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TECHNICAL NOTE ON SUPERVISION OF SPANISH BANKS—SELECT ISSUES

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November 3, 2017

TECHNICAL NOTE

SUPERVISION OF SPANISH BANKS: SELECT ISSUES

Prepared By
Monetary and Capital Markets Department, IMF

This Technical Note was prepared by IMF staff in the context of the Financial Sector Assessment Program in Spain. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Please also see the Financial System Stability Assessment at
http://www.imf.org/~/media/Files/Publications/CR/2017/cr17321.ashx
Further information on the FSAP can be found at
http://www.imf.org/external/np/fsap/fssa.aspx

CONTENTS

Glossary 4

EXECUTIVE SUMMARY 7

INTRODUCTION 12

A. Scope and Approach 12

B. Institutional Setting 12

C. Market Structure 13

MAIN FINDINGS 14

A. Progress Since 2012 14

B. Banco de España and the Single Supervisory Mechanism 17

C. BdE's Powers, Independence, Resources 19

D. Supervisory Approach 25

E. Capital 33

F. Credit Risk and Problem Assets 37

G. Interest Rate Risk 42

H. Liquidity and Funding 44

I. Corporate Governance 46

J. Related Party and Intra-Group Transactions 47

K. Sanctioning Powers 48

L. Financial Integrity 50

RECOMMENDATIONS 52

A. Main Recommendations 52

B. Other Recommendations 54

BOX

1. Banks' Mortgage Floor Clauses 23

FIGURES

1. Fully-Loaded vs. Transitional CET1 Ratios 34
2. Banks' Reliance on ECB and Wholesale Funding 45

TABLES

1. Recommendations 10
2. Banks Operating in Spain 14

3. Implementation Status of 2012 FSAP Recommendations ____ 16
4. SREP Capital Decision: CET1 'Stacking' Order ____ 35

Glossary

AECR	Asociación Española de Cajas Rurales
AML	Anti-Money Laundering
AQR	Asset Quality Review
BBVA	Banco Bilbao Vizcaya Argentaria
BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principles for effective banking supervision
BdE	Banco de España (Bank of Spain)
BMN	Banco Mare Nostrum
BRRD	Bank Recovery and Resolution Directive
CC.AA.	Comunidades autónomas (autonomous regions)
CCB	Capital conservation buffer
CE	Comisión Ejecutiva
CFT	Combating the Financing of Terrorism
CG	Consejo de Gobierno
CIR	Central de Información de Riesgos (Central credit register)
CNMV	Comisión Nacional del Mercado de Valores (National Securities Market Commission)
COREP	Common Reporting (in the EU)
CRD	Capital Requirements Directive
CRE	Commercial real estate
CRR	Capital Requirements Regulation
DG	Directorate General
DGSyFP	Dirección General de Seguros y Fondos de Pensiones del Ministerio de Economía
DTA	Deferred tax assets
DTC	Deferred tax credits
EA	Euro Area
EBA	European Banking Authority
ECB	European Central Bank
EEA	European Economic Area
EU	European Union
EUR	Euro
EV	Economic Value
FATF	Financial Action Task Force
FHC	Financial Holding Company
FICOD	Financial conglomerate directive
FROB	Fund for Orderly Banking Restructuring
FSAP	Financial Sector Assessment Program
FX	Foreign exchange
G-SIB	Global Systemically Important Bank

GDP	Gross Domestic Product
ICAAP	Internal Capital Adequacy Assessment Process
ICAC	Instituto de Contabilidad y Auditoría de Cuentas (Institute of Accounting and Auditing)
IFRS	International Financial Reporting Standards
ILAAP	Internal Liquidity Adequacy Assessment Process
IMF	International Monetary Fund
IPS	Institutional Protection Scheme
IRB	Internal Ratings-Based approach
IRRBB	Interest Rate Risk in the Banking Book
IT	Information Technology
JST	Joint Supervisory Team
LABE	Law on the Autonomy of Banco de España
LCR	Liquidity Coverage Ratio
LOSS	Ley 10/2014 de ordenación, supervisión y solvencia de entidades de crédito (Law on the regulation, supervision and solvency of credit institutions)
LSI	Less Significant Institution
LTRO	Longer-term Refinancing Operations
MCD	Mortgage Credit Directive
MCM	Monetary and Capital Markets department
MDA	Maximum distributable amount
MdE	Ministry of Economy, Industry and Competitiveness
MFHC	Mixed Financial Holding Company
MEL	Minimum Engagement Level
MPE	Multiple point of entry
NCA	National Competent Authority
NII	Net interest income
NPL	Non-Performing Loan
NSFR	Net Stable Funding Ratio
O-SII	Other Significantly Important Institution
RAS	Risk Assessment System
RRE	Residential real estate
RWA	Risk-Weighted Asset
SAREB	Company for the Management of Assets Acquired from the Restructuring of the Banking System
SB	Supervisory Board (of the ECB)
SEP	Supervisory Examination Program
SEPBLAC	Servicio Ejecutivo de la Comisión de Prevención del Blanqueo de Capitales e Infracciones Monetarias
SI	Significant Institution
SME	Small and Medium Enterprise
SREP	Supervisory Review and Evaluation Process

SSM	Single Supervisory Mechanism
STE	Short Term Exercises data
TLTRO	Targeted Longer-term Refinancing Operations
TRIM	Targeted Review of Internal Models
UK	United Kingdom

EXECUTIVE SUMMARY

Banking regulation and supervision of Spanish banks has improved considerably since the 2012 FSAP. Swift and determined action addressed the major weaknesses that led to the accumulation of imbalances in the banking system in the period leading to the crisis. This was a result of several factors, including the authorities' commitment to implement the measures agreed at the time of the 2012 program for the restructuring and recapitalization of the banking system; the national transposition and implementation of European Union (EU) directives and regulations; and the establishment in 2014 of the Single Supervisory Mechanism (SSM) to which Banco de España (BdE) participates as a national competent authority (NCA).

Spain's participation in the SSM has placed the post-crisis progress on supervision of Spanish banks on firmer grounds. The joint ECB-BdE supervisory responsibilities on the largest players in the European and international financial markets allow, inter alia, a more insightful peer comparison and supervisory analysis of the significant Spanish banks. The SSM has equipped itself, since the start, with very structured methodologies and procedures, that place greater emphasis on governance and internal controls and a continuing dialogue with the banks at a senior management level.

As an NCA, the BdE has demonstrated its strong commitment to the SSM. Many of its experienced staff move to the ECB to take senior managerial roles in banking supervision. The BdE also contributes to other SSM operations, such as by participating in the Joint Supervisory Teams (JSTs), and directly supervising of less significant institutions (LSIs). The BdE also brings to the SSM its solid supervisory tradition, based on off-site reviews, combined with intensive programs of onsite inspections, and a strong emphasis on the review of asset classification and provisioning.

Further reforms are still needed as the transformation of the banking supervision function is far from complete. First, there are areas outside ECB's competence, such as the authorization of banks' mergers, which falls in the remit of the Ministry of Economy, Industry and Competitiveness (MdE), subject to mandatory opinions from BdE and other authorities, including—in the case of credit cooperatives and savings banks—the autonomous regions. The decision-making process on mergers should ensure that concerns of prudential and supervisory nature are not subordinated to non-economic considerations.[1] Second, there are other areas where powers and competences remain national (the detailed definition of fit and proper criteria). Compatible with the Spanish constitutional framework, the BdE could be granted broader autonomy—through appropriate legislative mandate—on updating prudential regulations in areas not yet harmonized at the EU or SSM level (unless these get harmonized because of legislative changes at the supranational level). Finally, while the BdE's independence is enhanced by its participation in the SSM, the national

[1] This could help avoid the kind of issues arisen during the saving banks crisis: as observed by the same authorities in their response to the 2012 FSAP-FSSA, "the fact that the Comunidades Autónomas exercised their power to approve the mergers of Cajas during the restructuring process significantly slowed down the process, given the need to hold long, complex and difficult negotiations with regional governments to reach adequate agreements."

legislation should grant the BdE full and unencumbered operational independence with respect to its supervisory function, in line with its independence as a central bank.

Actions to address misclassification and under-provisioning of assets have shown very good progress but oversight vigil must remain. A review of some onsite inspection and SREP reports shows that despite improvements the level of NPLs remain high. Supervisory vigilance should continue to be maintained, especially on the assessment of forborne loan classification and collateral valuations, and by seeking increased bank boards' attention to this area. The use of supervisory tools based on the analysis of appraisers' valuation should be further promoted as a support to 'en masse' offsite supervisory analysis of credit risk.

Banks' internal governance practices have improved since the last FSAP. The SSM has also placed heightened focus on governance and internal controls. However, this area remains work in progress, especially in the case of LSIs. Suitability of board members and their knowledge and skills (on internal audit and IT matters) need to improve further. Related-party requirements also need to be extended to all significant stakeholders and their interests.

The LSIs—viewed as less risky—are subject to a lighter touch with limited direct interaction with the BdE. No mandatory meetings with the bank's representatives are envisaged in the minimum engagement levels (MEL) of these LSIs. While a proportional approach might be justified on smaller and less complex banks, prudential and oversight vigil must remain. From this point of view, the BdE's decision to contain the gap between on-site inspection cycles is a step in the right direction.

A general obligation is missing for banks to communicate material changes or adverse developments to the supervisors. While this is legally required in certain specific circumstances—listed banks have their own communication obligations to the securities market regulator—with a rise of non-traditional sources of risks facing banks (fintech, conduct, cyber risks) swift communication with the supervisor is of paramount importance. A recent SSM initiative requiring banks to inform supervisors of any cyber incident is now in place. A general obligation to communicate material changes and adverse developments should be introduced in the legislation.

Retail orientation of Spanish banks business-model makes consumer protection and market conduct issues important areas for supervisory focus; these risks could spill over into the prudential realm. Incidents relating to the placement of preference shares, floor clauses, and mortgage fees bring along both financial, prudential, and reputational risks. Legal reforms have recently been adopted to foster consumer protection, and the ECB and BdE are closely monitoring banks' preparedness to the impact of 'floor clause' liabilities, one of the major consumer protection issues. The supervisors should continue monitoring the impact on banks of the most recent episodes, and further develop a pro-active approach to promptly identify emerging issues or possible future developments affecting banks.

Finally, in the LSI segment, the credit cooperative sector is long overdue for a fundamental reform.[2] Pointed out also in earlier FSAPS, the subsector is still fragmented. Its efficiency is challenged by its relatively higher operating costs (compared to other banks), limited opportunities to change the business model (which contributed to the cooperative bank sector's overall resilience during the crisis, but could now constrain its development), and its special ownership structure. The main goal of the reform should be to increase the resilience of this sector either via higher mutualization of losses, and/or the ability to raise capital in the market. The government initiative to incentivize higher mutualization of losses in the credit cooperative sector is welcome; should that prove not sufficient to induce an industry-driven reform, the authorities should consider compulsory schemes to achieve similar goals.

[2] The FSAP analysis of the credit cooperative sector is based on the information made available by the authorities. To a large degree, the FSAP team had to rely on the BdE. Also, the cut off period was May 2017. Thus, a view has not been taken on the new legal regime to strengthen credit cooperatives approved by the government on June 2017. The government initiative to incentivize higher mutualization of losses in the credit cooperative sector is a welcome one. The industry-driven approach of this reform is ideal, incentivizing the set-up of Institutional Protection Mechanisms (IPMs) with the aim of contributing to strengthening these institutions and establishing certain measures to boost their good functioning. Should an industry-driven initiative fail to materialize, the government could draw upon reforms of cooperative sector carried out recently by a few euro-area member states. The main goal should be to increase the resilience by either higher mutualization of losses, and/or the ability to raise capital in the market, should the need arise.

Table 1. Recommendations		
Main recommendations		
1. Ensure that in the decision-making process on mergers, concerns of prudential nature are not subordinated to others of non-economic nature.	MT	MdE
2. Compatible with the Spanish constitutional framework, grant the BdE autonomy in updating prudential regulations in areas not yet harmonized at EU or SSM level.	MT	MdE
3. Reinforce the requirement for banks to apply strict and accurate assessments when classifying loans, valuing collateral, and creating provisions (in line with the new provisions of Circular 4/2004, Annex IX), as well as ensuring that forborne loans terms are not too generous.	NT	ECB, BdE
4. Maintain and reinforce the monitoring of banks to ensure that they provision adequately against potential liabilities in litigation cases including mortgage 'floor clause' liabilities and fees incurred by mortgage customers at the commencement of the loan.	NT	ECB, BdE
5. Intensify the drive to improve corporate governance practices in banks, particularly in the LSIs and the credit cooperatives, as well as addressing weaknesses in the internal audit function.	NT	ECB, BdE
6. Require the LSIs to conduct periodic liquidity stress tests using the in-house liquidity stress test tool (FLESB) to cross check the results.	NT	BdE
7. Introduce a general obligation for banks to notify the supervisory authority, in advance, of all material changes in their activities, structure, and overall conditions.	MT	MdE
8. Reduce the heterogeneity of onsite practices at different levels: methodology (providing finer criteria to define the scope and depth of investigations, the modality of interaction with the bank), implementation (using the revision of inspection reports to further harmonize inspection styles), resourcing (to be able to have more missions headed by ECB staff and comprising staff from different NCAs).	NT	ECB
9. Extend related-party requirements on directors and senior management to cover major shareholders and significant interests held by such shareholders.	NT	BdE
10. Increase the number of AML/CFT inspections of banks particularly for the LSIs.	NT	BdE, SEPBLAC
Other Recommendations		
11. Streamline the recruitment process for inspectors, make it more flexible, and reduce the time needed for new hires to become operational.	NT	BdE
12. Further develop a pro-active stance on the potential prudential impact of conduct risk and consumer protection issues.	NT	ECB, BdE
13. Amend legislation to replace the MdE as the appeals body by an independent tribunal, on matters of appeal against BdE decisions.	MT	MdE

Table 1. Recommendations (concluded)		
14. Make more use of monetary fines as part of the sanctioning regime for credit institutions.	NT	BdE
15. Further the use of tools based on the analysis of appraisers' valuation for supervisory credit risk analysis.	MT	ECB, BdE
NT = Near Term (within 6 months / 1 year); MT = Medium Term (within 2-3 years)		

INTRODUCTION

A. Scope and Approach

1. This note presents a review of some select issues concerning the supervision of SIs and the LSIs in Spain. The review was carried out by a dedicated FSAP supervisory and regulatory team[3] who held discussions in Madrid, Spain on March 30–April 12, 2017 and May 9–18, 2017 and the European Central Bank (ECB) Banking Supervision, Frankfurt, on March 27–29, 2017.

2. The mission focused on select topics: the institutional setup of the banking regulatory and supervisory framework in terms of powers and responsibilities, independence, accountability, and resourcing; monitoring and analysis of supervisory risks, on/offsite surveillance approaches, techniques, and reporting tools at solo, consolidated, systemic, and cross-border levels. The team also held discussions on corporate governance, capital adequacy, credit risk and problem loan concentration risk and related party transactions, interest rate and liquidity risks, and abuse of financial services.

3. The IMF team wishes to thank the authorities and private sector participants for their excellent cooperation. The authorities provided a self-assessment of compliance with the 2012 Basel Core Principles, response to an FSAP questionnaire, and examples of actual supervisory practices. The review kept in view the findings of the 2012 FSAP for Spain on certain BCPs relevant from a financial stability perspective.

B. Institutional Setting

4. The MdE has broad-based responsibility to determine the bank regulatory framework, while the BdE is the national competent authority (NCA) for banking supervision within the SSM. The Governor of the BdE is appointed by the King based on a proposal by the President of the government, following a hearing of the Minister of Economy before the relevant parliamentary committee to report on the proposed candidate. The Deputy Governor is appointed by the government based on a proposal by the Governor and must meet the same conditions as the Governor (be Spanish and have recognized competence in monetary or banking matters). They are both appointed for a non-renewable six-year term. The law does not require that the reasons for removal of the Governor or Deputy Governor be publicly disclosed; however, there have been no cases of removal in the history of BdE.

