

# THE CHALLENGES TO THE SPANISH BANKING INDUSTRY

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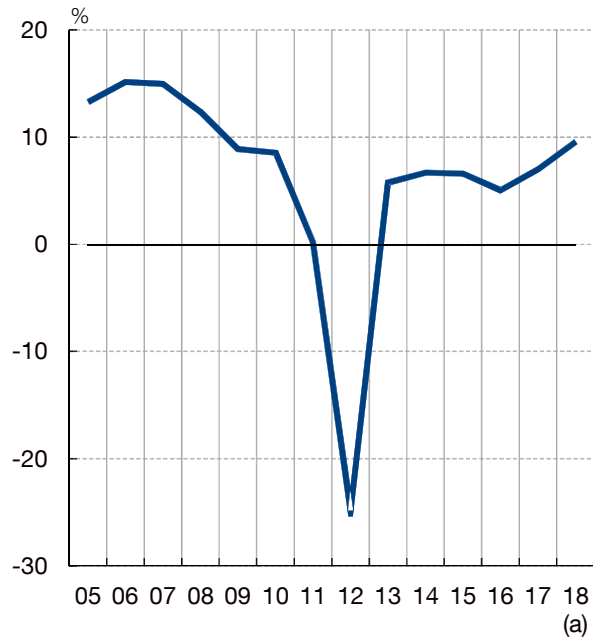
# IMPROVEMENT IN THE FINANCIAL POSITION OF THE BANKING INDUSTRY



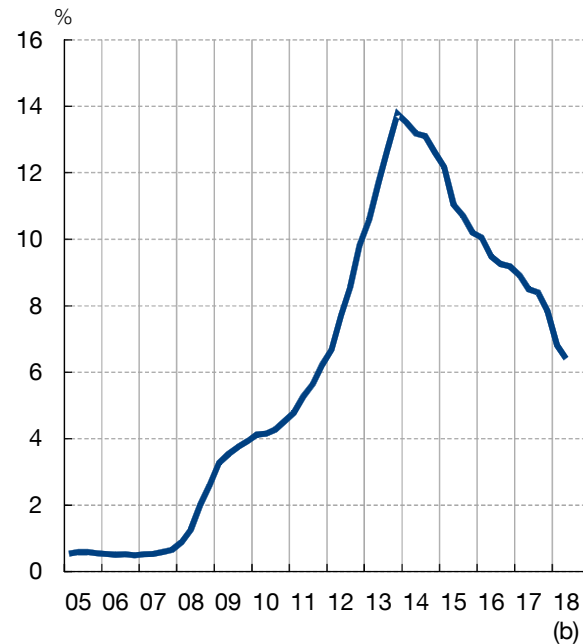
The Spanish banking industry was greatly affected by the last crisis.

In recent years there has been a significant improvement in the financial position of Spanish banks, in terms of profitability, solvency and asset quality.

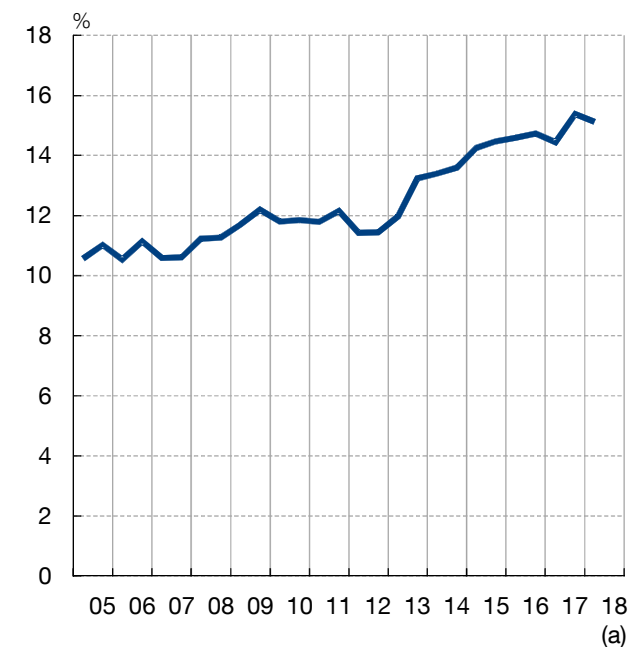
RETURN ON EQUITY (ROE)



NPL RATIO



TOTAL REGULATORY CAPITAL RATIO



SOURCES: ECB (Consolidated Banking Data), EBA and Banco de España.

a. The 2018 figure is for Q1.

b. The latest 2018 figure is for Q2.



Despite this progress, the banking industry faces significant challenges, of which the most important are:

- 1) Reducing the assets impaired by the crisis.
- 2) Restoring profitability.
- 3) Adapting to the new regulatory framework.
- 4) The new competitive setting characterised by the emergence of new technologies and competitors.

