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Banking union 1.0: challenges for Spanish banks

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VI Jornada Sector Bancario Español, IVIE

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1.- The banking union:1.0: a milestone that needs completion

BU 1.0 was pivotal in underpinning the euro and BU 2.0 will be so in breaking the bank-sovereign doom loop for good

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Banking union 1.0: we are already there

New **supranational** architecture for banking regulation & oversight

Pillar I

SINGLE RULEBOOK

- Common rules

(CRDIV, BRRD, DGS)

2014-2015 ✓

Pillar II

SINGLE SUPERVISOR (SSM)

- Since Nov 2014
- Comprehensive Assesment + recaps

2013-2014 ✓

Pillar III

SINGLE RESOLUTION (SRM)

- Starting Jan 2015 (full powers 2016)
- € 55bn Fund by 2023

2015-2016 ✓

Pillar IV

SINGLE DGS

- Dropped from the agenda (!)

?

Built up in record time!

The BU 1.0 helped underpin the Euro…and it has achieved a lot more

A new genuinely European institutional setup

1	Single Rulebook	Better regulation Level playing field: CRDIV BRRD, DGS
2	Single Supervision	Single interpretation of CRDIV No supervisory ring-fencing Confidence in banking sector
3	Single Resolution	Single interpretation of BRRD Predictability in resolution Cross border resolution Resolution costs mutualized

- A **European control center for banks:** unthinkable only a few years ago!!
- But: complex setup and further harmonization in key concepts still required: RWA, NPL, national discretionalities, model validation, etc

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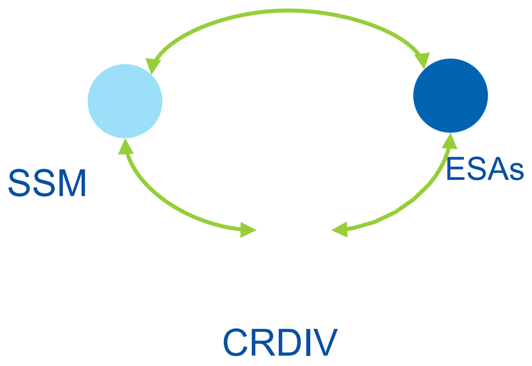
Triple regulatory action to restore confidence in banking sector

A PREDICTABLE AND CLEAR FRAMEWORK

I Reduce probability of failure



II Reduce costs of eventual resolution for taxpayers

1. Private solutions
2. Bail-in (min 8%)
3. Resolution Fund (max 5%)
4. Public backstop (national, ESM)

III Deposit protection

- DGSD: Covered deposits <100.000€
- BRRD: Other (depo preference)

Legacy issue addressed through Comprehensive Assessment prior to SSM launch

Financial firepower of the resolution fund: will it suffice?

All banks in the EZ should contribute

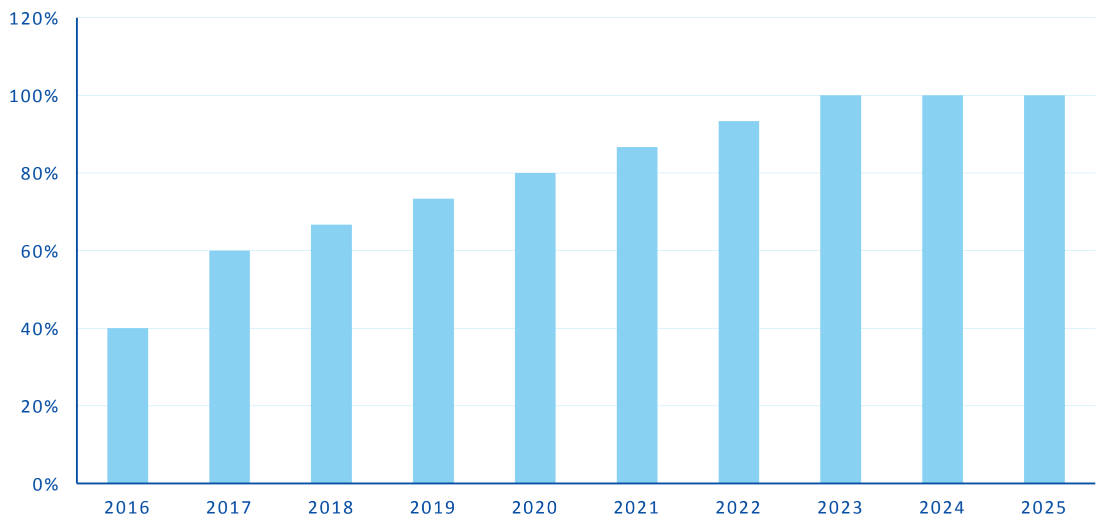
Ex-ante €55bn (1% covered depos) only in 2023, but together with a **new paradigm**

- More vigilance
- Better plans (RRPs)
- Bail-in

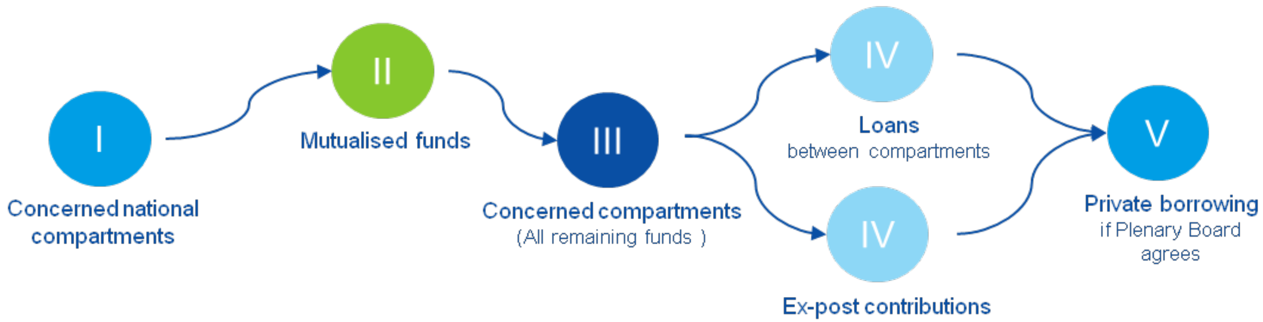
And also **ex-post** financial power:

