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TECHNICAL NOTE ON REGULATION AND SUPERVISION OF LESS SIGNIFICANT INSTITUTIONS

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TECHNICAL NOTE

REGULATION AND SUPERVISION OF LESS SIGNIFICANT INSTITUTIONS

Prepared By
Monetary and Capital Markets Department

This Technical Note was prepared by IMF staff in the context of the 2024 Financial Sector Assessment Program (FSAP) in Spain. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP can be found at http://www.imf.org/external/np/fsap/fssa.aspx

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Glossary

AMCESFI	Spain's Autoridad Macroprudencial Consejo de Estabilidad Financiera (Macroprudential Authority Financial Stability Council)
AML	Anti-Money Laundering
BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principles for Effective Banking Supervision
BdE	Banco de España (Bank of Spain)
BRRD	Banking Recovery and Resolution Directive
CC.AA.	Comunidades Autónomas (Spain's Autonomous Communities)
CFT	Counter-financing of Terrorism
CNMV	Comisión Nacional del Mercado de Valores (Spain's National Securities Markets Commission)
COREP	Common Reporting
CRD	EU Capital Requirements Directive (Directive 2013/36/EU)
CRR	EU Capital Requirements Regulation (Regulation (EU) No. 575/2013)
CTEF	AMCESFI's Technical Committee on Financial Stability
C&E	Climate-related and Environmental Risks
CCyB	Counter-cyclical Capital Buffer
CPBCIM	Comisión de Prevención del Blanqueo de Capitales e Infracciones Monetarias (Spain's Commission for the Prevention of Money Laundering and Monetary Offenses)
CVA	Credit Valuation Adjustment
DGSFP	Spain's Dirección General de Seguros y Fondos de Pensiones (Directorate General Insurance and Pension Funds)
EA	Euro Area
EBA	European Banking Authority
ECL	Expected Credit Losses
ECB	European Central Bank
EU	European Union
EVE	Economic Value of Equity
FATF	Financial Action Task Force
FINREP	Financial Reporting
FLESB	Forward-looking Exercise on Spanish banks – BdE's tool for assessing solvency of Spanish institutions in different macro-economic scenarios
FROB	Spain's Executive Resolution Authority
FSAP	Financial Sector Assessment Program
GDP	Gross Domestic Product
HI	High Impact
HP	High Priority
HR	High Risk
ICAAP	Internal Capital Adequacy Assessment Process

ICO	Spain's Instituto de Crédito Oficial
IFRS	International Financial Reporting Standard
ILAAP	Internal Liquidity Adequacy Assessment Process
IPS	Institutional Protection Scheme
IRB	Internal Ratings-Based (approach)
IRRBB	Interest Rate Risk in the Banking Book
JIMDDU	Junta Interministerial Reguladora del Comercio Exterior de Material de Defensa y de Doble Uso (Spain's Inter-ministerial Body on Material of Defense and Dual Use)
KRIs	Key Risk Indicators
LABE	Spanish Law on the Autonomy of the BdE
LCR	Liquidity Coverage Ratio
LOSS	Spanish Law 10/2014 of 26 June 2014 on the Regulation, Supervision, and Solvency of Credit Institutions
LSI	Less Significant Institutions
LTD	Loan to Deposit
MINECO	Ministry of Economy, Trade and Enterprise
ML/TF	Money Laundering/ Terrorism Financing
MREL	Minimum Requirement for own Funds and Eligible Liabilities
NCA	National Competent Authority
NII	Net Interest Income
NSFR	Net Stable Funding Ratio
P2G	Pillar 2 Guidance
P2R	Pillar 2 Requirements
RCAP	Regulatory Consistency Assessment Program (BCBS)
ROA	Return on Assets
Sareb	La Sociedad de Gestión de Activos procedentes de la Reestructuración Bancaria (Company for the management of assets acquired from the restructuring of the banking system)
Sepblac	Servicio Ejecutivo de la Comisión de Prevención del Blanqueo de Capitales e Infracciones Monetarias (Spain's Financial Intelligence Unit)
SI	Significant Institution
SNCI	Small and Non-complex Institutions
SREP	Supervisory Review and Evaluation Process
SSM	Single Supervision Mechanism
TCSP	Trust and Company Service Provider

EXECUTIVE SUMMARY

The FSAP undertook a targeted review of the banking regulation and supervision of Spain's Less Significant Institutions (LSIs). The review is part of the 2024 Financial Sector Assessment Program (FSAP) of Spain. In scoping this targeted review, the IMF team took account of the recommendations of the previous FSAP for Spain (2017) and relevant Euro-Area (EA) and global regulatory and market developments. The review covered: (i) the supervisory powers and independence of Banco de España (BdE); (ii) the supervisory approach and tools for LSIs; (iii) the oversight of LSIs' governance and risk management; (iv) the regulation and supervision of LSIs' key risks (including credit risk and problem assets, related party transactions, funding and liquidity risks, and interest rate risk in the banking book); and (v) the oversight approach with respect to LSIs' climate-related financial risks. The findings and recommendations of this technical note are based on an analysis of the regulatory framework in place and supervisory practices employed as of October 2023.

The Spanish authorities, including the BdE, have made significant progress to enhance LSI regulation and supervision, but some of the recommendations of the previous FSAP remain to be implemented. The enhancement of the regulatory and supervisory framework for LSIs has been facilitated by the evolution of the European Union (EU) regulatory and supervisory framework and efforts made by the Spanish authorities to transpose this framework and to upgrade their legal and regulatory framework. The BdE has also upgraded its practices and processes and implemented key elements of the Single Supervisory Mechanism's (SSM) LSI supervisory methodology. At the same time, progress is yet to be made on some important recommendations made by the previous FSAP with respect to strengthening the BdE's powers and enhancing its operational independence in supervision.

Notwithstanding the BdE's broad range of supervisory and corrective powers and the lack of evidence of any interference, establishing key additional safeguards would serve to secure its operational independence in supervision and reduce potential constraints on its ability to deliver on its prudential mandate. Specifically, the BdE's powers should be strengthened by granting it more autonomy in issuing prudential regulations that are not harmonized at the EU level (such as for related party transactions). In addition, the authorities should explore potential options (including feasible changes in the legal framework) that would provide more flexibility for the BdE to issue prudential requirements for regulatory issues that might emerge in the future in a timely manner. In addition, the supervisory independence of the BdE would also be increased by removing the possibility for banks to appeal BdE supervisory decisions and sanctions to the Ministry of Economy, Trade and Enterprise (MINECO) and by limiting the role of official political representatives on the BdE's Governing Council in relation to deciding on supervisory issues, decisions, and sanctions.

The BdE's supervisory priorities and activities focus on relevant LSI risks and vulnerabilities, albeit increasing targeted and thematic onsite activities and streamlining offsite monitoring processes would enhance the effectiveness of the risk-based supervisory approach. BdE has relied on thorough offsite analyses (including a framework based on four blocks of alerts) and a horizontal monitoring system that provides a wealth of information on the performance and vulnerabilities of LSIs. However, there is scope to further streamline the alert-based offsite monitoring system to limit any overlap between the various indicators used and better integrate this system in supervisory planning, while ensuring that such streamlining does not result in missing important supervisory information. In addition, the risk-based aspects of the supervisory approach could be enhanced by performing more frequent targeted onsite activities for medium- and high-risk/-impact LSIs, conducting thematic onsite inspections or reviews for selected topics, and implementing more proportionately some strenuous offsite processes, particularly the Supervisory Review and Evaluation Process (SREP) which is applied annually for all LSIs. The BdE should generally ensure that it has the adequate resources, on a forward-looking basis, to effectively apply the enhancements to its supervisory approach and enforce regulatory requirements in a timely manner.

The BdE's extensive efforts to improve corporate governance of cooperative LSIs are commendable, and in this context, it is recommended that work continue with additional focus on onsite activities. The thematic reviews led by the BdE on corporate governance of cooperatives and BdE's participation in the ECB thematic review on LSI governance have been vital to progress on improving several aspects of governance. As BdE's work and follow-up continue, performing targeted and thematic onsite inspections or reviews on LSIs' governance and risk management would be more effective in assessing remaining weaknesses and addressing them.

The BdE should further increase its supervisory scrutiny of LSIs' management of liquidity risk and interest rate risk in the banking book (IRRBB), building on its existing monitoring of LSIs' capital and liquidity levels and exposures to IRRBB. Monitoring LSIs' capital and liquidity levels and analyzing their exposures to IRRBB are core aspects of the BdE's offsite and horizontal analyses. Given that the few recent inspections have revealed weaknesses in LSIs' management of their liquidity risk and IRRBB, greater focus on these aspects of risk management is warranted through a mix of targeted and thematic onsite activities.

The extensive regulatory requirements and supervisory activities of LSIs' credit risk have been instrumental to cover this key priority, but reform is needed to enhance the related-parties framework and address gaps relative to international standards. The BdE's offsite and onsite activities have been focused on credit risk and problem assets which are among the main risks of LSIs. However, the prudential framework for related party transactions should be aligned with the Basel Core Principles for effective banking supervision (BCPs), which would allow a more conservative approach to these transactions and the removal of the BdE's power to authorize banks' loans to their directors and senior management.

The BdE's proactive approach to climate-related financial risks should continue to ensure that its assessment of these risks becomes embedded in its supervisory activities and its supervisory approach. The BdE's outreach, expectations, and reviews of LSIs' management of climate-related financial risks have increased LSIs' awareness in this area and ensured that they take steps to meet supervisory expectations. Going forward, the BdE should further develop its approach to ensure that climate-related financial risks become embedded in overall supervisory activities and processes.

The BdE's joint work with Sepblac should be an opportunity to enhance the risk-based aspects of oversight of anti-money laundering and countering the financing of terrorism (AML/CFT). Developing a joint risk matrix, in addition to a new supervisory manual and a joint inspection plan would facilitate better cooperation and more effective oversight of ML/TF risks. Work should continue to implement the risk matrix and setting it as a basis for planning supervision and inspection activities. In addition, more efforts need to be made to increase onsite coverage of AML/CFT issues in the banking sector. Finally, consideration should be given to granting the BdE more powers to issue requirements and sanctions vis-à-vis AML/CFT weaknesses and breaches, which could enable a timelier corrective action and sanctioning process.

