

Banking union 1.0: challenges for Spanish banks

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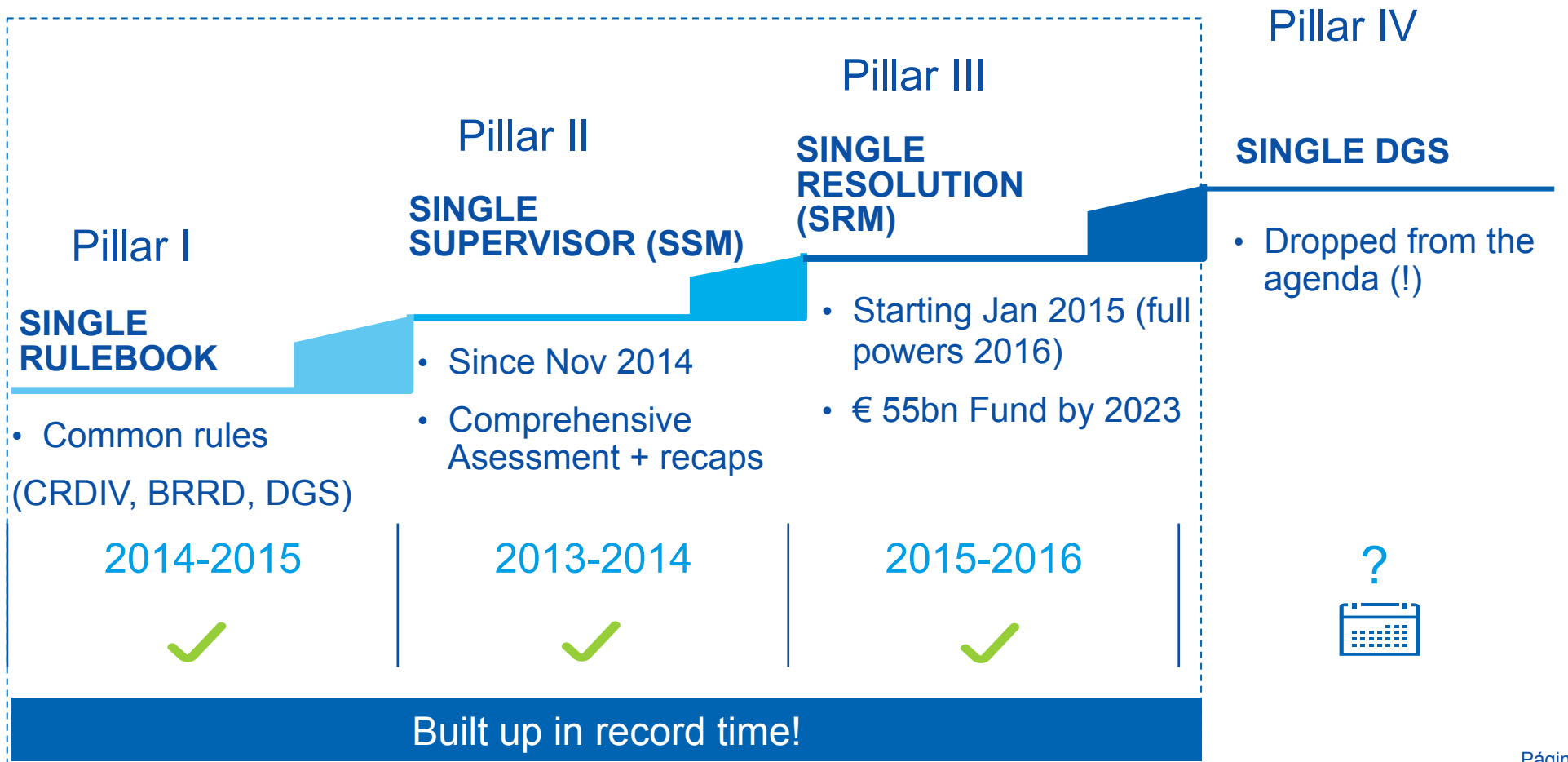
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1.- The banking union: 1.0: a milestone that needs completion

