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II. CLASSIFICATION OF TRANSACTIONS ON THE BASIS OF CREDIT RISK

ANNEX IX CREDIT RISK ANALYSIS, ALLOWANCES AND PROVISIONS

INTRODUCTION

1. The annex has a dual goal:

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

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

2. Transactions or exposures shall be understood here to mean debt instruments (loans, advances other than loans, and debt securities) and off-balance sheet exposures entailing credit risk as defined in rule sixty-five (loan commitments, financial guarantees, and other commitments given). For the purpose of estimating allowances and provisions in accordance with this annex, for debt instruments, the amount of the exposure shall be the gross carrying amount, and for off-balance sheet exposures, it shall be the estimate of the amount of the expected disbursement.

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

4. The alternative solutions for estimating the credit risk allowances or provisions and the benchmarks for valuing foreclosed assets or those received in payment of debt envisaged herein shall be applied to transactions classified as business in Spain at Spanish credit institutions, i.e. transactions recognised in the accounting records of Spanish entities, with the exception of those recorded in the books of foreign branches.

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

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

7. Without prejudice to the provisions of this annex, Royal Decree-Law 2/2012 of 3 February 2012 on balance sheet clean-up of the financial sector shall be applicable to financing and foreclosed assets or those received in payment of

debt relating to the Spanish real estate sector, including both those existing at 31 December 2011 and those arising from refinancing thereof at a later date.

I. GENERAL CREDIT-RISK-MANAGEMENT FRAMEWORK

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

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

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

   Among other points, the following should be specified:

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

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

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

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

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

A) GRANTING OF TRANSACTIONS

11. Policies for the granting of transactions must cover matters such as:

   a) The market, product, customer type, currency and maturities with which transactions are to be conducted, the requirements borrowers and economic groups must meet, and any guarantees or collateral for transactions.

   b) The overall risk limits and their annual rates of growth, and the circumstances in which, exceptionally, transactions may be permitted outside these limits and approved general conditions.

   c) The pricing policy, which should at least aim to cover the funding, overhead and credit risk costs of each class of transaction.

      The entity shall calculate the credit risk cost for the various homogeneous risk groups in which transactions are categorised in a manner that is

consistent with its historical experience of recognition of allowances and provisions, total write-offs, amounts partially written off in exposures which remain on the balance sheet and recoveries, as well as with the expected progress of the economy. For the purposes of this calculation, income or savings in expenses from other cross transactions with the borrower shall not be included.

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

The granting of a transaction at an interest rate below its cost is evidence that the transaction price differs from fair value. In such cases, the transaction granted must be recognised initially at fair value, such that the difference between the fair value and the amount drawn down will be directly recognised as an expense on the statement of profit or loss, either immediately or on a deferred basis, as an adjustment to fair value, as applicable under paragraph 8 of rule twenty-two.

d) The financing policy for related parties or entities, which must envisage terms and conditions similar to those granted to other entities of similar credit risk with which there is no link.

e) The financing policy for property developments, which must include an upper limit on the percentage of financing of the cost of acquiring ownership of the land and its subsequent development, including urban development and building. Financing of the cost of acquiring land for subsequent urban development shall not exceed 50% of the acquisition cost or the appraised value, whichever is lower, determined as established in Section I(D) "Collateral/guarantees and appraisals", except under circumstances envisaged in the entity's policies and duly documented.

f) The criteria for granting transactions in foreign currency, which shall primarily address the borrowers' capacity to withstand adverse shocks in interest rates and exchange rates, bearing in mind the repayment structure of the transaction. The criteria for the granting of transactions in foreign currency shall be stricter as regards the required ratio between the debt servicing and the borrower's income, and the amount of the transaction and the value of the collateral, where applicable.

12. Credit standards shall be attuned to borrowers' ability to meet all their financial obligations as and when required. Ability to pay shall be assessed based on the funds or net cash-flows from their day-to-day business or source of revenue, without relying on guarantors, sureties or collateral. When assessing the granting of the transaction the latter must always be considered a secondary and exceptional means of recovery to be used when the first has failed.

In this regard, granting procedures must require that the sources generating each borrower's ordinary income, which will serve as the primary and basic means of recovering the amounts lent, be identified and quantified in each transaction. For these purposes, such procedures shall include minimum documentation requirements for evidencing the recurring nature of the sources of funds.

13. For the case of lending to corporations and sole proprietorships in general, the main source of repayment should be recurring net cash flow generation, estimated from up-to-date and, where applicable, audited financial statements.

For individuals, the primary source of recovery shall be the income from their day-to-day work and other recurring sources of net cash flow generation.

14. The policy for granting transactions with special characteristics, such as very long terms, total or partial principal or interest grace periods, or increasing repayments, shall include stricter criteria than apply to transactions not subject to such circumstances. Transactions with individuals for the purchase of housing shall be subject to special analysis and stricter credit standards when more than 80% of the purchase price of the dwelling is financed.

15. Based on an analysis of the borrower's payment capacity, the conditions for granting transactions should result in a realistic payment plan with instalments whose periodicity is related to the periodicity of the borrower's primary sources of net cash flow generation. The useful life of the collateral shall also be taken into account.

    In the case of transactions with individuals, credit standards shall observe a maximum ratio between total debt servicing, including all recurring payments to meet the borrower's financial obligations to the credit institution and other entities, and the borrower's recurring disposable income. The repayment schedules offered must be attuned to these criteria. In no case may they cause borrowers' disposable income after all debt service to be reduced to such an extent as to manifestly limit their ability to cover their household expenses.

16. The policies, procedures and methods shall require that the entity adequately document all transactions and that it have up-to-date documentation on each borrower's source of ordinary fund generation, updated with the frequency best matched to the borrower's risk profile. In this regard, the entity shall have criteria defining the minimum updated documentation required for the various transaction types, and procedures and methods to avoid the use of out-of-date or unreliable financial information about the borrower. The available documentation shall therefore include both information on the borrower or group to which the borrower belongs for management purposes, and the conditions of the transaction itself. This documentation must be up-to-date both at the origination date and at the other significant times in the life of the transaction, including, among others, when the credit conditions are modified and when doubtful exposures are reclassified to standard. The documentation in the credit file of each transaction shall include at least:

    a) The agreements signed by the borrowers, duly verified to ensure they have no legal defects that may hinder payment or recovery of the transaction amount.

    b) Economic and financial information enabling borrowers' and guarantors' solvency and ability to pay to be analysed. In the case of transactions with companies, this information shall include their up-to-date (and, where applicable, audited) financial statements; and if the borrower is part of an economic group that prepares consolidated financial statements, these consolidated financial statements must also be included. In the case of transactions with individuals, this information shall include documents on day-to-day sources of revenue such as payslips and tax returns.

    c) The information necessary in order to determine the value of the collateral/guarantees received in accordance with Section I(D) "Collateral/guarantees and appraisals".

    d) The analysis and assessments of the transaction carried out by the entity or third parties.

17. Notwithstanding the above, the obligation that the documentation needed to determine the value of collateral/guarantees be kept up-to-date in accordance with paragraph 16(c) will not be necessary in the case of finance lease transactions or transactions secured by effective guarantees or collateral of less than €150,000, provided that they are classified as standard (including those

identified as standard under special monitoring) and the estimated value of the leased assets or of the effective guarantees or collateral exceeds the amount of the exposure.

