BANCO DE ESPAÑA
Eurosistema

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Presentation of the PwC report “Banking union: A challenge amid overlapping crises”

PwC España

Madrid

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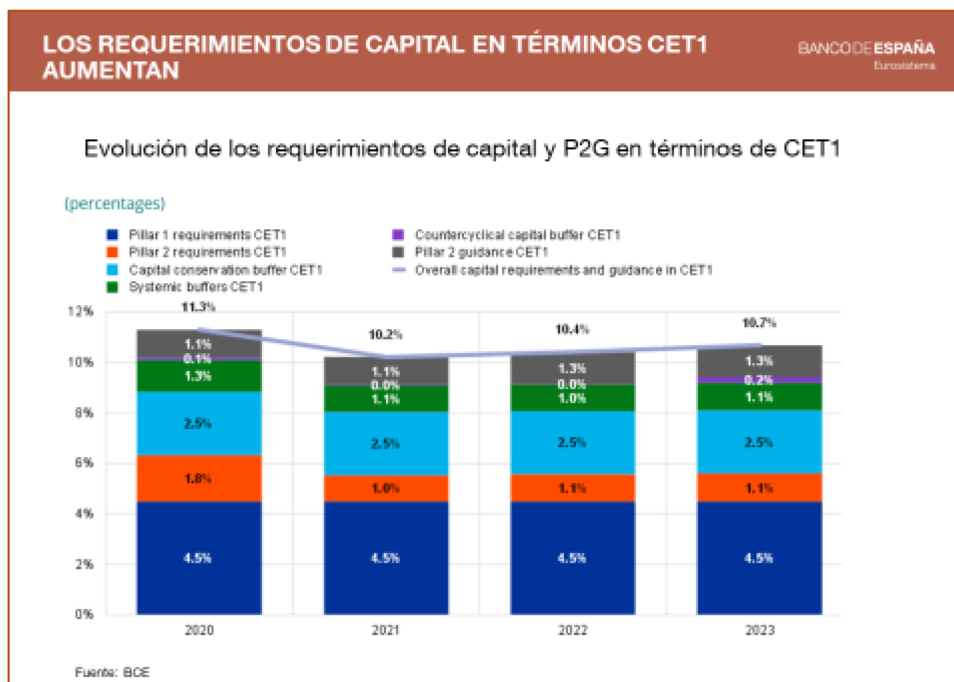
Good morning. I would like to begin by thanking PwC for again kindly inviting me to take part in the presentation of its annual report on the banking union.

This report once again sets out a precise analysis of where the banking sector stands in the current environment of macroeconomic uncertainty, which has been compounded this week by fresh turmoil on both sides of the Atlantic.

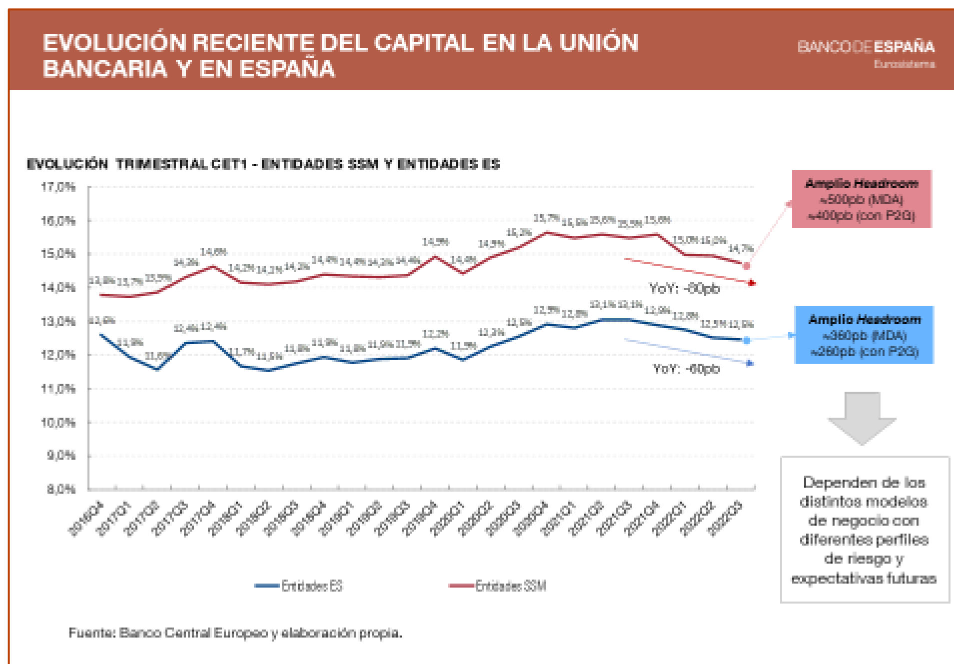
I would draw your attention to a new aspect singled out in the report: the challenges and implications that the new interest rate environment represents for the banking sector, which come on top of the more familiar structural challenges posed by digitalisation and sustainability.

