BANCO DE ESPAÑA
Eurosistema

12.12.2018

Opening of the 14th banking industry meeting: should we reinvent banks or improve their management?

IESE

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Good morning. I should like to thank the IESE for its kind invitation to open the 14th edition of the banking industry meeting. This gives me an excellent opportunity to review the progress made by the Spanish banking industry and the main challenges it currently faces.

Let me start, however, with a brief explanation regarding the content of my speech. As a member of the Governing Council of the European Central Bank I am, as of today, subject to a "quiet period", before a meeting at which monetary policy decisions are due to be taken. Accordingly, my reflections in this speech should not be interpreted as indicating the monetary or economic outlook (see Chart 1).

Following the last crisis, Spanish banks have carried out a major balance sheet clean-up, recapitalisation and restructuring which, over the last four and a half years, has notably improved the situation of the industry in terms of its basic parameters, such as asset quality, profitability and solvency.

Starting with asset quality, between December 2013 and June 2018 the reduction in non-performing loans and foreclosed real estate assets has been very notable. Also, the return on equity has turned positive again and is above the euro area average, following its collapse in 2012, to minus 25%. The total capital ratio, meanwhile, has increased by 1.7 percentage points over the last four years, and the leverage and liquidity ratios are above the European averages. Indeed, the recent stress tests carried out by the European Banking Authority (EBA) and the Banco de España show the considerable resilience of Spanish banks' solvency under adverse scenarios.

However, while recognising the significant progress made in recent years, the Spanish banking industry continues to face significant challenges, which are largely shared by other euro area banking systems.

Notable among them are: i) the need for further progress in reducing unproductive assets which remain at high levels; ii) raising profitability; iii) strengthening the industry's reputation by preventing misconduct; iv) adapting to the new regulatory framework and strengthening the highest-quality capital ratios; and v) competing in a new financial environment arising from technological progress and the emergence of new players (see Chart 2).

Reducing unproductive assets

As I have already said, the reduction in non-performing loans and foreclosed assets from the peak levels they reached during the crisis has been significant. Private-sector non-performing loans, which have fallen by 60% from their peak in 2013, currently stand at the same level as in 2009. Foreclosed assets have followed a similar pattern, falling by 40% from their peak in 2012. The economic recovery has certainly contributed to this process, but it has also been driven by credit institutions' management of troubled assets and by supervisory pressure.

Spain has made relatively more progress than other euro area countries in reducing the volume of non-performing loans built up during the crisis. Moreover, economic growth – albeit at lower rates – can be expected to continue to help to gradually reduce them over the next few years. Despite these improvements, the level of unproductive assets of Spanish banks (especially those related to business in Spain) remains relatively high and above pre-crisis levels.

Reducing unproductive assets continues to be a challenge for the industry, requiring banks to strengthen the application of active management policies to their impaired assets. In this respect, the agreements to sell troubled asset portfolios announced over the past year will accelerate the reduction of future NPL ratios more than initially estimated solely on the basis of the cyclical improvement in the economy and the experience of previous credit cycles.

In order to address this challenge, which most other European banks also face, the European economic and supervisory authorities have taken initiatives to accelerate the reduction of NPLs. In particular, the European Commission announced a package of measures in March this year, which included a proposal to review the capital requirement regulations and an NPL provisioning schedule.

Correcting the high level of impaired assets is key for two basic reasons. First, because the balance-sheet clean-up will improve banks' profitability and solvency. That is to say, it will free up resources currently devoted to financing unproductive assets and allow them to be used to finance new lending. And second, because correcting the levels of bad debts in the euro area should smooth the path to creation of a pan-European, fully mutualised deposit guarantee scheme with sufficient fiscal backing, since it would enable risks to be shared without problems inherited from before the establishment of the Single Supervisory and Resolution Mechanisms. This is the third pillar of the Banking Union, a key element which seeks, moreover, to reduce the link between banking risk and sovereign risk (see Chart 3).

Restoring profitability

Restoring profitability is another of the main challenges facing the Spanish banking industry. Although it has returned to positive values (7% in June 2018), and stands above the EU average, profitability remains below pre-crisis levels and, in any case, below the levels in other developed-economy banking systems.