- Ex-post contributions
- Private borrowing
- Public backstop

Progressive mutualization of contributions to the SRF



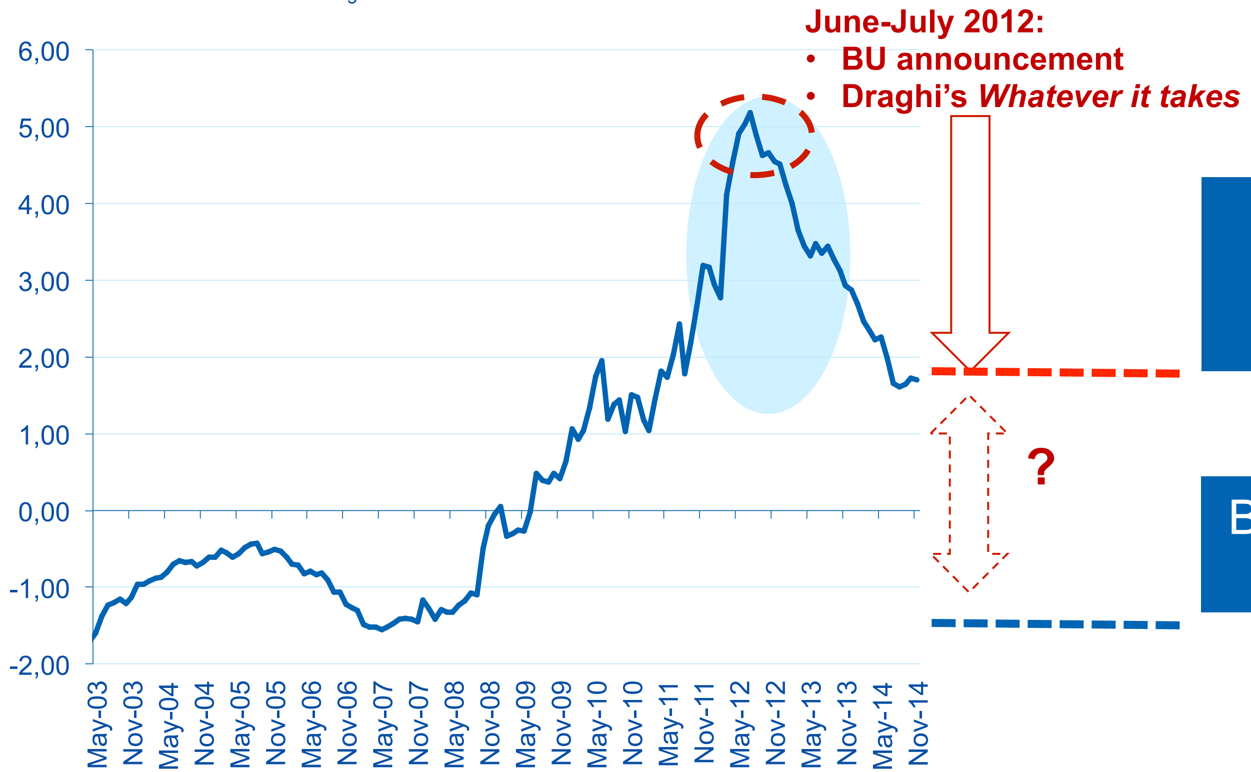
Use of the Single Resolution Fund (2016 - 2023)



It will take time to break the vicious circle but BU 1.0 has put us on the good track…

Composite measure of EZ financial fragmentation

Source: BBVA Research and Bloomberg



Financial fragmentation has gone down but the problem still persists

By how much? We don't know but we are not there yet

Arrival point: credit conditions dependent on credit worthiness (not location!)

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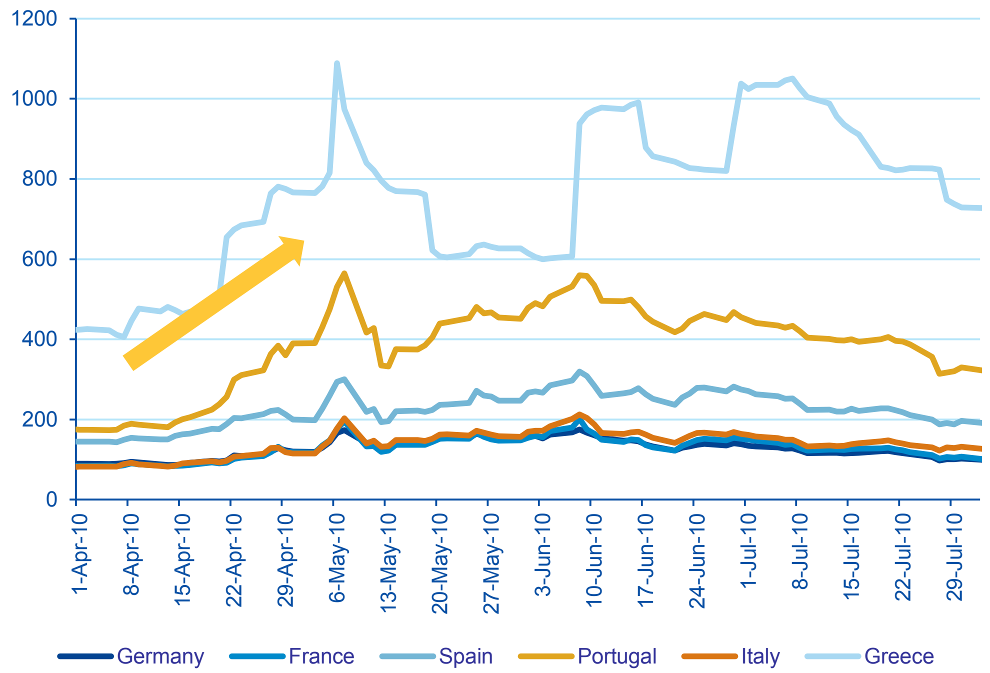
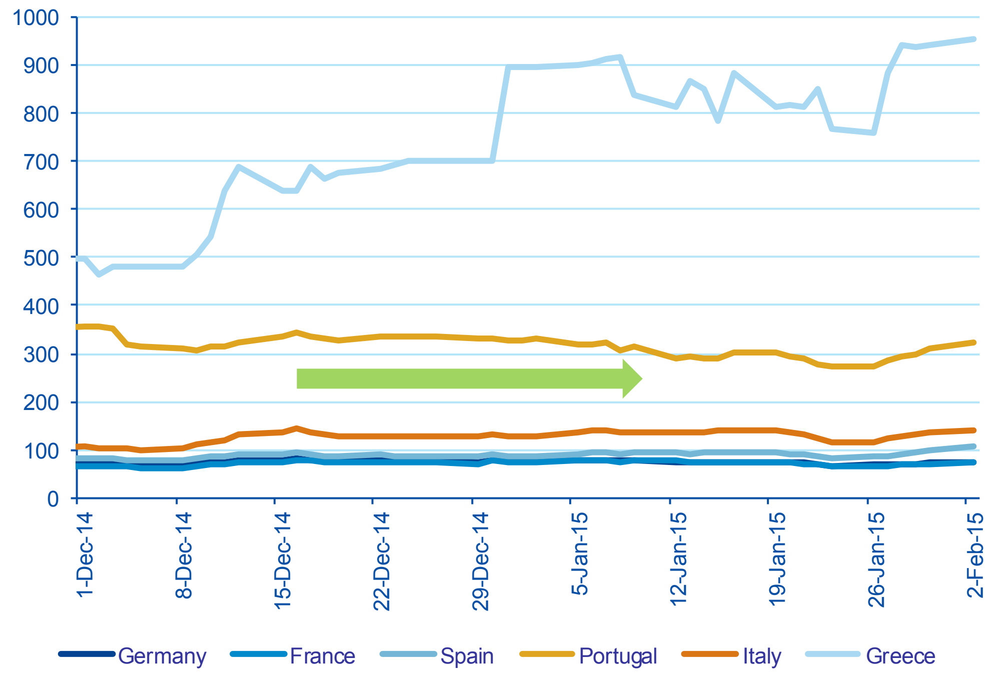
The banking union has helped moderating the contagion of banking crises

