Looking beyond Spanish banks' profitability

The Spanish banks reported sharp earnings growth in 2023, with the six largest banks recording over €26 billion in profits on aggregate, up 27% from 2022. This situation has prompted a deep dive into the issue in an attempt to understand the role these earnings play not only in the stability and growth of the financial institutions themselves but also in creating general economic wellbeing.

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Abstract: The Spanish banks reported sharp earnings growth in 2023, with the six largest banks recording over €26 billion in profits on aggregate, growth of 27% from 2022. Several relative indicators suggest that the increase in earnings is due to the recovery of some of the profit lost since before the pandemic, although this claim warrants caution. As well, it is also important to note that profitability is a broader concept than their bottom lines: the banks, like any other private corporations, are valued by the market and their shareholders. Indeed, the six largest banks are trading at an average price to book value of 0.78x. An analysis of the banks' share price performance taking a long-term perspective shows that the banking sector has come back – gradually – from very low levels of profitability to revisit pre-pandemic levels. This has sparked the debate about whether the Spanish banking sector should be subject to additional taxation. This situation has prompted a deep dive into the issue in an attempt to understand the role these earnings play not only in the stability and growth of the financial institutions themselves but also in the creation of general economic wellbeing. In addition to reinforcing the banks' capital reserves, which are essential to their solvency and ability to tackle adversity, bank profits can finance growth, investments and, ultimately, stimulate the real economy.

> "Despite facing significant challenges over the past few decades, prudent management and strategic adaptation have enabled the Spanish banks not only to survive but even to prosper, as is evident in their recent earnings performance."

Bank earnings: Deconstructing the debate?

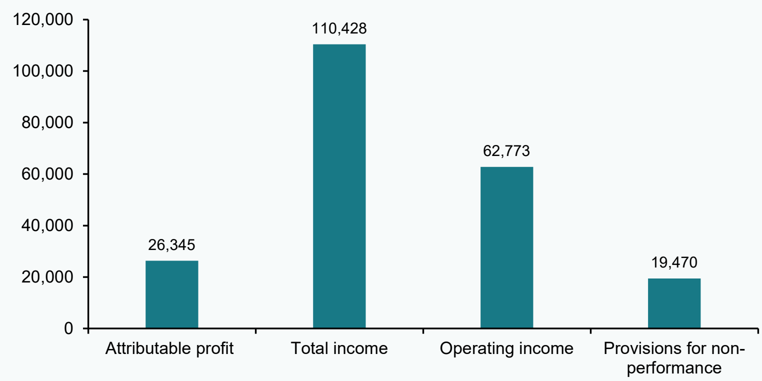
The Spanish banks' recorded earnings growth in 2023, with the six largest banks reporting over €26 billion of profits on aggregate, growth of 27% from 2022. While cause for celebration within the sector, the recovery has triggered a series of debates, which have largely pivoted around the scale of their profits and whether a higher windfall tax is justified as a result. That situation has prompted us to delve deeper into the issue in an attempt to understand the role these earnings play not only in the stability and growth of the financial institutions themselves and but also in creating general economic wellbeing. It is important to understand that, in addition to reinforcing the banks' capital reserves, which are essential to their solidity and ability to tackle adversity, bank profits can finance growth, investments and, ultimately, stimulate the real economy.

Recent history shows us how the banking sector has faced considerable challenges, from the financial crisis of 2008 to regulatory and technological changes. Despite those

Exhibit 1

Breakdown of the combined earnings of the six largest Spanish banks in 2023

Millions of euros



Source: Authors' own elaboration based on the banks' individual financial statements.

> "Recently, the gap between the cost of credit and deposit rates has closed considerably in Spain, driven by a significant increase in deposit rates, particularly the rates offered on term deposits."

difficulties, prudent management and strategic adaptation have enabled the Spanish banks not only to survive but even to prosper, as is evident in their recent earnings performance. In the banking sector, where regulations impose strict capital requirements, those earnings play a critical role. They allow the banks to meet their capital requirements without having to compromise their ability to lend money, which is vital for channelling savings into productive investment. It is also important to note that profitability is a broader concept than their bottom lines: the banks, like any other private corporations, are valued by the market and their shareholders. Indeed, most of the European financial institutions, despite recent share price gains, continue to trade below their book value. As well, the introduction of sector-specific taxes at a time of strong earnings has generated controversy. The concern is that those measures could be failing to consider the banks' need to continually reinforce their capital and remain competitive at the international level. The European Central Bank has cautioned about the possible consequences of such taxes, flagging the complexity of balancing fiscal targets with long-term financial health and stability.

