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"The challenges facing the Spanish banking industry"
Closing address to the seminar "La Cuarta revolución. ¿Cómo afecta la agenda digital a la economía y a la industria?" ("The fourth revolution. How does the digital agenda affect the economy and industry?", UIMP – APIE (Santander)

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Good morning. It is a pleasure to be here in Santander today, at the Universidad Internacional Menéndez Pelayo, continuing the tradition for the Deputy Governor of the Banco de España to participate in the closing session of this seminar. Thank you to the University, to its Rector, to the APIE (Association of Economics Journalists) and, in particular, to Miguel Ángel Noceda, for organising this event and for his kind invitation.

This year, the focus of the seminar is technological developments and, in particular, the so-called "digital agenda". This gives me the opportunity to speak about one of the main challenges facing the banking industry (new technologies and the entry into the banking market of what are known as "fintech" companies).

However, I do not wish to overlook other important challenges for the industry, such as its profitability, compliance with the new regulatory requirements (in particular on resolution) and the need to maintain customer confidence: the most important and fragile of bank assets and the fundamental basis of banking activity.

1 The Spanish banking industry

In order to clarify the background, before addressing the challenges, allow me to briefly describe some of the main features of developments in the Spanish banking industry as a whole.

In terms of solvency, the position of the Spanish banking industry has improved significantly in recent years, thanks to the reforms implemented in the industry, the strengthening of regulation and supervision, and the recovery in economic activity that has taken place in Spain.

It should be recalled that the regulatory response to the financial crisis led to a substantial increase in capital requirements, as part of a raft of measures geared to minimising the probability of bank crises and to reducing their impact if they do occur, in particular in terms of the use of public funds. Not only were the own funds requirements increased for institutions but also the quality of own funds (i.e. their loss absorbing capacity) was improved, through the introduction of a number of more restrictive criteria for the determination of eligible capital, known as "common equity tier 1" (CET1).

Thus, in terms of CET1, although the Spanish banking system still has a ratio below that of the main European countries, its strengthening in recent years has been notable: by more than one percentage point on average since its introduction in 2014. As at December 2016 this ratio for the Spanish banking industry as a whole reached 12.8%, exceeding the regulatory minimum requirements and standing not far from the average for banks supervised by the Single Supervisory Mechanism (SSM), which is close to 14%.

At the same time, in comparison with the situation at the outset of the financial crisis, the banking industry is not only more capitalised, but has also carried out an intense balance sheet clean-up, as a result of the far-reaching process of transformation of the sector. As has been quantified on other occasions, the industry has set aside provisions totalling around €300 billion since the start of the crisis.

The volume of non-performing loans has also been reduced significantly from the highs reached at the end of 2013. Thus, non-performing loans to the private sector in Spain have fallen by more than €77 billion in absolute terms and by more than 40% in relative terms over the last three years.

This decline in non-performing loans is based on various factors, such as lower obstacles to the sale of non-performing loans to third parties and also, to some extent, more prudent lending policies on the part of institutions. However it is basically a result of the stabilisation and progressive improvement in economic and business activity, which has reduced the credit default rate. If the economy maintains its present growth trend, the reduction in the volume of non-performing loans can be expected to continue.

The fall in non-performing loans (which exceeds credit growth, which is still negative) has resulted in an improvement in the non-performing loans ratio. This ratio has in fact fallen by several percentage points in recent years, to 5.7% in December 2016, on consolidated data. In comparative terms, the NPL ratio of the Spanish banking industry in consolidated terms stands at similar levels to the European average, although it is still above those of some of the main European countries.

2 Challenges

That said, as I indicated at the start, the banking sector needs to address important challenges, affecting not only Spanish banks but also the other euro area countries.

2.1 Profitability

The first challenge I wish to mention is profitability; adequate profitability is essential to ensure banks' viability for the medium and long term. Since the onset of the crisis, the banking sector's profitability has been quite low, well short of the double-digit figures observed in earlier periods. Last year, Spanish deposit institutions overall saw their return on equity fall by 1.3 percentage points, from 5.6% in 2015 to 4.3% in 2016, although it remains slightly above that of the main European countries and the European average.

