# Luis M Linde: Reflections on the road and challenges ahead – regulatory changes affecting banking activity

Closing address by Mr Luis M Linde, Governor of the Bank of Spain, at the IX IESE (Instituto de Estudios Superiores de la Empresa/Business School of the University of Navarra) Banking Sector Meeting "Banks – beyond the crisis", Madrid, 12 December 2013.

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Firstly, let me thank Professor Juan José Toribio, the president of the Centro Internacional de Finanzas, for inviting me to participate in this IESE Banking Sector Meeting. And allow me to congratulate the IESE on this ninth edition of a forum that has become a classic and has consistently been of the greatest interest and highest calibre.

I am not going to address certain matters that are very important and topical, such as the signs of recovery in the Spanish economy, the initial steps of the launch of the Single Supervisory Mechanism, or the asset quality review or stress tests for those banks that are to be supervised by the Single Mechanism. I would hardly have anything novel to say there.

Rather, I wish to review some aspects of the regulatory changes which, once the crisis has been overcome, are going to significantly affect banking activity.

Three matters concern us: the elements of the new Basel III capital accord that have not yet been fully finalised; the Financial Stability Board's work on the regulatory framework for the treatment of systemically important institutions; and the new powers of the Banco de España under the draft bill on the supervision of credit institutions, which will foreseeably be approved in the first quarter of next year.

I shall begin with ***Basel III***.

The new capital accord improves the comparability and, thereby, the credibility of capital ratios. Basel III increases capital requirements with better-quality instruments, and it seeks consistency and a uniform application across banks and countries. It also adds two new prudential tools: one in the area of liquidity, and the other in that of leverage.

First, the inclusion of the ***leverage ratio***, the relationship between Tier 1 capital and exposure both on and off the balance sheet, i.e. the total banking book, without taking into account risk weights. Calculations are made at the consolidated level and, in principle, the level is set at a minimum of 3%. It is scheduled to come into force in 2018, although an earlier date will probably be set for the required disclosure of this figure.

This new tool has been designed as a straightforward measure that complements and acts as a floor to the minimum risk-based capital ratio. It aims to provide additional protection against what is known as "model risk", i.e. underestimating the regulatory capital needed further to a calculation using the sophisticated models allowed by Basel II and III.

On the more technical side, there appears to be agreement on the definition and calculation of the ratio, the treatment of derivatives and repos, and operations with CCPs. But doubts remain over its final calibration and how it affects certain business models, specifically those most centred on retail activity.

The Banco de España has supported the setting of this leverage ratio in Pillar 1 on the understanding that it can be a good prudential tool, once correctly calibrated. In this respect, the monitoring period prior to its entry into force will provide information and experience. Although European regulations envisage that countries may apply this ratio as they deem fit until its harmonisation in 2018, it is not the intention of the Banco de España, in principle, to bring forward its application.

As regards ***liquidity***, Basel III has added new regulatory requirements: a short-term liquidity coverage ratio (LCR), and a long-term requirement, the net stable funding ratio (NSFR).

The short-term liquidity coverage ratio is designed so that banks may have an asset buffer with which to meet their maximum foreseeable liquidity or funding needs over a period of at least 30 days. As what is involved is a safety margin, this ratio might at times of stress be below 100% of such maximum foreseeable needs, which is the level demanded once the requirements come fully into force. However, if a bank's liquidity-generating capacity stands at below 100% of the maximum foreseeable needs, it will be obliged to inform the supervisor, with which it will have to agree a plan to regain the 100% level.

The initial design of this ratio is very demanding and, perhaps, not very realistic. The year 2015 was too early a date for its full implementation, and the definition of "high-quality liquid assets" or the assumptions of liquidity needs were overly rigorous. Hence, in January 2012, the Basel Committee of Central Bank Governors and Heads of Supervision revised the accord to widen the base of assets considered highly liquid and to soften the implementation timetable. This regulation is also practically finalised, at least in the Basel Committee, as an agreement on its design and calibration has already been reached.

