

## 2 MICROPRUDENTIAL SUPERVISION

### 2.1 Supervisory priorities and strategies

The year 2015 was the first in which the supervisory priorities were established jointly under the SSM framework, through its decision-making bodies, in which the Banco de España participated actively. The main areas requiring special attention by the supervisor in 2015 and those on which the work in 2016 will focus are discussed below and summarised in Schema 2.1. Also set out below is one of the main strategic challenges that the Banco de España considers needs to be addressed promptly: the convergence towards best practices in the review of financial information of credit institutions and in the review of the quality of the loan portfolio.

#### 2.1.1 SUPERVISORY PRIORITIES IN 2015

- 1 *Business model sustainability*: banks' profitability has been adversely affected in recent years due to the narrow interest margins resulting from the low interest rates environment and weak economic growth, and to high loan impairment losses. The sustainability of institutions' business models was therefore under the supervisory spotlight in 2015, with a dual purpose: i) to avoid excessive assumption of risk in order to offset the negative impact of low profitability on the quality of the loan portfolio; and ii) to avoid cost cuts centred on control functions, with the resulting impact on operational risk.
- 2 *Credit portfolio quality*: the supervisory work in 2015 in this area was centred on monitoring the correct presentation in the institutions' financial statements, or in their Pillar 2 requirements, of the outcome of the 2014 comprehensive assessment exercise. Also, in 2015 there were further reviews of non-performing loan levels, the coverage of operations and the overall volume of forborne exposures.

The main scope of around 60% of the 32 on-site inspections carried out in 2015, including significant and less significant Spanish credit institutions, was to review credit risk.

In this regard, the Banco de España is participating in the thematic review<sup>1</sup> of leveraged financing at the SSM level. The objective has been to achieve a greater understanding of this activity, in which credit institutions engage, and to identify best practices. It also participates in a working group that analyses best practices in the management and recognition of impaired risks in order to establish a coherent cross-country approach.

- 3 *Corporate governance*: in 2015 a thematic review was performed on the governance structure and risk appetite framework of the main significant institutions. The objective was to assess the Board's involvement in decision-making, the extent of its knowledge of risk exposure and the correct implementation of the risk appetite framework.
- 4 *Capital adequacy*: in 2015 institutions' capital planning was analysed for compliance with the new regulatory requirements.

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<sup>1</sup> A thematic review focuses on one particular matter and is conducted in the same way for all the significant credit institutions in the SSM sphere.



SOURCE: Banco de España.

The ECB and the Banco de España issued recommendations on the dividends distribution policies of the significant and less significant institutions respectively, urging them to maintain conservative distribution standards: institutions must follow a linear path, over four years, to cover the amount required to reach their fully loaded<sup>2</sup> ratio at 31 December 2014.

Lastly, it should be noted that in 2015 changes were introduced into Spanish fiscal legislation that have removed all doubt as to the compatibility of Spanish

<sup>2</sup> Fully loaded: compliance with the capital requirements upon completion of the transitional adjustment periods provided for in the new solvency regulations.

regulations on deferred tax assets on banks' balance sheets, that do not reduce own funds, with European competition law.

- 5 *Regulatory harmonisation*: in 2015 there was a review of the national options and discretions permitted by European solvency regulations, with a view to harmonising the treatment of the institutions supervised by the SSM and to make progress towards convergence in supervisory practices. That analysis, in which the Banco de España participated actively, resulted in a common approach for the application of most national discretions.
- 6 *So-called "technology risk and cybersecurity"*: the Banco de España participated in the thematic review of cyber risk, carried out in 2015 in the SSM framework, and in the horizontal group on this matter. The aim was to assess institutions' cyber risk profile in order to establish an on-site inspection plan for this matter. The ECB is also creating a database with records of incidents relating to cyber-criminal activities.
- 7 *Conduct and legal risks*: malpractice does not only lead to the loss of confidence of banking customers, but also directly impacts institutions' income statements; accordingly, malpractice surveillance was a supervisory priority for the Banco de España in 2015.

#### 2.1.2 SUPERVISORY PRIORITIES IN 2016

In 2016 further work will be carried out on the supervisory priorities identified the previous year. Additional work will most notably include:

- 1 *Adaptation to new regulatory developments*: in 2016 institutions will have to make a considerable effort to adapt to the new regulatory requirements, which impose new liquidity and leverage ratios, higher capital requirements and, in particular, the requirements of the resolution regulations. All of the foregoing is likely to bring about changes in the structure of banks' balance sheets and strong competition in the capital markets due to the need to reinforce own funds and liabilities with loss absorbing capacity, which will be subject to special supervisory monitoring.
- 2 *Business model sustainability*: as a result of the economic environment, marked by the still-incipient economic recovery, low interest rates and the high volume of unproductive assets, the sustainability of institutions' business models continues to demand attention. In 2016, a thematic review is planned on the business models of SSM significant institutions. That review will be centred on the identification of possible problems, such as the easing of lending standards or the excessive increase in the risk assumed in the search for profitability.
- 3 *Credit quality*: particular attention will continue to be paid to credit quality. Also, special monitoring will continue of certain banks' exposures to vulnerable emerging economies.

The Banco de España will participate in a thematic review within the SSM on the preparatory work by significant institutions for the application of the new IFRS 9, once it has been adopted and enters into force, foreseeably in 2018. This new accounting standard involves replacing the incurred loss model with

the expected loss model in loan loss provision calculations. This standard improves the measurement and coverage of lending risk, but at the same time the subjectivity and complexity of the calculation of provisions increases, thereby jeopardising cross-bank consistency and comparability. Therefore, the supervisory review of institutions' adaptation to this new standard is a priority issue for the coming years.

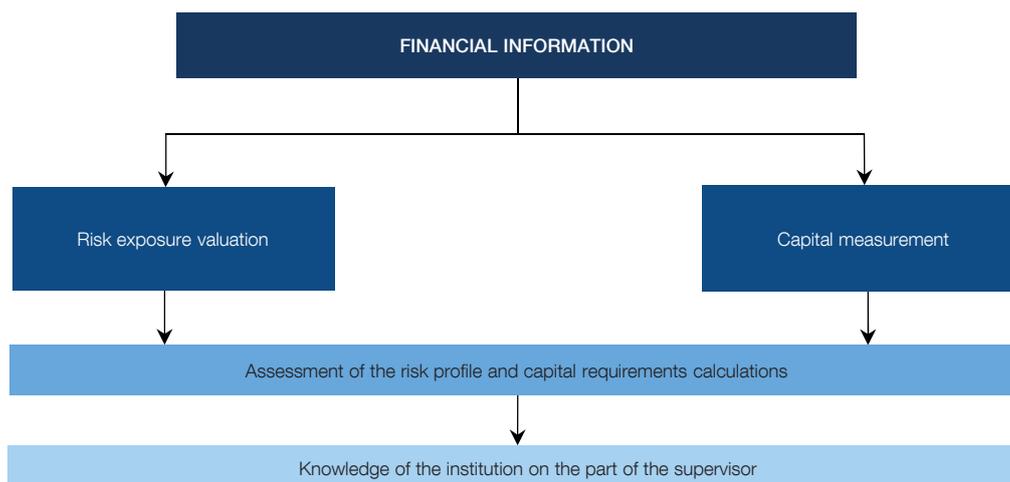
- 4 *Review of internal models:* 2016 will see the beginning of an in-depth review of the internal capital models in force within the SSM. Various tasks carried out by the EBA since 2013, as part of its review on the consistency of risk-weighted assets, have revealed a high variability in calculations, due not to the institutions' different risk profiles but mainly to the characteristics of the internal models. Therefore, the review scheduled for the coming years is intended to contribute to achieving consistency in the calculation of solvency ratios among the various institutions.
- 5 *Quality of information:* the Banco de España will participate in the thematic review of compliance with the Basel Principles for the effective aggregation of risk data and reports within the SSM. The quality of management information is essential to ensure correct decision-making by institutions' governing bodies. To this end, a modern technological infrastructure is fundamental.
- 6 *Monitoring of financing and liquidity risk:* particular attention will be paid to the impact of the new regulatory requirements in respect of institutions' liquidity risk on both their financing costs and their balance sheet structure, and to liquidity risk management and the internal liquidity adequacy assessment process (ILAAP).
- 7 *Performance of a stress test:* in 2016 the Spanish significant institutions will participate in a stress test, following the EBA methodology. As was the case in 2014, analyses will be performed on the impact of two macroeconomic scenarios – baseline and adverse – on institutions' solvency and results. A new feature in 2016 is the inclusion of conduct and exchange rate risk.

