

Miguel Fernández Ordóñez: Turbulence in the world markets – a Spanish view (five lessons and some homework)

Address by Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, at the “Círculo Financiero”, Barcelona, 14 May 2008.

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Let me begin by thanking you for the invitation to deliver this speech.

I shall not be going into details today on either the sequence of events that have triggered the turbulence in international financial markets, or on the various suggestions for reform that may prevent a similar situation from arising in the future. We currently have several reports by various institutions addressing these matters in depth, including, for example, the most thoroughgoing report by the Financial Stability Forum.

The scope of my speech this evening will be more modest: to examine the Spanish banking system in the context of this turbulence. The central idea I wish to convey is as follows. Spanish banks and savings banks have not contributed to any extent either to the generation or to the subsequent propagation of the turbulence, which in principle puts them in a sound position to withstand it. However, and as recent events have clearly reminded us, we live in an increasingly global world. Accordingly, the Spanish financial system cannot remain immune to the consequences of the current problems, which affect not only those who originated them but all of us.

To some extent, the turbulence may be viewed as the necessary response to the financial exuberance experienced by the world economy in recent years, a situation that was unsustainable. This period was marked by very low volatility and risk premiums amid very accommodative financing conditions. That contributed to a failure to assess risks correctly, leading to exaggerated asset price rises and excessive levels of leverage. True, we are no doubt currently witnessing an overreaction in certain markets, in which the premiums demanded are not in line with asset quality; but as the turbulence progressively abates, risk premiums will normalise, albeit at higher levels than the excessively low ones recorded before the summer of 2007, and that will bear favourably on financial stability in the medium and long run.

This normalisation will contribute to alleviating the sharp growth in credit that has led to high household and corporate debt in many countries. Admittedly, in Spain this debt was largely used to finance housing investment and the expansion of companies' productive capacity, as well as their internationalisation. But this makes it no less necessary now to undertake an adjustment to return these variables to more reasonable levels.

This adjustment has begun in Spain with households and corporations generally in a sound financial position. At the same time, the quality of bank balance sheets is high compared with other countries' banking systems. Notwithstanding this, and as a natural consequence of credit growth in the past, and of a macroeconomic setting characterised by a cyclical turning point, we should expect continuing rises in bad debts in the coming months. This rise in bad debts should concern us, and indeed it would be alarming if bank regulators and supervisors were unconcerned; but it does so only moderately, bearing in mind the resilience of the banking sector according to the stress tests performed by the Banco de España under assumptions in which extremely adverse scenarios materialise.

Nor will I be referring today to the problems that are common to all adjustment processes, the adjustment in the Spanish economy having moreover begun before the turbulence emerged last summer. Rather, I shall be focusing on what for me is the worst effect of this turbulence: the global financial market dysfunctions. So you may better understand my subsequent remarks, I would like to very briefly outline how, starting from a very limited

segment of the US mortgage market (the subprime mortgage segment), we have reached a generalised situation of international financial market turbulence.

The factors behind the current situation are complex. But in my opinion there are two key elements that explain such an intense process of propagation. First, and as already stated, low risk premiums and very low volatility led to a strong increase in leverage on international financial markets and a big appetite for risk in the search for high yields, a tendency in which certain financial institutions in some countries participated. Also, and in relation to the foregoing, the development of a banking model focusing on the origination of loans for their subsequent distribution on the financial markets, underpinned by the securitisation of assets through certain complex structured products and by the use of off-balance sheet investment vehicles, introduced inappropriate incentives as regards the granting of financing and the subsequent management of the associated risks. In my view, it is these latter elements which explain the intensity and speed with which the turbulence has spread.

Starting from this idea, I shall draw five lessons which I consider highly relevant for the future. I will then evaluate the Spanish banking system in relation to each of them in order, finally, to identify certain tasks which we should, each from our own area of responsibility, address so as to limit the adverse consequences for the Spanish economy of the international financial market turbulence.