Table 1. Spain: Key Recommendations

	Recommendation	Priority	Timing
	BdE's Supervisory Powers and Independence		
1)	Grant the BdE legal powers to issue prudential regulations in areas not harmonized at EU level and explore options to allow the BdE the flexibility to timely issue prudential requirements for other areas that could emerge in the future	H	NT
2)	Remove the appeal powers of MINECO with respect to BdE supervisory decisions and sanctions, without prejudice to the possibility of instituting an internal administrative appeal process within the BdE	H	NT
3)	Limit the role of official political representatives in the BdE Governing Council with respect to deciding on supervisory issues and sanctions	H	NT
4)	Ensure that prudential considerations are not subordinated to other factors in deciding on mergers and acquisitions	M	I
	Supervisory Approach and Tools		
5)	Review the offsite monitoring system to streamline alerts and reduce their overlap, better integrate it in supervisory planning processes, and tailor the depth/ frequency of offsite activities (particularly SREP) to LSI impact and risk	H	I
6)	Increase the frequency of onsite activities and perform more targeted inspections (especially for medium and high priority LSIs) and more thematic onsite activities	H	I
7)	Engage periodically with banks' independent board members and heads of control functions, especially for high priority LSIs	H	I
8)	Utilize the full panoply of enforcement tools, including sanctions, where appropriate.	M	I
	Regulation and Oversight of Key Risks		
9)	Continue monitoring and addressing LSIs' governance and risk management weaknesses by performing more targeted / thematic onsite activities	H	I
10)	Strengthen BdE oversight and inspection activities on banks' liquidity risk management policies and practices	H	I
11)	Align the framework on related party transactions with the BCPs in relation to definition of related parties, arms' length and conflict of interest rules, and a limit on aggregate exposures to related parties	H	NT
12)	Remove the requirement for the BdE to authorize banks' loans to their directors and senior management.	M	NT
13)	Take into account excessive concentration risk for a broader range of exposure types, including sovereign risk concentration, when setting P2R.	M	NT

Table 1. Spain: Key Recommendations (concluded)			
14)	Ensure more focus on onsite inspection of IRRBB risk management policies and practices, through thematic or targeted onsite activities.	H	I
15)	Continue monitoring and assessing climate risk through targeted and thematic work, ensure climate risk oversight becomes gradually integrated in routine supervisory processes, and increase related resources	M	NT
16)	Implement the AML/CFT matrix and integrate it in supervisory planning activities; Increase AML/CFT risk-based targeted inspection activities; and grant BdE powers to issue requirements and sanctions related to ML/TF risks	H	NT
Note: In terms of priorities, H, M, and L stand for high, medium and low. In terms of time frame, I, NT, and MT stand for immediate (within one year), near-term (within 2–3 years), and medium-term (within 3–5 years).			

INTRODUCTION[1]

A. Context

1. The Spanish economy and financial system have shown resilience following consecutive global shocks over the past few years. Such resilience was facilitated by the considerable improvement in the regulation and supervision of Spanish banks noted by the previous FSAP. Spain's participation in the Single Supervisory Mechanism (SSM) has also placed the progress on banking supervision on firmer ground. Following the pandemic, the Spanish economy has exhibited resilience in the face of headwinds, e.g., from the war in Ukraine. But tighter global financial conditions could pose challenges to the banking sector due to interest rate risk combined with a potential reduction in borrowers' repayment capacity. While the EA and Spanish banks have weathered well the March 2023 events in the global banking sector, the authorities should continue evaluating lessons learnt and adapt the regulatory framework and supervisory approach where needed.

2. Since the 2017 FSAP, the EU regulatory framework and the oversight framework for EA banks has been significantly strengthened. While there are some areas where the National Competent Authorities (NCAs) can adapt the framework to local circumstances, the wider EU legislation sets the main requirements for banks. The SSM assigns the European Central Bank (ECB) the responsibility to directly supervise Significant Banking Institutions (SIs), whereas LSIs are placed under the direct supervision of NCAs and the indirect oversight of the ECB. In view of these arrangements, the IMF and ECB/SSM have agreed to focus on regulation and supervision of LSIs as part of EA member country FSAPs.

B. Scope

3. In this context, the FSAP undertook a targeted review of the regulation and supervision of LSIs in Spain. In scoping this review, the 2017 FSAP recommendations as well as relevant EA and global regulatory and market developments were taken into account. As a result, the review covered: (i) the supervisory powers and independence of the BdE; (ii) the supervisory approach and tools for LSIs; (iii) the oversight of LSIs' governance and risk management; (iv) the regulation and supervision of LSIs' key risks, including credit risk and problem assets, related party transactions, funding and liquidity risk, and interest rate risk in the banking book (IRRBB); and (v) the oversight approach with respect to LSIs' climate-related financial risks. The review is based on the regulatory framework and supervisory practices that were in place by end-October 2023.

4. The findings of this review were guided by the 2012 Basel Core Principles for Effective Banking Supervision (BCPs) and build on the most recent assessment of the EA framework. The assessment of the regulation and supervision of EA banks performed as part of the 2018 EA

[1] This Technical Note was prepared by Rachid Awad (IMF).

FSAP, in addition to the Regulatory Consistency Assessment Program (RCAP) reports issued by the Basel Committee on Banking Supervision (BCBS) about the EU provide relevant context for this review.[2]

5. **The IMF team would like to express its appreciation for the excellent cooperation accorded by the Spanish authorities and private sector participants.** The BdE provided a self-assessment of compliance with the 2012 BCPs (building on the most recent EA BCP self-assessment) and responses to a complementary questionnaire. The ECB has also provided responses to a dedicated questionnaire. In addition, the authorities provided examples of actual supervisory practices and assessments. The IMF team benefitted greatly from the inputs received and exchanges of views during the meetings with the BdE, the Ministry of Economy, Trade and Enterprise (MINECO), the ECB/SSM, professional organizations, and banks. The IMF team sincerely thanks the authorities for their excellent arrangements that have greatly facilitated the work of the mission.

MARKET STRUCTURE

6. **The banking sector accounts for the largest part of the Spanish financial system.** At the end of 2022, banks account for 67 percent of financial sector assets, at 203 percent of GDP. The majority of banking sector assets are directly supervised by the ECB. These include ten Spanish banking groups, considered SIs, that account for over 90 percent of banking sector assets as of end March 2023. Spanish LSIs and the Instituto de Crédito Oficial (ICO), a state-owned, wholesale-funded credit institution, represent 5.5 percent of the banking sector, and the remaining 4 percent belong to subsidiaries and branches of foreign credit institutions.[3]

Table 2. Spain: Banks Operating in Spain

	2021		2022	
	Number of Groups	Percent of Assets	Number of Groups	Percent of Assets
Spanish SIs	10	90.2	10	90.5
Other SSM SIs via subsidiary/ branch	26	3.6	29	3.6
Spanish LSIs	57	5.7	56	5.5
Branches of other SSM LSIs	40	0.3	38	0.3
Branches of non-EU banking groups	4	0.2	4	0.2
Total	**137**	**100.0**	**137**	**100.0**

Source: BdE, Supervision Report 2022

[2] The first BCP Detailed Assessment Report of EA bank regulation and supervision was published in July 2018. In addition, the BCBS published several RCAPs for the EU, including on risk-based capital standards, liquidity coverage ratio (LCR), Net stable funding ratio (NSFR) and the large exposure framework.

[3] ICO is a state-owned entity, attached to MINECO, whose objective is to sustain and promote economic activities oriented towards the growth and improvement of the distribution of the national wealth. Given that ICO does not accept retail deposits and is fully guaranteed by the state, it was not included in the scope of this technical note.

7. While the activities of the Spanish LSI sector are mostly retail oriented, they operate according to different business structures. There are 66 individual LSIs organized under 56 credit institutions or groups subject to a capital decision. They are distributed among 35 credit cooperatives, 19 banks, and 2 savings banks. The LSI cooperative sector comprises 42 individual institutions that are organized under two cooperative groups and 4 separate institutions. The two groups operate under two different forms of integrated models (See Box 1). LSIs predominantly perform retail activities, but they also include entities with other business models that cater for specific market niches (see Figure 1).

Box 1. Spain: Existing Institutional Protection Schemes' (IPS) Cooperative Structures

The Spanish credit cooperative sector underwent a series of structural reforms and changes over the last two decades. Before the Global Financial Crisis (GFC), there were about 83 independent credit cooperatives. Between 2009 and 2014, there was some consolidation that reduced the number of credit cooperatives to 63, 25 of which formed part of two IPS. Following the launch of regulatory IPS in 2017-8, most of the independent cooperatives became part of a new regular IPS, based on article 113.7 of the EU Capital Requirement Regulation (CRR). As a result of all those reforms, the sector now consists of: 18 cooperatives that are part of a reinforced IPS considered as a SI; 30 LSI cooperatives forming part of a regular IPS; eight LSI cooperatives forming part of a reinforced IPS, based on article 10 CRR and additional provision 5 of the Spanish Law 10/2014 of June 26, 2014 on the Regulation, Supervision, and Solvency of Credit Institutions (LOSS); and four independent LSI cooperatives.