### 2.1.3 REVIEW OF FINANCIAL REPORTING BY THE SUPERVISOR

In recent years major efforts have been made to create a common regulatory framework for credit institutions and, in short, to converge towards best supervisory practices, both within the EU and globally. The new capital definition of the Basel Committee of Banking Supervision (BCBS), the approval in the EU of Regulation 575/2013 and the EBA guidelines on best supervisory practices in various areas have, inter alia, contributed to that progress.

Also, areas have been identified where homogenisation efforts must be stepped up. One field where further progress should be made is the convergence towards best supervisory practices in respect of financial analysis.

The main focus of supervision is the assessment of each institution's risk profile and the appropriate level of capital for that profile. Accounting information is the raw material used to assess the risks and the resources available to address them: its reliability determines how robust and comparable solvency ratios are. Consequently, the supervisor has a legitimate interest in the quality of that information and, therefore, its supervisory tasks should include checks on financial statements and the accounting criteria of relevant items, along with the review of risk files of specific operations granted by the credit institution.



SOURCE: Banco de España.

In accordance with strict banking supervision practices and international supervisory standards, the review of banks' financial statements by external auditors is an input in the supervisory process but it does not replace supervisory validation. The latter pursues broader objectives, safeguarding the institution's long-term solvency. The particular complexity and subjectivity inherent in the preparation and review of banking financial information reinforce the need for further supervisory review in addition to that of the auditor. Also, the supervisory review of financial information provides knowledge of the institution that is valuable in terms of assessing risk profile and capital adequacy.

At the international level, different supervisory practices are observed in the review of that information and in the actions arising from it. If that situation continues, it is necessary to prevent the risk of a de facto convergence towards the least rigorous supervisory practices to the detriment of the quality of supervisory work. Accordingly, it is important to build a strong culture of supervisory review of financial information on an international scale, based on best practices, which permits the correct diagnosis of institutions' positions by their supervisors and favours the adoption of measures geared to reinforcing their correct reflection in bank balance sheets.

## 2.2 Supervision of credit institutions

Table 2.1 shows the number of credit institutions operating in Spain at 31 December 2015 and that feature in the Banco de España register, and Table 2.2 contains details of the changes in the last year.

Spanish credit institutions are subject to ongoing supervision, previously conducted exclusively by the Banco de España and currently within the framework of the SSM, based on a prospective risk approach that is intensive in terms of supervisory activities and resources and intrusive in scope. That supervision combines supervisory ongoing monitoring activities with the performance of specific on-site inspections. The purpose of ongoing monitoring is to analyse the risk profile and financial position of each supervised institution, while the on-site inspections are reviews of specific previously identified areas.

The objectives of this model are the constant updating of the institution's risk profile, the early detection of potential risks and the immediate adoption of corrective actions and disciplinary measures.

## OFFICIAL REGISTERS OF INSTITUTIONS

TABLE 2.1

Year-end data. Number (a)

	2012	2013	2014	2015
<b>INSTITUTIONS WITH AN ESTABLISHMENT</b>	<b>305</b>	<b>288</b>	<b>273</b>	<b>264</b>
Credit institutions	258	244	227	220
Banks	75	72	70	67
Savings banks	27	18	5	2
Credit cooperatives	70	67	65	65
ICO	1	1	1	1
Branches of EU institutions	77	78	79	79
Branches of non-EU institutions	8	8	7	6
Controlling companies	1	1	3	3
Representative offices	46	43	43	41
<b>Institutions operating without an establishment</b>	<b>538</b>	<b>548</b>	<b>560</b>	<b>578</b>
EU CIs operating without an establishment (b)	534	544	555	573
Non-EU CIs operating without an establishment	4	4	5	5

SOURCE: Banco de España.

- a The number of institutions also includes those that are non-operational and in the process of deregistering.  
b Including financial subsidiaries of EU CIs.

GRANTING AND WITHDRAWALS OF BANKING LICENCES  
Changes in 2015

TABLE 2.2

Number

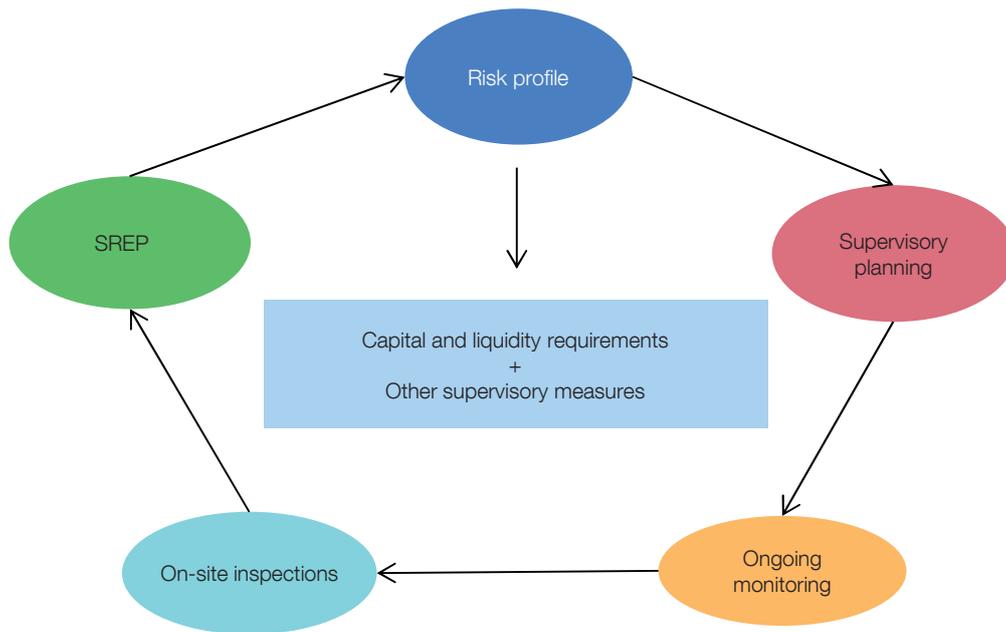
	Credit institutions	Branches of EU institutions	Branches of non-EU institutions
Registrations (a)	0	5	0
Deregistrations (b)	6	5	1
<i>Of which: savings banks converting into foundations</i>	3		
<i>Of which: owing to mergers</i>	1		

SOURCE: Banco de España.

- a ABN AMRO Bank, CM-CIC BAIL, Bank of América Merrill Lynch International, Banca Farmafactoring SPA, China Construction Bank (Europe).  
b Banks: Barclays Bank, S.A.; General Electric Capital Bank, S.A.; Banco Financiero y de Ahorros, S.A. Saving banks: Caja de Ahorros y Monte de Piedad de las Baleares, Caja de Ahorros y Monte de Piedad de Gipuzkoa y San Sebastián y Caja de Ahorros de Murcia. Branches of EU institutions: Europe Arab Bank PLC; JCB Finance, S.A.S.; MCE Bank GMBH; ING Belgium, S.A.; Cortal Consors. Branches of non-EU institutions: Bank of America, National Association.

This intensive and intrusive supervisory approach makes it possible to obtain deeper knowledge of the institution, and at the same time facilitates the early identification of problems, and the assessment of its recovery and resolution capacity in crisis scenarios. Proximity to the institution facilitates the flow of information and promotes dialogue with managers and the swift transmission of requirements of preventative and corrective actions.