First lesson: on the originate-to-distribute model

In recent years some banking systems have developed a banking model based on the origination of loans for subsequent distribution on the financial markets. This type of model has been largely underpinned by asset securitisation, a process that enables bank loans to be batched and converted into marketable products. This mechanism has allowed banks to transfer the risk of the financing they originate to the market.

Until the turbulence emerged, the originate-to-distribute model had generally been understood to be a very effective instrument of risk management: the banks using the model had an additional mechanism to decide on the degree of risk exposure on their balance sheets, while these risks were transferred within the financial system to those agents most prepared to assume them. However, the present situation seems to show that the risks have not ended up with those investors most prepared to assume them, but with those who least understood them.

What problems have led this business model to the current difficulties? Firstly, and insofar as the banks that granted the financing rapidly packaged the loans and placed them on the market, very powerful incentives arose to lower credit standards in the extension of loans, so that the selection of borrowers was not made following sound banking risk management practices. What is more, perverse incentives also came into play in the monitoring of borrowers, since the originators disassociated themselves from the financing.

Furthermore, once the problems surfaced in the form of an increase in defaults, the possibilities of resolving these problems were also seen to be very limited. The number of agents intervening in the process is high and their interests do not always fully coincide. In other words, compounding the incentive-related problems that emerge when the economic situation is favourable are conflicts of interests once the situation has turned adverse.

In fact, the originate-to-distribute model has stymied one of the essential functions of banking: the extraction of valuable information to allow proper discrimination between borrowers.

This business model has been highly fashionable in certain countries, but not in all. The Spanish banking system has not adopted it, and the model here has continued to be a traditional banking one with closeness to bank customers, detailed knowledge of them and the forging of links over time being some of its defining characteristics.

True, Spanish banks have made considerable use of asset securitisation, but to a totally different end than those banks which developed the originate-to-distribute model. As conceived by Spanish banks, asset securitisation was not a business in itself but a mechanism to obtain additional funding. In this way, risks were not transferred to the financial markets but were retained on the balance sheets of the banks granting financing, and the perverse incentives under the originate-to-distribute model were thus avoided.

Second lesson: on the use of complex products that are difficult to assess and lacking in transparency

The process of asset securitisation has also differed across banking systems as concerns the complexity of the products developed. The second key aspect of the turbulence is that some international banks, particularly when securitising US subprime mortgage loans, used highly complex structured products that are difficult to assess and lacking in transparency. Products such as CDOs, CDOs of ABS and CDO squared have been prominent in recent months in the business news, especially because of their adverse impact on the results of the biggest international financial institutions. Some of these products used the bonds resulting from a specific securitisation, packaging them and combining them with other financial instruments in order to re-securitise them. Other products, to offer another example, were made up of securitisations of relatively heterogeneous asset portfolios, in which the degree of concentration was high.

Evaluating these products required the use of sophisticated models based on numerous assumptions and on information not directly observable in the markets. Also, owing to their recent development, the models had not been tested in a highly adverse scenario. In addition, the sophistication of these products meant that the calculation of the parameters needed for the valuation models was more complex, making it increasingly difficult to value the level of risk incurred.

Events have highlighted the fact that the valuation models have not worked well, meaning that many banks have miscalculated the level of risk assumed and that stress tests have not worked properly. Beyond these quantitative considerations, the use of these complex products also indicates significant shortcomings in the more qualitative facet of risk management. Quite simply, numerous banks and investors took positions in products that they did not properly understand. And today it is quite clear to see that they have perhaps committed the most basic error contrary to sound risk management, i.e. investing in products whose risks have not been fully understood.

The third ingredient the turbulence has revealed in relation to this type of product has been the lack of transparency, both regarding the valuation models used and the degree of exposure assumed. The lack of confidence in the financial markets is largely related to a lack of information, to such an extent that financial institutions themselves have not trusted one another, prompting serious problems in interbank markets.

