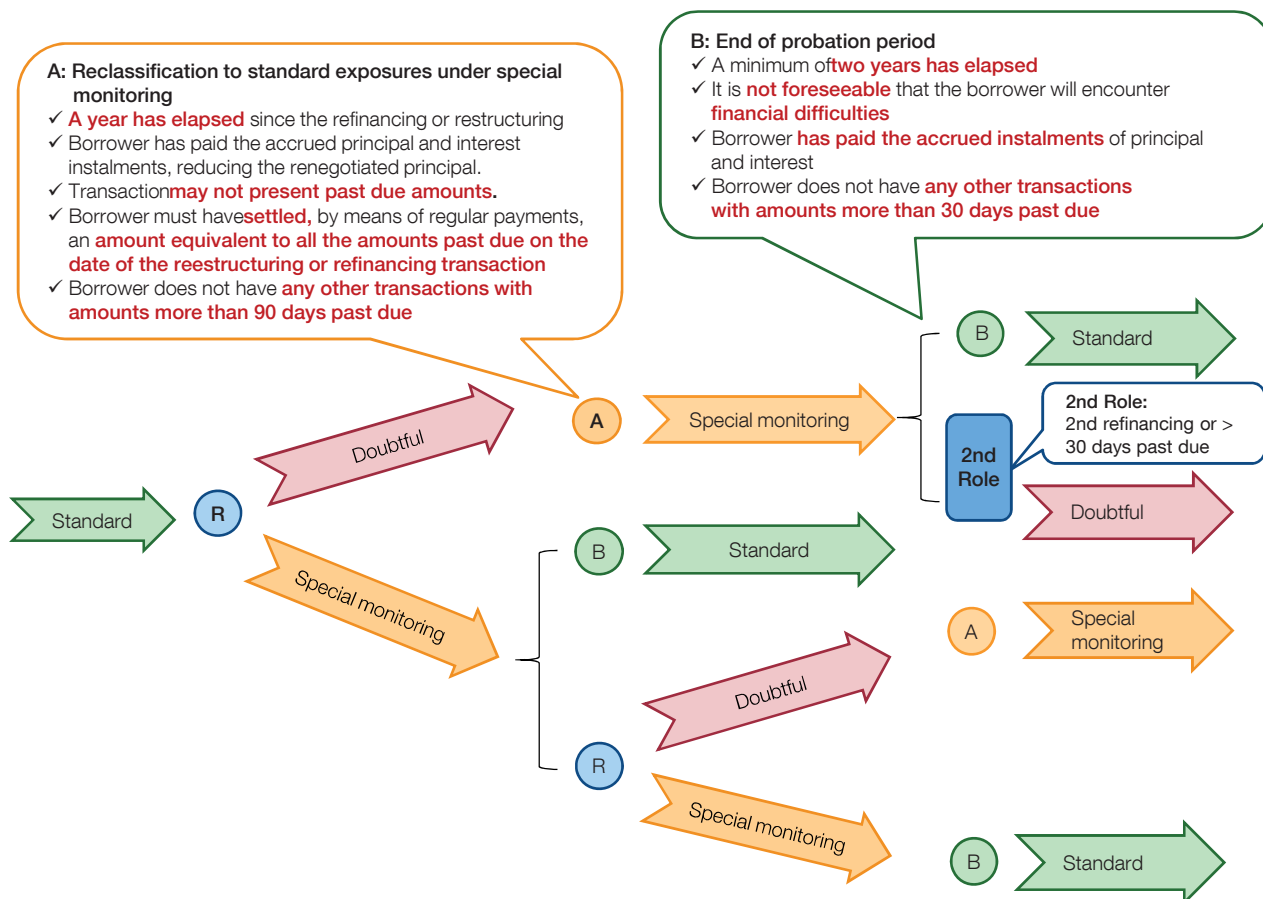
The purpose of the amendment of Annex IX, introduced in Circular 4/2016, is to update it to include the most recent developments in banking regulation and best practices identified in recognition of credit risk. The update, which came into force on 1 October 2016, is part of the process to improve and adapt Circular 4/2004, to promote uniform application of the IFRS accounting framework. The key elements of this update are:

- 1 Criteria for accounting classification of exposures. The distinction between performing and non-performing loans is fully aligned with the corresponding definitions of the European reporting standards (FINREP). Convergence with FINREP as to the accounting treatment of "forbearance" is also strengthened. Exposures that are performing but present weaknesses should be classified in the new category – "standard exposures under special monitoring" – that also includes, inter alia, "forborne" exposures under probation.

