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The Spanish banking system: transformations and challenges

Opening of the seminar "Sustainable finances and their importance in the future of the economy", Universidad Internacional Menéndez Pelayo, organised by the Spanish Association of Economics Journalists

Pablo Hernández de Cos
Governor

Ladies and gentlemen, good morning:

It is an honour and a pleasure to be able to participate in the opening of this seminar, organised by the Spanish Association of Economics Journalists (APIE) as part of the Universidad Internacional Menéndez Pelayo's summer programme of seminars, being held, once again, on this Santander soil, of which I am so fond.

I should like to begin by recalling, here in this historic Magdalena palace, that 2019 is particularly rich in anniversaries relating to the opening up and liberalisation of the Spanish economy. The process began with the Stabilisation Plan 60 years ago, while one of the most important milestones was passed 20 years ago, when Spain adopted the single European currency, the euro.

And, exactly 25 years ago, in order to reach that stage, it was necessary for the Spanish parliament to approve the Law of Autonomy of the Banco de España, which confirmed the Spanish central bank's autonomy and independence. By means of this law, moreover, Spain established an institutional framework in line with the requirements for adopting the single currency, and also put in place a fundamental pillar for a culture of stability in the conduct of economic policy.

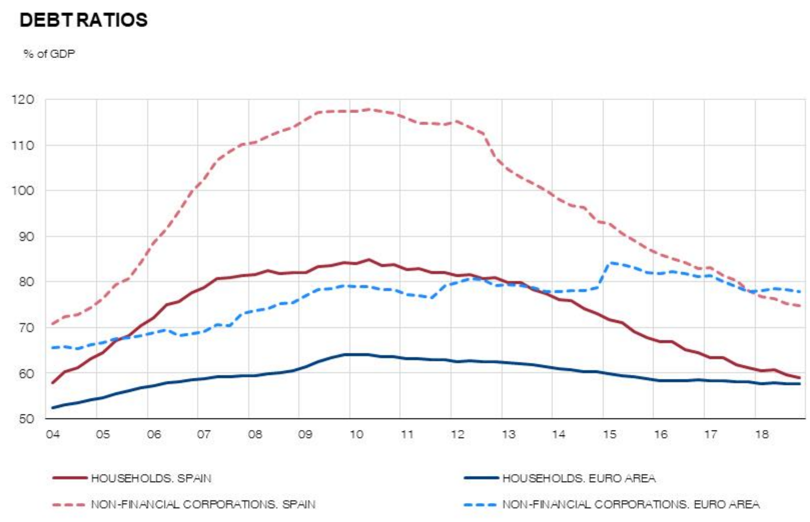
Accountability and transparency are essential counterparts of independence, and the media play a fundamental role in ensuring that they are put into practice, which is why our participation in events such as this one is so important. So I should like to thank the APIE for organising this event and inviting us to participate.

This look back reminds us that, more than 10 years ago now, an international financial crisis hit Spain particularly strongly, arriving at a time when the economy was suffering from significant domestic and external macro-financial imbalances. Spain's banking system was clearly excessively large at the time, over-concentrated on lending funds to real estate and residential construction activities and highly dependent on international wholesale financing.

These significant vulnerabilities meant that the cost of the crisis in terms of GDP and – even more importantly for society – unemployment, was very high and much larger than for our main competitors. In fact, Spain's GDP returned to its pre-crisis level only two years ago. As regards the labour market, the unemployment rate is still five percentage points higher than in 2008 and more than 10 percentage points higher than in countries like the United States and Germany.

And that is a reminder of the importance of strengthening mechanisms to analyse and diagnose promptly the risks and vulnerabilities facing the economy and, in particular, the financial system.

CHART 1



Sources: INE and Banco de España.

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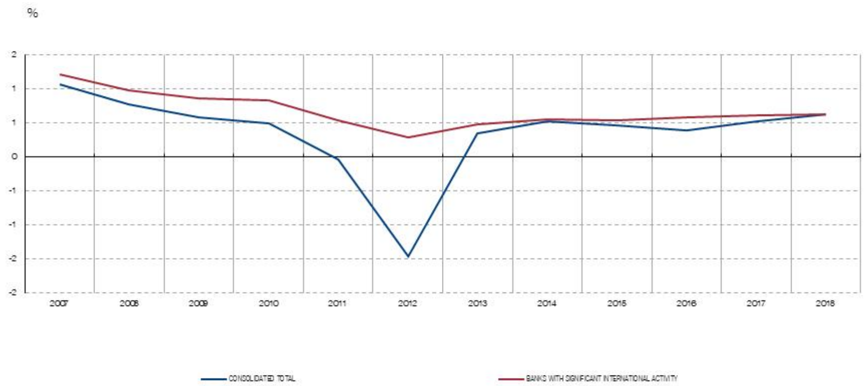
Many of these vulnerabilities have been corrected during the current decade, in particular those relating to the high indebtedness of the non-financial private sector, which is now at similar levels to those of the euro area, having fallen by 69 percentage points of GDP since peaking in 2010. However, new vulnerabilities have emerged, such as public debt. This, among other consequences, limits fiscal policy's future room for manoeuvre. However, I would like to focus today on the financial sector and the challenges it will have to address.

A decade of transformation and downsizing of the Spanish banking industry

As I have already mentioned, the crisis highlighted the need to adjust the size of the banking industry. Since non-financial private sector debt was excessive by any reckoning, its reduction had to be matched by a slimming down of the financial sector and, thus, banks, whose assets accounted for two thirds of the total assets of the sector. This capacity adjustment, moreover, had to be confined to business in Spain, since business abroad was one of the main factors behind the resilience of some institutions.

