BANCO DE ESPAÑA
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Opening address

The current challenges of the financial sector / KPMG

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Deputy Governor

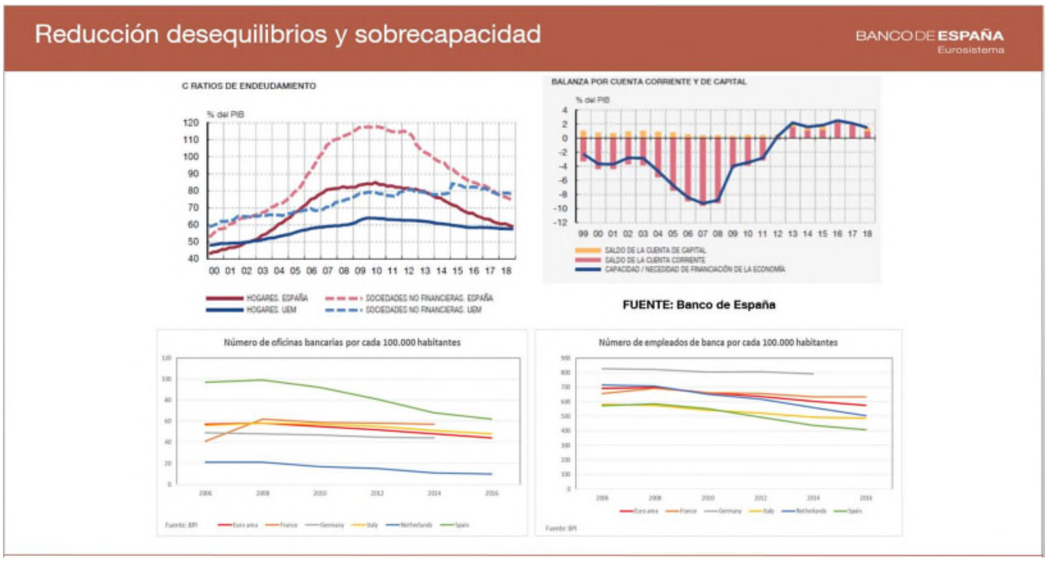
Good morning, and many thanks to KPMG for the opportunity to inaugurate this meeting on the current challenges of the financial sector.

Dictionaries define a challenge as an objective or a task that is difficult to carry out, and which is a stimulus and a trial for the person facing it. I believe the challenges facing our banks conform perfectly to this definition; they are not in the least easy or straightforward to carry out, and sufficient motivation is clearly needed to tackle them. The challenges I refer to are fairly well-known and, generally, shared by all.

As supervisors we are always addressing two such challenges: improved profitability and improved solvency. I believe profitability and solvency should be related. Without sufficient profitability, capital cannot be generated organically nor shareholders remunerated. And that in turn is an impediment to tapping the markets for new resources. Without capital, the growth of the business will be limited, exerting downward pressure on banks' profitability.

I should stress that, in my view, these two challenges are end-goals, i.e. they can only be directly attained as a result of achieving intermediate goals. I shall refer throughout my address to these intermediate objectives, which may be summarised in the form of another challenge: transforming the business model.

Developments since the crisis broke

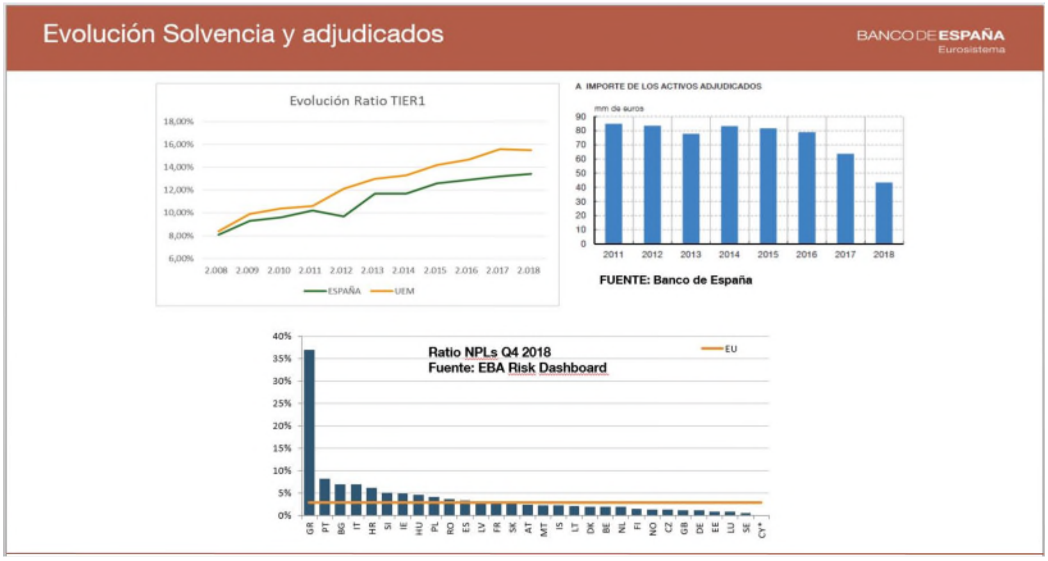


It is fair to stress that, following the crisis, Spanish banks have undertaken intense recapitalisation and restructuring. This process has, in the past five years, notably improved the sector's position in terms of basic metrics such as asset quality and profitability and solvency levels.