The supervisory cycle, described in Schema 2.3, is based on the institution's risk profile. The latter shapes the planning of supervisory activities, which comprise ongoing monitoring and on-site inspections. The Supervisory Review and Examination Process (SREP) is conducted on the basis of the conclusions obtained from the aforementioned activities. That process involves updating the assessment of the institution's risks and controls that determine its risk profile and at the same time assessing the adequacy of the institution's



SOURCE: Banco de España.

capital and its liquidity position. Depending on the assessment made, additional capital and liquidity requirements (Pillar 2) and any other supervisory measures deemed appropriate are imposed on the institution. The SREP is ongoing and, therefore, the risk profile is updated constantly using the results of the supervisory activity.

The start-up of the SSM has not involved a break with the approach of the supervisory model traditionally applied by the Banco de España. However, there has been a considerable change in the supervisory methodology and processes relating to the supervision of significant institutions.

2.2.1 ONGOING SUPERVISION OF SPANISH SIGNIFICANT INSTITUTIONS

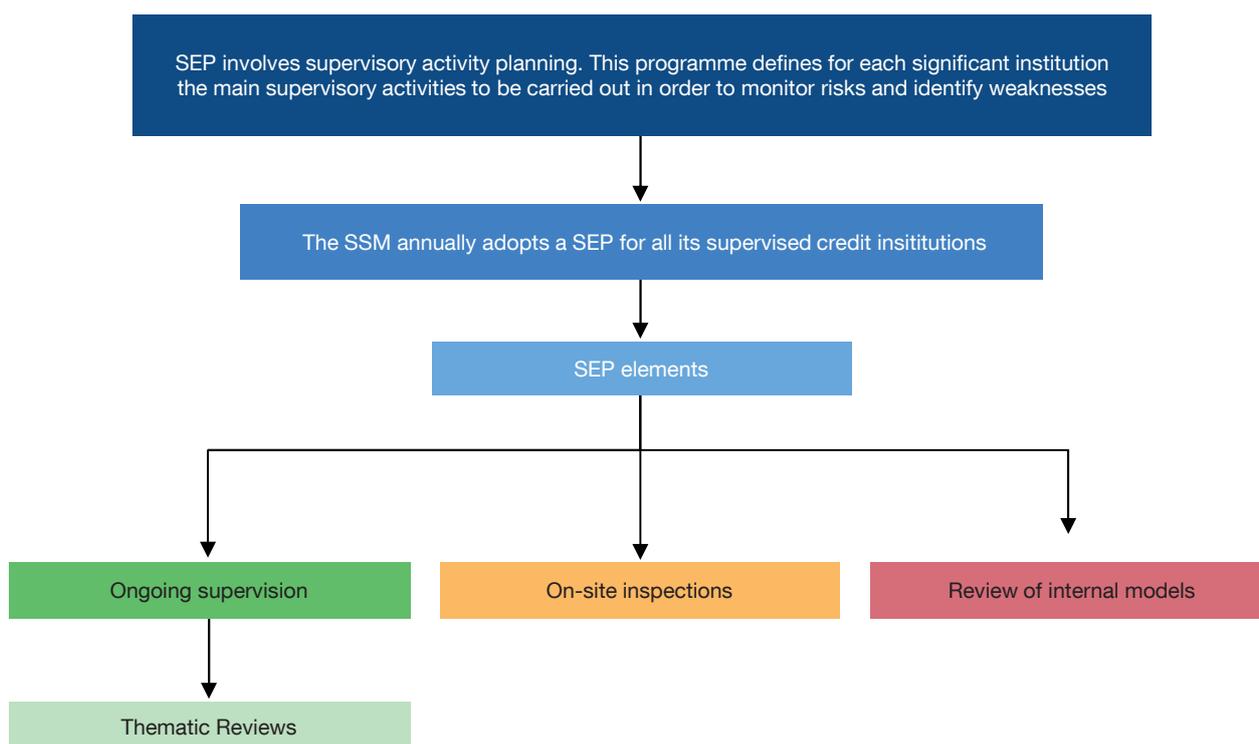
As regards significant credit institutions, within the SSM there are supervisory tasks led by the ECB and performed with the intense participation of the Banco de España through the JSTs, among other mechanisms; other supervisory tasks are the joint responsibility of the ECB and the Banco de España; and lastly; some supervisory tasks are the sole responsibility of the Banco de España.

For the purpose of planning supervisory tasks, annual Supervisory Examination Programmes (SEPs) are prepared, with the participation of the Banco de España. These programmes, described in Schema 2.4, are drawn up based on the institutions' risk profiles and on the SSM-defined supervisory priorities. The programmes establish the main supervisory ongoing monitoring tasks, their objectives and their frequency and timetable, along with the need for on-site inspections and for reviews of internal models.

Supervisory Review and Examination Process

The performance of these supervisory tasks is structured by means of the SREP, which concludes with an evaluation of the risk profile and of the adequacy of the solvency and liquidity of the institutions under supervision.

For operational purposes, the supervisory tasks are distributed among various areas: analysis of the business model; evaluation of internal governance and global controls; assessment of the risks affecting capital and of capital adequacy to cover those risks; and



SOURCE: Banco de España.

assessment of the risks affecting liquidity and of the adequacy of liquidity sources to cover those risks.

In order to conduct those reviews, as part of the ongoing supervision, the JSTs analyse the institution's regulatory reports, financial statements, management information and internal documentation; they hold regular and one-off meetings with managers at different hierarchical levels; they review recovery plans, analysing their complexity, quality and credibility; and they perform validation tasks checking the correct application of policies and procedures, and the correct valuation of risks.

Also, the JSTs participate in the significant institutions' supervisory colleges. In the case of Spanish institutions, these colleges are presided over by the ECB. The Banco de España participates as an observer.

Cross-functional thematic reviews

The SEP's tasks include cross-functional thematic reviews, planned on the basis of the SSM's supervisory concerns. Their purpose is to assess and compare practices in the system and to feed the SREP.

In 2015 the JSTs carried out three cross-functional thematic reviews. Their scope and the main conclusions reached for the European significant institutions as a whole are as follows:

- *Review of internal governance and risk appetite*: the board's involvement in decision-making and its knowledge of the risks to which the institutions are exposed were evaluated, along with the correct implementation of the risk appetite frameworks in management. The review enabled the JSTs to improve their knowledge of institutions' internal governance and to identify the best

practices at the level of euro area institutions. In general, the significant institutions still have room for improvement in this area and can draw closer to international best practices. The main areas of attention are: the capacity of boards of directors to act as a counterweight to the executive function; the inclusion of the risk perspective in the discussions of governing bodies; and the increased interaction between the institution's risk appetite and its long-term strategy.

- *Review of institutions' leveraged financing portfolios*: the scope of this review covered products such as collateralised loan obligations and bonds rated as “high risk”. The review was intended to achieve greater knowledge of transactions, management practices, governance and profit maximising strategies. Moreover, it served as a comparison exercise among institutions and enabled the main financial backers to be identified. Areas of improvement were detected in risk control and, in addition, an increase in the granting of those operations was observed.
- *Review of cyber risk*: the aims were: i) to assess the institution's risk profile in view of external IT threats and its capacity to handle those threats; ii) to identify good practices in the SSM among similar institutions; and iii) to support the identification of corrective actions. The review revealed certain security weaknesses, in particular in institutions involved in mergers. Also, on-site inspections were conducted, which led to the issuance of recommendations. All the information obtained following this review will be of use for the subsequent implementation of the methodology to be applied in the review of cyber risk.

#### Other tasks

Also, the JSTs respond to mandatory applications for authorisation made by the supervised institutions, preparing reports for the adoption of resolutions at the SSM level (Supervisory Board and Governing Council). Some examples of applications are those relating to the authorisation to include instruments as prudential capital or the granting of certain exemptions from prudential requirements provided for in the legislation.

It should be noted that the JSTs can perform specific tasks and activities on top of those in the supervisory plan, especially in order to swiftly address possible emerging risks or circumstances that might affect the institution.

