
16.09.2021

Bank governance and conduct. Keys for the reputation and sustainability of banks' business models in Spain*

Finanza forum on finance

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*English translation of the original speech in Spanish

Honourable Government Delegate, Provincial Deputies, other dignitaries, ladies and gentlemen, good morning:

I should like to begin by thanking Elkargi and, in particular, its Chairman Josu Sánchez and General Manager Zenón Vázquez for organising this forum and giving me the opportunity to participate.

Today, I am going to share with you some thoughts about two qualitative aspects of the banking sector's culture and way of working: governance quality and banking conduct. In my opinion, these aspects have a large bearing on the medium and long-term sustainability of banking business models and on the sector's reputation.

The global financial crisis demonstrated how bad banking practice can erode the foundations of the financial system. Hence the emphasis placed by legislators, regulators and supervisors on improving this practice, through the development of an extensive regulatory framework on such matters and the reinforcement of their supervision.

I would like to review the progress in these two areas and the main challenges that we face, in a setting where one of the main challenges for the banking sector continues to be improving its reputation.

The importance of governance at credit institutions

“Governance” is understood to be the set of rules, principles and procedures that regulate the structure and functioning of an enterprise's governing bodies and enable decision-making. This mechanism is structured into two facets: an internal facet, which determines how activity is managed, and an external facet, which defines the framework of the entity's relationship with different market agents (analysts, customers, shareholders, investors, supervisors and regulators).

With this definition, it is clear that governance is a key determinant for entities' capacity to satisfactorily respond to new challenges and risks in a changing environment and, therefore, for banks' soundness.

Assessing governance is a difficult task for a number of reasons. First, it entails analysing a large number of highly diverse aspects, at the theoretical level and in their practical effectiveness as lines of defence. Second, given that supervised institutions can take different legal forms and be listed or unlisted, varied management structures and methods exist, and open supervision models that enable assessing all such situations have therefore had to be designed. Third, and perhaps most importantly, unlike other risks, governance cannot easily be put into objective terms, nor is it directly measurable, although it can be calibrated.

However, while there is no ratio or minimum level that banks must attain in this respect, there are factors that determine appropriate governance, such as market transparency, healthy and prudent risk management and a suitable organisational structure. Indeed, in European banking supervision, governance is one of the four key elements analysed as part of our annual assessment of credit institutions, and it influences the minimum capital

requirements that we set and, therefore, the maximum amount that can be distributed to shareholders.

The depth, scale and economic and social fallout of the 2007 financial crisis, along with the weak governance structures of some institutions that suffered most in that crisis, shone a light on the need for a detailed analysis of this aspect of credit institutions and a substantial expansion of their regulatory framework.

Thus, at the global level, weaknesses were detected regarding the composition and independence of boards of directors, antiquated organisational structures and a lack of rigour in the controls, occasionally preventing successful decision-making. Moreover, institutions had short-termist remuneration schemes that encouraged excessive risk-taking and failed to take into account long-term viability.

Regulatory activity concerning governance and transparency has been far-reaching in Europe, and in Spain in particular.¹ As regards remuneration, current European legislation requires that institutions' variable remuneration structures be in line with their risk profile so as to prevent them from leading to excessive risk-taking. In addition, a comprehensive and detailed suitability regime has been established for members of the board of directors, and the rules on conflicts of interest and limitations of senior officers have been strengthened. Turning to the functioning of management bodies, banks are now required to set up four committees (appointments, remuneration, audit and risk).

In the area of transparency, in the so-called *Pillar 3 report*, institutions must disclose information about their decision-making processes, the composition and functioning of their governing bodies, and the remuneration system for both their directors and their senior management.

These greater demands from the regulator, the market and society, together with the need to address increasingly significant and complex risks (e.g. conduct and technology) and the difficulty in doing so, have also led to a significant stepping-up in supervision and to new processes for determining the suitability of directors and general managers or the individuals who run key areas of banks, which are increasingly exigent as regards their reputation and knowledge.

As a result, there has been an improvement in the quality of governance structures, which have evolved towards more professional models that are adapted to society, abandoning personal management structures that are impervious to diversity, technological development and collegiate decisions.