Below are the main regulatory particularities of the two types of IPS in Spain:

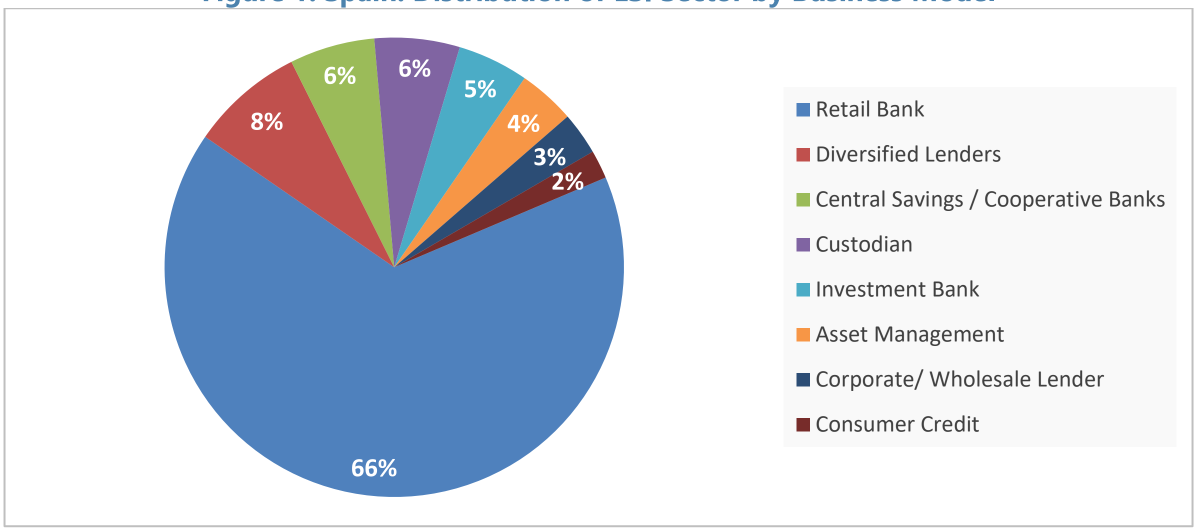
	Regular IPS (article 113.7 CRR)	**Reinforced IPS** (article 10 CRR and additional provision 5 LOSS)
Financial Support arrangements	- Financial support agreement with immediately available funds through an ex-ante established Fund.	- Commitments of central body and affiliated institutions are joint, and the commitments of affiliated institutions are entirely guaranteed by the central body.
Internal Oversight / Governance arrangements	- Internal uniform system to monitor and classify risks of all members, giving a complete overview of the risk profile of members and the whole IPS (should also be shared with other IPS members).	- Institutions are permanently affiliated to a central body that monitors their solvency and liquidity and issues instructions to their management. - Central entity determines the business policies and strategies of IPS members.
Application of regulatory requirements	- Requirements should apply at the level of each IPS member. - Zero percent risk weight for credit exposures or non-deduction of holdings in own funds to other IPS members. - Publication of an annual aggregate/ consolidated report comprising key financial statements and risk reports.	- Requirements are applied at the consolidated level of the overall IPS.

Box 1. Spain: Existing Institutional Protection Schemes' (IPS) Cooperative Structures (concluded)

Deposit guarantee	IPS members' Deposit Guarantee Scheme contributions are reduced by their contribution in ex-ante fund.	Contributions are made at the consolidated level of the IPS.
Minimum Required Eligible Liabilities (MREL)	- If relevant, MREL is set at the level of each IPS member. MREL are reduced by contributions to the ex-ante fund.	- MREL requirements are to be met at the consolidated level of the IPS.

Source: BdE.

Figure 1. Spain: Distribution of LSI Sector by Business Model



Source: BdE

8. **The prudential indicators of the LSI sector have strengthened in the last few years.** On average, LSIs' capital and liquidity levels have been comfortably above minimum requirements. NPL levels have shown a slight improvement and profitability has increased. LSIs have a lower loan to deposit (LTD) ratio compared to SIs. This reflects the increased exposures of LSIs to government and other debt securities which accounted for about 33 percent of LSIs' assets at the end of Q1-2023, almost double the same ratio for SIs (of around 17 percent).

Table 3. Spain: LSIs' Key Prudential Indicators

	2021	2022	Q2-2023
Total Capital Adequacy	20.54	21.03	21.37
Liquidity Coverage Ratio (LCR)	281.53	285.41	298.90
LTD	67.65	67.26	68.47
Nonperforming Loans Ratio (NPL)	2.80	2.58	2.62
NPL Coverage	45.08	47.16	47.26
ROA	0.35	0.48	0.89

Source: BdE

INSTITUTIONAL SETTING

A. Supervisory Responsibilities

9. The institutional framework for the supervision of banks in the EA is reflected in the composition and operation of the SSM.[4] Together the ECB and the NCAs of the countries participating in the Banking Union form the SSM. The ECB, working closely with NCAs, is directly responsible for the supervision of SIs. LSIs are under the direct supervision of NCAs while the ECB is responsible for exercising oversight for the functioning of the system.[5] In addition to its oversight role for LSI supervision, the ECB has direct responsibility over approvals (for proposals drafted by the NCA) for licensing, withdrawal of licenses, and qualifying holdings in LSIs. For both SIs and LSIs, authorization and supervision of non-EEA bank branches as well as supervision of anti-money laundering and countering the financing of terrorism (AML/CFT) are the responsibility of the NCAs.

10. The BdE is the NCA responsible for prudential supervision of Spanish LSIs and of branches of banks from third countries operating in Spain. These provisions are established in the law 10/2014 transposing the Capital Requirement Directive (CRD) to the Spanish legal system. This law on the regulation, supervision, and solvency of credit institutions (LOSS) applies not only to LSIs but also to SIs without prejudice to the EU regulation. The legal framework also includes law 13/1994 (updated in 2015) on the autonomy of the BdE (LABE), and its supporting regulations.

11. The BdE is the direct prudential supervisor of other financial institutions. Those financial institutions include specialized lending institutions, mutual guarantee societies, re-guarantee companies, appraisal companies, payments institutions, electronic money institutions, account information service providers, and currency exchange bureaus. In addition, the BdE supervises banking foundations (limited scope), ICO, and the Sociedad de Gestión de Activos procedentes de la Reestructuración Bancaria (Sareb). The BdE supervises those institutions to ensure their proper functioning considering their impact on financial stability.

12. Apart from its prudential mandate, the BdE has oversight competencies in other matters, including the supervision of banking conduct, transparency, and consumer protection; oversight of AML/CFT in cooperation with Spain's Financial Intelligence unit - Servicio Ejecutivo de la Comisión de Prevención del Blanqueo de Capitales (Sepblac); supervision and authorization of covered bond programs; supervision of certain provisions for securitizations with respect to certain originators, sponsors, or original lenders; and oversight of payment systems and instruments.

[4] The SSM Regulation and the SSM Framework Regulation set out the fundamental principles governing collaboration within the SSM.

[5] Although the ECB has the authority to take enforcement action and take over the direct supervision of an LSI, it has in practice so far has relied on the NCAs and only in exceptional circumstances assisted in onsite inspections or taken over supervision of certain institutions at the request of NCAs (e.g., assisting in stressed situations and circumstances in which NCAs were resource constrained).

13. The BdE is also the banking accounting regulator in Spain and issued the national Generally Accepted Accounting Principles (GAAP) applicable to banks. The BdE issued Circular 4/2017 which is considered as the banking accounting circular. The circular's accounting criteria are compatible with the International Financial Reporting Standards (IFRS). IFRS directly apply to the consolidated financial statements of banking groups with listed securities and to consolidated financial statements of other banking groups that decide to apply IFRS on a voluntary basis. Circular 4/2017 is directly applicable to: (i) consolidated financial statements of banks without traded securities that do not opt to apply IFRS and (ii) to individual financial statements of all banks.

B. Cooperation and Information Exchange

14. The Spanish institutional framework establishes separate oversight authorities for insurance firms and financial markets. The Comisión Nacional del Mercado de Valores (CNMV) is responsible for supervising financial markets and investor protection while the General Directorate of Insurance and Pension Funds (DGSFP) is in charge for supervising insurance companies and pension funds. The BdE has signed bilateral Memoranda of Understanding (MoUs) with the DGSFP in 2004 and with the CNMV in 2009 (they are in the process of being updated since they recently expired).

15. The institutional framework for resolution establishes two authorities for executive and preventive functions. The Law 11/2015 on recovery and resolution of credit institutions and investment firms transposes the Bank Recovery and Resolution Directive (BRRD) into Spanish law. It allocates an executive resolution authority to FROB, the Spanish Executive Resolution Authority. It also assigns the BdE with a preventive resolution function which acts independently from the BdE supervisory function.[6] FROB and the BdE resolution function signed a MoU in 2017.[7] Additionally, the BdE has developed internal regulations to facilitate and further formalize cooperation and exchange of information between the resolution and the supervision functions within the BdE (Internal Circular 1/2020, of February 18). This framework also provides for the proper identification and management of potential conflicts of interest that may arise in the exercise of the functions attributed to the BdE.

16. Spain's Macroprudential Authority Financial Stability Council, Autoridad Macroprudencial Consejo de Estabilidad Financiera (AMCESFI) was established in 2019.[8] AMCESFI brings together high-level representatives from the MINECO, the BdE, the CNMV, and the DGSFP. The Royal Decree 102/2019, which sets out the organisation and functioning of AMCESFI, entrusts it with the tasks of identification, monitoring and regular analysis of systemic risk factors that might negatively affect the real economy. The AMCESFI can issue and publish warnings and recommendations on issues affecting financial stability and opinions on proposed macroprudential

[6] The main tasks of the BdE preventive resolution function are to draft banks' resolution plans, conduct resolvability assessments, and determine MREL to be met by institutions.

[7] An addendum was signed in November 2021 to extend the validity of the MoU until November 2025.

[8] See also the technical note of this FSAP, Spain: Macroprudential Policy Framework and Tools.

policy measures by sectoral authorities. AMCESFI is structured around a Council and a Financial Stability Technical Committee (CTEF). The Council meets at least twice per year, while the CTEF meets at least quarterly. Key responsibilities of the AMCESFI are assigned to members of the MINECO (Chair and Secretary of the Council, Vice-chair of the CTEF) and the BdE (Vice-chair of the Council, Chair and Secretary of the CTEF).

17. The Commission for the Prevention of Money Laundering (ML) and Monetary Offences (CPBCIM) is in charge of the promotion and coordination for implementation of measures to prevent ML and the resolution of disciplinary proceedings for breaching AML obligations. CPBCIM is chaired by the Secretary of State for Economy and Business Support, and its executive service is the Sepblac which is also Spain's Financial Intelligence Unit (FIU). Law 10/2010, of April 28, is the main legislation for Prevention of Money Laundering and Financing of Terrorism. Royal Decree 304/2014, developing Act 10/2010 comprises, among others, rules related the different levels of customer due diligence.[9] The CPBCIM comprises over 20 of Spain's key AML/CFT agencies, including policy makers, the FIU, law enforcement authorities, the BdE and other supervisory authorities, customs and tax authorities, intelligence services, data protection authorities, and the judiciary, among others. The CPBCIM acts in plenary, and through its Standing Committee that is responsible for the formulation of formal requests to obliged persons to comply with AML/CFT obligations and its Financial Intelligence Committee that is responsible for coordinating ML/TF risk analysis activities. Its Secretariat resides in the Secretariat General of the Treasury and International Financing. The CPBCIM can convene whenever necessary but is required to meet at least twice a year.

