Miguel Fernández Ordóñez: Mechanisms to prevent and manage banking crises in the future

Speech by Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, at the presentation of the report entitled “Mecanismos de prevención y gestión de futures crisis bancarias”, Fundación de Estudios Financieros, Madrid, 1 December 2011.

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The crisis still with us has seen the adoption of a broad package of financial measures at the global, European and national levels. The global response has had political backing at the highest level of the G-20. In the implementation of this response, a key role has been played by the Financial Stability Board (FSB), which has coordinated the work of numerous international institutions and committees. In Europe, in addition to the implementation of these global agreements on the continent, other worthwhile initiatives have been adopted. These include most notably changes in the supranational supervisory architecture. Finally, with regard to Spain, both the Banco de España and the Finance Ministry have contributed long and hard to implementing these global and European initiatives. But, to highlight a singular facet of the Spanish response, I should like to mention the restructuring of our financial system.

I shall spare you my assessment of the numerous and substantial changes stemming from various fora that have marked progress in recent years. The authors of the book give a good account of this and, were I to repeat what they say, they might not be read. And it is precisely my role here today to encourage people to read them. I would therefore prefer to share some broad reflections with you, having experienced this crisis from my vantage points on the FSB, the ECB Governing Council and at the Banco de España. Further, given the key juncture at which we stand, I shall add further remarks as to what we must do in Spain to emerge from a crisis in which, after four years, we remain immersed.

My first suggestion is that we cease to refer to the “crisis” in the singular and start talking about “crises” in the plural. This is because the far-reaching shock the Spanish economy and its banking system have undergone has not been caused by a single crisis but by the extraordinary overlapping of three economic/financial crises. Spain had never experienced such an occurrence in its history, a fact which should be borne in mind when deciding on the best exit therapies. The impact of the first of the three crises, the so-called international financial crisis, came about in a context in which the banking system was reasonably well-supervised and focused on the traditional retail business. But, as was noted at the time, neither the economy nor its credit institutions would prove immune to its consequences, in particular to the global recession and to the seizing-up of the regularly used external funding mechanisms. The second crisis is a typically Spanish crisis, associated with excesses in the real estate sector, private-sector debt and deteriorating competitiveness, a crisis which in principle seemed to be a familiar bugbear. However, this time the imbalances emerged within a monetary union, which has invalidated many of the instruments used in the past to overcome apparently similar crises. The third crisis is in the euro area, the clearest but not the only sign of which has been the sovereign debt crisis, which has affected Spain with particular force. The upshot of the overall impact of these three crises is an extraordinarily complex scenario with multiple and unprecedented interactions, which means we must avoid intellectual laziness and seek innovative solutions to manage an exit from the situation. This is because many of the solutions used in the past are not only no longer available or useless, but – given the side-effects – may even prove harmful.

I shall now try to draw your attention to the responses that crises prompt. As is well known, crises, which entail so many personal tragedies, may ultimately have beneficial effects in the countries they affect if the response to them is the correct one. My first observation is that any crisis usually generates not only one response but three types of response. The first reaction leads to the design and adoption of measures whose aim is to prevent a similar crisis recurring. The second response to the crisis drives us to equip ourselves with new tools that mitigate the effects of future crises, because experience tells us that, even assuming that all the preventive measures conceivable today are adopted, it will never be possible to do away once and for all with economic crises. The third response to a crisis does not involve preventing or adopting tools to manage future crises, but looking for the right way to manage the current crisis from which, need I remind you, we have not yet emerged.

I make this distinction between the three types of response that an economic crisis always elicits so that my following remarks may be better understood. Firstly, I think that most of the huge efforts deployed to date at the global and European level in response to the crisis have focused on avoiding or mitigating future crises. Yet much less time and imagination has been used in designing and agreeing on measures to emerge from where we are. I am certain that we are now much better prepared to prevent the recurrence of a crisis such as the present one, but the problem is that we still do not know how to exit from it. Moreover, there is a second reason for stressing the difference between the three types of response, which is that both the measures seeking to prevent the recurrence of a similar crisis, and those seeking to increase the future resilience of the financial system are usually of little use in resolving the problems that affect economies and financial systems in the short term, that is to say now. The authorities naturally wish to "sell" the decisions they are adopting. But nobody should think that the immediate application of the measures aimed at preventing future crises or mitigating their intensity will suffice to resolve our short-term problems.

