Report by the Internal Committee

Analysis of the supervisory procedures of the Banco de España and recommendations for their reform

Translation of a report originally written in Spanish. In the event of a discrepancy, the Spanish-language version prevails.

31 October 2012

Contents

1 Executive summary

On 20 July 2012 the *Memorandum of Understanding on Financial-Sector Policy Conditionality* (MoU) was signed. Paragraph 24 of the MoU referred to the commitment by the Banco de España (BdE) to conduct an internal review of its supervisory procedures, including the decision-making process. The review has been led by the BdE Council Member, Mr. Ángel Luis López Roa, assisted by an Internal Committee.

The aim of the review has been to perform a diagnosis of the supervisory procedures of the BdE for the purpose of identifying shortcomings and formulating proposals for reform.[1] With the aim of responding to the stipulations in the aforementioned MoU recommendation, this report pays particular attention to the following two issues: a) testing whether the procedures in place in the BdE, including the recent improvements introduced hitherto, ensure that the findings of supervisory actions translate effectively and without delay into remedial action; b) defining a system that ensures that macroprudential supervision is properly incorporated into microprudential supervision and into supervisory policy decision-making.

The report details the scope of and the way in which the Internal Committee has worked, the inputs it has used (including recommendations by independent third parties and the recent work by various international fora on best supervisory practices), analysis of recent innovations to BdE supervisory procedures and the specific work performed by the Internal Committee.

As a result of the latter, the Internal Committee has set out the proposals summarised below[2]: a) to define a standardised framework for the adoption of supervisory actions on the basis of each bank's risk profile, strengthening the preventive arm of prudential supervision; b) to fully implement on-site continuous supervisory arrangements at all significant Spanish banking groups; c) to improve the execution of supervisory actions; d) to establish an organisational structure and procedures that ensure that macro- and microprudential supervision are properly linked, enabling the regulatory or supervisory policy decisions deemed appropriate to be adopted; e) to pursue other proposals which, in the Internal

[1] For a readier understanding of this report, of the reforms already undertaken and of the proposals to improve supervisory procedures considered in it, see BdE supervisory model (www.bde.es).

[2] The Commission stresses that it should be borne in mind that a significant change in the supervisory framework for credit institutions is taking place in Europe and that, consequently, BdE supervisory procedures will have to adapt in the future to this new situation.

Committee's judgment, would help improve the effectiveness of the BdE's supervisory procedures.

a) Pillar 2 supervisory actions on the basis of the risk profile

It is proposed to set in place an early correction procedure so that, as a specific bank's risk profile increases, predetermined supervisory actions are activated relatively automatically, and progressively more coercively, to halt as soon as possible the foreseeable future deterioration.

The procedure recommended combines qualitative measures (improvements in internal governance, inherent risk) and quantitative measures (percentages of retained profits, capital add-ons), which change from being recommendations to becoming formal requirements. This pre-emptive procedure aims to focus the supervisory strategy so that all Spanish institutions tend towards a low or medium-low risk profile.

b) On-site continuous monitoring at significant institutions

It is proposed to move further with extending on-site continuous monitoring to all significant Spanish institutions. The composition and working structure of the on-site monitoring teams will be flexible so that they may adapt to the needs arising at different institutions.

For other institutions, it is proposed to develop a specific supervisory procedure based on a powerful, annual, off-site monitoring programme. In the case of deposits institutions, such off-site monitoring would be supplemented by regular inspection visits every three years.

c) Formalisation of supervisory actions

It is proposed that, once the related on-site supervisory inspection is complete, a summary document of the situations requiring correction or that have been corrected during the inspection be delivered to the bank that has been inspected.

It is proposed that, for banks in on-site continuous monitoring programme, a report summarising the work performed be drawn up half-yearly. This report should include all the adjustments and shortcomings observed in the last half-year period. On the basis of this report, the related letter of requirements or recommendations shall be proposed to the Executive Commission, including all the adjustments and shortcomings detected during the half-year period, as well as those already rectified.

It is proposed that information for the Executive Commission about possible discrepancies between the inspection report, on one hand, and the information and the proposal to the Executive Commission, on the other, be included in a specific section of the reports referred to in Articles 17.1 and 18.2 of Circular 7/2011.

It is proposed to strengthen the inspection planning procedure and the procedure for monitoring compliance with letters of requirements and recommendations.

d) Procedure for linking macroprudential supervision to microprudential supervision

It is proposed that a cross-departmental organisational structure be created at the highest level, the Macroprudential Policy Committee (MPC), to analyse macroprudential risks, to propose macroprudential policy measures to the Executive Commission, to monitor the decisions adopted and report on the degree of compliance therewith and on changes in the related macroprudential risk. A support group will report to this Committee.

The MPC will submit two kinds of proposals for action to the Executive Commission: warnings and requirements, which may be addressed to financial institutions or to the pertinent Directorates General of the BdE. Warnings will be issued on those risks or vulnerabilities that may potentially affect the financial system but which do not exceed a minimum threshold of materiality that warrants the adoption of specific measures. Requirements of specific measures will involve observing changes in the macroprudential risk, verification of the extent the actions required have been implemented, and the evaluation of their impact and effectiveness.

The warnings and requirements that the BdE decides to make public shall be made sufficiently visible on the Banco de España public website.

e) Other methodological, procedural and quality-related reforms

In addition, a further series of proposals to reform BdE supervisory procedures has been considered: a) updating the procedures provided for in Circular 7/2011; b) developing a procedure for the review of institutions' governance; c) creating a horizontal group for the review of regulatory compliance; d) improving the procedure for the evaluation of the quality and effectiveness of the supervisory function; e) changing the staff rotation procedure; f) conducting studies of the Directorate General Banking Supervision staff needs, career path, spaces and resources; g) publishing information relating to BdE supervisory procedures on the BdE external website.

f) Other proposals

It is proposed to delimit the supervisory procedure for non-significant institutions and improve the relationship between supervisors and auditors.

2 Scope of the work performed.

On 20 July 2012 the *Memorandum of Understanding on Financial-Sector Policy Conditionality* (MoU) was signed, paragraph 24 of which included the following commitment:

"*The supervisory procedures of Banco de España will be further enhanced based on a formal internal review. The Banco de España will conduct a full internal review of its supervisory and decision-making processes by end-October 2012 in order to identify shortcomings and make all the necessary improvements. In this internal review, the Banco de España will test recent improvements made to the supervisory procedures in order to ensure that the findings of on-site inspections translate effectively and without delays into remedial actions. Specifically, the authorities will analyse the need for any further improvements in the communication to the decision making bodies of vulnerabilities and risk in the banking system, in order to ensure the adoption of corrective actions. Furthermore, the authorities will ensure that macro-prudential supervision will properly feed into the micro supervision process and adequate policy responses".*

The BdE has performed an internal review of its supervisory procedures, including the decision-making process. The review has been led by the BdE Council Member, Mr. Ángel Luis López Roa, assisted by an Internal Committee - hereafter the Committee - made up of four people from Directorate General Banking Supervision (DGS), one from Directorate General Banking Regulation and one from the BdE Internal Audit Department (IAD).

Staff from the following BdE business areas have collaborated in the review: four from the DGS departments responsible for the supervision of institutions, four from the Associate Directorate General Banking Supervision, two from Supervisory Planning and two from the Financial Stability Department of the Directorate General Banking Regulation.

The Committee was also assisted by two foreign experts from the central bank of France and of the Netherlands. Further, the Committee sounded the opinions of the Directors General for Banking Supervision and Banking Regulation, and those of the Association of Inspectors of Credit and Savings Institutions.

The aim of the review was to perform a diagnosis of BdE supervisory procedures for the purpose of identifying shortcomings and formulating proposals for improvement. Accordingly, this Report is confined to the aspects indicated by recommendation 24 of the above-mentioned MoU. It does not analyse the causes of the current financial crisis, nor may it be considered a comprehensive response to the lessons that may have been drawn from the crisis which, in accordance with the analyses conducted by most international authorities, are very wide-ranging.

As a starting point for the Committee's work and recommendations, the latest reports on BdE supervisory procedures taken from the related evaluations made by independent third parties have been considered. Specifically, the Committee has considered a) the documents from the June 2012 "*Spain: Financial Stability Assessment*" (FSAP), prepared by the International Monetary Fund (IMF); b) the November 2011 Report on Supervisory Practices by the consultancy Oliver Wyman (OW). In addition, the latest reports by the BdE Internal Audit Department on the review of various DGS supervisory procedures have been analysed. Section 3 of this document includes the main findings of the work mentioned.

In parallel, the recent work in various international fora on best supervisory practices has been reviewed, with a view to identifying potential ways of refining the supervisory procedures currently applied by the BdE. The findings of this review are presented in Section 4 of this Report.

In keeping with the express mandate of the MoU, a review has also been made of the recent innovations to BdE supervisory procedures and the extent to which they address, in full or in part, the weaknesses and the areas for improvement identified by the IMF and by the above-mentioned independent third parties. This analysis features in Section 5 of the Report.

