Fernando Restoy: Forging a new financial system – reforms outstanding and ongoing

Opening address by Mr Fernando Restoy, Deputy Governor of the Bank of Spain, at a conference at Complutense University of Madrid, Madrid, 27 October 2014.

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Let me first thank the organisers, in particular professor Carmen Alonso Ledesma, a fellow sufferer on the Banco de España Governing Council, for their kind invitation to participate in this conference.

Looking at the programme, the topics to be discussed in the various papers and roundtables, and the expertise of the speakers, I harbour no doubts that this conference will prove enormously useful in enriching the knowledge of all those present about the reforms undertaken and the challenges still pending for the financial system.

A good number of these reforms and challenges are linked to the flaws identified in the functioning of the sector as a result of the international financial crisis that broke in 2007. In particular, the crisis has highlighted considerable structural shortcomings – which led to an incorrect evaluation and management of key risks by financial institutions – and major limitations to the prevailing crisis-prevention and management systems.

In the euro area, as you know, the perverse link between the vulnerability of the credit sector and the weakness of public finances precipitated an institutional crisis which jeopardised the very continuity of the Monetary Union.

The consequences of the financial crisis have been very adverse. It plunged many economies into recession, considerably weakened public finances in many countries and, generally, entailed considerable losses in well-being. Fortunately, and this is a positive message worth emphasising, the authorities' response was generally correct. In a relatively short time, sweeping regulatory changes – which you will be able to review in detail in this conference – were ushered in. Moreover, the euro area has managed, at unprecedented speed, to launch an institutional reform, namely the banking union, whose scope cannot be overstated and which entails the strengthening of the Monetary Union.

In Spain, I believe the work done in reforming our financial system has had very satisfactory results. International agencies, in particular the IMF and the European Commission, have repeatedly testified to these results. So too have the markets, where there have been significant increases in the valuation of instruments issued by Spanish banks. And, most recently, there was further acknowledgement in the comprehensive assessment of the European banking sector by the ECB and the European Banking Authority.

Given the importance of this exercise, as a prior step to the start-up of the Single Supervisory Mechanism (SSM), allow me to refer to the results disclosed yesterday, before discussing the most significant measures taken in Spain to strengthen the financial system and highlighting some of the challenges to be faced in the near future.

Results of the comprehensive asset-assessment exercise

As you probably all know, the European bank assessment exercise, covering 130 banks, most of which will be directly overseen by the SSM, essentially comprised two components. First, an asset quality review (the AQR), which basically involved an analysis of the rigour with which bank balance sheets reflect the value of different assets. The review evaluated, as appropriate, accounting classifications, collateral values, fair value calculation methods and the recognition of borrowers' impaired creditworthiness. Second, a stress test, evaluating how solvency would fare in two macroeconomic scenarios: a baseline scenario, considered likely, and another highly adverse scenario.

In addition to increasing the transparency of banks' financial position and to providing information to help ensure the effective functioning of the SSM as a supervisory authority from the outset, the analysis aimed to detect potential capital shortfalls that needed to be rapidly redressed. To do this, quantitative benchmarks were set for capital adequacy ratios – measured by the ratio of common equity tier 1 (CET1) capital to risk-weighted assets – for each part of the exercise (8% in the AQR and in the baseline scenario of the stress test, and 5.5% for the adverse scenario).

The exercise was designed to high standards. This was manifest in the breadth of the field work done for the review of bank balance sheets, in the severity of the adverse macroeconomic scenario envisaged and in the wide range of risk (credit, market, sovereign, etc.) factors considered. Also, several thousand experts, including auditors, consultants, appraisers, etc., participated in the exercise and strict quality assurance was enforced both at the level of the national supervisory authorities and by the ECB.

The results disclosed yesterday show that European banks have, in the main, a comfortable solvency cushion.

