Luis M Linde: Central bank monetary policy, regulatory and supervisory measures

Closing remarks by Mr Luis M Linde, Governor of the Bank of Spain, at the V International Banking Conference/Grupo Santander, Madrid, 14 November 2012.

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Let me first thank Banco Santander, its Chairman Emilio Botín and its Chief Executive Officer, Alfredo Sáez, for inviting me to the closure of this fifth International Banking Conference.

The first of these annual conferences was held in 2008. A review of the matters addressed that year, which now seems distant, and those on the agenda today, reveals a high degree of coincidence.

We are still in the management of the post-crisis and the economic situation is, in some respects, worse than it was five years ago. It is worse in terms of growth or, at least, growth prospects, and worse in terms of unemployment or stock market capitalisation.

The financial crisis, which began in 2007 in the United States and took on a systemic dimension in 2008, following the Lehman Brothers debacle, has confronted the developed countries' central banks with great challenges.

I wish to refer to the central banks' response in two specific areas. Firstly, in respect of monetary policy. And secondly, in the area of banking regulation and supervision.

Central bank measures in the monetary area

In the conventional monetary policy domain, since there was no inflationary risk over the relevant horizon owing to the deterioration of the economic outlook, the central banks' priority has been preventing the disinflationary process in the Western economies from translating into deflation. Back in October 2008, in a concerted move the central banks of the main economics cut interest rates by 50 basis points, and this was followed by further cuts in late 2008 and early 2009. Currently, after an unprecedented monetary impulse, rates stand at one of the lowest points in history.

The narrowing of the room for manoeuvre for conventional monetary policy measures gave a leading role to liquidity-provision policies and the implementation of exceptional or non-conventional measures, aimed at ensuring the transmission of interest rate cuts to agents' financial costs and to facilitating their access to funding.

Since the crisis began in August 2007, there have been numerous innovations in monetary policy implementation. These have involved increasing the number of institutions with access to central bank funding; extending the collateral eligible in monetary policy operations; lengthening the maturities at which liquidity was supplied to the market; and public and private asset-purchase programmes (or loans to the private sector for such purchases). As a result, there has been an unprecedented expansion in the balance sheets of the central banks concerned, and a substantial change in the composition of their assets.

Central bank responses have also tended to adapt themselves to the structure of the respective financial systems, and to the specific dysfunctions and tensions. For instance, the fact that the banking sector plays a predominant role in channelling credit in the euro area economy — compared with the Anglo-Saxon model which is underpinned to a greater extent by the capital market — was from the outset a distinguishing feature in the design of the ECB's response. Also, set against the strategies deployed by the Federal Reserve or the Bank of England, based principally on "quantitative easing", the Eurosystem's response has been more complex over time, adapting itself to the difficulties that have arisen at the different stages of the euro area crisis, though seeking always to act on the segments of the transmission monetary policy mechanism that were seen to be most impaired.

The perception that the interbank market had ceased to operate as an efficient liquidity distribution mechanism between banks meant that the liquidity-provision policy had to become more flexible. And, when the crisis worsened in September 2008, far-reaching changes had to be made to the monetary policy operational framework, to allow the ECB to meet the system's gross liquidity needs, with a substantial expansion of the size of its balance sheet.

Later, when the financial crisis became one of sovereign debt, and most especially, when it turned systemic in the summer of 2011, the ECB had to approve further non-conventional measures that reinforced its position as intermediary in the distribution of liquidity. It substantially lengthened the horizon of its loans, up to three years, when it injected more than €1 billion in gross terms in two auctions in December 2011 and February 2012.

In sum, the financial crisis compelled central banks to adopt, along with robust monetary policy responses, exceptional measures and an unprecedented expansion in their balance sheets. Central banks have been decisive in preventing, even though not always with total success, the deflationary risks that characterised other major financial crises in the past.

Measures in the regulatory and supervisory areas

The financial crisis has triggered fundamental changes in the international financial system's regulatory architecture.

Since the first G20 meeting in November 2008 in Washington, work has advanced on many fronts. I shall refer to two in particular. First, the changes in the prudential regulation of solvency, the move from Basel II to Basel III. And second, the progress in what has become known as macroprudential supervision.

As we know, the financial crisis especially affected banks and, in particular, certain global systemic banks. The response of international banking regulators has had to be commensurate with the dangers of the crisis and with the cost of the crisis to taxpayers.

