REPORT ON BANKING SUPERVISION IN SPAIN

2017

BANCO DE ESPAÑA
Eurosistema

REPORT ON BANKING SUPERVISION IN SPAIN 2017

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ISSN: 1696-4179 (online)

ABBREVIATIONS

AEG	Accounting Experts 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
CCyB	Countercyclical Capital Buffer
CCF	Credit Conversion Factor
CCP	Central Counterparty
CET1	Common Equity Tier 1
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
DGBS	Directorate General Banking Supervision
DGS	Deposit Guarantee Scheme
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 Programme
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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DEPUTY GOVERNOR'S INTRODUCTORY LETTER

This Report sets out the main activities performed by the Banco de España in 2017 in the exercise of its supervisory powers in the micro- and macroprudential areas and in consumer protection. It also describes the progress made in the international regulatory and supervisory fora in which the Banco de España participates. Lastly, it highlights the key regulatory changes in supervision-related matters, with special emphasis on the Circulars issued by the Banco de España in its capacity as credit institution supervisor and industry regulator.

In 2017 the Single Supervisory Mechanism (SSM), now in its third year, continued to consolidate its position as a key element of microprudential supervision of euro area credit institutions. The Banco de España participates in the SSM, performing its microprudential supervisory work through three main channels. First, through its participation in decision-making by the ECB's governing bodies relating to Spanish institutions and to institutions from other euro area countries. Second, through the participation of Banco de España staff, together with staff from the ECB and other euro area supervisory authorities, in the joint supervisory teams and on-site actions that are at the core of direct supervision of the significant institutions. And lastly, through the exercise of its direct supervisory powers over the less significant institutions, within the framework that is being rolled out by the SSM to ensure uniform supervision of these institutions.

The creation of the SSM has indeed been the most important step along the road to European financial integration since the introduction of the euro, and it is the basis for the banking union being built in Europe to safeguard financial stability.

Since the SSM officially entered into operation on 4 November 2014, we have made continuous progress in the harmonisation of supervisory practices in the euro area. Nevertheless, further progress is still needed, since certain differences persist owing to the different supervisory traditions of the SSM member countries. It is essential that both the supervisory review process and application of the European regulatory framework are consistent throughout the euro area, to ensure that banks compete on a level playing field.

In some cases, specific projects are already under way to address the differences persisting. For example, the different national supervisory practices for authorisation and review of the internal models used to calculate capital requirements are being subjected to a cross-section analysis. This will allow guidelines to be drawn up setting out the supervisory expectations in this matter, with the ultimate aim of strengthening the credibility of the internal models.

In other cases, certain differences persist that will also have to be duly addressed. For example, those deriving from the differences in scope and approach observed in on-site actions. I believe it is extremely important to progress in this area towards a common supervisory practice, in keeping with the best international supervisory standards, to strengthen the quality and consistency of European supervision.

The Banco de España is committed to this aim and makes a significant contribution, through its representation on the ECB's Supervisory Board and through its participation in the various technical and high-level working groups, such as that on cross-border on-site inspections. In this context, another key development in 2017 was the amendment of Banco de España Circular 2/2014, which includes exercise in Spain of the national options and discretions provided for in European prudential regulations, to adapt them to the recommendation issued by the ECB in April. In addition, Circular 4/2017 on credit institutions' accounting took note of the SSM's supervisory expectations in accounting matters relating to non-performing loans and valuation of collateral and foreclosed assets, published in the Guidance issued in March 2017, and expected-loss accounting.

Chapter 2 of this Report describes the Banco de España's supervisory priorities and strategies in the microprudential area, and the supervisory activity performed both within and outside the SSM (in the latter case, relating to functions not transferred to the SSM and to institutions other than credit institutions that pursue financial sector-related activities). In this respect, particularly noteworthy was the work undertaken by the Banco de España in 2017 in connection with the activities of appraisal companies, aiming to strengthen the consistency and quality of property valuations using automated and mass appraisal models.

The past crisis showed that it was essential to have in place macroprudential tools capable of addressing certain risks that affect the banking sector overall. Chapter 3 describes the macroprudential instruments that the Banco de España has used since 2016 to prevent systemic risk, highlighting its participation in the relevant ECB bodies.

In accordance with current regulations, in 2017 the Banco de España updated the list of systemically important institutions and their respective capital buffers. In view of the evolution of bank lending in the year, the countercyclical capital buffer for credit exposures in Spain remained unactivated.

As regards financial consumer protection, in 2017 the Banco de España stepped up its supervision of institutions' conduct, aiming to boost customer trust in the banking system. As described in detail in Chapter 4, the activities performed in the year focused on mortgage lending and advertising.

The key aspects of the Banco de España's exercise of sanctioning powers are set out in Chapter 5. Notably, much of this activity is connected with infringements of transparency rules and of the Code of Good Practice.

Chapters 6 and 7 highlight the main advances achieved to which the Banco de España has contributed through its participation in international banking regulation and supervision fora, and the main regulatory changes made in the supervision area. Stronger supervision and regulation, banking sector reforms, economic recovery and the steps taken by the banks themselves have all served to fortify the solvency of the Spanish banking sector as a whole in recent years.

Nevertheless, despite this improvement, in 2017 the effects of the crisis were still evident, for instance, in the resolution of Banco Popular Español, a significant institution supervised by the SSM. On 6 June the ECB informed the Single Resolution Board (SRB) that the bank was failing or likely to fail. On 7 June the SRB determined that it met the conditions for resolution, and it was sold to Banco Santander on that same date.

Looking ahead, although Spanish credit institutions have strengthened their positions, they still have major challenges to address in coming years and the supervisor will have to assess the measures they adopt to meet each of these challenges.

The first challenge is to define the business model. In order to remain viable in the medium and long term, banks need to have appropriate profit levels. Since the onset of the crisis, the profitability of the banking sector has remained relatively low and at some distance from the levels observed in previous periods. The very low interest rate environment is one of the main factors behind recent profitability trends. Other factors are: the lower volume of banking business, since although the economic recovery is expected to continue, growth will be limited, in the short term because of the prolonged effects of the crisis and in the medium term on account of structural weaknesses and the continuingly high unemployment rate; the still significant presence of non-productive assets on banks' balance sheets, despite their decline in recent years; and the increase in legal costs which have lately gained prominence among the factors behind lower profitability.

The supervisor has no place interfering in banks' strategic decisions, but it should monitor those decisions and it should share its analysis with the banks and support all decisions that promote financial stability. Accordingly, in its capacity as an SSM member, the Banco de España examines banks' business models as part of its supervisory assessment of their solvency and viability.

The second challenge that banks need to address is how to manage the non-productive assets cited above as one of the factors adversely affecting their profitability. The ECB's Guidance to banks on non-performing loans, published in March 2017, identifies a number of best practices for managing these assets. In coming years the Banco de España will continue to verify that banks take measures to ensure the correct identification and provisioning of non-performing loans.

A third challenge that banks must address is the need to adapt to regulatory changes. At the start of 2018 Spanish credit institutions have had to change from an incurred loss-based accounting model to an expected loss model, in keeping with the change in European accounting criteria. Moreover, in coming years, banks will have to comply with further requirements that are currently under discussion such as, for example, the minimum leverage ratio, the net stable funding ratio or minimum required eligible liabilities (MREL).

Complying with MREL will be particularly challenging for all European credit institutions, as they will have to hold on their balance sheets instruments with sufficient capacity to absorb possible losses and, where appropriate, to enable banks to recapitalise to a highly significant extent. Thus, in the event of resolution, a bank could continue to perform its critical functions, with no need to apply for public assistance and without jeopardising the financial stability of the system. Unquestionably, the introduction of MREL will strengthen financial stability. However, in order to ensure that it will not act as a further drag on banks' profitability or place excess constraints on their business models, a reasonable period for compliance with this new requirement must be considered.

All these regulatory changes pose a dual challenge for the supervisory authorities: the need to assess how well prepared banks are for their implementation, and the need to adapt supervisory procedures to the new requirements.

The fourth challenge is concerned with technology and is not insignificant, considering the importance of proper technology risk management and the galvanising effect of technological change on the banking sector. Digital innovation is now transforming traditional banking activity, and is at the same time fomenting the entry of new firms into certain areas of the banking industry. Since these fintech firms may eventually compete with traditional banks in a specific part of the banking business value chain, the more similar their activity is to traditional banking, the more important it will be to ensure that they are subject to requirements and controls similar to those applied to banks, adapted to the relevant business risk, to guarantee the neutrality of the regulatory framework.

Technological progress brings with it opportunities to make the financial system more efficient, through greater knowledge of customer behaviour, which in short would allow banks to tailor their products, adapting them better to specific needs and to individual customers' risk profiles. However, this progress also entails risks that must be managed, such as data security, the possible impact on bank/customer relations and the potential for increased fraud.

Customer service and regaining customer trust – undermined as a result of the recent financial crisis and certain banking practices – are precisely the fifth challenge that the banking sector must face. Customer trust is the most valuable and yet also the most fragile of a bank's assets. To regain that trust, transparency in communications with customers must be enhanced and inappropriate marketing practices overhauled. To that end, the Banco de España is stepping up its actions relating to supervision of institutions' conduct.

In short, the Spanish banking sector, akin to its European counterparts, is facing major challenges, at a time when the traditional banking business is adjusting to the new economic, regulatory and technological environment. In consequence, in 2018 the Banco de España's supervisory activity will continue to focus on preserving the stability of the Spanish financial system and, in short, to contributing to an improvement in the economic situation.

Lastly, to conclude, a mention should be given to Mr Mariano Herrera, Director General Banking Supervision, Mr Pedro Comín, Associate Director General Banking Supervision, and Mr Pedro González, Director of Supervision Department IV who, on 13 February

2017, stood down from their posts, having learned that they had been summoned by the National High Court to appear as persons under investigation, together with other former Banco de España officers, in the proceedings relating to Bankia. This was indeed a sad day for all of us in the Banco de España who had witnessed at first hand their outstanding career achievements – each with more than 25 years' service in the Banco de España – and personal calibre. In May 2017 the National High Court's Central Examining Court Num. 4 dismissed and closed the case. This ruling was subsequently confirmed by the National High Court's Chamber for Criminal Matters.[1] At this point I wish to publicly acknowledge the work performed by these three senior officers while they held positions of responsibility in the Banco de España, their close collaboration with the courts to clarify the facts, and their decision to step down immediately from their posts so as to ensure that the Banco de España's supervisory function was not affected while the court investigations were under way.

1 The May 2017 ruling states that "there is no indication whatsoever of their involvement in the commission of the offences investigated, there being no evidence, not even circumstantial evidence, of their involvement in any manner in the preparation or approval of the accounts contained in the prospectus that BANKIA submitted to the CNMV for its market flotation".


ESPAÑA

1 ORGANISATION OF SUPERVISION IN SPAIN

Louis XVI mantel clock. 18th century. Banco de España collection.

1.1 Supervisory functions of the Banco de España

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. The microprudential supervision of credit institutions: geared to monitoring the solvency of credit institutions, with a view to reducing to a minimum the likelihood and the effects of crises at individual institutions.

2. The microprudential supervision of other institutions, other than credit institutions, that provide services or engage in activities related to the financial sector.

3. The functions conferred upon the supervisor by the regulations on the recovery and resolution of credit institutions.

4. Macroprudential supervision, aimed at safeguarding the stability of the financial system, in particular the banking system.

5. The 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.

6. Other supervisory functions, in collaboration with different agencies.

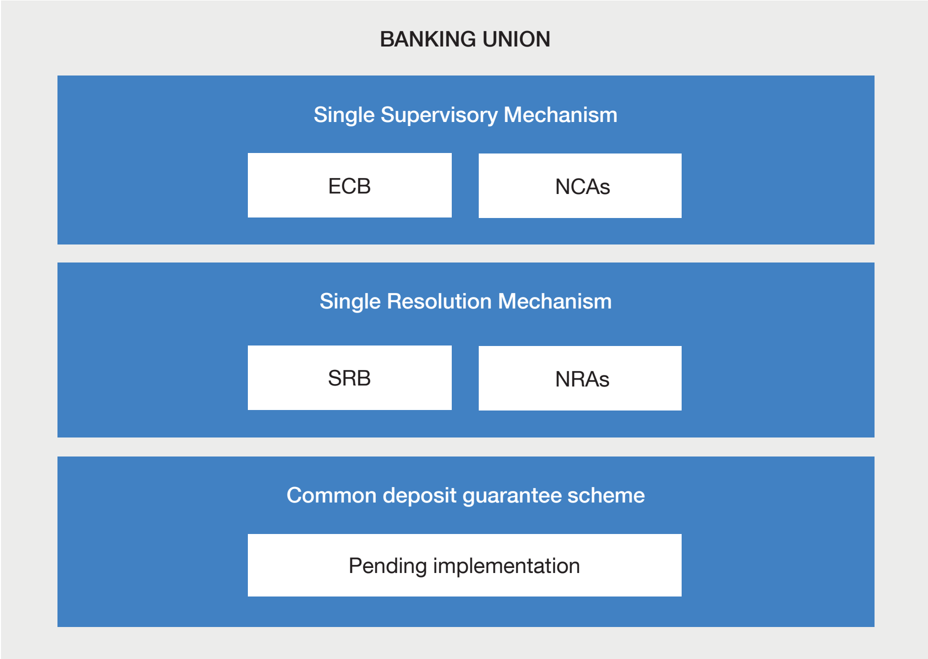
The microprudential supervisory functions of the Banco de España are performed mainly within the Single Supervisory Mechanism (SSM), which is entrusted with the supervision of the credit institutions of the European Union Member States belonging to the euro area or those which, while not belonging to the euro area, decide to be part of the SSM.

The SSM is the first pillar of the Banking Union, a project that gathered pace further to the financial crisis that broke in 2008 and the subsequent sovereign debt crisis in Europe. The Banking Union comprises three key elements: a single supervisory mechanism led by the ECB and in which the national competent authorities (NCAs) participate; a single resolution mechanism, made up by a central resolution body, the Single Resolution Board (SRB), and the National Resolution Authorities (NRAs) of each member country; and a common deposit guarantee scheme, which has yet to be implemented (see Figure 1.1). These elements are complemented by the setting in place of a single rulebook.

The fundamental aims of the SSM are to ensure the solvency of the European banking system, to increase financial integration and the stability of the system, and to ensure consistent and uniform supervision in the Banking Union countries. The SSM performs its mission by overseeing the compliance by banks with the obligations established in the general framework laid down in European legislation (the Single Rulebook).

PILLARS OF BANKING UNION

FIGURE 1.1



SOURCE: Banco de España.

The SSM is responsible for the prudential supervision of all the credit institutions of the member countries, a task in which it is assisted by the ECB and the national competent authorities. The legal basis for supervisory functions being conferred upon the ECB and for its organisation being regulated to this end is the SSM Regulation and the SSM Framework Regulation. The Banco de España sits on the ECB's Supervisory Council and on its Governing Council, where supervisory decisions, along with the supervisory methodology, practices and criteria applied in the countries belonging to the system,[1] are discussed and approved.

The SSM carries out the supervision of around 4,000 institutions, which are classified by virtue of their size or importance in each country as significant institutions (SIs) or less significant institutions (LSIs).

The ECB is directly responsible for the supervision of the significant institutions, while the Banco de España directly supervises Spanish less significant institutions. There were 869 groups of significant institutions as at 31 December 2017, 13 of which are Spanish. Groups of Spanish less significant institutions numbered 69 at the close of 2017.

As regards the distribution of competencies within the SSM, since 2016 it has been established that, in the case of powers conferred upon the supervisory authority under national law, the ECB shall be responsible for SIs, if such powers refer to its supervisory tasks and contribute to the performance of supervisory functions. The NCAs, for their part, exercise those powers that do not come under the ECB's tasks or which do not support its supervisory functions, although in these cases the ECB may provide guidance to the NCAs, as stipulated in the SSM Regulation.

1 The current members of the SSM are the euro area countries, which are obliged to belong to the system (so far, no other EU country has applied to join this mechanism, which they can do voluntarily).

Meeting between the Directorate General Banking Supervision Directors and Danièle Nouy. Salón de los Cuarenta, Banco de España.

The ongoing monitoring of significant institutions is performed by the Joint Supervisory Teams (JSTs). The JSTs are led by a coordinator who belongs to the ECB and, in the case of Spanish institutions, a sub-coordinator of the Banco de España, and they are made up of staff from both institutions (the Banco de España provides approximately two-thirds of the human resources). If the institutions have a presence in other SSM countries, the JSTs will also feature staff from the national supervisory authorities in those countries and a sub-coordinator from each such country.

In the SSM the Banco de España also plays an essential role in other supervisory activities, such as on-site inspections and internal model reviews, which complement the ongoing monitoring of Spanish significant institutions, and in the processing of authorisations for the institutions that are subject to the common procedures described in section 2.2.5.

Finally, through its participation in the SSM's Supervisory Council, the Banco de España contributes to decision-making on institutions from other EU countries that belong to the euro area.

A second group concerns supervisory functions performed on other financial institutions, other than credit institutions, that offer specific financial services or have specific links to the financial sector: specialised lending institutions, mutual 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 (Sareb).

Thirdly, within the framework of the distribution of SSM competencies, the Banco de España performs the functions that the regulations on the recovery and resolution of credit institutions assign to it as a microprudential supervisor. The European framework for the recovery and resolution of European Union credit institutions and its transposition into Spanish regulations confers upon banking supervisors functions that are essentially focused on the pre-resolution phase, before an institution is declared to be non-viable, such as the assessment of recovery plans or the adoption of early intervention measures and the declaration of non-viability.

Induction ceremony for new bank examiners. Hemiciclo II Auditorium, Banco de España.

Macroprudential policy, geared to promoting the stability of the financial system, is the fourth type of supervisory function performed by the Banco de España. To this end, the Banco de España has the macroprudential tools envisaged in the European legislation on capital requirements for credit institutions and in its transposition into Spanish regulations. These competencies include the annual identification of systemically significant institutions and the determining of the associated capital surcharges, the quarterly setting of the level of the countercyclical capital buffer and the assessment of the possibility of activating other macroprudential instruments envisaged in the regulatory framework.

The Banco de España also supervises the market conduct, transparency and protection of the customers of the institutions registered in the Banco de España's official registers of institutions (credit institutions and other institutions offering certain financial services) for which there are specific regulations on transparency and customer protection.

Finally, it performs **other supervisory functions**, such as cooperation with the Executive Service of the Commission for the Prevention of Money Laundering (SEPBLAC) in the supervision of money-laundering rules, and cooperation with the National Securities Market Commission (CNMV) in the supervision of activities related to the financial markets.

1.2 Organisation of banking supervision at the Banco de España

The various supervisory functions performed by the Banco de España and their distribution across the central bank's different directorates general and departments are detailed in Figure 1.2.

Microprudential supervisory functions are performed by various departments within the Banco de España, whose Directorate General Banking Supervision (DGBS) has a similar organisational structure to that of the ECB in order to participate as efficiently as possible in the SSM.

SUPERVISORY FUNCTIONS OF THE BANCO DE ESPAÑA

FIGURE 1.2

DIRECTORATE GENERAL BANKING SUPERVISION	Supervision Deparment I	— Ongoing superivision of the four largest significant institutions through the JSTs.
	Supervision Department II	— Ongoing supervision of the remaining significant institutions through the JSTs.
	Supervision Department III	— Ongoing supervision and on-site inspections of: • less significant institutions under the SSM. • entities belonging to foreign significant groups. • other entities outside the scope of the SSM.
	Supervision Department IV	— Specialised or cross-cutting tasks affecting all institutions. — On-site inspections and reviews of internal models of significant institutions.
	Planning and Analysis Department	— Definition of supervisory policies. — Implementation and interpretation of accounting legislation. — Development and monitoring of annual supervision plans. — Supervisory methodology. — Quality control over supervisory activities. — Selection and training of DGBS staff. — Computer processing of financial information received from institutions. — Specific analyses of developments in the Spanish financial system and its main risks.
	SSM Coordination	— Supporting the Banco de España's representative on the SSM Supervisory Board. — Managing information received in relation to the SSM.
GENERAL SECRETARIAT	Market Conduct and Claims Department	— Supervision of market conduct and compliance with regulations on transparency of information and customer protection in the marketing of banking services and products. — Definition of regulatory and supervisory policies concerning market conduct.
	Deputy General Secretariat	— Assessing the compliance with the suitability requirements of board members, managing directors and similar officers. — Maintaining the Senior Officer Register. — Participating in the granting and withdrawal of institutions' authorisation. — Maintaining the Institutions Register.
	Legal Department	— Examining disciplinary proceedings.
DIRECTORATE GENERAL FINANCIAL STABILITY, REGULATION AND RESOLUTION	Financial Stability and Macroprudential Policy Department	— Analysis of financial system risks and vulnerabilities. — Formulation of macroprudential policy proposals.
	Financial Reporting and CCR Department	— Reception, quality control and forwarding of supervisory information that credit institutions are required to submit to the ECB, within the SSM, and to the Banco de España, in the exercise of their microprudential supervision and inspection powers over institutions. — Management of the Central Credit Registry.
	Regulation Department	— Analysis, definition and monitoring of regulatory policies at the global and European levels. — Coordination with the EBA and other international forums and bodies. — Development and interpretation of prudential regulations.