- 2 Internal controls and governance. Greater involvement of credit institutions' boards of directors is required, not only in approving accounting policies but also in the periodic monitoring of their implementation. This involvement is also required in the initial and periodic internal validation of the accounting methods used to estimate allowances and provisions. The role of internal audit and control functions is also strengthened, especially in respect of information systems and databases, the quality and coherence of which are essential for developing own methodologies for estimating allowances and provisions and for decision-making at all management levels.
- 3 Effectiveness and simplicity in the development of accounting methodologies. Any complexity that entails no evident improvement in the quality or coherence of the results obtained should be avoided. Own methodologies cannot be "black boxes", but should be comprehensible and offer results that are both understandable and realistic. For that purpose, institutions should conduct periodic backtesting, to compare the accuracy of their estimates with the actual losses observed. In addition, they should periodically undertake sensitivity analyses and benchmarking exercises. These exercises will be used to fine tune accounting methodologies on an ongoing basis to strengthen their effectiveness.
- 4 Appraisal of guarantees/collateral. Institutions should assess the effectiveness of guarantees/collateral for consideration in estimating allowances and provisions based on their experience. Annex IX establishes requirements on procedures and minimum frequencies for updating values of guarantees/collateral for their accounting consideration as an effective means of credit risk mitigation. The worse the accounting classification of exposures, the more stringent the requirements.
- 5 Principle of proportionality. In the case of institutions that have not rolled out internal methods for collective estimation of allowances and provisions, Annex IX offers alternative solutions (percentages of allowances and provisions and haircuts to the reference value of guarantees/collateral), drawn from the sectoral information and experience of the Banco de España.
- 6 Real estate assets foreclosed or received in payment of debt. Changes are made to the initial recognition system and the subsequent appraisal of these assets, in an endeavour to ensure that appraisals are as close as possible to market value.

These improvements, which strengthen credit risk management, the correct classification of exposures, the appropriate treatment of guarantees/collateral for accounting purposes, the robustness of estimates of credit risk provisions and market-adjusted valuations of "foreclosed" real estate assets, will remain in full force and effect when IFRS 9 is adopted by the EU, without prejudice to future amendment of Circular 4/2004, aiming to replace the existing "incurred loss" accounting model with an "expected loss" model. The various elements relating to credit risk accounting that have been updated and furthered are essential elements for progress towards robust accounting models.

There follows a description of the treatment awarded to forbore exposures, collateral and foreclosed assets.



SOURCE: Banco de España.

Forbearance in Circular 4/2016

Modifying the terms and conditions of financial contracts is legitimate and customary banking practice, allowing maturities and other contractual elements to be adjusted to borrowers' ability to pay. In recent years, however, supervisory concerns have arisen at an international level as to whether these modifications may be being used to delay the recognition of losses.

At the European level, in its FINREP harmonised reporting standards published in October 2013, the EBA defined forbearance as the modification of the terms and conditions of a contract or its refinancing, granted to a counterparty facing financial difficulties.

Circular 4/2016 adapts the definition of forbearance measures to fully align it with the definition of the EBA, incorporating it, via the Circular, into the latest amendment of Accounting Circular 4/2004, so that Spanish credit institutions must use the same definition of forbearance measures when preparing their annual accounts as in their financial reporting to the supervisor. Forborne exposures cannot continue to be recorded in the accounts as performing, but must be classified as either standard exposures under special monitoring or non-performing exposures.

Although the identification and accounting treatment of forborne exposures must be developed in each credit institution's accounting policies, Annex IX to Circular 4/2004 contains a series of general criteria, presumptions and automatic factors, in keeping with the EBA's above-mentioned reporting standards, to promote uniform and comparable accounting treatment. For example, Annex IX includes:

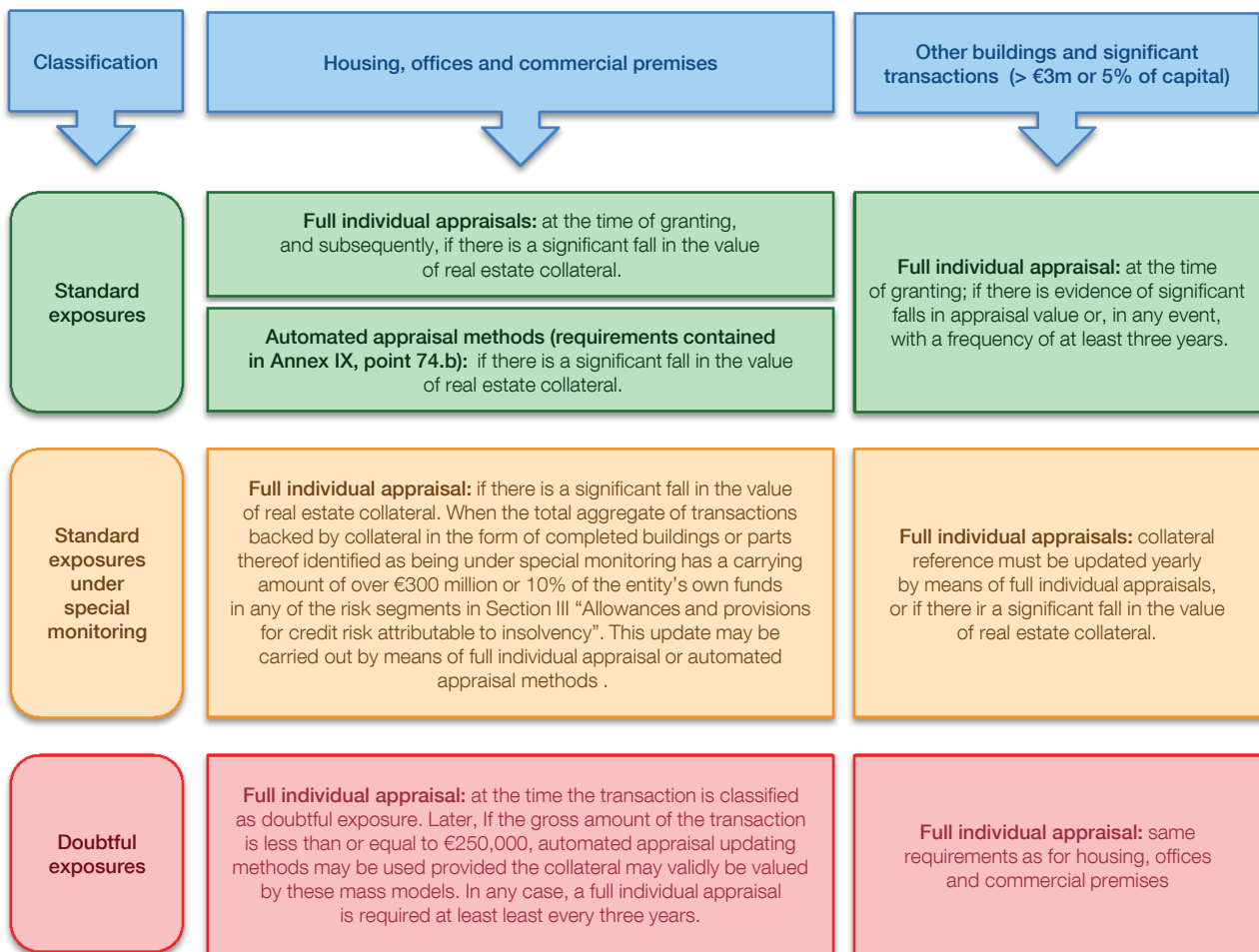
- The conditions in which a forborne exposure may be reclassified from non-performing to standard under special monitoring (cure period).
- The conditions in which a forborne exposure may be reclassified from standard under special monitoring to performing (probation period).
- Automatic classification as non-performing of a forborne exposure that is classified as standard under special monitoring if it is subject to further forbearance measures or if it becomes more than 30 days past due and had previously been classified as non-performing.

Updating of collateral value in Circular 4/2016

One of the main new features of new Annex IX (Circular 4/2016) is the higher impact of real estate serving as collateral on the calculation of allowances and provisions for credit risk losses. Since new Annex IX came into force, on 1 October 2016, allowances and provisions for all exposures, whether performing or non-performing, are calculated based on the non-collateralised part of the exposure. Thus, correct collateral valuation becomes particularly important. In this respect, the present Annex IX requires more frequent updates than its predecessor, to ensure that collateral values are more in keeping with foreseeable foreclosure and sale values. In certain cases, automatic valuation methods (AVMs) rather than complete individual appraisals may be used to update collateral values.