However, since it was created in 2014, the Single Supervisory Mechanism (SSM) has carried out numerous supervisory activities in this area that have evidenced the need for improvements both in Spain and in the rest of Europe. These improvements centre around three key aspects: providing evidence about the quality of debate at the highest decision-

¹ In Spain, the reform dealing with corporate governance at credit institutions is set out in major substantive rules, such as Law 10/2014, Royal Decree 84/2015 and Circular 2/2016, which transpose and implement the European Capital Directive and are applicable to all credit institutions, regardless of their size/volume of assets or their particular characteristics. Also applicable are the specific guidelines developed by the European Banking Authority and adopted by the Banco de España and the European Central Bank, which has been the consolidating supervisor of significant banks since 2014.

making bodies and the ability to challenge the decisions brought for approval; improving the knowledge and independence of directors, and the allocation of their responsibilities; and necessarily designing more robust and detailed risk appetite frameworks.

In Spain, as a result of national company law, credit institutions' governance models have some unique characteristics distinguishing them from other systems in Europe that need to be taken into account in their assessment.

The first is the so-called one-tier model. Here, the board of directors (or governing board, in the case of credit cooperatives) combines both the institution's management function and its supervisory function, in contrast to the two-tier model in other European countries where the two functions are allocated between two governing bodies. In such cases, the mandatory creation of the delegated board committees and the audit, appointment, remuneration and risk committees strengthens the governance bodies' supervisory function through the review and ongoing monitoring of some areas of particular significance. Crucially, these committees must solely comprise non-executive directors and include a minimum number of independent directors, one of whom shall be the chairperson.

The second is the existence, in many instances, of an executive chairperson. In such cases, pursuant to Spanish legislation for public limited companies, such appointments must be approved by a qualified majority of two-thirds of the board. This legislation also requires the appointment, from among the independent directors, of a lead director who is to act as a counterweight to the executive directors to ensure that the oversight function is implemented in a full and effective manner.

While the international standards advocate appointing a non-executive chairperson to facilitate the allocation of functions, one of the main lessons from the reviews carried out within the SSM is that the perfect governance structure does not exist. This is because, in practice, all governance structures pose similar problems as regards the effectiveness of the management and supervision functions. Indeed, regardless of their legal form, it is vital that institutions with a non-executive chairperson attain the required balance and distribution of functions between its chairperson (whose functions should be more focused on strategic aspects) and its chief executive, who is in charge of the purely business functions and whose direct reporting to the board serves to mitigate an excessive concentration of power in the chairperson.

In the European context, there is currently a duality in the governance of Spanish institutions. On the one hand are institutions that, despite still having some room for improvement, have made substantial headway in their governance structures in recent years, combining more flexible decision-making mechanisms with more robust control processes. This group chiefly comprises larger institutions in the form of public limited companies and those with securities admitted to trading, which are more directly subject to market discipline.

On the other is a second group of institutions that still have some way to go before fully complying with the regulation and supervisory expectations concerning governance. This group mainly includes institutions that are not public limited companies or that are smaller in size, despite this latter aspect being tempered by the application of the principle of proportionality. Nevertheless, it should be stressed that neither aspect (legal form or size) is

an absolute factor that determines the quality of governance. That said, the difficulties small institutions have in adequately segregating internal governance functions have broadly speaking been borne out, as has the significant value that market discipline brings to the governance of institutions active on listed markets.

As examples of this duality in terms of headway, the first group of banks has gradually increased the proportion of independent directors so as to improve the supervisory function within the board and guarantee that the rights of all shareholders, members or unit-holders are protected. At the other extreme are banks that still have a low proportion of independent directors (below 50%) or even no such directors on their governing bodies. There are also banks whose directors have been in office for a long period of time, representing another shortcoming.

Second, as regards the professionalism and diversity of the board, it has been observed that the larger the bank, the greater the board's diversity in all dimensions (gender, age, relevant specialist knowledge, international profiles, etc.). Moreover, those institutions that have made the most progress in this respect have seen a clear improvement in the collective functioning of their management body.

Third, turning to the independence of the control functions (second line of defence and internal audit), many banks have clearly separated such functions from the management units, preventing any potential conflict of interest while ensuring that the heads of such functions have greater resources and direct access to the board. Other banks need to make even further progress in this respect to ensure that their governing bodies can oversee and monitor the management. The smaller the bank is, the more likely it is that such management is concentrated in a single person (generally the chief executive), posing a risk for proper governance.

In sum, while significant improvements have been made in governance models over the last decade, we cannot overlook the need to continue making headway in this area, as it is a mainstay for guaranteeing banks' soundness and sustainability.

