Fernando Restoy: Presentation of the book “Financial regulation: the solution or the problem?”

Closing address by Mr Fernando Restoy, Deputy Governor of the Bank of Spain, at the presentation of the book “Financial regulation: the solution or the problem?”, Fundación de Estudios Financieros, Madrid, 5 March 2015.

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Good morning.

Many thanks for your introduction and for the opportunity to participate in the presentation of this report on financial regulation by a group of veritable authorities on the matter. I have had professional dealings with all of them to some extent in recent years and, in particular, with the report’s coordinator, José Pérez, who contributed to my joining the Banco de España – when he was Director General of the Research Department – some years ago and who therefore bears some responsibility for me being here before you today.

The book’s title is admittedly a provocative one: “Financial regulation: the solution or the problem?” It is comforting to see that the work’s conclusion is not that regulation is the problem and, therefore, that deregulation is the solution. On the contrary, I believe that the authors, on the whole, appreciate the effort made to strengthen prudential regulation and, in particular, to gear it to the aim of achieving more and better capital.

At the same time, I understand and largely share the concern to avoid excesses. Regulation, like the vast majority of public policies, is no free lunch. It is there to redress market failings that harm the collective well-being. Yet it also introduces distortions into resource allocation that may prove costly. Accordingly, ahead of any regulatory proposal it is more than advisable to assess the scope of these distortions.

The book, in various chapters, correctly identifies potential adverse effects of what is categorically referred to as a “regulatory tsunami” or even, as one author puts it, a “regulatory orgy”. The text broaches the possibility that the pace and scope of regulatory change might be affecting the liquidity of certain securities markets and also risk-taking by relatively unsupervised sectors, and may be reducing banks’ loan-granting capacity or lessening competition, among other developments. The authors rightly suggest that the reasonableness of the changes, their parameterisation and their implementation schedule must be properly evaluated taking into account not only their direct contribution to financial stability but also possible side-effects.

One idea intimated in the analysis is that, given the risks over-regulation entails, an alternative approach might be to economise on regulatory changes and to increase supervisory intensity instead. That is to say, there should be an attempt to contain the avalanche of new regulatory requirements applicable across the board, replacing some of them with intrusive supervisory measures, adapted to each bank’s specific situation. This is admittedly a very attractive idea which I would like to explore in the rest of my speech.

Supervisory challenges

Until recently, core supervisory actions in many jurisdictions had focused, perhaps excessively, on the surveillance of banks’ solvency through the monitoring of capital ratios as defined under current regulations.

It is nevertheless true that the implementation of Basel Pillar 2 on the basis of the regular supervisory review exercises has somewhat changed the situation. Pillar 2 allows specific requirements to be made of each bank on the basis of its risk profile so as to cover aspects not contained in Pillar 1 (minimum regulatory capital ratios). In that way the supervisor can regulate solvency requirements by adjusting them to each bank’s situation, thereby

extending the supervisor's discretion and reinforcing its role, while reducing commensurately the relative significance of the general solvency requirements set in the regulations.

Likewise, the inclusion of stress tests as a supervisory tool extends the supervisor's capacity to impose capital requirements or other constraints on banks when this is necessary to withstand adverse scenarios, even if such scenarios are rather unlikely. Once again, this tool broadens the weight of supervisory action.

That said, in order to optimise the scope of supervision, supplementary instruments – that are not always available in accordance with the prudential regulations in force – are needed. For instance, not in all jurisdictions must the supervisor expressly authorise the eligibility of certain capital instruments, the acquisition of qualifying holdings in other financial institutions or dividend pay-outs charged to reserves.

Above all, effective supervision should occasionally be based on discretionary actions rather than mere application of the instruments expressly provided for under the regulations. In particular, the supervisor should have the real capacity to influence bank managers' decisions through moral suasion and to formulate non-legally binding recommendations, in the sure knowledge that they will in practice be very widely followed. Supervisory actions would otherwise be excessively hampered by a regulatory framework which, despite having been honed in recent years, can hardly envisage all situations of supervisory significance or include the full range of instruments needed to tackle such situations with the speed required in each instance.

Finally, it is difficult for supervision to be effective if it does not include a thoroughgoing review of banks' financial statements. Allow me to elaborate on this point.

Evidently, an essential aim of supervision is to oversee banks' solvency through the monitoring of capital ratios. Insofar as these ratios are calculated on the basis of accounting information, it is essential to ensure that such information properly reflects the value of the bank's assets and liabilities. It is true that auditors and securities supervisors also perform this task. However, the specific nature and complexity of bank business, the evident relationship between published financial information and financial stability, and the occasional lack of specificity of prevailing accounting principles all make it advisable that the prudential supervisor should contribute to encouraging supervised banks to follow the best practices, in full conformity with current regulations and the distribution of competencies among institutions thereunder.