5. The governance structure of BdE includes a Governing Council (Consejo de Gobierno, CG) and the Executive Commission (Comisión Ejecutiva, CE). The CG is composed of Governor, Deputy Governor, six elected Council members (with six-year term, renewable once), Secretary-General of the Treasury and Financial Policy and Vice-president of the National Securities Market

[3] The authors of this note are Pierpaolo Grippa (IMF) and Michael J. Deasy (IMF expert). Both were part of the Spain FSAP 2017 team, led by Udaibir S. Das. The note has benefited from discussions and feedback from the BdE, the Spanish Treasury, the ECB, and the reviewers ate the IMF HQ.

Commission (CNMV). It approves the general guidelines for the Bank's activities (including issuing Circulars and approving or imposing sanctions) and ratifies the appointment of the Directors-Generals. The Directors-Generals and a representative of the BdE's personnel attend CG meetings in a participatory but nonvoting capacity. The CE comprises the Governor, who acts as President, the Deputy Governor and two elected Council members. The Directors-Generals and the Secretary of the BdE attend the meetings in a participatory but non-voting capacity. Based on delegation of powers decided by the CE, the Deputy Governor is the BdE representative on the Supervisory Board (SB) of the SSM at the ECB. The CE and CG make decisions by simple majority (Art. 23(2) and 21(4) LABE). The Secretary-General of the Treasury and Financial Policy and the Vice-president of the National Securities Market Commission are permitted to vote when the CG takes decisions on all supervisory matters, including on LSI issues.

6. The BdE prepares its own budget, which is approved internally by its CG, then forwarded to the government, which submits it to the Parliament for final approval. The BdE remains accountable to Parliament through the submission of the yearly budget report, including the amendments of the initial budget and the appropriation of the credits. The 2017 state budget was approved by the Government on March 31, 2017 and has subsequently been submitted to the Parliament, where it was eventually approved on June 26, 2017.

C. Market Structure

7. The banking sector contracted sharply following the 2009–2013 banking crisis. Deleveraging of bank assets is continuing and number of banking institutions has fallen considerably following bank mergers and acquisitions, involving mainly savings banks;[4] still, the share of banks' assets in the financial sector remained approximately constant (around 70 percent). Despite the post-crisis contraction, the banking sector remains large in terms of GDP (almost 250 percent as of December 2016).

8. Spanish banks follow a universal banking model with a strong retail orientation, both on the asset and funding sides. As of end May 2017, 14 Spanish banking groups are considered significant institutions (SIs) within the SSM. They are subject to direct prudential supervision by the ECB, in collaboration with the BdE and, for those with cross-border operations, other relevant NCAs (Table 2). The two largest banks (Santander and BBVA) have most of their assets abroad and their foreign subsidiaries are systemically important in several countries. Three other banks have non-trivial foreign assets (Banco de Sabadell, Banco Popular and Abanca), whereas the rest are essentially domestically focused. Europe and Latin America form most non-Spanish exposures.

[4] The consolidation process is continuing. Since the cut-off date of this FSAP review of banking supervision topics, Banco Popular has been bought by Santander as a result of resolution, and the merger between Bankia and BMN, both controlled by FROB, has been approved by their Shareholder Meetings. Talks are underway for the consolidation of some other banks and credit institutions. Banco Santander announced on August 8, 2017 the sale of a majority stake in the real estate portfolio of Banco Popular, which would result in the deconsolidation of EUR 30 billion in real estate nonperforming loans and foreclosed assets from its balance sheet. Reportedly, this transaction is the biggest of its kind ever in Spain and one of the biggest ever in Europe. This operation could help reduce both the stock and ratio of NPLs in the Spanish banking system and may impact on the CET1 capital ratios.

9. There are 56 banks, entirely domestic, that are considered less significant institutions (LSIs) within the SSM and are directly supervised by the BdE under the oversight of the ECB. Among these, two savings banks and 43 credit cooperatives (while Banco de Crédito Social Cooperativo, the largest credit cooperative group, is classified as SI). Ten EA non-Spanish banks (seven SIs and three LSIs) and six non-EU banks operate in Spain through a subsidiary. Finally, there are 68 branches of euro-area (EA) banks operating in Spain (38 of SIs and 30 of LSIs), and 15 from outside the EA (of which ten branches are of U.K. banks and 5 branches of non-EU banks). The branches of non-EU banks fall outside the remit of the SSM.

Table 2. Banks Operating in Spain

	Spanish banks	Subsidiaries of …	Branches of …
SIs	54 (*)		
LSIs	56 (**)		
… other SSM SIs		7	38
… other SSM LSIs		3	30
… non-SSM banks		6	15

(*): 54 individual banks belonging to the 14 banking groups identified as SIs, of which one is a Credit Cooperative Group (Banco de Crédito Social Cooperativo), which includes 19 individual credit cooperatives
(**): of which 2 are Savings Banks (Cajas de ahorro) and 43 Credit Cooperatives (Cooperativas de crédito)
Source: BdE

10. Foreign banks are present through branches and subsidiaries. Foreign subsidiaries and branches engage in four main business lines: (i) retail, such as consumer loans and mortgages and captive lenders (banks financing the customers of the automotive or IT group they belong to); (ii) corporate banking, focusing on derivatives and syndicated loans (origination) and largely funded by the parent group; (iii) bilateral trade finance; and (iv) private banking business. For non-EU banks, it has been common to set up subsidiaries in the United Kingdom, Luxemburg, Germany, and Ireland, and then operate as a bank branch in Spain based on EU passporting rights. Subsidiaries and branches of SIs from the euro area operating in Spain are supervised by the ECB, while the BdE as the NCA directly supervises subsidiaries and branches of LSIs (with the ECB overseeing LSI supervision), and assumes sole responsibility in the supervision of non-EU banks' branches.

MAIN FINDINGS

A. Progress Since 2012

11. Banking regulation and supervision in Spain have improved significantly since the last FSAP in 2012. Many changes were promoted by the program agreed by the Government with the EC to restructure and recapitalize the troubled banks and to restore financial stability. Apart from the immediate measures—like the launch of an asset quality review (AQR) and the establishment of an asset management company (SAREB)—the changes included the transfer of licensing and

sanctioning powers to BdE,[5] a review of the framework on credit concentration and related party transactions, the transformation of savings banks into commercially operated banks owned by banking foundations.

12. Several significant EU Banking Directives came into effect since 2012. These include the Capital Requirements Directive and Regulation (CRD IV/CRR), which effectively transposed Basel III into European law, and the Bank Recovery and Resolution Directive (BRRD), which is designed to harmonize and improve the tools for dealing with bank crises across Europe and the Directive on Deposit Guarantee Schemes. The CRD IV has been transposed and certain aspects of CRR have been opted for in the Spanish legislation through: Law 10/2014 and Circular 2/2014;[6] and Royal Decree 84/2015 and Circular 2/2016.[7]

13. The BdE has taken several steps designed to improve practices among banks. It has updated its policies on the analysis and provisioning of credit risk, most notably in Circular 4/2016, which seeks to adapt its rules to recent accounting regulatory developments and the Basel Committee's Guidelines on credit risk management; it tightens the provisions relating to foreclosed assets. The BdE has also introduced some changes in the scope of the Central Credit Register. Other amendments introduced include changes in corporate governance, including rules on the assessment of the suitability of members of the management body and key function holders of credit institutions and other financial institutions; and consumer protection. Amendments have also been made in relation to recommendations made in the 2012 FSAP (see table 3) .[8] Much of this improvement has come about through the advent of the SSM and the transposition into Spanish law of CRD IV/CRR. Some issues remain, however, as discussed below.

[5] Licensing powers on credit institutions have then been assigned to the ECB with the start of the SSM, in 2014.

[6] In the Circular, the Banco de España exercises some of the permanent regulatory options, in general with a view to maintaining the treatment afforded by Spanish legislation to certain matters, justified in some cases by the traditional business model of Spanish institutions. The Circular also determines how institutions should comply with the transitional regulatory options envisaged in CRR, to permit gradual adaptation to the new requirements, and specifies the treatment to be afforded to certain matters up to the entry into force of the regulatory technical standards to be prepared by the European Banking Authority (EBA).

[7] The main new developments introduced by the Circular are: the use of the national option, whereby public-sector entities may receive the same weighting as the government to which they rely on; the regulation of certain matters that had not been transposed on the supervision of financial conglomerates; the mandatory characteristics of the supervisory review and evaluation process that the competent authority will perform; and the implementation of the regulation on capital buffers, internal governance and remuneration policy.

[8] At the time of the visit the BdE was preparing a report on the BdE role during the financial crisis, spanning the period 2000-2014, presenting the most important facts and proposing an explanation of the roots of the crisis and the response by the BdE and the other authorities involved. See http://www.bde.es/f/webbde/GAP/Secciones/SalaPrensa/NotasInformativas/17/presbe2017_11.pdf.

Table 3. Implementation Status of 2012 FSAP Recommendations

Recommendations	Status (Per Spanish Authorities)	IMF Observations
Change the legal regime to clearly prescribe the sole and exclusive roles of the BdE in prudential oversight of financial institutions, avoiding inconsistency in the division of responsibilities (MdE).	**Implemented by Law 10/2014.** The implementation of prudential rules has been done by the transposition of CRR-CRDIV. This transposition in Spain has been articulated in two stages: The first stage—comprising the more urgent changes required, including the exercise of certain options contained in the CRR—was completed, with the publication of Royal Decree-law 14/2013 and Circular 2/2014 of BdE and Circular 2/2014 of CNMV. The second stage involved the development of a Law (Law 10/2014), two Royal Decrees (Royal Decree 84/2015 and Royal Decree 358/2015) and the Circular 2/2016 of BdE.	Notwithstanding the establishment of the SSM and the implementation of CRD/CRR, there are still residual areas where the BdE does not have the sole and exclusive prudential role. For instance, the MdE is still responsible for authorizing mergers, carve outs or the transfer of assets and liabilities, in whole or in part, in which a bank is involved, or any other agreement that has similar or legal effects to the foregoing, together with the amendments to the constitutional documents deriving from them. The MdE consults the Banco de España in its consideration of such operations.
Amend legislation to give BdE operational independence in its supervisory function in line with its independence as a central bank (MdE).	**Implemented by Law 10/2014.** According with EU prudential rules BdE has operational independence in its supervisory function and, henceforth, BdE belong to the Single Supervisory Mechanism (SSM).	While membership of the SSM provides operational independence for the BdE, Spanish legislation has not been amended to confirm its operational independence in respect of its supervisory function, in line with its independence as a central bank.
Amend the current legal framework for banking supervision to provide BdE with effective powers to promulgate prudential rules and sanctioning (MdE, Government).	**Implemented**. Royal Decree Law 24/2012 and Law 9/2012 of 14 November 2012 on credit institution restructuring and resolution clearly separates the functions of BdE from those of the Ministry of Economy and Competitiveness in respect of the licensing and sanctioning of credit institutions, transferring to BdE those functions previously corresponding to the Ministry of Economy and Competitiveness on credit institutions. It came into effect on the 1st January 2013. In addition, Royal Decree-law 14/2013 modified Law 13/1994 of 1 June, by increasing the powers of BdE, to enable it to develop technical guidelines and binding answer queries, providing it with adequate instruments for interpretation and application of the rules of supervision. (Measures 13 and 24 of the MoU).	While sanctioning powers have been completely transferred to the supervisory authorities (BdE and, since the start of the SSM, the ECB), the BdE has not been provided with effective powers to promulgate prudential rules: as explained by the authorities, under Spanish constitutional arrangements an institution such as BdE cannot have an autonomous regulatory power. This is largely mitigated by the introduction, in the EU, of the single rule book (through the CRD/CRR and deriving regulation and implementing standards) and further reduced by the introduction, in the Euro Area, of the SSM, with its own regulation and with the centralized exercise, by the ECB, of all options and national discretions granted by the CRD/CRR to competent authorities.

Table 3. Implementation Status of 2012 FSAP Recommendations (concluded)		
Recommendations	**Status (Per Spanish Authorities)**	**IMF Observations**
Require banks to value their real estate portfolios more frequently, especially during economic downturns, to ensure rapid adjustments to provisions (BdE).	**Implemented.** The abovementioned accounting Circular (Circular 4/2016) of BdE requires a more frequent update of the valuation of collaterals (i.e., annually for impaired loans).	The October 2016 revision of Annex IX of Circular 4/2004 has introduced the obligation to update the valuation of real estate collateral with given frequencies: • annual appraisal for all doubtful and foreclosed assets above EUR 250,000 and standard non-RRE/CRE exposures under special monitoring; • all doubtful and foreclosed assets below EUR 250,000 and standard non-RRE/CRE exposures need to be re-appraised every 3 years (and the latter even more frequently if a fall in the price is observed); • at least annually, statistical updating needed for all doubtful and foreclosed assets below EUR 250,000, for standard RRE/CRE exposures under special monitoring that exceed certain volume/risk thresholds and/or whose price has fallen, and for RRE/CRE standard exposures if a fall in the price is observed.

B. Banco de España and the Single Supervisory Mechanism

14. The responsibility of the BdE for the prudential supervision of the banking sector has changed substantially with the introduction of the Single Supervisory Mechanism (SSM). The creation of the SSM was prompted by the Euro area crisis in Europe and the desire to build a supra-national authority to promote a safer European banking system in the currency union.

15. As the first pillar of the European banking union,[9] the SSM comprises the ECB and the national competent authorities (NCAs) of the participating countries (currently only the members of the euro area). In November 2014, the ECB assumed responsibility for the supervision of the euro area banking system. The ECB directly supervises 'significant institutions' (SIs): 120 banking groups (comprising around 1,000 banks) headquartered in the 19 Euro Area (EA) countries—including eight global systemically important banks (G-SIBs) and covering more than 80 percent of EA banking assets. The remaining banks (Less Significant Institutions or LSIs, around 3500 in number) continue to be directly supervised by NCAs, although the ECB maintains oversight responsibilities relating to the performance of the NCA's supervision of the LSIs and ensures the overall well-functioning of the SSM. NCAs (or other national authorities) also continue to be

[9] The other two being a common framework for recovery and resolution (in the form of the Single Resolution Mechanism and Single Resolution Fund) and for deposit protection (at the moment limited to EU-wide harmonization of national schemes).

responsible for the supervision and regulation of consumer protection, payments systems, and AML/CFT in both SIs and LSIs.

16. The objective of the SSM is to contribute to the safety and soundness of the European banking system and the stability of the financial system within the union and each member state, and ensure effective and consistent supervision across the EA. Within the SSM, the ECB's role is to establish a common approach to supervision and to foster the consistent application of regulations and supervisory practices across SSM countries, particularly by directly supervising SIs. For LSIs, the ECB carries out an oversight function to promote a more consistent supervisory approach across the SSM. As part of this oversight function, the ECB further provides its views on draft material supervisory decisions on certain LSIs, which are to be notified by NCAs to the ECB before their adoption.

17. The Supervisory Board (SB) comprises the Chair and Vice-Chair, four representatives of the ECB, and all heads of banking supervision in NCAs.[10] According to the SSM institutional setup, rooted in the EU treaties, the SB has no formal decision-making powers, but proposes complete draft decisions for adoption by the Governing Council of the ECB (GC), which comprises all EA central bank governors.[11] The Supervisory Board and Governing Council meet on average twice a month for the adoption of supervisory decisions.