Banking conduct within the financial regulation framework

The regulation of the banking sector, as well as its supervision by the public authorities, is founded on two main pillars. The first consists of the prudential requirements and supervision, chiefly via imposing levels of own funds linked to the risks assumed and requiring robust procedures to identify and manage such risks. The second relates to the proper protection of financial customers by means of comprehensive regulation on institutions' relationships with their customers and supervising compliance therewith.

These two pillars are very closely related. Banks and the banking business are underpinned by the trust placed in banks by customers and that that they place in each other. And this trust is founded not only on their financial soundness, but also on their compliance with certain values and principles ("banking culture") that promote proper behaviour at all levels and, in particular, with their customers.

This trust can be undermined by improper conduct, which also ultimately generates direct financial costs in the form of lawsuits, refunds to customers, damages, etc. In Spain, these costs materialised most notably in the years after the global financial crisis.² In turn, the build-up of such events could end up affecting the calculation of banks' operational risk and, therefore, their future prudential requirements.

From the public sphere, the aim has been to foster and ensure institutions' appropriate behaviour with respect to their customers through four main instruments: regulation, banking supervision, the resolution of customer complaints and enquiries, and the nurturing of the general public's financial education.

Banking conduct regulation has seen a significant overhaul in recent decades. The deregulation of the financial sector in the 1980s – which culminated in the freedom to set prices for all credit institutions in 1989 – was followed by an increase of both national and European rules.³ Since then, transparency and information for customers have acquired particular importance, as have the advertising and proper marketing of banking services. Moreover, the regulation began to require that banks offer certain pieces of pre-contractual information to their customers so that borrowers can base their decisions on the actual risk of the products.⁴

Subsequently, as part of the lessons from the global financial crisis, there was a shift towards a more advanced conduct model, with regulation for the first time on responsible lending, obliging credit institutions to assess their customers' creditworthiness and the suitability of products for them. Since then, boosted by a set of European directives,⁵ the general regulatory framework has been constructed and, with some amendments and additions, remains in place today.

In tandem, the Banco de España has gradually adapted and reinforced its supervisory activity in this area,⁶ adjusting its own organisation to maximise effectiveness. By way of illustration, its Institutions' Conduct Department was set up with 38 people in 2013, and today it has 107 people.

In view of the importance of the mortgage loan segment for Spanish families (accounting for somewhat more than 74% of the credit extended by the banking system to Spanish households), priority was given to the supervision of transparency in the arrangement of mortgage loans and the protection of mortgage borrowers in economic hardship. The focus has since shifted towards consumer finance, which saw significant rates of growth in the

² By way of example, between 2014 and 2020 the cumulative amount of Spanish credit institutions' operational risk losses associated with breaches of their obligations to customers or flawed product design exceeded €19 billion at consolidated level.

³ In the regulatory arena, in addition to the legislation passed by the (Spanish or European) Parliament, the Banco de España also issues circulars specifying the precise provisions for implementing those rules for which it has been expressly empowered.

⁴ It was then that the concept of the annual percentage rate (APR) first appeared. This is a basic piece of information for customers about the cost of, or return on, bank products, and a key tool for comparing offers from different banks to this day.

⁵ Mainly those relating to consumer loans, mortgage loans, payment services, distance marketing and payment accounts with basic features.

⁶ The Banco de España is responsible for supervising the conduct of institutions that market banking or payment products and services.

quarters running up to the outbreak of the pandemic.^{7, 8} And, more recently, during the pandemic particular attention has been paid to supervised institutions' correct implementation of the different debt relief measures approved by the Government (the moratoria on mortgage loans and consumer credit).

Allow me to remind you at this point that supervisory actions concerning conduct can lead to the adoption of corrective measures. In this respect, the Banco de España issues binding requirements for the entities concerned and, where needed, it can impose different types of sanctions, including economic ones. Thus, in 2016-2020, 26 disciplinary proceedings for conduct-related infringements were resolved, resulting in sanctions amounting to €52 million. Added to these are the 982 requirements approved by the Executive Commission in the same period, many of which entailed the refund of significant amounts to the customers concerned.

Aside from supervision, the Banco de España's bank customer-related activities are focused on a further three major areas.

