2

MICROPRUDENTIAL SUPERVISION

2.1 The Spanish banking sector and supervisory priorities

2.1.1 The Spanish banking sector

The credit institutions making up the Spanish banking sector total €3,877 billion in consolidated assets. Of this total, 90% correspond to Spanish SIs and the remaining 10% to other credit institutions, which include Spanish LSIs, the subsidiaries and branches of foreign credit institutions in Spain and the ICO.

At the onset of the crisis prompted by the pandemic, Spanish banks were better prepared than they had been on previous occasions owing to the regulatory changes introduced in response to the global financial crisis and the efforts undertaken thereafter. Far-reaching balance sheet repair has taken place in recent years, particularly in terms of exposures in Spain, while solvency and liquidity levels have been bolstered significantly. However, profitability remains an issue amid a persistent low interest rate environment and strong competitive pressure from both inside and outside the sector.

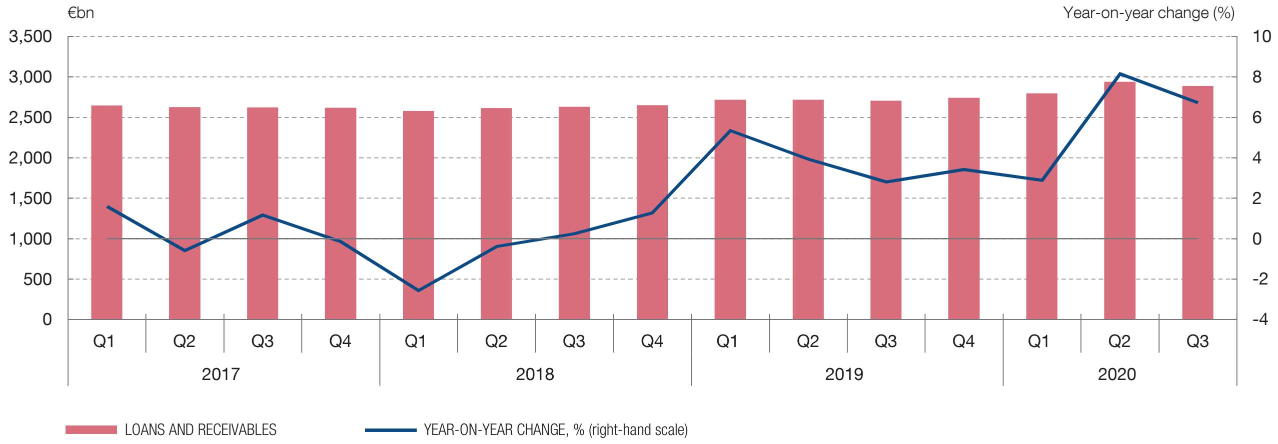
This stronger position meant credit institutions were more favourably positioned to cope with the problems stemming from the COVID-19 crisis. Since the outbreak of the pandemic, banks have provided economic agents with significant amounts of financing and have simultaneously offered considerable payment facilities, all underpinned by State programmes intended to support the economy (ICO guarantees and moratoria).

The total volume of loans extended by Spanish institutions at consolidated level rose significantly in 2020, particularly from Q2 onwards, fuelled by the stimuli implemented by central banks and robust growth in lending to firms following the launch of State guarantee schemes in response to the pandemic. This stands in contrast to the stability of the preceding years, with the slight exception of 2019. Chart 2.1 shows developments in the outstanding credit of Spanish institutions over the past four years.

The amount of non-performing loans (NPLs) appears to have stabilised during the last year, following several years of pronounced decline, as a result of institutions' efforts to clean up their balance sheets. Even so, the NPL ratio has continued to improve as a result of growth in the denominator, the volume of credit (see Chart 2.2). Both figures can be expected to begin rising in the foreseeable future, as the adverse effects stemming from the COVID-19 crisis materialise on banks' balance sheets.

Chart 2.1
LOANS AND CREDIT. DEVELOPMENTS

There was an increase in outstanding credit from 2020 Q2 onwards, owing to the stimuli introduced by central banks and the launch of State guarantee schemes for firms.

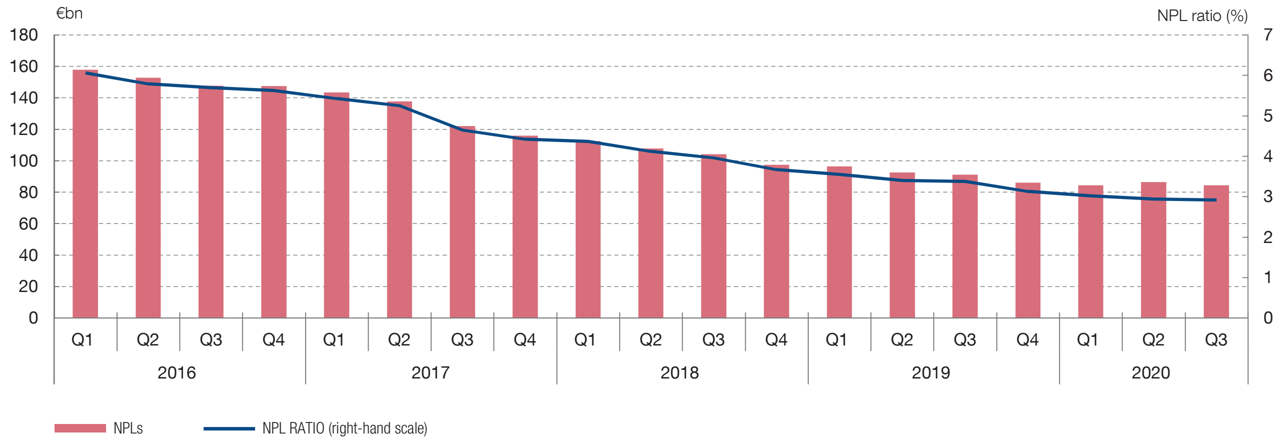


SOURCE: Banco de España (supervisory statistics on credit institutions).

Chart 2.2
NPLs AND NPL RATIO

The steady decline in NPLs has come to a halt, although the ratio has continued to decline owing to growth of the denominator.

NON-PERFORMING LOANS AND CREDIT



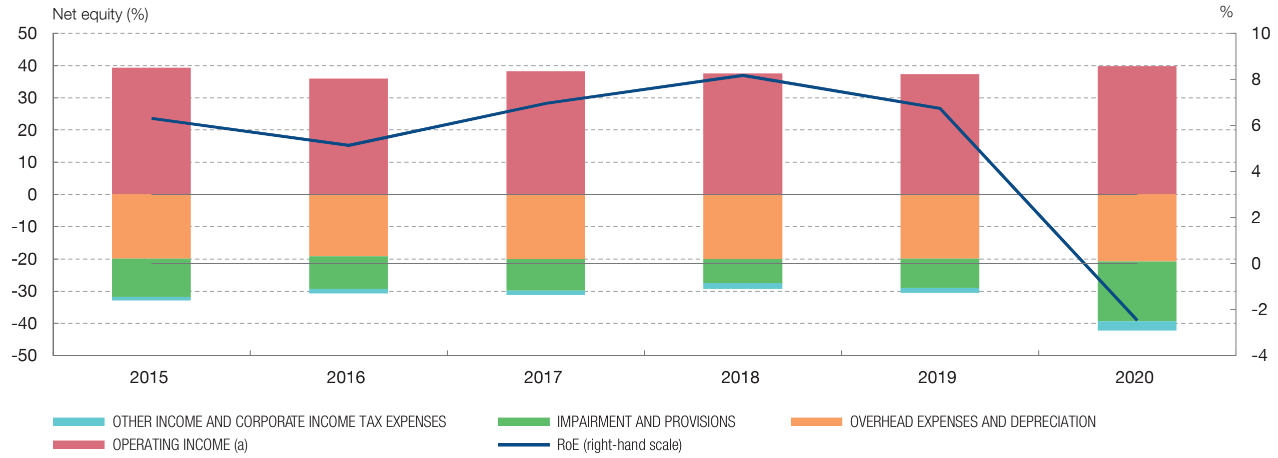
SOURCE: Banco de España (supervisory statistics on credit institutions).

The profitability of Spanish institutions, measured in terms of return on equity (RoE), declined significantly in 2020, particularly as a result of the extraordinary write-downs ensuing from the crisis prompted by the pandemic. As Chart 2.3 shows, RoE had previously stood between 5% and 8%, holding below the estimated cost of equity.

Chart 2.3
RoE BY COMPONENTS. ANNUAL CHANGE

Profitability declined sharply in 2020, due above all to write-downs in anticipation of a deterioration of the situation prompted by the pandemic.

RoE - BREAKDOWN BY COMPONENTS



SOURCE: Banco de España (supervisory statistics on credit institutions).

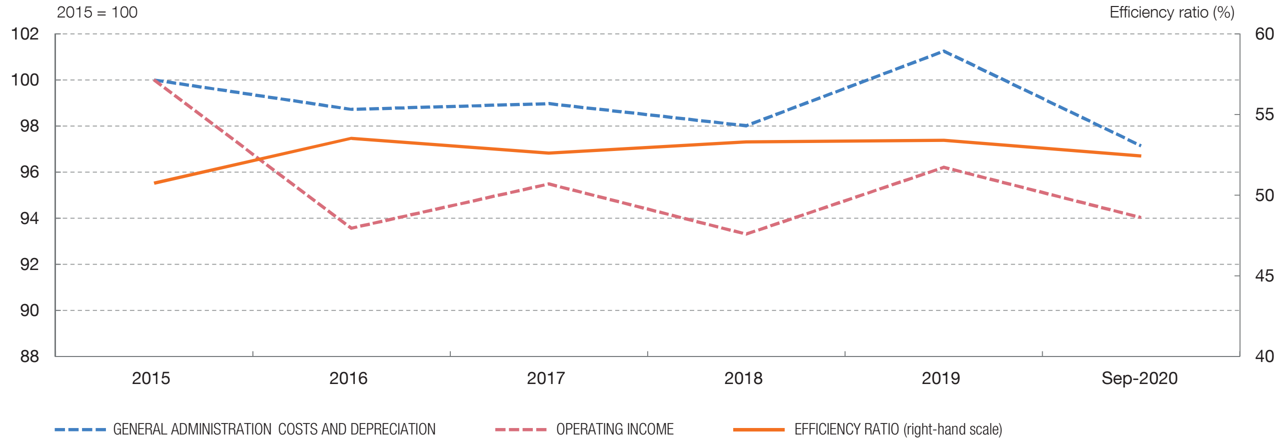
a Operating income is the sum of net interest income, net fee and commission income, net income from financial operations, net exchange differences and other net operating income.

The efficiency ratio has been quite stable in recent years, including in 2020 (see Chart 2.4). During this period, institutions have managed to offset the progressive decline in net interest income, and the resulting decrease in gross income, by reducing their overhead costs.

Chart 2.4
ANNUAL EFFICIENCY RATIO

Efficiency has held stable in the period thanks to the reduction of overhead costs, partly resulting from the adjustments implemented in previous years.

EFFICIENCY RATIO AND DEVELOPMENTS IN ITS COMPONENTS

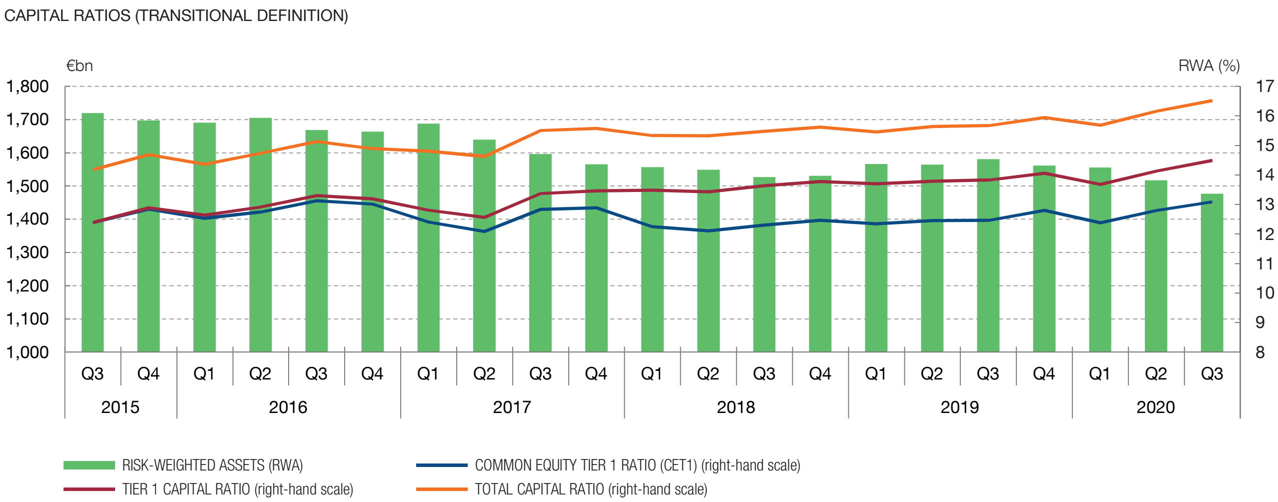


SOURCE: Banco de España (supervisory statistics on credit institutions).

The solvency of Spanish institutions has increased gradually since 2015, as Chart 2.5 shows. Until 2020, this increase took place despite the stricter criteria ushered in with the implementation of the new Basel III capital regulations. The increase observed as of 2020 Q2 owes, in part, to the regulatory and supervisory measures implemented as a result of the pandemic, which have eased some capital requirements and curtailed dividend distribution.

Chart 2.5
CAPITAL RATIOS (PHASED-IN)

Solvency increased following a decline in Q1, owing in part to the introduction of the quick fix and the recommendations to limit dividend payments.



SOURCE: Banco de España (supervisory statistics on credit institutions).

The leverage ratio has recorded a relatively stable performance, with slight downside fluctuations (see Chart 2.6). In 2020 H1, the series was notably affected by a sharp reduction in the ratio, resulting from an increase in the denominator which mainly derived from the institutions' considerable recourse to ECB financing as a consequence of the pandemic. In Q3, this was offset by the regulatory changes introduced to mitigate the effect.

The loan-to-deposit ratio of non-financial corporations and households has been on a steady downward trajectory since 2015, as a result of deposits growing faster than loans. As of 2020, this trend was accentuated by the pandemic, which has generated a significant increase in deposits, exceeding the growth observed in credit. Chart 2.7 shows the change in this ratio during the last six years.

