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The Spanish banking system: situation and challenges

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Let me first thank the Universidad de Almería and all the sponsors for their invitation to participate in the inauguration of this three-day conference on cooperative banks.

In my address I shall first briefly review the current situation of the Spanish banking system, including the cooperative sector, and the main challenges it faces. Secondly, I shall tackle some of the current regulatory developments in the banking sector, with a reference to the European regulation on bank recovery and resolution.

Situation of and main challenges to the Spanish banking sector

During the first half of 2016 global financial markets were markedly volatile, as a result of various factors.

Firstly, forecasts of global economic growth have been revised downwards since the last quarter of 2015; secondly, the weakness shown by the emerging economies, particularly those most dependent on commodities exports; and, thirdly, the unstable social and political setting, compounded by the decision by UK citizens on 23 June to back the exit from the European Union.

These factors have prompted a correction in asset prices on different markets which, though it eased from mid-February, has regained momentum since 23 June as a result of the increase in uncertainty and greater volatility.

The correction in prices was particularly marked in the case of assets issued by the European banking sector; the above-mentioned global factors were joined by other elements stemming from the euro area, from its banking systems and, indeed, from specific banks.

These factors include most notably the following: the low profitability of banking business in Europe, a matter on which I shall focus in view of its significance; the concern over the high volume of non-performing loans in certain European jurisdictions; and the extension and intensification of regulatory requirements, a clear example of which is the new Recovery and Resolution Directive which, ultimately, may translate into an increase in requirements in respect of capital or of the holding of loss-absorbing liabilities. Against this background, it is vital to understand the causes behind the European bank stock market corrections, given that their lower share prices hamper the possibility of tapping the markets for capital to reinforce their solvency levels.

In this setting common to European banks, Spanish institutions increased their consolidated assets by 2.5% in 2015, essentially owing to their international activity. As to business in Spain, credit to the resident private sector continued to fall in 2015, albeit at more moderate rates than in 2014, both for households and for non-financial corporations. For the latter the fall in credit progressively eased, with the rate of decline for SMEs (-2.8%) appreciably lower than that for credit to large corporations (-6.4%).

Non-performing loans continued to decline in 2015, falling by more than €37 billion (against the fall of €24 billion in 2014). At end-2015 the proportion of NPLs on Spanish banks' balance sheets was 22% down on the previous year. This trend has been seen both in credit to non-financial corporations and in that to households.

Profitability is unquestionably a fundamental challenge facing European and Spanish banks.

In 2015, consolidated income at the global level for the sector as a whole was close to €14 billion, almost 13% down on the previous year; and the return on equity fell from 6.9% in 2014 to 5.6% in 2015. In terms of domestic business, profitability was worse than for consolidated activity at the global level, with the ROE in 2015 standing at 4.4% (against 5% in 2014).

The main factor bearing down on the sector's profitability may be said to be the environment of very low interest rates, and this environment might be expected to hold as long as inflation expectations justify the highly expansionary monetary policy stance in the euro area. The spread between the return on assets and liabilities in domestic business is at levels very close to all-time lows. Also, there is little room for further downward movement as regards the cost of funds; accordingly, if asset-side rates continue falling, net interest income may continue declining.

But we should mention another two factors bearing down on profitability. On one hand, a still-low level of banking activity (as credit continues to fall). On the other, the significant volume of non-productive assets (non-performing and foreclosed) still on bank balance sheets, although it is true that non-performing assets are declining notably, which translates into fewer provisions and an improvement, therefore, in results. Against this backdrop, efforts to cut costs and bring about efficiency gains are of particular importance.

Lastly, it should be stressed in connection with banks' solvency that the maximum-quality capital ratio, namely CET1, has increased by more than 80 bp over the last year, rising to 12.6% at end-2015 for Spanish banks as a whole, comfortably exceeding the regulatory minimum.

The cooperative sector in Spain

Let me now turn to the cooperative sector.

I should begin by stressing that, although the relative weight of cooperative banks in Spain is modest compared with that of commercial banks, the cooperative sector plays a significant role in financing the productive system in various industries and, therefore, in activity and employment generation.

