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Banking business model: challenges and opportunities

IX Financial Meeting. “Transformation of the banking industry in a new setting of digital innovation”

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Good morning.

It is a pleasure to participate in this ninth edition of the Financial Meeting, a classic in our calendar widely acknowledged for its prestige and which gathers together a large number of banking industry leaders. I thank the organisers for their kind invitation to me to speak at the start of the event. And it is a pleasure to follow on from Ramón Quintana, my "brother-in-arms" over the course of intense years of work, first at the Banco de España and then at the European Central Bank.

Indeed, in connection with Ramón's words, and in this my first address as Deputy Governor of the Banco de España, I wish to focus on the banking business model and the need to adapt it to a changing environment.

Like all private companies, banks can only survive in a stable fashion over time if they are profitable. And, set against the current transformation of the banking industry, ensuring profitability over time calls for a comprehensive, strategic and individualised reflection on the business model.

Allow me to develop this idea of "comprehensive, strategic and individualised". In doing so, I will perforce refer to some of the findings included by the Single Supervisory Mechanism (SSM) in its recently published thematic review of the determinants of profitability and business models.[1]

A comprehensive reflection

Taking the first adjective, when I say a comprehensive reflection is necessary I refer to the fact that a bank should examine its income and costs at the greatest level of detail possible: by product and not by customer, by business line and by geography. It should seek to gain detailed knowledge of which activities generate recurring profits, and which occasional profits or even losses, delving into the reasons that may explain each of these results.

This will allow the bank to identify whether there is scope to turn the profitability of certain activities around, or whether it is better to change tack or abandon such activity. In addition, the bank will be in a position to judge whether the reality of its business, understood as its assets/liabilities mix, and the decisions taken in and bearing on such activity are appropriate or need adjusting.

In short, if the bank has advanced tools to improve profitability, it can develop an appropriate, consistent and comprehensive price-setting policy to ensure that the price it charges for a product or service matches its total cost, including the risk premium.

I should like to highlight this latter aspect of price-setting policy at the level of products or services since, traditionally, services that are not explicitly charged and whose cost has been covered by the net interest margin have been provided to customers. I believe it is important to introduce transparency and rigour into price-setting. Without it, the reality of the business is distorted as is, consequently, the attendant analysis, and informed decision-

[1] "*SSM thematic review on profitability and business models. Report on the outcome of the assessment.*", September 2018.

making is hampered. Not in vain, in the aforementioned thematic review price-setting is included among the areas where the SSM recommends making improvements.

I would further stress that, in this comprehensive analysis of the bank's accounts, there should be some thought on the weight of operating expenses. Unquestionably, Spanish banks have made a great effort in terms of capacity adjustment in recent years. Numbers of staff and offices have fallen approximately by 32% and 40%, respectively, from their 2008 peaks. It is necessary to continue paying attention to these expenses, so as to ensure they are in step with developments in lending activity and in revenue.

Against this background, progress in new technologies, and the alternatives these offer to the traditional means of providing bank services, may prove an opportunity to cut costs and come into line with the change under way in the customer-bank relationship. However, the digitalisation path should be pursued after a cost-benefit analysis, having regard to the risks and additional costs that are taken on. It should, moreover, be accompanied by processes that allow for the identification, monitoring and mitigation of such risks, in such a way that ensures they are included in price-setting models.

In sum, any effort geared to obtaining comprehensive knowledge of the profitability of the activity being pursued and to refining price-setting processes with a long-term vision will be time well spent.

That said, while the foregoing condition is necessary for ensuring sustained, profitable activity over time, it is not however a sufficient one. The analysis must, moreover, be strategically oriented to anticipating future changes. Reflection is needed on the capacity of banks to manage and strategically focus the business.

A strategic reflection

Reflection on the business model should allow medium and long-term objectives to be set and a path plotted towards attaining these objectives. Appropriate business models are those that generate recurring and sustained profitability over time, this being the fundamental pillar for the organic generation of capital. This is the virtuous circle that must be drawn and, to do this, banks' management bodies will have to take the necessary measures enabling them to face a changing and demanding future.