B) MODIFICATION OF CONDITIONS

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

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

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

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

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

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

19. Unless there is evidence to the contrary, transactions shall be deemed to be a restructuring or refinancing in the following circumstances:

    a) When some or all of the payments of the modified transaction have been due for more than 30 days (without being classified as doubtful) at least once in the three months preceding its modification, or would be due for more than 30 days without said modification.

    b) When, simultaneously or nearly simultaneously with the granting of additional financing by the entity, the borrower has made payments of

interest on another transaction with it, on which some or all of the payments have been due for more than 30 days at least once in the three months prior to the refinancing;

c) When the entity approves the use of implicit restructuring or refinancing clauses in relation to borrowers with outstanding amounts 30 days past due or more than 30 days past due if such clauses have not been exercised.

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

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

Policies for the modification of transactions shall specify the modification criteria, including aspects such as the minimum experience with the borrower, the existence of a sufficiently extensive borrower compliance record, and the existence of new collateral/guarantees. They should also set a minimum validity period and a time limit on the frequency of changes in transaction conditions.

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

22. Moreover, rollover or renegotiation policies shall focus on the collection of recoverable amounts, which implies the need for immediate derecognition of amounts that are deemed irrecoverable, where applicable. The remaining amount of transactions shall, in accordance with the stipulations for transactions with partial write-offs, be classified in full in the appropriate category on the basis of the credit risk attributable to the borrower or to the transaction.

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

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

23. Refinancing and restructuring policies shall ensure that the entity has an internal reporting system with mechanisms allowing proper identification and monitoring of refinancing, refinanced and restructured transactions, and their appropriate accounting classification according to their credit risk. The decisions taken must be regularly reviewed to check proper compliance with refinancing and restructuring policies.

Transactions shall cease to be identified as refinancing, refinanced or restructured if the requirements of paragraph 90 for their reclassification from standard under special monitoring to standard are met. However, in accordance with the principle of traceability set out in paragraph 44, an entity's internal information system must retain such information on the change made as is

necessary to ensure at all times the proper monitoring, evaluation and control of the transaction.

24. Credit institutions shall, in all cases, adhere to the criteria set out in Section II for the accounting classification of transactions according to their credit risk.

C) EVALUATION, MONITORING AND CONTROL OF CREDIT RISK

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

25. Credit institutions shall have policies for the assessment, monitoring and control of credit risk, that require:

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

    b) Databases of transactions enabling proper assessment, monitoring and control of credit risk, and the preparation of reports and other timely and comprehensive documentation both for management and to inform third parties or respond to requests from the supervisor.

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

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

26. These policies will be implemented in methodologies, procedures and criteria that specify, among other things, the characteristics these databases are to have. In any event, credit institutions must have databases complying with the following requirements:

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

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

    c) Consistency. They should be based on common sources of information and uniform definitions of the concepts used for credit-risk management.

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

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

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

28. Furthermore, the methods, procedures and criteria in which the policies are implemented shall specify how transactions are to be classified according to their credit risk, distinguishing between standard exposures, doubtful exposures

and write-offs, and how individual and collective estimates of credit-risk losses are quantified and covered.

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

29. The methods, procedures and criteria for the accounting classification of transactions shall be integrated in the credit-risk management system. They shall take past experience into account together with all relevant risk factors, including those listed in paragraph 2 of rule twenty-nine.

30. The credit risk allowances and provisions envisaged in the entity's policies may be generic (i.e. associated with a group of transactions with similar risk characteristics) or specific (i.e. to cover a particular transaction). While generic allowances and provisions shall always be estimated collectively, based on the losses on transactions with similar risk characteristics, specific allowances and provisions may either be estimated individually, based on the losses on the transaction in question, or they may be estimated collectively.

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

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

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

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

    c) Documentation and traceability.

    These principles are set out in more detail in paragraphs 32 to 44 below.

2.1. Governance and integration in management

32. The board of directors shall:

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

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

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

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

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

        v) Processes for the internal verification of estimates.

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

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

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

34. The entity's various internal control functions shall review the methods and procedures for estimating allowances and provisions in the light of the principles set out in paragraph 31, seeking at all times to ensure they are observed and periodically reporting on such observance to the board of directors.

35. The review mentioned in paragraph 34 above must cover at least the information systems used, analysing the suitability of the databases for the allowance and provision estimation principles defined, and their integration in risk management, as regards aspects such as the consistency of the concepts used for internal purposes and those defined herein.

2.2. Simplicity and effectiveness

36. The methods and processes for monitoring and updating estimates of allowances and provisions must ensure at all times that the results obtained are attuned to the reality of the transactions, the prevailing economic climate, and the entity's policies.

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

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

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

40. The entity shall establish and document the periodic procedures for checking the reliability and consistency of its transaction classifications and its estimates of allowances and provisions over the course of the various stages of the credit-risk management cycle. The periodic check of its allowance and provision estimates shall be by means of backtesting whereby it assesses their accuracy by comparing them a posteriori with the actual losses effectively observed on transactions.

41. As an additional support, the entity shall periodically undertake:

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

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

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

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

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

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

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

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

2.3. Documentation and traceability

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

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

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

3. Requirements for individualised estimates of allowances and provisions

45. Credit institutions must develop methodologies for the estimation of all specific allowances and provisions subject to individual estimation. These individual estimation methods must comply with the general principles for estimating allowances and provisions set out in paragraphs 31 to 44.

    The following must be estimated individually:

    a) Allowances and provisions for transactions that are doubtful as a result of arrears and that the entity considers to be significant.

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

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

       i €3 million, or

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

       Nevertheless, credit institutions may establish thresholds different from those in the preceding subparagraph when necessary for individualised estimates to comply with the general principles for estimating allowances and provisions set out in paragraphs 31 to 44.

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

    b) Allowances and provisions for transactions considered doubtful for reasons other than arrears. As an exception, allowances and provisions for transactions other than those of negligible risk that are classified as doubtful for reasons other than arrears solely on the basis of automatic classification factors, such as the transactions listed in paragraph 54(c) below, shall be subject to collective estimation.

    c) Allowances and provisions for transactions identified as being of negligible risk as described in paragraph 83, classified as doubtful, whether on account of arrears or for other reasons.

    d) Allowances and provisions for doubtful transactions not belonging to a homogeneous risk group, and, therefore, for which the entity cannot develop internal methods for collective estimation of the allowances and provisions for these transactions.

46. Credit institutions may extend individual estimation of specific allowances and provisions to transactions with effective personal guarantees by guarantors whose risk is negligible (full or partial guarantees), and to transactions with effective personal guarantees by guarantors with significant transactions (full guarantees) as described in the preceding paragraph.

47. The allowances and provisions shall be equal to the difference between the gross carrying amount of the transaction and the present value of the estimated cash flows expected to be collected, discounted using the original effective interest rate of the transaction. For this purpose, regard shall be had to the effective

guarantees received in accordance with Sub-section I (D) "Collateral/guarantees and appraisals".

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

48. Only when the entity has reliable up-to-date information on the solvency and ability to pay of borrowers or guarantors may it use their recurring cash flows in the individual estimation of specific allowances and provisions.

When it does not have such information, the entity must consider that the estimation of contractual flows receivable from borrowers or guarantors is subject to high uncertainty and the individual estimation of specific allowances and provisions must be carried out as provided in paragraph 49.

In particular, the entity must consider that the estimation of contractual flows receivable from borrowers or guarantors is subject to high uncertainty in the case of transactions with amounts more than 18 months past-due.

