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Challenges and opportunities for the Spanish banking industry

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I would like to thank you for inviting me to participate in day two of the twenty-fourth (24th) Financial Industry Meeting organised by the newspaper ABC, Deloitte and Sociedad de Tasación. It is a pleasure to be here with you today.

I wish to take this opportunity, my first public address as Deputy Governor of the Banco de España, to share with you some reflections regarding the challenges facing the Spanish banking industry in the short and medium-term.

In particular, I am going to focus on three aspects that I consider especially important: i) the need to maintain the profitability of the industry in order to guarantee its correct functioning, ii) the challenge for traditional banking posed by the development of new technologies (FinTech) iii) and, finally, the importance of increasing customer confidence, the linchpin of banking activity.

1 Profitability

Bank profitability has been a recurrent challenge lately and is, once again, one of the priorities of the Single Supervisory Mechanism (SSM) for 2017. A number of factors are putting pressure on the profitability of Spanish deposit institutions and of their European peers.

First, the very low interest rate environment puts pressure on financial intermediation margins. Although the interbank market interest rate, Euribor, is negative, banks find it very difficult to reduce their deposit rates below zero. At the same time, the existence of fierce competition for good customers makes it difficult to raise lending rates.

A second factor putting pressure on profitability is the still low level of banking activity. In fact, despite the improvement in recent years, year-on-year growth in lending to the private resident sector remains negative, standing at -4% at the end of 2016.

Another factor is the still significant volume of non-productive assets (non-performing and foreclosed) on bank balance sheets. The good news is that this volume is falling – last year it fell by 9% –, which translates into lower provisions.

Finally, as a result of the financial crisis there has been an increase in the regulatory pressure to which banks are subject. The tightening of the minimum capital requirements for banks, in terms of quantity and quality, has not been accompanied by an equivalent reduction in the perception of the riskiness of banking business, so that its cost of capital remains high and exceeds its profitability.

Moreover, the stricter prudential requirements are compounded by the obligation to comply with the new resolution regulations, which requires banks to have a minimum level of liabilities enabling losses to be absorbed should this be necessary (MREL). Again, complying with this minimum volume of liabilities will not be cheap and may in fact be particularly difficult for those banks which, as a consequence of their business model, do not have the necessary experience of issuing this type of instrument.

Against this background of low profitability, banks have already made significant efforts to reduce their operating expenses, by adjusting their productive capacity. The number of banking groups has been reduced by 44% since 2007. And, from their peak levels in 2008, the number of offices and employees in the banking industry have been reduced by 37% and by 31%, respectively.

Orderly correction of the excess capacity in the Spanish banking industry has raised its level of efficiency relative to the banking systems of other European countries. However there is still room for further improvement.

2 New technologies - FinTech

The second challenge facing traditional banking activity arises from the development of new technologies and entry into the banking market of so-called FinTech companies.

Banks are sometimes presented as rigid, inefficient institutions, in contrast to new agile unregulated businesses, which seek to offer a better service to customers through a broad range of innovations. An extreme view is that these businesses could actually displace credit institutions from the provision of traditional financial services. In my opinion this is a simplistic, distorted view of a much more complex reality.

Certainly we are facing a major technological transformation of banking activity. Permanent connectivity and the sheer number of mobile devices affect the way in which financial services are provided and used. Users increasingly demand the ability to access their current accounts and to initiate transactions at all times and in all places. However not all the initiatives that have arisen in response to this demand have the same impact on banking business. Allow me to introduce some nuances.

1. First, it is important to understand that, rather than projects that directly compete with banks, some of these technological innovations are in fact operational tools or improvements that credit institutions can incorporate into their own operations.

Without giving an exhaustive list, this would, for example, be true of the use of technology to analyse so-called big data i.e. the analysis at great speed of a massive volume of data also generated at great speed and obtained from many sources. There are businesses that, with this tool, are capable of analysing or predicting customer behaviour using a large amount of unstructured information. This technology has many applications in the field of banking. In fact, one of the main assets of credit institutions is the information they have on their customers. Properly harnessed, this information would enable them to better know their risk profile and their preferences and needs, and thus to adapt the offering of financial products for the benefit of both parties. Moreover, banks have an invaluable asset, namely the confidence of bank customers in the confidentiality of their transactions which, as I will mention later should be nurtured and properly valued.

The same could be said about cloud computing technologies, which enable the information systems of all kinds of businesses to be adapted flexibly to their changing needs, converting a large part of their fixed costs into variable costs. This technology may notably reduce the costs for banks of their information systems, which, precisely due to the use of new technologies, are growing rapidly, although there are security risks that must be controlled.

Another example are mobile payment services. These may seem new, but ultimately the transaction usually ends with an interbank transfer or a simple credit or debit card payment. Spanish banks have been pioneers in the euro area in the incorporation of this technology through the Bizum platform, an interbank initiative for immediate payments, allowing payment to be made from one account to another in a matter of seconds.

The list of technological developments available to credit institutions is longer. To mention some more, I would also point out the new methods to validate identity by means of voice or image, which make it possible to identify and register new customers remotely, bypassing the traditional branch network; or the provision of automated advisory services, known as "robo advice", which enable advice to be provided in areas where just recently it was impossible to imagine that automated solutions could be developed.

