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**The role of the Banco de España in Spanish Banking**

IESE and Harvard Business School

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First of all, I would like to thank both IESE and Harvard Business School for the opportunity to address such a distinguished audience on the occasion of this anniversary. It is a great pleasure to be here to join in the celebrations. My sincere congratulations to IESE on its 50th anniversary and to the HBS on its centenary. Both institutions have so much to be proud of and some of their students are here as witnesses of their success in paving the way forward for international business schools.

In this panel devoted to banking, I want to talk about the contribution that the regulatory and supervisory authorities can make to the successful development of the banking system. For this reason I will touch on the Spanish experience, which I think provides a very clear example of the above.

I will divide my talk into two parts. The first will be backward-looking and will focus on how banking regulation and supervision have contributed to the modernisation and success of Spanish banks. The second will be forward-looking and will examine how well-placed our banks are to cope with the challenges posed by the "new global financial system" that has evolved in recent years, and which is now under tension as a result of the turmoil that started in the summer on the back of the US sub-prime problems.

### **Spanish banking: a success story**

But before I go on to address specific issues, let me briefly recall that having a sound and efficient banking system is key for achieving sustained economic growth and for minimising the intensity of cyclical fluctuations, both of which favourably influence economic well-being. As far as growth is concerned, a soundly functioning banking system which efficiently performs its role of intermediating between savers and investors helps to achieve a better allocation of resources in the overall economy and ultimately fosters total factor productivity and growth. As for cyclical fluctuations, a solid banking system is by definition less crisis-prone. On the one hand, it reduces the likelihood and potential costs associated with financial shocks; and, on the other, it helps to reduce the overall economic costs arising from real shocks insofar as it acts as a buffer. For all these reasons, a sound and efficient banking system is an important source of economic growth and stability.

In fact, Spain's very successful overall economic performance over the past twenty years cannot be explained without taking into account the significant contribution made by the financial sector and, in particular, by the banking system. To be sure, the transformation of our banking system in this period has been remarkable. Much like the mythical Phoenix, it rose from the ashes after the very severe crisis that hit our credit institutions in the late 70s and early 80s to become a most successful banking system. This is evidenced, for example, by its very good performance in terms of profitability, efficiency and solvency both on an absolute basis and by comparison to other countries.

In the light of the above, a key question is what were the factors behind this success story. Although it is by no means easy to answer this question in such a short time, let me nevertheless mention some of the main drivers.

One initial driver is that both banks and the authorities learned the right lessons from the crisis and took measures to avoid the mistakes that led to it in the first place. In the run-up to the crisis our banking system was weak and old-fashioned. It had got used to living in a closed environment and taking advantage of protectionist policies. In fact, it was not well-prepared to face liberalisation, with no good professional teams or systems to adequately identify and manage risk. At the same time, our regulatory and supervisory framework was weak and outdated.

### **What the authorities did**

In the years after the crisis, a number of initiatives were launched by the authorities to foster both efficiency and soundness. As a result, regulatory changes were made to promote a freer and more competitive banking environment. To name just the most significant ones, public-sector commercial banks were privatised and barriers to potential entrants were gradually dismantled, letting foreign banks come in and allowing saving banks to engage in the full range of banking activities. Over time, and as a result of the new rules of the game, which led to a more open, competitive environment, banks embarked first upon processes of consolidation to better exploit economies of scale and scope and, later, significantly internationalised their activities.

It was also clearly recognised that a freer, more competitive banking system needed a significant overhaul of the regulatory and supervisory framework in order to preserve the soundness of the system and to avoid new systemic crises.

Banking regulators and supervisors encouraged banks to adopt better risk management systems, to be more transparent vis-à-vis clients and markets, and to provide more complete and frequent information to the supervisor: Banco de España. The establishment of a strong, professional and independent team of supervisors conducting frequent on-site inspections and the reinforcement of the legal powers of the Banco de España to enforce banking norms and regulations was also of paramount importance. So too was the creation of a central credit registry, the establishment of tougher-than-Basel I solvency requirements and, since 2000, the introduction of a system of counter-cyclical provisions. Finally, and also to keep pace with the internationalisation of the banking system in recent years, the supervision of banking groups is carried out on a consolidated basis and coordination with other national supervisors has been strengthened through the signing of bilateral MoUs.

Another distinctive feature of our framework is that Banco de España is also the accounting regulator for banks. This has allowed our accounting rules to take into account supervisory goals, thus fostering prudential objectives. This allows, for example, for the application of conservative asset valuation principles to enhance asset quality. Needless to say, since 2004 our norms have also been consistent with the new international financial reporting standards.

Beyond these regulatory and supervisory changes, Banco de España has also directly contributed towards financial modernisation through the development of bond market and clearing and settlement payment system infrastructures.

As I mentioned earlier, the regulatory and supervisory framework has established “the rules of the game”. At the same time, banks have, by sticking to these rules, made most significant progress in terms of modernisation.

### **What banks did**

In Spain, banks learned the lessons from the banking crisis and learned, too, how to cope with the challenges of competing in a liberalised environment so as to better seize their opportunities. In fact, banks realised that they have to make continuous efforts to retain adequate internal risk control methods and to invest in technology and human capital. Furthermore, banks have constantly to maintain the capacity to adapt to –and take advantage of– a changing environment.

