

Luis M Linde: IV Meeting – Financial System Reform

Speech by Mr Luis M Linde, Governor of the Bank of Spain, at the inauguration of the meeting on “Financial System Reform” organised by Expansión, Madrid, 9 July 2013.

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Introduction

It is an honour for me to participate in the inauguration of this meeting on “Financial System Reform”, organised by Expansión.

Given the agenda and the list of participants, this meeting will be an excellent opportunity for players in the Spanish financial system to review the latest developments and to assess, from the standpoint of their own institutions, the more immediate future.

The future of our financial system and of our banks will necessarily be framed within the new international regulatory system, whose design has been under way since the international economic and financial crisis broke six years back, in 2007.

This crisis, whose consequences have clearly not yet been overcome, has given rise to numerous initiatives. Various international financial organisations, public and private alike, including the International Monetary Fund and the Bank for International Settlements, have been involved in studying and addressing such initiatives.

But we should mention, above all, the establishment of new institutional frameworks. These include most notably the creation of the Financial Stability Board (FSB), which was promoted by the G20 and has assumed a key role in designing and coordinating international financial reform.

We have also seen the main economies create institutions entrusted specifically with overseeing the financial system from a macroprudential perspective. Notable examples are the Financial Stability Oversight Council in the United States, the UK Financial Policy Committee and the European Systemic Risk Board (ESRB) in the EU.

I shall focus in my address on the proposals by the FSB and the Basel Committee on Banking Supervision, which has worked under its guidelines. I shall refer to four broad issues which I consider to be most important in the new regulatory framework being designed.

Firstly, the entry into force of the new capital rules known as Basel III, the basic thrust of which, as we all know, is to strengthen banks’ capital; second, the new treatment of systemic banks and the new banking resolution frameworks. Here, I shall comment on potential reforms to banking business models, which we normally call “structural reforms”. And finally, I shall refer to outstanding accounting issues, with significant consequences

for bank balance sheet management, geared to achieving the sought-after convergence between US Financial Accounting Standards Board (FASB) rules and the International Accounting Standards Board (IASB) criteria applied in Europe.

The entry into force of the new Basel III capital accord

One of the key elements of the new regulatory framework is the amendment of the prudential rules governing the banking sector by means of the agreement we refer to as “Basel III”. The adaptation of this accord to the European arena came about just a few days ago with the approval of the new Capital Requirements Directive.

Among other things, the application of Basel III will entail an increase in the minimum level of core capital, which will rise from 2% to 4.5%, and the creation of a capital conservation buffer of 2.5%. Accordingly, banks must at all times maintain a level of high-quality capital of, at least, 7% of risk-weighted assets. In addition, there will be a countercyclical capital buffer of

up to 2.5%, which for the first time introduces a macroprudential component into the regulation of capital levels, whose ultimate aim is to smooth the fluctuations in credit over the course of the cycle.

The new Basel III framework further includes other important additions. These include most notably the introduction of a leverage ratio in which assets will not be risk-weighted and the introduction, for the first time, of liquidity requirements. On one hand, the *liquidity coverage ratio* will require banks to hold a sufficient volume of liquid assets to withstand scenarios of tension. On the other, the introduction of a *net stable funding ratio* is envisaged, whose aim is to limit maturity mismatches.

The new regulation envisages that these new standards, to which the changes in the definition of capital must be added, will be applied progressively, such that the transition period will finalise in 2019. The aim is to prevent the strengthening of banks' solvency from being achieved at the expense of a reduction in the financing that banks provide to the economy as a whole.

However, there is pressure in the markets for banks to comply ahead of schedule with the requirements laid down in Basel III. In many countries, moreover, a weak macroeconomic scenario contributes to increasing bad debts, making a case for sufficient buffers being in place to absorb the losses that may materialise.

Banks should therefore use the room for manoeuvre they have to strengthen their capital, dispelling any existing doubts about their ability to comply with the new requirements on schedule. But it should also be said that the early full application of the new requirements in the short term, in an economic environment such as the present one, would prove excessively procyclical.

The regulation of systemic banks

The second key aspect of the regulatory reform promoted by the FSB has been the creation of a new framework for the treatment of "systemically important" banks.

Systemically important banks are those whose bankruptcy might trigger serious problems in the global financial system owing to their size, complexity and interconnectedness. The problem they pose arises from the fact that, in the absence of an appropriate legislative framework, the threat of their bankruptcy often leaves no other option to the authorities than to bail them out, which may involve major costs for taxpayers.

In response to this problem, the FSB designed a framework for the treatment of these banks. Its starting point was the definition of a methodology to identify them and the publication in November 2011 of a list drawn up in accordance with this methodology.