2. Second, the development of new services will require regulation in accordance with the risks they introduce into the system, both in terms of customer protection and the stability of the financial system.

In fact, new competitors are specialising in specific parts of the value chain of banking business, beyond deposit-taking and payment service provision, which are activities reserved for authorised institutions. The development of these new services will require adjustment of the regulatory perimeter. Thus, for example, the new payment services Directive already covers new services not previously regulated, such as payment initiation and account aggregation.

Another case is that of crowdfunding platforms, which seek to put lenders and borrowers directly in touch with each other, without the need for banks – the traditional intermediaries. The development of these services and their resilience in situations of stress might require further adjustments to current regulations.

3. Third, it is important that the price of services charged to the customer reflects their cost. Currently, a large part of the technological improvements offered do not seem to have an additional cost for the user. For example, immediate access to data through mobile devices, automatic repetition of consultations every few seconds, or the dispatch of instructions or data requests en masse, are offered without any apparent cost to the customer. However, the new services do have costs and these must be clearly and transparently passed on to customers.

4. Finally, it should not be forgotten that the benefits promised by new technologies are neither cost-free nor risk-free. There may be costs arising from investments in innovation that fail to bear fruit or from investments with payback cycles that end up being much longer than expected, as apparently may be the case, in principle, of some of the initiatives being developed in relation to Distributed Ledger Technology. And risks relating, inter alia, to personal information privacy, fraud or cyber-attacks. In addition, the proliferation of new technologies may also lead to the financial exclusion of those users at a distance from them, who could be adversely affected if the continuity of service provision through traditional systems is not guaranteed.

In short, we are facing great technological change in the banking industry, the effects of which are still not clear. The development of new services is a great opportunity for renewal for the more dynamic banks, as it may provide them with efficiency improvements and mean that they can offer greater services to their customers. And, improving customer service is precisely one of the main challenges facing the banking industry, which brings me to the final point of my address: the importance of maintaining the confidence of bank customers.

3 Confidence

Confidence is the most important and the most fragile of a bank's assets and determines the nature of its relationship with its customers, beyond the ambit of mere commercial transactions.

Bank customers deposit their savings with credit institutions, trusting that they will return those savings to them, when they need them, on the terms agreed. In turn, credit institutions provide financing to customers, trusting that they will repay those funds on the terms agreed. Likewise, customers conduct all their business with their banks because they trust them not to sell or reveal any information they have on them as customers.

Unfortunately, the bank crisis weakened the general public's trust in credit institutions. Some strategies followed by certain banks may have made them less customer-centric. I am thinking, for example, of the incentive schemes based, perhaps to excess, on growing business rather than incrementing customer loyalty. In addition, the lack of good practices in the selling of bank products and services has clearly played some part in this loss of trust.

One of the most important future challenges we face is to restore and strengthen the industry's reputation both with investors and customers. The first step to achieve this must be to make simplicity and accuracy a priority in all communications with customers. This includes aspects such as improving the language that is used in relations with customers, refining selling policies and promoting transparency. Allow me, in conclusion, to expand on these points a little further.

First, the use of language. The names and descriptions of bank products must not be misleading as to their return and risk characteristics, nor must they be used as misleading advertising tools. Accordingly, terms that offer a false sense of security as to the return or interest that may be obtained must be avoided.

The need to improve the use of language is even more pressing, bearing in mind that the dialogue between banks and their customers is not, shall we say, a dialogue between equals. In this respect, since 2008 both the Banco de España and the National Securities Market Commission (the CNMV) have made great efforts with a view to improving financial knowledge among the general public through the Financial Education Plan. The initiatives taken in this period, to cite just a couple, include the launch of the Finance for All portal (www.finanzasparatodos.com) and the project to include financial education in the school syllabus.

A second key aspect of this process is to improve selling practices. Financial institutions have made advances in the service they offer and the resources they dedicate to the monitoring of regulatory compliance. But greater efforts are needed to ensure that bank customers – banks' main assets – are able to understand the terms of the transactions concerned (clauses of agreements, the cost of services provided, etc.).

In this respect, greater zeal is required to ensure that customers receive appropriate pre-contractual information, and the sale of products to customers whose profile does not fit the product in question must be eradicated.

Lastly, with regard to transparency, and as I have indicated, banks must be clear about the cost of the services they offer and pass on those costs to bank customers in appropriate fashion.

To that end, the Banco de España is stepping up its activities relating to supervision of banking conduct. The Market Conduct and Claims Department was set up for that purpose in 2013 and has been allocated an increasing amount of resources. In 2016 a total of 109 measures were taken, mostly relating to compliance with transparency regulations in the sale of mortgage and consumer loans, the operation of banks' customer service departments and observance of the rules on bank advertising. These activities are expected to intensify this year and other measures will be launched relating to the use of new technologies in the sale and purchase of bank products.

4 Closing comments

To conclude, we are indeed in the midst of a profound transformation of traditional banking activity. The setting is one of pressure on financial intermediation margins that means institutions need to seek further ways to enhance their operating efficiency. We are waiting to see the as yet uncertain impact that new technologies linked to the provision of financial services will have on traditional banking business. And above all, we are at a point in time when banks must ensure that their customers are their main priority, as this is the only way to maintain confidence in the correct functioning of the banking industry.

Thank you very much.