Miguel Fernández Ordóñez: Contribution of global banks to financial stability

Opening speech by Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, at the International Capital Markets and Emerging Markets Roundtable, Institute of International Finance (IIF), Washington DC, 17 April 2011.

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Let me start by thanking the IIF for giving me this opportunity to present my views on global banks. I will speak from my perspective as Spanish banking supervisor. And I should say from the outset that in my country global banks have not given us the most problems. Indeed, the main message of my intervention today is that we should not fall into the trap of automatically equating "global banks" with "dangerous banks" in terms of financial stability. This may be an intuitive reaction to the crisis. But it would be a mistaken one, in my view. In fact, based on our experience, I would like to give you some examples of how global banks can make a positive contribution to financial stability. Naturally, these are only examples, and I would certainly not presume to have all of the answers on this complex issue. But I hope these examples will be illustrative of the point I am trying to make.

First of all, it is true that some global banks have experienced severe problems. We have seen large, complex and interconnected banks and financial companies on the brink of bankruptcy, both here in the United States, and across Europe. The taxpayers of some of the most developed countries of the world have been called on to support global banks headquartered in their countries. Indeed, after the Lehman bankruptcy, it is fair to say that the entire global financial system was put at risk by the difficulties of some banks operating worldwide.

It quickly became clear that an unprecedented and unacceptable level of systemic risk had built up over the "boom" years. And that a significant amount of taxpayer's money had been put at risk as a result. This prompted a forceful, and understandable, reaction from all sides. The public, bank investors, regulators, supervisors and politicians alike all agreed that we needed a profound overhaul of the treatment of systemic risk.

I believe that the reactions to this challenge from the G-20, at the highest political level, as well as from the Financial Stability Board (FSB) and the Basel Committee of Banking Supervisors (BCBS), have been proportionate to the size of the problems and risks we have encountered since the outbreak of the crisis. The costs have been huge and there is widespread agreement that we cannot allow this to happen again.

Nevertheless, we should also recognize that a number of global banks have managed to navigate these rough and unchartered waters without capsizing, Indeed, if you allow me to extend the metaphor, some have even been able to help to calm the waters. It is important to learn the lessons from all of our experiences, both good and bad, to help us better shape the future regulation and supervision of the financial system. And it is with this in mind that I want to comment on our experience with global banks headquartered in Spain.

As I will stress throughout my intervention, the global nature of systemically important banks should not be seen as a negative attribute. Globalization allows countries and cultures to learn from each others' experiences, enriching us in a very broad sense. Of course we want a safer world, but a key foundation of safety is a world that is able to grow. And growth goes hand-in-hand with openness and globalization. In fact, globalization has been the engine of growth in the years before the crisis.

And global banks have played a key role in this process and, therefore, in delivering growth to our societies. Some banks have become global because they have accompanied domestic non-financial companies in their international expansion process.

Our largest global banks became international around fifteen years ago. They went first to Latin America, following their large domestic customers (utilities, oil companies, telecom firms, construction and technology firms and so on) into those new markets. Once in the new markets, the banks were able to familiarize themselves with the needs of other local customers and started to provide banking services to local households and firms. The beneficiaries of this process were not only Spanish companies, but also firms and households of the host countries.

This natural expansion process has created benefits in terms of risk and income diversification for the banks involved, thus reducing their probability of failure and contributing to a safer financial system worldwide. Moreover, global banks help to better allocate resources across the planet by contributing to fund investment processes in countries where savings are insufficient and, in the opposite situation, providing more opportunities for depositors and savers to channel their funds to better opportunities. This natural expansion process should continue for banks in emerging countries whose non-financial companies are expanding abroad into other emerging countries or into more mature countries. We should not bring this process into a halt, reducing welfare across the board.

And global banks do not only make contributions to growth, but can also act as a stabilizing force in the financial system, both in the countries in which they operate and at home.

