Interview with the Deputy Governor Margarita Delgado Tejero

How would you summarise the current macroeconomic situation and the macroeconomic outlook and their effects on banking activity?

2022 was marked by an economic and geopolitical context of unprecedented uncertainty, with intense and persistent inflationary pressures on a global scale, which led to the tightening of most central banks' monetary policy and, therefore, of the financial conditions of companies and households.

Over the past year, we have witnessed, on the one hand, the withdrawal of the health restrictions stemming from the pandemic and, on the other, Russia's invasion of Ukraine. The withdrawal of restrictions was a major economic stimulus in the first part of 2022, but the effects of the reopening of the economy have faded over time as the recessionary drive intensified with the war in Ukraine, due in particular to its impact on international commodity markets and especially the energy market.

Recently, we have experienced additional disruptions originating from certain regional banks in the United States and from Credit Suisse. These elements generated tensions in the financial markets, the competent authorities' response to which was firm. These two situations can in no way be extrapolated to EU or Spanish banks, but they have undoubtedly added another layer of uncertainty to the situation we have been going through. Thanks to all the reforms implemented over the years, Spanish banks' solvency and liquidity levels and governance standards make them resilient to such shocks. All of this is accompanied by strengthened supervisory frameworks, which have put the spotlight on interest rate risk, and by a functioning resolution mechanism.

Despite this overall context of uncertainty, both the European and Spanish economies are showing greater resilience than was expected a few months ago, with growth that could be around 1.6% in 2023 (1% for the euro area). This is also the case with the labour market, which is in a good situation, although the Spanish rate is still much higher than the European rate.

The increase in interest rates has a clear positive impact on bank margins. However, it cannot be ruled out that companies and households will end up feeling the effects of this scenario of tightening financial conditions, high inflation and economic uncertainty, and that it will, therefore, affect their ability to pay. Against this backdrop, banks need to be extremely prudent in quantifying the negative income impacts on companies and households and manage the associated risks correctly.

What supervisory priorities would you highlight in the current context?

Logically, the Banco de España, as national competent authority and member of the European Single Supervisory Mechanism (SSM), aligns and coordinates its supervisory priorities with those set by the European Central Bank (ECB). They are set for a medium-term time horizon (three years), they can be reviewed annually, or more frequently if necessary, and they are based on the identification of sources of risk and vulnerabilities specific to the banking sector, enhancing the effectiveness and efficiency of its supervisory activity plan.

In short, and in the light of the economic context, the current priorities revolve around three central factors:

1 Requiring banks to increase their resilience to macro-financial and geopolitical shocks. This block includes most notably the ongoing review of credit risk and the assessment of funding and liquidity risks in a context of more restrictive financial conditions following a period of abundant liquidity at low costs. Banks must have diverse, credible and plan-based funding sources that can adapt flexibly to the changing environment. In this respect, the EU-wide stress test to be conducted in 2023 and coordinated by the European Banking Authority will support this first supervisory objective.

2 Digitalisation and governance. This central factor aims to analyse how banks manage their structural challenges. Close monitoring of technology risks, in order to boost the strengthening of IT security and cyber resilience frameworks, and business model transformation strategies are aspects to be assessed within this block.

Attention also continues to be focused on resolving shortcomings in the composition and functioning of governing bodies, at a time when the magnitude of the challenges facing financial institutions enhances the importance of robust and effective governance.

3 Lastly, climate and environmental risk management. In relation to this central factor, the assessment of institutions' progress in identifying and incorporating the financial effects of climate change into their strategy, governance, day-to-day management and public reporting is key for the supervisor. Banks should adequately incorporate climate and environmental risks into their business strategy, governance and risk management frameworks.

Where do Spanish banks stand in the current global environment of uncertainty and volatility?

Spanish institutions have a good solvency, liquidity and earnings generation situation with which to tackle possible impacts arising from the uncertain global macroeconomic context.

In particular, the sector's capital levels are adequate and have increased over the last three years. Moreover, in 2022, banking activity was more profitable than in 2019 for a second consecutive year, which is evidence, among other things, of the presence of robust business models that have the capacity to generate recurring earnings. The generation of recurring earnings is the first line of defence in ensuring a sound banking business.

