BANCO DE ESPAÑA
Eurosistema

30.06.2011

The Banco de España Supervisory Model[1]

[1] Translation of a document originally written in Spanish. In the event of a discrepancy, the Spanish version prevails.

CONTENT

LIST OF ACRONYMS AND ABBREVIATIONS USED IN THE DOCUMENT

BCBS	Basel Committee on Banking Supervision
CCR	Central Credit Register
CNMV	National Securities Market Commission
CEBS	Committee of European Banking Supervisors
ICAAP	Internal Capital Adequacy Assessment Process
SREP	Supervisory Review and Evaluation Process
SABER	Risk-Based Supervisory Methodology Approach
SAD	Data Analysis System
SIA	System of Information on Borrowers
SIGAS	Integrated Supervisory Management System

1 Introduction

Financial institutions are subject to a special regulatory and supervisory regime, one much more intense than that governing other economic sectors. The reasons for this are, first, that financial institutions, given their intermediate function between saving and credit, raise significant funds from the public; and further, that a solvent and well-managed financial system has a favourable effect on financial stability and general economic activity.

Article 7 of Law 13/1994 on the Autonomy of the Banco de España stipulates that it is for the Banco de España to promote the sound functioning and stability of the financial system, and to supervise, in accordance with the provisions in force, credit institutions' solvency, conduct and compliance with their sectoral regulations.

The Banco de España supervisory model seeks to ensure the effectiveness and efficiency of this function, making certain that credit institutions are appropriately capitalised, comply with current regulations and are prudent in the management and control of their business and risks.

To this end the Banco de España has developed a supervisory model which is explained below. The essential attribute of this model is its proximity to the prevailing reality of supervised institutions; in addition, the model is underpinned and complemented by highly detailed periodic reporting by credit institutions to the Banco de España. The model is intended to allow supervisors to gain an up-to-date and in-depth knowledge of the situation and progress of each supervised institution.

Another attribute of the Banco de España supervisory model is that, without abandoning traditional supervisory activities, it has been complemented in recent years by a risk-based approach. Faced with a dynamic banking system, the traditional supervisory model, based on the knowledge provided by the current accounting and financial situation and on the administrative control of compliance with regulations, proved insufficient. It was also necessary to evaluate the future viability of institutions and, in doing so, prevent potential problems. The supervisory process must be pre-emptive and try to avoid crisis situations in most cases. To do this it should ensure that institutions not only comply with current regulations, but that they are well-governed, manage risks properly and have capital commensurate with the risks they assume.

The essential aim of the Banco de España supervisory process is to determine and keep each institution’s supervisory risk profile updated, taking the measures needed to correct it when necessary. The supervisory risk profile encapsulates, in a single variable, the Banco the España’s assessment of the probability that a credit institution will have solvency, profitability and/or liquidity problems in the future.

The supervisory risk profile cannot be determined exclusively by analysing institutions’ financial magnitudes and ratios. Analysis of how institutions are governed and of their risk management and control systems is also essential in determining their risk profile. A combination of quantitative analysis and qualitative evaluations is thus required to determine the supervisory risk profile.

The Banco de España analyses, in the course of its supervisory activities, many questions that are related to and affect financial stability. These include periodic analysis of specific economic sectors and the regular evaluation of the banking system credit risk performance. However, the supervisory model set out below refers solely to the (micro) analysis of the stability of each individual credit institution and does not therefore cover supervisory activity related to general financial stability (macro analysis).

The supervisory process also has effects on the Banco de España regimes governing authorisations and sanctions, which restrict, prohibit or sanction inappropriate practices. This is not addressed either in this document.

Banking supervision should anticipate and mitigate, as far as possible, foreseeable future problems at institutions and pre-empt crisis situations. When they arise, such situations are tackled using the extraordinary intervention measures available to the Banco de España that are geared to resolving serious situations of bank illiquidity or insolvency. This document makes no reference either to the taking over of ailing institutions, but addresses ordinary supervision, whose aim is to prevent such situations.

2 The Banco de España supervisory process

2.1 Aim of the Banco de España supervisory process

The aim of the Banco de España supervisory process is to keep its knowledge of the institutions it supervises up-to-date. Drawing on this knowledge, the supervisory risk profile of each institution is determined and, where appropriate, any measures needed to improve it are taken.

The risk profile encapsulates, in a single variable, the probability that, in the Banco de España's judgement, a credit institution would have solvency, profitability or liquidity problems in the future. The risk profile is a key element for determining the supervisory framework applicable to each institution, since the higher the risk profile, the more intense the supervision of the institution will be.

The duty of determining the supervisory risk profile lies at a first level with the Head of Division (see Section 2.2) responsible for the institution, together with the bank examiners and other staff participating directly in the supervision of the institution. At a secondary level, it is for the Department Director, assisted by the Executive Coordinator, to give final approval to the assessment of the risk profile of each of the institutions under his watch.

The risk profile of each institution is continually updated. To do this, use is made of the knowledge and information arising from the various supervisory activities. Whenever supervisory activities are conducted at an institution, its supervisory risk profile is updated and altered, if appropriate.

The risk profile is established on the basis of the risk matrix, using the following scale:

SUPERVISORY RISK PROFILE	MEANING
HIGH	The institution's capital strategy, the own funds held, recurring profits, its corporate or internal governance and its risk management and control systems are considered clearly insufficient for the activities it undertakes and the risks assumed.
MEDIUM-HIGH	The institution's capital strategy, the own funds held, recurring profits, its corporate or internal governance and its risk management and control systems are considered insufficient for the activities it undertakes and the risks assumed.
MEDIUM-LOW	The institution's capital strategy, the own funds held, recurring profits, its corporate or internal governance and its risk management and control systems are suitable for the activities it undertakes and the risks assumed.
LOW	The institution's capital strategy, the own funds held, recurring profits, its corporate or internal governance and its risk management and control systems are suitable for the activities it undertakes and, moreover, the risks assumed by the institution (inherent risk profile) are low.

The supervisory risk profile, along with the institution's systemic importance,[2] determines the institution's supervisory priority. This priority level is classified from 1 to 4 as follows:

[2] To determine the systemic importance of each institution, use is made - along with subjective judgment - of a series of basic quantitative indicators.

SUPERVISORY PRIORITY	MEANING
1	Maximum priority: under constant watch, subject to intensive and very frequent on-site inspection. Applicable to highly systemic institutions or those with a high supervisory risk profile.
2	High priority: special monitoring, subject to frequent inspection. Applicable to systemic institutions or those with a medium-high supervisory risk profile.
3	Normal priority. Applicable to institutions in a normal situation to be inspected under an ordinary inspection programme.
4	Low priority. Applicable to institutions with no particular problems and which, given their small size, their activity, their situation as subsidiaries of another institution or their particular characteristics, do not require specific inspection or may be inspected with a lower-than-normal frequency.

As the above scale infers, there may be institutions with a low supervisory risk profile which, because of their systemic importance, are classified as priority 1 or priority 2. Institutions with a high supervisory risk profile are always priority 1, and institutions with a medium-high supervisory risk profile are at least priority 2.

Based on the supervisory risk profile and on the inspection priority assigned, the supervisory framework for each institution is established. The supervisory framework sets the supervisory objectives for the institution (geared to lowering, where necessary, the supervisory risk profile),[3] and the degree of supervisory intensity to be applied, highlighting the issues to which more attention will be given. The supervisory framework enables annual action plans to be established, detailing the specific tasks to be undertaken in relation to each institution.

To establish the supervisory risk profile of each institution, the Banco de España has developed a risk-based supervisory methodology approach known by its Spanish name SABER (Supervisión de la Actividad Bancaria Bajo el Enfoque Riesgo). This approach has been progressively set in place in the Directorate General Banking Supervision since 2001.

