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“Banks and society. Looking to the future”

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Margarita Delgado
Deputy Governor

Good evening.

I would like to thank Fundación La Caixa for their kind invitation to me to take the rostrum today at the Círculo Financiero. It is firstly an opportunity to address an eminently distinguished audience. But it also allows me to visit Barcelona again, a city I know very well from my time as a bank supervisor and to which it is always a pleasure to return.

You know better than me that Círculo Financiero has, throughout its long history, always offered a forum for open and frank debate on current topics. It has sought to tackle, from a constructive and European-oriented approach, the problems and difficulties we face as a society.

Admittedly, the challenges before us at present are most significant ones. But it is no less true that Spain, throughout the history of this institution, has experienced and overcome even more turbulent times. Each of these convulsive periods was seen by our society as a crisis.

Crisis and change

The word “crisis” is from the Greek. Despite the adverse emotional reaction we all feel on hearing the word, the Greek term does not necessarily have a negative connotation.

The root of “crisis” means “choice”, “dispute” or “decision”. Originally, then, the word “crisis” necessarily implied a change. But, above all, it reflected the need to act resolutely and decidedly in the face of such a change.

In this respect, the world we live in is the outcome of how we have handled, reacted to, faced and resolved each of the crises we have experienced as a society.

It’s no big revelation to state that the financial sector has recently undergone one of the biggest crises in its history. The crisis was deep-seated, lasting and, most regrettably, it had severe consequences for groups that had little or nothing to do with it arising.

As banks and supervisors, we share a responsibility for what happened. We should learn from our mistakes. But, above all, we should correct whatever is needed to prevent anything like this happening again.

Much has changed since the global financial crisis broke in the summer of 2007. It is widely acknowledged that the banking sector has undergone far-reaching change, but supervision has also been enormously affected.

The old institutional framework has been replaced. In this process, we have sought to draw on the lessons from the crisis, equipping supervision with a set of tools that allow us to act in a coordinated and, we hope, preventive manner. Further, we have moved decidedly towards a truly European-based supervision. This is an essential step towards a Banking Union that will make the overall European financial system safer, thereby promoting sustainable growth in the economy.

Much still has to be done to complete the Banking Union. In particular, we are still lacking a pan-European and adequately funded deposit guarantee scheme and a recapitalisation fund. But, in my opinion, we are moving in the right direction.

Were we to compare the snapshot of 10-12 years ago with what we can see today, I believe we could describe events as a revolution rather than evolution. Despite this revolution, what has not changed over this period is the type of relationship that we supervisors have with banks. The supervisor/supervisee relationship is not straightforward, and nor is it free from tensions and differences.

These tensions and differences are inevitable and part of the so-called "supervisory dialogue". I would go so far as to say that these differences in our relationship are not only inevitable but indeed positive. As Gonzalo said earlier, we should understand one another both in our agreements and disagreements, constantly maintaining a transparent and sincere dialogue.

Despite these differences, supervisors and supervisees share a common goal. We both want banks to be sustainable and continue servicing their customers, both now and in the future. To achieve this goal society needs solvent banks, with a sufficient level of capital to withstand economic ups and downs, and profitable banks, with enough capacity to generate profits to remunerate capital.

In my public appearances. I usually go on now to give an itemised list of "duties" for banks. It's a familiar list and the duties are constantly referred to and published in the press. But for once I will sidestep this list of duties, something which both banks and, very possibly, all of you will appreciate.

Instead, I would like to reflect today on how relevant a role banks still have to play in society as an engine of healthy economic growth. I shall also refer to the lessons we should draw from the crisis and the changes that have come about in how we work as supervisors. I shall conclude by focusing on the changes which, in my opinion, are under way in society, and on the type of influence that these changes may exert on the banking business model and on our actions as supervisors.

Validity of the role of banks

While the height of the crisis is now some way behind us, we continue having to deal with its consequences. Every day the headlines report some news on the legacy of the crisis.

Being a banker or, more modestly, working in the banking industry has now lost a lot of popularity. And something similar can be said about working at the banking supervisor. We have to acknowledge that our work has lost out in terms of repute, and we must reflect and work hard to recover this.

