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The challenges to the Spanish banking industry

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Good morning. Let me first thank the organisers for their kind invitation to me to participate in this Deusto University event. It is a pleasure to be here with you today and to share some thoughts on the Banco España's view of the main challenges currently facing the Spanish banking industry.

As is well known, credit institutions were greatly affected by the last crisis. This was manifest in a strong rise in impaired assets, including both non-performing loans and real estate foreclosures, and in a significant fall-off in profitability, which even turned negative in 2012.

To address these problems it was necessary to undertake intense recapitalisation and restructuring in the industry. As a result, there has been a notable and generalised improvement in Spanish banks' financial position. Also contributing here have been the recent roll-out of an extensive package of regulatory measures and the favourable course since 2013 of the macroeconomic setting and financial conditions, assisted by the ECB's monetary policy measures and by other actions at the European and domestic levels.

The Spanish banking industry's improved financial position in recent years can clearly be seen both in terms of asset quality and in its profitability and solvency levels. Thus, from December 2013, when the deterioration in bank balance sheets was at its worst, to June 2018 the volume of non-performing loans in transactions with the resident private sector has declined by 60%. And the amount of foreclosures has done so by 40% since its 2012 peak. The consolidated return on equity, which in 2012 stood at around -25%, has gradually picked up to levels of 7% on data as at June 2018, and the overall capital ratio has risen from 11.4% in 2012 to 15.1%.

Despite this notable improvement in its financial position, the Spanish banking industry continues to face significant challenges. These are largely shared by other banking systems in the euro area, and include i) the reduction in assets impaired by the crisis, ii) the recovery in profitability, such that Spanish banks may draw closer to the solvency levels of other euro area banks, iii) adaptation to the new regulatory framework and, iv) the configuration of a new competitive setting characterised by the emergence of new technologies and competitors.

I shall now focus on describing each of these challenges, beginning with that of the reduction in assets impaired by the crisis.

As stated, the volume of non-performing loans has diminished significantly from its 2013 peak. This reduction has been assisted by the economic recovery, insofar as it has favourably impacted debtors' ability to pay, and also by the disposal of impaired portfolios. The correction in terms of non-performing asset levels is in line with what was observed in previous cycles; but the adjustment in terms of the non-performing loans ratio is proving slower than on previous occasions, which is attributable to the flatness of credit during the current cycle.

Compared with the banking systems in other euro area countries that have also accumulated a high volume of non-performing assets during the crisis, the correction in Spain is at a relatively more advanced stage. Indeed, the non-performing loans ratio in our country, at the consolidated level, stands at around the average for the euro area countries.

Moreover, the fall at banks is across the board, albeit sharper for those that were in a position of greater vulnerability, the reflection of which has been a lessening of the dispersion of the non-performing loan ratio.

Despite this progress, the non-performing assets ratio in Spain is still at a high level from a historical perspective. Our forecasts indicate that non-performing assets will continue on a path of correction in the coming years, boosted by economic growth, which we expect to run into the medium term, albeit at more moderate rates than those observed in recent years.

In the absence of an active management policy pursued by banks, the non-performing loan ratio will continue to be relatively high in late 2020. That would be in line with international evidence showing the general slowness of these adjustment processes and highlights the need for such a process to be complemented by banks' active management by means of sale agreements in respect of their portfolios of problem assets. Indeed, in 2017 and this year there have been successive announcements by banks of agreements with asset management companies to reduce the volume of non-productive assets on their balance sheets. This will result in an improvement in the quality of Spanish bank balance sheets and, consequently, in their supply of credit to the economy as a whole. In fact, the evidence available shows that there is a negative correlation between the non-performing loan ratio and credit growth.

From another perspective, the swift progress in correcting the high levels of bad debts in Spain and in other euro area countries is crucial for easing the way to finalising the Banking Union project in respect of its remaining pillar, which is none other than the definitive creation of a pan-European, pooled and sufficiently backed deposit guarantee scheme.

All the foregoing justifies the special interest we have as economic and supervisory authorities in credit institutions taking the appropriate measures to expedite the ongoing reduction in the volume of impaired assets. One of the most significant initiatives here is the package disclosed by the European Commission in March. It includes a proposal to review capital requirement regulations with a provisioning calendar for non-performing loans, a draft directive for the creation of a secondary market in this type of asset and an extra-judicial mechanism to speed the recovery of collateral, and the publication of guidelines supporting the development of asset management companies. For its part, the Single Supervisory Mechanism published guidelines in March 2017 for the management of non-performing assets and, more recently, it has released an addendum to this in which it sets out explicitly its supervisory expectations on provisioning, both for newly-arising non-performing assets and for the existing stock, as part of the supervisory review process.

Restoring profitability levels is another of the main challenges the Spanish banking industry faces. While the profitability of Spanish banks has returned to positive figures and stands somewhat above average EU levels, it continues to be down on pre-crisis levels and below those observed in the banking systems of other developed economies such as Australia, Canada, the United States and Sweden.

