Fernando Restoy: Capital requirements and banking union

Speech by Mr Fernando Restoy, Deputy Governor of the Bank of Spain, to the Analistas Financieros Internacionales (AFI) conference on banking regulation, Madrid, 27 January 2014.

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Good morning.

Thank you, Emilio, for your kind introduction and for the invitation to take part in this AFI (Analistas Financieros Internacionales) conference on banking regulation.

As we move into 2014, we face a year of major challenges for the banking industry. This is so, above all, because of the historic importance of the start-up of the single supervisory mechanism, which will effectively come on stream next November. At that point the ECB will assume supervisory powers over the main euro area banks. And this institutional change, marking the origin of the banking union, will come about against a background of deep-seated changes in the regulatory framework of banking activity.

Allow me to begin by reviewing some of the latest regulatory changes in the prudential field, before sharing some thoughts with you on the ongoing construction of the banking union in Europe.

Solvency regulations

One of the pillars of the financial reform, which arose in response to the shortcomings evidenced during the crisis, has been the measures aimed at strengthening bank solvency. As you know, the new solvency rules, known as Basel III, have been applied since the start of this year in the European Union. They have been incorporated into legislation through a Directive and a Regulation on capital requirements. The rules require banks to appreciably increase the quality and quantity of regulatory capital. Further, they increase the instruments at supervisors' disposal to restrict the risks of bank operations and to ensure financial institutions have sufficient loss-absorbing capacity, and, more generally, to safeguard the stability of the financial system as a whole.

Yet the mission to strengthen the regulatory framework in order to minimise the likelihood of banking crises, together with their associated costs, is far from complete. You will be aware that the Basel Committee on Banking Supervision is working on the definition and appropriate parameterisation of new liquidity requirements to complement the solvency requirements. At the same time, one task to be undertaken in the near future is the enhancement of the current tools for measuring and provisioning risk on bank balance sheets.

Specifically, the Basel Committee has advocated the advisability of working on improving the methods for calculating risk-weighted assets and thus increasing their consistency and homogeneity.

Indeed, an appreciable degree of heterogeneity has recently been evident in the internal models banks use to calculate risk weightings under the advanced approach, whose use must be approved by the supervisor. Supervisory practice indicates the technical difficulty entailed in approving the models presented by banks and, in particular, in gauging their ability to properly measure the sensitivity of the various portfolios to risk. It is thus not unusual that the studies available should question the fact that banks with the same risk profile are actually subject in practice to comparable capital requirements when they operate in different jurisdictions.

The dissatisfaction arising from the difficulties in achieving an appropriate estimation of asset risk weightings should not lead to conventional solvency ratios being discarded or to their role as essential indicators of the financial strength of banks being questioned. Nor is it easy to justify renouncing the use of the specific information at hand at banks – through the advanced approach – to improve the measurement of the risk of exposures. Indeed, I believe any effective regulatory reform should continue to aspire to have capital requirements discriminate between different types of exposures on the basis of their risk and to avoid excessively simplistic approaches that prevent capital requirements being adapted to each bank's business model. What's more, the calculation of the solvency ratios and, in particular, the use of advanced models should be subject to more demanding tests.

In this respect, various options – which are not mutually exclusive – have emerged in the ongoing debate to refine the calculation of regulatory capital, and these merit in-depth study. The first approach involves developing more accurate guidelines for the design and parameterisation of acceptable models. A second course of action is the possibility of imposing restrictions on the saving of own funds prompted by the use of the advanced as opposed to the standardised approach which, at an extreme, could lead to the results of the standardised approach being used as a floor for the required capital. A third proposal is the use of a leverage ratio as a complement to the traditional solvency ratios.

As you know, the Basel Committee published, scarcely two weeks ago, a document detailing the work performed to introduce, in the near future, a minimum leverage ratio in the regulatory framework of banking activity.

As a concept, the leverage ratio can be defined very simply as the ratio of the bank's high-quality capital to its total exposure. However, transposing the concept to regulation requires, in practice, adopting complex decisions on how to measure certain exposures (such as repos and derivatives) and the extent to which these exposures should be netted or not for the purposes of calculating the ratio denominator. And all this must be done bearing in mind the existence of various approaches in the different jurisdictions linked largely to the heterogeneity of the accounting frameworks in place.

The definition proposed by the Basel Committee is a pragmatic approach to the problem that should provide for the application of a similar methodology for the calculation of the leverage ratio worldwide.