If we analyse the matters addressed on the FSB or European Commission's agendas, we will see that, until relatively recently, most progress has been centred on preventing the repetition of a crisis such as the current one, which has affected the entire financial system. And in the case of a fresh crisis arising, the aim has been for the financial system – for banks and for the authorities – to have resolution mechanisms that mitigate its adverse effects. With sole regard to the management of future crises, although major efforts have been made to move towards more effective crisis-resolution arrangements, most of the prescriptions admittedly require time to be effectively set in place, meaning that they cannot be used to manage the current crisis.

Returning to the management of the euro area sovereign debt crisis, much progress has clearly been made in the reform of European governance. Indeed, henceforth instruments will be available that make the recurrence of a crisis such as the present one highly unlikely, and undoubtedly this work is very useful and very important going forward. Had these instruments been available to us from the outset of the Monetary Union, the current crisis in the euro area would surely not have broken, since the levels of cross-country divergence in terms of competitiveness, excessive debt or budget deficits that we are trying to redress would not have been reached. But all this progress has a very limited impact on our most immediate problem, which is to manage the crisis in which we are immersed. And what I wish to stress here is that this task requires very different tools from those needed to prevent this type of divergence recurring in the future. 18 months on from the outbreak of the sovereign debt crisis, we have robust mechanisms to prevent and sanction future imbalances, mechanisms that may be reinforced further if the improvements proposed by the ECB or some of the suggestions by the German government are finally heeded. But we have still not managed to activate the right mechanisms to halt the current market dynamic.

Another example of reasonable approaches in respect of financial regulation – but which may prove insufficient to emerge from the current crisis – is the handling of moral hazard, the perverse incentive which induces agents to pursue inappropriate and risky behaviour because they assume they are not going to pay for the consequences. It is known that banks and countries behave imprudently when they think that they will be bailed out, that others will bear the consequences of their conduct. There is broad consensus that both in the regulation of banking business and in that of sovereign debt, elements are needed to reduce moral hazard to a minimum, and sufficient deterrents must be in place so that banks and countries have an interest in acting correctly. Indeed, a large part of our work for the future, and in particular the change in resolution arrangements, is geared to preventing such irresponsible behaviour.

However, as things currently stand, the strategy of punishing with bankruptcy those who have "done wrong" or "lent badly" may have undesirable and far-reaching side-effects both in the banking sector and as regards sovereign debt. The disorderly bankruptcy of an institution might have very adverse repercussions for the national or indeed European banking system as a whole. Default by a Monetary Union member country might cause a most considerable knock-on effect on other sovereign risks. It is not reasonable to ignore these externalities when calibrating the true scale of this "moral" consideration.

The recent years of crisis have offered us two patent examples of the adverse consequences of applying a "moral" view to the solution of problems at an inappropriate time, i.e. not before they occur – which would have its logic – but during the crisis. One example was when the authority of a European country suggested letting a bank go bankrupt for having made management mistakes. Wisely, it quickly changed its mind, showing that wisdom does not mean never committing errors but rather recognising such errors in time. The consequences of the other example of the mishandling of moral hazard were worse. I refer here to the initial reaction to the euro area sovereign debt crisis. As we have often repeated at the European Central Bank, the negative consequences of openly admitting the possibility of sovereign debt default by one of the euro area countries, and even of demanding default as a centrepiece of any bail-out programme, were perhaps not taken sufficiently into account. And these factors have no doubt contributed significantly to the crisis attaining its current scale.

But let us be clear: avoiding the costs associated with the potential bankruptcy of or default by banks and countries is perfectly compatible with laying down rigorous conditionality criteria when extending aid to resolve crises. Averting bankruptcies in specific cases does not mean going "soft" on banks or countries which took on too many risks or incurred excessive debt. Countries or credit institutions should be helped only in exchange for strict conditions. And not only for moral reasons (never helping those who do not help themselves), but essentially because to be able to stand on one's own two feet it is necessary to enact far-reaching restructuring and reforms. The experience of the IMF is most illustrative as regards the importance of demanding strict conditionality criteria so that aid programmes may be successful.