CHART 2

INTERNATIONAL ACTIVITY AND PROFITABILITY
Consolidated statements



Source: Banco de España.
a. The 2017 figures do not show the losses by Banco Popular Español in the first half of that year. Had they been included, ROA in 2017 would have been 0.09%.

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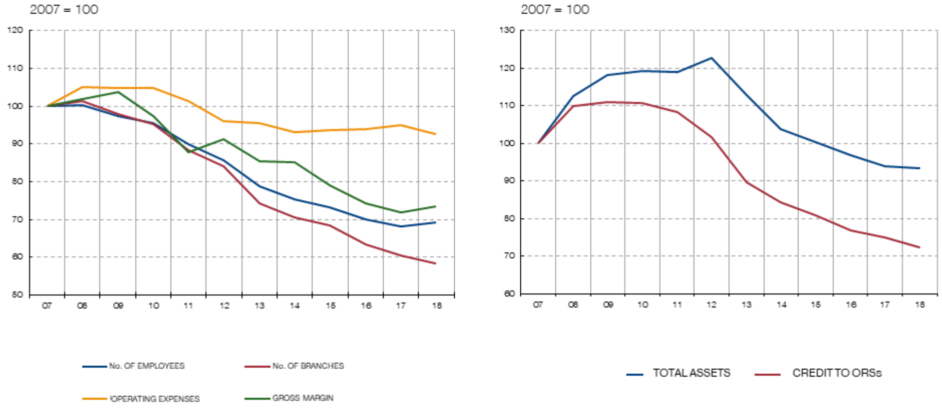
In fact, the geographical diversification of Spanish banks, especially their participation in emerging economies, which were little affected by the international financial crisis, allowed Spanish banks with an international presence (which accounted for almost half of total bank assets) to limit their overall losses and to continue to cover part of their capital requirements internally. Furthermore, these institutions played a very important role in resolving the crisis, since they were able to take over other institutions in a weaker position.

It is not surprising, therefore, that the international presence of Spanish banks has increased since the crisis, in contrast to that of the banks of most European countries, which have tended to reduce their international operations. Over the last decade, Spanish banks have increased their international exposure by 45%, while the banks of countries such as Germany, France and Italy have reduced theirs by 38%, 16% and 15%, respectively.

CHART 3

1 CAPACITY ADJUSTMENT IN SPANISH DEPOSIT INSTITUTIONS (a)

2 TOTAL ASSETS AND CREDIT TO ORSs (a)



SOURCE: Banco de España.

a. Individual statements. Business in Spain.

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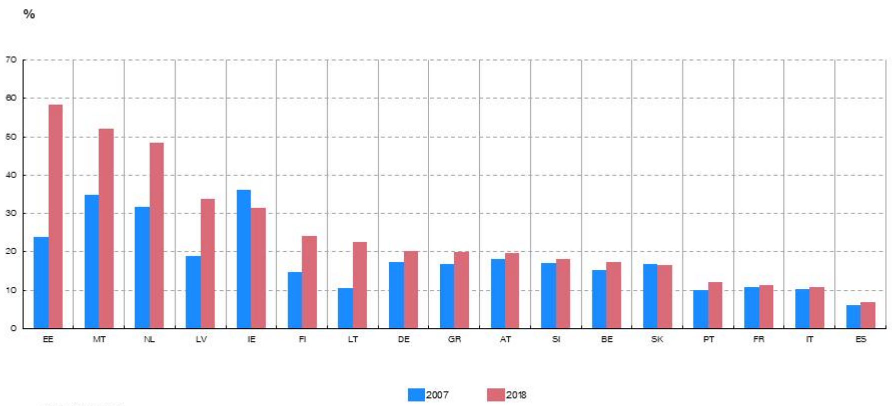
On the other hand, the effort to adjust business in Spain has been highly significant. Specifically, over the last 10 years, the total assets of business in Spain have been reduced by 20% and employment in the industry by 32%. Also, the number of institutions has fallen by 34%, with a decrease in the number of domestic banks[1] from 122 at the beginning of the crisis to 61 in 2018. As a result, concentration has increased significantly. Most of the mergers and takeovers have given rise to healthier banks, with significant cost savings.

CHART 4

EUROPEAN COMPARISON OF EMPLOYEES PER BRANCH.
Single Supervisory Mechanism Countries. December 2007 and December 2018



SOURCE: ECB.

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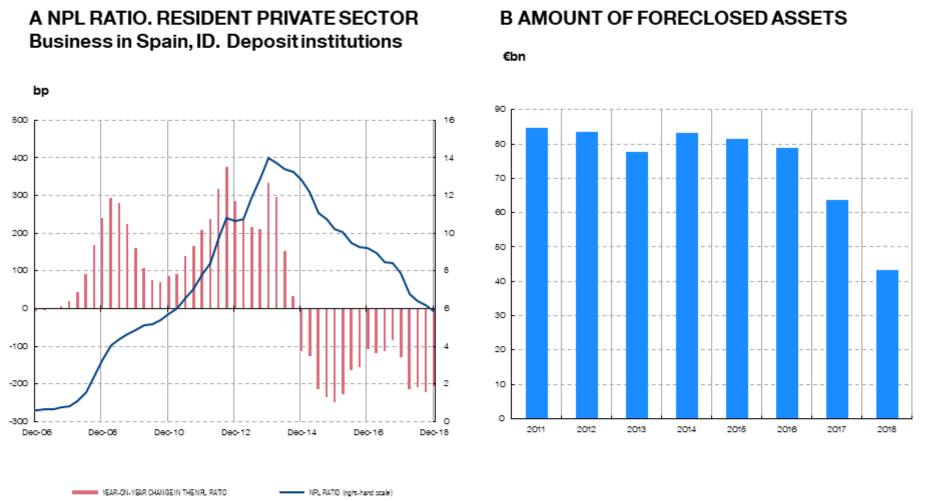
[1] Grupos consolidados y entidades sin grupo, de propiedad nacional.

