BANCO DE **ESPAÑA**
Eurosistema

31.05.2018

“Banks’ traditional funding sources: opportunities for capital markets”

Keynote address at 50th ICMA Annual Conference

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Good afternoon.

I would like to thank ICMA for its kind invitation to take part in this special day: ICMA’s 50th Annual General Meeting and Conference. It is a pleasure to be here and to speak to such a large audience of professionals from such varied backgrounds, representing, among others, issuers, intermediaries, investors, capital market infrastructure providers, regulators and supervisors.

Capital markets being at the heart of this event, and banks being at the heart of my day to day work, what I would like to do in this speech is to highlight some developments related to banks’ funding sources that I think may offer new opportunities for capital markets. I would also like to briefly touch upon Brexit, an event that is generating great uncertainty and for which careful preparation is required. All of it, from my perspective as Deputy Governor of the Banco de España and as member of the Supervisory Board of the Single Supervisory Mechanism, which explains why my speech will be focused on developments in the European Union.

New opportunities

Let me start with what appear to me to be promising developments for reactivation of the markets.

Firstly, the renewed political commitment reached at the Euro Summit on 15 December 2017 to press ahead with improvements to euro area governance provides new opportunities to accelerate progress in areas where developments so far have been somewhat sluggish. Last week, the Banco de España held a high level seminar on the future of euro area governance titled “*Strengthening euro area economic governance: short-term priorities and the long-term view*”. A webcast of the seminar is available on the Banco de España’s website which I recommend to those interested in the subject. I will not dwell on this topic but I would like to say that, on the financial side, completing the Banking Union and fostering the Capital Markets Union must be at the top of the political agenda.

Completing the Banking Union will help to weaken the links between banks and sovereigns and to be better prepared to deal with large macroeconomic shocks. Fostering the Capital Markets Union will help to promote greater diversification of private sector funding sources and greater robustness of private risk-sharing arrangements. These projects pay attention to the two main channels through which credit flows to the economy in Europe, and they are key blocks in EMU’s future architecture. A window of opportunity seems to be open now and it should not be wasted.

Secondly, focusing on the Capital Markets Union, despite progress having been somewhat slow, there are certainly areas where advances have been made. Later today, the programme of this conference offers an opportunity to hear directly from the European Commission on the Capital Markets Union. Accordingly, my objective now is merely to point out a couple of areas where initiatives have been taken to reactivate specific markets. One of those areas is the securitisation market. Another one is the covered bond market.

Both securitisations and covered bonds have traditionally been important financing sources for banks and it is my opinion that they will regain importance in banks' funding strategies as the ECB's targeted longer-term refinancing operations (TLTRO II) progressively mature, opening up new opportunities for the markets.

In the field of securitisations, despite the stigma that has surrounded this product since the recent financial crisis, the European authorities have considered that appropriately regulated and well-structured securitisations can contribute to diversify funding sources, to promote better risk management and, ultimately, to mobilise more funds for the real economy.

For these reasons, two Regulations were published on 28 December 2017 in the Official Journal of the European Union amending the regulatory framework applicable to securitisations, in an attempt to harness their benefits, restricting the risks arising from their inappropriate use.

One Regulation establishes a general framework for all securitisations, and creates a specific framework for those that are to be known as STS (simple, transparent and standardised). The other Regulation transposes the new Basel III framework, making amendments to the prudential regulation of credit institutions and investment firms, both for general and for simple, transparent and standardised securitisations, which will benefit from a better treatment.

These regulatory changes may incentivise changes in banks' funding and risk management strategies, and may trigger a renewed interest in securitisations, providing an opportunity to reactivate this market.

Covered bonds are another instrument where progress is being made. In particular, on 12 March the European Commission released a proposal that seeks to harmonise their regulation in Europe.

The proposal includes a Directive that specifies the core elements of what may be termed "European covered bonds". It also amends banking prudential regulations, strengthening the conditions under which banks investing in these products may benefit from lower regulatory capital requirements.

Once the Commission's proposal is approved, the Directive shall be transposed so that banks may begin to issue as soon as possible instruments that benefit from the advantages of obtaining the "European covered bond" label.

So, it is true that there is still a long way to go before these regulatory changes materialise but first steps are being taken to pave the way for more harmonised covered bond markets, which will foreseeably enlarge the potential investor base for these bonds.