The low average profit levels generated by Spanish banks are especially apparent in their business in Spain. In addition, the international activity of Spanish banks, which entailed significant diversification of risk and a valuable source of profits during the crisis, has its own challenges. Some of the emerging market economies to which Spanish banks are exposed – such as Turkey and Argentina – are currently in considerable difficulty.

That said, I should like to point out that geographical diversification of banks is a source of value added and of medium and long-term stability and is relevant to any assessment of profitability and risk for two reasons. First, because the correlation of activity between countries may be negative. This has historically been the case for many of the emerging countries in which Spanish banks have international activity. Second, the characteristics of the banking markets in which they operate (much more concentrated, and with less banking penetration) are conducive to the existence of higher margins (see Chart 4).

Returning to the profitability of the banking business in Spain, its comparatively low level is explained by a variety of factors. First, as I have already mentioned, the high volume of unproductive assets has a direct negative impact on banks' income statements by reducing interest income and increasing impairment provisioning.

Second, low profitability is also explained by the significant fall in income associated with banks' deleveraging. In addition, the current levels of interest rates have squeezed banks' net interest income. That said, the ECB's monetary policy has also had a positive effect on economic activity (thus reducing the losses from loan defaults) and on banks' capital gains. In short, the ultimate net impact of low interest rates on bank profitability seems to have been smaller than that of the other factors I have mentioned.

As regards operating expenses, they remain on the downward trend seen in recent years. This containment of expenses is taking place against a background of adjustment of the operating capacity of Spanish banks and has basically taken the form of a significant reduction in the numbers of staff and branches in their business in Spain. The adjustment of the productive capacity of the Spanish banking system has already lasted ten years, the number of branches having been reduced by more than 40% from its peak in 2008, while staff numbers have fallen by more than 30%.

In this scenario, in which extraordinary growth in total lending is not expected in the short or medium term, efforts to restore profitability should be based on adjusting expenses to the new size of balance sheets, seeking alternative sources of income and improving efficiency.

That said, we must remember that the search for profitable business cannot be at the expense of the necessary vigilance of credit conditions. This basic premise is a necessary condition for the appropriate management of credit risk. I wish to point this out because we are seeing high rates of growth in bank lending to households for the acquisition of consumer durables (15% year-on-year in September 2008, after rates of more than 20% in previous quarters) and, what is more symptomatic, the default rate associated with this activity has already begun to accelerate significantly.

This situation suggests that there has been some easing of the risk acceptance and selection standards in this segment. It is vital that the lessons of the crisis not be forgotten here: past experience has shown that loosening credit standards eventually leads to notable increases in default rates.

Although the weight of this business segment in the lending of Spanish banks as a whole is low, the growth observed should be a warning sign. It would not be acceptable for the search for an alternative source of income in the short term to become once again a potential source of future losses.

In this respect, price-setting policies at product or service level are fundamental to ensure an appropriate risk-adjusted profitability. These policies must be consistent, comprehensive and rigorous to ensure that the price charged for a product or service covers at least its total cost, including the risk premium inherent in each type of transaction.

From the viewpoint of appropriate risk management, controlling the risks incurred, assessing how they develop over time and applying conservative conditions when negotiating the rollover of loans are basic elements of credit standards that banks must observe and keep up to date in their policies. Moreover, from the viewpoint of customer protection, the appropriate assessment of their solvency and capacity to repay is also protection against future vulnerabilities (see Chart 5).

Reputation and conduct

One of the largest challenges facing banks today is precisely that of managing one of their main assets: their reputation, which is fundamental to generate the appropriate framework of trust within which to develop customer relations.

The reputation of banks was eroded during the last crisis, not only as a result of management failures in part of the system, but also as a result of inappropriate marketing to customers, which undermined their trust. In fact, the number of complaints by customers to banks' customer complaints services increased almost six-fold between 2014 and 2017.

This has led to growing concern about conduct risk in the social, political and supervisory domains, and naturally in the industry itself. This concern is also shared internationally, as reflected in the recent work of the Financial Stability Board to strengthen the governance and remuneration frameworks in order to mitigate the risk of misconduct.