Naturally, the crisis and its consequences, which we continue to experience, largely explain this change in attitude. Yet it is fair to say that the criticism levelled at the banking sector is, on many occasions, somewhat contradictory. Public opinion shifts rapidly from criticising banks for their mistakes – frequently, for the mistakes "inherited" from banks that disappeared some time back – to criticising them for not sufficiently easing the way for credit to reach economic agents; indeed, for the risk of financial exclusion stemming from potential branch closures.

Like the song, it would seem we can't live with or without them. But the truth is, with or without criticism, the role of banks remains as essential today for our economy as it was 20 or 30 years ago.

However, debate has arisen over the future role of banks, set against the emergence on the scene of the so-called Fintech. This can be seen as a threat or as an opportunity. I believe it entails both. But in any event, banks must evidently adapt their business model to technological change, as Gonzalo so rightly said.

If instead of looking at the small, innovative and nimble Fintech, we assess the potential effect that the irruption of one of the so-called Big Tech may have on the system as a whole, the debate takes on a systemic dimension. In this connection, the recent announcement of the launch of the "Libra" project, the virtual currency sponsored by Facebook, has potentially systemic implications. These are so serious that supervisors, central banks and credit institutions must all evaluate the possible consequences. Evidently, we must be sure that the project will not compromise the integrity of payment systems and the stability of the system as a whole. The type of regulation to which it should be subject is also uncertain.

Irrespective of what the future may hold, banks' classical role remains fundamental today to economic development. In the absence of deep secondary markets at the European level, where it would be possible to convert long-term funding into liquidity through the market, the banking sector is still the main vehicle through which savers' wish to have their savings available can be reconciled with the need of those demanding funds to have stable funding over time.[1]

Naturally, this does not mean that credit growth should always be positive, as we were painfully reminded by the crisis. In this respect, the debt ratios of households and firms in Spain reached excessive levels of 85% and 133% of GDP, respectively, before the crisis broke. Fortunately, since their 2008/2009 peak, debt ratios have moved on a markedly downward trend, converging late last year with the average EU levels of 60% for households and 90% for firms.

Bank lending has been decreasing throughout this period of household and corporate deleveraging. Nonetheless, this decrease has recently reversed. Specifically, if we look at 12-month cumulative data, the net flow of financing granted to households turned positive in June 2018, posting a year-on-year growth rate of 0.5% in April 2019. Firms' net global financing flows have also held at positive levels since October, attaining year-on-year growth of 2.6% in April 2019.

Irrespective of credit developments, I believe we all agree that wealth and economic development always go hand in hand with entrepreneurial initiative. A country cannot progress without entrepreneurs and companies deploying their resources, efforts and work, while risking their reputation and assets, to service society, on many occasions creating

[1] As is known, some economies, such as the United States, depend less on bank financing as their markets are much more developed. In the EU, attempts are being made to develop the so-called Capital Markets Union (CMU), but we are still far from having a truly alternative financing channel to banks, excepting large corporations.

something new, different and innovative. Of course, this is an area where Catalonia has always been a point of reference within Spain.

Though we may tend to forget, Spain continues to have European and even global leaders among its companies, which are a benchmark in their sector.

Undoubtedly, to develop and grow, business activity needs financing. Hence the significance of banks for economic development. In this respect, when institutions manage their risks appropriately, they are promoting an effective allocation of available economic resources.

Banks' risk analysis and evaluation, prior to granting financing, means they act as an essential filter for the functioning of the economy. They enable the correct allocation of available financial resources by distinguishing between those projects with a high probability of success and those lacking in medium-term viability.

True, excessively tight lending standards may act as a brake on innovation and growth. But, as we have seen, when this filter does not work properly, and when lending standards are excessively loose, ultimately too many projects that prove non-viable are financed, destroying value for the economy.

