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Banking regulation challenges

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I would like to start by thanking the Universidad Complutense for the opportunity to open this conference on banking regulation.

Any law student and, certainly, any lawyer will be familiar with the fact that legislation changes over time.

Banking regulation is certainly no exception to this rule, but rather a prime example of it. Indeed, if we look at the publications of the Basel Committee, which, as you know, is the international banking regulator, we observe clear exponential growth in terms of standards set.

The Committee was established in 1974 as the G10's response to the failure of the German bank Herstatt, which led to significant losses in various jurisdictions as foreign exchange settlement risk materialised. Since then, settlement risk is also known as Herstatt risk.

A year later, the Committee produced its first standard, the Concordat, which established a series of principles applicable to individual and consolidated supervision for capital and liquidity. It also proposed guidelines for collaboration between home and host authorities, distinguishing between subsidiaries and branches. And it did all this in five pages that, incidentally, still remain in force.

In its first 22 years, the Committee's output in terms of standards was not very voluminous, at least in terms of length. Of course it produced several guidelines and reports, but until 1996 it only issued two standards. These are still very relevant in a large number of jurisdictions, though.

In 1988 it issued the first Capital Accord, known as Basel I,[1] although of course back then it was just referred to as the Basel Accord. In 28 pages, including the Annexes, the accord established a definition of capital, risk weights and a target capital ratio to be achieved gradually.

Then, in 1996 it issued an Amendment To The Capital Accord To Incorporate Market Risks.[2] Its 56 pages, in addition to establishing what was then considered to be an extensive standardised method, regulated for the first time the possibility of using internal models to calculate regulatory capital, a circumstance to which we, the supervisors, have had to adapt ever since.

In total, the three aforementioned standards, which are still applied in a large number of emerging jurisdictions, amount to 89 pages and are relatively easy to understand and apply.

The second half of the Committee's life paints a truly different picture. In 2004, following successive documents for consultation, the New Basel Capital Accord - now known as Basel II - was issued. It contained close to 350 pages.

Subsequently, as a result of the crisis, new standards on liquidity, leverage, market risk, counterparty risk and credit valuation adjustments, in addition to various adjustments for systemic banks and other corrections, have been added. As a whole, these new standards,

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1 https://www.bis.org/publ/bcbs04a.pdf
2 https://www.bis.org/publ/bcbs24.pdf

developed over a decade, are known as Basel III, although the sector often says that we have gone past III and that we are now at IV. I would call it 3.5.

The overall scale of the resulting regulations is truly striking. The consolidated framework,[3] recently published on the BCBS's website, contains 60 existing standards totalling 1,868 pages. Its technical complexity has also increased considerably.

Of course, the expansion of standards and their increased technicality is largely due to the growing complexity of banking activities and the need to maintain a risk-sensitive capital framework that encourages best practices and professional bank management; yet clearly this banking-regulation revolution has also arisen in response to the financial crisis. The Basel Capital Accord has been reformulated practically in its entirety to include the lessons learned from the 2008 financial crisis, whose consequences are observable to this day.

The changes up to 2018 are far-reaching, affecting all components of the capital ratio, which, as you well know, is central to the solvency framework. The crisis also showed us that focusing solely on one metric can be counterproductive. Therefore, other aspects concerning banks' liquidity or leverage, which complement traditional solvency, have been introduced. Furthermore, banks' business model and governance have become a focal point, with limits and restrictions even being imposed on credit institutions' remuneration policies in order to correct, or at least mitigate, certain perverse incentives.

Despite the benefits provided in terms of risk sensitivity and improvements to management incentives, we must acknowledge that the regulations' complexity and scale pose unquestionable challenges to banks, particularly smaller ones, and certainly to supervisors. Prior to 2004 it was perfectly feasible for someone to be fully familiar with the entire capital framework. Nowadays that is almost impossible given its scale and technical complexity.

Clearly, returning to past solutions is not the answer. Despite the attraction of their simplicity and ease of implementation, we know they are inadequate for the type of banking business prevailing in the EU. Instead, we need to increase our ability as supervisors, by focusing on the training and specialisation of our staff in order to provide an appropriate response to this complex reality.

In this regard, since the creation of the Single Supervisory Mechanism (SSM) five years ago, headway has been made in improving the skills of the European supervisor's members. Training has been boosted. But, above all, we have worked resolutely on preparing shared practices and guidelines applicable throughout the euro area. These are based on the best practices observed at national supervisors, with the twin objective of improving technical skills and achieving a shared supervisory culture and practices in many of the framework's most technical aspects, such as the use of internal models and the application of the Pillar 2 framework.

With my personal experience of having participated in the creation of the SSM, I can assert that this process has been difficult. Indeed, it would actually be more accurate to say that it is still difficult, since it has not yet concluded. As you will appreciate, achieving a truly shared supervisory culture, methodologies and practices is very complicated. The SSM comprises

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[3] https://www.bis.org/basel_framework/index.htm?export=pdf&pdfid=15693359902244600

members from the 28 European Union Member States, i.e. not just the euro area, which have their own culture, language and work methodology.