Yet not all products related to securitisations are so complex or pose such valuation problems as those I have mentioned. The most straightforward securitisations, such as those used by Spanish financial institutions, are characterised by their use of well-diversified, granular portfolios made up of homogenous assets. In these conditions, the models available do not have product-valuation problems, and it is straightforward to calculate the expected losses associated with the bonds classified in the different tranches of the securitisation. What is more, in Spain's case, where no market segment comparable with the US subprime one has been developed, the quality of the securitised assets is very high.

Not only have Spanish credit institutions not designed complex structured products, they have not invested in them either. In this respect, risk management has functioned correctly, since excessively risky products of which full understanding was lacking have been avoided:

the absolute absence of direct and indirect exposures to US subprime mortgage loans is a clear example of this.

Third lesson: on off-balance sheet investment vehicles

The originate-to-distribute model also drew on the development of off-balance sheet investment vehicles, namely conduits and SIVs. The way in which these vehicles operate is to make long-term investments and to finance themselves short term, by issuing collateralised commercial paper.

As concerns the term structure of their assets and liabilities, these special-purpose entities engage in a very similar activity to banking. However, unlike banks, they are not required to have their own capital and are not subject to appropriate supervision. They could be said to be parallel banks without capital or regulation and, therefore, they do not have access to central bank liquidity.

These conduits and SIVs have played a considerable role in amplifying the turbulence, and in the speed with which it has spread. This was because some banks had to lend to these vehicles under the liquidity facilities they had open with them, or because an attempt was made to prevent a massive sell-off of securities, or else because large institutions considered that the cost of letting conduits and SIVs go to the wall, in terms of the reputational risk involved, was greater than the cost of coming to their assistance. The fact is that many of the risks that were believed to have been transferred to the market have unexpectedly returned to bank balance sheets.

The proliferation of these investment vehicles is due to, at least, two reasons. First, because some banks saw them as a means of achieving greater profitability, while alleviating their capital requirements. And second, because prudential supervision was not sufficiently active in detecting and preventing this type of instrument.

None of these elements has been present in the Spanish banking system, which explains why Spanish banks have no exposure to these vehicles. Spanish banks have obtained sufficient profits pursuing their traditional and typically retail activity, meaning they have had no great interest in developing either the structures or products that are at the root of the current problems.

The Banco de España has been categorical regarding its requirement that these vehicles be consolidated for accounting and capital purposes. Today, following the application of International Financial Reporting Standards in 2005, this requirement to consolidate conduits and SIVs is now very clear. But even before the IFRSs came into force, Spanish banks had no incentive to develop these off-balance sheet vehicles, because the Banco de España always analysed the risks assumed by banks from a consolidated perspective.

Fourth lesson: on the procyclicality of banking regulation

The fourth lesson to be drawn from the turbulence is related to the debate that has re-opened on international markets about the way in which financial regulation should address so-called procyclicality. In particular, concern has been raised about Basel II and international accounting standards.

We should perhaps begin by acknowledging that financial market participants themselves behave in a procyclical way, as they tend at favourable times in the cycle to forget about the consequences of an excessive build-up in risks. The pertinent question to ask, therefore, is whether or not prudential regulation amplifies this natural behaviour by financial market participants.

Before analysing the elements of procyclicality that Basel II and international accounting standards may contain, it should be stressed that this set of rules includes numerous positive

elements. Basel II will entail, and is in fact entailing, notable progress in the management of the risks credit institutions face. Had Basel II been in force some years back, many of the dysfunctions currently lying behind the turbulence would not have taken place. Moreover, international accounting standards, and in particular the financial reporting standards adopted in 2005 by the European Union, contribute to the common goal of a single financial market, since it appears reasonable that companies operating in a single area should be subject to the same accounting rules.

