

## Luis M Linde: Key issues on today's banking industry

Closing speech by Mr Luis M Linde, Governor of the Bank of Spain, at the 6th Santander International Banking Conference, Madrid, 5 November 2013.

\* \* \*

I would like first to give my thanks to Banco de Santander for inviting me to take part in this final session of your 6th International Banking Conference, an excellent opportunity to review and assess key issues on today's banking industry, which has to face, in the next few years, important regulatory and operational changes.

I will comment on several elements of the new Basel III capital framework that remain contentious or are still open to discussion. Among those, the leverage ratio, the liquidity ratio and the very important issue of consistency in implementation. Then, I will move on to the Financial Stability Board's work on resolution strategies and, finally, I will comment on the European Union Bank Recovery and Resolution Directive (BRRD), and one of the most important elements it contains, the bail-in tool.

First, the **leverage ratio**, the ratio between Tier 1 capital and total balance-sheet and off-balance-sheet exposures not deducted from the calculation of Tier 1. This ratio is set, in principle, at a minimum of 3%. Its entry into force as an obligatory Pillar 1 ratio is foreseen to be in 2018.

This new tool has been designed as a simple, transparent measure, not linked to risk, complementing and acting as a floor with respect to the risk-based minimum capital ratio. It seeks to reduce excess leverage in the banking system, and to afford an additional measure of protection against the so-called "model risk", i.e. against the risks associated with the use of sophisticated models allowed under Basel III.

There are still doubts about this ratio as a Pillar 1 measure. I understand that the doubts do not concern the concept, but, rather, its final calibration and how it will impact on specific business models, in particular, those most focused on retail activity.

Moreover, it is not fully clear whether the best option will be a single percentage for all banks, irrespective of their size or business model; or whether it would be better to opt for different percentages, depending on the type of business or activity of the bank; or to establish a range within which the supervisor would have discretion to decide which figure applies best to specific institutions.

We believe that this new ratio can be a good prudential tool, once it is correctly calibrated. European regulations envisage that countries may apply the leverage ratio as they consider best until its harmonization in 2018, but the Banco de España does not consider necessary to bring forward its entry into force.

With regard to **liquidity regulation**, Basel III has included, for the first time, a short-term liquidity ratio (LCR) which seeks to ensure that banks have a buffer of high-liquidity assets equal to 100% of foreseeable liquidity requirements for, at least, 30 days.

The initial design of this ratio was too demanding and, perhaps, not realistic. 2015 for full implementation was clearly too early a date. Another controversial element was the definition of the "high-quality liquid assets" to be included in the numerator. However, after the review agreed by the Basel Committee in January, the ratio definition should be now fairly stable.

It should be noted that, rather than a minimum ratio that has to be met at each point in time, such as the capital or the leverage ratios, what is involved with this new liquidity ratio is the setting up of "liquidity buffers" that can be used in times of need. Hence, although the minimum level is set at 100%, a bank could maintain a lower level at stressed times, but should inform the supervisor, in order to agree on a plan to restore the required minimum level.

As in the case of the leverage ratio, the short-term liquidity ratio does not come into force immediately. We are now – the present year and next – in an observation period that needs to be used for its fine tuning. At the end of this period, the ratio will be phased in from 2015 – when it will be required at the 60% level – to 2018, when it will fully apply. However, this timetable may be accelerated at national discretion.

In this regard, Banco de España does not consider necessary to accelerate the implementation timetable, although we believe that banks should make reasonable efforts to comply with the liquidity ratio as soon as possible.

**To sum up:** We support banking prudential regulations incorporating liquidity ratios such as those proposed. We are aware that this will entail a major effort for banks, mainly because it demands changes in their management of this risk. Spanish banks must be active in improving balance sheet structures.

I would like to conclude my comments on Basel III by referring to the importance of ensuring that ***it is implemented in a consistent way across institutions and across countries.***

This objective is framed in a project undertaken by the Basel Committee to ensure that the benefits of having risk-sensitive regulation, like Basel III, are not achieved at the cost of an ***extremely complex legislation*** which, apart from other problems, brings about results that are not comparable across banks.

The Banco de España agrees with this initiative. We are in favor of simplifying current regulations, seeking an appropriate balance – indeed, always a difficult balance - between simplicity, comparability and risk sensitivity.

So, we view very positively the ***transparency*** exercise carried out by the Basel Committee, with the publication of the results of the comparative analysis of banks' calculations of risk weighted assets, both in the banking and in the trading book.

These exercises have identified significant differences which would not cause concern if they were due to real factors, meaning different type of business or risk profiles. There would be a cause for concern if the conclusion of such work still undergoing, together with other initiatives taken by the European Banking Authority, showed that those differences were largely due to differences in the application of the internal models approved by supervisors. In this vein, I think that the Single Supervisory Mechanism, once fully operational, will bring a higher degree of harmonization across the euro zone.

The results of this exercise demand for the Basel Committee taking measures to reduce those differences, so that the credibility of the solvency ratios is not called into question. However, these measures should not go to such an extreme as to abandon the use of internal methods for calculating capital requirements: these models have been useful for improving banks' internal management of risk. We think that the solution may lie along the line of using as a reference for the internal models more standardized models, based on parameters determined by supervisors.

Let me now move on to the debate on ***Resolution of financial institutions***. I will first refer to the Financial Stability Board's work, dealing with resolution strategies and loss absorbing capacity.

The FSB has developed a framework to address the ***“too-big-to-fail”*** (TBTF) problem associated with ***“global systemically important financial institutions”*** (G-SIFIs). As we know, this framework is based on four pillars: an enhanced supervisory intensity; the requirement of a higher loss absorption capacity; the existence of effective resolution regimes; and an improved resilience of market infrastructures.

