

GOVERNOR'S INTRODUCTORY LETTER



2016 was the second full year in which the Banco de España performed its supervisory functions within the framework of the Single Supervisory Mechanism (SSM) for European credit institutions. The Banco de España is working with the European Central Bank (ECB) and the other central banks and national supervisors of the euro area countries within this framework to firmly establish uniform, high-quality European supervision.

In particular, progress continued to be made in 2016 in establishing supervisory procedures and practices. Advances were made in the uniform application of the process of supervisory review and evaluation of the solvency and liquidity situation of institutions, as well as in the cross-functional review of the internal models used by institutions to calculate their capital requirements. Experience shows that, in addition to having a common regulatory framework, its application and subsequent supervisory review also need to follow common guidelines to ensure that institutions compete on a level playing field.

The importance of making progress towards the convergence of supervisory practices obviously applies to all areas of banking activity and regulation. Consequently, although important steps have been taken within the SSM to establish common supervisory procedures in the prudential area, it should not be forgotten that there are other important spheres, closely related to the latter, which need to be explored in order for progress to be made in entrenching a genuine, effective and uniform European banking supervision system. I am referring here to the sphere of financial data, the raw material for all supervisory analysis of the financial and solvency position of credit institutions. In 2016 a major effort was made to address the problem how the non-performing loans on bank balance sheets should be managed, and I trust that progress will continue to be made in this respect.

Apart from SSM-related tasks, in 2016 the Banco de España carried out important work in other areas related to the supervision of financial institutions. In particular, macroprudential tools began to be applied from 1 January 2016 and greater efforts were made in relation to the supervision of institutions' conduct, with the aim of improving customer confidence in the banking system.

All in all, the balance of supervisory activity in 2016 was positive. That said, given the important challenges posed by the demanding macroeconomic, regulatory and technological environment in which Spanish credit institutions operate, the Banco de España will continue to endeavour to achieve increasingly efficient supervision with the ultimate aim of promoting a stable Spanish banking system capable of effectively channelling the economy's financial flows and of contributing to the welfare of the general public.

INTERVIEW WITH THE DEPUTY GOVERNOR



Until his recent appointment as Deputy Governor he performed various functions in the Banco de España, basically in the area of central banking. He is now embarking on a new phase in which he will also address supervisory tasks. To what extent does this new phase involve change or continuity with respect to your previous experience?

It certainly involves a change as I have been working for many years in central banking-related areas and now I am focusing to a greater extent on supervision-related functions, as required by my new position. However I think that these duties have important aspects in common. Specifically, both are pursued in markedly European environments; the Eurosystem and the Single Supervisory Mechanism (SSM).

These two frameworks are at different phases of development. While the Eurosystem is fully formed, since it has been in operation since January 1999, when the euro area was created and monetary policy competence was transferred from the then 11 national central banks (now 19) to the ECB, the SSM had been in existence for little more than two years. I recall how the establishment of the euro area and the creation of the ECB were an important landmark in the long and complex process of European integration. We now face the challenge of entrenching the SSM. I believe that the experience of the Eurosystem – of working jointly with the other central banks and the ECB – is proving key to the development of a common European system of supervision today.

Is there any particular lesson for the SSM that stands out from the Eurosystem experience?

The Eurosystem experience showed us that procedures and instruments need to be extensively harmonised for the system to work properly. All parts play an important role in achieving the common purpose, namely an appropriate definition for and smooth implementation of European monetary policy, but this requires uniform procedures. I believe that this insight is directly extendable to the SSM, and that we now need to press ahead with the harmonisation of supervisory practices.

Have all the Banco de España's supervisory powers been transferred to the ECB?

Not exactly. Not all the Banco de España's supervisory powers have been transferred to the ECB. The Banco de España has transferred to the SSM the direct supervision of significant credit institutions, but retains that of less significant institutions, in respect of which the SSM exercises indirect supervisory functions. In addition, even in those cases in which the SSM is directly responsible for supervision, the Banco de España participates actively in the supervision of Spanish institutions, and in the supervision of the institutions of other SSM Member States.