Based on these reviews, a series of specific areas of work have been undertaken, as reflected in Section 6 of the document, for the purposes of identifying potential additional weaknesses in the BdE's current supervisory procedures. This work has enabled a diagnosis to be made of BdE supervisory procedures and, especially, of what is the core purpose of this report, i.e. to list the areas for reform and improvement identified and to set out the related recommendations for action, which are detailed in the last section of the report.

3 Findings of the reviews of BdE supervisory procedures recently made by independent experts

Two external independent agencies have very recently evaluated the BdE's supervisory procedures: a) the IMF, as part of the FSAP for Spain in the first half of 2012; b) the consultancy Oliver Wyman (OW) which, commissioned by the BdE itself, made a comparative study of BdE supervisory practices in the second half of 2011 and those of seven other developed countries.

Furthermore, the BdE Internal Audit Department has recently reviewed various DGS supervisory procedures and set out recommendations.

3.1 Recommendations by the IMF

Listed below are the main findings of the recent IMF evaluation, relating to BdE supervisory procedures:[3]

IMF.1 To review internal governance at the BdE in order to strengthen the independence of the supervisory process and its transparency, so that it may be better understood by third parties. Specifically, the IMF indicates that selection, appointment and assignment of responsibilities in supervisory processes should be clear and public.

IMF.2 To complement the current risk-based supervisory methodology SABER (Risk-based Approach to Banking Supervision) with a more structured and forward-looking approach that allows for prompt and flexible adoption of preventive and corrective measures prior to crises. The BdE should define in advance a series of specific supervisory actions to be considered for each risk category in which banks are classified, retaining flexibility when it comes to deciding on the specific measures to be adopted at each point in time.[4]

IMF.3 Review by the BdE of its procedures to ensure that legislation and its requirements of banks are complied with, adding speed to the taking of early measures. For example: a) to set in place early notification to the bank of matters susceptible to improvement. Specifically, to set greater store by written communication by the inspection team to the bank on completion of the

[3] The recommendations made by the IMF as part of the FSAP are confined to those affecting supervisory procedures, since this is the scope of the current Report.

[4] In clear reference to the Canadian supervisory model.

inspection or the inspection-related action. b) to link the issuance of letters of requirements to specific risk-based benchmarks, such as risk matrix trends, level of capital and the level of supervisory risk extended to a bank.

IMF.4 To continue with the application of the internal capital adequacy assessment to all institutions and its integration into the risk matrix.

3.2 Improvements to supervisory practices indicated by OW

In 2011 the consultancy OW conducted an analysis comparing the supervisory practices of the BdE with those of seven other countries (Australia, Canada, France, the Netherlands, Sweden, the United Kingdom and the United States). To perform this review, OW held meetings with many people from all the DGS Departments. The report by OW offers the following best practices in respect of BdE supervisory procedures:

OW.1 To improve the interaction between micro- and macroprudential supervision. OW considers that this is one of the clearest emerging areas in which all the supervisors analysed may advance.

OW.2 To define the "appetite for risk"[5] of the BdE. The risk appetite framework of the BdE should be jointly determined with the Ministry of Economic Affairs and Competitiveness, through the Financial Stability Committee. Once defined, it should be driven from the top throughout the organisation and it should influence supervisory strategic planning, giving structure to its risk tolerance.

OW.3 To reflect on the model for assigning inspection teams to institutions. In Spain, most inspectors are assigned to a specific bank. This structure reinforces a deeper knowledge of the institutions, but it is relatively inflexible. Conversely, the pool structure strengthens cross-departmental knowledge and uniformity of criteria, and it makes resource allocation more flexible, albeit at the expense of less knowledge of each specific bank[6].

OW.4 To reflect on the functions of the horizontal groups. The cross-departmental support functions for certain areas (risk specialists, policies, regulation, authorisations, sanctions, macroprudential supervision) are essential. At all the

[5] Term coined which attempts to identify the "degree of risk tolerance".

[6] OW does not say which of the two structures it considers better (the permanent assignment of inspectors to specific institutions or a pool of inspectors), confining itself to setting out the advantages and disadvantages of each.

supervisors analysed there are cross-departmental support functions, with solely advisory tasks. However, inefficiencies may arise if there is no clarity in communication and hierarchy structures.

OW.5 To reflect on the process of application of supervisory measures.[7] In all cases, the report is signed by the division head, and agreed with the head's superiors. The role of the department director ensures a coordinated view of the bank, providing at the same time his experience both in the drafting of the report and in the proposal of supervisory measures. The director-general for banking supervision ensures that criteria are cross-departmental and uniform across institutions, likewise providing his experience. The leadership and the signing of the report by the head of the inspection team reinforces its independent nature. The adoption of supervisory actions is made through a collegiate committee or body (Executive Commission), in line with the practices pursued by 100% of the supervisors analysed.

3.3 Recommendations by the BdE Internal Audit Department.

The BdE's IAD has recently reviewed various supervisory procedures of the DGS: a) in 2010, authorisation and administrative procedures; b) in 2011, bank-monitoring procedures. These reviews gave rise to the recommendations listed below:[8]

IAD.1 Operational processes involving authorisations and administrative procedures. Formal determination of the documentation received that has to be included in the SIGAS (Integrated Supervisory Activity Management System) records, and the setting in place of the necessary measures so that the records are duly substantiated and documented and so that, based on the authorisation typology, their content is homogeneous.

IAD.2 Information Systems. Information management. Analysis of the advisability of making the necessary changes to the SIGAS application, with the aim of adding greater flexibility to timelines.

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[7] OW does not consider recommendations relating to the process of adoption of supervisory actions, as it views the process as appropriate.

[8] In response to these recommendations, the related plans for reform affecting the DGS and the BdE Information Systems Department were drawn up.

IAD.3 Monitoring of institutions. Ensure that the evidence and findings of the monitoring of supervised institutions are recorded in the SIGAS system so as to guarantee the application of homogeneous and standardised procedures in the performance of this supervisory activity and to maintain effective control over the performance of these monitoring activities. If, as a result of such monitoring, a considerable change were to come about in risk evaluation, the updated Executive Summary and Risk Matrix must be incorporated into the system.

IAD.4 Monitoring of institutions. Study of the advisability of implementing measures that enable: a) a distinction to be drawn between those periodic monitoring exercises considered necessary according to the type of bank, and one-off monitoring exercises that may be made on the basis of circumstances. b) Incorporation of early warning mechanisms into the system for the periodic execution of activities, for the purpose of reinforcing control over the performance of such activities. c) Incorporation into SIGAS of all monitoring measures included in the Annual Plan of Action, for the purposes of effectively controlling execution of the plan.

Currently, the IAD of the BdE is reviewing the supervisory procedures for on-site inspection visits. Although the review has not been completed, the preliminary conclusions recommend the following:

IAD.5 Supervisory framework and annual action plan. Improve the preparation of the supervisory framework through the creation of shared, uniform and standard procedures for all departments of the Directorate General Banking Supervision, so that the Executive Commission is furnished with individual Information on each bank's risk profile.

IAD.6 On-site inspections. The preliminary report prepared prior to commencement of on-site inspections should set out an estimated schedule with suggested time periods and deadlines for the main milestones during the course of the inspection, including the inspection report. Any significant deviation from the initially defined timetable must be justified in an explanatory note including a new schedule, which must be approved.

IAD.7 Continuous on-site monitoring. Implement reporting procedures to inform the Executive Commission of the results derived from continuous on-site monitoring. These reporting procedures should be similar to those in place for inspection actions.

IAD.8 Assessment of the quality of supervision. Define a procedure for assessing the quality and effectiveness of the supervisory function through periodic evaluation of the performance and execution thereof. This procedure should allow possible means of improving supervisory methodology and processes to be identified.

4 Work on supervisory practices in international fora

Different international organisations are reflecting on possible improvements in supervisory procedures, including the relationship between supervisors and external auditors. Their work has given rise to various recommendations considered useful for reforming and improving the BdE's supervisory procedures. The fora mainly involved in this analysis are: a) FSB-SRC (Financial Stability Board, Standing Committee on Supervisory and Regulatory Cooperation); b) EBA-SCOP (European Banking Authority, Standing Committee on Oversight and Practices); c) BCBS-ATF-AS (Basel Committee on Banking Supervision, Accounting Task Force, Audit Subgroup); d) European Commission (EC), Working Group on External Auditing.

In November 2010 the FSB published a report entitled "Intensity and effectiveness of SIFI supervision" setting out 32 recommendations for more intensive, effective and reliable supervision. The following recommendations, directly related to supervisory procedures, are considered particularly useful:

FSB.1 Supervisory resources: a) *"…Resource allocation must consider systemic risks posed by banks and should reflect the fact that for SIFIs, there is a minimum acceptable level of annual work that should not be breached". b) "As part of their annual resource planning exercise, supervisors should regularly (at least annually; on a rolling basis) take stock of existing skills and projected requirements over the short to medium term and review and implement measures that could be taken to bridge any gaps in numbers and/or skill-sets…"*

FSB.2 Horizontal reviews: *"Consideration should be given to expanding BCP 19 and BCP 20 on supervisory approach and supervisory techniques respectively. In particular, there should be greater discussion of the use of horizontal reviews and good practice around the use of this valuable supervisory tool".*[9]

[9] This recommendation has been included in the recent review of the "Core Principles (CP) for Effective Banking Supervision (BCP)" published by the Basel Committee (in September 2012). CP 9, on supervisory techniques and tools, includes horizontal comparative reviews among the various tools available to supervisors for reviewing and evaluating banks and banking systems.