This has come about against the background of the correction of structural imbalances, built up on bank balance sheets during the pre-crisis upturn. Arguably, the cause and, largely, the effect of the formation of these imbalances was excess capacity in the development of Spanish deposit institutions' business.

We can observe the scale of the adjustment that has come about, both in the volume of banking activity and in the total volume of lending to the resident private sector. From its June 2009 peak, when the stock of lending practically amounted to €1.8 trillion, to the present day there has been a reduction of almost 40% in volume, i.e. of over €600 billion. In terms of GDP we have moved into line with the European average. Also, the excessive dependence on external financing has been corrected; specifically, the Spanish economy's net debtor position has declined from accounting for almost 100% of GDP in 2014 to 77.1% of GDP in 2018.

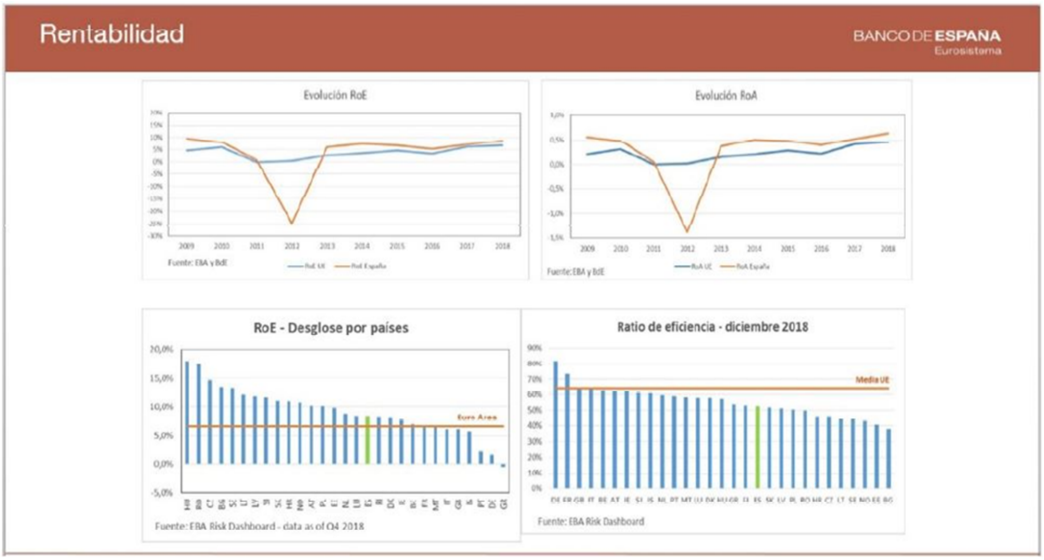
The consolidation process, which began in 2009, has entailed a reduction of more than 30% in the number of institutions. The most striking impact has been on the former savings banks, of which only two have survived, although another seven have converted into banks. Also paradigmatic is the change in the number of bank offices, which have fallen by more than 40% (20,000 fewer), and in staff numbers, which are down by more than 30% (around 90,000 fewer workers).



Against this backdrop of substantial business adjustment, banks have managed to improve their solvency and the quality of their balance sheets. The average Tier 1 capital ratio has risen from 8.1% in 2008 to 13.4% late last year. Banks have also been active in the disposal of their non-earning assets, and non-performing and foreclosed loans, which has allowed volumes to be reduced most considerably.

This divestment of non-earning assets has come about against a background of economic growth, which, undoubtedly, has helped the process. But I believe it is important to stress that supervisory pressure has also notably influenced this improvement.

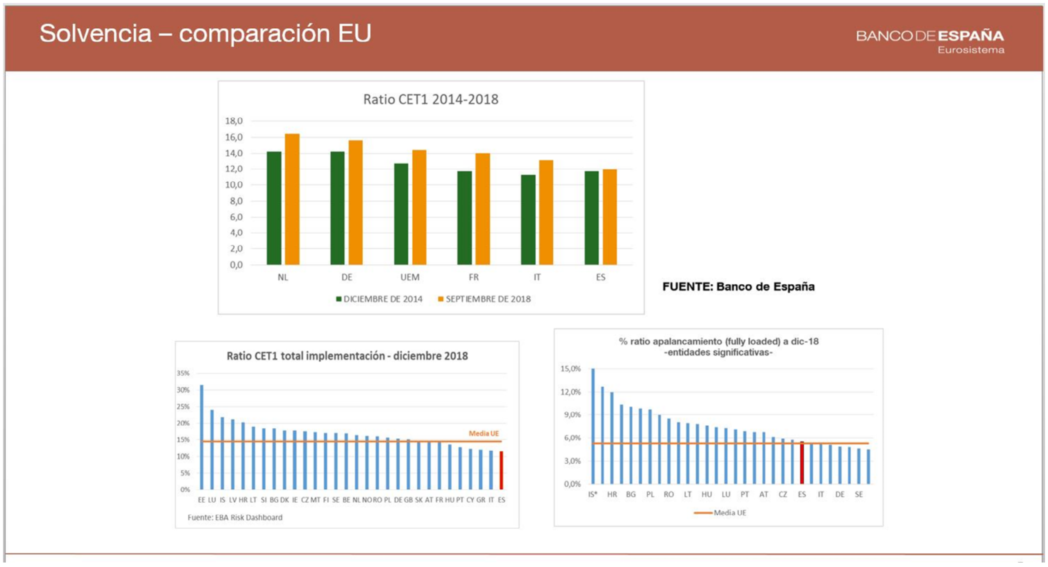
The chart shows clearly how the volume of NPLs has fallen almost exclusively over the past two years. To my understanding, the publication of the SSM guidance in March 2017 and of its addendum a year later have had a lot to do with this.



