

Luis M Linde: New challenges for a new era

Speech by Mr Luis M Linde, Governor of the Bank of Spain, at the 8th Santander International Banking Conference, Madrid, 26 November 2015.

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1. Introduction

Good morning. First, I would like to thank Banco Santander for inviting me to participate in this new edition of your International Banking Conference.

The first edition took place in the autumn of 2008, right after the fall of Lehman Brothers and just before the G20 leaders agreed to launch the financial regulatory reform in an unprecedented globally coordinated action. The objective was clear and so was the mandate given to the Financial Stability Board and the Basel Committee on Banking Supervision: to build a stronger and more resilient financial system.

Since then, the main pillars of the reform have been put in place. The list of new measures implemented is long and, I would say, impressive. I will not review the list, which is very clearly and well explained in the latest progress reports published by the Financial Stability Board and the Basel Committee.

I will focus my remarks on three different aspects of the global post-crisis reform that I find particularly relevant for the topic of this Conference:

- First of all, the finalisation, next year, of the Basel III framework.
- Second, the new total-loss-absorbing-capacity (TLAC) standard, developed by the Financial Stability Board and recently endorsed by the G20 leaders.
- To finalise, I will briefly refer to a line of work that the Financial Stability Board is coordinating to address the systemic risks associated with misconduct in financial institutions and markets.

2. The completion of Basel III

When the crisis started, the global banking system had built up several vulnerabilities:

- Many banks were highly leveraged.
- Capital proved to be insufficient and its quality was low.
- There was an excessive exposure to liquidity risk.
- The measurement of risk had major shortcomings.
- And there was a lack of awareness of the dangers associated with systemic risk stemming from complex, opaque and highly interconnected global financial markets.

Basel III is the regulatory response to address these vulnerabilities and, as such, it is one of the main elements of the global banking prudential reform. With Basel III the Basel Committee has:

- Raised the level and quality of capital, especially core Equity Tier 1 capital.
- Introduced additional requirements in order to reduce systemic risk, such as those imposed on systemically important banks, or the countercyclical capital buffers.
- Introduced two new liquidity ratios to mitigate liquidity risk.

- Introduced a new leverage ratio to limit leverage and reinforce risk-based requirements.
- Developed a large-exposures framework to limit the maximum loss in case of counterparty's failure.
- Last, but not least, the Basel Committee has improved the effectiveness of supervision by upgrading its Core Principles and by strengthening the supervision of systemically important banks.

Many of these new rules are now in place and we can say that banks are more resilient now than in 2009. But different weaknesses persist. For this reason, the Basel Committee is undertaking a review of the capital framework that will be finalised by the end of 2016. In particular, the methodologies used to measure banks' risks are being reviewed, both under the standardised approaches and under internal models.

The standardised approaches are being revised to incorporate the lessons learned from the crisis so as to increase their risk sensitivity without, however, making them unduly complex.

Regarding the internal models, they have been criticised because of their lack of comparability, the variability of the resulting risk-weighted assets, and their complexity and lack of transparency. These, let's say, "faults" have undermined the credibility of capital ratios. Therefore, the Basel Committee is considering including several constraints on internal models in order to strike a better balance between simplicity, comparability and risk sensitivity.

The other remaining major challenge is calibration. Basel III has changed the prudential setting quite significantly. The days when there was a single metric (the risk-weighted capital ratio) are over. We now have several prudential measures that will most probably be interacting in different ways. Banks will have to comply with a risk-weighted capital ratio (including additional buffers); a leverage ratio; two liquidity ratios and the large exposure limits. Additionally, banks that apply internal models will most likely face capital floors based on standardised approaches. Finally, some systemic banks will have to hold additional capital to meet global-systemically-important-bank (GSIB) buffer and total-loss-absorbing-capacity (TLAC) requirements.

Applying different metrics will make the framework more resilient because some metrics will avoid the limitations of others. For instance, floors based on standardised approaches are meant to be a kind of control or safeguard on internal model risk calculations.

Therefore, during 2016 the Basel Committee will be quite busy deciding on the constraints on internal models, calibrating the risk-weighted assets under standardised approaches (as well as the floors to be based on such standardised approaches) and performing a review of the calibration of the leverage ratio.

I would like to underline that this calibration process will build upon the information provided by banks in the context of the next Quantitative Impact Study (QIS) exercises that will be undertaken by the Committee. As always when quantitative issues are involved, the quality of the data will be a main driver for success in the calibration process. It is therefore very important that banks provide accurate data to these impact studies. Of course, any constructive feedback on the Committee's consultative documents will also be very helpful in order to improve the whole exercise.

3. The new TLAC framework

The agreement on total-loss-absorbing-capacity, which was published on 9th November and endorsed by the G20 leaders, is an example of cooperation at global level towards ending the too-big-to-fail problem.

This new TLAC standard guarantees that global-systemically-important-banks (GSIBs) will have a sufficient (and well distributed) amount of loss absorbing capacity to ensure the continuity of their critical functions at the point of resolution, avoiding the use of public funds. As such, it will contribute to the credibility of bail-in as an effective resolution tool.

The TLAC requirement establishes that a banking group will have to issue (and maintain) a minimum amount of capital and debt liabilities to absorb losses first in case of resolution. The minimum external TLAC requirement would be placed at each “resolution entity” within the group (that is, the legal entity where resolution actions would take place).

G-SIBs must comply with the TLAC minimum standard from 1st January 2019, subject to a phase-in. This minimum requirement will be calculated as the higher of 16 % of the risk weighted assets associated to the consolidated balance sheet of the resolution group and 6% of the denominator of the Basel III leverage ratio. As of 1st January 2022, these minimum requirements will rise up to 18 % and 6.75 % respectively. The TLAC will be required alongside minimum Basel III capital requirements, and the extra capital buffers (systemic, conservation and countercyclical) will sit on top of the TLAC risk-weighted metric. In addition, in order to ensure that there is enough recapitalisation capacity in resolution, one-third of the minimum TLAC requirement is expected to be covered with instruments other than CET1 (that is, debt).