Debate has also centred around how much the banks pay for deposits. The normalisation in interest rates from negative rates to current

Exhibit 2

Banks' share price performance in the last 1 and 5 years. Ibex-35 Banks

Past year

Past 5 year

Source: Ibex- 35 Banks.

levels (3% - 4%) has materialised in faster pass-through to the cost of credit than deposit rates. Banks in other countries initially passed the increase in interest rates through to their deposits faster than the Spanish banks. Recently, however, that gap has closed considerably, driven by a significant increase in deposit rates in Spain, particularly the rates offered on term deposits. Remember that the market still has a substantial volume of "official" ECB liquidity (as analysed below) and the Spanish banks also market products that compete for customer savings, such as investment funds (Carbó y Rodríguez, 2023).

An analysis of the simplified statements of profit or loss of the six biggest Spanish banks (Exhibit 1) is insightful. Their aggregate profit in 2023 was 26.35 billion euros. Their total income (net interest income from their conventional intermediation activities and non-interest or net fee income), amounted to 110.44 billion euros. Operating income, after deducting operating expenses (staff costs and depreciation charges), amounted to 62.77 billion euros, of which the banks set aside around one-third (19.47 billion euros) to cover potential non-performance.

As already noted, it is not easy to interpret these numbers in absolute terms. There are several relative indicators that suggest that the increase in earnings constitutes, to a large extent, the recovery of some of the profits lost since before the pandemic (and more intensely during it), although this claim warrants caution. For example, Spain's six largest banks are trading at an average price to book value of 0.78x (per Bloomberg as of 1 March 2024). An analysis of the banks' share price performance from 1 March 2023 to 1 March 2024 compared with a five-year perspective (Exhibit 2) shows that the banking sector has come back – gradually – from very low levels of profitability to revisit pre-pandemic levels.

The role of the monetary environment and financing costs

In 2023, the prevailing monetary policy affected the Spanish banks' earnings in several key ways. The rise in interest rates brought about by the central banks to curb inflation has had a significant impact on the Spanish banks, throwing up a mix of opportunities and challenges. On the one hand, the banks reported earnings growth. That was partly driven by an economy showing signs of recovery, marked by GDP growth and intense recovery in key sectors like tourism. Stable demand for credit and solid risk management allowed the banks to boost their profits and keep non-performance in check despite the rise in interest rates and economic uncertainties.

However, the volume of credit extended to households and businesses continues to shrink year-on-year, shaped mainly by a contraction in demand in response to higher financing costs. That situation warrants a degree of caution: tighter borrowing terms and conditions could end up driving an uptick in asset non-performance.

These dynamics underscore how monetary policy and the banks managerial responses are vital to understanding the banks' earnings performance. These considerations highlight the importance of effective risk management and the need to adapt to an evolving economic and financial panorama in which monetary policy is playing a key role in shaping the opportunities and challenges facing the banks.

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Indeed, the market largely expects monetary policy to start to ease with rate cuts coming some time in 2024. At its last meeting on 7 March 2024, the ECB's Governing Council announced it had "decided to keep the three key ECB interest rates unchanged". Inflation has continued to ease since the ECB's previous Council meeting. Indeed, the ECB's latest inflation forecasts have been cut, particularly for 2024, due mainly to a lower contribution by energy prices. The ECB's experts now expect headline inflation to average 2.3% in 2024, 2% in 2025 and 1.9% in 2026. Its forecasts for core inflation (excluding energy and unprocessed food prices) have also been revised downwards and currently call for levels of 2.6% in 2024, 2.1% in 2025 and 2.0% in 2026. Although most measures of underlying inflation have eased further, domestic price pressures remain high, in part owing to strong growth in wages.

However, at that meeting, the ECB also threw a little cold water on the expectations for rate cuts. Specifically, it noted that "based on its current assessment, the Governing Council considers that the key ECB interest rates are at levels that, maintained for a sufficiently long duration, will make a substantial contribution to this goal [of ensuring inflation returns to 2%]. The Governing Council's future decisions will ensure that policy rates will be set at sufficiently restrictive levels for as long as necessary."

More importantly, a more indirect statement by the ECB's President Christine Lagarde created the expectation of possible rate cuts from June when she said, in relation to the need for more data and evidence, that "we will know a little more in April, but we will know a lot more in June".

The European monetary authority therefore left the interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility unchanged at 4.50%, 4.75% and 4.00%, respectively. Besides the influence of these interest rate levels on the banks' margins and profits, it also worth highlighting the shift in the ECB's liquidity operations. Here we analyse the banks' financing in the Eurosystem using the information published by the Bank of Spain (the last update dates to January 2024). As shown in Exhibit 3, the Spanish banks' use of ECB financing in the form of its special long-term refinancing operations decreased from 289.97 billion euros in August 2022 to 22.46 billion in January 2024. As a result, it is likely that the banks will start to look for alternative sources of funding (such as deposits) for which they may have to pay more. In contrast, however, the ECB's asset purchase programmes (mainly debt) remained quantitatively significant, standing at 605.21 billion euros in January 2024.

