Back to "boring banking" in the age of deleveraging and new financial regulation

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In their effort to reduce overall risk, banks are adopting more boring business models based on lessons learned from the crisis and the pressure of new regulatory requirements. This trend is improving the liabilities side of banks' balance sheets. However, banks in Spain and elsewhere must further transform their business models to include new sources of income and increase the efficiency in provision of financial services.

In response to new financial regulation in the wake of the recent crisis, many banking sectors are embracing more traditional business models, often times referred to as boring banking. The new regulations are expected to impact financial institutions´ funding strategies, reducing reliance on short-term wholesale funding, and prompt a renationalization of activities. The new rules may also generate unintended consequences and contradictory effects, such as the creation of disparities in financing terms across funding instruments and the reduction of banks´ balance sheets in an effort to meet more stringent capital requirements. In the case of Spain, reliance on a more traditional, retail-oriented commercial banking model did not isolate financial institutions from the crisis. While the country´s financial reform has been successful in improving performance on key indicators and facilitating access to capital markets, the outlook for profitability in Spain, and elsewhere, raises concerns. Looking forward, banks in Spain, as well as in other countries, should seek to improve profitability through alternative channels, in addition to traditional efforts.

The banking sector has probably suffered the largest transformation as a consequence of the 2007 crisis. These changes are associated with the intensification of structural tendencies (for instance, the aging of population in developed countries, the impact of Internet and new technologies on the business models of industry, etc.) as well as new regulatory changes to try to overcome the chain of perverse incentives that resulted in the financial crisis. The need to transform business models to the new conditions of competition and regulation in the banking sector remains a key challenge for banks' future profitability and viability. The reaction to the conditions that led to the crisis and to the financial regulation established to avoid new episodes in the future has been summarized as BB ("back to basics") or BBB ("back to boring banking").

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But, what do we mean by boring banking? There is no precise definition of this term. In general, boring banking is taken as synonymous to retail or commercial banking although this category is not a properly defined business model. The most commonly accepted interpretation of boring banking makes a distinction between core, or boring, activities, and non-core activities. Although the activities included in each group may not coincide when we compare the strategic plans of different banks or documents of international organizations. In fact, the traditional typology of banking business models (commercial or retail versus investment; national versus international; universal versus specialized) is no longer adequate to characterize many of the changes we are seeing in the business models of banks. The new taxonomies include many different dimensions that have been affected by the consequences of the crisis, and the new competitive and regulatory environment. Those dimensions include size, geographical orientation, income and funding diversification, and capital and legal structure (Montalvo, 2013).

Boring banking can also be defined in function of the business model of the banks that performed well during the financial crisis. Several studies have identified the elements of the business model of banks that had major problems during the financial crisis. They have in common a high level of wholesale funding (repos, brokered deposits, interbank loans and/or commercial paper), a low level of capitalization (measured as the equity-to-asset ratio), a high reliance on short term debt and a high loan-to-deposit ratio. New regulations target most of these problems together with the "too big to fail" issue.

The adjustment towards boring banking, driven mostly by regulation but also by macroeconomic conditions, has taken different paths and rhythms depending on the initial business model of the banks, the specific regulations that affect them, the new competitive environment and the level of deleveraging that has to be accomplished in each economy to go back to a sustainable pattern. It is the interaction between new regulation and the need to deleverage the economy that will shape the specific process towards a new and successful business model.

Obviously, the size of each bank and its current business model will also influence its reaction to the new regulation since some pieces target the "too big to fail" (TBTF) issue like, for instance, structural reform or the extra capital buffers for systemically important banks. In addition, the national specificities of some of these regulations and their implementation periods (even in Europe, despite calling the CRDIV/CRR the "single rule book") or the slow evolution of some parts of that regulation (uncertainty on the effect of bail-in and resolution mechanisms, etc.) generate regulatory uncertainty that may slow down and complicate the adoption of a new business model.

