EUROPEAN LEAGUE FOR ECONOMIC CO-OPERATION – E.L.E.C.

MONETARY PANEL

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Introduction

It is more than 500 days since the start of the most important financial crisis of recent decades. It began with significant losses in the portfolios of certain international banks forced to write down their investments in structured products. Subsequently, we also discovered the existence of equally large losses in major investments in these products through structures (SIVs or conduits) that were not recorded in their supervised balance sheets, and accordingly were excessively leveraged.

The financial crisis has been transmitted extremely rapidly among different countries, and the losses have extended to all markets. It is a systemic and global crisis that has impacted the financial system as a whole (institutions, markets and infrastructures) in many countries, but fundamentally in those that are most financially developed. At the same time, the financial crisis has contaminated the real economy, leading to negative growth forecasts in nearly all the advanced economies in 2009.

The bankruptcy of Lehman Brothers was crucial in the development of the crisis. However, it is not my intention today to analyse the reasons for the crisis nor its development. Rather, I would like to put forward certain ideas relating to four specific questions:

1. The European response to the crisis and the problems that may result for the Internal Market.

2. The Spanish banking sector model and its capitalisation level.

3. An outline of the future reform of the international financial system and its implication for the Spanish banking system.

4. The future of banking supervision in Europe.

I. The European response to the crisis

- The bankruptcy of Lehman Brothers triggered major reactions in subsequent weeks. They culminated at the start of October 2008 with a near collapse of the international financial system. In this critical context, the Heads of State and Government of the eurozone agreed, at their summit meeting on 12 October 2008 on a coordinated action plan, which was subsequently ratified by the European Council of 15 and 16 October 2008.

  The action plan approved by the European authorities consists of a set of broadly defined measures that can be implemented by Member States in a coordinated fashion. The decision was made to rescue those institutions with serious solvency problems; recapitalise solvent institutions that were in difficulties; facilitate access to finance; reinforce the confidence of depositors by increasing the cover provided by the Deposit Guarantee Funds; and, finally, make accounting rules more flexible in applying fair value rules for opaque or illiquid assets.

- It is important to stress that Spain has not had to rescue any credit institutions due to solvency problems, and no Spanish institution has been recapitalised using public funds. As in other countries, access to term finance is being facilitated through state guarantees for debt emissions and the creation of a fund for the acquisition of financial assets held by credit institutions. These facilities are being provided at non-subsidised prices and against the highest quality guarantees. Therefore, they are not gifts to the Spanish credit institutions. Nor did the accounting changes that have been authorised – to reclassify assets from the trading portfolio to other portfolios in which fair value is not applied – entailed any gains for the profit and loss account of Spanish banks. This is because our trading portfolio is a lot smaller than that of our European competitors. What is more, we have not invested in opaque products that are impossible to value.

- Although we recognise and support the need to stabilise the situation that has arisen, state aids to banks with solvency problems must be undertaken with the maximum level of transparency.

  We are concerned. The European Commission, pursuant to its competences under the Treaty, has to analyse the measures adopted by Member States under the "concerted European action plan of the euro-area countries" of 12 October 2008. The Commission has published two Communications on this subject, dated 13 October and 5 December 2008, which determined the criteria that should guide the authorisation of state aid to the banking sector.

A meeting of the Ecofin Council took place on 2 December 2008, between the first and second Commission Communication. Probably as a result of the conclusions of this Ecofin Council, the Commission Communication of 5 December 2008 appears to have introduced changes in the criteria to be applied by the Commission in assessing the aid.

One of the most significant changes is that the second Commission Communication does not appear to condition the authorisation of public capital injections for banks on the approval of a restructuring plan for the beneficiaries. In our opinion, the recapitalisation of banks with public funds leads inevitably to a distortion of competition between banks, and this may be seriously detrimental to those that do not receive this kind of assistance. If in addition the recapitalisation mechanisms are different for each country, they will lead to a serious segmentation of the Single European Market.

In our opinion, the best way of avoiding any possible distortion of competition and the resulting detriment to banks not benefiting from financial aid would be for the state aid in the form of capital injections to be conditional on the approval of a restructuring plan for the beneficiary banks, as established by the European Commission Communication of 13 October 2008. The more inefficient banks cannot be allowed to benefit to the detriment of banks that have managed their risks better.

- There is also a serious lack of transparency in terms of capital levels which are apparently required from banks in some Member States. These levels are not only different but also they have not been officially explained or justified. Furthermore and more seriously they are apparently being required without any amendments to the EU Capital Requirements Directive.

  This also entails a segmentation of the Single European Market, which is of concern to Spanish banks. This is why we have been comforted by the declaration of the Ecofin Council of 20 January, which states: "*The Council today confirmed that the provision of capital to the banking sector is not intended to create new higher statutory capital requirements for the banking sector. The capital requirements of Banks should continue to be assessed on a case-by-case basis, in line with existing EU regulation, based on their individual risk-profile and rigorous stress testing. It should be recognised that capital provides a buffer both to withstand the challenging economic conditions and to maintain lending to credit worthy borrowers.*"

II. The Spanish banking sector model and capitalisation

- One of the reasons that the Spanish banking system has been initially less affected by the crisis is that it has a profitable business model based on commercial banking, with the focus on the customer. This provides more recurrent income and a lower risk profile for its operations. Because of this, its results tend to be more stable and recurrent.