One effect of this consolidation process has been the disappearance of 43% of the bank branches existing in Spain. However, analysis of Spanish bank capillarity shows that between 2007 and 2017 the increase in the proportion of the population without a bank branch nearby was 0.7%, as the closures were concentrated in areas of high branch density. Also, the emergence of new technologies allows bank services to be offered using more flexible and mobile methods. In any case, we should not forget that the average size of Spanish bank branches remains small, in comparison with other European countries.

CHART 5



SOURCE: Banco de España.

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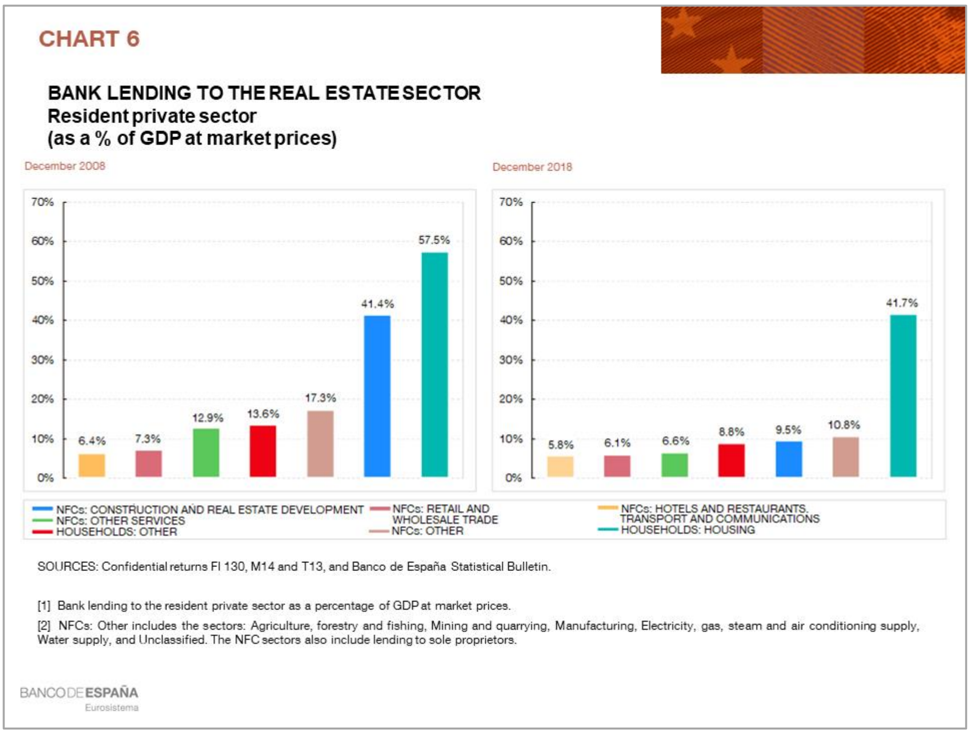
This drive to correct the excessive size of the Spanish banking system has been accompanied by significant restructuring. As you well know, the financial crisis led to considerable deterioration in the quality of Spanish banks' assets. In fact, the excessive concentration of Spanish banks on the real estate sector and the intensity of the recession caused the non-performing loan (NPL) ratio to reach, within just five years, unprecedented levels of around 14% by the end of 2013. Moreover, as a consequence of defaults, banks foreclosed a considerable volume of real estate, which formed part of the collateral for many loans. In 2014, their foreclosed assets amounted to more than €80 billion.

The lower return on assets, along with the increase in provisions for NPLs, when a large part of the general provisions built up during the preceding expansion had been used, caused the banking industry as a whole to post a loss in 2012. This obviously had an impact on bank solvency, giving rise to significant capital requirements for some banks, which needed public support to cover the capital shortfalls identified.