Indeed, although today's address was prepared before the events of these past few days, my chosen topic – solvency – is key to ensuring bank resilience. I will focus on the capital requirements framework, and offer a few thoughts on the resolution mechanism.

Capital in the banking union and Spain: current situation and recent developments



The European **significant institutions** supervised by the Single Supervisory Mechanism (SSM) have a sound capital position, for the most part comfortably exceeding the required capital levels. **In terms of CET1**, the capital and P2G requirements taken together have on average increased very slightly with respect to last year: 10.7% in 2023 as a result of the 2022 SREP cycle, as compared with 10.4% in 2022. This was essentially due to higher countercyclical and systemic risk buffers.



On **the latest data available, the average CET1 capital ratio stood at 14.7% in 2022 Q3**, resulting in additional leeway (or "headroom", in banker speak) above the MDA[1] of more than 500 bp on average, or around 400 bp if we factor in the P2G. Compared with 2021 Q3, the capital ratio had fallen by 80 bp in September 2022.

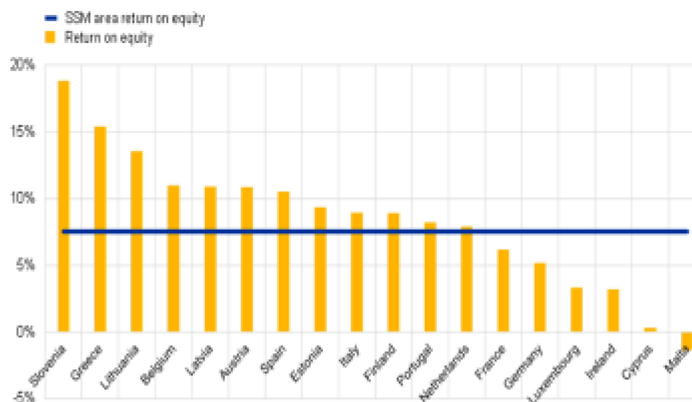
Moreover, rising interest rates have led to a very significant improvement in profitability, with ROE standing at 7.6% in 2022 Q3.

Spanish banks can also boast a sound capital position, and all of them, in turn, have ample headroom over and above the capital and P2G requirements. Compared with the significant institutions under the SSM overall, Spanish banks' capital requirements were slightly lower (9.8% versus 10.7%). The same can be said of their capital ratios, though to a greater degree (12.5% versus 14.7%), ultimately resulting in less headroom (slightly more than 360 bp in terms of the MDA, or 260 bp if we include the P2G).

The capital ratio has fallen by around 60 bp since 2021 Q3, slightly less than in the case of the SSM significant institutions overall (80 bp).

When making this comparison, the significant impact of business model heterogeneity, with different risk profiles and future expectations, should be borne in mind.

[1] MDA: Maximum Distributable Amount



In Spain the retail banking business is pre-eminent, with a high degree of risk diversification that makes it possible to generate recurring, sustainable returns.

Thus, Spanish banks' ROE ratio stood at 10.1% in 2022, or 10.2% excluding extraordinary items, 140 bp up on the previous year's figure.

Complexity of the capital requirements framework

One aspect to consider in terms of the current differences across capital requirement ratios is the highly complex nature of the current capital requirements framework.