SOURCE: Banco de España.

In the course of 2017, two of the directorates general engaging in supervisory functions were reorganised. In the Directorate General Financial Stability, Regulation and Resolution, the functions relating to financial regulation, which previously came under the remit of DGBS, and the Banco de España's participation in various international bodies were brought together in order to enhance the formulation of regulatory policy in the international arena and in internal coordination. In the DGBS, with the aim of better coordinating the

STAFF OF THE DIRECTORATE GENERAL BANKING SUPERVISION, THE DIRECTORATE GENERAL FINANCIAL STABILITY, REGULATION AND RESOLUTION, THE MARKET CONDUCT AND CLAIMS DEPARTMENT AND THE DEPUTY GENERAL SECRETARIAT, AS AT 31 DECEMBER 2017

TABLE 1.1

Number

	Directorate General Banking Supervision (a)	Directorate General Financial Stability, Regulation and Resolution	Market Conduct and Claims Department (b)	Deputy General Secretariat (c)
Directors and other managers	42	31	10	4
Bank examiners/inspection auditors	281	15	6	
Senior analysts/lawyers/experts	19	53	22	6
IT auditors	45		2	
Junior analysts	42	59	46	13
Administrative and other staff	48	22	10	9
TOTAL	**477**	**180**	**96**	**32**

SOURCE: Banco de España.

a The staff of the Directorate General Banking Supervision have the following functions:
– 157 persons have functions relating to the ongoing supervision of significant institutions conducted through joint supervisory teams set up by the SSM.
– 21 persons have functions relating to the ongoing supervision of less significant institutions supervised directly by the Banco de España and indirectly by the ECB.
– 21 persons have functions relating to institutions whose supervision has not been taken on by the ECB.
– 111 persons have functions relating to on-site inspections or the review of models.
– 102 persons have cross-departmental functions.
– 65 persons have other functions.

b Of the total department staff, 40 staff members (the Director and 39 staff assigned to the Oversight of Institutions' Conduct Division) perform direct supervision functions.

c Includes only information on staff of the Suitability Assessment and Individuals Register Division, and the Institution Authorisation and Registration Division.

work of the four operational banking supervision departments, the latter now report directly to the Associate Director General. Also, a new department – Planning and Analysis – has been created, grouping together different horizontal functions that had hitherto been assigned to different departments or areas of the DGBS, in order to strengthen the coordination of cross-departmental functions.

1.3 Staff

The SSM and the existence of an increasingly extensive body of regulations have entailed a substantial increase in supervisory tasks, giving rise to a growing need for more human resources.

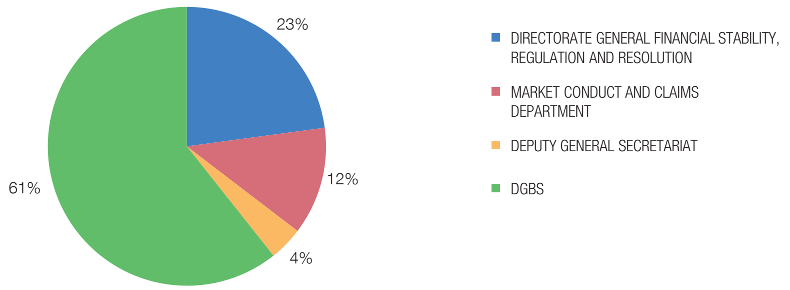
To address this need, in the second half of 2017 the Executive Commission of the Banco de España approved staff increases in the form of 70 bank examiners and 17 experts on risk models and information technologies for microprudential supervision.

This increase in staff will be covered in the main during the first half of 2018, essentially through three selection processes: i) bank examiners for credit institutions; ii) specialists in banking risk measurement models; and iii) experts in information technologies. As at 31 December 2017, these three processes were under way. While vacancies will be covered with staff on permanent contracts, temporary contracts will continue to be extended.

Further, with a view to better adapting new positions to the current needs of the supervisory function within the SSM framework, certain changes have been made to the selection process for bank examiners for credit institutions: i) inclusion of a skills testing exercise; ii) introduction of a merit evaluation phase to analyse professional skills; and iii) greater demands in respect of the command of English. Additionally, the number of vacancies advertised has increased (from approximately 30, as had been the case in recent years, to 45) and the duration of the training and selection phase has been shortened.

DISTRIBUTION OF STAFF FOR SUPERVISORY FUNCTIONS

CHART 1.1



SOURCE: Banco de España.

With regard to other supervisory functions not linked to the SSM, the Executive Commission also approved another selection process to hire 21 specialists to cover, inter alia, supervisory requirements in respect of market conduct and macroprudential policy.

Table 1.1 and Chart 1.1 detail the staff assigned to supervisory functions, with a breakdown by directorate general.

2 MICROPRUDENTIAL SUPERVISION

Louis XV mantel clock. 18th century. Banco de España collection.

2.1 Supervisory priorities

As in previous years, the supervisory priorities for 2017 were established jointly in the framework of the SSM, with the active participation of the Banco de España. This section outlines the main areas on which supervisory attention focused in 2017, and the priorities for 2018, which are summarised in Figure 2.1.

SUPERVISORY PRIORITIES IN 2017 AND 2018 — FIGURE 2.1

2017	2018
SUSTAINABILITY OF THE BUSINESS MODEL	
Thematic review of business models	Implications of the interest rate for the income statement
QUALITY OF CREDIT PORTFOLIOS	
Assessment of impaired assets	Revew of strategies to reduce non-performing assets
Thematic review of adaptation to IFRS 9	Checking the adequacy of provisioning and write-downs
RISK MANAGEMENT	
Thematic review of data aggregation and risk reporting	Monitoring of IFRS 9 implementation progress
Review of internal models	Review of internal models
Adaptation to new regulations	Preparations for Brexit
Risks of outsourcing	EBA stress tests for significant institutions
Improvement of ICAAP	Improvement of ICAAP

SOURCE: Banco de España.

2.1.1 SUPERVISORY PRIORITIES IN 2017

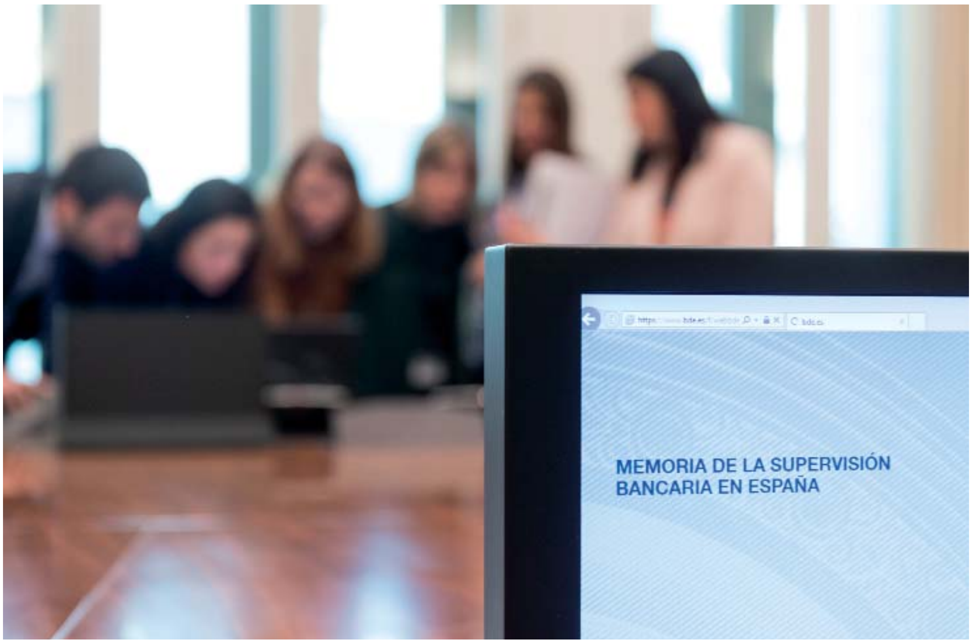
Supervisory priorities are set as the outcome of a process of analysis of the risks the financial system faces. This section outlines the main areas on which supervisory attention focused in 2017 and the priorities for 2018.

For 2017, in line with the SSM's supervisory objectives, the Banco de España defined its priority areas to be institutions' business models and profitability, the quality of the loan portfolio, and risk management.

— Business models and profitability: the context in which banks are operating, with historically low interest rates, is putting considerable pressure on their profits, which calls for particular attention from supervisors. Therefore, in 2017 further progress was made on the cross-cutting thematic review of banks' business models begun in 2016 and planned over a two-year horizon.

— Quality of the loan portfolio: progress continued on the evaluation of the portfolio of impaired assets. In this connection, the ECB's Guidance to banks on non-performing loans, published in March 2017, incorporated both guidelines on the management of impaired assets and criteria for their accounting treatment, placing particular emphasis on their identification and coverage. These supervisory expectations were already incorporated in Circular 4/2016, along with the update to the general framework for credit risk management and the criteria for the classification and coverage of impaired assets, and they have been maintained in Circular 4/2017. Box 2.1 summarises the main accounting matters covered by the ECB's Guidance on NPLs.

  The review of institutions' level of adaptation to the expected loss model in IFRS 9 also continued, and recommendations were made to each institution under review on areas for improvement based on the SSM's supervisory expectations regarding the application of the new accounting standards. Banco de España Circular 4/2017 also covers these supervisory expectations regarding the application of the expected-loss model.



Supervisory team working meeting.

ACCOUNTING EXPECTATIONS OF THE ECB GUIDELINES ON MANAGEMENT OF AND ACCOUNTING FOR NON-PERFORMING LOANS

BOX 2.1

In March 2017 the Single Supervisory Mechanism published guidelines including its supervisory expectations relating to management of and accounting for non-performing loans (NPLs), with the aim of harmonising the supervisory approach applicable to them. These supervisory guidelines contain principles based on best practices regarding NPLs. On one hand, the guidelines include supervisory expectations relating to management of impaired assets, calling on the establishment of goals and specific strategies to reduce such assets. On the other, they contain accounting expectations, with NPL identification and provisioning criteria, including valuation of collateral for accounting purposes. We summarise below the accounting expectations of the ECB guidelines, which are fully in line with the criteria established by Annex 9 of Banco de España Accounting Circular 4/2017, of 27 November 2017.

Identification of NPLs	— **NPL definitions are equated for accounting and solvency purposes:** non-performing exposures are those that satisfy any of the following criteria: a) there are amounts more than 90 days past-due (arrears). b) there are reasonable doubts as to their full repayment. Additionally, the "pulling effect" is also included (all the positions of a client are deemed non-performing when transactions with unpaid balances account for 20% or more of the total exposure). — **Forbearance:** forbearance of non-performing exposures does not automatically lead to their reclassification. The classification of an exposure may improve only if the criteria required under paragraph 120 of Annex 9 of the above-mentioned Circular are complied with.
Estimation of provisions	**Estimation for calculation of the provision for each exposure may be individual or collective, depending on the characteristics of the provisioned exposure:** — Individual estimation: applied to exposures which the institution deems significant, non-performing for reasons other than arrears and not to form part of a homogeneous risk group. The provision is calculated as the difference between the carrying amount of the transaction and the discounted cash flows which the institution expects to receive from the debtor. — Collective estimation: applicable to the remaining exposures. To calculate the provision the historical loss experience of the institution with assets having similar credit risk features to those of the group is taken into account. — **Periodic backtesting:** provisions calculated in the past should be compared with actual losses to assess the quality of the institution’s estimates.
Valuation of collateral	— **Institutions should have written policies and procedures** on the valuation of collateral for immovable property approved by the Board of Directors, including adequate control and monitoring of such valuations. — **The use of full individual appraisals and automated valuation methods** to update the valuation of transactions amounting to less than €300,000 is permitted. — **Appraiser independence requirements are established.** — **The frequency of valuations is regulated.** A comprehensive individual appraisal is required for exposures classified as non-performing, which should be updated at least once a year. — **There will be discounts (haircuts) based on the reference value (appraisal value)** when the amount to be recovered through the realisation of collateral is considered for the purpose of taking into account the possible selling costs or the possibility of the selling price being lower than the appraisal value.

SOURCE: Banco de España.

— Risk management: three lines of supervisory action stand out. Firstly, work continued on the thematic review begun in 2016 to assess compliance with the Basel Committee’s principles on the effective aggregation of risk data and the submission of risk reports. Secondly, in order to allay concerns about disparities in the way institutions apply internal models to calculate capital requirements, the specific review of the internal models begun in 2016 was continued. Finally, in relation to banks’ internal risk management activities, and in line with the measures adopted in 2016 and 2017, the ongoing improvement of the capital (ICAAP) and liquidity (ILAAP) self-assessment processes was supported, and the way in which banks are managing the risks deriving from business outsourcing was examined.

Directorate General Banking Supervision working meeting.

2.1.2 SUPERVISORY PRIORITIES IN 2018

The main risks the financial sector needs to address in 2018 were already present in previous years, and although they are arguably somewhat less marked, they continue to pose challenges for institutions' profitability and stability. In particular, these risks include the persistence of a low interest-rate environment, and the need to manage considerable volumes of non-performing loans, while adapting to significant regulatory changes.

In order to assess institutions' capacity to address these risks, in 2018 supervision will continue to focus on the three priorities identified in 2017, along with certain other areas:

— Business models: the examination of institutions' business models and profitability will continue to be a supervisory priority in 2018, focusing in particular on the implications of interest-rate risk for profits.

— Credit risk: the strategies institutions have implemented to reduce non-performing exposures, along with recognition criteria and their coverage with provisions, will continue to be reviewed in 2018.

  One aspect on which particular attention will be focused in relation to loan loss provision estimates is the valuation of collateral for credit exposures. The ECB's Guidance on NPLs lays down the criteria for estimating the recoverable value of collateral. These are set out and elaborated upon in Circular 4/2017. In this regard, guaranteeing the quality of the valuations performed using automated methods will be an important step.

— Risk management: targeted review of internal models (TRIM) of own funds requirements for credit, market and counterparty risk will continue in 2018 and 2019. On this point, work is under way on the publication of the ECB guidelines for internal models, drawing on the experience gained from these reviews. In 2018, the ECB will also be submitting the ICAAP and ILAAP guidelines for public consultation, in order to help improve institutions' internal management procedures. Finally, the application of the new expected loss accounting framework will also be a focal point for supervisory attention.

— Other points include the review of the suitability and quality of governance structures in less significant institutions, and Brexit, which affects the financial sector both through institutions with subsidiaries or branches in the United Kingdom, and the possible relocation of currently UK-based institutions to EU Member States. It is therefore essential that transition or relocation plans be drawn up for this eventuality.

Finally, in 2018 a new stress test led by the EBA will be carried out on significant institutions, in order to evaluate and compare institutions' resilience to future crises, based on data at 31 December 2017 and considering two different scenarios, a baseline and an adverse scenario, over a period of three years. The results of these tests will be used as input for the SREP.

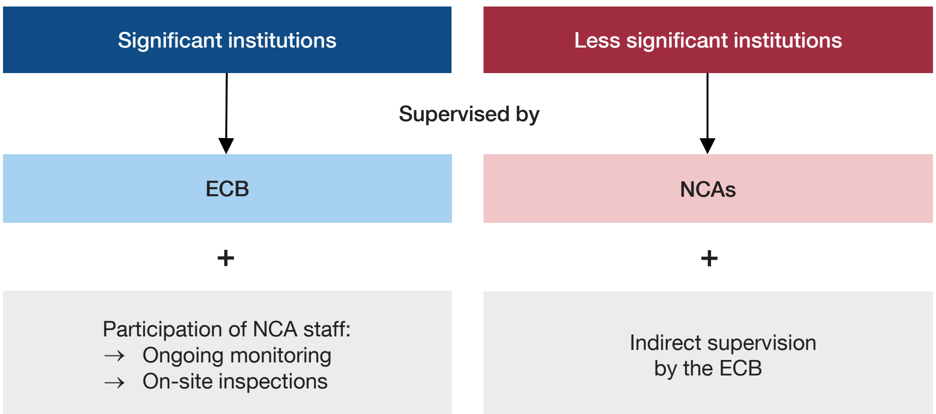
2.2 Supervision of credit institutions

As explained when outlining the distribution of supervisory tasks in the SSM, the ECB supervises institutions defined as significant directly with the collaboration of the NCAs, whereas the NCAs supervise the less significant institutions in their respective jurisdictions. This distribution is shown in Figure 2.2.

At 31 December 2017, there were 119 groups of significant institutions in the SSM, comprising 869 individual institutions, and 2,869 groups of less significant institutions, comprising 3,163 individual institutions. In Spain, there were 13 groups of significant institutions[1] on that date, 69 groups of less significant institutions, and seven sub-groups of Spanish institutions belonging to significant institutions in other countries.

Groups of significant institutions account for 94.3% of total assets in the Spanish banking system, although in December 2017 they comprised just 13 groups. The rest of the system consists of less significant institutions and subgroups of Spanish institutions that belong to significant institutions in other countries, as shown in Table 2.1.

SUPERVISION OF CREDIT INSTITUTIONS IN THE SSM FIGURE 2.2



SOURCE: Banco de España.

1 Santander, BBVA, Caixabank, Bankia, Sabadell, Unicaja, Bankinter, Kutxabank, Ibercaja, Abanca, Liberbank, BMN and Banco de Crédito Social Cooperativo. Following the merger by absorption of BMN by Bankia, which took place in January 2018, the number of groups of significant institutions was 12.

GROUPS AND SUBGROUPS OF SPANISH CREDIT INSTITUTIONS

TABLE 2.1

Figures at December 2016 and 2017

	2016		2017	
	Groups	Assets	Groups	Assets
Groups of Spanish significant institutions	14	94.3%	13	94.3%
Subgroups of Spanish institutions dependent on groups of foreign significant institutions	8	1.2%	7	1.0%
Groups of Spanish less significant institutions (a)	69	4.5%	69	4.7%
TOTAL	**91**		**89**	

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 (10 branches in 2016 and 10 branches in 2017).

Table 2.2 shows the classification of credit institutions operating in Spain broken down by institution type.

The supervision of both significant and less significant institutions is carried out along two complementary channels: ongoing monitoring and on-site inspections.

In the case of ongoing monitoring, the intensity depends on the size of the institution, its systemic importance, complexity and type, as well as its risk profile (principle of proportionality). This monitoring of Spanish significant institutions takes place through joint supervisory teams (JSTs), in which staff from the ECB and the Banco de España work side by side.

On-site inspections reviewing specific areas of institutions' activity are scheduled according to institutions' risk profiles and the analysis performed by ongoing monitoring teams, and they are sometimes proposed as the result of cross-cutting analysis of certain types of risks or certain methodologies applied by institutions.

Since the launch of the SSM, there has been a gradual harmonisation of supervision methodologies and practices across the different Member States, in line with the guidelines issued by the EBA, the principles and standards in CRD-IV, and the experience that has been accumulated by mixed supervisory teams. Thus, the Supervisory Board has taken decisions and issued guidelines enabling the progressive convergence of practices and the creation of basic principles of supervision within the SSM to enable a common supervisory culture to develop.

As part of this process, a risk-based supervision methodology has been designed for the supervisory review and evaluation process (SREP) that is applied to significant and less significant institutions on the basis of the principle of proportionality, in accordance with the European regulatory framework and following supervisory best practices. This methodology has been improved and updated to optimise the assessment of the risks in the system.

The SREP methodology assesses the main risks assumed by each institution, assigning it an overall score depending on its risk profile. On this basis the supervisor determines whether the institution's level of capital and liquidity is appropriate for its risk profile or whether additional requirements or other supervisory methods should be imposed.