As you are aware, there are several factors exerting downward pressure on banking sector profitability. The very low interest rate environment, in response to a euro area inflation rate that is below the ECB's target rate, is one of the main factors behind the low levels of profitability in recent years. Against this low interest rate backdrop, both financial revenues and costs have fallen, although it is increasingly difficult to achieve further cuts in the cost of liabilities, now that levels close to zero have been reached, and this has a direct impact on the net interest income of Spanish banks.

Other factors that continue to affect banking sector profitability are the lower volume of banking activity – in a setting in which the year-on-year rate of change in credit to the resident private sector remains in negative territory – and the presence of still significant levels of non-productive assets on banks' balance sheets. These assets weigh on profitability, despite the reductions achieved in the volume of non-performing loans that I spoke of earlier. Lastly, I must also mention the increase in legal costs, which has recently become a further factor in the decline in profitability.

By contrast, the decrease in the volume of non-performing loans from the highs of 2013, which has been reflected in a continued decline in banks' provisioning needs, is one of the main factors making a positive contribution to Spanish credit institutions' income statements, offsetting to a certain extent the decline in margins.

2.2 Resolution requirements: MREL

The second challenge I wish to highlight is the need for banks to comply with the new resolution requirements that were introduced post-crisis, aiming to secure the stability of the financial system, minimise the cost for the taxpayer of banking crises and ensure that banks' critical functions are maintained.

As you are aware, banks will have to comply with the minimum requirement for own funds and eligible liabilities (MREL). For that purpose they will have to have, on their balance sheets, instruments that provide sufficient loss-absorbing capacity and that will allow them, where appropriate, to recapitalise. Accordingly, should a bank find itself in resolution, it would be able to continue to perform its critical functions – essentially lending and holding deposits – without having to resort to public support and without jeopardising the financial stability of the system.

Although the Resolution Directive entered into force on 1 January 2015, setting of the MREL requirements is still at a preliminary stage and there is as yet no specific date for compliance with the requirements. The Single Resolution Board, which is the European resolution authority, will set the MREL requirements for the institutions for which it is responsible, that is, those that are directly supervised by the SSM, at the end of the year. These requirements, for which the transition period for compliance therewith has still not been determined, are not expected to come into force before 1 January 2019. In the case of the less significant institutions, for which responsibility lies with the national resolution authorities, the time frame for adaptation to the new requirements will foreseeably be longer.

The requirements set will fundamentally depend on two components: the loss absorption component, which in general will be common to all banks and will be equivalent to their capital requirements; and the recapitalisation component, the amount of which should depend on the resolution strategy deemed most appropriate for each institution. For instance if, in the event of resolution, and after absorption of possible losses, it is expected that the institution in question would continue to perform its critical functions, the recapitalisation component would be equivalent to the new capital requirements estimated for the institution following the resolution process.

In any event, the European regulations are currently under review, and will continue to be at least into next year, so it is still too early to know the precise details of the final requirements and, therefore, to accurately estimate the issuance volumes that institutions would need in order to comply with those requirements. Also, in order to allow the markets to absorb the foreseeably high issuance volume that would be needed to meet those requirements, there is a common understanding that an appropriate transition period is essential for implementation of the MREL requirements.

That said, it is clear that although their introduction will be greatly beneficial for financial stability, they may pose a significant challenge for the banks themselves, especially for small and medium-sized banks that, owing to their business model, have less experience than their larger peers in raising funds on the debt markets. It is to be hoped that the MREL requirements will not act as a further drag on these banks' profitability, nor place excess constraints on their business models.

2.3 Technological innovation

Lastly, and as I said at the start of my address, I wish to focus on the challenge posed by technology and the changes it may bring in the banking sector.

We unquestionably face a situation in which digital innovation is transforming traditional banking. This transformation is already apparent in our ability to communicate with banks without having to go to a branch, in the constant supply of new products and services, in the new ways that data can be used or in the improvement of market systems and infrastructures allowing instantaneous execution of transactions which previously took several days. Further, technological innovation is giving rise to the penetration of some areas of banking by new firms known as "fintechs", which provide financial services under a wide range of business models.

The implications of this technological revolution are complex and varied both for the banking sector and for regulators and supervisors, and must be analysed with caution taking into account the particularities of the banking sector and avoiding oversimplification.