As noted by the Bank of Spain in a report on these indicators, it is important to note the importance of the ECB's deposit facility for the banks: "The significant rebalancing of the excess liquidity positions of the credit institutions observed in September 2022, with reserve accounts decreasing in favour of deposit facility balances, is linked to the decision of the Governing Council of the ECB to increase the remuneration of the deposit facility to 0.75%." That rate has since increased gradually to 4% at present and the Spanish banks presented a net deposit facility balance of 240.67 billion euros in January 2024.

Lastly, it is interesting to analyse how the interbank market is interpreting the outlook

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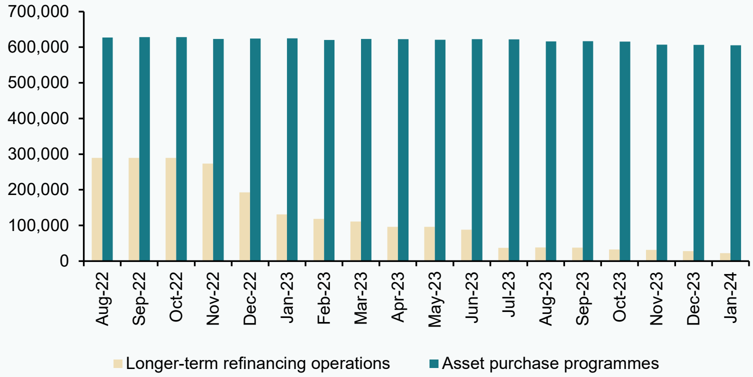
Exhibit 3

Spanish banks' reliance on Eurosystem funding

Millions of euros



Source: Bank of Spain and authors' own elaboration.

for interest rates, as borne out by the trend in 12-month Euribor. That rate was negative for the last time in August 2022 (-0.23%), from where it went to notch up consecutive gains until October 2023, when it reached 4.16%. After that it traded lower and appears to have stabilised at around 3.6%, pending new messaging from the ECB around possible monetary decisions in the near- and medium-term.

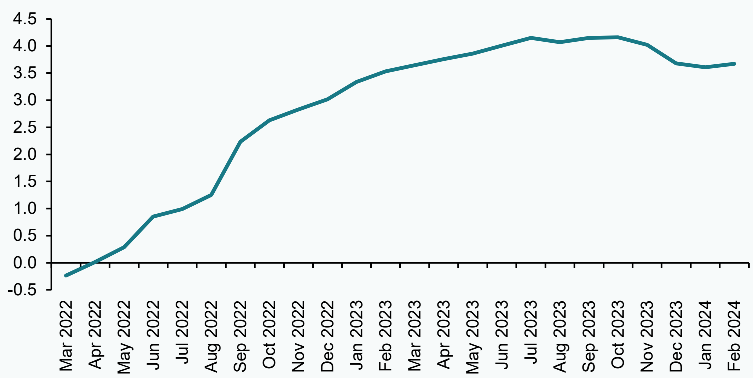
What can we expect in 2024?

Once again in 2024, the Spanish banks are navigating between transformation and opportunity. The scenario is being shaped by a changing global economic context, complex geopolitical channels and a regulatory framework that is constantly being fine-tuned. The drop in the volume of liquidity provided by the European Central Bank

Exhibit 4

Trend in 12-month Euribor

Percentage



Source: Bank of Spain and authors' own elaboration.

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(ECB) will be a significant milestone for the banks, stimulating their traditional role as intermediaries and underscoring the need to attract savings, particularly in the form of deposits. This environment presents the banks with an opportunity to consolidate their essential role in the economy, fostering credibility and stability in the financial sector. On the asset side, despite the slowdown in demand for loans, the banks' lending activity remains vital, particularly in the corporate sector.

Digitalisation will remain key, with the focus on increasing financial service accessibility and security. The creation of banking hubs is looking like a creative solution to the reduction in physical branches, in an attempt to provide a more personal and accessible experience, especially in less urbanised and rural areas. These hubs look set to revolutionise how we interact with our banks by mixing the recent trend towards more and more technology with a more human and personal approach. Artificial intelligence is emerging as an essential tool for driving operational efficiency and service personalisation, with applications ranging from ATM administration to customer behaviour prediction. However, this digital thrust brings challenges, particularly in the area of cybersecurity. Ensuring protection against attacks, whether physical or digital, is a top priority for the banks at a time in which financial technology is advancing rapidly. In this panorama of transformation, innovation in financial products and services, coupled with a renewed focus on sustainability and social responsibility, places the Spanish banking sector in a position to drive economic growth and social progress.

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