Fernando Restoy: The financial sector and the banking union

Speech by Mr Fernando Restoy, Deputy Governor of the Bank of Spain, at the Círculo Financiero, organised by La Caixa, Barcelona, 18 May 2015.

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1. Introduction

Good evening. It is a pleasure to visit Barcelona again and an honour to stand on this rostrum at the Círculo Financiero, which has borne witness to the key debates affecting Catalonian, Spanish and European society over the past forty years.

Allow me to thank the organisers and, in particular, Isidro Fainé, for the opportunity to participate in this forum. Following Isidro's suggestion, I have decided to share with this eminent audience tonight some thoughts on the transformation the Spanish banking system has undergone.

I think the current juncture is a most timely one for addressing the subject: in July three years will have elapsed since the signing of the Memorandum of Understanding (MoU), which marked the start of the financial assistance programme, approved by the European authorities, under which a most substantial portion of the reforms to the Spanish banking system were undertaken. Six months have likewise gone by since the Single Supervisory Mechanism commenced operating in the euro area, and the Single Resolution Mechanism has now been set up. These landmarks make for an appropriate setting both for reviewing the scope of what has been achieved and, naturally, for discussing the challenges ahead for Spanish banks in the new economic and institutional environment of which the banking union is a key part.

I shall structure my address around four simple questions. What were the problems of the Spanish banking system? What was done to try to resolve them? What results were achieved? And, finally, what is left to be done and what challenges lie ahead?

2. The problems

Looking back, the crisis can be seen to have had an enormous impact – one not yet fully absorbed – on levels of employment and well-being. Likewise apparent are the significance of the banking sector in the development of the crisis and the efforts taxpayers have had to make to restore financial stability. And in this light, it is difficult to avoid having a very negative perception of the functioning of the banking system in the run-up to the crisis.

That said, the Spanish banking industry has, traditionally, been a rather profitable one, capable of successfully pursuing a very effective commercial banking model, of developing valuable franchises built on a highly stable customer base and, in the case of the biggest banks, of significantly expanding their business beyond our borders.

Moreover, thanks to the business model then prevailing and to the supervisory action, the industry remained immune to destabilising practices common to other banking systems, such as investment in complex products that were short on liquidity and inadequately valued, which triggered the global financial crisis in 2007.

Undoubtedly, however, Spanish banks had particular shortcomings which, along with the turbulence on European debt markets, account for a relevant part of the crisis in the sector from 2010.

In my opinion, there were essentially four such shortcomings: i) the markedly excessive size of the financial sector, which took the form of an accelerated expansion in lending in a low interest rate setting, ii) excessive exposure to the real estate sector, which underwent an unsustainable boom, iii) an insufficient own funds base to meet the risks assumed, and iv), lastly, appreciable weaknesses in corporate governance, management and risk control systems in a relevant segment of the sector.

The reforms since undertaken should indeed be understood as a set of actions whose aim was to redress these singular weaknesses of our financial system.

3. The measures taken

What was done to combat these shortcomings? I believe the measures taken may be grouped into four central issues.

i) Balance sheet clean-up

Firstly, it was necessary to facilitate the clean-up of bank balance sheets and, in particular, to reduce exposure to the real estate sector, which was weighing on banks' solvency. This was mainly achieved through two types of measures. On one hand, further to two decree-laws and various supervisory initiatives, the already-demanding provisioning requirements were increased, particularly for the most sensitive exposures. And on the other, Sareb (the asset management company for assets arising from bank restructuring) was created, and all banks that received public assistance were obliged to transfer their real estate assets, whether impaired or not, to this company. As a result, by end-2014, Spanish deposit institutions' level of exposure to real estate development, net of provisions, had fallen by around €140 billion since 2011, almost 60% of the exposure then existing.

ii) Consolidation

A second package of measures involved driving greater consolidation in the sector and thus redressing its excessive size. This was achieved through corporate integration operations, the acceptance by most banks of business restructuring strategies and the elimination of non-viable banks, through resolution processes.

Overall, since 2007, the number of banking groups has diminished by 40% (or 40 banks). Likewise, the number of offices in the banking sector has declined by 30% relative to the 2008 peak, and staffing numbers have fallen by 25%. That makes for a notable capacity-adjustment drive which has been decisive in improving operating efficiency in the industry.

iii) Recapitalisation

Thirdly, the measures aimed at promoting the recapitalisation of banks should be highlighted.

