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Closing address. Challenges for the Spanish banking sector

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Fernando Restoy
Deputy Governor

Good morning.

Thank you, Paco, for your kind words. It's a great pleasure for me to be with you this year for the closure of the 21st edition of the Financial Sector Meeting organised by ABC, Deloitte and Sociedad de Tasación, in which the Banco de España has traditionally taken part. The conference has had a very full day, in which the country's main financial institutions have had their say. Allow me to bring some thoughts to the discussion on the main challenges for the banking sector ahead of the changes in the regulatory and supervisory framework and, most particularly, ahead of the banking union.

1. Introduction

Looking back, I believe such significant structural transformations as those currently sweeping the banking industry are almost unprecedented.

At present, the banking sector must face a host of highly relevant changes on various fronts. Changes in prudential regulations, arising from the adoption of the new Basel III requirements, whose implementation has yet to be completed; possible rule changes that restrict banks' business model (the so-called structural measures); far-reaching changes in the regulations governing the resolution of weak institutions and changes also in supervisory practices, with the foreseeable increase in capital requirements derived from stress tests, the development and deepening of Pillar 2, and the inclusion of macroprudential considerations, among other factors.

In Europe, in particular, the reforms take on a special dimension following the start-up of a new unified regime for the prevention, management and coverage of banking crises. Following the approval last year of the Regulation setting up the single supervisory mechanism, preparations for which are – as I shall later mention – well under way, the political agreement reached last week on the single resolution mechanism allows us to envisage the start-up of an effective banking union in Europe.

It is difficult to overstate the importance of the steps taken here, in light both of their scope and their speed. The combination of unified supervision, with the adoption of common rules of conduct for vulnerable institutions, the creation of the European resolution agency, with significant executive capacity, and the establishment of pan-European bank risk-mutualisation mechanisms all mark a huge step forward for the monetary union and, by extension, for European integration.

Admittedly, the political agreement on the single resolution mechanism has some limitations, insofar as it does not entail per se the full lifting of national borders in respect

of the management and resolution of banking crises. Unquestionably, though, the agreement marks decisive progress towards cross-country uniformity in the treatment of different bank liabilities in the event of viability problems and, in turn, it minimises the vulnerability of national public finances to bank crises, by ensuring that investors, and not taxpayers, will bear the brunt of the costs of these crises. In doing so, it does in fact successfully defuse many of the factors that have destabilised the monetary union over the past four years.

At the same time, the creation of a single resolution mechanism is a vital complement to the single supervisory mechanism. It resolves the problems of legitimacy and compatibility of incentives that would have been generated by the relinquishing of sovereignty over the surveillance of the banking sector and crisis-prevention without concurrently having a common mechanism for managing and covering the ensuing consequences.

Accordingly, the political agreements reached are added motivation for all those involved – the ECB, national supervisory authorities and banks themselves – in the intense preparations for the single supervisory mechanism.

At the moment, a good deal of effort is being focused on the comprehensive exercise to assess the solvency of European banks which, as reflected in the Community Regulation creating the single supervisory mechanism, must be conducted before the mechanism commences operating next November.

Allow me now to turn to the design and implications of this analytical exercise.

2. The comprehensive assessment of European banks

The comprehensive assessment being conducted by the ECB chiefly comprises two fundamental elements: the analysis of asset quality and the stress tests.

The asset quality analysis involves evaluating, taking balance sheets as at 31 December 2013 as a reference, how rigorously financial statements reflect the value of banks' different assets. This requires reviewing aspects such as the accounting classification of assets, the principles used to recognise their impairment, the sufficiency of the provisions set aside, how collateral is considered and, in the case of assets recorded at fair value, the suitability of the methodology used to determine their value.

Having completed the selection of the asset portfolios for review, actual analysis has now begun in what is called phase 2 of the exercise, whose methodology was made public on 11 March.

The process will not only require banks and supervisory authorities to assign sizeable resources; it will also involve the leading European audit and asset valuation firms. The ECB estimates that, not counting supervisory staff and bank employees themselves, more than 1,000 people will work on the exercise. Remember that the portfolios selected for the review amount to 58% of the risk-weighted assets of the 128 institutions, i.e. some €3.72 trillion, which will involve reviewing in detail an average of 1,250 credit records per bank. In Spain, we calculate that the review will affect assets valued at €663 billion, and will require the analysis of more than 21,000 loan records.