Another fairly common mistake is to believe that crisis-management solutions should always and everywhere be the same. Before applying uniform measures, it should be borne in mind that countries may differ in respect of their problems, their legislation and their institutional structure. Likewise, learning from the past may prove of limited use when it comes to teaching us how to act in the face of a crisis such as the present one. As I have illustrated when talking about the Spanish case, the current crises may generate a very different pathology from those in the past, which means new solutions tailored to the present-day problems must be sought.

In this respect, a consistent and internationally coordinated response to the crisis must be made compatible with a reasonable adaptation to the specific circumstances of each country. For example, it is one thing handling a bank crisis in a country where the major systemic institutions have been seriously affected and where, therefore, a rapid response is called for, providing all the public aid needed to avoid the harmful consequences that a bank failure might have on the banking sector and on the economy as a whole. It is quite different in another country where the problems are confined to small institutions, where the ultimate aim should not be their survival in order to avoid a serious interruption in the flow of credit, but rather their removal as soon as possible at as little cost as possible.

Indeed, some of the biggest developed economies witnessed, at the onset of the financial crisis, how several of their leading banks were collapsing. This was because, in addition to the sudden downturn in the value of their assets, they saw the short-term funding channels on which they relied so heavily disappear. Given this scenario, the logical and no doubt inevitable reaction was to swiftly inject huge amounts of public money. Yet in Spain's case, there was overall excess capacity in the sector and the problems were at a group of small or medium-sized institutions with a reasonably long-term financing structure. All told, the advisability of earmarking public funds to these institutions immediately was much less evident. On one hand, it is not surprising that ailing institutions should apply for public aid, if possible without conditions. But the mission of the authorities is to look out for the general interest, setting conditions for this aid that ensure the adjustment and restructuring of the sector and the creation of new, stronger and better managed institutions, of a sufficient size to gain access to wholesale funding, thus enabling them to channel funds appropriately to the economy as a whole.

Conversely, it is not surprising that those institutions in a better position should call for the swift winding up of the institutions facing problems. Yet as one of the articles in the book being presented today clearly explains, bank-resolution processes can entail enormous costs for taxpayers, which must be set against the unquestionable benefits of shortening restructuring time. Moreover, insofar as these costs may affect sovereign risk, the cure might prove worse than the illness.

But let us talk about the present, about what we should do now. Evidently, not only have we not exited the crisis, but the information reaching us shows that the crisis may worsen in the coming months. Exit will depend on what the reaction is on the domestic, European and global fronts. At present, the key to our future lies in the capacity of the European institutions, the European Council, the Eurogroup and the ECB, and the national governments, to act in unison, each in its own area of responsibility, with a single, shared objective: to halt the dangerous current market dynamic. In the absence of joint action, any piecemeal and uncoordinated progress on any of those fronts will be worth little. European progress is absolutely vital so that the adjustment drive in the national economies should not prove sterile. Headway in these adjustments is likewise vital for preparing the terrain on which the European institutions must progress.

So as not to overstay my welcome, and given that next week several meetings involving these European institutions are to be held, I propose that we assume that these meetings will eventually see the adoption of the decisions needed to turn the markets around.

This assumption about what the European institutions will do allows me to conclude my address by talking exclusively about our national problems. What must Spain do to emerge from the crisis? As I said at the outset, the conjunction of three economic crises, and in particular the worsening of the sovereign debt crisis, mean that precise economic policy implementation is extremely difficult at present, although the diagnosis as to what must be done is relatively simple and widely known.

At present, what is most important is to promptly pursue an ambitious reform of our labour market institutions, while continuing to make headway on two key fronts: budgetary consolidation and financial system restructuring. In the past two years significant steps have been taken in both these areas, but to achieve fully satisfactory results, perseverance with the path of reform is needed.

