

DEPUTY GOVERNOR'S INTRODUCTORY LETTER



This Report sets out the main activities performed by the Banco de España in 2017 in the exercise of its supervisory powers in the micro- and macroprudential areas and in consumer protection. It also describes the progress made in the international regulatory and supervisory fora in which the Banco de España participates. Lastly, it highlights the key regulatory changes in supervision-related matters, with special emphasis on the Circulars issued by the Banco de España in its capacity as credit institution supervisor and industry regulator.

In 2017 the Single Supervisory Mechanism (SSM), now in its third year, continued to consolidate its position as a key element of microprudential supervision of euro area credit institutions. The Banco de España participates in the SSM, performing its microprudential supervisory work through three main channels. First, through its participation in decision-making by the ECB's governing bodies relating to Spanish institutions and to institutions from other euro area countries. Second, through the participation of Banco de España staff, together with staff from the ECB and other euro area supervisory authorities, in the joint supervisory teams and on-site actions that are at the core of direct supervision of the significant institutions. And lastly, through the exercise of its direct supervisory powers over the less significant institutions, within the framework that is being rolled out by the SSM to ensure uniform supervision of these institutions.

The creation of the SSM has indeed been the most important step along the road to European financial integration since the introduction of the euro, and it is the basis for the banking union being built in Europe to safeguard financial stability.

Since the SSM officially entered into operation on 4 November 2014, we have made continuous progress in the harmonisation of supervisory practices in the euro area. Nevertheless, further progress is still needed, since certain differences persist owing to the

different supervisory traditions of the SSM member countries. It is essential that both the supervisory review process and application of the European regulatory framework are consistent throughout the euro area, to ensure that banks compete on a level playing field.

In some cases, specific projects are already under way to address the differences persisting. For example, the different national supervisory practices for authorisation and review of the internal models used to calculate capital requirements are being subjected to a cross-section analysis. This will allow guidelines to be drawn up setting out the supervisory expectations in this matter, with the ultimate aim of strengthening the credibility of the internal models.

In other cases, certain differences persist that will also have to be duly addressed. For example, those deriving from the differences in scope and approach observed in on-site actions. I believe it is extremely important to progress in this area towards a common supervisory practice, in keeping with the best international supervisory standards, to strengthen the quality and consistency of European supervision.

The Banco de España is committed to this aim and makes a significant contribution, through its representation on the ECB's Supervisory Board and through its participation in the various technical and high-level working groups, such as that on cross-border on-site inspections. In this context, another key development in 2017 was the amendment of Banco de España Circular 2/2014, which includes exercise in Spain of the national options and discretions provided for in European prudential regulations, to adapt them to the recommendation issued by the ECB in April. In addition, Circular 4/2017 on credit institutions' accounting took note of the SSM's supervisory expectations in accounting matters relating to non-performing loans and valuation of collateral and foreclosed assets, published in the Guidance issued in March 2017, and expected-loss accounting.

Chapter 2 of this Report describes the Banco de España's supervisory priorities and strategies in the microprudential area, and the supervisory activity performed both within and outside the SSM (in the latter case, relating to functions not transferred to the SSM and to institutions other than credit institutions that pursue financial sector-related activities). In this respect, particularly noteworthy was the work undertaken by the Banco de España in 2017 in connection with the activities of appraisal companies, aiming to strengthen the consistency and quality of property valuations using automated and mass appraisal models.

The past crisis showed that it was essential to have in place macroprudential tools capable of addressing certain risks that affect the banking sector overall. Chapter 3 describes the macroprudential instruments that the Banco de España has used since 2016 to prevent systemic risk, highlighting its participation in the relevant ECB bodies.

In accordance with current regulations, in 2017 the Banco de España updated the list of systemically important institutions and their respective capital buffers. In view of the evolution of bank lending in the year, the countercyclical capital buffer for credit exposures in Spain remained unactivated.

As regards financial consumer protection, in 2017 the Banco de España stepped up its supervision of institutions' conduct, aiming to boost customer trust in the banking system. As described in detail in Chapter 4, the activities performed in the year focused on mortgage lending and advertising.

The key aspects of the Banco de España's exercise of sanctioning powers are set out in Chapter 5. Notably, much of this activity is connected with infringements of transparency rules and of the Code of Good Practice.

Chapters 6 and 7 highlight the main advances achieved to which the Banco de España has contributed through its participation in international banking regulation and supervision fora, and the main regulatory changes made in the supervision area. Stronger supervision and regulation, banking sector reforms, economic recovery and the steps taken by the banks themselves have all served to fortify the solvency of the Spanish banking sector as a whole in recent years.

Nevertheless, despite this improvement, in 2017 the effects of the crisis were still evident, for instance, in the resolution of Banco Popular Español, a significant institution supervised by the SSM. On 6 June the ECB informed the Single Resolution Board (SRB) that the bank was failing or likely to fail. On 7 June the SRB determined that it met the conditions for resolution, and it was sold to Banco Santander on that same date.

Looking ahead, although Spanish credit institutions have strengthened their positions, they still have major challenges to address in coming years and the supervisor will have to assess the measures they adopt to meet each of these challenges.

