7.1 Banco de España Circulars

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

7.1.1 BANCO DE ESPAÑA CIRCULAR 2/2016 ON SOLVENCY

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

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

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

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

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

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

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

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

2 Internal controls and governance. Greater involvement of credit institutions' boards of directors is required, not only in approving accounting policies but also in the periodic monitoring of their implementation. This involvement is also required in the initial and periodic internal validation of the accounting methods used to estimate allowances and provisions. The role of internal audit and control functions is also strengthened, especially in respect of information systems and databases, the quality and coherence of which are essential for developing own methodologies for estimating allowances and provisions and for decision-making at all management levels.

3 Effectiveness and simplicity in the development of accounting methodologies. Any complexity that entails no evident improvement in the quality or coherence of the results obtained should be avoided. Own methodologies cannot be "black boxes", but should be comprehensible and offer results that are both understandable and realistic. For that purpose, institutions should conduct periodic backtesting, to compare the accuracy of their estimates with the actual losses observed. In addition, they should periodically undertake sensitivity analyses and benchmarking exercises. These exercises will be used to fine tune accounting methodologies on an ongoing basis to strengthen their effectiveness.

4 Appraisal of guarantees/collateral. Institutions should assess the effectiveness of guarantees/collateral for consideration in estimating allowances and provisions based on their experience. Annex IX establishes requirements on procedures and minimum frequencies for updating values of guarantees/collateral for their accounting consideration as an effective means of credit risk mitigation. The worse the accounting classification of exposures, the more stringent the requirements.

5 Principle of proportionality. In the case of institutions that have not rolled out internal methods for collective estimation of allowances and provisions, Annex IX offers alternative solutions (percentages of allowances and provisions and haircuts to the reference value of guarantees/collateral), drawn from the sectoral information and experience of the Banco de España.

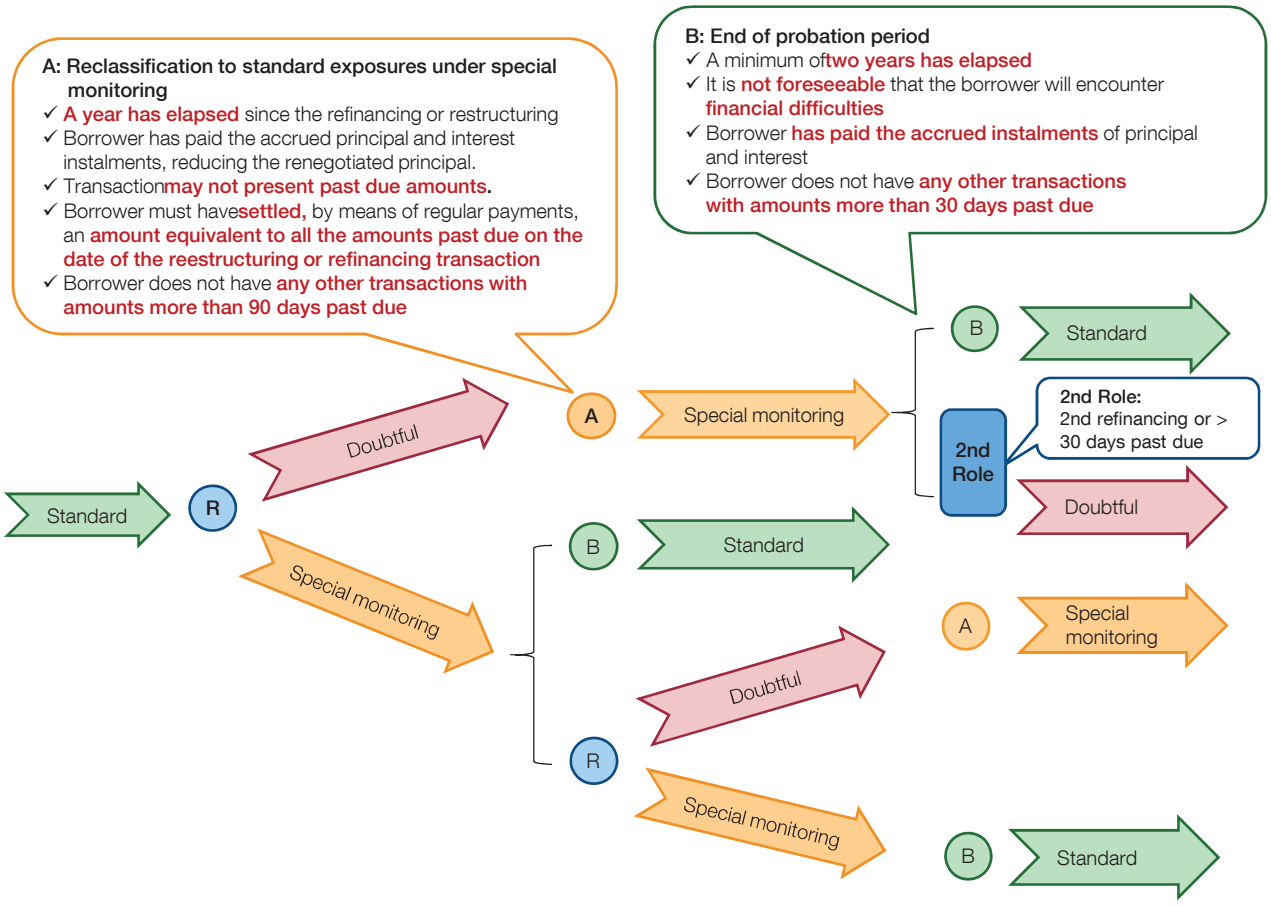
6 Real estate assets foreclosed or received in payment of debt. Changes are made to the initial recognition system and the subsequent appraisal of these assets, in an endeavour to ensure that appraisals are as close as possible to market value.