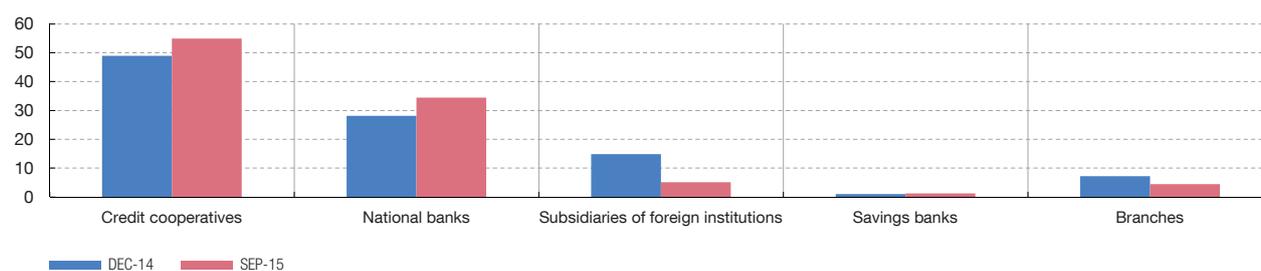
Lastly, the Banco de España also participates, together with the ECB, in the supervision of foreign banking groups with a presence in Spain, 8 of them with subsidiaries and others with branches, the parents of which are classified as significant.

#### 2.2.2 ONGOING SUPERVISION OF SPANISH LESS SIGNIFICANT INSTITUTIONS

The Banco de España is responsible for the direct supervision of less significant institutions (LSIs), while their indirect supervision falls to the ECB, as explained below. The Banco de España performs general monitoring actions and other actions relating to specific areas of less significant institutions.

The general monitoring actions of Spanish less significant credit institutions are performed quarterly or half-yearly and they cover, at least, the areas of financial monitoring, credit risk and liquidity. The objective of those actions is to update the risk profile, identify weaknesses and detect areas or matters which should be explored in greater depth. Smaller institutions, with an insignificant volume of deposits raised on the retail market, are

WEIGHT IN TOTAL ASSETS BY TYPE OF INSTITUTION



SOURCE: Banco de España.

subject to simplified remote monitoring in the form of quarterly alerts based on information from confidential financial statements and the Central Credit Register. The purpose of that remote monitoring is to detect potential future liquidity, solvency or profitability problems.

Given that the branches of institutions with head offices in European Union Member States that are not under the supervision of the SSM are not subject to prudential or liquidity requirements at the branch level, the supervision of the Banco de España is based on simplified remote monitoring and on the regular exchange of information with the authorities of the home country of the branch, under the terms established in Commission Implementing Regulation (EU) No 620/2014 laying down implementing technical standards with regard to information exchange between competent authorities of home and host Member States.

An annual report on the monitoring of less significant institutions is prepared on the basis of all the general and specific monitoring actions performed throughout the year.

In 2015 supervisory actions were performed consisting of the comprehensive ongoing monitoring of 19 of the 62 groups of LSIs that were under the supervision of the Banco de España and the simplified remote monitoring of the remaining 43 groups. Also, more than 200 detailed actions were performed, including, inter alia, reviews of audit reports and reviews of internal capital adequacy assessment reports. In addition to the aforementioned actions, regular meetings were held with persons in positions of responsibility at the institutions.

The Banco de España continued to cooperate with other NCAs in the area of colleges of supervisors of foreign banking groups with LSI parents, participating in three colleges<sup>3</sup> in 2015.

Such direct supervision of the LSIs by the Banco de España is supplemented by the indirect supervision by the ECB, which consists of:

- overseeing the functioning of the LSI sector, and
- ensuring the application of high and harmonised supervisory standards by the NCAs.

<sup>3</sup> A&G Banca Privada, Banco Finantia Sofinloc and Banco Mediolanum.

The ECB's performance of those two functions benefited from the intense cooperation by the Banco de España, which contributed its staff's experience and knowledge of the characteristics of the Spanish less significant institutions.

In particular, the Banco de España cooperates with the ECB in the oversight of the functioning of the LSI sector by submitting regular and ad hoc information on the manner in which the supervisory activity is performed and its results. And this following the procedures laid down by the ECB, which has meant considerable efforts to adapt.

The Banco de España cooperates with the ECB and the other NCAs in defining high supervisory standards which, once approved in the form of guidelines or recommendations, must be applied or taken into consideration by all the SSM countries in the supervision of their LSIs.

That intense cooperation will be maintained in the coming years, since ensuring that the supervisory standards are consistent and effective and that there is an appropriate level of consistency within the SSM is deemed a priority, without prejudice to the fact that the characteristics of the LSIs of each country must be taken into account.

#### 2.2.3 COMMON SSM PROCEDURES

Among the common ECB-Banco de España procedures, the Banco de España is responsible for making an initial assessment and drafting a proposal on each specific case. Subsequently, on the basis of the report issued by the Banco de España and other additional tasks that it might perform, the ECB must adopt a final decision. The common procedures are authorisations to create institutions and to acquire qualifying holdings in credit institutions, and the withdrawal of licences from credit institutions.

In 2015, ten common procedures were performed relating solely to the acquisition of qualifying holdings in Spanish credit institutions.

#### 2.2.4 ON-SITE INSPECTIONS

As regards both significant and less significant credit institutions, the on-site inspection function is separate from ongoing monitoring for the purpose of reinforcing the independence and objectivity of the conclusions obtained from those tasks. Table 2.3 details the on-site actions performed on credit institutions in 2015.

### ON-SITE SUPERVISORY ACTIVITY AT CREDIT INSTITUTIONS. ACTIONS

TABLE 2.3

Credit Institutions	2015		Total
	Significant institutions	Less significant institutions	
Banks	35	3	38
Of which: on-site on internal models	16		16
Savings banks		2	2
Credit cooperatives		8	8
Foreign branches			–
<b>TOTAL</b>	<b>35</b>	<b>13</b>	<b>48</b>

SOURCE: Banco de España.

#### On-site actions on significant institutions

On-site inspection actions for significant institutions are planned as part of the SEP.

In 2015, 35 on-site inspections of Spanish significant institutions were performed. The Banco de España played a major role in those supervision tasks:

- Of the 35 on-site inspections, 32 were led by Banco de España staff and the remaining 3 were led by a person responsible at the ECB.
- Almost all of the other personnel who participated in the inspection visits were from the Banco de España.

Of note among the tasks performed in 2015, together with the normal reviews of internal controls and loan portfolio quality, were the supervisory efforts in the area of IT (information technology). In the wake of the cyber-attacks on two Finnish banks at the end of 2014, the SSM deemed cyber risk to be one of its supervisory objectives. Against this background, the Banco de España staff who are experts in this matter completed two on-site actions on cyber risk in 2015 and they started two further thematic reviews on cyber security which will be completed in 2016.

To uniformly apply on-site inspections in all SSM countries, in 2015 the ECB Centralised On-Site Inspection Division organised a series of working meetings, normally on a monthly basis, between the ECB and the various national supervisors. The meetings were intended to coordinate the on-site inspection actions relating to matters such as reporting models, inspection plans and recommendations for institutions.

The Banco de España participated actively in these meetings, and in several working groups on various specific matters relating to inspections such as, for example, technological matters, the inspection manual and the review of the custody activity or market risk.

For the purpose of boosting the efficiency of inspections, efforts were made to develop mechanisms and routines reducing inspection turnaround times, and to precisely define the scope of each of the actions that must be performed.

Also noteworthy within the SEP of Spanish significant institutions are the reviews of internal risk models. In 2015, 16 of those reviews were started. With the exception of one review, in which ECB resources were involved, they were performed by Banco de España staff. The Banco de España also participated intensely in 2015 in the planning of the across-the-board review of internal models that the SSM will undertake on in 2016. Those actions gave rise to 13 authorisations relating to the validation of internal models, of which 12 related to credit risk models.