18. Day-to-day supervision of significant groups is conducted by Joint Supervisory Teams (JSTs), supported by the ECB's horizontal and specialized divisions. The ECB has responsibility for the size and composition of JSTs and on-site inspection teams. The size, overall composition and organization of a JST vary depending on the nature, complexity, scale, business model and risk profile of the supervised institution. Each JST is led by a Coordinator at the ECB (who is generally not from the country where the supervised institution is headquartered) and the team is made up of ECB and NCA[12] staff (with NCA staff generally representing the largest component of JSTs) managed by one or more local sub-coordinators. The ECB component of the JSTs is allocated in two Directorates General (DG-MS1 and DG-MS2), while all the horizontal functions (e.g., Internal Models, Onsite Inspections, Authorizations, Crisis Management, Methodologies, Risk Analysis) are allocated in another Directorate General (DG-MS4).

19. The ECB banking supervision's Directorate General (DG-MS3) is entrusted with the oversight of NCAs' supervision of LSIs. Its main mission is to promote consistent and effective supervision of LSIs across NCAs. If necessary to protect the interests of the SSM, the DG can propose to the Supervisory Board that the ECB assume direct responsibility for the supervision of an LSI. This option has never been activated so far. The DG carries out its tasks in a proportionate and

[10] Where the NCA is not a central bank, the respective NCA member may bring a representative from the central bank; for the purpose of voting, the representatives of one member state shall be considered as a single member.

[11] Under the non-objection procedure, the decisions are deemed adopted unless the GC objects within a maximum of 10 days.

[12] From the member state in which the bank is active.

collaborative manner, through regular interaction with NCAs and risk-based oversight of LSIs (especially the most relevant ones, so called 'high priority' LSIs or HPLSIs)[13] and of NCAs' supervisory activity. The DG also includes a unit in charge of licensing and approval of qualified holdings for LSIs.

20. BdE has embraced since the beginning the SSM efforts to support the banking union and harmonize supervisory standards across the EA. Some 80 staff have taken positions within the banking supervision area of the ECB (including a director general and two deputy director generals, out of the ten senior management positions in the SSM). This has represented a major challenge for BdE in terms of human resources, especially in view of the necessary adaptation to new common procedures and methodologies, the need to use English as the official language, and the significant regulatory changes in the banking sector in recent years. BdE has responded to this challenge by intensifying its training program and adapting its recruitment strategy (more below).

21. The internal organization of BdE's DG Banking Supervision has been revamped to broadly mirror that of the ECB. Two departments have been created for SIs, with the four largest ones (followed at the ECB by DG-MS1) assigned to the "Inspección I" department of BdE and the remaining SIs (followed at the ECB by DG-MS2) assigned to the "Inspección II" department. The "Inspección III" department follows the offsite and onsite activities on LSIs (and on other financial institutions under BdE's oversight), while the horizontal activities that in the ECB are concentrated in the DG-MS4, within BdE are split between the "Inspección IV" department (onsite inspections on SIs, risk and internal model specialists and technological innovation) and a Planning and Analysis department in charge of supervisory planning, methodologies, IT support, analysis of regulation and supervisory policies. A unit reporting directly to the Director General has been specifically created for the technical coordination with the SSM.

22. Collaboration between the ECB and BdE as a NCA is considered productive and functioning well by both sides. Even when situations of tensions or disagreement have emerged (as can be expected in such an intense cooperation effort), they have been addressed in an appropriately collaborative spirit.

C. BdE's Powers, Independence, Resources

Powers

23. The Spanish banking supervisory system is governed by several key pieces of legislation. These basically include Law 13/1994 (as subsequently amended)—Law on the Autonomy of the Banco de España (so called "LABE"), and those laws and regulations which implement EU legislation, notably CRD IV and CRR, namely, Law 10/2014 (on the regulation, supervision and solvency of credit institution, so called "LOSS"), Circular 2/2014, Royal Decree 84/2015 and Circular 2/2016.

[13] Banks with total assets above EUR 500 million are designated HPLSIs according to their intrinsic riskiness (as expressed by the RAS score) and their impact on the domestic financial systems (subject to the condition of identifying at least three HPLSIs from those countries where LSIs represent no less than 15 percent of total assets).

24. Within the SSM, BdE is the sole NCA for prudential regulation and supervision of depository institutions in Spain. In this respect, the finding of the 2012 FSAP of a concurrent responsibility with other public authorities (like the autonomous regions, or CC.AA.) has been largely overcome, though not completely.

25. There are still a few residual areas where BdE does not have the sole and exclusive prudential role. For instance, the MdE is still responsible for authorizing mergers, carve outs or the transfer of assets and liabilities, in whole or in part, in which a bank is involved, or approving any other agreement that has similar or legal effects. In its consideration of such operations, the MdE requests a report from BdE (and from other authorities, including the CC.AA. for credit cooperatives and the two residual savings banks). Also, the CC.AA. still retain certain corporate governance powers such as being able to determine the number of assembly meetings of cooperative banks and can start a proceeding against cooperative banks for breaches of obligations that fall under the remit of the CC.AA.

26. BdE has still no effective powers to promulgate prudential rules. Normally, a law empowers the Government or a Minister to rule on a certain matter (by means of a Royal Decree or a Minister Order), which subsequently may, within the scope of such delegation and if deemed necessary, expressly empower BdE to further develop the regulation by means of a Circular. As such, the direct granting of regulatory powers by way of law—and not through a legal act of the Government or a Minister—to BdE is rather exceptional. Depending on the delegation contained in the law or Royal decree, BdE might enjoy some flexibility to update the regulation. In some cases, the delegation rule entitles BdE to issue technical criteria (Circular) and to change and update the Circular without any additional permission from the government or from the parliament. In other cases, certain aspects are ruled in the Law/Royal Decree/ministerial order and cannot be changed by BdE without a previous amendment of the higher rank legal text. While this lack of full autonomy in issuing regulations is largely mitigated by the introduction, in the EU, of the single rule book and further reduced by the introduction, in the Euro Area, of the SSM, for those residual areas that still fall under the competence of NCAs (e.g., fit and proper criteria for LSIs outside the context of licensing and qualifying holding authorizations)[14] the situation has not changed since 2012.

27. Banking accounting rules are under BdE's responsibility. The MdE may authorize BdE, CNMV or ICAC (Institute of Accounting and Auditing) to establish and amend the accounting rules and formats for banks and banking groups (art. 84 LOSS). Currently the standard-setting powers on bank accounting are conferred on BdE, that regulates the matter through its Circular 4/2004.

28. National accounting principles for Spanish banks are closely aligned with IFRS. The only significant divergence from IFRS is represented by the amortization of goodwill, that is subject to deterioration test under IFRS and to linear amortization under the BdE Circular (but only on a solo basis). BdE expects no effect on own funds, as goodwill is deducted anyway. Verifications made by

[14] The ECB applies national law transposing CRDIV in the assessment of the members of the management body of significant supervised entities. Spain has adopted the EBA Guideline on the assessment of the suitability of members of the management body and key function holders, by including it into national regulation in the Royal Decree 256/2013.

BdE showed no significant divergence in practice, as goodwill mostly materializes at the consolidated level.

29. The banking foundations created at the time of the savings banks crisis are subject to BdE´s supervision and sanctioning power on certain prudential issues. BdE oversees the compliance with the rules on the management protocol of banking foundations and on their financial plans. For non-prudential issues, banking foundations are subject to the MdE if they operate in more than one autonomous region or to the CC.AA. in case of operating in only one. The MdE has supervisory responsibilities with respect to the social purposes of foundations (a type of nonprofit organization).

30. BdE's sanctioning powers with respect to Spanish individuals and entities who control credit institutions in other EU member states are established by article 89 of Law 10/2014. The sanctioning powers may extend to natural or legal persons who, being of Spanish nationality, control a credit institution in another European Union Member State, as well as to those acquisitions subject to the notification obligation laid down in Article 17 of the same law; this is a specific feature of the Spanish legislation, not stemming from EU laws. Furthermore, the sanctioning powers extend to (i) branches opened in Spain by all foreign credit institutions, (ii) financial holding companies, mixed financial holding companies and their directors and executives, (iii) all other institutions provided for under the legal system—when the Law may state that, and (iv) those third parties to which the previously mentioned institutions have outsourced operational functions or activities.

31. Holding companies are not subject to authorization. However, if they are parents of a consolidated banking group and meet the definition of a financial holding company (FHC) or a mixed financial holding company (MFHC) (article 4 CRR), they are subject to supervision on a consolidated basis as the parent of the group (Article 82 Royal Decree 84/2015).[15]

32. BdE may ask for information from an FHC or MFHC, and also from a mixed-activity holding company. The legal basis is in article 50 of LOSS for entities under BdE´s supervision (as it is Article 10 of the SSM Regulation for SIs). This applies also in case of subsidiaries excluded from the prudential consolidation under the article 19 of CRR (according to article 82 of Royal Decree 84/2015 in case of FHC or MFHC and article 83 of the same decree in case of mixed-activity holding companies and their subsidiaries). BdE may also carry out onsite inspections (or have them carried out by auditors) to check information received from mixed-activity holding companies and their subsidiaries (Article 83 Royal Decree 84/2015) even located in another Member State—in cooperation with local authorities (Articles 87 and 89 Royal Decree 84/2015).

33. Board members of FHC and MFHC are subject to fit and proper tests. The assessment criteria include management skills and experience, reputation, time commitment, and possible conflicts of interest.

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[15] This is the case of Criteria Caixa (holding of CaixaBank), BFA Tenedora De Acciones (holding of Bankia), ABANCA Holding Financiero (holding of Abanca), and Asesores y Gestores Financieros (holding of A&G Banca Privada, an LSI).

34. There is no general obligation for banks to communicate to BdE any substantive changes or materially adverse developments beyond the circumstances explicitly stated in the laws and decrees. Some examples are the law 10/2014, which requires banks to notify to BdE as soon as they become aware of any acquisition or disposal of holdings in their capital that cross one of the thresholds established by the same law (art. 22), and the Royal Decree 84/2015, which requires banks to communicate immediately to BdE any deficit of eligible own funds according to applicable regulations (art. 57). In addition, every listed company and every firm who issues securities traded in secondary markets in Spain is obliged to report any relevant fact to the securities market regulator (CNMV).[16]

35. A type of adverse development that has become increasingly frequent for banks in recent years is represented by cyber-attacks. There is no legal obligation for banks to report cyber incidents. The financial entities that are considered as critical infrastructures can communicate these incidents to the INCIBE (National Institute of Cybersecurity) acting as CERT (Computer Emergency Response Team); the communication to the CERT will become mandatory for all entities considered critical infrastructures once the European Directive on Networks and Information Systems is transposed (before May 2018). The SSM will soon launch a procedure for SIs to communicate all cyber incidents directly to the ECB. Depending on the severity of the incident the ECB may partake in the crisis management team.

36. Article 5 of Law 10/2014 entrusts BdE with the responsibility for the supervision of the relevant banking consumer protection rules. The MdE is in charge of issuing the relevant regulation. Its implementation is in the responsibility of the Market Conduct department within the General Secretariat of the BdE, composed of three divisions in charge, respectively, of dealing with complaints by customers, of transparency and market conduct regulations, and of supervising compliance with these rules (both onsite and offsite); the latter division comprises 32 staff and conducted 17 inspections in 2016. BdE is responsible for the supervision of consumer protection rules relating to banking products and services, while for financial instruments CNMV is the relevant competent authority. The MdE is working at the transposition of a few EU Directives aiming at ensuring banking consumers' protection (Directive 11/2013 on Alternative Dispute Resolution, Directive 2014/17 on Credit Agreements for Consumers relating to residential immovable property, Directive 92/2014 on the comparability of fees related to payment accounts, payment account switching and access to payment accounts).

37. Decisions aimed at defending the interests of banking customers may prove relevant from a prudential perspective. Conduct and customer protection issues, in general, can impact banks' reputation and profitability (via customers' redress and/or fines) and, ultimately, their solvency too (see Box 1). The Government's decisions on the future architecture of financial sector oversight and on how to allocate the responsibilities for customer protection and conduct supervision will likely matter also from a prudential perspective.

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[16] At the time of the assessment, equities of nine banks were traded at the Spanish Stock Exchange; eight of these and other six banks also had bonds traded in the market.

Box 1. Banks' Mortgage Floor Clauses

In the past, most Spanish banks used embedded floor clauses in their mortgage loans. These clauses limited the reduction of floating loan rates in response to drops in market benchmarks. In 2013 the Spanish Supreme Court ruled against some of these clauses because of lack of transparency. In its decision, the Supreme Court excluded the retroactive application of its ruling. However, in December 2016 the European Court of Justice ruled against this limitation on grounds of incompatibility with the EU law. To favor the identification of private solutions, the Spanish government issued in January 2017 a Royal Decree-Law that established an out-of-court settlement procedure for credit institutions to deal with their customers' claims. Under both IFRS and national GAAPs, banks are required to provision against the potential redress of customers, based on their best estimate.

JSTs of Spanish SIs engaged with them to get an understanding of the likely impact of the floor clauses' redress. In particular, JSTs collected information about different client segments (based on the ex-ante likelihood of raising claims and accepting out-of-court settlements); they asked banks to provide both the maximum possible amount to be reimbursed (worst case scenario) and their own best estimates; they analyzed the underlying assumptions for the calculation of best estimates; they engaged both the external auditors and heads of internal audit committee to hear their opinion about the banks' best estimates; they identified the outliers and contacted them to ask for explanations about their estimates; they are monitoring quarterly the evolution of customers' claims and consequent redresses.

Similarly, BdE requested the LSIs affected by this type of claims to provide related information. This comprised: maximum gross impact of amounts to be reimbursed, including possible interests on arrears; maximum gross impact of amounts to be reimbursed, including possible interest on arrears but excluding those in which the entity had negotiated a settlement with the client; banks' best estimates, considering the bank's portfolio and its experience with complaints received; provisions to be allocated by end 2016 to deal with the reimbursements. BdE analyzed the impact on banks' CET1 ratios in different scenarios and concluded that, in the worst scenario, only two LSIs would fail to comply with their overall requirement (Pillar 1 + Pillar 2 + CCB buffer) as of December 2016,

The transposition of the EU Mortgage Credit Directive (MCD), with additional provisions introduced by the Spanish authorities, will enhance the transparency of retail mortgage contracts. Lenders are already obliged to provide borrowers with a standardized pre-contractual information sheet and, in case of variable rate and/or FX loans, with a separate document with a special reference to the periodic installments to be met by the client in different interest rate evolution scenarios; these will be brought in line with the Directive's indications. As an additional measure (not envisaged by MCD), the proposal introduces the requirement, for lenders, to provide clients with a standardized warnings document, attached to the information sheet, informing them of the existence of relevant clauses or contractual elements (floor clauses, early expiration options, allocation of expenses associated with the granting of the loan and with loans in foreign currency) and of the risks associated with them.

Independence

38. The 2012 FSAP recommended strengthening the BdE's independence. At that time, the IMF assessors found no evidence of government or industry interference in the operation of supervision, but observed that the involvement of political bodies (such as the CC.AA.) in licensing, sanctioning, and resolution created a potential for such an interference. They also observed that the presence of the Secretary General of the Treasury in BdE's CG was not conducive to independence.

39. The Secretary-General of the Treasury and Financial Policy represents the government in the BdE's CG. The Minister of Economy or the Secretary of State for Economy may also attend the meetings of the CG, as participating but non-voting members, when they consider it necessary in the light of the importance of the matters under consideration and they may also submit a motion for consideration by the Governing Council. The Minister attended a Council meeting only on one occasion when he was invited in June 2013 about the establishment of the Financial Stability Council. Neither the Minister nor the Secretary of State ever submitted a motion for consideration.

40. Legislation has not been amended to give BdE operational independence in its supervisory function in line with its independence as a central bank, as recommended by the 2012 FSAP. Even if, in practice, BdE appears to have operational independence in carrying out its supervisory function, the case for formally reinforcing the BdE's independence as a supervisor remains valid. This could be achieved by preventing the representatives of the government from participating in the decisions on supervisory issues, including the nomination of senior supervisory staff and the allocation of supervisory budget.

41. The MdE is the appeals body for submissions by aggrieved parties against BdE decisions, including sanctions.[17] Such an appeals mechanism has the potential, at least in theory, for government interference. In many jurisdictions, the appeals mechanism involves an independent tribunal, independent of government or industry influence.

