

## **Luis M Linde: The regulatory responses to the crisis**

Speech by Mr Luis M Linde, Governor of the Bank of Spain, at the Fundación de Estudios Financieros, Madrid, 22 May 2014.

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Good morning and many thanks to the *Fundación de Estudios Financieros* for your kind invitation. Let me start by recalling that just three years ago I contributed to another book of the *Fundación*, on the international financial crisis, as we then saw it. As Governor of the Banco de España and erstwhile collaborator of the *Fundación*, it is a pleasure for me to participate in this presentation.

Knowing the authors' profile, I have no doubt the book will make us reflect on how to enhance our financial culture and also on the much-needed recovery, following the crisis of confidence in the financial sector.

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My intention today is not to talk once more about the crisis and its causes. I would rather focus on the regulatory consequences of the crisis which, as we all know, have been far-reaching and which we cannot consider as complete.

That crises should have regulatory consequences has been a fairly frequent occurrence in financial history. You may recall, for instance, that the Basel Committee on Banking Supervision was created in 1974, in the wake of the mistrust triggered by the bankruptcy of the German bank Herstatt; that the Financial Stability Forum was set up in 1999, following the bankruptcy some months earlier of the hedge fund "Long Term Capital Management"; and that the successor to this forum, the Financial Stability Board (FSB), came into being in 2009, after the Lehman Brothers debacle some months earlier.

It is this latter institution, the FSB, which is pushing through a thoroughgoing amendment of the international regulatory framework, seeking to reduce the likelihood of further crises in the future. In this connection, the FSB has benefited from decisive contributions by, among others, the Basel Committee on Banking Supervision.

### **Identification of initiatives on the international regulatory agenda**

Initially, the FSB identified a series of issues with a view to organising a coordinated agenda of regulatory initiatives at the international level.

Some aspects of the initial analysis, such as the design of structural measures in the banking sector (which were, in principle, highly oriented towards setting limits on the size of banks), were initially rejected by the FSB. However, as we now know, there have been several initiatives along these lines. Cases in point are the Volcker Rule in the United States, or the measures in the Vickers Report in the case of the United Kingdom. On 29 January this year the European Commission published its legislative initiative in this area, based on the recommendations of a group of experts led by Erkki Liikanen, the Governor of the Bank of Finland.

Other aspects identified by the FSB, which have occupied much of its deliberations, refer to the reform of the derivatives markets, the growing problem of "shadow banking" and convergence between different international accounting standard-setters.

On this very extensive agenda, I should like to focus on two matters: first, I shall review the measures aimed at reinforcing the resilience of banks, which are laid down in the Accord known as Basel III; and second, the treatment of "too-big-to-fail" banks, which has given rise, among other things, to the new banking resolution frameworks.

## **The construction of a more robust banking system**

One of the first lessons learned from this crisis was that the level of capital in the banking system had been insufficient to withstand the risks made manifest by the crisis.

Further, certain instruments which did not prove effective in countering losses had been considered eligible as regulatory capital. Likewise, there were specific risks which were not appropriately evaluated under banks' prudential regime.

The Basel Committee, which had been exploring potential prudential improvements, finally rolled out the Basel III Accord. Basel III notably strengthens the capital framework: its quality has been enhanced, insofar as new, stricter definitions were agreed upon; capital ratios were raised; and two new buffers – a capital conservation buffer and a countercyclical buffer – were created.

One notable singularity in the configuration of this latter buffer is that it also offered a response to macro-prudential objectives. That is, admittedly, something new and positive in the regulatory paradigm which, until then, had essentially been micro-prudentially geared.

The second novel feature of Basel III has been the design of a common prudential framework for liquidity risk, both in the short term (the liquidity coverage ratio) and the long term (the net stable funding ratio). It is worth stressing that this is the first time an agreement has been forged internationally for the prudential treatment of this risk.

The combined tightening of liquidity and capital requirements advises prudent application of such requirements. In this respect, it was agreed the new standard should be gradually phased in, with a transition period running to 2019; however, market pressure will in practice speed up this phase-in.

Other new features of Basel III relate to the strengthening of capital requirements for certain banking business risks. This is the case with securitisations, the trading book and counterparty risk.

Finally, I should mention the agreement reached to introduce a new supervisory instrument, the leverage ratio, which is not directly linked to a bank's level of risk; for this reason, it counters to some extent the potential shortcomings present in internal models for calculating capital needs. That leads us to one of the major issues currently under consideration: the use of internal models for evaluating the weighting of risks.

There is known to be wide-ranging variability in the calculation of risk-weighted assets across different banks. The Basel Committee itself has published a report on this matter, and increasing numbers of experts and regulators deem it advisable to study the implications of the use of internal models in terms of how they affect the lack of transparency in the calculation of capital requirements and in order to ensure a level playing field for all banks.

## **The prudential regime of systemic banks: more capital and a resolution framework**

A further aim of the FSB has been to eradicate, or at least alleviate, the externalities created by systemic "too-big-to-fail" institutions.