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One may think that the Spanish banking sector would be less affected by the impact of the new regulation since it has always been considered a relatively boring one and, therefore, there is less need to search for a new business model. Reality seems to indicate the opposite. The large pre-crisis increase in the leverage rates of households and non-financial corporations, the bail-out of part of the financial system, the weak outlook for profitability in the future and the deep changes in the structure of the industry as a results of support measures (mergers, acquisitions, etc.) provide the bases for an important adjustment of the business model as a reaction to the new regulation and the new competitive environment.

The general context of the process of "borification" of the banking sector is conditioned by two basic

factors: the need to deleverage families and firms, and the regulatory requirements for larger, better-quality capital buffers to absorb losses. The reduction of leverage, defined as the debt to GDP ratio, can be achieved in several ways: increasing GDP growth, increasing inflation or reducing the stock of debt. The change in the stock of debt is the result of the change of net lending plus valuation changes plus write-offs. The composition of the deleveraging that is taking place in each country is very different (Garrote, Llopis and Valles, 2013). In the US, most of the deleveraging process is coming from GDP growth and write-offs, especially for families, while net financing is increasing. In the UK, most of the deleveraging process comes from inflation while net lending is increasing although not as much as in the US. In Spain, the situation is quite different: GDP growth has a leverage-increasing impact and inflation is low enough not to contribute to the relaxation of the problem. Therefore, the deleverage driver is basically a drastic reduction in net lending, together with write-offs for non-financial companies. In a low inflation and low economic growth environment, the deleveraging process in the Spanish economy goes through the reduction of net lending.

On the other hand, the requirement of new regulation to hold more high quality capital and more liquidity, in the context of low current and expected RoE, produces a natural tendency towards reducing the risk weighted assets to reduce the need for additional capital. The effect of the introduction of the leverage ratio[2] also pushes towards a reduction in total assets. The reduction of European banks' balance sheets began some time ago but it is now at full throttle in the Spanish financial system.

The new regulatory context

Most of the regulatory changes can be classified into three blocks: changes derived from the application of Basel III; changes associated to structural reform, or measures to deal with the TBTF issue; and changes related to bank resolution reform. The changes derived from the transposition of Basel III are mostly well known. There are still some uncertainties with respect to the specific definition and triggers of the leverage ratio or the liquidity ratio as well as the transition period for application of each requirement. There is also uncertainty about the decision of national authorities with respect to some of the capital buffers that the regulation only defines as an interval of possible values. Most banks have been preparing during several years for the new regulation despite the lack of precise definition of some indicators, even though there is a long transition period. In fact, it is believed that most of the banks had an average liquidity coverage ratio of more than 100% in its 2013 definition (Basel Committee on Banking Supervision, 2013). There is much more uncertainty about the structural reform and the reform of bank resolution, especially in the Euro area.

There are four main areas of new regulation that have an important effect on the future business model of banks, making them boring again: new capital requirements (Basel III and the European CRDIV/CRR), structural reform (separation of commercial and investment banking activities, limitations in the size of institutions, etc.), financial markets reform (for instance OTC reform) and new resolution frameworks.

The **CRDIV/CRR regulation**, which is the application of Basel III to the European financial system, went into effect the first of January of 2014 although the transitional period will last until 2019. The basic components of this regulation are:

- Increase the quality of capital over risk-weighted assets to improve its absorption capacity in

[2] The specific calculation and limit of the leverage ratio is still a source of heated debate and large disparities among different jurisdictions.

case of losses. Add extra capital buffers for systemic entities, cyclical situations and long lasting periods of stress.

- Implementation of the Liquidity Coverage Ratio (the LCR is defined as high-quality liquid assets as a proportion of banks´ net cash outflows over a 30-days period) to improve the resilience to short-term liquidity shocks.

- Implementation of the Net Stable Funding Ratio (The NSFR is defined as long term assets over long term funding) to reduce maturity mismatches and short term funding incentives to use more long term funding and deposits.

- Implementation of the Leverage Ratio (capital over assets) which serves as a backstop to the arbitrage-ridden risk based measures of capital requirements.

- Increased consumption of capital of derivatives and some types of participations and reduction in the consumption of capital of loans to small and medium firms.