The short-term ratio will not come into force immediately. It will be phased in from 2015 – when a level of 60% will be demanded – to 2019, when it will reach 100%. Nonetheless, this timetable may be speeded up at the discretion of the different national authorities.

The Banco de España has backed the setting of the short-term liquidity ratio, and the amendments to it, which have softened the original framework proposed. Nor does it intend to accelerate the implementation timetable, although we believe that banks should strive to meet it as soon as possible. As regards reporting and transparency obligations, we consider they should be obligatory for internationally active banks, but that they could be simplified for others.

Basel III also envisages the implementation of a ***long-term liquidity*** ratio so that banks maintain stable funding profiles, tailored to their assets and activities. In that way, banks' dependence on short-term funding markets is structurally reduced, since that proved to be a very disruptive weakness in the 2008 financial crisis.

The design of this ratio is at a relatively early stage, as the preliminary proposal published in 2010 is being revised. It is expected that, early next year, a consultative document will be available, and that the regulations will have been finalised before 2015, with this entailing a simplification of the original rule. Further, it will be necessary to agree on certain aspects of relevance for Spanish banks, such as, in relation to liquidity requirements, the treatment of high-quality mortgages or matters pertaining to asset encumbrance. This ratio is expected to come into force in 2018, although in the case of the EU, the Commission will have to submit a legislative proposal before 2016.

I shall now move on to certain elements relating to the ***review of capital requirements***. This is part of a broader project: to attempt to ensure that the benefits of risk-adjusted regulations, such as Basel III, are not achieved at the cost of introducing ***excessively complex regulations*** which, in addition to other problems, yield results that cannot be compared from one bank to another.

The Banco de España is in favour of simplifying the current regulations, striking a balance between simplicity, comparability and risk-sensitivity. In this respect, it views favourably the ***transparency*** exercise conducted by the Basel Committee on the comparability of asset risk weights.

The results of this exercise allow an argument to be made for the need to lessen the differences between requirements obtained by applying the standard method and those calculated using internal models, so that the credibility of the solvency ratios should not be compromised. However, we believe they should not go so far as to abandon the use of internal models; rather, standardised models, based on parameters determined by the supervisors, should be used as a reference for internal models.

I should also like to mention here the review of the ***treatment of the trading book***, with the aim of reducing regulatory capital differences between this book and the banking book, thus avoiding regulatory arbitrage.

At the Banco de España we broadly concur with these lines of work. However, concerning the review of sovereign risk and in order to avoid undesirable effects and consequences for financial stability, we believe a wholesale approach should be taken, not one that is independent or isolated in respect of each working group.

As to the review of the current framework for the treatment of ***securitisations,*** I should like to underscore the importance of the calibration of capital requirements associated with securitisations not being excessively conservative, and that the reopening of these markets should not be hampered in an unwarranted fashion.

I would like to end my comments on the work of the Basel Committee by touching briefly on another regulatory matter currently under review, the ***treatment of large exposures***.

This falls within the field of prudential measures additional to the solvency ratio, which aim to ensure the survival of banks in extreme situations. The review focuses on the treatment of exposures to third parties, since that of intra-group exposures has been postponed for the time being. The general principle is that exposures to all counterparties should be subject to limits based on the capital of the bank.

That limit has been set generally at 25% of tier 1 capital, although for certain exposures, such as those between systemic banks, it is stricter. Notably, provision is made for the possibility, after an observation period, of limiting exposures to central counterparties (CCPs), although this matter is open and first requires an assessment of the effects of other rules governing relationships between banks and CCPs.

Let me now say a few words on some of the main regulatory projects on which the ***Financial Stability Board*** (FSB) is currently working, particularly that to promote a new regulatory framework for the treatment of systemically important institutions, i.e. those whose complexity, size and interconnectedness are such that their failure could cause serious problems to the global financial system.