In any event, the final calibration of the minimum ratio should be completed in 2017, with a view to its definitive inclusion in the solvency rules in 2018. This calibration will define the interrelatedness of the ratio to the other solvency measures and, specifically, the conditions under which it will act as a binding constraint. We are still, therefore, at the analysis and calibration phase. Next year, banks will be required to publish the ratio as a transparency measure, which will be conducive to the final design of the new regulatory requirement attaining a sufficient degree of consistency and homogeneity.

Evidently, the introduction of new prudential control measures entails an additional effort for banks, at a time when the sluggishness of economic activity is exerting significant pressure on their margins. Undoubtedly, however, adopting these measures while observing a prudent implementation calendar will have an appreciably positive effect on the industry's soundness and resilience and, consequently, on the economy as a whole.

Banking union

That said, as experience categorically shows, the harmonisation of solvency rules is not a sufficient guarantee to ensure homogenous control of the financial position of banks located in different jurisdictions. As important as having similar rules is the application of a common supervisory approach. And the homogeneity of the prudential control exerted over financial institutions is particularly important in economic areas that share an integrated banking market and a common currency. Hence the importance for Europe of setting up a single supervisory mechanism.

This mechanism, as the first piece of the banking union project, is essential for contributing to doing away fully with the financial fragmentation that threatened the continuity of the euro and to deactivating the vicious feedback loop between banking and sovereign risk, which caused so much harm to economies such as Spain in terms of greater funding costs, difficulty of access to credit and, in sum, lower employment and growth.

The single supervisory mechanism

As you are aware, the start-up of the single supervisory mechanism, the first pillar of the banking union, is at a very advanced stage following the entry into force, just a few days back, of the Community Regulation creating it. Currently, intense preparatory work is under way, and I can assure you this poses a significant organisational challenge.

A key element is to establish an appropriate governance structure combining the leadership of the ECB in the supervisory function with the involvement of the national authorities, all the while ensuring that the assumption of prudential functions by the ECB does not clash with its monetary policy responsibilities. Supervisory powers will mainly be channelled through the Supervisory Board, whose chairperson and vice-chairperson, along with the representatives of the national authorities, have already been appointed. The Board will convene for the first time this very week. The four Directors-General of the ECB responsible for supervision have already been designated, one of whom is the current Director-General of Banking Supervision of the Banco de España, which is a cause of satisfaction for our institution. The selection processes for the remaining management positions will continue over the coming months.

Thanks to the work by several groups of experts, two essential pieces of the future mechanism are at an advanced stage. These are, namely: the Framework Regulation that will define the supervisory function, its internal organisation and the assignment of responsibilities among the various authorities making up the mechanism; and the supervisory manual, which will precisely set out the procedures to be followed by all the members of the mechanism, including naturally the supervisory personnel of the national authorities.

The ECB and the national authorities are also working on developing the comprehensive assessment of credit institutions in the participating countries, which began last November and will be completed before the ECB assumes supervisory powers. This assessment will include an asset quality review, performed with the help of auditors or external consultants, and subsequent stress tests, which will be conducted in collaboration with the European Banking Authority (EBA).

Shortly, the thrust of the design of these two exercises will be made public, although certain features are already known, such as the minimum capital ratio that will be required in the accounting review phase and which stands at 8% of common equity tier 1 capital (CET1), according to the definition established in the Community Regulations, including the envisaged timetable for the application of the various deductions.

Evidently, the exercise aims to strengthen confidence in the European financial system through transparency and reinforcing the solvency of those banks that need it. Nonetheless, the Spanish experience, in particular that from the exercises performed in 2012 under the financial assistance programme, shows that the proper metric for measuring attainable credibility is not based on the estimated capital needs resulting from the exercise, but on the application of a sufficiently rigorous methodology enabling all potentially vulnerable segments of the European banking system to be evaluated consistently, particularly those whose reflection in the financial information published is of greater complexity. It is moreover important that, as announced in the public communiqué released, the measurements of capital made should be consistent with the regulatory framework in force which, in Europe, essentially comprises the recently enacted Community Directive and Regulation on capital requirements.

Thanks to the reform undertaken and the measures applied by banks, the Spanish banking system is, generally, in a reasonable position to face these exercises. However, obtaining a positive result in the exercise is only a favourable starting point for assuming the new supervisory regime in a macroeconomic and financial framework which, despite the recent improvement, remains beset by challenges to banks. Accordingly, irrespective of the results of the exercise, banks should continue to focus on implementing measures geared to capital preservation, improved efficiency and the pursuit of rigour in the recording and monitoring of asset quality.