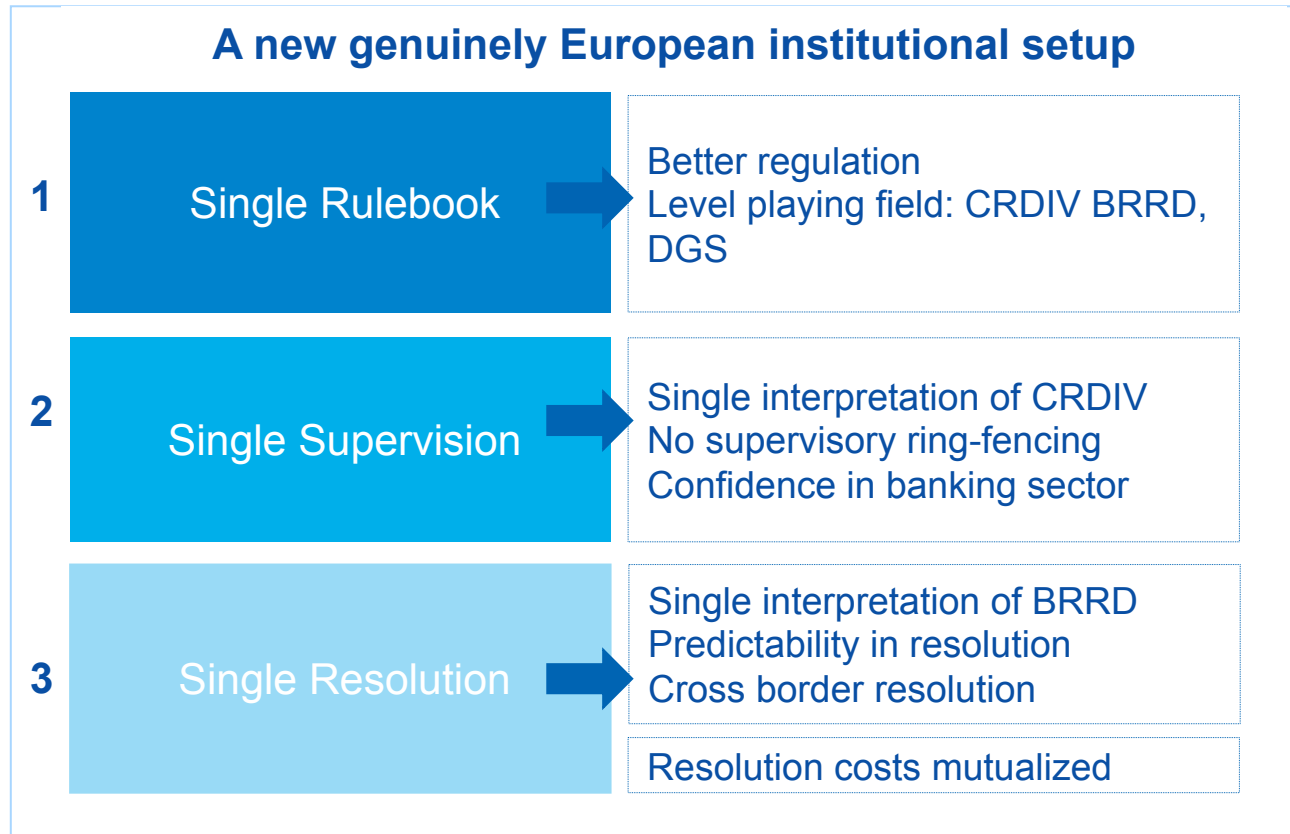
BU 1.0 was pivotal in underpinning the euro and BU 2.0 will be so in breaking the bank-sovereign doom loop for good