A good number of them have been able in recent months to reinforce their solvency levels notably, meaning that the capital measures needed to comply with the requirements arising from the exercise are modest in scope. However, the analysis has shown that some European banks are in a vulnerable solvency position, which they should redress as soon as possible.

All told, as important as the solvency assessment the exercise provides is the detailed information furnished on each bank. In particular, the asset quality review offers significant data on the potential shortcomings of the way in which the financial information disclosed by banks reflects the risk they assume. Here it can be seen, once again, that there is no widespread material understatement of risk, in the form of valuation failings or provisioning shortfalls. But there are European banks where the asset review has evidenced shortcomings of some significance.

In the case of Spanish banks, the analysis has offered fairly satisfactory results. In particular, the asset quality review situates Spain as the country where fewest failings have been detected in proportion to the sector's aggregate assets. In other words, according to the exercise, the balance sheets published by Spanish banks reflect, on average, the risks arising from their investment with greater rigour than that seen in the other jurisdictions, with fewer valuation flaws or provisioning shortfalls being detected as a result.

This is a particularly positive outcome as it arises from the application of a methodology – common to all the banks analysed – based on objective observations and which, unlike the stress test, does not depend on the design of debatable macroeconomic scenarios or working hypotheses.

In any event, the stress test also provides positive results for the Spanish banking sector which, in virtually all cases, exceeds fairly comfortably the minimum capital thresholds set. Only one bank evidenced a very small capital shortfall as at 31 December 2013, and this has now been more than covered following the capital increase made by the bank in the first half of 2014, which gives it a solvency level in line with the sector average.

Accordingly, Spanish banks may be said to have comfortably passed the test, evidencing both high quality of disclosed financial information and considerable resilience to adverse macroeconomic developments.

Naturally, there is no room for complacency, and the results should not be taken as conclusive proof of the unquestionable and generalised health of our banks.

The challenges are manifold, and I shall refer to some of them later. However, it would seem fair to say that the exercise has validated the collective efforts made to overcome the huge impact that the international and European financial crisis and the harsh macroeconomic conditions – linked in part to the collapse of the real estate sector – has had on our banking system.

What has changed, then, since 2012, when Spain signed up to the financial assistance programme?

Naturally, much of the soundness gained by our financial system reflects the general improvement in economic conditions over the past two years, stemming from the stabilisation of international markets, the institutional changes and the monetary policy measures taken at the European level, along with the reforms to our economy's productive sector.

At the same time, however, I believe that the reforms in the financial sector have managed to significantly mitigate, if not eliminate, some of our banking system's negative particularities, which made it especially vulnerable to the macroeconomic and financial shocks witnessed since the start of the crisis.

In my view there were four such vulnerabilities.

1. Firstly, the lack of sufficient capital at that time and, generally, of loss-absorption capacity in a significant part of the banking sector. Correcting this shortcoming was, as you will recall, the main objective of the financial assistance programme.

   The capital shortfalls identified in the 2012 stress tests were corrected by recapitalisation measures that combined capital increases at some banks, burden-sharing mechanisms and the contribution of public funds in eight banking groups that were unable to cover their needs by their own means.

   More recently, an appreciable number of banks have taken advantage of improved market conditions to issue various capital instruments (for an amount of over €3.7 billion since the start of the year). Moreover, banks have generally pursued a policy of containing dividend payouts and returns on deposits, following the recommendations made by the Banco de España.

2. The second main flaw in our financial system was a disproportionate exposure to assets with highly pro-cyclical credit quality and, in particular, to the real estate sector. This vulnerability was corrected through two main channels: by increasing the volume of development risk provisioning required in 2012 and, of course, by establishing SAREB, the external asset management company to which all the real estate exposure of the most vulnerable institutions was transferred.

   More recently, the level of coverage of credit portfolio risk was reinforced by the review, by the Banco de España, of the criteria for classifying refinanced and restructured loans by risk and, therefore, of the level of provisioning required.