Banks' CDS (weighted average, by assets)
Source: BBVA Research and Bloomberg



Greek first rescue: May-10

Banks' CDS (weighted average, by assets)
Source: BBVA Research and Bloomberg



Greek elections and deposit run: Jan-15

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What's missing from banking union 1,0?

Elements needed to break bank-sovereign doom loop

Enough for now? Complacency?

Banking union 2.0

Further harmonization (e.g soft capital)
Completion of BU 1.0 with EMU safety net:
- **Single DGS**
- **Common public backstop**

Main hurdle: Treaty change, fiscal union
Main risk: overshadowed by CMU?

Fiscal and economic union

Back to **Four President's roadmap** (Fiscal, economic and political union)
Main hurdle: Treaty change required
Main risk: deadlock in fiscal front/ BU 2.0

Hand in hand?

Good, but… Long Term

Capital Markets Union

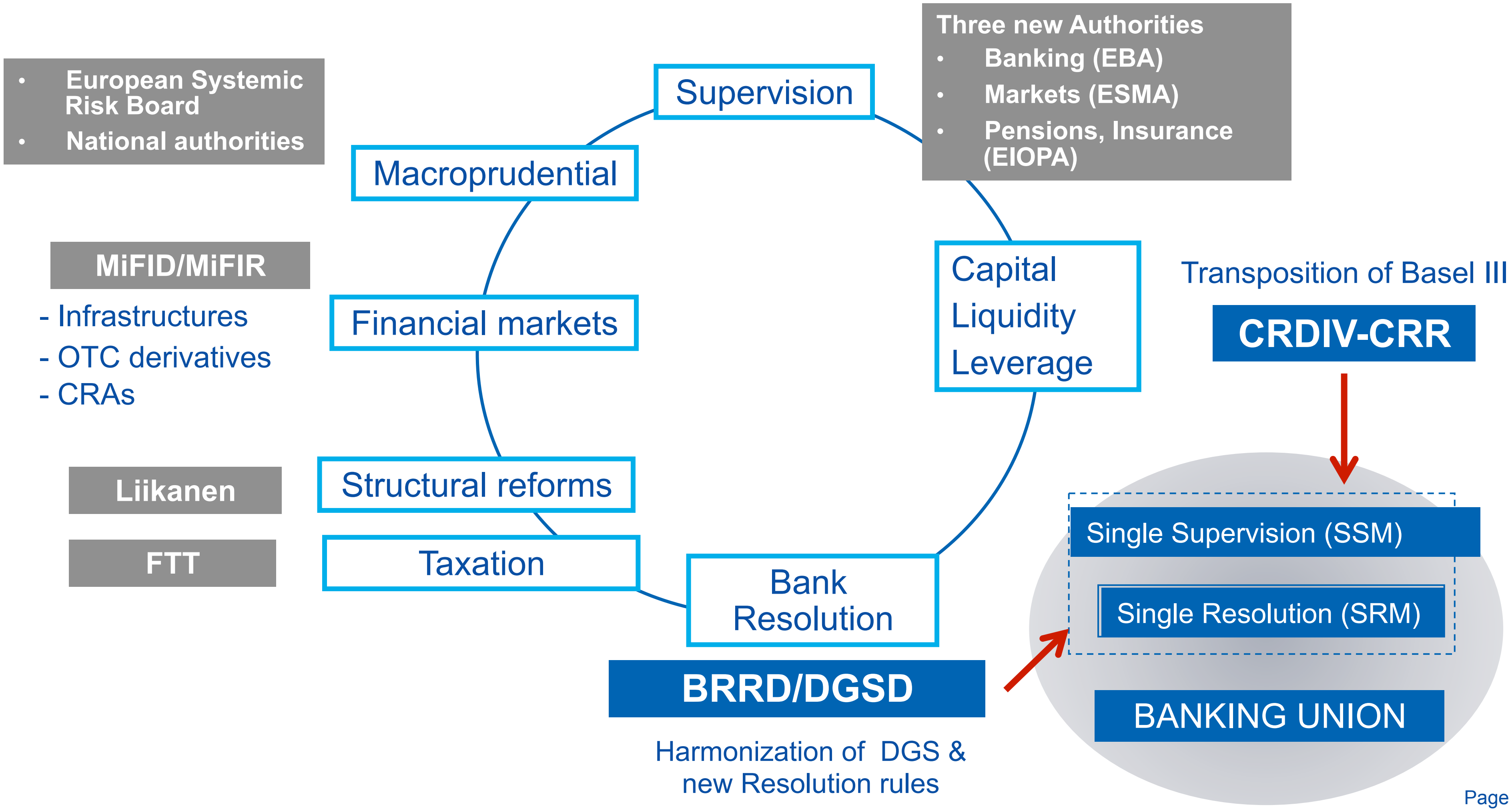
New Commision's **flagship** project
Main hurdle: Long-distance race but not a substitute for healthy banking to foster growth
Main risk: resistance to hand over sovereignty on insolvency law, some taxes, etc