FSB.3 Review of governance: *"Consideration should be given to developing expanded BCBS guidance to supervisors on how to assess a board with the goal of being better armed with tools and techniques which enable better determination of board effectiveness".* [10]

FSB.4 Focus on results: *"Supervisory authorities should determine whether their frameworks for risk assessment focus enough on the risk outcomes that result from the processes which are being evaluated. This would include both looking at trends in the quality of outcomes and "truing up" risk assessments against stress test outcomes (i.e. do business lines rated as low risk show outcomes that support this assessment in stress tests?)"*

FSB.5 Continuous and full supervision: *"All supervisory authorities should develop and codify a comprehensive communication regime which calls for frequent communication between senior levels of supervisory authorities and firms to ensure that information flows between industry and regulators on a continuous basis. In addition, a less formal but equally important regime must be developed and maintained between the authority and the firm in the areas of specialized expertise including credit, market and operations risk. (It is expected that such frequent communication is already in place between line functions in a firm and the generalist supervisory teams.) The supervisor's internal communication regime should express the need for escalation of issues vertically and horizontally, and the need to aggregate the outcomes of these interactions into thematic conclusions for senior level consideration".*

FSB.6 Macroprudential supervision: *"Supervisory authorities must have a well developed macro-prudential surveillance approach which is designed to identify trends and developments that might negatively impact the risk profile of its firms. It should be endorsed by all government stakeholders, provide for consultation and coordination with those stakeholders, identify the key sources of market and industry information, articulate a regular communication regime with those sources and take into account the expertise of all of its various disciplines (credit, market, operations risk) when assessing that information. This approach must regularly inform the senior management team within the supervisory authority and where appropriate should generate senior level communication between firms and the supervisor".* [11]

[10] CP 9 also includes analysis of corporate governance, risk management and internal control systems.

[11] The BCPs also incorporate macroprudential supervision. Although they do not dedicate a specific principle to it, the document contains innumerable references to it.

FSB.7 Review of business risk: *"Consideration should be given to expanding BCP 19 and BCP 20 on supervisory approach and supervisory techniques respectively. The BCPs should consider covering the area of business model assessment and product oriented risk analysis, such that supervisors are guided to better understand the risk embedded in the business models of the banks as well as in the design of their product offerings. In addition, the BCPs should reflect the need for supervisors to ensure that firms have processes to monitor post-approval alterations made to new products which may alter their risk profile. In such cases, the firm's new product approval process should be re-applied".*

FSB.8 Supervisory risk appetite: *"National supervisors should consider how their supervisory frameworks set control expectations for SIFIs, and they should be confident that the assessment criteria for the control environment at SIFISs set a "higher bar" for those firms to achieve in the areas of internal controls given the potential systemic impact that they pose."*[12]

The EBA's SCOP is reviewing the supervisory models of the EU countries with a view to publishing shortly a "Report on the findings, and the range of practices". The work is still in the preliminary phase, but two proposals on supervisory procedures have been presented which are considered to be important:

SCOP.1 When the supervisory actions have been completed and the initial proposals made by the inspection teams, a different unit must be responsible for drawing up the final proposals. The aim would be, on one hand, to ensure greater homogeneity and equality of treatment across institutions and, on the other, to avoid problems of loss of objectivity on the part of inspection teams.

SCOP.2 There must be a specific procedure available for "low impact" institutions based on a risk approach and on the rapid application of more severe measures.

Finally, the BCBS-ATF is analysing various possibilities for improving the relationship between banking supervisors and external auditors, so that the work of the latter can be a more useful input for the former. In the same vein, the EC is studying various proposals for legislative changes in relation to the auditing of public interest entities, which include credit institutions, with the aim of strengthening auditors' independence and the quality of their work. The following two proposals are notable:

EC.1 Rotation of the audit firm at least once every six years, with a subsequent compulsory four-year cooling off period.

[12] CP 9 also includes business model analysis among the various supervisory tools.

EC.2 A report, additional to the audit report, addressed to the audit committee of the bank, explaining the audit results in detail. This report will be available to the supervisor and is intended to guarantee the quality of the external audit work.

5 Recent innovations in the supervisory procedures of the Banco de España

In recent years the BdE has undertaken three projects to reform and enhance (M, in the following paragraphs) its supervisory processes, the details of which are as follows:

M.1 Implementation of internal Circular 7/2011 of 26 October 2011

In October 2011 the Executive Commission of the BdE approved the internal Circular 7/2011 on the general framework for procedures applied by DGS. This Circular systematises the procedures applied by DGS when performing its activities, issuing reports and taking decisions, in relation to the following areas: a) supervisory assessment methodology and reports; b) planning of supervisory actions; c) inspection and monitoring of institutions; d) horizontal review of certain risks; e) subsequent actions and f) administrative procedures.

The Circular states that the various areas of activity of DGS must have detailed action protocols and working procedures, to ensure the homogeneity and consistency of supervisory actions. These protocols and procedures, to be established by means of the relevant internal regulations, will ensure that the data-processing system put in place to provide support (SIGAS) is consistent with the general framework envisaged in the Circular.

The Circular regulates the composition and functions of the Management Advisory Committee and the Coordination Technical Committee (CTC). The functions of these committees are, respectively, to advise the Director General and to foster uniform criteria for action within DGS.

This Circular, and the internal regulations implementing it, formalise in writing the various procedures that DGS is currently applying, but incorporates some enhancements that were considered necessary. In this respect, the Circular makes two important changes intended to ensure that the conclusions of on-site inspections are communicated effectively and without delay to the BdE's decision-making bodies: a) the conclusions of inspection visits must be transmitted rapidly to the decision-making bodies – specifically, no more than 60 days shall pass between the signing of the inspection report and submission to the Executive Commission of the relevant proposal by the Director General (Article 18); b) in the event of discrepancy between the person responsible for drafting the report and the head of division, the Director General shall inform the Executive Commission of this circumstance (Article 10).

M.2 Implementation of Pillar 2 of Basel II

The objectives of Pillar 2 of Basel II are: a) to ensure an adequate relationship between the credit institutions' risk profile institutions and the capital they effectively hold; b) to ensure that the Banks are appropriately governed and have sufficient and reasonable risk management and control systems for the risks they assume. To achieve these objectives Basel II lays down that institutions must perform, every year, an internal assessment of their own capital adequacy, which supervisors will review, taking the appropriate measures if it is not to their satisfaction.

The implementation process for Pillar 2 of Basel II was commenced at the Banco de España in 2007. A working group was set up for the purpose, which first developed the guidelines on the internal capital adequacy assessment process (ICAAP) at credit institutions. After being submitted to public consultation, the guidelines were approved by the BdE's Executive Commission and published on 25 June 2008. They have subsequently been amended in March 2009 and January 2011, to incorporate the changes that were necessary in the light of the experience acquired. The purpose of the guidelines is to facilitate banks the application of the above-mentioned internal capital adequacy assessment process referred to by Basel II.

Subsequently, in February 2010, the Executive Commission approved the Guidelines on the Capital Review Process, the purpose of which is to inform institutions of the criteria and methodologies used by the Banco de España for the review and evaluation of the internal capital adequacy assessment process of credit institutions. These guidelines have also been published and, like the ICAAP guidelines, are available on the Banco de España's website.

Since 2009, institutions have been drawing up each year the internal capital adequacy assessment report (IAC, by its Spanish initials), referred to by the above-mentioned guidelines, which they send to the BdE along with the year-end own funds reporting. In the IAC the institutions describe and justify their risk profile, their internal governance, their organisational structure and risk management and control systems. In addition, they establish their target capital ratio, which must be in line with their risk profile, and present medium-term (3-year) capital plans which will enable them to meet such target on a permanent basis, along with an adequate buffer over the minimum legal requirements.

For their part, the inspection teams review and assess the report and determine whether the institution's risk profile, risk management and control and level of own funds are appropriate. More specifically, the inspection teams carry out the following tasks: a) they assess the quality of the IAC received from the institution; b) check the assessment of the inherent risk in the IAC against the inherent risk in the BdE's risk matrix; c) evaluate whether the own funds target established by the institution is appropriate for its risk profile; d) examine the differences, with respect to the previous year's IAC, in the risk profile, own funds target and capital planning; e) analyse certain unregulated risks: individual and sectoral concentration, structural interest rate, business and reputational; and f) review the capital planning presented by the bank, assessing its reasonableness, the deviations from the capital plan in the previous year's IAC and the stress tests presented by the institutions.

Since 2009 annual meetings have been held on the IAC with a large proportion of the significant institutions, in order to point out the shortcomings detected in the report and the necessary improvements, and to compare the view of the institution itself, as expressed in the IAC, with that of the BdE, based on its supervisory actions, with respect to: a) the risk profile; b) the necessary own funds target; c) the foreseeable future developments in the solvency ratio; d) the appropriateness and sufficiency of its governance, risk management and control systems.

