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**Opening Address: XXVII Financial Sector Meeting\***

Construyendo futuro/ABC and Deloitte

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\*English translation of the original speech in Spanish

Good morning.

Let me thank Deloitte, Sociedad de Tasación and the newspaper ABC for their invitation to open the second session of this Financial Sector Meeting, now into its 27th edition.

Just over 18 months back, it was my honour to open the previous edition of the same meeting. In my address I listed a series of no doubt known and shared challenges and opportunities for the industry, many of which arose in response to the global financial crisis.

A cursory analysis leads us to conclude that the COVID-19 crisis has meant that these have gained in importance. Though oft-repeated, it is still a fact that this crisis has accelerated trends that were already in place, and to which banks were already responding, albeit gradually.

## **Introduction**

The environment in which we have been moving these past few months has been marked by the non-conventional measures of central banks, government, supervisors and regulators. Their actions have been against a backdrop of extreme uncertainty, which remains present and which conditions the measures to be taken to adapt to the pandemic and its effect on the economy.

Unquestionably, economic stability is related to the soundness of a country's institutions, particularly in crisis situations. And it is precisely in such situations that soundness is put to the test.

Governments, organisations and national and international authorities have acted resolutely and in coordination in the face of the unprecedented challenge the pandemic has posed. The institutional response has been very different from that in the financial crisis, and has contributed to cushioning the impact on the economy.

The financial system is a key part of this institutional front. We need a sound industry that contributes to absorbing rather than multiplying the impact of the crisis, lessening the economic uncertainty that the pandemic has generated.

The industry cannot contribute to controlling the virus, but it can at least alleviate its economic effects. As has been reiterated, banks must be part of the solution, not of the problem.

Admittedly, when the health crisis struck in the first quarter of this year, we had still not finished cleaning up the effects of the crisis on bank balance sheets.

However, we had left the worst of the crisis behind us and were on the right road to reconstructing balance sheets and improving solvency levels.

## **Solvency developments and stress tests**

Since 2008 there has been broad and sustained growth in the sector's solvency ratios. Moreover, these ratios are now based on sounder calculations, as their numerator has a much stricter definition of capital while their denominator reflects risks not envisaged in Basel II.

As a result, solvency levels in the European financial system are much better than at the onset of the previous crisis.

Another essential difference is that we are now an integral part of the Single Supervisory Mechanism (SSM), which allows us to address challenges and difficulties in a coordinated fashion, offering a genuinely European response.

As you will know, last July the SSM published the aggregate results of a vulnerability analysis of significant European banks.

This exercise was conducted without interacting with the banks. Hence, as in any fully top-down exercise, there are some methodological and data-reliability limitations.

While the results should be viewed with some caution, the conclusion is that the European banking sector as a whole is sufficiently capitalised, especially considering that these results do not take into account mitigating management actions.

Under a severe scenario of a strong decline in GDP in 2020 and a delayed recovery, the impact on capital levels is no doubt high, evidencing an average fall of 5.7 percentage points (pp). Even so, the average ratio by 2022 is 8.8%.

The Banco de España *Financial Stability Report* has recently published the results of its annual stress test which, as you can imagine, also envisages the stressed effect of the pandemic.

The conclusion is similar. Despite the major impact, the sector proves to be appropriately resilient both under the baseline and adverse scenarios although, as in any exercise of this nature, there is dispersion among the individual results.

According to both exercises, international banks benefit to a lesser extent than usual from their geographical diversification. That is in keeping with the global scale of the pandemic, which affects all economies.

Yet irrespective of the fact that in the current setting their benefits may be more limited, as a European supervisor I cannot but stress the advantages of diversification, both geographically and in terms of business lines.

## **Non-productive assets**

Apart from this improvement in solvency and resilience compared with the previous crisis, banks have made a major effort to reduce non-productive assets, although supervisory measures have admittedly had much to do with this.