On the basis of the work conducted under the SABER methodology, a risk matrix of each institution is completed using the information arising from the different supervisory activities. This matrix draws together the conclusions and the scores attributed to each institution. It is accompanied by the risk profile and institutional profile reports on the institution, which detail key aspects (see Sections 4.8 and 4.9).

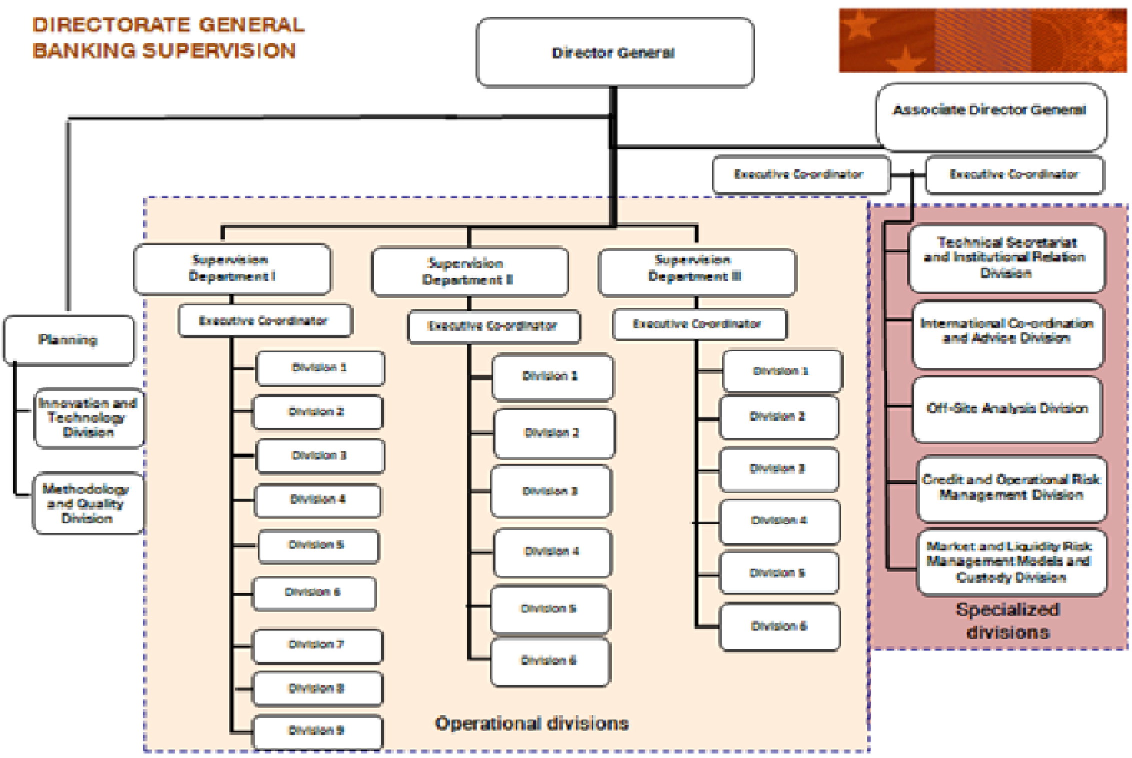
The risk matrix scores provide for a structured and uniform supervisory risk profile which may be changed or updated as a consequence of the different supervisory activities. An example of a risk matrix for a hypothetical institution is given below.[4]

[3] For example, the supervisory objective may consist in reducing specific inherent risks, increasing the solvency ratio, etc.
[4] A reduced-form matrix is used for simple institutions (see Annex 2).

FINANCIAL INSTITUTION:	**RISK MATRIX**			
Type of risk	Inherent risk/Trend	Internal governance	Risk management and control	Residual risk/Trend
Credit	(1) Low/increasing	(23) Good	(2) Acceptable	(3) Low/increasing
Credit concentration	*Low*		*Deficient*	*Medium-low*
Equity securities	*Medium-low*		*Good*	*Medium-low*
Market	(4) Low/stable		(5) Deficient	(6) Medium-low/stable
On-balance-sheet structural exchange risk	(7) Medium-low/stable		(8) Improvable	(9) Medium-high/stable
Operational	(10) Low/increasing		(11) Improvable	(12) Medium-low/increasing
Liquidity	(13) Low/stable		(14) Good	(15) Low/stable
Interest rate risk in the banking book	(16) Medium-low/decreasing		(17) Deficient	(18) Medium-high/decreasing
Other risks	(19) Low/stable		(20) Acceptable	(21) Low/stable
Business	*Medium-low*		*Good*	*Medium*
Reputational	*Low*		*Acceptable*	*Low*
Weighted aggregation of risks and controls	(22) Low/increasing	(24) Improvable		(25) Medium-low/increasing
Corporate governance	(26) Good			
Institution's risk profile	(27) Medium-low/increasing			
Assessment of solvency	(28) Acceptable / stable			
Supervisory risk profile	(29) Medium-low/increasing			
Systemic institution	yes			
Supervisory priority	2			

2.2 *Structure and organisation of banking supervision in the Banco de España*

The organisation chart of the Directorate General Banking Supervision is as follows:



Departments and operational divisions

Analysis, monitoring and inspection of institutions is shared the three existing supervision departments: Dept. I for savings banks and credit cooperatives[5]), Dept. II for the two major Spanish banking groups and Dept. III for other institutions.

Each of these departments consists of a series of operational divisions, led by a head of division who is directly responsible for the inspection and monitoring of the institutions under his remit. The divisions are made up of bank examiners with a generalist background[6], which allows them to have an overall view and knowledge of institutions. The operational divisions receives transversal support from specialist staff (see the following paragraph) and, where appropriate (depending on the type of institution involved), own specialists in specific areas (e.g. IT auditors).

Each of these divisions is specifically assigned a series of credit institutions in respect of which it undertakes off-site monitoring and analysis, inspection visits, and talks and direct contact with the managers. As a result, off-site analysis and monitoring and inspection visits are jointly performed by the same group of staff, strengthening the ongoing supervision process, i.e. the updated knowledge of each institution and banking group.

Transversal and support divisions

The Directorate General Banking Supervision also has transversal divisions whose function is to offer specialized support to the operational divisions in certain areas. In this connection, specific skilled tasks are undertaken such as those performed by the Technical Secretariat and Institutional Relations Division, the International Coordination and Advice Division, the Off-Site Analysis Division (GAD), the Credit and Operational Risk Management Models Division and the Market and Liquidity Risk Management Models and Custody Division. All these divisions report to the Associate Directorate General Banking Supervision.

These divisions collaborate in inspection tasks by means of activities ranging from analysis and monitoring to direct participation in inspections together with the operational divisions.

Reporting directly to the Director General is the Head of Planning, to whom the Methodology and Quality Division and the Innovation and Technology Division report.

2.3 Types of supervisory actions

As part of its ongoing supervisory process, the Banco de España performs three types of supervisory actions: off-site monitoring and analysis, inspection visits and on-site continuous monitoring.

These actions enable supervisors to update their knowledge, information and opinions in respect of each supervised institution. Specifically, supervisory actions allow updating of the institutions' risk profile, provide knowledge of institutions' strengths and weaknesses, anticipate potential problems, assess governance and risk management and control policies, assess solvency, detect areas requiring further supervisory action, etc.

Inspection visits and on-site continuous monitoring are a fundamental means of supervisory action and review, as they provide for better knowledge of and opinions on the institution by way of direct, close contact with those responsible for the effective management of the institutions, and for the direct cross-checking of the information received.

[5] On 14 April, 2010, the supervision of credit cooperatives was assigned to Supervision Department III and the Latin America and United States Division's functions reassigned to the International Coordination and Advice Division and the three Supervision Departments, in order to improve efficiency and effectiveness of the available resources.