Resources

42. The depletion of skilled resources at the BdE because of SSM implementation has been addressed through an intensification of the recruitment process for supervisors ("inspectors"), although this has not been sufficient. The increased need of personnel (to work on SIs in JSTs, on LSIs, and to coordinate with the ECB) has been addressed in part by increasing the number of inspectors recruited every year (from the traditional 12–15 to around 25), and in part, by hiring analysts with fixed term of 3 to 5 year contracts (around 100 in the last two years). With respect to a "theoretical" headcount of about 500, the Directorate General for supervision is currently understaffed by about 20 people, with the shortage of personnel concentrated in the "Inspección II" department, Planning and Analysis department and, even more, the "Inspección III" department; BdE estimates that in about four or five years, the DGs' permanent staff numbers will once again be at full capacity. In some cases, inspection teams have been partially staffed (by the ECB) with personnel

[17] Under Spanish law, there is also always the possibility to appeal before the Contentious-administrative Courts.

from auditing firms (in junior positions within the team); this represents an innovation with respect to the tradition of BdE, which had never worked before in teams partially composed of external experts to conduct supervisory activities.

43. Traditionally supervisory personnel ("inspectors") at BdE are recruited through a very rigorous and lengthy process. The selection process for inspectors entails several exams such as written tests on financial mathematics, statistics, law, accounting, and the Spanish financial system; an exercise on balance sheet analysis; written and oral tests on the English proficiency; an essay on the financial system followed the day after by a discussion of the same topic before a panel. The whole process spans approximately a six-month period (including the minimum disclosure times BdE is subject to as a public institution) and is considered very demanding.

44. Successful candidates gain access to a full time 10-month educational course ('master') on supervisory matters. The course's program includes macroeconomics, statistics and econometrics, accounting and bank auditing, financial products and markets, commercial and banking law, bank risks, and financial supervision; it is conducted by teaching staff of renowned academic institutions, practitioners from the financial sector and BdE professionals. Approximately 25 percent of the course is delivered in English.

45. This very rigorous recruitment process guarantees the high quality of BdE's inspectors and is, understandably, a source of pride for the supervisory personnel. At the same time, it entails an extremely long time span until new recruits are assigned to their units and start working (about 18 months), which represents a non-negligible cost to BdE, in terms both of new hires being non-productive in that time span and of existing BdE personnel being absorbed by the recruitment and training activities. In a phase when pressure on resources is so intense, the question is whether, from a cost-benefit perspective, such a cost is justifiable or other solutions could be envisaged with a reduction of the time-to-job for new hires.

46. BdE has adopted an Ethics Code mirroring the ECB one and has specific rules for personnel leaving the institution to be hired by supervised entities ("cooling-off"). Managers and officers involved, in the previous six months, in supervisory tasks or inspections of a bank must wait one year before joining that same bank or six months before joining one of its direct competitors. The cooling-off period is halved for other staff (i.e., below officer). For managers and officers having worked, in the previous six months, in the General Secretariat or in the Directorates General for Banking Supervision, Financial Stability, Research, Monetary Operations, Markets and Payment Systems, International Affairs, the cooling-off period is six months; for all other BdE staff, it is three months.

D. Supervisory Approach

Overall Process

47. The supervisory "production cycle" is typically annual and is based on a Supervisory Examination Program (SEP) tailored individually to all SIs (by their JSTs) and to the most

relevant LSIs (by BdE). The starting point for supervisory planning is represented by the identification of the supervisory priorities. For the years 2017 and beyond, thematic reviews are planned on banks' business models and profitability drivers, their preparedness for IFRS 9 (loan loss provisions based on expected losses), compliance with the BCBS' principles on risk data aggregation and risk reporting, outsourcing.

48. The SEP establishes Minimum Engagement Levels (MEL). For SIs, DG-MS4 proposes a bank-by-bank MEL based on the supervisory priorities and on the overall risk level and cluster of each bank. The MEL includes regular tasks (including a minimum level of engagement with the banks' governing and supervisory bodies and with their management) and thematic reviews; the JST specifies some of the tasks (e.g., deep dives) and, if needed, adds further tasks; the SEP is then approved by the management of the responsible Directorate General (DG). The SEP is defined towards the end of each year, but further ad-hoc (non-SEP) tasks can be added on an ongoing basis, should the need arise.

49. The implementation of SEPs for SIs is monitored on an ongoing basis. This happens at different levels, within each JST, at the DG level, or by DG-4. Practically, the process includes identification of a specific risk, follow-up interaction with the bank (e.g., notification letter) or further investigation by the SSM (e.g., request and execution of an onsite inspection, followed by a follow-up letter), development of detailed deadlines for banks to respond, and monitoring of the progress of remedial actions.

50. The main task in the SEP is the Supervisory Review and Evaluation Process (SREP). Established by Art. 97 CRD as a major task for supervisory authorities, the SREP is further detailed in a number of other documents, mainly the EBA's 2014 Guidelines on common procedures and methodologies for the SREP[18] and the 2015 Implementing Technical Standards (ITS) on joint decisions on prudential requirements. It represents a structured framework for a holistic annual assessment of banks across the SSM, aimed at providing a synthetic overview of each bank's risk profile, considering its capital and liquidity planning in terms of both its internal consistency and comparison with peers. The overall SREP represents the basis for assessing capital and liquidity adequacy and for addressing concerns by taking supervisory measures of both quantitative (on capital and liquidity) and qualitative nature.

Supervisory Approach to LSIs

51. BdE has adapted its supervisory planning to the new SSM framework, which envisages a common methodology for all LSIs across the EA. BdE subjects its LSIs to two different types of monitoring—ordinary or simplified, depending on the size, complexity, RAS score and supervisory priority for each entity. The choice impacts the nature and number of tasks and the way they are performed.

[18] EBA/GL/2014/13.

52. The MEL for LSIs under ordinary monitoring also envisages a minimum level of engagement with the banks' senior management. Typically, BdE would hold annual meetings with chief officers, sometimes accompanied by the Chair of the board of directors. The supervisors challenge banks' boards and/or senior management with respect to their entities' strategy and business model. BdE examiners rely on a bank's internal audit findings as part of their onsite assessments. Examiners might ask for the list of reports, and sometimes offsite supervisors ask for internal audit plans.

53. Regular engagement with the external auditors is part of the SSM supervisory approach. Based on feedback received, the IMF mission found that communication of external auditors with both BdE and ECB is perceived as fluent, and trust between supervisors and external auditors has generally increased. Supervisors and external auditors meet at least once per year to discuss banks' corporate governance (e.g., how to increase professionalism within Boards), internal controls, and internal audit.

54. For LSIs subject to a simplified monitoring system, the objective is to summarize their main ratios and data to identify the entities most likely to be in trouble. All LSIs under simplified monitoring are subject to an annual SREP decision, their risk profiles are also evaluated in the assessment of the ICAAP report (annually), and recovery plans for 2016 were analyzed for all of them. The warning signal about possible troubles is triggered by breaches of certain thresholds, based on legally binding rules or supervisory experience. Around 70 percent of the non-SI entities (LSIs and non-SSM branches), representing around 2 percent of total assets of the banking system, are under simplified monitoring; 19 entities are under ordinary monitoring. When the monitoring gives rise to an alert that is considered problematic, BdE can take several possible actions such as requesting additional information, notifying the entity about its weakness and asking it to solve it, conducting an ad-hoc onsite inspection, and undertaking supervisory actions.

55. LSIs under simplified monitoring are subject to less direct interaction with the supervisors. No meetings with the bank's representatives are envisaged in their MEL—though regular meetings with senior managers took place for nearly 60 percent of them during 2016. Based on BdE's current internal regulations, onsite inspections traditionally occur at time intervals no longer than four years; the maximum time interval between subsequent inspections could be raised to 10 years for LSIs under simplified monitoring, according to SSM standards. However, the intention of BdE is to maintain the current frequency.

56. A reduced supervisory intensity on smaller and less complex banks, signaled as low risk by the alert system, is certainly justifiable in terms of both proportionality and efficient prioritization, especially considering resource constraints. However, there is a limit in how far this simplification can be pushed; as demonstrated in several cases during the crisis, a failure doesn't need to concern a systemic bank for the trust of the public in the banking system to be undermined. A supervisor might want to avoid the risk of being perceived, ex-post, as having not been sufficiently intrusive—and, ultimately, effective—in the case of failure by a small bank, even absent any relevant consequence for financial stability. Quantitative alerts are not sufficient to detect all forms of deterioration in a bank's performance and cannot substitute for the kind of unstructured but rich

information a supervisor obtains by interacting personally with the bank's board, managers and staff. From this point of view, the BdE's decision to avoid an increase in the maximum time interval between subsequent inspections is considered appropriate.

57. The ECB is developing a common SREP methodology for LSIs; BdE participates in the project. The model is based on that for SIs with adaptations inspired by the proportionality principle (e.g., shorter list of questions on corporate governance). A common RAS has already been developed and approved by the SB while a field testing and trial period is ongoing, as is the development of criteria for the quantification of capital and liquidity. It entails minor changes to the existing BdE SREP framework (e.g., in the risk matrix), but is otherwise similar.

Credit Cooperatives in Spain

58. Traditionally corporate governance has been relatively weak in the credit cooperative LSI sector. Some of these weaknesses relate to the nature of cooperatives, and others to specific issues relating to credit cooperatives. A typical weakness relating to the nature of cooperatives is the low level of member participation which can result in boards remaining unchallenged for long periods. It can also result in long tenure-ships of office on the part of individual directors and the absence of up-to-date banking expertise and diversity. In the case of some cooperatives in more remote areas, there is an insufficient pool of suitable board candidates.

59. In relation to credit cooperatives, several weaknesses were identified through a review of documentation provided by the BdE to the FSAP team, and discussions with relevant parties. These are:

- General lack of awareness of good corporate governance in some institutions;
- Relatively low number of independent members in the boards of directors;
- An underdeveloped risk culture in some institutions;
- Board documentation being dispatched to directors too close to annual meetings;
- Inadequate recording of board and board committee meetings;
- Insufficient succession planning at senior level;
- Board committees (e.g., audit committee) being staffed by persons with no or limited financial experience.

60. The current shareholding structure of cooperatives also lacks clarity. Capital is subscribed by members but there appears to be a lack of awareness on the part of some members that their subscriptions are capital and not deposits. Credit cooperatives can release up to 2 percent of capital by way of redemption each year subject to board approval. Any distribution requires the approval of BdE. BdE has advocated since 2013 the need to apply to the commercialization of shares the same analysis as for MiFID products.

61. Shares in credit cooperatives are not seen as financial instruments and are therefore not subject to MiFID rules. To address this anomaly, the credit cooperatives have established rules, consistent with best international practice, about share ownership. Each of the members has an information document, like a prospectus, which highlights all potential risks relating to share ownership. Each prospective purchaser of shares must sign a statement that he/she/it understands and acknowledges such risks.

62. The level of nonperforming loans in the cooperative sector is higher than that in the banking sector. At end December 2016, it stood at 8.7 percent compared to 6.1 percent for all banks. This compares to a figure of 10.2 percent (6.6 percent for all banks) at end-December 2015. Within the figure of 8.7 percent, NPLs in respect of residential mortgages amounted to 5.4 percent (the same as for the previous year) and 11.7 percent for all other loans, down from 14.5 percent in 2015. Foreclosed assets in the cooperative sector amounted to EUR 5.0 billion at end-December 2016 compared to a figure of EUR 79.3 billion for all banks. The corresponding figures for 2015 were EUR 4.5 billion and EUR 81.7 billion respectively. The coverage ratio (the ratio of bad debt provisions to total NPLs) was 55.2 percent at end-December 2016, down from 60.4 percent the previous year.

63. Net income for the cooperative sector in 2016 was EUR 457 million. This compares to a figure of EUR 443 million in 2015. In terms of profitability, the return on equity for the cooperative sector in 2016 at 4.3 percent was largely the same as that for all banks—4.4 percent. Total capital amounted to EUR 15 billion of which 94 percent was in the form of Tier 1. Regulatory capital as a percentage of risk weighted assets was 15.1 percent (14.8 percent for all banks). The corresponding figure for 2015 was 14.2 percent (14.5 percent for all banks).

Reform of Cooperatives

64. The credit cooperative movement in Spain faces two broad challenges—at micro-level and macro-level, although the two are interconnected. At micro-level, the limited capital base, poor corporate governance, high costs, relatively high levels of NPLs, restricted business opportunities, threats from more advanced forms of banking are all significant issues. On an individual cooperative basis, most appear to be performing adequately, although there have been/are poor performing institutions, as evidenced by the need on the part of AECR to provide financial assistance to some of its members. At the same time, the sector prides itself in having survived the economic crisis without significant damage, unlike the savings banks sector.

65. At the macro-level, there are no clear solutions to changing the system. In many rural areas, the credit cooperatives are the only banks in the locality, other banks having closed their branches in recent years. Cooperatives are supported in the Spanish constitution which ordains that government authorities should promote cooperatives by means of adequate legislation.

66. Evolution and reform of credit cooperatives in other jurisdictions may offer some guidance for the way forward in Spain. Developments elsewhere may act as a pointer for the Spanish authorities. However, any comparison must consider that the credit cooperative sector is smaller in Spain than in other jurisdictions and the business models in these other jurisdictions are in

most cases very different from that in Spain. In France, the market share is 50 percent, 30 percent in the Netherlands and Italy, and 15 percent in Germany compared to about 7 percent in Spain.

67. The uniqueness of the credit cooperative sector in Spain requires a carefully thought solution. While small in its totality relative to the banking system, its diversity in terms of constitutional structure (IPSs, AECR, non-aligned, independent credit cooperatives), size of individual institution, business model, financial performance, etc., would not lend itself to creating a single, unified structure that would embrace all credit cooperatives, like Rabobank at an earlier stage of its development.

68. During the mission the IMF team discussed the perspectives of the cooperative sector with AECR. The association, that represents a large part of the sector, believes that the sector has a viable future, particularly in the context of greater cooperation among individual credit cooperatives, with no need for radical reforms.

69. However, the aforementioned weaknesses highlight the need for a stronger form of mutual support among cooperatives. The lack of a binding obligation to financially support its members shows the limitations of an association as opposed to an IPS or affiliation.

70. It would be ideal to have an industry-driven reform. Such initiative would be to create one or more further IPS or affiliations of cooperative banks with a central body. The affiliation model would allow individual credit cooperatives to retain their own brand but have the benefit of a substantial and professional central point which would be responsible for all policy, management and regulatory issues on behalf of the group. Should an industry-driven initiative fail to materialize, the authorities should consider compulsory schemes to achieve similar goals.

71. The authorities could always complement these efforts with measures to strengthen the sector. A more exacting corporate governance regime should be introduced. BdE has commenced this process through, for instance, a more rigorous fit and proper regime but firmer measures are required to bring other corporate governance requirements in line with best practice. For instance, shares in credit cooperatives should be made formally subject to MiFID-type rules; boards should be specifically required to have greater diversification with emphasis on expertise and independence, and the tenure of individual directors should be fixed. The authorities should also seek to encourage greater participation at annual meetings, possibly by amending the one-member-one-vote rule. The relevant legal rules should be amended to allow BdE to apply the above-mentioned measures.

Offsite Monitoring and Onsite Inspections

72. BdE pursues the quality, effectiveness, and integration of its onsite and offsite functions at different levels. First, internal procedures are common across the onsite and offsite units; then, horizontal reviews of SREP analyses and decisions for LSIs are conducted within Inspección III before escalating to the Executive Committee; also, formal quality assurance is presided over by a dedicated unit under supervision planning; finally, the internal audit of BdE

regularly performs investigations in the Directorate General for supervision (on average three per year in the past few years).