In addition, the regular internal stress tests carried out by the Banco de España[1] confirm the banking system's resilience with regard to potential scenarios of macroeconomic turbulence, although, logically, the individual results differ from one institution to another.

Although financial conditions have tightened, so far this has not led to an increase in NPL ratios, which, on the contrary, continued to decline slightly over the course of 2022 to 3.1%.

The foregoing positive assessment does not preclude a prudent stance, which is particularly necessary in view of the global uncertainty and volatility. This is precisely why it is vital that both supervisors and institutions remain particularly vigilant against any possible materialisation of risks that could harm the sector's solvency and profits. And, as part of the prudence that must always be exhibited by banking managers, institutions must take advantage of earnings bonanzas to strengthen their resilience through appropriate risk hedging and capitalisation of profits.

What effects could monetary policy normalisation have on Spanish banks?

As is well known, the normalisation of monetary policy has been reflected in a series of ECB measures, including successive interest rate rises, modification of TLTRO III operations conditions and the start of Quantitative Tightening, with the reduction of the purchase programme.

As for the possible impact of monetary policy measures, on the one hand there will be a progressive reduction in funding from TLTRO III operations, via early repayments or maturities, with a consequent decline in the unusually high volumes of high-quality liquid assets that financial institutions have been holding in the context of the pandemic. On the other hand, in the euro area as a whole, the decline in liquidity

1 *Financial Stability Report*.

could increase competition for funds and thus make market funding conditions less favourable.

Moreover, interest rate rises could have conflicting effects on financial institutions' income statements. While their net interest income is expected to improve, because their balance sheets are generally favourably positioned for the repricing of their components in the face of interest rate rises, it is also important to consider the possible negative effects of such rises in terms of credit quality deterioration and the need for additional provisions in a context of economic slowdown.

Lastly, another potential impact that could negatively affect institutions is linked to the valuations of financial assets due to the increase in interest rates.

What changes do you foresee in Spanish banks' business models? In particular, what risks and opportunities does financial digitalisation present, and how and to what extent might they affect the banking business model?

We have already pointed out that one of the strengths of the Spanish banking system lies precisely in the development of well-established business models with the capacity to generate recurring revenue.

However, in a constantly evolving environment, the financial sector is subject to processes of change that can significantly affect banks' business models. Therefore, it is essential that institutions constantly analyse the merits of their business models and identify what strategic and tactical changes they could introduce to take advantage of market opportunities, to strengthen customer relationships, improve results and gain in efficiency. In short, the ultimate goal would be to promote sustainability in the medium and long term.

In this connection, digitalisation represents a major change in many areas of the lives of citizens and economic players. The financial world cannot remain on the sidelines of this phenomenon and it must inevitably adapt quickly and effectively to the new digital environment, which brings with it, among other aspects, very significant and increasing competition from new operators and considerable changes in consumer behaviour.

Logically, digitalisation is a source of opportunity, but also of risks and costs. It can offer new formulas and channels for income growth and allow them to keep pace with technological innovations applied to the financial sector (thereby strengthening their capacity to compete with other players, such as BigTechs and FinTechs), as well as enabling efficiency gains. But digital transformation can also entail significant risks and transition costs, which banks will need to take into account in their decision-making.

Also, institutions should analyse how these changes affect their business model, risk management and customer interactions, where they should take particular care to avoid undue exclusion from accessing banking products and services.

What recent supervisory actions would you highlight in the area of climate and environmental risks?

Climate change is one of the main concerns of today's society, insofar as it constitutes a global threat to the future of our planet. Climate risks fall into two broad categories: on the one hand, physical risks, which are related to the direct effects of climate change, such as damage caused by floods, hurricanes, fires or natural disasters (phenomena whose frequency and magnitude have increased in recent years); on the other hand, energy transition risks, which are associated with the process of adapting to a sustainable economy and which can be very diverse.

Concern about climate change leaves no economic sector untouched, the financial sector included. Banks could suffer significant devastation as a result of climate risks, so they need to identify these risks, assess them and integrate them appropriately into their management.

The ECB and the Banco de España are fully conscious of the importance of climate and environmental risk management and have, therefore, integrated this matter into their supervisory priorities and have issued expectations setting out how this risk should be included in institutions' business model, strategy and internal capital adequacy assessment processes.

Other relevant supervisory actions in 2022 in this area include most notably a climate stress test and a thematic review.