Returning to procyclicality, I must remind you that this was a very significant debate during the period Basel II was being prepared. Insofar as capital requirements are more sensitive to risk, it is reasonable to believe that procyclicality is greater, requiring less capital when things go well and more capital when they go badly. The Basel Committee on Banking Supervision was mindful of this and that is why the new regulatory framework for capital includes elements that mitigate it, both under Pillar 1 and under Pillar 2. However, procyclicality can be most mitigated by improving risk management: the most procyclical banks are those incapable of properly managing their risks over the course of the cycle, so that when the cycle turns adverse, they have to react abruptly.

The debate on the procyclicality of international accounting standards has, to date, been more limited. This is surprising since, as current events are showing, the impact of fair value valuation on banks' income statements, and therefore on their retained earnings and on their capital, is notable, especially when markets are illiquid and internal valuation models are suffering the consequences.

I believe that a reform now would only increase investor uncertainty. Therefore, once this period of turbulence is behind us, the debate on the procyclicality of accounting standards should be deepened, to consider what the weaknesses of using fair value in specific circumstances are. Further, it would be advisable to focus the discussion on the role of provisions, i.e. on measuring the losses incurred by banks due to credit risk. Greater flexibility in their calculation would enable procyclicality to be reduced, making the accounting standards more consistent with prudent risk management.

This has been the traditional position of the Banco de España on accounting regulation, to consider it always as a key element of prudential regulation. In this respect, accounting Circular 4/2004, on the adaptation to international accounting standards, made a notable effort to retain prudential criteria in those areas in which the standards permitted more than one option.

One clear example of this is the rules on provisions. Criteria are laid down specifying the provisions that should be made in relation to losses incurred and identifiable in specific operations. The level of provisions at any given moment depends on the time elapsed since the default arose. In this respect, the new accounting Circular of the Banco de España has increased the percentages that must be applied in the calculation of these specific provisions.

The requirement is also laid down to make provisions to cover the losses, likewise incurred, but not identifiable in specific operations. This is possible on the basis of statistical procedures and the past experience of the banks. From a conceptual standpoint, these provisions reflect the fact that, in banking systems, risks tend to build up during cyclical upturns, which has to do with the procyclicality characterising the participants in financial systems. From a practical point of view, what the current provisioning system has achieved is to give Spanish banks greater strength greater room for manoeuvre to withstand a potential worsening of the conditions in which they are pursuing their activity. Indeed, the system is designed in such a way that it has obliged banks to set aside funds that will enable them to absorb the impact of a potential increase in specific provisions.

The system approved in Spain was the most demanding possible within the framework of international accounting standards. Consequently, thanks to the design of a general provision such as the present one, along with a tightening of the parameters that determine

the specific provision, the Spanish banking system had the highest volume of provisions among the developed countries when the market turbulence emerged.

Last lesson: on how the turbulence affects us all

I have attempted to convey to you that, in Spain, banking regulation has proven to be strict, having included concern over procyclicality among its criteria for action, and that Spanish banks have properly managed the risks associated with financial developments in recent years. The absence of a subprime segment, of an originate-to-distribute model, of complex structured products and of off-balance sheet investment vehicles attest to the fact we have all done the right things. Can we afford to be complacent? I would say no, for three reasons. First, because if we have not made certain mistakes, this is largely due to the fact that our financial system has been very traditional, without sophisticated institutions such as those that have most suffered from the turbulence. Second, because, as I have already said, the Spanish economy needs to undergo adjustment in several areas, but essentially in that of residential investment. And third, because the strong interconnections within the financial system, which is today more global than ever, mean that if markets cease to function, that has negative consequences not only for those that generate the problems but for all those participating in them. This is the last lesson I will refer to: globalisation has brought many benefits but, even if the right things have been done in one quarter, if others generate problems, such problems ultimately also affect those who did not create them and that is why we must respond to them.