With BU 1.0 we bought time to refine the whole new setting but needs to be done now that we have the time

2.- Challenges for the Spanish banking system

Banks will go under significant internal changes in order to adapt to the new environment but costs are manageable and certainly for a greater good

BU adds (further) regulatory burden…

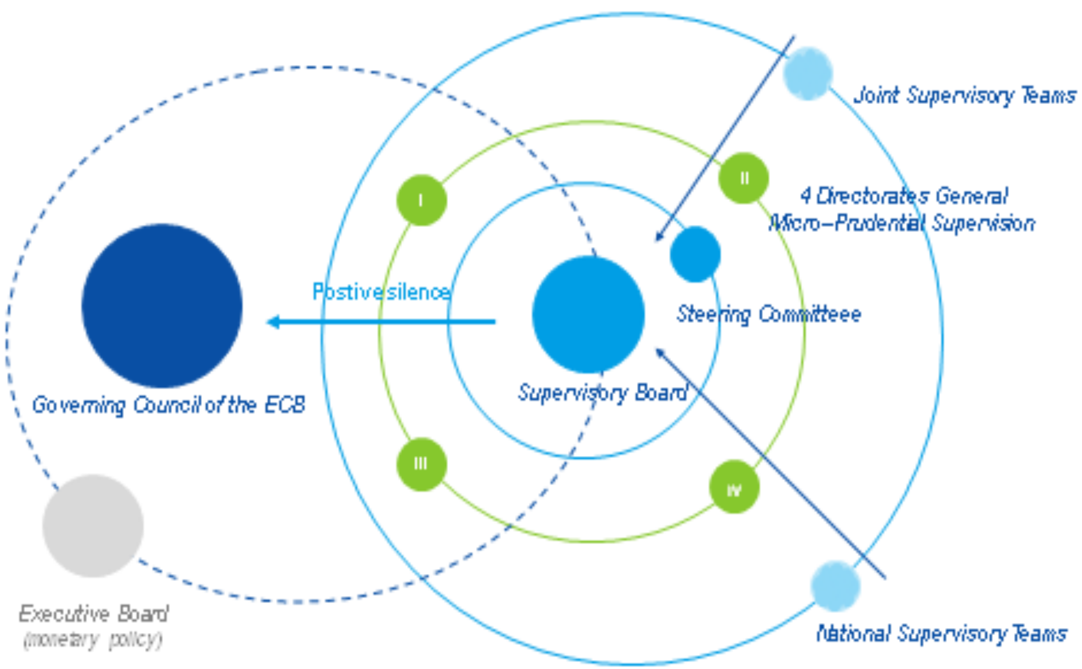


… with a new institutional complexity

		SPAIN	Eurozone	EU
FRANKFURT	SSM	BANCO DE ESPAÑA Eurosistema	EUROPEAN CENTRAL BANK BANKING SUPERVISION	EBA EUROPEAN BANKING AUTHORITY; Supervisory colleges; ESRB European Systemic Risk Board European System of Financial Supervision
BRUSSELS	SRM	FROB; BANCO DE ESPAÑA Eurosistema	SRB SINGLE RESOLUTION BOARD; SRF; European Stability Mechanism esm	European Commission Competition; Resolution colleges
SPAIN	DGS	FGD		

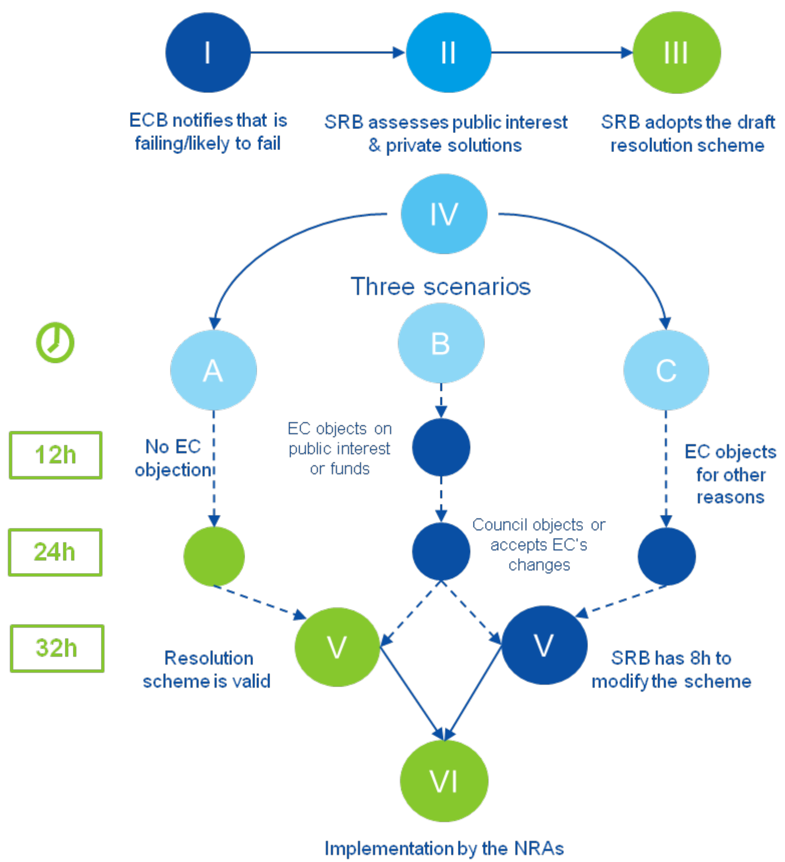
These new animals have complex internal structures and governance