Systemic banks are those which, given their interrelatedness, size and complexity, might entail, in the event of bankruptcy and disorderly liquidation, serious difficulties for the rest of the financial system.

The systemic repercussions of the collapse of a bank of such characteristics, as evidenced following the Lehman Brothers bankruptcy, was the driving force behind the authorities having subsequently to bail out other institutions, with the ensuing burden on public funds.

The reforms aimed at the treatment of systemic institutions may be grouped under two major headings: supervisory measures and new legal frameworks.

Addressing firstly supervisory measures, solvency requirements for these systemic institutions have been tightened. Such tightening, on top of the levels set under Basel III, has been implemented in two phases.

An initial step involved the Basel Committee establishing a methodology, based on five indicators, to identify these institutions. These indicators reflect the size of banks, their interrelatedness, the lack of substitutes for the services they provide, the global scope of their activity and their complexity. The following step was to impose capital surcharges, on a staggered scale from 1% to 2.5%.

The second group of reforms refers to resolution, which involves an authority restructuring a bank through the use of specific tools, with the aim of ensuring the continuity of the bank's critical functions and thus preserving financial stability.

The essential characteristics all resolution regimes must meet were listed in the FSB document entitled "*Key Attributes for Effective Resolution Regimes*". This has been one of the most important agreements reached to date on the matter.

## Resolution

In the European sphere, the Bank Recovery and Resolution Directive have recently been approved, incorporating the FSB guidelines into the *acquis communautaire*. In Spain, Law 9/2012 of 14 November 2012 on the restructuring and resolution of credit institutions had already foreseen several of the elements required in this area by the FSB and by the Directive.

The resolution frameworks, in step with the text of the Directive, are structured in three phases: prevention; early intervention; and resolution in the true sense of the term.

1.- In the **preventive** phase, recovery and resolution plans must be designed.

**Recovery plans** are drawn up by the banks themselves and should include a series of actions relating to the institution's capital and liquidity in order, should the case arise, to restore its financial equilibrium. Supervisors must revise these plans, identifying potential impediments to their proper application.

**Resolution plans** are agreed by the resolution authorities and seek to establish a catalogue of actions that the authorities might take in situations in which a credit institution is close to non-viability.

2.- For the **early intervention** phase, supervisors are entitled to take measures before a bank's financial position deteriorates irremediably. These measures have helped bolster conventional tools, such as limiting dividend pay-outs. These new measures include most notably the possibility of altering a bank's business strategy or the power to call for legal changes in a bank's structure.

3.- The third, **resolution** phase is what leads to the reorganisation of a credit institution, making use of specific mechanisms. Most prominent in this connection has been the so-called bail-in, involving rescuing a bank from the inside, as opposed to the traditional public-sector bail-out. A bail-in entails the possibility of cancelling – or converting into capital – the entitlements of specific shareholders and creditors of credit institutions in a position close to insolvency.

Spanish resolution regulations are already based on this bail-in model. That said, the scope of the bail-in under Law 9/2012 is somewhat more limited than in the Directive, which requires that resolution costs be borne not only by shareholders and the holders of hybrid and subordinated instruments (as envisaged under Law 9/2012), but also by the institution's creditors (with some exceptions, e.g. secured creditors or depositors for the amount guaranteed by the Deposit Guarantee Fund). That will necessitate the updating of Spanish resolution rules to broaden the set of creditors who must bear the cost of resolution.

Closely connected with the idea of the bail-in is a new term called GLAC (gone concern loss absorption capacity), which consists of establishing a loss-absorption requirement once resolution has been reached.

Current debate on GLAC turns on what attributes financial instruments must have so they may be considered as possessing such loss absorption capacity. It is also being discussed what the appropriate amount for GLAC should be for banks to be able to continue performing their critical functions.

### **Final considerations: simplification for the sake of effective regulation**

To conclude, this entire programme of reforms will be of little use if the various agents involved cannot implement it effectively. Implementation should involve two stages.

Firstly, authorities should ensure that international agreements are properly transposed to their respective national frameworks.

Secondly, for effective regulatory implementation to take place, there must be a pass-through from the theoretical and legal plane to everyday reality. Here it is essential that practitioners such as risk experts, auditors, consultants and the supervisors themselves should strive to learn of and transpose all these regulations to their daily duties.

I believe it is time to reflect on our subject today in something of a critical frame of mind. I have some concerns over the scope of the new regulatory arrangements. By way of example, the transposition of Basel III to the European Union has required almost 700 articles, many of which not only involve notable technical complexity, but also entail the promulgation of extensive technical standards and additional supervisory guidelines for better implementation.

Just as banking industry practitioners face the challenge of implementing and applying this regulatory agenda, the challenge to regulators and supervisors is to reflect on how to square effective regulations with a framework that should ideally be simpler and more transparent, since the effectiveness of the new regulations will also hinge on this.

Thank you.