Miguel Fernández Ordóñez: The restructuring of the financial system

Opening speech by Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, at the XVII Meeting on the Financial Sector/Deloitte-ABC, Madrid, 13 April 2010.

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Good morning.

Let me first thank ABC and Deloitte for the opportunity to address such a select audience as that gathered here today.

I have tried to explain from the outset of the crisis that, although it may have compounded the main problems besetting our economy, these are specifically Spanish problems. Accordingly, their solution unavoidably involves adopting domestic measures without counting on an improvement in the external environment to resolve them for us.

Among these problems is the necessary restructuring of the Spanish banking system. This sector, which grew in parallel with the extraordinary real estate expansion of the past 15 years, now shows overcapacity and insufficient capitalisation in the case of certain institutions, meaning re-sizing and appropriate restructuring are needed. Last year, in this same forum, I referred to the need for banks to be aware of the situation facing them and to set about the task at hand. Today, with few exceptions, I believe they are doing their homework.

Regarding the restructuring of the financial system, the government and Parliament too have done what they had to, and correctly so in my view. On one hand, formulas such as nationalisations, “bad banks” and capital injections without requiring that capacity be reduced have been rejected. Such formulas were probably unavoidable in countries that have seen the bulk of their banking systems collapse, but are absolutely inappropriate for Spain’s circumstances, where most of the sector is essentially healthy. On the other, the capacity of the Banco de España has been reinforced to act effectively when it is necessary to take control of banks and, in turn, an appropriate framework has been set in place so that those banks that so require may access the funds needed to restructure. Even if still currently viable, they are encouraged in this way to go ahead with restructuring, which allows them to be prepared to lend without problems once the recovery arrives and the current declining pattern of the demand for credit turns around.

These measures – implemented in the Royal Decree Law creating the FROB (Fund for the Orderly Restructuring of Banks) – have been adopted with a broad Parliamentary consensus, enjoying the support of the two main parties, in a similar fashion to the consensus behind the swift response of our authorities to the closure of the wholesale markets. The latter event saw the approval of Royal Decree Laws for the fund for the acquisition of financial assets and for State backing of bond issues by credit institutions, both of which initiatives smoothed the way for the wholesale funding of much of the Spanish banking system at a most delicate juncture in the crisis. All these measures for the support and restructuring of the financial system have proven technically correct, they are well adjusted to Spain’s situation, and they were rapidly designed and approved with broad consensus. Certainly, such characteristics should be applied to other areas so needy of reform, such as the rebalancing of public finances and certain labour market institutions.

The need for restructuring has been understood by most of the banks that required this to ensure their viability and soundness in the future, and they have reacted by working on various integration processes. In previous talks I explained the criteria used by the legislator for these processes, and which are those that should prevail: the sufficient reduction of capacity, the soundness of the resulting banks and the minimal use of public funds. These should be the goals both of banks themselves and of all the public authorities intervening in the process.

Along with restructuring, my recent speeches on the financial system have focused on a matter I consider, unquestionably, to be the biggest risk hanging over Spanish credit institutions, especially the least diversified ones: mass unemployment. Unless a reform of our labour institutions that tackles this most serious and most Spanish problem with resolve is approved promptly and with the widest possible consensus, many of our credit institutions will suffer the consequences: more bad debts, less business, higher public indebtedness and, consequently, dearer wholesale funding, etc. If these millions of workers remain unemployed in Spain for any lengthy period the banking system, having served to underpin the economy during the crisis, might turn into an obstacle to achieving economic recovery.

These are the issues I believe we should pay greatest attention to at present. But I shall focus today on the changes taking place in the regulation and supervision of the financial system globally. While not so immediate, these changes will ultimately exert effects on the Spanish banking system and we should all prepare for this new regulatory setting.