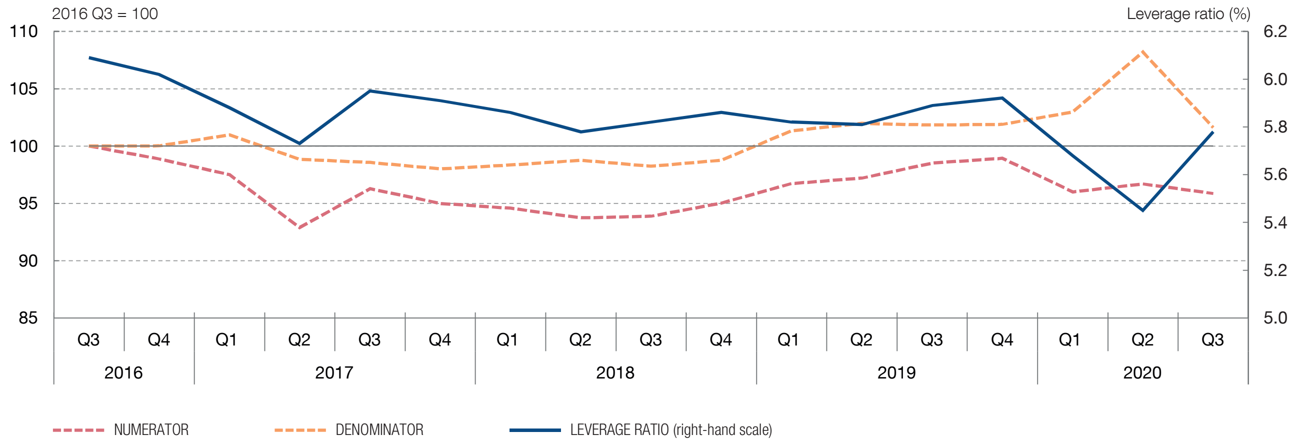
The liquidity coverage ratio of Spanish institutions rose again in 2020, following progressive increases between 2016 and 2018, and after holding relatively stable in 2019 (see Chart 2.8). The institutions' liquidity buffers have expanded further as a result of the

Chart 2.6

LEVERAGE RATIO AND DEVELOPMENTS IN ITS COMPONENTS

The leverage ratio declined in the early stages of 2020 owing to the institutions' considerable recourse to the ECB, with a subsequent correction due to the introduction of regulatory amendments.

LEVERAGE RATIO AND DEVELOPMENTS IN ITS COMPONENTS



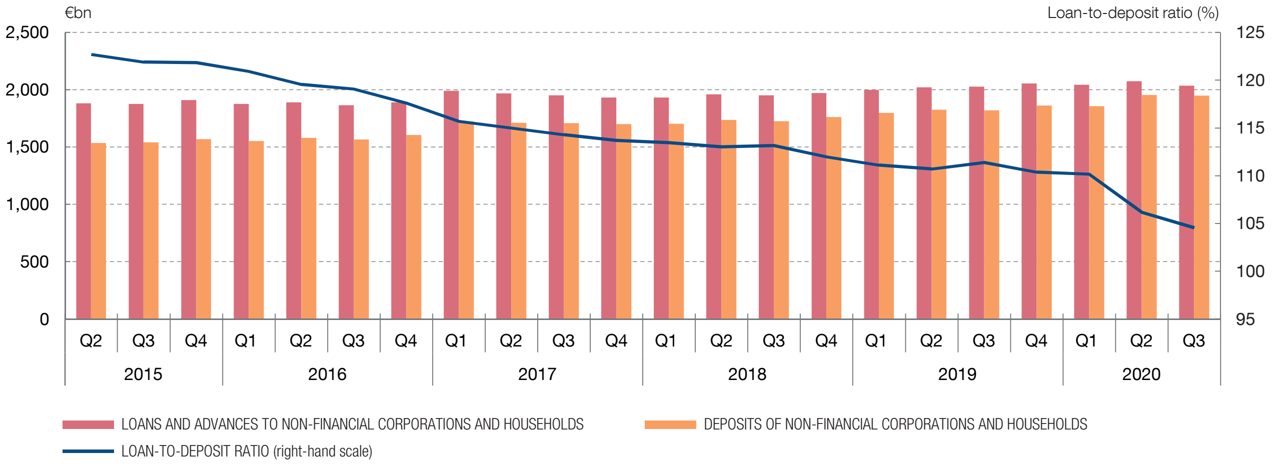
SOURCE: Banco de España (supervisory statistics on credit institutions).

Chart 2.7

NON-FINANCIAL CORPORATIONS AND HOUSEHOLDS. DEVELOPMENTS IN LOANS AND ADVANCES RELATIVE TO DEPOSITS

The loan-to-deposit (LTD) ratio has improved owing to stronger growth in deposits than loans in the non-financial corporations and households segment.

LOANS AND DEPOSITS, NON-FINANCIAL CORPORATIONS AND HOUSEHOLDS

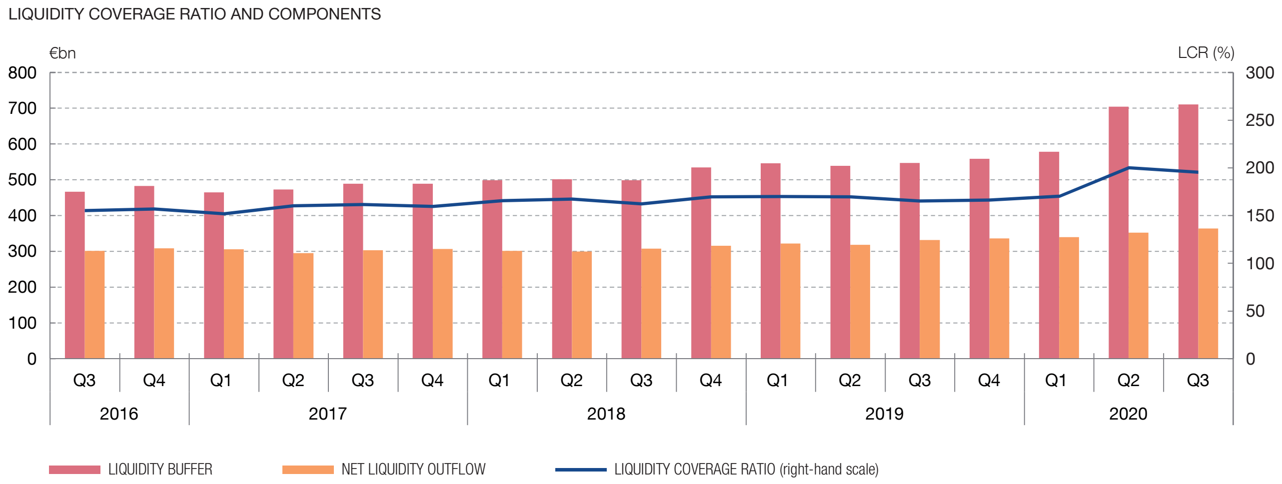


SOURCE: Banco de España (supervisory statistics on credit institutions).

onset of the pandemic in 2020 and the monetary policy measures implemented by the ECB in response. The implementation of the third series of targeted longer-term refinancing operations (TLTRO-III) in 2020 Q2 had a particularly visible impact.

Chart 2.8
LIQUIDITY COVERAGE RATIO

The institutions' liquidity rose markedly in 2020 owing to considerable recourse to ECB funding for precautionary reasons.



SOURCE: Banco de España (supervisory statistics on credit institutions).

2.1.2 Response to the crisis and supervisory focal points in 2020

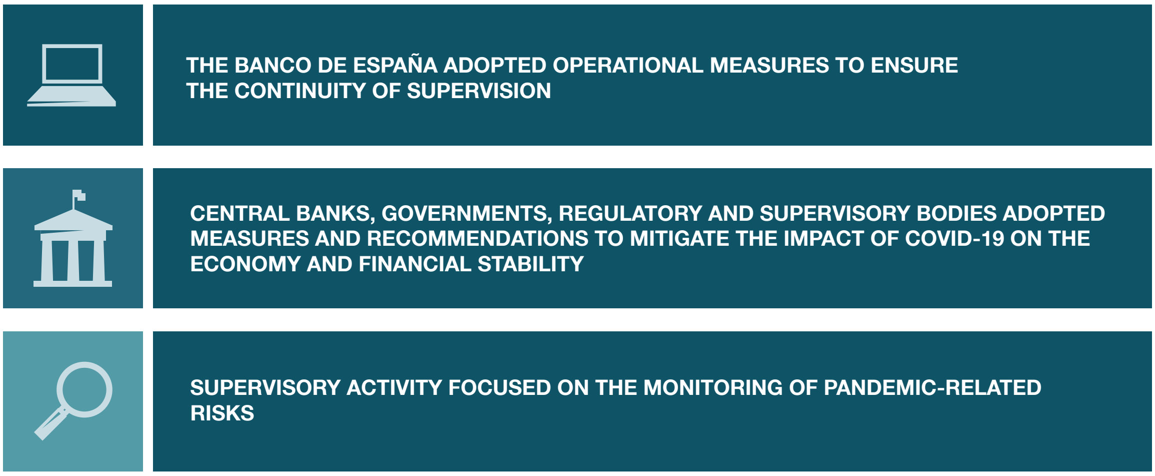
In 2019, the ECB established a series of supervisory focal points for 2020, grouped into the following priority areas: i) the continuation of balance sheet repair, which includes monitoring the reduction of NPLs; ii) strengthening institutions' future resilience through stress testing, examining the quality of banks' credit underwriting criteria, assessing IT and cyber risks, etc.; and iii) other priorities, mainly monitoring Brexit-related work.[1]

However, in 2020 supervisory activity was conditioned by the crisis prompted by COVID-19, which forced the supervisory priorities and actions to be refocused in view of the main risks arising from the pandemic (see Figure 2.1).

First, like the ECB, the Banco de España urgently adopted the measures required to ensure that prudential supervision, along with its other functions, remained in full effect under the new circumstances. The supervisory activity successfully accommodated the sudden and widespread shift to remote working and simultaneously managed to intensify the ongoing contact with institutions.

1 For further details, see Banco de España (2020), "Supervisory priorities in 2020", Section 2.1.2, Report on Banking Supervision in Spain, 2019.

Figure 2.1
RESPONSE TO THE COVID-19 CRISIS



SOURCE: Banco de España.

Second, central banks, governments and supervisory and regulatory bodies have adopted and published a broad set of measures and recommendations to mitigate COVID-19's impact on the economy and on financial stability, and to minimise the medium and long-term effects of the shock.

Aside from the monetary policy measures adopted by the ECB, which have allowed institutions broad access to liquidity, notable among the financial and fiscal initiatives in Spain are the legislative moratoria and the State guarantee schemes (see Box 2.1). The legislative moratoria have afforded protection to the most vulnerable groups, as well as the sectors hardest hit by the crisis. Aside from applying the legislative moratoria, institutions have fostered sector agreements via their associations to ensure more cases of application; as a result, this financial relief initiative has reached more beneficiaries and payment deferrals have been extended.

For their part, the State guarantee programmes support firms' access to much-needed liquidity, thereby protecting economic activity and employment. Spanish institutions have very actively extended these State-guaranteed loans, enabling a large number of firms to access such financing and helping to sustain the business sector.

European regulators have conducted an urgent review of capital requirement regulations. These so-called "quick fix" amendments are intended to maintain institutions' capacity to lend and to absorb pandemic-related losses, while simultaneously preserving their resilience (see Section 8.3 for further details).

For their part, the supervisory authorities have eased capital and liquidity requirements, and have also fostered the flexible application of accounting

Box 2.1

STABILISATION MEASURES: MORATORIA AND ICO GUARANTEES

The grave pandemic-induced economic crisis has forced the majority of European countries to implement urgent and specific support programmes, such as the moratoria and State guarantees.

A moratorium temporarily defers loan repayments for a set period of time. Initially legislative moratoria for mortgage loans and non-mortgage loans to vulnerable individuals affected by the pandemic were established (Royal Decree-Laws 8/2020 and 11/2020). Specific legislative moratoria were subsequently approved for firms in the tourism and transportation sectors (Royal Decree-Laws 25/2020 and 26/2020). In addition to the legislative moratoria, financial institutions voluntarily implemented banking sector moratoria via their associations,[1] thus widening the group of beneficiaries of debt deferrals and extending the grace periods.

In Spain at 31 December 2020, more than 1.3 million moratoria on payments had been granted to around 1.8 million beneficiaries, of whom 77% were wage and salaried workers and 23% were self-employed. In total, these deferrals have affected exposures amounting to €54 billion, of which 42% correspond to legislative moratoria and 58% to banking sector moratoria.

The central government has provided State guarantees on a certain percentage (up to 80% of the principal) of financing extended to firms and the self-employed to cover liquidity needs and for new investments. To be eligible, the borrowers had to be domiciled in Spain and not be in default nor subject to insolvency proceedings.

Two guarantee facilities have been implemented for up to €100 billion and €40 billion, respectively (Royal Decree-Laws 8/2020 and 25/2020). Overseen by the Official Credit Institute, both facilities are processed through the credit institutions, which assess the viability of the borrowers and assume the risk for the unsecured portion of financing.

In Spain at 31 December 2020, some 944,000 loans had been guaranteed, corresponding to more than 591,000 firms and accounting for 87% of the initial programme. This injected €114 billion of liquidity, 70% of which was extended to the self-employed and SMEs and the remaining 30% to large firms.

The banking sector has been in constant contact with the economic authorities, creating an environment of close cooperation that has allowed the measures to be introduced swiftly and smoothly.

Thus, banks have played an essential role in channelling government support. The management capability of financial institutions, in particular credit institutions, has meant measures could be taken to protect the most vulnerable groups and the sectors hardest hit by the crisis, such as transportation and tourism. In addition, they have allowed more people to benefit from these financial relief measures through the banking sector moratoria.

With the support of State guarantees, banks have continued to provide access to credit and liquidity, and have helped address and mitigate the economic and social impact of COVID-19.

1 Banking sector moratoria agreements were established by the Spanish Banking Association, the Spanish Confederation of Savings Banks, the National Union of Credit Cooperatives and the National Association of Specialised Lending Institutions.

standards (see Box 2.2). These relief measures, agreed upon by the ECB and the Banco de España within the scope of their responsibilities, are in keeping with the initiatives implemented by other authorities, such as the Single Resolution Board, the European Banking Authority (EBA), the European Systemic Risk Board (ESRB) and the European Securities and Markets Authority.

Further, supervisors have eased the operational burden of supervisory activity to encourage institutions to concentrate efforts on ensuring their operational continuity and on performing their critical economic functions. For example, the EBA and ECB stress tests due to take place in 2020 have been postponed until 2021, certain deadlines to implement action plans ensuing from

Box 2.2

RELAXING APPLICATION OF PRUDENTIAL REGULATIONS AND ACCOUNTING STANDARDS. ECB AND BANCO DE ESPAÑA MEASURES

In response to the extraordinary situation prompted by the pandemic, the authorities swiftly adopted a raft of monetary, fiscal and financial policy measures aimed at mitigating the impact of the crisis.

The initial supervisory measures focused on easing capital and liquidity requirements and lightening certain operational burdens imposed by supervision.

The easing of capital and liquidity requirements has allowed institutions to temporarily operate below the levels set for their Pillar 2 Guidance (P2G), capital conservation buffer and liquidity coverage ratio (LCR).

The supervisor expects institutions to replenish LCR levels by end-2021 at the earliest and P2G levels a year later (no sooner than end-2022), although those dates may be put back depending on the economic situation and each institution's particular position, with a view to heading off procyclical effects.