[6] To join the Banco de España's Directorate General Banking Supervision, staff has first to pass a competitive entrance examination, with a subsequent training course. Together with the prestige of the profession, this has meant that DG Banking Supervision is made up of a group of stable and highly qualified staff. The qualification of this group is a significant characteristic of the Banco de España supervisory model.

On the basis of such knowledge and opinions, moves are made where necessary to set in place the appropriate improvements, including the lowering of the institution risk profile. That is to say, as a result of any type of supervisory action, the risk profile of each institution may be altered, and there may also be changes, if deemed desirable, to its supervisory framework. As a practical means of operating, the Banco de España, if considered necessary, sends letters of recommendations or requirements to institutions.[7] The requirements and recommendations that the Banco de España conveys to institutions seek to rectify not only the shortcomings observed in regulatory compliance, but also to address shortcomings in governance, management and internal control.

On overall estimates, approximately 25% of supervisory human resources (as a percentage of hours worked by DG Banking Supervision staff as a whole) are dedicated to off-site monitoring and analysis, 30% to inspection visits, 30% to on-site continuous monitoring and 15% to in-house support functions and tasks such as advice on co-ordination, design and development of the supervisory function, international co-operation and advice to Banco de España senior management.

Off-site monitoring and analysis

Each institution is controlled and analysed by a team that has been assigned the function of keeping knowledge of this institution updated by means of the monitoring and analysis of all the information available.

The basic source of information for off-site monitoring and analysis are the confidential accounting returns and own funds returns periodically received at the Banco de España, along with other periodic statements such as the reports to the central credit register and shareholders statements. These periodic returns and statements are supplemented by further information which is requested ad-hoc when deemed necessary (e.g. information prepared by institutions for the purpose of internal management).[8]

As part of monitoring, there are periodic actions of particular importance such as the review and evaluation of the financial statements sent by institutions, the review and evaluation of periodic own funds returns, the periodic review of liquidity and credit risk evolution, the annual review of external audit reports and the annual review of institutions' internal capital adequacy assessment reports. There are also specific and very important actions such as the monitoring of certain risks, and the monitoring of compliance with the recommendations or prudential measures established by the Banco de España.

As a result of off-site monitoring and analysis, the institution’s risk matrix is updated and altered, if necessary, and also the supervisory risk profile, where appropriate. If it is deemed necessary, the institution’s managers are directly contacted or unscheduled inspection visits are made.

Inspection visits

The monitoring system outlined above is reinforced and complemented by an intensive programme of inspection visits that allows direct verification of the figures and other information provided to the Banco de España. The onsite visits also enable greater knowledge of the risk management and asset valuation practices pursued by the institution, the verification of the degree of compliance with regulations and the evaluation of all the qualitative aspects (policies, organisation, management, controls) that affect the situation of credit institutions.

---

[7] Without prejudice to the more severe measures envisaged by law when the situation so requires it, such as the initiation of sanctioning proceedings against institutions and their management bodies, the approval of restructuring plans, and the exceptional measures to take control of institutions, to replace boards of directors and to restructure institutions.

[8] Both periodic and specific requests for information by the Banco de España to institutions are frequent and very detailed, and this is an important characteristic of its supervisory model, as it provides for deep and updated knowledge of institutions.

Inspections are classified in two broad categories: comprehensive and partial.

Comprehensive inspections are those in which a reasonably complete assessment is made of all relevant aspects of the institution.

Partial inspections are those whose scope is more limited and which seek to evaluate solely one or several aspects of an institution. The aim of partial inspections is usually to review specific areas (e.g. the credit portfolio, the treasury department, custody, etc.) or to review specific aspects or issues (e.g. the degree of compliance with requirements previously formulated by the Banco de España, significant matters concerning the close of the year, etc.).

Occasionally, partial inspections are made across the board and in parallel for a set of institutions in order to review a specific aspect of each of them (e.g. rules governing conduct with customers).

The periodicity and type of inspection visits are generally established in the annual supervisory action plan, although unscheduled visits are made when necessary.

On-site continuous monitoring

The size and complexity of the two major Spanish banking groups have shown that appropriate supervision is difficult using only the two foregoing types of action.

Indeed, the systemic importance these banking groups have acquired, along with their dynamism and flexibility, and their significant international presence, call for significant and ongoing requests for information by DG Banking Supervision, since far-reaching and sufficiently updated knowledge of these institutions is not possible using only the confidential returns periodically sent to the Banco de España. Moreover, the growing sophistication of the management systems of these groups has obliged them to improve substantially the information underpinning decision-making and risk control, and this management information is very useful for their supervision.

Accordingly, on-site continuous monitoring has been established for these of institutions, with inspection teams located permanently within each institution. Such monitoring yields more and earlier information, providing for better knowledge of how these institutions are performing. Also, there is greater anticipation in respect of the adoption of supervisory measures in the face of potential problems, and the flow of swift information exchange is kept smooth.

On-site continuous monitoring addresses the banking group as a whole (including the parent and the relevant subsidiaries abroad), and provides most of the information needed to give basis to supervisory decisions, including administrative authorisations.

On-site continuous monitoring essentially involves analysis and evaluation, but it is complemented by verification and cross-checking activities, when it is deemed appropriate to delve further into specific issues or risks. As part of on-site continuous monitoring, the following activities are conducted:

- Financial monitoring (earnings, turnover and solvency).
- Risk monitoring (credit, structural-interest rate, exchange rate, liquidity, market, operational, technological, compliance and reputational).
- Monitoring of business areas and significant subsidiaries.
- Internal audit (scope, quality and effectiveness).
- Corporate governance.

But the proper supervision of these banking groups also requires that on-site continuous monitoring be conducted simultaneously with specific, more detailed and in-depth reviews of limited scope. Accordingly, on-site continuous monitoring is complemented by traditional inspection visits, which allow for in-depth knowledge of specific issues. Notable among these inspections are, given their growing importance, those relating to international activity.

This form of supervisory action (on-site continuous monitoring), which initially arose to meet the supervisory needs of the two major Spanish banking groups, is gradually spreading to other institutions which have grown significantly in size and complexity in recent years.

2.4 ***IT and methodological tools of Banco de España supervision***

The Banco de España has developed a series of tools that facilitate and reinforce its supervisory actions. The most significant of these are detailed below, having regard both to their potential as a means of analysis and to their role in integrating and steering supervisory action.

- Data Analysis System (SAD). The SAD allows for consultation of the financial information that the Banco de España receives from credit institutions, and for the preparation of standard and made-to-measure reports based on this information. Among other possibilities, the information provided by the SAD allows for: analysis of the structure of the balance sheet and P&L statements, both at the individual and consolidated levels, with a significant degree of disaggregation; the establishment of financial indicators (ratios) to evaluate institutions' strengths and weaknesses; trends over time of different financial magnitudes; and the establishment of benchmark groups to compare different institutions' financial indicators and magnitudes. The system is equipped to readily transmit data to PC platforms, enabling users to work easily with them.

- Central Credit Register (CIR) processing system. With this IT tool, reports are obtained on the data that credit institutions send to the CCR in relation to the loans they have granted to their customers. These reports allow information to be obtained on risks by individual borrower, by economic group, by sector of activity, etc., and also allow for comparisons to be made among different institutions.

- Other analytical IT tools, such as the treasury application which provides for review of institutions' treasury area, the deposit and safekeeping application, various reconciliation and matching routines, etc.

- System of information on borrowers (SIA). This unit analyses the economic and financial situation of borrowers (on an individual o consolidated basis) which have the largest loans in the credit system and proposes a grading of them, exclusively for internal use in Banking Supervision. The main objective is to avoid duplicating tasks in the evaluation of these borrowers in inspection visits, which allows the onsite review to only focus, in relation to these risks, in the analysis of how the loans are instrumented and their specific situation in the institution under inspection. The SIA also provides for periodic sectoral studies.