UPDATING OF COLLATERAL VALUATIONS

SCHEMA 7.2



SOURCE: Banco de España.

Where collateral values are updated using AVMs, banks should check the reliability of these methods by conducting precision and bias analyses of the results obtained by comparing them with a significant sample of complete individual appraisals.

Annex IX establishes a series of conditions for updating of collateral values, in terms of procedures used (i.e. complete individual appraisal or AVMs) and frequencies (the lower the rating of the exposure concerned, the higher the frequency).

Foreclosed assets
in Circular 4/2016

Real estate assets foreclosed or received in payment of debt will be initially recognised for the lower of the following values:

- a) Carrying amount of the financial asset applied, calculated as follows:

$$\text{Gross amount} - \left[\left(\text{Gross amount} - \frac{\text{Reference Value} \times (1 - \text{Adjustment})}{\text{Amount recoverable through collateral}} \right) \times \% \text{ Provision} \right]$$

$$\frac{\text{Amount of exposure not covered by collateral}}{\text{Provision set aside}}$$

Where:

- Reference value: the complete individual appraisal value of the foreclosed asset.
- Adjustment: under the Circular, foreclosure adjustments are applicable in the event of high turnover of stock, or otherwise collateral adjustments. In either case, banks that have developed internal methods may apply their own adjustments. For purposes of reference, turnover is considered high when sales exceed 25% (completed housing), 20% (completed multi-purpose industrial premises, commercial premises or offices) or 15% (all other real estate assets).

- b) Fair value minus the selling costs of the real estate asset, calculated as follows:

$$\text{Appraisal value} \times (1 - \text{Foreclosure adjustment}) - \text{Selling costs}$$

Where:

- Foreclosure adjustment: applying the adjustment envisaged for foreclosed real estate assets. In the case of banks that have developed internal methods of estimation of adjustment to the reference value (appraisal value), their own adjustments.
- Selling costs will include all costs directly attributable to the sale and which arise from the fact of the sale. It will not include any costs incurred irrespective of whether or not the real estate asset is sold.

For subsequent valuation of foreclosed assets, it will be analysed whether or not the fair value minus the selling costs is below the carrying amount. For that purpose, the reference value of the foreclosed assets, which is the starting point for estimation of their fair value, should be updated annually, either through a complete individual appraisal or using automatic valuation methods in those cases envisaged in the Circular.

Other new key features introduced by Circular 4/2016 relating to the carrying amount of assets foreclosed or received in payment of debt are as follows:

- Banks should calculate the haircuts to the reference value of foreclosed assets required to estimate their fair value bearing in mind the specific conditions of the assets or of the markets in which they are traded and their level of permanence on the balance sheet, based on their own experience of the sale of similar assets.
- Banks should regularly backtest their estimates of haircuts to reference values and selling costs. They should also regularly compare their estimates with the references provided in Annex IX.

7.1.3 BANCO DE ESPAÑA
CIRCULAR 5/2016
ON THE METHOD
FOR CALCULATING
CONTRIBUTIONS
TO THE DGS
PROPORTIONATE
TO RISK PROFILE

Banco de España Circular 5/2016, on the method of calculation to be used to ensure that banks' contributions to the Deposit Guarantee Scheme for Credit Institutions (DGSCI) are proportionate to their risk profile, fulfils the mandate issued to the Banco de España in Article 6(3) of Royal Decree-Law 16/2011 to develop the method of calculation of contributions to the Deposit Guarantee Scheme (DGS) to be used by the Management Committee to calculate the contributions of banks participating in the deposit guarantee scheme. The contributions are to be calculated on the basis of the volume of deposits guaranteed and the risk profile of each bank. The risk profile has been included in the method of calculation by means of an aggregate risk weighting.

The method developed in the Circular was first used to calculate the 2016 contributions.

The entry into force of the new Circular does not affect the total amount of ordinary contributions made by the banks overall, but rather their distribution based on the risk profile determined by the indicators.

7.1.4 BANCO DE ESPAÑA
CIRCULAR 6/2016
ON SMES

One of the fundamental objectives of Law 5/2015 of 27 April 2015 on the promotion of business financing is to make bank financing more flexible and more accessible for small and medium-sized enterprises (SMEs). To this end, it establishes that when banks decide to cancel or reduce the flow of financing to their SME or self-employed customers, in addition to giving them at least three months' notice, they should provide them with extensive information on their financial situation and payment record in a document entitled "SME-Financial Information". This document, which will include a classification of the customer's risk, should also be delivered at their request, against payment of the corresponding charge.