Our experience as supervisors is that our large and global banks have been a stabilizing factor during the crisis. Of course, our banking system has been affected by the crisis, but our problems have been concentrated in a limited number of small and medium-sized local savings banks.

The performance of our large banks during the crisis has been very different from that of this group of savings banks. Since August 2007, like the rest of the banking sector worldwide they have taken a hit on their share price. However, they have contributed positively to the restoration of financial stability worldwide, by helping in the restructuring of other banking systems, buying banks or pieces of banks that were experiencing difficulties. They thus contributed to stabilize markets and financial systems in a time of turmoil. Moreover, they have maintained their commitment to households and firms – both large corporate and SMEs – in the emerging markets in which they operate. We have not seen any halt in banking intermediation in those markets or any retrenchment from those markets. And finally, they are still entering new banking markets, both in Europe and in Asia.

Resilient global banks do not only benefit the host markets in which they operate, in particular emerging countries. They have also been very beneficial to the home market. Wide-ranging geographical diversification has helped these banks to withstand our real estate crisis much better. They have been able to compensate the difficulties in the local banking market in Spain, resulting from a recession and the ongoing slow recovery, with much more buoyant and dynamic banking business abroad.

Until now, the benefits that I have mentioned can be said to apply regardless of the legal structure chosen by the banks for their international expansion. But our large global banks have also adopted a business model which has some specific strengths that I would like to highlight. Namely that their international expansion was based on the subsidiary model, as opposed to the branch model. As a recent paper by IMF staff stresses, a branch model for internationalization may be cheaper than one based on subsidiaries. However, it may also be riskier, both for the host and the home markets. Although nobody expects that these banks will need to be liquidated, we have seen sufficient black swans in recent years to show us that we need to hope for the best but be prepared for the worst. And if liquidation were needed, a stand-alone subsidiary model would have important advantages over a branch model, especially if there is substantial deposit taking activity at the local level. I am not saying that the liquidation of a global bank organized through subsidiaries would be an easy task. What I mean is that it would be much easier than for global banks which are deeply interconnected across countries through branches.

The stand-alone subsidiaries model has an additional advantage, from the perspective of the supervisor. It is far more symmetric for the local supervisor than the alternative model, allowing them to really supervise the institution. And as a home supervisor, if a foreign bank has a significant share of a domestic market, I would rather have the domestic supervisor deeply involved in the monitoring of that bank. Our experience has taught us that local supervisors usually have a deeper knowledge and more accurate information on developments in their home banking sectors than distant parent company supervisors. The expansion of global banks through subsidiaries provides for this deep involvement of the local supervisor. This may be a more effective – and therefore safer – arrangement, as it provides for a double layer of supervision, by both home and local supervisors. Moreover, from the group's perspective, the combination of decentralized management and strong controls at the parent company creates as well a double layer of control within the group. This can have a drawback in terms of higher costs but some international active banks have demonstrated that it can be compatible with a good efficiency ratio.

The subsidiaries model is one way of approaching this issue, but I am very conscious that it is not the only one. Nor is it suitable for all banks. It depends on many factors, including the type of business conducted by the institution – retail, investment banking etc. So let me be clear that I am not prescribing this model, and that I do not think it is the answer in all circumstances. But it is a factor that makes certain international groups less dangerous for the rest of the system in terms of their likely impact in case of difficulties. In other cases, the institutions concerned may also be able to argue that they have other controls, or business models, in place which reduce their risks. The validity of all reasonable approaches should be explored.

In this context, let me mention here the work underway in the FSB and BCBS to deal with the global SIFIs issue. In my opinion, this work is going in the right direction. For example, we have a general agreement that not all SIFIs are the same or pose the same degree of risk to the system, and that the framework should recognize this. Along the same lines, the idea is to have a system which builds in a sufficient degree of supervisory judgement to reflect aspects that cannot be quantified, but balanced with "constrained discretion" and a peer review process to ensure that there is a level playing field. And I think, and others think, that the resolvability of an institution should be taken into account in determining the systemic risk of a Global SIFI. For instance, a proper "living will" is a mechanism to reduce the impact of a bank failure and, therefore, to reduce the systemic risk these institutions pose. Finally, the FSB places strong emphasis on the importance of intensive supervision.