The **structural reform** pretends to reduce the impact of the “too-big to fail issue” and eliminate the implicit subsidy to large banks in their investment bank activities. The structural reform (Vickers-Liikanen-Volcker) adopts alternative approaches in different countries[3] and it is not yet fully specified neither operational. It is not even obvious that the Vickers ring-fence and the Liikanen proposal are totally compatible which has led some experts to talk about the possibility of a double fencing.

The most developed proposal is the so-called Volker’s rule, which is supposed to be the 21st century’s Glass-Steagall act that separated investment banks from commercial banking activities. Since the approval of the Volcker rule by the banking, securities and commodities regulators, there has been an intense debate on its impact on the business model of large banks. The rule is presented in a document of almost 1000 pages by contrast to the 30-something pages of the original Glass-Steagall act. Critics argue that the many exceptions included in the legislation open possibilities to continue business as usual and it relies heavily in policing and enforcing the rule. For instance, proprietary trading is banned except for operations that relate to banks´ liquidity management. Another exception: the amount and types of financial instruments in the trading desk’s market maker inventory cannot exceed the “reasonable” expected near-term future demands of clients, costumers and counterparts. There is strong resistance on the part of the financial system to a strict separation of activities. It is claimed that, for instance, the investment bank of a financial institution will not be allow to take deposits which makes it quite difficult to fulfill the NSFR indicator. In addition, the small size of the investment bank may preclude the possibility of finding capital.

Even without specific regulation on separation of investment and commercial activities, already some banks are feeling the pressure to reorganize along the lines established by structural reforms. For instance, UBS could be considering spinning off its investment bank under the pressure of the Swiss government. UBS and Credit Suisse have already announced plans to “ring fence” parts of their business.

OTC derivatives reform is another regulation that will have important implications for the business model of banks. There are several versions like the EMIR in the European Union, the specific rules of the Dodd-Frank act, the Japanese FIEA, etc. These regulations try to increase the transparency and safety of derivative markets by reducing the counterpart credit risk, having common rules for central counterparties and specific reporting requirement.

Finally, there is the difficult issue of **banking resolution**. The objective of this regulation is to reduce the likelihood of having to inject public

[3] France and Germany have proposed their particular “ring-fencing” mechanisms.

money from the state, or protect the state from losses. This is a basic issue of the process of banking union in Europe. However, there is not a final mechanism and, in fact, the financial rescue of some European countries has shown a very *ad-hoc* approach to banking resolution. The resolution framework may establish the preference of creditors in case of liquidation or their bail-in for continuing activities. Depositors' preference or bail-in bonds can affect the price of senior unsecured bonds and the ability of banks to issue them.

Basic implications of the new regulatory environment

Most of the regulatory changes have a direct implication on the composition of the liabilities structure. Empirical studies show that bank-specific factors, like past choices on funding structures, are very important in the explanation of change in funding sources and their speed, since capital structures are very persistent. Obviously size also matters for the structure of funding.

The changes in the funding strategies of banks are affected largely by regulation and the experience of the financial crisis. The LCR, the NSFR and the run during the crisis will produce a tendency to reduce wholesale short-run funding. Some European banks with a business model that relies heavily on wholesale funding will have to transform their operations substantially with respect to the pre-crisis situation. In some cases it is possible to see a temporal increase in the use of wholesale short-term funding to substitute ECB funding, especially for banks that had problems to access wholesale markets since the beginning of the financial crisis.

In addition, the uncertain application of the ring fencing derived from the structural reform and the slow progress on the resolution regulation has produced a renationalization of banking activity meaning that international banks will tend to match their assets and liabilities country-by-country with subsidiaries self-financing.