   All these steps, on top of the traditionally conservative provisioning policies followed in Spain, reduced the latent risk on balance sheets and increased coverage, and are largely responsible for the Spanish banking sector's generally satisfactory results in the asset quality review.

3. The third flaw in our financial system was the inappropriate corporate regime governing the savings banks, which came to account for almost half the Spanish banking sector.

   If the crisis has shown us anything it is that, despite the good management performance at numerous savings banks, the former ownership regime of those institutions and, in some cases, their reliance on political power, created risks that hindered their proper management. The successive reform measures taken, and in particular the legislation on savings banks and bank foundations enacted last year, are a key qualitative change, requiring that former savings banks over a certain size be transformed into (ordinary or bank) foundations and that those which maintained a significant shareholding in a bank have sufficient incentive to waive control of the bank and meet, in any event, certain conditions to ensure they are professionally and independently managed.

I take this opportunity to confirm that in the next few days the Banco de España will be issuing, for public consultation, a draft circular which implements the above-mentioned legislation and sets out in detail some of the requirements that the bank foundations will have to satisfy.

4. The fourth and last main flaw in the Spanish banking system was its surplus capacity, as a result of the tremendous growth in loan demand during Spain's long period of economic expansion. In the present setting of ongoing deleveraging of the non-financial private sector, mounting regulatory pressure and narrow interest margins, re-sizing of the industry was essential.

Much of this re-sizing has come on the back of the intense process of rationalising the balance sheets of the banks that received public support, in accordance with the conditions laid down in the restructuring and resolution plans approved by the Banco de España and the European Commission.

Moreover, the concentration processes involving the integration of some of these institutions into other bank groups (for example, Caja 3 in Ibercaja, Banco Gallego with Banco de Sabadell, Banco de Valencia with Caixabank, CEISS with Unicaja and, most recently, Catalunya Banc with BBVA), added to those completed previously, have reduced the number of bank groups in Spain by more than 30 in recent years.

Accordingly, the reform of the Spanish financial system may be said not only to have restored stability, but also to have placed the banking sector in general back onto a normal footing, through the recapitalisation and consolidation processes undertaken, the clean-up of balance sheets and the reform of the savings banks.

Upcoming challenges

Nevertheless, however positive this return to normal – which has now been evidenced by the tests conducted in the run-up to the SSM – has been, especially following the turmoil experienced, there is no respite, as there are major challenges ahead for Spain's banks, as there are for the banks of our European partners.

In particular, banks will have to learn to live with the considerable increase in regulatory demands. These will arise especially from the imminent entry into force of the liquidity and provisioning requirements included in the Basel III Accord, and from the foreseeable introduction of additional measures, such as those that will demand separation in some cases between the investment banking business (proprietary trading, market-making, etc.) and the traditional banking business, or that will require banks to have liabilities available that may be converted into equity in the event of resolution. At the same time, greater restrictions can be expected on the admittance of internal asset risk assessment models when they represent savings in regulatory capital.

In turn, within the framework of the SSM, work can be expected to begin to try to harmonise the regulatory differences that persist (for example, in the calendars for application of the capital deductions established in Basel III) as well as supervisory practices (for example, relating to the approval of internal risk assessment models). Insofar as greater harmonisation can be expected to be conducive to stricter supervisory practices, in each area the new supervisory framework will generally tend to raise the bar for all European banks.

Hence, in order to adapt to the new regulatory and supervisory environment, many banks will need to make further efforts to strengthen their own funds. Moreover, this will have to be done against a complicated macroeconomic backdrop in Europe, where economic conditions are still prone to vulnerability and interest rates remain very low, acting as a brake on improvements in the quality of loanable assets, growth in lending and recovery in interest margins.

That said, at the Banco de España we are convinced that Spain's banks will successfully adapt to all these challenges, adjusting where necessary their business strategies, improving where possible their efficiency levels and harnessing any opportunities the market may offer to continue to bolster their balance sheets in keeping with the new demands.

Thank you for your attention.