

# 2

## MICROPRUDENTIAL SUPERVISION



### 2.1 Supervisory priorities

**The ECB identifies the banking sector's sources of risk in cooperation with the NCAs**, based on the information provided by the JSTs, the ECB's micro- and macroprudential analyses and the reports of international organisations. Using this risk map as a starting point, a set of supervisory priorities are defined annually for SIs, taking into account the viewpoint of the NCAs and JSTs, and the results of on-site actions (on-site inspections and model investigations). The Banco de España likewise sets each year's supervisory priorities for LSIs.

#### 2.1.1 Supervisory focal points in 2019

In 2019 the supervisory focus for SIs remained on aspects relating to risks that had already been present in previous years. Specifically, the work focused on:

- Credit risk: the assessment of compliance with institutions' plans to reduce the volume of non-performing exposures (NPEs), and their adequate provisioning, continued. Also, special attention was paid to reviewing banks' loan origination criteria, policies and procedures, and assessing the quality of new loans.
- Risk management: the targeted review of internal models for calculating own fund requirements (TRIM)<sup>1</sup> continued. Work has continued in enhancing the internal procedures and mechanisms in place at institutions to manage, control and mitigate technology risk. In this respect, inspections were conducted on aspects related to technology risk. Attention was also paid to reviewing the internal capital and liquidity assessment processes (respectively, ICAAP<sup>2</sup> and ILAAP<sup>3</sup>) at institutions and their alignment with the ECB guidelines published in November 2018.

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1 The TRIM project aims to reduce inconsistencies and unwarranted variability in risk-weighted assets (RWAs) calculated using internal models.

2 The ICAAP encompasses institutions' internal strategies and processes to assess and maintain on an ongoing basis the amounts, types and distribution of internal capital that they consider adequate to cover the risks to which they are exposed.

3 The ILAAP encompasses institutions' internal strategies and processes for the identification, measurement, management and monitoring of liquidity risk to ensure that they have adequate liquidity buffers.

Additionally, special attention was given to liquidity risk through the performance of specific stress tests by the ECB (Sensitivity Analysis of Liquidity Risk – Stress Test 2019). Following these tests, the ECB confirmed that credit institutions in the Euro area have overall comfortable liquidity positions despite some vulnerabilities that require further attention (specifically, those relating to foreign currency financing, data quality and collateral management).

- Other aspects: follow-up of the implementation of plans drawn up by institutions to ensure their preparedness for Brexit, and analysis of market and trading risks.

In turn, the supervisory effort on LSIs focused on the supervisory priorities set for 2019, namely: analysis of the business model and profitability, follow-up of credit risk, assessment of governance and risk management, and capital adequacy. Technology risk is considered particularly important, and a communication protocol for cybersecurity incidents has been set up for the 23 most significant LSIs.

### 2.1.2 Supervisory priorities in 2020

The main risk factors for SIs identified for 2020 are: i) the economic and political situation, and the sustainability of debt in the euro area; ii) the sustainability of business models, and iii) cybercrime and technological challenges. Another series of significant risk factors have been detected, including those relating to the execution of strategies to reduce NPLs, easing of lending standards, repricing in financial markets, misconduct in marketing of banking products, money laundering and terrorist financing (ML/TF), geopolitical uncertainty, reactions to regulation and, at medium and long term, climate change.

To ensure that institutions effectively address the challenges facing them, supervisory priorities have been reviewed, grouping them into the following broad targets (see Figure 2.1):

- Continuing balance sheet repair. The ECB will continue to work on monitoring the reduction of NPLs. Work will also be carried out for institutions to remedy the internal model shortcomings detected in the TRIM. Actions relating to market risk will continue.
- Strengthening institutions' future resilience. The next supervisory stress tests for SIs will be conducted in 2020. The project relating to reviewing the quality of new loan origination practices, which was initiated in 2019 with the collection of data, will also continue. Work will continue

Figure 2.1

**SSM SUPERVISORY PRIORITIES 2020**

CONTINUING BALANCE SHEET REPAIR	STRENGTHENING FUTURE RESILIENCE	OTHER PRIORITIES
Follow-up on <i>NPL guidance for credit institutions</i>	Credit underwriting criteria and exposure quality (e.g. real estate, leveraged finance)	Follow-up on Brexit work
Follow-up on internal ratings-based models	Capital and liquidity management, ICAAP and ILAAP and further integration into SREP	
Trading risk and asset valuations	Business model sustainability	
	IT and cyber risk	
	EU-wide (biennial) and/or ECB stress test exercises	
	Governance	

SOURCE: ECB.

in improving ICAAP and ILAAP. Institutions' business models and profitability will also be assessed, with digitalisation being particularly important. Technology and cyber risk will remain an area of particular attention. IT outsourcing is especially significant in this connection (see Box 2.1). Likewise, compliance with governance expectations will be analysed.

- Other priorities. Brexit continues to be one of the ECB's banking supervision priorities and it will continue to monitor the application of institutions' plans in this connection.

The supervisory priorities for LSIs in 2020 are: assessment of institutions' business models and their sustainability over time (with particular attention on changes in margins, efficiency ratio and potential impact of customer complaints regarding the mortgage loan reference index (IRPH by its Spanish abbreviation) and mortgage costs), monitoring of the strategies to reduce NPLs and foreclosed assets, as well as analysis of loan origination conditions (to detect the possible easing of lending standards), assessment of internal and external governance and of control and risk management, and monitoring of operational risk, in technological and legal terms.

**ASSESSMENT OF IT OUTSOURCING PROJECTS IN THE DGBS**

In recent years financial institutions have shown growing interest in outsourcing activities to reduce costs during periods of low profitability, to increase flexibility and to improve efficiency, among other advantages.

IT activities are one of the most commonly outsourced services, since they allow institutions to obtain relatively easy access to new technologies and to focus on those activities that are essential for the business. In particular, the outsourcing of functions to cloud service providers has increased, becoming one of the levers for digitalising the sector, since this model permits implementing new solutions with minimal service provider interaction.

Despite its advantages, IT outsourcing poses security and internal governance challenges for institutions. It also poses other risks for them, such as those arising from the possible loss of control and knowledge of the outsourced service, or greater exposure to data loss or theft in certain environments, particularly at a time when innovation and competition result in data being one of the business' most valuable assets.

In response to their concern about this trend, which can be considered unstoppable, European supervisors have made a significant effort to homogenise the requirements applicable to these outsourcing processes. This work led to the publication of the EBA guidelines on outsourcing (EBA/GL/2019/02), in force from 30 September 2019.

To achieve a uniform assessment of the projects to be valued by the supervisor, a permanent team has been set up within the DGBS which: i) supports and advises JSTs in analysing and assessing IT outsourcing at SIs, and ii) conducts a full assessment of LSIs' outsourcing projects in cooperation with the ongoing supervisory teams.

In 2019 it participated in the analysis of 100 initiatives, 81 of which use cloud services.

The projects analysed are very mixed, although two trends can be observed: i) those which focus on changing to new platforms or systems, such as the migration of core banking to a public cloud infrastructure, changing the banking platform and adopting that of a new provider, and using customer relationship management (CRM) systems, corporate e-mail and collaboration tools deployed on the cloud, and ii) more innovative projects which make use of technologies such as machine learning to manage documents, chatbots or financial data aggregators.

In addition, the team holds frequent meetings with institutions and providers to keep abreast of trends and to attempt to achieve, among other things, that contract clauses meet supervisory expectations such as the need to include access and audit permits without restrictions for institutions and supervisors, the mandatory notification of material changes in the service or the outsourcing chain, or the existence of termination and exit clauses.

The work of the aforementioned permanent team is supported by a cross-cutting outsourcing committee in which, apart from the members of the team, other IT auditors of the DGBS participate. Its mission is to share information about these projects and draw up proposals to establish the DGBS' position on the different aspects to be considered, such as defining the criteria for assessing the projects and the requirements to be met by institutions.

Undoubtedly, the advent of new technologies will trigger an increase in IT outsourcing, and the emergence of new risks and supervisory challenges.

## 2.2 Supervision of credit institutions

**Since the entry into force of the SSM in 2014, the ECB heads the supervisory function of all the credit institutions in the participating States, with the participation of the NCAs,** and establishes the distribution of supervisory tasks depending on whether the institutions are SIs or LSIs, as detailed in Figure 2.2.

The ECB is responsible for the direct supervision of SIs, while the Banco de España directly supervises LSIs incorporated in Spain, following the guidelines established by the ECB, which supervises them indirectly and has ultimate responsibility for the functioning of the SSM.

Figure 2.2

**DISTRIBUTION OF SUPERVISORY POWERS OVER CREDIT INSTITUTIONS**

	Tasks assigned to the ECB within the SSM	Tasks assigned to the NCAs within the SSM
Supervision of SIs	Direct supervision of SIs	Assistance to the ECB for SI supervision: participation in JSTs and in on-site inspections
Supervision of LSIs	Indirect supervision of LSIs	Direct supervision of LSIs
Common procedures	The common procedures are the responsibility of the ECB, both for SIs and LSIs, with proposal by the NCAs: granting and withdrawal of authorisations to CIs and of authorisations to purchase/sell qualifying holdings in CIs	Preparation of proposals for SIs and LSIs
Sanctions	SIs: sanctioning powers in the event of non-compliance with directly applicable EU law, except non-pecuniary penalties and penalties on natural persons LSIs: sanctioning power in the event of non-compliance with an ECB decision or regulation	SIs: sanctioning powers, upon prior examination by the ECB, for non-compliance with national laws transposed from Community directives; for infringements by directors and managers; and for non-pecuniary penalties LSIs: powers to sanction LSIs for other instances of non-compliance, in some cases after prior examination by the ECB
Macroprudential measures	Possibility of tightening certain macroprudential policy measures set by the national authorities, if deemed justified	Initiative to implement macroprudential policy in close cooperation with the ECB (and any other European bodies)
<b>Tasks outside the SSM's scope: the Banco de España's powers</b>		
Market conduct and transparency	Supervision and sanctioning in the areas of market conduct, transparency and consumer protection of Spanish CIs and institutions other than CIs	
Supervision of other institutions	Supervisory and sanctioning functions regarding the Official Credit Institute and institutions other than CIs: specialised lending institutions, payment institutions, account information service providers, electronic money institutions, currency-exchange bureaux, mutual guarantee companies, reguarantee companies, appraisal companies, banking foundations, Sareb and branches of third-country institutions	
AML/CFT	Cooperation with SEPBLAC in the prevention of money laundering and terrorist financing	
Provision of payment services	Supervision of the provision of payment services	

SOURCE: Banco de España.

At end-2019 the SSM supervised, in consolidated terms, 117 significant groups in the euro area and 2,369 LSIs. In Spain there are 12 groups of SIs<sup>4</sup> and 59 Spanish less significant groups or institutions, accounting for 91.3% and 4.6%, respectively, of the total assets of the Spanish banking system. The rest is accounted for by subsidiaries and branches of significant groups in the euro area

4 Santander, BBVA, Caixabank, Bankia, Sabadell, Unicaja, Bankinter, Kutxabank, Ibercaja, Abanca, Liberbank and Banco de Crédito Social Cooperativo.

Table 2.1

**SPANISH CREDIT INSTITUTIONS**

Data at 31 December

	2018		2019	
	Groups	Assets (%)	Groups	Assets (%)
Significant institutions				
Spanish groups of credit institutions	12	91.3	12	91.3
EU subsidiaries and branches (a)	22	3.5	26	3.6
Less significant institutions				
Spanish credit institutions (b)	58	4.5	59	4.6
Branches of institutions from non-SSM EU countries	10	0.2	4	0.0
Branches of institutions from SSM EU countries (a)	33	0.4	33	0.3
Non-EU branches	3	0.1	3	0.1
<b>Total</b>	<b>138</b>		<b>137</b>	

**SOURCES:** ECB and Banco de España.

- a** Two or more branches/subsidiaries are deemed to belong to the same group when they are part of a higher consolidated group, even if the latter is not Spanish.
- b** Including subsidiaries from EU and non-EU countries.

