Interview with the Deputy Governor Margarita Delgado Tejero

November 2024 will mark the tenth anniversary of the launch of the Single Supervisory Mechanism (SSM), a major European initiative to which the Banco de España made a decisive contribution. What is your assessment of the last decade and what are the main challenges that still remain?

There is no doubt that setting up the SSM was a major challenge, especially given the time pressure and the difficult economic and financial context. Despite the intense work, I would highlight the enthusiasm and confidence we felt in that first phase and how much we achieved in a short space of time. Since then, the SSM has made steady progress towards becoming the robust, credible, flexible and internationally respected supervisor that it is today. However, although there have been many achievements over this decade, we must not become complacent, especially in a different economic, technological and geopolitical environment to that of ten years ago.

We need to further enhance the following: effectiveness, by deepening the risk-sensitivity of supervision; efficiency, with clear support for SupTech tools and streamlining procedures and methodologies; flexibility, to respond swiftly to an increasingly dynamic environment; consistency of supervisory practices; and organisational integration.

In this ever-changing scenario, what will be the main focal points of supervisory activity in the coming years?

It is precisely this environment of high uncertainty and complexity that has focused our attention on institutions' ability to withstand the potential consequences of geopolitical turmoil and other macro-financial shocks. The management of credit risks, including counterparty risk, as well as liquidity and interest rate risk, is key, as we saw in the US banking crises of spring 2023.

On the one hand, we had unprecedented interest rate rises that benefited banks and, on the other hand, the European Central Bank has started to gradually withdraw its expansionary measures. This new paradigm has consequences that need to be analysed and managed. I am referring both to the impact of interest rate rises on the cost of financing companies and households and, consequently, on their payment capacity, and to the need for institutions to have robust funding plans, with diversified sources that can withstand any short-term liquidity shocks.

We have also identified as priorities other structural challenges that institutions must deal with in the medium term, such as the need to remedy shortcomings in governance and in climate and environmental risk management, as well as challenges posed by digital transformation for business models and institutions' operational resilience and adaptation to technological risk. To this end, we have already launched a series of supervisory activities for this year.

You referred to the US banking crises last spring. What conclusions should we draw from this turmoil, and from the turmoil at Credit Suisse?

To put it very briefly, we must conclude that the crises were the result, in the first place, of inadequate governance and poor risk management and control. Imbalances in the balance sheet structure, with high concentrations in certain types of assets and liabilities, as well as exponential balance sheet growth, led these banks to assume very high interest rate and liquidity risks, which eventually materialised as a result of monetary policy changes in the United States. In other words, unsustainable business models.

Secondly, there were also clear shortcomings in the supervision of these institutions. On the one hand, the complex supervisory framework in the US, with several supervisory authorities, did not help. And on the other, supervisors did not act swiftly enough in relation to the shortcomings detected, because of slow internal decision-making processes and the absence of sufficiently effective supervisory measures.

Thirdly, we also have to mention regulation. It should be recalled that US medium-sized institutions are not subject to the much stricter Basel standards to which all the European Union (EU) institutions are subject.

The case of Credit Suisse was a result of a general market reaction to the crises of the US banks, which indicated a lack of confidence in its business adjustment strategies. Once again, this highlights the importance of analysing the viability and sustainability of business models.

Speaking of business models, we have seen a huge recovery this year in the profitability of European banks in general, and Spanish banks in particular. To what extent do you think these increases are sustainable?

The increase is explained by the improvement in net interest income, with the rise in financial revenues far outstripping financial costs. We should remember that banks were starting from an environment where interest rates, which, if I may say so, are the “raw material” of the sector, had been zero or negative for more than ten years. This affected banks and meant they had to strive to become more efficient in operational costs and remain profitable during this time.

The current context of positive rates, which is the natural context, has had a very favourable effect on income statements. But I want to be cautious, as such a significant increase in net interest income cannot be considered sustainable. Firstly, the transfer of the rise in interest rates to loan portfolios is almost complete; even some of the loans that will be repriced in the first quarter of 2024 will be at lower rates. Secondly, lending volumes continued to fall in 2023, which will also affect future margins. In addition, the cost of funding may increase as the tightening of monetary policy continues to permeate. And, lastly, we are already seeing some signs of rising NPLs in some portfolios. Added to this, geopolitical conflicts further compound uncertainty, and the economic outlook remains poor in Europe.

For all these reasons and, despite the fact that, in the stress tests carried out in 2023, Spanish institutions showed satisfactory levels of capital in the adverse scenario, which was more severe than in previous tests, I would like to repeat the message I have already delivered on other occasions: it is essential that institutions have robust provisioning and capital planning policies. This is necessary to continue to operate soundly in a changing environment and to face the structural challenges of digitalisation and transformation to a more sustainable economy.

You mentioned earlier that the review of technology risk is one of the supervisory priorities. How does the review of this risk materialise?

Indeed, the importance of technology risk has grown in recent years as institutions have become increasingly digitalised. When we talk about technology risk, we are not only referring to cyber attacks, which are potentially relevant in the current geopolitical context, but also to all incidents that might affect the infrastructures of digital processes, with critical consequences.

Institutions should be prepared to detect and remedy system failures caused by cyber incidents in the shortest possible time. It is not just a question of putting up barriers, but also having procedures in place to mitigate the consequences of incidents on operational processes.

To this end, we have two groups of experts at the Banco de España: one is responsible for on-site inspections and the other for more cross-institutional matters such as conducting cybersecurity stress tests, participating in international working groups and supporting the entire Directorate General on these issues.

This is undoubtedly an area of growing significance as a result of the new supervisory powers on this matter arising from new European regulations.