Institutions are given a SREP score each year and their weaknesses and risk profile are discussed with them, along with any supervisory measures taken. This approach enables

REGISTER OF CREDIT INSTITUTIONS | TABLE 2.2

Data at 31 December. Number (a)

	2014	2015	2016	2017 Registrations	2017 Deregistrations	2017 Final
Credit institutions	227	220	208	6	7	207
Banks	70	67	60	1	2	59
Savings banks	5	2	2	0	0	2
Credit cooperatives	65	65	63	0	0	63
ICO	1	1	1	0	0	1
Branches of EU credit institutions	79	79	77	5	4	78
Branches of non-EU credit institutions	7	6	5	0	1	4
Controlling companies	3	3	4	0	1	3
	230	223	212	6	8	210

SOURCE: Banco de España.

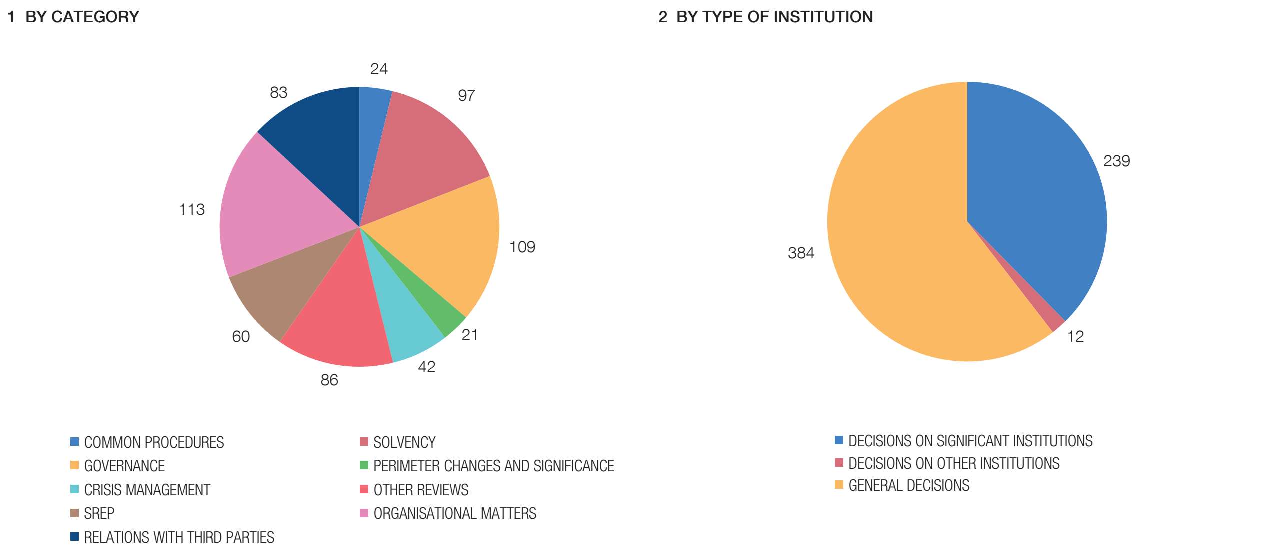
a The number of institutions also includes those that are non-operational and in the process of deregistering.

supervisors to detect risks that may affect an institution's viability early and so implement recovery measures.

The intensity of supervisory activities (ongoing monitoring and on-site inspections) depends on the supervisory priority assigned to each institution, which, in turn, depends on its risk profile. Depending on the priority assigned, the SSM establishes a supervision plan setting out the tasks to be performed, their estimated dates and the resources needed. The following sections describe the main activities carried out by the Banco de España in 2017.

Working groups and expert networks, in which technical and supervisory policy proposals are analysed and developed, are also key elements of the SSM's operation, enabling the supervisory methodology, organisation and functioning of the single supervisory mechanism to be improved. The Banco de España has taken part in 74 groups of this kind out of a total of 98 active in the SSM in 2017. These groups' proposals are discussed by the Supervisory Board.

DISTRIBUTION OF DECISIONS | CHART 2.1



SOURCE: Banco de España.

The Supervisory Board (SB), of which the Banco de España is a member, adopted around 1,900 supervisory decisions in 2017. These decisions were sent to the ECB Governing Council for final approval by the non-objection procedure, given that the SB does not have executive legal capacity. Recently, a new procedure for delegation of certain non-strategic decisions to ECB executives in order to reduce the administrative burden was successfully implemented.

The SB's decisions refer to both specific institutions and cross-cutting issues affecting supervisory policy, methodology and organisational aspects. Chart 2.1 shows the distribution of the 635 decisions made in 2017 affecting Spanish institutions, broken down by category and institution type.

2.2.1 ONGOING SUPERVISION OF SPANISH SIGNIFICANT INSTITUTIONS

The Banco de España plays a key role in the JSTs responsible for ongoing monitoring of significant institutions.

The Banco de España participates in the JSTs of 13 groups (12 following the integration of BMN in Bankia) of Spanish credit institutions classified as significant in accordance with the SSM's criteria, and in the JSTs of 22 foreign significant banking groups operating in Spain. At end-2017, the Banco de España contributed a total of 157 examiners and technical staff to the JSTs supervising Spanish banks.

Ongoing supervision applies the SREP methodology. This comprises four basic components: analysis of the business model; assessment of internal governance and overall controls; assessment of the risks affecting capital and the adequacy of the capital available to cover these risks; and assessment of the risks affecting liquidity and the adequacy of the liquidity position to cover these risks. This methodology is outlined in Figure 2.3.

On the current supervisory approach, the conclusions of the SREP and other supervisory activities are shared with the significant institutions. This supervisor-supervised dialogue is key to the flow of information on the weaknesses detected, the assessment of the institution and the supervisory priorities and expectations, as well as fostering an exchange of opinions and the discussion of the main areas under review. The JSTs maintain direct ongoing contact with the institution at various hierarchical levels, including the board of directors and top management. Moreover, in the case of large Spanish significant institutions, some members of the JSTs are actually based on the institution's premises so as to facilitate access to its managers and its information.

In 2017, the supervisory plans for significant institutions were geared towards the supervisory priorities defined by the SSM in collaboration with the Banco de España. These priorities were outlined in Section 2.1 and included thematic and cross-cutting reviews:

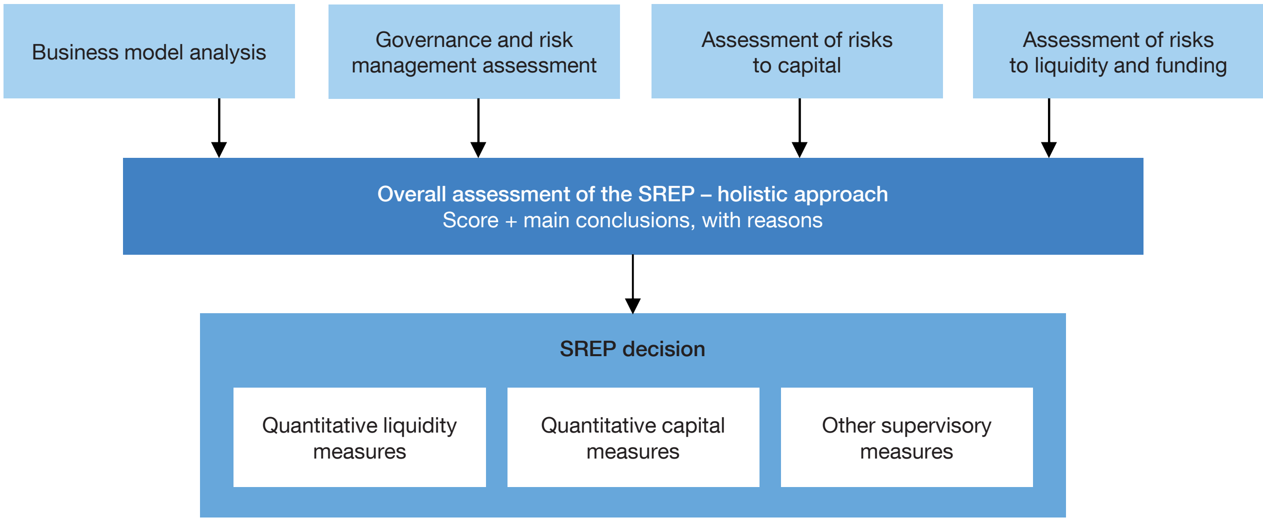
— Review of business-model and profitability risk: thematic review begun in 2016 focusing on analysis of the factors affecting profitability, at both the institution level and by business model segment, in the context of low interest rates.

— Intensive monitoring of institutions with high NPL rates.

— Review of the level of preparation and potential impact of the introduction of IFRS-9 on financial instruments.

SINGLE SUPERVISORY MECHANISM
Supervisory review and evaluation process (SREP)

FIGURE 2.3



SOURCE: Banco de España.

— Review of internal capital models (Targeted Review of Internal Models, TRIM): this multi-annual review begun in 2016 aims to evaluate and confirm the adequacy of the internal Pillar 1 models approved for risk measurement (see Box 2.2).

— Review of compliance with the Basel Committee's Risk Data Aggregation and Risk Reporting (RDA) principles.

— Review of outsourcing: this review was limited to a small group of two institutions. The interest derives from institutions' growing recourse to outsourcing functions, with the attendant risks this entails.

The JST's recurrent activities include periodic monitoring of the main risks to which institutions are exposed, with the frequency and intensity determined by the supervisory importance assigned to the institutions concerned. The teams also analyse: regulatory reports; financial statements; management information; strategic and financial plans; policies, manuals and procedures; minutes of the institution's various decision-making and management bodies; and other relevant internal documents. Of this range of documents, the ICAAP and ILAAP stand out as the cornerstones of determining the sufficiency and adequacy of liquidity and capital, making them the focus of heightened supervisory attention in the 2017 supervisory cycle in order to enhance these processes. The JSTs also reviewed cross-cutting issues common to several institutions and conducted specific reviews of particular processes, policies and systems deemed relevant under the JST's strategy of supervision for each institution.

In 2017, the JSTs took part in the ECB's stress testing to assess the sensitivity of the banks' portfolio of investment assets and liabilities to interest-rate risk (interest rate risk in the banking book, IRRBB). The results of the exercise were used along with those of the 2016 stress tests and institution-specific considerations to determine the Pillar 2 Guidance (P2G) recommendations. Section 2.2.3 gives more details about this supervisory expectation introduced in 2016.

The Targeted Review of Internal Models (TRIM) project aims to enhance the credibility and ensure the adequacy of significant institutions' internal models, guaranteeing compliance with regulatory standards, harmonising supervisory practices within the SSM, reducing unwarranted variability in risk-weighted assets (RWAs) and, ultimately, confirming compliance with capital requirements.

Over the course of 2016 the preparatory phase of the project was developed, mainly focusing on establishing practical inspection criteria and tools for the on-site teams. A cross-sectional review of general aspects of the models was also conducted (governance, use, control units, etc.).

As a starting point, a series of aspects requiring a harmonised approach were identified, which led to the preparation of a guide for defining best practices. The TRIM guide aims to cover certain gaps in the regulation of internal models in connection with the three types of risk covered by the TRIM (credit, market and counterparty risk) and general topics. The guide has also been prepared in such a way as to ensure close alignment with upcoming changes in the regulation of internal models. The guide, therefore, sets out the ECB's view on the most appropriate supervisory practices and how the relevant European legislation should be applied in a particular area.

From 2017, the TRIM guide entered into an execution phase. Based on several indicators, a criticality and materiality analysis of the models was conducted to ensure that the most relevant models were selected for their on-site review, guaranteeing, in turn, sufficient coverage of the inspections in terms of exposure and risk-weighted assets.

The purpose of the TRIM on-site investigations is to assess different significant institutions' practices regarding the aspects identified as requiring harmonisation and to identify potential shortcomings in respect of the best practices defined in the guide.

The on-site investigations were divided into two phases:

— The first phase focuses on internal credit risk models for individuals and SMEs, as well as on internal market and counterparty risk models. This phase commenced in April 2017 and is expected to last approximately one year. A total of 118 investigations have been scheduled, of which nine refer to Spanish significant institutions.

— The second phase, which is scheduled to commence starting in the third quarter of 2018, will focus on credit risk models associated with the remaining portfolios not covered during the first phase (mainly including low-default-portfolios).

The outcome of these investigations will be subject to comprehensive horizontal controls to ensure a high level of consistency.

The effects of the TRIM will persist beyond completion of the exercise, since the criteria and tools developed will be integrated into the SSM's regular model supervision practices, thus meeting the TRIM's main goal of harmonising such practices.

In the case of significant institutions with a presence in countries outside the scope of the SSM, the JSTs take part in the colleges of supervisors with collaboration and information sharing with other supervisory authorities. In the case of Spanish groups, these colleges are chaired by the ECB.

The JSTs also take part in authorisation processes initiated by supervised entities, preparing assessment reports for decisions to be made within the SSM. These types of processes include: issues, amortisations and repurchases of elements of capital; changes to internal capital models; payment of variable remuneration; corporate operations; and outsourcing processes.

In addition, the JSTs work with various European and international authorities and bodies, conducting surveys and impact studies, either mediating between these organisations and the participating entities, or responding directly to requests from them.

Lastly, the JSTs carry out other tasks and activities that, although not included in the supervisory plan, are necessary in order to respond rapidly to any possible emerging risks or situations potentially impacting institutions. One instance of this was monitoring the management of contingencies deriving from floor clauses.

BANCO POPULAR ESPAÑOL DECLARED NON-VIABLE

BOX 2.3

Through the JST entrusted with the ongoing supervision of Banco Popular Español, the European Central Bank (ECB) had monitored the Spanish bank very closely in 2017, before determining its resolution in June.

In February 2017 Banco Popular reported losses for FY-2016 of €3.5 billion. Following this, the bank's credit rating was downgraded, prompting more concern among both shareholders and customers. In turn, this led to a sharp fall in the share price and in its deposit base, and ultimately available liquidity was affected, despite the measures taken by the bank.

This deterioration in the bank's situation, which was subject to particularly intense monitoring by the supervisor throughout the year and by the SRB in the bank's last few weeks, led the ECB to determine that it would, in the near future, be unable to pay its debts or other liabilities as they fell due, or in other words, that it was failing or likely to fail (FOLTF). Thus, in accordance with Article 18(1) of Regulation 806/2014/EU on the Single Resolution Mechanism Regulation (SRMR), on 6 June 2017 the ECB declared that Banco Popular Español was non-viable.

The Single Resolution Board triggered the resolution of Banco Popular, which culminated in the sale of the bank to Banco Santander. The details of the resolution process are set out in the Banco de España's November 2017 *Financial Stability Report.*

2.2.2 ONGOING SUPERVISION OF SPANISH LESS SIGNIFICANT INSTITUTIONS

The Banco de España is responsible for the direct supervision of less significant institutions (LSI), which account for approximately 4.5% of the Spanish banking system's assets, while the ECB is responsible for their indirect supervision.

In the exercise of its supervision of these institutions, the Banco de España conducts general monitoring actions on a quarterly or half-yearly basis. Among other areas, these cover financial monitoring, credit risk and liquidity.

Table 2.3 shows the relative size of each of the types of less significant institution in terms of total assets.

The purpose of these actions is to update the supervisor's knowledge of the institution's risk profile, identify possible weaknesses and detect areas or issues that require closer examination. The principle of proportionality is applied in all these reviews, such that smaller institutions, with a relatively insignificant volume of retail deposits, are subject to simplified off-site monitoring, based on quarterly alerts using the information in the confidential returns and the Bank of Spain's central credit register, in order to detect potential future problems of liquidity, solvency or sustainability of the business model.

PERCENTAGE OF THE DIFFERENT TYPES OF LESS SIGNIFICANT INSTITUTIONS

TABLE 2.3

% total assets/sector

	December 2016	December 2017
Domestic banks	31.5	28
Subsidiaries of foreign banks	4.3	4.5
Credit cooperatives	59.5	62.9
Savings banks	1.2	1.1
Foreign branches	3.5	3.5
TOTAL	**100.0**	**100.0**

SOURCE: Banco de España.

In 2017, comprehensive off-site monitoring was carried out on 18 of the 69 groups of LSIs, accounting for around two thirds of LSIs' total assets, with simplified off-site monitoring being performed for the remaining 51 groups.

Additionally, 570 detailed actions were carried out, including reviews of audit reports, reviews of internal capital adequacy assessment reports, and capital decisions. Periodic meetings were also held with institutions' management.

The Banco de España continued to work with other NCAs in the colleges of supervisors for foreign banking groups whose parent is an LSI, participating in three colleges in 2017.

Direct supervision of LSIs by the Banco de España is backed up with indirect supervision by the ECB. This consists of:

— overseeing the performance of the LSI sector, and

— ensuring the application by NCAs of uniform high standards of supervision.

As in previous years, the Banco de España supported the ECB in these two functions by contributing its staff's experience and familiarity with the characteristics of Spain's less significant institutions. In particular, the Banco de España participates jointly with the ECB in the Senior Management Network and sends periodic and ad hoc information on the way in which supervisory activity has been conducted, and its results, in accordance with the procedures laid down by the ECB.

The Banco de España also works with the ECB and other NCAs on the definition of supervisory standards. Once approved in the form of guidelines or recommendations, these must be applied or taken into consideration by all SSM countries in the supervision of their LSIs – a task to which considerable human resources are dedicated. This collaboration will be continued in the coming years, as ensuring that supervisory standards are consistent and effective is considered a priority, given that there needs to be an appropriate level of consistency within the SSM, without prejudice to the fact that the characteristics of each country's LSIs must be taken into account.

Lastly, given that the branches in Spain 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 Banco de España's supervision is based on simplified off-site monitoring and on the regular exchange of information with the authorities in the branch's home country, under the terms established in Commission Implementing Regulation (EU) 620/2014.

2.2.3 OUTCOME OF THE SUPERVISORY REVIEW AND EVALUATION PROCESS (SREP)

The supervisory assessment of each credit institution is based on the conclusions of the off- and on-site reviews and determines the annual capital decision (known as "Pillar 2"). Institutions are notified in December each year of the decision they are to comply with the following year.

The main input to this decision is the SREP, which includes the assessment of the institution's risks, controls and governance, and the calculation of its capital and liquidity needs, based on this assessment. This is backed up with the supervisory review of the institution's self-assessment of its risks, capital base and liquidity in accordance with its internal processes (ICAAP and ILAAP).

On 22 December 2017 the Banco de España published the new Guidelines on the Internal Capital Adequacy Assessment Process (ICAAP) and the Internal Liquidity Adequacy Assessment Process (ILAAP).

These guidelines aim to facilitate the application of internal capital and liquidity adequacy assessment processes by institutions.

These new guidelines adapt the Guidelines on the Internal Capital Adequacy Assessment Process (ICAAP) which were published by the Banco de España in June 2008 to the regulatory changes implemented, to recent changes in supervisory criteria and to the guidelines published by the European Banking Authority (EBA) in November 2016 on the collection of information relating to the ICAAP and the ILAAP for supervisory review and evaluation process (SREP) purposes.[1]

The Banco de España adopted the EBA guidelines as its own per a resolution of the Executive Commission on 4 April 2017. The changes introduced in these updated guidelines are inspired in the principle of proportionality, aiming to facilitate compliance of non-systemic institutions with the guidelines.

The recommendations contained in these new guidelines are targeted at less significant credit institutions.

The most important changes are as follows:

— Development of the internal liquidity adequacy assessment process (ILAAP).

— Inclusion of the risk appetite framework, which defines the risk that the institution is willing to accept in pursuing its objectives.

— Updating of the assessment of interest rate risk in the banking book.

— Recommendation to attach an internal audit report relating to the review of the design and consistency of information for both processes.

The Banco de España's updated guidelines will be applied for the first time in the internal capital and liquidity adequacy assessment report for 31 December 2017 which must be drawn up and submitted by the institutions by 30 April 2018.

1 EBA/GL/2016/10 on ICAAP and ILAAP information collected for SREP purposes.

The basic outline of the supervisory criteria guiding these tasks is set out in the guidelines prepared by the EBA on the SREP, published in December 2014 (EBA/GL/2014/13).These guidelines are currently being revised, with the updated version due to be applicable as of January 2019. Additionally, in late 2016 the EBA published guidelines on the information supervisors are to request from institutions in order to review and assess their ICAAP and ILAAP (EBA/GL/2016/10). The adoption of the latter by the Banco de España was a decisive factor in its publication on 22 December 2017 of its new Guidelines on Capital Adequacy and Liquidity, discussed in Box 2.4.