73. BdE is currently reviewing its Guidelines on the ICAAP at credit institutions, initially issued in 2008, to ensure its consistency with the SREP framework in the SSM. The guidelines provide an indication to banks on how to prepare their ICAAP report, from describing their risk profile and assessing their own governance, risk management and control systems, to establishing the target level and composition of capital (and intragroup distribution for groups), summarizing and self-assessing their capital plans (and the stress test assumptions and methodologies used to formulate them), and describing their plan for future measures.

74. BdE is adapting its onsite inspection planning and procedures to the new SSM harmonized framework. In general, they do not differ significantly from the previous modus operandi of BdE; minor changes will be needed (e.g., providing for the final report to be sent to the bank first for comments). An internal regulation ('Ordenanza') currently establishes a maximum interval between two subsequent inspection of three years and the possibility of extending it to four years for smaller entities.

Coordination with Foreign Supervisory Agencies

75. Four Spanish SIs have important foreign operations. Loans abroad are predominant for Santander and BBVA, and non-negligible for Sabadell and Popular. The two largest banks have locally systemic subsidiaries in United Kingdom, Portugal, Mexico, Chile, Brazil (Santander), and Mexico and Turkey (BBVA); they have traditionally adopted a highly decentralized model, with largely independent subsidiaries that operate according to a simple business model (only banking, mainly retail), are financially and operationally self-sufficient, but bound to comply with the quality standards established at the group level and to follow centrally issued guidelines and policies; from a resolution perspective, they adopt a multiple point of entry (MPE) approach.

76. Cooperation between the ECB and host supervisors is overall smooth and well-functioning. The host supervisors are generally comfortable with the two main banks' decentralized model and MPE approach. Collaboration is based on MoUs signed with the ECB, and in their absence, by those previously established with BdE (although the latter are not directly 'transferable' from the former signatory to the new supervisory authority and, consequently, not always sufficient to guarantee that the ECB receives full and immediate collaboration). The MoUs covers the exchange of information and the arrangement of joint activities, such as workshops and onsite inspections. Overall, bilateral interaction is characterized by open dialogue, shared perspectives and good working relationships and communication. Cooperation also works multilaterally, through the supervisory colleges: host supervisors appear equally satisfied with the exchange of information and degree of involvement by the ECB (e.g., periodic feedback provided by the ECB on the groups' risk situation across the globe is appreciated).

77. BdE is directly responsible for the supervision of all non-EEA subsidiaries and all non-EA branches. BdE has signed a MoU with two of the six non-EEA countries whose banking groups

have a subsidiary in Spain. BdE does not participate in any non-EEA college and there have been no inspections of non-EEA home supervisors on Spanish subsidiaries of banking groups supervised by BdE in the last five years.

Conglomerate Supervision

78. Four Spanish SIs have been designated as financial conglomerates, as per the Financial conglomerate directive (FICOD).[19] Financial conglomerates are defined as large financial groups which provide services and products in both the banking/investment services sector and the insurance sector and both financial activities are considered material per FICOD. The Spanish groups identified as financial conglomerates are Santander, BBVA, Ibercaja, and Criteria Caixa.

79. Criteria Caixa and Ibercaja are subject to supplementary supervision per FICOD.[20] Supplementary supervision on financial conglomerates requires the identification of a coordinator, among the different sectoral authorities involved; the coordinator for both conglomerates are the ECB. Based on Art. 49(1) CRR, when a financial conglomerate is subject to supplementary supervision, the banking supervisor can exempt the holdings of the conglomerate's insurance companies' capital instruments from being deducted from the conglomerate's banks' own funds (so called "Danish compromise"); the equity holdings which are not deducted qualify as exposures and are risk weighted at 370 percent. The exemption has been granted by BdE to both conglomerates.

80. Supplementary supervision covers the following areas: (i) capital adequacy; (ii) risk concentration; (iii) intra group transactions; (iv) internal control mechanism and risk management processes. In practice this involve a series of activities:

- annual check of identification criteria, in collaboration with the Spanish insurance supervisor (DGSyFP);
- quarterly information exchange and annual meeting with DGSyFP on insurance subgroup business, financial results of the life company, main risks;
- quarterly monitoring report (capital adequacy, risk concentration, and intragroup transactions);
- annual analysis of internal control mechanism and risk management processes at conglomerate level;
- annual SREP at conglomerate level;
- interaction with DGSyFP on Solvency II implementation;
- deep dives can be conducted on specific topics, such as the business lines' contributions to profitability and asset growth, commercial practices and interlinkages between banking and insurance activities, identification of additional potential sources of risk for the group.

[19] Directive 2002/87/EC on financial conglomerates.

[20] Supplementary supervision is mandatory for financial conglomerates in which the smaller sector (between banking/investment services and insurance) represents more than 10 percent in terms of the average between its shares of balance-sheet total and solvency requirements with respect to the whole conglomerate; it is subject to a discretionary decision by the supervisors when the average share is less than 10 percent but total assets in the smaller sector exceed EUR 6 billion.

81. BdE signed bilateral agreements with several sectorial supervisors following the mandate established in Law 44/2002. The purpose of these agreements is to standardize the exchange of information within both control and supervision functions of financial institutions and to improve the efficiency, effectiveness and quality of supervision procedures. BdE signed agreements with DGSyFP (March 2004), CNMV (June 2009), and SEPBLAC (October 2013).

82. While the basic procedures and channels of interaction with the insurance supervisors are well established, the analysis of financial conglomerates' situation is still mainly ad-hoc. The procedures for conglomerate identification and capital adequacy assessment are well-tested and meetings and exchange of information with DGDyFP work smoothly; but the JSTs tasked with supplementary supervision of their conglomerates lack set criteria for the evaluation of the information received (e.g., on risk concentration and intra-group transaction) and do not follow a given methodology to incorporate the results of their analysis of the conglomerate at large into the annual SREP of the banking group.

E. Capital

Capital Quality

83. While capitalization markedly improved since the crisis, Spanish banks' own funds remain characterized by the large incidence of deductions that are going to be progressively phased in, mainly deferred tax assets (DTAs).[21] Average Tier 1 and Total capital ratios at end 2016—at 13.1 and 14.8 percent, respectively—are lower than the EU average capital ratios (15.5. and 18.5, respectively). According to CRR, the phase-in for DTAs' deduction can be extended until 2024; this represents a deviation from the Basel framework, which requires full deduction from 2019. However, the ECB has opted for bringing the end of the phase-in to 2019 for SIs; ECB has expressed its orientation in favor of a 2019 deadline also for LSIs and a modification of the Spanish regulation is in process to align it with ECB Orientations; this will bring both the SI and LSI calendars to 2019.

84. In 2013 Spain amended the Corporate Income Tax law to reduce uncertainty around certain DTAs so that they do not have to be deducted from CET1 capital. A mechanism to

[21] "DTAs are claims against the government on the assets side of banks' balance sheets. They arise on account of taxes paid or tax losses carried forward that may entail a refund from the government in the future. From a regulatory and accounting point of view, there are two broad categories of DTAs. Depending on their loss absorption capacity in the case of insolvency, DTAs have a different regulatory treatment. First, there are DTAs that rely on future profitability. In principle, these DTAs would not have to be honored by governments in the event of the liquidation or insolvency of an institution. They can be entered into the financial statements of a bank to the extent that, according to the bank and its statutory auditors, future taxable profit is likely to be available. Second, there are DTAs that do not rely on future profitability and arise from temporary differences between the value of an asset or a liability in the financial statements (accounting value) and its tax base. These DTAs, which are also called deferred tax credits (DTCs), need to satisfy the conditions set out in Article 39(2) of the Capital Requirements Regulation (CRR). In principle, only this type of DTAs has to be honored by governments in the event of the liquidation or insolvency of an institution [..]. According to the CRR, DTCs receive a 100 percent risk weight for the calculation of the solvency ratio and are therefore not deducted from regulatory capital." Letter from Danièle Nouy, Chair of the Supervisory Board, to several Members of the European Parliament, on deferred tax assets, July 2015; https://www.bankingsupervision.europa.eu/ecb/pub/pdf/150713letter_starbattyetal.en.pdf

guarantee the recovery of certain DTAs arising from temporary differences was established; these guaranteed DTAs are considered deferred tax credits (DTCs) and are therefore eligible for CET1 fully loaded. The reform is only limited to temporary differences generated by (i) provisions for loan losses or foreclosed assets and (ii) pension commitment expenses. DTCs will be activated fully in the event of insolvency of the bank or partially when the bank makes a loss (i.e., only cover the loss). If the DTCs are not reversed within 18 years, they may be exchanged into government securities.

85. The presence of DTAs on banks' CET1 capital is considerable, when compared with other EU countries. Except for Belgium and Ireland, Spanish banks show the largest gap between transitional and fully-loaded CET1 ratios at end 2016 (i.e., between CET1 ratios calculated without and with full deduction, respectively): on average, it is 1.5 percent, with a range between 0 and 4 percent among Spanish SIs.

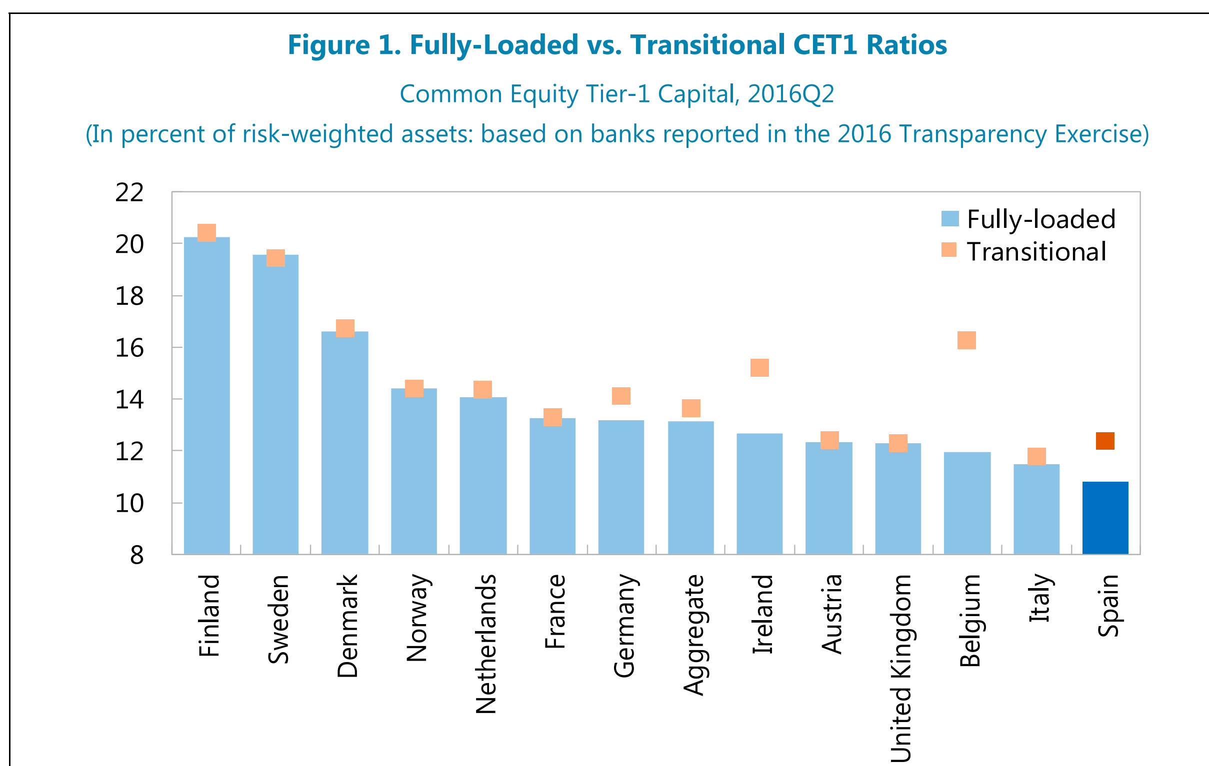


Figure 1. Fully-Loaded vs. Transitional CET1 Ratios

Common Equity Tier-1 Capital, 2016Q2

(In percent of risk-weighted assets: based on banks reported in the 2016 Transparency Exercise)

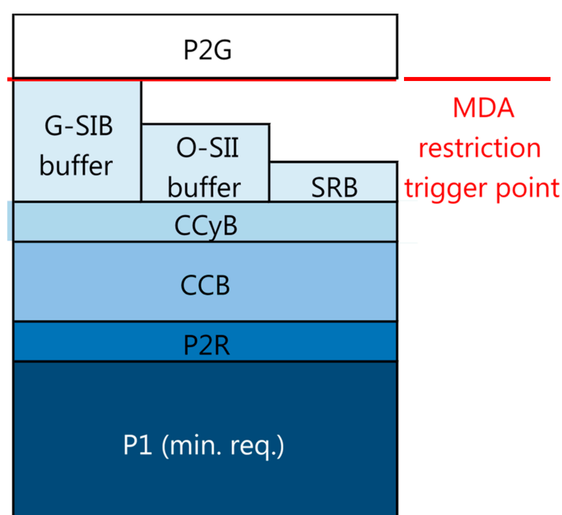
Capital Adequacy

86. One of the most important outcomes of the SREP is the capital decision, i.e., what the SSM considers an adequate level of own funds for each bank, taking into consideration its risk profile and other elements of the SREP assessment. The capital decision takes the form of a Pillar 2 capital add-on (in terms of CET1 capital) that is added to the Pillar 1 minimum requirements and to the capital buffers envisaged in the Basel framework and regulated by the CRD. The criteria for the capital decision have undergone important changes through time and the SREP for 2016 has clarified that:

- The Pillar 2 add-on is composed of a Pillar 2 Requirement (P2R) and a Pillar 2 Guidance (P2G);

- P2R is a binding requirement, as the Pillar 1 and capital buffers:[22] banks are expected to observe it always and its breach affects the maximum distributable amount (MDA) of a bank's profits;
- P2G does not affect MDA decisions (i.e., a breach of P2G does not automatically trigger restrictions to the dividend a bank can distribute);
- The Pillar 2 add-on (both P2R and P2G) does not overlap with the CCB: i.e., the same CET1 cannot be used to cover both the CCB and the P2 add-on;
- The other capital buffers except CCyB (i.e., G-SIB, O-SII, and systemic risk buffer) do not stack: i.e., only the largest of the three counts for the calculation of the combined buffer.

Table 4. SREP Capital Decision: CET1 'Stacking' Order



Source: ECB

87. Pillar 2 guidance was first applied by the ECB for the Pillar 2 decision in 2016. An important input into the determination of P2G was provided by the outcome of the 2016 EU-wide stress test exercise. The following elements were considered: capital depletion under the exercise adverse scenario; specific risk profile of the individual bank and its sensitivity towards the stress scenarios; changes in its risk profile since the cut-off date (December 31, 2015) and measures taken by the bank to mitigate risk sensitivities, such as relevant sale of assets, etc.

88. LSIs are subject to Pillar 2 requirement and CCB with an approach like that for SIs. P2G has not been applied to LSIs yet, since the SSM methodology for LSIs is under trial process (it will be binding in 2018). BdE intends to use, as an input for the Pillar 2 level, the results of the top-down

[22] Capital buffers include the Capital Conservation Buffer (CCB), the Countercyclical Buffer (CCyB), the G-SIB buffer, the Other Systemically Important Institution (O-SII) buffer, and the systemic risk buffer. Currently CCB is 1.25 percent of risk-weighted assets (until end 2017); CCyB and systemic risk buffer are both set at 0 percent in Spain (though for international banks, the actual CCyB depends on the CCyB ratios established in the jurisdiction where they operate); the G-SIB buffer for Santander is 1 percent.

FLESB[23] stress test model, based on granular data available to BdE (from credit register, "ficheros de inversion crediticia," detailed reporting on forborne exposures, etc.).

