

7 REGULATORY CHANGES IN SUPERVISORY ISSUES IN SPAIN



Louis XVI "Las Fuentes del Amor" mantel clock. 19th century. Banco de España collection.

7 REGULATORY CHANGES IN SUPERVISORY ISSUES IN SPAIN

7.1 Banco de España Circulars

7.1.1 BANCO DE ESPAÑA CIRCULAR 1/2017

Banco de España Circular 1/2017 of 30 June 2017 amending Circular 1/2013 of 24 May 2013 on the Central Credit Register (CCR) aims to adapt the latter to Regulation (EU) 867/2016 of the European Central Bank of 18 May 2016 on the collection of granular credit and credit risk data (ECB/2016/13).

The Regulation (known as AnaCredit and applicable from 31 December 2017), has established a long-term framework for the collection of granular credit data by the European System of Central Banks (ESCB) for the purpose of establishing a common set of granular data supplementing and improving the ECB's harmonised statistics. It has been envisaged for the first phase that the reporting agents (credit institutions resident in euro area countries and foreign credit institution branches in the euro area) must send to the ECB, through their respective national central banks, information relating to their customers' loans or to loans they manage for the account of third parties, provided the debtor (or, at least, one of them) is a legal entity in which the institution has an accumulated exposure of €25,000 or more.

Taking into account that there is a similar reporting system in Spain, it was decided to include the requirements of AnaCredit in Circular 1/2013. Accordingly, it was amended so that the data which the Banco de España has to request from the reporting agencies is collected by the CCR and sent to the ECB in accordance with the provisions of the above-mentioned regulation. This has been possible owing to the similarities between the two data reporting systems (AnaCredit and Circular 1/2013). In both cases exposures are reported instrument by instrument and the blocks of information on individuals, instruments, collateral and their interrelations contain similar information and are structured in a similar manner. The implementation of a new reporting system has thus been avoided, which allows the reporting agents and the Banco de España to treat the information as a whole and more efficiently. Indeed, the fact that reporting agents only need to submit one report to comply with both requirements facilitates the processes relating to data quality management and to the transfer of data to AnaCredit. The ECB will include the data so collected, together with the other data sent by other national central banks, in a centralised credit database within the sphere of the Eurosystem.

The implementation of AnaCredit has involved the introduction of certain reporting requirements not addressed by Circular 1/2013 to date. Specifically, new data are requested in connection with the counterparties, the instruments reported, financial data, collateral received, and interest rates and accounting status of the instruments. Additionally, in some cases it has been necessary to homogenise the set of attributes, concepts and definitions of Circular 1/2013 with those of the AnaCredit regulation. Apart from the requirements derived from this regulation (whose inclusion in the CCR is the main purpose of the Circular), other changes have been made to Circular 1/2013 to clarify and update the rule, including most notably the simplification of the reasons why counterparties are reported to the CCR.

The Circular has two annexes on the data modules and the instructions for their preparation. A transitional period has been envisaged during which institutions will continue reporting: (i) new data and changes to data on reportable counterparties, as well as requests for identifiers for non-residents (until 31 March 2018); and (ii) the rest of the

modules (until 30 April 2018), in accordance with the provisions of Circular 1/2013, as amended by Circular 7/2016 of 29 November 2016.

7.1.2 BANCO DE ESPAÑA
CIRCULAR 2/2017

Law 9/2012 of 14 November 2012 on credit institution restructuring and resolution regulates the accounting specificities applied by the Spanish asset management company Sareb in preparing its financial statements. The Banco de España gave effect to those provisions through Circular 5/2015 of 30 September 2015, implementing the accounting specificities of Sareb.

Subsequently, Royal Decree Law 4/2016 introduced certain amendments to Law 9/2012 for the purpose of establishing, inter alia, a new criterion for recording Sareb's impaired assets. Specifically, it established that the recognition of value corrections for asset impairment should be directly charged to the institution's equity and that these adjustments are to remain in equity until they can be allocated to the income statement when there is positive profit for the year.

Banco de España Circular 2/2017 of 28 July 2017 amending Circular 5/2015 established the new criterion for the recording of impairment, also specifying the rules for reversal thereof, stating that the impairment of an "asset unit" may be reversed when there is evidence that the assets in the "asset unit" have recovered their value. Such reversal shall be recorded by first reducing the balance of the "Valuation adjustments" caption in equity. Once the balance of this account reaches zero, the reversal amount pending recognition, if any, will be credited to the income statement.

