

Miguel Fernández Ordóñez: Reform of the financial sector

Opening remarks by Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, at the Third Conference on the reform of the financial sector on the occasion of the 25th Anniversary of Expansión, organised by Expansión and KPMG, Madrid, 13 May 2011.

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Let me first thank Expansión and KPMG for kindly inviting me to take part in this forum on the reform of the financial sector.

Financial system reform is under worldwide scrutiny by multilateral agencies, governments, central banks, supervisors and even public opinion. Their interest is understandable, as the unprecedentedly acute economic crisis in recent years did indeed originate in the financial system. The concern to identify the errors that led us to crisis and, above all, to prevent it recurring is therefore not surprising.

The response to the crisis is largely taking shape in the international arena, given that the main factors at its root have a global reach. Also, many of the measures needed to prevent its recurrence can only be implemented if they are tackled in a coordinated fashion by the main world economies.

In recent years we have also witnessed changes in world economic governance of a speed and on a scale that would have been inconceivable a short time ago. Good examples of this are the work by the G-20, the creation of the Financial Stability Board (FSB), the strengthening of the Basel Committee on Banking Supervision and the changes in the governance structure of the BIS and the IMF.

Highly significant progress is being made in international financial regulation, including most notably the regulatory reform of capital and liquidity (known as Basel III), which will come into force in 2013. Both the reforms already approved and those still under discussion within the FSB are geared to countering the problems identified as lying at the root of the recent crisis. Examples here are the measures aimed at smoothing the cyclical fluctuations inherent in the banking system, namely procyclicality, at restricting high-risk activities, at mitigating systemic risks (in particular those arising from the so-called systemic financial institutions) and at setting in place more rigorous and effective supervision.

To this must be added the efforts made in Europe, both in terms of governance and crisis management in the EU, and of the revision of financial system regulation and surveillance arrangements. In this respect, a new supervisory structure has been set up in the EU, namely the European Systemic Risk Board, which will be entrusted with the surveillance of risks to financial stability. It will be joined by three supervisory agencies covering banking, markets and insurance, which should contribute to providing for much more fluid and efficient coordination among national supervisors.

But apart from this progress on the international and European levels, the crisis has also required national governments to come up with energetic responses at home. This is because not all economies faced the onset of this crisis with the same macroeconomic imbalances or the same weaknesses in their banking systems or supervisory arrangements.

From the start of the crisis, governments in some of the biggest economies were, in addition to compensating for the effects of the tightening – and even closing down – of certain funding markets, obliged to support some of their major banks with public funds. Fortunately, the more strictly regulated and supervised Spanish banking system withstood reasonably well this first wave of the crisis. But that does not mean we were immune to it. The crisis entailed an abrupt decline in world growth and gave rise to major problems on international funding markets which significantly affected the Spanish economy in general, and its banking system in particular.

In the long upturn prior to the crisis, the Spanish economy had built up significant imbalances, such as the external deficit, the increase in private debt and the excessive expansion of the real estate sector. In parallel, weaknesses had been incubating in the banking industry, especially in parts of the savings bank sector. Such weaknesses arose from the rapid growth in credit, the high exposure to the real estate development sector and the increase in capacity, which grew so as to adapt to what were unsustainable rates of expansion. The global crisis broke at a time when the adjustment of the imbalances had just begun, and it contributed to exacerbating their significance.

The measures adopted in the Spanish banking sector have been specifically aimed at countering the weaknesses incubated during the expansionary phase. Undoubtedly, the key challenge has been the restructuring of savings banks, undertaken with the support of the Fund for the Orderly Restructuring of the Banking Sector (FROB). The 45 pre-existing savings banks have since seen their number reduced by two-thirds, in a consolidation process that has affected 95% of the sector's total assets. This has enabled excess capacity in both networks and central services to be cut; it corrects the excessive fragmentation of the sector, which hitherto comprised a large number of institutions whose small size curtailed future prospects; and it allows advantage to be taken of the resources and management capacity of those savings banks which, on the basis of their greater soundness, have led the various integration processes.