M.3 Implementation of on-site continuous monitoring at medium-sized institutions

On-site continuous monitoring, implemented more than ten years ago at the two large Spanish banks, Santander and BBVA, yields rapidly and constantly all the relevant information on both institutions, including the internal management information used by the institutions themselves. This supervisory approach provides constant up-to-date information on the institutions and enables prompt supervisory action to be taken.

The basic idea behind on-site continuous monitoring is that it is not done "simply" to monitor institutions, but to influence them in good time. The sole reason for being continuously present at institutions is for the supervisory response to be more flexible and faster, without waiting for problems to worsen.

DGS has for the last three years been extending on-site continuous monitoring to other smaller albeit significant institutions (Caixa, Banco Popular, Banco de Sabadell, etc.), because it considers that this form of supervision is better than traditional supervision — based on off-site continuous monitoring and inspection visits every two or three years — since problematic situations are revealed sooner and in more detail.[13]

6 Specific reviews of the Working Group

In the light of the conclusions of the reviews made by independent third parties and of the work on supervisory practices in the various international fora, and of the scope of the work referred to in paragraph 24 of the MoU, the Working Group has reviewed and reflected on the following aspects of the BdE's supervisory process, in order to identify possible areas for improvement.

T.1 Review of compliance with Circular 7/2011

The most relevant aspects of the actual implementation of Circular 7/2011 have been reviewed. Specifically, in relation to the new procedures proposed in Articles 10 and 18, which seek to ensure that the conclusions of the on-site inspections are effectively communicated without delay to the BdE's decision-making bodies, it has been confirmed that: a) of the 15 inspection reports signed and submitted to the Executive Commission since the implementation of the Circular, only two were outside the 60 day limit (albeit by a small margin; 63 and 68 days, respectively); b) the criterion discrepancy referred to by Article 10 has not existed.

On the basis of the work carried out, it is considered that although the general framework for procedures referred to by the Circular has been sufficiently implemented, it needs to be further developed. Specifically: a) the internal regulations referred to by the Circular have still to be developed, although in many cases the procedures that will be included in the internal regulations are already well defined, implemented and incorporated into SIGAS; b) the data-processing

[13] However, on-site continuous monitoring makes intensive use of supervisory resources, an issue that needs to be borne when considering its extension. Specifically, 45 inspectors are currently involved in the on-site continuous monitoring of Banco de Santander and 35 in that of BBVA.

system supporting the work of the inspectors (SIGAS) should be better adapted to certain supervisory procedures of the BdE (especially on-site continuous monitoring), so as to ensure its consistency with the general framework for procedures envisaged in the Circular; c) a specific procedure should be designed for designing the supervisory framework and the annual action plan, referred to respectively by Articles 4 and 5 of Circular 7/2011.

T.2 Review of the degree of implementation of Pillar 2

Since 2007 Pillar 2 has been gradually incorporated into the BdE's supervisory process. This incorporation has not been simple for two reasons: a) it was necessary for institutions to understand and assume the nature of this new supervisory tool: to influence, by means of increasingly coercive supervisory measures, the risk profile of institutions insofar as it is deteriorating; b) the crisis itself has prevented completion of the implementation of Pillar 2 since it is more a supervisory tool for crisis prevention than crisis resolution.

To coordinate and foster implementation of Pillar 2 a horizontal support team was created, within the Supervision Technical Secretariat and Institutional Relations Division of DGS. This approach has been positive since it has facilitated an increasingly significant involvement of the inspection operating divisions in Pillar 2. However, as the IMF has stated, the implementation of Pillar 2 is not complete and should be continued by means of the application of the IAC to all institutions and its integration into the risk matrix.

The following shortcomings have been detected: a) annual IAC review meetings have not been held with all institutions, although the number has been increasing over the years. In 2009 meetings were held with 10 institutions, in 2010 the number of meetings was 28 and in 2011 there were 36 meetings; b) in some of these meetings the seniority of the participants has not been appropriate, in the light of the problems existing (the failure of top executives of some institutions to participate has been regrettable); c) the conclusions of the IAC review have not been communicated in writing to the institutions, despite the existence of significant discrepancies between the views of the institution and those of the inspection team (the conclusions of the meeting have always been in the form of notes drafted by the operating divisions, but these notes have not been sent to the institutions); d) at some meetings with the institutions, the discussion of the institution's risk profile was not sufficiently structured by the inspection teams; e) sometimes the institution's risk profile was not sufficiently up to date.

It is considered necessary to complete the implementation of the Pillar 2 actions procedure (at a very advanced stage of development), so that the actions of the BdE are standardised on the basis of the risk profile of each institution, in line with a specific recommendation of the IMF.

T.3 Review of the procedure of on-site continuous monitoring at medium-sized institutions

Implementation of this type of monitoring at significant Spanish institutions that are smaller than the two large banks has been reviewed, and the following issues identified: a) the need for more human resources for the effective application of this procedure; b) the need to redefine the objectives, procedures and milestones, in accordance with the fewer resources available and the different supervision requirements of these institutions relative to the two large banks; c) the contradiction between the long-term objectives of on-site continuous monitoring (access to sources of information, knowledge of procedures and organisation and, above all, the prompt adoption of measures) and the current delicate situation of some institutions, in the middle of restructuring processes; d) the need to homogenise the actions of different inspection teams and the difficulty of doing so.

In addition, the way in which on-site continuous monitoring has been carried out (both at medium-sized and large banks) involves a number of potential risks that must be monitored: a) it involves a loss of benchmarks for comparison, since basically the team works with the institution's own management information; b) the objective of influencing the institutions by means of persuasion is placed before strict supervisory demands; c) it gives greater weight to the knowledge built up by the inspection team than to the necessary rotation of inspectors.

It is considered that on-site continuous monitoring needs to be better adapted to the lower level of human resources available[14] at medium-sized institutions and to the different supervisory requirements of these institutions compared with the two large Spanish banks. In addition, the BdE's supervisory procedures must avoid materialisation of the potential risks mentioned in the previous paragraph.

[14] Or, if necessary, the supervisory resources need to be increased.

T.4 Review of the procedures and transmission of the results of macroprudential supervision to microprudential supervision.

As a result of the international financial crisis that began in 2007, various international organisations, including the IMF, the FSB and the Basel Committee, have highlighted the need to strengthen macroprudential supervision. Another of these organisations, the European Commission, following the study of the crisis tasked to the "Larosière Group",[15] decided to set up the European Systemic Risk Board (ESRB) in 2010. This body – independent of the European Union – has been charged with generally safeguarding financial stability through the exercise of macroprudential supervision at the EU level. For its part, Basel III puts special emphasis on macroprudential supervision, incorporating effective supervisory tools, such as, for example, the countercyclical capital buffer, which are in the process of transposition to the new EU Capital Requirements Directive (CRD IV).

It is considered necessary to formalise the mechanisms for effective linkage between macroprudential supervision and microprudential supervision, both in relation to the detection of risks which may become systemic and the actions to be taken to monitor and mitigate them.[16]

T.5 Review of the notification of requirements and recommendations to institutions within the framework of on-site continuous monitoring

It has been verified that in recent years institutions subject to on-site continuous monitoring have followed the recommendations and requests of inspection teams and carried out the adjustments (of billions of euro) proposed, in most cases through supervisory persuasion, without any formal requirements or recommendations being made in writing. In general, the proposals have been made orally during a regular monitoring meeting or via e-mail. This has led, as the data of the Reports on Banking Supervision in Spain for 2006 to 2011 show, to a significant decrease in the number of recommendation and requirement letters.

This way of proceeding has the advantage that compliance with inspection recommendations is speeded up; but also the drawback, especially vis-à-vis third parties, that supervisory demands are not adequately formalised. Moreover, a

[15] Report of the High-Level Group on Financial Supervision in the EU, chaired by Jacques de Larosière, February 2009.

[16] The design of these mechanisms will be consistent with the new developments in Europe.

system with these characteristics, which may be effective if applied to a pair of institutions, as was the case until a relatively short time ago, will probably not be effective if it is extended to a larger number of institutions, owing to the difficulty of control and the lack of transparency involved. Ultimately, the situation might arise in which such recommendations or requirements are not complied with, since they are not formally made, without this failure to comply having any consequences.

It is considered necessary for the recommendations and requirements that arise during on-site continuous monitoring to be periodically formalised in writing.

T.6 Review of compliance with the recommendations and requirements notified to institutions

Following an inspection visit a document is prepared known as the "triptych", which includes the recommendations and requests made, the response of the institution thereto and an assessment of compliance with each of them. The triptych may be drawn up on the basis of actions still to be taken by the institution (measures that the institution's management have given assurances will be adopted, which in the opinion of the inspection team are appropriate to resolve the weaknesses, but for various reasons have still to be taken).

In this situation the inspection is closed and the head of the division concerned checks actual compliance with the recommendations or requirements. If considered necessary a specific monitoring action may be commenced, but this is not usually done.

It is considered necessary to formalise the procedure to monitor compliance with the recommendations and requirements made as a consequence of any supervisory action, so as to ensure effective compliance by the institutions within a reasonable period.