The second part of the assessment will consist of the stress test. The aim of this exercise is to analyse the ability of banks to maintain appropriate solvency levels in two different scenarios: a baseline or more likely scenario, and another alternative, highly adverse scenario, with less likelihood of occurrence.

The stress test is being developed in collaboration with the European Banking Authority (EBA). The methodology of the exercise is currently at the review stage following the finalisation some days back of the public consultation process. The final version of the methodology and details of the macroeconomic scenarios are expected to be published towards the end of this month.

The implementation and quality control stages of the stress test will commence from next month, meaning there will be some overlap with the asset review exercise. The outcome of the comprehensive assessment will be made known in late October, and will include both the results of the asset quality analysis and of the stress test.

As indicated on several occasions, the overall aim of the comprehensive assessment of banks is two-pronged: on one hand, the exercise seeks to offer a high degree of transparency concerning the situation of banks whose supervision will be conducted by the single supervisory mechanism as from November; on the other, it intends to promote the recapitalisation of those viable institutions that show insufficient levels of solvency. Both avenues will help reinforce the credibility of European banks ahead of the transfer of the supervisory function to the new authority.

I should emphasise that it would be mistaken to quantify the value of the stress test in terms of the capital requirements it brings to light; and even more mistaken to measure its success on the basis of the proximity of the final result to the relatively sizeable estimates in the analyses published so far which, often, have been lacking in information and rigour. Experience shows that, beyond the size of the capital shortfall identified, these analyses

are only credible if they manage to provide rigorous and consistent information on banks' real situation and their ability to withstand adverse scenarios.

Accordingly, the strategy to pursue can be none other than to ensure the methodological soundness and consistency of the exercise, and to provide the market with sufficiently accurate information on the results obtained and the process followed.

In this respect, what should reasonably be expected from the comprehensive assessment under way? I would essentially highlight three issues:

- First, that the exercise should be rigorous and demanding in terms of its scope. Contributing to this is the breadth and depth of the portfolios to be analysed in the asset quality review, the involvement of independent consultants and auditors, the consideration for the stress test of a very harsh macroeconomic scenario, and the setting of capital thresholds appreciably higher than the regulatory minimum set: 8% in the baseline scenario and 5.5% in the adverse scenario.

- Second, that the exercise should be robust from the legal standpoint and reasonable from the economic perspective. Specifically, the exercise should observe current prudential and accounting regulations. In this connection, it uses the definitions of regulatory capital in force at present, in keeping with the European Directive and Regulation on capital requirements. Moreover, the macroeconomic scenarios being designed for the stress test should include shocks to economic variables that are mutually compatible and consistent with past experience and economic logic. That is to say, as publicly announced by the ECB, the adverse macroeconomic scenario ultimately adopted should be severe but plausible.

- Third, we should expect the analysis to be balanced. Namely, it should seek to reflect and analyse the impact of all factors of vulnerability of European banks in terms of their objective relevance, irrespective of how technically difficult their treatment is. It should also be ensured that the macroeconomic scenarios envisaged have a similar likelihood of occurrence in all jurisdictions and that the estimation of capital needs acknowledges the existence of diverse national accounting frameworks in which provisioning requirements are defined to differing degrees of stringency.

As I said, while the challenges of this task are not minor, work is proceeding apace at the EBA, the ECB and NCAs to ensure that the exercise meets the best quality standards.

3. How are Spanish banks facing up to these exercises?

We may well ask how Spanish banks are facing up to these exercises. As is known, the financial sector has recently undergone intense reform involving the clean-up of balance sheets, recapitalisation and restructuring, and the resolution of non-viable institutions under the recently concluded financial assistance programme.

As you will recall, this process rested largely on an asset quality review exercise and a stress test similar to those now being undertaken as part of the preparations for the single supervisory mechanism.

There are, in any event, some notable differences that should be taken into account when comparing both exercises. For instance, the Spanish asset review exercise involved an exhaustive analysis of all domestic business, while its European counterpart will review a selection of portfolios, albeit encompassing both domestic and foreign-based business.

Further, although the 2012 stress test envisaged a highly adverse macroeconomic scenario, its focus was on the loans portfolio of institutions in Spain. Conversely, the scope of the European exercise will be much broader, including in its adverse scenario shocks – both at the level of the global economy and at that of each national economy – that affect all types of exposures, including the sovereign debt portfolio.