The formal structure of the 2017 capital decision, establishing the amount of capital necessary to comply with Pillar 2, remains largely the same as in the 2016 version and affects both significant institutions supervised by the SSM and less significant institutions (LSIs).

With regard to significant institutions, 2017 was the third year in which the SSM methodology for determining the capital decision was applied, thus ensuring that all European significant institutions are assessed on a uniform basis. Following the expiry of the period granted to institutions for making representations, the 2017 SREP capital decisions approved by the SSM Supervisory Board will remain in force until the next capital decision, which is scheduled for December 2018.

The capital decisions issued by the SSM in 2017 for significant institutions continue to apply "Pillar 2 guidance" or P2G. This is a supervisory tool that sets capital expectations above the level of overall capital requirements. These capital expectations supplement the Pillar 2 requirements and are not legally binding. This guidance relies on the outcome of the supervisory stress tests on interest rate risk (IRRBB) carried out in 2017 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.

No automatic supervisory action is taken if a bank fails to comply with this expectation. However, supervisors will consider adopting supervisory measures on a case by case basis, with the approval of the SSM's Supervisory Board. Such measures may include the conversion of the capital expectation into a Pillar 2 capital requirement, which the bank in question would then be obliged to comply with.

In the case of less significant institutions, similar, though simpler, arrangements were applied in 2017 than was the case for significant institutions, increasingly taking into account the part of 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 2017 SREPs were completed, the Banco de España adopted capital decisions for the less significant institutions by means of a procedure taking representations from the institutions into account.

The supervisory practices of the Banco de España are in line, in all material respects, with the current framework established by international agreements, European legislation, the EBA guidelines adopted by the Banco de España on 31 December 2017, and the SSM's cooperation framework. In 2018, it will be necessary to complete the adaptation of the SREP applicable to less significant institutions, in accordance with the SSM's guidelines.

2.2.4 ON-SITE INSPECTIONS

The on-site inspection function is separate from ongoing monitoring in order to reinforce the independence and objectivity of the conclusions obtained from these inspections. Table 2.4 details the on-site actions performed on credit institutions in 2017.

On-site inspection actions for significant institutions are planned as part of the supervision plan. In 2017, a total of 31 on-site actions were carried out on significant institutions together with two anti-money laundering inspections, as described in more detail below.

The Banco de España played a major role in these supervision tasks. Of the 31 on-site actions, 28 were led by Banco de España staff, two by ECB staff and one by staff from another SSM Member State. Moreover, a significant proportion of the personnel who participated in the aforementioned on-site inspections were from the Banco de España.

As regards the inspection methodology, in 2017 work continued to improve on-site inspections, particularly to boost efficiency by establishing procedures to shorten their duration, and mechanisms and practices that reduce the time between one inspection and the next.

The Banco de España is also participating actively in the working groups set up in the SSM to develop the most suitable techniques for on-site supervision of the various risks (credit, technology, market risk, etc.) and to continue making progress on the uniform application of on-site inspection in all SSM Member States.

ON-SITE SUPERVISORY ACTIVITY AT CREDIT INSTITUTIONS. ACTIONS

TABLE 2.4

	2017		Total
	Significant institutions	Less significant institutions	
On-site inspections	19 (a)	10	29
Internal model reviews	12	—	12
Anti-money laundering inspections	2	1	3
TOTAL	**33**	**11**	**44**

SOURCE: Banco de España.

a Of which, three were led by staff from other authorities.

The Banco de España has played an active role in drawing up the Supervisory Examination Programme for 2018, which defines the on-site inspections that are due to be carried out over the course of the year. The main points are:

— An increase in the number of cross-border missions in order to foster harmonised application of SSM methodology during on-site inspections. Some of these missions to institutions in other SSM countries are due to be headed by Banco de España staff. In this regard, Banco de España staff have taken part in inspections of institutions belonging to four financial groups from other SSM Member States, leading two of them.

— The ambitious programme of investigation of internal models in 2018. As in 2017, the programme concentrates on an in-depth review of the internal capital models in force within the SSM (TRIM). In 2018, investigations of TRIM will concentrate on portfolio models with small numbers of non-compliances.

Meanwhile, since the supervision of the prevention of money laundering and financing of terrorism has been excluded from the scope of the SSM's supervisory activities, the Banco de España will continue cooperating and collaborating with SEPLAC in this area. Three inspections were carried out in 2017, and international cooperation and participation in various working groups in this area was continued.

A total of 11 on-site actions were carried out on less significant institutions in 2017. An annual action plan is drawn up for these institutions, which, together with monitoring activities, describes the on-site actions that are due to be performed on the LSIs, bearing in mind the supervisory risk profile of the various institutions and the number of years since the last action. This plan is approved by the Executive Commission of the Banco de España.

2.2.5 COMMON PROCEDURES

The common procedures, set out in Regulation (EU) 468/2014 of the ECB, relate to authorisations to take up the business of a credit institution, withdrawals of such authorisations and the acquisitions of qualifying holdings. In these procedures the Banco de España makes an initial assessment and draws up a proposal for a decision in each specific case. The ECB then makes a final decision on the basis of this proposal, and any additional study it considers appropriate to undertake.

Table 2.6 shows more details of the procedures concerning credit institutions in which the Banco de España has taken part.

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 Banking Supervision reports to the Executive Commission on:

— Supervisory decisions affecting Spanish significant institutions, including capital decisions.

— 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, the situation of Spanish institutions.

2.2.7 QUALITY FUNCTION

The quality function is responsible for ensuring that banking supervision is consistent and applies the best supervisory practices. In practical terms, the ultimate goal of the quality function is to contribute to the ongoing improvement of the exercise of the supervisory function by identifying best practices and areas for improvement.

In the context of the SSM, the distribution of competencies between the ECB and the Banco de España over quality matters has remained unchanged. The ECB is responsible for the quality function in relation to significant institutions. In turn, the Banco de España is responsible for the quality of the supervision of less significant institutions. The Banco de España also collaborates with the ECB to review the quality of the supervision of Spanish significant institutions.

This is supplemented by the ECB and the NCAs cooperating through the SQA Network by holding meetings and exchanging experience and comments on the various quality activities carried out.

Various quality reviews were carried out on the supervision of less significant institutions in 2017.

2.2.8 SUITABILITY

The Banco de España, in the case of less significant institutions, and the ECB, in close collaboration with the Banco de España, in the case of significant institutions, supervise compliance with the rules on the suitability of credit institutions' senior officers. Thus, at all times during the exercise of their offices, and not just at the time of taking them up, all officers are required to meet the requirements of good repute and professional standing, have appropriate knowledge and experience for the exercise of their functions, comply with the rules on conflicts of interest and limitations (where applicable), and in the case of the members of the board of directors, be in a position to exercise good governance, i.e. (i) have sufficient time to exercise the office, and (ii) act in a way that is free from conflicts of interest.

The supervision of the suitability regime for senior officers is constantly being adapted to the new criteria published by the 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, while always observing the limits established under national legislations.

Directorate General Banking Supervision working meeting.

As well as participating actively in the preparation of the criteria and practices that began to be defined in previous years (culminating, as discussed below, in the approval of ECB and EBA/ESMA guidelines on suitability assessments), the Banco de España has worked to improve the coordination of the ongoing supervision of institutions' corporate governance, and the suitability regime for senior officers, both individually and collectively.

In 2017, the ECB's suitability guidelines and the joint guidelines of the EBA and ESMA were approved. These will undoubtedly be crucial to the harmonisation of supervisory practices of different NCAs, while also improving the transparency of the assessment criteria they apply.

The ECB's *Guide to Fit and Proper Assessment* explains how ECB Banking Supervision ensures consistent application of the fit and proper assessment criteria, with a view to establishing common supervisory practices for assessing the qualifications, skills and good repute of a candidate for a position on a bank's board. The public consultation process resulted in the guide providing more detailed clarification on the experience and time commitment required of board members, as well as explaining potential conflicts of interest. The publication of this guide will help institutions – which are responsible for selecting and appointing their senior officers and ensuring that they comply with the rules on suitability at all times – to comply with the ECB's banking supervision policies and better understand their assessment processes.

For their part, among other things, the guidelines on assessing the suitability of members of the management bodies and individuals performing key functions issued jointly by the ESMA and the EBA[2] elaborate upon the concepts of (i) dedicating sufficient time to perform their duties; (ii) collective possession of the appropriate knowledge, skills and experience

2 As of 30 June 2018 these new guidelines will replace the "Guidelines on the assessment of the suitability of members of the management body and key function holders (EBA/GL/2012/06)" dated 22 November 2012, and the competent supervisory authorities will be required to inform the EBA of the degree of compliance with the guidelines, and where necessary, explain any breaches, on the date of entry into force.

by the management body; (iii) the trustworthiness, integrity and independence of mind of the members of the management body; (iv) dedication of the appropriate human and financial resources to induct and train members of the management body; and (v) diversity, which must be taken into account in the selection of the members of the management body. The guidelines also set out the rules on suitability for key positions and their supervision by NCAs (and the ECB, where applicable). Among others, such positions include institutions' chief risk officer (CRO), chief compliance officer (CCO), head of internal audit, and chief financial officer (CFO).

These guidelines shed light on the interpretation of the legal requirements for suitability to which the senior officers of credit institutions are subject, and on the supervisory processes at the NCAs. They are also intended to be a tool for harmonisation of supervisory practices and criteria, and of the information institutions are required to submit along with the manner in which they are to do so.

In 2017, the Banco de España adapted the suitability questionnaire prepared by the ECB, in collaboration with all the NCAs, and published it in its "virtual office", thus incorporating it in the suitability assessment procedure. As well as harmonising the information required in all the euro area Member States, the purpose of this new questionnaire is to streamline the procedure by helping ensure that the suitability assessment requests submitted by institutions are as detailed as possible and so avoid the competent authorities having to ask for additional information during their processing.

2.2.9 ROLE OF THE BANCO DE ESPAÑA'S SUPERVISION IN THE CRISIS MANAGEMENT FRAMEWORK

The recovery and resolution framework in Spain is regulated by Law 11/2015 and Royal Decree 1012/2015, which transposed the Banking Recovery and Resolution Directive (BRRD) into Spanish legislation and set out the distribution of powers in this area between the supervisory and resolution authorities. The *2016 Report on Banking Supervision* describes in detail the distribuition of powers.

Figure 2.4 summarises the main stages of the crisis management framework and the tasks assigned to each authority in the different phases.

The supervisor's role in each phase and the Banco de España's supervision work in this area during 2017 are described in more detail below.

Preventive phase

In the preventive phase, institutions and authorities get ready to address possible crisis situations. In the course of their ordinary activity, institutions are required to prepare recovery plans that are assessed by the supervisor and that identify the options available to the institutions that would enable them to survive severe stress situations.

Recovery plans

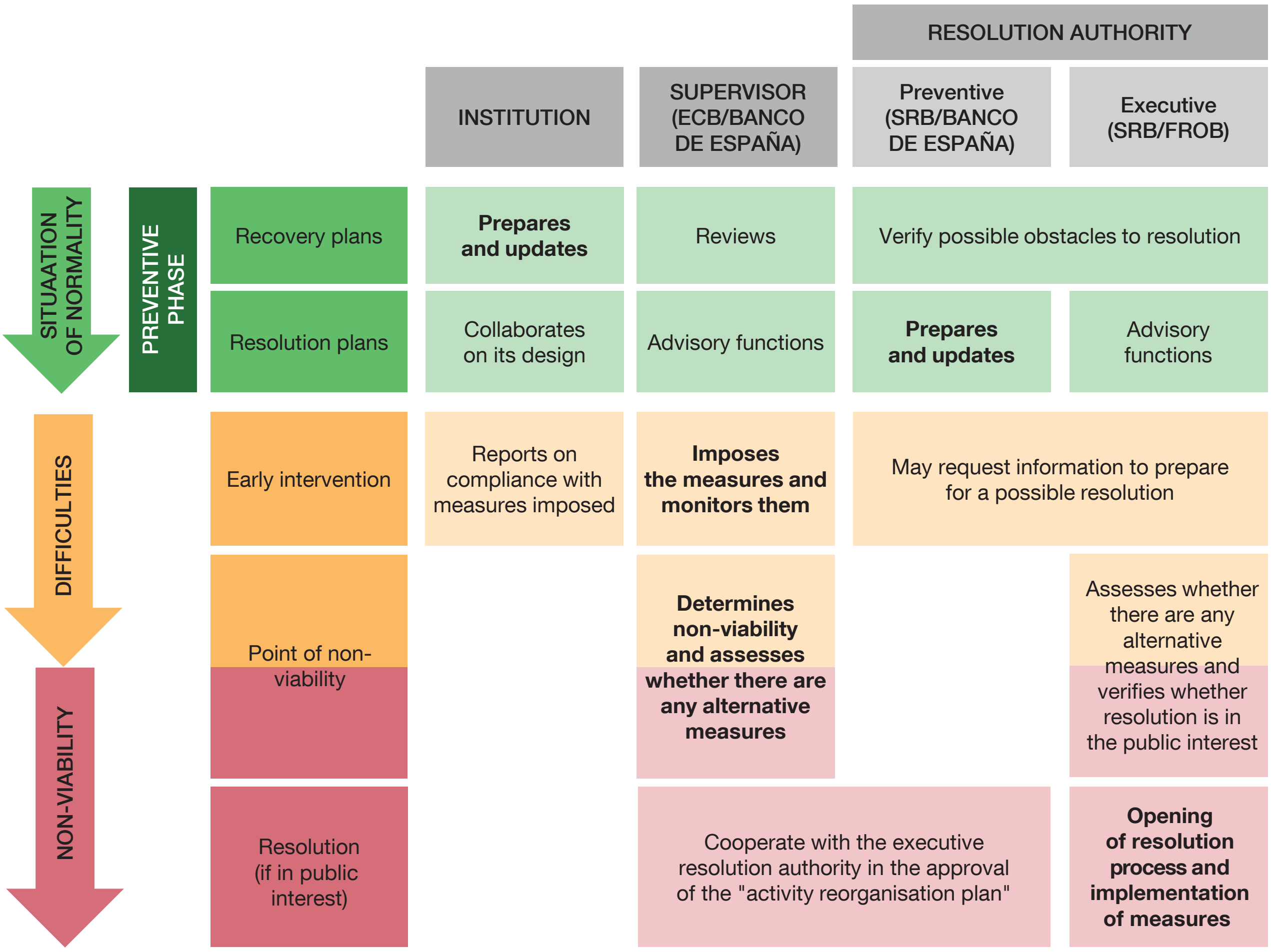
Recovery plans are drafted each year by the institutions[3] to determine the measures that they would take to restore their long-term viability if their financial situation were to deteriorate significantly.[4]

In cases where the supervisor concludes that a plan has material deficiencies, it requires that a new plan be submitted within a three-month deadline and, in extreme cases, it may require the institution to adopt specific measures and even limit the businesses it conducts.

3 These plans should be updated whenever there is a significant change which affects the institution. The legislation allows certain institutions to apply simplified obligations as a result of which the recovery plans can be updated over a longer period.

4 The measures envisaged cannot assume that there will be access to public financial assistance.

RECOVERY AND RESOLUTION PHASES: ACTIVITIES AND COMPETENCIES FIGURE 2.4



SOURCE: Banco de España.

From the supervisory standpoint, the following items of the plans are especially important:

— The recovery plan indicators determined and their integration into the institution's internal risk management framework. These indicators determine when the institution activates the decision-making process for assessing whether it implements the recovery options. Properly adjusted recovery plan indicators are conducive to the institution identifying crisis situations at an early stage and being able to redress the situation.

— Available recovery options. It is essential that institutions are selective and realistic in determining recovery options and they must provide evidence that they have identified, at least, the prior necessary measures in order to put them into practice in a crisis situation.

— The definition of sufficiently severe (yet plausible) scenarios for activating the plan, as a result of which the effects of applying the available recovery options can be analysed and the best options in each crisis situation can be identified.

Furthermore, it should be noted that the supervisor's assessment of the recovery plan provides it with valuable information when evaluating the governance component of the SREP.

Early intervention phase

The early intervention phase is initiated by the competent supervisor where there is a rapid deterioration in the institution's financial situation which results in an infringement of the solvency regulations or in a foreseeable infringement in the near future. The supervisor has a series of tools which range from requiring the implementation of a measure in the recovery plan to even deciding on the intervention of the institution. Identifying the time at which early intervention is triggered is essential to prevent the institution from reaching the point of non-viability.

Supervisory activity of the Banco de España in recovery and resolution in 2017

With respect to the groups of significant institutions, the JSTs performed the following actions in the area of recovery and resolution in 2017:

— The cycle of reviewing the 2016 recovery plans, which began in the fourth quarter of last year, was completed. As a result of the assessment, letters were sent to the institutions informing them of aspects which must be improved in the 2017 plans. Similarly, in those plans where material deficiencies were detected, institutions were requested to send "revised plans" that remedy such deficiencies.

  In general, a clear improvement was seen in the quality of the plans compared with those submitted the previous year, with the consequent positive effects on institutions' crisis management capacity.

— The JSTs participated in the process of reviewing resolution plans in the prior consultation phase with the SRB. In 2017 the SRB set the MREL targets for the most "systemic" institutions.

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

— Completed the assessment of the first recovery plans submitted by 53 institutions in the final quarter of 2016. As a result of the review, letters were sent to the institutions either requesting that they remedy the deficiencies detected in the next plan sent or requiring that a new plan be sent by the legally established deadline in the case of significant deficiencies.

  The Banco de España participated in three colleges of supervisors of less significant European groups with a presence in Spain, and all of them reached joint decisions on recovery plans.

— It participated in the legally envisaged prior consultation phase on resolution plans of less significant institutions.

2.2.10 LETTERS

In the performance of its supervisory tasks, the Banco de España sent 138 letters to credit institutions containing requirements and recommendations, as detailed in Table 2.5. Of these, 55 related to capital decisions, 54 to recovery plans, 19 to the outcome of the comprehensive annual monitoring and 10 to on-site inspections and monitoring of requirements.

2.2.11 OTHER ACTIONS

The Banco de España's supervisory tasks 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.

LETTERS ADDRESSED TO CREDIT INSTITUTIONS TABLE 2.5

Number

Credit institutions (a)	2017
Banks	40
Savings banks	4
Credit cooperatives	92
Branches of foreign credit institutions	2
TOTAL	**138**

SOURCE: Banco de España.

a Of these letters, two relate to SIs, arising from competencies that the SSM has not assumed, and the remainder relate to LSIs.

PROCEDURES IN RESPECT OF CREDIT INSTITUTIONS INVOLVING THE BANCO DE ESPAÑA TABLE 2.6

	Total number
Qualifying holdings, merger, spin-off and other significant acquisitions	18
Cross-border activity of Spanish credit institutions	110
Branches in the EU	24
Branches in third countries	3
Freedom to provide services	83
Cessation of business	2
Loans to senior officers	44
Suitability of senior officers	281
Procedures relating to own funds	22
Amendments of articles of association (a)	16
Communications with other supervisory authorities or institutions	13
Other procedures	15
TOTAL	**521**

SOURCE: Banco de España.

a In addition to those indicated here, 19 significant institutions (11 banks and 8 credit cooperatives) were reported to the ECB.

Noteworthy is the Banco de España's collaboration with:

— The Executive Service of the Commission for the Prevention of Money Laundering and Monetary Offences (SEPBLAC, by its Spanish abbreviation) in the supervision and inspection of the prevention of money laundering obligations and in the adoption of the measures needed by virtue of the cooperation regime between the two bodies.

— Other national supervisors such as the Directorate General of Insurance and the National Securities Markets Commission (CNMV, by its Spanish abbreviation).

— International organisations such as the International Monetary Fund (IMF) and the World Bank.

In this respect, during 2017 the Banco de España collaborated actively with the IMF in its exhaustive in-depth assessment of the Spanish financial sector as part of the Financial

REGISTER OF OTHER INSTITUTIONS

TABLE 2.7

Number. Year-end data (a)

	2014	2015	2016	2017
Spanish institutions	185	178	177	170
Specialised lending institutions	47	39	35	31
Hybrid specialised lending institutions	—	5	8	8
Mutual guarantee companies	24	21	21	19
Reguarantee companies	1	1	1	1
Electronic money institutions	4	3	4	5
Payment institutions	45	43	41	39
Hybrid payment institutions	—	2	3	3
Currency-exchange bureaux (b)	10	13	12	14
Appraisal companies	40	36	37	35
Banking foundations	13	14	14	14
Sareb	1	1	1	1
Foreign institutions operating in Spain	328	415	501	572
Branches of EU payment institutions	8	12	15	14
EU payment institutions operating without an establishment	263	326	372	400
Branches of EU electronic money institutions	2	2	2	2
EU electronic money institutions operating without an establishment	55	75	112	156

SOURCE: Banco de España.

a The number of institutions also includes those that are non-operational and in the process of deregistering.
b Not including establishments only authorised to purchase foreign currency with payment in euro.