The current low level of the average profitability of Spanish banks is particularly apparent in business in Spain, which was the area most affected by the crisis. The international activity of Spanish banks, concentrated in a very small number of institutions, was a major source of risk diversification during the crisis since it enabled them to counter the downturn in Spain's situation with the sound economic progress in other areas. In any event, this business segment is not free from challenges, especially at present when some of the economies to which our banks are exposed, such as Turkey and Argentina, are undergoing significant difficulties. Against this background, the international business model of Spanish banks, based primarily on activities conducted through subsidiaries operating in a decentralised fashion, with financial independence and engaging in traditional banking activities, is a mitigating factor that should be borne in mind. That said, and despite the conjunctural difficulties facing some of the countries in which Spanish banks are present, I would like to underscore the undoubted importance of geographical diversification as a source of medium and long-term value added and stability for these banks.

The low profitability of the banking business in Spain is attributable to a combination of factors, some cyclical and others more structural. First, the high level of non-performing assets ensuing from the effects of the crisis adversely affects banks' income statements both through the decline in interest received and, especially, the increase in the attendant asset impairment losses. The volume of these losses for Spanish deposit institutions as a whole peaked in 2012 and has subsequently tended to fall, although these losses continue to consume a large portion of revenue, meaning that pre-crisis levels have not been restored. Specifically, in terms of assets, these losses were, between 2015 and 2017, double those recorded between 2003 and 2005.

Another telling determinant of the low profitability of the banking business in Spain is the significant decline in income since the outbreak of the crisis, associated with the strong reduction in the size of bank balance sheets. During the upturn prior to the crisis, against a backdrop of high demand for bank lending and of very easy financing conditions, banks expanded their balance sheets notably, the reflection of which was a strong increase in typical revenue in the banking business. To cater for this surge in activity, banks increased their capacity by means of increasing the number of offices and staff, thereby raising operating expenses; but given that such expenses grew more moderately than income, the operating efficiency ratio underwent no erosion and results improved.

With the onset of the crisis it became clear that the aggregate debt levels of Spanish households and firms were unsustainable, which triggered an intense and lengthy process of deleveraging. The ensuing reduction in the size of bank balance sheets has undoubtedly affected net interest income.

Banks reacted to this contraction in activity and in operating income by cutting back their capacity, both in terms of offices and of staff, a correction which was assisted by the ongoing concentration in the banking industry. Despite the notable adjustment in productive capacity, operating expenses declined to a lesser extent than operating income, the result of the existence of certain overheads and of the expansionary behaviour of certain items. The upshot has been a decline in the profitability of the banking business.

Given that the outstanding balances of lending in the short and medium term are not expected to grow in a similar way to how they did in the expansion prior to the crisis and such that they may offset the reduction in net interest income, the recovery in bank profitability will have to be based on the continuing adjustment of expenses, on the search for alternative sources of income and on improved efficiency.

In any event, in the search for profitable business, banks cannot ease off in their vigilance regarding lending standards. In the current setting, very high rates of credit expansion, as is occurring in the household bank lending segment for the purchase of consumer durables, might be indicative of an easing of risk acceptance and selection standards which, as past experience shows time and time again, ultimately translates into notable increases in non-performing loans. Despite the limited weight of this business segment in Spanish banks' overall credit portfolio, the rise in the volume of non-performing assets in this activity as a result of overly rapid credit growth should strike a note of caution: from being an alternative source of income it should not become a potential source of losses.

Low interest rate levels have contributed to compressing banks' net interest income given that, with zero proving an effective floor for the remuneration of most deposits, once that level is reached banks have not been able to continue reducing their funding costs in a setting in which risk-free returns have come to stand at negative values. In any event, the evidence available indicates that this negative effect on net interest income has been partly offset by a lesser pass-through of market movements to the interest rates on the outstanding balance of lending.

It should be borne in mind, moreover, that the reduction in interest rates also has some positive effects on bank profits via various channels. On one hand, the expansionary monetary policy has a favourable impact on economic activity, boosting the demand for credit and for other banking services. On the other, the decline in the return on risk-free assets tends to raise the value of assets by reducing the discount factor implicit in their price, which translates into capital gains for the banks. Lastly, the decline in interest rates is conducive to a decline in loan default losses, as it reduces the debt burden and raises borrowers' income as a result of the boost to economic activity it entails.

Overall, the above points suggest that the net final impact of the low interest rate levels on bank profitability has been comparatively low compared with the other above-mentioned factors.

I will now move on to the third major challenge the Spanish banking industry faces. This is associated with the adaptation to a more demanding regulatory framework that involves higher requirements in respect of own funds and liquid assets, along with other additional demands derived from the new resolution regulations.

These regulatory changes, which have been introduced globally, are the response by the economic authorities to the shortcomings highlighted by the international financial crisis. Their essential aim is to increase banking systems' resilience in the face of adverse shocks and to prevent taxpayers from having to bear the cost of the resolution of ailing banks.