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

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

REFINANCING TRANSACTIONS

SCHEMA 7.1



SOURCE: Banco de España.

Forbearance in Circular 4/2016

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

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

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

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

— The conditions in which a forborne exposure may be reclassified from non-performing to standard under special monitoring (cure period).

— The conditions in which a forborne exposure may be reclassified from standard under special monitoring to performing (probation period).

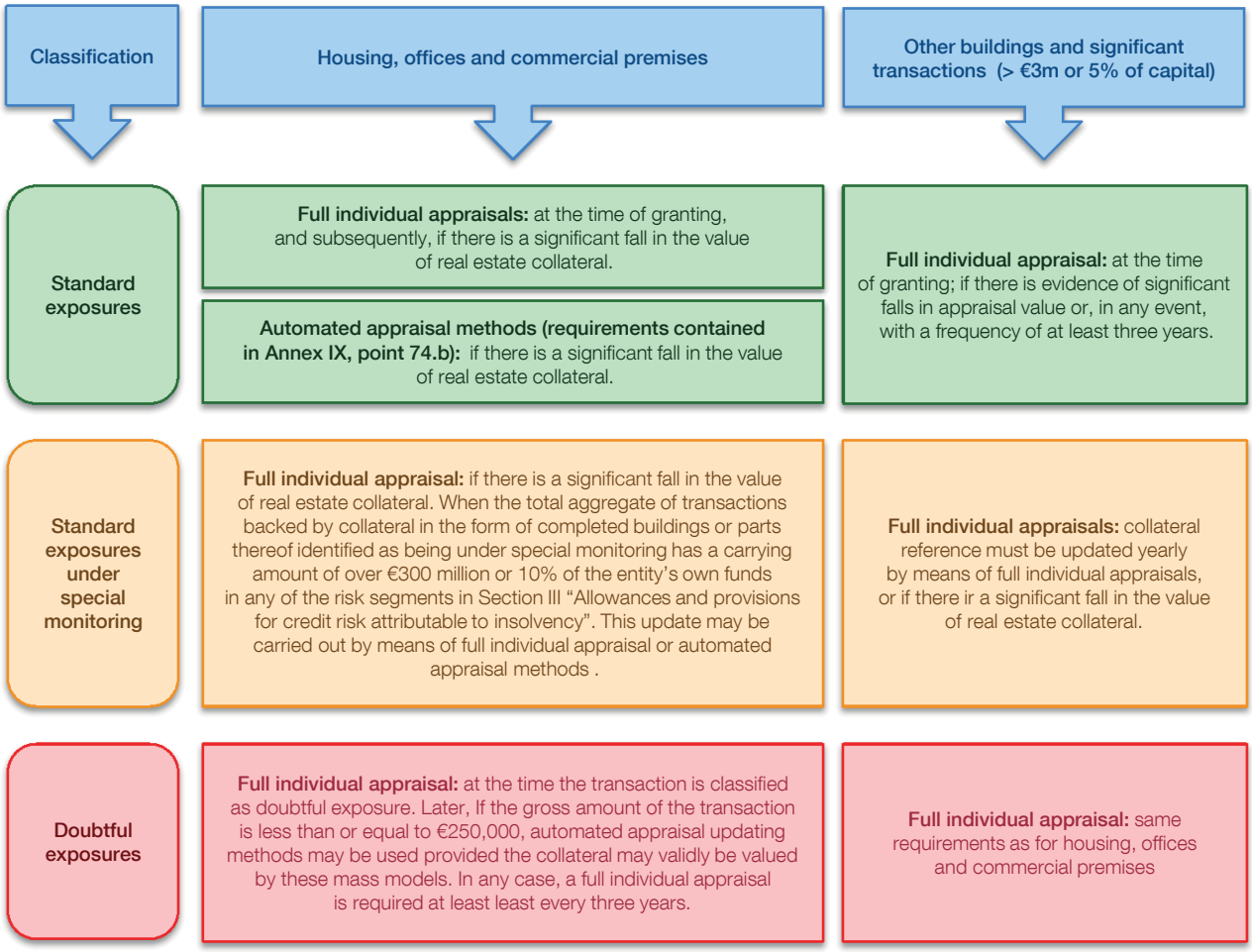
— Automatic classification as non-performing of a forborne exposure that is classified as standard under special monitoring if it is subject to further forbearance measures or if it becomes more than 30 days past due and had previously been classified as non-performing.