C. BdE Internal Structure and Decision-Making Processes

18. BdE supervisory responsibilities are performed by the BdE Directorate General for Banking Supervision. The Directorate General for Banking Supervision is organized into six departments: Significant Institutions Departments I and II; LSI and other non-SSM Institutions Department; Inspection, Internal Model and AML Department; Horizontal Functions Department; and the SSM Coordination and Supervisory Strategy Department. The LSI supervision activities are mainly performed by the LSI and other non-SSM Institutions Department (comprising 62 staff for LSI supervision) with the assistance of other departments, including the Horizontal Functions Department and the SSM Coordination and Supervisory Strategy Department.

19. Supervisory decision making at the BdE rests with its Executive Commission and Governing Council which are both headed by the BdE Governor. The Executive Commission is competent, among others, to decide on authorization proceedings, issue recommendations and

[9] The two rules were amended in 2018 to incorporate the transposition of Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing (AMLD4). The rules were modified again in 2021 to adapt the Spanish legislation to the fifth Anti-Money Laundering Directive (AMLD5), to introduce several changes, among them, a whole set of specific requirements to be taken into account by virtual currency exchange providers and custodian wallet providers.

requirements to banks, and initiate sanction proceedings.[10] The Executive Commission is chaired by the Governor and includes the Deputy Governor and two elected Governing Council members. The imposition of sanctions is within the competencies of the Governing Council.[11] The Governing Council is composed of the Governor and the Deputy Governor, six elected members, the Secretary General of the Treasury and International Financing (within MINECO), and the Vice-Chair of the CNMV. BdE's Directors-General and the Secretary General attend the meetings of the Governing Council and the Executive Commission in a nonvoting capacity. The Minister of Economy, Trade and Enterprise or the Secretary of State for the Economy and Business Support may attend the meetings of the Governing Council, as participating but non-voting members, when they consider it necessary in light of the importance of matters under consideration. They may also submit a motion for consideration by the Governing Council. Yet, it is worth noting that these prerogatives have not been used at least in the recent past.

SUPERVISORY POWERS AND INDEPENDENCE

A. BdE Prudential Powers

20. While the BdE has broad supervisory powers within the limitations of the EU and EA frameworks, the BdE needs to be empowered by the legislation to set prudential rules. The government, as the head of the executive power, is empowered to issue regulatory rules under article 97 of the Spanish Constitution. 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 the BdE to further develop the regulation by means of a Circular. The direct granting of regulatory powers by way of law to BdE—and not through a legal act of the Government or a Minister— is rather exceptional, given that consultative bodies (such as the State Council) impose restrictions on the empowerment to regulators based on the Spanish constitutional and legal framework.

21. Given the national transposition and application of the EU prudential regulatory framework, this limitation on the BdE's powers to set prudential requirements is mostly relevant for areas not harmonized at the EU level. The legal and regulatory framework for banks (including LSIs) is based on EU regulation and the transposition of the European CRD. Hence, banking regulations and requirements in the Spanish law mirror European requirements with the

[10] In addition to those responsibilities, the LABE empowers the Executive Commission, among others, to: contribute to the implementation of the monetary policy formulated by the European System of Central Banks, organize the BdE and appoint Directors-General and personnel and fixing their salaries, submit to the Governing Council proposals for its approval and carry out tasks expressly delegated to it by the Governing Council.

[11] Based on LABE, the Governing Council is granted the following powers among others: approving the general guidelines to fulfill the BdE's assigned functions, observing the guidelines and instructions of the ECB, approving the annual report of the BdE and other relevant reports, approving proposed BdE's budgets and guidelines on personnel policy, ratifying the appointments of Directors-General, approving BdE's circulars, and imposing sanctions.

exception of national discretion issues and areas not covered by the EU framework. These areas include, for example, requirements for related party transactions.

22. A few other prudential areas also fall outside the remit of the BdE. MINECO is responsible for authorizing mergers, carveouts and 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 legal effect. In its consideration of such operations, MINECO requests a report from the BdE (and from other authorities, including the "comunidades autónomas" or CC.AA. - regional authorities—for credit cooperatives and the two residual savings banks). Also, the CC.AA. have 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. It is not clear how the views of the BdE would be considered in cases where they may diverge from the reports submitted by other authorities. Hence, this process should ensure that prudential considerations made by the BdE do not get subordinated to other considerations.

B. BdE's Supervisory Independence

23. The LABE establishes the main rules for the operational autonomy of the BdE. Based on LABE, the BdE is an institution under public law with its own legal personality and full public and private legal capacity. It shall pursue its activities and fulfil its objectives with autonomy from the Spanish general administration. The BdE is not subject to general provisions on organization and functioning of the Spanish general administration. The BdE is under their own rules governing economic and public budget, staff matters, property, obligation of secrecy and legal framework of the governing bodies and staff (Chapter I LABE). But the BdE is subject to the public procurement rules applicable to the public sector (Law 9/2017), as far as they do not affect its autonomy.

24. While the BdE is empowered to issue supervisory measures and sanctions against banks, its decisions could be appealed at the administrative level before MINECO. In these cases, the BdE sanctions are only final and enforceable after the end of the administrative appeal process which could take sometimes up to one year. There are also additional appeal possibilities. According to LABE (article 2), the "Sala de lo Contencioso-Administrativo of the Audiencia Nacional" (administrative chamber of the National Court) shall have sole jurisdiction in the case of appeals filed against acts adopted by the BdE not subject to administrative appeal, as well as against decisions of the Minister of Economy, Trade and Enterprise on appeals filed against acts adopted by the BdE.[12] The judgement of the Audiencia Nacional may be appealed (recurso de casación) before the Supreme Court. The appeal in front of the Ministry (recurso de alzada) could potentially lead to government interference in BdE's operational decisions. However, it is worthwhile to note that the

[12] Sanctions imposed are directly enforceable even if a judicial appeal has been filed against them, provided that no administrative appeal has been filed within a month against the Decision or that the MINECO has decided to reject the appeal.

Ministry has rejected these appeals in practice, at least in the recent past, based on the examples discussed by the BdE.

25. The representation of political appointees on the BdE's decision-making bodies also has the potential to cause or be perceived to cause government interference that could undermine the BdE's operational independence. Therefore, the membership of the Secretary General of the Treasury and International Financing on the BdE's Governing Council could be seen as an indication of the potential for such interference since the Governing Council decides on supervisory matters including sanctions, supervisory budgets and nomination of senior supervisory staff. In addition, the possibility of the participation of the Minister of Economy, Trade and Enterprise or the Secretary of State for the Economy and Business Support, in a nonvoting capacity, could be seen as another form of potential government interference since they may also submit a motion for consideration by the Governing Council. However, the authorities indicated that such participation has not occurred in practice at least in the more recent past. In case the main objective of those arrangements were to enhance cooperation between the government and supervisory authorities, alternative cooperation structures could be sought that would promote exchange of information and cooperation without potentially undermining the BdE's operational independence.

C. Recommendations

26. The BdE's powers and independence should be further reinforced through:

- Granting the BdE the legal powers to issue prudential regulations and requirements for areas not harmonized at the EU level (e.g., related parties) and exploring potential solutions to ensure that the BdE has the power to issue prudential requirements for regulatory issues that might arise in the future in a timely manner.
- Removing the appeal powers of MINECO with respect to BdE supervisory decisions and sanctions, without prejudice to the possibility of instituting an internal administrative appeal process within the BdE.
- Ensuring that prudential considerations are not subordinated to other factors in deciding on mergers and acquisitions.
- Limiting the role of official political representatives in the BdE Governing Council with respect to deciding on supervisory issues, sanctions, budget, and nomination of senior supervisory staff.

SUPERVISORY APPROACH AND TOOLS

A. Supervisory Approach and Tools

27. The supervisory priorities set by the BdE for the LSI sector are focused on the main risks and vulnerabilities of LSIs. The priorities for 2023 include: credit risk management, business model and sustainability, operational risk, governance, capital planning and climate risk expectations. The priorities for 2022 and 2021 were mostly similar to those set for 2023. These priorities are derived from the SSM supervisory priorities that are based on an analysis of the sources of banking sector risks and vulnerabilities.

28. The BdE's supervisory activities for LSIs are determined based on an annual action plan. The BdE first prepares a supervisory framework document which provides an overview of the main risks and priorities for all supervised entities in addition to a more detailed overview of the supervisory strategy to be followed for each LSI or LSI group. Based on the supervisory framework, an annual action plan is designed to determine the offsite analysis and inspection tasks to be carried out for each LSI during the year. Both the supervisory framework and the annual action plan are approved by the BdE's Executive Commission. The summary of both documents is also shared with the ECB.

29. LSIs are classified based on their risk and impact. The new LSI classification methodology, approved by the ECB Supervisory Board in January 2021, introduces the categories of High-Impact (HI) LSIs and High-Risk (HR) LSIs, which are identified using separate impact and risk criteria.[13] This methodology replaces the LSI prioritization concept used earlier. The first application of this methodology came into effect as of January 2022.[14] The BdE has further tailored this classification by categorizing LSIs as high priority (HP), medium priority (MP), and low priority (LP). HI and HR LSIs are included in the BdE's HP list, in addition to other LSIs selected based on a set of indicators such as size, profitability, and credit risk. Those indicators are also used to distinguish between MP and LP LSIs. As outlined later, the main use of this priority list is for prioritizing onsite inspections since offsite monitoring is applied to all LSIs with almost the same breadth irrespective of their priority classification.

Offsite Supervision

30. The Supervisory Review and Evaluation Process (SREP) is one of the key tools used by the BdE offsite team to assess LSIs' risks and determine their capital requirements. This tool is based on the SSM LSI SREP methodology. The risk profile of each LSI is assessed based on a score from one to four. The SREP also concludes with a decision that determines the required Pillar 2 capital surcharge (P2R) and the recommended additional capital surplus (P2G) for each LSI or LSI group. The BdE performs the SREP exercise annually for all LSIs or LSI groups but the P2G component, which started being applied in 2021, is calibrated every other year. Hence, it would be useful for the BdE to consider further proportionality in its offsite processes, particularly the annual application of SREP to all LSIs.