This new framework rests on four pillars: additional loss absorbency, effective resolution mechanisms, increased supervisory intensity and more resilient financial market infrastructure.

Unquestionable progress has been made in implementing this framework. In particular, the G-20 has approved, as a new international standard, the so-called ***Key Attributes of Effective Resolution Regimes for Financial Institutions***, which have to be complied with in each jurisdiction.

In Spain, Law 9/2012 adopts and applies many of the principles set forth in the "Key Attributes". Meanwhile, the European Union expects to adopt the Bank Recovery and Resolution Directive by the end of the year, which will be an important step forward in fully implementing the "Key Attributes" in all Member States.

On this last point, as you know Ecofin is currently discussing the Single Resolution Mechanism and the Resolution Fund. It seems that agreements, or draft agreements, are being reached and that progress is being made in the area of resolution, such as the determination of the competent authority. Also, in the more difficult and complicated issue of financing, headway is being made on the characteristics of the proposed Single Resolution Fund. Negotiations are following their course and an extraordinary Ecofin meeting is scheduled for next week to address these matters.

Let me now look at the new powers assigned to the Banco de España in the draft bill on credit institution supervision and solvency to be debated shortly.

Obviously all the functions and powers conferred on the Banco de España, which I will describe shortly, will have to be interpreted and implemented taking into account the powers of the European Central Bank in the framework of the implementation of the Single Supervisory Mechanism.

From the formal standpoint, the draft bill will consolidate in a kind of "Bank Code" all the regulatory provisions on the creation, activity and control of credit institutions, thus putting an end to the dispersion of legislation which has characterised the credit sector for various decades.

Furthermore, the aforementioned consolidation aims to write into Spanish law the changes introduced in June 2013 by the so-called CRD-IV package, i.e. the Directive and the Regulation which incorporate the Basel III Accord into European legislation. As you know, that transposition has been partly handled by the promulgation of Royal Decree-Law 14/2013, which includes those matters considered essential for incorporation before 1 January 2014.

Under the draft bill, and without prejudice to the framework resulting from the entry into force of the Single Supervisory Mechanism, the Banco de España will retain its current power to authorise the exercise of banking activities. Moreover, it will receive additional powers, such as that to revoke banking licences.

Regarding the regime governing the purchase of qualifying holdings in credit institutions, the Banco de España will continue to be the authority responsible for assessing the proposals of potential purchasers, although now there are plans to give it powers of supervisory intervention, senior officer replacement, suspension of voting rights or, in extreme situations, licence revocation.

As bank supervisor, the Banco de España will continue overseeing compliance with organisational and disciplinary regulations. To this end, the draft bill maintains its existing inspection and verification powers, although with some changes, such as that requiring the Banco de España to carry out yearly stress tests on supervised institutions to evaluate their solvency.

Additionally, in the context of the Banco de España's prudential supervisory tasks, the draft bill equips it with certain tools envisaged in EU legislation, including the so-called Pillar 2 measures such as additional own funds requirements, limitations on dividend distribution, restriction of certain activities and limitation of variable compensation.

The Banco de España will also be empowered to set the "additional capital margins" envisaged in the draft bill.

The Banco de España will continue drawing up supervisory guidelines. As a new development, it is envisaged that, if institutions' conduct does not comply with the guidelines, they will, if required by the supervisor, have to explain the reasons for such non-compliance.

In the area of sanctions, the Banco de España retains its current powers, independently from the powers which may at any time be exercised by the European Central Bank within the framework of the Single Supervisory Mechanism. Against this background, significant changes were made which generally strengthen the regime currently in force.

Finally, the draft bill endows the Banco de España with supervisory, inspection and sanctioning powers in respect of compliance with obligations to offset, notify and reduce risks associated with the use of OTC derivatives.

To conclude: 2014 will, as we all know, be an extremely intense year as far as international financial regulation and supervision are concerned. There will be no lack of work. My best wishes to all of you and good luck.

Thank you.