BANCO DE ESPAÑA
Eurosistema

15.12.16

The future of Spanish banking

Introduction of the 12th Banking Industry Meeting, "Banking in the future", IESE (Madrid)

Fernando Restoy
Deputy Governor

I am most grateful to the organisers, and to IESE in particular, for inviting me to participate in this prestigious annual event. As circumstances have it, this will in all likelihood be my last public appearance before my departure from the Banco de España to take up, in January, the presidency of the Financial Stability Institute in Basel.

This is then a good opportunity to reflect on the current situation and the challenges our banking industry faces as a member of the banking union.

1 The overall situation in the industry

Simply viewing the figures on the position of European banks gives an idea of the industry's substantial vulnerability. European banks overall have posted very scant returns on equity (slightly below 6% on average), which stand below any reasonable estimate of the cost of capital, despite the technical difficulty any rigorous valuation of this latter concept entails.

The low profitability in the industry is the result of the depressed net interest margin and, in many cases, of the build-up of non-productive assets on bank balance sheets. The potential of fees and commissions to mitigate the worsening profitability of intermediation business does not appear so far to have been harnessed. Indeed, during the first half of 2016, such fees and commissions were approximately 5% down on those a year earlier.

Likewise, the increase in solvency requirements and the emergence of the new resolution requirements – which broaden demands in respect of loss-absorbing liabilities – exert further pressure on the industry's profitability.

Evidently, some of the factors behind banks' low profitability, such as the extremely low level of interest rates, are conjunctural, and their foreseeable discontinuation in the future might provide relief. However, even when monetary conditions normalise, the secular factors exerting a downside influence on interest rates, growing competition in the market for transactional and portfolio management services, the likely development of the capital markets as an alternative source of funding to bank credit and the consolidation of a considerably more demanding regulatory environment than in the past might all exert continuous pressure on banking business in general.

It is thus not difficult to foresee that the banking industry will, in future and on the whole, be smaller, and that the banks comprising the sector will perhaps be less profitable, although probably also more secure. That will necessarily entail significant changes in the industry's structure and will give rise to natural selection processes. Those who succeed here will not only be those best adapted to the new environment, but also those which, while not fully adapted, are capable of clear-sightedly managing their involvement in potentially sounder projects.

Specifically, I believe the new economic and regulatory conditions might allow the survival of small credit institutions that harness the advantage of closeness to very specific customers and that are capable of maintaining sufficient regulatory capital, especially if they do not necessarily have to remunerate it under market conditions. The business model of these banks should be tailored to their status as non-systemic institutions which, faced with a potential situation of non-viability, would be liquidated through an ordinary insolvency procedure, with no external protection other than that provided by the Deposit Guarantee Fund for insured deposits.

Yet as from a certain size threshold, e.g. that marked by being a significant institution directly supervised by the Single Supervisory Mechanism (SSM), the requirements in respect of capital and of debt convertible into equity will normally oblige banks to participate actively in the capital markets and, therefore, to remunerate these instruments as market conditions demand.

In an environment of low interest rates and increasing regulatory and competitive pressure, covering the cost of liabilities will require very high levels of efficiency. But that alone would not apparently suffice. Foreseeably, the profitability required to withstand costs may only be maintained in a stable fashion over time if the bank has sufficiently diversified sources of revenue. That affects both the location of its credit exposures and its capacity to generate income through providing a sufficiently broad range of financial services. And the latter requires of banks not only sufficient capacity to withstand competition from the non-bank Fintechs, but also the flexibility to hone its supply of products through the intelligent and nimble use of new technologies.

It therefore seems likely that the earlier mentioned reduction in the industry's overall size and its average profitability will be accompanied by a small number of banks which, normally, will be more capitalised, more efficient, more technologically advanced and more active in capital markets, and which will pursue a more diversified business model.

2 How are Spanish banks positioned to face these challenges?

I believe that appreciation of the work carried out in Spain in recent years to restore its financial system's soundness is today commonplace.

