Interview with the Deputy Governor Margarita Delgado Tejero

November 2019 marked the fifth anniversary of the SSM's launch. Since then, this project has significantly changed the supervisory methodology and approach. Which, in your opinion, are the most important changes?

Supervisory arrangements have changed significantly as a result of the SSM's launch. Evidently, the new framework in which both the European Central Bank (ECB) and the National Competent Authorities (NCAs) participate has necessitated significant adaptation efforts. We must bear in mind that continuous monitoring of significant institutions falls to joint supervisory teams comprising personnel from the ECB and the respective national competent authority. The efforts to harmonise supervisory practices are also worthy of mention.

A single supervisory system naturally requires a consensus regarding common practices and methodologies. Therefore, we actively participate in international working groups where these work methodologies are agreed upon. A case in point is the Supervisory Review and Evaluation Process (SREP) which, as set out in this report, is the continuous monitoring teams' central and most demanding task. The SREP is based on a common methodology that continues to evolve, owing to new legislative developments and the issuance of new guidelines by the European Banking Authority (EBA) and the ECB.

Stress testing is also to the fore, having become a core tool for supervision. The ECB runs EU-wide biennial stress tests, which alternate with thematic reviews. The outcome of the exercises is fed into the SREP. Again, it is key that all NCAs participate in the development of stress-test methodologies, which are constantly evolving.

In short, clear progress has been made, although the process of switching from an exclusively national supervisory model to one based on a common culture, methodologies and practices requires even greater coordination. That remains a challenge for everyone.

Last year you told us that, while the launch of the SSM had contributed to the integration of the European banking market, some matters were still outstanding. One year on, how complete is the Banking Union?

The SSM's and the SRM's respective launches were very important milestones for the integration of the European banking system. Clearly, they have significantly increased its soundness. Nevertheless, a year later, the Banking Union is still lacking one of its three basic pillars, the European Deposit Insurance Scheme. This pillar would help increase financial stability in the region, particularly at times of stress, which is really when the resilience of structures is put to the test. Discussion about ending the deadlock concerning the third basic pillar of the Union recently resumed; for example, the German Finance Minister's opinion article for the Financial Times, in which he intimated, albeit very warily, that he would consider this possibility.

Nevertheless, we must underscore that, in addition to finishing the Banking Union, other elements are required to move towards a more complete union. First, euro area regulation requires greater harmonisation; for example, matters that in the Capital Requirements Directive (CRD) remain under national discretionality, or the legal framework governing winding-up proceedings. And further, resolute impetus needs to be given to the "Capital Markets Union", which would supplement the Banking Union.

Do you think that today's credit institutions are more solvent and profitable as a result of banking supervision being consolidated at the European level?

In recent years, the supervisory focus has been on banks' recovery and the cleaning-up of their balance sheets, and emphasis has been placed on the need to strengthen their solvency and profitability ratios. An example of this would be the SSM's *Guidance to banks on non-performing loans* published in March 2017, and its *Addendum* the following year. In all fairness, banks have risen to the challenge and made significant strengthening and cleaning-up efforts.

The outcome of this difficult process is that European banks are in a much sounder position than in prior years. If we focus on Spanish banks, the resident private sector's non-performing loans have fallen 69% from their end-2013 peak, when they amounted to almost €190 billion. In September 2019 they totalled €58.5 billion.

Spanish banks have also endeavoured to improve their solvency. Even so, it is common knowledge that our solvency ratios are currently one of the lowest in Europe. Since the SSM's launch, banks in other jurisdictions have improved their capital ratios more than Spanish banks. In this period, European banks have increased their fully-loaded ratio by 290 basis points (bp) on average, compared with Spanish banks' 200 bp increase.

The gradual entry into force of certain aspects of Basel III over the past five years has afflicted the capital ratios of Spanish banks more than those of its European peers. For example, the deductions of goodwill from capital directly impacted the most global Spanish banks. Goodwill is of course the result of a business model based on international expansion through subsidiaries, which offers advantages over expansion through branches. It has, however, had an impact on capital, although this has now ended.

I would like to send two positive messages. First, we must not forget that our starting position in terms of leveraging is better than the European average; reduced use of internal models is, to a certain extent, behind this. Second, I would point out that the yet-to-be-implemented aspects of the Basel III framework (specifically, the output floor) will have a reduced impact on Spanish banks, owing precisely to their lesser use of internal models. Therefore, the gradual entry into force of those aspects of Basel III still outstanding is an opportunity for Spanish banks to improve their solvency position in absolute and relative terms.

In any event, banks must plan appropriately for their future capital needs, taking into consideration business projections and the future legislative changes I have mentioned, so they may to continue to operate with sufficient headroom. Such planning must include the new recovery and resolution framework, which will require new issues of eligible liabilities.