The aspect of the FSB approach to SIFIs which has attracted most attention is the setting of higher capital requirements (or "loss absorbing capacity") for SIFIs. We would be extremely naïve to think that extra capital is the answer to systemic risk. Holding extra capital does not resolve the problems of poor management or ill-advised risk taking. And we will never be able to require SIFIs to hold a level of capital sufficient to absorb the huge costs related to their potential bankruptcy. But capital does help to reinforce the system, because it provides an incentive for institutions to reduce the risk that they pose to the system. Banks which show that they are less risky should be subject to lower requirements, thereby incentivizing responsible and safe behaviour. Instead, those banks that pose higher risks should meet more stringent requirements.

Let me stress, yet again, that my point is not about having all global banks following this organizational philosophy. On the contrary, I do believe a diversity of institutions from either a business model or an organizational perspective is needed to ensure that financial globalization promotes global growth. But we should also be aware that, if the regulatory framework in areas such as SIFIs capital surcharge is ill defined, we may end up promoting the convergence of global banks towards the most complex business model of the current landscape.

In this respect, I would like to draw your attention to the fact that we have recently raised core capital requirements – to 8% – for all institutions operating in Spain, in order to boost the stability of the financial system. However, we have also gone a step further and placed an additional 2% charge – to reach 10% – on those institutions which could potentially create more problems for the supervisor. To be more precise, this higher capital requirement will be applied on those which have less than 20% of their share capital or voting rights with third parties and that have wholesale funding of more than 20%. These institutions are not the globally active ones, but they are the locally oriented ones that have created the highest risk for financial stability in Spain during recent times.

While our largest banks have been more a support factor than a problem, and part of our savings banks sector is sound and profitable, we have faced serious challenges regarding a number of the local savings banks. Our experience in this crisis illustrates that we should be careful not to establish over-simplistic solutions to be applied generally. Instead, we should concentrate on solving the problems where they really originated. This is precisely the goal of the measures we have adopted in Spain during the last two years. We are currently dealing with a deep restructuring process that will end up by transforming those savings banks into larger commercial banks that, in the future, could also become global banks or a part of a global foreign bank.

In conclusion, we should not demonise global banks for being global. They can play an important role in the international economy. Provided they are safe and soundly managed, they can facilitate the internationalization of non-financial firms, and they can bring greater competition, efficiency and stability to the markets in which they operate. What we need to do as supervisors is to make sure that global banks have adequate risk management capabilities, sufficient loss-absorbing capital, and are subject to intensive and coordinated supervision, so that we are able to contain the systemic risk they pose without curtailing their contribution to economic growth worldwide.

We have nothing to fear from global banks which are well-managed, well-capitalised and well-supervised by home and host authorities. What we should do is prevent the emergence of badly managed, badly-disciplined banks, whatever their geographical dimension, as they can expose our financial systems to important risks.

I hope that this humble contribution provides food for thought. As I said at the beginning of my intervention, I do not have all of the answers. But I do think that we can and should learn lessons from all experiences, both positive and negative.

My words reflect the experience that we have had with our global banks in the last three years. But of course, past successes are not, per se, a guarantee of future success. Sophocles wrote in one of his tragedies that “we cannot call a mortal being happy until he’s passed beyond life free from pain”. Following the same principle of precaution, neither supervisors nor credit institutions should succumb to the temptation of unfounded optimism about the future. This is the reason why we will continue pushing for a very intense supervisory process for these global institutions and we will ensure that they are complying with the highest standards in any field. Supervisors can make several different types of mistakes, but one they cannot afford is complacency.

Thank you very much for your time and patience.