As I said, while the Spanish banking sector was generally able to meet comfortably the regulatory requirements in force before the crisis, overall it had insufficient leeway in terms of capital to withstand such adverse scenarios as those arising from the far-reaching downturn in the macroeconomic situation as from 2010, and the acute correction of the real estate market.

The recognition of losses caused by the adverse turn in macroeconomic conditions weakened the financial situation of the sector as a whole. In the case of the most vulnerable banks – which accounted for little more than 20% of the system – these developments ultimately threatened their viability, generating appreciable risks to continuing financial stability. As you all know, this situation could only be resolved through the contribution of significant public funds, most of which under the financial assistance programme and financed, therefore, with European funds.

Thus, through the Fund for the Orderly Restructuring of the Banking Sector (FROB) the State has since 2009 contributed a total of €53,553 million in various forms of capital. The industry has also contributed to the recapitalisation of vulnerable banks by providing, through the Deposit Guarantee Fund (FGDEC), a total of €7,942 million, on top of the €2,250 million provided to the FROB in 2009. Also to be added here is the value of the various guarantees granted on the different sale processes involving State stakes, discounting the consideration obtained thereon. All these calculations are detailed in the related information regularly published by the Banco de España.[1]

Clearly, then, the public effort for the recapitalisation of the system has been considerable. In comparative terms, the assistance granted in the form of capital in Spain (FROB and FGDEC), amounting to 6% of GDP, is similar to that provided in Belgium and the United Kingdom, somewhat higher than that furnished in Germany and the Netherlands, where it stands between 2% and 4% of GDP, and clearly below that made available in other countries such as Cyprus, Greece and Ireland, where it accounts for between 11% and 38% of GDP, according to European Commission figures.

This most sizeable contribution of taxpayer funds can be justified by the need to mitigate the harm caused by banking crises to the economic system as a whole via the effects on the confidence of bank customers and the proper functioning of financing flows in the real economy. That said, in view of the enormous impact the crisis has had on numerous countries' public coffers, the international regulatory community is developing new resolution regulations – largely already incorporated into our legal system – which should in future allow for the management of banking crises with much less involvement of public funds.

In any event, the clean-up and recapitalisation of the Spanish banking system goes far beyond the measures taken by the public sector. The strengthening of balance sheets has been across the board in the entire industry, which has resolutely set about raising provisioning substantially and increasing its own funds.

Hence, since 2008, the sector has set aside provisions for outstanding loans or foreclosures for more than €280 billion. After absorbing this substantial balance sheet clean-up into results or reserves, banks have managed to increase their own funds by more than €60 billion over the same period. This massive effort is unprecedented in Spanish financial history.

iv) Regulatory reform

As regards the fourth and final ingredient of the reform process undertaken, I should like to highlight the initiatives aimed at improving the regulatory framework for credit institutions. These include most notably the reform of the savings bank sector in Law 26/2013.

I believe that, irrespective of the sound trajectory of some savings banks, it is currently an indisputable fact that their particular legal form often hindered the rigorous professional management of banking business, in a setting in which savings banks had become more complex and bigger, increasingly moving away from their foundational goals. Above all, the nature of savings banks frequently prevented a reaction to adverse developments that seriously impaired their solvency. To a greater or lesser degree, these factors contributed to the crisis at various savings banks, which appreciably damaged the stability of the banking system as a whole, and whose rectification, as earlier stated, entailed sizeable costs for the public at large.

The reform firstly seeks to confine the application of the traditional status of savings banks to those that retain a limited size and scope, thereby ensuring the link between the institution's welfare function and its operating region.

The former savings banks that exceeded a specific size have had to convert into foundations, whose main function is the management of their welfare projects drawing on the

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[1] See "Background note on public financial assistance in the restructuring of the Spanish banking sector (2009–2015)".

return on their assets. Likewise, the Law provides for various mechanisms – such as the requirement, where appropriate, for a management protocol, a financial plan and the setting-up of a reserve fund in foundations – to safeguard the independence and professionalism of bank management and to generate incentives for the orderly reduction of the stake of these foundations in banks, to levels compatible with the absence of control.