As regards results, once the 2012 downturn was behind us, banks showed returns on assets and on equity moving around 0.55% and 7.22%, respectively.

As a result of all these efforts, Spanish banks are in a much sounder position and currently have unquestionable strengths compared with their European rivals, essentially as regards their profitability and efficiency.

As can be seen, profitability, measured both in terms of RoA and of RoE, is above the European average. If we analyse average efficiency, we see that Spanish banks clearly have lower management expenses in relation to their revenue than their European competitors, particularly those in the core euro area countries.



Regrettably, these strengths do not change our position relative to the comparative average levels of solvency.

Admittedly, supervisors are always applying pressure in relation to capital levels; that is our mission. Banks usually protest about this growing capital requirement which, as the most widespread complaints have it, appears to be never-ending and may lead to credit being squeezed. Reference is also made, with some justification, to the low density of many European banks' risk-weighted assets, owing to a more extensive use of internal models.

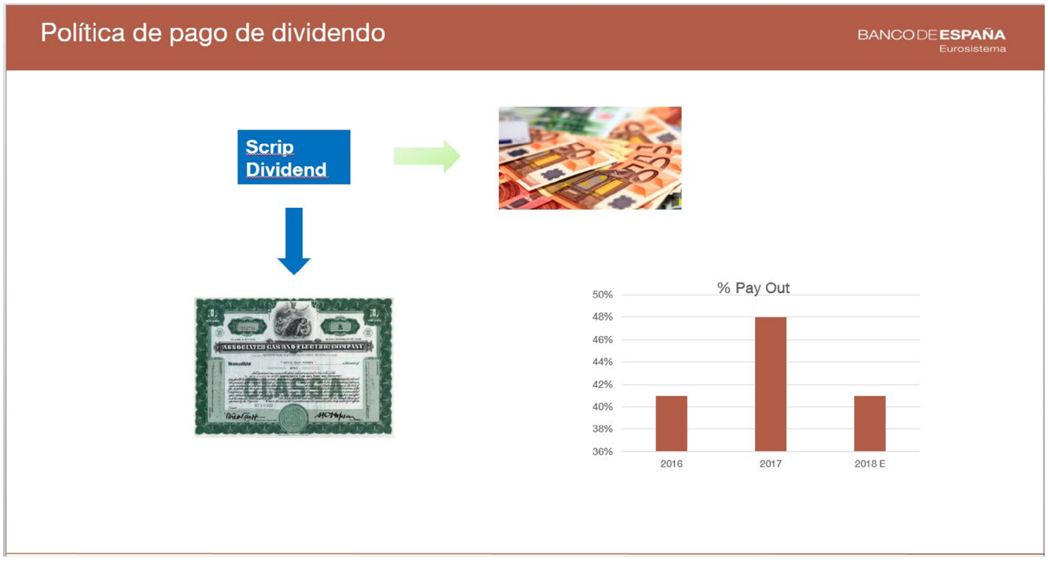
I have indicated on more than one occasion that our banks have comparative strengths. For instance, we are in a better position in terms of leverage when set against the industry average in Europe; moreover, the low use of internal models by Spanish banks enables the volatility of capital requirements to be reduced, while in turn keeping our banks unaffected by the introduction of the Basel III "Output floor". Nonetheless, I do not share the rest of the analysis of the sector.

I would point out that a high level of capital is neither a weakness nor a disadvantage. That might sound flippant; but the fact is that if anyone were to read certain statements for the first time, they might reach the conclusion that raising solvency levels entails all kinds of problems. As I said earlier, profitability and capital should go hand in hand. But the flattening in solvency ratios has come about against the background of a sustained decline in lending, not an increase therein.

If we analyse the change in CET1 capital ratios since the start-up of the SSM, we see that in 2014 Spanish banks had average levels below the European average, very similar to those of French banks and indeed higher than those of Italian banks. Yet at the end of this period our banks show levels clearly below those of both these countries. It would be worth reflecting on why our banks – which initially showed lower solvency levels than the European average and which, moreover, have maintained higher average profitability than their peer group – should have seen not only a reduction in the starting difference in solvency levels, but also a widening in this difference. Unlike their counterparts, Spanish banks have not been able to offset the erosion in CET1 brought about by the gradual entry into force of Basel III with increases in capital or reserves.