The Banco de España strengthened its supervisory activity in relation to conduct four years ago. This greater supervisory presence, along with regulatory requirements, the need to adapt to new and more demanding customers and judicial rulings in defence of consumers, is prompting banks to react, and they are making efforts to implement the measures needed to correct these practices.

However, much remains to be done. Banks must be more proactive in developing a strong culture that is not only oriented towards complying with customer transparency regulations, but also fundamentally towards identifying and satisfying customer interests. This requires the involvement and commitment of governing bodies and the spread of these values throughout the institution; especially to the sales network, which must have an incentive mechanism that does not give rise to perverse or counter-productive incentives.

In short, banks must incorporate the customer protection perspective into their risk appetite framework, making it a cornerstone of their governance and decision-making processes.

For this process to be successful, the control of regulatory compliance in the marketing and management of banking products and services needs to be strengthened. And, simultaneously, the role of customer service departments needs to be bolstered, with the focus not only on improving the treatment of complaints, but also on ensuring that they serve as an alert mechanism for conduct risks, so that managers are promptly aware of the areas of customer relations giving rise to conflict or dissatisfaction.

Thus, a comprehensive approach to customer relations is required. A satisfied customer is one of the main assets of any bank and the basis for sustained profitability (see Chart 6).

Adapting to the new regulatory framework and strengthening solvency

I shall now turn to the fourth important challenge facing the Spanish banking industry: adapting to the new regulatory framework. I will start with one of the elements introduced in the context of Basel III: the inclusion of macro-prudential tools to supplement micro-prudential regulation and supervision.

From a financial stability perspective, providing supervisors with macro-prudential tools would allow them to better adjust financial expansions, on the one hand cushioning the impact of contractions and, on the other, helping financial institutions to continue to perform their function of financing the real economy in times of tension.

The arsenal of macro-prudential tools has indeed been expanded significantly since the financial crisis. Apart from the countercyclical capital buffer, we have the systemic risk buffer, the buffers for global and local systemically important banks, the possibility to limit excessive risk concentrations, to increase capital requirements and to review the risk weighted assets for real estate exposures. These tools will allow us supervisors to develop macro-prudential policies that interact with micro-prudential policies and monetary policy.

However, creating macro-prudential tools is not sufficient. To ensure their effectiveness, they must be appropriately assigned from an institutional point of view to avoid so-called inaction bias. In this respect, the Spanish Government has announced that a macro-prudential authority is to be set up, composed of representatives of the Ministry of the Economy and Enterprise, the Banco de España and the National Securities Market Commission.

Spain was one of the few European countries still without a national macro-prudential authority. By setting up this new authority, Spain is complying with the recommendation of the European systemic risk board, which urged EU Member States to establish such an authority.

The aim of this authority will be to carry out the macro-prudential supervision of the Spanish financial system, in order to contribute to the prevention or mitigation of systemic risk. For this purpose, the Banco de España is due to be given new powers in this area. These include, notably, the possibility of activating tools, such as the sectoral countercyclical capital buffer, limiting sectoral credit concentration and others relating to credit standards.

Giving the Banco de España these new macro-prudential tools clearly strengthens the Spanish supervisory system and brings it into line with best international practice. Macro-prudential policy is especially important in a country like Spain, which belongs to a monetary union and a banking union, since – as we have seen in the past – the financial and business cycles of the various countries that make up the currency are not always harmonised with those of the euro area as a whole.

Considering that the euro area has a common monetary policy and supervisory policy and that there is limited scope for fiscal policy measures, macro-prudential policy has a fundamental role to play in addressing the credit cycle.

I will now move on to institutions' adaptation to the other components of the international regulatory reform such as stricter requirements for own funds and liquid assets, and other requirements under the new resolution legislation. These regulatory changes were agreed at international level in response to the shortcomings that became apparent when the financial crisis broke out ten years ago now. Their aim is to boost banking systems' resilience to adverse shocks, and to minimise the cost to taxpayers in the event of resolution. In other words, they seek to reduce the likelihood of future financial crises, and if they do happen, reduce their impact on society.

The first phase of the reforms, agreed between 2010 and 2011, focused, among other things, on strengthening the quantity and quality of banks' capital and introducing new liquidity requirements and limits on credit concentration. Almost all of these requirements will have come into force by the end of 2019.