The turbulence on international financial markets has led some markets on which Spanish banks usually obtained additional financing, for instance the private fixed-income and securitisation markets, to dry up abruptly. The malfunctioning of these markets has affected everybody since investors, disillusioned with the complex products I mentioned earlier, have not wished to take the time to discriminate properly between different products.

Whatever the case may be, the difficulties in gaining access to wholesale financing have posed a considerable management challenge. To date, the response of Spanish banks has been appropriate, partly because the structure of their liabilities is such that the wholesale financing raised in recent years, at a higher cost, has been predominantly with longer maturities, which now affords them greater freedom; and partly because they have been able to resort to alternatives, such as shorter-dated financing to cover their funding needs.

These alternative ways of obtaining financing are somewhat temporary in nature, which is consistent with the high degree of uncertainty prevailing at present and which will conceivably not persist over time. Naturally, the potential impact of this situation on banks' financial position, and therefore on the Spanish economy, will largely hinge on the duration of the bout of turbulence.

Indeed, the events of recent weeks offer grounds for some optimism: after a virtual drought for seven months, in only three weeks a notable group of banks have obtained over 13,550 million euro on the international market.

"Homework"

The starting position of Spanish banks at the outset of the turbulence was, as I have already said, very sound, and this has allowed them to avoid its more immediate and direct effects. The reporting of results both for the fourth quarter of 2007, and those being released for the first quarter of 2008, show the notable differences in comparison with other international banks. However, the dysfunctions continue affecting international financial markets, and that does not leave the Spanish financial system immune to what we might call second-round effects. Accordingly, financial market participants - each in their own area of responsibility - must act in such a way as to ensure these effects are minimised.

Indeed, the tasks to be performed pose an even more demanding challenge, considering that the turbulence is coinciding with a period of internal adjustment and deceleration in the world economy. The deterioration in macroeconomic conditions is most patent in the United States, with most analysts forecasting a sharp slowdown in the opening quarters of 2008. But slacker growth is also expected in Europe in the coming months. The Spanish economy, after an upturn lasting more than ten years, has also begun its adjustment. For all these reasons, as economic agents we all have a significant "to do" list ahead of us.

I shall begin by referring to credit institutions, since it is up to them to continue managing properly the risks they assume, developing adequate risk measurement, control and management systems and, in short, determining what level of solvency is appropriate to their risk profile. In the present circumstances of the international financial markets, there are certain considerations that I believe to be particularly significant.

First, Spanish banks must respond appropriately to the change in cycle under way in our economy. This entails not only properly managing defaults as they occur, but also tempering the slowdown in the rate of credit expansion. It would be counter-productive for the Spanish economy if an excessive reduction in credit growth were to limit its capacity to grow.

Second, as I have pointed out already, Spanish banks' income statements have escaped the effects of the US sub-prime mortgage crisis. However, unquestionably the environment in which Spanish banks will have to operate, and indeed in which they already do operate, has become very difficult. Insofar as higher financing costs may affect their operating margins, alternative mechanisms for keeping their income statements sound must be strengthened. An initial consideration in this respect is that a high percentage of the financing granted in Spain is variable rate, so banks have a greater, almost automatic, ability to pass cost increases through to borrowers. Further, in the last few years Spanish institutions have shown notable skill in managing operating costs, becoming some of the most efficient players in the world. In the current circumstances, progress along these lines is even more necessary.

Third, and very importantly, some of the international markets on which Spanish institutions have raised financing in recent years have narrowed substantially. In this respect, the lack of discrimination seen in the last few months is surprising, as the markets have similarly penalised products whose features, in terms of level of complexity and risk, are substantially different. This is the case, for example, of Spanish securitisations which, on account of their simplicity, the high quality of the securitised collateral and the low level of bad debts recorded, bear no relation to the more complex structured products used by banks in other countries. A particularly striking case is mortgage covered bonds, whose credit quality is very high and easily measurable. This quality resides in their legal characteristics, since they are backed by the whole of the issuer's mortgage portfolio and their minimum level of over-collateralisation is 25%.