First, as far as the denominator is concerned, comparisons are skewed by the **use of internal capital models**. Although guidance has been issued and supervisory exercises conducted to reduce unwarranted disparities in the use of such models (the TRIM project), the intrinsically discretionary nature of internal models and the differing degrees to which they are used across the different regions may lie behind a great many of the differences in the density of risk-weighted assets. Here, Spanish banks report higher densities than the European average, owing, in part, to the fact that they make less use of internal models. Nonetheless, this source of variability will be mitigated with the implementation of the Basel III output floor.

Second, the current system of capital buffers on top of the minimum requirements, which emerged in the wake of the Great Recession, also has a part to play in any comparisons made. The patchwork of buffers currently in place has various aims, and there are therefore occasional differences in **how such buffers are applied**.

The **capital conservation buffer stands at 2.5%** across the board, and is *applied to all exposures* without exception.

COLCHONES DE CAPITAL G-SII Y O-SII EN EL SSM

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Country	Number of O-SIIs	O-SII buffer range	Number of G-SIIs	G-SII buffer range
Austria	9	1-2%		
Belgium	8	0.75-1.5%		
Croatia	7	0.5-2%		
Cyprus	11	0.5-2%		
Estonia	4	1-2%		
Finland	3	0.5-2%		
France	7	0.25-1.5%	4	1-1.5%
Germany	13	0.25-2%	1	1.5%
Greece	4	0.75-1%		
Ireland	6	0.5-1.5%		
Italy	4	0.25-1%	1	1%
Latvia	4	1.25-2%		
Lithuania	3	1-2%		
Luxembourg	7	0.5-2%		
Malta	4	0.25-2%		
Netherlands	5	1-2.5%	1	1%
Slovenia	6	0.25-1%		
Portugal	6	0.25-1%		
Slovenia	6	0.25-1%		
Spain	5	0.25-1%	1	1%

Nonetheless, there are also buffers that are set *on a bank-by-bank basis*, such as the **systemically important institution buffers**, designed to address the externalities deriving from the way such institutions operate. Here, we see differences in terms of the number of systemically important institutions in each country (only five countries have G-SIIs, while there are between three and 13 O-SIIs per country[2]) and the levels established. Spain currently has one G-SII and five O-SIIs, with buffers ranging between 0.25% and 1%.[3]

In late 2022 the European Central Bank (ECB) decided to revise its floor methodology for assessing the capital buffers for each country's systemically important institutions. This new framework[4] will apply within the banking union as from 1 January 2024 and will make the requirements more stringent. In the event of a failure to comply with the methodological guidance deriving from this framework, the ECB has the power to apply higher macroprudential buffers than those initially established by the relevant national authority.

[2] G-SIIs: Global Systemically Important Institutions. O-SIIs: Other Systemically Important Institutions.

[3] Table of G-SII and O-SII buffers

[4] Governing Council statement on macroprudential policies, 21 December 2022.

COLCHONES DE CAPITAL SISTÉMICO EN EL SSM

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Country	SyRB	Exposures	Type of SyRB
Austria	0.25-1%	All exposures	general
Belgium	9%	Retail exposures secured by residential property	sectoral
Croatia	1.5%	All exposures	general
Germany	2%	All exposures secured by residential property	sectoral
Lithuania	2%	Retail exposures secured by residential property	sectoral
Slovenia	1%	Retail exposures secured by residential property	sectoral
	0.5%	Other exposures to natural persons	sectoral

In addition, there are some buffers that may be restricted to particular *exposures, institutions, sectors or regions*. A case in point is the **systemic risk buffer** (SyRB), activated mainly in countries in northern and eastern Europe. Differences can be seen in terms of both the scope of application and the range within which the buffer can be set, since there is no maximum limit. For example, at the lower end Austria has opted to apply 0.25% to all exposures, while the highest levels can be seen in Belgium (9% for retail mortgage exposures). This buffer is currently set at 0% in Spain.[5]

Meanwhile, there are also differences in the **economic criteria used to set** the buffers.

Some requirements are established using a *microprudential* approach. One such example is the **Pillar 2** framework, which seeks to capture, for each bank, any risks that have been underestimated or that are not covered by Pillar 1. The Pillar 2 requirement (P2R) is set via the supervisory review and evaluation process (SREP). Additional guidance (P2G) is established based on the results of the stress tests. This enables banks to address financial stress, which constitutes a supervisory expectation.