But regulatory reform could also have unintended consequences and contradictory effects (IMF, 2013). The improvements in the quality of capital, the capital surcharge for systemic banks (extra buffers) and the better loss-absorbing capacity of junior debt (subordinated debt and CoCos) reduce the probability of default and, therefore, reduce the cost of senior debt. However, there may be a differential effect on secured versus unsecured debt depending on other regulatory changes. Liquidity coverage ratios and OTC reform produce a tendency to increase the degree of encumbrance of banks´ assets.[4] This implies a reduction in the cost of secured senior debt (covered bonds, OTC collateral, etc.) and an increase in the case of unsecured, with the net effect being uncertain. The changes in the resolution framework also have significant effects on the cost of debt. In particular depositor preference in liquidation or the possibility of bail-in powers in resolution (statutory bail-in) increase the cost of unsecured bail-in debt and, therefore, have an important effect on the structure of funding. The size of the effect on the cost of unsecured debt depends on the specific form of depositors' preference (plain or "tiered") and bail-in (minimum bail-in debt, etc). For instance, tiered depositors' preference will concentrate potential losses on a small group of unsecured creditors.

Usually the spread between secured and unsecured bank debt is small, especially when compared with subordinated debt. The IMF estimates that the yield of unsecured debt could increase up to 300 basis points in case of approval of a resolution framework with bail-in power. As a comparison, CoCos have a 500 basis points spread with respect to senior debt.[5]

[4] Central bank funding also implies collateralization although this is a recourse that will not have bearing on the long run business model.

[5] IMF (2013) uses option pricing to calculate the effect of new regulations (increase of capital, asset encumbrance, depositors' preference, etc) on the spread of different sources of banks' funding.

The new regulation requires more and better capital. However, some new regulatory indicators, like the liquidity coverage ratio or the leverage ratio, reduce, or at least limit, the RoE. This pressure adds to the current situation, associated with the increase in impaired assets and delinquency rates caused by the financial crisis: since 2007 the average return on equity has been below the cost of equity.[6] This means that to reach a comfortable regulatory capital ratio the main option is deleveraging. All the strategic plans of large banks adopt the same strategy: reduction of balance sheets and risk weighted assets (RWA).

The actions to reduce balance sheets include selling noncore (legacy) assets and business units (investment bank divisions, etc.), selling business lines in noncore countries, minority stakes in some business, trading portfolios, non-government securities, exposure to some sectors (like real estate and construction), and selling non-performing loans and distressed assets. Banks with large investment banking operations are cutting in nonstandard derivatives, securitized and structured products, proprietary trading and repurchase agreements. Corporate banking also contributes to the process of deleveraging by scaling back in activities that are wholesale-funding intensive, such as syndicated loans, factoring and leasing, project and trade finance, and interbank lending. But the strategic plans also include the reduction in retail banking, especially commercial real estate, bank branches and credit business. The latest data of the ECB (November 2013) show that loans for families and companies are down at 2.3% (annual rate), the largest reduction since the beginning of the crisis and the 19th month of decline.

The reduction of RWA and the process to optimize capital consumption includes the transformation of loan portfolios to increase those assets that consume less capital and reduce categories that have higher risk weight. This could imply a reduction in the mortgage business and an increase in the loans to small and medium size firms. Another example is the reduction of trading books and derivatives (especially for macro coverage) through derivative credit risk optimization. At the same time there has been an increase in government bond holdings since the new regulation continues giving zero-weight to public debt.

Looking at the strategic plans of many European banks for the next 3-5 years we can find many common elements that define the boring banking of the future. The basic objective is to reduce overall risk by transforming the business model to accommodate the lessons learned, the new regulatory requirements and the objective of increasing the RoE. Banks expect to reduce their size relative to the beginning of the financial crisis (except the ones that have grown inorganically during the crisis). In the new steady state assets will be down between 20% and 50% (case of nationalized institutions). The reduction in RWA can amount to 20%-30% with the exception of nationalized banks which can go down as far as 30%-50%. These size reductions, and the need to optimize costs, imply a reduction in branches and workers enough to reach an efficiency ratio between 45 and 50. Another common objective in all the strategic plans is to reduce the loan to deposit ratio. A frequent target is 115-110. Deposits increase their weight among funds reaching 60% and the loan portfolio gains weight among assets. At the same time the proportion of wholesale short term funding will be significantly reduced. The target for a comfortable CET1 ratio is set at 10-10.5% (BIS III fully loaded). Finally, Chief Credit Risk Officers (CCRO) will increase their institutional role and risk committees will increase their responsibility. The final objective is to improve RoE although the target in most banks