7.1.3 BANCO DE ESPAÑA
CIRCULAR 3/2017

Royal Decree-Law 14/2013 of 29 November 2013 on urgent measures to adapt Spanish law to EU standards on the supervision and solvency of financial institutions carried out the most urgent adjustments to the Spanish legal system to comply with the provisions of CRD IV and CRR. Under the Royal Decree-Law, the Banco de España may make use of the options attributed by the CRR to the national competent authorities and it exercised some of the permanent and transitional options through Circular 2/2014.

This Circular came into force prior to the start-up of the Single Supervisory Mechanism (SSM). Since then, the ECB is the competent authority to exercise certain supervisory functions over institutions classified as significant under Council Regulation (EU) 1024/2013 of 15 October 2013 conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions. Consequently, the ECB may make use of the permanent and transitional options attributed by the CRR to the competent authority, albeit only with regard to significant institutions, while the Banco de España retains the authority to exercise these options in respect of the Spanish less significant institutions.

In the exercise of its power, the ECB approved Regulation (EU) 2016/445 of the European Central Bank of 14 March 2016 on the exercise of options and discretions available in Union law (ECB/2016/4), setting out the decisions of this authority in connection with the options mentioned. Also, in the exercise of its power to issue guidelines to national competent authorities for the performance of supervisory functions and the adoption of supervisory decisions, the ECB has approved Guideline (EU) 2017/697.

In order to adapt to the new regulatory framework, Banco de España Circular 3/2017 of 24 October 2017, amending Circular 2/2014 of 31 January 2014 to credit institutions on the exercise of various regulatory options contained in Regulation (EU) No 575/2013 of

the European Parliament and of the Council of 26 June 2013, modifies the scope of application of Circular 2/2014, which is now limited to less significant institutions, and adapts its criteria to the ECB's guidelines.

The basic purpose of the new Accounting Circular (Banco de España Circular 4/2017 of 27 November 2017 to credit institutions, on public and confidential financial reporting rules and formats) is to adapt the accounting regime for Spanish credit institutions to the changes in the European accounting regulations derived from two new International Financial Reporting Standards (IFRSs), IFRS 9 and IFRS 15, amending the accounting criteria for financial instruments and ordinary income, respectively, from 1 January 2018.

The breadth and depth of the changes brought about by IFRS 9 advised updating the accounting regulations on this occasion through a new Circular which replaces Circular 4/2004 and came into force in 2018.

The Banco de España, as the accounting regulator for the industry, provides continuity through this Circular to the strategy it has followed to date, which is to maintain:

- Comprehensive regulations for credit institutions; accordingly, these are not restricted to providing an accounting treatment for financial instruments and credit risk, but include registration, assessment and reporting criteria for the different transactions conducted by such institutions, even if they do not relate to sectoral specificities.
- Compatibility of the rule with the IFRS framework. Thus, the Circular, which constitutes the implementation of the general principles addressed by the Commercial Code, in accordance with the authority conferred on the Banco de España, is in line with international standards criteria.

Because of its importance, the Circular's scope of application remains unchanged with respect to the Circular it repeals, although there have been changes in the wording relating to public financial information in order to align it with the Commercial Code.

In this respect, the Banco de España understands that the adoption by security issuer groups of the criteria included in the Circular would be an appropriate application of the IFRS framework, except in the case of specific issues where the Circular, which must necessarily be aligned with the Commercial Code, includes a criterion that does not belong in the IFRS framework.¹

The main changes in the Circular include most notably:

- Implementation of a new impairment model (for all financial assets subject to impairment) based on expected loss versus the current incurred loss model. The aim is to recognise losses earlier and for a higher amount.
- The valuation of financial assets, explained in Box 7.1, and a new classification, which aim to reduce the complexity of current criteria.

¹ As in the recording of holdings in joint ventures by the proportionate consolidation method or the amortisation of all intangible assets, including goodwill.

Financial assets are measured at amortised cost, at fair value through other comprehensive income or at fair value through profit and loss.

The classification is based on both the institution's business model for managing the financial assets and the contractual cash flow characteristics of each instrument.

The business model is the manner in which an institution manages groups of financial assets to generate cash flows. The institution may hold groups of financial assets for the purpose of collecting contractual cash flows, selling the financial assets or a combination of both.

Based on their contractual cash flow characteristics, financial assets are classified into one of these two categories:

- Assets giving rise to cash flows that are solely payments of principal and interest on the principal amount outstanding.

- Assets entailing cash flows other than payments of principal and interest on principal.

