Fernando Restoy: European reform – challenges for the Spanish banking sector

Presentation by Mr Fernando Restoy, Deputy Governor of the Bank of Spain, of Issue no 137 of Papeles de Economía Española "Constructing a Banking Union", Fundación de las Cajas de Ahorros (FUNCAS), Madrid, 11 November 2013.

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Good evening. Thank you, José María, for your introduction. I am delighted to be here on the occasion of the publication of Issue no. 137 of *Papeles de Economía Española*, under the title "Constructing a banking union". I understand it contains articles of great quality and interest, which is no surprise considering the calibre of the contributing authors.

During the seminar this evening, I imagine you will have dealt in depth with the main elements of the Banking Union project.

Allow me to add my own thoughts on the significance of this process and its consequences for the banking industry.

I believe the history of European integration categorically illustrates how this process has been subject to diverse and complex forces that reiteratedly test its ability to move forward. These destabilising forces usually arise from the interaction between exogenous shocks and internal structural deficiencies. During the most recent bout of instability, this has again been the case: the international financial crisis has revealed substantial structural flaws within the monetary union, allowing marked imbalances to emerge in national economies and making their correction difficult without upsetting the stability of the common monetary area.

As in the past, in this latest episode the structural deficiencies identified are partly linked to a deficit of cohesion among the national economies that can only be remedied through further relinquishing of sovereignty.

Perhaps the relative novelty of the recent crisis in the monetary union is that it shows, with particular seriousness, that any delay or lack of resolve in adopting the necessary reforms would not only be harmful to European construction but would generate very pronounced risks to economic and financial stability in Europe and the rest of the world.

Admittedly, major reforms to monetary union governance have been made to date. I refer, for instance, to the new requirements made of domestic policies to contain macroeconomic imbalances in several areas, to the surveillance mechanisms established for these requirements and to the setting in place of national crisis-management systems, with centralised financial support arrangements for those countries most affected.

However, such progress is not sufficient to ensure the proper functioning of a common monetary area.

One of the main manifestations of the shortcomings observed is the continuing market fragmentation within the euro area. This is, namely, the existence of a country-risk component that means that markets assign different valuations to similar financial assets on the basis of the issuer's nationality.

In particular, the perceived risk of financial institutions' liabilities depends to some extent on their geographical location.

This fragmentation has quite considerable consequences in terms of differences in the borrowing costs for households and firms according to their geographical location, which reflects the deficient functioning of the common monetary policy transmission mechanism and leads to highly destabilising imbalances between countries. This is why the banking union – whose aim is none other than to ensure the disappearance of the country-risk component of banking liabilities – has been seen as essential to ensure the stability of the monetary union, radically altering the European authorities' set of priorities. What is today a reasonably well-defined project was but a short time ago a mere concept in the minds only of the most visionary pro-Europeans.

Single supervisory mechanism

The first step towards creating the banking union is the start-up of a ***single supervisory mechanism***, the Regulation for which has recently been approved. We cannot overstate the importance of this milestone: according to the Regulation, in less than one year the financial system of the euro area countries – and of the other EU countries that should decide to join – will come to be supervised by the single mechanism set up within the European Central Bank. In particular, significant banks – which account for 80% of the sector – will be directly overseen by the new European supervisory authority.

The single supervisory mechanism has been defined as an integrated system of surveillance of financial institutions under the clear leadership of the ECB, which in turn benefits from the supervisory experience of the competent national authorities. Specifically, the ECB assumes all the relevant powers in respect of the supervision of credit institutions, and exercises them through decision-making arrangements centralised in a Supervisory Board on which both the ECB and the national supervisory authorities sit. The latter contribute, according to the Regulation, to the preparation and application of the decisions taken in a centralised fashion. The work of the national authorities will be channelled through what are known as the Joint Supervision Teams. These teams, which will regularly monitor each institution, will be made up of supervisory staff from the ECB and from the national authorities. Regular on-site inspections will, as a general rule, be conducted by the national authorities, following centrally set mandates and arrangements.

As you can imagine, the work ahead over the coming months will be very intense. Having to assume supervisory powers in scarcely one year will make great demands in terms of organisation. Specifically, several groups made up of staff from the ECB and the national authorities have been set up in Frankfurt and are pushing ahead with the extensive groundwork. Currently, the focus is on defining the scope of conduct which will determine the internal organisation of the single mechanism, on developing a supervisory manual and on designing an exhaustive analysis of the situation of each of the banks that will be directly supervised by the single mechanism.