This reduction has come to a halt in 2020. Unfortunately, the COVID-19 crisis has clearly led the path to reducing non-productive assets to be interrupted.

As has been pointed out, the non-performing assets ratio will, even under the most optimistic scenario, inevitably grow in the coming quarters, for which banks must be prepared.

## **Financing and liquidity**

True, so far there has been no increase in the NPL ratio. That is largely because credit growth has offset doubtful loans and, evidently, because the measures adopted – in the form of fiscal support, furlough schemes, State-backed financing and moratoria – have helped ease or lessen the enormous impact the pandemic would otherwise have had on households and firms.

Since the crisis broke, governments, supervisors, central banks and regulators have acted in unison to ensure that credit flows.

In this respect, it might seem somewhat contradictory for us, as supervisors, to be calling for the credit tap to be left fully open in a crisis setting like the present.

The big difference on this occasion lies in the exogenous nature of the crisis. The shutdown in the economy has been caused by the pandemic-control measures, and not by macroeconomic or financial imbalances.

The absence of the measures adopted would inevitably have prompted a liquidity crisis for many companies and entrepreneurs, particularly in certain sectors we all have in mind. Therefore, the aim has been to prevent a liquidity crisis from ultimately becoming necessarily a solvency crisis.

During the lockdown, banks were identified as an essential service. Financial institutions have been pivotal for the proper channelling of funds and the application of moratoria thanks to (i) their role as intermediaries, (ii) their in-depth knowledge of customers' financial needs and (iii) their capacity to analyse business solvency in the current difficult circumstances. Such a capacity will be key when it comes to evaluating the situation of those borrowers experiencing financial difficulties.

As you know, the moratoria, once the eligibility criteria were clarified, have shown an acceptance rate of between 85% and 93%, and their total outstanding balance accounts

for around 4.7% of bank lending to the non-financial private sector, with the biggest amount relating to the sectoral moratoria.

As regards the guarantee facilities provided by ICO (the Official Credit Institute), we can see that take-up has been very uneven. SMEs have made very significant use of the different tranches, with a large number of small-value transactions, whereas the facilities for tourism, vehicles and the alternative fixed-income market have been much less used.

Conversely, the new ICO guarantee facilities intended for investment have not been used in practice. As can be seen, scarcely 0.2% of the outstanding balance available had been drawn down as at September. This lack of demand may be partly due to the fact that the previous liquidity facilities have not yet been exhausted; but it may also be attributable, in the current uncertain circumstances, to business investment plans having mainly ground to a halt.

The demand for ICO-backed financing shows that, at least as regards the first wave of the virus, we have been able to leave the worst of this initial liquidity crisis behind us.

The take-up of the guarantee facilities was seen to be very rapid during the initial months, slowing subsequently, especially as from July.

There have also been firms that have taken advantage of this access to financing under preferential conditions to build up liquidity buffers, although this situation varies significantly from company to company.

As can be seen, the volume of individuals' deposits, but also those of corporations and SMEs, has increased significantly since the start of the year, especially in the second quarter, in which ICO-backed financing surged.

Indeed, the credit-to-deposit ratio has continued declining during this period.

Also substantiating this conclusion are the results of the bank lending survey recently published by the BdE and the ECB. They find that the demand for loans by firms is estimated to have fallen both in Spain and in the euro area between July and September 2020, following the strong increase the previous quarter.

Accordingly, and with all due caution, I consider we might draw two conclusions: (i) that the measures were absolutely necessary; and (ii) that they have attained their sought objective, namely to head off the business liquidity crisis, at least in the short term.

Naturally, we cannot forget that we are looking at aggregate average data, and that the situation varies enormously across sectors and companies. After the initial phase of the virus, we are facing a fresh wave. The pandemic is still far from under control, although we are learning to live with it.

The health measures adopted are evolving day by day and so too, in tandem, are households' and firms' potential liquidity needs. Clearly, certain sectors are being hit hard.