## REDUCING THE ASSETS IMPAIRED BY THE CRISIS (1)

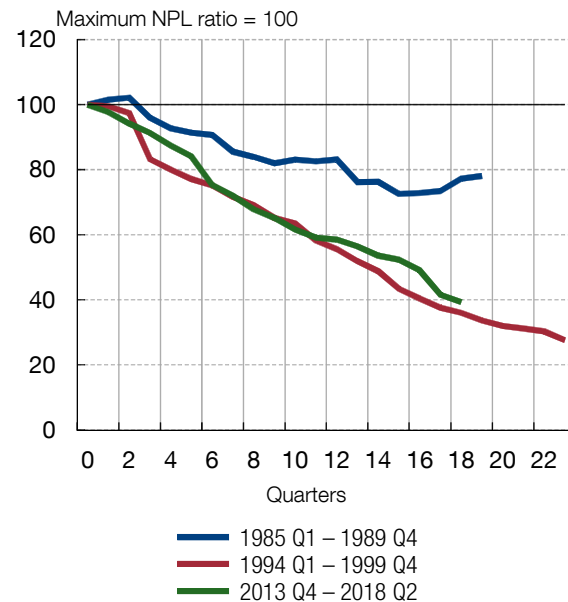


In recent years, the volume of non-performing loans has been falling.

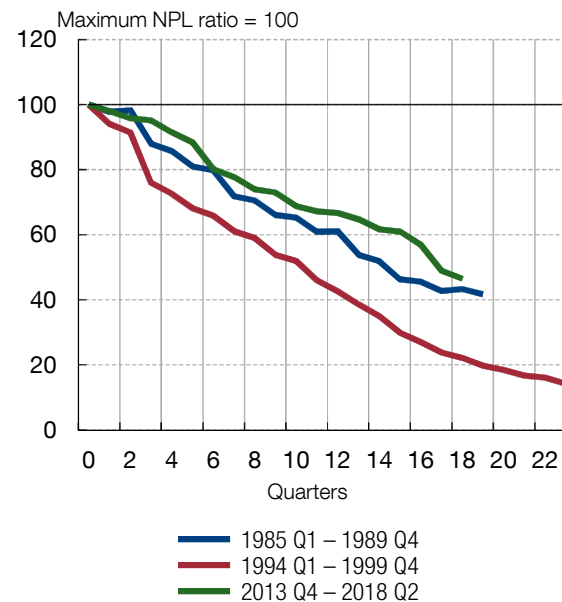
In volume terms, the decline is in line with previous episodes.

In terms of the non-performing loans ratio, the adjustment is taking place more slowly owing to the flatness of credit during the current episode.

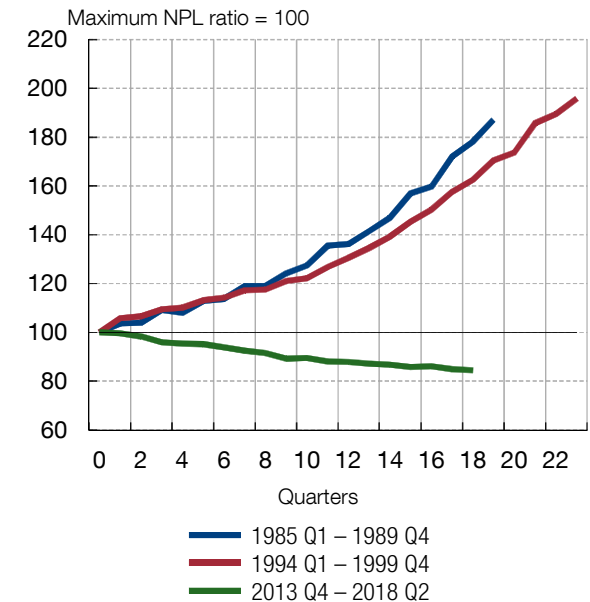
**THE VOLUME OF NPLs FALLS AS IN THE PREVIOUS RECOVERY**



**THE NPL RATIO (a) DECLINES MORE SLOWLY THAN IN PREVIOUS EPISODES**



**CREDIT CONTRACTS**



SOURCE: Banco de España.

a. NPLs as a proportion of total loans to the resident private sector.

## REDUCING THE ASSETS IMPAIRED BY THE CRISIS (2)



In spite of the progress, the non-performing loans ratio still stands at historically high levels.