Clearly, our banks consider that, since the launch of the SSM, the demands placed on them in respect of capital needs have been very great. But looking at the comparison, I wonder what banks in the other euro area countries that have significantly reinforced their capital ratios will think. Moreover, unlike Spain, most of our peers have activated – or have announced the activation – of countercyclical capital buffers, which may partly explain the increase in their solvency ratios.

Dividend policy



It is worth remembering that the clearest route to strengthening capital is through the organic generation of reserves. That leads once again to highlighting the importance of profitability and, in relation to profits, of dividend policy. Each bank should give structure to this dividend policy, bearing in mind its present and future capital needs.

As I have occasionally indicated, in my view dividend payments are excessively rigid. They have functioned more as a fixed remuneration than as a genuine, variable distribution of each year's return.

In this respect, one possibility used by banks at various times has been to use scrip dividends. These allow remuneration to the shareholder to take the form of the delivery of new issued shares, instead of cash.

This policy enables the necessary remuneration of capital to be combined with the organic generation of capital, although it inevitably entails some dilution of earnings per share, as also occurs whenever there are capital increases. It is the responsibility of each bank to assess these aspects when setting its dividend policy.

Implementation of Basel III

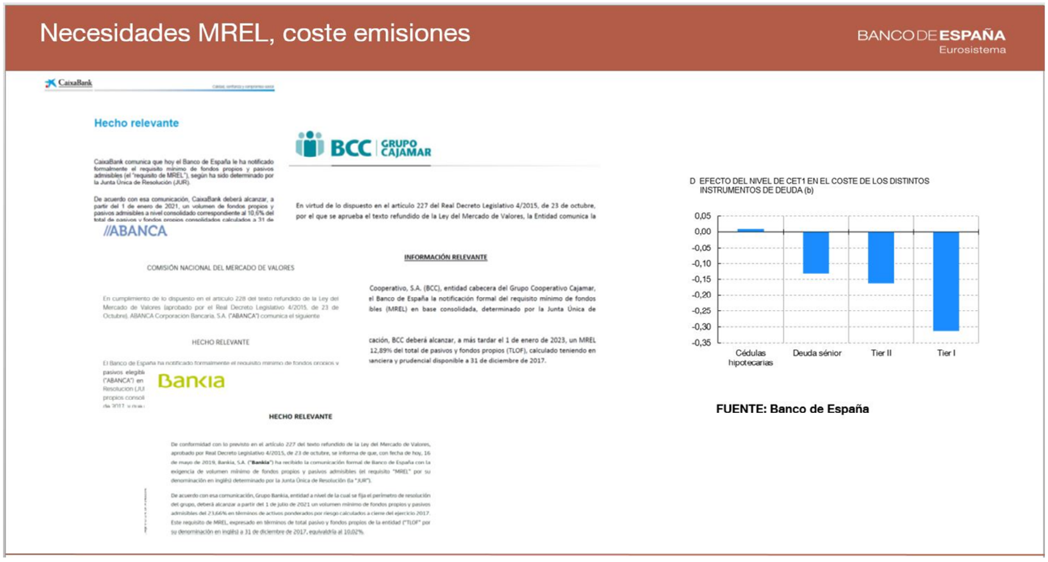
I have previously referred to the need for banks to plan their future capital requirements, whether as a result of their business projections or of regulatory changes. In this connection, the importance of strengthening, as far as possible, current capital levels should be interpreted against the background of the challenge – a further challenge – entailed by the entry into force of the final stage of Basel III.

Last week the EBA published an update of the estimated impact that the implementation of the outstanding elements of Basel III will have on European Union (EU) banks. According to this estimate, risk-weighted assets (RWAs) will increase in the EU as a whole by 24.4%, meaning additional capital totalling €135 billion in order to respond to new needs. Naturally, we should qualify these figures. Let us not forget that they reflect estimates made under conservative assumptions that banks will not adjust their portfolios to lessen the attendant impact.

The EBA itself indicates that needs would fall to €58.7 billion if banks decided to retain all their profits during the transitory period. The reforms will not affect all banks equally. Large banks, in particular those that use internal models (IRB), will be most affected, with the impact being restricted to an 11.3% increase in RWAs for medium-sized banks and of only 5.5% for the smallest banks.

The main impact will stem from the application of the regulatory floor for those risk-weighted assets calculated using the internal ratings-based approach. As indicated, the lower use of IRB models by our banks means they will not be affected by this concept. However, other changes, such as the new operational risk and Credit Valuation Adjustment (CVA) frameworks, or the introduction of changes in the standardised approach, will indeed affect our banks, which should prepare themselves to absorb the new requirements.

