BANCO DE **ESPAÑA**
Eurosistema

10.04.18

"The challenges to the financial system"

Address at the Conference "*Los retos de la banca europea: rentabilidad y modelos de negocio"* ("The challenges to European banks: profitability and business models"), organised by Cinco Días and Abanca (Madrid)

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Good morning.

Let me begin by thanking the organisers for their invitation to participate in this conference entitled “The challenges to European banks: profitability and business models”. My public interventions over the last 15 months have turned on the various challenges facing European banks, and it is a pleasure to be able to continue sharing my thoughts with you today on this subject.

At the same time, I would not wish to excessively repeat the content of my previous speeches, not because I have changed my mind but because I believe it is now more than sufficiently known that I consider it necessary to carry on exploring avenues to improve efficiency and continue the orderly correction of overcapacity. Nor would I wish to overlap with the roundtables that follow and which will focus exclusively on profitability, first, and on business models, thereafter.

Concerning profitability it is likely that, inter alia, aspects relating to low interest rates, the still-significant volume of non-productive assets, the adaptation to recent regulatory changes that have entailed an increase in capital requirements, and new technologies will all be mentioned. As to business models, various approaches can be made. But ultimately I believe the debate will turn, in one way or another, on the sources of revenue and funding that define different business models.

In any event, both roundtables are inextricably related, since a key aspect regarding a business model is that, for it to be sustainable, it must be profitable. It should generate sufficient returns to cover its risks on the basis of a stable funding structure.

Against this background, in my address today I wish to briefly mention new technologies, as an aspect which affects the traditional banking business in Europe across the board. In addition, and from the standpoint of banks’ traditional funding sources, I would like to take this opportunity to highlight certain regulatory changes under way in Europe in respect of covered bonds and securitisations.

New technologies

As regards new technologies, technological developments have clearly been conducive to the emergence of new service providers which, in some cases, compete with traditional banks in specific market niches. Further, as a result of the possibilities these new technologies offer, the patterns of behaviour of bank service users are changing radically.

Traditional banks react to this change in different ways: (i) harnessing the advantages arising from co-operative initiatives at the sectoral level; (ii) entering into alliances with new agents; (iii) incorporating new technologies and changing the way in which they pursue their activity in order to become more competitive and place greater emphasis on aspects such as the “customer experience”; and (iv) exerting pressure on the authorities to open the way to innovation through the creation, for instance, of controlled test spaces with tempered regulatory requirements (the so-called regulatory sandbox).

To analyse and understand all these changes, the central bank and the regulators must transform themselves. In this respect, at the Banco de España we have recently created a new Associate Directorate General with the aim of strengthening the analysis of these changes and the implications they have for the financial sector and for the public policies that must, where appropriate, be implemented.

In this connection, cross-departmental work is needed in this new area at the Banco de España, given the numerous dimensions affected: payment systems, market conduct, regulation, supervision, financial stability, research and studies, and authorisations, among others. Fluid dialogue should also be maintained with other authorities – such as the CNMV (National Securities Market Commission) and the General Secretariat of the Treasury and Financial Policy - and with the market, both through the fora already in place and through bilateral meetings.

And the aim is not only to understand the implications of the emergence of new agents and new forms of operating among Spanish institutions, but also, and necessarily, to take an international overview. This is because one of the characteristics of the change we face is the transnational dimension of many of the new initiatives and the speed with which successful forms of operating that develop in one country ultimately spread to other jurisdictions. In this respect it is not surprising that, among the courses of action of the European programme known as the Capital Markets Union, measures relating to these new agents are included where it is sought, precisely, to promote an orderly reaction at the European level.

Legislative reform in the area of funding sources

Allow me now to move on to two legislative reforms, also part of the Capital Markets Union, and which I believe are noteworthy since they relate to two traditional funding sources for banks which will foreseeably become important again as the ECB's targeted longer-term refinancing operations (TLTRO II) progressively mature. Specifically at issue here are the reforms affecting covered bonds and securitisations.

These reforms seek to promote deeper and more efficient European markets for these financial products, thereby contributing to enhancing the funding of credit institutions and, therefore, their capacity to route funds towards the real economy. Equally, the reform of the securitisations framework seeks to help investors evaluate the attendant risks, thereby contributing to risk management.

Ensuing from both legislative reforms will be changes in the practices that credit institutions currently follow and, therefore, they will require an adaptation effort on the part both of issuers and investors.

I shall briefly refer to each reform.

Covered bonds

Starting with covered bonds, on 12 March the European Commission released a proposal that seeks to harmonise their regulation in Europe.

