Luis M Linde: Situation of and challenges facing the European and Spanish banking industry following the start-up of the Single Supervisory Mechanism (SSM)

Opening address by Mr Luis M Linde, Governor of the Bank of Spain, at the 10th Banking Industry/IESE (Escuela de Negocios de la Universidad de Navarra) Meeting, Madrid, 10 December 2014.

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I much appreciate Professor Juan José Toribio's kind invitation to me to participate in this 10th ***Banking Industry Meeting***. In my address I shall review the situation of and the challenges facing the European and Spanish banking industry following the start-up of the Single Supervisory Mechanism (SSM).

Since the height of the tensions in mid-2012, the position of the Spanish banking industry has improved notably. This improvement has been due to a series of factors, ranging from far-reaching changes in European institutional arrangements to common monetary policy measures and, no doubt, to the reforms in Spain.

Clearly, however, the improvement cannot be explained without recalling the changes made in our banking system. Recapitalisation, restructuring, downsizing and reform of the savings bank sector have spearheaded the Spanish banking industry reform and have contributed to correcting the imbalances that had built up.

The improvement in Spanish banks was substantiated by the interim assessments made by the European (the ECB and the European Commission) and international (IMF) authorities until the European Union's financial assistance programme for the recapitalisation of Spanish banks was successfully concluded in January this year.

These assessments have been recently upheld by the comprehensive assessment exercise for the European banking system carried out by the ECB, in collaboration with national supervisors, as a prior step to the start-up of the SSM.

The Spanish banking industry can claim today to have healthy balance sheets and to be considerably resilient to potentially adverse macroeconomic scenarios with a limited probability of occurrence.

The European banking industry following the comprehensive assessment exercise

From a European standpoint, the exercise identified certain banks whose solvency had to improve, a matter which will no doubt be among the priorities of the SSM, to which I will later refer.

Broadly, the exercise highlighted the fact that European banks evidence ample solvency and that the asset quality review did not detect significant valuation failings or substantial provisioning shortfalls.

In short, the ECB's comprehensive assessment contributed to allaying doubts over the vulnerability of European bank balance sheets and over their resilience, both of which had been identified as factors of risk to financial stability.

That said, the European banking industry faces a series of additional challenges stemming from the changes under way in regulation and supervision, which have arisen as a response to the financial crisis.

I shall now turn to some of these challenges, beginning with those linked to the current macroeconomic and financial situation.

First, it is a concern that in some market segments investors, in their search for yield, may be taking on excessive risks. Financial conditions might be adversely affected were there to be a sudden reversal in this process, in particular if that reversal were to bring about sharp price corrections, especially in less liquid market segments.

Second, there are also worries about low profitability. The comprehensive assessment deemed solvency to be comfortably acceptable, but profitability in the banking industry remains prone to downside pressures, particularly in a macroeconomic setting that is worse than was expected some months back. Low returns hamper organic capital accumulation and raise doubts over the medium-term sustainability of banking activities. Banks will have to adapt their strategies and business models to enhance their profitability in a sustained fashion.

Finally, I would highlight the risk of concerns re-emerging over the sustainability of sovereign debt, especially against a background of low nominal growth. This risk has not fully abated and might rear up again in the event of a substantial macroeconomic downturn.

These three risks are not mutually exclusive. Indeed, a common denominator they share is the current weakness of euro area economic growth. But, irrespective of the transmission channels through which sluggish economic growth may translate into financial instability, it is precisely this weakness in nominal growth in the European economy that is the main risk to the area at present.

The Spanish banking industry

The Spanish banking industry is not immune to these risks.

To date in 2014, the rate of decline of lending to the resident private sector has shown signs of easing, in terms both of bank lending to households and of that to non-financial corporations, especially those not pursuing real estate or construction-related activities. In any event, the performance of lending at the aggregate level is affected by the need to continue redressing high private-sector debt.

The NPL ratio of the Spanish banking industry continues to post higher levels than those observed a year ago. However, it has improved slightly in 2014. This correction has come about despite the fact that lending, the denominator of the ratio, has continued posting negative rates of change. Hence, the comparatively larger fall in NPL in 2014 has been the main determinant of this reduction.