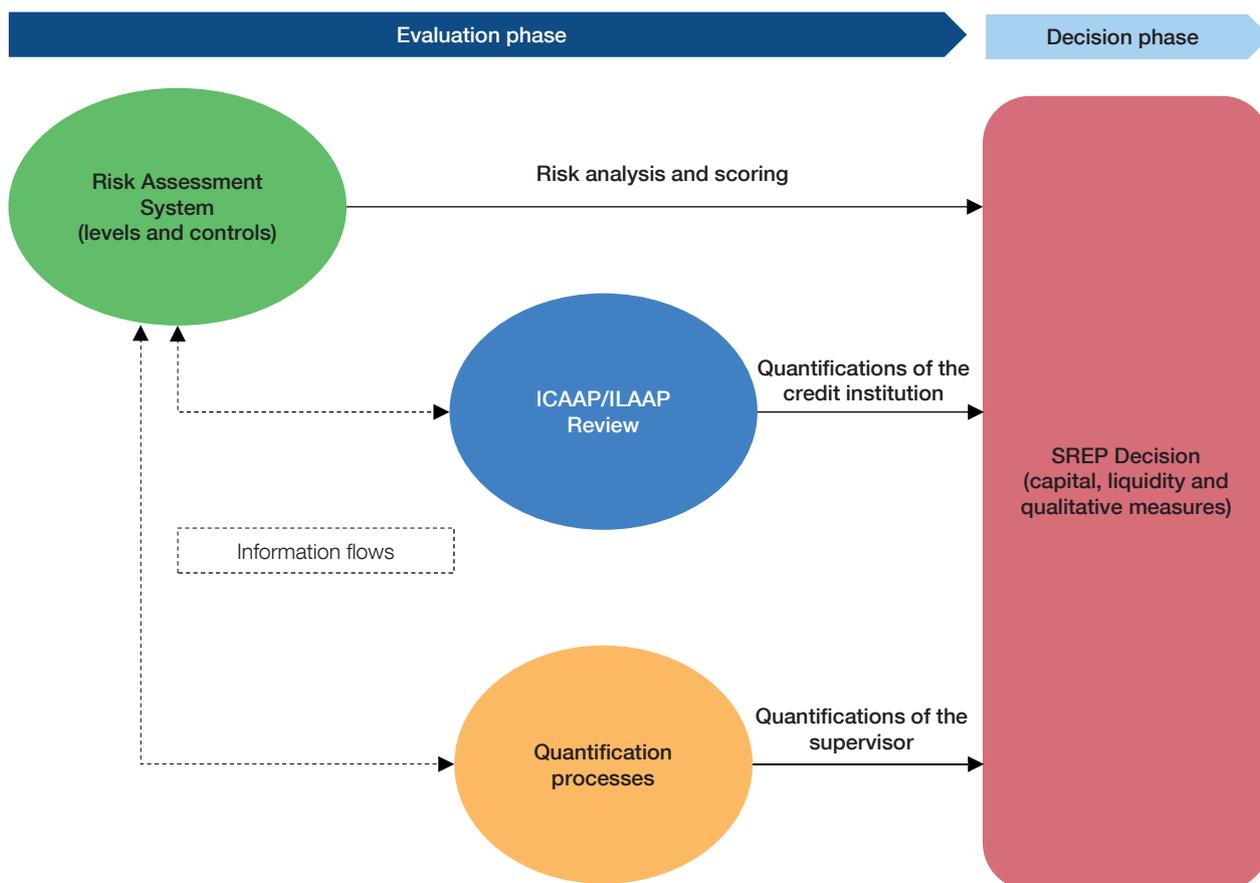
In the last quarter of 2015, the Banco de España participated in the preparation of the 2016 SEP, which established the on-site inspections to be performed throughout the year.

On-site actions on less significant institutions

A total of 13 actions were performed in the year. The SEP approved by the Banco de España Executive Commission foresaw the performance of 12 on-site inspections in 2015. The SEP was prepared taking into consideration the supervisory risk profile of the various institutions and the years elapsed since the last action. 11 of the 12 on-site inspections planned were conducted in 2015, and the inspection of one bank was postponed to 2016 because it was in the process of migrating its IT system. Also, a further two inspections were conducted that did not feature in the SEP.

2.2.5 THE OUTCOME OF THE SUPERVISORY REVIEW AND EXAMINATION PROCESS

The knowledge of the institution obtained through remote and on-site reviews makes it possible to complete the supervisor's assessment of each credit institution. The capital and liquidity decision that the supervisor will demand of each credit institution is adopted on the basis of this assessment. Most progress in 2015 was made in connection with the capital decision.



SOURCE: ECB.

This requirement of each institution of capital additional to the minimum regulatory requirement (Pillar 1) is called, in the terms of the Basel accords, "Pillar 2". By means of the capital decision, the supervisor formally requires the institutions to have a minimum level of capital in order to adequately cover all their risks, including those with regulatory requirements, i.e. Pillar 1 risks (credit, counterparty, market and operational risks), and those without regulatory requirements, i.e. Pillar 2 risks (basically business risk, balance sheet interest rate and exchange rate risk, concentration risk and reputational risk).

To take the capital decision, the supervisor has two sources of information:

- The assessment that the institution itself makes of its risks and its capital base in accordance with its internal process. This process is called "Internal Capital Adequacy Assessment Process" (ICAAP);
- The Supervisory Review and Examination Process (SREP), which includes the examination of the institution's risks, controls and governance.

Until 2015, the ICAAP and the SREP had been carried out following national guidelines, but as from this year they must take into consideration the guidelines prepared by the EBA and published in December 2014 (EBA/GL/2014/13).

Capital decision of significant institutions

With regard to significant institutions, 2015 saw for the first time the full application of the methodology implemented within the SSM for determining the capital decision and,

therefore, Spanish credit institutions were assessed using the same methodology as other European significant institutions. That common framework covers:

- i) a system for the assessment of credit institutions' risks;
- ii) a review of the ICAAP and ILAAP applied by the institutions; and
- iii) a methodology for calculating the capital and liquidity needs on the basis of the assessment of their risks.

In short, in 2015 the SSM adopted the first capital decisions resulting from the full application of the common SREP methodology. The preparation of the SSM capital decisions is based on a first draft prepared by the JSTs, taking into account the conclusions of the ongoing monitoring and any other relevant information on the institution, such as, for example, the outcome of the on-site inspections. Next, the ECB conducts various horizontal reviews, with the aim of applying a uniform degree of strictness in the level of capital required of the institutions. Subsequently, the draft capital decision is communicated to the institutions and they are given the opportunity to make representations. Once approved by the Supervisory Board, those capital decisions are communicated to the institutions and will be in force until the next capital decision, which will foreseeably be adopted in December 2016.

It should be noted that the 2015 SREP capital decisions of the SSM were expressed solely in terms of the highest quality capital (CET1) and that they took into account the new macroprudential buffers introduced in the European solvency legislation.

Capital decisions of less significant institutions

With respect to less significant institutions under the direct supervision of the Banco de España, a similar though simpler arrangement was applied in 2015, taking into account the Banco de España guidelines on the ICAAP and the SREP.

The supervisory practices of the Banco de España are adapted, in all material respects, to the new framework established by international agreements, European legislation, EBA guidelines and the SSM cooperation framework. In particular, the traditional supervisory approach followed by the Banco de España based on the institutions' risk profile and systemic importance is very similar to that currently established under EBA guidelines.

At the end of 2015, once the corresponding SREPs had concluded, the Banco de España adopted capital decisions for the less significant institutions by means of a procedure that includes the consideration of institutions' representations. The decisions have resulted in the setting of a specific capital level, in CET1 terms, which each institution or group must achieve.

2.2.6 SUITABILITY

The purpose of the supervision of the suitability regime for senior officers is to assess compliance with the requirements that the persons appointed to occupy the positions of board members, managing directors or similar officers must fulfil in accordance with the applicable legislation: commercial and professional repute, appropriate knowledge and experience to exercise their functions, capacity to dedicate sufficient time, compliance with the incompatibilities and limitations regime (where applicable) and, in the case of board members, willingness to exercise good governance. The suitability assessment by the supervisor is conducted mainly upon the appointment of the senior officer, but also in an ongoing manner, when there are significant events or changes which might affect it.

