Recent key developments in the area of Spanish financial regulation

Prepared by the Regulation and Research Department of the Spanish Confederation of Savings Banks (CECA)

Bank of Spain Circular amending the Accounting Circular and the Circular on the Central Credit Register (Circular 4/2016, published in the State Official Gazette (BOE) on May 6th, 2016)

The aim of this Circular is to adapt the Accounting Circular, and its Annex IX in particular, to the latest regulatory developments, while ensuring it remains compatible with the IFRS accounting framework.

I. Amendments to the Accounting Circular and the Circular on the Central Credit Register

The **main changes** to the **Accounting Circular** concern the following points:

- The changes to the Bank of Spain's organisation chart taking place in 2015 are reflected.
- In the case of the sale of capital instruments, the change in ownership is now deemed to take place on the settlement date rather than the contract date.
- New criteria for the amortisation of intangible assets.
- Adaptation of public and confidential statements and incorporation of new statements.

For their part, the **amendments to the Circular on the Central Credit Register** aim to adapt it to the accounting criteria for operations subject to credit risk under the new Annex IX, and amend the content of the data module on collateral.

II. New Annex IX of the Accounting Circular

■ **General credit-risk management framework**

The Circular stipulates that policies for **granting transactions** must include the following points: (i) the markets, products, customer types, currencies and applicable terms, and the requirements to be met by holders; (ii) the overall risk limits; (iii) the policy on lending to **related parties** or entities; (iv) the policy on financing **property developments**; (v) the criteria for the granting of transactions in **foreign currency**; and (vi) entities' **price policies**. The final point stipulates that if a transaction is granted at less than cost, its price will be taken as a sign that the transaction deviates from fair value. In this case, the transaction has to be registered initially at fair value, such that the difference between fair value and the amount drawn down is **recognised directly as an expense on the profit and loss account**, either immediately, or deferred as an adjustment to fair value, as applicable.

Moreover, it determines what will be considered a refinancing or renewal transaction, a refinanced, restructured or renegotiated transaction, and the circumstances under which a restructuring or refinancing is deemed to exist.

The **evaluation, monitoring and control of credit ris**k contains the general principles for estimates of coverage of credit risk losses. **General allowances and provisions** are to be estimated collectively while **specific allowances and provisions** may be estimated individually or collectively, if a series of conditions are met.

Institutions are to develop **methodologies** for estimating all the specific allowances and provisions that are subject to **individualised estimates** and will use alternative solutions for **collective estimates** for comparative purposes. For the estimation of allowances and provisions on transactions that are subject to collective estimates (normal exposures, doubtful due to insignificant arrears and doubtful for reasons other than arrears), institutions that have not developed internal methodologies are to use **alternative solutions** provided by the Bank of Spain.

The types of guarantees that may be considered effective and the **requirements for their appraisal,** and the **procedures and minimum frequency of collateral appraisal** are established.

■ **Classification of transactions on the basis of credit risk due to insolvency**

Transactions are classified into three categories: **normal, doubtful** (due to customer arrears and for reasons other than arrears) and **write-off. The substandard category has been eliminated.**

- Within **normal exposures,** there is a **new subcategory of exposures subject to special monitoring**, which is to include transactions presenting weaknesses that may mean assuming losses greater than those on other similar transactions classified as normal exposures. A **carry-over effect** is also introduced whereby transactions involving a party that has accumulated refinancing or restructuring transactions are reclassified in the normal exposures under special monitoring category.

- **Doubtful exposures** may be classed in the following categories: due to customer arrears and for reasons other than customer arrears. In both cases, unless there are other reasons for their classification as doubtful exposures, transactions may be **reclassified as normal exposures** if the causes or reasonable doubts as to total reimbursement disappear and the holder does not have amounts more than 90 days past due on other transactions at the time of the reclassification.

- The **write-off** classification is to include debt instruments, whether due or not, for which the entity, after analysing them individually, considers the possibility of recovery to be remote due to serious and irreversible deterioration of the borrower's of the transaction's solvency. This classification entails the writing off of the full gross book value of the transaction and its total derecognition from the assets.

■ **Allowances and provisions for credit risk losses due to insolvency**

- The existence of **effective guarantees** will be taken into account and in the case of effective personal guarantees, the holder may be substituted by the guarantor for the purposes of calculating the allowances and provisions.