Furthermore, the change in the composition of P2R, originally envisaged in the Capital Requirements Directive V for January 2021, was brought forward to March 2020: P2R should have the same capital composition as that of Pillar 1, meaning at least 56.25% of P2R should be held in common equity Tier 1 capital (CET1) and 75% in Tier 1 capital, instead of 100% in CET1 as established hitherto.

To complement these capital measures, the macroprudential authorities eased the countercyclical capital buffer in those Single Supervisory Mechanism countries where it was activated or scheduled to be activated over 2020-2021.

In addition, it is worth mentioning that both the Banco de España and the European Central Bank (ECB) announced greater supervisory flexibility in the prudential treatment of loans backed by State guarantees.

Furthermore, in line with statements made by international regulators and supervisors, the Banco de España and the ECB also encouraged institutions to make use of the flexibility afforded by International Financial Reporting Standard 9. Specifically, they indicated that measures such as moratoria and State guarantees should not automatically mean worse credit risk classifications for exposures. This would afford institutions greater scope to discriminate between viable and non-viable credit transactions. Likewise, they were reminded that the remaining lifetime of a loan should be considered when determining whether there has been a significant increase in credit risk (entailing a deterioration of their accounting classification).

Broadly speaking, these measures are geared towards forestalling the potential procyclical effects of capital and liquidity requirements, and the application of the accounting framework, such that the institutions remain unfettered in their capacity to lend to the overall economy, at a time when this is an essential function to mitigate the impact of the crisis[1].

1 For a more extensive summary of the prudential and accounting regulation flexibility measures, see R. Anguren, L. Gutiérrez de Rozas, E. Palomeque and C.J. Rodríguez García (2020), "The regulatory and supervisory response to the COVID-19 crisis", *Financial Stability Review,* No 39, Autumn, Banco de España.

recent on-site inspections have been extended and some of the planned on-site actions have been postponed.

Further, the ECB and the Banco de España have recommended that institutions refrain from paying dividends to shareholders, so as to ensure that they have the maximum possible capital available to provide financing to economic agents and to absorb potential losses. They have also reiterated their expectations that institutions be extremely moderate with regard to variable remuneration over the same period (see Section 2.2.4 for further details). Figure 2.2 shows a summary of the main measures and recommendations adopted by the supervisors.

Figure 2.2
MEASURES AND RECOMMENDATIONS OF SUPERVISORY AUTHORITIES

FLEXIBILITY IN CAPITAL AND LIQUIDITY REQUIREMENTS

– Institutions have been temporarily allowed to operate with lower capital levels than set out for the P2G, the capital conservation buffer and LCR.
– The composition of the P2R has been amended setting as the mininum requirement the same composition as for Pillar 1.
– Macroprudential authorities have relaxed the CCyB in those SSM countries where it was activated or due to be activated over the course of 2020-2021.

FLEXIBILITY IN APPLICATION OF ACCOUNTING STANDARDS

Supervisors have urged use of the flexibility allowed by the accounting framework of the IFRS-EU 9 for financial instruments. Measures such as moratoria or State guarantees do not necessarily entail the reclassification of an exposure to a lower credit quality category.

OPERATIONAL FLEXIBILITY

– Certain on-site actions scheduled for 2020 have been postponed or cancelled.
– The pragmatic approach to the SREP has been applied.
– Certain flexibility has been allowed to institutions in the preparation and updating of recovery plans.
– EBA and ECB stress tests scheduled for 2020 have been postponed until 2021.
– Certain deadlines to implement action plans ensuing from supervisory actions have been extended.

RECOMMENDATION NOT TO PAY DIVIDENDS AND TO MODERATE VARIABLE REMUNERATION

– Institutions have been asked to consider refraining from paying dividends in cash and buying back shares, or limiting such remuneration until 30 September 2021.
– Institutions have been asked to be extremely moderate in their variable remuneration until 30 September 2021.

SOURCE: Banco de España.

Lastly, supervisory efforts have been refocused to ensure adequate monitoring of pandemic-related risks, prioritising their impact on institutions' risk profiles and operational continuity. For instance, particular emphasis was initially placed on institutions' liquidity and contingency plans, particularly in relation to cybersecurity and business continuity. Analysis of the impact of the crisis on asset quality has partly focused on the application of moratoria and the use of State guarantee facilities. Finally, the effects on institutions' activity, income statement and capital levels have been monitored.

2.1.3 Supervisory priorities in 2021

Each year's supervisory priorities for the SSM as a whole are determined by means of an analysis conducted by the ECB in cooperation with the NCAs. This

Figure 2.3
SSM SUPERVISORY PRIORITIES 2021

CREDIT RISK MANAGEMENT	STRENGTHENING THE CAPITAL OF INSTITUTIONS	BUSINESS MODEL SUSTAINABILITY	GOVERNANCE
Review of the procedures and practices for the management, monitoring and reporting of this risk	Monitoring of the institutions' capital plans, with emphasis on dividend distribution and share buyback policies	Review of the strategic plans and measures presented by the institutions to remedy shortcomings	Monitoring of the institutions' crisis management procedures and capacity to adapt
Identification of asset impairment and management thereof	EU-wide stress test (postponed in 2020)	Assessment of headway made in digitalisation plans and impact on business models	Assessment of management systems for the provision of relevant management information and data
			IT and cyber risk
			Assessment of ML/TF risk

SOURCE: ECB.

analysis considers the economic and financial environment, regulatory developments and the main risks and vulnerabilities facing the banking system. The supervisory priorities eventuate in a series of supervisory actions, some of which take place over a time horizon of several years. The Banco de España likewise sets each year's supervisory priorities for LSIs.

The pandemic, its effects on the banking sector and the uncertainty surrounding the expectations for economic recovery played a key role in identifying the main risks for 2021. Ultimately, these were identified as follows: i) the pandemic's protracted impact on economic activity and the potential rise in NPLs; ii) price corrections on financial markets; iii) cybercrime and technological challenges; and iv) geopolitical uncertainties.

A further series of risk factors have been detected, the majority of which have persisted for several years, including those related to money laundering and terrorist financing (ML/TF), climate change and Brexit.

In addition, this year a series of vulnerabilities, both external and internal, have been identified for SSM institutions which may exacerbate the above-mentioned risks. Specifically, these include vulnerabilities relating to credit risk management and coverage, low structural income and profitability levels, information technology (IT) shortcomings, governance and strategic management that could

Box 2.3

SUPERVISORY POLICY IN MERGERS BETWEEN INSTITUTIONS

Declining profitability in recent years, together with the financial and economic situation triggered by the COVID-19 crisis, is prompting the consolidation of the financial system in several countries, among them Spain, where some institutions have decided to merge. These mergers aim to make the banks more resilient and boost their capacity to serve the economy in the context of the pandemic. Institutions need to strengthen their efficiency in light of narrowing margins and the write-downs that may be necessary.

These mergers will allow the resulting institutions to achieve economies of scale, make efficiency gains and improve their capacity to tackle new challenges – such as digitalisation – and, consequently, expand the supply of banking products through new channels.

In consolidation processes, supervisory authorities are tasked with making sure that the resulting business combination complies with prudential requirements and ensures effective and prudent risk management.

In the interest of transparency and clarity in its supervisory approach to merger and concentration processes, in January 2021 the ECB approved a guide that sets out the following supervisory expectations:

i) The sustainability of the resulting institution's business model. ECB Banking Supervision will analyse the business viability of the submitted merger plan, assessing the resulting institution's solvency and ability to generate profit going forward. Such ability must be based on efficiency gains, via a reduction in costs; geographic, product, and customer complementarity; and value generation at the resulting institution.

Further, merger projects must be based on a credible business plan, with reasonable and conservative assumptions.

ii) Robust governance and risk management requirements. The internal governance and organisational structure of the combined institution must satisfy the principles established in the EBA guidelines on internal governance (EBA/GL/2017/11). To this end, ECB Banking Supervision must check that governing bodies are adequately composed and function smoothly, that responsibilities are clearly allocated and that remuneration systems setting the right incentives are established.

Furthermore, the guide establishes that the supervisor will make use of its supervisory toolkit to smooth the completion of merger projects, through: i) non-penalisation of merger plans with higher capital requirements; ii) prudent recognition of badwill, which must help strengthen balance sheets at the time of integration; and iii) temporary acceptance of the use of internal capital requirement calculation models.

The principles set out in the above-mentioned guide on banking consolidation are being deployed in Spain, where there are two processes under way. First, the merger between CaixaBank and Bankia, which will be completed over the course of 2021 and will foreseeably result in the leading bank in terms of operations in Spain. Second, Liberbank and Unicaja are also negotiating their consolidation to create Spain's fifth-largest bank in terms of assets. It cannot be ruled out that other institutions attempt to merge in the future, with a view to gaining in profitability, size and competitiveness.

be improved, long-standing cost inefficiencies, high levels of public and private debt, surplus capacity in the banking sector and fragmentation in the regulatory and legal framework.

Mindful of these risks and vulnerabilities, the supervisory priorities for 2021 have been grouped into the following general categories (see Figure 2.3):

— credit risk management.

— strengthening the capital of institutions.

Box 2.4

NEW DEVELOPMENTS IN REGULATIONS ON TECHNOLOGY-RELATED RISKS AND THEIR SUPERVISION

In an increasingly digital world, financial institutions rely entirely on technology to implement their business models and to smoothly and securely offer the products and services that their customers demand. In order to ensure the institutions' operational resilience, i.e. their capacity to continue providing services in the face of any adverse situation, it is crucial to ensure the resilience of their IT systems, not only against the increasingly frequent and sophisticated cyberattacks financial institutions suffer, but also against other types of disruptive situations, such as natural disasters or the global COVID-19 pandemic.

Over the past five years, Europe's regulators have pushed to improve the resilience of the financial sector, with particular emphasis on IT and digital resilience. Two initiatives stand out:

i) European Banking Authority (EBA) guidelines on ICT and security risk management (EBA/GL/2019/04).

ii) The EU proposal for a Digital Operational Resilience Act (DORA).

The EBA guidelines, which have been in force since 30 June 2020, apply to credit institutions, payment institutions, account information service providers, electronic money institutions and investment firms. Their implementation should always take into account the principle of proportionality. They also include obligations for the competent authorities.

Among these guidelines' most notable aspects are their requirements regarding governance and strategy, risk management and security and business continuity testing, which heighten and align the standards.

Meanwhile, the text of the legislative proposal for a new regulation, DORA, was published in late September 2020 and is currently being discussed by the European Council and European Parliament. DORA is part of the European Commission's digital finance strategy, and its aim is to mitigate the risks associated with digitalisation and strengthen the resilience of the European financial sector.

For the first time in the European Union, a single regulation on technological resilience will apply to all types of financial institutions, in proportion to their size and complexity. The text includes requirements for institutions on managing technology-related risks, managing and notifying technological incidents, resilience testing of systems and managing relations with third parties. It also fosters information sharing between institutions and cooperation between authorities.

One of the main new developments introduced by DORA is an oversight framework for critical technology providers in the financial sector. Given that financial institutions are increasingly reliant on their technology providers, this proposal represents a very significant step towards improving the resilience of the European financial sector as a whole.

— business model sustainability. In addition to reviewing strategic plans and assessing the headway made in digitalisation plans, also subject to close monitoring are consolidation processes in the interest of shoring up the resilience and efficiency of institutions in the face of the continuous narrowing of margins and the foreseeable increase in write-downs owing to impairments arising from the COVID-19 crisis (see Box 2.3).

— governance. In addition to observing crisis management procedures, assessing the systems that provide management data and evaluating ML/TF risk, in the realm of IT and cyber risk particular emphasis will be placed on IT outsourcing (see Box 2.4).

Under a similar process, the following supervisory priorities were established for LSIs in 2021: i) asset quality and credit risk management; ii) profitability and business

Box 2.5

BANCO DE ESPAÑA SUPERVISORY EXPECTATIONS ON CLIMATE CHANGE AND ENVIRONMENTAL RISK, AND THE ECB GUIDE

Climate change and environmental degradation represent a global concern that has prompted initiatives in various fields. These reflect the need for measures geared towards achieving the demanding global warming reduction targets.

New risk factors are emerging as a result of the measures introduced to transition to an environmentally friendly low-carbon economy, along with the physical risks deriving from climate change and environmental events. These are having an impact on financial risks, which has attracted the attention of supervisors and central banks. Both are therefore adding to their work agendas analysis of the financial risks associated with climate change and environmental degradation.

The Banco de España and the European Central Bank (ECB) have been party to the debates surrounding the energy transition and its implications for credit institutions in the euro area. In this regard, and besides their participation in a number of international fora and bodies, they have implemented public initiatives in the interest of raising the banking sector's awareness and readiness.

One good example of these initiatives is the publication of the Banco de España supervisory expectations document on risks posed by climate change and environmental degradation, and the ECB guide on climate-related and environmental risks. Both documents recognise climate-related and environmental risks as sources of financial risk; institutions must therefore begin to factor these into their oversight of the traditional banking risks (credit risk, market risk, liquidity risks and operational risk). While these expectations are not binding for the institutions, they do provide guidance on how to incorporate and approach climate-related and environmental risks in the following aspects:

i) Business model and strategy: institutions are expected to incorporate those risks that may be material in both the short and long term.

ii) Governance: ultimate responsibility for integrating these risks in the overall strategy, and for establishing the necessary mechanisms to review these arrangements, is expected to lie with the board of directors.

iii) Risk management: institutions are expected to consider the risks posed by climate change and environmental degradation seamlessly within its existing risk management procedures and to adopt a comprehensive approach to their identification, assessment, monitoring and mitigation.

iv) Disclosures: institutions are expected to publish material information on significant events, taking into account their characteristics and, in particular, their time horizons.

The ECB guide is directly applicable to significant institutions and recommends that national competent authorities apply the guide in a proportionate manner in their supervision of less significant institutions (LSIs), whereas the Banco de España supervisory expectations are addressed to the LSIs under its supervision.

Although the two documents differ in the degree of detail of the expectations, both envisage the institutions applying the expectations based on the materiality of their exposure to climate-related and environmental risks, which is not necessarily linked to their size.

Both the Banco de España and the ECB are aware of the novel nature of this subject matter and the considerable uncertainty regarding the materialisation of these risks, along with the challenges relating to methodology and the availability of information that institutions face when identifying and measuring such risks. They are therefore of the view that the institutions need time; accordingly, they do not expect all of the expectations set out in these documents to be implemented immediately, and instead will assess their gradual deployment as part of the supervisory dialogue.

models; iii) governance; iv) the strength of own funds; and v) IT risk, cybersecurity and operational resilience.

As regards the first of the priorities, credit risk management, two specific credit risk monitoring tasks conducted by the Banco de España in 2020

should help to quantify and monitor the potential impact on the Spanish banking system in 2021:

- **credit portfolio segmentation based on the level of vulnerability to the crisis prompted by COVID-19:** in view of the evidence that the crisis will have a highly uneven impact, the different credit exposures are classified in order to segment the portfolio into exposures potentially more or potentially less affected by the crisis.

- **definition and monitoring of early warning indicators:** given that the mitigating measures implemented by authorities may delay the onset of the more or less traditional signs of credit impairment, monthly monitoring has begun of new leading indicators based on broader definitions of risk that factor in the information received on State-guaranteed transactions and transactions subject to moratoria. This makes it possible to anticipate the course of credit impairment.