Lessons from the crisis

One thing the crisis has reminded us of, sadly, is that financing a firm or individual which, a priori, has little chance of meeting its payment obligations is very poor business, for three reasons. First, economically, this is a bad agreement both for the customer concerned and for the bank. Second, it is too for the country's legal system, which sees a significant increase in its workload, thereby delaying and hampering its workability. And third, from a social standpoint, what is involved is very poor business with harmful consequences for society in the form of dismissals and evictions.

It is always better not to have granted a loan than to have to deal with a non-performing loan, although some error in granting loans is inevitable. Moreover, looking at our real estate bubble, it is likewise obvious that any loan should be granted thinking of the likelihood of both the principal and the associated interest being repaid, instead of basing oneself on the value of the collateral.

Of course, the responsibility for analysing the ability to pay falls on the bank, not on the customer. Undoubtedly, applying strict standards means having to say “no” on many occasions to applications for funds. And at times of heady growth, this entails very bad press and is difficult for the bank to assume, particularly if the competition is lax in its lending standards.

Naturally, it is tempting to imitate the competition when a strategy produces short-term profit. Those banks that decide not to follow this path will undergo pressure from the market and shareholders to imitate their rivals and boost those business areas that are proving profitable at that time. Risk culture plays a crucial role in being able to withstand such pressure.

Let us not forget that runaway credit growth and the subsequent build-up of structural imbalances on the balance sheet do not produce evident negative effects during an upturn. On the contrary. Such growth enables banks to increase their profitability, entailing a false sense of security and of good times that – mistakenly – warrants growing risk-taking. Even the supervisor itself may succumb to this false sense of security.

However, this strategy is heading for disaster if there is a change in cycle. The scale of potential losses will be directly proportionate to the volume of lending irresponsibly granted.

Both supervisors and banks must be fully aware of the road ahead in this situation, looking always to the long term. As I said earlier, supervisors and supervisees have an interest in common: for banks to continue servicing their customers in the future. The problem, of course, is one of terms: the long-term business sustainability objective clashes with other short-term objectives, in particular the search for swift profit, under the pressure occasionally of shareholders.

Changes in bank regulation, management and supervision

Keynes once criticised those unprofessional bankers who imitate the short-term strategies of their rivals only to hide behind the behaviour of the sector as a whole as justification for their own mistaken decisions.[2]

Unfortunately, the crisis suggests Keynes may have been right. Though not so in all instances, the search for short-term profit may lead to the pursuit of risky strategies, despite the fact that this may compromise the bank's future in the medium and long term. We have also seen that, if a large number of banks coincides in a mistaken strategy, entailing future problems, the problem ceases to be an individual one and become systemic, and individual responsibility is diluted.

I appreciate that the question we must ask ourselves here is what we have changed in attempting to correct this type of behaviour. Or, expressed otherwise, why should this time be different?

Regulatory changes

Firstly, deep-seated changes have been made to the regulations applicable to banks. The biggest revolution is in the Basel capital framework, which has been reformulated in its virtual entirety so as to incorporate the lessons from the crisis.

The changes are far-reaching, and describing them would alone take up the rest of my address today. I shall confine myself to saying that the changes have affected all the elements making up the well-known capital ratio, which is the centrepiece of solvency regulations.[3]

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[2] "A sound banker, alas, is not one who foresees danger and avoids it, but one who, when he is ruined, is ruined in a conventional way along with his fellows, so that no one can really blame him."

[3] Any regulatory ratio is structured on the basis of the definitions of what should eligible for calculation purposes, both in the ratio's numerator and denominator, and of the level it should reach. The new regulations have changed these three elements of the ratio: (i) the numerator shows a figure for capital calculated in keeping with a new, much more demanding definition; (ii) the way in which risks are translated into weighted assets has been changed in the denominator and various caveats have been added regarding the use of internal models; and finally, (iii) the required ratio level has been raised considerably, and additional "buffers" have been added, inter alia, to cover the risks systemic institutions evidence.

While the capital ratio is important, it is not by any means the only significant measure. The crisis has shown that focusing solely on one metric may be counter-productive. Thus, other elements have been added. These complement the classic solvency metric, and relate to banks' liquidity or leverage. Moreover, the focus has been placed on banks' business model and governance.