Subsequently, December 2017 saw the completion of the second phase of reforms in the Basel III framework. Among other things these reforms introduced enhancements to the standardised methods for calculating credit and operational risk, restrictions on the use of internal models and changes in the leverage ratio. These changes will be implemented in two phases, due to be completed in 2027.

As regards bank resolution, the common European resolution framework defines the situations in which failing banks must be subject to liquidation or resolution. For this purpose a new category of non-preferred debt instruments has been created, ranked below senior debt in the order of priority of creditors to facilitate compliance with minimum requirements for the own funds and eligible liabilities available to absorb losses.

The Single Resolution Board has started to establish the requirements for these liabilities for European significant institutions and they will gradually be extended to less significant institutions. Smaller Spanish institutions tend basically to be funded via capital and deposits rather than by tapping capital markets. While this feature generally gives their liabilities greater stability, it means they have lower levels of eligible liabilities and a more limited pool of investors, with possible difficulties accessing non-preferred debt markets.

Lastly, issuance of this type of instrument is likely to have a much bigger impact on the cost of funding for medium-sized Spanish institutions than for larger ones. This is due to the difficulties accessing markets I mentioned earlier, in conjunction with the higher liquidity premia potential investors are likely to demand.

As can be seen, the regulatory reforms are far-reaching and it is worth anticipating their impact as, although Spanish banks have largely adapted to the regulatory changes, application of some reforms is still outstanding.

Although the total capital ratio has risen by 1.7 percentage points over the last four years (reaching 15.1% in June 2018, exceeding the regulatory minimum), and the leverage and liquidity ratios are slightly above their European averages, when we focus on the regulatory capital with greatest loss-absorbing capacity, i.e. ordinary capital or CET1, the ratio has risen by just 0.3 percentage points.

In this regard, the Banco de España's in-house stress tests to assess prospectively the level of solvency of the Spanish banking system revealed that institutions have a high degree of resilience to possible adverse macroeconomic scenarios. Nevertheless, in view of the dispersion of results across banks and the possibility that the risks which materialise exceed those envisaged in the adverse scenario, banks would be advised to strengthen their capital insofar as the recovery in profits allows.

Indeed, according to June 2018 data from the European Banking Authority, Spanish institutions' CET1 and Tier 1 solvency ratios are some of the lowest among the euro area's banking systems. Apart from the need to adopt strategies to strengthen their top quality capital shown by comparison across Europe, Spanish banks also need to: (i) take advantage of the current economic growth and recovery in profits to raise levels of solvency and generate operating margin with which to meet the economy's future credit demand in a stable way; (ii) anticipate the impact of the reforms pending implementation in the framework of Basel III; and (iii) ensure compliance with the resolution requirements without excessive dependence on the market's appetite to absorb new non-preferred debt instruments (see Chart 7).

The new competitive environment

However, beyond the difficulties of adapting to post-crisis regulation and restoring banks' balance-sheet and income statement quality, the biggest challenge being faced by the Spanish banking sector is the new competitive framework in which it operates, and in particular, that deriving from new technologies and the advance of financial disintermediation.

In this new competitive environment, both BigTechs and FinTechs are altering some of the traditional paradigms of retail banking, in particular, the traditional role of customer accounts in building loyalty and as the essential pillar on which to offer universal banking services. These new operators can leverage the opportunities offered by technology and the new payments regulation to offer their value-added services using the "basic" deposit-taking and account-management service platform provided by the banking system.

This scenario represents both a short-term challenge, insofar as new competitors may enter specific areas, such as retail payment services, with the consequent drop in business and income for banks in this area, and, fundamentally, a major future challenge deriving from the risk that banks may be relegated to providing undifferentiated and low value-added basic services.

Against this competitive background, banks have a number of initial advantages but are being forced to react in order to capitalise on the opportunities the new situation offers. The responses may range from specialisation to digital transformation, taking advantage of the possibilities offered by technology and the new regulations, with an emphasis on adequate data management. In any event, this transition will entail a short-term increase in costs in a context of low profitability.

Issues such as cybersecurity also take on particular significance in the process of adaptation of institutions to new technologies as they can also lead to an increase in operational and reputational risk.

