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Situation and outlook of the Spanish financial sector

24th S'Agaró Economics Symposium: "Where is the world heading?"

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Thank you very much for the invitation to participate in the 24th S'Agaró Economics Symposium.

A total of 24 symposia is a considerable number, which is undoubtedly a sign of their importance and significance. Clearly, though, the privileged setting where they are held should definitely help to sustain interest every year.

The **title of this symposium is “Where is the world heading?”**. Consequently, **I'm going to talk about the future of banking**. However, to talk about the future we must be aware of our current starting point and, for that reason, we must understand our past.

If we go back 10 years, I think the word which would best define the situation of the banking sector would be **“oversized”**. This was caused by the process of excessive credit growth, in particular of real estate developer loans.

This excessive credit was accompanied by a **considerable easing of credit standards, tying the credit** in many cases **to the value of the collateral rather than to the ability to pay**. It did not take long for **negative effects** to emerge: there was **an unprecedented surge in NPLs and an ongoing adjustment in the volume of credit**.

Consolidation

As a result of these adjustments, the **banking sector** saw **abrupt consolidation**. In terms of figures, since **2009 the number of banks has fallen by more than 30%**. Specifically, the **number of branches has decreased by more than 40% (approximately 20,000)**, while **staffing levels** have been cut by more than 30% **(around 90,000 fewer employees)**.

Although efforts have clearly been made, **consolidation may not be considered to be over yet**, particularly where **reducing overheads is one of the few “levers” available for improving the bottom line**.

The present

The bank representatives who are with us today will agree that the current setting for the banking business is increasingly complicated. In addition to the **need to continue to reduce non-productive assets**, there is pressure **to improve solvency levels**. This is against a **backdrop of negative interest rates** which bring pressure to bear on margins (where talk of **“low for long”** has been replaced by **“lower for longer”**), and of **increasing competition with the emergence of non-banking actors**. Further, **the sector continues to be dogged by previous problems in the form of litigation and loss of reputation** on account of certain actions in the past.

The banking sector must respond to the very complicated and competitive environment shaped by all these challenges and difficulties. The question is: how? The **answer lies in banks' business models**. One **key aspect of this future model is sustainability and another is that technology must play a core role in it**.

Beginning with the model's sustainability, we should recall how, **before the crisis**, **certain banking operations were apparently highly profitable**; unfortunately, **those same operations caused enormous losses once the crisis had broken**, both in the form of bad debts and court decisions handed down against banks due to questionable action.

The banks' pre-crisis **model** was unquestionably **profitable but also** no doubt **unsustainable**. To sum up, profits in the short term became massive losses in the medium and long term. Evidently, this should be a powerful reminder for us when looking ahead.

The future

How can we avoid such short-termism from recurring? In my speeches, **I always like to refer to two key points: governance and customer relations**. Both are **long-term** aspects which are essential for ensuring future business sustainability. Yet **they do not involve an immediate improvement in the bottom line**. Quite the contrary. Consequently, **in such a complicated setting** as the present, it is **easy for these points to be considered as secondary**.

However, **without proper governance, banks cannot manage the conflicts of interest inherent in banking**. These include most notably the conflict which arises between the search for short-term profit and the bank's sustainability and viability in the long run.

Observing the unbridled credit growth and the weakening in credit standards, we can readily conclude that, regrettably, before the outbreak of the crisis short-term incentives prevailed over long-term ones.

As for **conduct**, I would like to briefly point out **two reasons why a change in the customer relations model will be vital in the medium and long term**, although in the short term it means giving up a specific type of business.

First, the **banking business is based on trust and reputation**, an intangible – albeit highly valuable – asset. A reputation is built up over a long period of time but can be lost in the blink of an eye. **The banking sector faces the challenge of rebuilding its image while cases from the past are cropping up**, which seems very difficult. However, **it is precisely banks' current conduct which will cement their reputation going forward**.