Sector Assessment Program (FSAP), and with the World Bank in the framework of the Bank Regulation and Supervision Survey. Also, in 2017 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 2.6.

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.

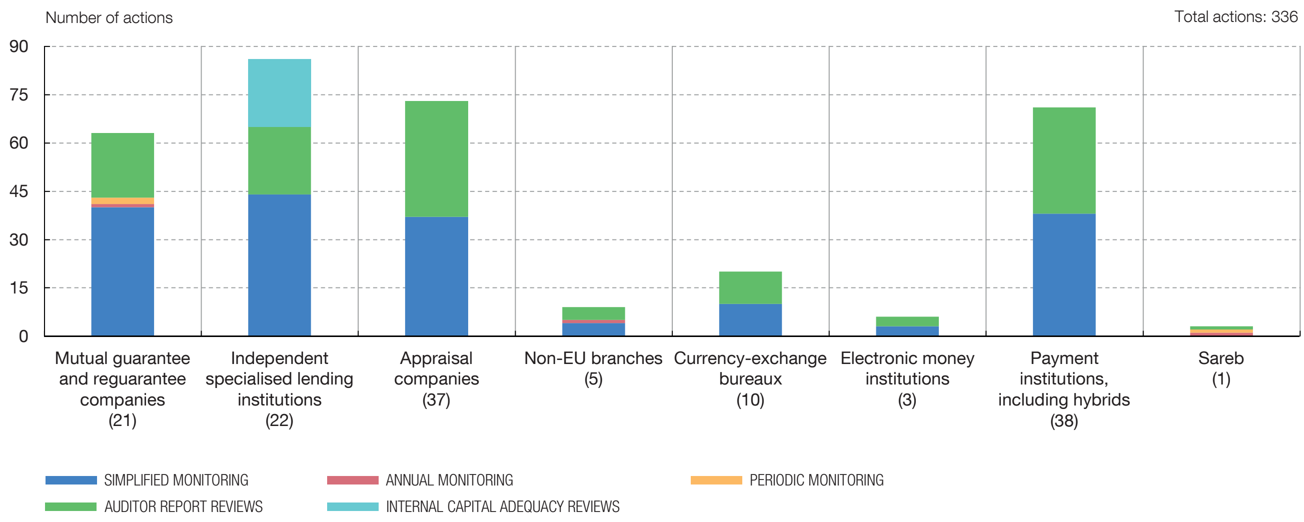
The legal basis under which the Banco de España supervises those institutions and the approach behind the tasks differ from case to case. However, the supervisory concern is always the same: to contribute to the proper functioning of those institutions, considering the role they play.

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 promotes the fluidity of financial intermediation mechanisms and generates a climate of confidence in financial institutions.

Section 2.3 of the *2016 Report on Banking Supervision* describes in detail the supervisory powers of the Banco de España over this type of institutions.

SUPERVISORY ACTIONS (a)

CHART 2.2



SOURCE: Banco de España.

a The number of institutions supervised in 2017 is shown under the caption for each column.

The following sections of this chapter refer, firstly, to the supervisory activity carried out in 2017 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 ACTIONS

In 2017, 336 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.

Also, a total of six inspections were performed in 2017, four of currency-exchange bureaux and two of payment institutions.

2.3.2 AUTHORISATIONS AND OTHER PROCEDURES

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. Nevertheless, 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.

— Reguarantee companies.

CHANGES IN THE NUMBER OF INSTITUTIONS OTHER THAN CREDIT INSTITUTIONS. 2017 VS. 2016

TABLE 2.8

	Number at 31/12/2016	Registrations	De-registrations	Number at 31/12/2017	Change 2017-2016
Specialised lending institutions (SLIs)	35	0	4	31	-4
Hybrid SLIs and payment institutions	8	1	1	8	0
Mutual guarantee and reguarantee companies	22	1	3	20	-2
Appraisal companies	37	0	2	35	-2
Currency-exchange bureaux	12	3	1	14	2
Payment institutions	41	0	2	39	-2
Hybrid payment institutions	3	0	0	3	0
Electronic money institutions	4	1	0	5	1
Branches of EU payment institutions	15	2	3	14	-1
Branches of EU electronic money institutions	2	0	0	2	0
Banking foundations	14	0	0	14	0
	193	**8**	**16**	**185**	**-8**

SOURCE: Banco de España.

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

TABLE 2.9

Number of procedures in 2017

	Payment institutions	Electronic money institutions	Specialised lending institutions	Mutual guarantee companies	Appraisal compa-nies	Currency-exchange bureaux	Sareb	Banking foundations	**Total other institutions**
Qualifying holdings, merger, spin-off and other significant acquisitions	1		2	3	4				10
Cross-border activity of Spanish institutions									112
Branches in the EU	8								8
Branches in third countries									0
Freedom to provide services	103	1							104
Cessation of business	2		2						4
Suitability of senior officers	75	19	62	85	23	5			269
Procedures relating to own funds	1	1		1					3
Amendments of articles of association	17	1	2	6					26
Communications with other supervisory authorities or institutions			1						1
Authorisation of management and financial protocols								10	10
Other procedures	5		2	1					8
TOTAL									**443**

SOURCE: Banco de España.

LETTERS ADDRESSED TO OTHER INSTITUTIONS — TABLE 2.10

Number

	2017
Specialised lending institutions	—
Appraisal companies	6
Mutual guarantee companies	3
Payment institutions	2
Currency-exchange bureaux	—
Electronic money institutions	—
Banking foundations	—
SAREB	2
TOTAL	**13**

SOURCE: Banco de España.

In 2017, a total of 8 requests to open institutions and 16 deletions in the register were processed, according to the breakdown in Table 2.8.

Similarly, in 2017, a further 443 procedures relating to supervisory powers over those institutions were performed, as detailed in Table 2.9.

Following the supervisory actions, 13 letters were sent to these institutions, addressed to the parties detailed in Table 2.10. Ten of the letters relate to the outcome of monitoring actions and three to inspections.

2.3.3 COMPLIANCE WITH VETTED ACCESS TO ACTIVITY

Spanish legislation establishes that certain 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.

2017 saw the initiation of supervisory actions relating to seven natural or legal persons which might be carrying out restricted activities without authorisation, the outcome of which might lead to the adoption of penalties. Additionally, six legal persons were investigated resulting in three notifications which were made to the CNMV for assessment by the latter.

19th century mantel clock. Banco de España collection.

3.1 Macroprudential instruments

The Banco de España is the national designated authority for application of the macroprudential policy instruments envisaged in the supervisory regulations for credit institutions.[1] The aim of macroprudential policy is to help safeguard the stability of the financial system, by reinforcing its resilience and mitigating systemic risks, ultimately to ensure that the financial sector makes a sustainable contribution to economic growth. For that purpose, the Banco de España carries out continuous identification and monitoring of risks and vulnerabilities in the financial system. The analysis is based on indicators and models developed by the Banco de España, which provide information on the macroprudential policy stance and the possible adoption of measures.[2]

The main macroprudential instruments available to the Banco de España are the capital buffers. These are Common Equity Tier 1 (CET1) requirements additional to those established under microprudential supervision and are determined as a set percentage of banks' risk exposures. Under current regulations, the Banco de España regularly sets two types of capital buffers to prevent and mitigate different (cyclical and structural) dimensions of systemic risk: the countercyclical capital buffer and the buffers for Spain's global and domestic systemically important institutions.

3.1.1 COUNTERCYCLICAL CAPITAL BUFFER

The Banco de España sets the countercyclical capital buffer (CCyB) for credit exposures in Spain quarterly. The purpose of the CCyB is to ensure that banks gradually build up a capital reserve in financial boom times that may be used to absorb losses when the cycle turns, to help stabilise the flow of credit to the economy. It is an instrument designed to address the time dimension of systemic risks; in this case those arising from excessive overall credit growth.

Since the CCyB was introduced on 1 January 2016 the Banco de España has held it unchanged at 0%. This decision, taken periodically, is based on technical analysis of specific quantitative indicators and on qualitative information and expert judgement. Among the quantitative indicators, the benchmark indicator is the credit-to-GDP gap which measures excess credit growth over GDP with respect to its long-term level. In recent quarters this indicator has stood at levels very distant from the activation threshold.[3]

3.1.2 CAPITAL BUFFERS FOR SYSTEMICALLY IMPORTANT INSTITUTIONS

Each year the Banco de España updates the list of systemically important institutions and sets their capital buffers. Since 2015 the Banco de España annually identifies global systemically important institutions (G-SIIs) and domestic or national systemically important institutions, formally known as other systemically important institutions (O-SIIs),[4] establishing capital buffers for each of them.

1 Directive 2013/36/EU (CRD IV) and Regulation (EU) No 575/2013 (CRR), Law 10/2014 on the regulation, supervision and solvency of credit institutions, Royal Decree 84/2015 and Banco de España Circular 2/2016.

2 For more details, see J. Mencía and J. Saurina (2016), *Macroprudential policy: objectives, instruments and indicators,* Banco de España Occasional Paper 1601.

3 See press release of 20 December 2017, "The Banco de España maintains the countercyclical capital buffer at 0%", and Chapter 3 (Macroprudential analysis and policy) of the Banco de España's *Financial Stability Report,* November 2017.

4 For more details, see Box 3.1 (Identification of systemic institutions) of the Banco de España's *Financial Stability Report,* May 2017.

CAPITAL BUFFERS FOR SYSTEMIC INSTITUTIONS

TABLE 3.1

Institution	Designation in 2017	Capital buffer required in 2018	Capital buffer to be required in 2019 (a)
Santander	G-SII and O-SII	0.75%	1.0%
BBVA	O-SII	0.5625%	0.75%
Caixabank	O-SII	0.1875%	0.25%
Sabadell	O-SII	0.1875%	0.25%
Bankia	O-SII	0.1875%	0.25%

SOURCE: Banco de España.

a The buffers indicated for 2019 would be applicable if the related institution were to maintain its O-SII status, and also its current classification, in the 2018 review.

Systemic institutions are those whose failure or malfunctioning would cause severe harm to the financial system and the real economy. This justifies imposing stricter prudential treatment on these institutions than on others, in order to ensure strengthened solvency. Systemic institution buffers take the form of capital surcharges, designed to mitigate and prevent the negative externalities deriving from the size and complexity of the activities pursued by these institutions. In this sense, the buffers seek to address the cross-sectional or structural dimension of systemic risks.

G-SIIs are identified in a coordinated manner at an international level, applying the methodological framework developed by the Basel Committee on Banking Supervision (BCBS) and endorsed by the Financial Stability Board (FSB). The Banco de España participates in both these fora. GSIIs are identified using quantitative indicators based on the main features of institutions classed under five categories: a) size; b) interconnectedness with the financial system; c) substitutability of the services or financial infrastructure provided; d) complexity; and e) cross-border activity. The G-SII framework also establishes the allocation of a capital buffer requirement based on objective criteria.

The Banco de España uses EBA guidelines to identify O-SIIs, also in line with a framework developed by the BCBS based on essentially quantitative criteria, similar to the G-SII framework. By contrast, for institutions identified as O-SIIs, the capital buffer requirements are determined using the Banco de España's own calibration system which is consistent with the guidelines agreed by the ECB in December 2016 for national authorities within the SSM.

In November 2017 the Banco de España published the list of institutions identified as G-SIIs for 2019 and as O-SIIs for 2018, along with their capital buffers.[5] The buffer requirements for G-SIIs and O-SIIs are being phased in gradually between 2016 and 2019, with 75% of the requirement to be met in 2018 and 100% in 2019 (see Table 3.1). Under the applicable legislation, if an institution is classed as both a G-SII and an O-SII, the higher of the two buffers will apply. The Banco de España will review the designations of institutions classed as G-SIIs and O-SIIs at the end of 2018.

3.2 Macroprudential tasks in the Single Supervisory Mechanism

In the framework of the Single Supervisory Mechanism (SSM), the Banco de España is in continuous dialogue with the ECB on macroprudential policy matters. In accordance with current legislation, the Banco de España periodically informs the ECB of its proposed

5 See press release of 24 November 2017, "Banco de España updates the list of systemically important institutions and sets their capital buffers".

macroprudential measures. Specifically in 2017, the Banco de España submitted to the ECB the quarterly countercyclical capital buffer measures and the annual review of systemic institutions.[6] This is part of a formal process whereby the ECB scrutinises national macroprudential policies in the euro area. Under the EU SSM Regulation, for certain macroprudential instruments the ECB has the power to tighten the measures applied by national authorities.

The Banco de España takes part in the discussions of the ECB's Financial Stability Committee (FSC), along with other euro area national central banks and supervisory authorities. Through its working groups the FSC aims to foment the analysis of risks and vulnerabilities for financial stability in Europe and facilitate the exchange of information, thus helping to coordinate macroprudential policy measures between national authorities.

The Banco de España is a member of the ECB's Macroprudential Forum (MPF). This is a platform where members of the ECB's Governing Council and Supervisory Board meet quarterly to discuss the situation of the euro area banking system and the impact on financial stability of various regulatory and supervisory initiatives from both a microprudential and macroprudential standpoint.

6 The information on systemic institutions must also be submitted to the European Commission, the EBA and the European Systemic Risk Board (ESRB).

19th century mantel clock. Banco de España collection.

Supervision of institutions' conduct is not included in the remit of the SSM. In consequence, the Banco de España supervises the conduct of all credit institutions that provide their services in Spain and of other supervised institutions.

Protecting bank customers is a fundamental objective for the Banco de España. It is, in addition, essential to safeguard public trust in the banking system and to prevent the risk associated with a general loss of public trust. In consequence, supervision of conduct by the Banco de España plays a key part in fostering the good functioning and stability of the financial system.

Together with the specific functions of oversight and inspection of conduct rules on transparency and consumer protection, the Banco de España performs other closely related functions, such as promoting good market practice or handling enquiries and resolving complaints and claims made by banking service users. Analysis of the numbers, trends and content of claims is one of the most valuable sources of information for the supervision of conduct. Indeed, certain actions taken that led to disciplinary measures being adopted arose from infringements detected through claims filed by banking service users.

In 2017 conduct risk scoring was applied to institutions.[1] This helps to establish supervisory priorities and to draw up the annual action plan. To assist with this task and with the pursuit of supervisory activity, work was carried out throughout the year on the design and creation of a new IT tool.

4.1 Conduct-related supervisory activity

Supervisory activity in 2017 comprised actions included in the annual plan and others that were unscheduled. Given the inherent characteristics of conduct-related supervisory activity, it is only natural that unscheduled supervisory needs will arise, either as a result of matters reported to the Banco de España by individuals or public or private bodies, or when certain practices are observed at institutions that are deemed to require immediate and specific supervisory action, brought to light by a claim or by regular monitoring of institutions.

Supervisory actions, planned or unplanned, carried out in 2017 comprised on-site inspections (thorough analysis of a specific matter at a specific institution) and other off-site supervisory monitoring (actions on varying scales, which may range from occasional limited monitoring at a specific institution to horizontal actions at several institutions).

In addition, 2017 saw the start of continuous monitoring of institutions' conduct, at an individual or aggregate level, according to the importance and conduct risk scoring of each institution.

Table 4.1 presents the details of the supervisory actions taken in 2017 and Figure 4.1 an overview of the main supervisory activities.

1 This scoring is calculated using parameters relating to each institution's conduct category (market share, type and provision of banking services to individuals) and market conduct risk profile. For more details, see Chapter 4 of the *2015 Report on Banking Supervision in Spain.*

SUPERVISORY ACTIVITIES IN RESPECT OF INSTITUTIONS' CONDUCT IN 2017 TABLE 4.1

Number

By type	Inspections (a)	Off-site monitoring (b)
Mortgages		
Mortgages (transparency)	34	4
Mortgages (Code of Good Practice)	1	26
Consumer loans	0	5
Advertising	1	168
Other (capital contributions credit cooperatives, ATMs, financial reporting to SMEs, customer service departments, transparency)	1	20
TOTAL	**37**	**223**
of which unplanned	*8*	*45*

SOURCE: Banco de España.

a Of these inspections, 24 were initiated before the beginning of 2017.
b Of these off-site monitoring activities, 93 were initiated before the beginning of 2017.

OVERSIGHT OF CONDUCT: MAIN AREAS OF ACTIVITY FIGURE 4.1

MORTGAGES	CONSUMER LOANS	ADVERTISING	OTHER
Transparency in marketing Application of contractual conditions Proper calculation and reporting of APR Protection for mortgage borrowers experiencing financial hardship	Pre-contractual information: — Actually supplied to customers — Appropriate content Safekeeping of contractual documentation Revolving credit cards	Review of advertising of banking products and services: — Policies, procedures and internal controls	Customer service departments Commission charges on ATM cash withdrawals SME financial information Capital contributions credit cooperatives Transparency Pre-contractual information for online products and services Fee and commission charges on websites

SOURCE: Banco de España.

4.1.1 MORTGAGE LENDING

Purchasing and paying for a home is one of the key milestones in a person's life. For this reason, one of the Banco de España's priority objectives is to ensure transparency in the marketing of mortgage loans.

Work was undertaken in 2017 to conclude the eight ongoing on-site inspections on mortgage lending, involving supervising correct compliance with the regulations on the pre-contractual and contractual information to be provided at the different stages of the marketing of mortgage loans and of their arrangement, settlement and payment. These inspections, which began in 2015, have reviewed a significant sample of Spanish households' residential mortgage loans. Another four inspections on mortgage lending were opened in the year.

All these actions included verification, among other aspects, of:

i) the content of the pre-contractual information and contractual documentation;

ii) calculation of the APR established in the pre-contractual and contractual documentation;

iii) application of the contractual terms, such as, for example, correct setting of the interest rate agreed or correct calculation of the regular instalments;

iv) application of the system for substitution of official benchmark indices; and

v) calculation of mortgage closure or early repayment fees.

In addition, six inspections were opened on transparency in the marketing of mortgage loans and, in particular, on the adequacy of the pre-contractual information and calculation of the APR.

4.1.2 MEASURES TO PROTECT MORTGAGORS EXPERIENCING FINANCIAL HARDSHIP

Protecting mortgagors experiencing serious economic difficulties is also a priority for the Banco de España. Accordingly, in 2017 supervisory efforts continued to be devoted to checking that the Code of Good Practice (CGP) contained at annex to Royal Decree-Law (RDL) 6/2012 of 9 March 2012 on urgent measures to protect mortgagors experiencing financial hardship was being correctly applied by its signatory institutions. The CGP contains a series of measures, which are mandatory for the signatory institutions, to allow restructuring of mortgage debts in the case of borrowers who are experiencing extraordinary difficulties meeting their mortgage payments and who satisfy

BANKING REGULATION AND DISCIPLINE LEGISLATION, RDL 6/2012 — FIGURE 4.2

Obligations	Most common incidents detected in recent years
Art. 5.9 **Information on the CGP** Institutions must provide appropriate information on the existence of the CGP and the possibility of having recourse to the CGP measures. This information must be made available through the branch network, to all customers, and in writing to customers who have failed to meet any loan repayments or who have payment difficulties.	— Proactive information on the CGP is not provided. — Written information on the CGP is not provided. — Requests are not dealt with diligently (delay in information on whether or not the documentation presented is complete). — Delays in attending to requests. — Incorrect analysis of the documentation presented. — Deficient information on the different CGP measures and the fact that they are successive measures.
Art. 5.4 **Application of the CGP** When a customer certifies that he/she has reached the exclusion threshold, the institution must apply the CGP measures (restructuring or reduction of loan or dation in payment) from that point in time.	— The restructuring plan is not notified and offered within one month from presentation of the request for application of the CGP. — The restructuring plan specifying the financial consequences for the customer is not provided. — Information on the complementary measures available if the restructuring plan is inviable is not provided. — The measures are not applied from the date of declaration of the exclusion threshold. — Novation costs are passed on to the customer when it is the institution that requests the recording as a public deed.