This task will involve taking into account all factors that may affect how the bank pursues its business, and everything that defines its environment which, by definition, is a changing one. By way of example: geopolitical considerations, present and future macroeconomic scenarios, regulatory and supervisory developments, technological developments and the emergence of new competitors.

The bank must also take into account its starting point, its strengths and weaknesses, and how it compares with its peers.

As you all know, new competitors need not be other banks, but the so-called fintech companies, which are destined to exert pressure on and accelerate the ongoing technological renewal of financial institutions. Undoubtedly, therefore, part of banks' strategic drive should focus on how to face this challenge and the competition.

I would next like to address four key aspects from the strategic standpoint: capital; the legacy of non-productive assets; liquidity; and governance.

As regards capital, while Spanish banks have strengthened their capital base and, consequently, have improved their ratios in recent years, duly meeting the minimum requirements, there are no grounds for complacency.

Firstly, although the current situation is that Spanish banks have, on average, high asset density (measured by their risk-weighted assets) and low leverage levels, it is also a fact that they continue to have lower capital ratios than their European peers. On EBA data for March 2018, Spanish institutions' CET1 solvency ratios are below the EU average at that date (14.4%).

This shows that Spanish banks must continue making headway in one of the key elements of the new rules of play, namely that they must have more and better-quality capital than before the financial crisis.

Secondly, while there is now greater certainty than some years back about regulatory and supervisory capital requirements, some factors continue to put pressure on capital ratios. These include the end of phase-in periods, which have enabled certain requirements, such as the capital conservation buffer, to come into force gradually over the course of several years.

Thirdly, regarding resolution regulations, compliance with loss absorption-related minimum requirements for own funds and eligible liabilities (MREL) poses a far from negligible challenge, especially for that segment of banks that finds it most difficult to tap the markets for funds. Part of the challenge lies in the low profitability of banking activity and in the high cost of issuing eligible liabilities.

In this scenario, it is essential that Spanish institutions pay due attention to the organic generation of capital in the design of their strategy and contemplate the steps needed to be well-prepared for the future regulatory scenario and to improve their relative position in the European banking industry.

Another key element in the design of Spanish banks' strategies should be to persevere with the efforts made to date to reduce non-productive assets.

Having regard to the figures for business in Spain, the resident private sector's non-performing loans have fallen by 60% from their end-2013 peak. At that time, they accounted for close to €190 billion. This figure was practically €75 billion as at June 2018.

In terms of the NPL ratio, the early-2014 peak was 13.9%. As at June 2018, the figure stood at 6.4%.

The effort is clear to see. It is too in terms of foreclosed assets, which have fallen by almost 40% from their 2012 peak, and stood, as at June 2018, at around €60 billion.

Nonetheless, the foregoing figures remain high in historical terms and dynamic management of these types of assets by banks remains necessary. They must set ambitious but credible objectives.

In designing these objectives, banks should bear in mind the supervisory expectations defined over the past 18 months. In particular, they should be very mindful of the guidelines the SSM published in March 2017 and the addendum thereto released in March 2018.

The guidelines are predominantly qualitative. They describe measures, processes and best practices in the management of non-performing exposures, with a view to banks defining strategies that enable them to reduce the accumulated volume of such exposures.

The addendum complements the guidelines and sets supervisory expectations as to the prudential provisioning levels for new non-performing exposures, considering as new those classified as such as from 1 April 2018. These expectations set a timeframe of two years for 100% provisioning of unsecured exposures, and one of seven years for 100% coverage of secured exposures. In this latter instance, moreover, provisioning is expected to be gradual, such that it is not left until the last year to set aside the provision.