First, dealing with enquiries about their rights concerning transparency and customer protection or about the legal channels for exercising their rights. By way of illustration, in 2020 the Banco de España responded to over 6,200 written enquiries and over 40,000 enquiries by telephone. Activity in this area was strengthened in order to handle enquiries in relation to the moratoria on debt payment and the other measures established as a result of the COVID-19 crisis.⁹

Second, and linked closely to dealing with enquires, is the resolution of disputes that can arise between users and financial institutions. The complaint process, which is identical to that followed by other financial supervisors in the areas of securities and insurance, is limited to analysing the conduct of supervised institutions as regards the correct application of transparency and consumer protection law and good banking practices.¹⁰

Over its more than 33 years of existence, the Complaints Service of the Banco de España has analysed tens of thousands of cases brought by the general public. This exhaustive work has generated a valuable doctrine on good banking practices, which is reviewed and updated each year in the *Complaints Report*, the 2020 edition of which was published last July.¹¹

⁷ Specifically, the focus has shifted towards: i) the verification of the marketing of revolving credit cards, financing for car purchase and loans in the form of overdrafts on sight deposits; ii) the review of responsible consumer lending practices; and iii) consumer loan marketing practices through non-bank operators (large retail outlets, retail chains, etc.).

⁸ The supervisory focus has also recently been put on: i) the direct verification of transparency obligations at bank branches, in order to assess whether the information and documentation provided to customers complies with transparency regulations; ii) the supervision of banking product and service advertising, so as to check and ensure that it is reliable, clear and concise; and iii) the supervision of institutions' customer service department activity.

⁹ Over 50% more written and telephone enquiries were handled in 2020 compared with 2019. Even stripping out the specific impact of COVID-19, more enquiries were dealt with in 2020 than in the previous year.

¹⁰ Good banking practices are understood to be those that, while not being imposed by contractual or supervisory precept or constituting financial custom, can be reasonably required for the purpose of managing financial business in a way that is responsible, diligent and respectful of customers.

¹¹ A good example from the last update is the criterion relating to charging debt recovery costs to customers. In 2020 this criterion was made stricter as regards the justification required from institutions on the reality and amount of said costs as a requirement for charging them to customers.

The complaints activity makes a vital contribution to conduct and transparency supervision processes, as disputes can frequently reveal the existence of non-compliance with regulation by supervised institutions. A case in point has been the marketing of revolving credit cards.

Also important is the value contributed by the complaints system for detecting gaps in the public's knowledge and the potential problems in understanding the products and services offered by bank and payment intermediaries. Hence our efforts to strengthen this area with the recent supervisory guidance on the organisational and operational criteria of the customer service departments of institutions supervised by the Banco de España.

Third, we should emphasise that nurturing financial stability requires a comprehensive approach, which means also fostering society's financial literacy. Indeed, enhancing such literacy has become a long-term priority for central banks and supervisors.

The starting point is not good. For example, the results of the Survey of Financial Competences, which measures the population's financial literacy, revealed that 42% of the Spanish population did not understand inflation.

Financial education is an essential means for helping the public understand the characteristics of financial products, their rights and obligations in using them and the associated risks and opportunities. Accordingly, financial education is a complement to regulation and the supervision of conduct, and generally helps promote financial system stability.

The Banco de España primarily engages in financial education through the Financial Education Plan, which was set up in 2008 with a collaboration agreement between the two institutions behind the initiative: the Banco de España and the National Securities Market Commission (CNMV). The Plan mainly operates through a network of partners, which include the competent bodies in the realms of finance, education and consumption, along with private agents such as professional associations, training and research institutes, consumer associations, the financial industry, education associations and social and third sector organisations. Thus, it stands as a paradigm of the public-private partnership model, which affords it a broad social and geographical reach.

A case in point is the Schools Programme, run in partnership with education authorities, which provides manuals for students and teachers, teacher training, and learning and support materials. The programme is complemented with competitions and awards, and has been a catalyst for the progressive inclusion of financial education in the school curriculum.

The Banco de España likewise runs the Bank Customer Portal, which offers information, warnings and practical resources on managing household finances and customers' dealings with banks in a highly accessible format. It also provides access to an enquiries system.¹²

¹² In 2020, the Bank Customer Portal received 5.5 million visits. Particularly noteworthy were the visits made to the simulators (mortgage loans, personal loans and APR) and the table of banks' lending and borrowing rates.

What are the main challenges that we presently face in the realm of conduct?

Primary responsibility for improvement in the field of conduct lies with the banks themselves. Banks have increased their organisational efforts and resources dedicated to conduct, and, broadly speaking, have positioned customer service departments more prominently within their organisational structure.

Nevertheless, in 2020 the Banco de España assessed 21,320 complaints, a figure in line with the average for the last ten years but up 46% on 2019. And with nearly 13,000 complaints in the first four months of this year, we cannot rule out the annual figure for 2021 being very close to the all-time highs of 2013, 2014 and 2017.