At present, our banking system is expanding abroad. Our two main banks are leaders in many Latin-American countries and recently their presence in the US, in other European countries and in Asia has also been relevant. Such internationalisation –which is now also being pursued by other Spanish banks– has widened their scope and activities and thus fostered diversification.

Another issue to be considered when talking about the features of the present Spanish banking system is its business model. This has retail banking and traditional banking intermediation as its core activity, far removed from the “originate to distribute” model so widespread and well-known today.

At this point I shall attempt to draw the two main lessons learned through this twenty-year process of modernisation.

Firstly, the regulator and banks have formed a “joint partnership”, prompting a fruitful “virtuous cycle” and matching goals and efforts in order to attain efficiency and soundness. Close communication and constant exchanges of views are the principles currently governing this relationship.

And secondly, as the Spanish case clearly shows, there has not been any adverse trade-off between profitability and soundness over the medium-term. Indeed, the competitive capacity of Spanish banks has not been dented in the least by supervisory policies, which have been oriented towards enhancing the solvency of banks, and to increasing the confidence of the public and of markets in banks.

### **New challenges in a global banking system**

So far, the story has been one of success. But the global banking system is continuously evolving within what is known as the “new global financial landscape”. This is characterised by several features: free international capital flows, global financial markets and global banks, faster transmission of risks from one area to another, and potential cross border contagion effects. In this context, some new products of increasing complexity, many of them derivatives, are being introduced. We are also observing new players such as hedge funds, private equity funds,

conduits, SIVs, etc., whose actions are less and less transparent and subject to little or no regulation. In certain countries the use of an “originate to distribute” strategy has been widespread.

Along with this new financial situation, the forthcoming Basel II package will have to accommodate these new risks. Banks will be able to calculate their capital requirements using internal risk-assessment methods and, at the same time, they will have incentives to better manage their risks.

Overall, the benefits from the new global financial landscape are considerable in terms of efficiency, by making national and international financial markets more complete, and also in terms of resilience, allowing for a wider dispersion of risks.

However, as the recent financial turmoil is showing, problems caused by certain excesses linked to the inappropriate incentives of various agents have also arisen. In fact, there is not as much risk dispersion as was thought, since it has been discovered that there were pockets of fragility where risks were being concentrated. Another point of concern is the increasing opacity of the financial system, with problems building up without their true scale being known until they finally explode. Moreover, some agents may have relaxed their oversight of risks (lenders, rating agencies, investors, and even some regulators and supervisors). Finally, the potential cross border contagion effects of globalized markets and intermediaries is also a point of concern.

And what about Spanish banks? I believe that the Spanish banking system is well-placed to meet the fresh challenges arising from the new financial landscape while continuing to exploit the opportunities this entails. Their successful performance in recent years is the best proof of it.

However, are Spanish banks well-positioned to withstand the current financial turmoil? Undoubtedly, the current tensions in global financial markets, originated by the US sub-prime problems, have increased overall uncertainty in markets, particularly in markets for complex structured products and in interbank markets. Yet I think that there are a number of features in the Spanish banking system that puts it in a relatively favourable position to cope with current tensions. In particular, banks in Spain are characterised by: retail rather than investment banking; not adhering to an originate-to-distribute model; having resorted to securitisation of (high-quality) mortgages to raise funds and not as a business model itself; not being directly or indirectly exposed to US sub-prime loans; having sound systems for credit risk assessment and management; and, finally, having important cushions in terms of profitability, provisions and solvency. In turn, the regulatory and supervisory framework has established: a wide supervisory perimeter not leaving any SIV or conduits outside of it; tough criteria applied to the credit risk transfer mechanism; and, since 2000, counter-cyclical provisioning.

At present, one of the main effects of the turbulence is the drying-up of market liquidity, with access to financing from capital markets proving more difficult and expensive for banks on a global basis. In principle, one should expect the Spanish banking system to be less vulnerable given its heavy reliance on deposits to finance credit, but if the turmoil lasts for a very long time all banking systems in the world will be tested.

Let me conclude with a couple of comments.

First, globalization and the financial innovation that in many cases is related to it, are, as I have already said, essentially positive developments. Nevertheless, the increasing complexity of certain operations we have witnessed can have a downside. As any instrument, they can be put to good and less good use. The present turmoil is providing us with what we could call a reality check that can give rise to a kind of Darwinist natural selection. In fact, this can be a positive development: those instruments whose characteristics and utilization are basically sound will strive and survive; those instruments, business strategies and, potentially, institutions whose *raison d'être* was exclusively the loose conditions of markets and trades experienced in recent years are bound to disappear.

And second, as you know, regulators and supervisors around the globe are analysing the present situation to obtain lessons and make the necessary adjustments. This analysis should be a calm one, making sure that we do not overreact and find ourselves lamenting in the near future rushed decisions taken today. Also, we must make sure that we strike the right balance between rules that enhance financial stability and the need to preserve an international level playing field.

Let me just end by saying that one of the lessons that has clearly come up is the increased need to coordinate these analysis and the corresponding actions among supervisors worldwide. It is true that we have a good and long lasting cooperation in many international committees and bodies. But it is also true that there is room for improvement in that cooperation to assure convergent and consistent reactions internationally.

I am convinced that the close cooperation and continuous feedback between supervisors and institutions, that give rise to the virtuous cycle I have mentioned, will allow us to respond adequately to the present circumstances and to get things back on track potentially on a healthier level than up to now.

Thank you.