[6] Many banks and banking associations claim that 2014 marks the switch from worrying about restructuring the business to concentrating again on profitability. The strategic plans of many banks set the objective of having a return on capital above the cost of capital or a return on capital above 12%.

is 14% or less,[7] when before the crisis the average acceptable RoE was around 20%). Nevertheless, the new regulation on limits to compensation to executives in the financial sector will probably deemphasize RoE as the main performance metric.[8]

Boring banking and the Spanish banks' business model

In principle it may seem that going back to boring banking should be trivial for the Spanish banking sector since, in theory, it had always been a boring financial system. In fact, this was the idea when, at the beginning of the financial crisis, Spanish bankers and government officials claimed that the Spanish banking sector would be isolated from the crisis. Still today one can read in the annual report of some Spanish banks that regulatory changes would affect them less than other international banks, and should not affect their strategy or business model since they were always commercial banks. In a way, it is true that Spanish banks, even the large ones, have never been as focused on capital markets and investment banking as banks in other countries like the UK or even Germany. However, the relevant experience of the Spanish financial crisis indicates that maintaining a retail-oriented commercial banking model does not immunize a business model from problems. For instance, a typical indicator of boring banking is a low loan-to-deposit ratio. That indicator was close to 170 for the Spanish banking system at the beginning of the financial crisis.

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In addition, the significant level of nonperforming loans point to a suboptimal risk management model that, further damaged by very strong competition and low spreads, gave priority to volume as the basic source of income. As argued before, the downsizing of Spanish banks' balance sheets has been fast and the net reduction in customers' loans is an important component of it. For instance, between September of 2012 and September of 2013 the loans to costumers have gone down 8.3% in the banking sector (AEB). In contrast, deposits have increased. Therefore, the loan-to-deposit ratio is going down in a path similar to the one projected by the IMF (Exhibit 1).

During the same period (Sept. 12-Sept. 13) the balance sheet of banks has shrunk 7.7%. Spanish banks have sold noncore assets (minority stakes, non government securities, real estate assets, and asset management arms), debt collection services, real estate management services, and exposure to the real estate and the construction industry, as well as non-performing loans and distressed assets. Most of these deals generated income, reduced capital consumption, and some reduced the number of employees, (like in the case of selling the real estate management service) increasing efficiency ratios.

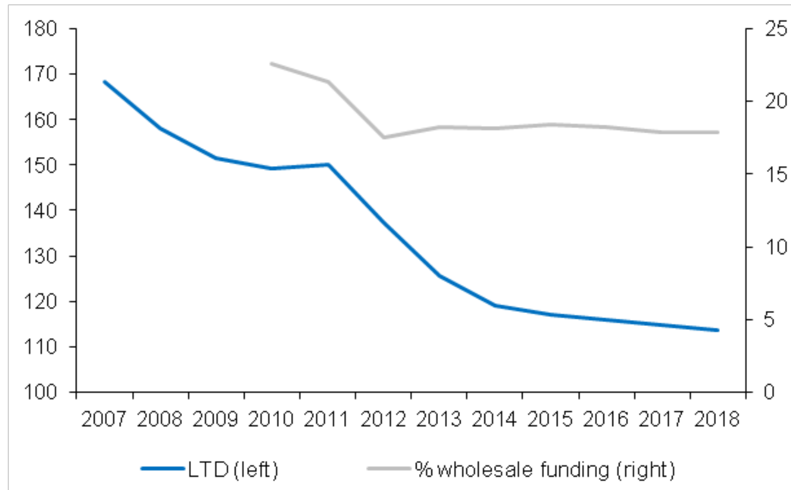
Despite the revenue obtain by these operations, the prospect for recurrent profits in the Spanish banking industry is not bright. The last visit of

[7] The Risk Assessment Questionnaire of the EBA shows a reduction from June-2013 to Dec-2013 in the proportion of respondents that consider a 14-16% long run target for the RoE, and an increase in the ones that target an interval between 12-14% although the mode is still at the 10-12% interval. Most of the respondents to the RAQ consider that the cost of equity is between 10 and 12%.