SOURCE: Banco de España.

certain conditions that place them on the exclusion threshold defined in the legislation. Broadly speaking, signatory institutions shall i) proactively inform their customers of the existence of these measures and the possibility of their having recourse to them, and ii) apply the measures without delay to borrowers who demonstrate that they meet these conditions.

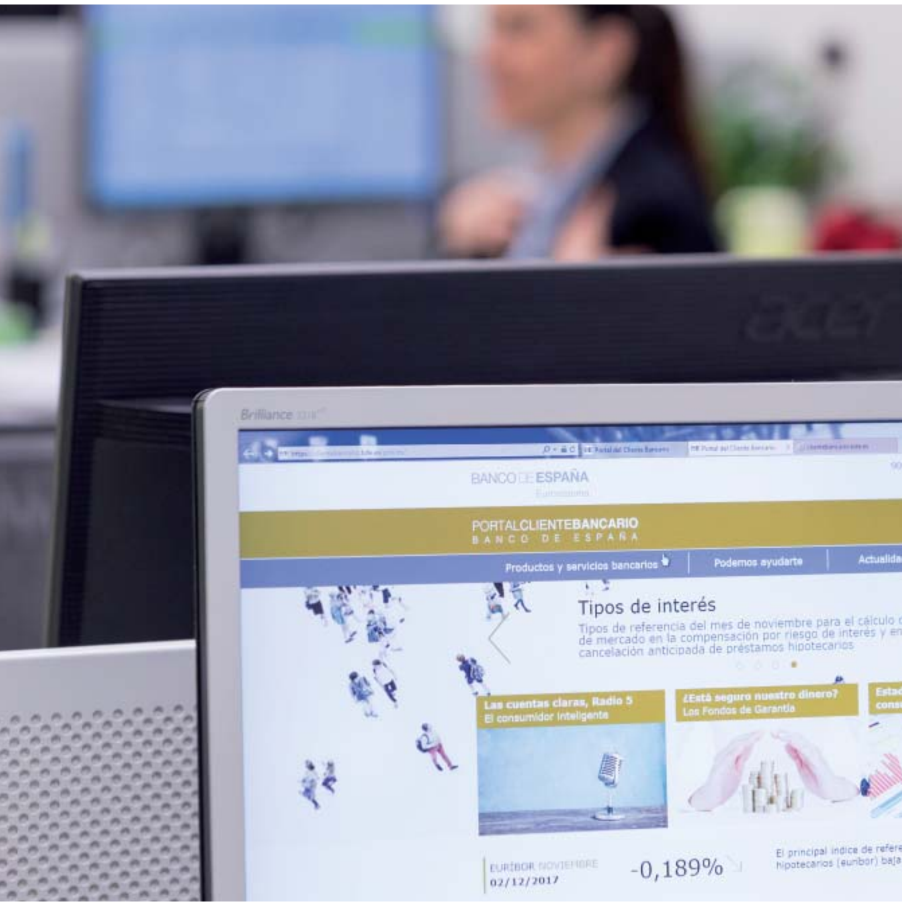
Figure 4.2 summarises the most common incidents detected in recent years relating to application of RDL 6/2012.

4.1.3 CONSUMER LENDING

It is vital that customers are aware of the conditions and risks they assume when they purchase a bank product. This is especially important in the case of consumer loans or credit, since neither the lower amounts involved nor the immediacy of obtaining the loan or credit is conducive to reflection.

In consumer lending the Banco de España's powers are limited to verifying that the institutions under its supervision comply with the regulatory and disciplinary rules. In consequence, it does not enter into other matters such as, for instance, assessing whether contractual terms are unfair, or monitoring loans or credit granted by other firms that are not under its supervision (non-supervised firms are free to grant consumer loans as it is not a restricted activity).

In 2017 this activity focused on verifying that supervised institutions effectively provided pre-contractual information to customers and that this information was clear and transparent, especially in the case of revolving credit.



Portal for Banking Customers.

Market Conduct and Claims Department.

Advertising by supervised institutions plays an essential role in the marketing of banking products and services, as it is frequently the first contact with potential customers and is a key factor in generating customer expectations.

In 2016 horizontal supervisory monitoring of advertising was begun in institutions within the scope of application of Ministerial Order EHA/1718/2010 of 11 June 2010 on regulation and control of advertising of banking products and services, and of Banco de España Circular 6/2010 of 28 September 2010 to credit institutions and payment institutions on advertising of banking products and services.

These regulations encourage self-regulation by institutions and are based, on one hand, on prevention measures, through internal controls and procedures, and on the other on corrective measures, through subsequent review by the supervisor of samples of the advertising material, which allow any misconduct to be corrected. These review measures by the Banco de España have been stepped up considerably in recent years.

In a first stage, all institutions covered by the above-mentioned regulations (312 in total) were asked to provide their internal advertising records, to allow the supervisor to verify that they were compliant with the regulations and to ascertain the actual volume of advertising.

In a second stage, institutions that were effectively pursuing advertising activities (170) were analysed, focusing on the following aspects: i) that internal advertising records were being kept correctly; ii) that the advertising was compliant with the regulations; and iii) that an appropriate commercial communication policy, procedures and controls were in place. As a result, 113 requirement letters (containing 326 individual requirements), 30 recommendation and comment letters and a further 24 other letters were sent.

The most common shortcomings identified were: i) incomplete internal records not consistent with the advertising reported; ii) advertising not fully compliant with the relevant regulations; and iii) shortcomings relating to the commercial communication policy document, which at some institutions did not exist and at others was very deficient or severely lacking.

In short, the supervisory assessment revealed the need for institutions to pay more attention to their advertising activity and seriously reconsider the division of functions and coordination between the marketing and the regulatory compliance areas, conferring on the latter the necessary importance in this respect. In addition, management bodies should become closely involved in the processes of approval and updating of their advertising procedures and controls, with audit plans necessarily in place for this control function.

The Banco de España intends to continue to oversee all advertising and to increase the volume of advertising actually reviewed.

Most revolving credit is extended in the form of cards and is generally offered to provide quick access to liquidity. Given their financial terms, default on these cards can lead to a build-up of interest and expenses, making it difficult for the debt to be repaid and resulting in debt overhang and, ultimately, financial exclusion for the borrower.

To facilitate daily life's typical financial calculations, and specifically those required for revolving credit, the Banco de España's website has a simulator that enables consumers to calculate when the last payment will be due on a revolving card. It also has other simulators which, for example, allow consumers to calculate loan instalments and obtain loan repayment schedules (https://clientebancario.bde.es/pcb/es/).

4.1.4 ADVERTISING

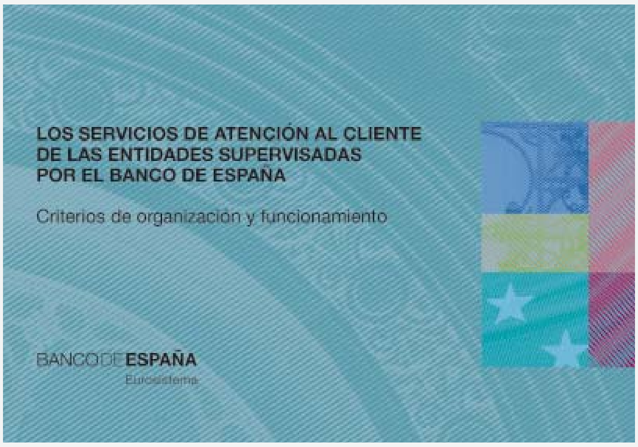
A key aspect of supervisory activity in 2017 was the review of bank product advertising, to verify and ensure that advertising was truthful, clear and concise. Box 4.1 describes the supervisory monitoring of advertising carried out in 2017, in the framework of actions begun in 2016.

4.1.5 OTHER SUPERVISORY ACTIONS

Supervisory actions in other areas in 2017 included, in particular, the following:

i) reviewing the correct functioning of customer service departments, described in Box 4.2;

CRITERIA FOR CUSTOMER SERVICE DEPARTMENTS AT SUPERVISED INSTITUTIONS BOX 4.2



As a result of the supervisory measures taken in recent years to verify the correct functioning of customer service departments (CSDs), the *2016 Memoria de Reclamaciones* (Claims Report, available only in Spanish) included an addendum on CSDs at institutions supervised by the Banco de España *(Adenda: Los servicios de atención al cliente de las entidades supervisadas por el Banco de España)* listing good practice criteria for the organisation and functioning of customer services at supervised institutions.

The underlying basis for these criteria is that institutions' CSDs are understood to be control bodies that play a vital role in their respective organisations. Thus, CSDs should not simply handle and settle claims, but should also play a key role alongside institutions' various other control bodies, in order to ensure correct risk control, prudent business conduct and compliance with legislation, regulations and supervisory requirements and with internal policies and procedures, located at the second line of defence in the three lines of defence model.

From this privileged position, CSDs should be a source of important information, an early warning mechanism for the early detection of problems, enabling any such problems to be corrected or prevented by institutions' governing bodies.

ii) verifying that obligations relating to ATM cash withdrawal charges were being met, for which purpose the information provided through banks' ATMs was monitored *in situ*, together with the procedures used by banks to notify changes in the charges they pass on to their customers who make cash withdrawals from other banks;

iii) verifying that institutions were complying with their obligations to provide information on the financial situation and payment history of SMEs and self-employed persons (through the "SME-Financial Information" document);

iv) reviewing the transparency of the information provided in the marketing of contributions to the capital of credit cooperatives;

SUPERVISORY MEASURES ADOPTED IN 2017 TABLE 4.2

Number

	Inspections (a)	Off-site monitoring (b)
Initiation of penalty procedures	5	1
Letters of requirements	8	114
Recommendation and observation letters	8	226
Other letters	0	81
Other actions concluded not involving letters	1	14
TOTAL	**22**	**436**

SOURCE: Banco de España.

a The eight requirements letters contain 68 specific requirements for the institutions. In addition, there are five completed inspections for which the adoption of supervisory measures has yet to be fomalised.
b The 114 requirements letters contain 330 specific requirements for the institutions.

v) verifying the pre-contractual information provided by institutions offering bank products that may be acquired online or through mobile apps; and

vi) monitoring that institutions comply with the transparency requirements relating to information provided on their websites on interest rates and fees and commissions.

4.2 Supervisory measures

In 2017 the Banco de España initiated six conduct-related penalty procedures, five of which arising from on-site inspections on mortgage lending and one from supervisory monitoring of the correct application of the CGP. Also, 122 requirement letters and 234 recommendation and comment letters were sent, seven of each relating to inspections on mortgage lending. Table 4.2 shows the type of measures adopted in the procedures concluded in 2017.

Imperial mantel clock. 19th century. Banco de España collection.

In 2017 the first four decisions imposing sanctions under Law 10/2014 as the substantive rule were adopted. These decisions[1] imposed sanctions on two banks, on a payment institution and its directors and on an unauthorised institution and its director. In three of these four cases the sanctions were calculated based on the gains obtained from the infringement.

The reductions in sanctions introduced in Administrative Procedure Law 39/2015 in cases of recognition of liability and/or voluntary payment came into force in 2017. As a result, several offenders obtained reductions – of 40% (for recognition of liability and voluntary payment) or 20% (for voluntary payment without recognition of liability) – in the sanctions proposed.

Much of the sanctioning activity in 2017 addressed infringements of the Code of Good Practice, which is designed to protect especially vulnerable groups of borrowers experiencing financial hardship and which credit institutions have been able to sign up to since 2012. Those that do so become subject to certain obligations, laid down in regulatory and disciplinary rules, relating to information and application of the measures envisaged in the Code (debt restructuring, debt reduction, dation in payment). In this area three decisions to impose sanctions were adopted, against two banks and a credit cooperative, and a fourth sanctioning proceeding was initiated against a bank.

Sanctioning of infringements of transparency rules was also noteworthy, and in particular infringements of obligations, especially relating to pre-contractual and contractual information, established in the rules on transparency and protection of bank customers. In this area, four proceedings – against two banks, a specialised lending institution and a currency-exchange bureau and its directors and senior managers – concluded with imposition of sanctions, and another five proceedings were initiated, all against banks.

Sanctions were also applied to institutions which, without the necessary authorisation, were pursuing restricted activities or using restricted names, to payment institutions (mainly for infringements relating to accounting, organisational structure or safekeeping of funds) and to infringements of Central Credit Register regulations. In this area three proceedings were concluded with imposition of sanctions on the institutions and on their directors and senior managers, including in one case withdrawal of the institution's licence, and another four proceedings were initiated. Also, in several of these proceedings interim measures, such as suspending the institution's activity, were adopted.

1 Regarding disclosure of the sanctions imposed and of the identity of the offenders, the provisions of Article 115(5), (6) and (7) of Law 10/2014 shall apply, establishing when those details should be published in the Official State Gazette (BOE) and on the Banco de España's website (https://www.bde.es/bde/es/areas/supervision/sancion/sanciones-impues/).

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

Imperial mantel clock. 19th century. Banco de España collection.

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

The Banco de España places strategic importance on its participation in international banking regulation and supervision fora. This is a growing priority, in light of the need to address the challenges posed by globalisation and the importance of increasing the capacity to influence new global and European policies affecting the banking industry. Figure 6.1 shows the international regulatory and supervisory bodies and committees in which the Banco de España plays a part.

The Banco de España has, therefore, focused on strategic issues and on coordinating positions that foster coherent and efficient participation in these fora. See the *2016 Report on Banking Supervision in Spain* for more details on the positions upheld by 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 and coordinate regulatory reform in response to the international financial crisis. With the main elements of the reform now complete, the FSB is currently finishing the final work pending. It is also focusing on evaluating the effects and reviewing the implementation of the reform, to ensure consistency, and on identifying and monitoring new risks for financial stability.

Latest regulatory reform work

The FSB made progress in several areas in 2017. The results of an analysis of interdependencies between CCPs and their members (especially banks) were published, highlighting the concentration of exposures among a small number of CCPs and of member institutions. The FSB continued to work on the plan established to prevent and mitigate misconduct, specifically to strengthen the role played by governance and compensation

INTERNATIONAL REGULATORY AND SUPERVISORY BODIES AND COMMITTEES IN WHICH THE BANCO DE ESPAÑA PARTICIPATES — FIGURE 6.1

GLOBAL FORA	Financial Stability Board (FSB)	— Coordinating national authorities and international regulatory bodies. — Identifying vulnerabilities of the financial system. — Defining and implementing regulatory and supervisory policies.
	Basel Committee on Banking Supervision (BCBS)	— Establishing international standards, guidelines and best practices for the prudential regulation of the banking sector. — Uniform implementation of standards and promotion of a level playing field for banks which operate internationally.
EUROPEAN UNION	European Banking Authority (EBA)	— Convergence of supervisory practices. — Single Rulebook. — Resolution. — Consumer protection and financial innovation. — Payments.
	European Systemic Risk Board (ESRB)	— Macroprudential oversight of the EU financial system to prevent and mitigate systemic risk. — Issuing recommendations, opinions and warnings on macroprudential matters.

SOURCE: Banco de España.
NB: This is not an exhaustive list. The Banco de España also actively participates in other international regulatory and supervisory bodies, especially the International Financial Consumer Protection Organisation (FinCoNet) and the Association of Supervisors of Banks of the Americas (ASBA) which is of strategic importance to the Banco de España.

frameworks. It is also studying ways to increase individual accountability and to prevent staff with a history of misconduct from moving from one firm to another. In addition, it published a progress report on reforming interest rate benchmarks.

Evaluating effects of reforms

In 2017 the FSB developed a framework for evaluating the effects of the G20 regulatory reforms, to analyse whether they are achieving their intended outcomes and to help identify material unintended consequences that may have to be addressed, without compromising on the objectives or the implementation of the reforms. The first two projects to be analysed in 2018 and in which the Banco de España will be involved are the effect on incentives to clear OTC derivatives at CCPs and the effects on financial intermediation (initially focusing on financing for infrastructure investment, before extending the analysis to other areas).

New technology challenges

In view of the development of new technologies applied to the financial sector (Fintech), the FSB has been working to identify the risks and opportunities posed. In June 2017 it published a report identifying the potential benefits of innovation (e.g. greater efficiency) and the potential risks for financial stability (e.g. greater interdependency). Although the report concludes that, for the time being and in general, the main risks are covered within existing regulatory frameworks, it also highlights a number of areas that require special attention (e.g. risks from third-party service providers).

In addition, growing digitalisation in the financial sector has made cyber risk a key priority. In this connection, in October 2017 the FSB published a report on national cybersecurity regulatory and supervisory practices, aimed at promoting a set of effective practices among G20 members.

6.1.2 BASEL COMMITTEE ON BANKING SUPERVISION

On 7 December 2017 the Basel Committee's oversight body, the Group of Central Bank Governors and Heads of Supervision (GHOS), endorsed the Basel III reforms outstanding. This package, which completes the post-crisis reform of the regulatory framework, seeks to reduce undue variability in risk-weighted assets (RWAs), improving the comparability and transparency of capital ratios. The essential changes relate to the capital ratio denominator and the leverage ratio (see Figure 6.2). The Banco de España played an active part in the preparation of these reforms.

Audit Sub Group (ASG) meeting. Sala Europa, Banco de España.

KEY FEATURES OF THE FINALISATION OF BASEL III

FIGURE 6.2

		Implementation
Credit risk	— Rewiew of the standardised approach: increase in risk sensitivity and reduction of reliance on external ratings. — Review of internal ratings-based (IRB) approach: constraints introduced on its use and minimum levels introduced for estimates.	**1 January 2022** (An agreement was also reached to delay the entry into force of the market risk framework by three years until January 2022 - this framework was published in January 2016 to be implemented by January 2019)
Operational risk	— The advanced measurement approach (AMA) is withdrawn. — A new standardised approach, replacing the current approaches, is introduced, where capital is a function of business volume and, at the discretion of each jurisdiction, of historical losses.	
Review of CVA framework	— Internally modelled approach removed and basic approach (BA-CVA) and standardised approach (SA-CVA) are introduced. — Banks with reduced trading in derivatives can perform the calculation based on counterparty risk requirements.	
Leverage ratio	— Surcharge introduced for G-SIBs: scaling factor of 50% applied to surcharge based on the institution's risk-weighted assets and its systemic importance. — Review of measurement of exposure.	
Output floor	— Aggregate floor: the requirements calculated using internal models cannot be lower than 72.5% of those calculated using the standardised approaches. — At national discretion the increase in RWAs, resulting from the application of the floor, may be capped at 25% until the end of the transition period. — Institutions must publish the RWAs calculated using standardised approaches as from the beginning of the transition period.	Transitional arrangements: 2022: 50% 2023: 55% 2024: 60% 2025: 65% 2026: 70% From 1 January 2027: 72.5%

SOURCE: Banco de España.

The GHOS also reaffirmed that it expected full, timely and consistent implementation of all the changes proposed. Looking ahead, the Committee will focus on continuing to ensure that the Basel standards are implemented and on evaluating the post-crisis reforms.

Also in December 2017 a discussion paper was published on the regulatory treatment of sovereign exposures. The paper indicated that there will be no changes in the short term, so the Committee decided not to consult on the ideas presented, although it admitted that the views received will be useful in informing the Committee's longer-term thinking on this issue.

Other regulatory framework reviews

The Committee published other significant changes in the year. First, ahead of the entry into force in January 2018 of IFRS 9, it published a document proposing a transitional arrangement for the prudential treatment of accounting provisions (see Box 7.4). Second, as part of the G20's shadow banking initiatives, it issued Guidelines on identification and management of step-in risk.[1] Lastly, relating to liquidity risk and in order to facilitate the entry into force, in January 2018, of the net stable funding ratio (NSFR), the Committee agreed to allow national discretion for the treatment of financial derivative liabilities.

1 Step-in risk is the risk that a bank decides to provide financial support to an entity that is facing stress, in the absence of, or in excess of, any contractual obligations to provide such support.

Accounting Experts Group

The Banco de España is a member of and chairs the Basel Committee's Accounting Experts Group. In 2017 the Group's work focused on monitoring the implementation of IFRS 9. In addition, the Group contributed to the project for reform of audit standard-setting bodies, with a view to increasing their independence.

The Group also prepared responses to documents subject to consultation of the international accounting (IASB) and audit (IAASB) standard-setting bodies and collaborated with other Basel groups on analysis of the interaction between accounting standards and prudential requirements. As a result of this collaboration, the following were published:

— In March 2017, a document on the transitional arrangement for provisions made as a consequence of implementation of IFRS 9, referred to above.

