Miguel Fernández Ordóñez: Spanish financial institutions in the face of the new competitive scenario

Opening address by Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, of the XVI Financial Sector Meeting "Spanish financial institutions in the face of the new competitive scenario", ABC-Deloitte Forum, Madrid, 21 April 2009.

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Thank you very much for inviting me to participate in this meeting which will address a subject –Spanish institutions in the face of the new competitive scenario – of the utmost importance at the current juncture.

The highly exceptional difficulties besetting the global financial system and economy require decisive action from all of us who, in one way or another, have responsibilities in these matters. The public authorities of different countries, including those in Spain, are taking measures which in many cases are unprecedented. But their efforts cannot and should not be restricted to this area: the managers of financial institutions must reorganise and adapt their business models to the new competitive environment, actively seeking out levers permitting this process of change. I will devote the bulk of my address to this issue, not without briefly describing the situation of the Spanish banking system as a whole set against the international outlook.

The external environment remains hugely complex. This is because, on one hand, acute uncertainty and instability continue to plague international financial markets, while the freeze persists in what were the key funding markets until 2007; and, on the other, the real economy has entered a sharp downturn manifest in a widespread synchronised recession affecting both developed and emerging countries.

The global dimension of this crisis and the interaction of the difficulties assailing the financial system with those of the real economy are shaping an outlook of unprecedented complexity. Accordingly, there is the risk of entering a vicious circle in which the difficulties of one sector feed back into those of another, aggravating problems and making them harder to resolve.

The seriousness of the situation has compelled economic and monetary authorities in many countries to adopt some extraordinary measures, including bailing out what are often very large financial institutions. International difficulties remain in this field and the disclosure of further losses related to complex structured products cannot be ruled out. This is forestalling any end to the climate of uncertainty and lack of confidence.

In recent months, central banks have adopted a wide range of measures, some of which are unconventional. Particular emphasis was placed on supplying the system with the necessary liquidity for it to continue to function. In the case of the ECB, this took the form, among other initiatives, of its decision in October 2008 to extend its commitment to satisfy all demands for liquidity at a fixed rate with full allotment, in such amounts as necessary, and at least until the beginning of 2010.

These actions of central banks have been complemented by others by governments, which have set up guarantee systems for the debt issues of financial institutions so that the latter can access the wholesale funding markets, which had been closed even to institutions with the best credit ratings.

This type of measure, which averted a total collapse of the financial system, enabled certain markets to show signs of a slight improvement in relation to their situation in September 2008. Such is the case, for example, of the money markets, where there has been a slight correction of risk premia. The public-sector guarantees for financial institutions' issues boosted the volumes issued on primary fixed-income markets.

However, as mentioned above, normality has not returned to the markets where institutions are looking for funding, and difficulties persist in terms of amounts, prices and maturities. Some of those markets, which had played a very important role prior to the summer of 2007, simply remain closed. This applies, for example, to securitisation and mortgage covered bond markets. There is no doubt that this poses a difficult challenge for credit institutions previously used to practically unlimited liquidity.

The recent forecasts by various international organisations indicate that, in fact, we are in a very serious worldwide recession, from which neither the euro area nor the Spanish economy have been spared. In general, according to the available forecasts for developed countries, the problems will be acute in 2009, although it is expected that at some point during 2010, taking into account the current high uncertainty any forecasting exercise entails, an incipient recovery may become discernible.

The Spanish banking system, as is inevitable when faced with a global financial crisis, has not been immune. Nevertheless, the impact has been no less than in other banking systems, where public authorities have had to take control of very large institutions, as I have said.

This better relative performance can be explained by at least two factors. Firstly, the business model of Spanish credit institutions is based on traditional retail banking and is founded on long-term relationships with customers and creditors. This type of banking model has enabled credit institutions to acquire in-depth knowledge of their customers, reducing the perverse effects linked to asymmetrical information present in any banking business model. Similarly, since it does not use asset securitisation as a risk transfer mechanism but only as a means of obtaining liquidity, the origination and acquisition of complex structured products has been avoided, which have proved to be substantially opaque and the cause of hefty losses for many institutions in various countries.

