Presentation by the Governor Pablo Hernández de Cos

Russia's unjustified invasion of Ukraine in February 2022, following two years of pandemic, has significantly aggravated geopolitical tensions. In particular, it has led to a major hike in the price of energy and other commodities —products that the euro area economies need to import— so that our terms of trade have deteriorated significantly. All this has occurred in a context of a sharp upturn in global inflation, which has reached levels not seen for decades and has generated significant falls in real income. Moreover, the robust monetary policy reaction in order to contain inflationary pressures has led to a tightening of financial conditions in the world's major economies.

Against this backdrop, the economic growth outlook for the euro area countries was gradually downgraded over the course of 2022. Nevertheless, both the European economy as a whole and Spain in particular have displayed greater resilience than expected, in a context in which the extraordinary energy price rises stemming from the Russian invasion of Ukraine and the bottlenecks in global value chains following the opening of the pandemic-related restrictions have been significantly corrected.

In any case, there is still an extremely high level of uncertainty, stemming from developments in the war in Ukraine and its economic repercussions, which are difficult to predict. But inflationary pressures also represent a genuine risk factor. Whether inflationary pressures increase further depends not only on the unfolding of the war, but also on domestic issues, such as a possible persistent rise in inflation expectations or higher-than-expected wage increases or corporate mark-ups. And more persistent inflation would force further tightening of monetary policy, which would increase the vulnerability of public or private players in a less sound economic and financial situation and would have a greater-than-expected impact on their spending levels.

More recently, tensions in the financial markets arising from difficulties at certain US regional banks and at Credit Suisse have contributed to the high level of uncertainty, while the swift and decisive decisions taken by the US and Swiss authorities are essential to ensure financial stability and restore appropriate market conditions.

The Spanish banking sector, like that of the euro area as a whole, is tackling this scenario of uncertainty and the most recent market tensions with a high resilience capacity and sound capital and liquidity positions. This has been the result of the regulatory reform agreed at the international level in the last decade, which, in the case of Europe, has been applied to all banks, irrespective of their size, so that all our banks are subject to the same strict capital and liquidity requirements.

This sound situation of the banking sector, together with the robust response of the authorities, is what has allowed institutions to continue providing financing to the economy over the last three years in the face of unprecedented negative shocks. They have even improved their solvency levels in this period and have continued to reduce their NPL ratios. They have also increased their profitability, which in 2022 exceeded the cost of capital, and have benefited from the positive effect of interest rate rises on net interest income and increased fees and commissions.

The stress tests conducted by both the Single Supervisory Mechanism and national macroprudential authorities, including the Banco de España, confirm the sector's high degree of resilience, even in very severe hypothetical adverse scenarios.

In any event, the uncertainty of the macro-financial context may generate a persistent increase in institutions' cost of funding. Moreover, the increase in the cost of funding, together with the impact of inflation on household and corporate disposable income, may also adversely affect their payment capacity, especially in the case of the most vulnerable segments, characterised by low income levels, dependence on energy and food products and, in some cases, high levels of indebtedness. And this, in turn, may force institutions to increase the necessary credit loss provisions, although the macroeconomic deterioration has not yet been reflected in credit quality, with slightly decreasing NPL ratios over the course of 2022, despite the end of the moratorium programmes.

In any event, it should not be forgotten that, in such an uncertain and volatile environment as the current one, preventing the possible materialisation of macroeconomic and banking-specific risks from impairing the solvency and profitability of financial institutions makes it particularly necessary for supervision tasks to focus on closely monitoring the evolution of risks at institutions and for their borrowers.

Thus, for example, even before the most recent tensions in financial markets became apparent, certain priorities were established in the supervisory area that sought precisely to mitigate and anticipate potential adverse effects of the current macroeconomic context. In particular, the Single Supervisory Mechanism placed the supervisory focus precisely on the interest rate risk faced by institutions and on the sustainability of their funding plans, issues that are crucial in a context of interest rate rises and liquidity withdrawal. And when cases of banking sector interconnections with non-bank financial intermediaries emerged, as in the Archegos case, which particularly affected Credit Suisse, it was also decided to focus supervision on analysing the risks to European banks of such exposures.

Beyond supervisory work, institutions should adopt a prudent stance and take advantage of the current increase in profitability to strengthen their resilience, through an adequate profit capitalisation and provisioning policy.

Also, the financial sector must continue to address structural and other more recent challenges decisively, including the digitalisation of finance, the increase in cyber risks, the emergence of new high-potential competitors (particularly BigTechs, FinTechs and the like), the financial effects associated with climate change and the popularisation of cryptoassets. Institutions must take these challenges into account in order to promote their medium- and long-term sustainability.

In particular, the new digital reality entails radical changes in consumer behaviour and distribution channels, and growing competition from new operators. The challenges presented by the digitalisation process include, most notably, increased cyber risk and greater use of the services of technology providers, which increases dependence on these providers. Both challenges demand the strengthening of processes and controls to ensure institutions' resilience and operational continuity.

With regard to the prudential treatment of bank exposures to cryptoassets, the Basel Committee on Banking Supervision (BCBS) published new international minimum standards at the end of 2022, the implementation of which will begin on 1 January 2025. The approach seeks to ensure that there is no contagion to the banking sector of the financial stability risks associated with these assets. However, given the dynamism of this market, it will be necessary to continue assessing developments in these products and providing users with adequate timely information on the associated risks.

Moreover, it is crucial that banks identify and incorporate the financial effects of climate change into their strategy, governance, day-to-day management and public reporting, whilst regulation and supervisory activity must properly take these risks into account. In this regard, as discussed in this Report, within the scope of their respective mandates, authorities such as the BCBS, the European Banking Authority and the European Commission are continuing to develop initiatives to effectively address environmental, social and governance risks in the prudential framework.

The significance of the challenges facing financial institutions once again highlights how important it is to have in place sound and effective governance. The governing bodies, in which independent members must play a fundamental role, should be equipped with mechanisms, information circuits and capacities that enable them to carry out in-depth monitoring of the institution's management, to issue and take adequately informed opinions and decisions, and to appropriately outline the strategic lines of future business.

The banking business is based on public confidence, which is achieved by demonstrating not only asset strength and adequate risk management, but also correct behaviour and a quality service. Therefore, the provision of banking services must be governed by transparency between the parties and be carried out by means that avoid undue exclusion from access to banking products and services, especially basic products and services.

Precisely for the purpose of reinforcing the strategy geared towards ensuring transparency and the responsible banking model for customers, the Banco de

España has created the new Directorate General Financial Conduct and Banknotes. Conduct supervision should boost a preventive approach based on institutions' risk, which should be strengthened by effective communication.

In this respect, given that one of the priorities must be the protection of the most vulnerable customers, in 2023 conduct supervision will pay special attention to institutions' actions within the framework of measures approved to alleviate the impact of interest rate rises on primary residence mortgages.

In short, in view of the persistence of the complex and uncertain economic and financial environment, the authorities must remain vigilant and closely monitor the unfolding of events and risks so as to be able to offer an appropriate timely response in order to guarantee the smooth functioning of the banking sector and safeguard financial stability, which are essential elements for economic growth and the enhanced well-being of citizens.

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