In any event, we should acknowledge that the reasons behind the exceptional economic support measures continue to be valid, in particular for the sectors most affected.

Precisely because of these circumstances, and remaining within the framework of the extraordinary assistance authorised by the European Commission, the regulations have been adapted to allow ICO-guaranteed financing to be extended for one year in terms of the payment holiday and by up to 3 years in terms of maturity.

### **Action in response to the course of the pandemic**

Against this backdrop, it will often be appropriate to renegotiate the debt of borrowers whose revenues remain impaired. However, we must also face the fact that the exit from the crisis will inevitably cause structural changes. Not all economic activity will be able to recover to pre-pandemic levels.

In my last speech at this forum, I argued that non-productive assets should be reduced for various reasons, most notably to free up human resources for allocation to more productive activities with a view to driving profitability.

Regrettably, the unexpected situation prompted by COVID-19 means that my message today must be the opposite. Institutions should allocate increasing resources to the assessment and management of exposures, including actively managing rollovers and renegotiations with those customers who will almost certainly be unable to comply with their original contractual terms.

Debt renegotiation may be a suitable option for highly indebted firms with viable business models. However, it is important to distinguish between instances in which one-off support may remedy the situation and cases that are more structural.

Assessing the financial situation of these customers is no simple task. The development of an effective vaccine may help to clarify the medium-term outlook and preclude the more extreme economic scenarios, but the current context remains marked by uncertainty.

Irrespective of these considerations, it is essential that institutions act before loans mature, promptly identifying those borrowers that may be unable to resume repayments in the medium term and recognising the provisions required to cover situations of non-viability.

To conclude, despite acknowledging that the survival of firms is a priority in the current circumstances, a smooth market exit must also be found for those businesses that lack a viable business model.

It seems clear that there is potential for improving the insolvency mechanisms in this country – in particular insolvency law – and making them more efficient. A study recently published

by the Banco de España<sup>1</sup> showed that very few firms apply for insolvency proceedings in Spain compared with other countries, particularly among small firms and sole proprietors.

There are several reasons for this. First, the procedure tends to be very protracted, taking three and a half years on average and destroying the firm's value. Further, the process almost inevitably ends in the firm's liquidation.

The inefficiency of the process is reflected in the very low percentage (0.4%) of firms that exit the market by means of insolvency proceedings (compared with 43.6% in Switzerland and 28% in France). The data are somewhat old, but the phenomenon does not seem to have changed substantially, despite the Insolvency Law undergoing numerous reforms during the global financial crisis.

As a result, it would be worthwhile capitalising on the current exceptional circumstances – in which the obligation to present an insolvency declaration has been postponed until mid-March 2021 – to consider a future reform of our insolvency framework.

We must equip ourselves with a range of tools to manage troubled business situations, eliminating the risk of a cliff effect once this period comes to an end.

Further, this reform should be capitalised on to launch a debate on the need for greater European harmonisation. As I have said in the past, uniform – or at least comparable – regulation in certain areas is a prerequisite for progress towards common European projects, such as the Banking Union or the Capital Markets Union.

For instance, it is very difficult to develop a fully-fledged European corporate debt market if each bond is subject to different national regulations in the event of insolvency. The same could be said of any European undertaking aimed at mobilising non-productive assets, whether through bad banks or private solutions.

As long as these differences persist, the valuation, management and mobilisation of non-performing assets, or traded financial instruments, will ultimately depend on their national regulations.

## **Profitability**

Allow me to turn now to profitability. A year and a half ago I indicated that improving profitability was the main challenge facing the sector.

I'm sure you need little persuading that the health crisis has only made that challenge all the more difficult. As you know, although non-performing loans are yet to rise, banks' income statements have already been adversely affected by the pandemic.

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<https://www.bde.es/f/webbde/SES/Secciones/Publicaciones/PublicacionesSeriadas/DocumentosOcasionales/20/Fich/do2029.pdf>

Specifically, in the first half of 2020, the consolidated net profit of the system as a whole was negative (around -€9.5 billion), down nearly €20 billion on the profit recorded in the same period of 2019.