However, financial market participants have not taken these arguments into consideration. In fact, banks have to keep explaining to the market the differences in their issues. An effective way of doing so is to start issuing medium-term securities again. And, as mentioned above, congratulations are in order because this is the path successfully taken by some banks in recent months.

The effort credit institutions have to make to explain their business model, which differs sharply from that of other international institutions currently in difficulty, can and should be supplemented by analysis and explanations provided by the Banco de España. When there is a lack of confidence, transmitting key information to the markets so that participants can make informed investment decisions is essential. For this reason, the institution I represent has taken various initiatives, such as publishing the Financial Stability Report nearly one-and-a-half months earlier than usual, and public appearances by Bank senior officials. This conference is, or so I hope, a good example of such initiatives: my aim is for you to leave this conference with a clearer idea of the situation of the Spanish banking system.

Naturally, the Banco de España's "homework" is not limited to this. Rather, as the authority responsible for regulation and prudential supervision, it is bound to continue providing the necessary incentives and to see to it that Spanish banks exercise prudent risk management and have sufficient provisions should those risks materialise.

In the area of financial regulation, debate is currently under way in international fora on the lessons to be drawn from this experience and on the measures to be taken in the future so that the weaknesses are not repeated. And we should acknowledge the notable efforts being made by different organisations in different areas. For its part, the Banco de España, in keeping with its remit, considers that this review must not succumb to the temptation of indiscriminately stepping up the level of regulation of the sector. The initiatives along these lines have to be thought out in depth and have to be justified by the existence of a market failure the resolution of which, through public intervention, gives rise to greater benefits than costs.

Lastly, in regard to the direct powers of the Banco de España, I would remind you of something that often seems to be overlooked: the institution I represent is part of the Eurosystem. In view of that fact it will continue working to ensure that monetary policy implementation is compatible with holding inflation within the bounds set by the central bank and, at the same time, will help guarantee that adequate liquidity is provided so that money markets function properly.

The social partners also have an important task: to co-operate so that, while the inevitable adjustment is taking place in the residential construction sector and in related activities, the rest of the economy, i.e. industry and services, becomes more dynamic. And for this to happen a moderation in private sector margins and in unit labour costs through wage moderation and/or productivity increases is fundamental. It should be quite clear for all that if the inevitable rise in unemployment in construction is not offset by greater dynamism in the rest of the private sector of the economy, employment may perform more negatively than expected.

Finally, I would like to mention the necessary action by government, in at least two areas of its competence.

The first is fiscal policy. One of the major advantages of the fiscal consolidation drive during the long period of expansion of the Spanish economy is that the government budget mechanisms, known as automatic stabilisers, can now operate fully. These mechanisms act rapidly, promoting confidence and facilitating agents' formation of expectations. However, the activation of fiscal policy measures of a discretionary nature must be prevented from jeopardising budget stability in the medium and long-term, since this would entail costs far exceeding any potential benefits that might be had in the short-term.

The second area of action is that of measures of a structural nature aimed at improving the functioning of certain markets, increasing the flexibility of wage and price formation mechanisms and expediting the reallocation of factors across sectors of the economy. For this task to be successful, the responsible co-operation of the social partners is also crucial.

To go into these matters in depth would need a whole conference in itself, so I shall conclude on this point, but not before reiterating once again the main idea I wish to leave with you today. The Spanish financial system has not participated in the causal factors of the current international financial turbulence and this, together with its financial soundness, puts it in a favourable starting position. However, we live in a global world, and the good work done so far is no antidote to the risk of turbulence. Indeed, the most effective way of limiting the materialisation of these risks in the Spanish banking system, and in the Spanish economy, is to acknowledge that we are not immune to them and, based on this premise, to work together to take the decisions that will enable us to meet the current challenges. I have no doubt that this is the spirit shared by all those of us who in one way or another have some responsibility in this field. Thank you.