Starting with the reform of the labour market institutions, certain measures have been taken recently. But the truth is that, since the outset of democracy, Spain has not been capable of making any meaningful progress in this area, whereas most European countries have used the past three decades to reform their labour systems, in order to achieve higher levels of flexibility and job protection, i.e. greater "flexicurity". During this time, the Spanish economy has been radically modernised in many other areas, through the adoption of regulatory frameworks and measures comparable to those of the most advanced economies, such as the removal of barriers to trade, the liberalisation of certain sectors, privatisations, etc. However, our labour market, which is characterised by the very high levels of unemployment generated during crises and also by its inability to reduce unemployment rates during upturns, has retained the same institutional structure with no substantial changes for 30 years. The cost for workers of this resistance to reform has been insecurity both for the unemployed and for those who have jobs but fear losing them. The insensitivity of wage growth to the cyclical situation and to productivity generates numerous perverse effects. First and foremost, the adjustment to shocks is borne entirely by employment. But also wage growth in some sectors or firms may be lower than it would have been if more flexible labour institutions had allowed productivity gains at the firm level. This is what one observes when the situation of Spanish workers is compared with that of workers in those European countries that have the highest levels of flexicurity.

For all these reasons, as I have so often said, Spain's labour institutions must be reformed in order to lay the foundations for employment creation and for reducing unemployment from its very high current level to one similar to those of other European countries. All I can add today is that a gradual process is no longer sufficient. The seriousness of the situation requires the adoption forthwith of a reform that draws our labour market closer to the levels of job flexibility and security prevailing in most European countries.

Reform of our labour institutions is very necessary for many reasons. First, to put an end to the personal and family drama that unemployment entails. But also to help reduce the budget deficit. Indeed a more efficient labour market, that gave us unemployment rates similar to those of other countries, would permit the costs of unemployment – which in Spain amount to around 4% of GDP – to be reduced, and would increase government receipts from income and consumption taxes without tax rates having to be raised. A reduction in unemployment and an increase in employment are also very important for the banking system. First, because high rates of unemployment eventually lead to higher default rates. Second, because a reduction in unemployment is essential to reverse a trend that is having very serious effects on banks, namely the fall in solvent demand for credit. That said, at present, owing to the worsening of the sovereign crisis, supply-side factors are also contributing to the decrease in lending to households and firms which, as usual in this type of situation, affects small and medium-sized firms disproportionately.

However, as I have repeatedly said, labour reform, accompanied by liberalisation processes to foster a more competitive environment, is the only way within the context of monetary union of achieving an internal devaluation within a relatively short space of time. This reform will not have immediate effects, but that only makes it all the more pressing. Without this reform, the recovery in competitiveness could only be achieved through an extremely slow and very painful, with unacceptable suffering for many Spaniards and negative consequences beyond the purely economic ones.

Turning to budgetary policy, lowering the deficit is absolutely necessary given the stance of the markets, whose distrust of the sovereign debt of the euro area countries has been increasing in recent weeks. Admittedly, tough decisions have already been taken in Spain, such as the reform of pensions, which have served to reduce the deficit not only in the short run, but also in the medium and long term. However, there is still a long way to go merely to comply in 2012 with the 4.4% budget deficit commitment, whatever the final figure for 2011.

Finally, some very significant progress has been made in Spain in recent years in financial restructuring. The banking system has written off bad debts (equivalent to more than 10% of GDP in the last three-and-a-half years), the average size of banks has increased, capacity has been reduced and a process is under way to transform the savings bank sector, which will help these institutions to meet the new prudential regulation requirements and strengthen their ability to fund themselves on the markets. Yet, as I said in September when presenting the results of the recapitalisation required by the royal decree law passed early this year, the restructuring process cannot be considered to have been completed. In fact, insofar as the economic forecasts for 2012 have in recent weeks been revised drastically downwards and funding problems on wholesale markets have worsened for all European banks, the pressure on our credit institutions has intensified and therefore the need for adjustment and financial restructuring not only remains but has actually increased.

During economic upturns the major danger is complacency, which leads one to think that reforms are not necessary because everything (growth, employment, government revenues) is going well. During crises however, the great danger is reform fatigue, tiring of reforms that have no visible effects in the short term.