The first raft of reforms, known as Basel III, which was designed between 2010 and 2011, focused on increasing the volume of bank capital and improving its quality, and on the introduction of new minimum liquidity requirements and counterparty exposure limits, and of macroprudential instruments, such as the so-called countercyclical capital buffer. All these requirements will be effective, practically in their entirety, in late 2019.

Spanish banks have already largely adapted to these new requirements, with their liquidity and capital ratios currently standing above the minimum levels stipulated. In any event, as regards the CET 1 and Tier 1 solvency ratios, their aggregate levels – albeit with significant dispersion across banks – are, as at March 2018, low compared with those of the euro area banking systems, according to data from the European Banking Authority.

This once again highlights the need for Spanish banks to adopt capital-strengthening strategies. With regard to the solvency regulatory measure, which does not take into account risk weightings, i.e. the leverage ratio, the Spanish banking system as a whole shows, on the contrary, slightly higher levels than the euro area average. Also, Spanish banks evidence, overall, a sound liquidity position, with their LCR ratio above the European average.

Regarding the resolution of institutions, in recent years a number of regulations have been approved in Europe establishing a common framework for the EU, and defining the circumstances in which banks with financial difficulties should enter wind-up or resolution processes. In this setting, a new category of senior non-preferred debt instruments has been created, which ranks below senior debt in the payment priority of insolvency proceedings, with a view to facilitating compliance with the minimum requirements for own funds and eligible loss-absorbing liabilities, known as MREL. The MREL requirements that the Single Resolution Board has started to set for significant European institutions are an added reason for Spanish banks to strengthen their capital in the present environment of recovering profitability and an economy that is growing at a significant pace.

More recently, December 2017 saw the completion of the second phase of reforms in the Basel III framework. The reforms include, inter alia, the improvement of the standardised methods for calculating credit and operational risk, restrictions on the use of internal models and changes in the leverage ratio. These changes will be implemented in two phases that will conclude in 2027.

Therefore, although Spanish institutions have already largely adapted to these regulatory changes, there are still some outstanding reforms to be applied, which will require them to make further adjustments.

Lastly, the main medium-term challenge lies in the new competition framework derived from the new technologies and progressive financial disintermediation.

New technologies can quickly change the competitive framework by increasing competition in some segments. That will oblige institutions to anticipate changes and adapt to the new environment, even though this entails a rise in costs in the short term, which will be difficult to manage in an environment of low profitability. One of the areas where the highest degree of penetration by new entrants has been observed is payment services, particularly retail payments, which is causing a decline in income from transactional services.

Furthermore, adapting to these technologies may involve greater operational, and even reputational, risks, with aspects such as cybersecurity gaining in importance.

But new technologies also entail fresh business opportunities for banks. On one hand, these technological changes allow immediate remote access to a broad range of financial services, which may enable general administrative expenses to be reduced. The relatively scant penetration of digital banking in Spain suggests that there is ample scope for this form of banking to grow, providing Spanish banks with an opportunity to expand their business. The application of artificial intelligence and the use of large databases with real-time information (known as big data) may also provide for significant efficiency gains.

Continuing financial disintermediation also involves increased competition for credit institutions. It is well known that, if trade credit is excluded, the bulk of borrowing by Spanish non-financial corporations has traditionally been in the form of bank loans. This funding structure is similar to that observed in other European countries, such as Germany or Italy, but contrasts with the greater weight of financial markets in other economies such as the United States and the United Kingdom.

Following the outbreak of the most recent crisis, a gradual increase in the weight of business funding raised on financial markets through the issuance of fixed-income securities has been observed in Spain and in other developed countries. This phenomenon especially affects large corporations. Among the factors potentially contributing to this development are the regulatory changes in the financial arena, imposing stricter requirements on banking activity, as mentioned earlier, and the corporate sector purchase programmes by central banks, which has reduced the cost of issuing these assets.

Looking ahead, this trend towards the expansion of capital markets might continue if progress can made on the European project to create a capital markets union. Also, a potential increase in long-term savings linked to the ageing of our society could also contribute in the same direction.

Although a greater diversification of financing sources could potentially be positive for non-financial corporations, making them less vulnerable to adverse shocks affecting a specific financing channel, for credit institutions it could entail a reduction in business volume and income. This is particularly relevant in the current setting of low demand for financing in Spain, in which this trend could contribute to further eroding the net interest margins in some market segments.

To conclude, let me sum up the key messages I would like to convey. In recent years, Spanish credit institutions have made sterling efforts to overcome the problems stemming from the crisis and to adapt to the new and stricter regulatory requirements. This has been reflected in the significant improvements in their solvency, profitability and asset quality. However, despite these improvements, Spanish banks continue to face major challenges, largely shared with other euro area banking systems. These include, most notably: (i) stepping up sales of non-productive assets (ii) the need to strengthen capital, (iii) addressing profitability challenges without unduly easing credit standards and, lastly (iv) harnessing new technologies in a competitive environment of potential new competitors. In an economy as highly banked as Spain's, overcoming these challenges is key to the banking industry gaining a sufficient position of strength from which to contribute to economic growth and job creation.

Thank you for your attention.