Table 2.2

**REGISTER OF CREDIT INSTITUTIONS**

Data at 31 December

	2015	2016	2017	2018	2019		
					Registrations	Deregistrations	Year-end
Credit institutions	220	208	207	198	11	12	197
Banks	67	60	59	52	1	1	52
Savings banks	2	2	2	2			2
Credit cooperatives	65	63	63	62		1	61
ICO	1	1	1	1			1
Branches of EU credit institutions	79	77	78	78	10	10	78
Branches of non-EU credit institutions	6	5	4	3			3
Controlling companies	3	4	3	5	1		6
<b>Total</b>	<b>223</b>	<b>212</b>	<b>210</b>	<b>203</b>	<b>12</b>	<b>12</b>	<b>203</b>

**SOURCE:** Banco de España.

(3.6%) and by branches of foreign LSIs, branches of credit institutions in EU countries not participating in the SSM and branches in non-EU countries (adding up to 0.4%) (see Table 2.1). Table 2.2 classifies credit institutions operating in Spain by institution type.

**The supervision of all credit institutions is carried out along two complementary channels: off-site ongoing supervision and on-site supervision.**



- The purpose of off-site ongoing supervision actions is to have an updated opinion on the situation and risk profile of institutions. The level of thoroughness of the analysis is established on the basis of each institution’s supervisory priority, which depends, inter alia, on the institution’s risk profile and size.

The supervisor conducts the SREP<sup>5</sup> annually, applying a methodology which is organised around four basic elements: analysis of the business model; evaluation of internal governance and risk management; assessment of the risks affecting capital and the capital adequacy to cover those risks; and assessment of the risks affecting liquidity and the adequacy of the liquidity position to cover those risks. The SREP also comprises the supervisory review of ICAAP and ILAAP.

- On-site supervision includes two types of actions. On-site inspection visits are a basic supervisory action which permits verifying the information provided by institutions to the supervisory authorities and analysing in greater depth institutions’ business models, governance, solvency, liquidity, profitability, risk profile, controls and compliance with the specific regulations governing them. The investigation of internal models refers to the review and, where appropriate, the authorisation of the models for calculating the capital requirements necessary to cover credit, counterparty, market and operational risks.

**The Banco de España contributes significantly to the supervision of Spanish SIs, both in off-site ongoing supervision work through the JSTs and in on-site inspections and model investigations of such institutions.** The Banco de España contributes not only its experience, but also the bulk of bank examiners that form part of the JSTs at Spanish SIs and of the teams participating in on-site actions.

**The outcome of the above-mentioned supervisory actions is the supervisory assessment of each institution, and the annual capital and liquidity decision (“Pillar 2”).** Institutions are notified each year of the decision they have to comply with in the following year.

The formal structure of the 2019 capital decision has not changed with respect to that of 2018 as far as its main features are concerned, which in principle affect both SIs and LSIs, and are as follows:

- It continues to establish the amount of Common Equity Tier 1 (CET-1) capital required to comply with Pillar 2.

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<sup>5</sup> The SREP is performed by supervisors to assess the risks faced by credit institutions and verify that they are able to properly manage them. This supervisory review and evaluation process allows for a consistent examination of institutions’ risk profiles and adoption of the supervisory measures necessary.

**THE BANCO DE ESPAÑA'S PARTICIPATION IN WORKING GROUPS AND EXPERT NETWORKS WITHIN THE SSM**

The Bank participates actively in a broad set of working groups and expert networks created within the SSM to channel technical discussions. These groups play a key role in defining the methodologies and setting the main supervisory policy lines, and they are essential to ensure that quality supervision is applied consistently in all the countries participating in the SSM.

There are multiple types of groups, based on their nature and their objectives. Some are high-level groups directly reporting to the SB. These structures have been crucial to making headway in core issues of the SSM's supervisory strategy, e.g. defining the guiding principles of the SREP methodology, establishing general criteria relating to sanctions or setting targets to foster the inspections conducted by cross-border teams.

There is also a series of permanent expert networks of top-level importance, through which the relationship between the ECB and NCAs is structured in the field of LSI supervision and in the horizontal and specialised areas. These groups discuss and contribute to the preparation of guidelines and procedures before submitting them to the SB.

One of these networks channels the relationship between the Directorate General responsible for supervising LSIs in the ECB and the high-level representatives of NCAs,

with the ultimate goal of ensuring an adequate degree of harmonisation in the supervision of these institutions. The remaining permanent networks steer the interaction between the ECB's horizontal divisions and the NCA experts. These groups are in charge of, among other aspects, risk analyses, development of methodologies, supervisory policy issues, supervisory planning, crisis management procedures, preparation and quality control of on-site inspections and internal model investigations, coordination of supervisory quality control work and definition of the criteria to be followed in areas such as authorisations or sanctioning processes.

In addition to these stable top-level groups, there is a substantial number of temporary sub-structures that are dependent on them whose names differ on the basis of the purpose of the job for which they were created (treatment of a concrete area deemed significant, preparation of a specific document, etc.).

The Bank currently participates in nearly 80 groups at all levels, involving approximately 100 employees. The considerable effort made in contributing to the work carried out by these groups is essential to ensure fully harmonised and quality supervision, based on the adoption of best international practices, which capitalises on the experience accumulated by the different NCAs.

- It refers to the combined buffer requirement. As the transitional arrangements established in the related regulations have concluded, 100% of the buffer applicable in each case is required of institutions.

In the interest of homogenising supervisory procedures and practices in the different Member States, the SSM makes significant efforts to prepare a clear and harmonised framework in accordance with the principles and standards in the CRD IV<sup>6</sup> and the Capital Requirements Regulation (CRR),<sup>7</sup> and with the guidelines issued by the EBA.

**Against this background, working groups and expert networks play a key role,** by analysing and developing technical and supervisory policy proposals, with the aim of improving the functioning of the SSM. The Banco de España actively participates in most of these groups (see Box 2.2). The proposals made by these

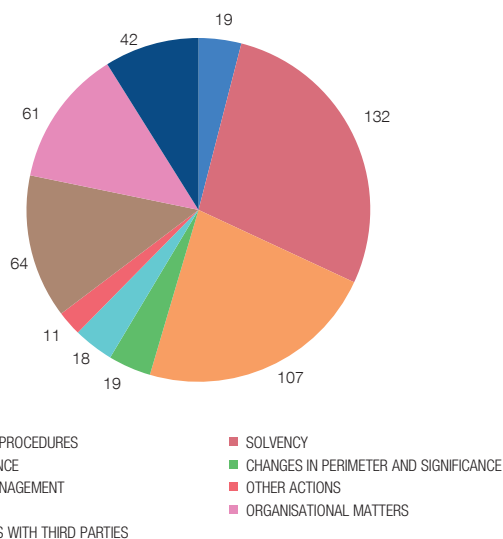
6 Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms.

7 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms.

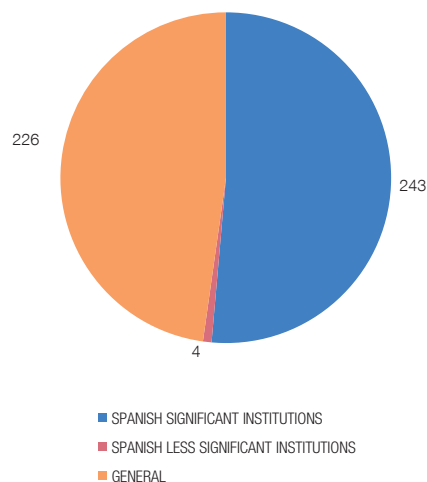
Chart 2.1

**DISTRIBUTION OF ECB DECISIONS IN 2019**

1 BY CATEGORY



2 BY TYPE OF INSTITUTION



SOURCE: Banco de España.

groups are discussed in the SB and, where appropriate, approved by the Governing Council of the ECB.

**The Banco de España takes part in decision-making relating to credit institutions through its representatives on the Governing Council of the ECB and on the SB,** where decisions are taken on a collegiate basis. The SB adopted in 2019 a total of 2,356 supervisory decisions, of which 473 affected Spanish institutions. As shown in Chart 2.1, 247 decisions related specifically to Spanish institutions (243 SIs and 4 LSIs). In addition to these decisions about specific institutions, a further 226 decisions of a more general nature or relating to organisational aspects and policies of the SSM, which also affected Spanish institutions, were taken.

**The Executive Commission of the Banco de España remains informed of supervisory and other decisions about relevant SSM issues adopted by the Governing Council of the ECB, supported by the SB.** In particular, the Director General Banking Supervision reports to the Executive Commission on:

- The supervisory decisions regarding Spanish SIs, including capital and liquidity decisions.
- The supervisory priorities and the annual supervisory examination programme (SEP) for the coming year.

- General SSM matters which may be of particular interest.
- Relevant decisions relating to foreign SSM institutions.
- Periodically, the situation of Spanish institutions.

### 2.2.1 Ongoing supervision of Spanish significant institutions

**The staff of the Banco de España is an integral part of the JSTs responsible for the ongoing supervision of SIs.** The JSTs of Spanish SIs are comprised of ECB and Banco de España staff and, where appropriate, staff from other NCAs of SSM countries where the institutions operate. Each JST performs its tasks under the coordination of an ECB representative who, in turn, is assisted by a coordinator from the Banco de España.

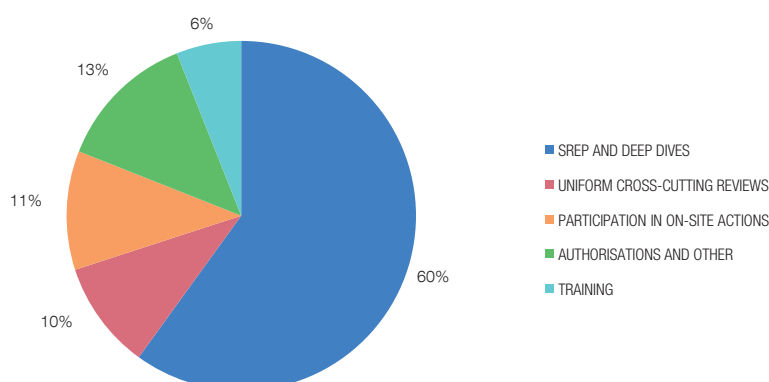
The Banco de España participates in the JSTs of the 12 groups of Spanish credit institutions classified as significant in accordance with the SSM's criteria and in some of the JSTs of 26 significant banking groups from SSM countries that have a presence in Spain (operating through five subsidiaries and 41 branches established in Spain). At end-2019 the Banco de España contributed to the JSTs of Spanish banks a total of 153 employees from the Inspection I and Inspection II departments.

**Ongoing supervisory task planning is performed annually, following a two-fold approach.** On the one hand, the supervisory priorities for each institution are defined, with a medium-term view, in the strategic supervisory plans for SIs. On the basis of the risk profiles and characteristics of the institutions, specific supervisory priorities are identified in these plans that, together with those already generally defined by the SSM (as explained in Section 2.1), determine the supervisory strategy applicable to each institution in the medium term. Strategic plans are live documents that are revised and updated annually.