Compared with the situation at the onset of the crisis, today we have a more consolidated, considerably healthier and better capitalised banking industry. Since 2007, the number of banking groups has been reduced by 44%. Further, more than 60% of the net exposure to the real estate sector as of 2011 has been eliminated from individual bank balance sheets and, since 2008, new provisioning of approximately €300 billion has been made for outstanding loans and foreclosures. While the volume of non-productive assets remains high, it is a promising sign that, from June 2015 to June 2016, NPLs fell by 18%. Finally, the pronounced balance sheet clean-up made have not stood in the way of intense recapitalisation, which has totalled €70 billion since 2008 at the consolidated level.

There has moreover been an overhaul of the regulations governing savings banks, adjusting their structure and functioning to the corporate models habitual in the industry, and preserving, in turn, the social function they perform.

Allow me to take this opportunity to highlight the work performed in this process by my institution. Indeed, as you know, the Banco de España participated from the very outset in an advisory capacity to the Government in the negotiation of the financial assistance programme approved by the European authorities in July 2012, in a process involving the IMF and the ECB, among others. Moreover, it made a fundamental contribution to the exercises to identify capital needs and it approved the recapitalisation and restructuring plans of the weakest banks. As a result of those plans requirements were laid down for the transfer of assets to Sareb (the asset management company for assets arising from bank restructuring) and capacity-reduction plans and burden-sharing exercises affecting the shareholders and subordinate creditors of the banks that received public aid were also established. All these actions had to be taken following complex negotiations, in particular with the European Commission.

The measures were implemented, as from the summer of 2012, against a backdrop of marked instability and in the face of very critical situations for certain banks, which had to be speedily resolved in the absence, at the time, of market confidence.

In parallel, key measures were taken in various areas that contributed to increasing banks' soundness and to restoring investor confidence. You may recall, for example, the guidelines or recommendations issued on transparency and the proper recording of forborne exposures, deposit remuneration and the distribution of dividends. More recently, the amendment of accounting circular 4/2004 will entail a further fine-tuning of how the quality of bank assets is reflected in financial statements.

In stressing these measures by the Banco de España, I would highlight above all that what are involved are components of a State strategy that required close cooperation among different agencies. The central bank acted at all times in coordination with the Government, which is in charge of promoting, inter alia, regulatory changes, and specifically with the Ministry of Economic Affairs, either through bilateral interaction or through both institutions' participation in the FROB (the Fund for the Orderly Restructuring of the Banking Sector), a key tool in the process and on whose Governing Committee, additionally, the Ministry of Finance sits.

Also worthy of mention is the participation of the industry as a whole in the efforts to clean up balance sheets and recapitalise its most vulnerable segment. Through the Deposit Guarantee Fund, the banking industry contributed assistance of close to €20 billion, by means of capital subscriptions or asset protection schemes, in the first part of the crisis, and later, in the form of the acquisition from retail investors of shares resulting from the conversion of hybrid instruments into capital. At the same time, most banks decided to participate in Sareb, which has played a pivotal role in the process of restoring health to the industry.

That said, the greatest effort has been that made by taxpayers who, in an adverse period for growth and employment, had to contribute most substantial resources amounting to close to 5% of GDP. It should, in any event, be stressed that those funds have not been to alleviate shareholders' losses but rather, essentially, to protect depositors and to restore financial stability, a staple public good.

In light of the foregoing, I believe that the reform and restructuring of our financial system have, above all, been the outcome of a collective effort in which the authorities and private institutions, along with society at large, have all participated. I believe this collective effort, as such, merits due acknowledgement.

The progress made in recent years means that Spanish banks have been able to join the banking union and, in particular, the Single Supervisory Mechanism (SSM) on a normal footing, having comfortably come through the detailed analysis of their balance sheets and the stress tests in 2014 and 2016.

I need not stress the importance of this project for European construction, the strengthening of the Monetary Union and the preservation of financial stability. Spain's significant participation in the start-up of the SSM is therefore a source of satisfaction for all of us. Specifically, around a hundred Banco de España experts joined the ranks of the new European supervisor, with Spain's central bank the institution that has provided most staff to the ECB for the exercise of its new supervisory function. Among these experts are a director general and three deputy directors general, along with a good number of staff in managerial posts. This undeniably attests to the professional standing of our specialists.