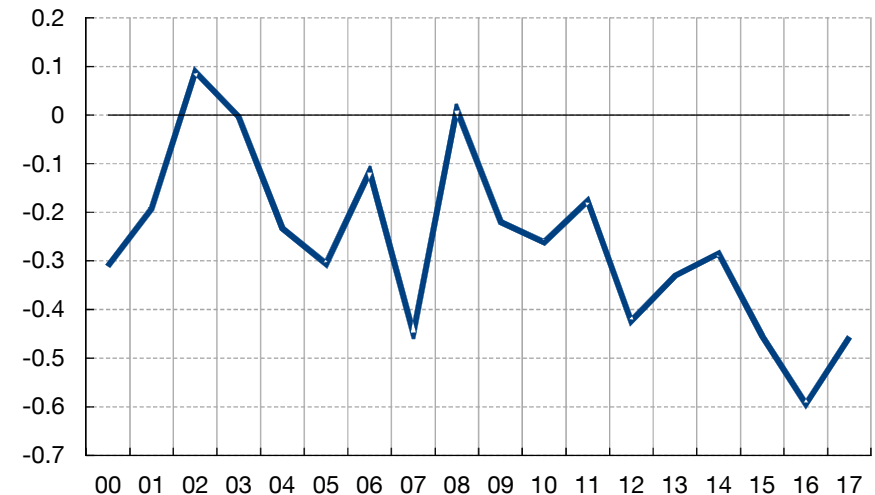
In the absence of active management of portfolio sales, the non-performing loans ratio will remain high at the end of 2020.

The persistence of high levels of non-performing loans would have negative implications owing, among other factors, to their negative impact on the supply of credit.

PROJECTIONS OF THE NPL RATIO (a)



CORRELATION BETWEEN YEAR-ON-YEAR CHANGE IN CREDIT EACH YEAR AND THE NPL RATIO A YEAR EARLIER (b)



SOURCE: Banco de España.

a. Based on a single-equation dynamic model in which the volume of NPLs is related to the level of GDP, the unemployment rate, the credit/GDP ratio and the changes in real GDP and in the nominal interest rate on credit, and on dependent variable lags.

b. Cross-section correlations of 61 Spanish deposit institutions (significant institutions and the most relevant less significant institutions, including the cooperatives sector in its entirety).

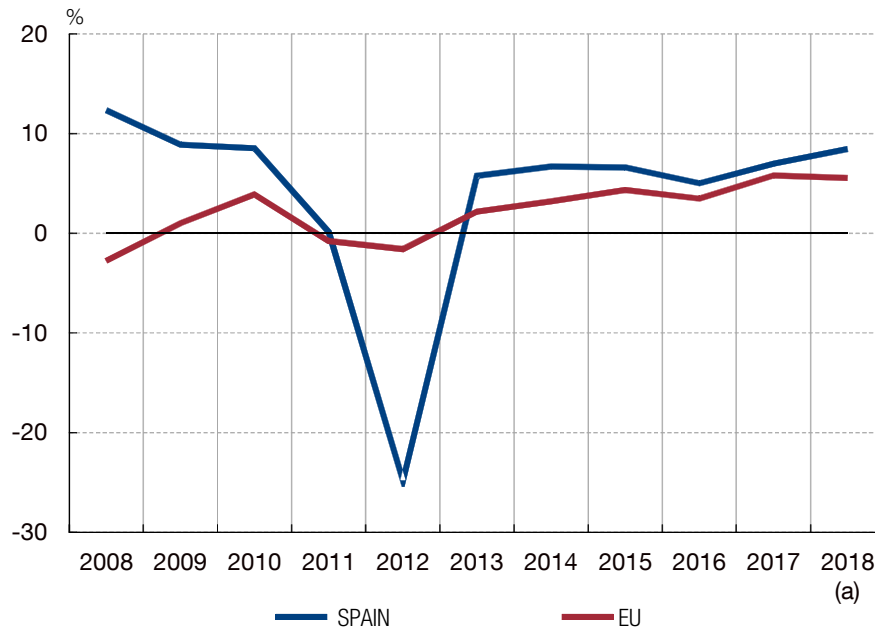
# RESTORING PROFITABILITY



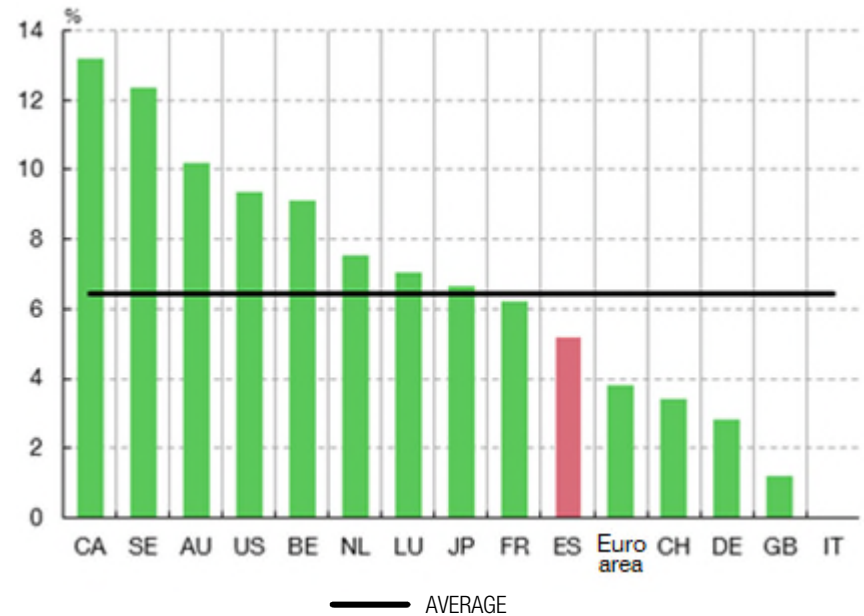
The average profitability of Spanish banks has returned to positive levels and stands somewhat above the EU average.