What avenues can banks pursue in the search for yield?

First and foremost, banks must perform an individualised analysis of their respective business models to assess how they should respond to the environment's new requirements. That will give an objective diagnosis of their strengths and weaknesses, and they can also assess their performance in technological-innovation and customer-relations terms.

There is no standard approach. Analysing the business models, we can see that the banks with the best profit ratios have different strategies. However, they share a set of levers, in particular improvements in management (e.g. adjusting the profitability required on the basis of the risk assumed at transaction level), the search for new business areas and, of course, cost streamlining. A common denominator in these initiatives is digitalisation, from the standpoint of improving management and business, and the potential cost savings.

To cut costs and improve efficiency, banks have actively outsourced information technologies and used cloud services in recent years. Banks therefore require a detailed analysis of the outsourced function and appropriate governance so as to maintain effective control over all those functions. The analyses and controls must be proportionate to the risks associated with the outsourcing; therefore, all due rigour will be necessary where the activities are deemed to be core business.

Also, mentioning mergers is practically unavoidable when talking about maintaining profitability levels and becoming more efficient in the current climate. We, the supervisor, are usually asked about the mergers that are under consideration or which mergers are a priority. As I have repeatedly stated, our role is not to go into that type of generic assessment. Instead we should stick to the objective assessment of any merger proposal from the industry and evaluate whether it enables the resulting bank's solvency and profitability to be improved and whether the business plan generates value added overall.

Unquestionably, there has been a radical consolidation of the Spanish banking system since 2009. However, given the extremely competitive environment at present, more mergers may still be forthcoming in Spain, especially when reducing structural costs is one of the few "levers" available to improve the bottom line.

You propose technological innovation as one of the solutions for the search for yield and progress in the business model, but how do banks go about that adaptation, and what new obstacles or challenges does it entail for supervision?

Technological change is, in effect, one of the main transformations banks must undergo. It's a complex subject, but there may be a significant correlation between gains in efficiency and technological change. The percentage of online users grows each year; therefore, and despite this meaning that larger initial investments are required in a context of needing to cut costs, the potential future saving may be quite significant.

Nor can we forget that intensive use of technology increases banks' exposure to significant risks that should be taken into consideration. The materialisation of this type of risk, such as that associated with cybersecurity, has an almost immediate impact that goes beyond direct economic losses and may affect banks' reputations and customer confidence. We must also bear in mind the numerous connections between the various players in the financial system, which mean that a single incident could spread very rapidly and reach systemic levels. As supervisors, we should be prepared to understand those risks, identify them, work to prevent them and act swiftly where necessary.

Banks are making significant progress to adapt to these new requirements, evidenced by the bolstering of digital channels. They are also making in-house investments to redesign their IT systems, refine their knowledge of modern technologies and implement structural changes for a more cross-departmental and customer-centric organisation. That banks should be able to extract, use and analyse their customers' data is essential. This information should obviously be used when making decisions on underwriting and pricing. There is a lot of room for improvement in this area and Spanish banks are in no worse a position than their European rivals.

In addition to the challenges inherent to this new environment, in 2019, as a result of the implementation of the Second Payment Services Directive (PSD-2), new financial actors emerged. Together with the fintech companies, these players represent greater competition for traditional financial institutions.

PSD-2, whose aim is to improve retail payment security and encourage innovation, has resulted in the need to supervise new intermediaries and to step up the supervision of existing providers.

Another major challenge posed by digitalisation is the key role of Big Tech. Big Tech companies, whose business focuses on, among other areas, being cloud service providers, are starting to create a complex ecosystem of interdependencies with the financial world. This points to the ability to access all kinds of customer information — not just financial information — that will play a key role in the coming years.

These activities are often very opaque for the authorities and may potentially have repercussions for financial stability, competition or consumer protection. Their impact is currently hard to gauge.

Consequently, to address these challenges the Banco de España is closely collaborating with authorities at international organisations such as the Financial Stability Board (FSB) and the Bank for International Settlements (BIS). Our main concern should be to focus on the transformation in the provision of financial services, maintaining appropriate levels of stability, security and customer protection while simultaneously enabling the incorporation of the efficiency gains that new technologies afford. To do so, it is important to have a set of rules ensuring a level playing field, so that similar risks arising from similar activities are subject to the same rules, regardless of the provider. Ideally, all players should have access to the same information sources.

Governance is one of the areas that has come under special monitoring from the supervisor. How can improvements in corporate governance help banks achieve their objectives?

Governance has always been a focal point for supervisors. This is by no means a new development; that said, it has acquired greater relevance, if that were possible, in the wake of the financial crisis. At times like this, faced with major challenges that need addressing (low interest rates, technological change, changes in the business model, etc.), we can fall into the trap of believing that improving governance is something secondary; that it's desirable, perhaps, but not a priority.