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

The recoverable amount of effective collateral shall be estimated by applying to its reference value, determined as specified in paragraphs 68 to 81, the adjustments needed to capture adequately the uncertainty of the estimate and consequent possible falls in value up to the time of foreclosure and sale, plus foreclosure costs, maintenance costs and costs to sell.

50. In compliance with the principle of consistency, described in paragraph 39, the specific allowances and provisions estimated on an individualised basis for a doubtful exposure must be greater than the generic allowance and provision that would apply to the transaction if it were classified as a standard exposure subject to special monitoring.

51. In compliance with the principle of documentation and traceability, described in paragraphs 43 and 44, entities must include in the credit file of transactions the documentation needed so that a third party can replicate the calculation of individual estimates of allowances and provisions made over time. This documentation must include, inter alia, information on the approach used to estimate the cash flows it is expected to collect, their amount, maturity periods and the effective interest rate used for cash-flow discounting.

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

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

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

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

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

4. Requirements for collective estimation of allowances and provisions

4.1. Common requirements for collective estimation of allowances and provisions

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

    a) Those classified as standard exposures.

    b) Those classified as doubtful owing to arrears (other than those of negligible risk) that are not considered significant, including those classified as doubtful due to arrears because of an accumulation of past-due amounts on other transactions with the same borrower.

    c) Transactions classified as doubtful for reasons other than arrears (other than those of negligible risk), solely on the basis of automatic classification factors, such as:

        i) Transactions that cease to have amounts more than 90 days past due but are not reclassified as standard exposures because the borrower has amounts more than 90 days past due in other transactions, in accordance with paragraphs 96 and 101.

        ii) Refinancing, refinanced or restructured transactions that do not have amounts more than 90 days past due but are not reclassified as standard exposures under special monitoring because the other requirements for this reclassification have not been met, in accordance with paragraph 104.

        iii) Refinancing, refinanced or restructured transactions in the probation period reclassified as doubtful because they have been subject to a second or subsequent refinancing or restructuring, or because they have amounts more than 30 days past due, in accordance with paragraph 92.

55. Credit institutions which have not developed internal methods for complying with the requirements of paragraphs 56 to 63 below shall make their collective estimations of allowances and provisions according to the alternative solutions given in Section III "Allowances and provisions for credit risk attributable to insolvency".

    The Banco de España shall regularly update these alternative solutions to reflect changes in the data for the sector.

4.2. Internal methods for collective estimation of allowances and provisions

56. Internal methods must comply with the general principles set out in paragraphs 31 to 44, which are common to all individualised and collective estimations, and with all the specific requirements for collective estimates set out below:

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

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

c) Internal methods must be consistent with one another and with the classification of transactions according to their credit risk. Thus, the specific allowances and provisions estimated collectively for a doubtful exposure will, in all cases, be higher than the generic allowances and provisions that would apply to the transaction if it were classified as a standard exposure under special monitoring. The generic allowance or provision estimated collectively for a standard exposure identified as requiring special monitoring should be higher than the generic allowance or provision that would be applicable to the transaction if it were not subject to special monitoring, in accordance with the principle of consistency set out in paragraph 39.

d) Estimates must be based on each entity's historical experience of observed losses, which, if necessary, will be adjusted to take the prevailing economic conditions and other current circumstances known at the time of the estimate into account. Historical experience of losses shall be adjusted, based on observable data, to reflect the effect of current conditions that did not affect the historical reference period and to eliminate the effect of past conditions no longer prevailing, as well as to incorporate possible differences in the composition and quality of the entity's current portfolio with respect to the historical reference period.

e) For transactions classified as standard, an estimate of incurred but not reported losses must be made taking the losses associated with new doubtful exposures over a 12-month horizon as the reference, conditional upon the point in the economic cycle and the entity's current operations. Credit institutions may consider shorter periods for certain homogeneous risk groups only when they have evidence that their reclassification procedures ensure that loss events are identified sooner.

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

both estimated future recoveries and possible increments in the drawn-down principal and expenses associated with the process of recovering each transaction are to be considered.

g) Credit institutions shall have methods enabling them to analyse the effectiveness of the collateral/guarantees and estimate the discounts necessary to estimate the recoverable amount for the purposes of calculating allowances and provisions. The recoverable amount of effective collateral shall be estimated from the applicable reference value, as specified in paragraphs 68 to 81, subtracting the adjustments needed to reflect adequately the potential fall in value up to the time of foreclosure and sale, plus foreclosure costs, maintenance costs and costs to sell, in accordance with paragraph 115. When estimating the recoverable amount of the collateral, the entity's ability to realise the collateral, once foreclosed, must be taken into account.

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

   i) Both systems must be based, on the one hand, on estimated inflows into exposures doubtful due to arrears (based on estimates of the probability of default) and, on the other, on estimates of recovery flows in the event of classification as doubtful due to arrears (by considering possible outcomes of recovery processes and estimates of the losses produced in each of them).

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

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

57. Credit institutions using internal methods for collective estimation of allowances and provisions shall have methods enabling them to estimate the fair value and costs to sell of assets foreclosed or received in payment of debt in accordance with paragraphs 130 and 137 below.

58. Credit institutions that intend to use internal methods for collective estimation of allowances and provisions must carry out a prior validation to demonstrate that these comply with the principles and requirements set out in paragraphs 56 and 57. For this purpose, before starting to use these internal methods in the calculation of allowances and provisions, for a period of at least six months, credit institutions shall:

a) Compare the allowances and provisions obtained with the alternative solutions in Section III "Allowances and provisions for credit risk attributable to insolvency" with those obtained by applying their internal methods and with those in the comparative information published by the Banco de España, as indicated in paragraph 64. The entity must analyse the possible reasons for any significant deviations resulting from this comparison.

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

59. The entity shall notify the Banco de España of the start of the comparison and backtesting period described in paragraph 58 above, and inform it of the causes of any significant deviation observed in the benchmarking exercises and of the results of backtesting. The entity's board of directors shall approve the procedures necessary to decide and notify the Banco de España of the start of the backtesting period described above and to inform it of the results of the benchmarking exercises and of backtesting.

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

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

62. Entities which have developed internal methods complying with paragraph 56 shall apply them to all transactions subject to collective estimation of allowances and provisions. Notwithstanding this, these entities may continue to use the alternative solutions set out in Section III "Allowances and provisions for credit risk attributable to insolvency" for:

    a) Collective estimates of allowances and provisions for exposures classified as standard (including those identified as requiring special monitoring) relating to credit risk segments which do not have sufficient transactions to be considered a homogeneous risk group and, therefore, for which the entity cannot develop internal methods.

    b) Collective estimates of allowances and provisions for exposures relating to homogeneous risk groups in which, in application of the principle of simplicity stated in paragraph 38, the increase in complexity and costs derived from developing and using internal methods substantially outweighs the improvements which would be obtained in the estimates higher utilising.

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

63. The entity must modify its internal methods for collective estimates if the results of the periodic backtesting, performed as established in paragraph 40 recurrently reveal significant differences between the estimated losses and the actual losses experienced, or if there are any significant non-compliances with the principles and requirements in this section for the estimation of allowances and provisions.

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

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

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

5. The Banco de España's benchmarking exercises

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

D) COLLATERAL/GUARANTEES AND APPRAISALS

1. Definition and types of effective collateral/guarantees

65. For the purposes of this annex, collateral and personal guarantees an entity is able to show are valid as a means of mitigating credit risk, and which are valued in accordance with the policies and procedures laid down in paragraphs 68 to 81, shall be considered effective collateral/guarantees.