The stress test consisted of a learning exercise with no direct impact on capital, and its main objectives included the improvement of the climate risk assessment capacity of institutions and the supervisor. Around 100 institutions participated, including the 10 Spanish significant institutions, and a specially developed methodology was applied. It could be concluded, in short, that institutions are making progress, but there is still some way to go in this area.

The thematic review focused on institutions' climate risk identification and management, and their strategies and governance, in light of supervisory expectations. Just over 100 significant institutions (including the 10 Spanish SIs) and almost 80 less significant institutions (including 4 Spanish LSIs) were also analysed. The exercise has shown that, despite the progress observed, institutions are still far from meeting supervisory expectations, which are expected to be met in full by December 2024 at the latest.

As a result of these actions, the ECB published the findings of the thematic review and a series of good practices observed in both exercises.

What are your views on the boom in artificial intelligence initiatives and advances and their application in supervisory practice?

In the performance of its supervisory work, the Banco de España has traditionally emphasised a supervisory model that was developed with multidisciplinary teams of inspectors, IT auditors and modelling experts, involving the handling of large amounts of data.

At the international level, the use of SupTech tools has expanded in recent years. These tools rely on the use of innovative technology, e.g. machine learning or big data, by supervisory authorities to support their work.

One of the objectives of the Banco de España's 2022-2024 Strategic Plan is to promote technological innovation within the institution and, with regard to supervisory functions, this materialises in the development, in-depth analysis and improvement of SupTech tools.

Our SupTech strategy is based on several interrelated pillars. These pillars are: i) active participation in SupTech initiatives conducted within the SSM; ii) in-house creation of SupTech tools; iii) fostering a culture of innovation; and lastly, iv) promotion of specific training in data science.

Moreover, in line with the priority granted to this matter, the SupTech function has been included in the Banco de España's programme of external evaluation by a team of independent international experts. The evaluation commenced in the first quarter of 2023.

What aspects would you highlight in terms of financial conduct and inclusion during 2022?

Over the last few years, the importance of banks having an appropriate culture and conduct has been highlighted, with the aim of preventing a bad sector reputation from affecting customer confidence and, therefore, the stability of the institution itself and of the financial system as a whole. Therefore, since then, institutions have been immersed in a gradual, ongoing and growing process to establish this culture. Similarly, regulators and supervisors, at the European and international level, have also paid more attention to these matters.

The Banco de España cannot stay on the sidelines. In this respect, I would like to highlight, firstly, the restructuring of the Banco de España's internal organisation, with the creation of the new Directorate General Financial Conduct and Banknotes.

The new internal organisation strengthens the Banco de España's strategy geared at ensuring the transparency of financial institutions' relationships with their customers and the responsible banking model.

The cost of an absence of confidence is too high, and the strategy must always be considered in a medium- to long-term scenario and sustained over time. Therefore, the Banco de España has included the strengthening of conduct supervision as one of its strategic objectives, the effective implementation of which includes the aforementioned restructuring, and it has boosted the preventive approach, amplified its impact through adequate communication and developed a risk-based supervisory approach, with the appropriate quantification of conduct risk.

The approach must also take into account market developments (new products and services, new ways of marketing) and equip itself with tools and powers adapted to the changing environment. An effective strategy regarding this issue should include an appropriate combination of proactive and reactive measures, and it should seek to maximise impact through efficient communication and cooperation with institutions. Supervision can help institutions' senior management address culture and conduct problems and, thus, this proactive, preventive supervisory approach requires collaborative mechanisms between supervisor and institutions.

This report highlights the most relevant supervisory actions of 2022. The strategic supervisory priorities in this area for 2023 were established taking into account the main risks identified in the area of conduct, the main one being the risk generated by the macroeconomic environment and the rise in interest rates, and the digitalisation of the provision of banking and payment services, and litigation issues. These risks are structured in three blocks:

- Customer protection, especially for the most vulnerable customers, through the verification of the effective implementation of the regulatory measures adopted, both in relation to mortgage debtors, in this environment of interest rate rises, and in relation to the basic payment account offering.

- Verification of the appropriate marketing of banking products, through both traditional and new channels, related sales and advertising communications.

- The institution's lines of defence to correct inappropriate actions with its customers, and the supervision of measures implemented to protect against fraud.