I believe the new regulations – soon to be complemented by a Banco de España circular – point the way for a new organisational model for the sector more in keeping with the current demands which include ever-stricter prudential and corporate governance requirements. Under this model, and after a suitable transition period where necessary, significant banks would generally adopt the form of a listed public limited company, so that they are able to compete in the market to raise the capital and funding required for the orderly pursuit of their activity in the new regulatory environment. I believe that in this forum – sponsored by La Caixa – I need not insist on the viability and reasonableness of this model for the former savings banks.

With the social need to ensure general access by the population to financial services having largely been met, an area in which the savings banks have undoubtedly made a historical contribution, the endowment and management of the welfare project fund – which should be maintained given its great public usefulness as the distinguishing mark of the foundations – can be perfectly fulfilled, and indeed strengthened, on the basis of the return on diversified assets that do not necessarily comprise a controlling position in a specific bank.

4. What results have been achieved?

I consider that the effort made has essentially enabled the objectives set to be achieved. This has been corroborated by the assessments made both domestically and by international organisations. In particular, the ECB’s comprehensive assessment of banks at the end of last year, as part of the groundwork for the start-up of the Single Supervisory Mechanism, was illustrative in this respect. As you will recall, the comprehensive assessment exercise comprised two legs: an asset quality review and a stress test.

The asset quality review revealed that Spanish bank balance sheets broadly reflected the risks derived from their investment with greater rigour than that observed in other jurisdictions, with fewer shortcomings having been detected in respect of valuation or provisioning for the exposures analysed. Hence, the incidents encountered in this review subtracted, on average, 14 bp from Spanish banks’ common equity tier 1 (CET1) ratio, compared with an average impact three times greater at the participating European banks.

The stress test in the face of an adverse macroeconomic scenario also showed satisfactory results for the Spanish banking sector. On average, the adverse scenario would have involved a reduction of 144 pp in Spanish banks’ CET1 ratio, without the minimum established capital ratio having failed to be met in any case. In the case of European banks, this average impact would have amounted to 300 bp.

These results confirm that the financial reform undertaken in Spain has managed to satisfactorily correct the shortcomings in our banking system, thus placing it in a favourable starting position as the SSM has commenced operating.

The latest profitability figures confirm the ongoing normalisation of the sector. Following the losses posted in 2012, against the background of the strong increase in provisions for asset impairment, deposit institutions, which had restored positive results in 2013, recorded profits after tax of almost €17 billion in 2014. Profitability in terms of equity, ROE, stood at 6.6% at December 2014, having increased by almost 1.5 pp on the previous year (5.2%).

That said, profits in the industry, which are still modest in historical terms, are largely based on lower provisioning as a result of the cyclical improvement in the economy and also on the gains and losses on financial assets and liabilities. Thus, as is the case in other developed countries, commercial banking business margins remain at low levels in what is a still-unfavourable setting marked by the contraction in lending and the low level of interest rates. I shall make some brief comments later on the challenge of profitability.

5. What are the challenges that lie ahead?

In recent years the environment in which the banks operate has undergone a significant transformation, owing to the changes in economic conditions and to the shift in attitudes provoked by the crisis, among investors, consumers of banking services and also the financial authorities themselves. As a result, banks are being required to make significant strategic adjustments.

From among the numerous challenges facing the industry in the short term, I would like to highlight three: i) those resulting from the far-reaching changes in the regulatory and supervisory framework; ii) those arising from the lower business profitability; iii) and lastly, those associated with restoring banking customer confidence in the wake of the reputational damage suffered during the crisis.

i) Regulation

The first main challenge facing banks is the need to adapt to the new European regulatory and supervisory framework.

As I have said, Spanish banks have successfully adapted to the new capital requirements, comfortably meeting the new limits established in the prudential regulations deriving from Basel III which have now been incorporated into Spanish law and are to be gradually phased in. In addition, bearing in mind the present composition of Spanish banks' balance sheets, no major adverse impact is to be expected from the upcoming introduction into European legislation of the new limits on liquidity and leverage.

