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Regulation and banking reform

The new financial regulatory system and its implications/University of Oviedo

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Good morning. I would like to thank the Dean, Manuel González, for his kind words of introduction and for inviting me to deliver the closing address at this event in the University of Oviedo. I would also especially like to thank Julio Segura for "brokering" my participation in this session today. I don't always have to say yes to everything my former mentor and boss proposes to me, but I have never regretted doing so.

Given the academic profile of this forum, allow me to step back from the immediate challenges of supervisory policy – which, as can be imagined, are numerous and complex in the midst of a financial crisis – and to take this opportunity to reflect, from a more general perspective, on the profound transformation taking place in the regulatory framework of the banking sector in response to the international financial crisis.

As usually occurs with crises triggered by significant shocks affecting the stability of the financial system, this crisis is very costly in terms of welfare. In the case of Spain, we have suffered a double-dip recession associated with the collapse of the real estate sector against a backdrop of profound macro-financial imbalances and marked turmoil in international markets. This double-dip recession has pushed us off the growth path we were on just five years back and halted the process of real convergence. GDP per capita in Spain currently stands at 90% of the euro area average, after having exceeded 95% in 2007. Or, if you prefer, production per capita, after rising notably in the pre-crisis years, today scarcely exceeds the levels of a decade ago.

Fortunately, the latest data support expectations of a gradual recovery of the Spanish economy, which might have already begun in the third quarter of this year according to data published by the Banco de España last week. However, the task ahead of returning to sustainable growth to place us back on track to regaining forgone prosperity remains formidable. This includes progressing further with the major reforms already undertaken in various areas, including the financial sector. In this latter field, nevertheless, the significant measures to be adopted in our country are closely linked to the regulatory reforms designed at European and international level.

In fact, the crisis has underlined noticeable deficiencies in the regulatory framework of banking. I imagine that during today's seminar you will have analysed them in detail. In short, I think that the regulatory system was not conducive to adequately measuring the significant risks taken by institutions; to providing the necessary incentives for controlling them; to ensuring sufficient capacity for absorbing losses when they materialised; and, finally, to avoiding contagion to the sector and to the economic system as a whole with the subsequent adverse consequences on public finances, growth and unemployment.

In response to these deficiencies, the main international authorities have agreed and, in some cases, already implemented important reforms affecting nearly all significant aspects of financial activity.

Allow me today to focus on what I consider are the three pillars of global regulatory reform of the credit sector: first, measures to strengthen the solvency of banks; second, reforms to facilitate the orderly resolution of non-viable institutions; and, finally, the structural measures to set limits on credit institutions' business model.

Solvency legislation

Let us begin with the solvency rules. The new solvency rules, known as Basel III, introduce significant changes in prudential requirements which envisage not only an increase in the amount and quality of capital required, but also supplementary prudential oversight aimed at strengthening the resilience of banks and the financial system as a whole. This new framework has been incorporated, as you know, into European legislation through the Capital Requirements Directive and Regulation which will be implemented on 1 January 2014.

Basel III includes far-reaching changes. First, it requires banks to considerably increase their loss-absorbing capacity. The basic instrument used is the introduction of a minimum level of top quality capital (core capital or common equity tier 1) which amounts to 4.5% of risk-weighted assets. On top of this minimum, an additional capital conservation buffer of 2.5% is introduced, which must be built up once the transition periods envisaged have ended, although it may be used in times of need. Thus, banks, as a rule, will have to maintain a minimum level of top quality capital of 7% in terms of their risk-weighted assets.

This CET1 capital ratio is calculated, furthermore, using more stringent criteria than those currently used. Thus, the admissibility requirements for eligible instruments have been made significantly more restrictive and deductions have been increased; for example, those relating to goodwill, qualifying holdings and deferred tax assets. For an idea of the overall impact of these measures, it suffices to say that the minimum CET1 requirement of 2% under the previous legislation could be, on average, around 1% if the new requirements are applied. Therefore, effectively, the minimum CET1 requirement, increases by around six percentage points in relation to risk-weighted assets. And this aside from the supplementary requirements which may be made of each institution based on its specific risk profile under the so-called Pillar 2 of the Capital Accord.