However, it remains down on pre-crisis levels and below those observed in the banking systems of other developed economies.

RETURN ON EQUITY (ROE)



INTERNATIONAL COMPARISON. ROE (2016) (b)



SOURCES: ECB (Consolidated Banking Data), BIS and Banco de España.

a. The 2018 figure is for Q1.

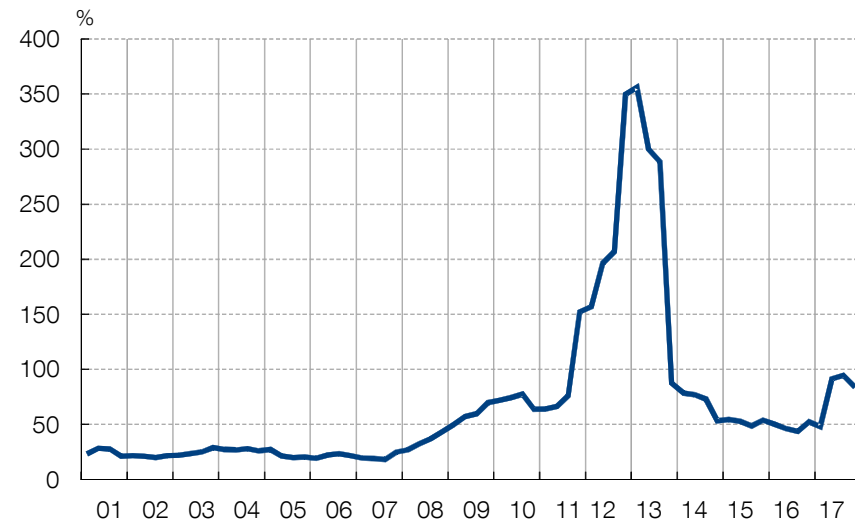
b. The figures are from the report by the BIS Committee on the Global Financial System entitled "Report on structural changes in banking after the crisis" (<https://www.bis.org/publ/cgfs60.htm>).

# THE ROLE OF IMPAIRED ASSETS IN THE LOW PROFITABILITY OF THE BANKING BUSINESS



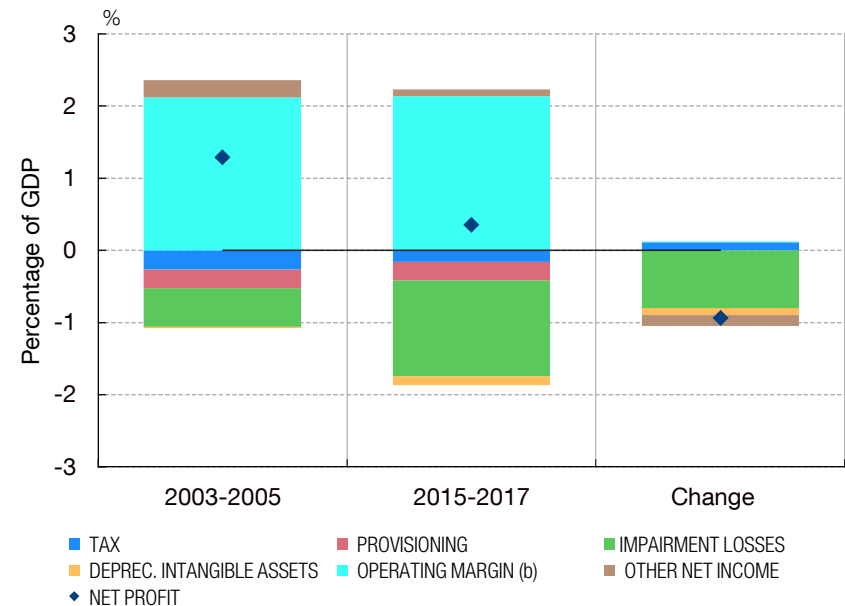
One of the main factors explaining the low profitability of the banking business is the high level of non-performing loans stemming from the effects of the crisis, which affects income statements through impairment losses and other channels.

**IMPAIRMENT LOSSES AS A PERCENTAGE OF THE OPERATING MARGIN**



SOURCE: Banco de España.