MREL



Another challenge banks face stems from the introduction of the new eligible liabilities requirements, known as MREL. As you will be aware, the introduction of MREL is the consequence of the change in paradigm in crisis resolution. We have now moved from the bail-out to the bail-in. The aim is to ensure that banks have sufficient unsecured liabilities on their balance sheet, whether own funds or “bailinable” debt, if you will allow me to use this expression, so as to avoid the use of public funds in the event of failure.

The Single Resolution Board (SRB) has set MREL objectives for each significant institution at the European level. It has also informed them of the maximum time available to cover these requirements, which must be met through organic growth of specific liabilities and new issues. It is essential that each institution should plan the issues to be made appropriately.

It is worth recalling here that the characteristics of these liabilities make them rather unsuitable for distribution among retail customers. As we have witnessed in some cases in the recent past, the holding of these securities by individuals entails problems in a context of crisis, turning them even into an obstacle for the institution’s “resolvability”. And that is exactly the opposite of what the rule originally sought. The Banco de España is determined to prevent this type of past situation from recurring. We should not make the same mistakes again.

For these reasons, the challenge of covering these issues is greater for smaller-sized banks, which have a scant presence on the markets and are more geared to the retail segment.

I think it is important that banks, in particular those with less access to the markets, should take advantage of those windows in which investors’ appetite for this type of asset increases, so as to bring forward as far as possible the issuance calendar.
One final aspect I wish to mention is the cost of these issues and of liabilities in general. The latest Banco de España *Financial Stability Report* offers the findings of a study on European banks which conclude that the higher the level of the CET1 capital ratio, the lower debt issuance costs are.

This effect increases as debt instruments become more akin to capital instruments. As can be seen in the chart, if the CET1 ratio increases by 1 pp, a 0.3% reduction may be expected in the cost of issuing instruments eligible as Tier 1. The effect is smaller, although significant, by around 0.13-0.16% for Tier 2 instruments or for senior debt.

The findings are, in my opinion, perfectly logical and rational. Evidently, a higher capital ratio is a guarantee for those debt-holders situated lower in the hierarchy of credit tranches. As a result, investors are prepared to buy debt at lower rates than those that are demanded of institutions showing lower CET1 levels.

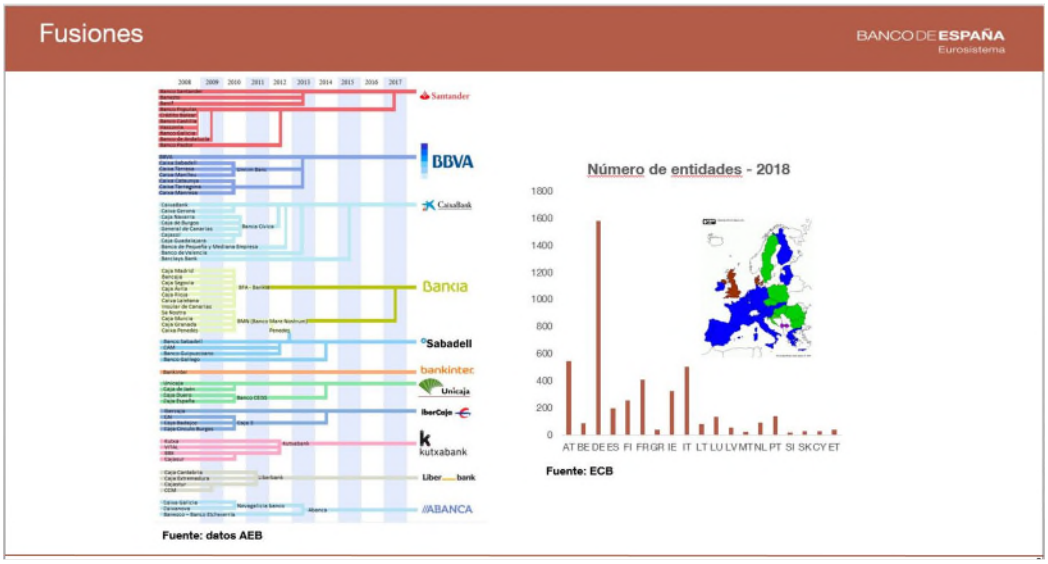
As I pointed out, showing a high level of capital is not a disadvantage. In addition to MREL eligibility, a high level of capital evidently enables the bank to reduce its funding costs, likewise improving its external rating and its access to markets.

Improving profitability

Apart from improved solvency, there are other levers that can help improve profitability. First, headway in reducing non-earning assets is important. Spanish banks have managed to significantly reduce their portfolios of NPLs and foreclosures, although we remain above the figures posted by other European Union banks and the level continues to be clearly above what it was pre-crisis.

As their name suggests, these assets are “unproductive“. But, moreover, maintaining them entails high costs in terms of human, financial and – in the case of property – tax and upkeep

resources. Evidently, their disposal allows costs to be cut and resources to be freed up and used for other productive activities.



In this setting of low margins and high competition, bank mergers are an alternative for gaining competitiveness. Mergers – or, I should rather say, their absence in light of the recent past – are always prominent in press headlines. In this respect, let me reiterate that mergers may be a means for securing gains in efficiency and profitability, but they are very complex operations and the attendant business plans must be appropriately assessed.