89. The leverage ratio in the EU represents a reporting and disclosure requirement until December 2018. It is taken into consideration within the supervisory analysis of capital adequacy (though not as hard requirement), as required by the EBA SREP guidelines. It will become an own funds requirement (Pillar 1) from Jan 2019, with the old exposure measure used for the first two years. Based on the current EC proposal to revise CRD/CRR, the minimum is set at 3 percent, the new exposure measure (from 2021) will include more exclusions than Basel and no G-SIB buffer is currently included (though it will be considered once Basel finalizes the standard).

Internal Models for Credit Risk

90. In Spain, seven[24] SIs and two subsidiaries of other EA countries' SIs use approved Internal Rating Based (IRB) models for some asset classes. All IRB banks have been authorized to use their internal models (mostly Advanced IRB) for corporate and retail portfolios; five also have models covering their bank exposures and three have models for their sovereign portfolios.

91. Spanish banks have a lower share of assets under the IRB approach than the EU average. Spanish banks consider their models very conservative, in their opinion largely as the result of BdE's prudent approach, especially regarding data quality and quantitative criteria.[25]

92. The SSM has launched in late 2015 a multi-year effort to review many IRB (and market risk) models across the SSM, the Targeted Review of Internal Models (TRIM). The preparatory phase of TRIM was conducted in 2016 and early 2017; in 2017, onsite credit risk model-specific reviews have been initiated on high-default portfolios (retail, SME) and, together with more on-site missions on market risk and counterparty credit risk, sum up to around 100 bank-specific missions; in addition, some 100 bank-specific missions (on the credit risk side mostly low-default portfolios, i.e. institutions, large corporates, specialized lending) will be conducted in 2018. The inspection teams, headed by SSM experts, are composed of SSM staff and external experts. The preparation, execution, and results are directed and monitored centrally by the ECB through consistency checks and peer reviews.

93. The overall objective of the TRIM is to enhance the credibility and confirm adequacy of approved internal models across the SSM. This is pursued through the verification of internal models' compliance with regulatory standards, the definition and implementation of harmonized interpretations and rules to constrain modeling freedom (as defined in the ECB's Guide to TRIM). The result should be an improved comparability across banks via a reduction of unwarranted variability (i.e., unrelated to the underlying risks) of the output of internal models.

[23] "Forward-Looking Exercise on Spanish Banks."

[24] Six, once the merger of Santander and Popular is finalized.

[25] The majority of models were validated and approved by BdE before the start of the SSM.

F. Credit Risk and Problem Assets

94. Since the 2012 FSAP assessment, the Spanish authorities have continued to address the banking problems brought about by the global financial crisis and, in Spain, the collapse of the real estate sector. As was noted in the 2012 assessment, the Government introduced two emergency Royal Decree Laws—RDLs- (02/2012 and 18/2012)—designed to restore confidence in the banking sector. The RDLs required banks to set aside one-off provisions for real estate loans that existed as at December 31, 2011 and for foreclosed assets subsequently held by banks in respect of these loans. The provisions ranged from 7 percent for performing real estate loans to 60 percent for loans secured on plots of land. The BdE no longer receives information on the level of assets in the accounts of banks still subject to the provisions of the RDLs. The last return dated September 2014 showed total assets of EUR 74.5 billion so affected, broken down between loans of EUR 44.7 billion and foreclosed assets of EUR 29.8 billion.

95. The BdE and the Government should consider whether maintaining the Royal Decree Laws is still appropriate. While considered necessary in 2012 to deal with the then crisis, they are restraining BdE's ability to establish a provisioning policy that would best address the current position in this area. Property values have changed and the real estate sector is making a tentative recovery so that fixed provisions levels established some six years ago, may not be totally valid today and deprive the BdE of the flexibility it should have in establishing credible rules for NPLs and foreclosed assets. Having arbitrary rules in this area is also at variance with good accounting practice and is contrary to IFRS. Nevertheless, any potential change in the current framework should not lead to a reduction in the total level of provisioning levels, which is key to incentivize banks to dispose of the nonperforming loans that are still lingering on their balance sheets because of the crisis.

96. There appears to be still some misclassification of loans in, at least, some Spanish banks. This was evident from a review of onsite inspection and SREP reports of both SIs and LSIs. For instance, certain loans were wrongly classified as performing and restructured loans were classified as performing without meeting the necessary probation period required of these loans. There was also evidence to a lesser extent of forborne loans' terms being generous and collateral valuations not being up-to-date with BdE requirements. These weaknesses and the misclassifications were confirmed by several sources, including BdE and external participants. Inevitably, misclassifications lead to BdE requiring additional provisions.

New Rules on Asset Classification and Provisioning

97. BdE introduced new rules on asset classification and provisioning in October 2016. The purpose of the initiative was multifaceted: the main objective was to develop principles and criteria for the estimation of loan loss provisions by banks using their own methodologies to enhance the alignment of the new rules with the IFRS framework adopted in the EU. Additionally, this update was aimed at bringing Spanish practices fully into line with the EBA definitions of non-performing and forborne exposures, to align with ECB's draft guidance on NPLs and to incorporate the Basel principles in this area as set out in its December 2015 paper on supervisory guidance on credit risk. It

is also seen as a prelude to the introduction of IFRS 9 in January 2018 in that many of the qualitative provisions in both exercises are similar.

98. The new initiative (a revision of Circular 4/2004—Annex IX) is a significant departure from the previous regime. The previous regime was prescriptive based on a strictly calendar approach to provisioning. The new initiative, while still retaining an element of a calendar approach, allows greater discretion by banks in determining provisions in line with IFRS and introduces a more tailored provisioning approach which, in turn, while maintaining the overall coverage of risks, has resulted in the reallocation of provisions between NPLs and foreclosed assets.

99. Banks are required to assess their own levels of provisions and values of collateral in compliance with certain principles and criteria. Annex IX sets out four grades of classifications—one less than the previous regime. These are performing; performing under special monitoring; doubtful for reasons of arrears; and doubtful for other reasons (e.g., a borrower facing poor trading conditions). Banks unable to develop robust internal methods based on the guidelines set out in the annex are then required to follow the alternative solution of using specific percentages of coverage for different portfolios per the classification grade of the risk; for doubtful arrears transactions, the percentages are based on age of past due amounts. These percentages relate to the amount of the loan not covered by collateral. They range from 20 percent for house purchase loans three-to-six months in arrears to 60 percent for consumer credit (e.g., credit card debt) for the same period.

100. Annex IX also contains rules for valuing collateral. As in the case of provisions, banks may use internal methods based on guidance given in the annex or, when unable to make robust estimations, they can use the discount figures provided in the annex to be applied on the reference price, ranging from zero percent for money deposits to sixty percent on urban land and unregulated building land. Annex IX also provides reference discounts for different types of foreclosed assets to adjust their appraisal values to reflect their fair value less cost of sale.

101. The implementation of the new regime has thrown up disparate results across banks, though the change in overall provisions is deemed not significant. Because of the newness of the exercise, the BdE has not had the opportunity to examine the results in depth, and the reliability of the results based on the internal methods. In broad terms, significant institutions are using internal methods whereas less significant institutions are using the tables in the annex. For those using internal methods, they must also carry out a parallel exercise using the tables, for comparative purposes. The BdE believes that the change to the new regime should not result in any significant change in the overall figure for total provisions but a re-allocation of provisions among the various classifications. From discussions with banks and other external sources, it appears that the new regime will result in some banks requiring a lower level of provisions and others requiring higher levels. Inevitably, the impact for each bank will differ depending on several factors, including the type of assets and their classifications. This disparity of results highlights the need for the BdE to continue assessing their reliability.

102. BdE believes that it is well-positioned to incorporate the expected loss approach into its provisioning framework for several reasons. IFRS 9, which is scheduled to come into effect in

January 2018, will allow the inclusion of expected losses in the calculation of provisions. Although at odds with the accepted accounting norms at the time, BdE used to have, in the years before the global financial crisis, a policy of dynamic provisioning that included elements of future losses, thereby anticipating the capital buffers introduced under Basel II/III. The introduction of the recent changes in Circular 4/2016, by anticipating the final adoption of IFRS 9 in 2018 (based on the expected loss concept), contributed to the abandonment of dynamic provisioning. BdE expects the impact of the introduction of IFRS 9 to be more contained in Spain than elsewhere because its accounting provisioning rules have been enhanced and are more stringent than in other jurisdictions. An advanced project is underway to adapt the accounting circular, including its Annex IX, to IFRS 9 so that banks complying with the new circular will at the same time comply with the new accounting standard.

Data and Tools for the Supervisory Analysis of Credit Risk

103. BdE manages the central credit register (Central de Información de Riesgos or CIR). Banks must report to the CIR all transactions in the form of loans, debt securities, financial guarantees, loan commitments, other commitments entailing credit risk and lending of securities. Monthly information is available on risk exposures reported by Spanish banks and branches in Spain of foreign banks, as well as information on doubtful loans. Information can be broken down by individual borrower, economic group, sector of activity, etc., and allow for comparisons to be made among different banks.

104. In 2013 the CIR was enhanced by improving the quantity and quality of information reported. As a consequence of the changes introduced, exposures must be reported on a transaction-by-transaction basis with no minimum reporting threshold;[26] more detailed breakdown was introduced for the major product types; data requested include those relating to the interest rates and the dates of execution, maturity, default and settlement of principal and interest; detailed information must be reported on each asset received as collateral; restructured, refinanced, renegotiated, subrogated and segregated transactions have to be separately identified.

105. While the CIR is meant to provide—together with other data sources—a service to the reporting institutions, its data prove extremely useful also as a support to supervisors' analysis of banks' credit risk.[27] Apart from allowing inquiries on the exposure of specific obligors with large exposures, CIR data can be used, when needed, to compare the classification of the same obligors across banks, singling out the outliers and providing directions for further investigations. They can also be used to conduct deep dives on the quality of banks' portfolios 'en masse'. While no substitute for the onsite work of examiners, this can indeed help in advancing the quality and timeliness of supervisory analysis of credit risk.

[26] Except for new nonrelevant products when the amount is less than EUR 6,000 and under certain conditions.

[27] Given the confidentiality of the CIR raw data, use by supervisors is allowed on a need-to-know basis and subject to strict security criteria.

106. Another promising direction for the collection of highly informative data is represented by the analyses performed by BdE on the valuations of appraisal companies. BdE is responsible, inter alia, for the supervision of appraisal companies; one of the main tasks carried out by the specific unit in charge of these entities is to guarantee the consistency of collateral valuations throughout the system.

107. In recent years, the unit has been developing a Valuations Analysis Tool for the comparison of residential real estate valuations across the different appraisal companies. Working on hundreds of thousands of appraisals, the tool allows the identification of outliers (valuations beyond statistically determined limits), ranks the appraisal companies in terms of the prudence of their valuations, and cross-references this information with the identity of the banks requesting the appraisals. The tool (which is about to leave the pilot phase) is subject to continuous improvements, like a finer definition of homogeneous-value zones; the acquisition and use of actual transaction data; and, in the near future, the extension to other property categories, more difficult to valuate, such as land, offices, and commercial real estate.

108. The tool lends itself to quick and large scale valuations of homogenous properties, thus helping supervisors to detect pockets of overvaluation in the banks' portfolios. Its use for supervisory analyses of credit risk should be further promoted in Spain and the development of similar tools fostered across the SSM, where local conditions allow.

Inspections on Credit Risk

109. BdE's approach to onsite supervision has traditionally focused - and still focuses - on accounting review and on the accuracy of asset classification, collateral valuations and provisioning levels in the credit portfolio. The main idea is that the robustness and comparability of solvency ratios, which are the backbone of supervisory analysis, hinges on the reliability of financial reporting. During onsite visits, BdE inspection teams typically perform a detailed review of datasets and analysis of specific credit files within a selected sample; the inspection is generally concluded with recommendations on the accounting classification of assets and a quantitative estimate of provisioning shortfalls that the institution should cover within an agreed timeframe. Recommendations on internal control are also included in most inspections.

110. The importance of credit quality reviews (CQRs) is clearly highlighted also in the SSM supervisory manual. CQRs—based on the analysis of the credit quality of individual credit files selected according to sampling criteria—are meant to assist the inspection team in its evaluation of the bank's credit risk portfolio (or of part of it), as a support to sufficiently prudent capital levels and loan loss provisions. The findings in the sample may lead the inspection team to calculate potential shortfalls in NPLs and/or in provisions for the selected portfolio.

111. Transaction testing—in the form of asset quality reviews or other forms of deep vetting of the adequacy of impairment and loss recognition—is a fundamental ingredient of the supervisory assessment of how banks manage their problem assets. It represents a fundamental component of the assessment of banks' policies and procedures for the early

identification and management of problem assets, and the maintenance of adequate provisions and reserves, as affirmed also by the BCPs.[28]

112. The results of the review also contribute to form an overall opinion of the management and controls on credit risk. They provide a practical test on how the processes and the procedures developed by the banks within their credit risk management framework work in practice, by means of the tracks of these processes contained in the credit files sampled.

113. Notwithstanding the importance of CQRs in the SSM methodology, the practice of onsite inspections within the SSM is mixed. Through its participation in the SSM, BdE has observed a lack of consistency between onsite inspection modalities, depending on the country where they are performed and on the supervisory tradition of the inspection team (and of the head of mission). Quantitative conclusions (i.e., misclassification of assets and provisioning shortfalls) are not necessarily made in the reports, even when deficiencies in accounting or valuation methods or procedures are reported; when the shortfalls are estimated, the follow-up letters do not always request the banks to adjust their provisions. The lack of a sufficiently homogeneous approach to the revision of the credit portfolio in onsite inspections within the SSM translates into a heterogeneity of supervisory findings. This, in turn, might lead to an unlevel playing field. BdE is understandably concerned that the resulting pressure to address the issue might ultimately lead to a race to the bottom, i.e., less emphasis on accounting review for all.

114. Divergences in inspection outcomes across the Euro Area were also identified by an internal ECB review. The review found that some inspections on credit risk end up with recommendations on asset classification and provisioning, other just on governance and policies and procedures.

115. The ECB is working on a refinement of the SSM manual to homogenize onsite credit risk practices. The inspection methodology will be complemented with a common methodology for the analysis of credit files from selected samples (also inspired by the AQR methodology "second level rules") to cover sampling methods, classification of exposures, accuracy of NPL identification and reporting, individual and collective provisioning, collateral valuation.

116. It is critical that bank supervisors be empowered to impose reclassification of assets and additional provisioning, where necessary.[29] While capital add-ons can be used—as an alternative solution—to mitigate rising impairment losses when the power to impose additional

[28] BCP 18, EC 5: "The supervisor tests banks' treatment of assets with a view to identifying any material circumvention of the classification and provisioning standards (e.g., rescheduling, refinancing or reclassification of loans)".

[29] See, inter alia, E. Gaston and I.W. Song: "Supervisory Roles in Loan Loss Provisioning in Countries Implementing IFRS," IMF, 2014.

provisioning is lacking or unclear, requiring higher provisioning is considered preferable to requiring higher capital ratios without proper provisioning.[30] This is the practice followed by BdE in Spain.

117. Importantly, the ECB should confirm that it has the power to impose additional provisioning. To ensure a homogeneous approach to the assessment of banks' asset classification and provisioning across the Euro Area, at least for SIs, the ECB needs to be able to require banks—typically because of an onsite inspection on credit risk—to adjust their loan loss provisions. Art. 16(2)(d) of the SSM regulation grants the ECB, as competent authority for SIs in the SSM, the power "to require banks to apply a specific provisioning policy." This power seems sufficient for requesting an adjustment of provisions, when needed; if any doubt remains about the nature of this power, it should be dispelled through an authentic interpretation of the regulation or an amendment aimed at avoiding any possible ambiguity.

Concentration Risk

118. In relation to concentration risk, the weaknesses identified in the 2012 assessment have been addressed by the adoption by Spain of CRD IV and CRR. These are complemented by rules issued by the EBA. These include improving tools and controls for the effectiveness of supervision regarding economic sector concentration, providing guidance specific to sector concentration and enhanced requirements whereby banks could identify monitor and manage exposures where a bank has granted many loans to different employees of a company, sector or local government. Circular 2/2016, which completes the adoption of CRDIV/CRR, requires banks to have effective controls relating to sectoral concentration and to have specific reporting requirements in respect of such risks.

