BBVA Economic Research Department

How Will the Crisis Shape Financial Regulation?:

A Market View from Spain

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ROADMAP

1. Regulation will be tougher

2. Aims of new regulation

3. Some problems with measures being proposed: Other ways to do it

4. Conclusions

1. Regulation will be tougher

- No doubt regulation will be tougher as a consequence of the crisis
- ***The question is how much tougher and through which tools!***
- Different tools will introduce asymmetric impact on financial institutions!

2. Aims of new regulation

1. Better capitalized banks to absorb losses:

   - Through Higher CAR

2. Less procyclical

   - Countercyclical capital charges

   And /or

   - Dynamic provisioning

2. Several aims of new regulation

3. More liquid

- New liquidity ratios (starting with FSA in England)

4. Penalizing systemic banks versus non systemic ones

- Requiring more capital if banks are more interconnected or simply larger

3. Some problems with measures being proposed

1. *Level playing field is not being reinstated*

- The banking landscape has changed radically in the West with a large number of banks either controlled by the State or under their influence
- If they do not return to private hands before the new regulation is introduced, they will be competing unequally against other banks
- This means that those banks with proper behavior, which did not suffer during the crisis, will be penalized twice through: (i) unfair competition; (ii) stricter regulation

2. Too much about size; too little about moral hazard

- The idea that only large banks can build empires and get in trouble is not proven by facts (also small banks went bust during this crisis and others)

- Taxing larger banks more is not the right way to reduce the likelihood of a crisis: The point is to create incentives for virtuous behavior and reduce moral hazard

- A way to reduce incentives to misbehave is **full consolidation** as is the case of Spain

  - In Spain no SIVs and conduits were created by banks and, thus, no subprime problems were discovered. This is because they required as much capital as any other activity (consolidated)

3. Too focused on increasing capital

- The amount of additional capital required to avoid the global crisis would have been enormous
- Banks operating with so much capital will imply:
  - Lower profitability of banking system
  - Transfer of resources from the banking sector elsewhere
  - Much bigger problem for emerging economies trying to increase bancarization!

4. *Probably not enough on provisioning*

- Capital is there for unexpected losses but many losses are to be expected specially after a credit boom

  Watch out for China ☺!

- For that purpose, provisioning is more effective.
- Furthermore, if credit swings are very much dependent on the cycle, introducing **countercyclical provisioning** tools seems ideal
  - Spain's experience has been quite successful: Although it did not manage to moderate the credit cycle, it did help to build a buffer for the bad times (now!) ***Research available upon request***

5. Not all is about regulation, supervision is also important

- The current agenda is all about regulation one but not much is said about supervision

- Regulation alone cannot change banks' behavior unless somebody imposes it

  - Improved supervision, specially for large banks, may have to go as far as having **<u>permanent supervisory teams</u>** at banks as is the case in Spain

4. Conclusions

- **The global crisis has been so huge that a regulatory response is not only unavoidable but should be welcome**
- **However, such response should be well designed and not introduce wrong incentives**
- **It should also not imply lower credit in the future and, thus, lower growth!**
- **All in all, it would be good for regulators to have a candid discussion with the market and also thoroughly calibrate new regulatory measures before introducing them**

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