We have seen a 30% reduction in the number of institutions there were in 2009. More recently we have seen how, in the absence of a context of acute crisis, many of the corporate operations announced do not reach fruition. Meantime, in some of the operations that are finalised, integration problems continue to be seen for years.

Our task in a setting such as the present one is to ensure that any merger process should lead to the creation of a new, more solvent institution, with a sound business model, enabling structural costs to be cut and, in short, value to be generated.

We must of course assess these same aspects with a view to potential cross-border mergers in Europe. The absence of such mergers may be seen as a sign that the Banking Union is not working as it should. True, several elements of the Banking Union are still not in place, including most notably the European Deposit Insurance Scheme (EDIS). It is likewise true that the regulations affecting the sector are still too heterogeneous across the different Member States. Yet it seems that the very excess capacity of the banking sector is acting as an entry barrier to banks from other jurisdictions, given that the potential gain in costs and synergies arising from the elimination of duplicated networks and services occurs chiefly in national mergers.

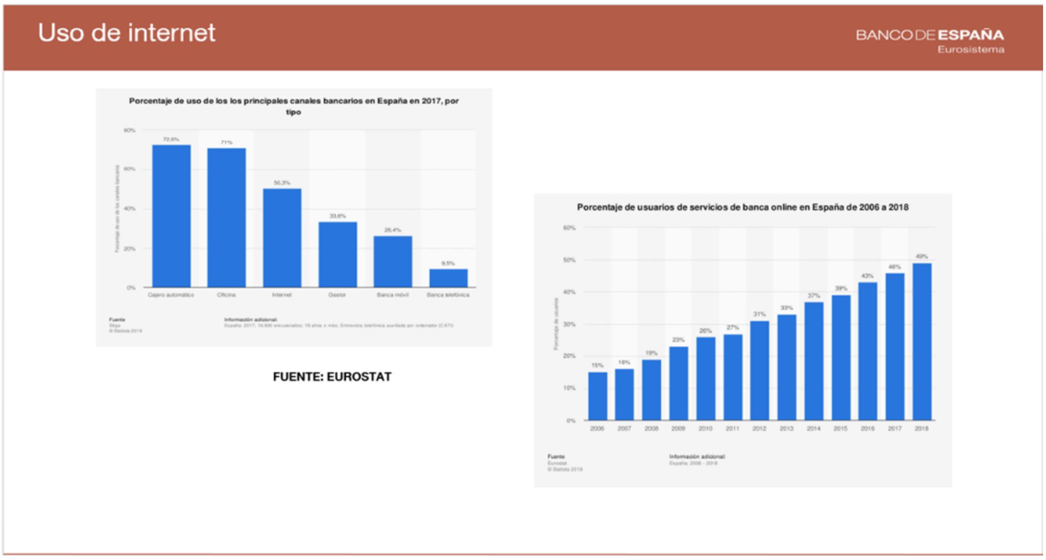
Lastly, another means of improvement would stem from cost-cutting and the subsequent enhanced efficiency. Admittedly, I did say our banks made notable efforts to shed the excess capacity in place pre-crisis; but there still remains room for improvement. In any event, further gains in efficiency appear to be closely linked to technological transformation.

Technological change

We are all aware that technological change is one of the main transformations banking must pursue. If we look at what has happened in recent years in other sectors, there is clearly a need for the banking business model to adapt.

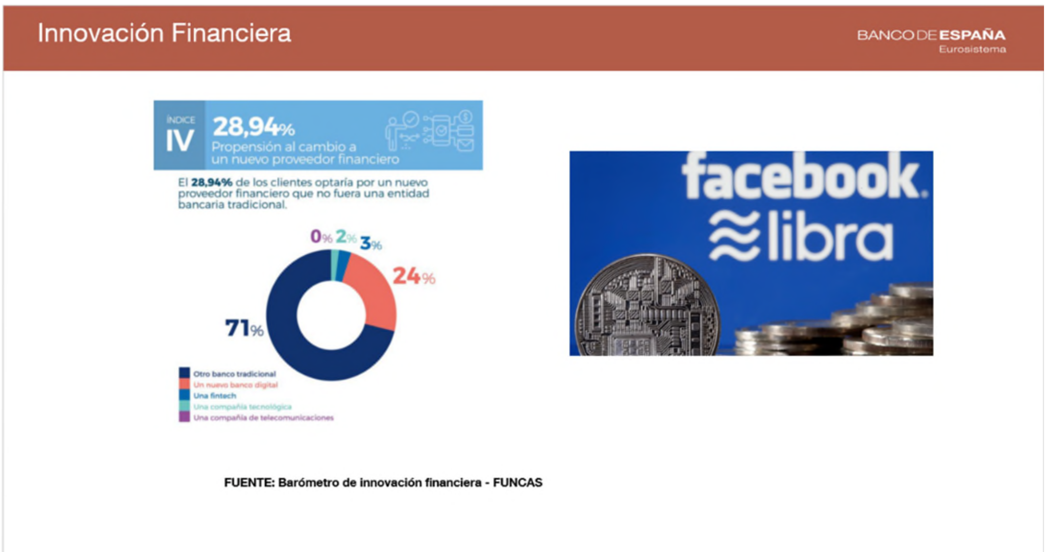
Technological change is a complex matter, but one that is fundamental for tackling the future. It should be part and parcel of deeper reflections relating to the banking business model and its sustainability in the long term.