**BREAKDOWN OF THE INCOME STATEMENT**



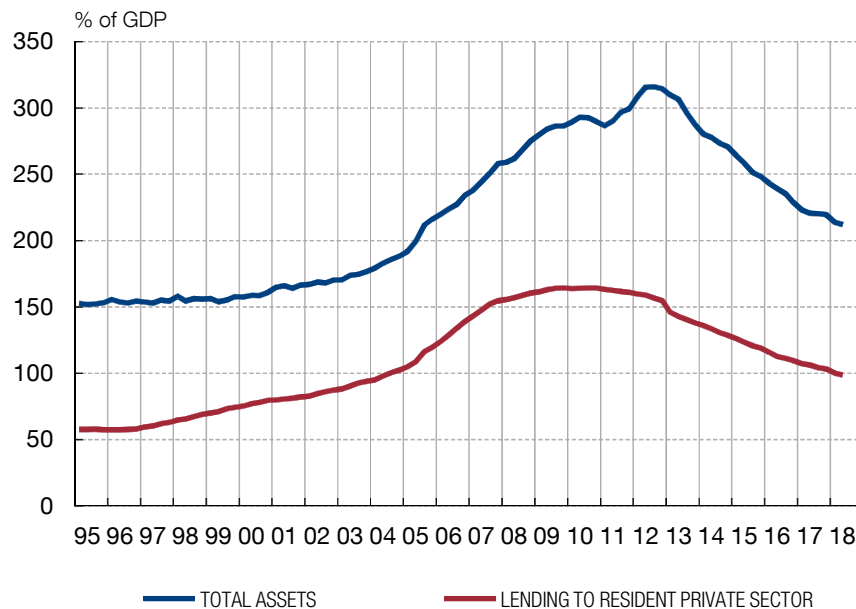
# THE ROLE OF THE FALL IN ACTIVITY IN THE LOW PROFITABILITY OF THE BANKING BUSINESS



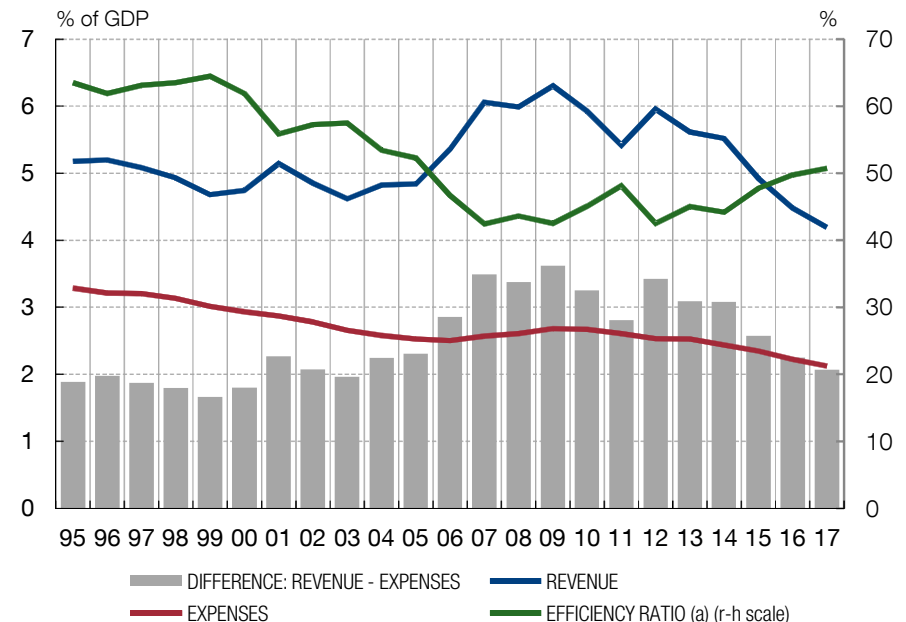
Another important factor explaining the low profitability of the banking business is the significant fall in income following the crisis as a result of the reduction in the size of bank balance sheets.

Operating expenses have also been reduced, but to a lesser degree, so that there has been a fall in profit.

## STRONG EXPANSION IN AND SUBSEQUENT CORRECTION OF THE VOLUME OF ACTIVITY



## OPERATING RESULTS



SOURCE: Banco de España.

a. Operating expenses/revenue or gross margin, excluding items with extraordinary results during the crisis.



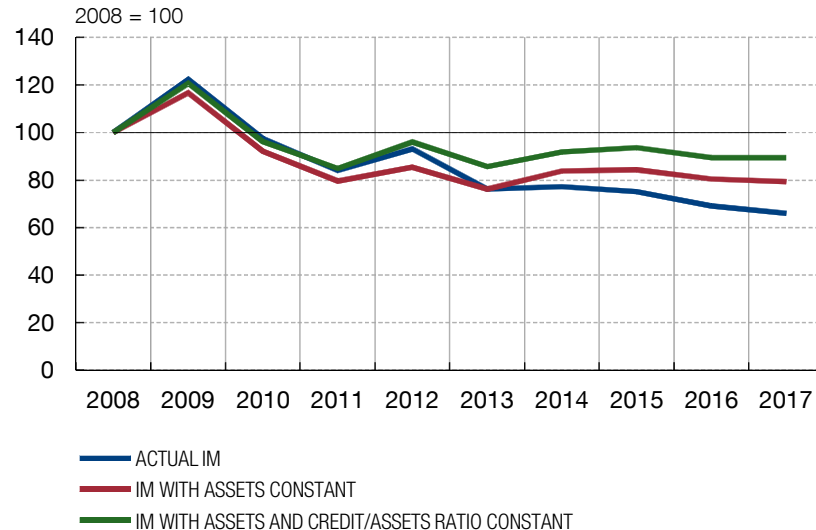
# THE ROLE OF LOW INTEREST RATES IN THE LOW PROFITABILITY OF THE BANKING BUSINESS



Low interest rates have contributed to compressing banks' net interest income, but their effect has been small in comparison with the two factors already mentioned.

