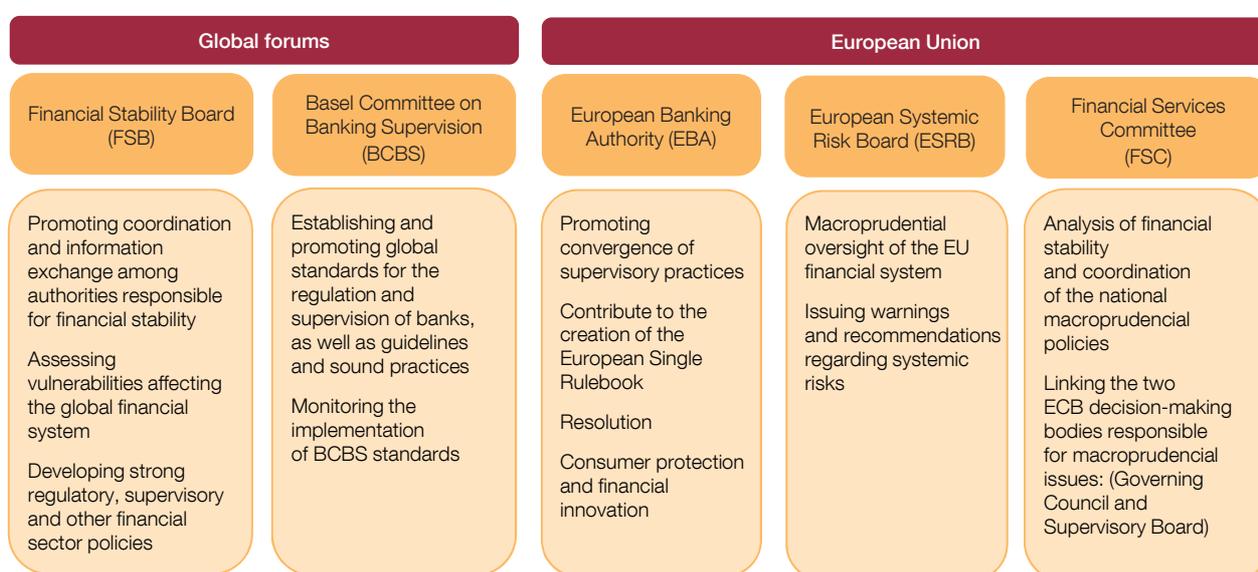


6 THE BANCO DE ESPAÑA'S PARTICIPATION IN INTERNATIONAL BANKING REGULATION AND SUPERVISION BODIES

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

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

SCHEMA 6.1



SOURCE: Banco de España.

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

6.1 Global fora

6.1.1 FINANCIAL STABILITY BOARD

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Shortcomings identified

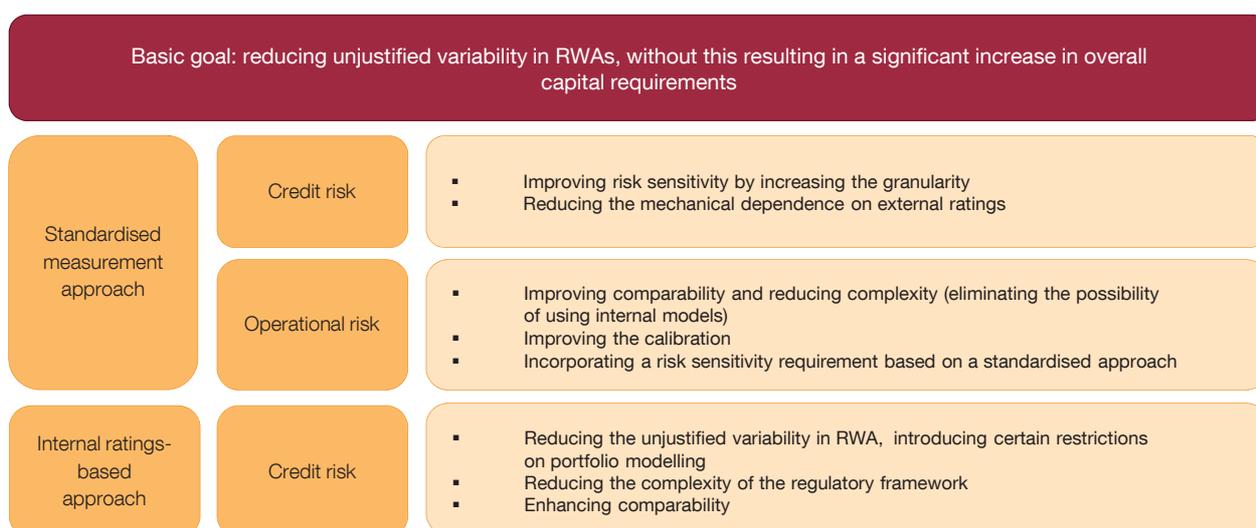
The international financial crisis revealed a high degree of variability in RWAs calculated by institutions using internal models and a lack of comparability between them, and this has not always been the result of differences in the risk of their respective portfolios. Moreover, limitations were also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

