BANCO DE ESPAÑA
Eurosistema

10.12.2015

Opening address

11th Banking Industry Meeting /IESE

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Good morning.

Let me first thank the IESE and its chairman, Professor Toribio, for inviting me to the opening session of this 11th Banking Industry Meeting, a prominent and always very interesting annual event on our financial calendar.

With the end of 2015 in sight, I believe this may be a good time to take stock of the current situation of our banking system. I shall review the milestones in terms of its recent developments and current situation, and I shall address the outlook and challenges facing us.

To begin, we may recall that the Spanish banking system was not affected by the various destabilising practices extensive to other banking systems, such as risks being housed in "vehicles" beyond the reach of supervisory review; investment in complex, illiquid or inappropriately valued products; or a not always clear distribution of risks. As we know, these factors played a decisive role in triggering the global financial crisis from 2007.

However, this strength did not mean that Spanish banks were free from a series of risks which, along with tensions in the euro area and turbulence on European debt markets, explain the crisis in the industry as from 2010.

There were, essentially, four risks: the excess capacity of the industry, resulting from an accelerated and clearly unsustainable expansion in lending, prompted by a lax interest rate environment; excessive and likewise unsustainable exposure to the real estate sector; insufficient own funds to cover the risks assumed; and, lastly, weaknesses in corporate governance in a major segment of the industry, namely savings banks.

From the vantage point offered by the passage of time, we can recall and assess the key decisions adopted to address the crisis and undertake reforms in the industry.

In 2008, shortly after the outbreak of the crisis in the United States, the Fund for the Acquisition of Financial Assets was set up, followed in mid-2009 by the Fund for the Orderly Restructuring of the Banking Sector (FROB), with the aim of facilitating concentration processes for viable banks, strengthening the solvency of the resulting institutions and providing a rapid solution for non-viable ones. In 2010 the legal regime governing savings banks was reformed, and in 2011 further steps were taken to shore up Spanish credit institutions' solvency, requiring of them higher minimum levels of top-quality capital, with the now well-grounded formula of "core capital" requirements.

However, the second recession that hit our economy from 2011, the scale of the risks assumed in the prior expansionary years and the contagion effects of the euro area crisis meant that the measures adopted were insufficient. This made it necessary to launch, with the help of the European Union, a more radical and transparent process to restructure and reorganise our banking system. The concrete expression of this was the Memorandum of Understanding signed on 20 July 2012, and its two core components: the recapitalisation and restructuring of the Spanish banking industry, and a major reform agenda.

The first of these components took the form of three courses of action: firstly, the determination of the capital requirements of each institution through an asset quality

review and a stress test under an adverse scenario; secondly, the recapitalisation, restructuring or orderly resolution of the weakest banks, on the basis of plans designed to tackle the capital shortfalls identified; and lastly, the segregation of impaired assets relating to exposures to the real estate sector.

To identify capital requirements, two stress tests were conducted in which the main Spanish banking groups, accounting overall for around 90% of the industry's assets, participated. The first test, a top-down analysis, was carried out in June 2012 and was the basis for defining the system's capital shortfall. Subsequently, from July to late September 2012, the second test was conducted to determine the capital needs of each bank. The results of this second test revealed maximum capital requirements, i.e. hypothetical needs under the most adverse scenario, of €57 billion.

Finally, the volume of State aid provided by the FROB and financed through the European Stability Mechanism under the Financial Assistance Programme was less than the needs identified. Of the 10 banks with capital needs, two were able to cover them by their own means through capital increases, repurchases of subordinated debt and disposals of assets. At other banks a series of measures were applied, including burden-sharing by holders of shares or hybrid instruments, the segregation of real estate assets and divestment from other assets. Following these adjustments, State aid stood at €39 billion, €37 billion of which were earmarked for the banks whose majority shareholder was the FROB. The recapitalisation of the banking indsutry was deemed to be concluded in the first quarter of 2013.

The granting of State aid was subject to compliance with strict conditions set and overseen by the European Commission's competition authorities; accordingly, banks had to submit restructuring and resolution plans that envisaged commitments to cutting office and staff numbers, re-orienting business models and divesting non-strategic assets.

Overall, since 2007, the number of banking groups has fallen by 40%, branch numbers are 30% down from their 2008 peak and there has been a 25% reduction in staff numbers.