These results were heavily skewed by goodwill impairments for the overseas subsidiaries of the two largest institutions. It is important to emphasise that these impairments have no bearing whatsoever on solvency, since they relate to intangible assets that were already deducted from capital.

It may seem that none of these extraordinary items are directly related to COVID-19, but in fact their impairment stems from the marked deterioration of economic expectations prompted by the pandemic.

If we strip out these extraordinary adjustments, net profit as at June for the system as a whole would stand in positive territory (RoE of 0.14%), albeit fundamentally weighed down by the increase in impairment write-downs, the progressive tightening of net interest income and the downturn in economic activity, leading to lower fees and dividends which could not be offset by means of capital gains or improvements in overheads (reflecting past adjustments).

It is important to emphasise that the impairment provisioning as at June was largely in anticipation of future loan losses, in keeping with my earlier comments on proactive risk measurement and management. However, it should be noted that the amount of those provisions was relaxed considerably in the third quarter, which hardly seems prudent in the current circumstances.

As I have said, it is important that banks analyse situations on a case-by-case basis, distinguishing between temporary difficulties and more permanent problems. Automatic reclassification, which leads to excessively procyclical behaviour, is to be avoided. But above all, institutions must be prudent, assessing their provisioning needs on the basis of plausible and conservative scenarios for the coming years.

## **Dividends**

Evidently, an unprofitable sector is unlikely to remunerate shareholders appropriately.

The sector has repeatedly expressed its view on dividend payments, a topic that has been grabbing headlines for some time.

According to statements made by various bankers and associations, the recommendation to restrict dividend payments is acting as a drag on share prices and harming shareholders, while also generating a stigma effect on the sector overall.

Regarding the impact that the restriction on dividends might be having on the sector's valuation, I think the disparity against other jurisdictions is largely explained by European banking's low profitability.



There has been a clear gap between the price-to-book ratios of the European and US financial sectors for some time. The divergence very much pre-dates the restriction on dividends, although admittedly the US financial sector has performed better since the restriction was introduced in the euro area.

We supervisors are not indifferent to the sector's rationale, but we believe another series of circumstances must also be considered. Obviously, the measure is intended to drive up capital accumulation so as to absorb potential losses amid a highly uncertain setting.

It is worth recalling that the organic generation of reserves, together with the potential divestment and disposal of business lines, represents the clearest path to capital strengthening, particularly in the current circumstances of low share prices.

Allow me to emphasise that uncertainty compels us to err on the side of caution. Our role as supervisors requires that we act prudently, readying the system for what might happen.

In short, this is a difficult decision for which there is no entirely satisfactory option. As you know, the SSM and the European Systemic Risk Board will review the recommendation before the end of the year. Their decision will take into account the macroeconomic situation and outlook at that time.

## **Consolidation**

Naturally, the search for profitability in the current setting leads us to another issue that has generated an even more intense public debate: banking sector consolidation.

In a context like today's, the reduction in costs arising from potential efficiency gains is a clear lever for improving profitability.

Gains in costs arise mainly from domestic corporate transactions, largely explaining the lack of interest for carrying out corporate transactions between euro area countries, regardless of other considerations such as the need to complete the Banking Union.

Since 2009 the Spanish banking sector has been correcting its high excess capacity, with the number of banks falling by more than 30%.

Even more pronounced was the reduction in the number of bank branches and employees, which declined by nearly 50% (more than 22,300) and by more than 35% (nearly 96,000 workers), respectively.

Despite the decline, banks in Spain continue to have clearly higher branch numbers relative to population than in the euro area.

By contrast, Spanish banks present lower staff numbers per 100,000 inhabitants than comparable European countries.

This is a reflection of the high number of branches with few employees at our banks, in turn, a result of population dispersion.