It is important to bear in mind that the TLAC establishes a common minimum global requirement and that national authorities have the right at any time to apply higher requirements in their jurisdictions.

The TLAC is a new prudential requirement that has different objectives than the capital ratio. Regulatory capital is mainly to absorb losses in a going-concern situation, whereas TLAC is meant to ensure loss absorption in gone-concern situations (that is, beyond the point of non-viability).

I should add that, in a resolution context, the location of loss absorbing resources becomes very important and, for this reason, the TLAC standard gives guidance on how these resources should be distributed within the banking group. This highlights another important difference between the capital framework and TLAC: the location of resources. While the former is required on a consolidated basis for the group as a whole, TLAC is required where resolution takes effect and where critical functions are performed.

One of the most complex issues in the design of the TLAC was the need to ensure consistency between the two main banking resolution strategies: the Single Point of Entry and the Multiple Point of Entry.

Under a Single Point of Entry strategy, resolution actions will be taken in a single legal entity that is basically the parent company of the group, which will have to hold sufficient external TLAC. Additionally, a certain amount of loss-absorbing capacity should be pre-positioned in all material subsidiaries. This would ensure that losses are up-streamed to the resolution entity, thus avoiding putting the material subsidiary into resolution.

By contrast, under a Multiple Point of Entry strategy, the application of resolution tools to different parts of the group is allowed under the assumption of limited interconnections between them. Therefore, in this model, loss-absorption capacity is primarily located in each resolution entity (subsidiaries and the parent company). This is the resolution model chosen by the global Spanish banks as it is a better fit with their business model.

As I said, one of the most complex issues in the design of the TLAC standard was to find the correct balance between taking into account the particularities of each resolution strategy and ensuring consistent treatment between them. In this respect, the Bank of Spain welcomes the inclusion of certain elements that go in the correct direction towards achieving regulatory consistency between resolution strategies. Let me stress, when mentioning

consistency, that it is important that different jurisdictions also strive to achieve this objective when introducing the TLAC standard into their regulations.

Crisis Management Groups (CMGs) will also play a crucial role in ensuring consistency. Therefore, coordination between the different national authorities participating in these CMGs will be relevant in the application of TLAC. Some examples of these key decisions are: (1) determining adjustments for Multiple Point of Entry groups regarding the location of deductions and requirements; (2) identifying material subsidiaries and resolution entities; and (3) discussions as to whether the minimum TLAC is sufficient to ensure orderly resolution or whether additional firm-specific requirements are needed.

TLAC is quite a demanding new standard. The estimated increase in issuances of TLAC debt is not negligible, if we consider the impact assessment performed by the Financial Stability Board and the Basel Committee: the aggregate shortfall for G-SIBs under the low calibration represents 16.9 % of the €4.5 trillion G-SIBs unsecured debt market.

Compliance will be facilitated by the agreed phase-in for TLAC and the replacement of unsecured liabilities maturing in coming years which will be an important source of TLAC eligible instruments. However, the success of both the roll-over and the issuance of new TLAC-eligible instruments will depend on the absorption capacity of financial markets. In any event, we should monitor compliance with the requirements and any potential unintended impact during the transition period.

4. The plan to address misconduct risks

With the publication of the TLAC term sheet, the Financial Stability Board has virtually completed its work to address the too-big-to-fail problem in the banking sector. But there are other important areas where the FSB is working to fulfil the G20 mandate.

In particular, the Financial Stability Board has claimed that the problems of misconduct in some financial institutions have the potential to create systemic risks, considering the scale of the associated fines and sanctions which could run into the millions and also the negative impact on confidence. This is a serious threat that must be properly addressed. The banking business is about trust; if confidence in the financial institutions and markets is lost, the potential for finance to serve the real economy and foster growth will be undermined.

In response to this threat, a new area of FSB-coordinated work has been set up. An action plan has been launched which, among other measures, explores the pivotal role played by compensation structures and, more generally, corporate governance frameworks in preventing and mitigating bad practice. The FSB is examining whether the reforms already in place, mainly as a result of principles and standards issued by the OECD, the Basel Committee and the FSB itself, have proven effective or if, on the contrary, more preventive measures are required.

5. Closing remarks

Let me conclude. Back in 2009 the FSB and other standard-setting bodies (such as the Basel Committee) received a mandate from the G20 to restore the resilience of the financial markets and make future financial crises less frequent and costly. Most of the agreed post-crisis measures are now in place and have already begun to deliver benefits in terms of bank resilience and financial stability.

The Basel Committee intends to finalise the Basel III framework in 2016. In this respect the two main challenges are: (i) to find a solution to measure risks in a sensitive, simple and comparable way; and (ii) to provide calibration of the capital floors and leverage ratio. A key driver for success in this calibration exercise will be having access to accurate data.

I have outlined the main strategic aspects of the new TLAC standard, designed to provide a first line of defence in a gone concern situations. Meeting TLAC and Basel III requirements will pose a challenge for banks.

One of these challenges has to do with the potential systemic impact of misconduct risks, which can undermine confidence. Having in place adequate compensation structures and sound corporate governance frameworks is the best way to tackle this.

The Financial Stability Board is leading the work to determine if and when more measures might be needed to ensure a strong culture in the finance industry, so that confidence is preserved and financial markets can continue to serve the real economy.

Thank you for your attention. I wish you a fruitful and interesting discussion in the rest of the Conference.