T.7 Review of the supervisory process for non-significant institutions

The current restructuring of the Spanish financial system has considerably reduced the number of deposit-taking institutions, especially in the savings bank sector. However, there are still a large number of small, highly diverse, institutions: subsidiaries of foreign banks, small independent banks, some savings banks and credit cooperatives that have not participated in the restructuring process, specialised credit institutions, payment institutions, mutual guarantee companies, etc.

In fact these institutions are not given the same attention as more systemic institutions, but it would be desirable to establish a specific and clear supervisory procedure based on close off-site monitoring, combined with short inspection visits every three or four years, distinguishing between deposit-taking and other institutions.

T.8 Review of the procedures for decision-making and documenting the supervisory work

The BdE's various supervisory procedures have been reviewed from the viewpoint of decision-making and documentation.

Some shortcomings, ambiguities and failures to update procedures have been detected, which should be corrected. For example, a) it has been verified that there is a lack of homogeneity between the inspection teams as regards the way in which they communicate to the institutions the preliminary conclusions of the inspections, and the way they file the documentation relating to the weaknesses detected; b) in certain procedures it is not adequately documented who proposes, who approves, who is responsible and who decides.

To overcome these shortcomings it would be useful to update the documentation relating to flowcharts for actions, documentation and decision-making corresponding to the following supervisory procedures: a) inspection; b) on-site continuous monitoring; c) off-site periodic monitoring; d) annual supervisory plan.

T.9 Analysis of the material and human resources of the Directorate General Banking Supervision

For various reasons, set out below, inspection tasks have increased significantly in recent years: a) expansion and internationalisation of the large Spanish banks; b) incorporation of the BdE into the Basel Committee with a very active participation by the BdE in the Basel II implementation process; c) increasing participation by DGS in – constantly more numerous – international working groups; d) approval and monitoring of Basel II advanced regulatory models; e) organisation of annual supervisory colleges for Spain's international banks and participation in the supervisory colleges for foreign banks with subsidiaries in

Spain; f) cooperation and coordination of supervisory actions with other foreign supervisors (the UK's FSA, the US Federal Reserve System, the Mexican *Comisión Bancaria*, etc.); g) increasing reporting requirements of international organisations (EC, ECB, EBA, IMF, FSB, ESRB, etc.); h) the need to review compliance with a set of regulations, guidelines and recommendations or warnings that, in the European sphere, has multiplied in volume and complexity, etc.

It is considered that while other supervisors with the same problems have increased their resources significantly, the BdE has not done so, at least not to the extent necessary, despite their having been a significant transfer from the operating teams tasked with daily traditional supervision of banks to the new support, cross-divisional or specialised supervisory functions mentioned above (participation in international working groups, supervisory colleges, cooperation with other supervisors, stress tests, periodic reporting to international bodies, etc.).

It is considered necessary for the possible need to augment DGS's human and material resources to be evaluated.

T.10 Review of the scope and functioning of horizontal inspection divisions.

All the independent experts consulted, as well as the international supervisory authorities, highlight the need for specialised inspection teams to support the inspection operating divisions in specific areas.

The BdE shares this opinion and DGS currently has the following horizontal inspection divisions: a) Supervision Technical Secretariat and Institutional Relations; b) International Coordination and Advice; c) Off-site Analysis; d) Credit and Operational Risk Management Models; e) Market and Liquidity Risk Management Models and Custody; f) Innovation and Technology; g) Methodology and Quality.

It is considered that the support of a specialised division would be useful for the appropriate monitoring of an additional specialised area, namely regulatory compliance. This division would cover: a) money laundering; b) executive compensation; c) customer relations; and d) loans to directors and related parties. These are very specific issues that require a high degree of specialisation.

Periodic reflection is considered necessary as to the appropriateness of the structure of the horizontal divisions, the resources allocated thereto and the relative weight of the resources allocated to the horizontal divisions and to the operating divisions, in the light of the needs and priorities existing at each time.[17]

Certain specialised reviews are carried out by teams in which inspectors of specialised divisions and operating divisions participate, with a formula for the sharing of responsibilities designed to align the performance of work with responsibility. In general, this structure is functioning correctly, but it is not free of certain risks, such as the possibility that some tasks overlap, or the risk that exists in every exercise with shared responsibilities that ultimate responsibility may not be clearly defined. Consequently, it is considered advisable for a periodic analysis to be carried out of whether the systems established to mitigate these risks function correctly or whether some measure needs to be introduced to ensure that the communication and hierarchical structures are clear.[18]

7 Proposals to enhance the BdE's supervisory procedures.

In view of the recommendations of the independent third parties mentioned above, who have reviewed the supervisory procedures of the BdE in detail, the proposals emerging in the various international supervisory fora (basically of the FSB, the BCBS and the EBA) and the internal reviews carried out, the Commission recommends the reforms to the BdE's supervisory procedures detailed below and summarised in Table 2 at the end of the Report.

P.1 Adopt a structured framework for Pillar 2 supervisory actions in accordance with the risk profile

The basic objective of the BdE's supervisory model is to determine and keep up to date the risk profile of each institution and, where necessary, to take the necessary measures to correct it. The risk profile of each institution summarises in a single variable the possibility that it will suffer solvency, profitability or liquidity problems in future.

It is necessary to implement a more standard, more practical and clearer procedure which can be adjusted early and is based on the situation of each institution, such that any increase in its risk profile automatically activates

[17] It would be advisable to reflect on the need to adapt the structure and composition of horizontal inspection divisions to developments in international supervisory practices (e.g. bank resolution).

[18] See Recommendation OW.4.

progressively more coercive predefined supervisory actions to halt promptly the foreseeable future deterioration.[19]

The recommended procedure, currently under discussion combines qualitative measures (improvements in internal governance, inherent risk…..) with quantitative measures (percentages of retained earnings, capital surcharges...), which, moreover, go beyond mere recommendations to become formal requirements, with progressively shorter compliance deadlines based on the time elapsed and the institution's risk profile. The proposed anticipatory procedure is intended to go beyond mere compliance of legal requirements and to focus the DGS's strategy on reducing institutions' risk profiles, once the problems have been identified.

The legal basis of this new operational framework draws on Pillar 2 of Basel II, referred to in Articles 22, 123, 124 and 136 of Directive 48/2006.[20, 21] This procedure seeks to provide an incentive for all Spanish banks to tend towards a low or medium-low risk profile,[22] which means that, according to the definition of risk profile established in the document "Banco de España Supervisory Model", the risk that they will have difficulties in the future is low, as a result of small inherent risk, good internal and corporate governance, and management and internal control systems suited to their activities.

Once approved by the Executive Commission, this procedure should be published. It is considered necessary that this early supervisory operational framework be known by the institutions to which it will apply.

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[19] This is one of the most important recommendations of the IMF. IMF Country Report No. 12/145. Spain Safety Net Bank Resolution, and Crisis Management Framework-Technical Note (page 4): "The early intervention powers of the BdE, whose objective is to promote financial stability, are strong and flexible, but a more structured and forward looking approach for dealing with weak Banks would be advisable. In this framework, supervisors have to consider an array of measures when a bank is assessed to be in a predefined overall risk category. This would further ensure early and equal treatment of all cases".

[20] Transposed to Spanish law in Article 30 bis, paragraph 1 bis of Law 26/1988 and in Article 6, paragraph 4 of Law 13/1985, both implemented in Royal Decree RD 216/2008 and in Banco de España Circular CBE 3/2008.

[21] The aforementioned procedure –the guidelines for Pillar 2 supervisory actions based on risk profile– has been sent for comment to the Internal Legal Affairs Division and to the Directorate General Banking Regulation. A favourable opinion has been received from the Internal Legal Affairs Division and some useful comments from the Directorate General Banking Regulation which should be taken into account, together with other possible considerations, including those derived from the coming entry into force of the European framework for adaptation to Basel III.

[22] That is to say, it is proposed that the BdE "risk appetite", referred to by the FSB and also by OW, be low or medium-low. In this respect, the "Progress report in implementing the recommendations on enhanced supervision" published by the FSB on 27 October 2011 stipulates that by the end of 2012 the SRC has to send a progress report to the FSB on various matters including the "risk appetite framework".

In this respect it should be noted that each institution's risk level, as reflected in its risk matrix,[23] is based on the knowledge and opinion of it at the time, and takes into account all supervisory actions. Although it is not an automatic assessment system, the BdE uses a standardised procedure for assessing the different cells of the risk matrix. It seeks to evaluate the significant risk factors in all institutions using, moreover, uniform criteria. To make it clear how the BdE assesses institutions and strengthen the commitment to transparency of the BdE, it is also recommended to approve formally and publish the guidelines for fulfilling the risk matrix[24]. It is important to specify, detail and disseminate the factors considered by the BdE in determining an institution's risk profile because this risk profile may, as stated in the preceding paragraphs, give rise to significant supervisory actions.

P.2 Refine implementation of on-site continuous monitoring in all significant institutions

It is recommended to refine the implementation of on-site continuous monitoring in all significant Spanish institutions, including those resulting from the process of financial sector restructuring,[25] adapting it to the characteristics of each institution.