However, regardless of the business model and the contractual characteristics of the financial assets, an institution may designate at initial recognition and irrevocably:

- A debt instrument in the fair value through profit and loss category if doing so eliminates inconsistencies with other assets or liabilities in the measurement or recognition of profit and loss (accounting mismatches).
- An equity instrument in the fair value through other comprehensive income category. In this case, valuation changes directly recorded in equity are not recorded in the income statement, not even when the instrument is derecognised.

Impairment losses on debt instruments (e.g. loans or bonds) at amortised cost and at fair value through other comprehensive income will be estimated on the basis of the expected credit loss model.

Types of payment	Business model		
	Collection of contractual cash flows	Collection of contractual cash flows or sale	Sale
Solely payments of principal and interest	Amortised cost	Fair value through other comprehensive income	Fair value through profit and loss
Other types of payment	Fair value through profit and loss		

SOURCE: Banco de España

- New criteria for the recording of provisions, additional to the current criteria, which aim to increase the number of economic provisions which can be accounted for in this manner and to achieve a more flexible practical application.

Aside from some exceptions expressly addressed in the rule, the application of these changes will be accounted for retrospectively, with the related impact being recorded in reserves. However, for prudential purposes, the European Union has established a transitional arrangement which allows recognising the effects of the increase in provisions progressively, as explained in Box 7.4.

The public and confidential financial statement models have also been modified as a result of the foregoing changes, in accordance with the European regulations on confidential financial statements.

Annex 9 of this Circular continues to include specific credit risk accounting criteria. It maintains the changes introduced by Circular 4/2016, which aim to strengthen credit risk management, the appropriate classification of transactions (with special emphasis on the definitions of non-performing loans and forbearance, both of which are compatible with those provided by the EBA), the robustness of provision estimation (indicating the

Both the ECB's NPL guidance for banks and Circular 4/2017 allow the use of automated valuations to estimate the recoverable amount of loan collateral and to value foreclosed properties, for accounting purposes, provided the value of the assets is lower than €300,000. The methodologies used to obtain these valuations are customarily known as Automated Valuation Models (AVMs) and may be defined as mathematical models of property valuations applied using computer programmes and developed on the basis of a broad database.

In order to correctly use these methodologies institutions need to have appraisal company selection policies and procedures in place that take into account the adequacy, technical capacity and independence of the appraisal companies.

Credit institutions should also ensure that appraisal companies follow robust procedures meeting the following criteria:

- The properties valued should have a certain degree of homogeneity and be located in an active transaction market.

- Both the market value and the value for mortgage purposes should be reported.
- The methodology used must be regular, robust and appropriately cross-checked, ensuring the traceability of the property valuations carried out.
- The valuation models used should be specified and calibrated and the supervisor should be provided with the information necessary to analyse the property valuations obtained.
- Mass appraisals require cross-checking the sufficiency and quality of the information available.
- A sample of complete individual appraisals must be taken from properties subjected to a mass appraisal in order to check the results obtained.

requirements to be met by individual estimation and the internal methodologies for collective estimation) and the valuation of efficient collateral and of foreclosed assets. Box 7.2 contains some basic criteria that need to be complied with by credit institutions that commission valuations of properties used as collateral, which will also ensure compliance with sound criteria by appraisal companies.

Annex 9 of the new Circular continues to provide alternative solutions for estimating credit risk provisions for the purpose of helping less complex institutions apply the expected loss model, in accordance with the principle of proportionality. These alternative solutions have been updated on the basis of the information, experience and projections of the Banco de España and, for the valuation of foreclosed assets, on the basis of the most recent available information. In both cases, they should be used in the benchmarking exercises of institutions which have developed internal estimation methodologies.

Annex 9 also includes the classification criteria for credit exposures. Box 7.3 describes the classification of loans as “performing under special monitoring”.

Finally, it should be noted that developments in the field of credit addressed by the Circular, specifically by Annex 9, include the best international practices (made available to the public by the Basel Committee on Banking Supervision and the EBA through their guidelines on expected credit loss), which are aligned with the ECB's accounting supervisory expectations addressed in its guidance on non-performing loans.

7.1.5 BANCO DE ESPAÑA CIRCULAR 5/2017

Circular 5/2017 of 22 December 2017 amending Circular 5/2012 of 27 June 2012, to credit institutions and payment services providers, on banking service transparency and responsible lending, was published in the Official State Gazette on 3 January 2018. The new Circular aims to adapt on a timely and eminently formal basis Annex 8 of Circular 5/2012 to several recent changes relating to the following issues:

Credit exposures are classified on the basis of credit risk into one of the following categories: performing exposures, performing exposures under special monitoring and non-performing exposures.

The determining factor for an exposure to be classified as performing under special monitoring is that a significant increase in credit risk occurs.