[5] SyRB map

COLCHONES DE CAPITAL CONTRACÍCLICO EN EL SSM

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Country	Implementation date	Current CCyB
Austria	1 Jan 2016	0%
Belgium	1 Apr 2020	0%
Croatia	1 Jan 2016	0%
	31-mar-23	0.5%
	31 Dec 2023	1%
Cyprus	1 Jan 2016	0%
	30-nov-23	0.5%
Estonia	7 Dec 2022	1%
	1 Dec 2023	1.5%
Finland	16-mar-15	0%
France	1 Apr 2020	0%
	7 Apr 2023	0.5%
	2 Jan 2024	1%
Germany	1 Apr 2020	0%
	01-feb-23	0.75%
Greece	1 Jan 2016	0%
Ireland	1 Apr 2020	0%
	15-jun-23	0.5%
	24-nov-23	1%
Italy	1 Jan 2016	0%
Latvia	01-feb-16	0%
Liechtenstein	01-jul-19	0%
Lithuania	1 Apr 2020	0%
	01-oct-23	1%
Luxembourg	1 Jan 2021	0.5%
Malta	1 Jan 2016	0%
Netherlands	1 Jan 2016	0%
	25-may-23	1%
Portugal	1 Jan 2016	0%
Slovakia	1 Aug 2020	1%
	1 Aug 2023	1.5%
Slovenia	1 Jan 2016	0%
Spain	1 Jan 2016	0%

A *macroprudential* approach is used to set the **countercyclical capital buffer** (CCyB), which is activated during expansionary phases and released during downturns. It is set via a guided discretionary procedure, having regard to the credit-to-GDP gap. While Spain has always held this buffer at 0%, it is currently activated in some countries in northern and eastern Europe, at levels ranging between 0% and 2.5%. It appears that a significant number of countries either reactivated or increased the buffer in 2022 or intend to do so in 2023, so as to be able to mitigate the future effects of a possible slowdown in the cycle.[6] The use of the credit-to-GDP gap as the key indicator of possible imbalances in economies is currently up for debate, and other additional factors are being considered.

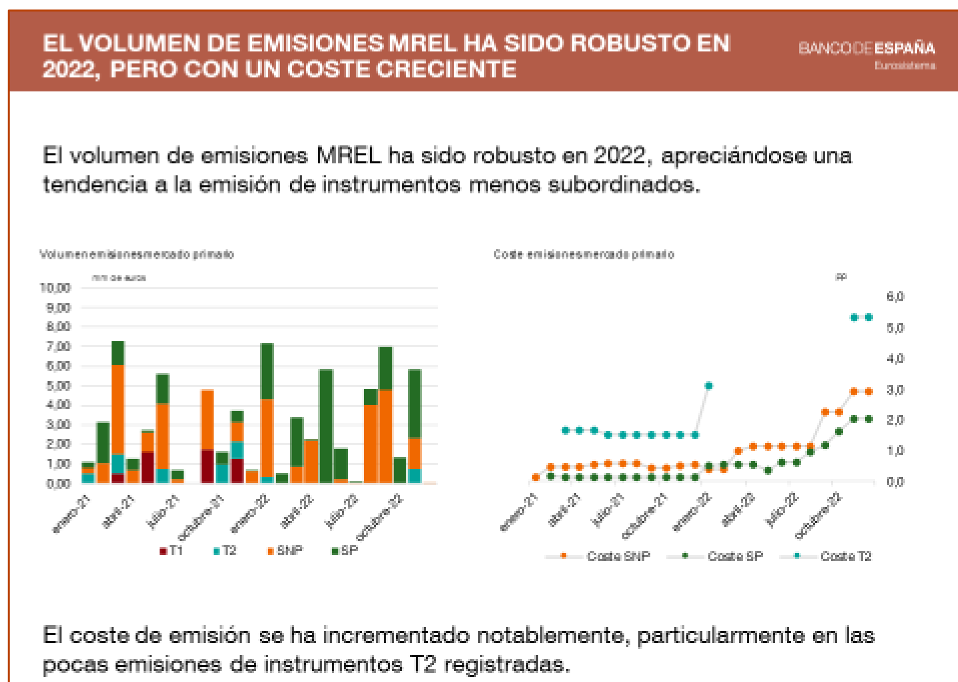
In short, establishing capital requirements involves a degree of complexity, and some aspects are left to the discretion of the national authorities.