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

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

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

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

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

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

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

i) Completed buildings and parts thereof, distinguishing between:
- Housing;
- Offices and commercial premises and multi-purpose industrial buildings;
- Other buildings, such as non-multi-purpose industrial buildings and hotels.

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

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

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

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

d) Personal guarantees and the inclusion of new borrowers covering the total amount of the transaction such that direct and joint liability to the entity falls on persons or credit institutions whose solvency is sufficiently verified to ensure the reimbursement of the transaction under the established terms. In addition, partial personal guarantees, i.e. those covering only part of the amount of the transaction, shall be considered to be effective when they are provided by guarantors identified as being of negligible risk, in accordance with paragraph 116. Personal guarantees, such as guarantees, credit or suretyship insurance, are defined in paragraph 15(c) of rule 64.

Finance leases shall be treated in the same way as mortgage collateral, and reverse repo loans shall be treated in the same way as collateral in the form of pledged financial instruments for the purposes of estimating allowances or provisions in accordance with this annex.

2. Valuation of collateral

2.1. General collateral valuation policies and procedures

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

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

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

c) the criteria for selecting appraisers.

69. The entity shall have databases with all the relevant information on properties and other collateral for its transactions and on the links between collateral and specific transactions. These databases must comply with the requirements of paragraph 26 above in order to be able to adequately support an analysis of the effectiveness of the collateral.

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

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

72. At the time of granting, credit institutions shall determine the reference value of the collateral received, and subsequently update this value at the minimum frequencies set, applying the procedures established by the entity. These reference valuations of collateral shall serve as the starting point for estimating its recoverable amount, as provided in paragraphs 49 and 150. In any event, credit institutions must observe the following criteria, depending on the type of collateral:

a) For the appraisal of real-estate collateral, the criteria in paragraphs 74 to 81 below shall be observed, depending upon the type of property and the accounting classification of the transactions according to their credit risk.

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

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

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

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

2.2.1. General real-estate collateral appraisal procedures

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

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

        i) The reference value shall be the mortgage value.

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

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

    b) Automated appraisal methods developed by independent appraisal companies or approved appraisal services registered in the Banco de España's Official Register of Appraisal Companies that comply with the following requirements:

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

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

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

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

2.2.2. Real-estate collateral in transactions classified as standard exposure

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

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

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

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

78. Appraisals of real estate collateral in the form of finished buildings and parts thereof may be updated by means of individual full appraisals or automated appraisal methods in those cases in which the requirements of paragraph 74(b) for the use of such mass models are met.

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

80. In the case of standard exposures under special monitoring, the verification of the presence of signs of significant declines in collateral reference values and the updating of these valuations shall be carried out in accordance with the foregoing paragraphs for other transactions classified as standard exposures.

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

    a) When the total aggregate of transactions backed by collateral in the form of completed buildings or parts thereof identified as being under special monitoring has a carrying amount of over €300 million or 10% of the entity's own funds in any of the risk segments in Section III "Allowances and provisions for credit risk attributable to insolvency". This update may be carried out by means of full individual appraisal or automated appraisal methods in accordance with paragraph 74.

    b) For transactions secured by collateral in the form of completed buildings or parts thereof with a gross carrying amount of over €1 million and a ratio of the transaction amount to the last available appraised value of the collateral

of over 70%. This update must be performed as a full individual appraisal. Exceptionally, the update may be performed using automated valuation methods provided that credit institutions justify the suitability of the use of such mass models;

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

2.2.3. Real-estate collateral in transactions classified as doubtful exposure

81. The collateral reference must be updated at the time the transaction is classified as doubtful exposure and at least annually while it continues to be classified as such.

As regards the admissible appraisal procedures for determining this valuation:

a) If the gross amount of the transaction is less than or equal to €250,000, automated appraisal updating methods may be used provided the collateral may validly be valued by these mass models and the suitability of their use is documented by the entities. Notwithstanding this, updating must be performed by means of a full individual appraisal if the transaction has been classified for more than three years as doubtful. Once this age in the category has been reached, a combination of automated appraisal methods and full individual appraisals may be used, such that the frequency of the latter is at least every three years.

b) A full individual valuation is required in the case of property other than those included in (a) above.

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

82. Debt instruments not included in financial assets held for trading and off-balance-sheet exposures shall be classified in terms of credit risk attributable to insolvency into one of the categories defined in the following sections.

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

This analysis shall include both the credit risk attributable to the borrower and any country risk to which transactions may be exposed. If there are reasons for rating a transaction in terms of credit risk due to both risk attributable to the borrower and country risk, that transaction shall be classified in the category of the risk attributable to the borrower, unless a less favourable country-risk category applies, without prejudice to impairment losses for risk attributable to the borrower being calculated by the procedure for country risk when this implies stricter criteria.

83. Irrespective of the category in which they are classified, the entity must identify the transactions with negligible risk for the purposes of estimating allowances and provisions, which are as follows:

a) transactions with central banks;

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

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

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

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

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

g) transactions with non-financial corporations considered to belong to the public sector as referred to in rule sixty-six, paragraph 7.

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

i) advances other than loans.

A) STANDARD EXPOSURES

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

Standard exposures include transactions that warrant special monitoring as established in Sub-section II(B) "Standard exposures under special monitoring" below.

B) STANDARD EXPOSURES UNDER SPECIAL MONITORING

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

85. This category includes all transactions that, while not meeting the criteria for individual classification as doubtful or write-off, present weaknesses that may lead to the incurrence of losses exceeding those on other similar transactions classified as standard exposures.

86. When determining what transactions present weaknesses, the following signs relating to the circumstances of the borrower will first of all be taken into account:

a) High debt levels;

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

c) Narrowing of operating margins or in disposable recurring income.

87. Additionally, credit institutions shall analyse other signs of possible weakness relating to the borrower's circumstances or operations, including, at least:

a) A fall in the price of the main product;

b) Difficulties accessing markets or deteriorating financing conditions;

c) Significant increases in the debt-service ratio, defined as the ratio of debt to operating cash flows;

d) A slowdown in business or unfavourable trend in the borrower's operations, indicating potential weaknesses in its financial position, without yet having endangered its debt service;

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

f) Economic or market volatility that may have a negative impact on the borrower;

g) Unfavourable developments in the borrower's sector of economic activity;

h) The borrower's belonging to a group in difficulties, such as residents of a specific geographical area at sub-country level;

i) Pending legal action that may significantly affect the borrower's financial position;

j) Market trends, such as interest-rate increases or higher requirements for collateral/guarantees, affecting similar transactions causing them to deviate significantly from the conditions originally established for the transaction or group of transactions.

k) Transaction granted at below cost, in accordance with paragraph 11(c).

l) Amounts more than 30 days past due in the transaction.

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

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

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

c) That it is preceded by an analysis of the quality of the management of the corporation. If the difficulties affecting the corporation cannot reasonably be

attributed to factors outside its ordinary management, it shall be necessary that the agreement include changes in the corporation's managers.

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

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

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

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

Transactions included in a special debt-sustainability agreement that complies with the conditions described above are considered, for classification purposes, as rollover or renegotiated transactions in accordance with paragraphs 18(d) and 18(e).