Thus, a risk previously classified as performing will be reclassified as performing under special monitoring when, in the absence of a default event, there has been a significant increase in credit risk since the origination date.

Annex 9 sets out a rebuttable presumption that there has been a significant increase in credit risk, a battery of indicators and certain

cases (automatic factors) in which reclassification to the performing exposure under special monitoring category will be necessary.

A risk previously classified as non-performing will be reclassified as performing under special monitoring if, although the event triggering its classification as non-performing ceases to exist, the credit risk is significantly higher than at the origination date.

The criteria for reclassification from performing exposures under special monitoring to other categories must be consistent with those determining the classification of credit exposures as performing under special monitoring. In the specific case of forborne transactions, a trial period of at least two years, during which the borrower must show good payment behaviour, must elapse.

Rebuttable presumption	— Exposures that have amounts more than 30 days past due
Estimation of allowances and provisions	<ul style="list-style-type: none"> — Adverse changes in financial situation — Significant decline in turnover — Significant drop in net operating income — Significant changes in cost of credit risk — Actual or expected downgrade in internal credit scoring of loan — Significant surge in economic or market volatility that may have a negative impact on borrower — Other
Automatic factors	<ul style="list-style-type: none"> — Exposures identified as forborne that should not be classified as non-performing — Exposures included in a special sustainable debt agreement — Exposures of borrowers subject to an insolvency order that should be reclassified from non-performing

SOURCE: Banco de España.

- Circular 5/2012 referred to the European Banking Federation as the administrator of the EURIBOR, although this body had changed its name to the European Money Markets Institute (EMMI).
- Also, it did not consider the EURIBOR as a “critical index”, having been declared as such by Commission Implementing Regulation (EU) 2016/1368 of 11 August 2016, which established a list of critical benchmark indices used in the financial markets.

Consequently, Annex 8 of Circular 5/2012 was updated through Circular 5/2017 as regards the definitions of EURIBOR and MIBOR, since the MIBOR is calculated with reference to the EURIBOR, to adapt them to the changes mentioned above.

7.1.6 BANCO DE ESPAÑA CIRCULAR 1/2018

A Deposit Guarantee Scheme for Credit Institutions (DGSCI) was set up under Royal Decree-Law 16/2011 of 14 October 2011, which establishes that in order to comply with its functions, the DGSCI must be funded by, among other sources, contributions by member institutions, and charges the Banco de España with implementing the methods necessary for such contributions to be proportional to institutions’ risk profiles. This was implemented in Circular 5/2016 of the Banco de España. Subsequently, under Royal Decree-Law 11/2017 of 23 June 2017 on urgent measures for financial matters, belonging

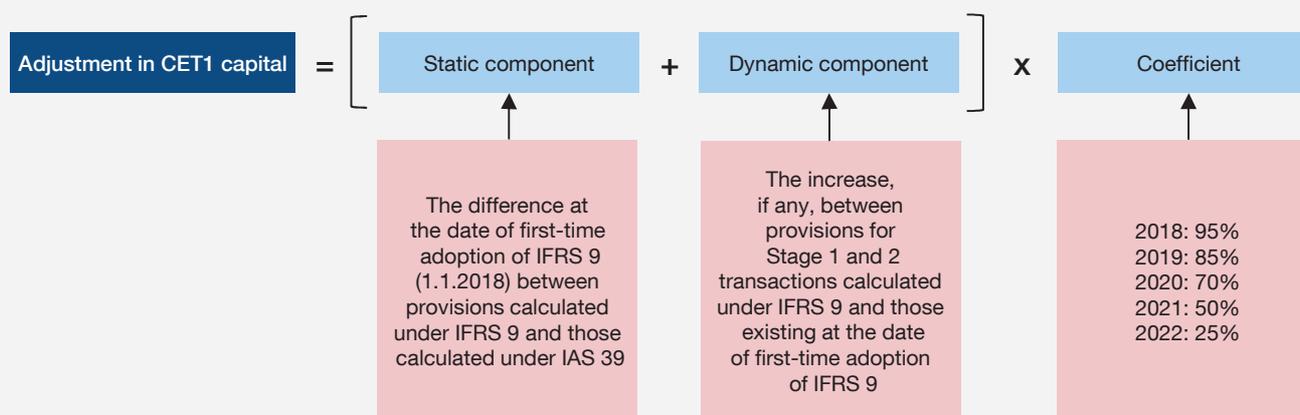
The entry into force of IFRS 9 and Circular 4/2017 will entail an increase in the provisions of institutions as a result of the shift from an incurred loss to an expected loss model. This increase will be recorded on 1 January 2018 against reserves, thereby reducing institutions' own funds. In view of this change in the calculation of provisions, in March 2017 the Basel Committee on Banking Supervision published a document which addressed the possibility for institutions starting to apply an expected loss model of taking advantage of a transitional arrangement to smooth the impact on capital ratios of this initial decline in reserves and of the subsequent provisioning. There are two reasons for proposing such an arrangement, namely: (i) the possibility that the impact could be significantly more material than expected; and (ii) the fact that the Committee has not yet clarified how expected loss accounting and the prudential regime will interact in the long term.