[8] There are some suggestions to use ROA or even RORWA as the most relevant metrics. This makes sense in a context where leverage will have regulatory limits.

Exhibit 1

Loan-to-deposit ratio and wholesale funding in the Spanish banking system



Source: IMF (2013).

the Troika (EC, IMF and ECB) emphasized the worries about the future profitability of the Spanish banking sector in contrast to the preoccupation about capital and provisions they showed in previous visits. This is not only a problem for Spanish banks. EBA (2013) points out that the risk premium of EU banks remains high "not least because of profitability concerns. Earnings may not be sufficient to cover rising bad loans… persistent low interest rates are also putting pressure on the business model sustainability of banks which find overall net interest margins squeezed contributing to profitability pressures." Spanish banks are not an exception. The shrinking net interest income, the lack of trust in the banking sector, the legal risks, the impact of the regulatory and macroeconomic situation do not provide reasons for optimism. Non-performing loans will remain high during some time, reducing the size of the interest producing loan portfolio. Low interest rates will not help either to increase net income. Despite the shrinking in total assets of banks, the ratio of net income to total assets has gone down from Sept. 2012 to Sept. 2013 (from 2.2% to 1.95%). This drop translates into a reduction in 0.2 pp in gross income and net operating income. The increase of ordinary profit before taxes (0.2% of total assets) is due only to the reduction of loan-loss provisions. The ordinary consolidated profit reached 0.46% of assets (from 0.24% in Sept. 2012).

The improvement in financial conditions and the reduction of sovereign spreads is producing very good news for Spanish financial institutions in the debt market since the beginning of 2014. Four banks have been able to issue senior debt with a large excess of demand, predominant interest of foreign investors and a small spread.

With respect to the liability side of the balance sheet, the Spanish banking sector is moving towards a normalized situation compatible with a boring funding scheme. Banks are replacing the LTRO provided by the ECB by increasing deposits, unsecured bonds and covered bonds.

Table 1

Issuance of senior debt (first half of January 2014) and a comparative benchmark of 2013

	Date	Year	Issuance	Demand	% foreigners	PB midswap	Coupon
BBVA	Jan-13	5	1500 M	5000 M	90%	295	3.75%
BBVA	Jan-14	5	1000 M	2600 M	81%	118	2.42%
Santander CF	Jan-14	2	1000 M	1900 M		93	1.46%
Bankia	Jan-14	5	1000 M	3000 M	85%	235	3.6%
BMN	Jan-14	3	500 M		72%	190	2.6%

The Bank of Spain points out that, through August 2013, deposits had increase 7.7% versus the reduction of 6% during 2012. Given the persistent reduction in balance sheets and the increase in deposits, banks continue to be negative net issuers of senior unsecured bonds and covered bonds. Spanish banks issued 28 billion euros in debt during 2013 including medium and long run senior debt and covered bond. The improvement in financial conditions and the reduction of the spread of the Spanish sovereign is producing very good news for Spanish financial institutions in the debt market since the beginning of 2014. Table 1 shows that four banks have been able to issue senior debt with a large excess of demand, predominant interest of foreign investors and a small spread. By comparison we can see that Bankia has issued debt with a spread smaller than the spread of the first debt emission of BBVA in 2013. In addition BMN, also a nationalized bank, has issued covered bonds (500 million euros) with a midswap of 190 points. During the first 15 days of 2014, there have already been 4 billion euros in emissions of debt by Spanish banks. This means that the Spanish financial reform has been able to generate some confidence among international investors.

With respect to capital requirements, the issuance of the first CoCos by BBVA has opened this market for additional Tier 1 capital. Société Générale, Crédit Suisse, Barclays and Popular have followed the lead of BBVA.

Banks’ profitability under boring banking: The next frontier

While the liabilities side is improving, the profitability indicators generate some concerns. EBA (2013) points out that “the sustainability of some EU banks’ business models remains a cause of concern whilst it is still unclear from where their future profitability drivers will originate”. Identical comments can be applied to Spanish banks. It is necessary to transform their business models finding new sources of income and increasing the efficiency in the provision of financial services.