89. This category shall also include exposures to borrowers declared subject to bankruptcy proceedings that should not be classified as doubtful exposures in accordance with the first subparagraph of paragraph 100. Also included in this category are exposures incurred after the approval of a creditors' agreement that should not be classified as doubtful exposures in accordance with the first subparagraph of paragraph 100.

The exposures to borrowers declared subject to bankruptcy proceedings that are not classified as doubtful shall remain classified as standard exposures under special monitoring so long as the borrower's status in bankruptcy proceedings remains unchanged.

2. Refinancing, refinanced or restructured transactions classified as standard exposures under special monitoring

90. Refinancing, refinanced or restructured transactions (transactions with forbearance measures) that are classified within the category of standard exposures — owing to their classification as doubtful not being applicable on the date of refinancing or restructuring, in accordance with paragraphs 102 and 103, or owing to their reclassification from the category of doubtful exposures, on fulfilling the provisions in paragraph 104 for their reclassification —shall continue to be identified as under special monitoring during a probation period until all the following requirements are met:

a) That, following an exhaustive review of the borrower's financial situation, it has been concluded that it is not foreseeable that the borrower will encounter financial difficulties and that, it is therefore highly probable that it will be able to comply with its obligations to the entity in the due time and form.

b) That a minimum of two years has elapsed since the later of the date of entry into the restructuring or refinancing transaction or the date of reclassification from the category of doubtful exposures.

c) That the borrower has paid the accrued instalments of principal and interest since the later of the date of entry into the restructuring or refinancing

transaction or the date of reclassification from the category of doubtful. Additionally, the borrower must have settled, by means of regular payments, an amount equal to all the amounts (principal and interest) that were past due or written down at the time of the restructuring or refinancing transaction. Therefore, the existence of contract terms that extend the repayment period, such as grace periods for the principal, will mean that the transaction remains identified as a standard exposure under special monitoring until the amounts described have been repaid by means of regular payments.

d) That the borrower does not have any other transactions with amounts more than 30 days past due at the end of the probation period.

Accordingly, if all the foregoing requirements are met, the transactions shall cease to be identified in the financial statements as refinancing, refinanced or restructured; without prejudice to the requirement that information on changes made in transactions must be duly held in the entity's databases, as provided in paragraph 23 in application of the principle of traceability, and reported to the Banco de España's central credit register.

91. The analysis of the recoverability in time and form of the exposure, as described in paragraph 90 above, shall be based on objective evidence, such as:

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

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

92. During the probation period described, a new refinancing or restructuring of refinancing, refinanced or restructured transactions or the existence of amounts more than 30 days past due shall entail the reclassification of these transactions on probation to the category of doubtful for reasons other than arrears.

C) DOUBTFUL EXPOSURES AS A RESULT OF BORROWER ARREARS

93. This includes the amount of debt instruments, whosoever the borrower and whatever the guarantee or collateral, any part of whose principal, interest or contractually agreed expenses is more than 90 days past due, unless such instruments should be classified as being written off. This category will also include guarantees given if the guaranteed party has fallen into in arrears in the guaranteed transaction.

This category shall include the amounts of all a borrower's transactions if the transactions with amounts more than 90 days past due exceed 20% of outstandings. For the sole purposes of determining the indicated percentage, the gross carrying amount of the transactions classified as doubtful due to arrears with past-due amounts shall form the numerator, and the gross carrying amount of all the debt instruments granted to the borrower shall form the denominator. If the percentage calculated thus exceeds 20%, both the debt instruments and the off-balance-sheet exposures entailing credit risk will be transferred to doubtful due to arrears.

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

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

In the case of transactions refinanced or restructured for the sole purpose of avoiding them being classified as or remaining in the category of doubtful due to arrears, the date for the calculation of their age shall be that of the oldest past-due amount that has been refinanced or restructured and remains outstanding, irrespective of the possibility that, as a result of the refinancing or restructuring, the refinanced transactions do not have past-due amounts. For these purposes, any amounts past due on the date of refinancing shall be considered past due, and the maturity date shall be the date on which they would have matured had the refinancing not taken place.

For the purposes of this annex, in order to carry out calculations of periods in terms of months, all months are deemed to have 30 days.

95. Doubtful transactions due to arrears in which simultaneously there are other circumstances for classifying them as doubtful shall be classed as doubtful due to arrears.

96. Unless reasons for classing them as doubtful exposures persist, transactions classified in this category may be reclassified as standard exposures if, as a result of the collection of a portion of the past-due amounts, the reasons for classifying them as doubtful assets in accordance with the foregoing paragraphs cease to exist, and the borrower does not have amounts more than 90 days past due in other transactions at the date of reclassification to the category of standard exposures.

D) DOUBTFUL EXPOSURES FOR REASONS OTHER THAN BORROWER ARREARS

1. General criteria for the classification of transactions as doubtful exposures for reasons other than arrears

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

98. This category will include, inter alia, transactions whose borrowers are in situations that represent a deterioration in their solvency. The following shall be considered to be signs of such deterioration:

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

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

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

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

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

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

This category shall also include all the transactions of any borrower with one or more balances classified as doubtful due to arrears that do not reach the

percentage indicated in the second sub-paragraph of paragraph 93 if, after individual analysis, it is concluded that there are reasonable doubts regarding full repayment (principal and interest).

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

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

b) Finance lease transactions in which the entity has decided to terminate the contract in order to repossess the asset;

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

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

e) Refinancing, refinanced or restructured transactions which in the probation period are refinanced or restructured or have amounts more than 30 days past due, in accordance with paragraph 92.

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

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

101. Unless other reasons persist for them to be classified as doubtful, transactions classified in this category may be reclassified as standard exposures if reasonable doubts regarding full repayment under the contractually agreed terms are dispelled and the borrower does not have amounts more than 90 days past due in other transactions at the date of reclassification to the category of standard exposures.

2. Refinancing, refinanced or restructured transactions classified as doubtful exposures for reasons other than arrears

102. On the date of the refinancing or restructuring transaction, the refinancing, refinanced or restructured transactions (transactions with forbearance measures) classified as standard exposures shall be analysed as at that date but prior to the refinancing or restructuring, to determine whether they should be reclassified from standard to doubtful. This analysis shall take into account the general criteria determining the classification of transactions as doubtful and the specific criteria set out below.

103. Unless there is evidence to the contrary, refinancing, refinanced or restructured transactions meeting any of the following criteria shall be reclassified as doubtful:

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

b) They include contract terms that extend the time for the regular repayment instalments on the transaction, such as grace periods of more than two years for the repayment of the principal;

c) They include amounts derecognised as being irrecoverable that exceed the allowances and provisions resulting from applying the percentages established for the corresponding risk segment in the alternative solutions in Section III "Allowances and provisions for credit risk attributable to insolvency", for standard exposures under special monitoring.

104. The refinancing or restructuring of a transaction that was previously classified as doubtful shall not lead to its reclassification in the category of standard exposures under special monitoring.

For this reclassification to standard exposures under special monitoring to take place, all the general criteria for classifying transactions in this category and the specific criteria set out below have to be met:

a) That a year has elapsed since the refinancing or restructuring;

b) That the borrower has paid the accrued principal and interest instalments, reducing the renegotiated principal, since the later of the date of entry into the restructuring or refinancing transaction or the date of reclassification of the transaction as doubtful. Consequently, the transaction may not present past-due amounts. Additionally, the borrower must have settled, by means of regular payments, an amount equivalent to all the amounts, including principal and interest, past due on the date of the restructuring or refinancing transaction, or which were derecognised as a result of it.

c) The borrower does not have any other transactions with amounts more than 90 days past due at the date the refinancing, refinanced or restructured transaction was reclassified to the category of standard exposures under special monitoring.