[13] The HR criteria include a set of financial deterioration indicators, SREP scores, and additional riskiness indicators. The HI criteria take into account the size of the institution, its importance for the economy, its cross-border activities, its business model, its minimum coverage, and whether it is potentially a SI.

[14] The identification exercise is being performed annually for HI LSIs and the list is published. By contrast, the update for the HR LSIs is done on a quarterly basis, and the outcome remains confidential for financial stability reasons.

31. Periodic offsite monitoring and analysis of LSIs' indicators are another key aspect of the supervisory process. This offsite monitoring entails a quarterly analysis of alerts that are complementary to the aspects that are assessed in the annual SREP. They consist of four blocks of alerts designed to monitor the financial situation of the LSI and consisting of: a system of alert indicators developed by the BdE to detect weaknesses in institutions, quarterly indicators of financial deterioration which are used by the ECB as part of their notification system, quarterly values of the automatic SREP rating score, and the values of the indicators and thresholds in each LSI's recovery plan. The quantitative alerts (including those linked to regulatory ratios) are collected and grouped into areas that accumulate penalty scores to determine the risk of the LSI in each area. Qualitative alerts do not carry a penalty score but are relied upon by the supervisor to assess the residual risks for each institution.

32. The quarterly monitoring alert system is a useful tool to develop a comprehensive view of the various components of an entity's risk profile. It allows the BdE to analyze the evolution of indicators and alerts using different risk perspectives ranging from regular early warning indicators to SREP-based scores and ending with thresholds in the recovery plan which indicate potential breaches to regulatory thresholds. This system has been gradually developed by the BdE and aims at ensuring that the monitoring of banks' performance uses the different sources of information and reporting available to the BdE.

33. Streamlining the alert system and integrating it into supervisory planning processes could enhance the risk-based approach used by the BdE. While the four blocks of alerts allow for the inclusion of different perspectives in the quarterly monitoring analysis, some of these alerts refer to the same risk or the same soundness indicator which may distort the comparative risk profile of different institutions and may not lead to a reliable distinction among institutions' risks. Hence, the BdE should consider streamlining the alert system and address any redundancies that could distort its outcome in relation to assessment of banks' risk profiles, while ensuring that such streamlining does not result in missing important supervisory information. In addition, the offsite system could be better integrated into supervisory processes. For example, it is not being used as a key direct additional input to plan supervisory activities, including onsite inspection, since the SREP is the main driver of this process. Further consideration of this alert system in determining the intensity and focus of other supervisory activities would increase the robustness of BdE's risk-based approach. It would also prove instrumental as the BdE plans to introduce more proportionality in the annual SREP exercise for banks.

34. The BdE supervisory teams perform additional offsite activities in the form of thematic reviews and horizontal analysis. These reviews and analyses represent deep dives focusing on particular topics using dedicated input or information requested from banks, in addition to the other reports and information available to the BdE. The BdE has done two main thematic reviews, on governance and business model, and there are three ongoing additional thematic reviews (IT questionnaire, outsourcing, and climate risk questionnaire). These reviews were an opportunity to review the SREP scores for related components and to develop recommendations and requirements to address gaps as part of the SREP process. The reviews led by the BdE included the following areas, among others: assessment of climate-related and environmental (C&E) risks; business model analysis; IT, outsourcing, and notification of cyber incidents; analysis of IT risk; and governance in the credit cooperative LSIs. Some of these reviews also leveraged similar reviews conducted by the ECB (with participation of Spanish LSIs) particularly on the topics of governance and C&E risks.

35. In addition, the BdE holds periodic meetings with LSIs' boards and senior management. These include two meetings, the first of which happens in the first quarter of the year and is dedicated to discussing the closing financial statements for the previous year. The second meeting, called "Supervisory dialogue" is intended to discuss the results of the annual SREP. Other meetings are typically held with LSIs to discuss the draft decision on SREP and the capital decision letter as well as recovery plan assessments. In addition, the BdE supervisory staff have informal ongoing exchanges with banks for various follow-up issues. However, the BdE has not periodically held, in the last few years, separate meetings with banks' independent directors or heads of internal control functions to get a better understanding of banks' risks and vulnerabilities.

Onsite Inspection

36. Onsite inspection of LSIs provides the BdE with a more thorough understanding of banks' risks, but it is currently being done at a lower frequency than the targeted supervisory cycle. The actual inspections performed by the BdE are general inspections with focus on selected topics determined ahead of the inspection. A letter of findings is prepared after the inspection based on which a letter of requirements or recommendations (approved by the BdE's Executive Commission) is sent to the banks setting the actions to be taken to address the inspection findings. The BdE targets a maximum inspection cycle of two years for LSIs with a SREP score of four, four years for LSIs considered high supervisory priority, and five years for other LSIs. However, the actual frequency of inspection activities for some of the institutions is lower than targeted, which the BdE attributes to the lack of available resources.[15] In addition, the inspection cycle targets set for LSIs with a four-score SREP or classified as HP seem to be too long given that these institutions warrant much closer supervisory scrutiny and more frequent onsite activities.

37. Rebalancing the mix of inspection types and increasing their risk-based aspects could help make the BdE's inspection process more efficient. The BdE's inspections consist of three types: general, partial and thematic. However, most of the inspections actually performed by the BdE are of the general category, with a particular focus on selected issues or risks. In addition, the BdE has not typically resorted to doing thematic onsite inspections or activities covering a particular topic horizontally across a number of LSIs. While performing a general full-

[15] For example, few institutions have not been inspected for about six or seven years, which does not align with the five-year maximum target for inspection cycles set by the BdE and only one out of 18 HP LSI had been inspected 4.5 years ago (slightly higher than the BdE's target inspection cycle of four years for HP LSIs).

scope inspection may be feasible for the smallest LSIs, targeted inspections would be more relevant for MP and HP LSIs, particularly those that are of high impact or high risk. This would allow for a more frequent inspection of these LSIs while enhancing the risk-based aspect of onsite activities. In addition, doing periodic thematic onsite activities (e.g., inspections or reviews) for a range of high priority topics, particularly in relation to governance and risk management, could be useful to ensure a more reliable and updated assessment of these areas. The BdE should generally ensure that it has the adequate resources, on a forward-looking basis, to effectively apply the enhancements to its supervisory approach (including in relation to onsite activities) and continue to perform its other supervisory and regulatory tasks.

Interaction with the ECB

38. The ECB performs a risk-based oversight of LSIs mostly relying on information and views exchanged with the NCAs. The ECB is provided with views on individual supervisory cases, through notifications of financial deterioration cases, and, for HR/ HI LSIs, via notifications of NCAs' material supervisory procedures and draft decisions. The ECB also performs thematic reviews, mostly offsite, to identify different practices and promote high supervisory standards. Moreover, the ECB conducts its oversight via the interaction between the country desk and the NCA, senior management visits as well as bilateral technical calls or visits.

B. Corrective Action Powers and Processes

39. LOSS provides the BdE with the ability to act to address banking problems. According to Article 68 of LOSS, the BdE shall require credit institutions or consolidated groups of credit institutions to immediately adopt the necessary measures when they do not meet requirements on solvency, liquidity, organizational structure, or internal risk control, as well as when the BdE has well-founded grounds to believe that the institution will not comply with those requirements over the next 12 months. The BdE can also apply those measures if it considers that an institution's own funds or liquidity do not guarantee sound risk management and cover.

40. The BdE has a broad range of powers and tools to bring about timely corrective actions. According to article 68 of LOSS, the BdE can impose a range of prudential measures which include: holding capital or liquidity in excess over minimum requirements; reinforcing processes, mechanisms and strategies; requiring a plan to restore compliance or the application of a specific provisioning policy; limiting the business, operations, and network of institutions or imposing a reduction in risks of particular activities or products; limiting variable remuneration or dividend distributions; and increasing disclosures. LOSS includes other measures relevant to particular risk areas. LOSS provides the BdE the power to intervene and replace the management body of an institution while giving a reasoned account of its decision to MINECO and the FROB.

41. The BdE uses certain indications and triggers when considering the application of corrective measures. Breaching P2G recommendations or some recovery indicators can be a basis for application of corrective measures. For early intervention cases, the BdE uses two blocks of triggers: SREP score (for institutions with an overall SREP score 4, or overall score of 3 with one of the subcomponents scored 4, mainly those related to governance, business model, capital adequacy and liquidity) and the indicators of financial deterioration as determined by the reporting to the ECB.

42. LOSS also provides the BdE with powers to apply sanctions for infringements of regulatory and disciplinary rules. Those sanctions consist of administrative penalties applied to credit institutions, their directors and executives, as well as natural and legal persons with a qualifying holding. LOSS classifies infringements into three categories (very serious, serious, and minor) and defines situations where each of these categories applies. It also indicates the penalties to be imposed on institutions and directors or executives for each category of infringements. LOSS also clarifies the criteria applied in each category of infringements which include, among others, the nature and scale of the infringement, the degree of responsibility for the event, the gravity and duration of the infringement, and its systemic consequences. Resolving matters during the supervisory process has been generally effective in addressing and correcting deficiencies at individual firms. Hence, the frequency of applying sanctions in relation to prudential matters has been rather low in the last few years. Where appropriate, the BdE should not hesitate to use the full range of enforcement tools, including sanctions.

43. While the corrective measures and sanctions are applied by various BdE governing bodies, they could be appealed in front of MINECO and before judicial courts. The BdE Executive Commission has the power to formulate necessary recommendations and requirements, agree to initiate sanctioning procedures and intervention measures, replace directors and take other precautionary measures based on the legal and regulatory framework. The final decision of imposing a sanction is taken by the BdE's Governing Council. As outlined earlier, BdE's decisions, measures, and sanctions can be appealed before MINECO and then in front of judicial courts. Nevertheless, it is worth to note that, in practice, MINECO has not overturned any of the BdE's decisions or sanctions in the recent past.

C. Recommendations

44. The BdE should continue enhancing its risk-based supervisory approach to LSIs by:

- Reviewing the offsite monitoring and alert system with a view to streamlining the various blocks of used alerts, to ensure that the overlap between various indicators does not distort the outcome of offsite analysis and the needed supervisory attention, but without missing important supervisory information.
- Better integrating the offsite alert system into supervisory prioritization and planning processes, including onsite inspection planning.
- Applying more proportionality to tailor the depth and frequency of offsite activities (particularly the SREP process) to the various priorities of LSIs, which could help make the process more efficient.