Banking union 1.0: we are already there

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



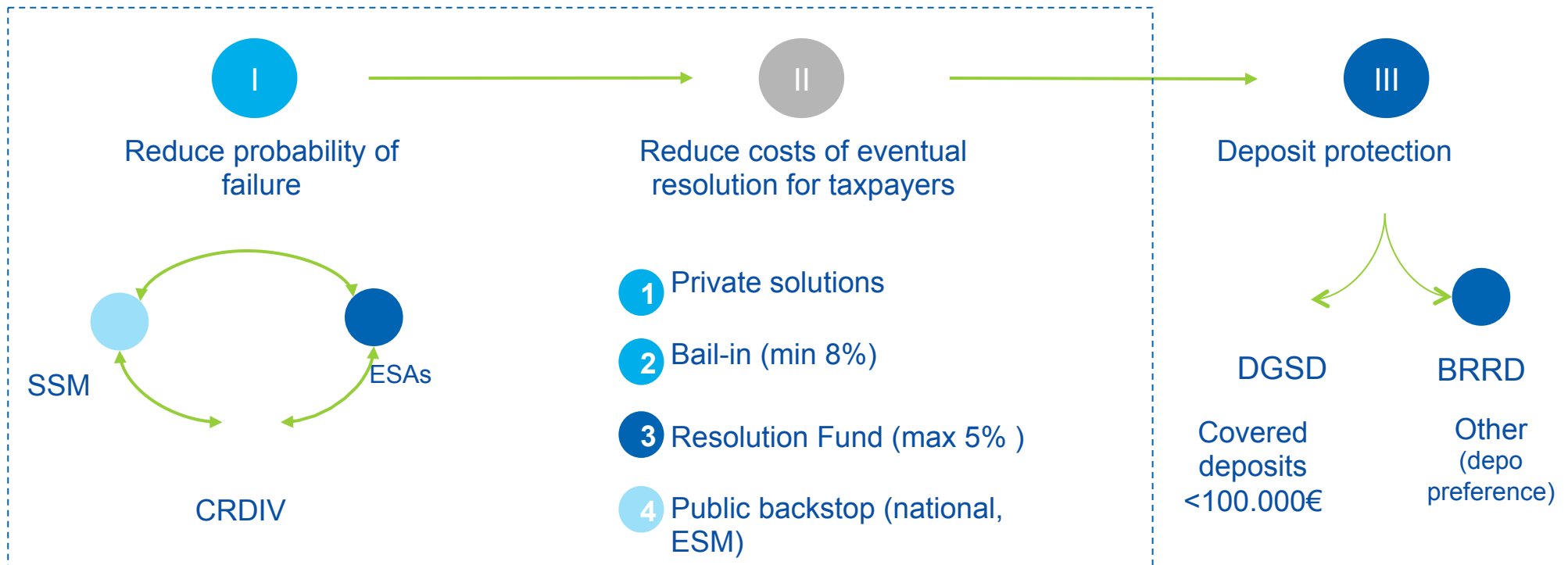
The BU 1.0 helped underpin the Euro...and it has achieved a lot more



- **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 discretionaryities, model validation, etc**

Triple regulatory action to restore confidence in banking sector

A PREDICTABLE AND CLEAR FRAMEWORK



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

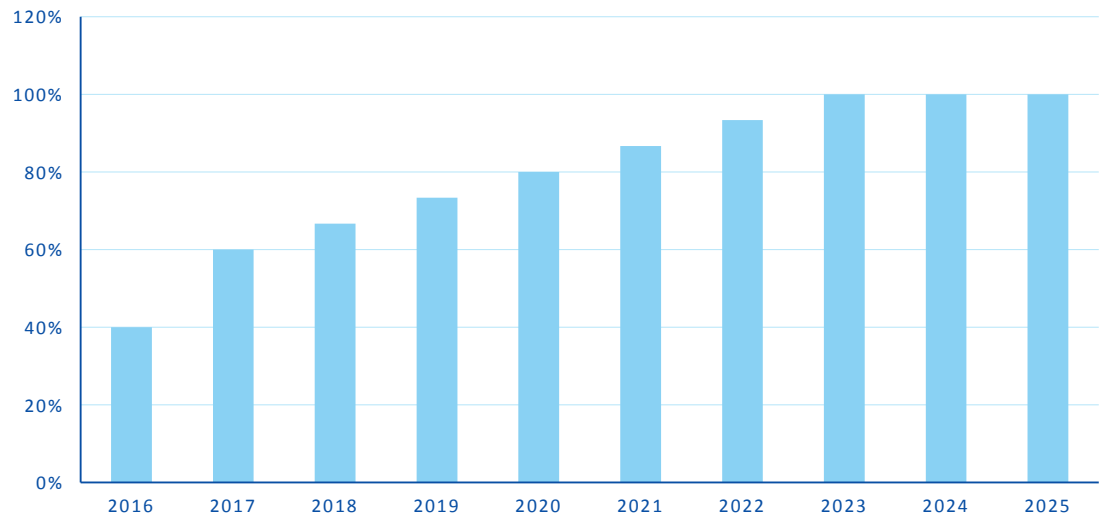
Ex-ante €55bn (1% covered depos) only in 2023, but together with a **new paradigm**

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

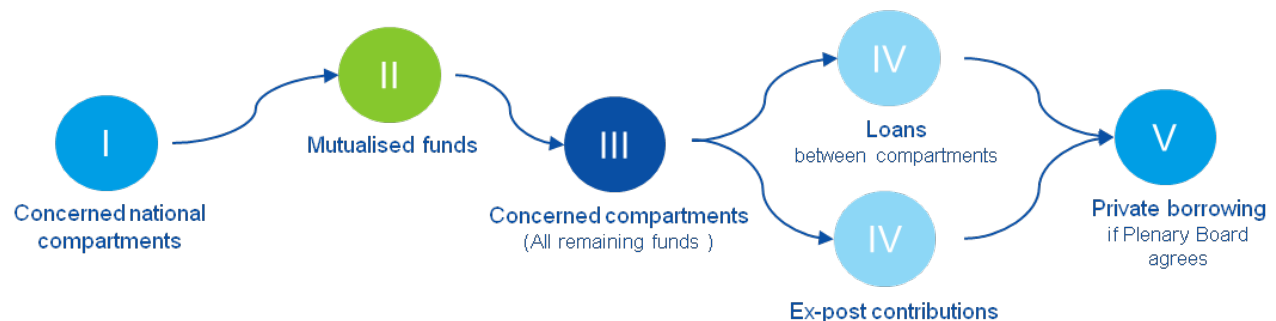
And also **ex-post** financial power:

- 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

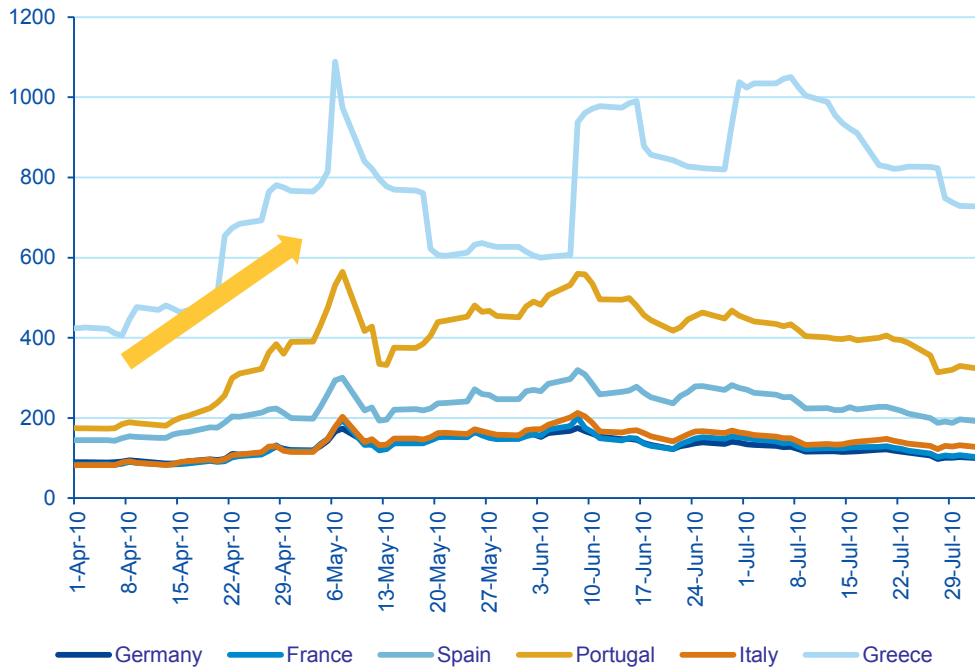


Arrival point: credit conditions dependent on credit worthiness (not location!)

The banking union has helped moderating the contagion of banking crises

Banks' CDS (weighted average, by assets)