The sector's total consolidated assets amounted in December 2015 to €131 billion. In comparative terms, they account for 3.6% of Spanish deposit institutions' total consolidated assets. We need not recall that one of our hosts, Cajamar, is a major component of the sector, accounting for slightly more than 30% of co-operatives' overall assets.

Co-operatives are for the most part small institutions, rooted in the territory where they operate. Focusing on business in Spain, with individual data, the cooperative sector has more than 18,000 employees distributed across more than 4,300 offices. On December 2015 data, cooperatives employ more than 9% of workers in the banking sector in Spain, and they account for 14% of the offices operating on national territory.

As regards the composition of the sector's balance sheet, of note on the liabilities side is the significance of private-sector deposits, equivalent to over 70% of total assets (almost 20 pp more than for total deposit institutions). On the asset side, the differences with the rest of the banking sector are fewer. However, the proportion of credit to the private sector is slightly higher for the cooperative sector. The proportion of own funds for cooperatives (7.2% in December 2015) is also slightly higher than that of the banking sector as a whole.

Focusing on business in Spain, the cooperative sector provides around 7% of the total volume of credit used to finance non-financial corporations and households, in particular house purchases. The sector's NPL ratio stood at 11.2% in December 2015, having fallen by almost 1.5 pp over the course of the year.

In the analysis by sector, the household NPL ratio stands at 5%, and at 20.4% in the case of non-financial corporations. Notably, on one hand, this ratio has fallen by more than 3 pp in 2015; and, on the other, if construction and real estate development companies are excluded, the ratio stands below 12%.

Net income for the cooperative sector as a whole in 2015 exceeded €450 million, entailing an increase of close to 15% on 2014. The return on equity was 4.8%, having increased by somewhat more than 0.5 pp in 2015.

This improvement in profitability is due to the almost 60% reduction in asset impairment losses over the past year (practically €700 million), the result of the reduction in NPLs I mentioned earlier. Net interest income held relatively stable, with both revenue and financial costs having fallen, while the efficiency ratio improved by several percentage points.

As regards the sector's solvency, the highest quality capital ratio, namely CET1, for Spanish cooperatives as a whole was 13.7% in December 2015, almost 70 bp up on the related December 2014 level. This gives a level of CET1 almost 1 pp higher than the aggregate for the Spanish banking sector.

In conclusion, the cooperative sector in Spain is holding up with figures and ratios in line with those of the rest of the banking sector, and is currently evidencing solvency levels somewhat higher than those of the rest of the sector.

Regulatory agenda: recent developments in the Basel III capital framework

I would now like to review the reforms outstanding. But I shall first offer you a brief reminder of the key elements of the new regulatory framework we know as Basel III.

The global financial crisis highlighted a series of weaknesses in regulation, including most notably high bank leveraging, excessive credit growth (boosted in part by lax lending standards), a high degree of systemic risk and insufficient liquidity levels.

The FSB and the Basel Committee have been developing a set of reforms involving, first, the adoption of more demanding criteria as regards the levels and quality of capital required of banks; and, further, a reassessment of the general framework, thereby acknowledging the need to complement the solvency ratios with other measures.

Among these measures we may first mention the leverage ratio, which purports to be a simple, transparent and complementary metric to the risk-based capital ratio.

Second, given the lack of liquidity risk regulation before the crisis, the Basle Committee decided to adopt two new ratios: one geared to ensuring the coverage of liquidity needs in the event of tensions (over a 30-day period); and the other aimed at achieving a financing structure suitable for the activities of each institution.

Finally, the Basel III regulatory framework has included a new micro-prudential facet with twin aims. The first, to consider the impact that problems at a very large or complex institution may have on the rest of the financial system; and the second, to attempt to avoid the tendency of banks to excessively increase their risk during the cyclical upturn.

Basel III has incorporated the so-called “capital buffer for the most significant (or systemic) institutions”, applicable to institutions exceeding certain size, complexity and interconnectedness thresholds; and, moreover, the “countercyclical capital buffer”, which requires an increase in capital at times of credit expansion in order to reinforce bank solvency when the risks associated with such credit materialise.