On the other hand, the strategic plans give rise to SEPs, documents that are more operational and set out the different tasks of the JSTs, whose frequency and intensity are determined by the supervisory importance assigned to the institutions. The supervised institutions are informed of these plans so that they are aware of and can handle the information requirements generated by these activities.

The JSTs focus on off-site ongoing supervision, aiming to maintain an updated opinion on the situation and risk profile of the institutions by applying the SREP methodology. Chart 2.2 shows the different ongoing supervisory tasks performed on SIs by the JSTs in 2019, and the weight of each of them.

**As can be observed, SREP tasks require the greatest effort,** since they include, among other many aspects, monitoring each of the different risks of the institutions,

**ONGOING OFF-SITE TASKS FOR SUPERVISION OF SIs (%)**

SOURCE: Banco de España.

specific monitoring of the main subsidiaries abroad and the annual determination of capital and liquidity requirements. They also include detailed one-off reviews specific to each institution (deep dives) where the JSTs seek to obtain in-depth knowledge of specific aspects or check the functioning or implementation of policies and procedures in specific areas.

**The cross-cutting reviews performed uniformly for SSM institutions also use up a substantial part of resources.** Noteworthy in 2019 were the following cross-cutting reviews, some of which had been initiated in previous years:

- Intensive monitoring of institutions with high NPE rates, focused on the institutions' divestment strategies. Box 2.3 describes developments in the reduction of NPEs.
- Review of internal models for calculating capital requirements. The first part of the review, conducted in 2018, addressed the credit risk models for retail and SME exposures, and the market risk models. In the second part, implemented in 2019, the review of low default portfolios was conducted, including exposures to other firms and specialised lending, and to institutions.
- Analysis of the quality of credit underwriting criteria. This is one of the SSM's supervisory priorities for 2019-2021. It consists of assessing the quality of the credit underwriting practices and standards of SIs. The project is divided into three phases: the first consists of designing, requesting and collecting data on new loans for the period 2016-2018; the second is the review of the quality of the data collected

**SUPERVISORY DEVELOPMENTS IN THE REDUCTION OF NON-PERFORMING EXPOSURES**

The management and reduction of non-performing exposures (NPEs)<sup>1</sup> are supervisory priorities of the SSM since its creation. The ECB has taken the initiative by adopting the following supervisory measures for SIs, as published in:

- The *Guidance to banks on non-performing loans*, published in March 2017, which describes best practices in the management of NPLs and forbore exposures, requires credit institutions with higher NPLs to have a strategy to reduce them and adequate governance.
- The addendum to the ECB Guidance, published in March 2018, which sets out supervisory expectations for additional provisioning under Pillar 2 for NPEs of a certain vintage classified as NPEs from 1 April 2018.
- A press release dated 11 July 2018, announcing supervisory expectations under Pillar 2 for additional provisioning for NPL stock (NPLs existing at 31 March 2018).

The two additional supervisory coverage expectations will be incorporated in the supervisory dialogue of the 2021 SREP (and onwards).

Additionally, in July 2017 the European Council announced its action plan to tackle NPLs, inviting several European institutions to adopt specific measures. These included most notably the following:

- The EBA published its Guidelines on management of non-performing and forbore exposures in October 2018 (EBA/GL/2018/06). Its content is very

similar to the ECB Guidance, with some differences: i) it introduces a definition of high-volume NPL banks (those with an NPL ratio equal to or above 5%), and ii) it is applicable to all EU credit institutions (whether significant or not).

- Regulation (EU) 2019/630 amending the CRR and published on 25 April 2019, sets a prudential backstop (a prudential minimum coverage) for NPEs. It is devised as a Pillar 1 prudential measure and is applicable to all NPEs originated as from April 26 2019.

In view of the new regulation, the ECB decided to bring its supervisory expectations into line with the CRR as regards additional provisioning for NPLs, changing them with two objectives in sight: avoiding overlaps of the NPL coverage requirement under Pillar 1 and Pillar 2, and achieving greater alignment of the calendar and coverage levels.

The ECB communicated these changes on 22 August 2019 through the publication on its website of a press release accompanied by a technical note entitled “Communication on supervisory coverage expectations for NPEs”.

In short, these measures have contributed significantly to reducing the NPL volume and ratio of SIs in recent years.

In particular, the volume of NPLs in the Euro area as a whole stood at around €1 trillion as at June 2016 (6.61% NPL ratio). By June 2019 this volume had been reduced to €561 billion (3.56% NPL ratio). The NPL ratio of Spanish SIs was slightly below the European average as at June 2019, standing at 3.47% (5.96% as at June 2016).<sup>2</sup>

1 Strictly speaking, NPLs refer to non-performing loans and advances, while NPEs refer to all non-performing exposures which, in addition to the former, also include debt securities and off-balance-sheet exposures, such as any guarantees given. In this report, as in EBA and ECB guidelines, the two terms are used interchangeably and NPLs are treated as NPEs. As a result, references to NPE or NPL management encompass all non-performing exposures. However, references to the NPL ratio should be understood as only including loans and advances in the calculation, in line with the EBA definition.

2 Source: Supervisory banking statistics, ECB.

and of the quantitative analysis; and the third phase, to be developed in 2020, is the qualitative analysis of a sample of selected portfolios.

- Review of the preparedness of institutions for Brexit, with special focus on contingency plans and the impact on customers.
- Review of recovery plans (see Section 2.2.6).

**Another significant block of activity is the cooperation of JSTs in on-site actions**, as detailed in Section 2.2.3. The JSTs are involved in the preparation and definition of the targets of each action, and in monitoring shortcomings identified and implementing measures to remedy them. It is also common for some JST members to join the inspection teams in order to share information and knowledge about the institution.

**Additionally, the supervisory effort focuses on other areas**, such as:

- Processing of authorisations (e.g. acquisition of qualifying holdings).
- Coordination with other supervisors, mainly through supervisory colleges. In the case of Spanish SIs with a presence in countries outside the scope of the SSM, the JSTs take part in the colleges of supervisors (presided over by the ECB and with the Banco de España acting as observer), collaborating and sharing information with other supervisory authorities. Also, a fluid communication between the JST and the foregoing authorities is maintained through periodic bilateral meetings.
- Stress tests. In 2019 the JSTs took part in the sensitivity analysis of liquidity risk organised by the ECB in which the relative vulnerability of institutions to the different liquidity shocks applied was assessed and the improvements required to manage this risk were identified.

**Finally, the time devoted to the continuous training of JST staff members** to remain up-to-date in a continuously evolving financial and regulatory environment is noteworthy.

**Information arising from the supervisory activities feeds the conclusions of the SREP, which are used to adopt the capital and liquidity decisions.** The methodology developed within the SSM framework has been applied since 2015 to determine the capital and liquidity decision, ensuring a uniform assessment in all SIs. This common framework covers:

- a) a system to assess the risks faced by credit institutions;
- b) a review of the ICAAP and ILAAP applied by institutions; and
- c) a methodology for calculating capital and liquidity needs on the basis of the assessment of their risks.

**The Pillar 2 guidance (P2G) is maintained in the 2019 capital decisions issued by the ECB for SIs.** This supervisory tool sets capital expectations above the total capital requirements. This guidance is not legally binding and supplements



Meeting between the Chair of the Supervisory Board of the ECB and the Banco de España's Directorate General Banking Supervision, as part of the "Banking Union – Five Years in the Making" event, 23 October 2019, Hemiciclo II Auditorium.

the Pillar 2 requirement (P2R). The P2G is set on the basis of the assessment of own funds needs (quality and quantity) under stressed conditions and is expressed in terms of CET-1. The ECB expects banks to comply with this guidance, the minimum regulatory requirements (Pillar 1), the P2R and the combined capital buffer requirement.

If a bank fails to comply with this guidance, there will be no automatic supervisory actions. Instead, supervisors will consider adopting supervisory measures on a case by case basis, with the approval of the SB. These measures could include the transformation of a P2G into a P2R.

**The capital and liquidity decisions approved by the SSM's decision-making bodies were notified to banks prior to end-2019**, once the hearing period had expired. These new decisions will remain in force until the next capital and liquidity decision, which will foreseeably be notified in December 2020.

The supervisor-supervised dialogue is a key part of the ongoing supervision approach. This is essential to transmitting the weaknesses detected, the assessment of the institution and the supervisory priorities and expectations, as well as for fostering an exchange of opinions and discussion of the main areas of attention. The JSTs maintain fluid contact with the institutions at various hierarchical levels, including the board of directors and top management.

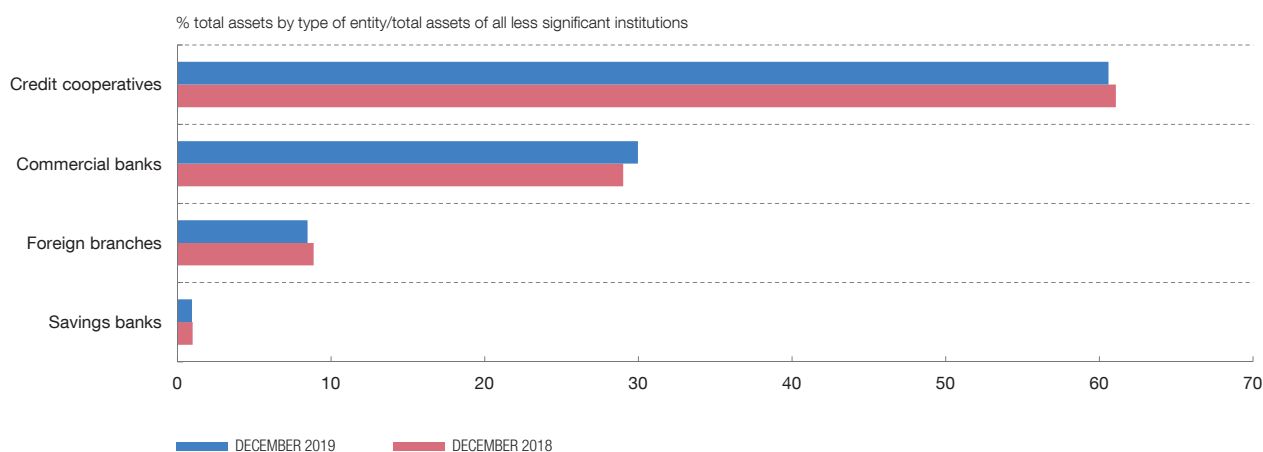
### 2.2.2 The ongoing supervision of less significant institutions, non-EU branches and of the ICO

**The Banco de España is responsible for the direct supervision of LSIs**, which account for approximately 4.6% of the Spanish banking system's assets, while



Chart 2.3

**WEIGHT OF THE VARIOUS TYPES OF LSIs**



SOURCE: Banco de España.

the ECB is responsible for their indirect supervision. Chart 2.3 shows the relative size of each of the types of LSIs in terms of total assets.

**The annual supervisory plan, which details the following year’s supervisory activities, is prepared each year on the basis of the supervisory priorities. As part of ongoing supervision, the performance of each bank is monitored periodically** (quarterly or half-yearly). Monitoring may be ordinary or simplified and is conducted in accordance with the principle of proportionality, considering factors such as each institution’s risk profile, size, volume of deposits raised on the retail market and business model. Thus, lower risk institutions, or those that are smaller in size or whose model so allows are subject to simplified monitoring. This is based on quarterly alerts using the information included in supervisory reporting and the Banco de España’s central credit register (CCR), in order to detect potential future problems of liquidity, solvency or sustainability of the business model.