An important feature of the reform was the restructuring and reduction of banks' exposure to the real estate sector, which was achieved through an increase in what were already-demanding provisioning requirements and through the transfer of real estate assets to Sareb (the asset management company for assets arising from bank restructuring). The total amount of assets transferred was €51 billion. As a result, by late 2014 the level of Spanish deposit institutions' exposure to real estate development activity, net of provisions, had fallen since 2011 by around €150 billion, almost 62% of the total exposure by then.

As to the second component of the Programme agreed on with the European Union, major reforms were made to banking sector regulations. These included most notably the new crisis-management framework established in 2012 (subsequently replaced by the harmonised European framework of the Recovery and Resolution Directive) and the reform of the savings bank sector in 2013.

It is also worth remembering that in the seven years from 2008 to 2014, the industry set aside provisions, against results or reserves, totalling more than €280 billion. If we add to this figure the capital increases made over the same period, the overall reinforcement of

capital from 2008 to 2014, without counting State aid, amounted to €330 billion, which is more than 30% of our average GDP in this period and gives some idea of the effort made by the industry.

The restructuring of the banking system concluded in January 2014, after the European Commission, the ECB and the IMF stated that the objectives and conditions included in the Memorandum of Understanding had been fulfilled. And this was ratified a year ago (it seems longer as we have experienced so many events, but it was just one year back) in November 2014, with the conclusion of the asset quality review and stress test exercises prior to the start-up of the Single Supervisory Mechanism (SSM). Of this entire process, all that remains to be determined is the exit strategy and sale for the banks in which the FROB holds a stake.

Current situation of the financial system

The Spanish banking system is currently sound and solvent. We may recall that the comprehensive assessment of banks by the ECB a year ago, as part of the preparatory work for the start-up of the SSM, revealed – judging by the fewer valuation shortcomings or provisioning shortfalls – that, generally, Spanish bank balance sheets rigorously reflected the risks arising from their activity. Hence, the incidents identified in this review entailed an average reduction of 14 basis points (bp) in the common equity Tier 1 (CET1) capital ratio of Spanish banks, compared with an impact three times higher at the European banks that participated.

The other component of the ECB's comprehensive assessment, the stress test under an adverse macroeconomic scenario, also showed satisfactory results for the Spanish banking industry. On average, the adverse scenario would have entailed a reduction of 144 bp in Spanish banks' CET1 capital ratio. In the case of European banks, this impact would have been 300 bp.

This positive performance has continued over the past year. Essentially, as a result of the capital increases made in the period, capital ratios have increased by over 80 bp from their June 2014 level, comfortably exceeding the regulatory minimum levels. The top-quality capital ratio, namely common equity Tier 1 or CET1, of Spanish deposit institutions as a whole stood last June at 12.4%; and the overall capital ratio was 14.3%.

Another indicator of the improved soundness of the Spanish banking system is a reduction in assets classified as non-performing. In June 2015 these accounted for 4.9% of the balance sheet, compared with 6% a year earlier. If we focus on business in Spain, total non-performing assets fell by almost 20% from June 2014 to June 2015, in line with the pick-up in economic activity, which has enabled the non-performing loan (NPL) ratio to fall to 11.2%. And refinanced or restructured credit to the resident private sector has also been declining.

The latest figures on profitability confirm the ongoing normalisation of the industry. After the losses recorded in 2012, caused by the strong increase in provisioning for asset impairment, deposit institutions posted positive results once more in 2013 and have continued improving since.

The total consolidated earnings of Spanish deposit institutions in the first half of 2015 confirm this recovery, rising to over €11 billion, which entails an increase of close to 39% on the same period in 2014. All margins improved by more than 10% on the previous year, including the net interest margin, as a result of the greater decline in the average cost of liabilities compared with the average return on assets. Also, furthering the trend of recent quarters, the decline in bad debts at most banks has lowered provisioning requirements for asset impairment, which contributes to the improvement in results.

Nonetheless, it should be borne in mind that part of this improvement is due to business earnings outside Spain. The profitability of activity in Spain is subject, as it is in our peer countries, to considerable pressures.

With regard to financing, Spanish deposit institutions reduced their recourse in net terms to the Eurosystem. Private sector deposits in Spain fell slightly, highlighting the response by households and firms to low interest rates, which is translating into a shift in their savings from deposits to other types of investment.