Internet banking is already a well-established alternative business channel to physical branches. But multichannel access to banks is not enough in an interconnected and “datafied” world. While department stores have been using data science to provide highly targeted and relevant offers to their customers, increasing their loyalty, banks are still years behind. This is quite paradoxical if we consider that banks have a unique perspective to understand costumers needs since they know their income and spending patterns, their saving profiles, their leverage levels, etc. The use of data science and big databases allows the analysis of billions of pieces of information to offer clients services and experiences that satisfy their needs. Banks have access to vast amounts of data, allowing them the possibility to offer personalized products and services to customers for covering their financial needs and not just commercial objectives fixed a priori by management. In

addition, this type of approach facilitates cross-selling of financial products.

Personalized banking democratizes financial services by offering advice to low net worth costumers using the techniques of data science (data management, statistics and algorithms) that substitute human advisors. Using all the knowledge about the history of investments, expenses, transactions, etc. of clients can help dramatically to offer them products that they find useful to manage their finances. At the same time, these procedures can avoid mistakes in the commercialization of products that are not appropriate to some costumers, which in the past have generated important reputational damage among banks and financial institutions. In essence, it is moving from a bank-centered business model to a client-centered approach. A successful strategy of personalized banking can also help to improve the relationship between banks and retail customers in an age of mistrust of banks.

At this time, the use of these procedures is primitive and quite unsophisticated in many banks: some banks offer automatically approved small loans based on a few indicators or send unsolicited credit cards to specific costumers. There is a world of new possibilities in personalized banking. Another reason why exploiting the huge amount of data generated by financial institutions is critical for their business model is the potential competition of big data firms in the provision of financial services. Using consistent and more granular data can help to price products efficiently in the face of growing competition from non-banks.

Obviously, for some business lines (wealth management, etc.) and costumers, the traditional financial advisor will still be needed. But for the majority - traditionally, low profit costumers - it is possible to have new business lines by tailoring offers and services to address their real needs, priorities, and risk profiles. This strategy would also counterbalance the reduced demand for banking products and services derived from low economic growth and reputational concerns.

Data science can also be critical to improve the internal models of scoring of costumers. The return to emphasis on risk evaluation, management and control implies that a significant improvement in the methodologies of risk evaluation can provide a high return in terms of increasing business and avoiding NPLs in the future. With small spreads, any gain in the procedures of risk evaluation can provide a competitive edge.

In a period of low interest rates, the pressure on net interest income is high but clients are willing to take some risk in search for yield. Therefore, asset management has some good opportunities to generate fees and commissions. It is also important to translate to costumers that financial services are costly to produce and, therefore, some fees cannot routinely be eliminated.

Finally, but also very important, Spanish banks should continue to increase their efficiency as a way to improve profitability. This is a general strategy that financial institutions are using in all countries. In the Spanish case, the sharp contraction of balance sheets of group 1,[9] and some group 2[10] banks, together with the acquisition of insolvent banks by healthy financial entities, has produced an important reduction in employment within the financial sector.

In sum, the pressures to maintain or improve profitability suggest that Spanish banks should concentrate on improving their efficiency, increasing fee and commission income and abandon business lines that do not belong

[9] Banks already owned by the government's Fund for Orderly Bank Restructuring (FROB), including financial institutions such as BFA/Bankia, Catalunya Caixa, NCG Banco, y Banco de Valencia (recently acquired by Caixabank).

[10] Banks with capital shortfalls identified by the Stress test and unable to meet those capital requirements privately without re-course to State aid, including BMN, Banco Caja 3, Liberbank and Ceiss.

to their core business. Funding should be diversified with a high proportion of deposits but a reasonable mix of secured and unsecured debt, avoiding excessive encumbrance of assets. The substitution of ECB funding for wholesale funding could result in a temporary and short lived increase in the proportion of those funds. Since raising capital will continue to be a challenging task, optimizing capital consumption and retaining earnings should provide a buffer large enough to absorb future losses and keep the spread low on unsecured debt. New capital instruments such as CoCos should also be considered in the mix of Tier I capital instruments. And, most importantly, risk evaluation and management should be handled with care and proficiency.

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