Admittedly, improvements to governance are clearly not enough to ensure a bank's viability in the medium and long term. But I strongly believe that they are necessary. Proper governance can prove conducive to seeing all levels of an entity's management forgo strategies that seek a short-term benefit based on assuming excessive risks, which could jeopardise business sustainability. Governance also has an important role to play in preventing events that can affect a bank's reputation in the future.

Along these same lines, do you think that the customer relations model could also contribute towards the long-term sustainability of the business model?

The banking sector faces the challenge of rebuilding its image in the public mind and its reputation with customers. Indeed, when the SSM was launched five years ago, supervision of conduct became functionally independent from prudential supervision, which remained a wholly national competence. Since then, supervisory activities have endeavoured to strengthen banks' compliance policies and encourage them to adopt better standards in the area of customer relations.

Customer protection regulations have seen significant development in recent years, in tandem with the changes seen in society. Both represent a clear step-up in the requirements regarding the transparency, diligence, rigour and integrity expected of banks. A good example of this new way of operating is the recent Real Estate Credit Law, which regulates the legal regime, and establishes new obligations, for real estate credit intermediaries and real estate lenders. Banks must provide their customers with financial products that are appropriate to their needs and capabilities.

In addition to the greater protection afforded to consumers of banking services, another highly positive aspect of this approach is the improvement to legal certainty, enabling the sector to strengthen its reputation going forward. Clearly, litigation and the associated uncertainty seriously harm banks, because of both the related cost and the impact on reputation. That said, we should also remind ourselves that, ultimately, it can also be negative for the end-customer. Uncertainty means that sometimes it is impossible for the costs and risks of a transaction to be known, which may have the effect of freezing up the market or raising the cost of bank loans.

As we have seen on other occasions, expanding and improving banks' compliance policies will be key elements in the medium and long term. If implementation is to be successful, a cultural change must permeate the organisation, with the unwavering support of senior management and the management teams.

One of the areas that can most affect a bank's reputation is money laundering. What role does the prudential supervisor play in this area?

Recent cases at the European level have shown that a critical element of an institution's viability is the quality of its anti-money laundering systems. A lack of control is closely linked to weak governance and deficient risk controls.

As supervisors, we are increasingly aware of the importance of the prevention of money laundering to banks' business models, the sector's reputation and, as a result, financial stability.

During 2019, the authorities have acted on this growing interest to achieve a series of milestones. The ECB, the EBA and the Banco de España have released statements highlighting the importance of this area for prudential supervision. Anti-money laundering and countering the financing of terrorism (AML/CFT) competent authorities (in Spain, the Commission for the Prevention of Money Laundering and Monetary Offences (CPBCIM, by its Spanish abbreviation)) have signed a multilateral agreement for the exchange of information with the ECB, as prudential supervisor. The EBA's role in this area has also been reinforced, and the Capital Requirements Directive (CRD-IV) has been amended to incorporate the risk of money laundering in the SREP.

Another clear development we have seen in society has been the so-called "Environment Challenge". We are aware of the Banco de España's clear commitment to this issue, but what steps are being taken to move forward here?

We are working on several fronts. First, we are attempting to raise awareness within the sector to foster the development of methodologies and controls that will enable banks to assess and quantify the risks associated with environmental transition. Included here are physical risks directly caused by climate change and transition risks related to the effect of the regulatory measures aimed at achieving a sustainable economy.

Further, as supervisors we must also be capable of assessing the impact of these risks on the banking sector. Among other courses of action, we are working to include these risks in the stress tests so as to observe banks' responsiveness to adverse events. To this end, within the SSM we are actively participating in the design of internal governance structures and methodologies, which will bring about a cultural change in the supervisory model.

We have also launched several initiatives to help raise awareness of the importance of this issue. For instance, there have been workshops and meetings with the industry to learn more about how the sector is coping with climate change and to promote its transformation.

There is certainly much to be done. I would however like to highlight the striking pace at which initiatives are moving and changes are being introduced. In this regard, the history of the Network for Greening the Financial System (NGFS) is illustrative. The NGFS, a network of supervisors and central banks in which the Banco de España actively participates, was created barely two years ago. But in this very short period of time it has published two comprehensive reports and guidance for central banks' investments. And not least, its membership has surged from 8 to 59 members and 12 observers.

In the Banco de España we have set up the Environmental Management Coordination function to foster sustainability internally and minimise our environmental impact. Also noteworthy is the announcement by the Banco de España in September that it would participate in a green bond fund launched by the BIS.

Moreover, the Eurosystem has included environmental sustainability objectives in the monetary policy strategy review recently launched by the ECB.

Lastly, I would also like to point out the high level of participation by the banking sector in this issue. A good example here was the sectoral agreement to combat climate change, signed during COP25 by more than 20 institutions representing over 95% of the Spanish financial system.