Banco de España Circular 6/2016 of 30 June 2016 to credit institutions and specialised lending institutions, which sets out the content and format of the "SME-Financial Information" and stipulates the method of risk classification, both envisaged in Law 5/2015 of 27 April 2015 on the promotion of business financing, fulfilling the mandate issued by that Law, aims to: i) stipulate the content and format of the SME-Financial Information, and the form-template used to convey that information; and ii) develop the methodology and the form-template for preparation of a standardised risk quality assessment report that will also be included in the SME-Financial Information.

In addition, banks will provide information on the relative position of their customers within their respective sectors of activity, using a tool provided by the Banco de España's Central Balance Sheet Data Office.

7.1.5 BANCO DE ESPAÑA
CIRCULAR 7/2016 ON
THE DEVELOPMENT
OF ACCOUNTING
SPECIFICATIONS
TO BE APPLIED BY
BANKING FOUNDATIONS

Banco de España Circular 7/2016 of 29 November 2016 developing the accounting specifications to be applied by banking foundations adapts the accounting regulations corresponding to them by virtue of their role as foundations to the singularities deriving from their obligations arising from their holdings in credit institutions.

Among other aspects, the Circular stipulates the accounting regime to be applied by banking foundations in their individual and consolidated annual accounts, it describes the additional information to be included in the report on the management protocol and financial plan and it establishes the obligation to submit certain individual confidential returns to the Banco de España.

Circular 7/2016 also makes changes to the Accounting Circular for credit institutions and the Circular on the Central Credit Register, incorporating technical details in both cases and updating the content of the Accounting Circular in keeping with the latest changes to the definitions and formats for preparation of the FINREP returns.

7.1.6 OTHER BANCO DE
ESPAÑA CIRCULARS
PUBLISHED IN 2016

In addition to the Circulars mentioned above, in 2016 the following Banco de España Circulars were also published:

- Banco de España Circular 1/2016 of 29 January 2016 amending Circular 1/2015, of 24 March 2015, to payment service providers, on information on merchant service charges and interchange fees received. This Circular amends Circular 1/2015 which, implementing Article 13 of Law 18/2014, establishes the reporting requirements of institutions that act as payment service providers in respect of merchant service charges and interchange fees received in payment transactions made on point of sale terminals located in Spain, using debit or credit cards, irrespective of the marketing channel used, when the payment service providers of both the originator and the payee are established in Spain. Circular 1/2016 enhances the information requested on interchange fees and merchant service charges received by banks, aiming to facilitate its analysis and comparability, amending the reports with information on interchange fees and merchant service charges that service providers must submit to the Banco de España.
- Banco de España Circular 3/2016 of 21 March 2016 to ATM owners and payment instrument and card issuers, on information on commission on ATM cash withdrawals. Circular 3/2016 regulates the form, content and periodicity of the reporting requirements established in the second additional provision of Law 16/2009 of 13 November 2009 on payment services, to enable appropriate monitoring of resolutions and decisions adopted by application of the new regulations on commission on ATM cash withdrawals brought in by Royal Decree-Law 11/2015 of 2 October 2015.

The present regulations govern, first, banks' powers to enter into agreements to determine the amount of commission to be paid by payment instrument or card issuers to ATM owners. If no such agreements are reached, the commission set by ATM owners for payment instrument or card issuers will be the same throughout the country and will not be discriminatory, with no differences being established for equivalent services and no distinctions drawn between issuing banks' customers. And second, the obligation for ATM owners and payment instrument or card issuers to inform the Banco de España of the commission to be paid by issuers to ATM owners for cash withdrawals. It is this latter obligation that is implemented in Banco de España Circular 3/2016.

7.2 Draft Banco de España Circulars

7.2.1 DRAFT BANCO DE ESPAÑA CIRCULAR TO AMEND CIRCULAR 2/2014 ON OPTIONS IN THE CRR

Through Circular 2/2014, the Banco de España exercised various regulatory options contained in the CRR. These options concern, for example, the transitional arrangements applicable to the calculation of solvency levels. Circular 2/2014 was initially applicable to all Spanish banks. However, in October 2016, ECB Regulation ECB/2016/4 came into force on the exercise of these options in the case of euro area institutions classified as significant. Since then, Circular 2/2014 applies only to less significant institutions, in respect of which the Banco de España continues to be the competent authority.