The first challenge is to define the business model. In order to remain viable in the medium and long term, banks need to have appropriate profit levels. Since the onset of the crisis, the profitability of the banking sector has remained relatively low and at some distance from the levels observed in previous periods. The very low interest rate environment is one of the main factors behind recent profitability trends. Other factors are: the lower volume of banking business, since although the economic recovery is expected to continue, growth will be limited, in the short term because of the prolonged effects of the crisis and in the medium term on account of structural weaknesses and the continuingly high unemployment rate; the still significant presence of non-productive assets on banks' balance sheets, despite their decline in recent years; and the increase in legal costs which have lately gained prominence among the factors behind lower profitability.

The supervisor has no place interfering in banks' strategic decisions, but it should monitor those decisions and it should share its analysis with the banks and support all decisions that promote financial stability. Accordingly, in its capacity as an SSM member, the Banco de España examines banks' business models as part of its supervisory assessment of their solvency and viability.

The second challenge that banks need to address is how to manage the non-productive assets cited above as one of the factors adversely affecting their profitability. The ECB's Guidance to banks on non-performing loans, published in March 2017, identifies a number of best practices for managing these assets. In coming years the Banco de España will continue to verify that banks take measures to ensure the correct identification and provisioning of non-performing loans.

A third challenge that banks must address is the need to adapt to regulatory changes. At the start of 2018 Spanish credit institutions have had to change from an incurred loss-based accounting model to an expected loss model, in keeping with the change in European accounting criteria. Moreover, in coming years, banks will have to comply with

further requirements that are currently under discussion such as, for example, the minimum leverage ratio, the net stable funding ratio or minimum required eligible liabilities (MREL).

Complying with MREL will be particularly challenging for all European credit institutions, as they will have to hold on their balance sheets instruments with sufficient capacity to absorb possible losses and, where appropriate, to enable banks to recapitalise to a highly significant extent. Thus, in the event of resolution, a bank could continue to perform its critical functions, with no need to apply for public assistance and without jeopardising the financial stability of the system. Unquestionably, the introduction of MREL will strengthen financial stability. However, in order to ensure that it will not act as a further drag on banks' profitability or place excess constraints on their business models, a reasonable period for compliance with this new requirement must be considered.

All these regulatory changes pose a dual challenge for the supervisory authorities: the need to assess how well prepared banks are for their implementation, and the need to adapt supervisory procedures to the new requirements.

The fourth challenge is concerned with technology and is not insignificant, considering the importance of proper technology risk management and the galvanising effect of technological change on the banking sector. Digital innovation is now transforming traditional banking activity, and is at the same time fomenting the entry of new firms into certain areas of the banking industry. Since these fintech firms may eventually compete with traditional banks in a specific part of the banking business value chain, the more similar their activity is to traditional banking, the more important it will be to ensure that they are subject to requirements and controls similar to those applied to banks, adapted to the relevant business risk, to guarantee the neutrality of the regulatory framework.

Technological progress brings with it opportunities to make the financial system more efficient, through greater knowledge of customer behaviour, which in short would allow banks to tailor their products, adapting them better to specific needs and to individual customers' risk profiles. However, this progress also entails risks that must be managed, such as data security, the possible impact on bank/customer relations and the potential for increased fraud.

Customer service and regaining customer trust – undermined as a result of the recent financial crisis and certain banking practices – are precisely the fifth challenge that the banking sector must face. Customer trust is the most valuable and yet also the most fragile of a bank's assets. To regain that trust, transparency in communications with customers must be enhanced and inappropriate marketing practices overhauled. To that end, the Banco de España is stepping up its actions relating to supervision of institutions' conduct.

In short, the Spanish banking sector, akin to its European counterparts, is facing major challenges, at a time when the traditional banking business is adjusting to the new economic, regulatory and technological environment. In consequence, in 2018 the Banco de España's supervisory activity will continue to focus on preserving the stability of the Spanish financial system and, in short, to contributing to an improvement in the economic situation.

Lastly, to conclude, a mention should be given to Mr Mariano Herrera, Director General Banking Supervision, Mr Pedro Comín, Associate Director General Banking Supervision, and Mr Pedro González, Director of Supervision Department IV who, on 13 February

2017, stood down from their posts, having learned that they had been summoned by the National High Court to appear as persons under investigation, together with other former Banco de España officers, in the proceedings relating to Bankia. This was indeed a sad day for all of us in the Banco de España who had witnessed at first hand their outstanding career achievements – each with more than 25 years’ service in the Banco de España – and personal calibre. In May 2017 the National High Court’s Central Examining Court Num. 4 dismissed and closed the case. This ruling was subsequently confirmed by the National High Court’s Chamber for Criminal Matters.¹ At this point I wish to publicly acknowledge the work performed by these three senior officers while they held positions of responsibility in the Banco de España, their close collaboration with the courts to clarify the facts, and their decision to step down immediately from their posts so as to ensure that the Banco de España’s supervisory function was not affected while the court investigations were under way.

¹ The May 2017 ruling states that “there is no indication whatsoever of their involvement in the commission of the offences investigated, there being no evidence, not even circumstantial evidence, of their involvement in any manner in the preparation or approval of the accounts contained in the prospectus that BANKIA submitted to the CNMV for its market flotation”.