In this way, credit institutions will have more and better quality capital to withstand the losses which might be caused by their activity. Nevertheless, as we have seen in the crisis, the availability of a large volume of capital does not per se guarantee an institution's resilience in the face of sufficiently adverse shocks. That justifies the introduction of further restrictions, such as those setting a maximum leverage ratio and minimum liquidity, which are currently subject to an observation period that will culminate in them being definitively parameterised and incorporated into the new regulatory requirements.

Finally, the new legislation includes **macroprudential tools** which seek to complement the requirements aimed at strengthening each institution's solvency with obligations directed at protecting the system as a whole. Two measures stand out among the macroprudential measures envisaged: those seeking to reduce the procyclicality of microprudential regulation by introducing a countercyclical capital buffer, and those aimed at mitigating the systemic effects of the possible insolvency of individual banks. The second set of measures includes an additional capital buffer for systemically important banks, which is complemented by supplementary requirements for those institutions with the capacity to affect the global financial system. Further, the new legislation includes the adoption of additional macroprudential controls (in the form of capital buffers, changes in risk weightings, etc.) for banks on the basis of their exposure to specific sectors where marked imbalances can be identified.

Undoubtedly, these regulatory changes will exert a noticeable positive effect on the capacity of banks to withstand periods of stress and that will result in less frequent and milder crises which, furthermore, should entail lower costs for the public.

That said, the new prudential legislation admittedly entails considerable challenges as to its implementation, and its introduction will restrict the capacity of banks to run risks. For this reason, it is appropriate, especially taking into account the relatively weak economic activity in Europe at present, to consider prudent implementation timetables taking advantage of the flexibility in the Basel Accord and in the new European solvency legislation.

We should apply the same prudence in the introduction of the new leverage and liquidity requirements. The observation periods currently in force should be used to painstakingly assess the resulting effects and, in particular, to better understand the possible interaction between the two tools.

Finally, in the area of the implementation of Basel III, we should not forget that there is still one issue to be resolved. It is important to ensure that the application of the new capital rules yield results which are comparable and consistent across institutions and countries. Specifically, the capital requirements for two institutions with a comparable risk profile should be similar, irrespective of the jurisdiction or jurisdictions in which they operate. In particular, although progress has been made recently in this area, additional effort is required to ensure that the internal models used by institutions and authorised by their supervisors to calculate risk weightings do not produce uneven results which question the robustness of the solvency ratios and introduce competitive distortions.

Legislation on resolution

The second major reform I would like to comment on refers to rules on the resolution of non-viable institutions.

Traditionally, the principle of constructive ambiguity has prevailed when action is taken by authorities in the face of problems of bank solvency. Under this approach, financial institutions' liabilities – except for guaranteed deposits – do not formally qualify for specific legal treatment, aside from the seniority established in the case of bankruptcy in accordance with conventional commercial law. However, the authorities have used discretionary power to protect the holders of banks' debt instruments – through capital injections which have prevented the winding up of such banks – when they have considered that their bankruptcy could entail undesired systemic effects.

In the recent past, it has become evident that the systemic effects of banking crises can be very marked, even when they affect institutions of no great size. Consequently, constructive ambiguity has resulted, at least in the first stage of the crisis, in widespread public action to assist ailing institutions. This has confirmed the existence of an implicit public guarantee of bank liabilities which, when activated, has generated considerable costs for the public finances of the countries most affected. Constructive ambiguity generates an incentives system which makes it difficult for institutions and their creditors to manage risk appropriately.

Thus, the restoration of an effective incentives system needs to limit confidence in public support schemes being activated across the board. That requires striking a suitable balance between measures to minimise the probability of the bankruptcy of systemic institutions – by imposing supplementary capital buffers – and, in the case of more complex institutions, the design of contingency action plans which ensure orderly resolution if a state of non-viability is reached. This is, in essence, the content of the work undertaken recently by the Financial Stability Board.