In the first half of this year, the Spanish banking industry posted somewhat lower consolidated profits than in the first half of 2013, although they were far removed from the heavy losses of 2012. In a setting still marked by low volumes of activity, low interest rates and a still-high level of non-earning assets, banks' ability to generate interest income remains subject to downside pressure. These factors were offset by the decline in operating expenses and by lower losses attributable to asset impairment.

As to the industry's solvency, Spanish banks as a whole had a CET1 ratio as at June 2014 that comfortably exceeded the required minimum.

The firming and intensification of these trends will largely depend on developments in the Spanish economy and on recovery taking root. The outlook for the economy remains favourable; so far, it has proven resilient to an external environment in which growth forecasts for the global economy have been revised downwards, and in which the recovery in European countries – those most important for our economy – has lost momentum. Thus, on the domestic front at least, it would be necessary to embed the reforms under way, thereby enhancing our capacity for recovery.

The start-up of the Single Supervisory Mechanism

Among the challenges posed by the SSM is that of attaining quality bank supervision, applying strengthened and uniform standards and making the most use possible of the acquired knowledge of the various national authorities, while setting in place a common supervisory culture. In light of the work undertaken to date and the intense collaboration between the ECB and the national authorities, these goals are realistic.

The Banco de España is striving to ensure this is a successful process, cooperating with the ECB and the other SSM participants. We have adapted our organisational arrangements and working methods to smooth interaction with the SSM and the ECB.

A further key challenge will be to maintain a level playing field in the member countries, applying uniform supervisory principles.

That is a major challenge, given that in Europe there is a wide diversity of banking models and legal systems. Further, while the heterogeneity of regulatory frameworks has recently been lessened following the entry into force of the Capital Requirements Directive and Regulation (CRD IV and CRR), differences persist and must be discussed.

Such differences include most notably so-called national discretions and options. On one hand, the new framework provides for a gradual transition to the new capital requirements, in line with the Basel III Accord. The regulation gives countries some discretion in setting the pace of convergence towards the new requirements, which may give rise to temporary differences in the treatment of some specific aspects. For instance, a country may decide to bring forward the application of the new capital conservation buffer, initially envisaged for 2016, or the deduction of certain capital components.

Moreover, the regulation provides for a series of national options that might give rise to permanent differences in the treatment of specific aspects.

It is logical that the SSM should work to achieve a degree of harmonisation, seeking to restrict national options of a permanent nature. It is perhaps less logical to take steps in the case of temporary discretionary arrangements, which by their very nature must disappear within a few years.

Different accounting practices, especially as regards provisioning, also significantly affect the uniformity of capital figures and should be a supervisory concern. It is thus reasonable to expect the SSM to contribute to convergence in the interpretation of international accounting standards.

And it is essential that the SSM should strive equally to revise the calculation of risk-weighted assets. That will call for a detailed review of the risk models used by banks and the adoption of corrective measures should unjustifiable deviations be detected.

Macroprudential policy

Macroprudential policy, insofar as it seeks to identify systemic risks, prevent them and increase the industry’s resilience, has an important role to play. The very nature of these risks is global in dimension, meaning that coordination between the various authorities with responsibilities in this field is needed.

At the same time, it should be borne in mind that while the risks may be considered common to the euro area as a whole, their impact and intensity vary from country to country. This heterogeneity not only depends on the characteristics of each country, but also on the particular juncture of the financial cycle. For example, at present certain euro area countries evidence risks associated with excessive real estate market prices, while in others this risk is not discernible.

Macroprudential policy thus requires a coordinated approach by the various institutions, and at the same time attention must be paid to considerations of a national nature. In a monetary union like the euro area, the heterogeneity of the member countries' financial cycles may be an important issue when it comes to designing these policies.

The European Systemic Risk Board was set up in late 2010 as the authority responsible for macroprudential oversight in the European Union, empowered to issue warnings and recommendations in this connection under the "act or explain" principle.