— In April 2017, FAQs on the new International Financial Reporting Standard – Leases (IFRS 16), establishing that assets arising as a consequence of the new standard should not be deducted from regulatory capital, that they should be risk-weighted at 100% provided that the underlying asset is a tangible asset, and that they should be included in the capital and leverage ratios.

6.2 European fora

6.2.1 EUROPEAN BANKING AUTHORITY

In 2017 the EBA continued to contribute to the Single Rulebook, approving various regulatory products. It also continued work to further strengthen convergence of supervisory practices throughout the European Union.

Particularly noteworthy, on account of its importance, was the work on the methodology to be applied to the stress testing of European credit institutions in 2018 to assess their solvency in an adverse economic scenario. This methodology was published at the end of 2017 and will be similar to that used in the 2016 exercise, although with one notable difference, namely the need to consider the new accounting framework with the entry into force of IFRS 9. In this respect, the calendar for the stress test exercise will be slightly different from that of previous years and will extend throughout most of 2018, in anticipation of possible difficulties, relating to the availability of the information that these tests require, associated with the first-time application of the new accounting standard. For this reason, the EBA does not expect to publish the results of the exercise before November.

Below we highlight – for the different areas of the EBA's activity – other important work carried out and in which the Banco de España played an active part. Box 6.1 contains a description of the work performed by the EBA on technological risk.

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

In 2017 the EBA published for consultation the revised version of its Guidelines on the Supervisory Review and Evaluation Process *(SREP).* The main change was the inclusion of the capital recommendation (Pillar 2 Capital Guidance, P2G) which, in the stacking order of capital requirements, sits above the combined buffer requirement (see Figure 6.3). P2G can only be met with CET1 instruments and will not be taken into account to calculate the maximum distributable amount (MDA). Figure 6.3 depicts the capital requirements structure.

Other relevant changes to guidelines concern: i) integration into one single document of the various requirements relating to the stress testing exercises addressed to supervisors; ii) clarification of certain aspects of the scoring framework contained in the guidelines; and iii) review of coherence with other standards and guidelines that entered into force after the publication of the original SREP guidelines in December 2014.

EBA STUDIES ON TECHNOLOGICAL RISK

BOX 6.1

Information and communication technology (ICT) is a key resource in developing and supporting banking services. Not only is it a key enabler of business strategies, but it also forms the backbone of almost all banking processes and their distribution channels. Aside from supporting the business, technological innovation also plays a crucial role from a strategic standpoint, as it is a fundamental tool to compete in the financial markets by offering new products and services and by restructuring and optimising the value chain.

The growing importance and complexity of ICT within the banking industry has brought associated risks which may have a highly significant prudential impact and may even threaten the viability of an institution. Notable in this connection is, among others, the increase in cyber threats, the growing reliance of banks on outsourcing of services and the risks associated with the FinTech phenomenon (understood as financial innovations arising from the intensive use of technology).

In this connection, the EBA has developed certain guidelines to assess the risks associated with ICT within the framework of the supervisory review and evaluation process (SREP). These guidelines, which were published in May 2017 and came into force on 1 January 2018, aim to guide supervisors in assessing technological risks at banks. They will provide a common supervisory framework for technology-related risks for the first time in Europe, a highly necessary step given the growing importance of ICT and a determining factor for enabling supervisory convergence to increase.

Another area requiring the EBA's attention is the use of cloud computing services, a rising trend in the banking industry owing to the significant advantages they provide to banks in terms of cost savings, scalability and flexibility. Alongside the advantages, cloud computing also involves an increase in certain risks, including those relating to data location and protection, security and concentration in a small number of providers which may become single points of failure. Although the outsourcing guidelines of the Committee of European Banking Supervisors (CEBS) are still in force, it has been considered necessary to work on specific guidelines relating to cloud outsourcing. Thus, in 2017 the EBA drew up a recommendation on cloud computing which will enter into force on 1 July 2018 and will subsequently be included in certain EBA guidelines on outsourcing which constitute a revision of the CEBS guidelines.

Finally, as regards FinTech, the EBA published in August 2017 a discussion paper on its approach to financial technology and its proposals for future work on the areas identified as most affected. Additionally, in 2017 a working group was set up which is analysing the prudential risks and opportunities which the use of certain technologies, such as biometrics, artificial intelligence, big data and distributed ledger technology (Blockchain), entail for banks.

Prudential regulations

One of the EBA's key projects in the field of prudential regulation has been the preparation of the Guidelines on PD and LGD estimation and the treatment of defaulted exposures. Regulatory Technical Standards (RTS), still in preparation, on the nature, severity and duration of economic downturn will be issued to complete these Guidelines.

These two products are the culmination of a regulatory process set in motion by the EBA in 2015, whose chief aim was to increase the reliability of the internal models used to calculate capital requirements, and to reduce the variability observed in the results of those calculations. Specifically, the Guidelines on PD and LGD estimation seek to clarify the main concepts and definitions underlying the calibration of the different regulatory parameters used as inputs in the calculation of capital requirements.

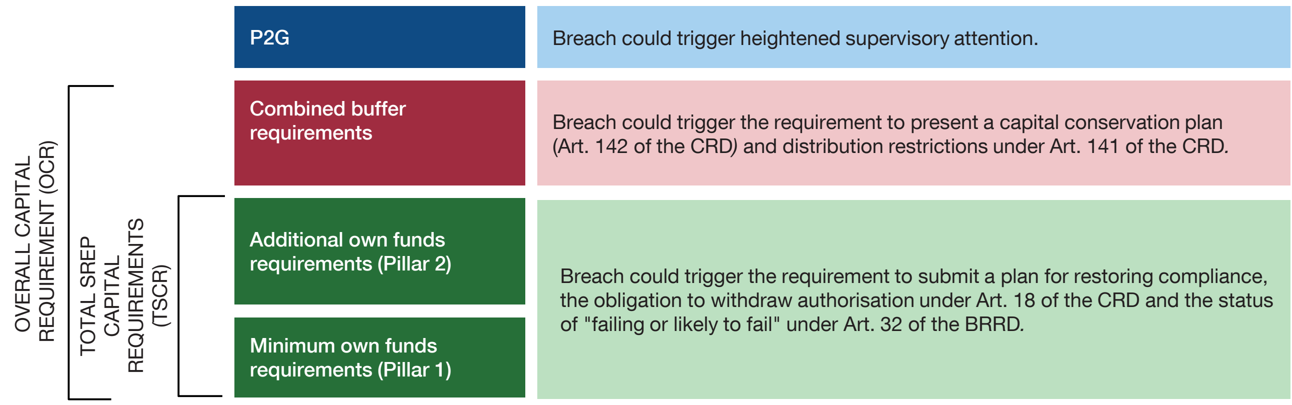
The Banco de España has contributed to this work from the outset, insisting on the importance of consistency with the work of the Basel Committee in this area.

Consumer protection and financial innovation

In the area of supervision of institutions' market conduct and financial consumer protection, the EBA has played an active part in achieving greater convergence in the application of standards. Work has been done, in particular, to define a harmonised interpretation of the guidelines on retail banking product oversight and governance processes, to ensure their uniform implementation and supervision.

STRUCTURE OF CAPITAL REQUIREMENTS

FIGURE 6.3



SOURCE: EBA Pillar 2 Roadmap.

Also noteworthy are the Guidelines on procedures for complaints of alleged infringements of PSD2.[2] These set out the requirements to be applied by competent authorities in connection with the complaints procedure to ensure and monitor effective compliance with the Directive. This procedure is, therefore, an important supervisory tool in the area of payment services.

Payments

In the payments area, development of the Regulatory Technical Standards on Strong Customer Authentication and Common and Secure Communication Standards under PSD2 merits special mention. The EBA has drawn up these standards, seeking to establish a correct balance between security and innovation and to address the different positions of the parties concerned: consumers, retailers, third-party payment service providers (TPPs) and account servicing payment service providers (ASPSPs), among others.

These technical standards, which lay down the technical requirements of the strong customer authentication process and regulate the cycle of personalised security credentials, include two measures that are particularly noteworthy. First, they provide for exemptions to the authentication process based on transaction risk analysis, conditional upon the payment service providers having exceptionally low fraud levels. Second, they include fall-back solutions as a contingency measure for when ASPSPs grant TPPs access to customers' payment accounts through specific interfaces (APIs). They also provide that, after consulting with the EBA, national competent authorities may exempt ASPSPs from implementing this measure when the corresponding APIs have been satisfactorily tested by the TPPs.

6.2.2 EUROPEAN SYSTEMIC RISK BOARD

In 2017 the ESRB continued to analyse the European Union's macroprudential and financial situation and the possible systemic risks and vulnerabilities in the area.

In addition to this regular task, in July 2017 it published a report on solutions for non-performing loans in Europe.[3] The report concludes that the volume of non-performing loans in Europe is significant, given that it generates a series of negative effects that have an adverse impact on economic growth. It highlights the pressing need to reduce these exposures and includes a series of recommendations to that end. For banks with very high NPL levels, the report recommends a return to sustainable profitability by means of restructurings, mergers or even resolution or liquidation processes.

2 Directive (EU) 2015/2366 of 25 November 2015 on payment services.
3 ESRB, *Resolving non-performing loans in Europe,* 11 July 2017.

Also noteworthy is the work arising from compliance with the ESRB's Recommendation on recognising and setting countercyclical buffer rates for exposures to third countries. The Recommendation seeks to ensure that macroprudential authorities monitor jurisdictions to which their domestic banking sector has what are considered material exposures, and where appropriate that a specific countercyclical buffer rate be set if that set by the local authorities is considered inadequate. In 2017 the Banco de España identified six material third countries for the Spanish banking sector (United States, Brazil, Mexico, Chile, Turkey and Peru), although it did not consider it necessary to activate the countercyclical capital buffer for any of them.[4]

6.3 Other fora

FinCoNet

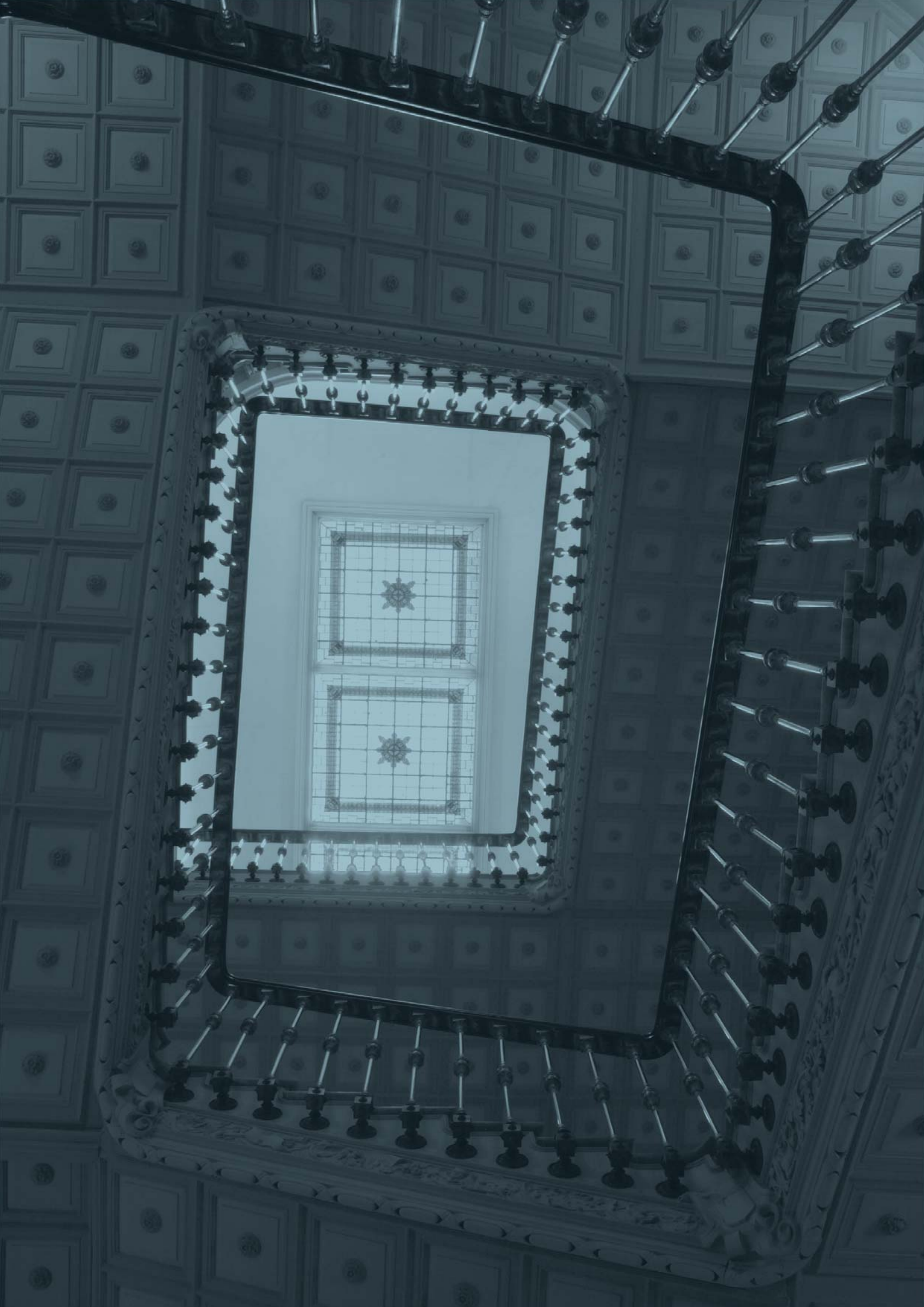
In the area of market conduct and financial consumer protection, the Banco de España is a member of the Governing Council of the International Financial Consumer Protection Organisation (FinCoNet). Since its launch in 2013, this international forum for financial market conduct supervision has continued to gain new members. Its work programme for the period 2017-18 will concentrate on the impact on consumers of the digitalisation of financial products and services, focusing in particular on work relating to the analysis of supervisory tools in a digitalised world and other lines of work relating to digitalisation of payments and fast credit.

ASBA

In 2017 the work programme of the Association of Supervisors of Banks of the Americas (ASBA) focused on strengthening the exchange and cooperation relations and the technical and leadership capabilities of its member institutions, and on further implementing best practice and regulatory and supervisory policies. The Association also addressed its efforts to areas such as technological innovation, deposit insurance schemes and bank resolution frameworks, and the process whereby financial institutions abandon or significantly pare down certain business lines to avoid regulatory and compliance risk.

As in previous years, the Banco de España played an active part in ASBA's activities in 2017 and gave its continued support to its Continental Training Plan, through seminars in the region and in Spain.

4 For more details, see Box 3.2 ("Material third countries for the purposes of the countercyclical capital buffer") in the Banco de España's *Financial Stability Report* of November 2017.



7 REGULATORY CHANGES IN SUPERVISORY ISSUES IN SPAIN

Louis XVI “Las Fuentes del Amor” mantel clock. 19th century. Banco de España collection.

7.1 Banco de España Circulars

7.1.1 BANCO DE ESPAÑA CIRCULAR 1/2017

Banco de España Circular 1/2017 of 30 June 2017 amending Circular 1/2013 of 24 May 2013 on the Central Credit Register (CCR) aims to adapt the latter to Regulation (EU) 867/2016 of the European Central Bank of 18 May 2016 on the collection of granular credit and credit risk data (ECB/2016/13).

The Regulation (known as AnaCredit and applicable from 31 December 2017), has established a long-term framework for the collection of granular credit data by the European System of Central Banks (ESCB) for the purpose of establishing a common set of granular data supplementing and improving the ECB's harmonised statistics. It has been envisaged for the first phase that the reporting agents (credit institutions resident in euro area countries and foreign credit institution branches in the euro area) must send to the ECB, through their respective national central banks, information relating to their customers' loans or to loans they manage for the account of third parties, provided the debtor (or, at least, one of them) is a legal entity in which the institution has an accumulated exposure of €25,000 or more.

Taking into account that there is a similar reporting system in Spain, it was decided to include the requirements of AnaCredit in Circular 1/2013. Accordingly, it was amended so that the data which the Banco de España has to request from the reporting agencies is collected by the CCR and sent to the ECB in accordance with the provisions of the above-mentioned regulation. This has been possible owing to the similarities between the two data reporting systems (AnaCredit and Circular 1/2013). In both cases exposures are reported instrument by instrument and the blocks of information on individuals, instruments, collateral and their interrelations contain similar information and are structured in a similar manner. The implementation of a new reporting system has thus been avoided, which allows the reporting agents and the Banco de España to treat the information as a whole and more efficiently. Indeed, the fact that reporting agents only need to submit one report to comply with both requirements facilitates the processes relating to data quality management and to the transfer of data to AnaCredit. The ECB will include the data so collected, together with the other data sent by other national central banks, in a centralised credit database within the sphere of the Eurosystem.

The implementation of AnaCredit has involved the introduction of certain reporting requirements not addressed by Circular 1/2013 to date. Specifically, new data are requested in connection with the counterparties, the instruments reported, financial data, collateral received, and interest rates and accounting status of the instruments. Additionally, in some cases it has been necessary to homogenise the set of attributes, concepts and definitions of Circular 1/2013 with those of the AnaCredit regulation. Apart from the requirements derived from this regulation (whose inclusion in the CCR is the main purpose of the Circular), other changes have been made to Circular 1/2013 to clarify and update the rule, including most notably the simplification of the reasons why counterparties are reported to the CCR.

The Circular has two annexes on the data modules and the instructions for their preparation. A transitional period has been envisaged during which institutions will continue reporting: (i) new data and changes to data on reportable counterparties, as well as requests for identifiers for non-residents (until 31 March 2018); and (ii) the rest of the modules (until 30 April 2018), in accordance with the provisions of Circular 1/2013, as amended by Circular 7/2016 of 29 November 2016.

7.1.2 BANCO DE ESPAÑA CIRCULAR 2/2017

Law 9/2012 of 14 November 2012 on credit institution restructuring and resolution regulates the accounting specificities applied by the Spanish asset management company Sareb in preparing its financial statements. The Banco de España gave effect to those provisions through Circular 5/2015 of 30 September 2015, implementing the accounting specificities of Sareb.

Subsequently, Royal Decree Law 4/2016 introduced certain amendments to Law 9/2012 for the purpose of establishing, inter alia, a new criterion for recording Sareb's impaired assets. Specifically, it established that the recognition of value corrections for asset impairment should be directly charged to the institution's equity and that these adjustments are to remain in equity until they can be allocated to the income statement when there is positive profit for the year.

Banco de España Circular 2/2017 of 28 July 2017 amending Circular 5/2015 established the new criterion for the recording of impairment, also specifying the rules for reversal thereof, stating that the impairment of an "asset unit" may be reversed when there is evidence that the assets in the "asset unit" have recovered their value. Such reversal shall be recorded by first reducing the balance of the "Valuation adjustments" caption in equity. Once the balance of this account reaches zero, the reversal amount pending recognition, if any, will be credited to the income statement.

7.1.3 BANCO DE ESPAÑA CIRCULAR 3/2017

Royal Decree-Law 14/2013 of 29 November 2013 on urgent measures to adapt Spanish law to EU standards on the supervision and solvency of financial institutions carried out the most urgent adjustments to the Spanish legal system to comply with the provisions of CRD IV and CRR. Under the Royal Decree-Law, the Banco de España may make use of the options attributed by the CRR to the national competent authorities and it exercised some of the permanent and transitional options through Circular 2/2014.

This Circular came into force prior to the start-up of the Single Supervisory Mechanism (SSM). Since then, the ECB is the competent authority to exercise certain supervisory functions over institutions classified as significant under Council Regulation (EU) 1024/2013 of 15 October 2013 conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions. Consequently, the ECB may make use of the permanent and transitional options attributed by the CRR to the competent authority, albeit only with regard to significant institutions, while the Banco de España retains the authority to exercise these options in respect of the Spanish less significant institutions.

In the exercise of its power, the ECB approved Regulation (EU) 2016/445 of the European Central Bank of 14 March 2016 on the exercise of options and discretions available in Union law (ECB/2016/4), setting out the decisions of this authority in connection with the options mentioned. Also, in the exercise of its power to issue guidelines to national competent authorities for the performance of supervisory functions and the adoption of supervisory decisions, the ECB has approved Guideline (EU) 2017/697.

