BANCO DE **ESPAÑA**
Eurosistema

05.07.2019

Ten years of the FROB and banking system transformations

Opening address to the conference: "Tenth Anniversary of the creation of the FROB"

Pablo Hernández de Cos
Governor

Chairman of the FROB, Chair of the Single Resolution Board, Chair of the European Banking Authority, Vice-President of the European Central Bank, Chairman of the Financial Stability Institute, dignitaries, ladies and gentlemen, good morning.

It is an honour and a pleasure for me to participate in the opening of this conference to commemorate the tenth anniversary of the creation of the FROB.

I should like to take this opportunity to congratulate the chairman of the FROB, Jaime Ponce, and also his predecessors, Fernando Restoy and Javier Aríztegui, and their teams, for the work they have performed over the last ten years.

The FROB embodies one of the main institutional changes made during the restructuring of the Spanish financial sector in the last decade, a process that has been fundamental in paving the way for the recovery of the Spanish economy in the aftermath of the crisis.

Transformation of the Spanish banking industry in the last decade

This period has witnessed one of the most far-reaching transformations in the Spanish financial system in recent decades and the FROB has played an important role in bringing about this transformation.

The Spanish economy was engulfed by the international financial crisis at a time when significant imbalances had built up, which were particularly significant in our financial system.

Spain had an oversized banking system, excessively concentrated on lending to the residential property sector and highly dependent on international wholesale financing.

In 2008, the consolidated assets of the banking system amounted to 304% of GDP, bank lending to the property sector (in the broad sense of the term) reached 99% of GDP and bank debt held by non-residents accounted for 24% of GDP. Moreover a significant number of deposit-taking institutions suffered from institutional and governance shortcomings.

Over the last decade many of these vulnerabilities have been resolved; in particular, those relating to the high level of non-financial private sector debt, which is now at levels similar to those in the rest of the euro area (having fallen by almost 70 percentage points of GDP from its peak in 2010). The weight of lending to property and construction activities has decreased by 47 percentage points of GDP.

This reduction in non-financial private sector debt has been reflected in a decrease in the size of the financial sector and, in particular, in bank balance sheets in Spain, since business abroad has proved to be one of the main determinants of the resilience of some institutions.

Thus, over the last ten years, the total assets of business in Spain have contracted by 20% (a fall of 72 percentage points of GDP) and employment in the sector has fallen by 32%. In addition, the number of bank branches has declined by 43%, while the number of Spanish banks[1] has fallen from 122 at the start of the crisis to 61 in 2018.

Also, all the former savings banks, apart from two, have been transformed into commercial banks, and most of the mergers and takeovers that have taken place have given rise to healthier institutions and have resulted in significant cost savings. The FROB, for its part, has played a prominent role in promoting some of these consolidation processes.

These efforts to correct the excessive size of the sector were also accompanied by a significant balance sheet clean-up. As we all know, the financial crisis caused the quality of Spanish bank assets to deteriorate significantly. Indeed, in just five years the non-performing loan ratio reached unprecedented levels (of around 14% at the end of 2013) and foreclosures rose to over €80 billion in 2014.

The decline in the return on assets and the increase in net provisions for bad debts caused the banking industry as a whole to post a loss in 2012. This weakened bank solvency and, moreover, led to significant capital requirements for some banks, to the extent that public support was necessary to cover the capital shortfalls identified and to guarantee financial stability and, ultimately, the deposits of the general public. The FROB was once again fundamental in this area since, along with the deposit guarantee scheme, it injected around €65 billion of capital into the system.

Another institution set up during the crisis, in which the FROB has a stake, the Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria (Sareb), also played a significant role in this process. Between December 2012 and March 2013, Sareb assumed property development loans with a gross value of approximately €75 billion and foreclosures of €30 billion.

Thus, against a background of notable declines in their activity levels, banks have managed to reduce the weight of troubled assets on their balance sheets very significantly. Specifically, the non-performing loans ratio has decreased by more than eight percentage points and currently stands at 5.7% of total credit. Foreclosures, meanwhile, are at half the level recorded in 2014.

Over this period there was also a significant improvement in the solvency ratios of Spanish credit institutions, which increased their tier 1 capital ratio from 7.5% in 2007 to 13.5% at the end of 2018.

Despite these improvements, the Spanish financial sector clearly continues to face significant challenges. Among other factors, these arise from a non-performing loans ratio that is still higher than before the crisis, a rate of return below the cost of capital, and capital levels that, despite exceeding the minimum regulatory requirements, are on average below those of other European countries and below those needed to restore its reputation.

[1] Consolidated groups and institutions not belonging to a group that are Spanish owned.

In any event, the improvement in the Spanish banking system has allowed it to support the economic recovery and job creation seen in recent years through a more efficient allocation of credit to businesses and industries.

The paradigm shift in bank resolution

This transformation of the Spanish financial sector has occurred in parallel with a far-reaching review at international level of the regulatory and supervisory frameworks for financial institutions. The aim has been to increase the resilience of the banking system and to reduce the impact of financial crises on the economy, with a wave of reforms, the last phase of which was completed in December 2017 by the Basel Committee on Banking Supervision and will be implemented progressively over the coming years.

In Europe, these reforms have been accompanied by very significant institutional changes, in particular, creation of the banking union. And one of the pillars of the banking union is the Single Resolution Mechanism.