This analysis of banks' balance sheets is three-pronged: i) an evaluation of the risks for supervisory purposes, ii) an analysis of asset quality and iii) a stress test to be conducted in collaboration with the European Banking Authority. The aim is to obtain a score for each bank as a joint result of the three parts of the analysis. On this basis, specific supervisory actions will ensue, including where appropriate the requirement of additional capital for banks that do not meet the solvency requirements set.

It is still somewhat premature to specify the details of the exercise. I would, however, like to stress the importance of the asset quality review – which focuses on substantiating their appropriate valuation in accordance with accounting principles – as a centrepiece of the analysis of the banks. The study will comprise a wide-ranging review of the banks' balance sheets as at 31 December 2013, which will include credit and market exposures, on- and off-balance sheet assets, and domestic and international exposures. All assets are potentially subject to review, although on the basis of a risk-based approach, the asset quality analysis will focus on those balance sheet items of the various banks that are considered most important under the objectives of the exercise.

Demanding capital thresholds have been set for this component of the exhaustive analysis. Specifically, the reference value has been set at 8% in respect of top-quality capital (CET1) under the definition of the Capital Requirements Directive and Regulation that incorporate the Basel III Accord into European legislation. This 8% threshold is equivalent to adding, to the regulatory minimum of 4.5%, the capital conservation buffer of 2.5% and an additional

1% to reflect the systemic importance of the significant institutions that will be overseen by the single supervisory mechanism.

Finally, strict governance arrangements have been set for conducting the analysis, so as to provide for the consistency of the work performed by the national authorities in each jurisdiction. In this way, although the exercise will be carried out in a decentralised fashion, a significant central structure – with the involvement of external advisers – has been set up to ensure the maximum possible degree of uniformity.

Evidently, it is a complex exercise posing numerous organisational challenges, and which must be performed with the utmost rigour to meet the objectives set and, above all, to ensure the comparability of the results obtained for each bank in each jurisdiction.

Naturally, since the exercise aims primarily to strengthen confidence in the European banking sector, it is vital that the European authorities should determine as soon as possible the formula to be used to cover the potential capital needs arising from the exercise, for those banks that cannot do so through their own means.

Single resolution mechanism

Yet if, as I said at the outset, we want to put an end to the current market fragmentation and to bank liabilities being valued differently depending on their location, the unified supervision of banks is not enough.

These liabilities also need to be treated similarly – irrespective of the jurisdiction under which they fall – if banks experience acute solvency problems. Thus, the banking union requires, as indicated by various authors in the issue of *Papeles de Economía Española* presented today, the adoption of a single resolution mechanism for non-viable institutions. In the past, supervisory authorities responded to banks' solvency problems following the principle of constructive ambiguity. Hence, except for guaranteed deposits, there was no specific legal framework for the treatment of banks' liabilities, should a bank experience solvency problems, aside from commercial law provisions on insolvency.

However, to prevent the undesired systemic effects of a disorderly bankruptcy of a bank, public authorities have traditionally used discretionary power to protect holders of bank liabilities (mainly deposits and debt) through capital injections so as to avoid the winding-up of these institutions.

One of the lessons of recent crises is that the principle of constructive ambiguity has become considerably weaker. Public authorities – at least in Europe – have tended to come to the aid of weak institutions, thus confirming the existence of an implicit guarantee for banks' liabilities. This guarantee distorts the incentive system for the managers of banks and for their creditors, generating considerable costs for the public finances of the countries concerned.

A key factor in encouraging the suitable risk perception of each liability instrument, and thus in minimising the cost for taxpayers, is bail-ins. These establish a clear order for the incurring of losses by shareholders and creditors, and provision is made for this arrangement to be activated prior to any injection of public funds.

In Europe, given the political agreement reached on the ***Recovery and Resolution Directive***, a set of common rules will be adopted in the near future establishing a clear and homogeneous order of seniority of liabilities in the event of bank resolution, and it will ensure the administrative power to impose losses on the holders of each instrument. That will notably minimise the cost to taxpayers of bank bail-outs.

But common rules are not enough. The only way to ensure the possible homogeneous application of these rules is through the creation of a common ***resolution authority*** for all countries.

Similarly, it is important to have a ***common resolution fund*** in place which ensures, under similar conditions, that there is the necessary financial support for those institutions which might need it, irrespective of the budgetary situation of the State concerned.

These ingredients of the single mechanism – a single authority and a common fund – are as essential as the existence of uniform rules and regulations to ensure that holders of bank liabilities in any jurisdiction are treated the same and to severe the link between bank risk and sovereign risk. At the same time, the creation of a genuine single resolution mechanism is essential so that the single supervisory mechanism can operate effectively. Otherwise, it would have to deal with complex interaction arrangements with a constellation of national resolution authorities – each managing its own funds – which would make its task notably more difficult.