In order to adapt to the new regulatory framework, Banco de España Circular 3/2017 of 24 October 2017, amending Circular 2/2014 of 31 January 2014 to credit institutions on the exercise of various regulatory options contained in Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013, modifies the scope of application of Circular 2/2014, which is now limited to less significant institutions, and adapts its criteria to the ECB's guidelines.

7.1.4 BANCO DE ESPAÑA CIRCULAR 4/2017

The basic purpose of the new Accounting Circular (Banco de España Circular 4/2017 of 27 November 2017 to credit institutions, on public and confidential financial reporting rules and formats) is to adapt the accounting regime for Spanish credit institutions to the changes in the European accounting regulations derived from two new International Financial Reporting Standards (IFRSs), IFRS 9 and IFRS 15, amending the accounting criteria for financial instruments and ordinary income, respectively, from 1 January 2018.

The breadth and depth of the changes brought about by IFRS 9 advised updating the accounting regulations on this occasion through a new Circular which replaces Circular 4/2004 and came into force in 2018.

The Banco de España, as the accounting regulator for the industry, provides continuity through this Circular to the strategy it has followed to date, which is to maintain:

— Comprehensive regulations for credit institutions; accordingly, these are not restricted to providing an accounting treatment for financial instruments and credit risk, but include registration, assessment and reporting criteria for the different transactions conducted by such institutions, even if they do not relate to sectoral specificities.

— Compatibility of the rule with the IFRS framework. Thus, the Circular, which constitutes the implementation of the general principles addressed by the Commercial Code, in accordance with the authority conferred on the Banco de España, is in line with international standards criteria.

Because of its importance, the Circular's scope of application remains unchanged with respect to the Circular it repeals, although there have been changes in the wording relating to public financial information in order to align it with the Commercial Code.

In this respect, the Banco de España understands that the adoption by security issuer groups of the criteria included in the Circular would be an appropriate application of the IFRS framework, except in the case of specific issues where the Circular, which must necessarily be aligned with the Commercial Code, includes a criterion that does not belong in the IFRS framework.[1]

The main changes in the Circular include most notably:

— Implementation of a new impairment model (for all financial assets subject to impairment) based on expected loss versus the current incurred loss model. The aim is to recognise losses earlier and for a higher amount.

— The valuation of financial assets, explained in Box 7.1, and a new classification, which aim to reduce the complexity of current criteria.

1 As in the recording of holdings in joint ventures by the proportionate consolidation method or the amortisation of all intangible assets, including goodwill.

Financial assets are measured at amortised cost, at fair value through other comprehensive income or at fair value through profit and loss.

The classification is based on both the institution's business model for managing the financial assets and the contractual cash flow characteristics of each instrument.

The business model is the manner in which an institution manages groups of financial assets to generate cash flows. The institution may hold groups of financial assets for the purpose of collecting contractual cash flows, selling the financial assets or a combination of both.

Based on their contractual cash flow characteristics, financial assets are classified into one of these two categories:

— Assets giving rise to cash flows that are solely payments of principal and interest on the principal amount outstanding.

— Assets entailing cash flows other than payments of principal and interest on principal.

However, regardless of the business model and the contractual characteristics of the financial assets, an institution may designate at initial recognition and irrevocably:

— A debt instrument in the fair value through profit and loss category if doing so eliminates inconsistencies with other assets or liabilities in the measurement or recognition of profit and loss (accounting mismatches).

— An equity instrument in the fair value through other comprehensive income category. In this case, valuation changes directly recorded in equity are not recorded in the income statement, not even when the instrument is derecognised.

Impairment losses on debt instruments (e.g. loans or bonds) at amortised cost and at fair value through other comprehensive income will be estimated on the basis of the expected credit loss model.

Types of payment	Business model		
	Collection of contractual cash flows	Collection of contractual cash flows or sale	Sale
Solely payments of principal and interest	Amortised cost	Fair value through other comprehensive income	Fair value through profit and loss
Other types of payment		Fair value through profit and loss	

SOURCE: Banco de España

— New criteria for the recording of provisions, additional to the current criteria, which aim to increase the number of economic provisions which can be accounted for in this manner and to achieve a more flexible practical application.

Aside from some exceptions expressly addressed in the rule, the application of these changes will be accounted for retrospectively, with the related impact being recorded in reserves. However, for prudential purposes, the European Union has established a transitional arrangement which allows recognising the effects of the increase in provisions progressively, as explained in Box 7.4.

The public and confidential financial statement models have also been modified as a result of the foregoing changes, in accordance with the European regulations on confidential financial statements.

Annex 9 of this Circular continues to include specific credit risk accounting criteria. It maintains the changes introduced by Circular 4/2016, which aim to strengthen credit risk management, the appropriate classification of transactions (with special emphasis on the definitions of non-performing loans and forbearance, both of which are compatible with those provided by the EBA), the robustness of provision estimation (indicating the

Both the ECB's NPL guidance for banks and Circular 4/2017 allow the use of automated valuations to estimate the recoverable amount of loan collateral and to value foreclosed properties, for accounting purposes, provided the value of the assets is lower than €300,000. The methodologies used to obtain these valuations are customarily known as Automated Valuation Models (AVMs) and may be defined as mathematical models of property valuations applied using computer programmes and developed on the basis of a broad database.

In order to correctly use these methodologies institutions need to have appraisal company selection policies and procedures in place that take into account the adequacy, technical capacity and independence of the appraisal companies.

Credit institutions should also ensure that appraisal companies follow robust procedures meeting the following criteria:

— The properties valued should have a certain degree of homogeneity and be located in an active transaction market.

— Both the market value and the value for mortgage purposes should be reported.

— The methodology used must be regular, robust and appropriately cross-checked, ensuring the traceability of the property valuations carried out.

— The valuation models used should be specified and calibrated and the supervisor should be provided with the information necessary to analyse the property valuations obtained.

— Mass appraisals require cross-checking the sufficiency and quality of the information available.

— A sample of complete individual appraisals must be taken from properties subjected to a mass appraisal in order to check the results obtained.

requirements to be met by individual estimation and the internal methodologies for collective estimation) and the valuation of efficient collateral and of foreclosed assets. Box 7.2 contains some basic criteria that need to be complied with by credit institutions that commission valuations of properties used as collateral, which will also ensure compliance with sound criteria by appraisal companies.

Annex 9 of the new Circular continues to provide alternative solutions for estimating credit risk provisions for the purpose of helping less complex institutions apply the expected loss model, in accordance with the principle of proportionality. These alternative solutions have been updated on the basis of the information, experience and projections of the Banco de España and, for the valuation of foreclosed assets, on the basis of the most recent available information. In both cases, they should be used in the benchmarking exercises of institutions which have developed internal estimation methodologies.

Annex 9 also includes the classification criteria for credit exposures. Box 7.3 describes the classification of loans as "performing under special monitoring".

Finally, it should be noted that developments in the field of credit addressed by the Circular, specifically by Annex 9, include the best international practices (made available to the public by the Basel Committee on Banking Supervision and the EBA through their guidelines on expected credit loss), which are aligned with the ECB's accounting supervisory expectations addressed in its guidance on non-performing loans.

7.1.5 BANCO DE ESPAÑA CIRCULAR 5/2017

Circular 5/2017 of 22 December 2017 amending Circular 5/2012 of 27 June 2012, to credit institutions and payment services providers, on banking service transparency and responsible lending, was published in the Official State Gazette on 3 January 2018. The new Circular aims to adapt on a timely and eminently formal basis Annex 8 of Circular 5/2012 to several recent changes relating to the following issues:

CLASSIFICATION OF PERFORMING EXPOSURES UNDER SPECIAL MONITORING

BOX 7.3

Credit exposures are classified on the basis of credit risk into one of the following categories: performing exposures, performing exposures under special monitoring and non-performing exposures.

The determining factor for an exposure to be classified as performing under special monitoring is that a significant increase in credit risk occurs.

Thus, a risk previously classified as performing will be reclassified as performing under special monitoring when, in the absence of a default event, there has been a significant increase in credit risk since the origination date.

Annex 9 sets out a rebuttable presumption that there has been a significant increase in credit risk, a battery of indicators and certain cases (automatic factors) in which reclassification to the performing exposure under special monitoring category will be necessary.

A risk previously classified as non-performing will be reclassified as performing under special monitoring if, although the event triggering its classification as non-performing ceases to exist, the credit risk is significantly higher than at the origination date.

The criteria for reclassification from performing exposures under special monitoring to other categories must be consistent with those determining the classification of credit exposures as performing under special monitoring. In the specific case of forborne transactions, a trial period of at least two years, during which the borrower must show good payment behaviour, must elapse.

Rebuttable presumption	— Exposures that have amounts more than 30 days past due
Estimation of allowances and provisions	— Adverse changes in financial situation — Significant decline in turnover — Significant drop in net operating income — Significant changes in cost of credit risk — Actual or expected downgrade in internal credit scoring of loan — Significant surge in economic or market volatility that may have a negative impact on borrower — Other
Automatic factors	— Exposures identified as forborne that should not be classified as non-performing — Exposures included in a special sustainable debt agreement — Exposures of borrowers subject to an insolvency order that should be reclassified from non-performing

SOURCE: Banco de España.

— Circular 5/2012 referred to the European Banking Federation as the administrator of the EURIBOR, although this body had changed its name to the European Money Markets Institute (EMMI).

— Also, it did not consider the EURIBOR as a "critical index", having been declared as such by Commission Implementing Regulation (EU) 2016/1368 of 11 August 2016, which established a list of critical benchmark indices used in the financial markets.

Consequently, Annex 8 of Circular 5/2012 was updated through Circular 5/2017 as regards the definitions of EURIBOR and MIBOR, since the MIBOR is calculated with reference to the EURIBOR, to adapt them to the changes mentioned above.

7.1.6 BANCO DE ESPAÑA CIRCULAR 1/2018

A Deposit Guarantee Scheme for Credit Institutions (DGSCI) was set up under Royal Decree-Law 16/2011 of 14 October 2011, which establishes that in order to comply with its functions, the DGSCI must be funded by, among other sources, contributions by member institutions, and charges the Banco de España with implementing the methods necessary for such contributions to be proportional to institutions' risk profiles. This was implemented in Circular 5/2016 of the Banco de España. Subsequently, under Royal Decree-Law 11/2017 of 23 June 2017 on urgent measures for financial matters, belonging

The entry into force of IFRS 9 and Circular 4/2017 will entail an increase in the provisions of institutions as a result of the shift from an incurred loss to an expected loss model. This increase will be recorded on 1 January 2018 against reserves, thereby reducing institutions' own funds. In view of this change in the calculation of provisions, in March 2017 the Basel Committee on Banking Supervision published a document which addressed the possibility for institutions starting to apply an expected loss model of taking advantage of a transitional arrangement to smooth the impact on capital ratios of this initial decline in reserves and of the subsequent provisioning. There are two reasons for proposing such an arrangement, namely: (i) the possibility that the impact could be significantly more material than expected; and (ii) the fact that the Committee has not yet clarified how expected loss accounting and the prudential regime will interact in the long term.

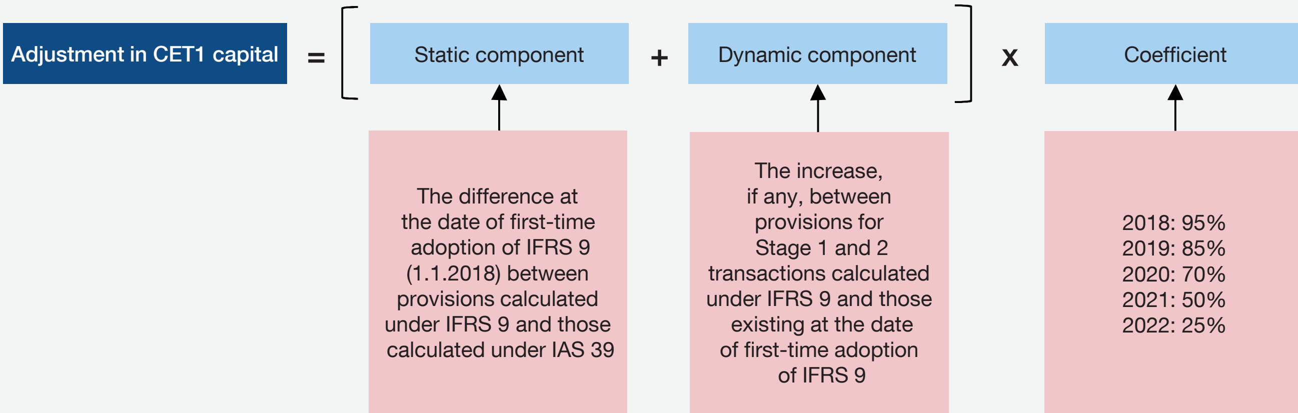
The European Union has decided to follow the recommendation of the Basel Committee in light of the entry into force of IFRS 9, amending the CRR (through Regulation 2017/2395 of the European Parliament and of the Council of 12 December 2017) to introduce a transitional arrangement which permits partially deferring the impact on capital during the first five years since the entry into force of the expected loss model. The functioning of this transitional arrangement is as follows:

— First, the amount susceptible to deferral is calculated, i.e. the impact on regulatory capital of applying the new regulations (IFRS 9 or Circular 4/2017). This amount has a static component, the impact of the first day of application of the IFRS 9, and a dynamic component. The latter is calculated at each reporting reference date as the increase in provisions for performing exposures (stages 1 and 2 of IFRS 9) from the date IFRS 9 is first applied, and is recorded against the income statement.

— Second, the amount susceptible to deferral is multiplied by a declining coefficient over the five-year period during which the transitional arrangement is in force.

It should be noted that this deferral regime is also applied to all the relevant items for solvency ratio calculation purposes affected by the increase in provisions, for instance, any tax assets which may have arisen. Additionally, this regime should be taken into account in calculating the decline in exposures under the standardised approach arising from provisioning and the eventual contribution to tier 2 capital of excess provisions at banks following the IRB approach.

This transitional arrangement is optional for institutions, as is the application of the dynamic component for those opting to avail themselves of it.



SOURCE: Banco de España.

to an Institutional Protection Scheme (IPS) became a new factor that the Banco de España will take into account in such calculation methods, since the creation of an IPS strengthens the solvency and liquidity of institutions belonging to it.

In order to comply with this last provision, the Banco de España approved Circular 1/2018 of 31 January 2018 amending: (i) Circular 5/2016 of 27 May 2016 on the calculation method to be used to ensure that the contributions of institutions belonging to the Deposit Guarantee Scheme for Credit Institutions are proportionate to their risk profile; and (ii) Circular 8/2015 of 18 December 2015 to institutions and branches belonging to the Deposit

Directorate General Banking Supervision working meeting.

Guarantee Scheme for Credit Institutions, on information for determining the basis of calculation of contributions to the Deposit Guarantee Scheme for Credit Institutions. The changes proposed will be used for the first time to calculate the contributions of DGSCI member institutions to be determined in 2018.

The amendment of Circular 5/2016 adds the new factor to the calculation method for the contributions. As a result, said calculation method is adjusted in such a way that IPS membership of a credit institution affiliated to the DGSCI is reflected in the amount of the contributions based on their risk profile.

The amendment of Circular 8/2015 seeks to obtain information about the ex-ante IPS fund. To this end, credit institutions belonging to an IPS as envisaged in Article 113.7 of the CRR should send certain information to the Banco de España on a quarterly basis.

7.2 Other significant regulations

7.2.1 REGULATION (EU) 2017/1538 OF THE ECB ON REPORTING OF SUPERVISORY FINANCIAL INFORMATION

Regulation (EU) 2017/1538 of the European Central Bank of 25 August 2017, amending Regulation (EU) 2015/534 on reporting of supervisory financial information (ECB/2017/25) to less significant supervised entities which are subject to national accounting frameworks (ECB/2017/26), was published in the Official Journal of the European Union on 19 September 2017. This amendment is the result of the incorporation of IFRS 9 into Union law in Commission Implementing Regulation (EU) 680/2014 of 16 April 2014 laying down implementing technical standards with regard to supervisory reporting of institutions according to the CRR. For this purpose, certain amendments are made to Regulation (EU) 2015/534 to harmonise it with the new accounting framework, aside from other minor technical and terminological amendments.

These amendments shall apply from 1 January 2018 to significant supervised entities and less significant supervised entities which are subject to national accounting frameworks based on Council Directive 86/635/EEC of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions. Notwithstanding the above, the ECB may decide, at the request of an NCA, to apply this Regulation to less significant supervised entities which are subject to national accounting frameworks based on Directive 86/635/EEC and established in the Member State of that NCA from 1 January 2019 if such national accounting framework is not compatible with IFRS.

8 INTERNAL AUDIT REPORT 2017
REPORT PROVIDED FOR IN THE CONSOLIDATED TEXT OF THE SECURITIES MARKET LAW APPROVED BY ROYAL LEGISLATIVE DECREE 4/2015 OF 23 OCTOBER 2015

19th century mantel clock. Banco de España collection.

1. Introduction

The tenth additional provision of the Consolidated Text of the Securities Market Law (LMV, by its Spanish initials) approved by Royal Legislative Decree 4/2015 of 23 October 2015 establishes that the Banco de España shall prepare an annual report on its supervisory function, describing the supervisory actions undertaken and procedures followed, permitting information to be gained on the effectiveness and efficiency of these procedures and actions. It also provides that such annual report shall include a report by the internal control body on the conformity of the decisions taken by the governing bodies of the Banco de España with the procedural regulations applicable in each case. This annual report shall be approved by the Governing Council of the Banco de España and sent to the Spanish Parliament and Government.

The Banco de España's 2018 Annual Internal Audit Plan, approved by the Governor on 20 December 2017 and reported to the Executive Commission on 12 January, includes the drafting of the report provided for 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 which, as indicated above, 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) The conformity of those decisions with the procedural regulations applicable.

As regards the reporting period, the report refers to the decisions taken by the Executive Commission in 2017, and the decisions adopted by delegation and notified to the Executive Commission in 2017.

In respect of the subject matter, the report relates to 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, Regulation and Resolution, and the General Secretariat.

Regarding 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 in the Internal Rules of the Banco de España were taken into account, together with those established by the Single Supervisory Mechanism (SSM) regulations (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). In addition, through various resolutions, the Executive Commission has established the procedural rules for proposals on matters within the competence of the aforementioned Directorates General.[1]

1 – Directorate General Banking Supervision: Executive Commission resolution of 6 May 2016.
– Directorate General Financial Stability, Regulation and Resolution: Executive Commission resolution of 20 May 2016.
– General Secretariat: Executive Commission resolution of 20 February 2015 and Executive Commission resolution of 18 April 2017 which replaced it.

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

Likewise, by means of a Resolution of 22 May 2015, the Executive Commission approved the regime governing the delegation of powers, published in the Official State Gazette of 2 June 2015,[2] and which provides for the delegation of signature and call-back of delegated powers.

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

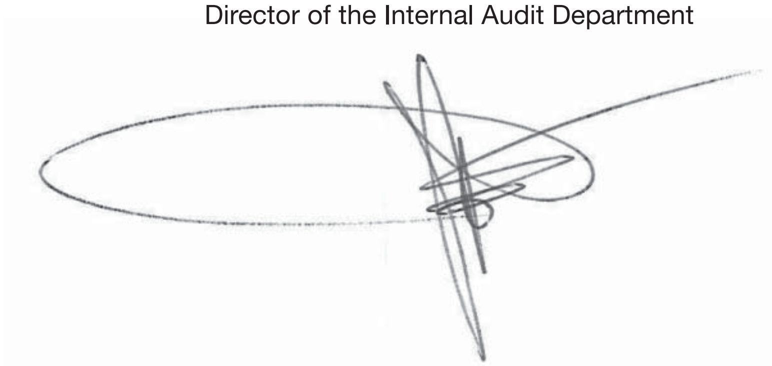
The work was performed in accordance with the Internal Audit Manual, which includes the International Standards for the Professional Practice of Internal Auditing, approved by the Institute of Internal Auditors, including those relating to the Code of Ethics.

3. Opinion

In our opinion, the decisions taken by the governing bodies of the Banco de España in 2017 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 conform, in all material aspects, with the procedural rules applicable in each case.

Madrid, 28 February 2018

Director of the Internal Audit Department



Juan González Gallego

GOVERNOR OF THE BANCO DE ESPAÑA

DEPUTY GOVERNOR OF THE BANCO DE ESPAÑA

2 Modified by the Resolution of the Executive Commission of 11 January 2017 (published in the Official State Gazette on 18 January 2017).

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