I would also like to highlight the growing challenge BigTech firms are posing in the financial sector, not in their more prominent customer-facing facet, but as providers of a significant amount of financial-sector infrastructure in areas such as cloud-based services. These actors now constitute a critical component of the financial sector.

In any event, new technologies offer banks fresh opportunities, both in terms of business and potential efficiency gains. The application of artificial intelligence and the use of large databases with real-time information (Big Data) may also provide for significant efficiency gains in terms of both business activity and regulatory compliance.

Similarly, the use of new technologies in the financial sector may offer advantages to society in that it reduces intermediation costs, improves households' and SMEs' access to finance and facilitates financial inclusion (see Chart 8).

Financial disintermediation

Another factor making the environment in which credit institutions operate more competitive is the advance of financial disintermediation. In Spain, as in countries such as Germany and Italy, the bulk of non-financial corporations' borrowing has traditionally come from bank loans. However, in other countries, such as the United States and the United Kingdom, capital markets play a much bigger role in corporate finance.

There is no consensus as to the optimal financing structure to best ensure financial stability and economic growth. On the one hand, it is true that the interaction between companies and banks involves the handling of non-public information about companies that may facilitate their access to bank lending at lower cost. On the other hand, having liquid and efficient financial markets makes it possible to channel households' savings into long-term projects with a larger share of finance in the form of capital.

Also, although the experience of the recent international crisis has taught us that an appropriate diversification of companies' sources of financing reduces their vulnerability to shocks affecting bank lending channels, there is also evidence that capital markets are more procyclical. These issues take on special importance in the context of the potential increase in long-term saving associated with population ageing.

In any event, in recent years companies have increasingly turned to European capital markets for finance. This trend towards financial disintermediation is explained by factors such as the ECB's corporate debt purchase programme, along with more permanent factors such as the introduction of new international banking regulation in response to the financial crisis.

The primary aim of the regulatory reform is to foster financial stability by strengthening banks' resilience to future shocks, but it has the side-effect of creating incentives to move typical bank services outside the reach of the sector's safety nets.

Indeed, various analytical studies –including the annual FSB non-banking financial intermediation monitoring reports– suggest that fund managers' business has grown substantially over the past decade. Moreover, this growth has been observed particularly in the case of open-ended funds that offer their unit-holders daily reimbursements and which invest in assets that are somewhat illiquid or have long maturities. In other words, they perform activities that share the need to manage some of the risks characteristic of typical banking business, such as maturity transformation, leverage or liquidity risk.

I therefore feel international financial regulation needs to follow the principle that activities with similar risks should be subject to similar supervision and regulation. And in the supervision and regulation of all entities and activities, the risks they pose to the financial system, particularly those of systemic importance, must be taken into account.

Looking beyond the regulatory viewpoint, the trend towards greater development of the capital markets could be further encouraged if headway is made in creating a Capital

Markets Union which, together with the culmination of Banking Union, would allow a better allocation of risk within the Economic and Monetary Union.

These changes in the structure of financial markets, in conjunction with the emergence of new technologies, clearly represent a challenge for banks, particularly in the current context of low profits among Europe's banking systems.

In any event, at this point in time the ultimate impact of new technologies on the structure of the financial system is highly uncertain, as it will depend on various factors, including the future regulatory treatment of new players.

Conclusions

To conclude, Spanish credit institutions have improved significantly in terms of their solvency, profitability and asset quality in recent years.

Despite this progress, the Spanish banking sector still faces important challenges, challenges which it largely shares with other euro area banking systems. The most significant of these challenges are: (i) stepping up the pace of sales of unproductive assets; (ii) strengthening capital and liabilities suitable for internal recapitalisation; (iii) building the sector's reputation by avoiding the risk of inappropriate conduct; (iv) confronting the challenge of making profits without undue easing of lending standards; and (v) utilising new technologies, which are both a major challenge for the sector and an opportunity for institutions that can harness them.

Additionally, challenges in the regulatory and supervisory area persist, such as the full integration of macro-prudential tools in economic policy design, and ensuring a regulatory framework that guarantees that typical banking risks are treated similarly regardless of the legal nature of the entity originating and managing them. In short, both institutions and the supervisory community share the challenge for the future of ensuring a more stable financial system that offers better services to society.

Thank you very much.