Adopting a new supervisory culture and new supervisory practices means renouncing, to some extent, practices we considered our own and accepting that other methodological approaches could possibly be more appropriate. This is not easy, because if there is one thing we do all have in common, irrespective of nationality, it is that we find it hard to accept and adapt to change.

In any event, I believe the outcome so far is very positive. We have pressed on with a fully fledged European supervision mechanism as a key step towards a Banking Union that makes the European financial system more secure, thereby favouring sustainable economic growth.

As I have stated on several occasions, we still have some way to go to complete the Banking Union. In particular, we still lack an appropriately funded European Deposit Guarantee Scheme. However, in my opinion, we are headed in the right direction.

Furthermore, supervision has been equipped with a set of tools that should allow for coordinated and, we hope, pre-emptive action. Specifically, the macroprudential tools emerge as a complement to microsupervision.

The macro perspective focuses on the aggregate risks in the system and aims to strengthen financial stability. It does so by preventing and mitigating the so-called systemic risks and vulnerabilities to ensure that the financial system contributes to sustainable economic growth.

Since 2014 the Banco de España has identified and monitored vulnerabilities in the financial system and has also been able to set countercyclical buffers. Nonetheless, further, far more specific tools were recently conferred on the Banco de España, enabling us to act by focusing on those credit segments where imbalances may be concentrated.

Evidently, as supervisors our work should focus on avoiding banking crises, and all the aforementioned changes target this goal. Yet we must accept that institution-specific crises may continue to arise, have the mechanisms to avert a transfer or spillover to the rest of the system and do our utmost to prevent the use of public funds. As the saying goes, we should aim for the best, but, at the same time, be prepared for the worst.

Against this backdrop, I would like to mention the bank recovery and resolution directive, adopted in 2014 and amended in 2019, which added a further 200 plus pages to European banking regulation. As a result of this directive, the bank resolution and winding-up framework was also radically amended.

Resolution planning by the institutions themselves is a key feature of this new framework. In this connection, it seems clear that a crisis setting is not the most favourable for improvisation. Although each crisis is different and it is practically impossible to anticipate all the circumstances, everything we do beforehand will help the process of managing each individual crisis. The other key feature concerns the shift in the resolution paradigm from bail-outs, largely using public funds, to bail-ins, borne by the bank's shareholders and creditors.

As you can see, the regulatory and institutional changes are enormous in scale. Based on this conference's schedule, many of these topics will be covered over the next two days. Despite the title chosen, these will not just focus on regulatory matters, but will also address other areas, particularly those concerning the new European supervisory and resolution framework.

In addition, other topical issues will be discussed at this conference that I would like to mention briefly.

First, I am pleased to see that banks' corporate governance and compliance will be addressed this afternoon. I say that because governance is something I have dedicated significant efforts to over my career. I consider it to receive little attention despite it being, in my opinion, a necessary, albeit not sufficient, condition for appropriate risk management.

Governance cannot be put into objective terms or fully quantified; it is a culture affecting the organisation as whole, although it should be fostered by its most senior officers. Inadequate governance does not always have short-term consequences, nor does it usually have an immediate effect on the business model. All this makes it hard to convey a sense of urgency to achieve proper governance.

Yet without it, the conflicts of interests that arise daily at banks cannot be managed. When a conflict of interest arises, the bank should create a control function. Evidently, the control function will only work if it is independent; otherwise, it will be neutralised or absorbed by the pressure of business.

Regrettably, we have seen how, without adequate governance, control functions are lacking in clout and effective power. This affords business units excessive - sometimes even exclusive - influence over day-to-day bank management.

Another core feature that is sadly a topical issue is the compliance function. As with governance, this function is only adequate if it has sufficient independence, capacity and resources.

Unfortunately, the importance of compliance and governance is not usually observed in expansionary phases. Indeed, sometimes they are a constraint on certain types of seemingly profitable businesses. Yet the banks that have overcome the financial crisis, in many cases managing to consolidate their starting position and prevent reputational risk from materialising, are those which had robust governance and compliance frameworks.

The last topic I would like to briefly broach is new technologies. At tomorrow's round table various aspects of the new technological context will be discussed, mainly concerning the implications of blockchain for different areas, such as AML controls and payment services. The possibility of central banks launching digital currencies, an increasingly topical issue in light of Libra's potential emergence, will also be discussed.

These issues are increasingly relevant. Banking's present and future evidently involve digitalisation. As I have previously stated, the technological context is an unavoidable challenge and, like any challenge, it is both a threat to and an opportunity for banks' business.

The difference between threat and opportunity lies in the mind-set with which the challenge is undertaken. The opportunity involves using customer data, banking's current greatest strength; the threat is posed by the emergence of new participants, in particular BigTech firms, which have proven ability for using the data available to banks. We should not forget that as a result of the entry into force of PSD2, these new participants may start to have access to this information.

Allow me to conclude by reiterating the importance of the issues that will be addressed over the next two days. Given the scope and complexity of many of these issues, it is a very ambitious schedule. Yet judging by the quality of the speakers, many of whom I have the pleasure of knowing, I am confident this conference will be a success.

Thank you very much.