The SSM multidimensional universe



The maze of SRM decision-making

Resolving a significant or cross-border bank



The new supervisory approach

- MORE QUANTITATIVE & PROCEDURAL
- BASED ON BEST PRACTICES
- SMOOTH TRANSITION TO NEW STANDARDS

CONSISTENCY

Level playing-field across EZ

SREP approach to Pillar 2 more quantitative

Based on **peer-review** analysis

PROPORTIONALITY

- Toughness and intrusiveness increasing with bank significance

RISK-BASED

- **Thematic** risk assessments
- Peer-review analysis

FORWARD LOOKING

- **Stress tests** here to stay
- Lots of **data** requirements

CONSTRAINED JUDGEMENT

- **Less supervisory judgement** than for most NCAs
- More **emphasis on rules**
- Especially for **non- significant** banks

PROCEDURAL AND TRANSPARENT

- SREP guides the whole process, with strong quantitative approach
- Governance become relevant (document every decision)
- Transparency and disclosure

The new SREP

SREP: *Supervisory Review and Evaluation Process*

CAPITAL	LIQUIDITY	GOVERNANCE	BUSINESSMODEL
RAS	RAS	RAS	RAS
ICAAP ICAAP STRESSED	ILAAP		

Arrival point: SREP score:
from 1 (no-risk to 4 (high risk) y F (Failed or about to fail)

SUPERVISORy MEASURES: CAPITAL, LIQUIDITY, OTHER

New key concepts: **SREP, ICAAP/ILAAP, RAS**

Risk Assessment System (RAS)
On-going evaluation by ECB

Internal Adequacy Assessment Process (ICAAP/ILAAP)
Annual, banks with ECB appraisal

Pillar 2 becomes essential part in supervisory dialogue: avoid national discretions to preserve **consistency**

Corporate governance and the new SREP

Supervisory Review and Evaluation Process (SREP): Scope

- Capital
- Liquidity
- Business Model
- Corporate Governance: should encompass the following areas
  1) Overall internal governance framework
  2) Corporate and risk culture
  3) Organisation & functioning of the management body
  4) Remuneration policies and practices
  5) Risk management framework
  6) Internal control framework
  7) Information systems and business continuity
  8) Recovery planning arrangements

Competent authorities will evaluate the risk of prudential impact posed by poor governance and control arrangements and their effect on the viability of the institution

Main challenges in supervision

PRODUCE AND MANAGE DATA	CULTIVATE GOOD RELATIONSHIP	SET UP GOOD PROCEDURES & DOCUMENTATION	EFFICIENT INTERNAL COORDINATION
Quantitative approach together with more **transparency** and **disclosure** generates **lots of data requests**	**Develop a good work environment with new authorities (SSM, BoS, ESRB, EBA, SRB/FROB)**	**Communicate efficiently data, business plans, governance, internal control procedures, etc**	**Strong internal coordination will be required to collaborate in the ICAAp, ILAAP, RRPs, RAF, etc**
Data must be **gathered and managed**	**Get them to understand the bank's business model**	All **decisions** must be properly **documented** and ready to be shown to the supervisor	
Update systems and processes	**Macroprudential**: who to address to and for what?		

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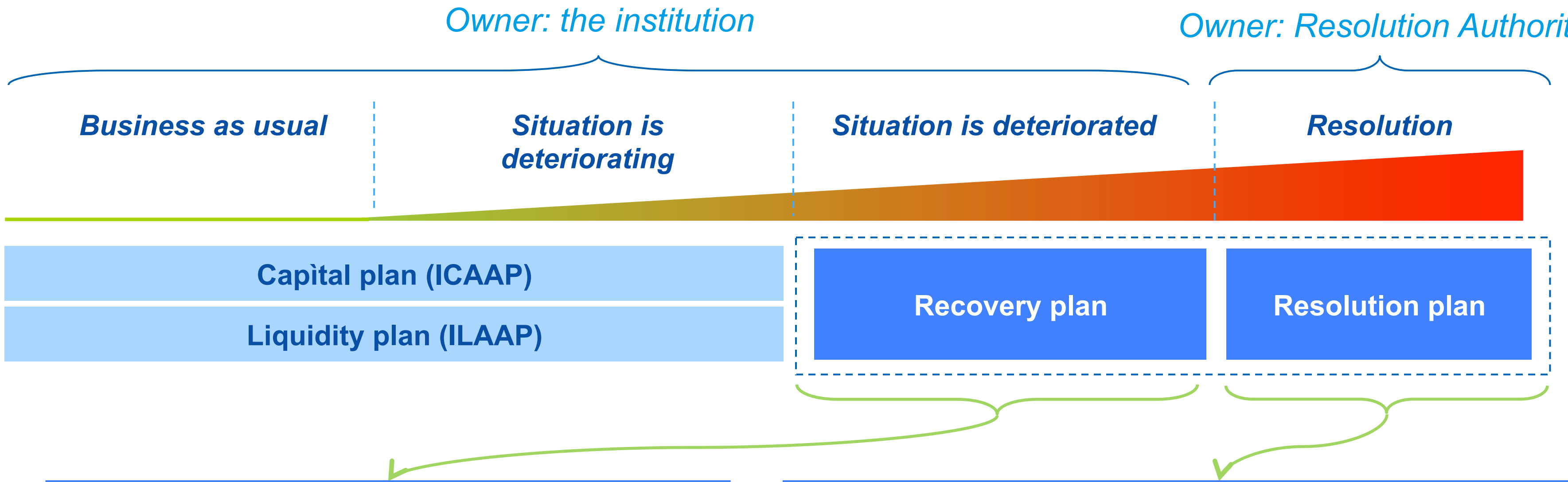
Main challenges in resolution