The system established in the new ECB Regulation differs in some respects from the stance adopted in 2014 by the Banco de España. Accordingly, in 2016 the Banco de España started work on amending Circular 2/2014, to adapt the system applicable to less significant institutions to that applicable to significant institutions.

The ECB, for its part, has published the criteria for adapting the regulatory options system approved for significant institutions to less significant institutions. The outcome of this work is being taken into account in the final wording of the amendment to Circular 2/2014.

7.3 Other significant regulations

7.3.1 REGULATION (EU) 2016/445 OF THE ECB ON THE EXERCISE OF OPTIONS AND DISCRETIONS AVAILABLE IN UNION LAW

Regulation (EU) 2016/445 of the ECB of 14 March 2016 on the exercise of options and discretions available in Union law (ECB/2016/4) was published in the Official Journal of the European Union on 24 March, and on the same date a Guide on the same topic was published on the SSM website. Both the Regulation and the Guide harmonise the exercise of these options and discretions in euro area banking legislation, especially in respect of Regulation (EU) No. 575/2013 (CRR), aiming to establish a level playing field in the banking sector.

The Regulation, which applies exclusively to credit institutions classified as significant institutions, harmonises certain prudential requirements in two respects: by eliminating options and shortening the period for exercise of options. The Regulation is binding and is directly applicable in all Member States; the Guide constitutes a manual for the JSTs.

On 10 August the ECB published the Addendum to the Guide on options and discretions available in Union law, incorporating eight options and discretions, thus supplementing the Guide and the Regulation.

7.3.2 REGULATION (EU) 2016/1011 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL, ON INDICES USED AS BENCHMARKS IN FINANCIAL INSTRUMENTS

Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 (Benchmarks Regulation) on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds, and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014, was published in the Official Journal of the European Union on 29 June.

The Regulation introduces a common framework to ensure the accuracy and integrity of indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds in the European Union. The new legal framework applies to the preparation of indices, the provision of input data and the use of the indices.

The following aspects of the new Regulation are noteworthy: i) it sets requirements for administrators, relating to governance and possible conflicts of interest, the control framework and record-keeping of all input data and the methodology used; ii) it sets the requirements that must be met by the input data and the methodology used to determine the benchmarks; iii) it sets requirements for the different kinds of benchmarks; and iv) it regulates the authorisation, registration and supervision of administrators.

8 INTERNAL AUDIT REPORT
REPORT PROVIDED FOR BY THE CONSOLIDATED TEXT OF THE SECURITIES
MARKET LAW, ENACTED BY LEGISLATIVE ROYAL DECREE 4/2015, 23 OCTOBER 2015

2016

1. Introduction

The tenth additional provision of the Consolidated Text of the Securities Market Law (LMV) enacted by Legislative Royal Decree 4/2015 of 23 October 2015, establishes that the Banco de España is to prepare an annual report on its supervisory function describing the measures taken and procedures followed in relation to supervision from which it is to be possible to deduce information about the effectiveness and efficiency of these measures and procedures. It also provides that this report is to include information from the internal control body on the conformity of the decisions adopted by its governing bodies with the procedural rules applicable in each case. This report is to be approved by the Governing Council of the Banco de España and sent to the Spanish Parliament and the government.

The Banco de España's 2017 annual audit plan, approved by the Governor on 31 January 2017 and reported to the Executive Commission on 14 February, includes the drafting of the report envisaged in the LMV in order that it may be included in the Banco de España's Annual Report on its supervisory function, referred to above.

2. Purpose, scope and methodology of the report

This report falls within the bounds of the legal mandate contained in the Tenth Additional Provision of the LMV. As mentioned above, this provision defines the scope of the report by reference to three basic elements:

1. The supervisory function of the Banco de España
2. The decisions taken by the governing bodies in exercise of the supervisory function.
3. Conformity of the foregoing decisions to the procedural rules applicable.

As regards the reporting period, the report refers to the decisions taken by the Executive Commission in 2016 and the decisions adopted by delegation of which the Executive Commission was notified in that period.

The subject matter of the report is the decisions taken by the Banco de España's governing bodies within the spheres of competence of the Directorate General Banking Supervision, the Directorate General Financial Stability and Resolution, and the General Secretariat.