Both documents, the guidelines and the addendum, clearly demonstrate the attention the supervisor has been paying to credit risk in general, and to non-performing exposures in particular, and they represent the benchmark supervisory tool in the supervisory dialogue with banks. In July 2018, the ECB announced that, along with the foregoing, and with the aim of achieving similar coverage of the flows and stock of non-performing loans, the setting of bank-specific supervisory expectations in respect of prudential provisioning levels for the stock of non-performing loans would also form part of the supervisory dialogue. The better prepared institutions are for this dialogue, the more fluid it will be.

Before addressing the last of the key strategic aspects I wish to talk about today, namely governance, I believe it should be said that any strategic reflection should also include appropriate liquidity planning. This should take into account those elements that may most affect it, with particular attention to monetary policy implementation decisions.

To conclude these considerations on strategic reflection by banks, I shall refer to governance and risk management.

The crucial element for being able to properly manage and attain profitable business models over time is to have suitable governance structures. Governance structures shape the decision framework on risks. They are thus determinants of how a bank's risk profile develops and, ultimately, of its medium and long-term sustainability. They are a necessary and basic element without which success in any project cannot be expected.

As many of you know, governance is an area in which I have been working for some time and with which I am very familiar. Let me recall for you the areas of improvement banks still have to tackle and which decisively influence the business model and future challenges.

Admittedly, considerable progress has been made in recent years in relation to governance. But I would like to highlight two areas where we must continue working: i) the functioning of boards; and ii) the implementation of risk appetite frameworks.

On boards there is scope for improvement in terms of independence, dedication and succession planning. Many institutions have carried out self-assessments of how their board works, but more still needs to be done as regards the time dedicated to preparing meetings and board oversight of control functions.

The oversight of managers and, in particular, internal control functions must be strengthened, especially in risks and compliance. And let us not overlook the quality of data and information on risks that are pivotal to determining strategy and decision-making.

In addition, work remains to be done on integrating the risk appetite framework into management, as a key instrument of risk control. For example, at many banks the involvement of the risks function in the limit-setting process is still poor and lacking in ambition.

In risk management, structured decision processes are needed, with incentive arrangements that are conducive to sustainable risk-related decisions. How these decisions materialise, which in the literature is known as "risk culture", is particular to each bank and the responsibility of each one. Supervisors observe and assess but, ultimately, this is one of the idiosyncratic aspects of banks' DNA.

In short, governance structures should be capable of measuring, heading off and analysing current risks and those that are arising. While there are no strong signs of any easing, for activity as a whole, in lending conditions and of aggressive pricing that might suggest that risk is not sufficiently reflected, banks must be careful to retain a suitable profitability/risk trade-off that is sustainable over the cycle in all business segments.

An individualised reflection, adapted to the characteristics of each institution.

I shall conclude with a brief but nevertheless important reference. In addition to being comprehensive and strategic, reflection on the business model should also be individualised, i.e. adapted to the idiosyncratic characteristics of each institution. Indeed, the findings of the SSM thematic review of profitability and business models show that there is no one single approach and that, even among those banks with better profitability results, there are differences in strategies.

Some pursue strategies geared to obtaining high income, which counter relatively high costs. Others place an emphasis on low costs that are compatible with relatively low income. And others strike a balance between a medium income-generating capacity and medium or low-level costs.

These differences in strategies are reflected in different action plans, some aimed at growth in loans or commissions, others at streamlining costs through various means, including digitalisation or externalisation.

The options are varied and should be adapted to the actual circumstances of each bank.

Conclusions

In conclusion, my address has focused on the importance of reflecting on the banking business model as a cornerstone for being able to achieve a sustainable level of profitability over time. I have stressed certain elements central to this reflection, such as detailed knowledge of the reality of the business, a price-setting policy that reflects the risk and cost of each product, a strategy geared to strengthening capital and reducing non-productive assets, sound governance and an individualised and tailor-made strategic approach.

Banks are preparing for the future and the new times ahead, although nobody knows for sure what this will be like. What is clear is that only banks that are proactive and better prepared from the strategic standpoint will be capable of exerting influence over their profitability and sustainability over time.

Thank you for your attention.