All told, Spanish banks’ starting position ahead of the new exercise can generally be confirmed as relatively favourable, if we consider the disposals of problem assets, especially by the most vulnerable banks, the recognition of impairment of the assets most affected by the crisis and the sizeable increase in all banks’ loss-absorption capacity.

4. Beyond the analysis exercise

In any event, the exercise will, irrespective of its final result, be a good opportunity to reflect on the relative strengths and weaknesses of the Spanish banking sector. And this can provide a platform for banks to take strategic measures enabling them to strengthen their competitive position in the new institutional framework.

In this connection, the regional diversification of the major banks – following a model of stand-alone subsidiaries, in terms of both capital and liquidity – has clearly been an advantage that has enabled them to soften the impact on their profits of adverse but not synchronised macroeconomic developments in different economic regions.

Also worth highlighting is their proven capacity to obtain high levels of profitability in the retail business and to maintain the value of franchises, despite the shortcomings evidenced in the selling of loan and deposit products.

Mention may also be made of the traditional conservatism in provisioning policy, advocated by the supervisor, which has enabled banks considerably to ease the impact of the economic crisis on their solvency levels.

On this latter point, the necessary harmonisation of the supervisory approach within the single supervisory mechanism may be expected in the medium term to entail some significant changes. In particular, it would be reasonable to expect that accounting requirements for banks tend to converge towards a common interpretation of the international financial reporting standards applicable in the European Union by mandate of the related Community Regulation. Consequently, the use of provisions as a supervisory policy tool will foreseeably diminish somewhat in significance, given that the determination of provisions will be steered to a greater extent by general accounting rules that naturally tend to set greater store by transparency and investor safeguards than by strictly prudential considerations.

As a result, the supervisory focus for Spanish banks will shift in the new institutional framework from an approach under which the monitoring of accounts was foremost to one where, while maintaining rigour in the revision of financial statements in respect of the classification and recognition of impairment of assets, the demand for high levels of capital is reinforced. Indeed, worldwide supervisory practice is following a clear trend, to which the single supervisory mechanism will immediately adhere according to the supervisory manual under preparation. This trend is, namely, towards a more intense and systematic use of the possibility of introducing capital requirements tailored to each bank’s actual risk profile (the so-called Pillar 2).

This tendency in supervisory practice interacts with the past or envisaged regulatory changes which quite openly pursue the progressive extension of banks’ loss-absorbing capacity. Such is the case with the introduction of macroprudential policies, the setting of supplementary requirements on leverage ratios, the adoption of capital surcharges for systemic institutions, the foreseeable upward revision of risk weightings for certain exposures and the introduction, from 2016, of minimum requirements for the coverage of losses by holders of weak banks’ debt instruments as a prior condition for mobilising resolution funds.

Naturally, under the single supervisory mechanism, the harmonisation of prudential surveillance arrangements may be expected to involve a uniform treatment of risk when it comes to determining the capital required of all European banks. In that way, the competitive distortions potentially generated by the different national approaches at present will be minimised. It is also to be expected that regulatory requirements will be introduced gradually, as is needed to avert excessive procyclical effects and significant market shocks.

Clearly, in keeping with regulatory developments and market demands, the key question for a large number of financial institutions in Europe and the rest of the world is not so much whether they should raise their loss-absorbing capacity, but rather what the most suitable way and the right time to do so are.

Faced with these foreseeable changes in the regulatory and supervisory framework, and irrespective of whether the ongoing assessment exercise is likely to be generally satisfactory, Spanish banks must evidently seize every opportunity to strengthen their capital position as the improvement observed in financial conditions progressively firms, be this through gains in efficiency, retained profits or new securities issues.

5. Conclusions

To conclude, I believe the major structural changes sweeping the banking industry will have been reiterated in this conference. We should assume that in the future the banking sector will be better capitalised and safer. As a counterpoint, however, it will likely be smaller and, probably, less profitable. All these changes will have appreciable consequences for banks' business models and competitive strategies.

The concurrence of this global process and the start-up of the banking union in Europe poses, in the short term, additional and considerable logistic and strategic challenges. Yet far from being a disadvantage, the banking union will over the medium term improve the European banking sector's competitive capacity. Banks will benefit not only from a genuinely unified market but also, more directly, from the added strength this project brings to the monetary union. And the soundness of banks and the stability of the financial system as a whole will hinge crucially on the proper functioning of this union.

Thank you.