In any event, the essential ingredient of orderly bank resolution schemes is the specification of a bail-in arrangement establishing a clear order of priority for the claims of shareholders and the various types of creditors that can be activated before insolvency proceedings are commenced and before any State aid is made available. The credibility of this framework will favour the appropriate perception of the risk effectively entailed by each liability instrument and will minimise the bill to be borne by taxpayers to prevent the disorderly winding-up of banks.

In the European arena, we have progressed greatly in the definition of a regulatory framework for the resolution of non-viable banks. There is already political agreement on a proposed Recovery and Resolution Directive which will establish a clear burden-sharing system for insolvent banks and thus minimise the possible cost of rescue for taxpayers.

This Directive is also a first step in the creation of a single resolution mechanism to supplement the nascent single supervisory mechanism which will enable a real banking union to be set up in Europe. This project is essential to overcome the problems of fragmentation which still beset European markets and which cause the perception of risk associated with banks' liability instruments to differ depending on the jurisdiction in which they operate.

However, as you know, to ensure that non-viable banks are resolved in the same way in the various Member States of the euro area, it does not suffice to have a set of common regulations; rather, it is necessary to have a single resolution authority to ensure that the regulations are applied uniformly in all countries.

Similarly, the financial support needed for orderly bank resolution must be available under similar conditions whenever required. Clearly the lack of a full European resolution mechanism (including uniform rules, a single authority and a common fund) would limit the effectiveness of the single supervisory mechanism. In that case, the single supervisory mechanism would have to resort to a complex system of interaction with the national authorities (which would have to continue using their resources to cover the fiscal effects of the problems of non-viability detected by the supervisor) to ensure financial stability.

In this respect the draft legislative proposal submitted by the European Commission (EC) last July for the establishment of a single resolution mechanism is very timely. The EC proposes the creation of a single resolution agency or authority, which would manage a common fund fed by contributions from the industry and ultimately report to the European Commission.

It is true that some countries have expressed doubts as to the legal basis of the proposal. Moreover, this initiative may possibly assign excessive protagonism to the EC in some cases. Nevertheless, it is important that a political agreement be reached rapidly, allowing the creation of a scheme which will contribute not only to remedying the current fragmentation of the bank instrument market in Europe, but also, as I mentioned earlier, to the effectiveness of the single supervisory mechanism.

Structural measures

Finally, the third pillar of global regulatory reform I wish to briefly inform you of is the measures aimed at restricting the business model of financial institutions. Here I refer to the Volcker rule in the United States, to the conclusions of the report drafted by an independent commission chaired by John Vickers in the United Kingdom and to the proposals in the European Union by a group of experts chaired by the governor of the Bank of Finland, Erkki Liikaanen.

The rationale of these reforms leaves little room, conceptually speaking, for discussion. In the years leading up to the crisis, banks devoted a substantial amount of funds to proprietary trading and own-account investment activities which notably increased the size and complexity of their balance sheets. This expansion of business may be partly related to the ease with which banks can access funds in a setting in which, as I described earlier, bank liabilities (and particularly the most traditional type, such as deposits) enjoy a kind of implicit public guarantee. That is to say, some banks have been able to use the taxpayers' guarantee to assume excessive risks which have made it increasingly likely that the guarantee will be called upon. Structural measures are intended, in this respect, to prevent risky activities such as proprietary trading from being pursued by banks which simultaneously take deposits from the public.

Unfortunately, these initiatives have remained outside the bounds of international coordination and, more specifically, lie beyond the remit of the Financial Stability Board (FSB), which has given rise to a lack of uniformity across jurisdictions.