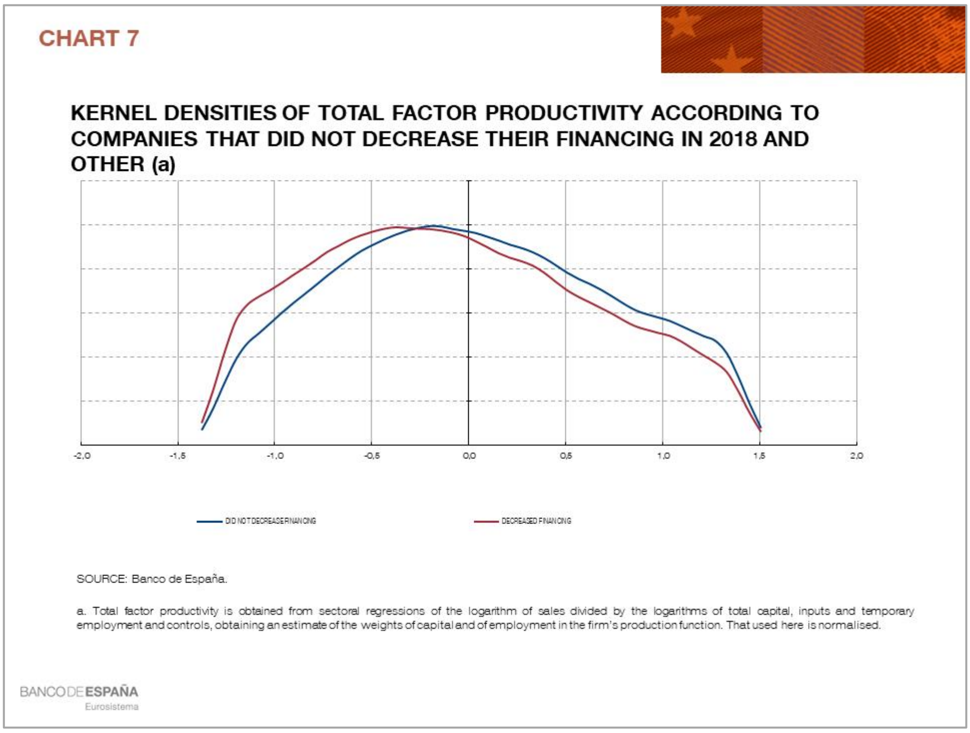
Since then, the situation has improved considerably, with the help of the monetary policy measures implemented by the European Central Bank to ensure that solvent banks had sufficient funding.

Against a background of significant decline in banking activity, banks have managed to reduce the weight of troubled assets in their balance sheets very significantly. Specifically, the NPL ratio has fallen by more than eight percentage points to stand at 5.8% of total lending. Foreclosed assets, meanwhile, are only 50% of the level recorded in 2014, so that their weight has been reduced to 3.6% of assets, vis-à-vis the resident private sector. Active management of these assets by banks, under supervisory pressure, has played a very important role in this process. In any event, there is still significant room for improvement; before the international financial crisis, the NPL ratio was below 1% and foreclosed assets were practically non-existent.

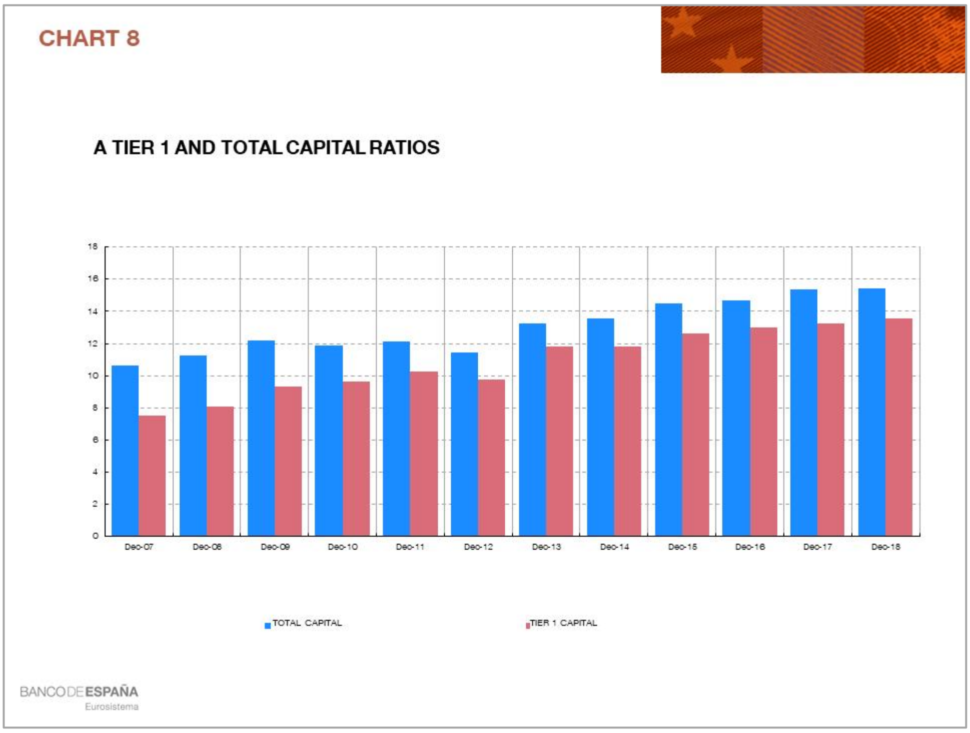


The restructuring of credit institutions is also reflected in the reduction in the weight of the real estate sector (broadly defined),[2] which stood at 52% of GDP in 2018, as compared with 99% in 2008.

[2] Loans for house purchase, plus loans to businesses in the construction industry and related areas.



At the same time, there is also evidence that these developments have been accompanied by some degree of borrower selection for the supply of credit, so that access to funding has improved more markedly in the case of firms in a more favourable economic and financial situation. This has been reflected in an increase in the positive association between the receipt of loans by firms and their productivity.



This period has also seen a significant improvement in credit institutions' solvency ratios, with their tier 1 capital ratio rising from 7.5% in 2007 to 13.5% by the end of 2018.