Second, in addition to the need to rebuild their image, implementing this **change is necessary from a purely economic standpoint**. The **cost of long-term litigation amply exceeds** the potential **profit** that certain banks might have obtained **in the short term** through questionable behaviour.

Let me refer to the challenge of **technology which – in my opinion quite rightly so – is one of the focal points for discussions at this symposium**.

Obviously, technology **is part of the response needed at present to increasing competition** from non-banks, **but it must also be part of the thinking about the business model of banks and their long-term sustainability**.

In a nutshell, **technology is a core feature for business strategy, competitive positioning, cost savings, and better risk management and profitability of operations with customers.**

I think that there are **two dimensions to the digital revolution, both of which are highly significant.** Firstly, there is the “**outward**” dimension which, if you allow me the analogy, would be the externally visible tip of the iceberg **determining something as important as customers’ perception of the bank.** The **interoperability with users, app quality and user experience** are key aspects today and will be ever more so in the future.

However, continuing with the analogy, it should not be forgotten that almost 90% of the iceberg is underwater. This hidden part is even more significant since, without it, the visible 10% could not function. As for consolidation and mergers, it should not be forgotten that **virtually all the current banks are the outcome of merger and concentration processes** and, surprising as it may seem, in many cases **they use the software of banks that disappeared some time ago.**

The existence of **non-cloud based applications without technical support** and for which, in certain cases, there is no alternative or no replacement planned, is regrettably commonplace. Except, that is, in the case of the so-called “neobanks”. Accordingly, it is essential to also make this **technological change “inwardly”.**

It is public knowledge that **the sector has announced major investments** in this field over the next few years, which indicates the strategic importance of technology. Clearly, **investing heavily in systems** is particularly difficult against a background of cost-cutting. Nevertheless, **today’s investments will be pivotal to future income.**

It seems clear that in future **efficiency gains will be closely linked to technological change.** Most **banking transactions** in Spain **continue to be performed via ATMs and at branches, notwithstanding the fact that the percentage of on-line users grows each year.** In step with this trend, **potential cost savings from this channel may be significant.**

Adding to what I said earlier, there is another key aspect of the future business which also hinges on technology. Naturally, I am talking about data, which are the raw material of this fourth industrial revolution It is usually said that **big tech’s interest in banking is more closely related to data than to the banking business in itself,** which is why there is a potential threat from the entry into force of PSD2. But, stating the obvious, **it is the banks that currently have the data.** Nevertheless, **if the banking sector does not make the most of this advantage today, other new competitors will do so tomorrow.**

In this respect, **having the information is not the same as being able to exploit it.** Banks’ access to the information is of no use if they do not extract, exploit and analyse their customers’ data as part of their daily management and, in particular, in loan origination and price-setting. **In a context like today’s, lending at a loss is not feasible. Each transaction needs to be assessed in terms of risk and cost.**

This matter gives cause for concern and hope. Concern, because based on the preliminary analyses of the European supervisor for virtually the whole sector, **there seems**

to be no correlation between the price of loans and their underlying risk. Hope, because the poor starting position **provides us with another “lever” to improve efficiency and raise profitability,** which are the real central issues in the current interest rate environment.

Looking ahead, **one last challenge** worth mentioning is the **environmental challenge**. I would like to point out two things. Firstly, **the consideration of sustainability factors in loan origination is a very significant change which supervisors are actively encouraging** and that **banks are gradually assimilating**. Banks are increasingly joining ethical or responsible banking initiatives, by adhering to international principles, and supervisors are making considerable efforts to adapt their structures, analyses and methodologies to this change.

Secondly, in addition to the risks that the banking sector must monitor and manage, the **ecological transition also involves opportunities** which banks should harness. To offer a specific example, according to the **EU's action plan** on sustainable finance, it is estimated that **around €180 billion of annual investments will be needed during the period 2021-2030** to achieve climate and energy targets.

Thank you very much. I am sure that during the question and answer session, we will have the opportunity to look in depth at these and other matters raised by fellow panel members.