- Integrated supervisory management system (SIGAS). This IT system is used to manage a good number of DG Banking Supervision processes: inspections, knowledge and monitoring of institutions, authorisations, registrations, management of the IT services and methodology and quality. It provides support for work flows; it allows access to the other IT and methodological tools and incorporates the information those tools provide; and it compiles and consistently stores, through its integration in the Corporate Documentation Management Tool, all quantitative and qualitative information arising from different supervisory actions.

- Electronic file. The aim of this IT application is to facilitate the review of credit risk in inspection visits. It allows the integrated consultation of loans per borrower and per economic group (in the institution and in the system as a whole), the compilation of credit risk samples and the selection of borrowers, the statistical analysis of the loan portfolio, the review of the statement to the Central Credit Register and the updating of risk analysed during inspection visits. It further provides assistance in preparing conclusions on credit investment and it makes for readier analysis lending policy and the monitoring of loans.

3 **Activities in the Banco de España supervisory process**

The Banco de España supervisory process comprises four activities:

– Accounting review, valuation of assets and liabilities.

– Economic and financial analysis.

– Review of general regulatory compliance.

– Review and evaluation of risks and of solvency.

3.1 Accounting review and valuation of assets and liabilities

This activity is basic to the Banco de España supervisory process, since the remaining activities (economic and financial analysis, the review of general regulatory compliance, and the review and evaluation of the risks and solvency of each institution) should be performed with the assurance that the accounting records give a true and fair view of the actual circumstances of institutions. Without such assurance, the remaining activities are fundamentally lacking. Accordingly, the accounting review is an absolutely vital activity for determining the risk profile of each institution.[9]

Reliable financial statements require the timely recognition of all transactions and the correct valuation of the various elements making up the balance sheet. The Banco de España devotes significant resources to accounting review and, under this heading, given their particular relevance, to the valuation of assets and liabilities and to the analysis of the sufficiency of provisions. This task is essentially performed in inspection visits, but also through monitoring.

Although the accounting review performed by the Banco de España uses the review work of the institution itself (internal audit) and, complementing this, by the work of the external auditors (review of the financial statements and annual reports), the Banco de España uses its own means to verify compliance with accounting rules.[10]

Senior management of institutions is responsible for ensuring that financial statements reflect at all times their true situation, that these statements are prepared in accordance with the accounting regulations in force, and for setting in place the procedures for maintaining the necessary supporting documentation justifying the financial statements. This responsibility includes ensuring that the external auditors who examine the annual accounts have full access to all relevant information that may enable them to issue a proper opinion.

The results of the accounting review are included in the risk matrix sections relating to internal governance (cell 23, see section 4 and annex 2) and to risk management and control (cells 2, 5, 8, 11, 14, 17 and 20). For example, if the senior management policy does not ensure sufficient accounting quality, the score for internal governance will be negative (cell 23); if the conclusion from the accounting review is that the level of provisioning is insufficient, the score for credit risk management and control will fall (cell 2); if it is concluded that the valuation of assets in the trading portfolio is inadequate, the score for market risk management and control will be worse (cell 5).

3.2 Economic and financial analysis

[9] Exceptionally in Europe, the Spanish central bank is the accounting regulator.

[10] In this respect, one of the specific tasks performed by the Banco de España is to check that the different asset and liability items balance, given the intrinsic value this process has and given the knowledge and information thereby provided on numerous aspects relating to the management and control of institutions.

The strength of a credit institution resides on a suitable asset-liability structure, sufficient net interest income, efficient costs and realistic write-downs, which allow for the generation of high recurring income and appropriate solvency.

The first line of defence of an institution faced with an adverse contingency is its own recurring profits, which will enable it to absorb losses without seeing its solvency affected. In the absence of sufficient recurring profits, no capital buffer can ensure the institution's viability in the medium and long term.

In the review and evaluation of institutions' economic and financial situation, the Banco de España essentially uses the information in the confidential returns sent quarterly to it by the institutions. This information is received both at the individual and consolidated levels, since in the case of groups of credit institutions, economic and financial analysis cannot be conducted without consolidated information. In addition, this information is complemented, where necessary, with management information provided by institutions themselves.

The Banco de España has developed tools to analyse this information. These tools are integrated into the DG Banking Supervision’s Data Analysis System (SAD), which contains exhaustive financial information on institutions, with highly detailed time series from the last 30 years. The Banco de España uses this information to prepare a range of reports and ratios which enable it to evaluate the financial status of the different institutions and groups, and of the financial system as a whole.

The quality of the results these analytical tools yield depends on the quality of the information received from institutions. Accordingly, the Banco de España periodically checks the financial information received in its inspection visits.

The conclusions of the economic and financial analysis are entered in the risk matrix in the section containing the inherent risk column (cells 1, 4, 7, 10, 13, 16 and 19). For example, scant provisioning for bad debts increases inherent credit risk (cell 1); an inadequate assets-liabilities structure increases the inherent liquidity risk (cell 13); an impaired net interest income and the consequent incapacity to generate future recurring profits are included under business risk, which is assessed as part of other risks in cell 19 on inherent risk.

The economic and financial analysis of institutions is performed quarterly, through off-site monitoring.[11] For this review and evaluation, additional information is requested from institutions when considered necessary.

3.3 Regulatory compliance review

The legislation regulating the activity of financial institutions includes European Directives, Spanish Laws, Banco de España Circulars, Guidelines and Recommendations issued by the Banco de España and by international supervisory agencies, particularly the Committee of European Banking Supervisors (CEBS) and the Basel Committee of Banking Supervisors (BCBS). But institutions also pay heed to market conventions and to codes of good practices promoted by the banking sector, which may encompass wider rules governing integrity and ethical conduct.

Credit institutions are heavily leveraged entities that raise money in the short term from depositors to lend it at a longer term. They need depositors’ confidence, since a massive withdrawal of deposits will endanger their continuity, even if they are solvent. The failure by credit institutions to comply with specific regulations (such as those on money laundering and on conduct vis-à-vis customers) may, besides being illegal, affect their reputation, prompt depositors' mistrust and endanger their future viability, ultimately affecting general financial stability.

Rigorous regulatory compliance is part of the corporate culture of credit institutions, and it is therefore closely linked to their corporate governance. Regulatory compliance should take the form

[11] In the major groups, such monitoring is on-site at the institution and, moreover, management information provided by the institution is used.

of policies, procedural manuals and codes of conduct applicable to employees. Institutions should have a regulatory compliance function commensurate with the size and complexity of their activity.

The regulatory compliance review to which this section refers does not include accounting or solvency regulations. These regulations, given their relevance, are analysed separately in the framework of the accounting-review and the risk and solvency analysis activities. Other regulations with which credit institutions must comply include most notably those on money laundering, market conduct, data protection, competition and customer advice.

The Banco de España's regulatory compliance review is conducted without prejudice to the leading responsibility that other authorities[12] have in these areas and, where appropriate, it is carried out under the existing cooperation agreements with such authorities.

Underpinning the regulatory compliance review are institutions' own regulatory compliance functions, together with the review work performed by internal and external auditors.

Among other matters, the Banco de España analyses the regulatory compliance function, the regulatory compliance policy approved by senior management, procedures, corrective measures when breaches are identified, codes of conduct applicable to employees, etc.

The general regulatory compliance review is conducted essentially in inspection visits and the outcome of the evaluation (where the information provided by other supervisory authorities with responsibilities in different areas is also considered) is incorporated into the risk matrix in the assessment of institutions' internal governance (cell 23).