- Increasing onsite inspection activities to better align them with the frequency set in internal guidelines and practices; and reinforcing the risk-based nature of onsite inspections by performing more targeted inspections, especially for medium and large sized LSIs, and thematic onsite activities.
- Engaging periodically with banks' independent board members and heads of control functions, especially for HP LSIs.
- Utilizing the full panoply of enforcement tools, including sanctions, where appropriate.

REGULATION AND OVERSIGHT OF KEY RISKS

A. Corporate Governance and Risk Management

45. Spanish LSIs are subject to a thorough corporate governance framework, that also includes some proportionality aspects. The main corporate governance and risk management requirements for credit institutions are based on LOSS, which transposes the Directive 2013/36/EU (CRD), in addition to Royal Decree 84/2015 and BdE circular 2/2016. They include, among others, requirements about banks' board functions and composition, board committees, fit and proper criteria, and the risk management function. Banks whose individual assets are less than EUR 10 billion are allowed to have joint audit and risk committees and joint nomination and remuneration committees. For credit cooperatives, the law on cooperatives (law 27/1999) still defines the minimum functions of the board, the overall direction, the supervision of senior management, and the representation of the cooperative. The functions of the board of savings banks are regulated in law 26/2013 on saving banks and foundations. The BdE has also adopted some EBA guidelines related to governance, including those on internal governance within the framework of the Spanish provisions transposing CRD.

46. The BdE reviews banks' Internal Capital Adequacy Assessment Processes (ICAAPs) and Internal Liquidity Adequacy Assessment Processes (ILAAPs) which are required on an annual basis. These reports are detailed in the BdE's ICAAP and ILAAP guidelines. The BdE reviews those reports and rates them with a four-step scale, from non-compliance to good. The results of the reports are taken into account in assigning the relevant P2R and P2G for LSIs. They are also discussed in the supervisory dialogue with LSIs as part of the SREP process.

47. LSIs' corporate governance and risk management are assessed through offsite and onsite processes. From an offsite perspective, the BdE supervisory teams assess bank governance and risk management through the regular yearly meetings held with LSIs' boards and management and the assessment of documents related to boards' governance. When undertaken, onsite inspections provide valuable information to assess governance and risk management. These various activities will feed into the SREP score which includes components related to risk controls and governance. As a result of these actions, requirements and recommendations concerning governance and risk management could be issued to LSIs as part of the SREP capital decision letters or in the letters sent to banks following onsite inspections.

48. The BdE undertook an offsite thematic review to review the corporate governance of all credit cooperatives in 2020. In addition, the ECB conducted a thematic review in 2021 on LSI governance arrangements which included several Spanish LSIs. The BdE thematic review was based on documents and responses to questionnaires prepared by the concerned LSIs. It revealed key governance weaknesses in relation to the composition and functioning of the boards of directors and the independence of the LSIs' internal control functions. The findings of this review have been followed up as part of the SREP in 2021 and 2022. The remaining findings are also being followed for the 2023 SREP measures. These measures and follow-ups mainly aim at ensuring an adequate number of independent directors on the boards of cooperatives and stressing the independence of the second and third lines of defense.

49. While the BdE has been performing various supervisory activities to improve the governance of LSIs, these efforts should continue, particularly in the context of targeted or thematic onsite activities. The work by the BdE has focused so far on doing dedicated offsite thematic reviews and follow-ups to remedy governance weaknesses, especially in cooperatives. While these tools have been useful to address some essential governance weaknesses, onsite reviews and activities would enable further progress to strengthen banks' risk culture and assess governance practices. Hence, the BdE's efforts to improve LSIs' governance practices should include targeted onsite inspections and/ or thematic onsite activities.

B. Capital

50. Spanish LSIs' capital requirements follow the EU framework. Those requirements are established in the EU Capital Requirement Regulation (CRR). The capital buffers as well as Pillar 2 capital add-ons have been transposed into national law based on LOSS, Royal Decree 84/2015 and BdE circular 2/2016. Those buffers include the capital conservation buffer, the counter-cyclical buffer (CCyB), the buffers for global and for other systemically important institutions, and the systemic risk buffer. The CCyB is set at zero percent (end-2023).

51. The EU capital framework includes some material deviations from Basel III but some of these may not be material given Spanish LSIs' business models and the approaches used for their risk-based capital requirements. In 2014, the BCBS RCAP assessed the EU capital framework to be materially non-compliant with the minimum capital standards in the Basel framework. The main areas of divergence include among others: permanent partial use of exemptions for various types of credit exposures in the Internal Ratings-Based (IRB) approach for credit risk; concessionary risk weights extended to small and medium enterprise exposures; the splitting of residential mortgage loans into lending qualifying for 35 percent risk weight and lending not qualifying for this preferential treatment; and credit valuation adjustment (CVA) exemptions provided for various exposures. Some of those deviations may not be particularly relevant for Spanish LSIs, particularly those related to CVA capital charges and the use of the IRB approach which is applied only by one LSI in Spain so far.

52. The BdE assesses LSIs' P2R and forward-looking capital targets P2G. The SREP methodology takes into account several factors in assessing P2R including business model, IRRBB risk, governance, and concentration. The P2R surcharges applied by the BdE are based on the ECB methodology for each SREP category. To assess forward-looking capital needs of supervised institutions, the BdE carries out annual stress test based on the forward-looking exercise on Spanish banks (FLESB) tool by assessing the solvency of Spanish institutions in different macroeconomic scenarios, which is conducted on an annual basis. P2G is assessed every other year based on BdE's stress test results.

C. Credit Risk and Problem Assets

53. The BdE has extensive requirements on management of credit risk and treatment of problem assets. Besides the general rules and requirements on risk management, Royal Decree 84/2015 sets some requirements in relation to credit risk management policies. Annex 9 of BdE circular 4/2017 also introduces several requirements related to credit risk management. The BdE has also indicated compliance with the EBA guidelines on loan origination and monitoring, and the EBA guidelines on management of non-performing and forborne exposures.

54. BdE's requirements on the treatment of problem assets stem mainly from its accounting requirements set in annex 9 of circular 4/2017. The circular specifies how transactions are to be classified according to their credit risk, distinguishing between performing exposures, performing exposures under special monitoring, nonperforming exposures and total write-offs, and how individual and collective estimates of credit-risk losses are quantified and covered. It requires banks to have policies to reclassify and provision transactions as soon as an abnormal situation or the deterioration of credit risk becomes apparent. In line with the EBA guidelines on the management of nonperforming and forborne exposure, the BdE requires high NPL banks to establish an annual NPL reduction strategy which is followed up by the BdE as part of its offsite monitoring activities.

55. Supervised entities should estimate their expected credit losses (ECL) and recognize the necessary allowances. The BdE circular 4/2017 has introduced alternative solutions for entities that do not have internal ECL models. For those entities, the circular established minimum provisioning requirements for ECL that banks should comply with at each stage of the loan classification process. All LSIs make use of those alternative solutions for ECL estimation. The BdE can enforce these provisions since LOSS (article 93.k) provides the BdE the power to impose sanctions for insufficient loan-loss provisions under accounting rules. In practice, the BdE has been requiring LSIs to increase provisions in the course of its onsite inspections or credit risk reviews in application of the provisions of Circular 4-2017. However, from a prudential perspective, the BdE has the explicit mandate (under LOSS) to only require the application of a specific provisioning policy but not the explicit power or discretion to require an increase in provisions against specific exposures. Given that the powers set in LOSS (artIcle 93.k) apply for provisions under accounting rules, LOSS should explicitly empower the BdE to require an increase in provisions against specific assets or exposures for prudential purposes (in line with essential criterion 7 of core principle 18 of the 2012 BCPs)

56. Review of LSIs' credit risk framework and the treatment of problem assets remain at the core of the BdE's on-inspection activities. The BdE inspectors usually review loan origination policies and processes, analyze various credit risk-related documents generated by various functions and risk areas, review a sample of loan files to verify the soundness of the accounting treatment for classification and provisioning, and review the report by the audit and internal control departments of supervised institutions.

57. Spanish LSIs have been subject to various thematic reviews and horizontal analysis related to credit risk. In 2020, the ECB/ SSM undertook a thematic review on LSI credit underwriting standards in which several Spanish LSIs with high investment growth participated. The review underlined weaknesses in terms of updating risk management policies and manuals, pricing of operations, proactive monitoring of credit risk, and inadequate identification and follow-up of refinanced operations. As a result, the BdE issued recommendations and requirements to address those gaps by the concerned LSIs.

D. Related Parties and Concentration Risk

58. The BdE's review of concentration risk is mainly conducted in the context of the SREP process. The main requirements for banks' management of concentration risk are established in Royal Decree 84/2015 and CBE circular 2/2016. They require institutions to have written policies and procedures to control concentration risk. Geographical and sectoral concentration is taken into account in credit risk assessment and in the business model risk assessment. In addition, concentration risk (both individual and sectoral) is taken into account as part of the institutions' ICAAP assessment and in the process of determining P2R. However, the assessment of excessive concentration risk is limited to corporate exposures and does not explicitly include concentration to sovereign exposures.

59. The large exposure framework for LSIs is an application of the EU regulatory framework, notably CRR. According to the CRR, an institution's exposure to a client or a group of connected clients is considered as a large exposure where its value equals or exceeds ten percent of its eligible capital. The large exposure limit to a client or a group of connected clients is 25 percent of an institution's eligible capital. The CRR defines the economic or control relationships under which counterparties can be considered as one group of connected counterparties. The BdE supervisors review the compliance with this limit as part of their regular offsite monitoring activities. The BCBS RCAP on the large exposure regulations in the EU concluded that the EU framework is largely compliant with the Basel large exposure standard(s). The main material finding relates to trading book exposures where the EU regulations allow for the limit to be exceeded up to 600 percent of a bank's Tier 1 capital. This deviation is less relevant for Spanish LSIs since their trading book exposure is negligible.

60. The definition of related party transactions in the legal and regulatory prudential framework is deficient in relation to international standards set in the 2012 BCPs. LOSS (Article 29.7) requires credit institutions to report information on loans granted to their board members and their related parties to the BdE.[16] If that was meant to be a definition of a bank's related party, then it is an extremely narrow definition compared to requirements in the 2012 BCPs. Rule 62(1) of BdE circular 4/2017 provides a more detailed definition of related parties.[17] However, this circular is an accounting circular, and the main purpose of that definition is to disclose related party transactions. In addition, the definition does not include board members, senior management, and their interests.