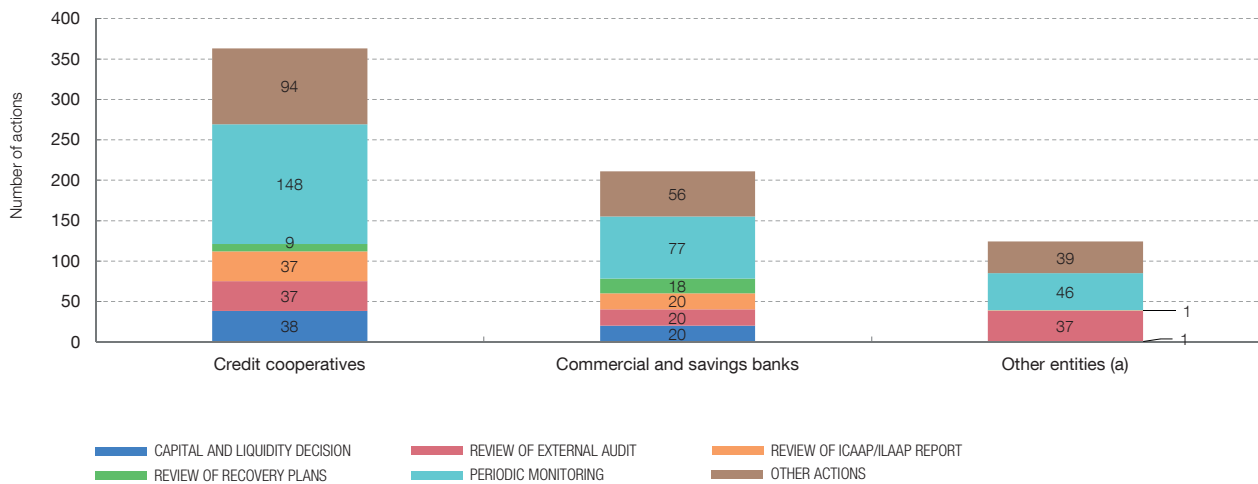
Ordinary periodic monitoring was carried out for 23 of the 59 groups of LSIs in 2019, accounting for around three quarters of LSIs’ total assets, with simplified periodic monitoring being performed for the remaining 36 groups.

**The Banco de España also performs other detailed actions**, including reviews of external audit reports, reviews of internal capital and liquidity adequacy assessment reports, review of the recovery plan (see Section 2.2.6), meetings with the external auditor and periodic meetings with persons in positions of responsibility at the institutions.

**As for SIs, the SREP is one of the key tasks of off-site ongoing supervision.** The SREP methodology approved by the SB, which envisages a similar arrangement

Chart 2.4

**NUMBER OF ONGOING OFF-SITE SUPERVISORY ACTIONS AT LSIs**



SOURCE: Banco de España.

a "Other entities" includes foreign branches and the ICO.

to that for SIs, was applied in 2019. However, the P2G will not be required until the capital decision for 2021 is adopted, in 2020. The SREP conclusions take into account the results of the stress test known as FLESB (Forward Looking Exercise on Spanish Banks), which is conducted by the Financial Stability and Macprudential Policy Department of the Directorate General Financial Stability, Regulation and Resolution, to assess the resilience of Spanish institutions. Once the related 2019 SREPs had concluded, and the institutions’ representations had been considered, the Bank adopted the 2020 capital and liquidity decisions for LSIs.

The Bank has continued to cooperate with other NCAs in the context of the supervisory colleges of other SSM-country LSIs with subsidiaries in Spain. It has participated in a total of three colleges in 2019, which have contributed to joint decision-making on capital and liquidity requirements.

In 2019 a total of 574 ongoing supervisory actions for Spanish LSIs were undertaken, as detailed by type of institution and by matter in Chart 2.4.

In the case of branches in Spain of institutions with head offices in other EU Member States (including those of countries not participating in the SSM and those of LSIs of other SSM countries), as they are not subject to prudential or liquidity requirements at the branch level, periodic monitoring of the performance of the branch is conducted, meetings are held with the management and information is regularly exchanged with the authorities of the home country of the branch, under the terms established in Commission Implementing Regulation (EU) No 620/2014 laying down

implementing technical standards with regard to information exchange between competent authorities of home and host Member States.

**Direct supervision of LSIs is backed up by indirect supervision by the ECB,** with the aim of:

- ensuring the uniform application of high supervisory standards, and
- guaranteeing the consistency of supervisory outcomes in the Member States participating in the SSM.

The ECB's performance of those two functions benefited, as in previous years, from the full cooperation provided by the Banco de España. The Bank is working with the ECB and other NCAs on the definition of supervisory standards. Once approved in the form of guidelines or recommendations, these must be taken into consideration by all SSM countries in the supervision of their LSIs. Considerable human resources are dedicated to that task. For instance, in 2019, the SREP methodology for LSIs has been updated and internal guidelines have been drawn up to apply to LSIs the same criteria established for SIs in connection with the materiality threshold for credit obligations past due for the purposes of the definition of default included in the CRR. This threshold is compatible with Banco de España Circular 3/2019, of 22 October 2019, which is described in greater depth in Chapter 8 of this report.

As regards the branches in Spain of institutions with head offices in non-EU countries, the Bank's supervision also includes half-yearly monitoring, external audit reviews and regular meetings with branch management.

As regards branches of LSIs, non-EU branches and the ICO, a total of 124 supervisory actions were carried out in 2019.

### 2.2.3 On-site supervision

**On-site supervision complements the off-site ongoing supervision of institutions.** It is performed by teams separate from those responsible for ongoing supervision, although the two teams are coordinated. Table 2.3 details the on-site actions performed in 2019 in which The Banco de España played a major role (i.e. all actions at Spanish institutions and actions led by Bank staff at institutions of other SSM countries).

**In 2019, 34 on-site actions were carried out at SIs,** of which 31 were at Spanish institutions and three were at financial groups from other SSM Member States. Of the 31 on-site actions at Spanish SIs, 22 were led by Bank staff, four by ECB

Table 2.3

**ON-SITE SUPERVISION OF CREDIT INSTITUTIONS. NUMBER OF ACTIONS**

	2019		Total
	Significant institutions	Less significant institutions	
On-site inspections	22	11	33
at Spanish credit institutions	20 (a)	11	31
at credit institutions from other SSM countries	2		2
Internal model investigations	12	—	12
at Spanish credit institutions	11 (b)	—	11
at credit institutions from other SSM countries	1		1
<b>Total</b>	<b>34</b>	<b>11</b>	<b>45</b>

**SOURCE:** Banco de España.

**a** Of which, 15 were led by Banco de España staff and 5 were led by staff from other authorities.

**b** Of which, 7 were led by Banco de España staff and 4 were led by staff from other authorities.

staff and five by staff from other SSM Member State authorities. Moreover, Bank staff participated in all the on-site actions at Spanish SIs.

Bank staff also participated in an additional four inspections of other SSM country institutions, without leading them.

The Banco de España has also participated actively in the working groups set up in the SSM to develop the most suitable techniques for on-site supervision of the various risks (credit, technology, market, etc.) and to continue making progress on the uniform and efficient application of on-site inspection in all SSM countries.

**On-site inspection actions at SIs are planned as part of the SEP**, taking into account institutions' risk profiles and the areas of attention defined by the JSTs. The Banco de España participates actively in drawing up the SEP. In the SEP for 2019, 50% of on-site inspections at Spanish SIs were concentrated in credit risk, with the rest being dedicated to governance, solvency and technology risk. Model investigations related in full to credit risk.

The SEP for 2020 defines the on-site inspections that are to be carried out over the course of the year. The challenges posed by the new on-site inspections are campaigns, cross-border inspections and those whose scope is the review of models to estimate accounting provisions under International Financial Reporting Standard 9 (IFRS 9), as detailed in Box 2.4.

In the internal models field, after completion in 2019 of the on-site phase of the TRIM, the intensity of the supervisory activities plan does not lessen: the priority for 2020 will be the review of the adjustments to be made by institutions to their models, in order to correct the deviations detected in the TRIM and to adapt to the new EBA guidelines.

### CHALLENGES POSED BY THE NEW ON-SITE INSPECTIONS: CAMPAIGNS, CROSS-BORDER INSPECTIONS AND PROVISIONING MODELS

In order to continue harmonising the methodology applied to on-site inspections within the SSM, the SEP for 2020 addresses the so-called “campaigns” and cross-border inspections.

Campaigns are groups of inspections which share a common topic (risk type, area, portfolio or types of operations analysed), can be performed simultaneously at different institutions, have a similar scope and use common techniques or tools. Their aim is to ensure that the area reviewed is treated consistently and that best practices are extracted to incorporate them into the inspection methodology. Logically, they require significant coordination work, which is performed by a group of experts comprising, among others, the persons responsible for the inspections, and is led by a coordinator.

Six campaigns have been included in the SEP for 2020, with the related inspections accounting for somewhat more than one fourth of all those scheduled for the year. The campaign topics were credit risk (retail mortgage portfolio, commercial mortgage portfolio and leveraged finance), technology risk (cybersecurity), market risk (derivative valuation), and capital and governance (ICAAP review). Nine of the inspections of Spanish institutions scheduled in the 2020 SEP relate to one of these campaigns.

Cross-border inspections are those where either the head of mission and at least one inspection team member (cross-border inspections, strictly speaking) or at least two

of the other team members (mixed-team inspections) are from an NCA other than that where the institution subject to inspection is located.

Planning, assigning resources and managing these inspections is, logically, more complex. Additionally, these inspections pose a challenge for the head of mission and for the team members who come from other countries, since they have to deal with the special features of the local context (characteristics of the banking system, specific regulations and language).

In 2017 the SB set the goal that approximately one third of all the inspections in the SSM were to be of this kind in the medium to long term.

The objective for 2020, which was set in 2019, that 30% of inspections within the SSM are to be of this kind, is maintained. Banco de España staff is scheduled to lead five cross-border inspections and to participate in another one.

As regards the inspection topic, because it is new, and with the aim of applying a consistent approach to all the inspections, a working group has been created for inspections whose aim is to review the models used to estimate accounting provisions within the IFRS 9. In all likelihood these types of inspections will be a form of campaign in the future. Four inspections of Spanish institutions of this kind have been planned in the SEP for 2020, accounting for 30% of the total scheduled within the SSM as a whole.

**Finally, the supervisory plan for LSIs is approved by the Bank’s Executive Commission, as they are subject to the Bank’s direct supervision.** However, the ECB is kept informed of the content of the plan. In 2019 11 on-site inspections were performed at LSIs. Nine more are scheduled for 2020.

In addition to the traditional areas and aspects, such as analysis of credit quality and foreclosed assets, governance and solvency, special emphasis has been placed on the sustainability of the business model during the on-site inspection visits performed at LSIs in 2019. This is because retail banking profitability has declined across the board in the European banking system, owing to the volume of non-earning assets, resistance to cost reduction, the process of deleveraging of the Spanish economy and the prolonged low, and even negative, interest rate environment, resulting

in the significant liquidity volumes at LSIs having a very high cost in terms of lower income.

In this connection, the policies implemented to combat the decline in profitability, a key component for maintaining adequate solvency, have been analysed. These necessarily involve management measures (e.g. an increase in fees and commissions and/or reduction of overheads) to adapt to the current economic environment, as well as decisions aiming to reduce non-earning assets (NPLs and foreclosed assets) at certain institutions.

The results of the inspection visits at LSIs are discussed with the institutions themselves through the so-called “preliminary conclusions letter” to establish the most significant points resulting from the inspection visits, after which the corresponding letters to the institutions, as approved by the Executive Commission of the Banco de España at the proposal of the Directorate General Banking Supervision, are drawn up (see Section 2.2.7 for further details).