How do you think Brexit will affect Spanish banks? What measures have been taken by the supervisor to mitigate the possible effects?

Let's be honest and admit that we are all uncertain, to some degree, when it comes to Brexit. We must bear in mind that the withdrawal agreement signed on 31 January 2020 is not an end point; it merely marks the beginning of the 11-month transition period for negotiations between the European and UK authorities on our future relationship. This will be a complex task, no less so given the very short period of time for completing it.

As supervisors, we have considered for some time that this matter is a priority, both in banks' analyses and in terms of supervision. In this regard, we have encouraged Spanish banks to draw up action plans that will ensure the continuity of their cross-border business. Furthermore, both the Banco de España and the ECB have strengthened their cooperation with the authorities responsible for prudential supervision and financial conduct in the UK.

In any event, we should not forget that the financial autonomy model adopted by Spanish banks ensures that the potential risks are almost solely macroeconomic in nature and are tied to the trend in activity in the United Kingdom and the sterling exchange rate.

Banks are also subject to other external threats. What measures are being taken as regards the coronavirus crisis? How does this crisis affect the economy and the banking sector?

The coronavirus crisis is a reminder that we must be ready for the unexpected, especially in a world as globalised as ours. What began as a health crisis primarily affecting certain provinces in China has, in a few short weeks, become a global crisis impacting our lives that will inevitably have an effect on economic growth to a greater or lesser extent.

We are all taking action to tackle this unexpected crisis. Central banks have reacted swiftly and forcefully. The ECB has adopted extremely far-reaching measures and announced that it is willing to extend their scope if necessary. Governments in different countries, among them Spain, are considering robust measures to sustain the economy and employment in this difficult situation. The onus is undoubtedly on the financial system to provide most of the response, which must contribute decisively to avoiding the inevitable halt in economic activity from dragging down companies and small businesses.

As supervisors, we are taking easing measures in order to deploy the resources needed in this situation, such as the possibility of banks mobilising capital and liquidity buffers (designed specifically for this type of scenario), or postponing stress test exercises and any other non-essential supervisory action, so as to fully release banks' resources to enable them to focus on supporting the economy.

From a macroeconomic perspective, events have moved at such a pace that at present it is almost impossible to assess the potential effect on the economy. Obviously, the final impact will depend on how this situation evolves and how long it lasts.

One initiative approved in 2019 for preventing possible financial crises was the establishment of AMCESFI. What is your assessment of its first year of operation? What role do you believe should be played by the new macroprudential tools?

AMCESFI is a collegiate body that, as of March 2019, regularly brings together high-ranking officials from the Banco de España, the Ministry of Economic Affairs and Digital Transformation, the Directorate General of Insurance and Pension Funds (DGSFP) and the National Securities Market Commission (CNMV), which exercise the prudential regulation and oversight powers applicable to the individual sectors that make up the Spanish financial system. AMCESFI plays a highly important role in pooling and coordinating systemic risk analysis and assessing measures and activities related to macroprudential policy. As the vice-chair of its Council and chair of its Financial Stability Technical Committee, the Banco de España plays a prominent role within the structure of AMCESFI.

During its first year of activity, work has focused on laying the foundations of its internal functioning and its organisation. In keeping with its mission, AMCESFI has served as a forum for discussing and sharing information on macrofinancial risks in Spain, presenting proposals of macroprudential measures and assessing recent developments in international committees. AMCESFI is expected to publish its first annual report in 2020.

Given its role in fostering financial stability, I believe that macroprudential policy is key to preventing financial crises. This is an extremely new field. Indeed, the methodologies for detecting overvaluations and imbalances, and the criteria to be followed when adopting and discontinuing macroprudential measures, are still being developed.

However, that is no excuse not to act. We have been provided with tools that would have been very useful in addressing or alleviating the last crisis. As such, we must continue to act responsibly, but also prudently and on a timely basis, should any structural imbalances be detected.

New technologies, green finance, Brexit, new capital requirements, pressure on the income statement, a culture of compliance, strengthened AML systems... the list goes on. Are we looking at a new way of banking?

Both banks and the supervisor are undoubtedly operating in a highly dynamic environment, where we must react quickly so as not to lose our way. On the one hand, banks must capitalise on the opportunities emerging in this economic environment, in order to strengthen their competitive position and make efficiency gains. On the other, as supervisors we must anticipate the challenges and vulnerabilities brought about by this new paradigm before they become a problem to the financial system.

We must strive to prevent financial crises by using the tools that mitigate risk accumulation and by strengthening banks' management skills. However, at the same time, we must be mindful that economic cycles will continue to exist, and we therefore need to have the tools necessary to enable us to manage them appropriately and anticipate the adverse stages of the cycles.

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