For example the use of technology for high-speed analysis of a large volume of heterogeneous data – known as "big data" – may have multiple applications in banking. Banks have a large amount of diverse information on their customers. Careful analysis of this information may give banks a better knowledge of their customers' behaviour and enable them to refine their products by fine-tuning them to the particular needs and risk profile of each customer. This, however, must be done in conformity with personal data protection regulations. We must not forget that customers trust a bank to observe the confidentiality of their transactions.

Similarly, services known as "cloud computing" have been on the rise for some time now. They unquestionably offer big advantages for banks: they reduce processing and storage costs and provide great flexibility for adjusting information systems to current needs, and, moreover, they are an efficient means of big data analysis. However, this increased dynamism is not free from a risk of data loss which must be controlled.

Much the same goes for automated advisory services, known as "robo advice". It is increasingly common to see automatic tools which act through digital channels in the process of providing advice. These solutions may be useful, for example, in the purchase of a product, because they simplify communication between banks and customers, but this service must conform to marketing regulations. It is necessary to ensure that customers have unrestricted access to sufficient and relevant information that allows them to fully understand the product in question, and that the product is not purchased automatically without understanding the conditions and the risks involved.

In short, technological innovations offer banks a way to reduce costs and better adapt their products to customers' needs, but their implementation in banking operations requires close monitoring of the new risks introduced into the system. Matters such as the privacy of personal information, security, the risk of cyberattacks or even the risk of exclusion, must be monitored and, where appropriate, duly regulated. Regulation has to achieve a balance, protecting financial stability and confidence in the system, without unjustifiably hindering the exploitation of these technological innovations by industry and society in general.

It is still too soon to gauge the impact of the technological revolution on the traditional banking sector. I believe that technological innovations will complement traditional banking activities, but to achieve this banks must be sufficiently flexible and dynamic to reap the benefits of technological innovation.

There is no question that innovation is also favouring the proliferation of new fintech firms, of highly varying profiles and business models, which may conceivably compete with traditional banks in a specific part of the banking value chain, but are more likely to engage in new ancillary services. One example is joint financing through online platforms, known as "crowdfunding". It is an alternative source of financing which may offer certain improvements over traditional banking in terms of convenience, speed and cost. But risks have also been identified, such as a potential increase in fraud or greater weaknesses in terms of investor confidence. There is a well-known case of a Swedish P2P platform which went bankrupt late last year after the detection of malpractices in credit extension, prompting a fall in the activity of the sector and closer regulatory attention.

In my opinion, fintech firms are at an early stage of development in which it is not yet clear which of them will become credible alternatives, so it is still early to say how they will evolve. In any event, the greater the likeness between their financial activity and traditional banking activity, the more they will be subject to requirements and controls similar to those of banks, tailored to the risk of the activity in question. That is to say, it is necessary to set fair rules of play ensuring neutrality on the basis of the risk involved and the activity carried out.

3 Final reflections

In short, the Spanish banking industry, and other European institutions, face major challenges at a time of far-reaching transformation of traditional banking business. Regulatory reform, with the tightening of capital requirements and the introduction of the new resolution requirements that I have described, and the development of new technologies are two of the vectors of change. In this new environment, it is difficult to imagine that it will be possible to sustainably achieve the pre-financial crisis levels of profitability (in double digits).

However, following the transformation undertaken in recent years and the progress achieved in terms of solvency and cleaning up balance sheets, the industry is today more resilient and in a better position to face these changes with confidence. In terms of efficiency, for example, Spanish banks are in a better position than the average institution supervised by the SSM. In addition, there is still room for improvement, particularly when it is noted that Spain continues to be the EU country with the highest density of branches per head of population. And this does not seem to be very compatible with the technological innovation I have been talking about, whose introduction permits a lesser physical presence. Banks must adapt to the new environment and continue the orderly correction of excess capacity carried out in recent years. The increases in efficiency required could lead to some further consolidation within the sector.

Finally, as I said at the start, I cannot finish without reminding you of the need to maintain the confidence of bank customers, the most important and also the most fragile asset of the business of deposit institutions. In my first public address as Deputy Governor I mentioned aspects that could be improved. The Banco de España is strengthening its supervisory activities in relation to the conduct of banks. The priority must be the customer, as this is the only way to maintain confidence in the sound functioning of the Spanish banking system.

Thank you very much for your attention.