It is true, however, that certain requirements could become somewhat more demanding, as a consequence of the harmonisation of the different national applications of the European legislation being undertaken by the SSM and which could affect, among other things, the implementation schedules for the Basel Accord.

In any event, even assuming immediate and comprehensive application of Basel III, the capital ratios of Spain's significant institutions would generally remain at relatively comfortable levels, although they would decline by more than the average for the institutions supervised by the SSM.

It should also be noted that the work on the harmonisation of solvency ratios is not confined to the calculation of regulatory capital, but also includes measuring the total risks assumed (the so-called risk-weighted assets) on which the capital requirements are based. In this respect, Spanish banks are somewhat better prepared than other euro area peers for an increase in supervisory demands. Thus, according to the figures recently published by the Banco de España,[2] Spain's banks are among the group of institutions that apply the strictest criteria – owing to the lesser use of internal models and their higher conservative nature – to measure the risk-weighted assets used to calculate the solvency ratios.

A key development that could play a significant part in shaping banks' balance sheet management policies is the forthcoming introduction of the minimum requirements for loss-absorbing capacity in the event of resolution of banks. These requirements, which are being analysed at a global level by the Financial Stability Board and, at the European level, by the

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[2] See the Financial Stability Report, May 2015.

European Banking Authority, aim to make it possible to handle the failure of credit institutions while minimising the need for public support.

This legislation will foreseeably prompt important changes in the composition of banks' liabilities which, in addition to a minimum volume of instruments eligible as regulatory capital, will have to include other instruments that may be converted into capital in the event of failure. These requirements could be especially demanding for institutions with lower levels of own funds and greater objective difficulties for issuing debt instruments on the markets that meet the new convertibility requirements.

Accordingly, despite their indisputable achievements, Spanish banks as well as other European peers must continue to strengthen their own funds and, where appropriate, to make the transformations necessary to allow them to raise on the market the funds needed to comply with the new regulatory conditions, both in the prudential sphere and in that of resolution.

ii) Profitability

The second key challenge for credit institutions is to restore acceptable profitability levels.

It is true, as I indicated earlier, that in recent years most European bank income statements have reflected sluggish growth. This is largely a result of cyclical factors such as persistent macroeconomic weakness (despite the recent improvement), subdued credit demand amidst deleveraging by households and firms alike and low interest rates which exert considerable pressure on financial margins.

Nevertheless, there would also appear to be structural factors that could keep banks' returns on capital permanently below their pre-crisis levels. In particular, it is reasonable to assume that stricter prudential regulations will moderate banks' profits, if for no other reason than the higher regulatory cost they impose on high-risk exposures which are usually also those that generate higher expected returns. More generally, as I mentioned earlier, one of the aims of the new legislation is to increase the participation of banks' shareholders and creditors in the absorption of losses in the event of bank failure. This means reducing to a minimum the idea of an implicit state guarantee for banks' liabilities, which will naturally have an impact on the industry's financing costs and, therefore, on bank profitability.

In addition, it should also be noted that medium-term trends in advanced economies – characterised by the need for deleveraging, moderate productivity growth and population ageing – exert downward pressure on potential growth and prompt excessive structural saving which will tend to keep interest rates low.

As a result, we may see marked changes in the banking business. Given the limited scope for cutting deposit rates, low interest rates tend to depress net interest income. Thus, it will become increasingly difficult to maintain the cross-product subsidy whereby banks often exploit the loan-deposit spread to cover the cost of providing services to customers. Indeed it seems reasonable to expect that the zero fees policy will gradually fade into the background and that competition for deposits will shift in part to the business of providing transactional services.

In any event, Spanish banks must adapt their business strategies to the new environment and must, in particular, take measures to continue to improve their operational efficiency. It is true to say that operational efficiency is, in general, already high in the Spanish industry in comparison with the rest of Europe, as Spanish banks on average have lower cost indicators than their euro area peers, but there are considerable differences from one institution to another and there is, therefore, room for improvement.

It seems particularly appropriate to reflect on the need to adjust the commercial model of Spanish banks which is characterised, despite the industry consolidation, by a number of offices per capita which is much higher than the European average. In my view, both technological progress, which allows banks to increasingly interact with customers beyond physical points of sale, and the need to restore bank profitability on a sustainable basis, are sufficient arguments to support this reflection.

iii) Reputation

Lastly, a third challenge that I consider particularly important in the present environment is to rebuild the industry's reputation with investors and customers, restoring to full health what is the banking industry's main asset and one which, although it does not figure on banks' balance sheets, is of vital importance to ensure their viability.

