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Challenges facing the retail banking sector

Remarks at the dinner event organised by the European Savings and Retail Banking Group (ESBG), Madrid

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Good evening.

It is a pleasure to have the opportunity to participate in this event and to address this eminent group of bankers. I am grateful to Isidro Fainé and José María Méndez for inviting me. I hope that you have now got your breath back and recomposed yourselves after viewing Picasso's impressive and to some extent disheartening masterpiece, Guernica. You certainly need a strong mind to discuss banking issues nowadays.

I imagine that probably much of the agenda of your regular meetings is devoted to exchanging experiences on how financial institutions such as those participating in the European Savings and Retail Banking Group (ESBG) are addressing the current challenges affecting the entire financial sector in the current post-crisis period. Allow me to attempt to make a modest contribution to that discussion.

I would like to say from the outset that I do not believe that the financial crisis, as such, has challenged any specific business model. We have seen institutions with quite different sizes, governance structures and business orientations failing all around the world. The crisis has affected both investment and commercial banks as well as wholesale and retail businesses. Indeed, I would subscribe to the idea that, by and large, the crisis does not provide clear arguments with which to question a particular business model or line of activities, such as retail intermediation, wealth management or investment services. It does however encourage us to analyse whether those banking activities are conducted in a sufficiently efficient way by specific institutions so as to make them profitable.

That said, pure European retail banks admittedly face specific challenges in the current environment, which need to be effectively addressed in order to preserve the social function that those institutions provide. Let me mention three of the most obvious challenges.

First, the low interest rate environment, which is putting heavy pressure on financial margins, particularly for institutions –such as most of those belonging to the ESBG - with little investment in securities that could be revalued as rates go down, and with much funding obtained from retail deposits, which impedes a full transmission of very low or negative market rates to funding costs.

Second, the accumulation of non-performing loans in several regions of the euro zone.
This is particularly a challenge for banks, again mostly retail banks, with a significant concentration of exposures in a single country or even a single region subject to a subdued macroeconomic performance in the recent past.

Third, regulation. Banks are now facing new requests to raise more and better-quality capital. More importantly, significant institutions will have to hold on their balance sheets substantial volumes of liabilities that could be subject to bail-in. Clearly, those retail banks with little or no tradition in issuing capital and other securities in capital markets will have particular difficulties coping with the enhanced regulatory framework.

Admittedly, though, the corporate structure of many retail banks -particularly those which are not yet regular corporations listed in capital markets - may face less immediate pressure to restore higher profitability levels. That may allow them to buy some time.

Yet, low sustained profitability is often a symptom of vulnerability and, certainly, of inefficient allocation of the resources employed in the banking business.

There is therefore a need to reflect on the best way to strengthen retail banks, to make them better able to cope with the new macroeconomic and regulatory conditions without damaging the social benefits associated with their activity.

It would be unsound to try to establish specific strategies with the pretention to be unconditionally applied in all circumstances. However, I see some difficulties for numerous retail banks in adapting to the low-profitability and tighter regulatory environment if they are not able to increase their ability to compete with banking corporations in terms of cost-efficiency, business diversification and access to capital markets. Some transformation of the retail and, in particular, the saving banking sector therefore seems unavoidable in order to meet the target. We, in Spain, have already taken some steps in that direction.

As you well know, in response to the financial crisis, measures were taken along different lines, which helped solve the main shortcomings affecting the Spanish banking sector at that moment in time and positioned it in a good starting point for the implementation of the SSM.

In addition to measures taken to reduce the level of exposure to real estate development and to drive greater consolidation in the sector, a major effort was made in the field of recapitalisation, which went beyond the actions taken by public authorities. Since 2008, the sector has set aside new provisions for outstanding loans or foreclosures for approximately €300 billion. And, after absorbing this substantial balance sheet clean-up into results or reserves, banks have managed to increase their own funds by approximately €70 billion over the same period.

However, a key part of the reform was the overhaul of the regulatory framework of the saving banks' sector, which represented almost half of the Spanish banking system.

As you are aware, this reform aimed at separating the ownership of the banking institutions from their management. Former saving banks (except for two small institutions) have all become banking foundations whose main asset is the participation in credit institutions. The latter are managed independently of the foundation and take the form of regular corporations which, in most cases, are or will soon be listed in capital markets. Moreover, the Law incorporates a number of incentives for foundations to relinquish control of the banks in which they participate, something that will normally happen in most cases in less than four years.

We believe that this approach will certainly promote better business management and facilitate access to capital markets. In doing so it will contribute to a smoother adjustment by saving banks to the new and very demanding environment, thereby contributing to the strength of the institutions themselves and to financial stability.

But more importantly, the highly relevant social objectives of the *cajas* are fully preserved through the operation of the foundations. These foundations continue to contribute very significantly to social welfare. It is just that the foundations´ wealth will now be more diversified and, therefore, they are likely to obtain a more robust stream of income with which to finance their activities.

Of course, I would not dare claim that this formula be pursued everywhere. Other reform strategies may also work in other jurisdictions. Yet, I strongly believe that some form of restructuring is required in the European banking market and that the strategy followed in Spain is a reasonable response to the new challenges all credit institutions have to face while preserving the essence of the social value that saving banks have historically provided.

Thank you for your attention.