How does the digitalisation process you mentioned affect business models?

Digital transition is affecting our economy across the board and banking is no stranger to this phenomenon.

Banks' business models have been greatly affected by this digitalisation process: in the area of banking and payments, new technologies are changing the financial services sector, allowing it to become more competitive and efficient. However, the process is not risk-free, so it is essential that banks establish an operational risk framework that addresses issues such as increasingly sophisticated and damaging cyber attacks, dependence on external providers, etc.

In this regard, as part of its digital finance strategy, the EU is equipping itself with a regulatory framework to ensure stability and consumer protection. Two important regulations were published in 2023: the crypto-asset markets regulation, MiCA, and the digital operational resilience act, DORA.

DORA governs requirements on technology risk management (paying special attention to governance), incident reporting and resilience testing similar to the tests we already have in Spain under the TIBER framework.

However, the most distinctive feature of DORA, the one that has made it a global benchmark, is the oversight framework of critical technology providers for the European financial sector as a whole.

Lastly, I would also like to highlight the fact that digitalisation also affects us supervisors. On the one hand, we must have an in-depth understanding of the technological tools that institutions use and the risks associated with them — for example, in the use of machine learning. On the other hand, we also make use of innovative technologies to support our work, known as SupTech, developed either in-house or in collaboration with SSM initiatives.

I would like to raise a topical issue: the risk of money laundering and financing of terrorism (AML/CFT), the latest approved regulation and, of course, the new European authority for the prevention of these matters.

The institutional architecture in Spain is clear and the powers assigned to us at the Banco de España in this area are limited to the supervision of certain obligations of the institutions under our supervision. This supervision is carried out in close cooperation with the Commission for the Prevention of Money Laundering and Monetary Offences and its Executive Service, SEPBLAC, and with the National Securities Market Commission and the Directorate General of Insurance and Pension Funds. For example, as well as coordinating the planning of the year's activities with the other authorities, in 2023 we cooperated with SEPBLAC in updating the AML/CFT risk assessment methodology.

However, at the moment, what is perhaps most noteworthy in this area stems from the strong European impetus initiated in 2020 with the European Commission's action plan. This plan involves, inter alia, two key milestones. On the one hand, the establishment of a single rulebook, which, following the agreement of the Council and the European Parliament in January this year, is now close to publication. On the other hand, the creation of a European authority, the Anti-Money Laundering and Countering the Financing of Terrorism Authority (AMLA), which will have direct and indirect supervisory powers over high-risk regulated institutions in the financial sector. The experience accumulated both by the institutions and by the Banco de España in the ten years of the SSM and the demanding Spanish AML/CFT regulatory framework represent strengths in this transition to a new regulatory framework and a single supervisor at the European level.

The Banco de España has a wide range of macroprudential tools at its disposal: buffers, sectoral tools and limits on lending criteria. What can you tell us about this?

Macroprudential policy has become a significant instrument to mitigate the build-up of systemic risk, which could harm the financial system and lead to disruptions in the provision of financial services, with serious negative effects on the economy. In 2023, the Banco de España applied the revised methodology for calibrating the buffers of other systemically important institutions for the first time, which led to the increase in the buffer required for 2024 for the two largest institutions out of the four identified. The other macroprudential measures were not activated.

The commercial real estate sector in Europe has been closely monitored by both the micro- and macro-supervisor. In 2021 the SSM was already prioritising the review of this sector and at the end of 2022 the European Systemic Risk Board issued a recommendation linked to vulnerabilities in this sector, which, among other issues, called on the competent authorities in the area of financial stability to closely oversee current and emerging vulnerabilities related to commercial real estate. In 2023, the Banco de España agreed to comply with this recommendation. However, I would like to stress that exposure to this sector is relatively low in Spain.

Conduct supervision has been in place for years. Which issues and actions would you highlight?

That is indeed the case. Having grown in importance for years, in 2022 the Law on the regulation, supervision and solvency of credit institutions was amended to expressly introduce the duty of institutions to act in an honest, impartial, transparent and professional manner, with respect for the rights and interests of customers.

The Banco de España's strategy in this area revolves around two central factors: the definition of priorities based on conduct risks and the preventive approach to supervision. In the current context, the proper marketing of products and services —including most notably consumer credit— and compliance with measures aimed at groups facing difficulties —especially the Code of Good Practices (revised in 2023)— are particularly important. In addition to these priorities, there are the now traditional actions in relation to advertising information and customer service departments.

Also, we have an increasingly comprehensive regulatory framework, as shown, for example, by the Banco de España's recent publication of the *Guidelines on the governance and transparency of revolving credit.*

Lastly, I would like you to share your thoughts on the role of the Basel III regulation over the last decade.

As I have already mentioned, I believe the European institutions were in a strong position to weather the successive crises of the last four years, including last spring's turmoil. And this is due in part to the Basel III regulation. The reforms already implemented have shown its robustness from multiple angles, helping protect the international banking system and the real economy from a more severe banking crisis. Thus, the lessons learned do not point to the need for a drastic change in the current regulatory framework, although there are issues that merit further reflection.

The Basel Committee on Banking Supervision has recalled the importance of full and consistent implementation of the framework as soon as possible, a view I fully share. The EU is now in the process of incorporating the last phase of Basel III, which is scheduled to enter into force in 2025. Adoption is, in general, complete and faithful to the international framework, although some options are exercised and certain particularities are introduced. Some of the most significant amendments it includes have been long awaited, such as the establishment of the output floor for the outcome of models. The full implementation of Basel III will undoubtedly be a milestone in international financial regulation.