2.2 Supervision of credit institutions

In the framework of the SSM, the ECB heads the supervisory function with the participation of the NCAs. According to the allocation of supervisory tasks (see Figure 2.4), the ECB is directly responsible for the supervision of SIs (115 significant groups at end-2020, of which 12 are Spanish), while the Banco de España is responsible for the direct supervision of the LSIs incorporated in Spain, which at end-2020 amounted to 59 institutions or groups (the SSM as a whole includes a total of 2,320 LSIs). Table 2.1 shows the weight of the different credit institution categories in Spain, differentiating between SIs and LSIs. Table 2.2 classifies the credit institutions operating in Spain by institution type.

However, the Banco de España contributes significantly to the supervision of Spanish SIs, both through off-site ongoing supervision work via the JSTs and through on-site inspections and model investigations performed on those institutions.[2]

The activities involved in the microprudential supervision of credit institutions are grouped into two distinct areas: off-site ongoing supervision and on-site supervision.

The first of these assesses the institutions' situation and risk profile in order to prioritise the work that needs to be conducted and the depth thereof.

2 The Banco de España contributes not only its experience, but also the bulk of the inspectors, IT auditors and junior analysts comprising the JSTs for Spanish SIs and the teams participating in on-site actions.

Figure 2.4
DISTRIBUTION OF SUPERVISORY POWERS

	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, with proposal by the NCAs: granting and withdrawal of authorisations to/from credit institutions and of authorisations to purchase/sell qualifying holdings in credit institutions	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 EU 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)
	Tasks outside the SSM's scope: the Banco de España's powers	
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: SLIs, PIs, ELMIs, currency-exchange bureaux, mutual guarantee societies and re-guarantee companies, appraisal companies, banking foundations, Sareb and branches of third-country institutions	
Money laundering	Cooperation with CPMLMO and SEPBLAC in AML/TF	
Provision of payment services	Supervision of the provision of payment services	

SOURCE: Banco de España.

In turn, on-site supervision comprises two types of action: inspections and model investigations. The latter specifically review capital requirement calculation models, whereas the former serve to verify any other area relating to the institutions.

The SSM makes significant efforts to standardise supervisory procedures and practices, complying with the principles and standards set out in the Capital

Table 2.1
SPANISH CREDIT INSTITUTIONS

The number of credit institutions in Spain remained stable, while the volume of assets increased by 5% overall. In relative terms, the most marked increases came in the segments of Spanish LSIs and of EU SI subsidiaries and branches.

Data at 31 December

	2019		2020	
	Groups	Assets (%)	Groups	Assets (%)
Signifcant institutions				
Spanish groups of credit institutions	12	91.3	12	90.7
EU subsidiaries and branches (a)	26	3.6	27	3.8
Less significant institutions				
Spanish credit institutions (b)	59	4.6	59	5.1
Branches of institutions from non-SSM EU countries	4	0.0	2	0.0
Branches of institutions from SSM EU countries (a)	33	0.3	33	0.3
Non-EU branches	3	0.1	3	0.2
TOTAL	**137**		**136**	

SOURCES: ECB and Banco de España.
NOTE: The figures for the institutions' assets have been obtained after the data cut-off date.

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	2020		
						Registrations	Deregistrations	Year-end
Credit institutions	220	208	207	198	197	2	6	193
Banks	67	60	59	52	52		1	51
Savings banks	2	2	2	2	2			2
Credit cooperatives	65	63	63	62	61			61
ICO	1	1	1	1	1			1
Branches of EU credit institutions	79	77	78	78	78	2	5	75
Branches of non-EU credit institutions	6	5	4	3	3			3
Controlling companies	3	4	3	5	6		1	5
TOTAL	**223**	**212**	**210**	**203**	**203**	**2**	**7**	**198**

SOURCE: Banco de España.

Requirements Directive (CRD),[3] the Capital Requirements Regulation (CRR)[4] and the guidelines issued by the EBA.

3 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, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

4 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 and amending Regulation (EU) No 648/2012.

Box 2.6

ORGANISATIONAL RESTRUCTURING OF ECB SUPERVISION

European Central Bank (ECB) Banking Supervision underwent far-reaching restructuring in October 2020. This was in response to the new strategic orientation building on the experience gained during the initial years of the Single Supervisory Mechanism (SSM), with a view to furthering the supervisory arm's development to ensure more effective and efficient supervision.

At the SSM's inception (November 2014), microprudential supervision at the ECB was structured into a Secretariat to the Supervisory Board (SB) of the ECB and four directorates general (DG): DG-MS1 and DG-MS2 for the direct supervision of significant institutions (SIs); DG-MS3 for the indirect supervision of less significant institutions (LSIs) and DG-MS4 for on-site inspections and horizontal and specialised functions. Certain subsequent adjustments had been made (such as the secretariat's conversion into a directorate general), but the overall organigram remained unchanged.

In July 2020, reorganisation plans for the ECB were submitted to the SB, as a key step towards shifting the supervisory focus.

The former DG-I, DG-II and DG-III were reorganised into three other DG, with the same ongoing supervisory functions for the institutions supervised directly or indirectly by the ECB, but grouping the institutions based on their business models: DG Systemic and International Banks, DG Universal and Diversified Institutions and DG Specialised Institutions and Less Significant Institutions. The aim was to shift towards more risk-focused supervision, create more synergies and allow a better comparison of common risks and challenges. Meanwhile, the integration of SI and LSI supervision will help to eliminate overlaps and ensure greater supervisory consistency.

The former DG-IV is now split into two: DG Horizontal Line Supervision (DG-HOL) and DG On-Site and Internal Model Inspections (DG-OMI).

DG-HOL retains some of the traditional horizontal areas, while also incorporating specialisation based on risks or supervisory areas (business model and capital adequacy, credit risk, market and liquidity risks, non-financial risks and stress tests), with the aim of creating groups of experts that will be in close contact with the joint supervisory teams and the on-site inspection teams. The aim was to strengthen risk-related technical skills in the supervision of institutions.

For its part, the DG-OMI, which is dedicated to on-site supervision, will comprise four divisions: financial risks inspections, non-financial risk inspections, internal models investigations and operations and integration.

A further new development was the creation of the Directorate Supervisory Strategy and Risk (D/SSR), responsible for strategic analysis and planning, resource allocation, defining and monitoring supervisory risk appetite and analysing the quality and consistency of supervision. It is organised into four areas: strategic analysis, financial risk, non-financial risk and strategic planning office. The D/SSR includes the second line of defence.

The former DG Secretariat was converted into the DG SSM Governance and Operations. It retains the same functions as before (secretariat to the SB; authorisations; fit and proper, which is separated from the previous function; and sanctioning proceedings), while a new technology and innovation division is added.

To ensure more effective and efficient supervision, in 2020 the ECB undertook organisational restructuring of these supervisory tasks (see Box 2.6). **The working groups and expert networks from the various member countries play a key role,** by analysing and developing technical and supervisory policy proposals with the aim of improving the functioning of the SSM. Further, they help to prepare and discuss the proposals that are subsequently debated by the SB and, if appropriate, approved by the ECB Governing Council. The Banco de España participates actively in most of these groups, participating in nearly 100 working groups with more than 100 supervisory staff members. In some cases, the Banco de España chairs or co-chairs these groups (see Box 2.7).

Box 2.7

LEADERSHIP OF PARTICULARLY SIGNIFICANT SSM PROJECTS

As a member of the Single Supervisory Mechanism (SSM), the Banco de España co-chairs certain projects with the European Central Bank (ECB). Of these, the two working groups described below stand out as particularly significant.

First, the working group on implementation of a new risk-by-risk approach to setting Pillar 2 capital requirements (P2R) in the SSM. After several years of applying the SREP methodology to determine the measures and requirements notified annually to the institutions, the SSM is revising the methodology for calculating institution-specific capital requirements.

The aim is to determine additional capital requirements on a risk-by-risk basis, paying particular attention to Pillar 2 risks, and bolstering the use of all kinds of available information, attaching greater importance to information stemming from each institution's internal capital adequacy assessment process.

Second, the SSM working group tasked with aligning and proposing improvements for the management of inspection teams in on-site supervisory actions.

To this end, the group is drawing up a document of recommended good practices, taking into account the experience of those who have participated in on-site actions since the SSM's inception, along with the opinions of their managers at the ECB and at the national competent authorities (NCAs).

This document has a dual aim: i) to optimise the utilisation of resources in on-site actions (particularly in cross-border inspections, which involve members of different NCAs and are harder to manage); and ii) to boost all participants' professional development.

The Banco de España also 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 Executive Commission of the Banco de España remains apprised of supervisory and other decisions about relevant SSM issues adopted by the Governing Council of the ECB, with the support of the SB (see Chart 2.9)**. In particular, the Director General Banking Supervision reports to the Executive Commission on the following matters:**

— supervisory decisions regarding SIs, including capital and liquidity decisions.

— the supervisory priorities and the annual supervisory examination programme for the coming year.

— general SSM matters of particular interest.

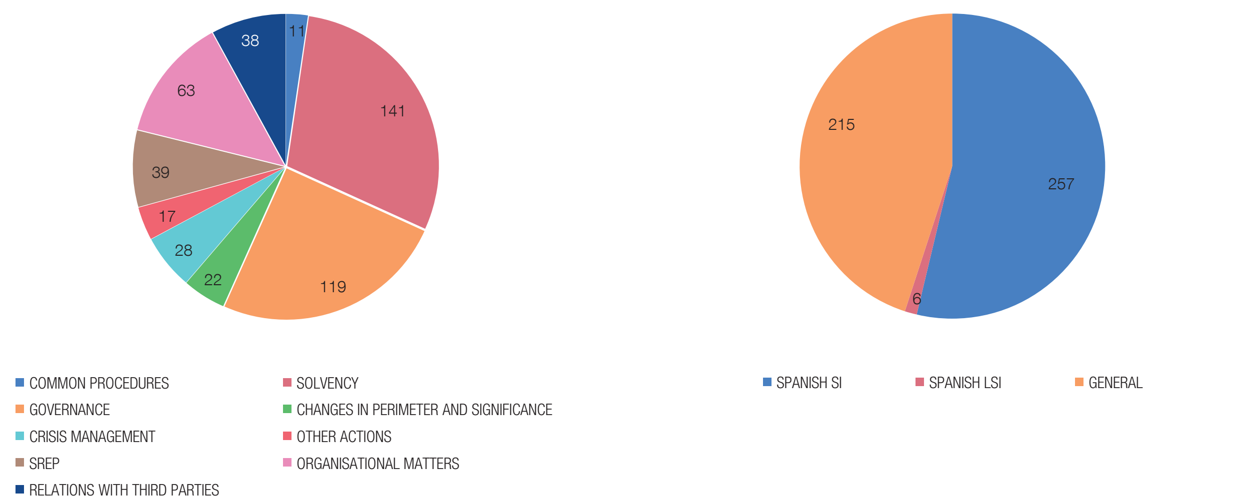
— the situation of Spanish institutions.

Chart 2.9
DISTRIBUTION OF THE ECB DECISIONS AND ACTIONS IN 2020 NOTIFIED TO THE EXECUTIVE COMMISSION

In 2020, the number of SREP decisions declined due to adoption of the pragmatic approach. Another notable change was the increase in decisions concerning governance, while the actions relating to the management of COVID-19 were recorded in the crisis management area.

1 BY CATEGORY

2 BY TYPE OF INSTITUTION



SOURCE: Banco de España.

2.2.1 Ongoing supervision of significant institutions

The JSTs are tasked with the ongoing supervision of SIs. The JSTs of Spanish SIs comprise 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 for the 12 groups of Spanish credit institutions classified as significant pursuant to the SSM's criteria, and likewise in some of the JSTs for 27 significant banking groups from SSM countries that have a presence in Spain (operating through six subsidiaries and 40 branches established in Spain). At end-2020, the Banco de España contributed to the JSTs for Spanish banks a total of 157 employees from the Inspection I and Inspection II departments.

The JSTs focus on off-site ongoing supervision, aiming to maintain an up-to-date opinion on the situation and risk profile of the institutions. To this end, annual planning is conducted for the ongoing supervisory tasks, whose frequency and intensity is determined by the supervisory significance of the institutions. Prominent among the off-site ongoing supervisory tasks are those related to the Supervisory Review and

Evaluation Process (SREP) – the most demanding in terms of effort and time –, including the annual determination of capital and liquidity requirements. In addition, the JSTs' tasks include the following: i) one-off detailed reviews specific to each institution; ii) participation in cross-cutting reviews, which are conducted for all SSM institutions in relation to areas of interest; iii) cooperation in on-site supervisory actions; and iv) reviews of recovery plans, processing of authorisations, coordination with other supervisors, provision of support to horizontal groups by contributing their practical experience, etc.

However, the 2020 supervisory activity was highly conditioned by the COVID-19 crisis, with a necessary adjustment to the new circumstances and a refocusing of efforts to ensure adequate monitoring of the pandemic-related risks. Accordingly, work on certain lower priority activities had to be scaled down in order to focus the ongoing supervision on how COVID-19 is impacting institutions' risk profiles and operational continuity. To conduct this monitoring, the supervisor asked institutions to report regularly on those aspects and has remained in permanent contact with the institutions through numerous remote meetings.

Specifically, in addition to the customary monitoring of the various risk areas, the JSTs have performed the following tasks:

— monitoring the impact of COVID-19 on asset quality. Much of the work performed by the JSTs has consisted of assessing credit quality developments for portfolios and monitoring the support provided by institutions to borrowers (moratoria, ICO-guaranteed loans, etc.).

— monitoring of the institutions' contingency plans, focusing particularly on cybersecurity and business continuity. In this connection, regular information has been requested on the widespread implementation of remote working and the impact thereof, and on the use of alternative channels to continue providing services to customers, along with infection trends among employees and branch closures (see Chart 2.10).

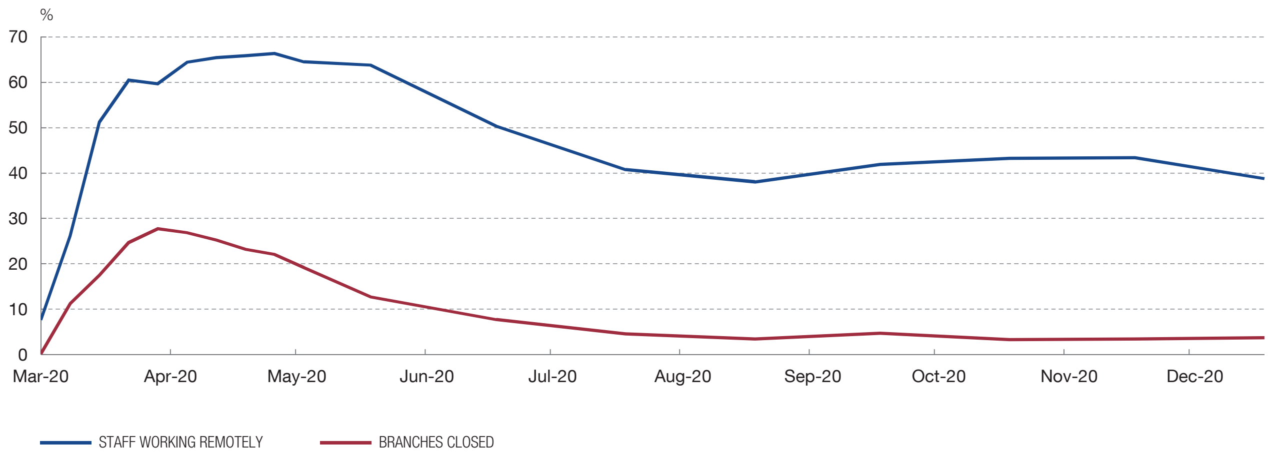
— monitoring of liquidity through regular meetings with institutions. Given that the supervisor's initial concerns regarding the impact of the crisis on banks' liquidity ultimately did not materialise, the frequency of these meetings was gradually reduced.