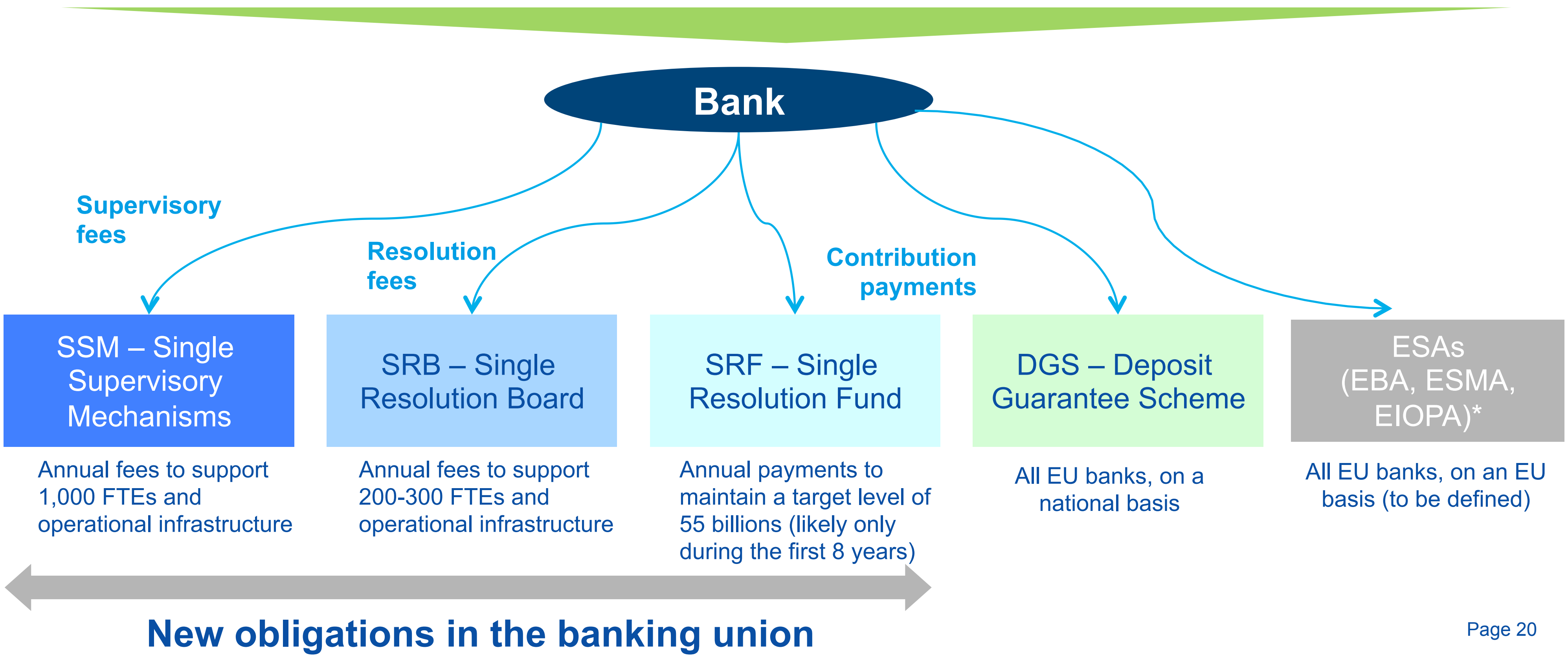
All banks have to develop annually a firm's **complete "menu of options" for addressing extreme financial stress** and describe the **firm's governance** (indicators, roles and responsibilities) in crisis periods.

Resolution authorities have also to carry out a resolvability assessment **identify and develop the preferred resolution strategy** in each banks with the aim of **making the resolution of any firm feasible** without severe systemic disruption and without taxpayer support.

As a result, resolution authorities will determine the **minimum requirement of bail-inable liabilities (MREL)**

The new fees & contributions for banks

All banks will have to finance the new institutional framework – the SSM and the SRB – and to fund the new private resolution fund – the SRF.



3.- How do Spanish banks stand amid the BU 1.0?

Spanish banks are now in good shape, but profitability will be an issue going forward

How do Spanish banks stand amid the BU 1.0?

The Spanish economy will grow at lower rates, closer to its potential growth

There will be low interest rates and the deleverage process will continue

New fintech players and technological progress will increase competition, changing the way in which entities operate and their relationships with their clients

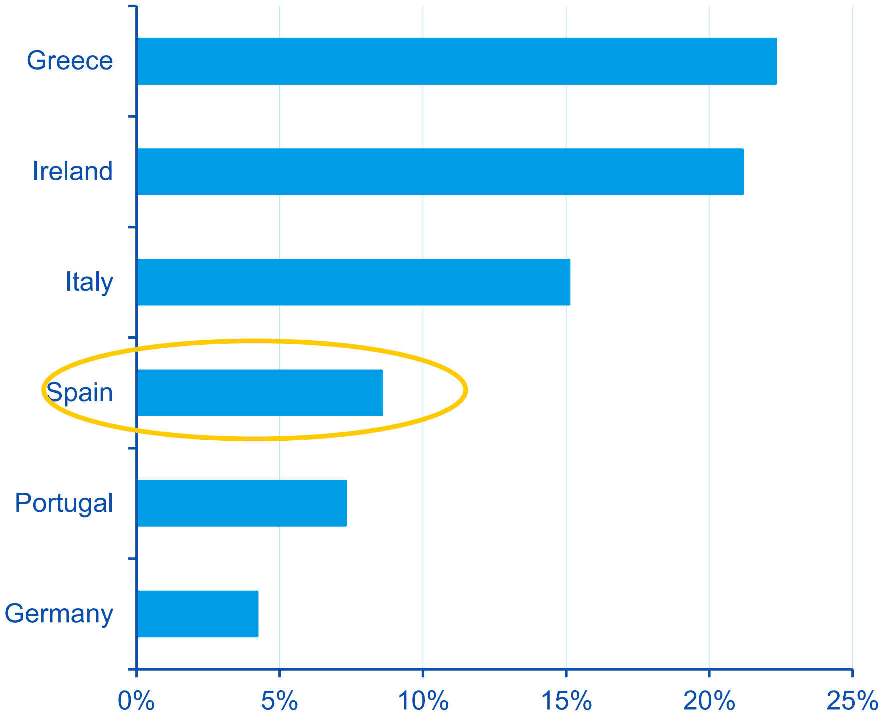
Capital Markets Union will foster non-banking financing