Single resolution mechanism and fund

The second essential element of banking union is a single resolution mechanism. It has been said on numerous occasions that unified supervision will not suffice to eliminate market fragmentation. Another prerequisite is that similar banking liabilities of banks based in different jurisdictions must receive similar treatment in the event of solvency problems. In order words, the resolution of vulnerable banks has to proceed according to common rules applied on a centralised basis by a single authority.

Regarding regulations, the agreement reached to approve the future Bank Recovery and Resolution Directive is a notable step forward because it offers a common framework for orderly bank resolution at a minimum cost to taxpayers.

The Directive introduces burden-sharing or bail-in arrangements establishing a minimum amount and clear order of cost assumption by shareholders and creditors. It thus makes for accurate perception of the risk associated with each liability instrument and minimises the bill to be footed by taxpayers for the disorderly winding-up of banks. Also envisaged is a resolution fund fed by contributions from the industry to meet any needs for capital which cannot be covered by burden-sharing exercises.

Furthermore, last December the Council of the European Union reached an important consensus after several months of complex negotiations, which, taken together with the aforementioned Directive, amounts in practice to the creation of a single resolution mechanism.

Further to this consensus, a bank resolution board will be set up whose scope of action will be the same as that of the single supervisory mechanism. It will have considerable freedom to act urgently in cases of restructuring or winding-up. It was also decided to set up a single resolution fund which will be progressively endowed with financial resources.

The bank resolution board will be entrusted with applying resolution rules uniformly, approving restructuring and resolution plans for banks supervised directly by the ECB and determining how the resolution fund is to be used.

The details of the single resolution fund are to be set forth in an intergovernmental agreement of the participating countries before March. However, the consensus reached stipulates that the fund will be financed through contributions from the European financial services industry, although the resources contributed by the banks in each jurisdiction will not be fully merged until ten years have passed. During these ten years the fund will have separate compartments funded by contributions from the banks of each country, which will be progressively mutualised year by year. Under this process, the system of burden-sharing among the national and mutualised funds will be gradually adjusted until the national compartments disappear completely around January 2025.

The complex agreement reached has yet to be accepted by the European Parliament, so there is still uncertainty as to the final design of the mechanism. Moreover, the capabilities of the mechanism will foreseeably be limited at first, since the single resolution fund is constrained by its modest size and reduced mutualisation. Furthermore, for the time being, the agreement does not include common public mechanisms for the resolution of vulnerable banks after the available private funds have all been used up.

In this respect, although the new resolution rules reduce the foreseeable scope of the required external funds, provision should be made for public financial support at EU level to ensure the orderly resolution of systemic banks if necessary. For example, following the example of the US, we could consider an arrangement in which the European Stability Mechanism could provide the resources needed to the common resolution fund with a charge to future contributions from the industry. Otherwise, the single resolution mechanism would, at least in the short-to-medium term, foreseeably be insufficient to prevent banking crises from continuing to be resolved with a charge to national funds, whether public or private.

That said, the agreement reached should by no means be underrated. In particular, the acceptance of the principle of transnational mutualisation of financial risk in Europe, although implemented very gradually and limited to funds contributed by the industry, is essential to ensure the homogeneous treatment of banking risk throughout the EU. Above all, from a broader standpoint, the agreement means that a significant political obstacle to extending the risk-sharing framework has been overcome. This will very likely pave the way for more significant progress in European integration in the future.

Let me finish by noting that in recent economic history it is difficult to find bouts of regulatory reform as intense as at present.

Globally, the unprecedented costs of the banking crisis for citizens as a whole have spurred major regulatory changes designed, firstly, to tighten up prudential regulation so as to reduce the likelihood of fresh crises in the future; and, secondly, to develop new resolution regulations to lower and allocate more fairly the cost of maintaining financial stability. In Europe the application of the regulatory reform coincides in time with a far-reaching institutional change which has to lead to the creation of a banking union. And, in Spain, all these important regulatory and institutional changes are taking place against a background of deep reform of our financial sector which has involved the clean-up of balance sheets, the recapitalisation of vulnerable banks, progress towards greater consolidation of the industry and enhancement of regulations, particularly those governing savings banks.

All this understandably poses a huge challenge to the entire financial system which, however, will emerge much stronger from a process of adaption that will, in all likelihood, make it sounder and more efficient. This will contribute to the sustainable recovery of Spain's economy in an increasingly integrated Europe.

Thank you.