- Entities are to evaluate **assets classed as doubtful due to** customer **arrears** in order to estimate credit risk loss allowances and provisions, bearing in mind how long the amounts have been past due, the effective personal guarantees and collateral received, and the economic situation of the borrower and guarantors. Individual or collective allowances or provisions for transactions that are doubtful due to arrears should not be less than the general allowances or provisions applicable to them if classified as standard exposures under special monitoring.

  The Bank of Spain has estimated percentage allowances and provisions in the form of an **alternative solution** for the collective estimation of allowances and provisions on exposures classed as doubtful due to arrears, according to the credit risk segment to which the transaction belongs and how long the amounts have been past due.

- Allowances and provisions for **transactions classed as doubtful for reasons other than arrears** have to be estimated individually, although when only automatic factors have been considered, a collective estimate may be made.

- Entities are to calculate **collective allowances and provisions for normal exposures under special monitoring** separately from those to which higher provisioning is required as a result of their greater risk.

■ **Real estate assets foreclosed or received in payment of debt**

The Circular determines the v**alue at which these assets should initially** be recognised. Real estate assets foreclosed or received in payment of debt are to be **valued at the time they are received,** taking the market value given in complete individual appraisals for reference as the starting point. The reference value must subsequently be updated at least once a year.

It is stipulated that institutions are to develop **internal methodologies** for estimating the discounts applicable to the reference value and costs of sale of assets foreclosed or received in payment of debt, complying with the principles and requirements established in the Circular. The **percentage haircuts** on the reference value that are to be used by institutions in comparison and benchmarking exercises and when preparing individual confidential reports is also given.

III. Entry into force and initial application

Institutions are to **apply amendments to the Accounting Circular and Annex IX prospectively** as a change in accounting estimates, and are to report on the changes in the notes to the individual and consolidated financial statements for 2016.

The Circular **will come into force on October 1st, 2016**, except for certain provisions concerning statements, which will come into effect earlier or later.

Bank of Spain Circular on the method of calculation to ensure member institutions' contributions to the Credit Institution Deposit Guarantee Fund are proportional to their risk profile (Circular 5/2016, published in the BOE on June 1st, 2016)

The Circular stipulates that once the amount of the contribution based on the volume of guaranteed deposits has been determined, it will be adjusted for each institution by means of **risk weighting** obtained by applying the method stipulated in Annex 1 of the Circular.

The main points are:

- The **calculation method** comprises the following six phases: (i) classification of member institutions in risk brackets; (ii) redimensioning of indicators; (iii) assigning a positive or negative sign to the indicators; (iv) calculating the aggregate risk indicator; (v) calculating the aggregate risk weighting and (vi) determining the contributions of the members of the Credit Institutions Deposit Guarantee Fund.

  This method will be **used for the first time to calculate member institutions' contributions in the 2016 financial year.**

- The calculation method will be based on the following **risk indicators and categories**, which will receive the weightings indicated in brackets:

  ✓ **Capital:** leverage ratio (12%) and common equity tier 1 ratio (CET1) (12%).

  ✓ **Liquidity and financing:** liquidity coverage ratio (LCR) (11%) and net stable funding ratio (NSFR) (11%).

- ✓ **Asset quality:** ratio of debt instruments in default (13%) and coverage ratio of debt instruments in default (5%).

- ✓ **Business model and management model:** ratio of risk-weighted assets to total assets (8%) and asset return ratio (8%).

- ✓ **Potential losses for the Credit Institution Deposit Guarantee Fund**: ratio of unencumbered assets (13%) and ratio of own funds and eligible liabilities (7%).

The values of the foregoing risk indicators will be **calculated on an individual basis** for each member institution, unless the institution is granted an exemption from the individual application of liquidity or prudential requirements. In such cases, they will be calculated on the basis of the single liquidity subgroup or on a consolidated basis, respectively. An explanation is also given on how to proceed when the information on the indicators is not available.

The Credit Institution Deposit Guarantee Fund may **raise or lower the contribution target** (by a maximum of 20%) depending on the following factors: **(i)** the counter-cyclical buffer rate applicable; and **(ii)** the potential impact of procyclical contributions on institutions' liquidity and solvency.