An unwanted legacy, worldwide, of the banking crisis has been the erosion of general public trust in financial institutions which have all too frequently breached current standards of conduct and, in some cases, have been involved in unlawful practices.

In Spain, the reputational damage suffered by the industry is associated in part with the allegations of irregular practices followed by former executives at institutions that subsequently received large amounts of public money and which are currently being investigated by the courts. Moreover, a number of banks have been ordered, through administrative proceedings or through the courts, to pay costs arising from breach of standards of conduct, especially relating to mis-selling of financial instruments and banking products.

Fortunately, Spain's banks have responded well, increasing the attention they pay and the resources they allocate to complying with legislation and honing their selling practices. Nevertheless, further measures could be envisaged, for example relating to the arrangements in place for settlement of bank customers' complaints and claims.

Under the existing two-tier complaints system, in the event of a dispute bank customers must first contact the bank concerned, which must necessarily have a customer service department or unit. If they are not satisfied with the response received, they may then apply to the claims departments of the financial supervisors – the Banco de España, the National Securities Market Commission (CNMV) or the Directorate General of Insurance and Pension Funds (DGSFP), according to the subject-matter of the claim – which will issue a non-binding opinion.

This system has several problems. On the one hand, it is not sufficiently flexible to provide customers improperly treated with due satisfaction in a reasonable period of time. And on the other, there is no arrangement in place for a third party to issue an opinion that is binding on banks if they are unable to reach an agreement with their customers. Accordingly, consumers are all too often obliged to go to the courts to obtain due reparation.

Certain regulations recently passed in Spain, such as Law 10/2014 of 26 June 2014 on the regulation, supervision and solvency of credit institutions, and Law 5/2015 of 27 April 2015 on the promotion of business financing, include provisions designed to foment improvements in the existing institutional arrangements for customer protection.

In any event, irrespective of any present or future legislative changes in this respect, I believe that banks have the capacity to drive improvements in the short term. For the moment, they appear to be readier to comply with the non-binding opinions issued by the Banco de España's claims system. In addition, it would be appropriate to consider the possibility of developing centralised and binding dispute settlement arrangements, such as those in place in other European countries, possibly with the participation of the industry, to correct the shortcomings of the present system.

6. Final thoughts

Let me finish by saying that in mid-2010, at the height of the financial crisis, Alexandre Lamfalussy, one of the architects of European monetary and financial integration, with whom I was fortunate enough to work with in the mid-1990s and who passed away just a few days ago, ended one of his last public speeches as follows:

All the actors – central banks, governments, international organisations and, naturally, market participants – are navigating in waters uncharted by reliable historical experience. The complexity of the current situation is without precedent. But there is no way of "opting out" of this complex world. Wishing that we could go back to the professional and intellectual comfort of the pre-crisis years is a pipe dream. This does not make me a pessimist.[3]

I believe that when one looks back at the work done to overcome the problems that beset the Spanish financial sector, Lamfalussy's words are fully applicable. Thanks to the efforts made by all the agents concerned the most serious shortcomings of the banking industry have been remedied, allowing it to resume, gradually, full exercise of its role in the economic system and which is vital for our prosperity as a nation.

However, as the former president of the European Monetary Institute suggests, the crisis has changed the world for ever, bringing about significant changes in the economic, regulatory and institutional environment in which the banking industry operates.

In particular, Spanish banks, similarly to their European peers, now face challenges that will require them to adapt their business models in a new environment characterised by a structural decline in profitability, a significant increase in regulatory requirements, the harmonisation of supervisory rules and practices in the framework of the banking union and the introduction of new demands by the resolution authorities. As Lamfalussy said, there are no grounds for pessimism, but this view is based essentially on the expectation that banks will be able to successfully complete the work they have started to fully restore investor, customer and general public confidence.

Thank you very much.

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[3] Taken from the keynote speech made at the Ninth BIS Annual Conference on "*The future of central banking under post-crisis mandates*", 24–25 June 2010.