In the three years it has now been operating, the SSM has progressively incorporated into its common supervisory procedures a large portion of the national authorities' best practices. Among these practices are, it is true, some that are deeply rooted in the Banco de España's inspection procedures and that give shape to the key features of its supervisory approach. For instance, in its procedures the SSM already assigns significant and growing importance to reviewing the valuation of assets on bank balance sheets (loan classification, collateral valuation, provisioning, etc.), just as the Banco de España, to a greater extent than other supervisors, has been doing for several years. Also, the SSM has launched an ambitious project to review banks' internal models for calculating the overall risk they assume (i.e. risk-weighted assets (RWAs)), which will foreseeably draw the standards applied by the SSM closer to Spanish supervisory practice, which is more conservative than that of other jurisdictions. This project, along with the regulatory work undertaken in parallel by the Basel Committee, will contribute to mitigating the excessive variability observed in the measurement of RWAs and, therefore, to fine-tuning the measurement of European banks' solvency.

3 Tasks outstanding

As stated, the balance sheet clean-up, recapitalisation and consolidation effort undertaken by the industry in recent years has provided for an orderly integration of our financial sector into the banking union. These developments, along with the improved efficiency and the diversified business model pursued by much of the industry, places Spanish banks in a somewhat more favourable position than that of other banking systems when it comes to facing the challenges I described at the beginning of my address.

However, we should be mindful that the excess capacity in the industry throughout Europe is increasingly discernible, albeit to differing degrees of intensity depending on the country. And in an environment as demanding as the current one, redressing this problem will likely require something more than an adjustment in banks' size or business models. As previously stated by the Banco de España, it does not seem possible to ensure that all the present significant institutions are potentially in a position to comfortably meet, to the same extent, the requirements in respect of efficiency, capitalisation, market access, diversification and the ability to harness new technologies which, as I said earlier, the new economic, regulatory and competitive environment will demand.

Given the significance of these challenges, banks must adopt the pertinent strategic decisions at the right time, in order to preserve their value and, thereby, better serve their shareholders and customers. As a general rule, the supervisor should not interfere in these decisions, which belong to the corporate realm, and nor in particular should it directly promote specific integration operations. Naturally, it is obliged to share its analysis with banks and to support those of the latter's strategic decisions that are beneficial for the system as a whole and, specifically, for the orderly adjustment of the industry to the new environment. I foresee both the Banco de España and the SSM continuing to pay particular heed to these developments in the immediate future.

In the national regulatory framework, following the ambitious reform undertaken and looking beyond taking on board the new international regulatory standards – in both the prudential and resolution-related realms – that the EU may progressively adopt, it would not seem that legislative projects as far-reaching as those diligently undertaken in recent years will be needed.

That said, there are at least two regulatory reforms outstanding that it would be desirable to pursue.

Firstly, as you know, I am in favour, when the time is considered right, and following the example of other jurisdictions, of revising our country's financial supervision arrangements.

Secondly, we have at the Banco de España been advocating the advisability of fine-tuning the legal regime and, in general, the regulations applicable to credit cooperatives. In both cases, the best practices of our peers should be taken as a reference.

The reforms I have indicated, unlike many of those undertaken in recent years, are not in response to the pressing need to amend aspects that may have contributed to triggering or exacerbating the recent financial crisis. Yet I believe it is the obligation of those in positions of public responsibility to pursue the early identification and correction of structural shortcomings, and indeed to do so before they unleash adverse effects on the workings of the financial system.

4 Final remarks

To conclude, I believe that in Spain we have sufficiently demonstrated our ability to resolve a critical financial system situation, thanks to the collective effort I described. What we now need is to apply the same drive in correctly identifying the challenges the industry must face and in setting in train, as soon as possible, the strategic, supervisory and regulatory responses needed to ensure that, in a more demanding environment, we maintain the industry's competitiveness and financial stability.

Thank you very much.