119. Under the new rules, banks are required to have a concise and practical definition of what constitutes a credit concentration. The definition should encompass the different types of credit concentration, including exposures to the same counterparties, exposures to groups of connected counterparties, exposures to counterparties in the same economic sector (real estate, agriculture, etc.), geographical (regions/countries) concentrations of asset exposure and concentrations in a commodities or currencies, as well as large indirect credit exposures (e.g., to a single collateral issuer). The definition also covers the application of credit risk mitigation techniques to the credit concentrations.

G. Interest Rate Risk

120. Interest rate risk in the banking book (IRRBB) is one of the four categories of the 'risks to capital' element of the Risk Assessment System (RAS).[31] The EBA SREP guidelines require supervisors to consider all forms of interest rate risk: those stemming from changes in the level, slope, or shape of the yield curve, from imperfect hedging of exposures due to differences in the

[30] "In general, it is preferable that supervisors ask for higher provisioning rather than the higher capital ratios without provisioning, as the latter would tend to overstate capital;" ibid. p. 17.

[31] The other three categories are credit, market, and operational risk.

reference rates (basis risk), from explicit options written in contracts and implicit options available to customers (e.g., withdrawal of non-maturity deposits and prepayment of mortgage loans).

121. JSTs and BdE's supervisory teams regularly monitor the evolution of IRRBB metrics, such as the change in a bank's economic value (EV) in response to changes in interest rates. Based on banks' reported data and supervisory calculations ("proxies"), they control if the change in EV in response to a 200 bps increase or drop in the level of interest rates exceeds the regulatory outlier rule (EV decline larger than 20 percent of regulatory capital). Larger banks are expected to develop their own methodologies for IRRBB estimation and capital allocation, based on their risk appetite, without relying only on supervisory proxies.

122. Attention is also paid to governance, management and controls of IRRBB. JSTs analyze the minutes of the Asset and Liabilities Committees and supporting documentation; they meet periodically the managers responsible for measuring, controlling and managing IRRBB. Two onsite inspections addressing IRRBB (among other subjects) have been conducted on LSIs in the last three years, and one on an SI is planned for 2017.

123. As a support to Spanish JSTs' SREP analysis, the BdE specialized IRRBB horizontal team runs annual supervisory estimates. It complements the data reported to the ECB by SIs (within the STE framework) with detailed information on implicit and explicit options embedded in the banks' assets and liabilities, based on specific sections of the Spanish supervisory reports (Circ. 2/2016, rule 63 and Annex II). The Spanish templates also provide separate evidence of IRRBB exposures for each material currency (while the STE requires separate evidence only for the euro and the most important non-euro currency), rates applied until following repricing date, information on internal parameters for non-maturity deposits (share of 'unstable' balances, separate pass-through rates for rate increase/decrease, average maturity of 'core' non-maturity deposits), finer breakdown for certain items (e.g., loans and advances, term deposits with customers and financial institutions, floating rate instruments by reference rate repricing term).

124. As its annual supervisory stress test for 2017, the ECB chose to carry out a sensitivity analysis of IRRBB. Considering the current extremely low level of interest rates, the ECB is interested in understanding the resilience of banks to movements in the term structure of interest rates, given that interest income makes up more than half of total income for large banks in the euro area. The analysis involves 112 SIs.

125. The exercise focuses on the changes in the economic value (EV) of the banking book assets and liabilities and on the development of net interest income (NII). It is based on six hypothetical scenarios drawn from the Basel Committee 2016 standards:[32] two parallel shocks of +/-200 bps, a flattening and a steepening scenario, an end-2010 scenario representing the yield curve before the acute phase of the euro area crisis, and an end-2016 scenario (baseline). It is run on EUR positions and on positions denominated in other currencies if they represent more than 20 percent of the aggregated banking book assets. The exercise also aims to analyze how banks model the

[32] BCBS, "Interest rate risk in the banking book", April 2016.

optionality implicit in contracts' features (such as the withdrawal of non-maturity deposits or prepayment of mortgage loans when interest rates change) and how banks use interest rate derivatives in their IRRBB management.

126. The results of the exercise are meant to feed in into the SREP 2017. The results will inform, in a non-mechanical way, the assessment of a bank's Pillar 2 guidance (P2G): the idea is to look at the relative vulnerability of the banks to the different interest rate shocks, rather than quantitative results of the exercise.

H. Liquidity and Funding

127. "Risks to liquidity and funding" is one of the four elements of the RAS. Supervisors are required to assess the inherent liquidity and funding risk and a bank's management and control of such risks. Beyond verifying compliance with minimum requirements (currently the Liquidity Coverage Ratio or LCR; from 2018 also the Net Stable Funding Ratio or NSFR), supervisors evaluate banks' liquidity needs in the short and medium terms under both normal and stressed conditions, intraday liquidity risk, liquidity buffers and counterbalancing capacity.

128. The analysis of funding is aimed at assessing whether a bank's medium- and long-term obligations are adequately met with a range of stable funding instruments under both normal and stressed conditions. This includes the capacity to roll over maturing funding and potentially increase liabilities in a sustainable way to cover refinancing needs: funding risk could increase because of restricted market access, e.g., because of a poor capital position, unclear strategy, negative rating outlook or negative investor opinion increasing funding risk.

129. In the assessment of funding sustainability, three main aspects are evaluated:

- structural funding mismatch (tendency of a bank to fund its balance sheet more with short-term liabilities and to have more assets than liabilities in the medium- and long-term time buckets);
- long term wholesale funding (a bank's ability to rollover and raise additional wholesale funds in terms of amount or capacity, maturity, currency, and price compared to the risk-free rate and to the price peer banks pay);
- retail funding strength (share of retail deposits over total funding and share of guaranteed deposits over total deposits).

130. The adequacy of liquidity buffers and sustainability of funding is assessed by monitoring the evolution of several indicators. The following early warning indicators are periodically reviewed under the monitoring process: LCR, loan-to-deposit ratio, share of wholesale funding, survival period.

131. Supervisors also assess the own liquidity assessment performed by a bank within its ICAAP and its recovery plan. They evaluate the assumptions adopted in these internal reports and whether the results of stress tests are appropriately reflected in a bank's strategies, policies and plans. They also analyze internal reports to the bank's management body, assess the integration of

stress test outcomes into the bank´s risk appetite, verify the inclusion of indicators under stress conditions within the bank's liquidity contingency plan.

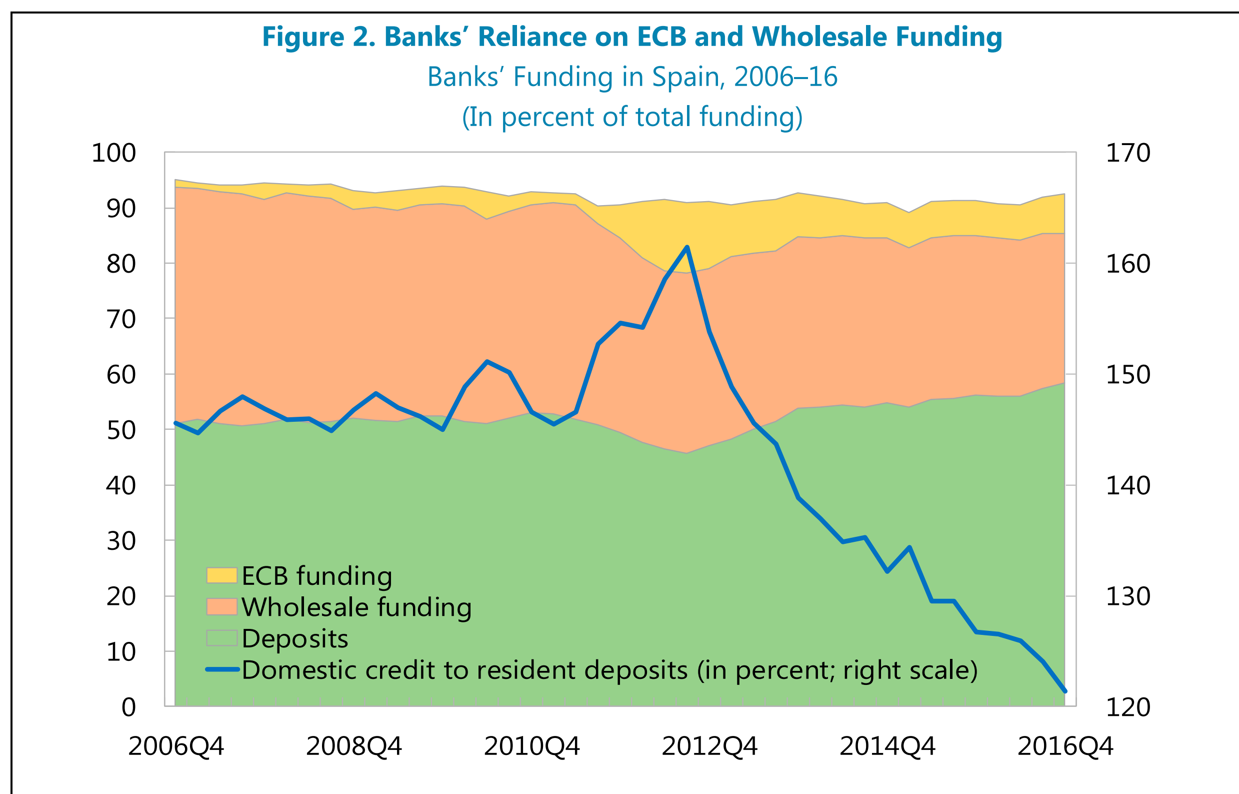
132. In the case of LSIs, a specific liquidity stress exercise has been carried out for the first time this year (under the FSAP scope). The smaller banks run simple sensitivity tests that leave less room for deep and detailed supervisory analysis. They should be invited to implement complete liquidity stress tests (as part of their ILAAP). Because of the current FSAP, the FLESB tool has extended its analysis to include a liquidity stress test exercise which can be used to challenge the results obtained by LSIs.[33]

133. Spanish banks rely substantially on wholesale and ECB funding (see Figure 2). The Spanish banking system is more reliant on foreign funding than peers, which makes it structurally vulnerable to potential shifts in investor confidence. Also, Spanish banks have absorbed a large share of the liquidity offered by the ECB with its targeted longer-term refinancing operations (TLTRO): they applied for TLTROII (maturity 2020) for an amount equal to around 25 percent of total. Most banks applied for the funding as an option to maximize their interest margin, given the favorable conditions compared to other alternatives.

Figure 2. Banks' Reliance on ECB and Wholesale Funding

Banks' Funding in Spain, 2006–16

(In percent of total funding)



[33] The internal liquidity adequacy assessment process (ILAAP) has been introduced by the EBA through its 2014 SREP guidelines and is based on Art. 86 CRD. In November 2016, the EBA has issued guidelines on ICAAP and ILAAP information to be submitted by banks, including information about their stress tests. The Guidelines apply since 1 January 2017; competent authorities need to report whether they comply with the Guidelines within two months after the publication of the translation in their national language (which, in Spain, has been published by BdE in May 2017).

134. Some market participants express the concern that the ECB's exit from its unconventional monetary policies might lead Spanish banks to further rely on external wholesale funding. In such a scenario, the stability of banks' funding profile in relation to their assets and off-balance sheet activities could be negatively affected, and profitability could also be impacted, via higher funding costs and lower interest income: exit from ECB extraordinary financing would hence also require a search for alternative income sources. On the other hand, the exit process is expected to be gradual, granting banks a time window to rebalance their funding, provided they act (and are constantly encouraged by supervisors to act) swiftly and decisively.

135. The evolution of ECB funding is part of the monitoring of liquidity risk under SSM ongoing supervision. Banks prepare and communicate to the authorities their exit strategy plans, including scenarios and strategies to reduce the share of ECB funding; these exit strategy plans also inform the banks' resolution plans.

136. However, supervisors observe that banks do not appear concerned about the substitution of ECB funding, as shown by their funding plans and minutes of their assets and liabilities committees. They generally have collateral available for additional funding, many do not renew their bonds issuances at maturity as they see no need of additional funding, some of them are still going through deleveraging processes (and would then feel less the pain of reduced central bank liquidity). Nonetheless, they express concern about the uncertainty surrounding the ultimate decisions on the size of MREL and on the instruments considered eligible: banks recognize that this might imply a delay in the decision of issuing bonds, and could also affect the markets at the expiry of ECB extraordinary financing.

137. The long experience of the crisis has indeed changed in depth the general attitude of banks—as well as that of the authorities—towards liquidity and funding risk. The availability of central bank liquidity is generally assumed while the stigma typically attached to accessing a central bank's discount window virtually vanished.

138. Yet, this ingrained confidence in central bank's ultimate availability to always provide liquidity support can generate a widespread complacency that runs counter to an appropriate risk management culture.

I. Corporate Governance

139. Corporate governance standards have improved significantly in Spanish banks in recent years and there is an increased awareness among bank boards and senior management of the need for a sound corporate governance environment. Several developments in recent years have resulted in better corporate governance in banks. Chief among these has been the transposition of CRD IV. It provides that banks must have robust governance arrangements including a clear organizational structure with well defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks it is or might be exposed to, adequate internal control mechanisms, including sound administrative and accounting procedures, and remuneration policies and practices that are consistent with and promote sound and effective

risk management. The CRD IV provisions are complemented by EBA Guidelines on Corporate Governance. These guidelines establish the responsibilities of a bank's Board and senior management with respect to corporate governance. They cover duties and responsibilities, composition and functioning, framework for the business conduct of the Management Body in its management and supervisory functions.

140. Apart from the above, the ECB and the BdE have been active in promoting good corporate governance in the banks. This includes highlighting the need for such in banks, giving the issue greater prominence in its inspection program, e.g., onsite inspections/SREP. They also insisted that, where a lack of knowledge is perceived at board level, the relevant members undertake further education in that area.

141. However, from a review of inspection and SREP reports at both ECB and BdE level and from discussions with various parties, signs of persistent weaknesses emerged in certain areas. This is particularly evident in the credit cooperative sector.

142. It was noted that in some instances there were insufficient levels and diversity of knowledge and skills in boards and board committees. Skill deficiencies in the areas of internal audit and IT seemed relatively common. Also, there was some evidence of insufficient attention been given to the management of risk and inadequate recording of board and board committee meetings.

143. The internal audit function in some banks (mainly LSIs) appears to be underdeveloped. At audit committee level, there were reports of members including the chairman not having sufficient expertise and experience. In the case of the internal audit function, it was noted that the function sometimes did not have sufficient status, did not have the necessary expertise and experience and had a too narrowly defined scope.

J. Related Party and Intra-Group Transactions

144. Spain has a largely adequate definition of related party. The rules also provide that all lending to related parties must be subject to the same conditions as those applicable to loans to non-related parties which have similar credit risk. There are no specific limits regarding the maximum level of exposures to related parties; instead they are governed by the large exposures criteria, i.e., such exposures must not exceed 25 percent of eligible capital.

145. While overall the rules apply to both directors/senior management and shareholders, certain rules apply to directors/senior management only. For instance, institutions must apply to BdE for authorization to grant loans and guarantees to members of the board of directors and managing directors and similar officers but not for any lending involving shareholders; also, half yearly, banks are required to provide the BdE with a list of board members and top management to whom loans have been extended but not to shareholders or their interests.

146. BdE has established a special regime for banking foundations to avoid conflicts of interest. Banking foundations were established to acquire saving banks as part of the resolution process for such banks. The law has established a mechanism to prevent any conflicts of interest that might arise between the foundation and the bank(s) it owns. Accordingly, banking foundations must provide a management protocol to the BdE setting out general criteria for the execution of transactions between the banking foundation and the credit entity(ies) it owns to prevent conflicts of interest.