— assessment of the effects of the crisis on the institutions' level of activity (including in terms of new lending, card expenditure and cash withdrawals), income statement (especially in terms of credit risk provisions, including extraordinary provisioning) and capital levels.

— other tasks, such as the following: i) reviewing the activity of the new committees set up to monitor and address the impact of the crisis;

Chart 2.10
THE EFFECTS OF THE PANDEMIC ON BRANCH CLOSURES AND THE RISE OF REMOTE WORKING

The COVID-19 crisis has clearly had an influence on the widespread implementation of remote working at Spanish credit institutions. Although a large portion of staff returned to the workplace from June 2020 onwards, the percentage of employees who continued working remotely throughout the year remains quite high. Likewise, the state of alert and lockdown gave rise to the closure of nearly 30% of the branch network and prompted some institutions to permanently close a great deal of branches. However, despite the branch closures and the rise of remote working, it is worth noting that the institutions have managed to operate as normal.



SOURCE: Banco de España.

ii) verifying the sufficiency and suitability of reporting to the governing bodies on COVID-19-related matters; and iii) analysing the plans for the return to normality, succession planning, the updating of financial plans and budgets, changes to credit policies, the adaptation of risk appetite frameworks and assessing the sectors hardest hit by the crisis.

Mindful of the difficulty of implementing the SREP guidelines (EBA/GL/2014/13) to the fullest extent owing to the heightened uncertainty prompted by the crisis, the EBA stated that the principles of efficacy, flexibility and pragmatism should determine the 2020 SREP supervisory approach. With a view to identifying how such flexibility could be applied, the EBA published guidelines on a pragmatic approach to the SREP (EBA/GL/2020/10) and established a special procedure for the 2020 SREP.

The ECB adopted those guidelines and opted for a simplified approach to the SREP in 2020. The main characteristics of this simplified approach are as follows: i) focusing the analysis on the institutions' aspects and risks most affected by the crisis, considering the information available at the time of the assessment; ii) leaving the SREP scores unchanged, given the uncertainties in the current scenario; and iii) as a general rule, maintaining the same capital requirements (P2R) and guidance (P2G).

Specifically, the supervisory analysis of each risk area prioritised a series of key aspects that might have been particularly affected by the crisis, or that could impact the institution's capacity to operate properly in future:

— the analysis of the business model focused on the near-term viability of each credit institution, taking into consideration the impact of the COVID-19 crisis on 2020 results, and the expected repercussions of the crisis on the institution's medium-term sustainability.

— with regard to governance and risk management, close attention has been paid to the responsiveness demonstrated by each institution's management body to the COVID-19 outbreak, along with the capacity to identify, measure and monitor the risks arising from the new economic situation.

— credit risk supervision reviewed the impact of the crisis on credit quality, the adaptation of processes to the new circumstances and the effectiveness of the mitigating measures introduced by each institution.

— with regard to market risk, the analysis included the impact of the COVID-19 crisis on the different business lines and products, along with profitability and risk deriving from the trading activity. The assessment also examined whether each institution's risk metrics, market risk management system and hedging strategies remained valid in the new economic environment.

— the analysis of operational risk focused on business continuity and the maintenance of critical services. A particular focal point was how the new situation might heighten IT and cyber risk.

— lastly, in terms of liquidity risk, the supervisor paid particular attention to the net liquidity position, intraday liquidity and the funding position, to analyse the potential for the COVID-19 crisis to give rise to liquidity problems.

Further, both from the risk standpoint and at a more general level, the JSTs assessed the institutions' capacity to manage the crisis and the impact thereof going forward (until the end of 2021 at least).

Lastly, the special circumstances under which the supervisory tasks were conducted in 2020 resulted in the postponement of the EBA and ECB stress test exercises scheduled for that year. These were replaced by what the ECB called a "vulnerability exercise" to analyse the banking system's resilience to the impact stemming from the COVID-19 crisis. The sample included 86 euro area banks. Two scenarios were analysed: a baseline scenario, envisaging a cumulative drop in gross domestic product (GDP) of -0.2% in three years; and a more severe scenario, envisaging a decline of -5.5%. The EBA stress test methodology was used as a starting point, although certain aspects were adapted given that it would be an internal ECB exercise without interaction with the institutions. The essential elements of the EBA methodology were unchanged, such as the comprehensive coverage of risk areas and the static balance sheet assumption. However, the methodology was tailored based on the information available through supervisory reporting. The results were generated using the ECB's own models, making this a fully top-down exercise.[5]

In terms of crisis-related action, and in particular the review of recovery plans, the requirements were eased for institutions during this cycle owing to the exceptional circumstances. Among these relief measures, institutions were permitted to not include certain information in the recovery plan, in order to focus on the more relevant information in the context of the crisis.

2.2.2 Ongoing supervision of less significant institutions, non-EU branches and the ICO

The Banco de España is responsible for the direct supervision of Spanish LSIs, while the ECB is responsible for their indirect supervision. The Banco de España likewise performs supervisory functions on the branches of LSIs from other SSM countries and the rest of the EU, along with the branches of non-EU credit institutions. This set of institutions accounts for 5.6% of the Spanish banking system's assets. Chart 2.11 details the weight of each institution type, calculated based on their total assets. The Banco de España also supervises the ICO.

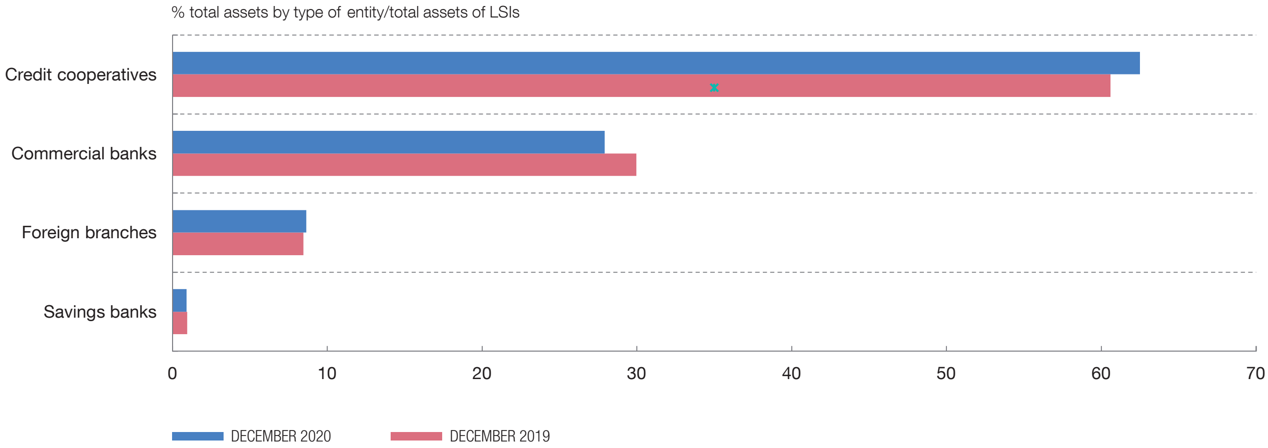
The annual action plan, which details the following year's supervisory activities, is prepared each year on the basis of the supervisory priorities. As part of ongoing supervision, each institution's performance is monitored periodically (quarterly or half-yearly). The monitoring may vary in depth and 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. This is based on quarterly alerts using the information in the confidential returns and the Banco de España's central credit register (CCR) in order to detect potential future problems relating to liquidity, solvency or business model sustainability.

In 2020, **quarterly monitoring** was conducted for the 59 Spanish LSI groups.

5 For further information on this exercise and the results thereof, see the ECB press release of 28 July 2020.

Chart 2.11
WEIGHT OF THE VARIOUS TYPES OF LSIs

The asset volume of LSIs as a whole grew 15%, with a more pronounced increase in the credit cooperatives segment.



SOURCE: Banco de España.
NOTE: The figures for the assets of institutions in 2020 were obtained after the data cut-off date.

The supervisory monitoring focused on the supervisory priorities established for 2020 and on the new requirements arising from COVID-19 and its impact on the domestic economy. This entailed redirecting resources and supervisory work to ensure adequate monitoring of the pandemic-related risks.

To conduct this monitoring, the supervisor asked the institutions to provide periodic reporting on those aspects. Likewise, it has remained in constant contact with the institutions through numerous remote meetings, requesting contingency plans that envisage the potential effects of the crisis on operational risk, particularly in relation to cybersecurity and business continuity.

In addition to the recurring aspects that are typically assessed on a quarterly basis (solvency, liquidity, profitability, asset quality and governance), monitoring was bolstered for aspects relating to credit risk and the impact on profitability and liquidity. These include the following:

— **in credit risk monitoring**, in-depth assessment of aspects such as the sectoral segmentation of loan portfolios; credit quality indicators (e.g. late payments); take-up of legal moratoria and State guarantees; and reclassifications, rollovers and forbearance.

— **in profitability,** analysis of aspects relating to loan portfolio profitability and the potential impact of loan impairment.

— **in liquidity,** monitoring frequency varied based on the institutions' different situations.

Other actions as part of ongoing supervision include reviews of external audit reports, internal capital and liquidity adequacy assessment reports and recovery plans; meetings with the external auditor and periodic meetings with persons in positions of responsibility at the institutions.

As is the case for SIs, the SREP is one of the key tasks of off-site ongoing supervision. In 2020, a simplified SREP methodology was implemented, pursuant to the EBA guidelines on the pragmatic approach for 2020, which were adopted by the Banco de España on 21 September 2020. The SREP conclusions take into account the results of the stress test known as the Forward Looking Exercise on Spanish Banks (FLESB), which is conducted annually by the Financial Stability and Macroprudential Policy Department of the DGFSRR to assess the resilience of Spanish institutions.[6] Once the related 2020 SREPs had concluded and the institutions' representations had been considered, the Banco de España adopted the 2021 capital and liquidity decisions for LSIs.

The Banco de España has continued to cooperate with other NCAs in the context of the supervisory colleges of LSIs in other SSM countries with subsidiaries in Spain. It participated in a total of three colleges in 2020, which contributed to joint decision-making on capital and liquidity requirements.

In 2020, it completed its assessment of the recovery plans sent in 2019 Q4. The Banco de España also allowed some flexibility vis-à-vis the submission of recovery plans in 2020.

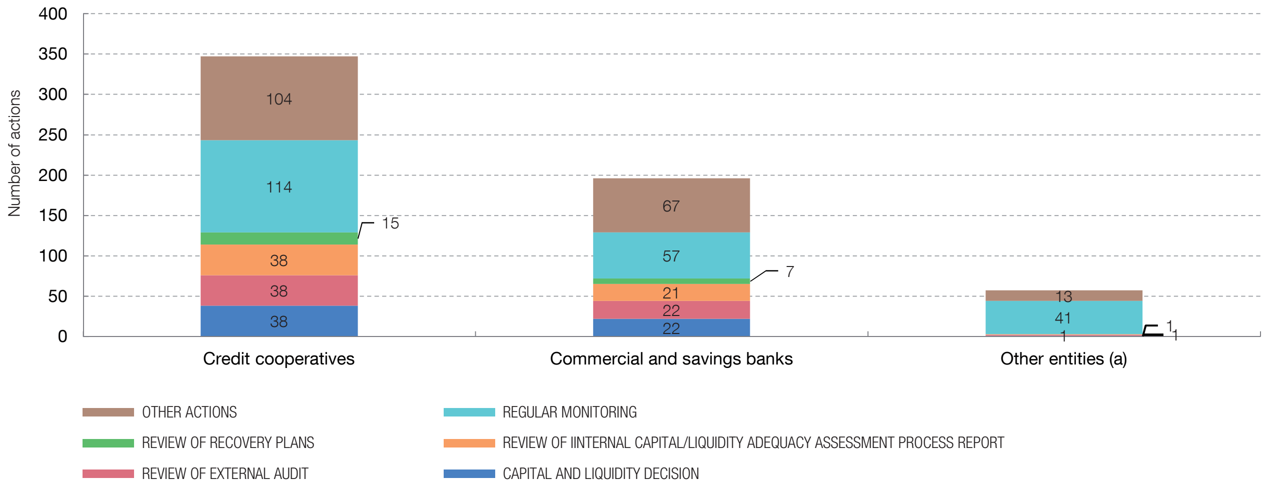
Since the branches in Spain of institutions with head offices in other EU Member States (including those of countries not participating in the SSM and those of LSIs of other SSM countries) are not subject to prudential or liquidity requirements at the branch level, periodic monitoring of the branch's performance is conducted, meetings are held with the management staff and information is regularly exchanged with the authorities of the branch's home country, under the terms established in Commission Implementing Regulation (EU) No 620/2014 of 4 June 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 supplemented by indirect supervision by the ECB, with the aim of:

6 For a summary of the results of the latest stress tests, see Banco de España (2020), "Risks to the financial sector and its resilience", Chapter 2, *Financial Stability Report,* Autumn 2020.

Chart 2.12
NUMBER OF ONGOING OFF-SITE SUPERVISORY ACTIONS AT LSIs, NON-EU BRANCHES AND THE ICO

In 2020, a set of extraordinary initiatives were undertaken as a result of COVID-19, with the aim of obtaining up-to-date information on developments relating to risks and the institutions' economic and financial situation. At the same time, the number of actions declined, owing, among other reasons, to a lower number of meetings.



SOURCE: Banco de España.

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

— ensuring the uniform application of high supervisory standards.

— guaranteeing the consistency of supervisory outcomes in the Member States participating in the SSM.

As in previous years, in performing these two functions the ECB benefited from the full cooperation of the Banco de España.

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

In 2020, a total of 600 ongoing supervisory actions for these institutions were undertaken, as detailed in Chart 2.12 by institution type and by supervisory matter.