*3.4 **Review and evaluation of risks and solvency***

Complementing the foregoing evaluations is another supervisory activity which, in addition to analysing the present, attempts to obtain an overview of institutions' future risks and, in this connection, it focuses on their governance and on the management and control of risks and solvency.

Institutions' balance sheet and income statement figures reflect their situation at a given moment, and financial indicators tend to signal the situation and weaknesses with some delay. Internal governance and risk management and control practices have a most important bearing on both the accuracy of present figures and on the likelihood that the problems highlighted by such figures will materialise or not in the future.

Each institution's solvency strategy should be linked to the risks assumed, and should anticipate how potential crisis situations in the future may be overcome. Accordingly, the review and evaluation of internal governance, of risks and of solvency are vital in determining each institution's risk profile.

But the review and evaluation of the different risks that institutions face and of their solvency position should be performed on the basis of an appropriate review of the valuation of assets and accounting practices, a prior analysis of the financial situation of the bank and a knowledge of the degree of the institution's compliance with regulations. Without prior knowledge of these three aspects, it would be nearly impossible to conduct a minimally reliable analysis of risks and solvency.

In sum, the review and evaluation of the institution's various risks and of its solvency must draw on these previous supervisory activities.

---

12 Among others, the CNMV (National Securities Market Commission) has supervisory powers regarding market regulations; money laundering regulations are the remit of SEPBLAC (Executive Service of the Commission for the Prevention of Money Laundering and Monetary Offences); the Ministry of Labour oversees labour regulations, and the Ministry of Economy and Finance is responsible for tax regulations.

Under the new regulatory framework for capital known as Basel II, the analysis and measurement of the various risks to which credit institutions are subject is a fundamental aspect for the assessment of each institution's capital adequacy. The Pillar 2 of the new Basel Accord, which addresses supervisory review, has been formally incorporated into Directive 48/2006 of the European Parliament and of the Council on the taking up and pursuit of the business of credit institutions, and into Spanish legislation by means of Law 13/1985 on Investment Ratios, Own Funds and Reporting Obligations of Financial Intermediaries.

Under the new regulations, institutions will undergo an internal capital adequacy assessment process (ICAAP), tailored to their size and complexity, and it will be for the Banco de España to review this capital adequacy assessment process and to ascertain whether the internal governance of institutions, their systems, risk management and control procedures and own funds held ensure proper management and coverage of the risks assumed. This review and evaluation is known as the supervisory review and evaluation process (SREP).

The SREP allows the Banco de España to assess whether the capital held by credit institutions is commensurate with the risks they assume, the economic environment in which they operate and with their governance and risk management and control systems. How the Banco de España performs this capital adequacy assessment process is explained in its SREP Guidelines.[13]

The SREP is part of the Banco de España's risk-based supervisory process and is informed by all supervisory activities which analyse, in one way or another, the solvency of institutions. The Banco de España assesses institutions' risk profiles by means of its different supervisory actions, i.e. through off-site monitoring and analysis, inspection visits and continuous on-site monitoring.

Although the SREP considers all the relevant information available to the Banco de España about an institution and, specifically, that resulting from all its supervisory actions and activities, the SREP consists basically of two activities:

- Review and evaluation of the own funds return.

- Review and evaluation of the internal capital adequacy assessment report (ICAAR).

In the review of compliance with legal capital requirements, a distinction is drawn between institutions that use standard approaches for this calculation and those that use advanced approaches, given that the review requires different criteria for the respective institutions. The conclusions of the review and evaluation of legal capital requirements are included in the risk matrix in the section on the assessment of solvency (cell 28).

The Banco de España judges institutions' internal capital adequacy assessment process (ICAAP) through the review and evaluation of the internal capital adequacy assessment report (ICAAR) and the dialogue with each institution.

The ICAAR is an annual report sent by institutions to the Banco de España which reflects their internal capital adequacy assessment process. The ICAAR is the document that provides the basis for the dialogue between institutions and the Banco de España. Such dialogue is an essential part of the supervisory review process and as part of it, the Banco de España informs each institution of its assessment of the ICAAP.

The supervisory review process is formalised in an annual conclusion, which is based on the review and evaluation of the ICAAR. And in view of this and of other supervisory activities made during the year, potential shortcomings are identified, the pertinent conclusions are drawn and the necessary measures taken.

The conclusions of the SREP are included in the risk matrix in the related section. Given the overall approach of this review and evaluation, these conclusions may affect any cell in the risk matrix.

---

[13] See "Guidelines on the capital review process" at the Banco de España website.

4 System for evaluating institutions

The SABER (risk-based supervisory approach) methodology provides a uniform and structured framework for rating institutions. The factors under analysis are reflected in the risk matrix:

FINANCIAL INSTITUTION:	**RISK MATRIX**			
Type of risk	Inherent risk/Trend	Internal governance	Risk management and control	Residual risk/Trend
Credit	(1) Low/increasing		(2) Acceptable	(3) Low/increasing
Credit concentration	*Low*		*Deficient*	*Medium-low*
Equity securities	*Medium-low*		*Good*	*Medium-low*
Market	(4) Low/stable		(5) Deficient	(6) Medium-low/stable
On-balance-sheet structural exchange risk	(7) Medium-low/stable		(8) Improvable	(9) Medium-high/stable
Operational	(10) Low/increasing	(23) Good	(11) Improvable	(12) Medium-low/increasing
Liquidity	(13) Low/stable		(14) Good	(15) Low/stable
Interest rate risk in the banking book	(16) Medium-low/decreasing		(17) Deficient	(18) Medium-high/decreasing
Other risks	(19) Low/stable		(20) Acceptable	(21) Low/stable
Business	*Medium-low*		*Good*	*Medium*
Reputational	*Low*		*Acceptable*	*Low*
Weighted aggregation of risks and controls	(22) Low/increasing	(24) Improvable		(25) Medium-low/increasing
Corporate governance	(26) Good			
Institution's risk profile	(27) Medium-low/increasing			
Assessment of solvency	(28) Acceptable / stable			
Supervisory risk profile	(29) Medium-low/increasing			
Systemic institution	yes			
Supervisory priority	2			

The ratings for the different cells in the risk matrix take into consideration all the pertinent supervisory activities and are based on the knowledge and the opinion held of the institutions at each moment. There is no automatic scoring system, since the different scores in the risk matrix, apart from taking into account objective figures, always include some subjective opinion, as many qualitative aspects (such as management and control) that are not quantifiable are assessed.

The SABER methodology provides insight into which institutions are more susceptible to pose problems in the future. In that way, additional supervisory resources may be assigned to such institutions, and future crises may be averted. Institutions with a supervisory risk profile above a certain score receive special attention.

To determine an institution's supervisory risk profile, successive steps are taken involving the review and evaluation of inherent risk, internal governance, risk management and control, the determination of residual risk, the assessment of corporate governance and the review and evaluation of own funds.

Scores in the risk matrix are set using the information and knowledge obtained from each of the Banco de España's supervisory activities and actions. Fundamental to the scores in the risk matrix are the conclusions of inspection visits and of continuous on-site monitoring.

4.1 *Inherent risk*

Inherent risk is the risk which, by its very nature, cannot be segregated from banking activity, i.e. it is the risk intrinsic to the institution´s various activities and business areas, without considering its control systems. Inherent risk depends on objective factors: level of exposure, degree of concentration, guarantees received, etc.

In determining inherent risk, the Banco de España uses the following risk classification:[14]

- Credit risk (includes credit concentration risk and the risk of equity securities not held for trading).
- Market risk.
- On-balance-sheet structural exchange risk.
- Operational risk.
- Liquidity risk.
- Interest rate in the banking book.
- Other risks (includes reputational risk, business risk, regulatory compliance risk and model risk).

The first task in determining the supervisory risk profile is to identify the risks that are material at each institution, since only these will be reviewed and evaluated (there will be institutions at which some of these risks will be lacking in significance owing to the type of business, volume of activity, etc.; however, at other institutions the same risks may prove most significant).