For the exercise of its functions, the SSM is set up as an integrated system, made up of the ECB and the national competent authorities, including the Banco de España. Membership of the SSM involves participation by the Banco de España in decision-making in relation to all euro area credit institutions, through its representation on the SSM's Supervisory Board and on the ECB's Governing Council.

At the same time, we should not forget that the supervisory powers over credit institutions in areas other than microprudential supervision, such as the protection of bank customers and the application of macroprudential tools, remain at the Banco de España. In addition, the latter continues to supervise entities, other than credit institutions, engaged in activities relating to the financial sector, such as specialised lending institutions, mutual guarantee companies and payment institutions. All these functions contribute to the objective of the Banco de España of preserving the stability of the Spanish financial system.

Further to your comment regarding the SSM as a milestone in the European integration process, what do you think its main achievements have been during its first two years of operation and what have been its main challenges?

Nobody doubts now that the SSM is the most important step in European financial integration since the introduction of the euro. Among its achievements, I would point to the various different initiatives to harmonise the supervisory practices applicable to European significant institutions in the prudential sphere. For example, the SSM has defined a single methodology for the supervisory review and evaluation process and has managed to harmonise supervisory options and discretions through a regulation and guidelines issued by the ECB.

Despite these notable efforts, there is still a long way to go in harmonising supervisory practices. This is not surprising, given that the SSM brings together supervisors with varied approaches and cultures. This diversity has been apparent, for example, in the differences of scope and depth of the criteria followed by national supervisors when authorising and reviewing internal models used to calculate capital requirements. To address this lack of supervisory uniformity, a cross-functional analysis of these models is currently being performed.

Also with the objective of achieving greater convergence of supervisory practices within the SSM, another area in which it is worth making further progress, closely linked to the purely prudential sphere, is that relating to the review of accounting information. This is the starting point for supervisory analysis of the situation of institutions, so that reviewing its reliability and quality, beyond mere formal compliance with the applicable accounting framework, is essential.

Focusing a little more on the challenges you mentioned to harmonise supervisory practices for the review of institutions' internal models, both the prudential (to calculate capital requirements) and the accounting ones (to calculate provisions), do you think there are any differences in the degree of progress made in this harmonisation?

The truth is that, so far, the concern and action to harmonise supervisory practices has mainly been focused on prudential aspects, rather than on financial aspects; we have already mentioned the harmonisation of options and national discretions, the supervisory review and evaluation process, and capital models. It is true that capital is a key element in the event of unexpected losses, and its appropriate calculation, in accordance with the risk of each institution, is fundamental when assessing the solvency of each institution and of the financial system as a whole. However, at least as important as the appropriate calculation of capital is the appropriate calculation of provisions to cover credit losses, the main banking risk.

The experience and conclusions obtained from the cross-functional review of capital models currently in progress may be useful to explore the harmonisation of the supervisory review of institutions' accounting methodologies.

Returning to the common methodologies being developed by the ECB to supervise significant institutions, like the one relating to the supervisory review and evaluation process, what are their implications for the direct supervision of less significant institutions by the Banco de España?

The subject of alignment of the supervision of significant institutions, carried out by joint supervisory teams from the SSM, with the supervision of less significant institutions, carried out directly by the Banco de España, is being addressed from two standpoints.

First, within the SSM work is being carried out to adapt the binding criteria applied to significant institutions to the specific circumstances of less significant institutions, through guidelines addressed to national authorities. The Banco de España actively participates in the preparation of these harmonised supervisory criteria both on the ECB's supervisory board and in the various technical level working groups.

Second, the Banco de España endeavours generally to align supervisory practices for less significant institutions with those agreed within the framework of the SSM for significant institutions. Thus, when supervisory criteria are defined or the options and discretions envisaged in the regulations for Spanish less significant institutions are exercised, it very much takes into account the criteria adopted by the ECB. In fact, we are working to adapt Circular 2/2014 to the exercise of options and discretions by the ECB. To apply different rules to different Spanish institutions may result in unwarranted competitive differences.

Let's talk about Spanish credit institutions. What is the current situation of the banking sector in Spain?