Consequently, the effectiveness of the supervisory framework, which has doubtless been broadly strengthened by the changes to prudential regulation, depends on three aspects: firstly, the legal availability of a broad set of instruments through which requirements or restrictions may be imposed on banks; secondly, the ability to effectively influence management decisions and policy through formally non-binding actions, and finally the ability to ensure the accounts give a fair view of the bank's financial situation.

True, these elements have largely been present in the supervisory framework in place in Spain in recent years. The Banco de España has had a relatively extensive range of powers and has, in the exercise of its supervision, frequently used moral suasion and the issuance of recommendations, which banks have always followed. Further, it has been empowered to issue accounting rules affecting individual statements, which banks and audit firms have used as a frame of reference to properly complete with the consolidated statements that, generally, must adhere throughout the European Union to International Financial Reporting Standards (IFRSs).

This supervisory approach is not identical to that followed in other jurisdictions. Within the Single Supervisory Mechanism (SSM), most authorities, including the ECB, have somewhat less extensive powers than the Banco de España. Moreover, in various European jurisdictions, the supervisory strategy adheres to a greater extent than in Spain to the strict

use of the supervisory instruments formally recognised in the rules, with less dependence on recommendations or informal guidelines.

For example, a recommendation, like the one made by the Banco de España in 2013 that the cash dividends paid that year should not exceed 25% of consolidated profit, would be relatively unusual in other countries. As you know, the recommendation made by the SSM Supervisory Board on this matter in January was only restrictive for those banks whose solvency ratios failed to comply with the minimum levels in line with regulatory requirements.

The more formalistic approach to supervision to be found in other jurisdictions provides greater clarity regarding the scope of supervision. It also facilitates identification of the respective responsibilities of bank managers and supervisors. However, rigidly subjecting to strict rules and standards of conduct naturally reduces the supervisor's ability to identify and correct in good time potentially destabilising developments for the bank.

In the field of accounting, the experience of the asset quality review recently conducted by the SSM shows that there are appreciable discrepancies between the specific accounting criteria used in the different jurisdictions, although IFRS principles must be applied in all of them.

In Spain's case, as I have already mentioned, the criteria followed are those established by the circular of the Banco de España on public and confidential financial reporting rules and formats (known as the accounting circular). In other countries the criteria applied have been established over time and, generally, with less involvement of the supervisor.

The harmonisation of these criteria would be highly desirable, especially in relation to the classification of exposures (an area in which the European Banking Authority has made notable progress in recent months) and, in particular, provisioning policy. It should be noted that, although the supervisor may adjust the capital requirements, imposing higher levels of capital does not sufficiently make up for the lack of adequate provisions. That is because the level of provisions always has direct and transparent implications for the profit or loss of the bank, while an increase in the minimum capital requirements via Pillar 2 is not usually transparent (as the Pillar 2 requirements are not public) and, in most cases, does not have any practical effect, insofar as the bank has a capital buffer that enables it to cover the new requirements. Accordingly, the supervisor should be concerned to promote the application of rigorous and uniform provisioning criteria involving the appropriate recognition on the balance sheet of the value of each exposure.

Clearly, the formal publication of binding accounting criteria by the SSM may be contested, insofar as accounting does not form part of its competencies according to the EU regulation under which it was set up. At the same time, subjecting all banks active in the markets to IFRSs for consolidated accounts, certainly reduces its ability to exert an influence in this area. In short, the Spanish experience shows both the usefulness and feasibility of an involvement of the supervisor that is compatible with the law in force.

The need for this involvement is heightened by the entry into force in 2018 of the new standard (IFRS 9) under which banks will switch from using the concept of incurred loss to that of expected loss in order to calculate the credit portfolio provision. This standard is undoubtedly an improvement on the current situation, since it enhances the measurement of the risks of loans and receivables. At the same time, it significantly increases the complexity of calculating provisions and, thus, increases the risk of heterogeneous application across banks, which is something the supervisor should be aiming to mitigate. The work under way in the Basel Committee on this matter is therefore very timely.

My comments so far imply that there are in practice significant obstacles to satisfying the legitimate expectations that a rigorous and granular supervision will help moderate the intensity of the regulatory changes needed to promote financial stability.

The regulatory frameworks in force and different supervisory cultures, along with the difficulty of becoming more involved in accounting practices, often place considerable limits on the intensity of supervision attainable.

This explains why the actions of the authorities to prevent financial crises largely rest on the definition of clear and demanding prudential standards to underpin the work of supervisors. In the area of the SSM, these restrictions are particularly significant at the moment since, given the variety of supervisory practices and cultures in place, only adequate codifying of rules and procedures can help to ensure that banks are treated equitably, even if this means that some of the benefits, in terms of supervisory effectiveness, that an appropriate amount of discretion involve, have to be sacrificed.

Clearly, as the new European supervisory regime matures, we must strive to develop a specific action framework that incorporates the best practices and that is sufficiently robust to enable its application to be adapted appropriately to each specific circumstance.

Thank you for your attention.