## José Manuel González-Páramo: How will historians judge our handling of this crisis?

Speech by Mr José Manuel González-Páramo, Member of the Executive Board of the European Central Bank, in the occasion of the presentation of the book titled "Un Siglo de Historia del Sistema Financiero Español", Bank of Spain, Madrid, 10 June 2011.

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Ladies and Gentlemen,

It is a great pleasure to have the opportunity to speak today at the Bank of Spain about the Spanish financial sector.

The book being presented today consists of a distinguished collection of essays providing a wealth of information on Spain's financial sector over the last century. Not only does it summarise the key data and the main developments, but it also provides deep analyses. It will definitely become *the* work of reference on the history of the financial sector in this country in the 20th century. Let me then congratulate the contributors and the editors, José Luis Malo de Molina and Pablo Martín Aceña for their excellent work.

Reading the book, notably the chapter by Raimundo Poveda, we can draw some interesting parallels between the current crisis and the banking crisis in the late 1970s and early 1980s. In particular, given the current circumstances, the main message I would like to emphasise today is that certain changes in the banking sector that are implemented in response to crises are essential to guarantee a strong, robust banking sector in the future. In other words, the implementation of reforms and changes in the banking sector after a banking crisis – in respect of business practices, regulation and supervision – has the potential to strengthen the foundations of the banking sector, thereby improving its ability to contribute to sustainable economic growth.

Given the limited time that I have, I will focus on some key structural developments in the banking sector that have taken place over the past twenty years and that are described and analysed in several chapters of the book. In addition, I will examine how the regulations introduced by the Bank of Spain during the boom years helped to prevent and mitigate the negative effects of the crisis and, especially, how some of the reforms and structural changes that are currently being considered may substantially reduce the fragilities of the banking sector. If implemented, they will strengthen the banking system and ultimately have positive effects on financial stability and economic growth in Spain.

### Some reflections on banking developments during the last two decades

As I see it, Spain's banking sector has undergone two fundamental changes since 1990: *banking liberalisation* and *financial innovation*.

*Banking liberalisation* has produced a notable increase in competition among institutions and in financial integration. For example, the cajas (savings banks) have started to compete geographically and in different business segments. The increased competition has also led, at different times during these 20 years, to strong competition for bank deposits (e.g. la "guerra del pasivo" at the end of the 80s). In general, banking competition brings very positive aspects for the real economy and to welfare, and there is no doubt that liberalisation of the banking sector in Spain has been very positive for the country. However, we should bear in mind, as some chapters of the book point out, that too much competition may significantly increase bank risk-taking and that this may have negative implications and that this may undermine financial stability.[1] The recent very intense competition for retail deposits may also be a notable example in this regard.

Another important aspect of liberalisation has been the internationalisation of the banking sector, which is very well explained in the book. I would like to stress two aspects of this phenomenon: i) the foreign expansion by Spanish banks (particularly Santander and BBVA), and ii) the significant dependence on foreign liquidity (mainly through international wholesale markets), especially after the introduction of the euro.[2]

Expansion abroad, when it is well executed, definitely brings benefits in terms of geographical diversification, which have become clear during the crisis, however a reliance on funding from abroad may bring some fragility if that source of liquidity dries up, as the crisis has shown.[3] In previous banking crises, banks typically suffered from runs on retail deposits, whereas nowadays these runs are wholesale-based.[4] In the light of this, the sector should aim to diversify its sources of funding liquidity.

The second defining element over the past decades has been the increase in *financial innovation*, notably in securitisation and market funding.

Securitisation can have many positive effects, e.g. by increasing the supply of bank credit to the private sector thanks to greater bank liquidity. Some crucial segments of the economy, such as small and medium-sized firms, may also significantly benefit from the development of securitisation. At the same time, recent research has shown that securitisation may lead to a lowering of banking standards and ultimately weaken financial stability.[5] Once a bank is no longer responsible for a loan that it has made, it has fewer incentives to monitor that loan. Besides, in periods of extensive securitisation, when the bank knows that new loans can be securitised – which in some countries can imply that the risk will be totally borne by investors outside the bank – the ex ante incentives for screening are notably reduced.

All these important changes in the banking industry have taken place against an ostensibly benign but potential dangerous macroeconomic backdrop: the so-called Great Moderation. Indeed, the protracted period of high economic growth and low short and long-term interest rates contributed to giving the banking sector some very good years. However, that is precisely when risk builds up – and it can be excessive.[6] Moreover, we should not overlook that macro fragilities emerged during the benign macroeconomic context: for example, both the current account deficit and the share of the real estate sector activity were around 10% of GDP in 2006.

All these elements contributed to a credit boom throughout the Spanish economy, particularly in the real estate sector. In this context, let me add that – crucially – the Bank of Spain reacted very well: notably by introducing a strict regulatory system for special purpose vehicles which significantly restricted regulatory capital arbitrage, and by introducing dynamic provisions, which may have reduced the very high credit supply in the good years. Without those measures the credit boom could have been even bigger.[7] Moreover, the provision

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1 See also Stiglitz et al. (2000); Matutes and Vives (2000), and Martínez-Miera and Repullo (2010).