This retail banking model was under debate before the financial crisis broke out in summer 2007, and many analysts considered it obsolete. However, it has proved to be more resilient in the current situation than the originate-to-distribute model which was used intensively in certain banking systems, and lies in fact at the heart of the crisis. Other considerations aside, since the institutions hold on to the risks originated, the perverse incentives associated with the originate-to-distribute model have not been generated in the extension of credit and in its subsequent monitoring.

A second factor why the international financial crisis did not directly impact the Spanish banking system has been the Banco de España's prudent regulation and supervision. I can offer two widely known and acknowledged examples. The first refers to supervision of credit institutions. The broad scope of this supervision acted as a deterrent for the creation and use of certain off-balance sheet vehicles. The second example refers to the area of regulation and, in particular, a system of provisions characterised by very demanding specific-purpose provisions and, especially, dynamic provisions. Under this latter type of provisioning, which has been in force in our system since mid-2000, latent risks and losses in upturns must be recognised, with the result that their build-up on banks' balance sheets has an immediate effect on institutions' income statements.

Obviously, the above-mentioned measures have not been sufficient to isolate Spanish institutions from the financial crisis. These institutions have been hit in particular by the closure of various wholesale funding markets which they had turned to in previous years to finance part of the growth of their lending activity.

The ability of Spanish institutions to step up deposit-taking, as an alternative source of financing to wholesale funding markets, and the ECB and governments' measures have alleviated the liquidity shortage. However, time deposits cannot grow indefinitely at rates of above 20% and, in fact, this source of funding will foreseeably peter out. Similarly, it cannot be assumed either that the measures adopted to facilitate liquidity in the system and the structural characteristics of the Spanish banking system, which I referred to before, are a foolproof guarantee that there will not be any problems.

In fact, the turmoil generated by the international crisis has fed through to the Spanish economy and impacted it at a time when it was beginning to adjust the imbalances which had built up during fifteen years of continuous high economic growth.

All these factors led Spain into an economic recession which is reflected most significantly in the sharp rise in unemployment. This, together with high corporate and household debt, in the framework of what had been excessively lax financing conditions, has now resulted in a weakening of households' and firms' spending capacity and of their financial position. And the consequence has been a rise in bad debts in the Spanish banking system.

Although the recent trend in interest rates is a considerable relief for many debtors, the rise in bad debts, which will continue over the next few quarters, poses a risk which deposit institutions must manage with great caution.

This results in the gradual weakening of the income statements of credit institutions, which requires them to react decisively. Thus, it is of paramount importance that business models and income statements are in step with the new reality.

In simple terms, in order for Spanish deposit institutions to remain in a sound position, they will have to face the new challenges of the current situation by finding levers for change which allow them to counter the adverse developments currently putting pressure on their income statements, and incorporating such levers into their business models.

Let me give you some figures on the recent trend in income statements. The consolidated profit of Spanish deposit institutions fell at a rate of approximately 20% in December 2008 with respect to December 2007, while in June 2008 it had declined by slightly less than 3% on June 2007.

Two general remarks can be made about these figures. First, comparison with the results posted by institutions in other banking systems in developed countries is favourable for Spanish institutions; practically all of them continued to post positive results, mainly due to the factors I mentioned earlier. The complex and rather opaque products that caused notable losses at institutions in other countries were avoided. At the same time, the banking model in Spain is less reliant on developments in financial markets and on investment banking activities.

Second, the data mentioned previously show that Spanish institutions' income statements have been affected by the gradual deterioration of the economic situation. Although it is natural to some extent that, in more adverse conditions, results and profitability have not increased as notably as in recent years, there is a clear and pressing need for resolute action by managers aimed at countering these pressures.

I would like to briefly describe the developments in the main income statement captions and then identify the courses of action available.