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Nobody with responsibilities for the financial system will be able to forget 14 November 2008. It was on that day, on a European initiative, that the Washington summit was held. This date will go down in history as the start of a sea change in the style and substance of financial regulation. In terms of style, because the summit marked the beginning of a radical turnaround in the governance of the global financial system with the creation of the enlarged G20 – to which Spain was invited – that would culminate in the transformation of the Financial Stability Forum into the Financial Stability Board (FSB), a "club" of which Spain became a fully fledged member for the first time. I shall not elaborate here on this change in style, but let me stress its historical nature, since it entailed the recognition of a far different world from that when the Bretton Woods institutions were designed at the end of the Second World War.

But the change in substance has not been any less. The philosophy behind international regulation until then had been based on the idea that private financial institutions knew better than anybody what they had to do, and we could therefore count on self-regulation. Meantime, in many countries, hands-off supervision was the prevailing philosophy: the less the public sector laid its hands on financial activity, the better. The crisis and the initiative of the G20 leaders have called this philosophy into question.

An example of this is the radical change in direction of the work of the Basel Committee. Although the so-called Basel II reform had some very positive aspects, such as the greater sensitivity to risk of regulatory requirements and the consequent stimulus for banks to set in place better risk management systems, the Committee's work was naturally infused by the self-regulation approach then prevailing. However, since late 2008, financial regulation has taken a radically different road. We need only review the documents published by the Basel Committee last December, at the request of the G20 and the FSB, to realise how sharp the change in direction has been, to the extent, indeed, that some have called this new regulation "Basel III": more capital of higher quality, more stringent requirements on trading activity, an obsession with avoiding procyclicality, etc. And the same can be said of the work of the various agencies and institutions (IMF, EU, IOSCO, etc.) that are contributing to shaping the new regulation of financial systems. The objective is clear: this can not happen again.

Taking advantage of the eminent audience here today, I shall mention some of the developments I consider most important, since this international regulatory earthquake will entail a substantial change in how financial system players from all countries can act. And although the effects will not be felt immediately, our banks should take them very much into account so that they may adapt in an orderly fashion to the new setting.

Among the vast number of issues under discussion today in various international fora, I am only going to mention those I consider to be of most importance to Spanish banks.

One of the guiding principles of the reform of the financial system promoted by the G20 is the ***reinforcement of the prudential regulation of capital and liquidity***. To this end, the Basel Committee has tabled an important set of measures aimed at increasing the financial system's resilience in the medium and long term. These include most notably:

– Firstly, the proposal to increase the amount and quality of capital required of banks in order to enhance their loss-absorption capacity. The definition of capital will, moreover, be more transparent and internationally comparable.

– Secondly, consideration is being given to introducing minimum global liquidity standards and establishing common criteria to help supervisors identify and evaluate liquidity risk.

– Thirdly, work is under way to define various measures to mitigate the procyclicality of the financial system, which was not taken sufficiently into account in the pre-crisis period. Along these lines, the creation of countercyclical capital buffers has been proposed so as to contribute to reducing and not amplifying credit cycles. The aim pursued would be for banks to reinforce their capital during upturns and to be able to use it subsequently in periods of stress.

In other areas, measures have been proposed to lessen the tendency of financial market participants to accentuate business cycles by their behaviour. Specifically, a series of criteria have been set for bankers' pay in order to lessen their incentives to adopt risky, short-termist strategies. These have already been applied in the main developed economies.

In the field of accounting regulations, too, significant efforts are being made to strengthen standards. Here work is being done to achieve convergence – hitherto non-existent – between the accounting standards of the main economic areas. Also of great interest is the analysis of proposals for the proper valuation and classification of financial instruments, and for the development of a countercyclical provisioning system, similar to that in place in Spain.

There is universal agreement that these improvements in regulation can hardly be successful unless they are implemented in a widespread and consistent manner.

Hence the FSB is acting on several fronts to ensure the implementation of international standards, demanding greater commitment (and transparency) of the main economies in terms of compliance. In this respect, peer review exercises have begun and a major effort is being made to identify those areas in which the regulatory framework does not sufficiently recognise risks, placing particular emphasis on those institutions, instruments and markets which are not currently regulated or supervised.