For this purpose, it is proposed to prepare a specific plan for each institution which addresses the following matters: a) Structure of the on-site continuous monitoring team. An appropriate reference here might be the structure currently in place at the two large banks: financial monitoring; risk analysis and governance; traditional inspections.[26] b) Number of team members and functions of each member. c) Setting of the percentage of resources assigned to traditional inspection, on the one hand, and to financial monitoring and risk analysis, on the other. As a starting point, percentages of 60% and 40%, respectively, could be taken. d) Determination of the periodic minimum tasks to be carried out and

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[23] As explained in the document "The Banco de España Supervisory Model", published on the Banco de España website.

[24] The guidelines for preparing the risk matrix seek to take into account all significant factors influencing an institution's risk profile, including governance. They consider major unregulated risks (individual and sectoral concentration, structural interest, liquidity, business, reputation…) which have had an enormous impact in the current crisis.

[25] The 16 more relevant Spanish banks.

[26] An assessment will be made of the need for a special team to cater for requests from international bodies, international working groups, supervisory colleges, etc., so as not to distract the bulk of the team from their supervisory responsibilities.

documentation to be prepared, specifying the frequency. e) Determination of the minimum periodic meetings to be held with the institution: subjects addressed, periodicity and interlocutor level. f) Determination of the minimum periodic meetings for internal coordination to be held by the full team, including the division head, the executive coordinator and the department director. g) Definition of the threshold for material transactions (credit, own funds, liquidity, business and results) of which the team will be informed at the time of origination and which will have to be analysed. h) Definition of the institution's organisational changes of which the inspection team will be informed.

The operational structure of the on-site continuous monitoring teams will be sufficiently flexible to allow adaptation to needs as and when they arise. All material credit portfolios will be inspected at least every three years.

To ensure uniformity of action, all the teams at institutions subject to continuous monitoring will hold at least one yearly coordination meeting with two other similar teams, in which they will share: annual inspection plan, organisation of tasks, concerns, findings and risk matrix. Additionally, it would be advisable to include yearly meetings between departments to present the risk profile of the main institutions, to share criteria horizontally for benchmarking purposes.

Taking advantage of the yearly rotation of inspectors, the human resources of the various on-site continuous monitoring teams will be re-assigned on the basis of the performance (improvement or worsening) of each institution's risk profile and of the supervisory strategy set for each institution in the supervisory framework.

Each year the list of institutions subject to on-site continuous monitoring will be reviewed and the inclusion or exclusion of specific institutions decided.

P.3 Delimit the supervisory procedure for non-significant institutions

It is recommended to establish a specific supervisory procedure for the other institutions (Spanish deposit-taking institutions not included in on-site continuous monitoring, subsidiaries of foreign banks, specialised credit institutions, branches of foreign deposit-taking institutions, payment institutions, mutual guarantee companies, appraisal companies, etc.) based on a strong programme of annual off-site monitoring (including telephone calls and clarifying meetings where necessary), which will generate the related annual recommendations and requirements letters, distinguishing between deposit-taking institutions with their own separate legal personality and others.[27]

In the case of deposit-taking institutions, the aforementioned off-site monitoring would be completed with: a) the respective yearly meetings with the external auditor and the management team, and b) dedicated on-site inspections every three years. The other institutions would only be subject to annual off-site monitoring, unless for some specific reason (size, nature of business, risks detected…) it were considered necessary to include them in the above group.

Notwithstanding the foregoing, if necessary a more intense inspection programme would be applied to any of these institutions.

P.4 Improve the formalisation of supervisory actions

It is recommended that, once the related on-site supervisory action (on-site inspection or on-site continuous monitoring) has been completed and in order to allow prompt compliance with the recommendations and requirements which will foreseeably be issued by the Executive Commission, the inspection team should, following approval of the division head, submit a letter summarising the situations observed which require rectification or have been rectified during the inspection.

It is recommended that every six months[28] the teams assigned to institutions subject to on-site continuous monitoring should prepare a report summarising the work carried out in the six-month period, the degree of completion of the annual plan, non-plan work completed and main conclusions. These reports would include the recommendations and requirements notified to the institution on the following matters detected in the six-month period: a) adjustments in results; b) adjustments in capital; c) reclassifications to doubtful assets; d) reclassifications to sub-standard exposures; d) deficiencies in internal control; and e) any other significant matter worthy of consideration. It is proposed that, on the basis of this report, the Director General Banking Supervision inform the Executive Commission on a six-monthly basis of the progress of the institution, proposing the related requirements and recommendations letter setting out all the

[27] In line with the SCOP.2 recommendation.

[28] Notwithstanding, as is customary, ad hoc reports will be prepared immediately if events or situations so warranting are detected.

adjustments and deficiencies detected in the six-month period, including those already remedied and indicating the remedial action taken.[29]

In order to facilitate compliance with Article 10.1 of Circular 7/2011,[30] it is recommended that the information provided to the Executive Commission on the possible discrepancy between the inspection report on the one hand, and the information and proposal provided to the Executive Commission on the other, be included in a specific section of the reports referred to in Articles 17.1 and 18.2 of Circular 7/2011.

It is recommended to review the procedure for monitoring compliance with Executive Commission recommendations and requirements derived from supervisory actions as follows: a) instruct institutions that in the reply letter they have to make reference to each recommendation or requirement, stating the person responsible for resolving it, the action plan to be followed and the envisaged date it will be resolved; b) once the *triptych*[31] has been prepared, if any unresolved shortcomings remain, a process of specific monitoring of compliance will commence and will not end until all the recommendations and requirements have been complied with; c) an assessment will be made of the need to make specific on-site inspections to check the degree of compliance with certain recommendations or requirements, given their importance; d) after a prudent length of time, at most six months after the on-site continuous inspection or monitoring has ended, the Executive Commission will be informed of the effective compliance with all recommendations and requirements; e) if it is considered that the institution has not complied with the related recommendations or requirements in that time period, a related proposal to open sanctioning proceedings and/or initiate a new on-site inspection, will be submitted to the Executive Commission; f) if the institution is supervised through on-site

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[29] Also, it is recommended to set up a procedure to deal with discrepancies. This procedure would be similar to that in place in the inspection process, such that any discrepancies between those responsible for preparing the 6-monthly report and those responsible for approving it will be notified to the Executive Commission by the Director General of Banking Supervision.

[30] This paragraph reads, in translation, as follows: On completion of the actions, the inspection report shall be drafted. This document shall set out the scope, results and conclusions of the work carried out. The person responsible for drafting this report shall be the person entrusted with the inspection, who may enlist the participation of the team. The Head of Division may express his conformity by approving it or may express his non-conformity. In the latter case, the Head of Division shall inform the Department Director of the difference of views in order for a departmental opinion to be issued. This opinion shall be forwarded to the Director General in the report described in Article 17, which must contain sufficient information on the matter, and the Director General shall in turn inform the Executive Commission of this circumstance.

[31] Document which includes the recommendations or requirements made, the institution's response to them, and the supervisory assessment of compliance with each of them.

continuous monitoring, the monitoring team will check effective compliance with the Executive Commission's requirements and recommendations.

It is recommended to develop a specific procedure for designing the supervisory framework and the annual supervisory action plan referred to respectively by Articles 4 and 5 of Circular 7/2011. This procedure would address the possible reallocation of human resources among the various inspection divisions and departments in order to accommodate them to the needs of each year's plan. Also, the 6-monthly monitoring of the progress of the plan referred to by the Circular will give account of all exceptional supervisory actions and the reasons for them (inspections made that are not included in the plan, inspections included in the plan but not made, inspections initiated but not completed, etc.).

Review the SIGAS computer processes relating to inspection, on-site continuous monitoring and off-site monitoring, so as to: 1) simplify SIGAS to make it easier to use as a tool for working and for recording the reports generated in supervisory actions; 2) ensure that all DGS documents evidencing supervisory actions are protected by the SIGAS system; 3) facilitate the control and monitoring of supervisory actions; 4) facilitate the electronic filing in SIGAS of the working papers documenting the weaknesses detected in supervisory actions.

P.5 Create an organisational structure and a procedure for linking macroprudential supervision and microprudential supervision

In line with the European Systemic Risk Board (ESRB), it is considered that the objective of macroprudential supervision is to contribute to the stability of the financial system as a whole, monitor its resilience to systemic risks and ensure a sustainable contribution by the financial sector to economic growth.

To contribute to the fulfilment of this objective, it is recommended that an organisational structure of a cross-departmental nature be created, focused on the creation of a Macroprudential Policy Committee (MPC) chaired by the Governor or Deputy Governor, with the relevant Directors-General as members. The MPC will direct the BdE's macroprudential policy analysis and decision-making, including the BdE's relationship with other macroprudential authorities.[32]
The MPC will submit to the Executive Commission the relevant proposal specifying the actions to be taken, as well as the directorate or directorates general responsible for their implementation. The Executive Commission will make

[32] The creation of this organisational structure will be consistent with developments at European level and with the ESRB's recommendations.

the final decision, on the basis of this proposal. Subsequently, in the phase of monitoring the actions taken, the MPC will periodically inform the Executive Commission of the degree of fulfilment of its decisions and the evolution of the corresponding macroprudential risk, insofar as the corresponding macroprudential action is not deactivated.