Competence in the case of significant institutions corresponds to the ECB, in close cooperation with the NCAs, whereas competence in the case of less significant institutions corresponds to the Banco de España.

The supervision of the suitability regime by the Banco de España was characterised by two events in 2015:

- the incorporation into supervisory practice of the new legislative developments and guidelines and reports that continue to be published on the subject of corporate governance, and
- the adaptation of the credit institutions' supervisory procedures and criteria to the report published by the EBA, referred to below, and to the guidelines issued by the SSM in its first year in operation.

The Banco de España develops and puts into practice all the tools and measures that make it possible to contribute depth to the analysis of the assessment and greater rigour to the conclusions. Thus, *inter alia*, interviews have started with candidates in the cases in which it is deemed appropriate from a monitoring standpoint, taking into account the characteristics of the post to be held and the importance of the institution. Also, particular emphasis is placed on the suitability assessment of non-executive directors, especially independent directors, and of executives responsible for the credit institutions' control functions. Their work is considered to be essential to ensure correct decision-making, efficient management and adequate risk control by the credit institutions.

Also, the use of measures to redress the shortcomings identified is becoming widespread. For example, when there is a rectifiable lack of knowledge or experience, the institutions are required to provide adequate training or integration courses. Similar steps are taken with the suitability assessment files which point to the existence of potential conflicts of interest, requiring, for example, the institutions to adopt an appropriate policy for the management of such conflicts. In some cases the application of the incompatibilities and limitations regime involves the need to resign from a post or the impossibility of assuming additional responsibilities.

The situations in which there is a failure to comply with the *repute* requirement have led, in general, to the voluntary resignation of the person in question. In other cases, where this requirement is not deemed to be absent but there is a situation which, depending on how it develops, might affect the person's *repute*, the institution is required to perform a specific and ongoing monitoring of the situation and to keep the Banco de España duly informed.

It can be concluded from the foregoing that this is a constantly developing area. The approval of Circular 2/2016, which completes the transposition of Capital Requirements Directive IV (CRD IV), will allow this process to move forward. In this regard, for example, more detail will be required on the data contained in the Banco de España Senior Officers Register, which will facilitate the review of incompatibilities in the simultaneous exercise of posts.

All of these matters will be affected considerably by the outcome of the work currently being carried out by the EBA on the definition of the holders of key functions and the preparation of guidelines in accordance with the CRD IV.

Harmonisation of supervisory practices among the SSM countries	In the context of the first year of functioning of the SSM, the ECB Authorisations Division created a working group, comprising experts from each of the participating countries, including the Banco de España. That group has worked intensely on the harmonisation of supervisory practices, taking the best practices identified by the various European supervisors and by the EBA as a reference. The work of the group has centred on the following criteria: assessment of repute, dedication capacity, potential conflicts of interest and the suitability of the board as a whole.
European Banking Authority Report	<p>Lastly, we turn to the results of the EBA report, <i>On the peer review of the Guidelines on the assessment of the suitability of members of the management body and key function holders</i>, published on 16 June 2015. The report analyses the amendments made to national bodies of law as a result of the publication of the EBA suitability guidelines in 2012, the best supervisory practices in the European Union, the degree of convergence achieved and the measures adopted when the suitability requirements are not met, identifying the best supervisory practices among the participating countries.</p> <p>Spain was found to comply with all the criteria included in the Guidelines.</p>
2.2.7 OTHER ACTIONS AND LETTERS	In addition to the tasks described above, the Banco de España's supervisory tasks also include, for both significant and less significant institutions: the common SSM procedures, the microprudential supervisory tasks not transferred to the SSM, the handling of certain procedures provided for in legislation and the issuance of letters.
Other supervisory tasks of the Banco de España	<p>Among the other supervisory tasks not transferred to the SSM which are performed by the Banco de España, the following are worthy of note:</p> <ul style="list-style-type: none"> <li>– The Banco de España is the competent body to authorise the opening of third-country branches in Spain. In 2015 no new authorisations were granted and there were two withdrawals due to branch closures.</li> <li>– As indicated in the Chapter 1, the supervision of the prevention of money laundering and terrorist financing (PML&amp;TF) at credit institutions in Spain is the competence of SEPBLAC, with which the Banco de España cooperates in the supervision of those procedures. In 2015 the Banco de España completed the plan commenced in 2013 to review the PML&amp;TF risk prevention and assessment measures at all significant institutions and some less significant institutions. Also, 2015 saw the start of a second cycle of assessment of the effectiveness and degree of implementation of the measures adopted by institutions to redress the deficiencies detected by the inspection.</li> </ul>
Procedures performed	Moreover, in 2015 the Banco de España, both as a member of the SSM and in the exercise of its exclusive supervisory powers, performed the procedures summarised in the table below:
Letters	In the performance of its supervisory tasks, the Banco de España sent 15 letters to credit institutions containing 37 requirements and recommendations, as detailed in Table 2.5. The most significant subject matters of those letters were: credit risk, both accounting and the quality of credit risk controls (41% of the total); management and internal control policies (27%); and capital and solvency (16%).

	In exercise of the exclusive competence of Banco de España	As part of the SSM	Total number
Suitability	181	85	266
Loans to senior officers	54	—	54
Reduction, repurchase or redemption of own funds	3	4	7
Other procedures relating to own funds (a)	9	3	12
Reports to Ministry of Economy on structural changes	10	—	10
Acquisition of credit institutions in third countries	8	—	8
Amendments of articles of association	73	—	73
Issuance of reports for other Spanish authorities	16	—	16
Other procedures	19	—	19
<b>TOTAL</b>	<b>373</b>	<b>92</b>	<b>465</b>

SOURCE: Banco de España.

a Including exemptions from deductions provided for in Regulation (EU) 575/2013, authorisations relating to the scope of that regulation and joint decisions on capital.

Additionally, the Banco de España sent a joint letter to all the credit institutions for them to examine entertainment expenses or similar costs over the last four years.

#### SUPERVISORY ACTIVITY. LETTERS ADDRESSED TO CREDIT INSTITUTIONS

TABLE 2.5

Number

Credit institutions (a)	
Banks	7
Savings banks	—
Credit cooperatives	7
Foreign branches	1
<b>TOTAL</b>	<b>15</b>

SOURCE: Banco de España.

a Of these letters, 12 relate to LSIs and 3 to SIs, arising from competencies that the SSM has not assumed.

Intervention of credit institutions

On 10 March 2015, as a consequence of the intervention of Banca Privada d'Andorra (BPA), an Andorran bank, by the INAF (the Andorran supervisor), the Banco de España resolved to intervene Banco de Madrid, a credit institution wholly owned by BPA. That precautionary measure was replaced, two days later, when the board of directors of the institution was replaced. Following the court decision to initiate insolvency proceedings, Banco de Madrid is now in the winding-up phase and the Deposit Guarantee Fund has reimbursed deposits up to €100,000.

### 2.3 Supervision of institutions other than credit institutions

The Banco de España has exclusive supervisory powers over the following institutions other than credit institutions that provide services or perform functions related to the financial sector: specialised lending institutions, mutual guarantee and reguarantee companies, appraisal companies, payment institutions, electronic money institutions, currency-exchange bureaux, banking foundations and Sareb. Table 2.6 contains the detail of those institutions.

Number. Year-end data (a)

	2012	2013	2014	2015
Institutions with an establishment	203	188	184	180
Specialised lending institutions (b)	54	48	47	44
Mutual guarantee companies	24	24	24	21
Reguarantee companies	1	1	1	1
Appraisal companies	57	46	40	36
Foreign currency-exchange bureaux (c)	10	9	10	13
Payment institutions	46	48	45	43
Hybrid payment institutitons	—	—	—	2
Branches of EU payment institutions	7	6	8	12
Agent networks of EU payment institutions	2	2	3	3
Electronic money institutions	2	3	4	3
Branches of EU electronic money institutions	—	1	2	2
Banking foundations	—	—	13	14
Sareb	1	1	1	1
Institutions operating without an establishment	181	265	317	400
Electronic money institutions	29	44	55	75
Payment institutions (d)	152	221	262	325

SOURCE: Banco de España.