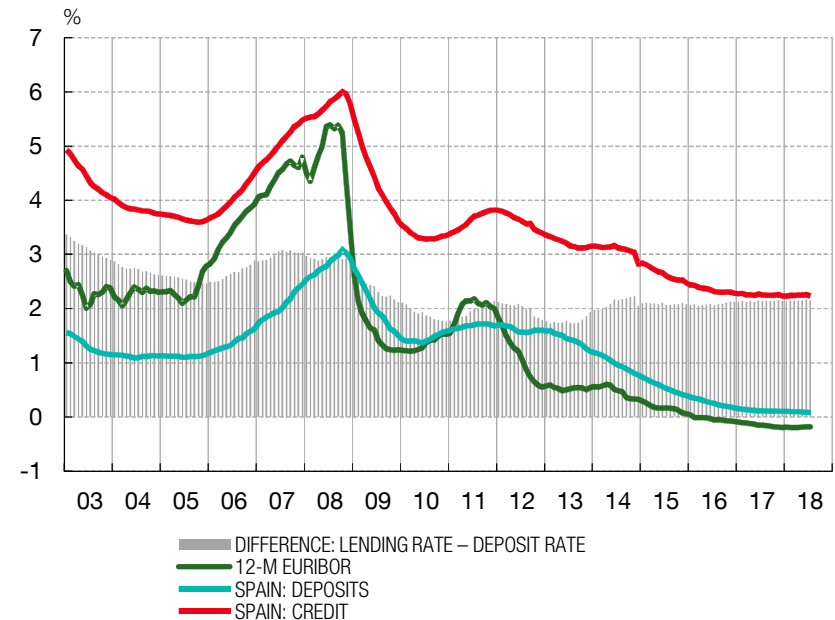
The decline in net interest income is explained more by quantity effects than by price effects, partly because the banks have not fully passed through market movements to the cost of credit.

**TWO-THIRDS OF THE DECLINE IN INTEREST MARGIN IN SPAIN IS DUE TO THE CONTRACTION IN ASSETS AND IN CREDIT**



SOURCE: Banco de España.

**INTEREST RATES ON OUTSTANDING BALANCES AND MARKET RATE**



## ADAPTING TO THE NEW REGULATORY FRAMEWORK

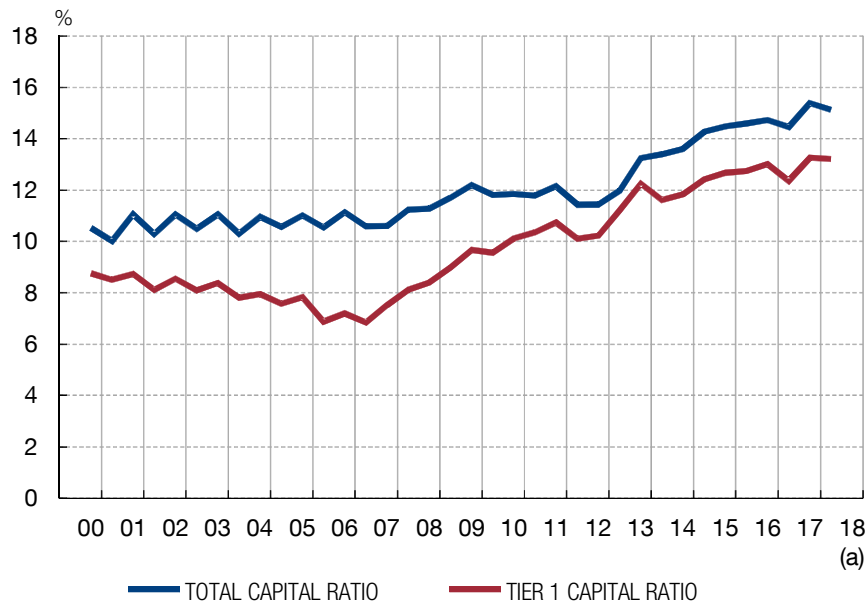


The new regulatory framework that has arisen in response to the crisis is characterised by higher capital and liquidity requirements, and additional resolution requirements.

Following recent progress, Spanish banks stand at around the EU average in terms of liquidity and leverage, but below the other European countries in terms of CET1 capital.

A large part of the regulatory changes have already been introduced, but some aspects are still to be completed.