E) WRITE-OFF

105. This category shall include debt instruments, whether due or not, for which the entity, after analysing them individually, considers the possibility of recovery to be remote due to manifest and irreversible deterioration of the solvency of the transaction or borrower. Classification in this category entails the writing-off of the full gross carrying amount of the transaction and its total derecognition from assets.

106. The remaining amount of transactions with amounts derecognised (partial derecognition) because the entity's claims are extinguished by, for example, debt forgiveness and debt reductions (definitive loss), or because they are deemed irrecoverable without extinguishment of the entity's claims (partial write-off), shall be classified in full in the category corresponding to it on the basis of the credit risk attributable to the borrower or the transaction, which is normally doubtful exposures. Credit institutions must keep separate records of

the definitive losses due to extinguishment of claims in transactions which remain in balance sheet assets and of the amounts written off or deemed irrecoverable.

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

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

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

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

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

An up-to-date appraisal of the collateral will be required in order to be able to apply the caveat regarding effective collateral covering at least 10% of the risk exposure indicated in (a) and (b) above. Updating must be carried out at least as frequently as required by paragraphs 72 and 73 for the category in which the transaction is classified, which is normally doubtful exposures.

108. Debt instruments, as established in paragraph 7(f) of rule sixty-four, shall continue to be classified and reported as write-offs until the extinguishment of all the entity's rights (by becoming time-barred, through debt forgiveness, or for other reasons) or until they are recovered.

III. ALLOWANCES AND PROVISIONS FOR CREDIT RISK ATTRIBUTABLE TO INSOLVENCY

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

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

a) They shall calculate the amount of the allowance and provision needed for credit risk attributable to the borrower and also for country risk. If there are reasons for simultaneously recording allowances or provisions against a transaction for both types of risk, the most demanding impairment recognition criteria shall be applied.

b) The allowances to be recorded for transferred financial assets that remain on the balance sheet because they do not meet the requirements laid down

in rule twenty-three for their derecognition shall be those applicable to such assets, with a limit equal to the amount assumed by the entity as its maximum loss.

c) The total allowances and provisions existing at any time shall be the sum of specific allowances and provisions (specific allowances and provisions for doubtful exposures) and generic allowances and provisions (allowances and provisions for standard exposures) corresponding to the credit risk attributable to insolvency, plus the allowances and provisions for country risk, as established in Section IV "Credit risk attributable to country risk".

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

111. In finance lease transactions, instalments due and receivable shall, until the time of physical recovery of possession or use of the leased assets, follow the impairment treatment specified for the other transactions in this paragraph.

112. Effective personal guarantees received will allow the substitution of the guarantor for the direct borrower for the purposes of the calculation of allowances and provisions. In the case of doubtful exposures subject to collective estimation of the related allowances and provisions secured by effective personal guarantees provided by guarantors identified as being of negligible risk (full or partial guarantees) in accordance with paragraph 45, individual estimation of said allowances and provisions is permissible in view of said guarantees. In the case of doubtful exposures subject to collective estimation of the related allowances and provisions secured by effective personal guarantees other than those referred to above, and standard exposures (including those identified as requiring special monitoring) secured by effective personal guarantees (full or partial guarantees), collective estimation of said allowances and provisions is permissible, attributing the guaranteed amount to the guarantor for the purposes of calculating the allowance or provision for the transaction.

113. The basis of calculation for the specific and generic allowances and provisions will be the amount of the risk exceeding the recoverable amount of the effective collateral.

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

A) SPECIFIC ALLOWANCES AND PROVISIONS FOR DOUBTFUL EXPOSURES

1. Doubtful as a result of borrower arrears

114. Credit institutions shall evaluate assets classified as doubtful due to borrower arrears in order to estimate credit risk loss allowances and provisions, bearing in mind the age of the amounts past-due, the effective personal guarantees and collateral received, and the economic situation of the borrower and guarantors.

The individual or collective allowances and provisions for transactions that are doubtful due to arrears may not be less than the generic allowances and provisions that would be applicable to them if they were classified as standard exposures under special monitoring.

115. When estimating allowances and provisions due to credit risk, the recoverable amount of effective collateral shall be estimated by applying to its reference value, determined as specified in paragraphs 68 to 81, the adjustments needed to capture adequately the uncertainty of the estimate and consequent possible falls in value up to the time of foreclosure and sale, plus foreclosure costs, maintenance costs and costs to sell.

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

The recoverable amount of collateral in the form of pledged financial instruments shall be determined from its reference value as indicated in paragraph 68 to 81, by subtracting an adjustment so as to factor in the uncertainty due to the variability of the market price of the asset, and adding the costs of foreclosure, maintenance and sale.

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

Credit institutions that have not developed internal methods for collective estimates of allowances and provisions complying with the requirements laid down in paragraphs 56 and 57 shall determine the recoverable amount of the effective collateral by applying to its reference value the percentage discounts shown in the following table as an alternative solution. These percentage discounts have been estimated by the Banco de España based on its experience and the information it holds on the Spanish banking sector.

<table>
<tr><td colspan="4"></td><td>% Discount on reference value</td></tr>
<tr><td rowspan="8">Type of collateral</td><td rowspan="5">Real estate collateral (first mortgage)</td><td rowspan="3">Completed buildings and parts thereof</td><td>Housing</td><td>30</td></tr>
<tr><td>Offices, commercial premises and multi-purpose industrial buildings</td><td>50</td></tr>
<tr><td>Other</td><td>45</td></tr>
<tr><td colspan="2">Urban land and regulated building land</td><td>60</td></tr>
<tr><td colspan="2">Other real estate</td><td>50</td></tr>
<tr><td rowspan="3">Financial instruments pledged as security</td><td colspan="2">Money deposits</td><td>0</td></tr>
<tr><td colspan="2">Other financial instruments with active market</td><td>10</td></tr>
<tr><td colspan="2">Other financial instruments with no active market</td><td>20</td></tr>
<tr><td colspan="3">Other collateral (e.g. second and subsequent real estate mortgages and collateral given in the form of movable property)</td><td>50</td></tr>
</table>

116. Due to the effect of the direct borrower being replaced by the guarantor providing an effective personal guarantee, the amounts guaranteed by the legal persons listed in paragraphs 83(a) to 83(b) and the following transactions may be treated as being of negligible risk for the purpose of estimating the allowances and provisions:

    a) Transactions guaranteed or reguaranteed by general governments of European Union countries and, in general, by central governments of countries classified in group 1 for the purposes of country risk;

    b) Transactions insured, guaranteed or reguaranteed by government enterprises or agencies of countries classified in group 1 for the purposes of country risk whose main activity is credit insurance or guarantees;

    c) Transactions with a full, joint and several, explicit and unconditional personal guarantee given by credit institutions, specialised lending institutions, and Spanish reciprocal guarantee companies that can be claimed on first demand.

    Accordingly, if there are full or partial personal guarantees from guarantors of negligible risk, the specific allowances or provisions for the guaranteed exposures may be determined by individual estimation, as indicated in paragraphs 46 and 112.