2.2.3 On-site supervision

Table 2.3 details the on-site inspections conducted at the head offices of credit institutions in 2020. On-site work was suspended owing to the lockdown in Spain imposed by the state of alert. The possibility of continuing the inspections already

Table 2.3
ON-SITE SUPERVISION OF CREDIT INSTITUTIONS. NUMBER OF ACTIONS

	2020		
	SIs	LSIs	Total
On-site inspections	10	6	16
at Spanish credit institutions	9 (a)	6	15
at credit institutions from other SSM countries	1		1
Internal model investigations	10	—	10
at Spanish credit institutions	9 (b)	—	9
at credit institutions from other SSM countries	1		1
TOTAL	**20**	**6**	**26**

SOURCE: Banco de España.

a Of which, 6 were led by Banco de España staff and 3 were led by staff from other authorities.
b Of which, 7 were led by Banco de España staff and 2 were led by staff from other authorities.

under way on a remote and online basis was assessed. The decision was made to continue those inspections that were in advanced stages and to suspend the rest. On-site inspections were resumed in the fourth quarter, all by remote and online means. The significant preparedness of both the supervisor and the supervised institutions meant the inspections could be completed without any significant incident relating to the fact that they were conducted remotely. In this regard, it is worth noting the headway made in applying new technologies to supervisory work (see Box 2.8).

The 2020 inspection plan for the SIs of SSM countries was revised as a result of the COVID-19 pandemic. For Spanish SIs, nine of the 28 inspections initially planned for 2020 were performed (six headed by the Banco de España and three by the ECB). In addition, the Banco de España led the inspection of a foreign SSM institution.

By risk type, the nine inspections of Spanish SIs were distributed as follows: two credit risk inspections for different portfolios; two technological risk inspections on cybersecurity and IT service outsourcing, respectively; two inspections relating to capital; two on governance, business model and profitability; and one on market risk.

The Banco de España also participated in two inspections of SIs from other SSM countries which were led by other supervisory authorities.

The pandemic had a more moderate impact on model investigations than on inspections. Despite remote work entailing an additional workload, as reflected in deadlines being extended somewhat, the 2020 plan remained at reasonably similar levels to previous years. In part, this was because model investigations take place at the institutions' request; for instance, when internal models need to be adjusted to ensure their adequate functioning, which requires prior supervisory validation.

Box 2.8

NEW TECHNOLOGIES IN SUPERVISION: SUPTECH[1]

The exponential technological advancement of recent years has led to deep digital transformation across all sectors of society. These advances have opened up new opportunities that are also being harnessed to improve supervisory capabilities.

As well as the availability of increasingly large amounts of data and more powerful computers, new methods of analysis, such as machine learning, have also emerged. Using these tools helps in decision-making processes and in identifying exceptions that are not apparent to the naked eye. Likewise, the implementation of suptech tools makes for more efficient supervisory processes and workflows through techniques such as robotic process automation. In short, new technologies allow supervisory authorities to perform their tasks more proactively and efficiently.

The Banco de España's 2024 Strategic Plan[2] sets out various initiatives to drive the digital transformation and incorporate new technologies across all areas. The Directorate General Banking Supervision (DGBS) has set up a multidisciplinary suptech forum, comprising inspectors and experts in models and in IT, to foster an innovation culture among supervisors.

As a result of the work conducted in this forum, the DGBS is currently designing a suptech-specific strategy and work plan, with a view to using these tools to their fullest. The aims are as follows: i) to drive coordination between areas in order to share knowledge and expertise in this field; ii) to identify key processes for digitalisation and for the use of new suptech tools; and iii) to assess the possibility of specialist profiles exploiting the information.

The DGBS has identified some tools that were already in use, including automated document validation and classification, error detection in leveraged transactions or the inference of relationships between borrowers. These tools will be the starting point for new developments that will be coordinated via this forum.

Rapid technological progress drives the need to bolster training. To this end, several courses have been created to incorporate new data analysis skills into the traditional skill sets.

In addition, the DGBS participates in the Single Supervisory Mechanism's digitalisation agenda initiatives and takes part in the various working groups set up to that effect. Among the most prominent is the group tasked with identifying opportunities for using suptech, with a plan devised to develop these over the coming years.

1 Suptech refers to the application of big data, artificial intelligence and other innovative technologies by financial supervisors to perform their functions (S. di Castri, S. Hohl, A. Kulenkampff and J. Prenio (2019), "The suptech generations", *FSI Insights on policy implementation,* No 19, October, Financial Stability Institute.

2 For more information on the Strategic Plan, see the press release of 15 January 2020, *The Banco de España launches its Strategic Plan 2024*.

Specifically, in 2020, nine reviews were conducted on Spanish institutions, eight of which focused on internal credit risk models and one on market risk models. As evidence of the Banco de España's active support for cross-border supervisory activities, two reviews of Spanish institutions were performed jointly with supervisors from the ECB and the National Bank of Belgium (NBB), respectively. In addition, the Banco de España led an investigation into counterparty risk in Italy.

After lockdown was imposed, all inspection action over the rest of the year was conducted remotely, making full use of audiovisual communication applications to support interaction with the institutions and communication between team members. The effectiveness and efficiency of the action was not significantly affected.

The pandemic has unquestionably resulted in less on-site activity relative to the previous year. However, specific projects have been launched to compensate for that reduced activity, involving most of the available inspectors. Notable among these were the analysis and assessment of the most common and most significant shortcomings identified in inspections conducted across the SSM, for the different areas and risk types. Another project entailed taking inventory of and systematically classifying a series of templates, tools and supervisory tests, with the ultimate aim of enhancing the quality and efficiency of on-site supervisory actions.

Lastly, the supervisory plan for LSIs is approved by the Banco de España's Executive Commission, since they are subject to the Banco de España's direct supervision. However, the ECB is kept apprised of the content of the plan. In 2020, six on-site inspections were performed at LSIs. Nine more are scheduled for 2021.

The on-site inspections conducted at LSIs during 2020 emphasised the assessment of credit quality, foreclosed assets, governance and solvency, along with IT-related matters.

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. Thereafter, the corresponding recommendation and requirement letters to the institutions are drafted, for approval by the Executive Commission of the Banco de España at the proposal of the DGBS (see Section 2.2.6 for further details).

2.2.4 Dividend distribution and variable remuneration policies

Institutions' profit distribution policies must comply with the precautionary principle 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. In February 2020, the Banco de España issued a recommendation for LSIs vis-à-vis dividend and variable remuneration policies, which also included the main aspects of the ECB's January 2020 recommendations for SIs.

In response to the situation stemming from the COVID-19 pandemic, on 27 March the ECB issued a new recommendation in which it asked SIs not to pay dividends nor assume irrevocable dividend commitments for 2019 and 2020 until 1 October 2020, and to refrain from share buybacks aimed at remunerating shareholders in cash. That same day, the Banco de España extended this recommendation to the LSIs.

Pursuant to the ESRB recommendation of 27 May on restrictions on capital distributions during the pandemic, on 27 July the ECB agreed to extend its previous recommendation until 1 January 2021. It also published the text of a letter sent to the

CEO of each SI, asking the institutions to be extraordinarily prudent in the payment of variable remuneration. The Banco de España extended these measures to the LSIs on the same day.

Lastly, in coordination with the ESRB, the ECB issued a new recommendation on 15 December 2020 asking SIs to consider refraining from cash dividends and share buybacks, or to limit such remuneration, until 30 September 2021. Given the persisting uncertainty over the economic impact of COVID-19, the ECB expects dividends and share buybacks to remain below 15% of cumulated 2019-20 profit and not higher than 20 basis points of the Common Equity Tier 1 (CET1) ratio, whichever is lower. Institutions that intend to pay dividends or buy back shares need to be profitable and have robust capital trajectories. In another letter addressed to SIs, the ECB also reiterated its expectation that institutions exercise extreme moderation on variable remuneration until 30 September 2021. These measures were likewise adopted by the Banco de España in relation to LSIs.

2.2.5 Common procedures, suitability and other procedures

The Banco de España and the ECB, within the scope of their respective competences, supervise compliance with the rules on the suitability of credit institutions' senior officers for the duration of their tenure.

The Banco de España participated in 195 suitability assessments for senior officers at institutions supervised directly by the ECB and by the Banco de España (see Table 2.4). Marked improvements were noted in the applications submitted by the institutions; these were increasingly complete in terms of the required documentation and in the detail of the candidate assessments conducted by the institutions. Nonetheless, compliance with certain suitability requirements remains a concern for the supervisor, and requires closer attention from the institutions.

When the supervisor identifies a shortcoming in the course of the procedure, certain conditions, obligations and recommendations are attached to favourable suitability assessments. The most adequate measure is chosen based on the circumstances of each case. The most common measures are the following:

i) Conditions relating to training, under which the institution commits to providing the candidate with the specific training considered necessary to adequately perform his/her duties. A transition period is sometimes agreed, during which the senior officer is ineligible to serve on board committees.

ii) Monitoring obligations, particularly regarding the due application of conflict of interest policies and the candidate devoting sufficient time to the role.

Table 2.4
PROCEDURES IN RESPECT OF CREDIT INSTITUTIONS INVOLVING THE BANCO DE ESPAÑA

	Total
Qualifying holdings, merger, spin-off and other significant acquisitions	18
Cross-border activity of Spanish credit institutions	62
Branches in the EU	12
Branches in third countries	5
Freedom to provide services	33
Representative offices	12
Cessation of business	
Loans to senior officers	39
Suitability of senior officers	195
Procedures relating to own funds	78
Amendments to articles of association	16
Communications with other supervisory authorities or institutions	3
Other procedures	79
TOTAL	**490**

SOURCE: Banco de España.

iii) Recommendations generally relating to the management body as a whole (for instance, where one specific area of expertise or experience should be strengthened).

The personal and professional requirements applicable to independent directors are subject to particular attention, with some resolutions including warnings to ensure that such directors are aware of their special obligation to act as a counterweight on boards of directors and that they must have the necessary skills to indicate dissenting views against the institution's executives.

Following the appointment of a senior officer, the supervised institutions must continue their assessments and notify the supervisor of any circumstances that may affect compliance with the suitability requirements for serving senior officers. The most common changes reported by the institutions are as follows: a senior officer undertaking new responsibilities at the same institution, which may require specific expertise or skills; the assumption of new roles at other companies, potentially affecting the director's time commitment or giving rise to potential conflicts of interest; and criminal investigations or administrative sanctioning procedures involving a senior officer.[7]

7 To conduct this assessment, the Banco de España consults the experts' committee set up pursuant to the provisions of Royal Decree 256/2013 of 12 April 2013. This legislation incorporates into the regulations governing credit institutions the EBA's Guidelines of 22 November 2012 on the assessment of the suitability of members of management bodies and key function holders.

In cooperation with NCAs, the ECB has worked to improve and smooth the processing of suitability procedures at institutions. This resulted in the creation of a new IMAS portal, which has been operational since January 2021 for the credit institutions under the ECB's direct supervision. This system was designed to be user-friendly and to expedite the processing of procedures.

In turn, the Banco de España has prepared and published a new "Questionnaire for assessing the suitability of senior officers (institutions other than credit institutions and SLIs)", which is available on the Banco de España website and similarly aims to enhance efficiency, ease administrative burdens and streamline the process.

The health crisis prompted by COVID-19 has inevitably impacted suitability procedures, affecting timeframes and driving the use of digital and online resources, such as the Banco de España's electronic register. During the initial phase of the state of alert, resolution deadlines were suspended pursuant to the regulations established to that effect, candidate interviews were paused and the deadlines granted to institutions to provide their candidates with the required skills training were extended, in view of the potential difficulties in this respect.

However, the situation has boosted the use of electronic and online resources, in particular: i) the Banco de España's electronic register, as a means of initiating the administrative procedure for suitability assessments, reducing paper usage and streamlining assessment processing; and ii) candidate interviews by videoconference, avoiding unnecessary risks for all concerned.

2.2.6 Letters

As a result of the above-described supervisory actions carried out in 2020, a total of 99 letters were sent to LSIs, with requirements and recommendations made by the Banco de España in the exercise of its supervisory powers. Chart 2.13 provides a breakdown of these letters by type of institution and subject matter. Of these, 57 related to capital decisions, 33 to recovery plan reviews and nine to on-site inspections.

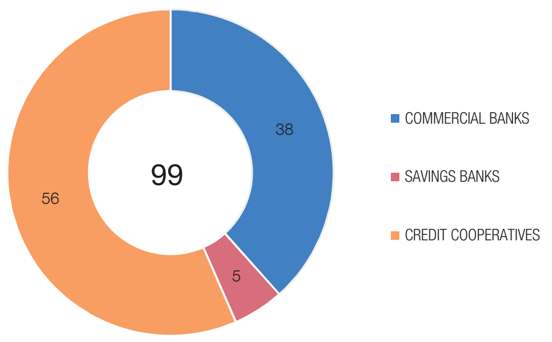
Chart 2.14 shows the breakdown by subject matter of the 405 requirements and recommendations contained in the 99 letters sent to credit institutions. The requirements notified to LSIs in 2020 largely related to solvency – specifically to capital decisions –, since all institutions are asked each year to satisfy a capital requirement level, and included improvements to recovery plans and internal capital and liquidity adequacy assessment reports.

Most of the requirements arising from the inspections related to governance, followed by credit risk. These governance requirements were issued to improve the composition and functions of committees, internal control and contingency planning.

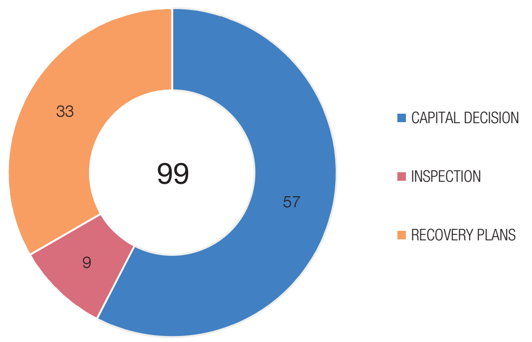
Chart 2.13
NUMBER OF LETTERS ADDRESSED TO CREDIT INSTITUTIONS

The majority of letters were addressed to credit cooperatives, since this group has the highest number of LSIs. The most common subject matters were capital decisions and recovery plans.

1 BY TYPE OF INSTITUTION (2020)



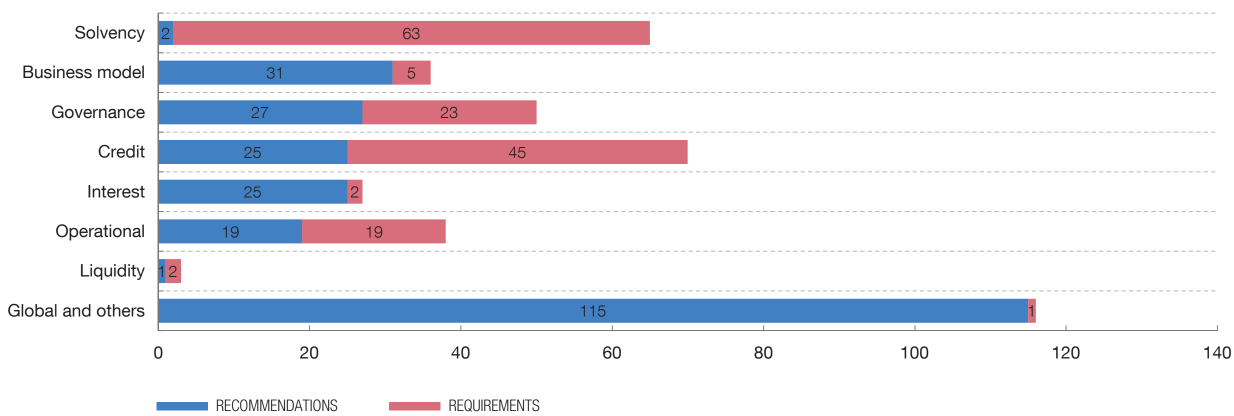
2 BY SUBJECT MATTER (2020)



SOURCE: Banco de España.