At large institutions, the supervisory review work often involves examining separately the different business areas. In this case it may be necessary to use a risk map, to assess the significance of every risk in each business area, and to obtain a final overview. The risk map indicates the relevant business areas and the significance of each risk in each of them, using the following scores: (5) Very high risk, (4) High risk, (3) Medium risk, (2) Low risk and (1) Minimal or non-existent.

The definition of the risk map draws on the criteria used by the institution, i.e. on the institution's own risk map, and this definition is adjusted if there is a different perception of the risks by the Banco de España. The following risk map is given by way of example:

<table>
<tr><th colspan="7">RISK MAP</th></tr>
<tr><th rowspan="2">BUSINESS AREA</th><th colspan="6">TYPE OF RISK</th></tr>
<tr><th>CREDIT</th><th>MARKET</th><th>OPERATIONAL</th><th>INTEREST RATE</th><th>LIQUIDITY</th><th>OTHER RISKS</th></tr>
<tr><td>Credit activity</td><td>5</td><td>1</td><td>3</td><td colspan="2" rowspan="4">risks managed globally</td><td>3</td></tr>
<tr><td>Raising of funds from the public</td><td>1</td><td>1</td><td>3</td><td>2</td></tr>
<tr><td>Treasury and Markets</td><td>2</td><td>5</td><td>4</td><td>2</td></tr>
<tr><td>Customer services</td><td>1</td><td>1</td><td>4</td><td>2</td></tr>
</table>

[14] Annex 1 offers a non-exhaustive definition of the various risks to which credit institutions are exposed.

Private banking	3	2	2			2
TOTAL INSTITUTION	5	4	3	3	3	2

The assessment of inherent risk is the result of evaluating the overall exposure to each risk (understood as the size or amount of the risk) and the quality of such exposures (solvency of counterparties, maturities, guarantees, size and volatility of losses, diversification…). To evaluate credit quality an assessment is made, if necessary, of the complexity of operations, the degree of competitiveness of the environment and the institution's market position.

The assessment is based on quantitative data whenever possible and, in this connection, indices or parameters of exposure and quality tailored to the different risks are used. However, in the case of specific risks that are difficult to quantify (e.g. reputational risk) the assessment is essentially a qualitative one.

In addition to the information provided by the institution, the information available at the Banco de España and any other useful external information are used to make this assessment. The off-site analysis group prepares ratios (including rankings and temporary trends) which are incorporated into the Data Analysis System (SAD) to help with the evaluation of the different risks.

To conclude, an assessment is made of each risk, which is assigned to one of the following categories, HIGH, MEDIUM-HIGH, MEDIUM-LOW and LOW, with the following meaning:

ASSESSMENT OF INHERENT RISK	MEANING
HIGH	The amount or quality of risk may lead to most significant losses that markedly affect the institution's solvency.
MEDIUM-HIGH	The amount or quality of risk may lead to most significant losses which, however, will not markedly affect the institution's solvency.
MEDIUM-LOW	The amount and quality of risk will give rise to manageable losses in the normal course of business.
LOW	The amount and quality of risk will give rise to foreseeable zero or insignificant losses.

In addition to a static assessment of inherent risk, its foreseeable future course is determined using the following scale: GROWING, STABLE and DECREASING.

Finally, and by weighted aggregation, the institution's overall inherent risk and its trend are determined. The assessment of overall inherent risk is also assigned to one of the following categories: HIGH, MEDIUM-HIGH, MEDIUM-LOW and LOW, and its trend is established as GROWING, STABLE or DECREASING.

4.2 Internal governance

Risk management and control should be based on corporate governance criteria and should be the result of a risk culture that is clearly defined by the Board of Directors, communicated by the Senior Management and set in place at all levels of the organisation.

In relation to internal governance, the Banco de España specifically assesses:

– The suitability of the composition, functions and responsibilities, organisational rules and functioning, powers invested in and delegated by the Board of Directors or equivalent body and its committees.

- The means by which the institution's Board of Directors is responsible for the nature and level of the risks assumed and how commensurate this level of risks is with existing capital.

- The way in which the institution's Board of Directors establishes the corporate culture and ensures that:

  - The complexity of risk management and measurement processes is suitable for the institution's risks and business.

  - The internal control systems are appropriate for ensuring an orderly and prudent management of the institution's business and risks.

  - Capital objectives are suited to the institution's risk profile and to the economic environment in which it operates.

- The way in which the Board of Directors takes responsibility for regulatory compliance and accepts the recommendations of the Banco de España.

- The organisation of the institution and its suitability to its activities and the risks assumed by it.

- The risk control functions assigned to internal audit and the means at its disposal to carry out these functions.

- Senior management compensation and indemnity arrangements and management incentive arrangements.

The assessment of internal governance is categorised as: DEFICIENT, IMPROVABLE, ACCEPTABLE and GOOD, as defined below:

ASSESSMENT OF INTERNAL GOVERNANCE	MEANING
DEFICIENT	Significant deficiencies in internal governance that endanger the institution or prevent proper risk management and control.
IMPROVABLE	Significant deficiencies in internal governance that do not endanger the institution since they do not prevent proper risk management and control.
ACCEPTABLE	There are no significant deficiencies in internal governance.
GOOD	The institution's internal governance is considered to be good.

4.3 Risk management and control

The management and control of each of the risks incurred by the institution should be commensurate with the level and size of such risks, but also with the complexity and sophistication of the activity pursued. Sophisticated institutions, with great product diversity and complexity and with international activity in different geographical areas need much more complex management and control systems than relatively unsophisticated institutions that operate in local and confined geographical areas. Accordingly, in evaluating the adequacy and effectiveness of the working of internal risk management and control systems, regard must be had to both the size and complexity of the risk assumed.

For each of the institution's significant risks, the Banco de España evaluates the adequacy and degree of compliance of the following:

- Risk policy: limits, diversification and mitigation.

- Organisation of the risk function: powers, segregation of functions, responsibilities and delegation; risk control function; reports on the risk function.

- Management tools: measurement systems and methodologies, acceptance, communication, control and monitoring; procedural manuals; quality and sufficiency of IT systems; quality and sufficiency of information.

- The policy and tools for impaired asset monitoring and recovery (where appropriate).

- The annual internal audit action plan for each risk.

The assessment of the management and control of each risk is assigned to one of the following categories: DEFICIENT, IMPROVABLE, ACCEPTABLE and GOOD, defined as follows:

ASSESSMENT OF RISK MANAGEMENT AND CONTROL	MEANING
DEFICIENT	Deficiencies in management or control systems that call into question the institution's capacity to manage the inherent risks to which it is exposed.
IMPROVABLE	Significant deficiencies in inherent risk management or control systems.
ACCEPTABLE	Minor deficiencies in management or control systems which, however, do not prevent the institution from managing inherent risk.
GOOD	Management and control systems are sufficient for the risk assumed by the institution.

4.4 Residual risk

To determine residual risk, an overall analysis is made of inherent risks and internal governance, and of management and control systems. This analysis is conducted at two levels:

- First, an overall assessment is made of the quality of internal governance (including the organisation of the institution) and how weaknesses in it may affect management and control of the various risks.

- Second, set against each of the relevant risks to which the institution is exposed are the quality and adequacy of the related management and control systems.

A very high inherent risk cannot be fully eliminated with excellent internal governance and management and control, while a low inherent risk may give rise to a high residual risk if internal governance or management and controls are not sufficient. Accordingly, in the Banco de España's assessment of residual risk, the weights of inherent risk and of internal governance and management and control are different and asymmetrical, since the latter may mitigate inherent risk to some extent but not eliminate it. On the contrary, deficient internal governance, or inadequate risk management and control may significantly increase the level of inherent risk.