Updating of collateral value in Circular 4/2016

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

UPDATING OF COLLATERAL VALUATIONS

SCHEMA 7.2



SOURCE: Banco de España.

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

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

Foreclosed assets in Circular 4/2016

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

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

Gross amount - [(Gross amount - (**Reference Value** x (1 - **Adjustment**))) x % Provision]

Amount recoverable through collateral

Amount of exposure not covered by collateral

Provision set aside

Where:

— Reference value: the complete individual appraisal value of the foreclosed asset.

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

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

Appraisal value x (1 – **Foreclosure adjustment**) – Selling costs

Where:

— Foreclosure adjustment: applying the adjustment envisaged for foreclosed real estate assets. In the case of banks that have developed internal methods of estimation of adjustment to the reference value (appraisal value), their own adjustments.

— Selling costs will include all costs directly attributable to the sale and which arise from the fact of the sale. It will not include any costs incurred irrespective of whether or not the real estate asset is sold.

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

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

— Banks should calculate the haircuts to the reference value of foreclosed assets required to estimate their fair value bearing in mind the specific conditions of the assets or of the markets in which they are traded and their level of permanence on the balance sheet, based on their own experience of the sale of similar assets.

— Banks should regularly backtest their estimates of haircuts to reference values and selling costs. They should also regularly compare their estimates with the references provided in Annex IX.

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

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

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

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

7.1.4 BANCO DE ESPAÑA CIRCULAR 6/2016 ON SMES

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

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

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

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

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

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

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

7.1.6 OTHER BANCO DE ESPAÑA CIRCULARS PUBLISHED IN 2016

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

— Banco de España Circular 1/2016 of 29 January 2016 amending Circular 1/2015, of 24 March 2015, to payment service providers, on information on merchant service charges and interchange fees received. This Circular amends Circular 1/2015 which, implementing Article 13 of Law 18/2014, establishes the reporting requirements of institutions that act as payment service providers in respect of merchant service charges and interchange fees received in payment transactions made on point of sale terminals located in Spain, using debit or credit cards, irrespective of the marketing channel used, when the payment service providers of both the originator and the payee are established in Spain. Circular 1/2016 enhances the information requested on interchange fees and merchant service charges received by banks, aiming to facilitate its analysis and comparability, amending the reports with information on interchange fees and merchant service charges that service providers must submit to the Banco de España.

— Banco de España Circular 3/2016 of 21 March 2016 to ATM owners and payment instrument and card issuers, on information on commission on ATM cash withdrawals. Circular 3/2016 regulates the form, content and periodicity of the reporting requirements established in the second additional provision of Law 16/2009 of 13 November 2009 on payment services, to enable appropriate monitoring of resolutions and decisions adopted by application of the new regulations on commission on ATM cash withdrawals brought in by Royal Decree-Law 11/2015 of 2 October 2015.

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

7.2 Draft Banco de España Circulars

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

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

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

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

7.3 Other significant regulations

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

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

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

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

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

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

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

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