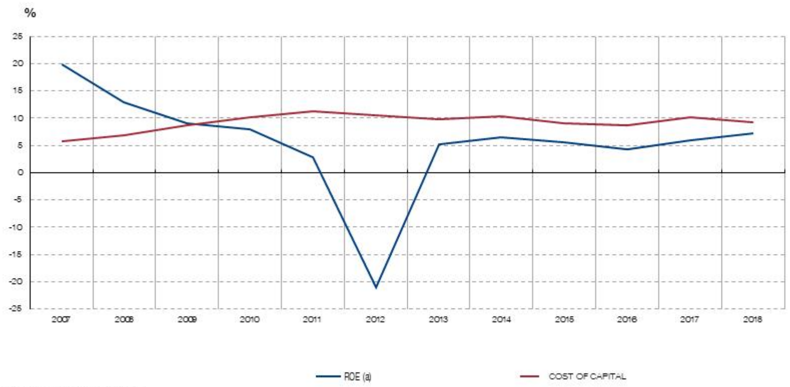
Current situation and future challenges of the Spanish banking sector

Despite all these improvements, the Spanish banking sector still faces significant challenges.

The challenge to banks represented by the task of reducing troubled assets is now greater, because the troubled assets already sold were naturally the most attractive ones. It is thus crucial for banks not to relax their credit standards if they wish to minimise their new bad debts and maintain their active management of NPL and foreclosed asset portfolios.

CHART 9

PROFITABILITY AND COST OF CAPITAL
Consolidated statements



SOURCE: Banco de España.

a. The ratio has been constructed with the profits attributed to the controlling entity.

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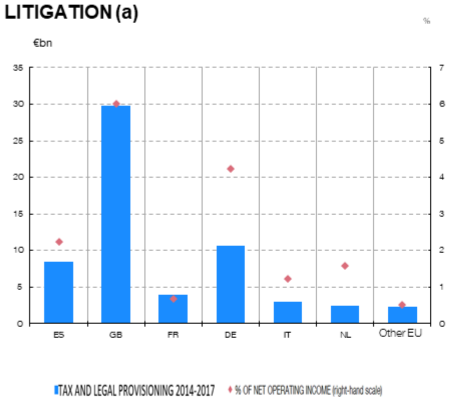
While net interest income has held steady, the decrease in unproductive assets and write-offs has helped to improve profitability. Specifically, at the end of 2018 the return on equity stood at 7.2%, the highest since the global financial crisis and also above the European average.

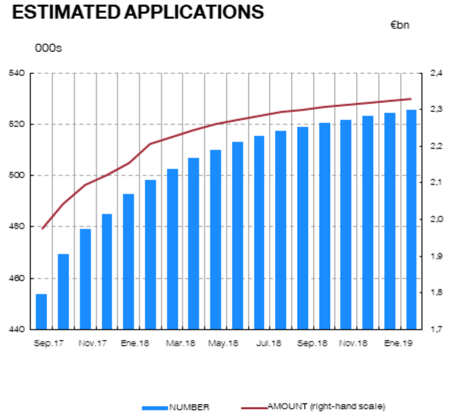
Despite this, the return on equity is still below the cost of capital, making low profitability one of the main risks facing Spanish and European banks. Improved profitability is, furthermore, one of the requirements for banks to be able to generate capital organically and raise their solvency.

CHART 10

1 PROVISIONING FOR LEGAL COSTS AND TAX LITIGATION (a)



2 RDL 1/2017 – FLOOR CLAUSES. ESTIMATED APPLICATIONS



Sources: EBA and Banco de España.

a. Annual data for the period 2014-2017 based on information from EBA transparency exercises. The data of each country relate to a set of significant institutions which may change each year.

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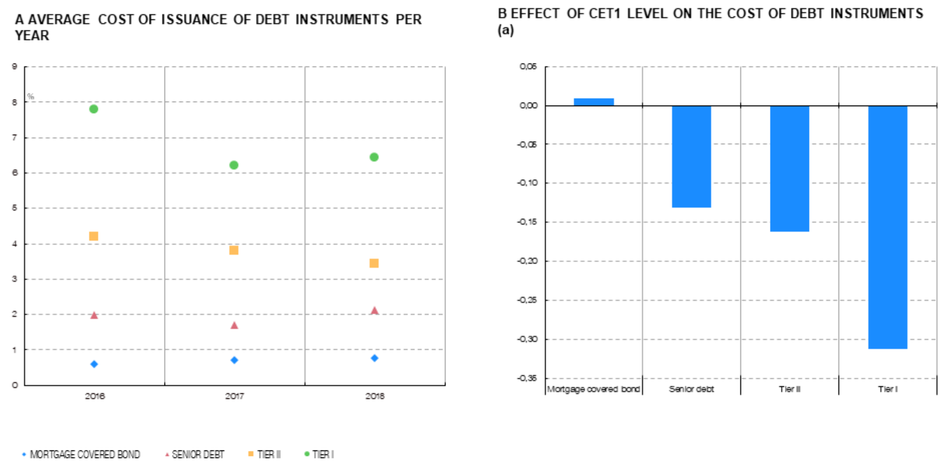
In recent years the legal risk of Spanish banks associated with litigation has increased significantly. Banks have been involved in a large number of legal proceedings questioning certain contractual conditions of their mortgage exposures. In many cases they have already paid the cost of these proceedings (for example, in relation to floor clauses more than €2,200 million was refunded to customers up to January 2019), but there are still many major legal proceedings yet to be resolved.

Above and beyond the cost that litigation may entail for banks, a more general implication is the loss of reputation for the banking sector. Banks must make an effort to reverse this perception by providing their customers with necessary information in a clear and transparent manner and affording them access to financial products suited to their needs and financial knowledge.