Other far-reaching measures have been brought to bear in this restructuring process. For instance, there is the reform of the savings bank regulatory framework, which is allowing for their conversion into institutions more subject to market discipline and better prepared to meet the requirements of the new international regulatory framework. And we have the tightening of provisioning arrangements, which has entailed stricter requirements in respect of asset valuation criteria. I would also like to highlight the efforts to reinforce transparency, through the disclosure of exhaustive information on all Spanish institutions' exposure to assets considered doubtful.

The latest measure of significance was the approval in Parliament of a Royal Decree-Law (RDL), whose aim was to dispel doubts about our banking system. These doubts emerged essentially as a result of the contagion of the mistrust stemming from the sovereign debt crisis in certain euro area countries. Three months later, this RDL may be said to have contributed significantly to allaying fears about the soundness of our banking sector and to substantially speeding through the restructuring of our savings banks. The RDL reinforces the solvency of all Spanish institutions, requiring of them a core capital ratio of at least 8%, with a further 2% required for unlisted banks and those more reliant on wholesale markets, which are those in which the main doubts were concentrated. The RDL also stipulates that institutions receiving public aid should pursue their financial activity through a bank, which will better enable them to obtain funds on markets and will contribute to enhancing their transparency in the face of investors.

The process laid down in the RDL is unfolding as scheduled. All institutions that have applied for aid from the FROB have sent their recapitalisation plans to the Banco de España, and the work on the valuation of these institutions, which will be set by independent experts, is already under way. Of the 13 institutions or groups of institutions that need to reinforce their capital, the four banks will fund themselves on the market, while the savings banks have submitted various strategies, which initially or ultimately include the possibility of obtaining the necessary funds from the FROB, which acts as a backstop that assures the markets that all Spanish institutions will have a core capital ratio of at least 8%.

Now, how and when Parliament has decreed, the final steps to conclude this far-reaching financial restructuring process must be taken.

In sum, Spain may be said to have taken what are to all intents and purposes historic measures to leave its banking system in a position to meet solvent demand for credit when such demand picks up. Recovery should come about sooner if the pertinent reforms are

adopted to lift the obstacles to job creation and to allow our massive jobless figures to begin to be reduced.

I shall close here, since today you are going to have the good fortune to listen to Jean-Claude Trichet, who will surely offer you a much fuller perspective on the response to the international and European financial crisis. It has been a pleasure and a privilege for me to cooperate with him as a member of the ECB Governing Council over the past five years, during times of great complexity for monetary policy and financial stability in the euro area.

In this period I have seen at first hand Jean-Claude's personal and professional qualities. He has shown he has the right blend of firmness and pragmatism required to take difficult decisions at the worst junctures of the crisis. And he also possesses the leadership and communication skills needed to convey a long-term vision of the European project and the central role that the ECB plays here.

During Jean-Claude Trichet's presidency, the ECB Governing Council has displayed the resolve needed to deploy all the instruments available to the common monetary policy and to take timely decisions that help ensure the goal of price stability in the medium term is achieved. Since the creation of the ECB, average inflation has stood just below 2% and inflation expectations have held stable.

The extraordinary scale of the financial crisis has put to the test the responsiveness of the Eurosystem in general, and of Jean-Claude Trichet in particular. Since the start of the crisis a series of bold and well-directed decisions have been adopted. And these have contributed notably to restoring the monetary policy transmission mechanism, which had been seriously damaged, and to preventing an unprecedented collapse of the financial system with incalculable consequences.

With the perspective that the passage of time accords, history will acknowledge Jean-Claude's leadership and his ability to maintain the appropriate degree of flexibility needed to respond to the crisis. These qualities were key to ensuring that the ECB and the Eurosystem were up to the task, contributing decisively, through the discharge of the responsibilities legally entrusted to each, to maintaining financial stability across the euro area.

Thank you very much.