The net interest margin performed well in 2008 and its growth of around 14% over the same period of the previous year was higher than that of activity. This favourable performance, despite representing a slowdown with respect to other years, reflects highly recurrent core income from banking activity, a characteristic of the Spanish banking system. Also, net interest margin growth was favoured by the high percentage of lending granted at variable rates, which allowed institutions to progressively raise interest rates in the first half of 2008.

However, financial costs also grew strongly, and may continue to do so in the future. The higher pressure from funding costs has three sources. First, the notable increase in risk premia, in a very sharp pendulum swing, has surely over-corrected the abnormally low levels reached in summer 2007, so these levels will foreseeably not be regained when conditions in the international financial markets return to normal. Second, the persistent difficulties in obtaining funding on the wholesale markets, which are also unlikely to regain the rate of expansion seen in the past, have led to notably heightened competition for new deposits, particularly time deposits, the cost of which is higher than that of other alternative sources of funding. Lastly, it should be recalled that in a setting of low interest rates, the cost of bank deposits has a floor, and this also contributes to the narrowing of margins.

For these reasons, the net interest margin will foreseeably come under downward pressure in an environment in which it is not, and will not conceivably be, offset by increases in the volume of activity.

Fees and commissions fell slightly in absolute terms. Firstly, analysis of the various components of fee and commission income shows that those directly related to more traditional banking activity have, in line with their lower rate of expansion, grown more moderately.

Secondly, Spanish deposit institutions have been marketing non-bank financial products and securities services to their customers, which has generated significant fees and commissions. However, the data for December 2008 reflect a fall in fee and commission income from business of this type. This is because the difficulties besetting financial markets have made these products less attractive to customers and because institutions have changed their product mix. It thus seems that their customer sales focus has moved from fee-generating products which they themselves market, such as pension and investment funds, certain insurance products, etc. towards deposits. This has unquestionably helped traditional fund raising at a time like the present, but at the cost, irrespective of other considerations, of lower fee and commission income in profit and loss accounts.

Another area in which institutions' income statements have come under pressure is in gains on financial transactions, which decreased significantly in 2008, largely due to the difficulties besetting financial markets, which have adversely affected trading book gains. In any event, as mentioned above, in the Spanish banking model the weight of income from financial transactions is low compared with that in the originate-to-distribute model.

Operating expenses grew moderately, albeit still at a rate similar to that of activity. This was the result of changes in their two main components: personnel costs, which, with a weight of nearly 60% of the total, grew by nearly 7%, and administrative expenses, which increased by 9%. These rises, which can be considered high in the current circumstances, meant that both the relative weight of operating expenses in average total assets and the efficiency ratio showed signs of stagnation in 2008, after having improved continuously over recent years.

Finally, loan loss provisioning expenses increased sharply against a backdrop of rapid and significant rises in bad debts. Higher bad debts mean higher specific provisions, which, however, were partly offset by general provisions, since some institutions began to use the provision which had been set up for this purpose at a favourable time in the business cycle. In addition, the rise in loan loss provisions was because some institutions decided to increase their provisions to help them face this more uncertain and troubled period, since the system in place in Spain sets an obligatory minimum but permits larger amounts to be set aside when there are signs of problems.

In short, analysis of the data for 2008 shows that, although the results of Spanish institutions compare favourably with those of their counterparts in banking systems in other developed countries, income statements have begun to come under downward pressure. This situation, which may persist in the medium-term, is due to a broad range of factors mentioned earlier: narrower net interest margins, smaller fees, lower gains on financial transactions and higher loan loss provisions.

Given this complex situation, what courses of action are available?

First, it does not now seem reasonable to expect that the narrowing of margins can be offset by increased volumes of activity. Banking activity, particularly lending, has gone from growth rates of more than twice nominal GDP growth before the crisis to rates currently around 5%. It cannot be ruled out that the slowdown of this variable will continue, or even that it will record zero or negative growth rates. From a medium-term perspective, and even when conditions are established that will free up the flow of credit from the banking sector to the real economy, it cannot be expected that rates of expansion will rise again to the heights of recent years. The de-leveraging process underway in the banking sector, and in the economy in general, is not a passing fad, but rather a means of achieving lower and more sustainable debt positions.