As regards the applicable regulations, the supervisory powers and proceedings set out in Law 13/1994 of 1 June 1994 on the Autonomy of the Banco de España and the Internal Rules of the Banco de España were taken into account, together with those established by the regulations on the Single Supervisory Mechanism (primarily Council Regulation (EU) No 1024/2013 of 15 October 2013 and Regulation (EU) No 468/2014 of the European Central Bank of 16 April 2014). Moreover, through various resolutions, the Executive Commission has established the procedural rules for the proposals on matters within the competence of the various directorates general (Directorate General Banking Supervision, Directorate General Financial Stability and Resolution, and the General Secretariat).¹

¹ - Directorate General Banking Supervision: Executive Commission resolution of 8 April 2014, and Executive Commission resolution of 6 May 2016 replacing the preceding resolution.
- Directorate General Financial Stability and Resolution: Executive Commission resolution of 30 June 2006, and Executive Commission resolution of 20 May 2016 replacing the preceding resolution.
- General Secretariat: Executive Commission resolution of 20 February 2015.

On 2 November 2012, rules were laid down on the reporting of matters to the Executive Commission by all the Directorates General of the Banco de España. These rules complement those of the aforementioned directorates general.

Similarly, via a resolution of 22 May 2015,² the Executive Commission approved the regime governing the delegation of powers, which was published in the Official State Gazette of 2 June 2015 and envisages the delegation of signature and the callback of delegated powers.

In order to review the decisions adopted by the Executive Commission, stratified sampling was performed on decisions taken by the Directorate General Banking Supervision, the Directorate General Banking Regulation and Financial Stability and the General Secretariat. Different sampling fractions were applied to these strata depending on the materiality, numerical volume and internal homogeneity of each stratum.

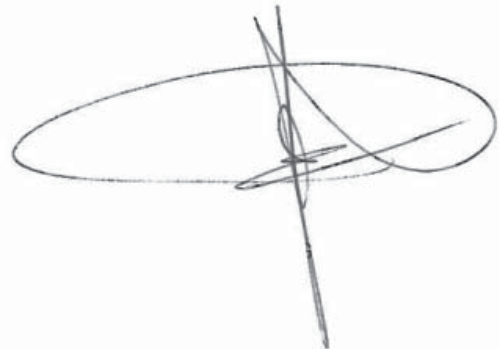
The work was performed in accordance with the Internal Audit Manual, which includes the International Standards for the Professional Practice of Internal Auditing, approved by the Institute of Internal Auditors, including those relating to the Code of Ethics.

3. Opinion

In our opinion, the decisions taken by the governing bodies of the Banco de España in 2016 in the exercise of its supervisory function were taken by bodies with sufficient own or delegated powers in accordance with the Banco de España's Internal Rules and with the provisions laid down by its Executive Commission, and are in conformity, in all material respects, with the existing procedural rules applicable in each case.

Madrid, 27 March 2017

Director of the Internal Audit Department

A handwritten signature in black ink, consisting of a large, horizontal oval shape with a vertical line crossing it, and a long, thin vertical line extending downwards from the center of the oval.

Juan González Gallegos

THE GOVERNOR OF THE BANCO DE ESPAÑA
THE DEPUTY GOVERNOR OF THE BANCO DE ESPAÑA

² This resolution was subsequently modified by the Resolution of the Executive Commission of 11 January 2017, published in the Official State Gazette on 18 January 2017.

BANCO DE ESPAÑA PUBLICATIONS

Studies and reports

PERIODICAL

Annual Report (in Spanish and English)
Balanza de Pagos y Posición de Inversión Internacional de España (annual)
Billetteria (in Spanish and English) (bi-annual)
Economic Bulletin (in Spanish and English) (monthly)
Estabilidad Financiera (bi-annual)
Financial Stability Report (in Spanish and English) (bi-annual)
Memoria Anual sobre la Vigilancia de Sistemas de Pago (annual)
Memoria de la Central de Información de Riesgos (annual)
Memoria del Servicio de Reclamaciones (annual)
Mercado de Deuda Pública (annual)
Report on Banking Supervision in Spain (in Spanish and English) (annual)
Research Update (bi-annual)

NON-PERIODICAL

Notas de Estabilidad Financiera

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- ² Moreover, it is updated daily in the Statistics section.
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