147. Information on exposures to related parties is available through the Central Credit Register (CIR). It holds the updated credit records of natural and legal persons (e.g., parent entity or person, entity or person with join control, rest of the entities of the same group, associate, family members of key management personnel, etc.). The reported information allows BdE to perform its banking supervision obligations.

148. The level of intra-group exemptions in respect of solvency and large exposures ratios is minuscule. For the purposes of calculating solvency ratios, the CRR (Article 113(1) requires banks to apply risk-weighted calculations to all exposures. Certain exemptions are permitted to this requirement with the prior approval of the competent authority (Article 113 (6)) including intra-group exposures (parents, subsidiaries, fellow subsidiaries, etc.) subject to certain conditions being met, e.g., the intra-group entity is supervised, is subject to consolidated supervision and is the same member state as the bank in question. Similarly, in respect of large exposures—subject to a limit of 25 percent of eligible capital (Article 395 of the CRR)—exemptions from the limit are allowed subject to similar conditions as apply under Article 113(6).

149. BdE has allowed only two such exemptions—one under each category—in respect of relatively small banks. Details of the exemptions are reported to BdE via COREP under specific columns.

K. Sanctioning Powers

150. Both the ECB and the BdE have a broad range of corrective and sanctioning powers available to them. The SSM framework for enforcement and sanctioning is based on a combination of powers assigned to either the ECB (as the power to withdraw an authorization) or the NCAs, with the latter not being fully harmonized. Where the ECB lacks the powers to directly impose and enforce measures or sanctions on a bank, it can request or instruct the NCAs to act, based on the powers available to them; this arrangement has not been put to the test so far in Spain.

151. The range of corrective measures available to the BdE with respect to LSIs include: (i) imposing more stringent prudential limits and requirements; (ii) restricting or limiting the business, operations or network of institutions, (iii) restricting or suspending payments to shareholders or share repurchases, (iv) restricting asset transfers, (v) barring individuals from the banking sector, (vi) replacing or restricting the powers of managers, board members or controlling owners, (vii) facilitating a takeover by or merger with a healthier institution, (viii) providing for the interim management of the bank, and (ix) proposal to ECB for revoking banking license.

152. Enforcement appears to work effectively in Spain. As part of its supervisory activity, BdE can issue two types of measures, usually in the follow-up to onsite inspections: requirements—which banks are required to implement—and recommendations, which banks are advised to follow. From a review of inspection reports, it appears that banks comply with the enforcement regime.

153. Under the Spanish legislation infringements are categorized under three headings—minor, serious and very serious. The sanctions applied will depend on the categorization. Serious and very serious infringements are each defined in law; minor infringements are not defined but represent those infringements that are neither serious or very serious. In the 2012 assessment, it was noted that the MdE was the sanctioning authority for very serious offences. By change of law, the BdE is now the sanctioning authority for all infringements. However, it must notify ex-post the MdE of all sanctions in respect of very serious infringements and submit quarterly to the latter the essential information on proceedings under way and the resolutions adopted. Annually, BdE must send to the Parliament a report on actions that have given rise to penalties for very serious infringements.

154. The BdE has the power to impose sanctions to LSIs and their directors and executives, including monetary fines. The authorities introduced a new fining regime in 2014. In the case of legal persons, one or more of the following penalties may be imposed:

- A fine, which, depending on the severity of the breach (with especial legal thresholds for each category of infringements—minor, severe, very severe), may be:
    i. between two and five times the amount of the gains arising from the infringement, when such gains may be quantified; or
    ii. between 0,5 percent and 10 percent of total net annual turnover; or a fine of between EUR 100,000 and EUR 10 million.
- Withdrawal of the institution's authorization, only in the case of very severe infringements.

155. Irrespective of any penalty imposed on the infringing credit institution, and depending on the severity of the breach as previously mentioned, one or more of the following penalties may be imposed on the credit institution's de facto or de jure directors or executives responsible for the infringement:

- A fine for each of them for an amount up to EUR 5 million.
- Suspension from the office of director or executive in the credit institution for a term of no more than three years.
- Removal from office in the credit institution, disqualifying such persons from holding a director's or executive post in this same credit institution for a maximum term of five years.
- Disqualification to hold a directorship or executive post at any credit institution in the financial sector and removal, where appropriate, from any such post held by the infringer at a credit institution, for a period of no more than ten years.

155. The BdE has been slow in imposing monetary fines in the case of credit institutions, particularly where infringements of prudential rules are concerned. In the past three years, it has imposed only one fine, EUR 150,000 in respect of a consumer protection infringement in a credit cooperative. Five further cases are currently being examined—all related to potential consumer protection infringements. No monetary fines have been imposed or contemplated in respect of infringements of prudential rules. Also, no sanction has been imposed in the last five years for incomplete or inaccurate reporting: the procedure was initiated only once, and the bank complied immediately Since November 2014, the ECB is the competent authority for the imposition of pecuniary sanctions on SIs for breaches of prudential requirements (and on LSIs for breaches of ECB regulations or decisions).

156. The power to decide on administrative appeals against decisions issued by BdE concerning credit institutions is conferred upon the MdE. This concerns all decisions, like sanctions, negative resolutions concerning authorizations, injunctions, etc.; the MdE can either uphold or overrule the affected decision.

L. Financial Integrity

157. Spain appears to have a well-managed AML/CFT regime. AML/CFT compliance and supervision are the responsibility of the Commission for the Prevention of Money Laundering (Commission), which is chaired by the Deputy Minister of Finance. The Commission's executive service is SEPBLAC ("Servicio Ejecutivo de la Comisión de Prevención del Blanqueo de Capitales e Infracciones Monetarias"), which acts as the Financial Intelligence Unit (FIU). All financial providers and relevant non-financial services are required to report suspicious transactions to the FIU and to the competent law enforcement authorities.

158. The Commission is made up of over 20 of Spain's key AML/CFT agencies. These include policy makers, the financial intelligence unit (SEPBLAC), law enforcement authorities, supervisors (among others, BdE), customs and tax authorities, intelligence services, data protection authorities, the judiciary, etc. It is responsible for developing and implementing AML/CFT policies and activities, facilitating domestic coordination and cooperation at the policy and operational level, and plays a role in sanctioning breaches of the AML/CFT requirements.

159. In October 2013, the Commission and the BdE signed a MoU which replaced an earlier version dated 2008. The 2013 MoU allowed BdE to carry out AML/CFT inspections relating to its area of competency (see next paragraph) in accordance with the 2010 AML/CFT Law. Before 2010, SEPLAC was the only agency permitted to carry out AML/CFT inspections.

160. In practice, while SEPBLAC is responsible for the supervision of AML/CFT, BdE supervises AML/CFT in so far as it falls within its remit of overseeing the soundness of banks' policies, procedures and internal controls as well as the compliance with general regulations. Both agencies carry out onsite inspections for their respective AML/CFT areas of responsibility. Both Authorities exchange their banks' supervision schedules, their findings, and any other relevant information. Simultaneous inspections by BdE and SEPBLAC are sometimes carried out.

161. Since 2013, BdE has carried out onsite AML/CFT inspections only on SIs. The number of inspections was 12 in 2013, 6 in 2014, 4 in 2015, and 2 in 2016. Four inspections are planned for 2017, some of them involving LSIs. In the same period, the number of inspections conducted by SEPBLAC of both SIs and LSIs was 4 in 2013, 23 in 2014, 22 in 2015 and 13 in 2016.

162. SEPBLAC, and sector supervisors (e.g., Banco de España) send their inspection reports to the Commission, throughout its Secretariat, which is responsible for starting and performing disciplinary proceedings in case of sanctioning for infringements of AML/CFT laws. Based on the inspection report, the Commission decides when to open a sanctioning procedure. The procedure is then conducted by the Secretariat of the Commission (the Treasury) and sanctions confirmed by the Cabinet of Ministers, the Minister of Finance, or the Director of the Treasury, per the seriousness of the violation.

163. Spain performed well in an FATF mutual assessment carried out in 2014. Among its key findings were:

- Spain has up-to-date laws and regulations which implement the revised FATF Standards and is compliant or largely compliant with most of the recommendations;
- The Commission for the Prevention of Money Laundering and Monetary Offences is an effective coordination mechanism for AML/CFT policies and its executive service, SEPBLAC, is a strong financial intelligence unit and supervisor.
- Spain has demonstrated significant successes in money laundering investigation and prosecution.
- Spain has a high level of understanding of its ML/TF risks.

164. The FATF report also identified certain weaknesses. These tended however to be largely outside the banking sector. These include:

- Limited capacity to handle complex ML cases in the judicial system in a timely manner;
- Significant gaps in the legal obligations regarding wire transfers;
- Lawyers do not adequately apply the required preventive measures.

165. With specific reference to banking, the report notes that Spain has a strong system to manage AML/CFT in the financial sector. Implementation of preventive measures is strongest in the banking sector, although it was noted that some larger banks do not yet oversee their foreign operations to a group-wide standard. The report also noted that BdE had improved its engagement with the AML/CFT supervisory body and that cooperation between supervisors generally works well and is particularly strong between SEPBLAC and BdE.

RECOMMENDATIONS

A. Main Recommendations

166. The law should further enhance BdE's independence and powers:

- Legislation has not been amended to give BdE operational independence in its supervisory function in line with its independence as a central bank, as recommended by the 2012 FSAP. Even if, in practice, BdE appears to have operational independence in carrying out its supervisory function, the case for formally reinforcing its independence as a supervisor remains valid, for example by preventing the representatives of the government in its board from participating in the decisions on supervisory issues (including the nomination of senior supervisory staff and the allocation of the supervisory budget).
- Also, BdE could be granted broader autonomy—through appropriate legislative mandate and compatibly with the Spanish constitutional framework —in updating prudential regulations in matters not harmonized at the EU or SSM level (unless these became harmonized because of legislative changes at the supranational level).
- Finally, the law should ensure that in respect of the authorization of mergers and similar operations—which falls under the responsibility of the MdE after hearing the opinion of BdE and other authorities—concerns of prudential nature never get subordinated to others of a non-economic nature. This could help avoid the kind of issues that arose during the saving banks crisis: as observed by the same authorities in their response to the 2012 FSSA, "the fact that the Comunidades Autónomas exercised their power to approve the mergers of Cajas during the restructuring process significantly slowed down the process, given the need to hold long, complex and difficult negotiations with regional governments to reach adequate agreements."

167. Supervisors should maintain their pressure on banks to apply stricter and more accurate assessments when classifying loans, creating provisions, restructuring loan terms, and assessing collateral valuation. There appears to be a certain degree of loan misclassification in, at least, some Spanish banks. This was evident from a review of onsite inspection and SREP reports of both SIs and LSIs.

168. Supervisors should verify that banks are implementing the new provisions of Circular 4/2016, Annex IX, in a conservative manner, particularly in relation to those areas (provisioning, collateral valuation) where banks have discretion. The implementation of the new regime has thrown up disparate results. Because of the newness of the exercise, the BdE has not had the opportunity to examine the results, and the reliability of the results based on the internal methods. In broad terms, significant institutions are using internal methods whereas less significant institutions are using the tables in the annex. For those using internal methods, they must also carry out a parallel exercise using the tables, for comparative purposes. This disparity of results highlights the need for the BdE to continue assessing their reliability.

169. Banks must be monitored to ensure they have provisioned adequately in respect of recent litigation cases, e.g., mortgage 'floor clause' liabilities and fees incurred by mortgage customers at the commencement of the loan. Supervisors have already engaged banks to get an understanding of the likely impact of the floor clauses' redress: the monitoring effort must be maintained.

170. Supervisors should intensify the drive to improve corporate governance in banks, particularly in cooperative banks. Notwithstanding the progress achieved, a review of inspection and SREP reports highlighted several weaknesses in corporate governance: it was noted that in some instances there were insufficient levels and diversity of knowledge and skills in boards and board committees, particularly in the areas of internal audit and IT. The attention given to the management of risk is not always adequate and the internal audit function in some banks appears to be underdeveloped.

171. LSIs should be invited to implement complete liquidity stress tests (as part of their ILAAP) and BdE should continue to improve its in-home liquidity stress test model to challenge their results. The smaller banks run simple sensitivity tests that leave less room for deep and detailed supervisory analysis. They should be invited to implement complete liquidity stress tests (as part of their ILAAP). Because of the current FSAP, the FLESB tool has been extended to include a liquidity stress test exercise which can be used to challenge the results obtained by LSIs.

172. A general obligation should be introduced in the law for banks to notify the BdE in advance of any substantive changes in their activities, structure and overall condition, or as soon as they become aware of any material adverse developments. Currently, there is no general obligation for banks to communicate to the BdE any substantive changes or materially adverse developments beyond the circumstances explicitly stated in the laws and decrees.

173. The heterogeneity of onsite practices across the SSM should be addressed. An internal ECB review found that some inspections on credit risk end up with recommendations on asset classification and provisioning, others just on governance and policies and procedures. This is confirmed by a similar analysis conducted by the BdE. The ECB is working on a refinement of the SSM manual to homogenize onsite credit risk practices. This dispersion of outcomes could be addressed at different levels: methodology (providing finer criteria to define the scope and depth of investigations, the modality of interaction with the bank, etc.), implementation (e.g., using the revision of inspection reports to further harmonize inspection styles), and resourcing (to increase the number of cross-border teams with the involvement of the ECB and NCAs).

174. Related-party requirements currently imposed by BdE on directors and senior management should be extended to significant bank shareholders and other significant interests held by such shareholders. While overall the rules on related parties apply to both directors/senior management and shareholders, certain rules apply to directors/senior management only.

175. The number of AML/CFT inspections in LSIs, should be increased. Since 2013, BdE has carried onsite AML/CFT inspections only on SIs. The number of inspections was 12 in 2013, 6 in 2014, 4 in 2015, and 2 in 2016. In the same period, the number of inspections conducted by SEPBLAC of both SIs and LSIs was 4 in 2013, 23 in 2014, 22 in 2015 and 13 in 2016.

B. Other Recommendations

176. The recruitment process for BdE inspectors should be streamlined and made more flexible to reduce the time needed for new hires to become operational. The very selective recruitment process guarantees the high quality of BdE's inspectors. At the same time, it entails an extremely long time span until new recruits are assigned to their units and start working (approximately a year and a half), which represents a non-negligible cost for the BdE. In a phase when pressure on resources is so intense, the question arises of whether, from a cost-benefit perspective, such a cost is justifiable or other solutions could be envisaged with a reduction of the time-to-job for new hires via a compression of the duration of (at least) the training phase.

177. The approach to the prudential impact of conduct risk and consumer protection issues should be further developed in a pro-active direction. Conduct and customer protection issues can impact banks' reputation and profitability (via customers' redress and/or fines) and, ultimately, their solvency too. Supervisors should continue monitoring the impact on banks of the most recent episodes and further develop a pro-active approach to promptly identify emerging issues or possible future developments impacting banks.

178. Legislation should be amended to replace the MdE as the appeals body in respect of appeals against BdE decisions in favor of an independent appeals tribunal. The MdE is the appeals body for submissions from aggrieved parties against BdE decisions, including sanctions. Such an appeals mechanism has the potential, in theory at least, for government interference. In many jurisdictions, the appeals mechanism involves an independent tribunal, independent of government or industry influence.

179. Monetary fines should be used more frequently, together with other sanctioning tools. No monetary fines have been imposed or contemplated in respect of infringements of prudential rules. Also, no sanction has been imposed in the last five years for incomplete or inaccurate reporting: the procedure was initiated only once, and the bank complied immediately.

180. The use of tools based on the analysis of appraisers' valuation should be further promoted for the supervisory analysis of credit risk and the development of similar tools fostered across the SSM, where local conditions allow. The unit in charge of appraisers' supervision has developed a Valuations Analysis Tool for the comparison of residential real estate valuations across the different appraisal companies. The tool lends itself to quick and large scale valuations of homogenous properties, thus helping supervisors to detect pockets of overvaluation in the banks' portfolios.