Banking resolution, a necessary framework presently under review

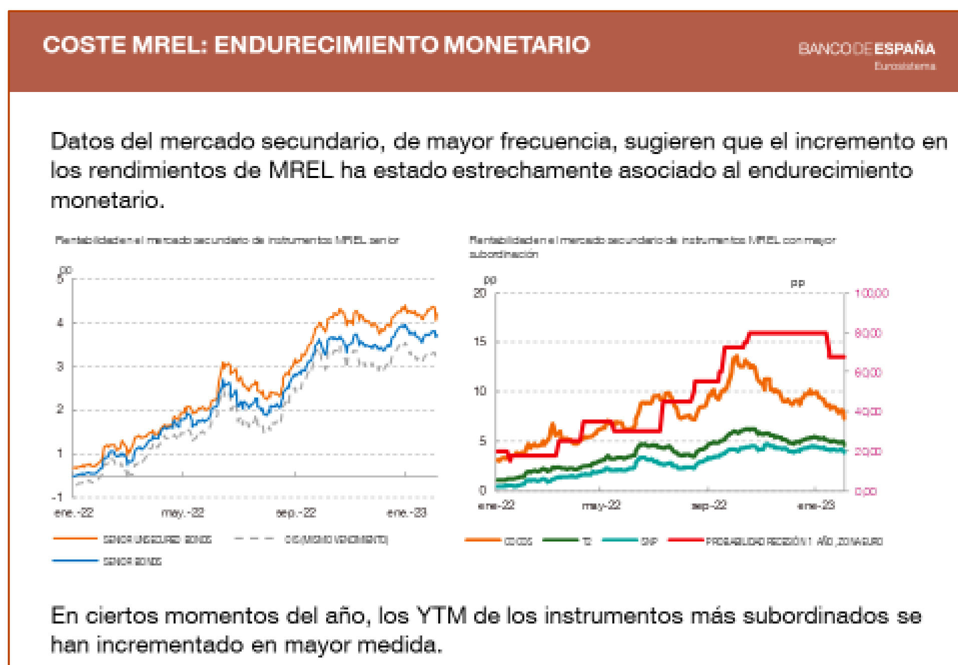
This far I have endeavoured to explain the capital requirements for European banks and their – increasingly complex – regulatory framework, but as recent events have shown, banking stability and soundness do not rest on capital alone. The structural aspects of the European environment comprise not only the capital framework (including the liquidity requirements) but also the sound resolution framework:

[6] CCyB map

Funding structure for loss absorption and ultimate capitalisation of banks



First it is important to note that European banks' MREL requirements are appropriately met. As you are all aware, the minimum requirement for own funds and eligible liabilities (MREL) is an essential requirement that minimises risks for depositors in a resolution process and acts as a buffer to strengthen soundness in such cases. European banks have issued MREL-eligible instruments even in this monetary policy tightening environment and have continued to access market funding as normal. Nevertheless, as is to be expected, the cost of these new issuances has increased as interest rates have risen.



The European Commission's proposed Crisis Management and Deposit Insurance (CMDI) framework entails a review of the existing framework to:

> **1** make it more proportionate, efficient and consistent when it comes to handling the resolution or liquidation of any bank in the European Union, ensuring appropriate funding;
> **2** improve the synergies between crisis management and depositor protection, taking measures to complete the banking union.

To achieve these aims, the proposal envisages broadening the application of the resolution, in addition to clarifying and standardising other essential resolution concepts. It also aims to strengthen and broaden the functions of the deposit guarantee schemes (DGSs). The Spanish scheme, which can generally only be used by banks in the event of winding up, but not resolution, is currently no more than a provider of cash.

This entire framework will only become truly meaningful once the third pillar of banking union, the European Deposit Insurance Scheme (EDIS), is in place. Regrettably, this essential element is still missing.