This was followed by regulatory capital requirements additional to those applicable to the rest of the sector. The latest FSB list, which includes two Spanish banks (Santander and BBVA), establishes different tranches, depending on the capital surcharges they must meet, which range between 1% and 2.5%.

Under the Basel III framework, these additional requirements will begin to be applied in 2016 and full implementation must be attained by 2019.

The need for effective resolution frameworks

Another key ingredient of the new framework for the treatment of systemic banks is the obligation for them to draw up effective recovery and resolution plans, and the introduction of legislative arrangements that allow their effective application.

In 2011 the FSB published a set of so-called *Key Attributes* with which the resolution regimes of each jurisdiction must comply.

In Spain, Law 9/2012 of 14 November 2012 on the restructuring and resolution of credit institutions introduced a regime which brings forward several of the resolution-related elements required by the FSB.

More recently, just some days back, the Ecofin reached agreement on the draft Directive on the resolution of credit institutions, which marks a crucial advance towards the implementation across Europe of the FSB's resolutions.

This draft Directive, which is still pending approval by the European Parliament, seeks to give national authorities the powers and instruments for heading off banking crises and for the orderly resolution of any credit institution. The draft Directive establishes an array of instruments with which to tackle banking crises in three phases or stages: in the preventive stage, in the case of early intervention and in the case of resolution.

In the preventive phase, banks must draw up recovery plans in the event that their situation should significantly worsen. The authorities will, in some cases, be empowered to appoint managers at banks. The principal resolution measures would be the sale of part of the business; the establishment of bridge banks for the temporary transfer of healthy assets to a bank controlled by the public sector; the segregation of assets through the transfer of impaired assets to a management vehicle; and measures that impose losses on shareholders and uninsured creditors, known as a bail-in as opposed to a bail-out, which involves or usually involves the assumption of losses by the public sector.

The bail-in tool will allow the resolution authorities to cancel or convert into capital the entitlements of the shareholders and creditors of banks that are insolvent or close to insolvency. Under the decision by Ecofin, the deposits of individuals and of small and medium-sized enterprises, along with liabilities to the European Investment Bank, will have preference over uninsured creditors and over the deposits of large corporations. The Deposit Guarantee Fund will at all times make good any guaranteed deposits, i.e. those of less than €100,000, which will have greater seniority or preference over other deposits. In any event, the bail-in will exclude, inter alia, insured deposits, i.e. deposits of less than

€100,000; secured liabilities, such as covered bonds; and liabilities arising from participation in payment systems, along with interbank liabilities with an original maturity of less than seven days.

The draft Directive further requires Member States to set up ex-ante resolution funds. These funds will be used to temporarily support banks under resolution by means of loans, guarantees, asset purchases or capital for bridge banks. They will also be used to fund what may be called an "element of flexibility" of the Directive, which I shall refer to in a moment. Over the next 10 years these funds must be built up to a volume equivalent to at least 0.8% of the insured deposits of the country's credit institutions. In this connection, banks must make annual contributions based on their liabilities. The draft Directive leaves to the discretion of the Member States the matter of whether resolution funds and deposit guarantee funds are merged or kept separate.

Finally, as I said earlier, the Ecofin agreement introduces an "element of flexibility" so that national resolution authorities, in certain exceptional cases and subject to strict criteria, may fully or partially exclude any category of liabilities from the bail-in, and use the resolution fund to finance this exclusion. However, as a general rule, they may only resort to such flexibility after losses have been imposed on shareholders and creditors for a minimum amount of 8% of the total liabilities of the bank subject to resolution. Moreover, the possible contribution of the resolution fund in substitution of other creditors may not exceed 5% of the bank's total liabilities.

The draft Directive is, in general terms, satisfactory. Firstly, it establishes a relatively harmonised resolution framework which has been non-existent to date. Secondly, while it was necessary to introduce the above-mentioned "element of flexibility" in order to reach agreement, the room for manoeuvre will be limited. Thirdly, the 8% of total liabilities that will

be subject initially to the bail-in, is liable to be covered relatively comfortably by capital and subordinated debt. Finally, the agreement affords security to deposits. Deposits of over €100,000 would only be subject to bail-in once they reach 13% of a bank's total liabilities and, even then, they might not be affected, given the possibility of funding by the European Stability Mechanism envisaged in the draft Directive.

In short, along with the Single Supervisory Mechanism, this greater harmonisation of national resolution regimes is one of the fundamental pillars of the future European Banking Union.

To conclude on the treatment of global systemic banks, it will be necessary to create, for each of them, Crisis Management Groups. It is envisaged that these Groups will conduct before 2014 an initial review of the viability of the resolution plans of the systemic banks included in the November 2011 list.