One way of making up for the lower rates of credit expansion, and thus countering the foreseeable narrowing of net interest margins, would be to diversify banking activity into new business segments. In principle, diversification is a positive thing, but it must be undertaken with caution. Experience shows that both in Spain and internationally, only on limited occasions can an institution's sound knowledge of its core business be directly transferred to activities that lie further afield. Accordingly, those in charge of institutions should show prudence and avoid what can be termed contrived diversification processes and carefully assess their entry into unfamiliar market segments in which they lack experience.

Second, in the short term bad debts will keep rising and so the pressure on loan loss provisions will continue to be high. It is true that the reduction in interest rates will bring relief for households and firms and help to limit the impact of the rise in bad debts, but the contractionary phase of the cycle will foreseeably last some quarters. In this respect, from the standpoint of income statements, credit institutions have limited room for manoeuvre. Nevertheless, they should avoid imposing indiscriminate rules on customers when they grant new loans; further, they should select borrowers more cautiously and appropriately differentiate the interest rates applied to each of them.

Against this background of moderate lending growth and higher loan loss provisions, it does not seem that fees or gains on financial transactions can offset the pressure on the income statement. First, as I just mentioned, because it is unlikely that growth rates will be very high in this more sluggish economic environment in which financial market difficulties persist. And second, because, even if they are, given the weight of these items in income statements, they would be unlikely to act as offsetting mechanisms because of the sheer size of the pressures mentioned earlier.

The most effective course of action, and that on which institutions' efforts should focus, is operating expenses. And homing in on operating expenses means not only limiting their growth, but should also lead to reducing those expenses which, because of their nature, are more variable. It is essential to exercise utmost care in taking on overheads, which are difficult to reverse. At a time like the present, it is preferable to have flexible cost structures which enable greater room for manoeuvre.

The effort needed is formidable, and will undoubtedly require operating structures to be accommodated to the new competitive reality of the sector. In regard to, for example, bank offices, institutions should reconsider their scale and probably reduce their number, as well as promoting the productivity of those which remain operational. It is true that the proximity to customers has afforded significant competitive advantages to the Spanish banking model. But it is equally true that the potential advantages of a larger scale and proximity to customers can turn into overhead costs which are burdensome in a crisis and can weaken income statements already under downward pressure due to other factors which are hard to deal with.

Having said this, my words cannot and must not be taken to mean that stricter cost management will be the cure-all enabling all institutions to circumvent the potential difficulties for their income statements. From the standpoint of business model redesign and adaptation to a new reality, it is evident that appropriate cost management is essential. But it may not be enough. I am sure that institutions are not going to disregard restructuring processes which will enable them to resize while harnessing synergies and economies of scale. Indeed, in the past, Spain has seen numerous processes of this type which have resulted in highly successful business models.

Let me sum up.

The complexity of the international financial crisis and of the synchronised weakening of the real economy in numerous countries puts banking systems in a complex and exceptional position.

In these circumstances, the firm adoption of measures to overcome the crisis is not only the responsibility of the public authorities – a task to which a strong commitment was shown following the last G20 summit – but also of those responsible for managing and designing the business models of credit institutions.

Spanish institutions, which so far have handled the difficulties comparatively better than those of banking systems in other developed countries, have to actively seek solutions to adapt their business model to the new realities of the banking sector both in Spain and internationally. They have to seek out the levers for change which will allow them to strengthen their business model and thus their income statements. Among the available options, that of redesigning their operating cost structure, at this point in time, seems unavoidable. However, this action alone will not be enough to overcome the pressures which affect and will continue to affect their income statements. At times it will be necessary and appropriate to turn to processes which take a step further and help institutions to exploit synergies and economies of scale.

Thank you.