For this reason, we must not only press ahead with financial restructuring, but must also be open to the possibility of taking further action when this is considered necessary. That said, irrespective of the instruments that may soon be adopted, both the objective and the main criteria that have been followed in recent years should, in my opinion, be maintained. The objective is clear and leaves little room for discussion: to have solid institutions that are able to contribute effectively to the financing of households and businesses. And it would also be useful to preserve the main criteria used hitherto in the financial restructuring. Specifically, I am referring to the anticipation of problems, minimisation of the use of public funds, reducing capacity, the conditionality of assistance, the emphasis on downsizing balance sheets and the promotion of transparency.

First it is very important to anticipate problems. The primary obligation of a banking supervisor is to ensure at all times that the credit institutions operating are solvent and viable. However, good supervisors should not limit themselves to analysing the present, but should also anticipate possible scenarios of non-viability that might arise in the future and attempt to reduce problems to a minimum before they emerge. When the crisis broke, the 45 Spanish savings banks then existing were all solvent and viable. However, taking into account the new economic and financial environment stemming from the crisis, it was possible to foresee that while some of them were very well-managed and unquestionably sound, many others, within a matter of years or months, might eventually be non-viable. That is why it was urgent to change the legislation on restructuring, which had been designed to resolve isolated, non-systemic crises and which, in particular, was not appropriate for managing the restructuring of savings banks. Moreover, the legislation then in force involved the use of tools that had been very useful for resolving crises in the past, but that were banned by the Monetary Union. Consequently it was important to create instruments such as the FROB to enable preventive action to be taken, before the situation worsened and required a wholesale winding up of institutions. Apart from the costs of winding up, there was a risk, especially at a time of global banking crisis, that contagion might spread throughout the Spanish financial system.

When examining the possible formulae for financial restructuring, the authorities ruled out some that definitely might have speeded up the process of restructuring the banks. They did so on the basis of prudence, since a sudden sharp deterioration in public finances in the midst of the crisis could, as it did elsewhere in Europe, have meant that the rescue of the banking system brought the country to the brink of bankruptcy and an eventual bail-out. The containment of public spending matters not only from a medium-term perspective; given the current vulnerability of sovereign debt on the markets, its short-term effects must also be considered.

It is also essential to maintain the criterion of demanding conditionality when designing public assistance, so that this is only received by institutions that adjust their capacity and manage to improve their efficiency, which is easier to do when their size is increased. At the same time, any strategy that encourages banks to seek private solutions requires more time than one of wholesale public intervention. But this system of incentives, which has required an enormous amount of work not only by the supervisory authorities at the Banco de España but also by many savings bank managers, has meant that most institutions have voluntarily undertaken integration and restructuring process. That has not only served to reduce the contribution of the Spanish taxpayer, but also to increase banks' size and reduce their capacity, thus giving rise to a banking system that is somewhat better prepared to withstand the crisis than the one we had when it started, although all the institutions still have much to do in the way of improving their efficiency.

It is also important to emphasise that the key to every restructuring is to clean up balance sheets. Some of the criticisms that you may have heard during the savings bank restructuring process have been that it was unfair to require savings banks first to write down their assets and then to recapitalise too. With the benefit of hindsight, I do not think that anybody would now consider that we should have started in any other way than by requiring assets be written down, and then at a later stage, requiring recapitalisation. Balance sheet restatement is not just "one" possible formula for restructuring, but rather a vital ingredient of all restructuring processes.

Finally, I understand but do not share the view of those who see a danger in forcing institutions to increase transparency in the midst of a crisis. I am convinced that, in the present situation of general distrust in the markets, suspicion is always much worse than reality, however problematic that may be. Admittedly, despite increased transparency, doubts persist as to the extent to which our banks have cleaned up their balance sheets. And although write-downs have been very intense, unsatisfactory economic performance might make further efforts along these lines necessary in future.

Be that as it may, let me conclude by reiterating that such is the speed of change in the economic environment in Spain, Europe and the world in recent months, and even in the last few weeks, that it would be a grave error to establish rigid criteria that rule out the possibility of incorporating fresh financial restructuring tools, if changing circumstances mean that they are required in order to achieve the final goal. That can be none other than to have a set of solid credit institutions ready to effectively meet the solvent demand of Spanish households and firms for funds.

Thank you very much.