Naturally, technological adaptation calls in many cases for significant investment in systems to be made. However, such investment today will be key to future income.

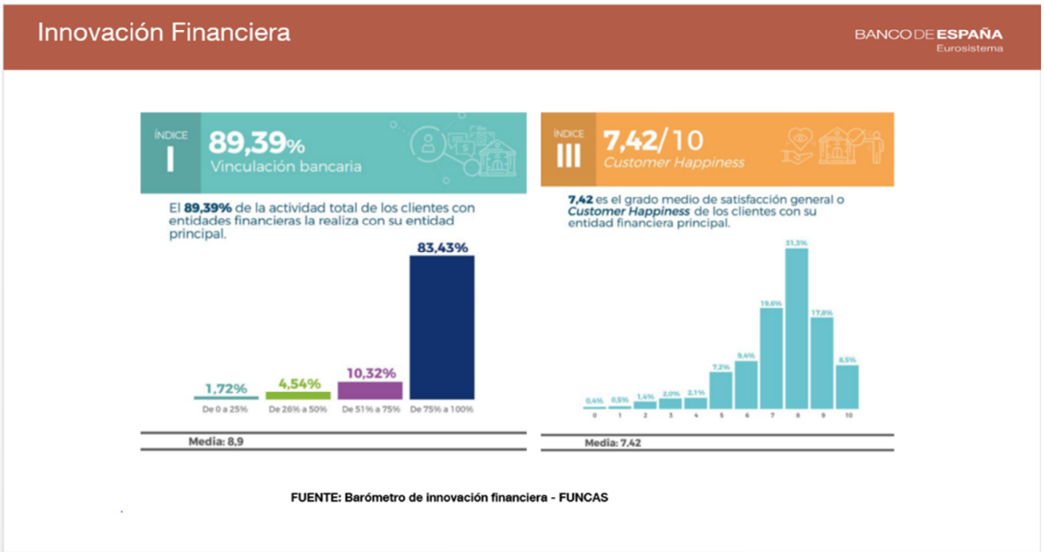


Clearly, the gains in efficiency will be very closely linked to technological change. Most banking transactions in Spain continue to be made through ATMs and bank windows. However, the proportion of online users is growing every year. In step with this trend, the potential for cost savings is significant.

I should stress that, when undertaking this transformation, banks have most significant starting strengths. Despite all the reputation problems, people continue to trust their bank, much more than any other service-providing company. Personal relationships with customers continue to be very important, particularly in certain segments and age groups.



According to the latest Funcas financial innovation barometer, in January this year, customer ties to their main financial institution remained very strong. Close to 90% of banking activity is conducted with the main institution. Also notable is the fact that customers' perception of quality of innovation and their degree of satisfaction with their institution is high; higher, indeed, that what the managers of institutions themselves think.



While the proportion is growing, still less than half of Spanish bank customers (4 out of 10) would be prepared to use exclusively digital channels to take out traditional financial products. Assuming a change in institution, traditional banks remain the first option (71%) for moving an account from one institution to another. Fully digital banks would be chosen by 24%, while FinTech are an option for only 3%. Lastly, only the 2% remaining would change their bank for a technological or telecommunications company that offered these services.

This starting position, which is a relatively good one from a “defensive” standpoint, should not have us forget that the tendency towards the use of alternative channels is on the rise. Despite the fact that FinTech have so far not had a significant effect on the market, specific events, such as the implementation of PSD2, may alter the current picture. There is concern over the possibility that third parties may have access to customers’ bank data. But I must point out here that it is in fact banks that currently have all this information. Naturally, the problem lies in knowing whether banks are ready to extract and properly exploit this information.