The MPC will have an informal (non-permanent members) support group which will meet frequently and will prepare its meetings. The Macroprudential Support Group ("MSG") will have a two-fold function: a) to carry out Secretariat tasks for the MPC; and b) to act as the technical support group of the MPC.

The MSG will be made up of representatives of all the directorates general belonging to the MPC, in principal at the Department Director level. Also, meetings will be attended by as many experts in the matters at hand as the MSG may consider appropriate. As part of its work in support of the MPC, the MSG will be responsible for identifying and prioritising sources of systemic risk that may affect financial stability, on the basis of the inputs supplied by the relevant directorates general. In particular, this process will link the macro-financial information with other information derived from microprudential supervision.

Macroprudential risks will be identified using two complementary approaches: a) a top-down approach, which will correspond to the relevant directorates general and which will supply overall analysis of risks in the system; b) a bottom-up approach, which will be initiated from the Directorate General Banking Supervision and the Directorate General Operations based on the individual knowledge of the institutions and markets.

To identify and prioritise risks, the MSG will develop a set of macroprudential indicators which it will update as material for its meetings. This set of indicators will be consistent with the ESRB's risk dashboard and will capture information on the main potential risks to financial stability. They will include ratios for monitoring, inter alia, macroeconomic risks (GDP growth, unemployment rate, debt ratios, etc.), credit risks (credit growth, credit-to-GDP gap, etc.), funding and liquidity risks (loan/deposit ratios, maturity mismatch, Basel III ratios, etc.) and market risks (equity prices, interest rates, etc.), as well as information on banking sector profitability and solvency (ROE, ROA, efficiency ratio, regulatory capital ratios, etc.). Developing and using these indicators does not mean that any other qualitative or quantitative information that may be deemed appropriate will not be analysed and taken into consideration. Having identified and prioritised the macroprudential risks, the MSG will submit the relevant report to the MPC for discussion and approval. After receiving the relevant report, the MPC may a) take note; b) request the MSG to carry out further work; c) submit a proposal for action to the Executive Commission for its approval.

The MSG will act as the recipient and transmitter to the MPC of the recommendations from other macroprudential bodies, in particular from the ESRB. Thus, when an external recommendation is received, the MSG will advise the MPC and will propose the actions it may consider most appropriate.

The MPC will submit to the Executive Commission proposals for action, which will be of two types: warnings and requirements.

Warnings will be of a qualitative nature and may be addressed to financial institutions or to the relevant Directorates General of the Banco de España, for examination and monitoring. Warnings are issued on those risks or vulnerabilities which may potentially affect the financial system but which do not currently exceed a minimum materiality threshold above which the adoption of a specific measure by the recipient of the warning would be justified. Also, in the case of macroprudential risks arising in the very short term, the BdE may wish to issue a warning while it considers the best means of mitigating this risk.

Warnings addressed to financial institutions will, in general, be public and aggregate, without identifying specific institutions. Warnings addressed to the relevant directorates general will be internal, so that they can examine and monitor the risk or vulnerability.

In short, warnings will draw attention to a specific risk, but not specify any specific measure to be adopted by the recipient of the warning. In any case, when the BdE has issued a warning, the MSG will periodically evaluate the evolution of the relevant risk and will propose to the MPC for decision: (1) to maintain the warning; (2) raise it to a requirement; (3) deactivate the warning.

Requirements may be adopted following a prior warning or independently of any warning. Like warnings, requirements may be addressed to financial institutions or to the relevant directorates general. Requirements shall entail a subsequent monitoring process. This means that not only will the development of the risk be observed, as in the case of warnings, but also the degree of implementation of the action required will be verified, and its impact and effectiveness assessed. This information feeds back into the risk-identification and decision-making processes and, at the same time, allows assessment of the progress and success of the measures adopted to mitigate the relevant risk.

Requirements may activate three types of action. 1) Initiation (without the need for a prior warning), continuation or stepping up (when the requirement is preceded by a warning) of the monitoring of certain risks. 2) Specific actions to reduce or mitigate the risks and vulnerabilities identified. This would include: a) specific measures expected of banks (for example, a reduction in exposure to a certain risk); b) supervisory remedial measures (for example, through the use of Pillar 2,[33] to raise the risk assessment of the institutions affected and, consequently, increase the capital buffer required); and c) regulatory changes (for example, amendments that within the scope of normative powers penalise the exposure to certain risks). 3) Measures based on the use of macroprudential instruments over which the supervisory authority has power and responsibility (for example, a requirement of this type would be an increase in counter-cyclical capital requirements to 2% of risk-weighted assets). Actions on macroprudential instruments shall generally be public.

Any requirement must be accompanied by a specific and sufficiently detailed implementation timetable, to enable the degree of compliance by means of the adoption of the actions required to be assessed. Also, the MPC will periodically evaluate the success, or lack of success, of the requirement in dealing with the risk which led to its adoption.

Warnings and requirements that the BdE decides to make public will have to be sufficiently visible on the Banco de España's website, with allocation of the appropriate space for the purpose.[34]

Table 1 sets out the organisational structure and the communication and decision-making channels proposed.

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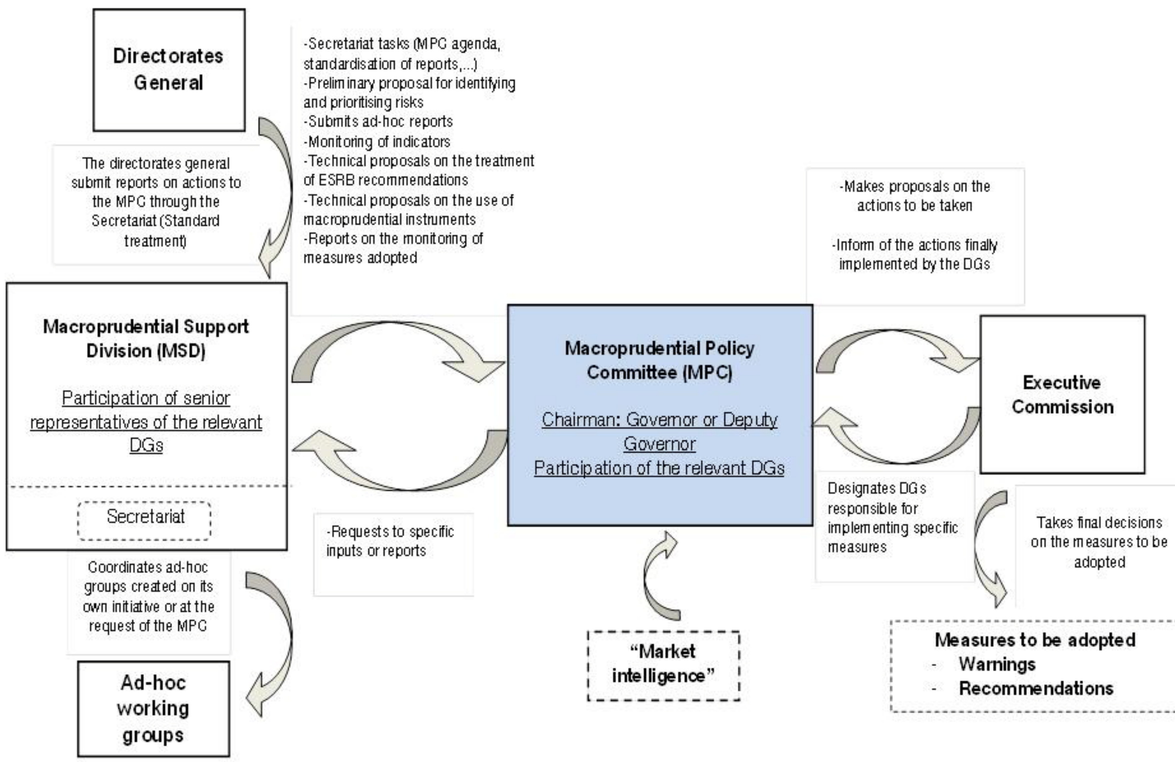
[33] The recent ESRB recommendation to increase capital requirements when the volume of foreign currency loans is high serves as an illustration of this type of measure.

[34] Following is a practical example illustrating the functioning of this new structure (see Annex 9 for more detail). The MSG receives information through a member or members on a possible heating-up of the Brazilian economy which may excessively raise the risk exposure of Spanish banks in that country. The MSG decides to lead an ad-hoc working group of experts from various directorates general of the BdE who provide detailed information on the exposures of the Spanish banks in Brazil and on the situation of the Brazilian economy. Next, it drafts a report and submits its conclusions to the MPC. This report considers the risk to be material and recommends that measures be taken. The MPC requests an assessment of the impact under three possible adverse macroeconomic scenarios and the MSG confirms the materiality of the risk. The MPC coincides with the MSG's viewpoint and proposes three actions to the Executive Commission: 1) issue a public warning on the risks which may derive from the heating-up of the Brazilian economy; 2) require the institutions with exposure in Brazil to draw up prevention plans; 3) recommend to the Directorate General Banking Supervision that it intensify review of Spanish banks' loans in Brazil and that it review and approve the prevention plans required of institutions. The Executive Commission approves these actions and requests regular assessment and monitoring of this risk, which matter is coordinated by the MSG informing the MPC within the time periods stipulated in the resolution of the Executive Commission.