#### 2.2.4 Dividend distribution and variable remuneration policies

**Institutions’ profit distribution policies must comply with the principle of prudence and be designed to maintain an adequate level of capitalisation at all times.** For this purpose, the competent authorities make an annual recommendation on the distribution of profit. The ECB’s recommendation of January 2020 distinguishes three situations:

- Institutions that, as at 31 December 2019, satisfied the applicable capital requirements and had already reached their fully-loaded capital ratios under the assumption that the transitional period has concluded should set the distribution of dividends in a conservative manner in 2020.
- Institutions that, as at 31 December 2019, satisfied the applicable capital requirements but had still not reached their fully-loaded capital ratios should set the distribution of dividends in a conservative manner, securing, furthermore, at a minimum, a linear path towards the fully-loaded capital ratios, with respect to the IFRS 9 transitional period envisaged in Article 473a of the CRR in the case of institutions that have chosen to apply it.
- Institutions in breach of the applicable capital requirements should in principle not distribute any dividend.

Additionally, all institutions are expected to comply for these purposes with the Pillar 2 capital requirements (P2R) and the Pillar 2 guidance (P2G).

On that date the ECB sent a letter to institutions recommending the application of a variable remuneration policy compatible with a conservative path, which is at least linear, towards compliance with the fully-loaded capital requirements.

In line with these criteria, in February 2020 the Banco de España issued a recommendation to LSIs on their dividend and variable remuneration policies. This recommendation included the main aspects of the ECB's recommendations.

### 2.2.5 Common procedures, suitability and other procedures

**The common procedures relate to authorisations to take up the business of credit institutions, withdrawals of such authorisations and the acquisition of qualifying holdings.** They are provided for by Regulation (EU) No 468/2014 of the ECB of 16 April 2014 establishing the framework for cooperation within the SSM between the ECB and NCAs. In these procedures, for Spanish institutions the Banco de España makes an initial assessment and draws up a proposal for each specific case. The ECB then makes a final decision on the basis of this proposal and any additional work it considers appropriate to undertake.

**The rest of procedures include most notably that relating to suitability.** At all times during which they hold office, and not just at the time they take it up, all senior officers of credit institutions are required to meet the suitability requirements stipulated in the regulations. Thus, they must have commercial and professional integrity, possess appropriate knowledge and experience for the exercise of their functions, comply with the rules on conflicts of interest and limitations (where applicable), and, in the case of the members of the board of directors, be in a position to exercise good governance, i.e. i) have sufficient time to carry out their duties, and ii) be free from conflicts of interest.

The Banco de España –in the case of LSIs– and the ECB, acting in close collaboration with the Banco de España –in the case of SIs– supervise compliance with the rules on the suitability of credit institutions' senior officers at all times during which they hold office.

Since December 2018 there is a single form to assess the suitability of all senior officers of credit institutions, whether they are directly supervised by the SSM or by the Bank. It has been verified during 2019 that the use of this form by the two types of credit institutions has served to improve the transparency of the suitability assessment criteria applied by the Bank and for the suitability assessment files to be more complete from the onset, which also contributes to their being processed in less time.

The adoption of the Guidelines on the assessment of the suitability of members of the management body and key function holders (EBA/GL/2017/12)

Table 2.4

**PROCEDURES IN RESPECT OF CREDIT INSTITUTIONS INVOLVING THE BANCO DE ESPAÑA**

	Total
Qualifying holdings, merger, spin-off and other significant acquisitions	11
Cross-border activity of Spanish credit institutions	90
Branches in the EU	10
Branches in third countries	1
Freedom to provide services	69
Representative offices	10
Cessation of business	1
Loans to senior officers	36
Suitability of senior officers	179
Procedures relating to own funds	17
Amendments to articles of association	39
Communications with other supervisory authorities or institutions	16
Other procedures	49
<b>Total</b>	<b>438</b>

SOURCE: Banco de España.

and the subsequent modification of the Guide to Fit and Proper Assessment, drafted by the ECB as a result of the entry into force of the aforementioned guidelines, both in 2018, had a significant impact on supervision in 2019, contributing to a more fluid supervisory dialogue and greater certainty for institutions as regards supervisory expectations relating to suitability criteria applicable to their senior officers.

Table 2.4 details both the common procedures and the rest of procedures for credit institutions in which the Banco de España has taken part.

### 2.2.6 Crisis management framework

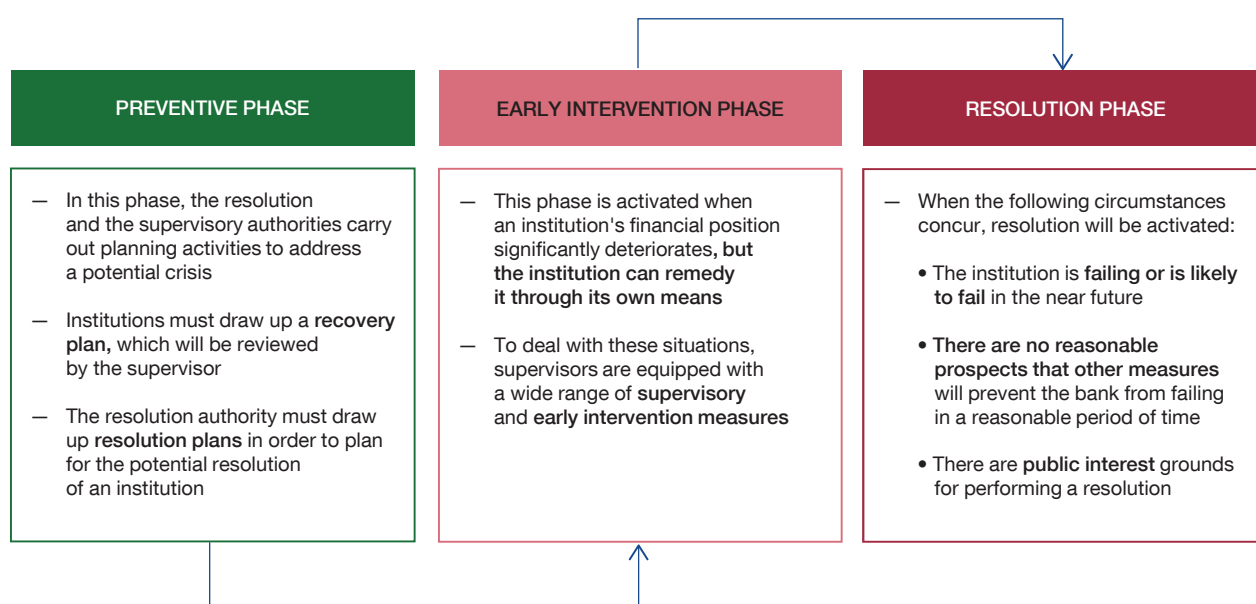
**The recovery and resolution framework defines three clearly distinct phases in distress and in the credit institutions' crisis: a preventive phase, an early intervention phase and the resolution phase.** The Bank has a determining role in the first two phases. The main functions and tasks of the different phases are defined in Figure 2.3.

**Recovery plans must, in general, be prepared at least yearly.** Their aim is to establish measures to restore institutions' financial position in the event it is financially impaired. They should at least contain the information envisaged in Annex 1 of Royal Decree 1012/2015 and should be updated whenever a significant change affects institutions. Although they are all required to prepare and maintain a recovery plan,



Figure 2.3

**MAIN FUNCTIONS AND TASKS IN THE VARIOUS PHASES OF DETERIORATION AND IN THE CREDIT INSTITUTION CRISIS**



SOURCE: Banco de España.

certain banks may comply with this obligation in a simplified manner, allowing for the plan's contents to be more reduced and for them to be updated less frequently.

**As regards LSIs, the eligibility policy for simplified obligations has changed this year**, as a result of the entry into force of Commission Delegated Regulation 2019/348 specifying the criteria for assessing the impact of an institution's failure on financial markets, on other institutions and on funding conditions, on the basis of quantitative and qualitative criteria. As a result, nine institutions or groups are subject to full obligations and 47 may comply with simplified obligations, updating their recovery plan at least every two years.

**As regards SIs in 2019, the importance of assessing overall recovery capacity (ORC) in the process of reviewing recovery plans should be noted.** The ORC provides an overall perspective of the extent to which institutions would be able to restore their financial position following significant deterioration. In this connection, banks should: i) provide a credible and realistic view of their ORC, taking into account the best practices identified by the ECB (see Table 2.5); ii) test the effectiveness of their options and the resulting ORC in a range of scenarios, and iii) include in the plan a justification of how the impact and viability of each recovery option have been estimated.

With respect to the groups of SIs, the JSTs performed the following activities within the crisis management framework:

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Table 2.5

**BEST PRACTICES IDENTIFIED BY THE ECB TO BETTER ESTIMATE ORC**

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Institutions must consider the existence of **mutually exclusive** recovery options (e.g. asset sale versus asset securitisation)

---

**Interdependencies between options** must be taken into account (e.g. dividend cancellation affecting capital increase measures)

---

The possible **reputational effects** of certain recovery measures (e.g. dividend cancellation) and the institution's **operational capability** (e.g. the possibility of preparing the securitisation of several asset portfolios in parallel) should be borne in mind

---

Institutions must consider the impact of the **economic situation** in the countries where they pursue certain activities or where they have subsidiaries on certain recovery options (e.g. disposal of subsidiaries in countries whose financial situation has deteriorated)

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**SOURCE:** ECB, *Report on recovery plans* (July 2018).

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- The 2018 recovery plan review cycle, initiated in the fourth quarter of the preceding year, was completed. As a result of the assessments, letters were sent to institutions notifying them of the aspects in which they have to improve in the following plan cycle and, in the case of more serious shortcomings, requesting the remittance of specific action plans to remedy them within a reasonable period.
- The JSTs participated in the prior consultation of resolution plans with the Single Resolution Board.

With regard to LSIs, the Banco de España:

- Completed in 2019 its assessment of the recovery plans sent by obliged entities in the fourth quarter of 2018. As a result of the review, wherever appropriate, letters were sent to the institutions either requesting that the shortcoming detected be remedied by them in the next plan sent or requiring that a new plan be sent by the legally established deadline in the case of significant shortcomings.
- Participated with the NCAs of less significant European groups with a presence in Spain in recovery plan decision-making.
- Likewise, it participated in the legally envisaged prior consultation phase on resolution plans of LSIs.