Low profitability, unlikely to return to pre-crisis levels

Spanish banks are now in better shape than other European peers

NPL ratio (% total loans, Dec-13)

Source: BBVA Research based on EBA Stress Test



Spanish banks have a lower burden of legacy assets than other European banking systems, as they have gone through the cleaning of the balance-sheets

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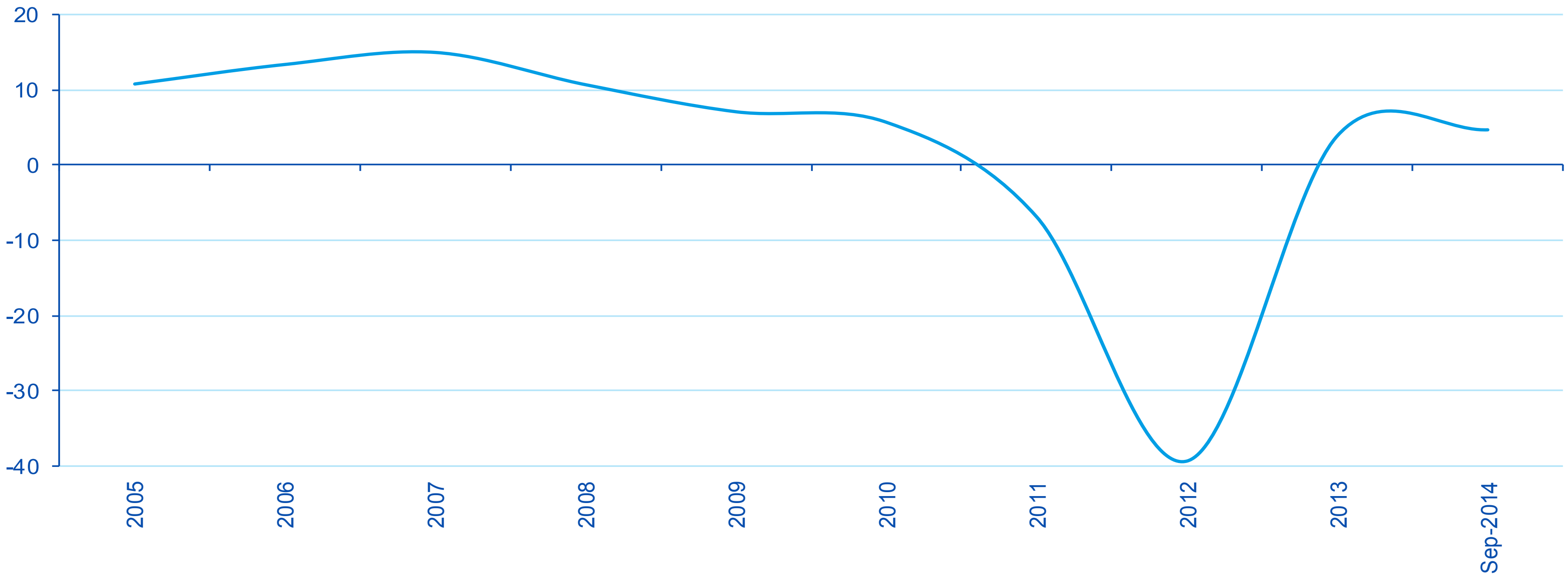
Profitability: The system is unlikely to return to pre-crisis levels

According to EBA, the Cost of Equity will be 8-10%

Return on Equity* (%)

*Profit after tax

Source: BBVA Research based on Bank of Spain and Bloomberg



Will profitability cover the cost of capital?

Banks will have to overcome obstacles and uncertainties in this new landscape

Higher cost of issuing capital, due to new requirements of more capital (and of better quality)

Obstacles for concentration / bank mergers:

- Retail and wholesale banking separation
- “Too big to fail” regulation
- Supervisory objections to international expansion

X

Lower profitability

The Banking Union will help to bridge the gap between cost of equity and profitability

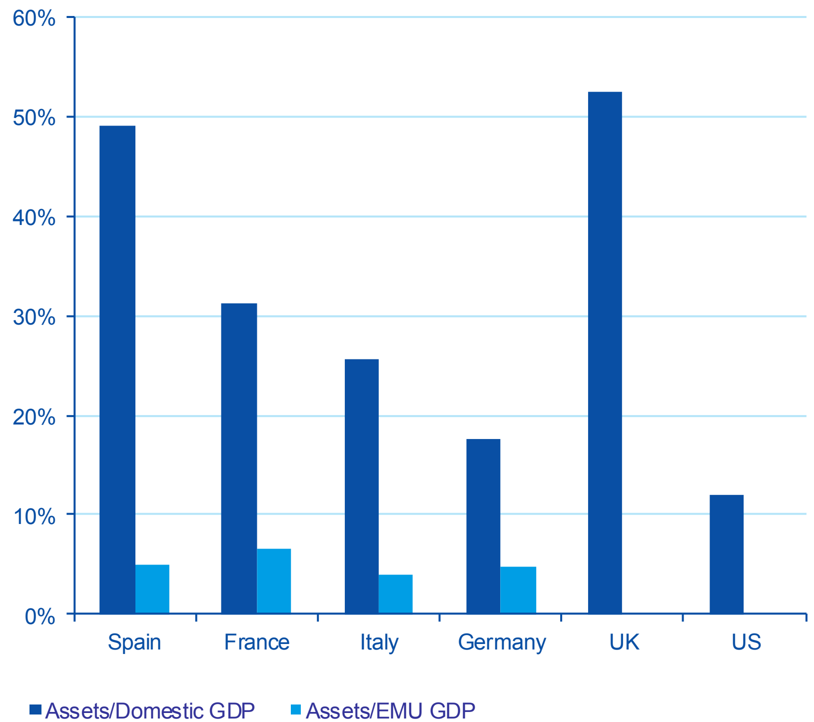
The European financial system will be more resilient