Recently, Dominique Laboureix, the new chair of the Single Resolution Board (SRB) told the Committee on Economic and Monetary Affairs of the European Parliament, referring to the CMDI, that resolution cannot be applied without sufficient access to funding, and that in this respect, where feasible, the national DGSs could play a vital temporary role as forerunners to the EDIS, together with the Single Resolution Fund (SRF).

Enhanced usability of resolution tools and strategies

The second point I wish to comment on is the enhanced usability of resolution tools and strategies, based on the experience acquired.

As you may well know, the **Banco de España has always prioritised the development of transfer tools and has emphasised the need to find an adequate mix for the available sources of funding**.

We cannot overlook the fact that in the banking crises of recent years, banks have generally been sold or bridge banks established, with no losses borne by depositors of any kind.

This **leads us to reflect** on the need to optimally develop **the most efficient tools for all kinds of banks in the event of resolution**.

In the near future, the use of **dry runs, deep dives, on-site inspections and various testing tools** should become widespread, so as to be as certain as possible that, were it to be necessary, these tools may be used without difficulty. This point was also noted by Dominique Laboureix in his appearance before the European Parliament.

Lastly, the latest events once again underline the importance of **liquidity in stressed situations.** Apart from all the liquidity requirements for the European banking sector, it is

important to recall that the present framework includes mechanisms to provide liquidity to banks where necessary. In a hypothetical case of resolution in Europe, the SRF will this year stand at €80 billion, and will also count on the ESM[7] backstop to supplement its support capacity.

Clearly new ideas are currently being discussed, and ahead of the forthcoming publication of a CMDI proposal by the European Commission, which seeks to standardise the scope of resolution processes (and where necessary of insolvency), we trust that the co-legislators will be able to find the optimum equilibrium that we all wish for.

Conclusion

Recent events have placed the spotlight on the need for appropriate management and strong supervisory, regulatory and banking resolution frameworks. There are several reasons why a crisis such as that seen at SVB is unlikely to occur in Europe. Moreover, European banks have very limited exposure to Credit Suisse.

A brief review of the specifics of the Californian bank shows that the situation cannot be extrapolated to Europe:

- SVB's **business model** is not comparable with the European banking business model. It is a niche bank that has grown very quickly and whose business volume is highly concentrated, both in terms of deposits (it has relatively few depositors, mainly firms, with deposits over the deposit guarantee limit) and loans (high investment in mainly long-term debt securities, the segment most affected and least well placed in the face of interest rate rises). In Spain, for instance, on average 66% of deposits are eligible for the deposit guarantee scheme, compared with just 11% at SVB, while 60.4 million account holders (96.5% of the total) have balances below €100,000. This highlights the fact that deposits in Spain are essentially retail deposits, which are traditionally much more stable.

- In Europe and in Spain, **liquidity requirements** are applicable to all banks, irrespective of size. The average short-term liquidity coverage ratio (LCR) in Europe stands at 165% (compared with 118% in the United States and 184% in Spain). Moreover, the LCR is calculated based on banks' high-quality liquid assets, mainly cash and reserves at central banks.

- European banks, and Spanish banks in particular, are well placed in the face of **interest rate** rises, as loan repricing goes farther and is faster than deposit repricing, precisely because of the different features of loans and deposits. In addition, European banks are subject to an interest rate risk management framework that is closely supervised by both the European and the national competent authorities.

In any event, as there is no way of fully preventing the emergence of unexpected cases such as those we have seen this week, I wish to highlight here the need to strengthen banks' **governance** framework. This was one of the lessons learned in the global financial crisis, and since then both the European and the Spanish financial system have taken great strides

[7] European Stability Mechanism.

to improve governance. Crises traditionally reveal failures in the governance and management of different risks.

Lastly, I should like to emphasise, as I mentioned earlier, that the European resolution framework is sound. But this does not mean that there is no room for improvement, and for this we await the Commission's CMDI proposal.

I trust that the events of this week will lead us to reflect on the importance of the global supervisory, regulatory and resolution framework and to complete the banking union, with the necessary steps being taken to implement the missing pillar.