Table 1: Organisational structure and communication and decision-making channels of macroprudential policy



P.6 Other methodological, procedural and quality improvements

It is recommended to strengthen the DGS's work methods and procedures by making the following reforms.

a) Update the following supervisory procedures as soon as possible to adapt them to Circular 7/2011 and to the recommendations set out above: a) inspection procedure; b) on-site continuous monitoring procedure; c) off-site monitoring procedure. For greater clarify, these procedures will be depicted in the related operational, documentation and decision-making flowcharts.[35]

b) Establish a specific procedure for reviewing institutions' governance which provides for, inter alia, the following tasks: 1) holding periodic meetings with directors and with key members of standing committees of the Board; 2) verify

[35] The working group has updated the operational, documentation and decision-making flowcharts relating to the aforementioned procedures, in line with the recommendations made.

that the BdE's recommendations and requirements letters reach the Board; 3) promote the recording of dissenting opinions in the minutes of Board meetings; 4) have a knowledge of the information furnished to directors and Board standing committee members; 5) verify effective compliance with the stipulated proportions of non-executive and nominee members of the Board, and with the time periods for renewal of their term of office; 6) verify compliance with the sound practices in corporate governance stipulated in legislation or recommended by the BdE; 7) indicate inadequate posts in the organisation chart; 8) review internal audit actions (integrity of the review, quality, effectiveness and transparency); 9) be informed quarterly of the significant deficiencies detected by the internal audit.

c) Create a horizontal inspection division to support the inspection operating divisions in reviewing regulatory compliance by the significant institutions subject to on-site continuous monitoring, with the scope set out in Section T.10.

d) Define a procedure for assessing the quality and efficacy of the supervisory function which allows the possible ways of improving supervisory methodologies and processes to be regularly identified. Under this procedure, cross-departmental comparison will be required of the supervisory actions in the various institutions and of the recommendations and requirements letters sent to them.

e) Establish an annual rotation procedure for staff, including heads/directors, which encourages the professional development of all DGS employees, based on the following: 1) in the case of heads of division and examiners in charge, establishment of an upper limit of six years in the same institution and of ten years in the same department, with a subsequent four-year period of compulsory separation; 2) for other staff (inspectors, IT personnel and junior analysts), these periods will be reduced to four, eight and two years, respectively; 3) inspectors will initially rotate every two years during the first six years, changing both institution and task (inspections, financial monitoring, risks and governance); 4) a special rotation procedure will be drawn up for persons belonging to horizontal divisions to ensure the effectiveness of the support provided by them.

Nevertheless, the rotation procedure will make provision for the exceptions needed to prevent such rotation from causing losses in the knowledge of institutions or in the necessary specialisation of horizontal divisions.

f) Publish Circular 7/2011 on the BdE external website, with a brief introduction explaining the allocation of responsibilities in the following BdE supervisory processes: 1) inspection; 2) on-site continuous monitoring; 3) annual off-site monitoring; 4) planning of annual actions.

g) Draft a notice for the BdE external website explaining the procedures for selecting, appointing and training inspectors (distinguishing the initial training inspectors receive on joining the BdE from their subsequent continuous training).

h) Update the BdE supervisory model document published on the BdE external website by adding to it the essential features of Circular 7/2011 and of its implementing internal regulations, including the supervisory action procedure based on risk profile referred to in P.1 above, along with any other matter considered necessary to lend unity and consistency to all BdE supervisory procedures and actions.

i) Conduct a study of staff needed in the DGS, based on the projected work to be carried out in the future and the objectives to be met.

j) Conduct a study of the professional career of the persons in the DGS, including their training, functions, promotions and professional category, in order to optimise and improve it where considered necessary.

k) Conduct a study of the current supervision space and resources in order to optimise and improve them where considered necessary.

P.7 Improve the relationship between supervisors and auditors

It is recommended to promote the rotation of audit firms, in line with the ideas emerging in the ATF and in the EC. Current Spanish regulation (Art. 19.2 of Royal Decree-Law 1/2011), which is in line with the European directive in force (Art. 42.2 of Directive 2006/43/EC), requires the rotation of the "the statutory auditor(s) who sign(s) the audit report" after seven years (with a two-year cooling-off period), but not of the audit firm. The proposal for audit firm rotation will therefore constitute an additional requirement, aimed at strengthening auditor independence by tackling the potential risks of familiarity, self-review and loss of objectivity towards the audited firm.

This objective will foreseeably be achieved when the current reform of European audit regulations is implemented. If the envisaged course of the currently proposed European audit regulation were changed or excessively delayed, consideration could be given to the BdE requesting credit institutions to establish audit firm rotation criteria.

Table 2. Summary of Commission proposals.

PROPOSAL NUMBER	COMMISSION RECOMMENDATION	INDEPENDENT THIRD PARTY IDENTIFYING IT	IMPROVEMENTS ALREADY MADE	SPECIFIC WORK CARRIED OUT BY THE WORKING GROUP
P1	Adopt a structured framework for Pillar 2 supervisory actions in accordance with the risk profile: -Establish specific procedure -Publish guidelines for preparing the risk matrix	IMF.2; IMF.4; OW.2; FSB.7; FSB.8	M2. Implementation of Basel Pillar 2.	T2. Review of the degree of implementation of Pillar 2
P2	Refine implementation of on-site continuous monitoring in all significant institutions	FSB.5	M3. Implementation of on-site continuous monitoring in medium-sized institutions	T3. Review of the procedure of on-site continuous monitoring: special reference to medium-sized institutions
P3	Delimit the supervisory procedure for non-significant institutions: - Annual off-site monitoring and dedicated on-site inspections every three years. - Distinction between deposit-taking and other institutions - Severe supervisory action in cases of high-risk profile.	SCOP.2		T.7 Review of the supervisory process for non-significant institutions.
P4	Improve the formalisation of supervisory actions: - Conclusions report for the institution - Formalisation of recommendations and requirements in on-site continuous monitoring - Improvements in the procedure for monitoring compliance with recommendations and requirements derived from supervisory actions	IMF.3; IAD.7		T.5 Review of the notification of requirements and recommendations to institutions within the framework of on-site continuous monitoring T.6 Review of compliance with the recommendations and requirements notified to institutions
P5	Create an organisational structure and a procedure for linking macroprudential supervision and microprudential supervision: - Macroprudential Policy Committee - Macroprudential Support Division -Issuance of warnings and recommendations	OW.1; FSB.6		T.4 Review of the procedures and transmission of the results of macroprudential supervision to microprudential supervision
P6	Other methodological, procedural and quality improvements: -Update supervisory procedures - Specific procedure for reviewing governance - Creation of a horizontal division to review regulatory compliance - Improvement of the procedure for annual planning of supervisory actions - Review of SIGAS IT processes - Improvement of annual procedure for inspector rotation - Transparency of supervisory procedures -Analysis of resources	IMF.1;OW.3; OW4; SCOP.1; FSB.1; FSB.2; FSB.3; IAD.2; IAD.3; IAD.4; IAD.5; IAD.6; IAD.8	M1. Implementation of Circular 7/2011	T.1 Review of compliance with Circular 7/2011 T.8 Review of the procedures for decision-making and documenting the supervisory work. T.9 Analysis of the material and human resources of the DGS T.10 Review of the scope and functioning of horizontal inspection divisions
P7	Improve the relationship between supervisors and auditors: -Promote rotation of audit firms.	EC.1; EC.2		

8. Abbreviations used

ATF	Accounting Task Force
BCBS-ATF-AS	Basel Committee on Banking Supervision, Accounting Task Force, Audit Subgroup
BCP	Basel core principles for effective banking supervision
BdE	Banco de España
CRD	Capital Requirements Directive
CTC	Coordination Technical Committee
DGS	Directorate General Banking Supervision
EBA-SCOP	European Banking Authority, Standing Committee on Oversight and Practices
EC	European Commission
ECB	European Central Bank
ESRB	European Systemic Risk Board
EU	European Union
FED	Federal Reserve System (USA)
FSA	Financial Services Authority (UK)
FSAP	Spain: Financial Sector Assessment Program
FSB-SRC	Financial Stability Board, Standing Committee on Supervisory and Regulatory Cooperation
I	Improvement
IAC	Internal Capital Adequacy Assessment Report
IAD	Internal Audit Department
ICAAP	Internal Capital Adequacy Assessment Process
IMF	International Monetary Fund
MoU	Memorandum of Understanding on Financial-Sector Policy Condicionality
MPC	Macroprudential Policy Committee
MSD	Macroprudential Support Division
OW	Oliver Wyman
RDL	Royal Decree-Law
ROA	Return on assets
ROE	Return on equity
SABER	Risk-Based Approach to Banking Supervision (*Supervisión de la Actividad Bancaria Bajo el Enfoque Riesgo*)
SIFI	Systemically important financial institution
SIGAS	Integrated Supervisory Activity Management System