A debate has also been raised as regards the level of competition in the sector. In this connection, one of the most common ways of measuring an industry's degree of concentration is through the well-known Herfindahl index.

A look at the national data for this index, recently published by the ECB, reveals that our financial system is in a moderate-low degree of concentration compared with the other European countries.

Even considering the corporate transactions that have been announced by the participating banks, the index would hold at a level deemed moderate. Additionally, the sector's low profitability and the difficulty of improving this by increasing prices and fees are indicative of high competition.

In any event, the authorities must determine if greater consolidation may have adverse effects on competition. However, we believe that there is still some room for manoeuvre.

As supervisors our job should be limited to analysing the business viability of the merger projects presented to us; this means assessing the solvency and the business model of the resulting bank and its potential impact on financial stability.

As regards the resulting business model, I would like to stress that the goal must go beyond improving efficiency via cost reduction. It is important to assess geographic, product, and customer complementarity, and for the resulting bank to have a value-generating business plan.

Indeed, at European level, in July the SSM published for consultation certain supervisory expectations aimed at instilling transparency and clarifying the conditions that will apply to operations of this kind.

These expectations include some flexibility regarding solvency requirements. In my view, this is very significant, since it enables the supervisory focus to shift from capital towards the business model resulting from the merger, which is key in these operations.

Allow me to end this address with a brief discussion of two other issues that I also pointed out as challenges a year and a half ago in this very forum: technological change and improving the sector's reputation.

## **Technology**

Before the pandemic we were already aware that technological change is one of the main transformations that the banking sector must implement. Developments over the last few years in other sectors evidence the need to adapt the banking business model.

Technological change is a complex matter, but one that is fundamental for tackling the future. Along with mergers, it is the other main lever for gaining efficiency. There is a clear trend towards a greater use of these channels, which has only gathered steam with the pandemic. Compared with other jurisdictions there is considerable potential in Spain in this respect.

Irrespective of cost reduction, technological change should be an essential part of a deeper reflection relating to data use and business model sustainability.

Naturally, technological adaptation requires significant investment in systems, which was already difficult prior to the crisis. But such investments, fostered by recent regulatory changes, are undoubtedly key for future income.

The potential entry of new non-bank competitors is an added risk, but one against which the banking sector has defensive strengths. According to several studies, there is a high level of loyalty between customers and their bank.

People continue to place far more trust in their bank than any other service provider and personal relationships with customers remain very important, particularly in certain segments and age groups.

## **Reputation**

This takes me to the subject of improving the sector's reputation.

It is a fact that the reputation of banks deteriorated enormously in the wake of the financial crisis. It is also a fact that society's level of requirement from the financial sector has changed, as have the regulations applying to customer-bank relationships.

The banking sector has initiated a change to respond to this new social and regulatory reality. The road to reputational recovery will not be easy. Litigation continues to weigh, although it should be noted that it relates to past actions and is declining in terms of magnitude, as the claims data submitted to the bank of the Banco de España show.

In any event, we must highlight the sector's support and commitment to its customers in these challenging circumstances. The banking sector must use the current setting to uphold its role, setting the foundations on which to build the sector's future reputation.

## **Conclusion**

Allow me to conclude.

This environment of utmost uncertainty justifies the set of exceptional measures adopted. The exogenous origin of the crisis requires acting with flexibility in the face of individual instances of corporate illiquidity, without losing sight of prudence. This includes strengthening risk areas to be able to anticipate and manage situations of financial difficulty and lack of viability.

The current health crisis underlines the importance of the challenges that the sector has been progressively dealing with. Our to-do list has not changed as a result of COVID-19, but its urgency has.

The crisis has brought forward the future. Digital banking and remote working already existed, but we have vaulted five years forward in their use in just a few months.

The sector must harness this environment of drastic change, exceptional circumstances and a degree of regulatory and supervisory flexibility, to initiate its transformation.

If not now, when?

Thank you very much.