Basel III is a complex set of measures that attempts to respond to the regulatory failings that the crisis highlighted. First, many banks found themselves at the start of the crisis with low levels of capital. Second, this same capital had an excessive proportion of hybrid instruments, with a limited or, at least, uncertain loss-absorption capacity. Third, and finally, the procyclicality of Basel II meant there was a trade-off between capital requirements and growth, which could push banks to lessen the risk they assume, with the subsequent adverse impact on credit and the economy.

Basel III has increased the minimum level of core capital, the highest-quality capital, to 4.5% from 2% under Basel II. On top of this minimum, Basel III has added a capital conservation buffer of 2.5% and established a connection between banks' dividend policy and compliance with this minimum capital level. Accordingly, to avoid any interference by the supervisor in their dividend policy, banks must at all times hold a minimum level of top-quality capital of 7%.

For the first time, too, Basel III has added a macroprudential component to capital levels. The countercyclical capital buffer could entail an additional capital requirement of up to 2.5%. Building up a capital buffer in good times, with the aim of depleting it in not so prosperous times, is a macroprudential mechanism that will help reduce the contraction of credit when there is a recession, and temper the growth of credit in upturns. However, calibrating the buffer is no easy task.

As governor of the Banco de España, allow me to point out how, in its economic significance, this countercyclical buffer is close to the so-called "dynamic provisions" the Banco de España established more than 10 years ago — with, I should say, less success than, we now know, would have been optimal. We believe this countercyclical buffer is a good instrument and we advocate its use as a new macroprudential instrument.

The fact that many ailing banks have been systemic banks has been another consideration influencing supervisors' stance as to what the response to the crisis should be. Consequently, another significant change in banking regulation arrangements is to set in place a capital surcharge for global systemic important banks (GSIBs). A global important bank is not only a large bank. It is a major bank with significant cross-border activity, a complex bank in terms of its structure, and an interconnected bank that is not liable to be replaced in certain markets.

Regarding global systemic important banks, I should also mention the so-called "recovery and resolution plans". It is important to highlight the value of this instrument in reducing systemic risk and also a formula for taking into account differences between business models in regulation and supervision.

One of the final components of Basel III is the leverage ratio, which should be seen as a complement to the risk-based regulatory framework. Its primary aim is to respond to the underpricing which may exists in the model-based calculation of risk, in particular trading book risk.

Basel III has entailed a considerable effort of convergence, at least regarding the calculation of the capital ratio numerator. However, we should strive to achieve greater convergence also in the calculation of the denominator. Some analysts and regulators, and some banks too, have pointed out that there are differences in the calculation of risk-weighted assets that are not the result solely and exclusively of differences in levels of risk. It would be frustrating if all efforts to strengthen capital levels were weakened by excessive disparities in the calculation of risk-weighted assets across different banks and countries.

Lying outside the Basel III framework are, finally, the possible structural reform of banking models, where we already have rules, such as the so-called Volcker Rule; proposals whose implementation is under way, such as those of the Vickers Commission in the United Kingdom; and the more recent proposals by the European Union's Experts Group, chaired by my colleague Erkki Liikanen. All these measures or proposals come down to different formulas to separate the riskiest banking activities, from the more traditional and less risky ones. The differences between Volcker, Vickers and Liikanen are in the formula for achieving this segregation and in its degree of complexity. This will never be a simple matter, given the need for banks, even those with simple business models, to pursue some trading activity linked to the services offered to their customers. However, the group chaired by Governor Liikanen has come out with the simplest proposal.

The second element of the reform of the regulatory framework is that of macroprudential supervision.

While microprudential supervision concerns itself with individually considered financial institutions, macroprudential supervision contributes to financial stability by identifying, monitoring and mitigating the risks that may affect the financial system as a whole.

While such a concept may not be entirely novel, this crisis has underlined the absence of macroprudential authorities with well-defined mandates in this field and clearly defined intervention instruments. The main advanced economies have set up macroprudential authorities such as the Financial Stability Oversight Council (FSOC) in the United States and, in the United Kingdom, the Bank of England's Financial Policy Committee. I would just mention that at the Banco de España, too, we have begun work to accommodate our organisational structures to the needs of the macroprudential approach.

Thank you very much for your attention.