Further institutional developments have since followed. Thus, without going into the details of the organisation of macroprudential regulation and supervision in the euro area, the member countries are moving ahead with the creation of national macroprudential authorities, while the ECB has been assigned responsibilities in European regulation. The institutional form of the national macroprudential authorities depends on the specific characteristics of each country, although, on the recommendations of the European Systemic Risk Board, their common feature has to be the major role played in one way or another by the central banks.

Challenges for the banking sector posed by changes in international regulation and supervision

Let me conclude by looking at the challenges for the banking sector derived from the major changes in banking regulation and supervision in the international sphere. I shall briefly describe the basic matters being discussed by the Financial Stability Board, or, as we all call it, the FSB.

In November 2008, the G20 agreed on an ambitious "action plan" and asked the FSB to overhaul international financial regulation, a reform which was to go to the root of the crisis and pave the way for a sounder and safer financial system allowing sustainable financing of economic growth.

The task has been both extensive and intensive. A substantial portion of the reforms needed to fulfil the mandate from the G20 have already been agreed, particularly with regard to the banking industry.

Apart from the reform of the Basel framework for banks (commonly known as Basel III), a basic pillar of the regulatory reform undertaken by the FSB is the new treatment of so- called "systemic institutions". Or, in other words, the problem posed by institutions which are too big and complex to fail, meaning the authorities have to recapitalise them with public funds when they are in distress.

Identifying an institution as "systemic" has consequences. They are subject to larger capital charges and to a stricter supervisory regime aimed at reducing the likelihood of them getting into difficulties.

That said, if there is in fact a key differentiating factor to reduce the impact of the potential failure of a systemic institution, it is unquestionably the new resolution framework.

This new framework encompasses (a) legislative reforms; (b) the requirement that institutions have resolution plans in place; (c) assessment of the effective resolution ability of the authorities of the respective Crisis Management Groups; and (d) the need for institutions to have the loss-absorbing capacity or funds to ensure that, in a situation of resolution, it can be carried out "from within", i.e. without need for capital injections by the relevant authorities and without destabilising the financial system as a whole.

Allow me to take a moment to talk about loss-absorbing capacity in resolution, or Total Loss-Absorbing Capacity (TLAC).

On 10 November the FSB published a proposal on the TLAC requirement to be met by systemically important banks, the final design of which is scheduled for the end of 2015.

The consultative process of the TLAC proposal will be conducted in parallel with an impact study which will include (i) an analysis of the TLAC needs for each institution which may have to be resolved; (ii) a survey to assess the depth of the market in each jurisdiction involved; (iii) an analysis of the historical losses incurred by global systemic banks at the height of the crisis; and (iv) an assessment of the economic impact of the proposal, both at institution level and as to how it will affect the supply of credit.

The difference from the Basel requirements lies in the instruments eligible for meeting the new requirement. Thus, in addition to all the equity instruments envisaged under Basel, the proposal permits, and in fact requires, the inclusion of debt instruments, generally subordinated debt instruments.

Experience shows that capital may disappear in a crisis, and quickly so. The authorities must, therefore, have debt and equity instruments which (through debt reduction and/or conversion into equity instruments) allow them to resolve and recapitalise institutions from within, without need for bail-out by the public authorities.

Will this be the end of the reforms? I think not, at least as far as other financial sectors are concerned.

The considerably higher prudential requirements on banks naturally cause some credit intermediation to shift to other financial sectors, in a phenomenon commonly known as “shadow banking”.

The FSB has set in train two courses of action to prevent an excessive concentration of banking risk off the balance sheets of banks: first, it monitors their size, activities and risk characteristics; and second, it is working on the introduction of measures both for institutions (particularly closed-end money market funds) and for activities (particularly certain forms of alternative funding, such as securitisation or the funds obtained through the repo market or securities lending).

Lastly, increasing emphasis will be placed on monitoring the implementation of reforms. One of the lessons learned during the crisis was that international standards must not only be appropriate, but also effectively and uniformly implemented across jurisdictions to avoid situations of lack of competitiveness, regulatory arbitrage or creation of systemic risk.

I am sure that, as in previous years, your Meeting will be extremely interesting and informative. There is no shortage of issues and problems.

Thank you.