In this context, the legislative proposal submitted last July by the European Commission is a good starting point. The EC proposes the creation of a single resolution agency or authority, ultimately reporting to the European Commission, which would manage a common fund fed by contributions from the industry.

It is common knowledge that the Commission's proposal is currently subject to intense debate. In particular, apart from the assignment of resolution powers to the European Commission, three matters are prompting most discussion. First, the legal basis of the proposal – anchored in Article 114 of the Treaty – is being questioned by some countries, which even raise the need for a reform of the Treaty. This is despite the favourable opinion on the proposed legal basis of the Council's legal services, the European Commission and most Member States.

Second, since the common fund would take some time in reaching the required size, it is essential to set in place a specific regime to cover, during this transition period, the needs arising from resolution processes. Compared with the alternative suggested by some countries of using national funds, it seems preferable to allow the ESM to finance the common fund while it is being brought up to the required size by contributions from the industry. Otherwise, national resolution schemes would remain in place for a relatively long period and this would delay the setting up of a genuine banking union and thus the remediation of the fragmentation problems besetting us at present.

Third, the distribution of powers between the supervisor, the resolution agency and the resolution authority envisaged in the proposal could be refined. In particular, it should perhaps be made slightly clearer – in line with Spanish law – that the supervisor must carry out the actions prior to determining the resolution of an institution and be responsible for commencing the process, all this aside from it maintaining the necessary coordination and exchange of information with the resolution authority. At the same time, the preparation and approval of the resolution plan should require the joint approval of the supervisor and the resolution authority. Lastly, the implementation of the plan and the monitoring of its fulfilment should – as set out by the European Commission's proposal and provided for in Spanish legislation – be the responsibility of the resolution authority.

And a final question: how is the Spanish banking system dealing with the banking union project?

Unquestionably, the banking union project entails appreciable challenges for the whole European banking system. In particular, the single supervisory mechanism inevitably involves the need to adapt to new rules, criteria and procedures for interacting with supervisors. Furthermore, the new resolution regulations, and particularly the burden-sharing procedures (along with the changes soon to be made to the solvency regulations), may affect the composition and cost of bank liabilities.

All in all, the Spanish banking system will foreseeably not face more complex challenges than those being posed in other jurisdictions, thanks to the unprecedented reform implemented in the past year following the assessment commissioned from an external consultant within the framework of the financial assistance programme.

The significant reduction of the exposure to the real estate sector through the substantial increase in provisions and the entry into operation of Sareb made it possible to defuse one of the main sources of vulnerability of the Spanish financial system. Also, the quality of assets and, in particular, the accounting treatment of restructured and refinanced loans, were reviewed. Finally, banks' solvency ratios were notably strengthened. Currently, all banks meet the capital requirement of 9% according to the EBA definition, generally by an appreciable margin. By the end of the year we expect capital levels to be above 10% for the sector as a whole, both under the EBA definition and under the Basel III definition of common equity tier 1 to be used from January when the new European solvency regulations come into force.

The improved situation of Spanish banks is also apparent in the liquidity indicators and in market valuations, both in absolute terms and in relation to net book value.

That said, obviously the banking sector has to address the adverse impact on its balance sheets exerted by the still-weak macroeconomic environment, the necessary process of non-financial sector deleveraging and the persisting fragmentation of European markets despite recent improvements.

In order to obtain a comprehensive assessment of the outlook for the sector, we have recently developed a supervisory tool to enable us to regularly conduct ***forward-looking analyses to evaluate the solvency*** of Spanish banks under different macroeconomic scenarios. This tool (FLESB) is not intended to estimate banks' solvency ratios, but rather to evaluate the sensitivity of their solvency to a given set of shocks over a time horizon.

The initial results, which were published some days ago in the Banco de España's Financial Stability Report, offer some comfort as to the ability of Spanish banks to meet the minimum regulatory capital requirements with a sufficient margin, even under adverse scenarios.

To conclude, monetary union is now unquestionably at a crossroads. Its stability and proper functioning depend directly on the adoption of far-reaching reforms to heighten the integration of the participating national economies.

We can take hope from the fact that European leaders have understood that banking union is key to the reform process and have, through the creation of the single supervisory mechanism, paved the way for its full operationality.

The challenge now is to complete the project as soon as possible by setting in place a single resolution mechanism, in order to optimise the capacity of the single supervisory mechanism to contribute effectively to strengthening monetary union.

In the coming months we must step up the required preparatory work. It is not a simple project. It will undoubtedly keep us busy – in both the official and the private sector – for some time. But it is an exciting undertaking in view of its importance for Europe and for Spain.

Thank you.