The following table acts as a guideline for assigning a score to the level of residual risk for each risk, based on its inherent risk and on the management and control systems that mitigate it. However, the final score for each residual risk also takes into account the overall internal governance of the institution.

ASSESSMENT OF RESIDUAL RISK		RISK MANAGEMENT AND CONTROL			
		DEFICIENT	IMPROVABLE	ACCEPTABLE	GOOD
INHERENT RISK	HIGH	*High*	*High*	*High*	*High*
	MEDIUM-HIGH	*High*	*High or Medium-High*	*Medium-High*	*Medium-High or Medium-Low*
	MEDIUM-LOW	*High or Medium-High*	*Medium-High or Medium-Low*	*Medium-High or Low*	*Medium-Low or Low*
	LOW	*Medium-High or Medium-Low*	*Medium-Low or Low*	*Low*	*Low*

The assessment of residual risk is scored as follows: HIGH, MEDIUM-HIGH, MEDIUM-LOW and LOW. The score is determined on the basis of the analysis of the inherent risk and of the management and controls applied, as defined below:

ASSESSMENT OF RESIDUAL RISK	MEANING
HIGH	High amount or poor quality of risk, together with a lack of good internal governance, management or control may result in a highly significant loss for the institution that may affect its solvency.
MEDIUM-HIGH	High amount or poor quality of risk, or lack of good internal governance, management or control that may result in a highly significant loss for the institution.
MEDIUM-LOW	The amount and quality of risk and internal governance, risk control and management mean that any losses will foreseeable be limited to those manageable within the institution's normal business.
LOW	The amount and quality of risk and governance, risk control and management mean that any losses will foreseeable be low and perfectly manageable within the institution's normal business.

Moreover, trend is also used as an additional factor in risk analysis (i.e. whether the risk is growing, stable or decreasing).

Lastly, and by way of weighted aggregation of the different risks, the institution's overall residual risk and its trend are determined. The assessment of overall residual risk is also scored as follows: HIGH, MEDIUM-HIGH, MEDIUM-LOW and LOW. The overall residual risk trend is established as: GROWING, STABLE or DECREASING.

4.5 Corporate governance

This section relates to the assessment of external corporate governance, i.e. that stemming from the relations between the institution's governing bodies, and specifically its Board of Directors, with interested third parties (shareholders, investors, depositors, customers, etc.)

The assessment of external corporate governance is based, inter alia, on the institution's corporate governance report, taking into account, insofar as is appropriate, the degree of compliance with the recommendations of the Unified Corporate Governance Code approved by the CNMV on 22 May 2006.

The assessment of corporate governance is scored as follows: DEFICIENT, IMPROVABLE, ACCEPTABLE and GOOD, with the following meaning:

ASSESSMENT OF CORPORATE GOVERNANCE	MEANING
DEFICIENT	Major deficiencies in corporate governance. For example, the structure, composition or functioning of the governing bodies, the institution's shareholding structure or the characteristics of the transactions with related parties or intra-group transactions pose a threat to the institution.
IMPROVABLE	Significant deficiencies in corporate governance but which do not jeopardise the institution. For example: incorrect structure, composition or functioning of the governing bodies; the existence of major transactions with related parties; insufficient dedication on the part of Directors, etc.
ACCEPTABLE	Minor deficiencies in corporate governance that do not jeopardise the institution.
GOOD	The institution is deemed to have good corporate governance.

*4.6 **Risk profile of the institution***

On the basis of all the assessments described above, the institution's risk profile is determined. This is a key aspect of the risk matrix, as it will determine the level of capital that the Banco de España considers the institution should hold.

In effect, logically, the higher the risk profile of an institution, the higher the level of own funds it should have, as there is a greater probability of reporting higher losses in the future.

The comparison of an institution's risk profile with its solvency situation permits the determination of the supervisory risk profile. While an institution's risk profile and own funds are balanced, the concern of the Banco de España about the institution will diminish and consequently the supervisory risk profile will be lower.

The institution´s risk profile is scored as follows: HIGH, MEDIUM-HIGH, MEDIUM-LOW and LOW, with the following meaning:

INSTITUTION´S RISK PROFILE	MEANING
HIGH	There is a high risk of the institution encountering future difficulties, as a consequence of high inherent risk, deficiencies in internal or corporate governance or internal control and management systems inappropriate to the institution’s activities. The institution is highly concentrated on certain business areas. Its economic and financial position (balance sheet or income statement) reflects serious structural weaknesses in terms of liquidity or profitability.
MEDIUM-HIGH	There is an appreciable risk of the institution encountering future difficulties, as a consequence of high inherent risk, deficiencies in internal or corporate governance or internal control and management systems inappropriate to the institution’s activities. The institution is not highly concentrated on certain business areas and its economic and financial position (balance sheet or income statement) does not reflect serious structural weaknesses in terms of liquidity or profitability.
MEDIUM-LOW	There is a low risk of the institution encountering difficulties in the future, considering its low inherent risk, its good internal and corporate governance and its internal control and management systems that are appropriate to its activities. The institution is not concentrated on specific business areas and its economic and financial position (balance sheet and income statement) reflects no weaknesses in terms of either liquidity or profitability.
LOW	There is a very low risk of the institution encountering difficulties in the future, considering its very low inherent risk, its good internal and corporate governance and its internal control and management systems that are appropriate to its activities. The institution is not concentrated on specific business areas and its economic and financial position (balance sheet or income statement) reflects no weaknesses in terms of either liquidity or profitability.

Trend is also used as an additional factor in this risk analysis (i.e. whether the risk is GROWING, STABLE or DECREASING).

4.7 Solvency analysis

To analyse the institution’s solvency, the level and quality of the own funds held are assessed (% core capital, % tier 1, % tier 2) and compared with the own funds necessary to cover all the risks to which the bank is exposed (including those requiring regulatory capital and also those classified as Pillar 2 risks).

In this part it is also assessed the regulatory capital target to which the institution is committed, to verify that it is appropriate its capital plan to meet its own funds requirements also in the near future. Accordingly, the supervisory review process (SREP) conducted by the Banco de España, as described in the SREP Guidelines, plays an essential part in this analysis.

The institution’s solvency is classified as GOOD, ACCEPTABLE, POOR or VERY POOR, with the following meaning:

ASSESSMENT OF SOLVENCY	MEANING
GOOD	The level of own funds is above the required minimum. The quality of own funds, the capital target and capital planning are appropriate.
ACCEPTABLE	The level of own funds is above the required minimum. The quality of own funds and the capital target are appropriate. Capital planning is appropriate but shows some weakness.
POOR	The level of own funds is above the required minimum. The quality of own funds is inadequate. The capital target is tight. There are weaknesses in capital planning.
VERY POOR	The level of own funds is below the required minimum. The quality of own funds is clearly inadequate. The capital target is tight. There are serious weaknesses in capital planning.

Trend is also used as an additional factor in this solvency analysis (i.e. whether own funds are GROWING, STABLE or DECREASING).

4.8 Supervisory risk profile and priority for inspection

All the above-mentioned scores are summarised in the risk matrix, which serves as the basis for determination of the institution's supervisory risk profile.

It should be noted that the assessment of the supervisory risk profile is not a quantitative measure of the individual assessments made previously but rather an overall assessment that includes an important subjective element (judgement), as it takes into account a multitude of qualitative and quantitative aspects that are impossible to aggregate mechanically.

The purpose of the risk matrix is threefold:

- It facilitates visualisation of the components that determine the supervisory risk profile.

- It establishes a link between the risk matrix cells and the supervisory risk profile finally assigned, thus enhancing the uniformity of criteria among the different Departments and operational divisions.

- It makes for better planning of supervisory activities, as it determines the areas on which supervisory resources should focus.

