Box 2.2

IMPROVING PROFITABILITY AS AN OPPORTUNITY TO STRENGTHEN RESILIENCE IN A CONTEXT OF HIGH UNCERTAINTY

In 2022, the Spanish banking sector showed a positive overall performance. Aggregate profitability in the sector recovered significantly following the health crisis, with return on equity (RoE) standing at around 10% for the second consecutive year, above the cost of capital. Net interest income improved in 2022 and, to a lesser extent, fee and commission income (noteworthy in both items is the contribution of foreign subsidiaries of Spanish banks), while recognised impairment losses remained moderate. Although the Common Equity Tier 1 (CET1) ratio fell around 46 basis points in 2022 to 13.1%, solvency ratios remained above pre-pandemic levels (the CET1 ratio stood at 12.8% at December 2019). The main quality indicators of Spanish banks' balance sheets performed positively, with the NPL ratio continuing to fall slightly in 2022.

However, the outlook for the banking sector for 2023 and beyond is shaped, in the shorter term, by the uncertainty associated with the macroeconomic and financial scenario, and, in the medium and long term, by the structural and business model changes facing Spanish institutions.

Although the latest economic forecasts point to upward revisions for growth and downward revisions for inflation, there are still huge uncertainties, in a context affected by geopolitical tensions, rising and persistently high inflation and a return to a tighter monetary policy intended to stabilise prices. If the economy develops in line with current forecasts, interest rate rises can be expected to have a positive effect on banking business in the short term, thanks to higher net interest income, and a possible negative effect on loan loss provisions if the increased financial pressure on companies and households leads in the medium term to a deterioration in the debt repayment capacity. These effects could be particularly significant in macroeconomic scenarios that are more adverse than expected.

Moreover, the banking sector is facing other types of uncertainties that may generate additional impacts in the medium and long term, which in some cases are difficult to estimate. Among these risks are those associated with the growing digitalisation of the financial sector and with climate change, which may reduce institutions' organic capital generation capacity in the coming years.

Given these uncertainties, institutions should adopt a prudent stance and take advantage of the current increase in profitability to strengthen their resilience. In this respect, in addition to allocating resources to further the implementation of sound strategies to address the sector's structural challenges, they should also be extremely rigorous and prudent in their accounting policies, adapting their provisioning levels to future economic forecasts. Also, they should be cautious in their capital planning, defining sound internal solvency targets, with minimum thresholds based on available evidence with prospective effect. The return on capital (either through share buybacks or dividend distributions) should be analysed taking into account credible, bank-specific baseline and adverse scenarios that adequately reflect the potential impact of economic forecasts.