Spanish institutions' solvency situation is adequate. This was reflected, for example, in the results of the European Banking Authority (EBA) stress tests, according to which the participating Spanish institutions' capital exceeded the requirements used as a reference in previous stress tests.

From this starting point, institutions have to deal with an environment that remains difficult, characterised by increasing competition and falling profitability. The current low level of interest rates and, to a lesser extent, the accumulation of unproductive assets threaten their profitability. Assessing these risks is a current supervisory priority, and managing them appropriately is a priority for directors.

How can credit institutions deal with the current economic environment of low interest rates, and what is the role of the supervisor in this area?

As a general rule, supervisors should not interfere in the strategic decisions of institutions, which are responsible for taking such measures as they deem appropriate from time to time, with the objective of protecting their value and better serving their shareholders and customers. However, I believe that supervisors should monitor such strategies, share their analysis with the institutions concerned and support decisions that promote financial stability.

In this respect, the current environment of low interest rates requires, in my opinion, very high levels of efficiency, with appropriate diversification of revenues, in terms of location and the range of financial services provided. Accordingly, further bank consolidation, which would result in a banking sector with fewer, better capitalised, more profitable and more efficient competitors, with a more diversified business model, cannot ultimately be ruled out.

The regulations applicable to credit institutions have undergone far-reaching amendments in recent years. What challenges does this pose to institutions and supervisors?

The regulations applicable to credit institutions have indeed undergone significant changes in recent years. These include, notably the new crisis management framework for credit institutions and, in particular, the new eligible liabilities requirement (MREL). Institutions will have to make changes to their financing structure in order to meet these new requirements. In addition capital buffers began to be required in 2016, one of their objectives being to address systemic risks.

In the accounting sphere, the transition from the incurred loss to the expected loss model will come into effect in January 2018, which involves a significant challenge for institutions in terms of databases and effective integration of accounting methodologies into credit risk management.

All these regulatory changes involve a challenge not only for institutions, but also for supervisors, as we have to adapt our procedures to the new requirements.

You mentioned, in relation to the initial application of macroprudential instruments, that 2016 was the first year in which capital buffers were required. What do you think will be the future impact of these measures?

The last crisis showed that the work of financial supervisors needs to address not only the individual situation of each institution (“microprudential supervision”), but also developments in the financial sector as a whole, from a macroprudential viewpoint. The various macroprudential tools now provided for in the regulations, including notably capital buffers, are the fruit of this lesson.

Specifically, buffers for institutions designated as systematically important are intended to address the negative externalities that these institutions pose for financial stability as a consequence of their size, activity and interconnectedness with other institutions. The countercyclical capital buffer, on the other hand, is intended to strengthen bank solvency and to smooth the credit cycle, forcing institutions to build up capital buffers during upswings, so that they can be used subsequently in an adverse macroeconomic environment.

One of the consequences of the recent crisis was the deterioration in the confidence of bank customers in credit institutions. How is the Banco de España addressing this situation?

The lack of good customer practices has undoubtedly generated significant reputational damage for the whole banking sector. For this reason the Banco de España has redoubled its efforts in the area of supervision of the conduct of institutions, allocating greater resources to these tasks, separating them from prudential supervision and setting up new procedures. This is an activity that will be intensified even further in future.

These actions are included in the process of continuous improvement of supervisory organisation and procedures, with the aim of adapting the tasks performed by the Banco de España to the various risks and threats to financial stability.

To finish, what are the main challenges of your term of office as deputy governor?

I believe that my main challenges relate to adaptation to change. That is to say, regulatory changes, changes in supervisory procedures and changes in the environment in which credit institutions operate. For example, the impact of new technologies and the entry into the financial market of so-called FinTech companies. Financial risks are constantly evolving, and this requires an appropriate response from institutions, regulators and supervisors. As a result of the work carried out in recent years, Spanish institutions are in a favourable position to confront these challenges.

I also consider it a priority to continue building a common supervisory culture in the euro area, in the EU as a whole and worldwide. As regards the euro area, notable efforts have been made in recent years by the ECB and by the national supervisors. However, building a supervisory model that combines the best of the various traditions existing in each participating State is an ambitious task that will take time.