Chart 2.14
NUMBER OF RECOMMENDATIONS AND REQUIREMENTS NOTIFIED TO CREDIT INSTITUTIONS

By specific areas, the requirements and recommendations on credit risk, solvency and governance stand out.



SOURCE: Banco de España.
NOTE: "Global and others" comprise recommendations set out in 33 letters on recovery plans and in others relating mainly to improvements to internal capital and liquidity adequacy assessment process reports.

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, and to the need to increase loan-loss provisions and to improve the specific internal controls in place for credit risk.

The bulk of recommendations resulting from the inspections referred to the business models and advocated an increase in recurring sources of income and adjustments to overhead costs, to ensure the institutions' long-term sustainability.

2.2.7 Other actions

The Banco de España cooperates closely with the CPMLMO and SEPBLAC in the supervision and inspection of compliance with AML/CTF obligations by institutions supervised by the Banco de España, pursuant to Spanish legislation and the cooperation and coordination agreement entered into with the CPMLMO.

The Banco de España further strengthened this function in 2020. Two general inspections were launched, focused on reviewing two LSIs' compliance with AML/CTF obligations, along with a specific monitoring action to check the implementation by a SI of an AML/CTF action plan. The inspections were ultimately performed remotely owing to the restrictions prompted by the COVID-19 pandemic. Also subject to review was compliance with the recommendations and requirements issued by the Banco de España and the CPMLMO, respectively, to financial institutions as a result of inspections conducted in prior years.

Likewise, the methodology for assessing ML/TF risk for credit institutions established in Spain was updated; on that basis, their ML/TF risk profile was devised and their supervisory priority established.

It is also important to underline the contributions to national initiatives, such as the transposition of Directive (EU) 2018/843 to Spanish legislation and the 2020 National Analysis of ML/TF risks, along with active participation in several international working groups, in cooperation with the Secretariat of the CPMLMO and SEPBLAC. For more details on the main ongoing initiatives in the EU, see Box 2.9.

The Banco de España also collaborates with other national supervisors. Specifically, with the CNMV, on the supervision of activities relating to financial markets and on 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 that body.

With regard to international organisations, in 2020 the Banco de España cooperated with the International Monetary Fund (IMF) on the latter's biannual assessment, pursuant to Article IV of the Fund's Articles of Agreement. The spring assessment had to be postponed due to the pandemic and was replaced by

Box 2.9
ANTI-MONEY LAUNDERING: A PRIORITY FOR THE EU

In 2020 the institutions of the European Union (EU) reiterated their commitment to anti-money laundering and countering the financing of terrorism (AML/CFT) through various initiatives, most notably the following:

EUROPEAN COMMISSION. The European Commission has published a new methodology for identifying high-risk ML/TF countries and has updated its list of countries[1] based on this approach. It has also prepared an Action Plan for an EU-wide approach to AML/CFT, which rests on six pillars:

1. Making sure the existing rules are effectively implemented, ensuring the effective transposition and implementation of the directives and full use of the enhanced mandate of the European Banking Authority (EBA).
2. Establishing a single rulebook, turning certain parts of the current minimum requirements directive into directly applicable provisions set out in a European regulation.
3. Bringing about EU level AML/CFT supervision.
4. Establishing a support and cooperation mechanism for Financial Intelligence Units (FIUs) to support the analysis of suspicious cross-border transactions.
5. Enforcing Union-level criminal law provisions and strengthening supra-national judicial and police cooperation, along with public-private partnerships.
6. Strengthening the EU's position in the world by playing a leading role in implementing the international AML/CFT standards established by the Financial Action Task Force.

This plan has been submitted for public consultation, with the corresponding legislative proposals likely to be presented in 2021 Q1.

EU COUNCIL. In November 2020, ECOFIN published conclusions that welcomed the initiatives set out by the Commission in its Action Plan and established guidance on the regulation, EU-level supervision and the cooperation and support mechanism for the Member States' FIUs. In particular, it set out which areas must be subject to uniform regulation and the establishment of an EU-level AML/CFT supervisor, with direct supervisory powers over certain high-risk obliged institutions, which would cooperate closely with national authorities.

EBA. In 2020 it began fulfilling its enhanced mandate to lead, coordinate and monitor AML/CFT efforts undertaken by all financial sector operators and the competent EU authorities. In addition to the initiatives undertaken through the AML CFT Standing Committee (see Section 7.2.1), the EBA has begun to develop guidelines on cooperation between prudential supervisors, AML/CFT supervisors and FIUs, pursuant to the mandate of Article 117(6) of Capital Requirements Directive V, and has published an opinion (EBA/Op/2020/18) on how to take money laundering and terrorist financing risks into account in the supervisory review and evaluation process (SREP). The Banco de España, along with SEPBLAC, has actively participated in the initiatives led by the EBA.

EUROPEAN CENTRAL BANK (ECB). 2020 saw the first regular exchange of information between the ECB and the national AML/CFT authorities pursuant to the January 2019 agreement.[2] The aim is to incorporate relevant information obtained from the AML/CFT supervisors into the SREP of significant institutions.

Meanwhile, on the supervisory cooperation front, in 2020 some EU Member States established AML/CFT colleges in accordance with the European Supervisory Authorities' joint guidelines on cooperation and information exchange for the purpose of Directive (EU) 2015/849 between competent authorities supervising credit and financial institutions.[3] There is a two-year transitional period to establish the colleges under these guidelines, in force since January 2020. Colleges for firms assessed as high risk for ML/TF purposes should be established first. In 2021 the Banco de España and SEPBLAC will jointly establish the first AML/CFT colleges for Spanish institutions.

1 Commission Delegated Regulation (EU) 2020/855 of 7 May 2020 amending Delegated Regulation (EU) 2016/1675 supplementing Directive (EU) 2015/849 of the European Parliament and of the Council, as regards adding the Bahamas, Barbados, Botswana, Cambodia, Ghana, Jamaica, Mauritius, Mongolia, Myanmar/Burma, Nicaragua, Panama and Zimbabwe to the table in point I of the Annex and deleting Bosnia-Herzegovina, Ethiopia, Guyana, Lao People's Democratic Republic, Sri Lanka and Tunisia from this table.

2 Multilateral agreement on the practical modalities for exchange of information pursuant to article 57a(2) of Directive (EU) 2015/849.

3 Joint guidelines on cooperation and information exchange for the purpose of Directive (EU) 2015/849 between competent authorities supervising credit and financial institutions (JC/2019/81).

virtual meetings that took place in April. The quarterly meetings were likewise held remotely. The findings of the analysis were shaped by the COVID-19 crisis. While signalling that the financial system's strength helped to mitigate the impact of the crisis, the IMF emphasised the need to maintain robust supervision, to adopt relief measures and to implement prudent dividend policies. It also underlined the need to strengthen crisis management frameworks, both at the national and European levels. It likewise noted the efforts to reinforce the framework for combating ML/TF.

The Banco de España also coordinated visits from the European Commission, the ECB and the European Stability Mechanism (ESM), in connection with post-programme surveillance (PPS),[8] during which the Spanish economy's actual financial position was analysed from a macroprudential and microprudential standpoint, including the situation of banks which had received State aid during the financial programme.

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: SLIs, mutual guarantee societies (MGSs), reguarantee companies, appraisal companies, PIs, account information service providers, ELMIs, currency-exchange bureaux, banking foundations and Sareb. Table 2.5 lists these institutions.

The legal basis under which the Banco de España supervises these institutions and the approach to the tasks differ from case to case. Although the weight of these institutions in the financial system is not comparable to that of credit institutions, an effective regulatory and supervisory model for these institutions is necessary to promote the fluidity of financial intermediation mechanisms and to generate a climate of trust in financial institutions.

2.3.1 Supervisory actions

In 2020, 380 off-site ongoing supervision actions were performed by various means: periodic monitoring, reviews of external audit reports and other actions, as detailed in Chart 2.15.

8 Since the end of the programme (January 2014), under which Spain received financial support from the ESM, and under the framework of the PPS (Article 14 of Regulation (EU) No 472/2013 of the European Parliament and of the Council of 21 May 2013 on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability), the European Commission, in coordination with the ECB, organises biannual visits to Spain that include meetings with the Banco de España.

Table 2.5
REGISTER OF OTHER INSTITUTIONS

Year-end data

	2014	2015	2016	2017	2018	2019	2020
Institutions with an establishment	195	192	194	186	186	187	534
SLIs	47	39	35	31	31	27	26
SLI-PIs		5	8	8	8	9	8
Branches of financial institutions subsidiaries of EU credit institutions							1
Real estate lenders							99
Real estate credit intermediaries							234
Branches of EU real estate intermediaries							1
Mutual guarantee societies	24	21	21	19	18	18	18
Reguarantee companies	1	1	1	1	1	1	1
Appraisal companies	40	36	37	35	35	32	32
Currency-exchange bureaux (a)	10	13	12	14	14	16	17
PIs	45	43	41	39	40	42	47
PIs exempt under Article 14 of Royal Decree-law 19/2018							1
Payment service providers excluded under Article 4 of Royal Decree-law 19/2018							3
Account information service providers						1	1
Hybrid PIs (b)		2	3	3	4		
Branches of EU PIs	8	12	15	14	12	12	14
ELMIs	4	3	4	5	5	7	9
Branches of EU ELMIs	2	2	2	2	4	8	8
Banking foundations (c)	13	14	14	14	13	13	13
Sareb (d)	1	1	1	1	1	1	1
Institutions without an establishment	318	401	484	556	597	712	833
ELMIs	55	75	112	156	187	242	294
PIs	263	326	372	400	410	454	506
Account information service providers						16	33

SOURCE: Banco de España.

a Not including establishments authorised only to purchase currency using euros.
b Reclassified as PIs.
c Banking foundations are not registered in the Register of Institutions of the Banco de España. At 31 December 2020, the Banco de España had competence over five of the 13 banking foundations.
d Sareb is not registered in the Register of Institutions of the Banco de España.

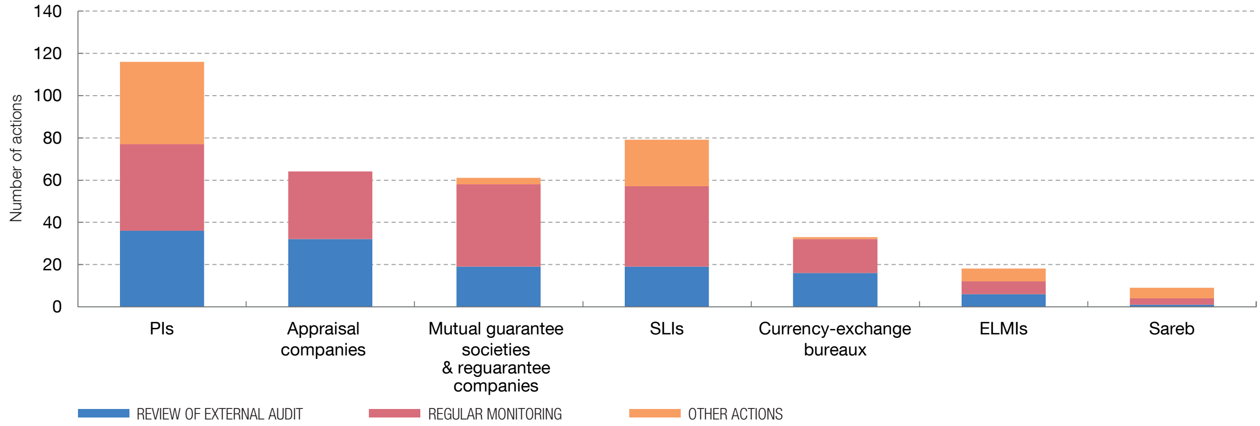
In addition, a total of three on-site inspections were performed in 2020: two inspections of appraisal companies and one of an SLI. A further five are planned for 2021.

Following the supervisory actions, four letters were sent to these institutions, addressed to the parties detailed in Chart 2.16. Chart 2.17 shows the number of recommendations and requirements, by area, contained in these letters.

Chart 2.15

NUMBER OF ONGOING OFF-SITE SUPERVISORY ACTIONS AT OTHER INSTITUTIONS

2020 saw an intensification of non-recurring actions in the PIs and ELMIs segments. Further, for the first time actions corresponding to the SLIs of EU SI groups were included and those of the PIs and ELMIs of Spanish SIs.

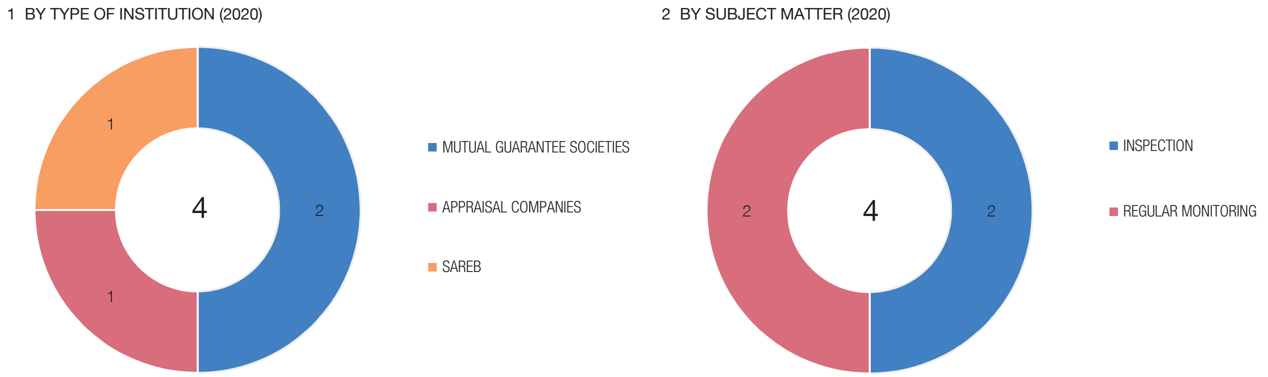


SOURCE: Banco de España.

Chart 2.16

NUMBER OF LETTERS ADDRESSED TO OTHER INSTITUTIONS

Of the letters addressed to other institutions, two relate to the findings of ongoing supervisory actions and two relate to inspections.