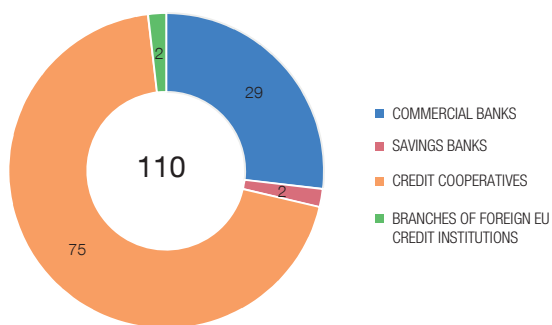
## 2.2.7 Letters

As a result of the above-described supervisory actions in 2019, a total of 110 letters were sent to LSIs, with requirements and recommendations made by the

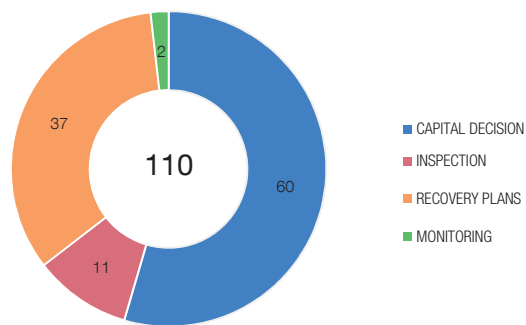
Chart 2.5

**NUMBER OF LETTERS ADDRESSED TO CREDIT INSTITUTIONS**

1 BY TYPE OF INSTITUTION (2019)



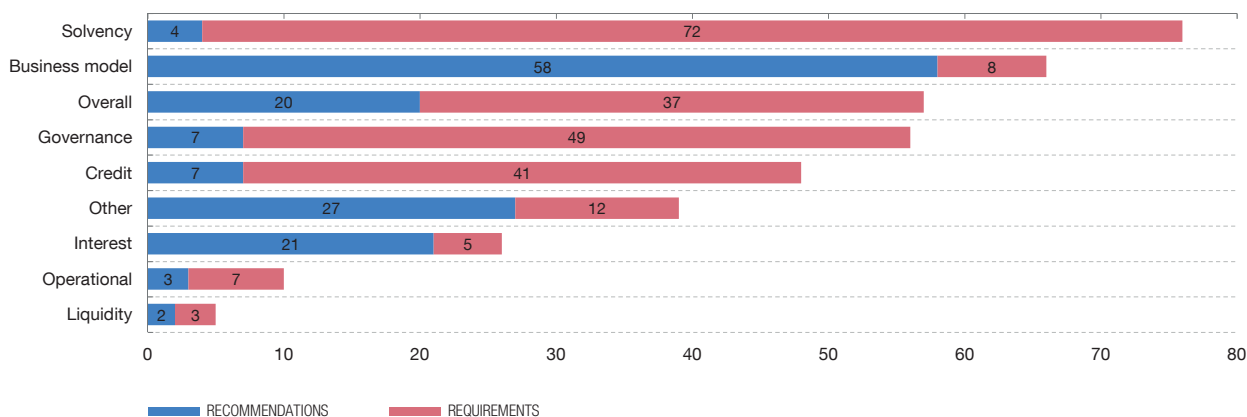
2 BY SUBJECT MATTER (2019)



SOURCE: Banco de España.

Chart 2.6

**NUMBER OF RECOMMENDATIONS AND REQUIREMENTS NOTIFIED TO CREDIT INSTITUTIONS**



SOURCE: Banco de España.

Banco de España in the exercise of its supervisory powers. Chart 2.5 provides a breakdown of these letters by type of institution and subject matter. Of these, 60 related to capital decisions, 37 to recovery plan reviews, 11 to on-site inspections and 2 to the findings of off-site monitoring.

Chart 2.6 shows the breakdown by subject matter of the 383 requirements and recommendations contained in the 110 letters sent to credit institutions. The requirements notified to LSIs in 2019 largely related to solvency and, specifically, to capital decisions, since all institutions are asked, on an annual basis, to satisfy a capital requirement level. Most of the requirements arising from the inspections

performed related to governance, followed by credit risk. These governance requirements were issued with a view to improving the composition and functions of committees, internal control and contingency plans. Credit risk requirements, which are accounted for by the type of business (retail banking) pursued by these institutions, related mostly to reclassifications to non-performing assets, and to the need for increasing loan-loss provisions and improving the specific internal controls in place for credit risk.

The bulk of recommendations referred to the business model and advocated increasing the recurring sources of income and adjusting overhead costs, to ensure institutions' sustainability in the long term.

### 2.2.8 Other actions

**The Banco de España cooperates closely with the CPBCIM (by its Spanish abbreviation) and its Executive Service (SEPBLAC)** in the supervision and inspection of compliance with AML/CTF obligations by institutions supervised by, or registered at, the Banco de España, pursuant to Spanish legislation and the cooperation and coordination agreement entered into with the CPBCIM.

In 2019, the Banco de España laid the groundwork for strengthening the internal function for the supervision and inspection of AML/CTF obligations. The work carried out during the year in this connection notably included the updating of the methodology for assessing banks' ML/TF risk and the review and documentation of the different AML/CTF inspection procedures. This work is scheduled for completion in the second quarter of the current year.

Also worth noting is the growing participation in various international working groups, in collaboration with other departments and directorates general of the Banco de España, and the completion of two inspections focusing specifically on reviewing these risks. For more details on the international initiatives relating to this issue, see Box 2.5.

**In addition, the Banco de España collaborates with other national supervisors.** Specifically, with the CNMV, on the supervision of activities relating to financial markets and the supervision of consolidated groups which include credit institutions and investment firms. It also works in coordination with the DGSFP, when a consolidated group of credit institutions includes institutions that are subject to supervision on an individual basis by the DGSFP.

**Lastly, it collaborates with international organisations such as the International Monetary Fund (IMF) and the World Bank.** In 2019, the DGBS continued working with the IMF on the tasks involved in the analyses of the financial and banking

**ANTI-MONEY LAUNDERING: INTERNATIONAL INITIATIVES**

In 2019, numerous major international initiatives were developed and completed to improve the global AML/CTF framework:

**European Union.** In December 2018, the Council of the European Union adopted an action plan to combat ML/TF risks more effectively. This plan entrusted the European Commission, the EBA and national supervisory authorities with a series of non-legislative short-term actions, on which they began working in 2019.

The amended Capital Requirements Directive published in 2019 (CRD-V) underlines the important role played by the prudential banking supervisor in identifying ML/TF risks, the need for these risks to be factored into supervisory tasks, the required cooperation with the EBA and the authorities responsible for the supervision of ML/TF, and the adoption, where appropriate, of the measures available to them. The amended directive completes the update of the global framework for the supervision of these risks.

**Basel Committee.** In 2019, the work of the Anti-Money Laundering Expert Group, of which the Banco de España is a member, centred on further developing their *Guidelines on sound management of risks related to money-laundering and financing of terrorism*, by adding an annex on cooperation between prudential supervisors and AML/CTF supervisors.

**European supervisory authorities (ESAs).** Namely: the EBA, the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA). The sub-committee of the ESAs' joint Anti-Money Laundering Committee (AMLC) worked on: i) drawing up the guidelines of the AML/CTF supervisory colleges; ii) updating the guidelines on ML/TF

risk factors, and iii) various initiatives to implement the aforementioned action plan adopted by the Council. Following the amendment of the ESA Regulations, the EBA's role in this area was strengthened, extending its mandate to the entire financial sector and creating a new high-level committee to take over the tasks currently performed by the AMLC.

In addition, in July 2019, the EBA published an opinion inviting prudential supervisors to send a common message to credit institutions about the relevance of AML/CFT concerns from a prudential perspective. Along the same lines, the ECB issued a statement highlighting the importance of, and the consideration given to, the prevention of such risks. The Banco de España also contributed to this initiative by issuing a statement on these concerns in December 2019, addressed to banking associations.

**Single Supervisory Mechanism.** In 2019, the SSM put considerable effort into integrating aspects relating to ML/TF risks into its prudential supervision tasks. This work included: i) signing a multi-lateral agreement with national AML/CTF authorities in the European Economic Area (EEA) to foster and facilitate the exchange of information, and ii) developing a methodology and adapting its processes to incorporate concerns relating to these risks into the SSM's prudential banking supervision tasks.

More specifically, the areas in which the SSM has included AML/CTF-related aspects are: i) the process for new credit institution authorisations; ii) assessment of the acquisition of qualifying holdings; iii) assessment of the suitability of Board members; iv) the SREP, and v) the adoption of prudential administrative measures that include the imposition of sanctions, if necessary.

system within the framework of Article IV of the IMF's Articles of Agreement and the Financial Sector Assessment Programme (FSAP).

Also, the Banco de España coordinated visits from the European Commission, the ECB and the European Stability Mechanism (ESM), in connection with post-programme surveillance (PPS),<sup>8</sup> at which the financial and real situation

<sup>8</sup> Since the conclusion of Spain's financial assistance programme in January 2014, during which the country received financial assistance from the ESM, and within the framework of the PPS (Article 14 of Regulation (EU) No 472/2013), the European Commission, in coordination with the ECB, organises twice-yearly visits to Spain, during which meetings with the Banco de España are scheduled.

of the Spanish economy was analysed from a macroprudential and microprudential standpoint, including that of banks which had received State aid during the financial programme.

### 2.2.9 The quality function

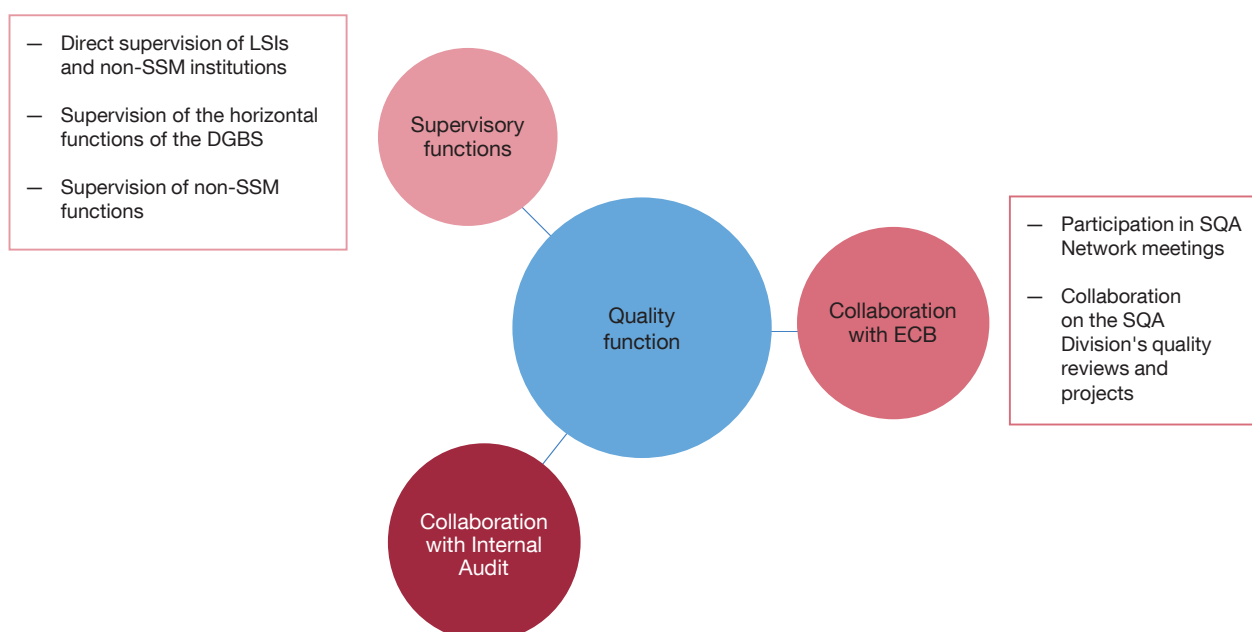
**The core purpose of the quality function is to ensure the excellence of the DGBS's activities**, by promoting consistency and uniformity, streamlining and simplifying its processes and verifying compliance with internal regulations.

The Quality Division is responsible for the quality of the direct supervision of LSIs and other institutions supervised by the DGBS outside the scope of the SSM, for the horizontal functions of the DGBS and for the review of activities not within the SSM scope (for example AML/CFT). It is also the DGBS's point of contact with the Internal Audit Department of the Banco de España, and cooperates with the ECB's Supervisory Quality Assurance (SQA) Division.

In the SSM, the SI supervisory quality function is the responsibility of the ECB. The latter and the NCAs work together through a cooperation and consultation group known as the SQA Network, which meets regularly several times a year and whose members are in permanent contact. These interdependencies and tasks are shown in Figure 2.4.

Figure 2.4

#### INTERDEPENDENCIES AND TASKS OF THE QUALITY FUNCTION



SOURCE: Banco de España.

**DEVELOPMENT OF A QUALITY METHODOLOGY FOR THE DGBS**

The quality methodology seeks to lend a formal structure to the working methods of the group, providing the basis for its activities. This methodology is built on six pillars:

**1 Objective of the quality function**

To contribute to the ongoing improvement of the work performed by the DGBS.