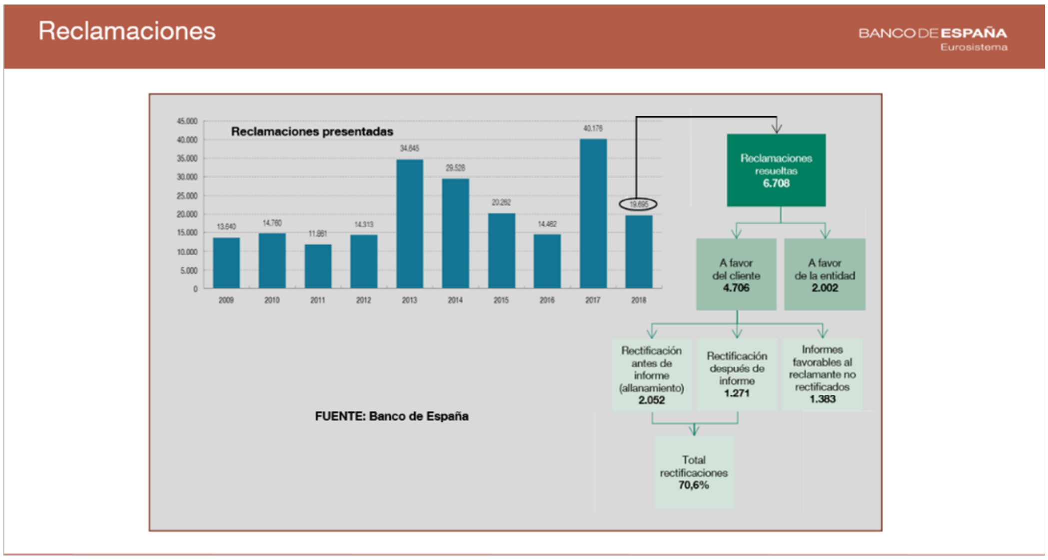
There is much talk about interaction with customers, the quality of apps and the user experience. Yet I would like to stress that it is even more important to undertake technological change “in-house”, as regards data aggregation and quality and internal applications. Here there is much potential for improvement, although Spanish banks are not in any way worse positioned than their European rivals.

Banks should be capable of extracting, exploiting and analysing their customers’ data. And in this connection, it will be necessary in many cases to invest in systems. Managers must have the information to take decisions. Without it, evaluation and transformation of the business model will not be possible.

Against this background of technological change, I would like to refer briefly to the recent announcement of the launch of the “libra” project, the virtual currency sponsored by Facebook. The reaction by the public sector, supervisors and central banks to this announcement has, to put it mildly, been shrouded in caution.

Testifying to this is the letter sent last week by the US authorities to Facebook. In its first paragraph, a request – or rather a demand – is made for the implementation of the project to be delayed while its potential consequences are evaluated. The same paragraph indicates that the libra project “is intended to rival US monetary policy and the dollar”.

I do not think this is an exaggerated reaction, since the irruption of big tech has potentially systemic implications.



Customer relations

I think it is also important to talk about customer relations as another key factor of any future business model. I shall not dwell on this point, the ground for which has been previously covered. But I would like to point out that this change is the only means of responding to the challenge the sector faces to restore its image and reputation.

Society has changed in terms of its demands of the financial sector. The rules governing customer-bank relations have likewise changed. A good example of this is the recent law on real estate lending. Banks should, therefore, change to respond to the new social and regulatory reality.

Evidently, legal cases from the past continue to weigh on and hamper the restoration of image. But if banks change their behaviour today they will be laying the foundations on which to build the industry’s future reputation.

In this respect, last year we saw a decline in claims lodged against banks. According to the Banco de España 2018 *Annual Claims Report*, published last Wednesday, the number of claims processed by the Bank last year fell by more than 50% on 2017 to close to 19,700.[1] Nonetheless, the total percentage of rectifications by banks relative to those estimated by the Banco de España was 70.6%, a similar percentage to that of 2017.

[1] In any event it should be borne in mind that, since 2013, the annual claims figures have shown strong year-to-year oscillations, generally linked to the impact of specific legal rulings.

Business model

Evidently, banks should analyse their current business models with a view to assessing to what extent they respond to this new technological and customer-relations reality, but also to identifying their strengths and weaknesses.

To conduct this analysis, the above-mentioned management information is needed, which depends, in turn, on the quality of systems. Consequently, technology becomes an objective of the change in business model and a prerequisite for such change to occur, hence its central role. Naturally, another prerequisite worth mentioning is governance, without which all these changes will be destined for failure.

Importantly, reflection on the business model should be individualised, and adapted to the particular characteristics of each bank. Indeed, the results of a theme-based review by the Single Supervisory Mechanism on profitability and business models show that there is no single approach and that there are differences in strategies among those banks with the best profitability results. Some pursue strategies geared to obtaining high revenue, which counter relatively high costs. Others focus on low costs that are compatible with relatively low revenue. And others strike a balance between average revenue-generating capacity and medium or low-level costs.

These differences in strategies are reflected in different action plans: some are geared to growth in loans or fees; others to streamlining costs through various means, although two appear to be prominent, namely digitalisation and externalisation.

Conclusions

To conclude, I believe we all share the view that the challenges the financial sector faces in Spain are far-reaching.

The social environment, supervision and regulation appear not to be helping, since they increase pressure on banks. However, experience shows that, sadly, it is almost always under pressure that reforms are undertaken.

Compared with their European competitors, Spanish banks have significant comparative strengths to address the changes. These include higher profitability and efficiency, and a lower potential impact from the implementation of Basel III. We should harness these advantages and attempt to correct those areas in which we are less competitive. Irrespective of improving profitability, efficiency and solvency levels, the key long-term challenge involves transforming the business model. And as I have said, technology is central to this challenge.

The future will be for those who are most prepared. In this respect, I believe that any challenge can be viewed from two different and, in fact, opposite standpoints: as a threat or as an opportunity. The difference between both views lies in the attitude adopted and the willingness deployed.

Thank you.