Financial reforms in Spain: main developments and some challenges

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• Domestically driven reforms

• Internationally driven reforms
  • Standard and IRB methods
  • The treatment of SMEs
  • The Countercyclical Capital Buffer
The Spanish financial sector has been adapted to the post-crisis environment,…

- Right after the global financial crisis, Spain started the process of reforming and restructuring its financial system. This included:
  - Reforming the governance of the “Cajas”
  - Restructuring and recapitalization of banks
  - Clean up of balances (additional provisions, creation of a “bad bank”), reform of insolvency law, second opportunity law,…
complementing the reforms introduced at the international and European levels

- The main reforms introduced in the Spanish financial system to meet the international requirements or the European agreements are the following:
  
  - The transposition of Basel III
    - More and better capital (Standard vs. IRB methods)
    - The leverage ratio
    - The SMEs supporting factor
    - Liquidity ratios
    - Macroprudential tools
  
  - The Banking Union
    - Single supervisory mechanism
    - Single resolution mechanism
    - Single deposit guarantee system
  
  - Other
    - New accounting standards
    - ...
The credit risk embedded in the balance sheet of a bank can be calculated using two approaches: the standard method and the IRB.

Among the European countries there is a considerable dispersion in the intensity of use of both methods; this has an important effect in the density of risk weighted assets.

Chart C
INTENSITY OF USE OF THE IRB APPROACH. PRIVATE SECTOR

Chart E
RWAs DENSITY. IRB AND SA APPROACHES

SOURCE: European Banking Authority.
The treatment of SMEs

- The treatment of SMEs in the European regulation is especially favorable, since asymmetries in the information could result on credit rationing.
- However, this should not be at the cost of financial stability and it should not create a discontinuity in firm growth.
Spain was one of the few developed countries using a macroprudential tool well before the crisis: the dynamic provisions.

Dynamic provisions are built up and released based on a formula:

- **Six risk categories are considered**
- **Parameters were calibrated using average of credit losses in previous crisis**

This is an automatic mechanism based on the evolution of specific provisions along the cycle.

Credit is a procyclical variable and the riskiest categories gain relevance as the expansion reinforces.

Transparent mechanism: banks have to publish the amount of dynamic provisions.

**Provisions’ Flow (% of total credit)**
Available empirical evidence in Jimenez et al., 2013, supports the view of countercyclical provisions as an effective tool for macroprudential policy.

In fact, they resembled the working of the Countercyclical Capital Buffer:

- After the introduction in 2000, banks reduced committed lending and tightened the general conditions for loans with the firms they used to work.
- That reduction was higher for those banks that had to provision the most.
- In 2004, after the first modification, similar effect was observed, but more muted due to the minor modification of alpha and beta parameters.
- In 2008, the second modification helped in easing the credit conditions for firms.
- This effect was higher in the case of banks where the fund of provisions was closer to the floor.

In hindsight, it seems that the level of provisions should have been higher... but not enough to curb the credit boom.
The Countercyclical Capital Buffer and the guided discretion principle

- Conceptually, the countercyclical capital buffer has important similarities with the dynamic provisions but its operation is very different:
  - It is based in the principle of guided discretion
  - The common standardised quantitative indicator to be used as a benchmark is the credit-to-GDP gap (the ‘Basel gap’)
  - Other quantitative indicators should inform the decision of activating the tool
  - Release indicators could be different, and this decision should be based more in expertise
In any case, a battery of indicators capturing the different dimensions of systemic risks should be considered:

- i) Credit growth and indebtedness;
- ii) Maturity transformation and market liquidity;
- iii) Concentration;
- iv) Incentives and moral hazard;
- v) Macroeconomic imbalances;
- and vi) Effective conditions.
THANK YOU FOR YOUR ATTENTION