Admittedly, complaints figures are heavily influenced by factors such as the announcement or implementation of new regulations, the circulation of news about banking products or circumstances that have arisen in the financial market, and legal proceedings or rulings that affect banks' marketing practices. At any rate, the high number of complaints is also illustrative of the work that remains to be done.

In this regard, I should like to emphasise that banks adapting to a new, more demanding regulatory framework, both from a prudential and conduct standpoint, is a necessary condition to maintain confidence in the industry. However, in my view it is no longer a sufficient condition. A suitable culture is also essential, conveyed effectively by banks' management bodies throughout their organisations, particularly to their commercial networks, along with continued efforts to reinforce those values among all employees.

Where complaints are concerned, in a sizeable percentage of cases (around 70%) banks comply with the Banco de España's findings and rectify their conduct. However, to my mind, the percentage of complaints in which some banks find against their customer, despite the Banco de España considering that they should find in favour, remains very high. Setting aside the fact that under current regulations the Banco de España's reports are non-binding for banks (which unquestionably constrains the effectiveness of the complaints system and should be given consideration in any future amendment to that regulation), I believe it would be significant, from the reputational standpoint and to improve relationships with their customers, if banks were to broadly accept the Banco de España's resolutions.

Further, banks must strengthen internal procedures relating to product design, marketing and governance, precisely to help develop and instil compliance conduct geared towards putting customers at the heart of their bank's strategy. Banks' management bodies must also get actively involved in aspects related to the products they market, such as their governance and whether their design is aligned with customers' needs, as well as the training and incentive mechanisms for sales personnel.

Indeed, the intense competition – with the threat from new market players, such as fintech and bigtech firms – should force banks to be more sensitive to their customers' needs.

The challenges also extend to the regulators and supervisors. Banks' constantly evolving business models and new market entrants (such as real estate lenders, real estate credit intermediaries and certain types of payment service providers) that sometimes carry out cross-border operations and largely provide their services in a digital environment pose a

considerable challenge for conduct supervision and regulation. We must be able to adapt regulation in a timely and proper manner to ensure that customers are protected in the face of these new developments and, at the same time, to provide a level playing field for all market players.

The complexity this has brought on the supervisory front necessitates that supervisors be furnished with new tools and skills. At the Banco de España, we will include a new bank reporting model designed specifically to monitor conduct, which we believe will give us better insight into their business models and the market trends in banking products and services. We will also be adding machine learning and computer vision techniques into the supervisory process, to enhance the efficiency of our supervision.

We should also reflect more deeply on the suitability of our present institutional supervision architecture, which is based on a sectoral model. Some countries have evolved towards more integrated models, with central banks playing a greater role. Such models include splitting the prudential supervision of financial institutions of all stripes (banks, insurance companies, securities firms, etc.) from the supervision of conduct in dealings with customers. In my view, assigning these two responsibilities to separate authorities (the Banco de España and the CNMV, respectively) would be an optimal institutional arrangement for managing potential conflicts between these two responsibilities and for improving the overall efficiency and effectiveness of supervisory activity.

In terms of financial education, the focus must remain on incorporating financial literacy into compulsory education. At present, the Financial Education Plan is targeted at secondary school students, but there are also concepts and behaviours that can be taught at primary level. The expert guidelines published by the Organisation for Economic Co-operation and Development, which are followed by most countries, state that financial education should be included in the school curriculum and positioned as a core life skill.

We should also bear in mind that the new landscape for how services are provided – generally allowing products and services to be accessed more swiftly, competitively and at a lower cost – can also make it challenging for certain groups to access banking services and introduces the need for new competences, such as digital literacy, in addition to financial skills. This could leave them at risk of financial exclusion and fraud. Given this situation, special attention must be paid to vulnerable groups and the older generation.

In conclusion, the changes in how banks interact with their customers are but a further manifestation of their response to the new technological and competitive environment in which they operate. This new environment calls for new capabilities, knowledge and procedures from those who are to lead the transformation: bank executives, who, supported by sound governance, are able to understand and manage the opportunities and risks that technological innovation presents for banks and their customers; and experts capable of ensuring that the new analytical tools emerging in the assessment and marketing of financial products are aligned with the organisations' principles and values. New competences will also be required in the legal, risk assessment and regulatory compliance areas that foster and propagate this new culture, from their design at head offices to the sales networks. And naturally, we supervisors and regulators must not fall behind when it comes to understanding and adapting to these transformations.

Thank you very much for your attention.