61. In addition, laws and regulations do not explicitly include many other prudential aspects for related party transactions. Given that the framework for related party transactions is still not harmonized at the EU level, the requirements for such transactions are mainly based on national laws and regulations. However, the banking laws and regulations in Spain lack some of the key requirements in the 2012 BCPs, including that: (i) related party transactions should not be undertaken on more favorable terms than corresponding exposures to non-related counterparties; (ii) transactions with related parties and the write-off of related party exposures exceeding specified amounts or posing special risks are subject to prior approval by the bank's board; and (iii) board members with conflict of interest are excluded from the approval process of granting and managing related party transactions. Nevertheless, it is worth noting that the BdE has adopted some EBA guidelines that discuss the need to establish policies to prevent and manage conflicts of interest in banks' transactions, including conducting them on an arms' length basis. However, those are not considered as binding requirements, which could make their enforcement challenging. In addition, there are no aggregate limits imposed on related party exposures or a requirement that such exposures be deducted from capital when assessing capital adequacy or be collateralized.

62. The BdE is assigned with the responsibility to authorize banks' requests to grant facilities to their board members and managers, which could expose the BdE to reputational risks and does not align with its prudential mandate. LOSS (Article 26.5) does not allow banks to grant loans to their board members and senior managers above a limit determined by the regulation unless they have obtained a prior authorization by the BdE. In that context, article 35 of Royal Decree 84/2015 sets the regime applicable for authorization of these loans and exceptions whereby credit institutions must apply to the BdE for authorization to grant loans and guarantees to members of boards of directors and managing directors and similar officers.[18] This authorization process gives the perception that the BdE is approving such loans

[16] Based on LOSS, those related parties include spouses of board members and their close relatives up to the first degree as well as any business entity in which the board members or their spouses and close relatives have a qualifying holding of about ten percent share of the entity's capital or at which they might exercise a significant influence.

[17] According to that rule, related parties consist of parent, subsidiaries, associated entities, legal entities and individuals related to them, or that control them, or have significant influence, act in concert to exert control, share one or more council or board member, pension funds for the entities' employees or for related companies, any key personnel in senior management and their families, entities where such persons may have control, significant influence or direct or indirect voting power. It also includes major shareholders.

[18] Such authorization is not needed for loans covered by collective labor agreements, granted in mass levels under contracts with standardized conditions provided that the loan does not exceed EUR 200 thousand.

and is responsible for their risks, which may pose reputational risk for the BdE. While the aggregate amount of these loans may be small relative to banking sector assets, such authorization process does not fit with the BdE's prudential and financial stability mandate. Removing this authorization process and establishing, instead, an overall robust prudential framework for related parties (including a limit on aggregate related party exposures) would limit the risks of these transactions while reducing reputational risks for the BdE.

E. Liquidity and Funding Risk

63. LSIs in Spain are subject to the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) as applied in the EU legislation. LSIs enjoy comfortable liquidity levels in general. The LCR requirement came into force starting January 2018 and the regulation incorporating NSFR entered into force in June 2021. LSIs report their LCR on a monthly basis and their NSFR on a quarterly basis. The 2017 BCBS RCAP assessment of LCR regulations in the EU concluded that the framework is overall largely compliant with the Basel LCR standard. The report identified one material deviation and four potentially material deviations that significantly overstate or might significantly overstate LCR for some banks in the EU.[19] The 2022 BCBS RCAP assessment of EU NSFR regulations assessed those regulations as largely compliant with the Basel NSFR standard. The main driver of that grade relates to the treatment of required stable funding which included nine not material findings.

64. Liquidity risk management requirements are detailed in Spanish banking laws and regulations. LOSS, Royal Decree 84/2015, and BdE circular 2/2016 detail the main arrangements for managing, monitoring and controlling liquidity risk in credit institutions in Spain. They also require institutions to have in place liquidity risk mitigation tools and develop contingency plans that must be tested at least once a year. The EU regulations have adopted different additional monitoring metrics for liquidity. These include the maturity ladder, concentration of funding by counterparty, and concentration of funding by product type.

65. The BdE offsite supervisory team reviews LSIs' liquidity ratios and some aspects of their liquidity and funding risk management as part of SREP. The BdE offsite supervisors typically assess short-term liquidity risk and funding sustainability, review liquidity risk controls, and challenge internal liquidity needs and stress test results based on the institution's ILAAP. The offsite team also reviews LSIs' liquidity contingency plan as part of SREP to check if the plan adequately specifies the policies and action plans for responding to severe potential funding disruptions and if those action plans are feasible given the established stress scenarios. Additional sensitivity and scenario analysis is usually done by the BdE Horizontal Functions Department to capture the effects of particular shocks or events. This overall analysis feeds into

[19] The material finding concerns the possibility of including certain financial instruments (such as high-quality covered bonds and assets issued by certain EU credit institutions) that do not fulfil the high-quality liquid assets (HQLA) requirements in the Basel LCR standard. The potentially material findings relate to treatment of asset backed securities and covered bonds, the symmetrical treatment of operational deposit inflows and outflows, and the disclosure basis for LCR levels.

the liquidity SREP score of the institutions with some relevant recommendations or requirements to be included in the SREP letter. The BdE also conducts liquidity stress test exercises based on its FLESB framework where it projects LCR levels under baseline and adverse scenarios.

66. While the onsite examination of the liquidity risk management framework has been included within the inspection scope in few cases, there is not much general focus on this issue in the BdE's inspection activities. The few inspections that were performed revealed some material deficiencies in liquidity risk management including the lack of a liquidity contingency plan, the failure to update internal liquidity risk management policies, and miscalculation of regulatory liquidity ratios. The BdE has addressed these specific issues as part of the requirements and recommendations sent in the inspection letters. However, the BdE has not planned or performed specific targeted or thematic onsite inspections focused on liquidity and funding risk management of LSIs. Conducting such inspections on a periodic basis would be key to identify, in a more structured way, weaknesses in LSIs' liquidity risk management frameworks and timely address them.

F. Interest Rate Risk in the Banking Book (IRRBB)

67. The main requirements for management of IRRBB are spelled out in LOSS, Royal Decree 84/2015 and the EBA guidelines adopted by the BdE. The Royal Decree requires credit institutions to implement policies and processes to identify and manage interest rate risk arising from non-trading activities. The BdE has also adopted the EBA guidelines on the management of interest rate risk arising from non-trading activities (EBA/GL/2022/14). These guidelines determine the framework for IRRBB internal capital evaluation, methodology and measurement assumptions, as well as scenarios and stress testing. LOSS stipulates that the BdE shall implement prudential supervision measures when, under the supervisory shock scenarios, the institution net worth declines by more than 15 percent of Tier 1 capital or when net interest income declines significantly due to a sudden and unexpected change in interest rates.

68. BdE supervisors assess IRRBB as part of the annual SREP exercise. The process is divided into two steps. The determination of IRRBB risk level is performed as a first step and comprises several phases: (i) phase 1, materiality assessment based on key risk indicators (KRIs); (ii) phase 2, in case of being material, the risk is assessed based on two perspectives—the economic value perspective and the earnings perspective—using also a set of KRIs; and finally, (iii) phase 3, complementing Phase 2 with additional aspects of economic value of equity (EVE) and earnings perspectives, and leveraging on a wider set of indicators. The second step is the assessment of controls put in place by the institutions (this also consists of phases, mainly leveraging on qualitative questionnaires). The overall IRRBB risk score is determined by the IRRBB risk level score and risk control score, applying the aggregation matrix included in the methodology.

69. The BdE Horizontal Functions Department performs horizontal analysis of the IRRBB exposures of Spanish SIs and LSIs and provides the BdE supervisory teams with

details of the IRRBB exposures as reported by institutions, particularly those for LSIs. A periodic analysis of the evolution of interest rate curves and market expectations together with the monitoring of the main internal IRRBB metrics (EVE and NII), is performed annually for LSIs as part of the horizontal analysis. An analysis of the composition of the debt portfolio in the banking book and of the impacts on the portfolio at fair value (general interest risk effects and stress effect on risk premiums) is also conducted on a frequent basis for both SIs and LSIs. These analyses help LSIs' supervisors improve their knowledge about the assumptions applied by banks in their IRRBB estimates.

70. The BdE has performed a few inspections where the scope included IRRBB, but more inspections are needed to better evaluate IRRBB risk management at LSIs. In those inspections, the BdE supervisory teams found some deficiencies in relation to lack of policies for identification, measurement, management, monitoring and control of this risk, inappropriate implementation of regulatory requirements for NII projections, and lack of implementation of IRRBB limits in terms of NII. The post-inspection letters included some requirements and recommendations to address those deficiencies. However, the BdE should do further targeted onsite inspections or thematic onsite activities to have a more comprehensive view of the status of IRRBB risk management in LSIs, particularly those that are more exposed to this risk.

G. Operational Risk

71. The regulatory framework for operational risk is based on the general risk management regulatory requirements in addition to specific requirements and guidelines on business continuity, outsourcing and event reporting. While LOSS establishes the general requirements about the institutions' risk management frameworks, Royal Decree 84/2015 requires institutions to evaluate and manage operational risk exposures, and to establish contingency and business continuity plans to enhance their operational resilience. The EBA SREP guidelines and EBA guidelines on internal governance, which were adopted by the BdE also include provisions for management of operational risk. Royal Decree 84/2015 establishes general conditions for outsourcing arrangements and specific conditions for outsourcing or delegation of essential functions. In addition to COREP requirements which include regular reports on operational risk losses by business lines and event type, the BdE requires institutions to immediately notify it about any significant cyber incidents.

72. The supervision of operational risk at the BdE is performed by offsite and onsite functions as well as by a horizontal team. Operational risk is mainly reviewed and assessed as part of the SREP process. Starting in 2023, the LSI department performs offsite monitoring of IT risk for those institutions where this risk is significant. The offsite analysis is based on IT questionnaires sent to banks which are then challenged by BdE's IT experts. IT specialists in the Horizontal Department also support offsite IT supervisors in their assessment of institutions' IT risks, besides supporting BdE senior management in IT risk and innovation topics. In addition, the IT risk onsite division is responsible for conducting IT risk onsite inspections for LSIs. Their findings feed into the offsite assessment done in the context of the SREP process. The BdE established different committees and coordination structures to exchange expertise and promote consistency in assessment of IT risk among the various IT teams.