2 See Kalemli-Ozcan, Pappaioannou and Peydró (2010).

3 See Allen and Gale (2000).

4 See Brunnermeier and Petersen (2009).

5 See Mian and Sufi (2009); Maddaloni and Peydró (2011); Jiménez, Mian, Peydró and Sufi (2011), Altunbas, Marqués and Gambacorta (2010).

6 See Pérez-Quirós (2000); Adrian and Shin (2009); Allen and Rogoff (2011); Rajan and Diamond (2009); Jiménez et al. (2011); Jiménez and Saurina (2006).

7 See Jiménez, Ongena, Peydró and Saurina (2011).

buffers have been vital during the crisis as they have allowed banks to continue supporting credit availability.

## The crisis calls for change

Some key features of the recent crisis have been, in my view, the fragility both on the liability and asset sides of banks, coupled with a densely interlinked global financial sector. Banks' capital reserves, transparency, funding, risk management, corporate governance and both micro and, especially, macro supervision and regulation need to be adjusted.

Let me start with the *fragile liabilities*. We have experienced since August 2007 a funding liquidity dry-up. As I said before, in the run-up to the crisis, Spanish banks were highly dependent on foreign wholesale funding. As a result, the sector as a whole ended up suffering and some of the more dependent banks have been hit very badly.

But bank liquidity also depends crucially on bank capital and, hence, banks with stronger balance sheets suffer much less from a lack of liquidity.[8] The liquidity provided by the Eurosystem has been vital to minimise the liquidity shortages, but bank capital needs to be stronger so that *all* banks have access to private funding liquidity.

*Fragile assets* were an important factor too, as very high volumes of credit (and risk) were granted during the good years. Some banks took more risk than others in the real estate bubble, and some banks recorded substantially lower profits and higher (realized and potential) loan losses during the current crisis. Hence, bank capital significantly decreased, especially for some groups of cajas; they, moreover, cannot easily raise capital because of their specific structure.

The availability of bank capital is essential for two additional reasons:

First, a bank capital crunch may lead to a credit crunch. Thus, in order to help the real economy recover, some weak banks need to be recapitalised. This is why the recent regulatory changes on capital in Spain are crucial.[9]

Banking assets are however opaque, which – combined with the high leverage – make recapitalisation in private markets difficult, especially in crisis periods.[10] Therefore, to reduce these problems, high transparency is extremely important: the stress tests and Bank of Spain's publications on key bank variables are thus indispensable. If, after these exercises to promote transparency, some small groups of banks cannot fulfill the capital requirements, restructuring may be the only solution.

Banks are still too highly exposed to real estate assets in their balance sheets and so the new haircuts introduced by the Bank of Spain go in the right direction. Geographical diversification (notably the internationalisation of some banks) and better risk management are also crucial factors, I believe, in addressing the current challenges. But also the strengthening of corporate governance is of utmost importance to avoid excessive risk-taking. In other words, transparency and risk management are important, as I said, but incentives as well! In this sense, the restructuring of some groups of banks may be vital.[11]

Second, looking into the future, with the crisis behind us, higher bank capital requirements will also play a positive role by reducing incentives for excessive bank risk-taking.[12] On that

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[8] See Iyer and Peydró (2011) and Rochet and Vives (2004).

[9] See Jiménez, Ongena, Peydró and Saurina (forthcoming).

[10] See Morgan (2002).

[11] See Cuñat and Garicano (2010).

[12] See Freixas and Rochet (1997) and Acharya and Richardson (2009).

same subject, we should welcome the changes made to EU and global banking regulations and supervision, both micro and macro-based: for example, the Basel III package of regulations (level and quality of capital, countercyclical buffers of capital, liquidity ratio. etc) and the developments in macroprudential supervision with the establishment of the ESRB in the EU.

**Concluding remarks**

Changes in the banking sector after the current crisis – at national, EU and global level – can make the Spanish banking sector stronger and provide a durable support for the real economy, as happened after the 1970–80 crisis. To be specific, changes in the business models and the restructuring of some banks, more and higher-quality bank capital, better risk management, improved transparency and corporate governance, as well as changes in banking regulations and supervision – all these factors will contribute towards sustainable economic growth.

However, as necessary as these changes are, they are not enough to bring about a strong and robust improvement in Spain's economy, and particularly to create jobs and boost productivity. To achieve these objectives, further progress must be made:

- in consolidating public finances, also to reduce the possible negative spillovers of the sovereign debt crisis to the banking sector;
- in liberalising product and factor markets, especially now the labour market with respect to "negociación colectiva" (collective bargaining).
- in improving the education system at all levels – it is critical to raising productivity over the medium term and, therefore, to improving welfare.

I truly hope that when another book like this one is written in, say 50 or 100 years' time, the authors will conclude that the steps taken in response to the crisis in the banking and in other key sectors of the Spanish economy were the right ones and, in particular, that they played a part in overcoming the crisis and increasing in a sustainable way the well-being of the citizens of this country.

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