√ **Lower cost of equity**

Concentration, first domestic and second cross border, searching for profitability.
Concentration is still far from generating competitive distortions

√ **Higher profitability**

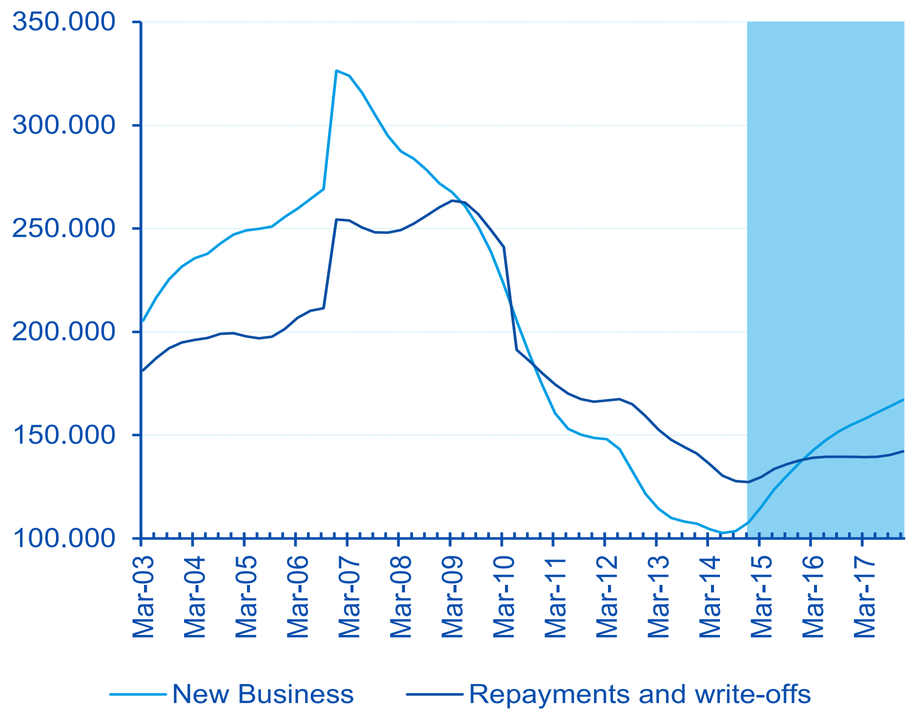
Assets of the main domestic player
(2013, %GDP)
Source: BBVA Research based on IMF, AEB and entities' annual accounts



The size of European financial institutions is not excessive, and even less so when compared to the euro area economy

The deleverage process will continue, so credit will not strongly support profitability in the short term

Private Sector: New Loans and Repayments
(Quarterly figures, EUR mn)
Source: Bank of Spain and BBVA Research



Deleverage is needed in terms of stocks but must be compatible with new credit to solvent demand, to support the recovery

New lending will not exceed repayments (outstanding credit will not grow) until end-2015

Should we think that the Say's law applies to credit?

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Financial fragmentation is affecting credit conditions

Determinants of interest rates on new bank lending

(to non-financial corporations, less than 1million €)

Source: BBVA Research based on ECB and Bloomberg

	France	Spain	Italy
Commercial policy	1,55	--	--
ECB official rate	0,79	1,37	1,26
Spread 12 months (12m-Euribor)	1,19	0,83	--
Spread EMU (10y-Euribor)	0,28	0,41	0,18
Spread sovereign (10y country-10y EMU)	--	0,70	0,69
Firms default rate	--	0,12	0,21

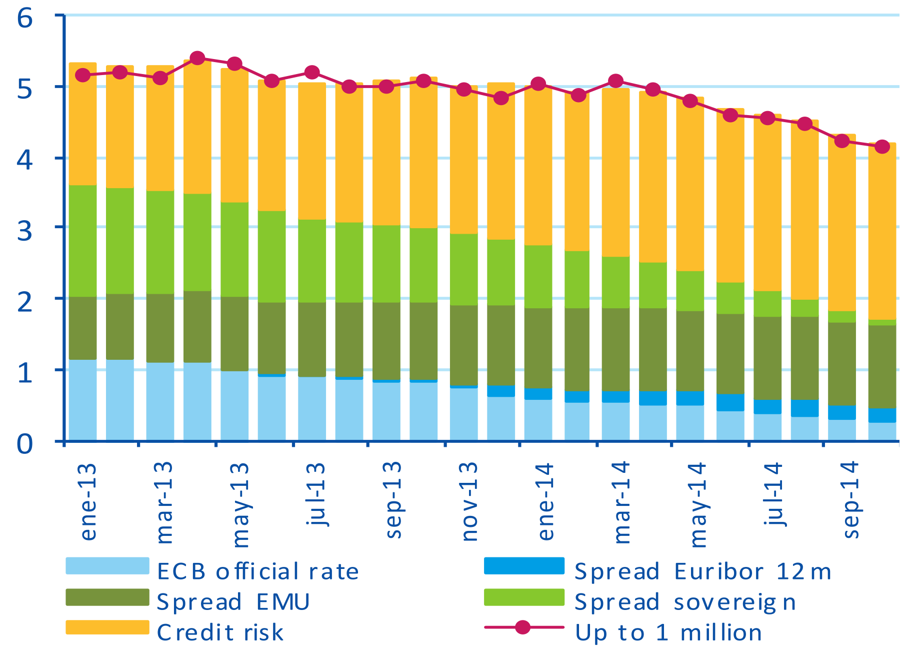
-- Does not differ significantly from zero

Contributions to interest rates on new bank lending

(%)

(to non-financial corporations, less than 1 million €)

Source: BBVA Research based on ECB



The reduction in the Spanish risk premium and in the ECB official rate have explained most of the fall of credit rates

In the future, the ongoing reduction in firms' default rate (credit risk) will contribute to the contraction of credit rates

Wrap up

BU 1.0 was pivotal in underpinning the euro and BU 2.0 will be decisive in breaking the bank-sovereign doom loop

Banks will go under significant internal changes in order to adapt to the new environment but costs are manageable and certainly for a greater good

Spanish banks are now in good shape, but profitability will be an issue going forward. Something´s got to give!

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Thank you!