Using the risk matrix classifications, the supervisory risk profile is scored as: HIGH, MEDIUM-HIGH, MEDIUM-LOW and LOW, with the following meaning:

SUPERVISORY RISK PROFILE	MEANING
HIGH	The institution's capital strategy, the own funds held, recurring profits, its corporate or internal governance and its risk management and control systems are considered clearly insufficient for the activities it undertakes and the risks assumed.
MEDIUM-HIGH	The institution's capital strategy, the own funds held, recurring profits, its corporate or internal governance and its risk management and control systems are considered insufficient for the activities it undertakes and the risks assumed.
MEDIUM-LOW	The institution's capital strategy, the own funds held, recurring profits, its corporate or internal governance and its risk management and control systems are suitable for the activities it undertakes and the risks assumed.
LOW	The institution's capital strategy, the own funds held, recurring profits, its corporate or internal governance and its risk management and control systems are suitable for the activities it undertakes and, moreover, the risks assumed by the institution (inherent risk profile) are low.

The supervisory risk profile, along with the institution's systemic importance, determines the institution's supervisory priority. These priority levels are classified from 1 to 4 as follows:

SUPERVISORY PRIORITY	MEANING
1	Maximum priority: under constant watch, subject to intensive and very frequent on-site inspection. Applicable to highly systemic institutions or those with a high supervisory risk profile.
2	High priority: special monitoring, subject to frequent inspection. Applicable to systemic institutions or those with a medium-high supervisory risk profile.
3	Normal priority. Applicable to institutions in a normal situation to be inspected under an ordinary inspection programme.
4	Low priority. Applicable to institutions with no particular problems and which, given their small size, their activity, because they are subsidiaries of another institution or because of their particular characteristics, do not require specific inspection or may be inspected with a lower-than-normal frequency.

The risk matrix is accompanied by the breakdowns considered necessary for each risk and by the risk profile report.

The *risk profile report* is a brief summary that explains the institution's supervisory risk profile and the Banco de España's supervisory priority.

The report also signals the aspects on which supervisory activities should focus (the institution's inspection priorities), which will help to plan the scope of the inspections.

Finally, it also identifies, where appropriate, any areas that may need improving and establishes the supervisory strategy for the institution. The supervisory strategy indicates the supervisory objectives for the institution, geared to lowering, where necessary, the supervisory risk profile, along with the steps to be taken and the projected schedule for achievement of these objectives.

The risk profile report is updated as and when necessary, and at least once a year.

4.9 *Supervisory framework and annual action plans*

Drawing on the supervisory risk profile and on the systemic importance of each institution, the supervisory framework for each institution is established. This framework includes the supervisory strategy and the intensity of supervision to be applied. The supervisory framework is updated when necessary, and at least once a year.

The supervisory framework consists of:

- The risk matrix.
- The supervisory risk profile report, which includes the inspection priorities and the supervisory strategy for the institution.
- The institutional profile report.

The *institutional profile report* provides general information on institutional aspects: shareholders, affiliates, structure of economic group, articles of association, effective control, governing and management bodies' organisational charts, Board profile, profile of management and control bodies, business areas, institution's strengths and weaknesses, etc. The institutional profile report explains the institution's corporate governance.

The supervisory framework materializes in the form of the supervisory annual action plans, detailing the specific tasks to be conducted in each institution during the year. The action plan is accompanied, where appropriate, by an assessment of the situation of the banking system as a whole.

The supervisory framework is notified periodically to the Banco de España Executive Commission for its information; the annual action plans are submitted to the Executive Commission each year for its approval.

5 Supervision of international groups. Cooperation with other supervisors

As large credit institutions have expanded into foreign countries in many different geographical areas, cooperation between supervisors has become an essential part of their tasks.

The Banco de España, in its dual role as consolidated supervisor of Spanish institutions that operate abroad and as host-country supervisor of foreign institutions that operate in Spain, is fully aware of this and considers collaboration between supervisors a fundamental aspect of the supervision of these international groups.

In this respect, the Banco de España has signed bilateral and multilateral cooperation protocols with numerous countries, mainly with those with which it collaborates on a regular basis. These protocols are established within the framework of mutual responsibilities envisaged in the "Core Principles for Effective Banking Supervision" issued by the Basel Committee of Banking Supervisors and which contain the commitment made by the signatory authorities to exchange information on the institutions supervised and to cooperate in their supervision, conducting these activities in accordance with high ethical and professional standards.[15]

As a result of these protocols, the Banco de España holds regular meetings with supervisors from other countries, to agree on methods of action and working methods and to exchange views and significant information on the institutions supervised. Recently, as a new stage in this cooperation policy, meetings have been held within the "colleges of supervisors" in which the Banco de España plays an active part as home-country supervisor, calling and running meetings of these colleges for

[15] A practical example of this cooperation is the coordinated review and approval of the advanced approach of Pillar 1, both within Europe, in accordance with the provisions of the Directive, and in Latin America, in accordance with bilateral agreements entered into with the national supervisors.

Spanish institutions that operate abroad, and as host-country supervisor, participating in meetings of these colleges called by other supervisors.

ANNEX 1. Definition of risks affecting institutions

- *Credit risk*: the possibility of having losses as a result of non-compliance by debtors with their contractual obligations. Includes counterparty risk.

- *Credit concentration risk:* the possibility of incurring significant losses, which may jeopardise the institution's future viability, as a result of concentration of exposure on a small group of borrowers, on a set of borrowers with similar behaviour, or on highly-correlated financial assets.

- *Equity risk*: the risk that financial holdings in other companies may decrease in value. Does not include equity trading book risk.

- *Market risk*: the possibility of incurring losses as a result of adverse moves in the market prices of negotiable products with which the institution operates.

- *Structural foreign exchange risk:* the possibility of incurring losses as a result of net structural positions in foreign currency. Includes the risk stemming from permanent financial holdings in foreign currency, but not from held-for-sale holdings.

- *Operational risk*: the possibility of incurring losses as a result of inappropriate processes or systems or technical or human resources, or due to failures in said processes, systems or resources, or outside events. Includes legal risk.

- *Structural interest rate risk:* the possibility of incurring losses due to the potential impact of interest rate fluctuations on the institution's earnings or on its net asset value.

- *Liquidity risk:* the possibility of incurring losses due to the institution having insufficient liquidity with which to promptly meet its payment obligations.

- *Business risk:* the possibility of incurring losses stemming from hypothetical (internal or external) adverse events that negatively affect an institution's ability to achieve its objectives and consequently have a negative effect on earnings (income statement) and, through the latter, on solvency.

- *Reputational risk*: arises from actions taken by institutions that may lead to negative publicity concerning their business relations and practices, which may result in a loss of confidence in the institutions, and thus affect their solvency.

ANNEX 2: Reduced risk matrix

FINANCIAL INSTITUTION:	REDUCED RISK MATRIX			
Type of risk	Inherent risk/Trend	Internal governance	Risk management and control	Residual risk/Trend
Credit	(1) Low	(23) Good	(2) Acceptable	(3) Low
Credit concentration	*Low*		*Deficient*	*Medium-low*
Market	(4) Low		(5) Deficient	(6) Medium-low
Operational	(10) Low		(11) Improvable	(12) Medium-low
Liquidity	(13) Low		(14) Good	(15) Low
Interest rate risk in the banking book	(16) Medium-low		(17) Deficient	(18) Medium-high
Other risks	(19) Low		(20) Acceptable	(21) Low
Weighted aggregation of risks and controls	(22) Low	(24) Improvable		(25) Medium-low
Corporate governance	(26) Good			
Institution's risk profile	(27) Medium-low			
Assessment of solvency	(28) Acceptable			
Supervisory risk profile	(29) Medium-low			
Supervisory priority	2			