Lastly, specific remunerative arrangements have also played a significant role in encouraging short-termist behaviour. One rather controversial novelty, especially in investment banks, has been to introduce ceilings on and restrictions to credit institutions' remunerative policies, the aim being to correct or, at least, mitigate certain perverse incentives.

Supervisory changes

Yet despite all these regulatory changes, we must be aware that no rules can stand in for proper supervision. The role of supervision remains essentially the same: it is preventive.

It is usually said that July and August forest fires are controlled and extinguished in the preceding months of March and April. At this earlier time, scrub is cleared and firewalls are set in place, enabling the future advance of the flames to be controlled. If the homework is not done in the spring, we pay the consequences in the summer.

Likewise, the fundamental role of the supervisor is to prevent. This means ensuring that, during upturns in the economy, the lending granted by banks has been correctly analysed and its price set so that the risks assumed are covered. That prevents excessive growth in lending that may lead to bubbles emerging.

Sadly, one of the lessons from the crisis is that our ability to act as supervisors is limited once the banking crisis has broken, and the solutions are always costly and painful.

New perspective: macroprudential supervision

So far I have referred to the so-called microprudential perspective of supervision. This focusses on ensuring the robustness and solvency of banks individually without evaluating their potential interconnectedness with other banks and markets, and their exposure to common economic factors of risk.

Something particularly worrying is the fact that banks fully complied with solvency rules during the build-up of our real estate bubble. Although the rules have changed so as to correct and avoid specific incentives, it cannot be ruled out that structural imbalances may accumulate again on bank balance sheets, just as they did during the pre-crisis phase.

Nor can it be ruled out that assets located in segments or geographical areas may be overvalued. If we look, for example, at real estate credit, we can see that we are far from the pre-crisis situation, since new real estate credit shows much healthier loan-to-value and affordability ratios. Nor are house prices overvalued if we look at Spain as a whole. However, and I believe here that Madrid and Barcelona are similar markets, in some places prices are reaching pre-crisis levels.

Consequently, and as a complement to the micro view, so-called macroprudential policy has emerged. Its aim is to boost financial stability by preventing and mitigating systemic risks and vulnerabilities, while also assessing potential imbalances or overvaluations that may affect a specific sector in our country. In this respect, it is not only individual risks that are considered; these are assessed in an aggregate fashion.

In sum, macroprudential policy complements microprudential supervision. Both are necessary, though both differ in terms of focus, instruments and the way risk is evaluated. Micro-supervision seeks to improve the safety and soundness of financial institutions, while macro-supervision focuses on the health of the financial system as a whole.

Since 2014 the Banco de España has indeed been identifying and monitoring vulnerabilities in the financial system, and it also has the possibility of introducing countercyclical capital buffers. Along these same lines, we have recently been given the possibility of using tools other than the mere activation of capital buffers. These tools are more specific, enabling us to take action focusing on the credit segment where imbalances may be concentrated.

Changes in banks, governance and business models, and changes in society

In any event, as supervisors we cannot ensure the sustainability of banking business in the long run. Actually, the keys to such sustainability have always been in the hands of banks themselves.

I should like to talk about some of these in-house keys. Specifically, I shall refer to governance and those aspects that should have a bearing on banking business models, some of which in direct response to changes in society.

Bank governance

As many of you are aware, governance is an aspect I often bring up in my speeches. I consider it to receive little attention, despite the fact that, in my view, it is a necessary though not sufficient condition for the proper functioning of banks.

Governance is not something totally quantifiable or directly measurable. Unlike any of the ratios we are used to handling, there is no minimum level of governance that banks should reach. Governance is a means of doing things and a culture. And attaining it is an objective that takes some time to be implemented. All this makes it difficult to transmit a sense of urgency.

Yet without proper governance, the conflicts of interests that arise daily at banks cannot be managed. When a conflict of interest arises, the bank must create a control function. Evidently, the control function will only work if it is independent and strong; otherwise, it will be neutralised or absorbed by the pressure of daily business.