CHART 11



SOURCES: Dealogic and SNL.

a. For each type of instrument, the chart shows the coefficient relating to the CET1 ratio in a multivariate regression with the issuance cost as a dependent variable, and other characteristics of the issue (term, volume), of the issuer (size of the assets, solvency, nationality), and market conditions (index of the European banking sector, type of government debt of the issuing country of the term closest to that of the issue) as explanatory variables. For example, the coefficient of -0.3 for Tier 1 indicates that a 1 pp increase in the CET1 ratio of an issuing bank is associated, all things being equal, with a -0.3 pp reduction in the issuance costs of this instrument. The estimate is made on issues by banks from Germany, Spain, France, Italy and the United Kingdom for the 2016-2018 period. .

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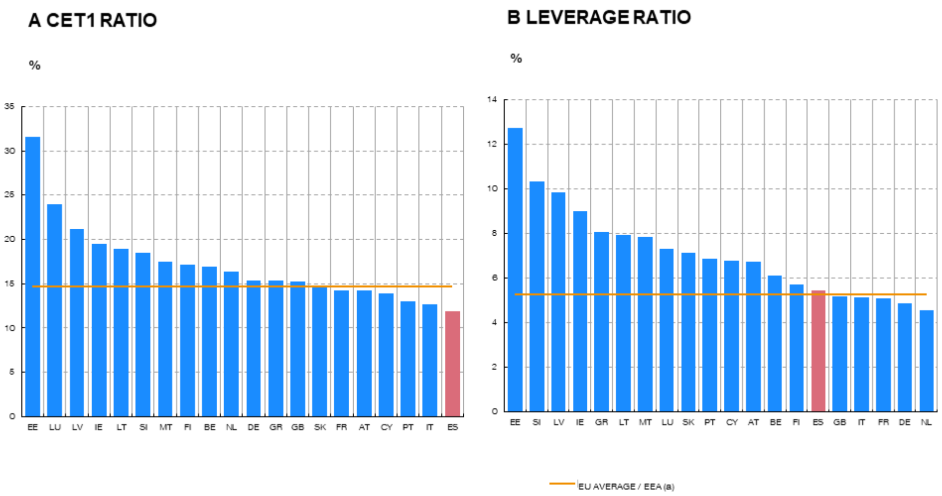
All this must not distract banks from persevering in their efforts to improve their efficiency ratios and pursue investments, particularly in new technologies, to enable them to reduce costs in the medium term.

It should be kept in mind that in the coming years banks will have to issue considerable volumes of debt with various levels of subordination to meet minimum requirements for own funds and eligible liabilities. The costs of issuing these liabilities are higher than those for senior debt and other secured instruments and, in fact, rise as they become more similar to capital in terms of seniority. But their cost also decreases as the solvency of the issuing bank increases.

CHART 12



SOURCE: EBA.

a. EBA data include Iceland.

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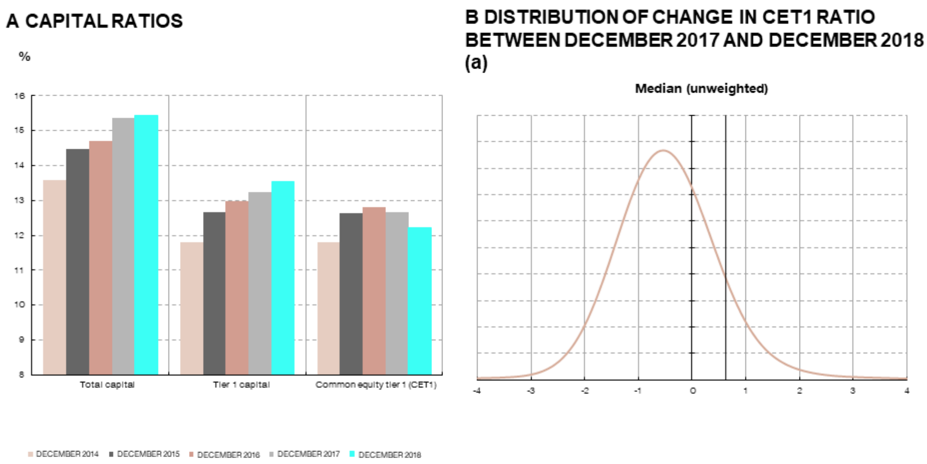
Compared with other European countries, Spanish banks have lower solvency levels almost irrespectively of what definition of capital is used. It is true that they comfortably exceed minimum regulatory requirements, that stress test results suggest they are more resilient to the risks now facing them, that is there is a certain dispersion among banks and that, in terms of leverage ratio, they exceed the European average. However, in a highly integrated world of competition for global financial resources, solvency is a key signal. Moreover, as I mentioned earlier, capital is the first line of defence against unexpected losses and therefore a means of reducing the likelihood of a systemic crisis.

CHART 13



SOURCE: Banco de España.

a. The chart shows the density function (or the frequency distribution) of the change in the CET1 ratio from December 2017 to December 2018 for Spanish deposit institutions, weighted by the risk-weighted assets of each bank in 2017. This density function is proxied by a kernel estimator, which enables a non-parametric estimate of the density function, providing a continuous and smoothed graphical representation of this function. The vertical line represents the median (unweighted) of the rate of change of the CET1 ratio from December 2017 to December 2018.