Structural measures

As a complement to the efforts to date regarding systemic banks, the authorities in several countries have adopted or are considering adopting reforms involving changes to banking business models, with legal restrictions on the size of credit institutions or the activities they may pursue. Examples of this are the Volcker rule, introduced in United States; the measures considered by an independent commission chaired by John Vickers in the United Kingdom; and the proposals of a group of experts chaired by the Governor of the bank of Finland, Erkki Liikanen, in the European Union.

Broadly, these measures seek to restrict the size of banks or to simplify their structure, segregating specific activities which are considered essential, such as taking deposits, from potential losses in other banking business areas, especially those related to trading. These reforms might help reduce the complexity and size of banks, and their interconnectedness with the so-called shadow banking system. They would thus contribute to facilitating bank management and supervision, and, where necessary, to simplifying bank resolution.

However, these proposals and the measures considered have so far remained outside the coordination of the Financial Stability Board. As a result, the main jurisdictions have drawn up their proposals in isolation, and there are significant differences between them.

For instance, there is no consensus on the boundaries of the activities to be segregated or on the legal procedures to do so. While US deposit-taking institutions may continue to engage in market-making activities, European Union and UK proposals would make it necessary for some separation of these lines of business. And there are various legal formulas to ring-fence the different activities, ranging from mandatory total separation in the United States to the obligation to create financially independent subsidiaries within the same group in the proposal being discussed in the European Union.

There are indeed doubts, which the Banco de España considers reasonable, about the advisability of implementing these initiatives, at least under their current design.

First, interaction with the other regulatory processes under way should be carefully analysed. The objectives of the structural measures largely coincide with those of the FSB's work on the treatment of systemic banks.

Second, consideration should be given to the consistency of the reforms proposed at the international level. In this respect, the new structural reform measures should be prevented from introducing unwarranted differences in the treatment of similar activities. Accordingly, the debate on these types of measures should be global in scale rather than national or regional, possibly taking place within the framework of the FSB discussions.

There is also a risk that divergences in structural reform models may lead to a greater fragmentation – or, if you will, to a certain re-nationalisation – of financial activity.

Lastly, the possible implications of these measures for the structure of the financial system should be taken into account. In particular, their application should not entail a shift of the riskiest activities to the shadow banking system.

In sum, before introducing new structural measures, their costs and benefits should be evaluated from a global perspective, bearing in mind progress in other areas of regulatory reform, especially those concerning new resolution frameworks and the treatment of systemic banks.

In any event, it seems reasonable to observe the principle that regulation should impose stricter requirements on the riskiest activities. A clear distinction should be drawn between banks whose trading volume is relatively small and geared chiefly to providing services to their customers, and those other banks with a more marked risk profile.

Strengthening of and convergence in accounting standards

The last issue I wished to address concerns accounting rules. In April 2009, the G20 called on the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) to adopt measures to strengthen and more closely align their respective standards. As a result, the treatment of business combinations and the consolidation of financial statements have been reviewed, with particular emphasis on the specific features of special-purpose vehicles. Work has also been done on defining fair value and on the criteria to be taken into account in its determination.

However, accounting standards-setters have not yet reached agreement on the treatment of impaired financial assets (through credit risk provisions, as they are traditionally called). Following lengthy debate, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) have issued two separate “expected loss” models, which are currently being deliberated on.

There is one significant change: compared with the current “incurred loss” model, both opt for earlier recording of losses and accept considering estimated or expected losses. To calculate them, they include reasonable forecasts of economic conditions and future events. The discrepancy does not therefore lie in the amount of the estimated losses, but in the time at which they are recognised. The IASB proposal defers recognition of a portion of the losses to the time at which a significant impairment in the credit quality of the assets becomes apparent, whereas the FASB proposal limits banks’ discretionality, obliging them to recognise all the expected losses that may reasonably be estimated. At the Banco de España, we understand that, in principle, the latter proposal responds more closely to the requirement of the G20, which has expressed concern about the procyclical nature of the current regulations.

Conclusions

Allow me to conclude by highlighting the unprecedented effort being made in international coordination of financial regulations and the role of the Financial Stability Board and the Basel Committee. Throughout the crisis there have been signs of a re-nationalisation of financial markets, and some supervisors have, at specific times, adopted protectionist measures entailing little or no coordination with other supervisors. Admittedly, though, the bulk of the regulatory initiatives have come from the reinforced international cooperation led by the FSB.

It is essential that this cooperative approach should be maintained in the future. Otherwise, we would run the risk of seeing the degree of integration of financial systems slip backwards, and that, along with the trade protectionism we have so far managed to avoid, would be a most negative consequence of the crisis.

Thank you for your attention.