We have seen how, without proper governance, control functions are lacking in weight and effective power. This gives business units excessive influence and even, occasionally, exclusive influence over day-to-day bank management.

Ultimately, then, it is governance that allows banks to manage the conflict in question which arises between the search for short-term profit and the bank's sustainability and viability in the long-run.

Regrettably, we have seen how, as the crisis was brewing, a good number of banks behaved just as Keynes had predicted they would. Others, in contrast, decided not to emulate their competitors or to do so to a much lesser extent. I believe the quality of governance structures had much to do with this uneven behaviour. But there is always room for improvement.

Business model and relationship with customers

I would like to offer some thoughts now on the reputation of banks and the relationship with customers in the context of the sustainability of banks' business model in the long run. Needless to say, banks face the challenge of re-forging their image before the public at large and their reputation with customers.

As regards reputation, banks are hostages to their past, as has occurred with the credit crisis. The economic and reputational losses they have incurred are directly related to past actions and behaviour.

Here, we must accept that it is very difficult to combat the sector's negative image while cases from the past are cropping up.

I believe the lesson here is the same as that for bank solvency: we must draw a line in the sand. We must move forward, and change behaviour and the relationship with customers to construct a viable business model for the medium and long term.

Four years back the Banco de España reinforced its conduct-related supervisory activity. We have observed how, in general, banks have been striving to set in place the measures needed to correct behavioural practices. But much remains to be done.

I stated once that we should be fair to the financial sector and acknowledge that customer-protection regulations have changed significantly in recent years. True, society has also evolved, and with it the demands in respect of the transparency, diligence, rigour and integrity expected of banks.

A good reflection of this new manner of conduct is in the recent real estate credit legislation. The financial crisis has given rise to more demanding legislation that calls on banks not only to inform but also to act impartially, transparently and professionally, taking into account the rights, interests and needs of their customers. It may be said that the regulations now transcend mere transparency in form.

One very positive aspect of the legislation is the improvement in legal certainty. Clearly, by properly protecting the customer, the risks of litigation are being significantly reduced. And such risks are one of the main costs the sector has been bearing.

Let us not forget that the cost of litigation far exceeds any potential benefit that some banks might have obtained in the short term through questionable conduct. Moreover, improper conduct does not only affect those banks guilty of it, but the reputation of the sector as a whole.

To conclude, this new type of customer-bank relationship must be the starting point for any sustainable banking business model. Naturally, if it is to be successfully set in place, a top-to-bottom cultural change is essential in the organisation. This change will be headed for failure if the bank's senior officers and management do not offer their resolute support. Once again, we are talking about governance as a precondition for change to occur.

Financial education

I have highlighted how society's demands with regard to banks' behaviour with customers have increased considerably. This awareness also reflects the difficult economic and financial context in which we have been moving.

Evidently, financial end-consumers, especially individuals, are the weakest party in the customer-bank relationship.[4]

Hence the importance of banks behaving irreproachably when it comes to advice to customers to engage their services. However, we should acknowledge that the starting point is a significant shortfall in financial knowledge among citizens, a fact that may have been conducive to erroneous decision-making.

Evidently, to be able to take an economic decision properly, a customer must be in full possession of all information and capable of understanding the implications that may arise in the future from what is to be signed. For instance, the consequences of taking on a variable interest rate throughout the life of a 30-year loan need to be understood, and variable income must be assumed to be so-named because of its variability.

Admittedly, the younger generations are facing growing challenges arising from labour market aspects. These include the lack of job security, the need for flexibility and mobility, and property market developments. They are also especially affected by the structural changes in society, such as increased life expectancy or the reduction in the birth rate. This all involves the need to plan carefully for the future.

We should not forget that education and financial knowledge are essential for improving financial inclusion. Clearly, digital transformation may help in this respect, especially in remote or thinly populated areas. However, this poses a new challenge for users with little prior experience with digital tools, or with little financial knowledge, as they will not be given personalised advice when engaging services.