**2 Planning of activities**

A key element for drawing up the annual plan is a quality “object map” encompassing all supervisory activities, procedures and/or tools subject to review.

**3 Type of activities performed by the quality function**

These include quality reviews (in-depth analysis of an activity, procedure and/or tool), other quality actions (on-the-spot, unscheduled reviews with a very specific scope)

and quality projects (definition or design of procedures and/or tools that contribute to improving supervisory activities).

**4 Point of contact between the DGBS and Internal Audit**

The quality group cooperates in the internal audits performed in the DGBS, monitors the requirements issued and tries to prevent overlaps between the quality reviews and this audit work.

**5 Cooperation with the ECB**

The quality group participates in the regular meetings of the Supervisory Quality Assurance (SQA) Network and cooperates in the reviews led by the SSM’s SQA Division.

**6 Activity report**

A report on the activities carried out during the year and on the related findings is prepared annually.

Figure 1  
QUALITY METHODOLOGY IN THE DGBS



SOURCE: Banco de España.

In 2019, the Banco de España quality function conducted various quality reviews envisaged in the Annual Plan, notably including a review of the internal tool used in supervision as a documentation repository and to record DGBS processes. In addition, it carried out nine quality-oriented actions not envisaged in the plan and a further ten quality projects. These included developing a methodology for the quality function which formalises and structures the group’s working methods and which, together with the definition of an “object map” (a set of activities, functions and tools subject to review), constitute the elements underpinning the Annual Plan drawn up by the Quality Division (see Box 2.6 for a description of the quality methodology). Another quality project that will prove highly useful for the oversight of supervisory activities was the development of a dashboard enabling the managers of the different DGBS organisational units to quickly identify the overall status of the last three years’ action plans and their degree of progress, and to use of the aforementioned internal tool.

The division carrying out the quality function cooperated actively on various ECB-led quality reviews of SI supervision and on a number of SQA Division quality projects.

## 2.3 Supervision of institutions other than credit institutions

**The Banco de España has exclusive microprudential supervisory powers over the following institutions other than credit institutions that provide financial services or perform functions related to the financial sector:** specialised lending institutions, mutual guarantee companies, reguarantee companies, appraisal companies, payment institutions, account information service providers, electronic money institutions, currency-exchange bureaux, banking foundations and Sareb.<sup>9</sup> Table 2.6 lists these institutions.

Table 2.6

### REGISTER OF OTHER INSTITUTIONS

	2014	2015	2016	2017	2018	2019
Institutions with an establishment	198	195	198	190	190	190
Specialised lending institutions	47	39	35	31	31	27
SLIs payment institutions	0	5	8	8	8	9
Mutual guarantee companies	24	21	21	19	18	18
Reguarantee companies	1	1	1	1	1	1
Appraisal companies	40	36	37	35	35	32
Currency-exchange bureaux (a)	10	13	12	14	14	16
Payment institutions	45	43	41	39	40	42
Hybrid payment institutions (b)	—	2	3	3	4	—
Branches of EU payment institutions	8	12	15	14	12	12
Agent networks of EU payment institutions	3	3	3	3	3	2
Electronic money institutions	4	3	4	5	5	7
Branches of EU electronic money institutions	2	2	2	2	4	8
Agent networks of EU electronic money institutions	0	0	1	1	1	1
Account information service providers						1
Banking foundations	13	14	14	14	13	13
Sareb	1	1	1	1	1	1
Institutions without an establishment	318	401	484	556	597	712
Electronic money institutions	55	75	112	156	187	242
Payment institutions	263	326	372	400	410	454
Account information service providers						16

**SOURCE:** Banco de España.

**a** Not including establishments authorised only to purchase currency using euros.

**b** Reclassified as payment institutions.

<sup>9</sup> Section 2.7 describes in detail the supervisory powers of the Banco de España over these types of institutions.



Table 2.7

**THE BANCO DE ESPAÑA'S SUPERVISORY POWERS OVER PAYMENT SERVICE PROVIDERS**

Type of institution	Activities pursued	Legal basis	Main actions
Payment institutions	Providers of payment services and instruments that play a key role in the functioning of an effective, efficient and secure payment system, which is, in turn, critical to the proper functioning of economic and business relations	Article 26 of Royal Decree-Law 19/2018 of 23 November 2018 on payment services and other urgent financial measures	The supervisory work conducted in relation to these institutions focuses on checking that the funds received from customers are appropriately safeguarded, the institutions' solvency and internal control, and, in particular, the adequacy of the mitigating measures and control mechanisms for neutralising the operational and security risks associated with payment services
Electronic money institutions		Article 20 of Law 21/2011 of 26 July 2011 on electronic money	
Account information service providers		Article 15 of Royal Decree-Law 19/2018 of 23 November 2018 on payment services and other urgent financial measures	

SOURCE: Banco de España.

The legal basis under which the Banco de España supervises these institutions and the approach behind the supervisory tasks differ from case to case. Although the weight of these institutions with respect to the financial system as a whole cannot be compared to that of credit institutions, an effective regulatory and supervisory model for these institutions promotes the fluidity of financial intermediation mechanisms and generates a climate of trust in financial institutions.

Following the transposition into Spanish legislation of PSD-2, it is important to note certain new regulatory developments affecting institutions specialising in providing payment services, as described in Table 2.7.

### 2.3.1 Supervisory actions

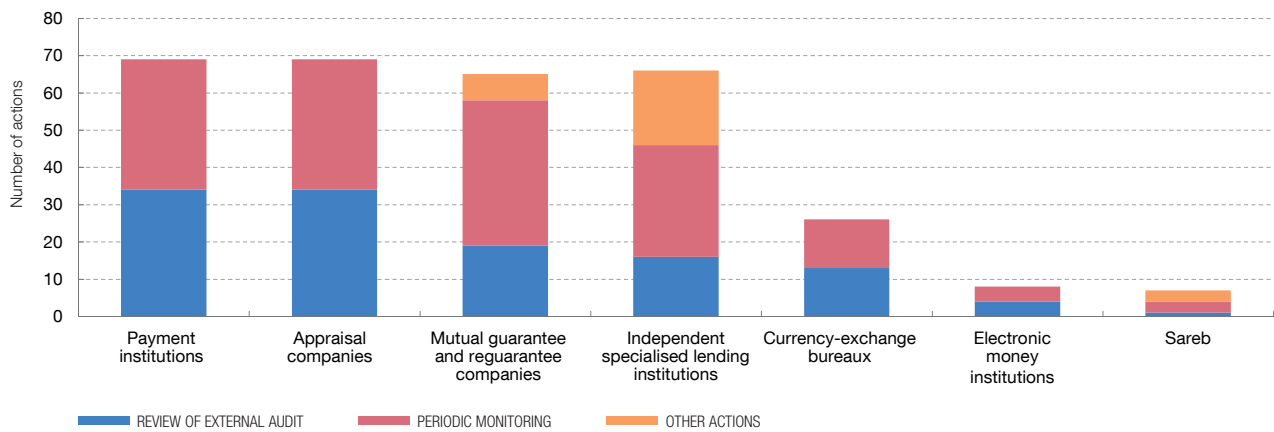
**In 2019, 310 ongoing off-site supervisory actions were performed** by various means: periodic monitoring, reviews of external audit reports and other actions, as detailed in Chart 2.7.

In addition, a total of three on-site inspections were performed in 2019, two at appraisal companies and one at a mutual guarantee company.

Following the supervisory actions, five letters were sent to these institutions, addressed to the parties detailed in Chart 2.8. Two of the letters relate to the outcome of ongoing monitoring actions and three to inspections. Chart 2.9 shows the number of recommendations and requirements, by area, contained in these letters.

Chart 2.7

**NUMBER OF ONGOING OFF-SITE SUPERVISORY ACTIONS AT OTHER INSTITUTIONS**

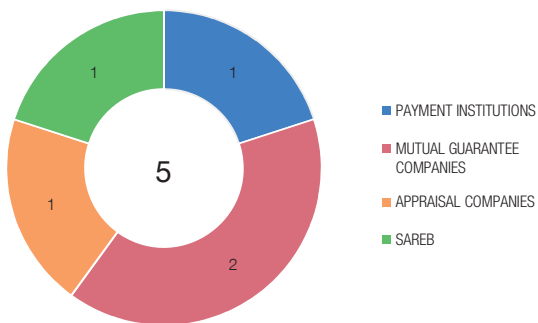


SOURCE: Banco de España.

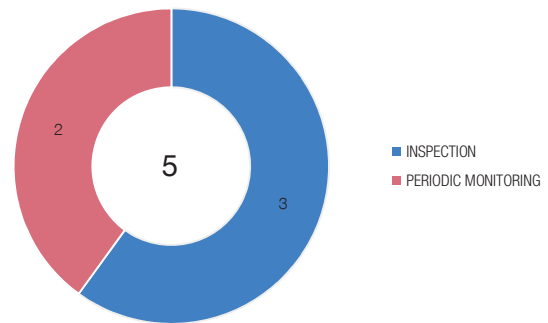
Chart 2.8

**NUMBER OF LETTERS ADDRESSED TO OTHER INSTITUTIONS**

1 BY TYPE OF INSTITUTION (2019)



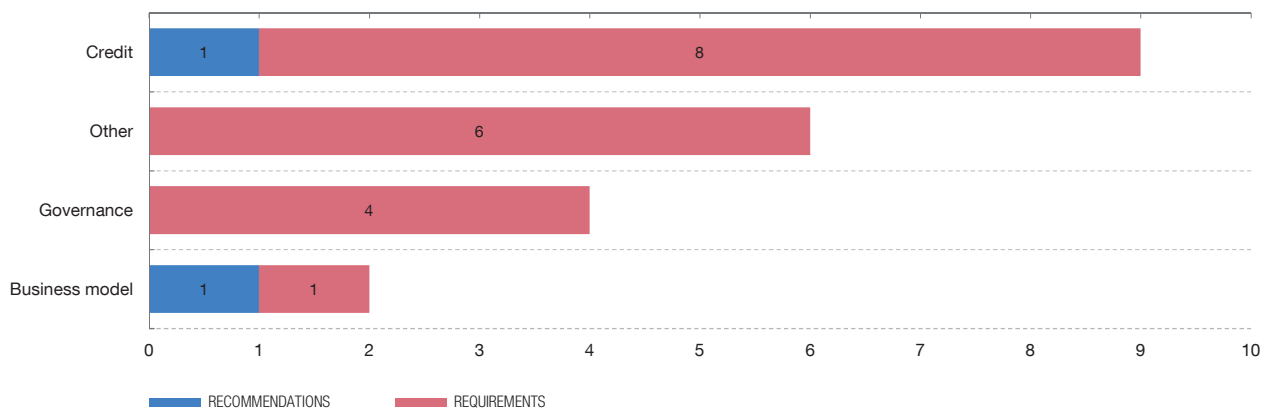
2 BY SUBJECT MATTER (2019)



SOURCE: Banco de España.

Chart 2.9

**NUMBER OF RECOMMENDATIONS AND REQUIREMENTS NOTIFIED TO OTHER INSTITUTIONS**



SOURCE: Banco de España.

## 2.3.2 Authorisations and other procedures

**The Banco de España participates in the granting and withdrawal of start-up licences for these institutions and in other procedures relating to the exercise of their activities.** That said, the scope of its involvement is not the same for all types of institutions. The Banco de España is the competent authority for granting and withdrawing licences for electronic money institutions, payment institutions, account information service providers, currency exchange bureaux and for the official recognition of appraisal companies. However, it only has to issue a mandatory report on the authorisation of specialised lending institutions, mutual guarantee companies and reguarantee companies, the granting of which is the prerogative of the Ministry of Economic Affairs and Digital Transformation, taking also into account, where required by law, the prior report by the SEPBLAC.