73. Reviewing LSIs' outsourcing arrangements represents a significant part of the work of the BdE IT teams. Royal Decree 84/2015 set general requirements for outsourcing by credit institutions. The BdE circular 2/2016 further details these requirements in line with the EBA guidelines on outsourcing arrangements. It requires banks to send a prior notification to the BdE for outsourcing arrangements regarding material activities. Planned outsourcing of critical or important functions is typically discussed as part of the BdE's supervisory dialogue with the institutions. As per LOSS, the BdE can trigger supervisory measures to require institutions to reduce the extent of outsourcing or mitigate operational risk exposure. There are two big service providers which provide material or important services to many LSIs, which results in a significant concentration in IT risks. These service providers happen to be under the supervision of the BdE since one is a financial institution under the BdE remit and the other is part of a financial group supervised by the BdE. The BdE has been supervising these two providers, including through onsite inspections focusing on IT risk.[20]

H. Climate Risk

74. Since 2020, the BdE has taken actions to announce its expectations for the management of climate-related financial risks and to build its staff expertise in that respect. In October 2020, the BdE published its supervisory expectations relating to risks posed by "climate change and environmental degradation". Those expectations set out explicitly how LSIs should consider climate-related financial risks in their business models and strategy, their governance and risk management, and in the disclosure of information to third parties.[21] The BdE announced that it would start analyzing the institutions' implementation progress 18 months after issuing those expectations. The BdE established a high-level Coordination Group to develop its strategy on climate change and facilitate coordination between the different business areas.[22] The BdE also has a horizontal working group in charge of coordinating internal actions and participating in international fora on climate-related topics. The BdE has a small team to coordinate actions regarding climate-related risks for LSIs as well as an internal supervision network where supervisors share knowledge and expertise.

75. The BdE has launched several exercises to raise LSIs' awareness regarding climate-related financial risks and assess their readiness to meet its supervisory expectations. Since 2019, the BdE organizes an annual outreach with the industry on climate-related financial risks. In 2021, the BdE launched a first questionnaire to assess LSIs' plans for the alignment with

[20] See this FSAP's technical note, Spain: Cyber Risk and Financial Stability.

[21] These expectations are in line with the ECB's Guide on climate-related and environmental risks published in November 2020 and aimed at SIs under its direct supervision.

[22] The Group comprises representatives of the various Directorates General and is coordinated by the Directorate General Financial Stability, Regulation and Resolution.

supervisory expectations. At that time, LSIs were at very early stages in the integration of climate-related risks into their systems and processes. The BdE launched a second questionnaire in 2023 to assess LSIs' progress. The BdE is currently performing a deep analysis of LSIs' questionnaire submissions to assess the progress made in implementing supervisory expectations. The BdE's assessment is included as part of the 2023 SREP and is discussed as part of the supervisory dialogue, based on which recommendations and requirements may be included in LSIs' capital decision letters.

76. BdE also participated in exercises led by the ECB on C&E risks for LSIs. The BdE opted-in for participation of four Spanish LSIs in an ECB-led thematic review and disclosure exercise on C&E risks. The report of the thematic review was publicly released in November 2022 and that of the disclosure exercise in April 2023. The BdE provided feedback to the four participating Spanish LSIs about the main findings from the thematic review as part of the supervisory dialogue.

77. Going forward, the BdE should establish a medium-term approach to the supervision of climate-related financial risks, which ensures integrating this component into its routine supervisory processes. The BdE plans to gradually include its assessment of LSIs' management of climate-related financial risks in its SREP process. As part of the analysis of the second questionnaire, the BdE plans to incorporate its assessment in the business model score component of SREP. Going forward, the BdE should establish a medium-term framework to incorporate the oversight of climate-related financial risks as part of its overall supervisory approach (including SREP) and its routine supervisory offsite and onsite activities. This might have short to medium term implications for BdE's resources dedicated to supervision of climate-related financial risks until that expertise is effectively transferred across supervisory teams.

I. AML/CFT Supervision

78. The CPBCIM and the BdE have been actively collaborating in relation to AML/CFT oversight. The latest agreement was signed in March 2021 based on which the BdE cooperates with the CPBCIM and the Sepblac in the supervision of AML/CFT obligations. The BdE, the Sepblac and the rest of supervisory authorities have also signed agreements with CPBCIM to draft a joint inspection plan and exchange information relating to their supervisory activities, like inspection reports. The BdE may carry out inspections and other supervisory actions to ensure compliance with some of the obligations established in the AML/CFT Spanish Law (e.g., due diligence, internal control and reporting) in respect of those regulated institutions under its supervision, focusing preferentially on the review of the policies and procedures established in the institutions. In addition, the BdE may make recommendations for improvement. However, requirements and sanctions based on those findings can only be decided by the CPBCIM.

79. The methodology to assess ML/TF risks has been recently updated with a development of a risk matrix and a supervisory manual. The common risk matrix has been developed jointly between the Sepblac and the BdE, but it is in the final stages of being adopted. The key components of the risk matrix include: (i) inherent risk which is assessed based on an analysis of four main risk factors—customer profiles, geographies, products, and distribution channels; (ii) assessment of AML/CFT controls using several data sources: automated indicators assessing the quality of risk mitigation measures, evaluation of the institution's governance based on AML/CFT inspection findings and external expert reports, information received during the meetings with supervised entities, and information received from other authorities; and (iii) a final risk profile based on the assessment of inherent risks and the institution's controls. The residual risk rating is classified in four categories: low, medium-low, medium-high, and high. In addition, the BdE has developed a supervisory manual in 2022 which sets out general principles and processes to be followed during inspections.

80. While the BdE has performed a number of general and thematic inspections during the last three years, a more frequent inspection coverage seems warranted. During the period 2020-22, BdE's inspection activities (for both SIs and LSIs) included general inspections at eight institutions, two targeted inspections on internal control, and a thematic inspection on currency exchange activities covering 15 institutions. The inspection activities should be increased to ensure a more frequent coverage of supervised entities. This could be at least partially achieved by conducting more risk-based inspection activities using the new common risk matrix as the basis for planning supervisory activities. In addition, the process for approving the inspection plan may need some streamlining. Based on a review of the details of the inspection plans, it seems that the process of approving the joint inspection plan which should be done at the CPBCIM level is time-consuming, which could delay the process for starting inspection activities. For example, inspections during 2021 did not start until April following the signing of the new cooperation agreement with the CPBCIM.

81. The BdE does not have the powers to issue requirements and sanctions to prevent and address weaknesses in banks' AML/CFT frameworks or breaches to AML/CFT laws and regulations. BdE AML inspections revealed several findings in relation to deficiencies in the banks' AML/CFT frameworks. However, based on law 10/2014 and the agreement signed between the BdE and the CPBCIM, the BdE has no enforcement powers in relation to AML/CFT obligations which can only be decided by the CPBCIM. The BdE can issue recommendations for improvement to banks. But it is up to the CPBCIM to issue requirements and sanctions to address deficiencies in AML/CFT framework. The CPBCIM meets two to three times a year. This enforcement process seems constraining to the BdE's ability to timely address deficiencies in its role as the AML/CFT supervisor for banks. Consideration could be made to grant the BdE more enforcement powers in relation to AML/CFT deficiencies and breaches. Having such powers would also align the BdE further with the core principle 29 of the 2012 BCPs which requires, among others, that the supervisor has adequate powers to take action against a bank that does not comply with its obligations relevant to laws and regulation regarding criminal activities.

82. The latest FATF follow-up report on Spain confirmed that progress has been made to improve the effectiveness of the AML/CFT system. The follow-up assessment report was published in December 2019 and was the fifth follow-up report following the mutual evaluation report adopted in October 2014. The report highlighted that Spain has made progress to improve the effectiveness of its AML/CFT system and achieved upgrades on two immediate outcomes in relation to intensifying supervision of lawyers, real estate agents and Trust and company service providers (TCSPs), as well as enhancing cooperation between Sepblac and the Inter-ministerial Body on Material of Defense and Dual-use (JIMDDU) to raise awareness and issue guidance, particularly in the financial sector, of the specific risks of proliferation-related target financial sanctions evasion. However, Spain maintained a moderate rating on the outcome related to preventive measures and financial sanctions. The priority action related to this outcome is to apply targeted financial sanctions when appropriate and without delay. Based on the report, Spain will remain in regular follow-up and will continue to report back to the FATF on progress to strengthen its implementation of AML/CFT measures.

J. Recommendations

83. In order to ensure more effective regulation and supervision of key risks of LSIs, the BdE and other concerned authorities should:

- Continue work to monitor and address LSIs' governance and risk management weaknesses by performing more targeted onsite inspections/ thematic onsite activities.
- Strengthen BdE oversight and inspection activities on banks' liquidity risk management policies and practices.
- Explicitly empower the BdE to require an increase in provisions against specific assets or exposures for prudential purposes.
- Align the framework on related party transactions with the 2012 BCPs by: expanding the prudential definition of related party transactions, applying rules on the need to ensure that related party transactions are conducted on arms' length basis and subject to strict rules on avoidance of conflict of interest, and introduce an overall limit on exposures to related parties that is at least as strict as the large exposure limit.
- Remove the requirement for the BdE to authorize banks' loans to their directors and senior management.
- Take into account excessive concentration risk for a broader range of exposure types, including sovereign risk concentration, when setting P2R.
- Ensure more focus on onsite inspection of IRRBB risk management policies and practices, through thematic or targeted onsite activities.

- Continue monitoring and assessing climate risk through targeted and thematic work, ensure climate risk oversight becomes gradually integrated in routine supervisory processes, and increase resources dedicated to work on climate-related risks.

- Continue with the implementation of the risk matrix for AML/CFT and integrate it in supervisory planning activities for AML/CFT, including for onsite; streamline the process to finalize and start executing the annual joint AML/CFT inspection plan and increase AML/CFT inspection activities, by performing more risk-based and targeted inspections; and grant the BdE more powers to issue requirements and sanctions related to ML/TF risks.