- a** The number of institutions also includes those that are non-operational and in the process of deregistering.  
**b** Includes 5 SLIs that have proved their hybrid status, pursuant to Law 5/2015 on the promotion of business financing.  
**c** Not including establishments only authorised to purchase foreign currency with payment in euro.  
**d** In application of Directive 2007/64/EC and of Law 16/2009 on payment services.

The legal basis under which the Banco de España supervises those institutions and the approach behind the tasks differs from case to case. However, the supervisory concern is always the same: to ensure the proper functioning of those institutions, considering the role they play and customer protection. Also, the senior officers at all those institutions are subject to suitability requirements.

#### Specialised lending institutions

The Banco de España is granted powers to supervise these institutions under Article 12.1 of Law 5/2015 of 27 April 2015 on the promotion of business financing.

The main characteristics of these institutions are: i) the specialisation of their activity, which is confined to the performance of lending activities by various means and the granting of bank and other guarantees; and ii) they are not allowed to take customer deposits. Setting aside these characteristics, their operations are subject to an administrative regulatory regime overseen by the Banco de España that is similar to that of credit institutions, in particular with regard to minimum capital.

The supervisory tasks regarding specialised lending institutions consist basically of the review of the quality of their loan portfolio, their profitability and their internal controls, which is performed through monitoring actions or on-site inspections.

Law 5/2015 of 27 April 2015 on the promotion of business financing established the regulatory framework for those institutions, which ceased to be classed as credit institutions on 1 January 2014. Under this new legislation, these institutions are subject to Law 10/2014 of 26 June 2014 on the regulation, supervision and solvency of credit

institutions and its implementing regulations, together with any special features provided by the regulations. Law 5/2015 exempts these institutions from certain requirements applicable to credit institutions.

Until the entry into force of the new law, the Banco de España had the powers to grant and revoke the licences of specialised lending institutions, but since that date the power to authorise has been held by the Ministry of Economy and Competitiveness, with a prior report from the Banco de España, whereas revocation and withdrawal remains the competence of the Banco de España, pending the approval of the planned royal decree on the rules governing specialised lending institutions.

#### Mutual guarantee companies

The Banco de España's supervisory powers over these institutions are established in Article 66 of Law 1/1994 of 11 March on the rules governing mutual guarantee companies.

Mutual guarantee companies are financial institutions that behave like corporate promotion instruments, helping provide small and medium enterprises (SMEs), which play a major role in creating wealth and generating employment, with access to financing in line with their possibilities. In particular, they grant bank guarantees to SMEs that enable them to access bank financing and they provide them with other complementary services, such as advice on negotiations with credit institutions for better credit conditions and on the assessment of investment projects. The supervisory work on mutual guarantee companies consists of the analysis of the quality of the guarantee portfolio and their liquidity, profitability and solvency by means of monitoring actions and, where appropriate, on-site inspections.

#### Appraisal companies

The Banco de España's supervisory powers over these institutions are established in Article 15 of Royal Decree 775/1997 of 30 May 1997 on the rules governing the approval of appraisal services and companies.

Also, the Banco de España officially recognises appraisal companies so that their valuations have effect in the cases envisaged in Article 1 of Royal Decree 775/1997 of 30 May 1997 on the rules governing the approval of appraisal services and companies.

The supervisory tasks regarding appraisal services and companies consist of the analysis of the procedures used to conduct the appraisal of assets that serve, in general, as collateral for the mortgage loans granted by credit institutions.

In addition to the annual monitoring of licensed appraisal companies, a tool was developed for the review, by statistical means, of the appraisals conducted by those companies. The theoretical implementation of this tool, the pilot scheme for which was completed in 2014, was conducted on 8 appraisal companies, and in 2015 it was applied to the entire sector for the appraisal of homes. That enabled the comparative analysis of 875,000 appraisals of homes, all of which were performed in 2014 by approved companies.

#### Payment companies, electronic money institutions and currency exchange bureaux

The Banco de España's power to control and inspect these institutions is established in Article 15 of Payment Services Law 16/2009 of 13 November 2009; Article 20 of Electronic Money Law 21/2011 of 26 July 2011; and Article 6 of Royal Decree 2660/1998 of 14 December 1998 on the changing of foreign currency in establishments open to the public other than credit institutions.

Payment service providers play a major role in the functioning of an effective, efficient and secure payment system, which in turn is an essential element in the correct functioning of

economic and commercial relationships. The safeguarding of the users' funds that the payment institutions and electronic money institutions receive for the performance of payment operations and the issuance of electronic money, respectively, and, in short, the safeguarding of the operating and financial stability of that payment system, ultimately impacts the proper functioning of the economy as a whole.

The supervisory tasks regarding these institutions consist of reviewing the correct safeguarding of the funds received from customers, the solvency of the institutions and their internal control.

#### Banking foundations

The Banco de España analyses the influence of banking foundations on the sound and prudent management of the credit institution in which they participate. There are currently 14 banking foundations<sup>4</sup>. Also, banking foundations that own a holding equal to or greater than 30% of the capital of a credit institution or a holding which grants them control over a credit institution must prepare a management protocol and a financial plan regarding the holding that are submitted to the Banco de España for authorisation. Also, in the cases in which the holding reaches 50% or grants control, the banking foundations are obliged to reinforce the financial plan and create a reserve fund to cover possible capital requirements of the investee credit institution or to submit a divestment programme detailing the measures to be adopted and implemented by the banking foundation in order to reduce its holding in the credit institution to below the levels indicated in Article 44.3 of Law 26/2013 over a maximum period of five years.

#### Sareb

The Banco de España's supervisory powers over this institution are provided for in the Seventh Additional Provision of Law 9/2012 of 14 November 2012 on credit institution restructuring and resolution. The supervisory tasks consist of verifying the correct application of the procedures approved for the disposal of the assets received from certain credit institutions and the correct appraisal thereof.

Although the weighting of the institutions discussed in this section with respect to the financial system as a whole cannot be compared to that of credit institutions, their supervision is conducted by the Banco de España with the conviction that an effective regulatory and supervisory model for these institutions promotes the fluidity of financial intermediation mechanisms and generates a climate of confidence in financial institutions.

The following sections of this chapter refer, firstly, to the supervisory activity carried out in 2015 on the above-mentioned institutions. Secondly, mention is made of the authorisations and other procedures relating to the exercise of their activity. And thirdly, a description is given of the actions relating to the oversight of vetted access to activity.

#### 2.3.1 SUPERVISORY ACTIVITY

In 2015, 282 off site monitoring actions were performed by various means: annual monitoring, periodic general monitoring, simplified monitoring, reviews of audit reports and reviews of internal capital adequacy assessment reports, as detailed in Chart 2.2.

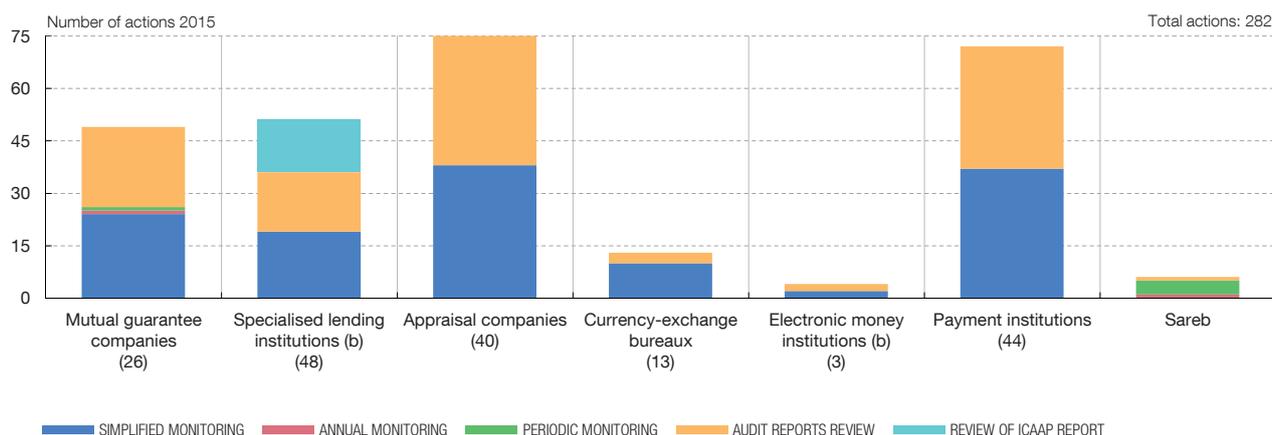
Also, 10 inspections were performed in 2015, the detail of which is shown in Table 2.7.