For example, although the US proposal permits deposit-taking institutions to engage in a wider range of activities than the European proposal does (including market-making activities), it does require the activities of unrelated entities to be totally separated. The proposal currently under discussion in Europe would permit the creation of financially independent subsidiaries to accommodate the activity of investment within a group also authorised to engage in traditional commercial banking. We are therefore confronted with the need to achieve closer international coordination to ensure the consistency of the reforms under way in the various jurisdictions. Otherwise the cross-jurisdictional inconsistencies may encourage regulatory arbitrage which would reduce the effectiveness of the reforms adopted and put at risk the sought-after simplification of banking.

In any event, the implementation of measures of this type affecting the specialisation of banking activity should be accompanied by an appropriate cost-benefit analysis. In this respect, it should be kept in mind that the crisis has not demonstrated the superiority of any specific model and that, by contrast, it has witnessed the collapse of all manner of institutions, whether they be specialised in traditional business, in investment banking or in a combination of the two. Moreover, given that the introduction of restrictions on banking activity means forgoing the potential benefits of diversification, it is essential to ensure that these are smaller than the risk of combining traditional banking and own-account investment activities, even after the entry into force of solvency regulations which strengthen and step up prudential controls. Finally, it is necessary to assess as precisely as possible the impact structural measures may have on the location of risk outside the regulated sector and on the liquidity and efficiency of securities markets.

More generally, we still lack an overall analysis of the diverse regulatory changes envisaged in the three areas in question, of their internal consistency and of their combined impact on the financial system and on the economy in general. For example, at the limit it could be argued that structural measures (perhaps those having the greatest impact on the business strategy of the main banks) are the least necessary if we are confident that the combination of the new solvency requirements and the reform of resolution regimes will really minimise the government support required to protect deposits. Furthermore, although the soundness and solvency of banks tend to strengthen their capacity to grant credit, it is true that the combined effect of all the measures will (by their very nature) tend to reduce the profitability of banking and banks' ability to channel savings to business activities involving risk. Further evidence on the quantitative importance of this effect would be useful for assessing the key parameters of each measure.

Effects in Spain

Against this background, how do the regulatory changes affect the Spanish banking sector? It is true that the regulatory avalanche represents a huge challenge for Spanish banks, but I do not think that it is greater than that faced by other banking systems, especially after all the financial reforms adopted in Spain over the past year.

Currently, we have confirmation that Spanish banks are reasonably capitalised, that they have substantially improved their liquidity situation and that their leverage ratios are relatively low, in comparison with those of other European banks. In addition, the bank business model in Spain continues to be based on traditional commercial activity so that own-account investment securities portfolios are generally moderately sized. As a result, the structural measures that may be approved by the European Union will have a more limited impact on Spanish banks than on banks in other jurisdictions. Moreover, international banks have established a model of independent subsidiaries that is conducive to the application of simple resolution arrangements

At the same time, unlike in most jurisdictions, we have already had for more than a year very advanced legislation on resolution that has been applied in the process of restructuring our financial system and that has entailed a significant saving of public funds.

That said, it is true that some specific aspects (especially associated with the deductions introduced for regulatory capital) could be specially demanding for certain Spanish banks, which are already responding in their strategic plans. More generally, the pressure exerted by the market on the availability of capital (beyond the new minimum regulatory requirements) requires an on-going effort to preserve capital and, specifically, to maintain prudent cost containment and dividend policies.

Also, it is clear that the productive specialisation of our economy and its dependence on bank financing make it vulnerable to any adverse impact of the new regulation on the ability of banks to finance the real economy. To counter this, all we can do is take advantage of the timetables established to ensure our institutions gradually adapt to the new requirements and, above all, work at the same time to promote the development of our capital markets in order to increase their capacity to intermediate the economy's financial flows.

All told – and I will finish here – the main challenge we face, as I have already mentioned, is the persistent fragmentation of European markets (despite the recent improvement) and the consequent link between sovereign risk and banking risk. Accordingly, our financial system will be significantly strengthened by the setting up of an effective banking union with all the important components, including the single resolution mechanism. Once again, it is clear that defence of the national interest requires unreserved support for initiatives that tend to deepen and speed up the process of European integration.

Thank you very much for your attention.