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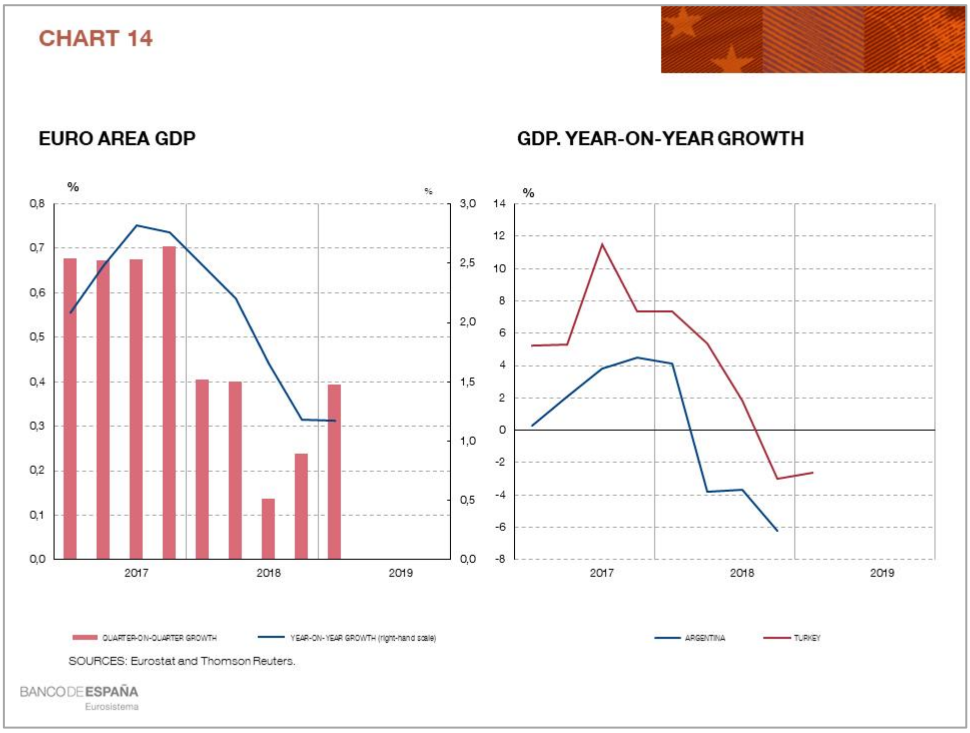
In this respect, over the last two years the phase-in top-quality capital (CET1) ratio has decreased by nearly one percentage point. This indicates that banks as a whole have not replaced to a sufficient extent the lower quality capital elements temporarily included in this category by others with a higher loss-absorbing capacity. This has not been an across-the-board phenomenon (many banks have raised their solvency ratios), but some have been guilty in this respect.

Main macro-financial risks

Apart from these challenges, what are the macro-financial risks confronting the Spanish financial system?

As emphasised in our *Financial Stability Report* published last May, the first of these risks is that derived from the possibility that asset prices may undergo a downward adjustment as a result of rising risk premia. The potential triggers of this situation are a slowdown in economic activity and geopolitical uncertainty.



Trade tensions indeed seem to have grown and the risk of a hard Brexit now seems greater. In addition, the economic situation in the euro area has deteriorated more than in other areas, particularly in some countries such as Italy and Germany.

Meriting special mention are some emerging economies where Spanish banks operate, which are undergoing difficulties associated with their high net borrowing in foreign currency and lack of a substantial cushion of international reserves.

Thus, Turkey, which went through a recession in the second half of 2018 and has shown weak momentum in recent months, is moreover facing a complicated political situation which has given rise to significant depreciation of the lira in the past year.

Meanwhile, the economic plan implemented in Argentina as part of the financial support programme agreed with the International Monetary Fund is helping to reduce its fiscal and external imbalances at the cost of a sharp recession, but has not altered the deterioration on the inflation front. Additionally, much uncertainty persists mainly in relation to the results of the presidential elections to be held at the end of the year and which will define the economic model for the coming years.

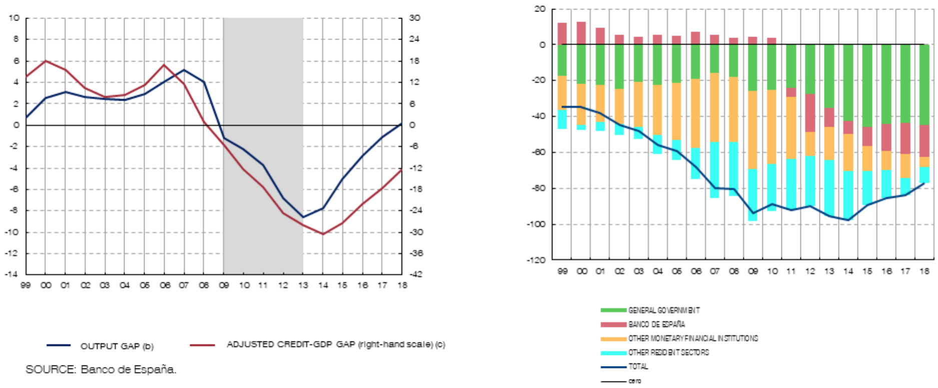
CHART 15

A OUTPUT AND CREDIT-GDP GAPS (a)

pp

B NET IIP. BREAKDOWN BY INSTITUTIONAL SECTOR (d)

% of GDP



SOURCE: Banco de España.

a The shaded area shows the last period of systemic banking crisis (2009 Q1-2013 Q4).
b The output gap is the percentage difference between the observed GDP and potential GDP. Values calculated at constant 2010 prices. See Cuadrado, P. and Moral-Benito, E. (2016) "Potential growth of the Spanish economy", Occasional Paper 1603, Banco de España.
c The adjusted credit-to-GDP gap is calculated as the difference, in percentage points, between the observed ratio and the long-term trend calculated using a one-tailed Hodrick-Prescott filter with a smoothing parameter equal to 25,000. This value is more in line with the financial cycles historically observed in Spain (see Box 3.1).
d The net IIP is the difference between the value of the external assets and liabilities of resident sectors vis-à-vis the rest of the world.