In addition to all these efforts in the field of regulation, work is ongoing to set in place ***more effective and uniform microprudential supervision of financial institutions***.

The financial crisis has revealed major supervisory failings in certain jurisdictions. In these cases supervision did not adapt sufficiently to the increasingly global nature of financial activities and it was not as intensive as would have been necessary. As a result, certain banks ultimately built up excessive risks, prompting public interventions with a high cost for taxpayers. This was due in part to excessively lax supervisory standards, which led to insufficient monitoring of institutions under inspection and to the underutilisation of the information available to supervisors, and which allowed the excessive growth of the "shadow banking system".

Work is now in progress to define and standardise ways in which material information on transnational institutions can be exchanged through so-called colleges of supervisors, which group together the supervisors of the countries where these institutions have a significant volume of activity. Substantial headway has been made in a short time and improved supervisory cooperation at international level and at European level (with the creation of new European supervisory authorities) will unquestionably enable more effective action.

I would like to emphasise here another dimension which the Banco de España considers crucial, namely the improvement of national supervision. The first step in achieving effective international supervision is to ensure high quality national supervision, not only of large institutions, but of the whole system, since systemic risk may flare up due to a mere contagion effect. The second step is to foster the convergence of a majority of countries towards uniform and higher-quality supervisory standards. In this respect, work is commencing on a review of the various national supervisory models with a view to developing principles based on sound supervisory practices.

Lastly, I would like to emphasise that a key issue in discussions on changes in regulation and supervision is the search for ways to mitigate the problem of moral hazard associated with so-called systemic institutions.

Some of the more perverse consequences of the crisis have manifested themselves in these institutions, i.e. those which, owing to their size, their inter-connectedness or the difficulty of replacement of their business areas, are too "big" to allow them to fail. The governments of most developed economies have had to intervene to avoid the consequences of their failure for the system as a whole, at a considerable cost to the public coffers of these countries.

The treatment of these systemic institutions is a cornerstone of the reforms proposed by the G20. The wide variety of work under way includes most notably improving countries' restructuring and resolution capabilities, i.e. the ability to disaggregate the balance sheet of these institutions, and reducing the likelihood and systemic impact of their possible bankruptcy or severe financial stress.

In this respect, the members of the FSB undertook to ensure that cross-border institutions have a restructuring plan whereby these can obtain emergency liquidity and deleverage their financial position to improve solvency, and that they have a detailed resolution plan if they are unable to continue operating.

That said, the solution to the problem of systemic institutions must be a global one and encompass many other measures. Key among these are improved national and international supervision, higher capital requirements depending on the particular features of each institution, improved prudential and accounting regulation, and the establishment of an incentives system to persuade institutions to adopt structures which are more solid and less exposed to the risks inherent in organic business expansion.

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Many of the proposals described here are still under discussion or at the public review/comment stage and are thus subject to change. Furthermore, there is general agreement on allowing a reasonable lapse of time before they come into force. Nevertheless, I believe that the direction of change is now sufficiently clear, and Spanish institutions should hasten to digest it so they have time to plan how they will adapt to the new regulatory environment in the least traumatic way.

To this end, institutions must not only prepare themselves to comply with higher capital requirements, but must also become familiar with many other significant changes, such as, for example, the applicable rates of deduction (minority interests, investments in financial and non-financial firms, tax assets, etc) and the required liquidity ratios, which are new to Spain, where regulation had previously focused only on the attendant qualitative aspects.

Spanish deposit institutions have in fact begun to increase their levels of capital, particularly higher-quality capital. In doing so, they are acting in anticipation of future regulatory requirements and, moreover, strengthening their solvency at a time of heightened uncertainty. This improvement evidences their willingness and ability to respond to market demands and to future regulatory requirements, although additional adaptive efforts to raise higher-quality capital may be required of some banks.