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<sup>4</sup> The banking foundations of BBK, Caja Vital, Kutxa, La Caixa, Unicaja, Cajastur, Santander y Cantabria, Ibercaja, Caja de Extremadura, Caja Círculo, Caja Canarias, Caja Burgos, Caja Castilla-La Mancha and Caja Navarra.

## SUPERVISORY ACTIONS TAKEN ON OTHER INSTITUTIONS (a)

CHART 2.2



SOURCE: Banco de España.

a The number of supervised institutions in 2015 is indicated in the legend to the chart.

b Not included here are 21 supervisory actions for specialised lending institutions and 1 electronic money institution, all of which belong to national banking groups.

## ON-SITE INSPECTIONS AT OTHER INSTITUTIONS

TABLE 2.7

Number

	Actions			
	2012	2013	2014	2015 (a)
Specialised lending institutions	1	2	—	3
Appraisal companies	—	—	—	—
Mutual guarantee companies	1	—	—	2
Payment institutions	3	3	5	3
Foreign currency-exchange bureaux	—	—	—	—
Electronic money institutions	1	—	—	1
Sareb	—	—	1	1
<b>TOTAL</b>	<b>6</b>	<b>5</b>	<b>6</b>	<b>10</b>

SOURCE: Banco de España.

a Of these inspections, 4 were in progress as at year-end.

### 2.3.2 AUTHORISATIONS AND OTHER PROCEDURES

The Banco de España participates in the granting and withdrawal of licences to open those institutions and to perform other procedures relating to the exercise of their activities.

#### Granting and withdrawal of licences

The Banco de España is the competent authority for granting and withdrawing licences for currency exchange bureaux.

However, it must issue the mandatory report on the authorisation of the following types of institutions, which is granted by the Ministry of Economy and Competitiveness.

- Specialised lending institutions.
- Electronic money institutions or branches in Spain of non-EU electronic money institutions.

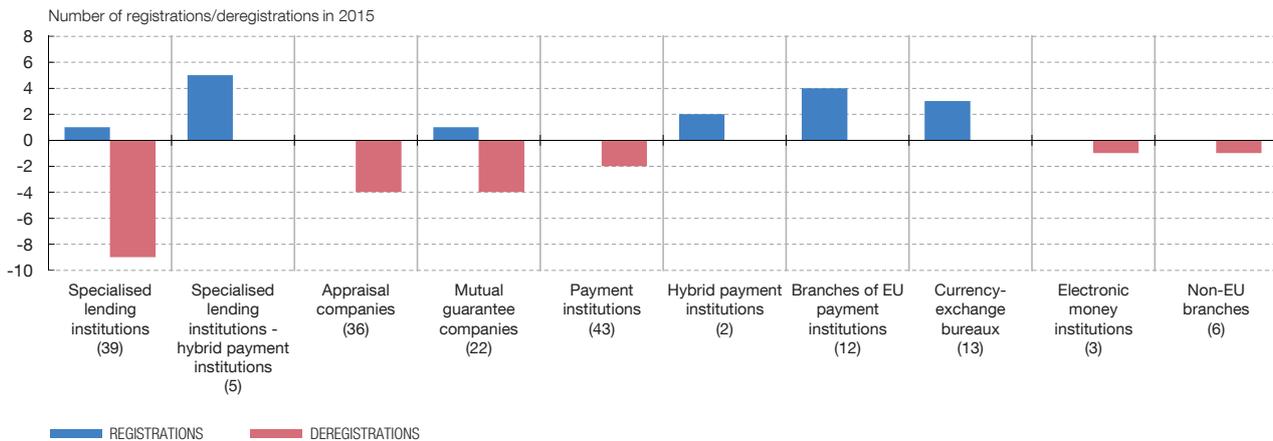
- Payment institutions or branches in Spain of non-EU payment institutions.
- Mutual guarantee companies.

In 2015, 16 requests to open institutions were processed, of which one related to credit financial intermediaries, five to hybrid payment institutions-credit financial intermediaries, one to mutual guarantee companies, two to hybrid payment institutions, four to branches of payment institutions and three to currency exchange bureaux.

Chart 2.3 shows the number of additions and deletions in the registers in 2015, broken down by type of institution.

REGISTRATIONS AND DEREGISTRATIONS OF OTHER INSTITUTIONS (a)

CHART 2.3



SOURCE: Banco de España.

a The number of institutions as at 31.12.15 is indicated in the legend to the chart.

#### Other procedures

The Banco de España holds various prudential supervisory powers over those institutions, relating to both the access to the activity and the exercise thereof. As indicated above, the Banco de España's specific powers over each of those institutions differ somewhat depending on the provisions of the legislation applicable to them.

In 2015, 232 procedures relating to those powers were performed, as detailed in Table 2.8. Additionally, two procedures were handled relating to consultations with other supervisors in the sphere of cross-border activity.

#### Letters

Following the supervisory actions, 10 letters were sent to those institutions containing 29 requirements and recommendations. The most significant subject matters were credit risk, both accounting and the quality of controls (34%); general internal control and management policies (21%); and capital and solvency (17%).

In addition to the figures in Table 2.9, 28 letters containing requirements were sent to appraisal companies for them to amend their internal codes of conduct, as they did not satisfy the minimum content of the provisions of Rule Five of Circular 7/2010.

**OTHER PROCEDURES PERFORMED BY THE BANCO DE ESPAÑA RELATING TO OTHER ENTITIES**
**TABLE 2.8**

Number of procedures in 2015

	Payment institutions	Electronic money institutions	Specialised lending institutions	Mutual guarantee companies	Appraisal companies	Currency-exchange bureaux	Sareb	Foundations	Total other institutions
Acquisition of qualifying holdings			1		2				3
Cross-border activity of Spanish credit institutions	7	2	2						11
Branches in the European Union	4		2						6
Branches in third countries									0
Freedom to provide services	3	2							5
Suitability	45	18	88		14	4			169
Other procedures relating to own funds (a)			1	1					2
Structural changes	5		5	3					13
Amendments of articles of association	5		14	8					27
Management Protocol								1	1
Other procedures	1		3	2			1		7
<b>TOTAL</b>	<b>63</b>	<b>20</b>	<b>114</b>	<b>14</b>	<b>16</b>	<b>4</b>	<b>1</b>	<b>1</b>	<b>233</b>

SOURCE: Banco de España.

a Includes exemptions from deductions provided for in Regulation (EU) 575/2013, authorisations relating to the scope of that regulation and joint decisions on capital.

**LETTERS ADDRESSED TO OTHER INSTITUTIONS**
**TABLE 2.9**

Number

	2012	2013	2014	2015
Specialised lending institutions	–	1	1	3
Appraisal companies	–	–	–	–
Mutual guarantee companies	2	–	2	2
Payment institutions	–	5	5	5
Currency-exchange bureaux	1	–	–	–
Electronic money institutions	1	1	–	–
Sareb	–	–	2	–
<b>TOTAL</b>	<b>4</b>	<b>7</b>	<b>10</b>	<b>10</b>

SOURCE: Banco de España.

**2.3.3 COMPLIANCE WITH VETTED ACCESS TO ACTIVITY**

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

2015 saw the initiation of supervisory actions relating to 32 natural or legal persons who might be carrying out restricted activities without authorisation, the outcome of which might lead to the adoption of penalties.