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

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

	Allowances and provisions for the amount not covered by effective collateral (%)	Age of past due-amounts						
		Over 3 months, but not exceed-ing 6 months	Over 6 months, but not exceed-ing 9 months	Over 9 months, but not exceed-ing 1 year	Over 1 year, but not exceed-ing 15 months	not exceed-ing 18 months	not exceed-ing 21 months	Over 21 months
Credit risk segment	Non-financial corporations and sole proprietorships							
	Specialised financing							
	For the financing of real-estate construction and property development, including land	*40*	*55*	*70*	*80*	*85*	*95*	*100*
	For financing the construction of civil works	*45*	*60*	*70*	*80*	*85*	*95*	*100*
	Other specialised financing	*20*	*30*	*30*	*55*	*80*	*85*	*100*
	Purposes other than specialised financing							
	Large corporations (a)	*30*	*70*	*80*	*90*	*95*	*100*	*100*
	SMEs	*40*	*55*	*65*	*75*	*80*	*90*	*100*
	Sole proprietorships	*25*	*40*	*55*	*70*	*80*	*90*	*100*
	Households (excluding sole proprietorships)							
	Housing purchases	20	30	40	55	65	80	100
	For the purchase of the principal residence (amount not exceeding 80% of the collateral value) (b)	*20*	*30*	*40*	*55*	*65*	*80*	*100*
	For the purchase of the principal residence (amount exceeding 80% of the collateral value) (b)	*20*	*30*	*40*	*55*	*65*	*80*	*100*
	For the purchase of housing other than the principal residence (c)	*20*	*30*	*40*	*55*	*65*	*80*	*100*
	Consumer credit	60	70	85	90	95	100	100
	Of which: credit card debt	*60*	*70*	*85*	*90*	*95*	*100*	*100*
	Other purposes	60	70	85	90	95	100	100

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

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

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

2. Doubtful for reasons other than borrower arrears

118. 101. Allowances and provisions for doubtful exposures for reasons other than arrears must be determined by individual estimation, in accordance with paragraphs 45 to 53. However, if the classification has been carried out solely on the basis of automatic factors, the allowances and provisions for the transactions classified in this category shall be determined by collective estimation, as required by paragraph 45(b). As an alternative solution for these collective estimations of allowances and provisions, the percentages for allowances and provisions for exposures deemed doubtful due to arrears in the same risk segment and shorter age shall apply.

B) GENERIC ALLOWANCE AND PROVISION FOR STANDARD EXPOSURES

119. The estimation of generic allowances and provisions shall be based on the recoverable amount of the effective collateral following application of the discounts estimated as established in paragraph 115 for allowances and provisions for doubtful exposures. Also, regard may also be had to the effect of effective personal guarantees, as provided in paragraph 112.

    Credit institutions shall calculate collective allowances and provisions for standard exposures under special monitoring separately from those for which greater provisioning is required as a result of their greater risk.

120. Based on its experience and the information it holds on the Spanish banking sector, the Banco de España has estimated the percentages credit institutions may use as an alternative solution for the calculation of allowances and provisions for transactions classified as standard exposures.

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

    In this alternative solution, a provisioning percentage of 0% shall be applied to the exposures identified as being of negligible risk in accordance with paragraph 83. This percentage may be applied to the total transactions with personal guarantees of guarantors of negligible risk listed in paragraph 116. If there are partial personal guarantees of guarantors of negligible risk, this percentage may be applied to the amount of the exposure covered by these personal guarantees.

Allowances and provisions for the amount not covered by effective collateral		Standard exposures	Standard exposures under special monitoring
Credit risk segment	Non-financial corporations and sole proprietorships		
	Specialised financing		
	For the financing of real-estate construction and property development, including land	*1.7*	*16.3*
	For financing the construction of civil works	*1.7*	*19.0*
	Other specialised financing	*0.4*	*2.6*
	Purposes other than specialised financing		
	Large corporations (a)	*0.2*	*2.3*
	SMEs	*1.0*	*7.7*
	Sole proprietorships	*1.2*	*10.1*
	Households (excluding sole proprietorships)		
	Housing purchases		
	For the purchase of the principal residence (amount not exceeding 80% of the collateral value) (b)	*0.4*	*3.7*
	For the purchase of the principal residence (amount exceeding 80% of the collateral value) (b)	*0.4*	*3.7*
	For the purchase of housing other than the principal residence (c)	*0.4*	*3.7*
	Consumer credit	2.4	18.6
	Of which: credit card debt	*1.4*	*10.5*
	Other purposes	2.4	18.6

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

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

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

IV. CREDIT RISK ATTRIBUTABLE TO COUNTRY RISK

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

121. Debt instruments not measured at fair value through profit or loss and off-balance-sheet exposures, whosoever the borrower, shall be analysed to determine their credit risk attributable to country risk.

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

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

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

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

    Transactions shall be allocated to the borrower's country of residence as at the date of the analysis, except in the following cases in which they shall be classified as indicated below:

    a) Amounts that are guaranteed in full by residents of another, better rated country, or by the CESCE (Spain's official export credit company) or other residents of Spain shall be classified in the same group as the guarantor provided that the guarantor has sufficient financial capacity to meet the commitments assumed.

    b) Amounts that are secured by pledged financial assets shall be reclassified in the country of residence of the issuer of the securities for the portion collateralised by them provided that the issuer resides in a country with a higher classification and the collateral is sufficient. Those that are otherwise collateralised, for the secured portion of the credit, provided that the collateral is sufficient and it is located and is realisable in Spain or another country in group 1, shall be classified in group 1.

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

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

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

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

c) The economic situation, based essentially on:

   i) Indicators relating to budgetary, monetary and balance-of-payments aggregates.

   ii) Indicators relating to economic growth (level of income, savings or investment rates, GDP growth, etc.) and to vulnerability (export diversification, dependence on aid, etc.).

d) Market indicators; taking into account, in particular, credit ratings by reputable credit rating agencies, secondary-market debt prices, market access and debt yield spreads.

123. Transactions shall be classified in the following groups:

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

   i) European Economic Area countries.

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

b) Group 2. This group shall include transactions with ultimate obligors resident in low-risk countries.

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

d) Group 4. This group shall at least include transactions with ultimate obligors resident in countries that show a profound macroeconomic deterioration that may seriously affect the country's ability to pay. Transactions allocated to countries classified in group 3 that experience a deterioration in the indicators mentioned in subparagraph (c) above shall be included in this group.

e) Group 5. This group shall include transactions with ultimate obligors resident in countries that have had long-standing difficulties in servicing their debt, the possibility of recovering such debt being considered as doubtful.

f) Group 6. This category shall include transactions the recovery of which is considered a remote possibility due to circumstances attributable to the country. In particular, this group shall include transactions with ultimate

obligors resident in countries that have repudiated their debt or have not made repayments of principal and payments of interest for four years.

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

124. Debt instruments and off-balance-sheet exposures classified in groups 3 to 6, except for transactions excluded from country-risk allowances and provisions in accordance with paragraph 125, shall be classified in the following categories for the purposes of estimating the country risk allowance or provision:

a) Standard exposure under special monitoring due to country risk: Transactions classified in groups 3 and 4, unless the transactions should be classified as doubtful or write-off due to risk attributable to the borrower.

b) Doubtful due to country risk: Transactions classified in group 5 and off-balance-sheet exposures classified in group 6, unless the transactions should be classified as doubtful or write-off as a result of risk attributable to the borrower.

c) Write-off due to country risk: Transactions classified in group 6, unless the transactions should be classified as write-off due to risk attributable to the borrower. Debt instruments classified in this category shall be derecognised.