Credit to the resident private sector continued to show negative year-on-year rates of change in October, albeit with increasingly lower figures in absolute terms, i.e. moving closer to a zero change, which means that credit volumes may stabilise in 2016 for the first time since 2011.

Outlook and challenges

Banking business today is conducted against a backdrop characterised by technological change, new regulations, growing competitive pressure and, clearly, low interest rates. Among the many challenges that banks need to address I will focus on low profitability and on the adaptation to the new regulatory framework, problems which are, naturally, not exclusive to the Spanish banking system.

First, the profitability of banking in Spain. The consolidated earnings of the Spanish banking system have improved considerably in comparison with the significant losses recorded in 2012. Nevertheless, return on equity in business in Spain is currently around 5%, below the estimated cost of capital although, as we all know, the range of these estimates is inevitably quite broad.

There are three main sources of pressure on the income statement relating to business in Spain.

In the current scenario of very low interest rates, the loan-deposit gap is at historically very narrow levels, verging on 1%. In this situation, where the interest rate spread is so tight, the sustainability of net interest income over time largely hinges on a level of activity, which needs to be sufficient to offset, by volume, the scant contribution of price to the income statement. This is not the case at present, as banking activity levels are still low, and this is the second source of pressure on the income statement. The third source of pressure is the significant volume of non-productive (non-performing and foreclosed) assets remaining on banks' balance sheets although, as I indicated earlier, there has been a sharp decline in NPLs since the economy resumed growth rates of around 3%.

There are, however, ways for the Spanish banking industry to adjust its strategy and increase its profitability.

First, Spanish banks still have higher branch density than the European average, so there is still some leeway available in that respect. Second, similarly to banks in other developed countries, Spain's banks can – and I am sure they will – make further efforts to embrace new technology and adapt to the digital realm. And third, there are clearly still opportunities for further consolidation, not only in Spain but also in the area of the SSM as a whole.

The second challenge I wish to refer to is the adaptation of the banking industry to the new regulatory and supervisory standards. The introduction of new liquidity and leverage ratios, higher capital requirements and new resolution requirements are some of the main regulatory requirements shaping the new environment.

At this point I would like to concentrate for a moment on the introduction of new resolution requirements, following the approval, at the latest G20 summit in November, of the proposed Total Loss Absorbing Capacity or TLAC requirements, designed by the Financial Stability Board whose Steering Committee members include the Banco de España. These new regulations will apply to the 30 banks identified as global systemically important institutions and will be phased in, albeit with some exceptions in the first phase, from 2019, and in a second phase, with what may be the final calibration, from 2022.

The TLAC requirements lay down a minimum volume of eligible liabilities for absorption of losses and recapitalisation of banks, to be available in the event of resolution. This is a similar requirement, although set out in different terms, to the Minimum Requirement for own funds and Eligible Liabilities or MREL, introduced into European legislation in the Directive on the Recovery and Resolution of credit institutions, which was transposed into Spanish law by means of Law 11/2015 and the Decree implementing it published in November. The Directive, together with the Single Resolution Mechanism (SRM) that came into force on 1 January this year, establishes a common European framework that should provide for orderly resolution with uniform criteria for all institutions under its jurisdiction. This new resolution framework entails a fundamental change in bank crisis management strategy, as it places the main burden of the resolution costs on shareholders and creditors, thus minimising the possibility of recourse to public funds while at the same time preserving financial stability.

The new European regulations will bring about changes in the structure of banks' balance sheets, as institutions will have to hold not only a minimum volume of eligible regulatory capital instruments, but also a minimum volume of other liability instruments capable of absorbing losses in the event of resolution.

Meanwhile, from the supervisory standpoint, it is now just a year since the SSM was launched and, insofar as greater harmonisation can be expected to be conducive to stricter supervisory practices in each area, supervisory harmonisation should, in general, raise the bar for all European banks.

And here I shall conclude. In the wake of the deep-seated restructuring witnessed since mid-2012 and the improvements made in asset quality and in liquidity and solvency, the Spanish banking industry is now in a position to address the challenges ahead. However it

is important to note that the present environment is very different from that prevailing before the crisis: today it is more demanding, more competitive, more subject to uncertainty and difficulties arising from technological change (including in payment systems), regulatory innovation, reputational problems and demands for customer-related improvements, together with a long etcetera.

Accordingly, the name of this Meeting, “Banking in Today’s Competitive Environment”, could be neither more appropriate nor more timely.

Thank you for your attention.