The European Union has decided to follow the recommendation of the Basel Committee in light of the entry into force of IFRS 9, amending the CRR (through Regulation 2017/2395 of the European Parliament and of the Council of 12 December 2017) to introduce a transitional arrangement which permits partially deferring the impact on capital during the first five years since the entry into force of the expected loss model. The functioning of this transitional arrangement is as follows:

- First, the amount susceptible to deferral is calculated, i.e. the impact on regulatory capital of applying the new regulations (IFRS 9 or Circular 4/2017). This amount has a static component, the impact of the first day of application of the IFRS 9, and a dynamic component. The latter is calculated at each reporting reference date as the increase in provisions for performing exposures (stages 1 and 2 of IFRS 9) from the date IFRS 9 is first applied, and is recorded against the income statement.
- Second, the amount susceptible to deferral is multiplied by a declining coefficient over the five-year period during which the transitional arrangement is in force.

It should be noted that this deferral regime is also applied to all the relevant items for solvency ratio calculation purposes affected by the increase in provisions, for instance, any tax assets which may have arisen. Additionally, this regime should be taken into account in calculating the decline in exposures under the standardised approach arising from provisioning and the eventual contribution to tier 2 capital of excess provisions at banks following the IRB approach.

This transitional arrangement is optional for institutions, as is the application of the dynamic component for those opting to avail themselves of it.



SOURCE: Banco de España.

to an Institutional Protection Scheme (IPS) became a new factor that the Banco de España will take into account in such calculation methods, since the creation of an IPS strengthens the solvency and liquidity of institutions belonging to it.

In order to comply with this last provision, the Banco de España approved Circular 1/2018 of 31 January 2018 amending: (i) Circular 5/2016 of 27 May 2016 on the calculation method to be used to ensure that the contributions of institutions belonging to the Deposit Guarantee Scheme for Credit Institutions are proportionate to their risk profile; and (ii) Circular 8/2015 of 18 December 2015 to institutions and branches belonging to the Deposit



Directorate General Banking Supervision working meeting.

Guarantee Scheme for Credit Institutions, on information for determining the basis of calculation of contributions to the Deposit Guarantee Scheme for Credit Institutions. The changes proposed will be used for the first time to calculate the contributions of DGSCI member institutions to be determined in 2018.

The amendment of Circular 5/2016 adds the new factor to the calculation method for the contributions. As a result, said calculation method is adjusted in such a way that IPS membership of a credit institution affiliated to the DGSCI is reflected in the amount of the contributions based on their risk profile.

The amendment of Circular 8/2015 seeks to obtain information about the ex-ante IPS fund. To this end, credit institutions belonging to an IPS as envisaged in Article 113.7 of the CRR should send certain information to the Banco de España on a quarterly basis.

7.2 Other significant regulations

7.2.1 REGULATION (EU) 2017/1538 OF THE ECB ON REPORTING OF SUPERVISORY FINANCIAL INFORMATION

Regulation (EU) 2017/1538 of the European Central Bank of 25 August 2017, amending Regulation (EU) 2015/534 on reporting of supervisory financial information (ECB/2017/25) to less significant supervised entities which are subject to national accounting frameworks (ECB/2017/26), was published in the Official Journal of the European Union on 19 September 2017. This amendment is the result of the incorporation of IFRS 9 into Union law in Commission Implementing Regulation (EU) 680/2014 of 16 April 2014 laying down implementing technical standards with regard to supervisory reporting of institutions according to the CRR. For this purpose, certain amendments are made to Regulation (EU) 2015/534 to harmonise it with the new accounting framework, aside from other minor technical and terminological amendments.

These amendments shall apply from 1 January 2018 to significant supervised entities and less significant supervised entities which are subject to national accounting frameworks based on Council Directive 86/635/EEC of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions. Notwithstanding the above, the ECB may decide, at the request of an NCA, to apply this Regulation to less significant supervised entities which are subject to national accounting frameworks based on Directive 86/635/EEC and established in the Member State of that NCA from 1 January 2019 if such national accounting framework is not compatible with IFRS.