Mirroring what I have said, concern over citizens' level of financial knowledge has been increasing in recent years. In developed and emerging countries financial education is viewed today as an essential element of stability and balanced economic development in society.

On OECD recommendations, many countries have developed national financial education strategies. In Spain, since 2008, the Financial Education Plan has been rolled out by means of a collaboration agreement between the CNMV (National Securities Market Commission) and the Banco de España, subsequently entered into also by the Ministry of the Economy and Enterprise. We consider these efforts to be essential and wish to boost them further in the future.

[4] It is widely known that the engagement of banking services is through standard form contracts, which hamper or prevent negotiation between the two parties.

In addition, it has been opted to integrate financial education into the compulsory secondary education system, and specific subjects address these matters in greater detail in higher secondary education.

Notwithstanding these efforts, much clearly remains to be done. According to the results of the 2015 PISA report, which evaluated for the first time the financial capabilities of pupils at the end of their secondary education, Spain stands significantly below the average for the 15 countries that participated in this evaluation, and it is ranked eighth out of the 10 OECD member countries that participated.

Sustainable finance

One last change directly affecting us, and which merits highlighting, is the environmental challenge. The term "environment" should be viewed as broadly as possible here. Previously, when talking about the environment, I was referring to the regulatory framework in which we move, to the prudential supervision we undertake, to the economic reality in which agents act and to society as a whole. Now, "environment" must go beyond this, referring also to climate and to the consequences human actions have on it.

It is here, moreover, that the aforementioned conflict between short-term actions and future benefit, in the very long term, are most manifest. The long term in this case is related to the life of future generations, which magnifies the importance of the matter.

If we turn to look at society again, there is clearly growing awareness regarding the climate challenge.

What are the public authorities doing in this respect? Though not with sufficient speed, it is to be acknowledged that the ecological transition is gaining visibility and importance on the agenda of international financial organisations.

There are a wealth of initiatives at present: the G20, the United Nations, the Financial Stability Board and the OECD are all involved. And notable within the EU, undoubtedly, is the European Commission's action plan on sustainable finance. In the case of Spain, we should mention the Draft Climate Change Law.

In the central banking and banking supervisory milieu, I would mention the work of the Network for Greening the Financial Sector (NGFS). We participate actively in this network, which has just published its second report. This includes best practices for boosting the role of the financial sector in complying with the Paris Agreement.

Banks themselves are increasingly joining ethical or responsible banking initiatives, observing international principles that not only look at environmental sustainability aspects, but also at the social impact of investments. The development of so-called "sustainable bonds" is also being encouraged. These are much in demand by investors, for which a growing market is being created.

We should be mindful that compliance with the Paris Agreement goals necessarily entails very substantial changes in our productive model. Clearly, too, to be successful, any transition of this type must include far-reaching measures and instruments that affect practically all economic agents, not only credit institutions.

However, banks can and should play a key role in this transition. At the start of my address I talked about the fundamental role of banks as a necessary filter for distinguishing between viable economic projects. Likewise, if banks incorporate the risks arising from the ecological transition into their analysis, they will become an engine for change: they will help financing reach those activities which, in addition to being economically profitable, contribute to the sustainable transformation of the economy.

In turn, as a central bank we are also in the process of incorporating the environmental factor into the internal ratings used to evaluate the eligibility of banks' collateral, and into the criteria used for taking own-portfolio investment decisions.

Conclusions

That brings me to the end of my address. The crisis has been severe and has had consequences at all levels. We have overcome its acute phase, but its legacy remains present. In response, regulation and supervision have changed radically, taking on board lessons we must never forget and equipping supervision with a set of tools necessary for preventing future crises.

Society has also changed. Specific values, such as growing awareness about climate and inclusion, have become more important. The demands made of financial institutions, supervisors and the public authorities have increased, along with society's financial knowledge. However, we must continue to boost education, as a tool for fomenting stability and balanced economic development in society.

We must all take note of these changes and rise to the demands being made of us. What we do today will determine the type of future we will have.

As Woody Allen said, the future is where we will be spending the rest of our lives, so we should all take an interest in it.

Thank you.