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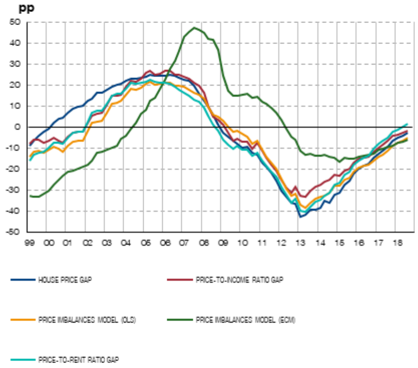
Regarding the Spanish economy, the latest forecasts of the Banco de España, published some days ago, indicate that, although GDP is expected to decelerate somewhat, it will continue growing above potential and the output gap will hence become progressively more positive.

This is therefore the time to reduce some of the structural vulnerabilities of our economy, derived partly from high external and public sector debt, which limit the room for manoeuvre of fiscal policy and increase vulnerability to rising interest rates or risk premia.

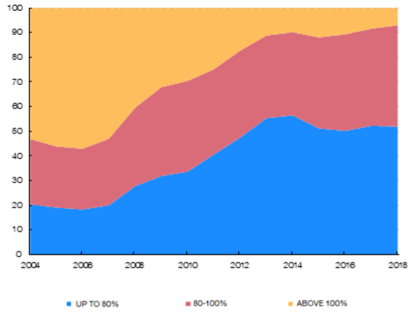
The financial cycle of the Spanish economy also seems to be gathering impetus, although according to our forecasts, some time will pass before it reaches the warning levels. Total credit to the non-financial private sector has begun to increase, albeit very slightly, and it continues to decrease as a proportion of GDP, albeit at a progressively slower pace. Only some specific portfolios, such as consumer lending, show high credit growth, so banks must tighten their credit standards in order to reduce the significant rise in NPLs being observed.

CHART 16

A INDICATORS OF HOUSE PRICE IMBALANCES (a)



B LOAN-TO-PRICE (LTP) RATIO. DISTRIBUTION



SOURCES: ECB, Eurostat, INE and Ministerio de Fomento.

a The five indicators include three gaps calculated as the difference between the value of the interest variable in each period and its long-term trend for: (i) house prices in real terms, (ii) the house prices-to-household-disposable-income ratio and (iii) the house prices-to-rent ratio. Two additional imbalance indicators are included for the house price variable in real terms based on econometric models. The first, which is estimated by Ordinary Least Squares (OLS), compares this variable with long-term trend estimations of household disposable income and mortgage interest rates. A second model, an Error Correction Model (ECM) compares this variable and the long-term equilibrium relationship between household disposable income, mortgage interest rates and fiscal effects. In all cases, long term trends are obtained using a one-tailed Hodrick-Prescott filter with a smoothing parameter equal to 400,000.

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However, the largest credit portfolio continues to be mortgage loans. Therefore analysis of the real estate sector is crucial for financial stability. As I have noted on other occasions, this market is reawakening, with an increase in transactions and rising house prices which, even so, are still on our estimates at levels compatible with their fundamentals. However, there is notable unevenness across geographical areas, with specific areas of the main Spanish cities and of the Balearic and Canary Islands where housing prices are rising sharply.

This rise in real estate activity is not resulting in an increase in the associated lending. Bank credit to real estate and construction firms continues to fall at rates above 10%, partly due to the sale of packages of non-performing loans. In addition, the stock of household mortgage loans is practically stagnant. It is true that the flow of new lending is fairly buoyant, but starting from a low level.

Furthermore, household mortgage credit standards remain prudent. Specifically, practically all the loans granted are for an amount below the value of the real estate transaction, as compared with only 50% before the crisis. Mortgages represent, on average, less than four times the annual income of households, and the related debt service (repayments plus interest) accounts for less than 20% of that income in 50% of mortgages. Also, mortgages with long maturities, of over 30 years, represent less than 10% of the total.

In any event, it should not be overlooked that, although the credit associated with this activity is not increasing and new household mortgages are being granted with prudence, a potential downward adjustment to housing prices would still have a negative impact (although logically a smaller one) on deposit-taking institutions through the effect on foreclosed asset valuations and the indirect impact on aggregate levels of consumption and activity.

A cyclical downturn not associated with prior excessive credit growth may also affect the profitability and solvency levels of financial institutions. It is thus advisable to improve banks' capital levels when the macroeconomic circumstances are propitious.

In short, to address these macro-financial challenges and risks, we need to internalise in our decision-making what should constitute responsible and efficient management of private and public matters: accumulating buffers in good times so they can be used in hard times. And this applies not only to lenders, but also to borrowers and, above all, to those responsible for managing economic policies, including myself. Contributing transparency and rigour to the establishment of this culture of stability is part of the mission entrusted to the Banco de España as an independent institution at the service of the community.

Thank you for your attention.