With regard to liquidity, Spanish banks have always been attentive to this risk, as evidenced by their bond issues and long-term securitisations, despite the fact that the cost of short-term funding was more attractive. This conservative funding term structure on the liabilities side is one of the factors explaining the strength of Spanish banks during the crisis. However, the financial markets are still far from being back to normal, so it is essential that institutions continue paying particular attention to liquidity and funding. In the medium term, and despite that strong starting point, the new regulations will require additional efforts, particularly with respect to the short-term liquidity buffers which banks must have in place.

Hence, in addition to the uncertainty resulting from the depth and duration of the financial crisis, banks have to deal with the additional pressure put on them by the new regulations, still to be defined in many cases. Banks have to make a special effort to explain to the market how they will meet the challenges posed by the crisis and to convey their plans for successfully coping with the regulatory changes. This transparency drive will have to be stepped up in the immediate future. Specifically, in situations of high uncertainty like the present, the lack of information on asset quality and loss provisioning may lead investors to believe that the situation is much worse than it actually is. It is in the interest of deposit institutions to inform the market of how their business is being affected by the crisis and of their short- and medium-term strategy for dealing with the situation, stating explicitly their level of risk by business segment and the provisions set aside for that risk.

But it is not only private institutions which have to do their homework; regulators and legislators have an obligation to amend national law so as to allow or help private institutions to adapt to the new international regulatory environment.

An example of this in the case of Spain is the need to change our legislation on the own funds of savings banks so that these singular institutions can comply with the exacting capital quality requirements which will be imposed by the new global regulation. Welcome news in this respect is the Government's announcement that it will soon propose new legislation to address this problem, the resolution of which is crucial for a significant part of our financial system.

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Let me finish with a medium-term consideration of particular concern to me, which is only on the margins of the agenda for global regulatory change. I refer to the availability of financing for small and medium-sized enterprises (SMEs) in the new banking universe which will emerge following all these regulatory changes.

I am not thinking of the credit problems of SMEs in the short term due to higher risk aversion or to their weakness during the crisis. These problems have been covered extensively in previous addresses and the measures being taken to alleviate them include exceptional and, naturally, temporary programmes such as those of the Official Credit Institute.

Here I am not referring to the short term. My concern is that, although it is positive that all the regulatory changes under way seek to ensure that banks will never again cause the serious problems which arose in many countries and ultimately spread to all of them, it should also be realised that those new post-crisis banks will, by definition, be less willing to lend money for business projects with a certain level of risk. Clearly, you can't remove the punchbowl and expect the party to swing.

The purpose of the calibration exercises undertaken is to avoid excessive requirements that stifle the economy. But nothing will prevent the post-crisis banks arising from the new regulatory regime from being much more prudent and focused on traditional intermediation than in the recent past. It will be possible to temper those requirements involving an excessive cost/benefit burden, but it is doubtful that a change enjoying such wide support will be stopped. The fact is that public opinion in the major countries wants the new international regulatory environment to oblige financial institutions to behave as conservatively as necessary to avoid a repeat of the current crisis.

If we take this new scenario as given, we then have to look at how, under those new conditions, entrepreneurs can get sufficient financing to see their projects through. This challenge is even more crucial in countries like Spain, where bank financing has much more weight than the alternative sources provided by the stock market, today only accessible to a small number of large companies.

Our efforts are now concentrated on how to exit the crisis and on avoiding a repeat experience, but we should also be thinking of how to stimulate economic growth under the new regulatory framework. The global agenda of structural reform should include this challenge of how to encourage high-risk business financing by banks which will inevitably be much more risk-averse than in the past and will find it difficult to hold large sums of risky investments on their balance sheets. Hence the new financial system which emerges from the crisis should also offer alternative non-bank financing to new entrepreneurs and medium-sized firms. Such alternatives sources of financing scarcely exist today, so all of us (credit institutions, governments, regulators and non-financial corporations) will have to contribute our intellectual and other efforts to address a problem which is not significant today but will undoubtedly be so in the future.

Thank you.