These types of bonds, encompassing the case of Spanish mortgage covered bonds (*cédulas hipotecarias*), involve banks issuing securities (bonds) whose repayment is guaranteed by a pool of assets. In this way, issuing banks retain the risk on their balance sheets (the cover assets) and the investors in the bonds are doubly protected in the event of default: first, they have direct recourse to the cover pool of assets of the covered bond programme; and further, they have recourse against the issuing institution as an ordinary creditor.

This protection, known as *dual recourse,* combined with the high quality demanded of the cover assets, means that what is involved here is a high-quality and liquid instrument, and that banks' investment in this type of bond receives preferential treatment in terms of regulatory demands.

In Europe, several countries have traditionally regulated these types of products and have sizeable markets for them. They include most notably Germany, Denmark, France and also Spain. As is known, in Spain *cédulas hipotecarias* have been notably important as a source of funding for credit institutions.

That said, the various European local markets for covered bonds have their own particularities, and their respective regulations differ. For example, in the Spanish case a very substantial difference from other countries is that *cédulas hipotecarias* are backed by the entire mortgage portfolio, despite which they have not traditionally been considered as better than other similar securities where the collateral for the bonds is significantly less.

Given the differences observed at the European level, a fundamental aim of the European Commission's recent proposal is to make headway in Europe in harmonising the regulation of covered bonds.

The proposal includes a Directive that specifies the core elements of what may be termed as "European covered bonds"; it also amends banking prudential regulations, strengthening the conditions under which banks investing in these products may benefit from lower regulatory capital demands.

The Directive offers a definition of covered bonds, highlighting the need for dual recourse, and furthers the tradition of confining the issuance of this product to credit institutions. It introduces, inter alia, demands for the segregation of the cover assets, liquidity requirements and several criteria to ensure the quality of the assets, including the possibility of a cover pool monitor. The Directive further demands the need for public supervision, in pursuit of greater protection for investors.

The amendment of the prudential regulation strengthens the requirements for lower regulatory capital demands on banks that invest in these products, including, among other issues, a minimum level of overcollateralisation, generally of at least 5%.

Once the Commission's proposal is approved, the Directive shall be transposed so that banks may begin to issue as soon as possible instruments that benefit from the advantages of obtaining the "European covered bond" label.

In this connection, I should like to highlight two matters. First, I consider that the transposition of the Directive should be tackled in a way that allows a reform to be undertaken that makes this funding market – traditionally so important for Spanish banks – even more efficient and sound. And second, during this transition period, banks should manage their issuance programmes appropriately so that, once the Directive has been transposed, they are in a position to undertake covered bond issues following the best practices required of "European covered bonds".

Securitisations

Unlike covered bonds, the performance of securitisations has been poor during the international financial crisis. What is more, their inappropriate use as part of the "originate to distribute" banking model was considered to be one of the factors contributing to the crisis. The stigma surrounding this product has not been confined to the United States, but has – perhaps with less justification – also affected Europe.

That said, the European authorities have considered that appropriately regulated and well-structured securitisations may contribute to diversifying funding sources, to promoting better risk management and, ultimately, to mobilising more funds towards the real economy.

For these reasons, two Regulations were published on 28 December in the Official Journal of the European Union amending the regulatory framework applicable to securitisations, in an attempt to harness their benefits, restricting the risks arising from their inappropriate use.

One Regulation establishes a general framework for all securitisations, creating a specific framework for those that are to be known as STS (simple, transparent and standardised). The other Regulation transposes the new Basel III framework, adding amendments to the prudential regulation of credit institutions and investment firms, both for general and for simple, transparent and standardised securitisations, which will benefit from a better treatment.

As to the specific framework for STS securitisations, and without going into excessive detail, the regulations establish a series of concrete requirements.

For them to be simple it is required, for example, that the underlying exposures be homogeneous as regards the type of asset and the attendant contractual and credit-risk characteristics.

To be transparent, the minimum information to be provided to investors is laid down, among other matters, which will simplify due diligence.

To be standardised, a series of contractual requirements to be met by the transaction are determined.

Finally, obligations to notify the European Securities and Markets Authority (ESMA) are required, while public supervision of these criteria is demanded.

This new and recently approved framework for simple, transparent and standardised securitisations, which will be applicable as from the start of next year, marks an opportunity to reactivate a market which has been stigmatised and penalised by the recent international financial crisis, but which may offer advantages to banks in terms of improvements to their funding and risk-management opportunities. It would be worth making the necessary efforts to converge towards these practices.

Conclusion

And I hereby conclude, returning to the beginning. Let us not lose sight of the challenges posed by the new technologies, but nor of the aspects related to banks' traditional funding, which will once again become important as the liquidity provided by the ECB progressively matures.