Lastly, in addition to the specific initiatives already taken under the umbrella of the Capital Markets Union to activate certain markets, I would also like to mention that other opportunities for the markets may arise from new instruments. I have in mind here, for example, the recently created non-preferred senior debt instruments. This new category of debt instrument ranks behind ordinary debt in the order of seniority of claims in insolvency proceedings and extends the range of liabilities that banks can issue to comply with their

MREL requirements. Some Spanish banks started last year to issue this new debt instrument and others will follow soon.

Let me now turn to the other side of the coin. Despite the above examples of areas where good prospects may arise for market activity, there are also elements of uncertainty on the horizon, and one of them is Brexit.

Brexit

On 29 March 2017, the United Kingdom notified the European Council of its intention to leave the European Union. This means that 30 March 2019 is, in principle, the “withdrawal date”. So far, in the draft Withdrawal Agreement, there is no specific regime with regard to financial services and this unquestionably generates a context of uncertainty that affects all market participants. Allow me to focus on how it affects banks.

“Wait and see” is not an option. Banks need to prepare. Within the framework of the Single Supervisory Mechanism (SSM), the ECB, together with National Competent Authorities, is trying to communicate, to banks which may be considering relocating their banking activities to the euro area, the SSM’s supervisory expectations on different aspects such as: authorisations and licences to carry out banking activities in the euro area; internal governance and staffing arrangements; or authorisations and use of internal models.

These expectations have a key underlying principle, which is the need to guarantee consistency across the existing and the relocating institutions, so that they both operate under the same regulatory, prudential and supervisory standards.

There is another key aspect, which is the need to ensure that relocating banks are not empty shells. The concern about empty shells arises because, given the uncertainty about the future relationship between the UK and the EU and the cost of making organisational changes, a good number of institutions are studying how to adapt to Brexit minimising the changes to be made to their structures, management and business models. They may be considering making extensive use of the capabilities of their UK headquarters through the use of back-to-back booking models for risk management, maintaining shared governance structures, extensive outsourcing within the group or keeping the bulk of their workforce in the UK through the artificial use of branches in the UK.

Empty-shell banks do not have risk management and governance structures that ensure a safe continuation of the local business or a smooth wind-down in crisis situations, and may present operational risks and financial stability issues for the countries hosting them.

For this reason, when assessing booking models, the ECB and national supervisors will pay attention to whether banks have adequate: (i) internal governance and organisation; (ii) access to financial market infrastructures; (iii) booking and hedging strategies; iv) intragroup arrangements; and v) IT infrastructure and reporting.

Lastly, another very relevant issue with regard to Brexit that I would like to mention is that of the transition period.

EU and UK negotiators have reached agreement that a transition period should be a matter of mutual benefit and have set the principles for the negotiation of a transition period between the date the withdrawal agreement enters into force and 31 December 2020.

But this transition period will be part of the second phase of the negotiations and there will be no certainty about it until at least this autumn. Up to now, the EU and the UK are following different strategies and even use a different wording to refer to this transition period, “implementation period” being the term used by the UK.

More specifically, the UK has welcomed the agreement on the transition period and has sent out the message that nothing will change up to the end of the “implementation period”. Further, to transmit certainty to institutions operating in the UK, it has committed to bring forward legislation, if necessary, to create temporary permissions in the “unlikely” event that the withdrawal agreement is not ratified.

The EU has a more prudent stance and recalls that nothing is agreed until everything is agreed. In fact, legal certainty will only come with the ratification of the Withdrawal Agreement by all sides involved in the negotiations.

In this context of uncertainty, within the SSM framework, banks are considered to be responsible for taking the necessary steps to obtain all authorisations required for them to carry out their activities in a timely manner to make sure that they can continue to serve their customers after 30 March 2019. They are expected to present credible Brexit plans and to use the possible transition period to implement their plans, not to delay planning. It is acknowledged that adapting to a scenario where the UK becomes a third country is challenging.

Conclusion

To sum up, capital markets - like banks - are facing major challenges at a time of far-reaching transformation. One of those challenges is the uncertainty that a structural change such as Brexit generates. But capital markets also find themselves at a juncture where, first, efforts made in recent years to reactivate specific markets may start showing results and, second, the European political context is such that there appears to be an opportunity to foster the Capital Markets Union and to contribute to deeper and more integrated markets in the European Union.

Thank you for your attention.