Reforms worked on in the Basel regulatory framework

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

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

SCHEMA 6.2



SOURCE: Banco de España.

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

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

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

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

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

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

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

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

BOX 6.2

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

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

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

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

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

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

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

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

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

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

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

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

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

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

6.2 European fora

6.2.1 EUROPEAN BANKING AUTHORITY (EBA)

Work relating to payment systems and FinTech is becoming more important

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

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

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

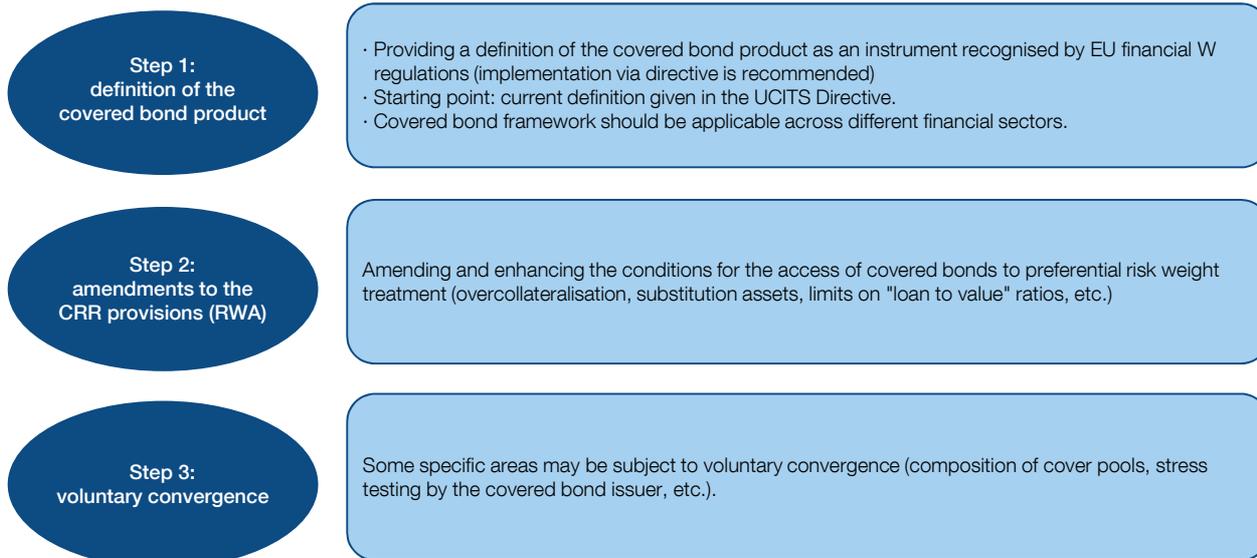
In relation to supervisory convergence, the main challenges of the Supervisory Committee, which has been chaired by the Banco de España since the EBA was set up in 2011, have been: i) strengthening the stacking order for the various types of capital requirements (pillar 1, pillar 2 and buffers); ii)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

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

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

Prudential regulation

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



SOURCE: Banco de España.

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

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

Customer protection and financial innovation

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

6.2.2 EUROPEAN SYSTEMIC RISK BOARD (ESRB)

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

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

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

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

6.3 Other fora

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

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

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

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

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

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

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