As regards bank resolution, these reforms have in fact generated a paradigm shift, as a result of the high cost of the global financial crisis for the public sector in numerous advanced countries. The paradigm shift consists in moving from a bail-out to a bail-in system of bank resolution, that is to say, from rescue or recapitalisation using public funds to rescue using private funds, belonging to the bank itself, through the use of capital, hybrid instruments and, where applicable, the most subordinated debt.

In Europe, the Single Resolution Board (SRB) is responsible for preparing the resolution of significant European institutions. This preparation has already included drawing up resolution plans for all significant institutions, analysing their resolvability on an individual basis and establishing a minimum requirement for own funds and eligible liabilities (MREL) that make it possible to comply with the paradigm shift I have just referred to.

The SRB has also put in place effective mechanisms for cooperation with the national resolution authorities that (like the FROB and the Banco de España) participate in the drawing up of resolution plans and in determining the MREL, and in implementing decisions taken by the SRB, as well as developing their own responsibilities for less significant institutions.

I should like to underline the importance in these European resolution arrangements of the requirement that European credit institutions (including Spanish ones, naturally) have sufficient levels of MREL. The paradigm shift from a bail-out to a bail-in system, and the other tools permitted by European legislation, require that banks have a sufficient level of MREL so that, if the case arises and there is a public interest involved, the institution can be resolved, while minimising the burden on the taxpayer and ensuring the continuity of critical functions and a minimum impact on the rest of the financial system.

For some institutions, this requirement represents a considerable challenge for the coming years. It should prompt them to make adequate planning, to retain sufficient own funds and to issue MREL-eligible debt, and to take any opportunity that may present itself to comply with the requirements within the period established for the purpose.

Challenges remaining on the resolution front in Europe

Despite the tremendous efforts made on the resolution front in Europe, there are clearly important challenges remaining.

First, the details of the backstop for the Single Resolution Fund (SRF) must be outlined. Recently it was agreed that the European Stability Mechanism (ESM) would assume this financial backstop, which would take the form of a credit line, to be used to address exceptional situations where the SRF's own resources prove insufficient for resolution of certain credit institutions. The backstop will have a limit of 1% of the deposits guaranteed in the banking union. It will come into force in 2024 at the latest and must be fiscally neutral in the medium term, so the resources committed will subsequently be recovered through banking sector contributions. In addition, the introduction of the financial backstop will eliminate the ESM's tool for direct recapitalisation of banks.

In this setting, it is vital to ensure that the backstop is sufficient to meet all the potential challenges that the SRF may have to face.

Second, the question of provision of liquidity in bank resolution has to be addressed. If a bank under resolution is sold, the purchaser assumes any liquidity commitments that may arise when the bank opens its doors the next day. However, if the resolution is carried out by means of a bail-in, there must be arrangements in place in case, when the doors open, some of the funding providers decide to withdraw their funds, because they have been affected by the bail-in*,* because they believe the bail-in has not been sufficient, or simply because they prefer not to run the risk of waiting to see what happens to the institution.

In such cases it is essential to ensure that there are sufficient mechanisms in place to provide the institution with liquidity, to grant credibility both to the resolution tool and the resolution process.

In view of how other advanced countries have solved this problem, the solution, in my opinion, could be to involve the central bank as a funding provider, with all due public guarantees provided jointly. However, if any or all of the guarantees were to be enforced, it would be important to ensure the fiscal neutrality of the mechanism in the medium term.

Third, insolvency regimes in Europe must be harmonised. If we have common supervision and resolution schemes for banks in Europe, I believe we should also have harmonised arrangements for winding up banks. This would require having a separate insolvency regime for banks, given their idiosyncrasies and the negative externalities that lengthy and inefficient winding up processes may have for other banks, deposit guarantee schemes and the real economy. This should be a common insolvency regime for all the countries of Europe.

The SRB and the national resolution authorities could play a fundamental role, acting as insolvency administrators, with similar instruments and criteria to those already in place at the European level for resolution of public interest entities (asset separation, sale, bridge bank, etc.). This is not an easy challenge to address, but it is important to analyse its viability and how it may be phased in.

Last but not least, we must complete the banking union. And we all know what that entails: establishing a common European deposit insurance scheme, by a specified date. We need to ensure that all European citizens' bank deposits up to €100,000 are equally secure, irrespective of the institution holding the deposits and of the depositor's country of residence within the banking union.

Once again, if banking supervision and resolution is centralised, then the responsibility for bank deposits should also be centralised. In other words, there should be correspondence between decisions and the consequences of those decisions. Moreover, the empirical evidence available[2] shows that if banks' contributions to deposit insurance schemes are risk sensitive they should not entail systematic cross-subsidisation between countries. It is not only a question of economic efficiency or of shared institutional responsibility, but also of equity between all those of us under the umbrella of this common project – the euro – that was launched now some 20 years ago.

In short, I would venture to say that neither Spain nor the rest of Europe has wasted time in this decade marked by the crisis. Together we have prepared the banking system for the new times ahead, and the FROB has played a key part in this process. Some very significant challenges remain, but we now have more mechanisms at our disposal and institutions that are better prepared to address these challenges.

Thank you very much for your attention.

I now give the floor to the Vice-President of the European Central Bank, Luis de Guindos.

---

[2] J. CARMASSI, S. DOBKOWITZ, J. EVRARD, L. PARISI, A. SILVA and M. WEDOW (2018), *Completing the Banking Union with a European Deposit Insurance Scheme: Who is Afraid of Cross-Subsidisation?,* Occasional Paper Series 208, European Central Bank.