  The model of prudent and transparent banking (the Spanish model) is characterised by:
  - A customer-focused retail banking model
  - Mortgages are the basis to establish a close link to customers.
  - Prudent risk analysis: the risk is not sold
  - Risks remain on the supervised balance sheet:
    - They consume capital
    - Liquidity management: finance for the issuer

  But what really makes the Spanish banking system stand apart is that in Spain shadow banking has not taken place. Therefore, there have been no surprises to provide provision against in the income statement for uncovered liabilities nor are there assets pending incorporation into the supervised balance sheets that require further capital provision.

- Therefore, without external support, as I have already said, the BIS solvency ratio of the Spanish banks as at 30 September 2008 was 11.4%, with a substantial excess of more than 41% over the minimum regulatory equity required. Tier 1 was 7.8% on the same date, which compares very well with the figures published by international competitors

- These aforementioned figures reflect that Spanish banks are well capitalised, given their solvency ratios, their business model and their risk profile. It is important to stress this fact, since according to a mistaken theory that is current in the market (and which the Ecofin declaration of 20 January 2009 that I have mentioned earlier aims to counteract), doubts are growing about the adequate solvency of those banks whose Tier 1 is below a certain percentage.

  As I have already mentioned, in Europe there have been no changes to the Capital Requirements Directive: the solvency ratio of a minimum of 8% of risk-weighted assets (Pillar 1) remains in force; and, depending on the institution's risk profile, the supervisor may request greater levels (Pillar 2), which would have to be explained to the market by the institution (Pillar 3).

But above all, it has to be remembered that when it comes to determining the capital level needed, a bank that has to change its business model based in "originate-to-distribute" and investment banking, is not the same as a bank that has a well-defined model of retail banking that provides it with recurrent income and a lower risk profile in its operations.

Talking of solvency, losing money is not the same as earning money and being profitable; and being likely to write-downs future losses is not the same as being likely to make future gains. Having assets that are impossible to value is not the same as not having them, and having a high default ratio and low coverage is not the same as having one of the highest coverage rates in the world. And in terms of solvency, having assets not recorded in the balance sheet and not calculating them in these capital ratios is not the same as not having them because all the assets were always included on the supervised balance sheet. No, it is not the same and it cannot be treated in the same way.

III. Future reform and its implication for the Spanish banking sector

- The outlines of the future reform of the international system are now emerging. (Broadly speaking, they have already been defined in the reports of the Financial Stability Forum (FSF) of April and October 2008, and by the conclusions of the G-20 meeting held in Washington on 15 November 2008. In Europe, they have also been defined by the road map outlined by Ecofin in May 2008.)

I would like to summarise the reforms by dividing them into the following categories:

- **Strengthening capital, liquidity and risk management**
  - Enhanced capital requirements for:
    - Trading portfolio
    - Off-balance-sheet activity
    - Structured products
  - Better management and supervision of liquidity risk

- **Increasing transparency in:**
  - Securitizations
  - Off – balance entities
  - Guidance for fair value accounting

- **Improving the rating systems of rating agencies**

- **Improving the management of financial crises by supervisors, central banks and deposit guarantee funds**

- These lines of reform are very welcome. They do not represent significant changes for Spanish banks because of the following factors:

  - **Their business model:**
    - Reduced trading portfolio exposure
    - Relative unimportance of structured products
    - No activity off the consolidated supervised balance sheet
    - Securitizations
      - Simple and transparent structures
      - Risks remain on the originator's balance sheet

  - **Their risk management culture:**
    - No dependence on external ratings
    - Own systems of analysis and risk rating
    - Checked by permanent supervision from the Bank of Spain

  - **The greater regulatory requirements that they have been subject to:**
    - The Bank of Spain is very demanding in:
      - Securitised capital
      - Quality of equity:
        - Lower hybrid equity computability
        - Greater discounts in calculating revaluations
    - Periodical and detailed financial information
    - Liquidity management: since June 2008 in the Self-Evaluation Report on capital

- Finally, with regard to the possible reforms to be introduced in the banking regulation, I would like to make two points.

  - In terms of the **dynamic provisions**, we of course support the system of dynamic provisions introduced by the Bank of Spain in 2000. So we are pleased to see the interest it has attracted on the part of the international regulatory community, which is currently studying the introduction of a similar system into international banking regulation in order to lessen prociclicality in the banking system.

  - With regard to the possible introduction of a **leverage ratio**, which is also the subject of present discussion, we support this proposal, given that one of the main causes of the crisis has been the high leverage level, as I have mentioned at the beginning. This ratio would provide comparable information and enhance transparency which would strengthen market confidence.

IV. The future of banking supervision in Europe

- With respect to the debate on the future architecture of banking supervision in Europe, I would like to point out that the AEB has defended an evolutionary and open model. Its final goal would be a pan-European supervisory authority, but there is no need to specify from neither the beginning concrete details nor the schedule for achieving such a goal. Progress from the starting point of the current situation should be on a step-by-step and pragmatic basis. Each step will give rise to a new model on which further improvements will be introduced, and so on.

- The priority steps forward to be taken with respect to the current model are as follows.

    - Establishment of a common reporting system for capital requirements (COREP), and of financial reporting in general (FINREP).

    - Implementation of a single rulebook for financial supervision

    - Full and consistent application of the aforementioned rulebook.

- The AEB has demonstrated its support to initiatives such as the following:

    - Full harmonization of regulation

    - Establishment of colleges of supervisors as a fundamental forum for the meeting of different authorities involved in the supervision of cross-border groups.

    - Enhancement of the role of the home/consolidating supervisor, extending its decision-making faculties to Pillars 2 and 3 (Proposal for Article 129.2 of the Capital Requirements Directive).

    - Granting greater powers to the Committee of European Banking Supervisors (CEBS), including decision-making for its members, and at the same time giving it more resources to ensure it can fulfil its functions properly.

Thank you for your attention.