**In 2019, a total of 24 institution start-up requests** and a total of 23 deregistrations were processed, as shown in Table 2.8.

**Similarly, in 2019, a further 2,426 procedures** relating to supervisory powers over these institutions were performed, as detailed in Table 2.9.

Table 2.8

### CHANGE IN THE NUMBER OF NON-CREDIT INSTITUTIONS. 2019 vs. 2018

	Value at 31/12/2018	Registrations	Deregistrations	Value at 31/12/2019	Change 2019-2018
Specialised lending institutions (SLIs)	31	1	5	27	-4
SLIs payment institutions (a)	8	2	1	9	1
Mutual guarantee and reguarantee companies	19	0	0	19	0
Appraisal companies	35	0	3	32	-3
Currency-exchange bureaux	14	3	1	16	2
Payment institutions	40	7	5	42	2
Hybrid payment institutions (b)	4	0	4	0	-4
Electronic money institutions	5	2	0	7	2
Account information service providers		1		1	1
Branches of EU payment institutions	12	4	4	12	0
Branches of EU electronic money institutions	4	4	0	8	4
<b>Total</b>	<b>172</b>	<b>24</b>	<b>23</b>	<b>173</b>	<b>1</b>

**SOURCE:** Banco de España.

**a** Formerly classified as SLIs, hybrid payment institutions.

**b** Reclassified as payment institutions.

Table 2.9

**OTHER PROCEDURES CONDUCTED BY THE BANCO DE ESPAÑA IN RESPECT OF OTHER INSTITUTIONS**

Number of procedures in 2019

	Payment institutions	Electronic money institutions	Specialised lending institutions	Mutual guarantee companies	Appraisal companies	Currency-exchange bureaux	Sareb	Banking foundations	Total other Institutions
Qualifying holdings, merger, spin-off and other significant acquisitions	6	1	7		1				15
Cross-border activity of Spanish institutions (a)	1,967	80	0	0	0	0	0	0	2,047
Branches in the EU	30	1							31
Branches in third countries	0	0							0
Freedom to provide services	544	79							623
Agents	1,393	0							1,393
Cessation of business	5		2			1			8
Suitability of senior officers	127	22	95	52	14	8			318
Procedures relating to own funds			3	3					6
Amendments to articles of association	4		4	6					14
Authorisation of management protocol and financial plan								13	13
Communications with other supervisory authorities or institutions	2								2
Other procedures						3			3
<b>Total</b>									<b>2,426</b>

SOURCE: Banco de España.

a Each daily notification per institution and recipient country is deemed a procedure.

## 2.4 Compliance with vetted access to activity

**Under Spanish legislation, several financial activities are subject to vetted access to activity, i.e. they can only be carried out by the institutions legally authorised to do so.** The Banco de España's functions include overseeing compliance with this legislation, taking action on those seeking to break into the financial market without meeting the conditions of access, whether it be through the exercise of activities legally restricted to credit institutions, payment service providers or other types of institutions supervised by the Bank, or through the use of generic names restricted to those institutions or any other name that may be confused with them.

The year 2019 saw the initiation of supervisory actions relating to 13 legal entities which might have been carrying out restricted activities without authorisation, the outcome of which could lead to the adoption of penalties.

## 2.5 Supervision of payment service providers

**The transposition of PSD-2 into Spanish legislation, and the national and EU implementing regulations deriving from this directive present far-reaching changes for payment services.** These regulatory amendments, which entail changes of a technical nature, changes to processes and even to the business strategy of payment service providers, have affected both the sector and the supervisory function of the Banco de España.

The new regulations allow for the provision of new payment services and have led to the emergence of new, more flexible, and technologically advanced actors, with a very low cost structure, who now compete with traditional payment services providers and are also subject to supervision by the Banco de España. Moreover, the financial sector's transformation, driven by digitalisation and technological innovation, has brought new risks, some of which may even be systemic. This means that the Banco de España must ensure that adequate levels of stability, security and protection are maintained for users in this transformation, in conditions of efficiency, accessibility and immediacy.

All the above requires supervisory teams to have a high degree of specialisation, from the very the outset when authorisation is requested by institutions specialising in the provision of such services.

In 2019, the Payment Systems Department began to gradually take on new supervisory tasks, exploiting the synergies stemming from knowledge of the business and of payment infrastructures, and devoting part of its activity to implementing some of the processes required to monitor the obligations arising from the transposition of PSD-2. Two of these processes merit special attention.

**The first is the process developed for the immediate reporting of major operational and security incidents,** in the terms provided for in the related EBA Guidelines (EBA/GL/2017/10), both by the payment service providers to the Banco de España and by the latter to other NCAs which may be concerned by the incident, to the EBA and the ECB.

The process for reporting such incidents through the Banco de España's Virtual Office was implemented in March 2019. Despite the short period of time lapsed since it was launched, some data relating to these incidents can be extracted. The following are among the most significant:

- Around 80% of incidents were reported by credit institutions, while the remaining 20% related to other payment service providers.
- Around 90% of the incidents reported were due to operational problems, and the remaining 10% were security incidents.

- The most frequent reporting criteria used for classifying an incident as serious was the volume of operations affected, present in practically all of the incidents reported.

**The second is the implementation of the process designed for reporting statistical data on fraud**, in the terms provided for in the related EBA Guidelines (EBA/GL/2018/05). In order to minimise the impact on payment service providers, this process followed the same methodology used for statistical reporting on payments pursuant to Regulation (EU) No 1409/2013 of the European Central Bank of 28 November 2013, on payment statistics. Statistical data on fraud, corresponding to the first half of the year, were first reported to the Banco de España in September 2019. After data cleansing and aggregation, the data were sent to the ECB and the EBA in December 2019.

Another new development with a significant impact on the payments industry was the obligation imposed on account servicing payment service providers (ASPSP)<sup>10</sup> to allow customers who are offered online payment accounts access to these accounts through third parties (TPP),<sup>11</sup> as detailed in Box 2.7.

Similarly, following the entry into force of Commission Delegated Regulation (EU) 2018/389,<sup>12</sup> the Banco de España stepped up its supervisory activity on strong customer authentication and common and secure open standards of communication. Thus, in the context of the supervisory flexibility announced by the EBA in its Opinion issued on 21 June 2019,<sup>13</sup> and specified in the Opinion dated 16 October 2019,<sup>14</sup> it embarked on a process to assess the migration plans of payment service providers to adapt e-commerce card-based payment transactions to the new security requirements.

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10 Account servicing payment service provider: payment service provider which provides a payer with one or more payment accounts and is responsible for servicing them (traditionally, credit institutions).

11 Third party provider: payment service provider authorised to participate in certain online transactions in the new context of open banking. These currently include three types of institutions:

- Account information service providers offering an online service which consists of providing aggregated information about one or more payment accounts held by the payment services user at another payment service provider or at several payment service providers.
- Payment initiation service providers offering an online service to initiate a payment order at the request of the payment service user with respect to a payment account held at another payment service provider.
- Payment service providers issuing card-based payment instruments, providing payers with a payment instrument they can use to initiate and process payment transactions, having first obtained confirmation from the ASPSP that funds are available in the payer's payment account.

12 Commission Delegated Regulation (EU) 2018/389 of 27 November 2017, supplementing Directive (EU) 2015/2366 of the European Parliament and of the Council with regard to regulatory technical standards for strong customer authentication and common and secure open standards of communication.

13 EBA Opinion on the elements of strong customer authentication under PSD-2 (EBA-Op\_2019-06).

14 EBA Opinion on the deadline and process for completing the migration to strong customer authentication (SCA) for e-commerce card-based payment transactions (EBA-Op-2019-11).

## PSD-2 AND SECURITY OF PAYMENTS: STRONG CUSTOMER AUTHENTICATION AND THE USE OF COMMON AND SECURE OPEN STANDARDS OF COMMUNICATION

In recent years, technological innovation has resulted in the rapid growth of electronic payments and the emergence of new types of services and new specialist payment service providers, particularly on the internet. This has led to a notable increase in operational and security risks relating to payment services, due to their greater technical complexity.

In order to ensure user protection and the security of payment services, PSD-2 lays down a requirement for strong customer authentication to verify the payment service user's identity or the validity of the payment instrument used. This procedure is based on the use of two or more elements, categorised as "knowledge" (something only the user knows, such as a password), "possession" (something only the user possesses, such as a mobile device), and "inherence" (something the user is, such as a fingerprint). These elements should be independent, so that the breach of one does not compromise the reliability of the others.

However, to find a balance between payment security and the level of risk posed by each service, strong authentication will only be required when a payer: 1) accesses her/his payment account online; 2) initiates an electronic payment transaction; or 3) carries out through a remote channel any action which may imply a risk of payment fraud or other abuse.

In any event, in electronic payment transactions conducted through a remote channel or a payment initiation service provider, one of the authentication elements must dynamically link the transaction to a specific amount and payee.

To allow for the development of broadly accessible and user-friendly payment systems, PSD-2 establishes that payment service providers may opt not to apply strong customer authentication depending on the level of risk, amount, recurrence and the payment channel used to carry out the payment transaction. The conditions for applying these exemptions (eligible transactions, acceptable level of risk, maximum amounts, etc.) are specified in the Commission Delegated Regulation (EU) 2018/389.

This regulation also establishes a set of measures aimed at protecting the confidentiality and integrity of personalised security credentials, both when they are created or associated with the user and when they are delivered or renewed (for example, by establishing mechanisms that guarantee the secure delivery of passwords via internet to the payment service user).

In addition, for the providers of new payment initiation and account information services (TPP) to be able to render their services without being required to use a particular business model, PSD-2 and, especially, the aforementioned Commission Delegated Regulation (EU) 2018/389, establish a series of measures to ensure secure communication in the context of those services and the interoperability of different technological communication solutions.

Thus, ASPSPs (traditionally, credit institutions) providing payment accounts that are accessible online should offer at least one access interface enabling third party payment service providers to access these accounts and lend their services in a secure and efficient manner. This interface should comply with standards of communication issued by international or European standard-setting bodies and should enable third party payment service providers to identify themselves to the account servicing payment service provider, and to use all the authentication procedures provided by the latter to its customers.

ASPSPs can comply with this requirement either by authorising the use by third party payment service providers of the interfaces offered directly to their customers or by implementing a dedicated interface, as long as it ensures the same level of availability and performance as the interfaces directly available to the payment service user (basically, by developing application programming interfaces (API)).<sup>1</sup> Most entities have pursued the second option.

In anticipation that this may not always be the case, Commission Delegated Regulation (EU) 2018/389

<sup>1</sup> Application Programming Interface: a technological solution consisting of a set of definitions and protocols used for developing and integrating application software.

**PSD-2 AND SECURITY OF PAYMENTS: STRONG CUSTOMER AUTHENTICATION AND THE USE OF COMMON AND SECURE OPEN STANDARDS OF COMMUNICATION (cont'd)**

provides for a series of contingency measures, one of which would be to establish an additional mechanism giving access through the interfaces offered directly to users, known as the fall-back mechanism. However, the above regulation makes provision for the national competent authority to, following consultation with the EBA, exempt account servicing payment service

providers from applying this contingency measure, subject to certain conditions relating to the proper functioning of the dedicated interface.

The Banco de España has set up an informal, *ad hoc* procedure to verify that the APIs implemented by Spanish ASPSPs comply with the aforementioned conditions.