Substantial progress has been made in implementing this framework. In particular, the so called ***“Key Attributes of Effective Resolution Regimes for Financial Institutions”*** have been endorsed by the G-20 as a new international standard.

Substantive reform has been implemented or is going to be implemented soon in the main jurisdictions in which G-SIFIs operate. In Spain, Law 9/2012 adopts and implements many of the principles set forth in the “Key Attributes”. In the European Union, the Bank Recovery and Resolution Directive is expected to be adopted later this year. It will be an important step towards full implementation of the “Key Attributes” in all EU Member countries.

The two main new elements of this new framework are, first, planning for orderly resolution; and, second, the scope of the resolution tool known as “bail-in”, which is linked to the existence of an adequate level of loss absorbing capacity in each G-SIFI.

Work on resolution planning is currently under way within Crisis Management Groups (CMGs), now set up for all the G-SIBs. There has been considerable progress in developing resolution strategies and identifying conditions relating to the firms’ legal, operational and financial structures and their impact on resolvability.

I would now like to comment on the resolution strategies being developed for global banking groups. These strategies are broadly based on two approaches:

- The one called “single point of entry resolution” (SPE groups), in which resolution powers are applied at the top of the group by a single resolution authority;
- And the one called “multiple point of entry resolution” (MPE groups), where resolution tools are applied to different parts of the group by two or more resolution authorities acting in a coordinated way.

Of course, the choice of the strategy needs to take into account the structure and business model of each banking group.

A “Single Point” strategy may be better suited to a firm that operates in a highly integrated manner (through, for example, centralised liquidity, trading, hedging and risk management). On the other hand, an “Multiple Point” strategy may be suitable for financial groups with a decentralised structure and greater financial, legal and operational separation along national or regional lines, with sub-groups of properly capitalised, self-funded subsidiaries, which have enough managerial resources as stand-alone businesses.

The feasibility and credibility of the “Multiple Point” strategy will mostly rely on two main issues:

- First, an effective cross-border coordination based on the cooperation agreements, the resolution plans and with the involvement of the resolution authorities of the main jurisdictions in which the groups operate.
- Second, a balanced loss absorbing capacity allocation across the group, according to local business risk profile in each jurisdiction.

Both elements will mitigate the risk of financial fragmentation due to non-coordinated measures taken by the different authorities, namely, “ring fencing” initiatives.

***Spanish G-SIBs fully comply with the pre-conditions to be considered “Multiple Point” groups:*** they are organised through local retail banking subsidiaries; critical economic functions, e.g. payment systems, are organized at the local level; subsidiaries are self-sufficient in capital and funding; and they rely on separate firms detached from the bank for operational support, for instance, on information systems.

So, although there are still many issues to be clarified, we think that the most realistic resolution approach for the Spanish international banking groups is the “Multiple Point” strategy, provided that, in the event of resolution, their organisational and financial structures are suitable for healthy parts to be sold or maintained as a surviving group, split from their distressed sister companies, using other resolution tools such as asset transfers or bridge banks.

Now, I will go to the second main element of the new framework, the bail-in instrument.

Next year, most of the FSB work on resolution will focus on preparing proposals on the **adequacy of G-SIFI loss absorbing capacity** in resolution, namely, what we call “gone concern loss absorbing capacity” or GLAC. This concept is similar to the Minimum Requirement of Eligible Liabilities (MREL) set up in the EU Bank Recovery and Resolution Directive.

This G-SIFIs loss absorbing capacity is a complex matter, involving the need to clarify or determine a long list of questions, for instance: its characteristics, minimum amount, intra-group distribution and triggers for it, enforceability of bail-in; regulatory limits on loss absorbing holdings, and disclosure.

Let me underline that a shared view on the characteristics and levels of this “loss absorbing capacity” is critical for a “level playing field” among G-SIFIs. Also, we must avoid any approach that might be considered as an additional layer of differentiated capital requirements, a sort of differentiated “Tier 3” requirement.

As I mentioned before, determination of the appropriate levels of GLAC must be dependent on the complexities and risk of the activities developed by each institution. The approach currently being worked out in the European Bank Recovery and Resolution Directive, in terms of both identifying characteristics and specific levels or of “eligible liabilities” is, in our opinion, a correct approach to the problem.

Now, my last point, the discussion in Europe regarding the European Union bank recovery and resolution directive and the entry into force of the bail-in arrangements included in that directive.

Although still under discussion, the Bank Recovery and Resolution Directive bail-in is to be introduced in a sequenced way. Bail-in of regulatory capital instruments will be applicable from the moment the Directive is transposed, while bail-in of senior creditors can be postponed to 2018, depending on each Member State.

Since we are also moving forward in setting-up a Single Resolution Mechanism [SRM] for the 17 Member States that share the Euro, an agreement has to be reached on the moment in which bail-in of senior creditors becomes applicable, as rules have to be the same to all Euro-members.

In this regard, it is important to note that, while sharing the main objective of bail-in, many of the Eurosystem Central Banks, including Banco de España, have shown concerns on the early application of bail-in tools for senior creditors, due to its potential destabilizing effects. We would advise against too short a sequencing.

I will finish my address of today saying that my guess for 2014 related to banking regulation and supervision, is that it is going to be a “fully loaded” year for the industry, and for national authorities and supervisors.

I wish all of you good luck and good courage, and for all our visitors, a happy stay in Madrid.

Thank you for your attention.