After all these changes, what would be left for post-crisis reform?

Fundamentally, the completion of the review of the risk-based capital framework being undertaken by the Basel Committee.

In terms of the essentials, Basel is reviewing the way the denominator of the capital ratio, Risk-Weighted Assets (RWAs), is calculated, i.e. the way in which the risks for which capital is required are measured. The aim of this review is to strike a better balance between simplicity, comparability and risk-sensitivity.

From now to the end of 2016, the date set for the finalisation of the post-crisis reforms, what are still to be decided are the reforms of the standardised approaches for measuring credit and operational risk; the use of internal models for these two risk categories: the possibility of establishing an additional surcharge based on the leverage ratio for global systemic institutions; and the design of the so-called “capital floors” in the calculation of RWAs.

With regard to the standardised approaches, I shall focus on that applied to measuring credit risk, as this aspect is one of the most important, as it is of course for credit cooperatives. In the opinion of the Banco de España, the standardised operational risk approach that the Basel Committee has submitted to public consultation should be improved in various respects

The review of the standardised approach seeks to provide greater sensitivity to credit risk in the calculation of RWAs and, in turn, to prevent the approach from residing excessively and automatically on the ratings given by external rating agencies.

The Basel Committee is striving to design a standardised approach that redresses these shortcomings, and is adjusting certain elements and deciding on their calibration. The position of the Banco de España, like that of other national supervisors, is that this review should not give rise to capital increases, or in any event increases that may prove significant for the banking sector.

The use of internal models is also under review, with the internal credit and operational risk models pending finalisation this year. The aim is to reduce the excessive variability of RWAs, and in this connection work is under way in several directions, which may be summarised as follows.

First, not all risks are deemed subject to modelling. Such is the case of operational risk. The current proposal is to cease to model this risk.

Second, under credit risk, not all portfolios will be equally subject to modelling. Specifically, "low-default portfolios" would be a case in point, as would, for instance, that of banks, or certain segments of that of corporations.

And third, and this would not only affect credit risk but might also have implications for the trading portfolio, there is a possibility that floors to the results of the internal models may be established, floors or minimum points that would be based on standardised approaches. Hence, the final result of a model could not stand below the threshold calculated using a certain percentage of the result that were to be obtained from applying the standardised approach.

In our opinion, this review of the use of internal models pursues a reasonable objective, namely to reduce the unwarranted variability of risk-weighted assets that is manifest among banks from different jurisdictions, conditional – as I stated – upon this not giving rise to significant increases in capital requirements.

We should further bear in mind that the greater regulatory requirements are not confined to prudential regulation. In this connection, allow me to refer to one of the key questions of the moment, namely the new requirement for own funds and eligible liabilities (MREL), which should allow for the bail-in of losses arising from bank crises, transferring the cost to private agents instead of the public coffers.

The current European regulation approved in 2014, i.e. the Recovery and Resolution Directive, is very demanding. Generally, this regulation prevents the use of public funds if there has previously been no burden-sharing by shareholders and creditors for an amount, at least, of 8% of the total balance sheet. This condition is currently difficult to comply with, since banks are still in the process of setting up their MREL and, for some, it will not be easy to attain these thresholds as their access to the capital markets is limited, or there may be an adverse impact on their income statement.

To date, the Single Resolution Board (SRB), the European resolution authority, has not taken a final, firm decision on the MREL, but everything suggests it will be demanding. At the Banco de España we advocate that the requirements should take into account the resolution strategy and should be prudent and adapted to banks' economic and financial reality.

In any event, cooperatives should build the concept of resolution into their planning and management, and continue working on the formation of voluntary and private mutual support mechanisms.

Conclusion

In sum, let me say that all the banking supervisors and regulators participating in this process are mindful of how important it is to finalise the Basel III review as soon as possible and of the significance of providing banks and market participants with certainty.

I would not wish to conclude without reiterating the importance of a healthy and efficient cooperative sector, as it faces today's challenges: the pressure exerted by the low interest rate environment on results, as is the case for other banks; the new regulatory demands; enhanced governance; the management and commercialisation of resources; and deeper association initiatives.

Thank you for your attention.