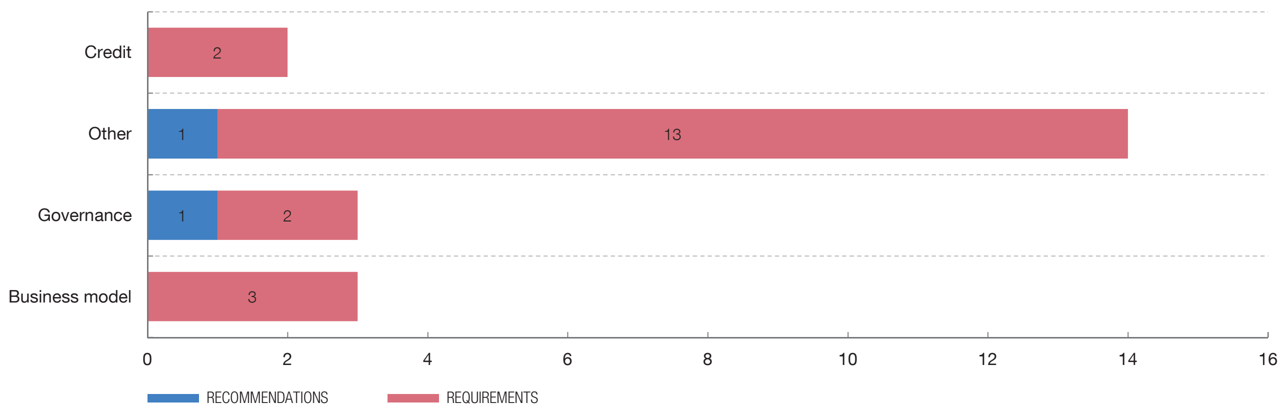


SOURCE: Banco de España.

Chart 2.17

NUMBER OF RECOMMENDATIONS AND REQUIREMENTS NOTIFIED TO OTHER INSTITUTIONS

By specific areas, the requirements and recommendations relating to business models and credit risk stand out.



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 pursuit of their activities. However, the scope of its involvement is not the same for all types of institutions. The Banco de España is the competent authority for registering, and granting and withdrawing the licenses of, SLIs which provide payment services (SLI-PIs) or which issue electronic money, ELMIs, PIs, exempt payment service providers pursuant to Article 14 of Royal Decree-Law 19/2018, account information service providers, real estate lenders, real estate credit intermediaries and currency-exchange bureaux. It is also the competent authority for the official recognition of appraisal companies. By contrast, it merely issues a mandatory report on the authorisation of SLIs, MGSs and reguarantee companies, the granting of which is the prerogative of the Ministry of Economic Affairs and Digital Transformation. Likewise, it is tasked with verifying that the institutions that report incurring any of the exclusions referred to in Article 4(k) and (l) meet the necessary criteria.

In 2020, a total of 388 institution start-up requests and a total of ten deregistrations were processed, as shown in Table 2.6.

Table 2.6
CHANGE IN THE NUMBER OF NON-CREDIT INSTITUTIONS. 2020 VS. 2019

	Value at 31.12.2019	Registrations	Deregistrations	Value at 31.12.2020	Change 2020-2019
SLIs	27		2	25	-2
SLI-PIs	9		1	8	-1
Branches of financial institutions subsidiaries of EU credit institutions	0	1		1	1
Real estate lenders	0	102		102	102
Real estate credit intermediaries	0	256		256	256
Branches of EU real estate intermediaries	0	2		2	2
Mutual guarantee societies and reguarantee companies	19			19	0
Appraisal companies	32			32	0
Currency-exchange bureaux (a)	16	1		17	1
PIs	42	6	1	47	5
PIs exempt under Article 14 of Royal Decree-law 19/2018	0	2		2	2
Payment service providers excluded under Article 4 of Royal Decree-law 19/2018	0	9		9	9
Account information service providers	1	1	1	1	0
ELMIs	7	3	1	9	2
Branches of EU PIs	12	3	1	14	2
Branches of EU ELMIs	8	2	3	7	-1
TOTAL	**173**	**388**	**10**	**551**	**378**

SOURCE: Banco de España.

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

Table 2.7
OTHER PROCEDURES CONDUCTED BY THE BANCO DE ESPAÑA IN RESPECT OF OTHER INSTITUTIONS

Number of procedures in 2020	PIs	ELMIs	SLIs	Mutual guarantee societies	Appraisal companies	Currency-exchange bureaux	Sareb	Banking foundations	**Total other Institutions**
Qualifying holdings, merger, spin-off and other significant acquisitions	7	4	7		3				**21**
Cross-border activity of Spanish institutions (a)	1,820	10	4						**1,834**
Branches in the EU	7		4						**11**
Branches in third countries									**0**
Freedom to provide services	275	7							**282**
Agents	1,538	3							**1,541**
Cessation of business	1		1						**2**
Suitability of senior officers	52	22	33	48	17	1			**173**
Procedures relating to own funds	1	1	7	3					**12**
Amendments to articles of association	2		4	4					**10**
Authorisation of management protocol and financial plan								16	**16**
Communications with other supervisory authorities or institutions							1		**1**
Other procedures	3	2		1			1		**7**
TOTAL									**2,076**

SOURCE: Banco de España.

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

Similarly, in 2020 a further 2,079 procedures relating to supervisory powers over these institutions were performed, as detailed in Table 2.7.

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 begin operations in the financial market without meeting the conditions of access, whether by conducting activities legally restricted to credit institutions, payment service providers or other types of institutions supervised by the Banco de España, or through the use of generic names restricted to those institutions or any other name that may confuse the public.

2020 saw supervisory action performed relating to 29 legal entities which may have been carrying out restricted activities without authorisation or making undue use of a name pertaining to supervised institutions, the outcome of which could lead to the adoption of penalties.

2.5 The quality function and training activities

2.5.1 The quality function

The primary mission of the quality function is to ensure excellence and consistency in the DGBS' activities, and to help drive efficiency and effectiveness in supervisory tasks.

The Organisation and Quality Division of the DGBS acts as second line of defence, ensuring the quality of the DGBS' processes, activities and tools, fostering consistency and uniformity in its activities, simplifying processes and verifying compliance with internal regulations.

This group 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 (e.g. AML/CFT). It is also the DGBS' point of contact with the Internal Audit Department of the Banco de España, and cooperates with the ECB's Supervisory Quality Assurance (SQA) Division.

The 2020 quality plan was amended to accommodate the special circumstances generated by COVID-19 and to help ease the pressure on the DGBS work teams. As a result, the number of quality reviews envisaged in the annual plan was reduced, although some actions and projects that had not been anticipated at the start of the year were carried out.

Partnership with the SSM's SQA Network also continued, although the situation prompted by the pandemic meant the meetings were held remotely and more frequently than usual. Against this backdrop, the participation in three significant projects should be noted: i) a streamlining project to optimise and improve SSM processes; ii) a digitalisation project to instil a digital culture among supervisors; and iii) a common European platform for sharing information requirements and expertise among staff.

2.5.2 Training activities

Each year the DGBS works on a training programme to foster excellence and professional development among employees, through a set of training

Figure 2.5
INTERNAL TRAINING

- Training more tailored to the work than is available on the market
- Optimisation of knowledge, generating a multiplier effect
- Example of win-win situations benefiting both the organisation and the trainer
- General incentive for the study and research of professional subject matters
- Internally conveying culture and knowledge within the organisation

SOURCE: Banco de España.

activities to strengthen the skills and expertise required for the satisfactory performance of supervisory activities. So as to identify the training needs and deliver the training programme, the opinions of the training recipients are gathered. Much of the DGBS training activities are conducted internally,[9] given the benefits that this offers (see Figure 2.5).

2020 was shaped by the exceptional circumstances arising from March as a result of COVID-19. This posed a major challenge for the DGBS training team, which was forced to suspend all face-to-face sessions (the usual format) and to seek out new teaching methods.

To address this challenge and continue the training activities on a remote basis, new online conferencing applications were adopted. Likewise, a blended learning method known as MVO has been designed, which combines three types of teaching through deliverable materials, video tutorials and online sessions. This approach allows for greater flexibility and compatibility with the normal supervisory tasks.

At the international level, the training provided by the DGBS is supplemented by other programmes offered by the ECB (within the SSM framework) and other courses run by various international organisations. In addition, DGBS staff have access to the FSI Connect programme, a remote training site provided by the Financial Stability Institute of the Bank for International Settlements (BIS).

Active cooperation continues with the Association of Supervisors of Banks of the Americas, both to prepare its own training plan and to determine certain basic principles for training programme design. Courses were also organised for that body and other central banks in Latin America, which involved speakers from the DGBS.

9 The aim is to organise training activities that are designed and delivered by and for staff members.

2.6 Supervision of payment service providers

Much of the supervisory activities performed in this domain during 2020 were geared towards verifying compliance with Commission Delegated Regulation 2018/389 on strong customer authentication and common and secure open standards of communication.[10]

These activities included monitoring the process of improving and adapting the specific interfaces offered by account servicing payment service providers (ASPSPs)[11] to third-party payment service providers (TPPs)[12] for the purposes of accessing customers' payment accounts. This process was largely shaped by the publication in June 2020 of the EBA Opinion on obstacles in specific interfaces.[13] In the Opinion, the EBA stated that some aspects of the interfaces observed in the European market created obstacles to the provision of services by TPPs; for example, failure to accept all of the strong authentication procedures offered to customers by ASPSPs, issues regarding inefficient redirection approaches and multiple and unnecessary authentication steps.

Consequently, the Banco de España asked Spanish ASPSPs whose specific interfaces included any of these obstacles to set out an action plan for eliminating these obstacles prior to 31 December 2020, at the same time as it monitored due compliance. The gradual alignment of these interfaces with the standards laid down by the EBA may be behind the decline in the number of notifications relating to problems with such interfaces in the second half of the year.

Second, regarding compliance with the Commission Delegated Regulation, monitoring has been conducted of the plans to migrate to strong customer authentication solutions for e-commerce card-based payment transactions, which were agreed in late 2019 with card-issuing payment service providers and with the

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10 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.

11 Payment service providers which provide a payer with one or more payment accounts and are responsible for their servicing.

12 These currently include three types of institutions:

- Account information service providers, offering an online service providing aggregated information about one or more payment accounts held by the payment services user at one or several other 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 to initiate and process payment transactions, having first obtained confirmation from the ASPSP that funds are available in the payer's payment account.

13 EBA Opinion on obstacles under Article 32(3) of the Regulatory Technical Standards on strong customer authentication and common and secure communication (EBA/OP/2020/10).

acquirers of the transactions paid for using these cards, within the framework of the supervisory flexibility introduced by the EBA under the respective Opinions issued in June[14] and October[15] 2019.

So as to check that the migration plans are progressing as expected, the Banco de España has met with representatives of the issuers and acquirers, merchants, card schemes and processing entities. In addition, the Banco de España monitored the key variables of the migration process, initially on a quarterly basis (with the exception of the June reporting, which was omitted to allow institutions to focus their efforts on overcoming the effects stemming from the health crisis) and on a weekly basis from October onwards. The granularity of the information, which in some cases was envisaged in the EBA Opinions, was likewise increased as implementation reached its latter stages, with a view to identifying and remedying the difficulties identified, amid close collaboration between all of the parties involved.

Third, and likewise relating to compliance with the Commission Delegated Regulation, the first resolutions were issued regarding the application of the exemption from strong customer authentication for secure corporate payment processes and protocols, available only to payers who are not consumers.

These resolutions have been issued both for particular payment solutions that are designed and managed fully and exclusively by the corresponding payment service providers, and in relation to certain configurations of various host-to-host connectivity protocols and direct channels. The majority of these resolutions have been favourable and have been limited specifically to the configurations submitted, with a view to ensuring that adequate endpoint authentication and data encryption mechanisms are in place to guarantee the authenticity and integrity of the data transferred.

As for other payment service provision-related procedures, there has been a significant increase in notifications of delegation of operational functions and substantial changes of activity, with the latter largely related to the digitalisation of money remittance services.

In 2020, work continued on the reporting of statistical data on fraud, following the amendment in January of the EBA Guidelines on fraud reporting (EBA/GL/2018/05) via the publication of EBA/GL/2020/01. This reporting entails the receipt, cleansing and submission to the ECB of half-yearly aggregated data for 285 payment service providers. Further, the Banco de España has participated in drafting the new ECB Regulation on payment statistics, which will include fraud reporting,

14 EBA Opinion on the elements of strong customer authentication under PSD2 (EBA-Op-2019-06).

15 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).

Box 2.10
NEW PAYMENT SERVICES BUSINESS MODELS

Royal Decree-Law 19/2018, which transposes into Spanish legislation the second payment services directive (PSD2), regulates two new payment services (payment initiation and account information) for the first time.

The inclusion of these two new services has encouraged the emergence of new and different business models, mainly for three reasons: the legal certainty afforded by the new regulatory framework, the competition stoked by the emergence of new providers and technological developments.

The new services are based on third-party providers (TPP) – payment initiation service providers and account information service providers – accessing users' payment accounts at other payment service providers. Such access, which requires the account holder's prior and express authorisation, under no circumstance grants the TPP access to the funds held in the account.

Turning to the account information service, business models incorporating a "fourth party" that has a business and contractual relationship with the TPP and the payment services user are becoming increasingly commonplace. In these fourth-party models, the information obtained by the TPP is not directly provided to the account holder. Instead, with the latter's authorisation, the information is provided to the "fourth party" so that it can offer the account holder certain additional services (e.g. financing, personalised offers, business services, etc.) whose swift and efficient provision would not be possible without the information provided by the TPP.

A prime example of these new business models would be using the payment account information of merchants' customers to feed credit scoring tools, thus enabling merchants to decide online about the possibility of financing their customers' purchases and the related financing conditions.

The possibility of combining the payment initiation service and the account information service has encouraged sophisticated forms of these services to emerge.

For example, business models geared towards managing firms' cash. Here, the ability to view online aggregate information about one or more payment accounts can be combined with the possibility of reacting instantaneously to that information, ordering payment transactions from the same interface used to view the information. Thus, instant access to all manner of personalised reports (forecasts, reconciliations, etc.) is enhanced by the opportunity to immediately take full advantage of that information through the appropriate fund movements.

Also, this business model may be used by both the firm benefiting from the aforementioned services, when it is the recipient of the information, and by providers specialising in this type of tool, which, with the firm's authorisation, would act as "fourth party" as described above.

Payment initiation service providers are improving the user experience by enabling payment at physical stores via the initiation of transfers that could be ordered through the payment initiator, by using QR codes for instance.

Lastly, there is no obligation to provide these payment services on an exclusive basis, which allows for business models where entities are their own providers of these services. An example of this would be insurance or management companies, where these payment services are used to more efficiently pursue the business or professional activities constituting their main corporate purpose.

However, given that this regulatory framework is relatively recent, the new business models are in their infancy and novel forms of interaction between the parties will likely emerge in the future.

along with the payments statistics manual, whose publication is scheduled for 2021 Q1, once the new Regulation has been published.

Internationally, the Banco de España has also been involved in revising the EBA Guidelines on major incident reporting under PSD2 (EBA/GL/2017/10), seeking to optimise and simplify the reporting process, whose publication is scheduled for late 2021. Other noteworthy work includes that relating to the EBA's PSD2 Q&A Network, which aims to foster a consistent interpretation of the more ambiguous concepts and aspects of the Regulation, including the Level 1 text, through the European Commission.

Lastly, the transposition of PSD2 gave rise to the regulation, for the first time in Spain, of new payment services: payment initiation services and account information services. Box 2.10 explains how these new services have generated new business models.