125. The following debt instruments and off-balance-sheet exposures shall be excluded from country-risk allowances and provisions:

a) Exposures allocated to a country, whatsoever the currency in which they are denominated, recorded at subsidiaries and jointly controlled entities established in the country of residence of the borrower; exposures in local currency, whosoever the borrower, recorded at branches established in the country of residence of the borrower; and exposures other than to general government denominated in the currency of the country of the borrower and recorded in the financial statements of branches or subsidiaries or jointly controlled entities established in a country other than that in which the borrower resides.

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

c) Pre-financing credit with terms of six months or less for specific export contracts, provided that this credit matures on the date of export.

d) Interbank transactions with the branches established in European Economic Area Member States of foreign credit institutions located in other countries, provided that the criteria applied by these branches for recording credit risk allowances and provisions in their financial statements are equivalent to those indicated herein.

e) Private-sector transactions of countries belonging to the monetary zone of a foreign currency issued by a country classified in group 1.

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

g) Advances other than loans, and contingent commitments given.

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

126. Amounts of debt instruments and off-balance-sheet exposures classified in groups 3 to 6 for the purposes of country risk, with the exception of transactions excluded from country risk allowances and provisions, must be covered by at least the following percentages:

	%
Group 3	10.1
Group 4	22.8
Group 5	83.5
Group 6	100

Notwithstanding the foregoing, the allowance and provision percentage for interbank credit with maturities of up to three months shall be 50% of those established in this section, provided that the country is included in groups 3 or 4 for the purposes of country risk and the debt has been serviced normally, without delays or renewals.

127. The financial, monetary or off-balance-sheet support provided to branches, subsidiaries and jointly controlled entities resident in countries classified in groups 3 to 6 for the purposes of country risk, denominated in a currency other than that of the country in which they are established, shall give rise to the recording of country risk allowances and provisions in the individual statements and also, where applicable, in the consolidated statements, of the entities providing the support, even if such support does not appear in such statements as a consequence of their process of preparation, unless the support consists of the financing of assets for which country risk allowances and provisions already exist.

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

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

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

b) The fair value at the date of foreclosure or receipt of the asset less the estimated costs to sell, as described in paragraphs 130 to 136.

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

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

To estimate the allowances and provisions for the financial assets applied, the recoverable amount of the collateral shall be taken as the fair value less the estimated costs to sell of the asset foreclosed or received in payment of debt, as indicated in paragraph 130, provided that the entity's experience of sales bears out its ability to realise said asset at its fair value. Otherwise, if the experience of sales does not corroborate this ability, the recoverable amount shall be estimated as specified in paragraph 115 for real estate collateral.

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

By way of a reference for assets located in Spain, the entity's experience of sales shall be considered to bear out its ability to realise the assets if the entity sells yearly the following minimum percentages of its annual average stock of similar real estate assets: 25% in the case of completed dwellings; 20% in the case of completed offices, commercial premises or multipurpose buildings; and 15% in the case of other real estate assets, including urban land and regulated building land.

130. Real estate assets foreclosed or received in payment of debt must be valued at the time of foreclosure or receipt, for which purpose the reference value shall be the market value determined in full individual appraisals, in accordance with paragraphs 74 and 75 hereof.

After the time of foreclosure or receipt, the reference value for updating the valuation shall also be the market value determined in full individual appraisals. Nevertheless, if the fair value of the real estate is less than or equal to €250,000, automated valuation methods may be used provided the real estate may validly be valued by these mass models and the entities substantiate the suitability of their use. In any event, once this real estate has been on the balance sheet for three years, its valuation shall be updated by means of the full individual appraisal. After that date, a combination of automated appraisal methods and full individual appraisals may be used, such that the frequency of the latter is at least every three years.

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

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

When no internal methods have been developed to estimate the adjustment for loss of value at the time of sale and the costs to sell, in compliance with paragraphs (114) and (115), credit institutions shall use as a practical solution the percentage reductions to the value of real-estate collateral set out in Section III hereof.

The entity shall have databases of assets foreclosed or received in payment of debt, and their links to specific transactions, in compliance with the requirements established in paragraph 64 for collateral databases.

In any event, the appraisal company or service and the professional responsible for updating the reference value by means of a full individual appraisal must be different from those conducting the immediately preceding full individual appraisal.

131. The estimated costs to sell shall be deducted from the fair value of the asset foreclosed or received in payment of debt.

132. The internal audit department shall regularly review the application of the policies and procedures for valuing the assets foreclosed or received in payment of debt as established in paragraph 71.

133. All legal expenses shall be recognised immediately in the statement of profit or loss for the period in which they accrue. Settled registration and tax charges may be included in the value at initial recognition provided that the resulting amount does not exceed the fair value less estimated costs to sell. All costs incurred between the foreclosure date and the sale date due to asset maintenance and protection, such as insurance or security services, shall be recognised in the statement of profit or loss covering the period in which they accrue.

134. Credit institutions must develop internal methods to estimate the discounts applicable to the reference value and the costs to sell of the assets foreclosed or received in payment of debt, taking into account their experience of sales, in terms of time scales, prices and volumes, trends in the value of these assets and the time taken to sell them.

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

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

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

b) Carry out periodic backtesting to compare their estimates and the observed actual losses, as well as periodic benchmarking exercises on these estimates. Entities must inform the Banco de España of the results of these tests and exercises and of any changes made in their internal methods, as described in paragraph 42.

c) Submit individual confidential statement FI 131-5.4 "Comparison of fair value less costs to sell of real estate foreclosed or received in payment of debt", describing the differences between the results obtained with the internal methods and those that would be obtained by applying the benchmarks in this section for each type of asset foreclosed or received in payment of debt.

d) Change their internal methods if the results of the periodic backtesting show recurrent significant differences or there are significant non-compliances with the principles and requirements referred to herein. In such cases, the entity must draw up a plan setting out the measures for correcting the differences or non-compliances and its implementation timetable. The internal audit department shall be responsible for monitoring this plan, as established in paragraph 63.

e) Notify the Banco de España of the start of the implementation period of the plan for changing their internal methods described in (d) above or the impossibility of completing development of internal methods to meet the requirements of this paragraph. While they are implementing the aforesaid plan completing the development of their internal methods, entities shall make their estimates using the discounts provided in the following paragraph.

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

			Discount on reference value (%)
Type of real estate asset foreclosed or received in payment of debt	Completed buildings and parts thereof	Housing	25
		Offices, commercial premises and multi-purpose industrial buildings	35
		Other	35
	Urban land and regulated building land		40
	Other real estate		35

137. In order to determine the amount of impairment at a time after the date of foreclosure or receipt in payment of debt, the entity shall calculate the

difference between the carrying amount of the asset foreclosed or received in payment of debt and its fair value less costs to sell.

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

The fair value shall be estimated as provided in paragraph 130 considering, additionally, that the time an asset foreclosed or received in payment of debt remains on the balance sheet in excess of the period initially envisaged in its disposal plan is an unequivocal sign that the entity is not able to realise this asset at its previously estimated fair value. Therefore, if the asset has exceeded the average holding period of real estate with active sale policies, the entity must revise the procedure for determining the fair value of this asset by incorporating a discount based on the time it has remained on the balance sheet, additional to those described in paragraph 130, such that income from reversal of impairment is not recognised for this asset.

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