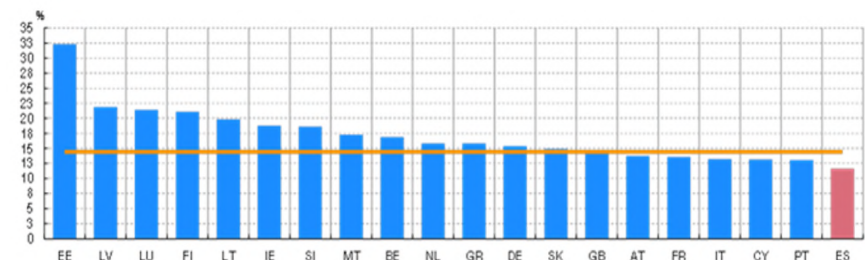
### REGULATORY CAPITAL RATIOS



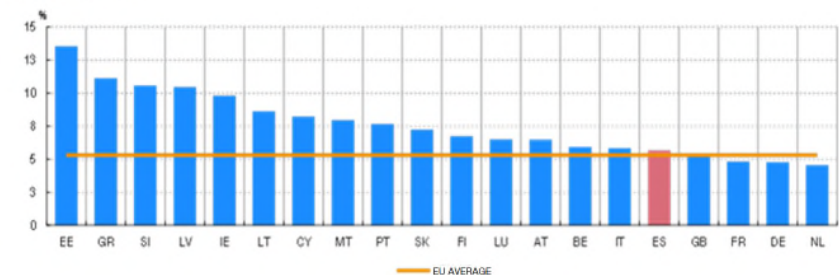
SOURCES: EBA and Banco de España.

a. The 2018 figure is for Q1.

A CET1 RATIO



D LEVERAGE RATIO



SOURCE: EBA.

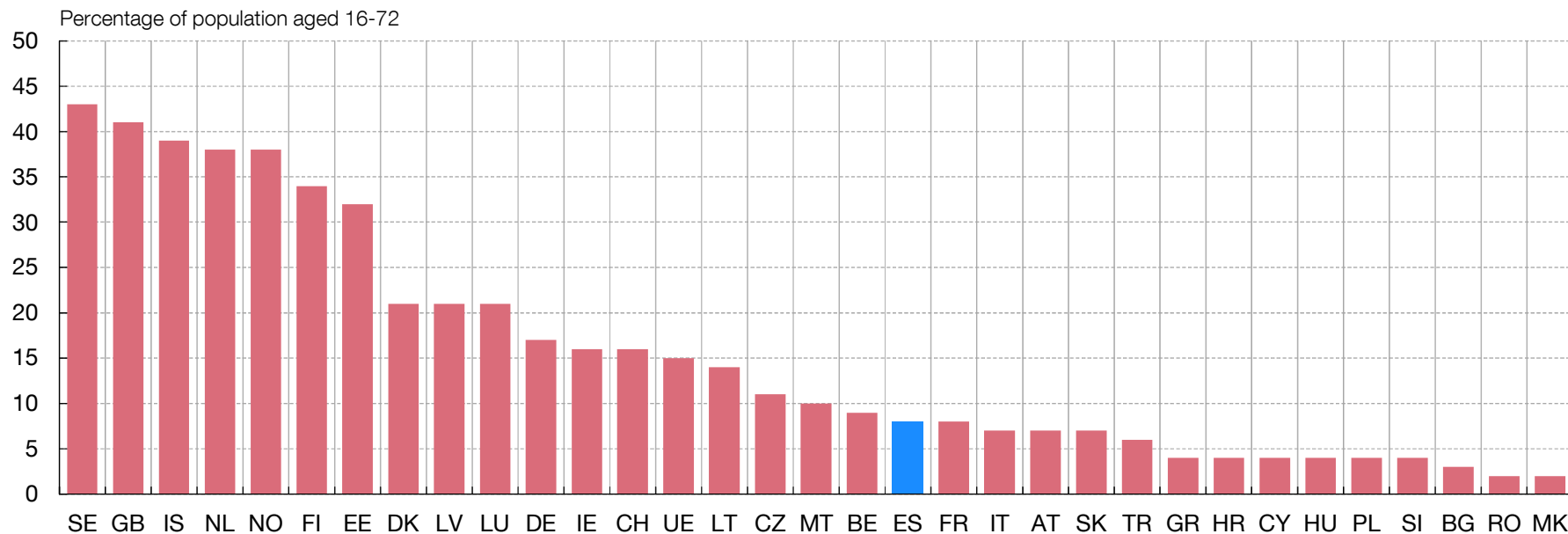
Data: March 2018

## THE NEW COMPETITIVE ENVIRONMENT: NEW TECHNOLOGIES

New technologies entail challenges, in terms of greater competition, among others; but also opportunities for Spanish banks.

The low current penetration of digital banking in Spain suggests that there is significant scope for its development.

### POPULATION USING INTERNET FOR AT LEAST ONE FINANCIAL ACTIVITY IN 2017



SOURCE: Eurostat.

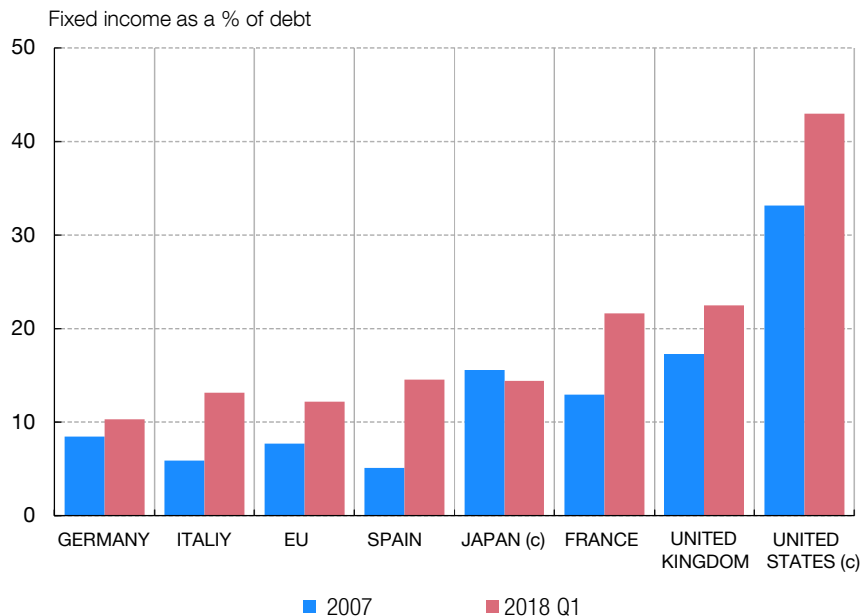
# THE NEW COMPETITIVE ENVIRONMENT: GREATER FINANCIAL DISINTERMEDIATION



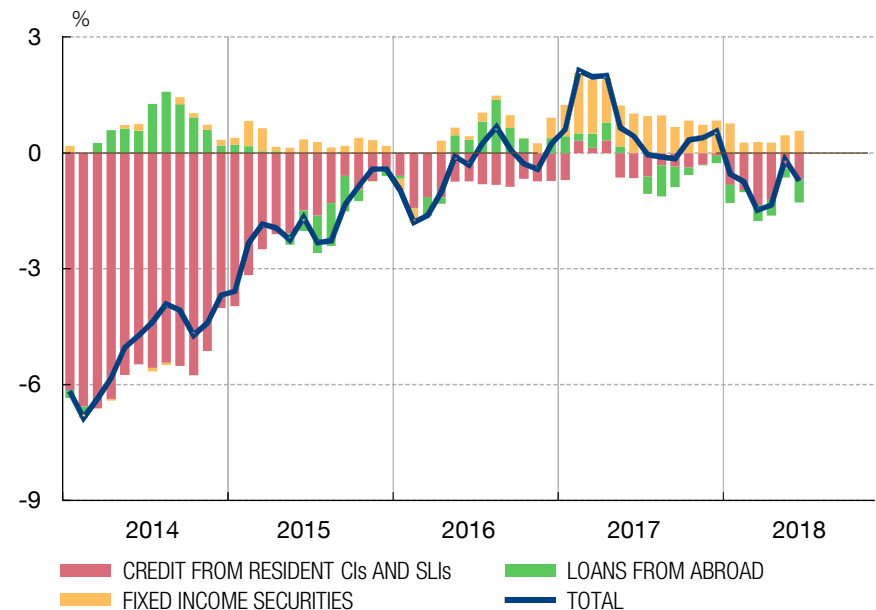
Following the outbreak of the crisis, a gradual increase has been observed in the weight of business financing raised on financial markets.

This tendency may continue over the coming years, which could lead to a decline in the volume of business and income of credit institutions.

**WEIGHT OF FIXED INCOME IN TOTAL NON-FINANCIAL CORPORATIONS' DEBT (a) (b)**



**CONTRIBUTIONS TO YEAR-ON-YEAR GROWTH OF FINANCING TO NON-FINANCIAL CORPORATIONS IN SPAIN**



SOURCES: ECB, BIS and Banco de España.

a. Spanish fixed income includes issues by resident and non-resident subsidiaries at market price which are deducted from the loans obtained by the sector. Issues by German non-resident subsidiaries are also high, but a precise figure cannot be given owing to the lack of information.

b. Debt includes fixed-income securitites and total loans.

c. December 2017 figures.

## CONCLUSIONS



In spite of the progress observed, the banking industry faces significant challenges, including notably:

- 1) Accelerating the sale of non-productive assets.
- 2) The need to strengthen capital.
- 3) Addressing the profitability challenge without unduly easing credit standards.
- 4) Harnessing new technologies in a competitive environment with potential new competitors.

Overcoming these challenges is key to the banking industry gaining a sufficient position of strength from which to contribute to economic growth and job creation.