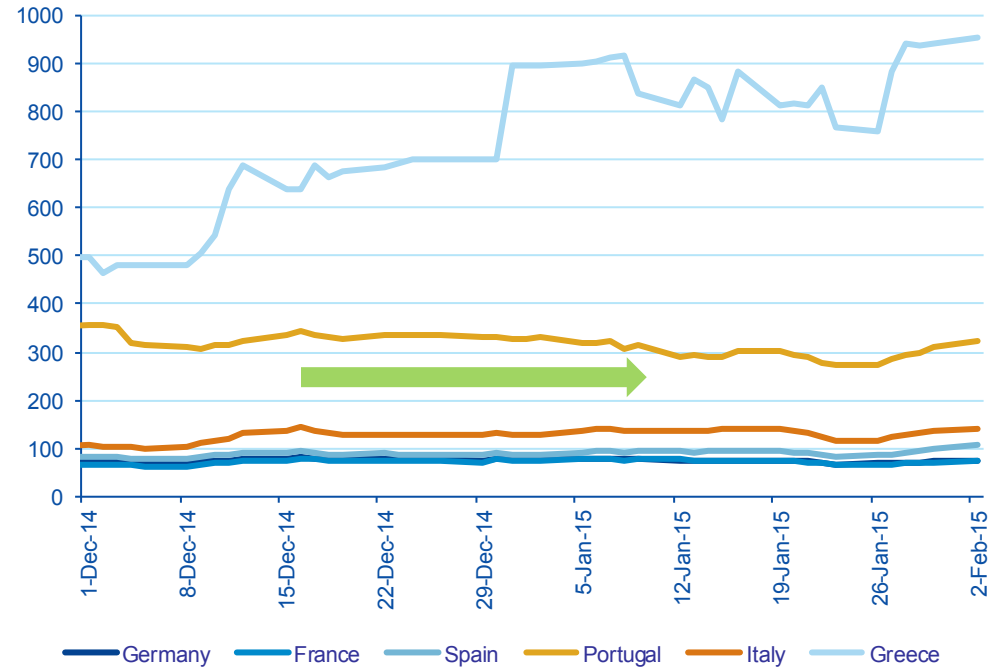
Source: BBVA Research and Bloomberg



Greek first rescue: May-10

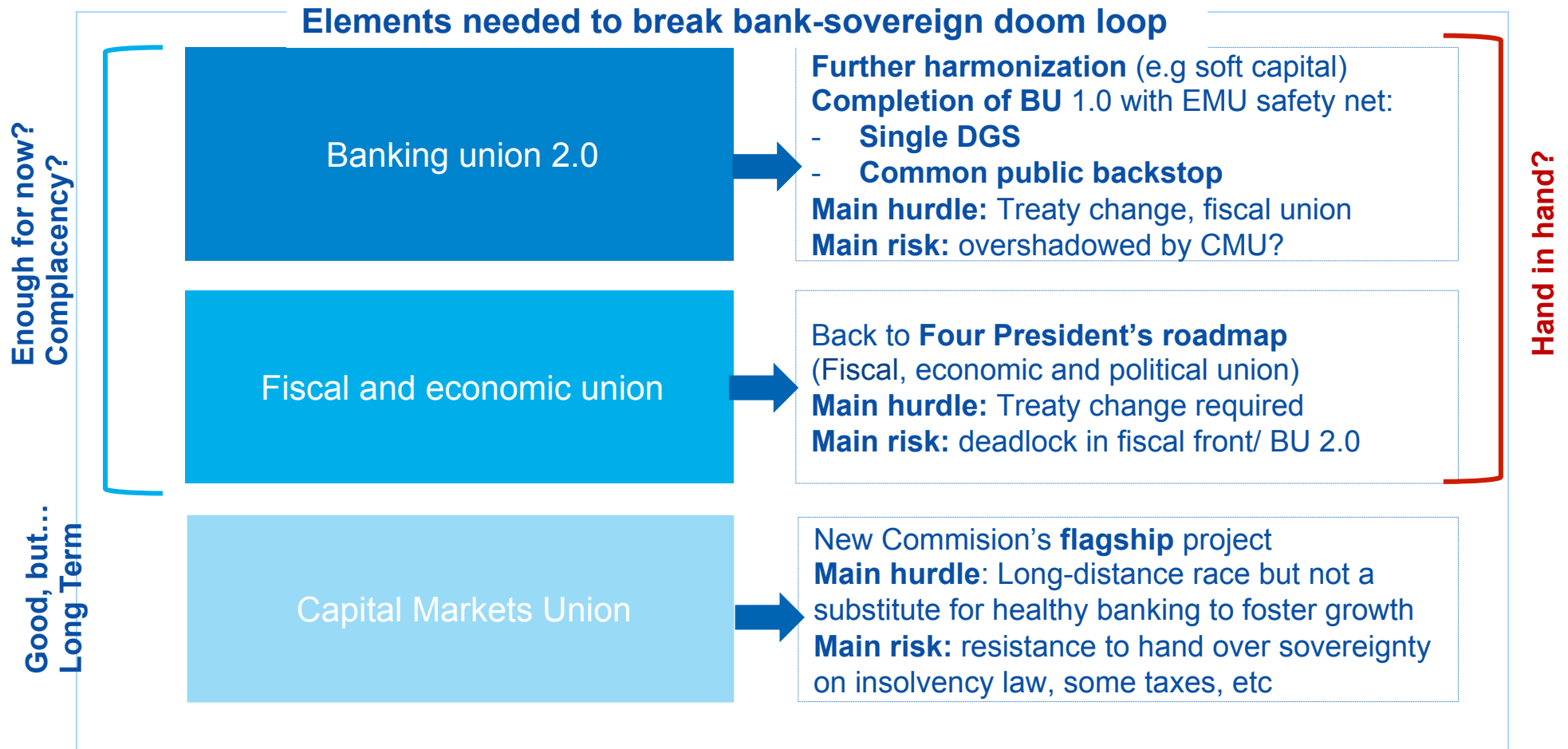
Banks' CDS (weighted average, by assets)

Source: BBVA Research and Bloomberg



Greek elections and deposit run: Jan-15

What's missing from banking union 1,0?



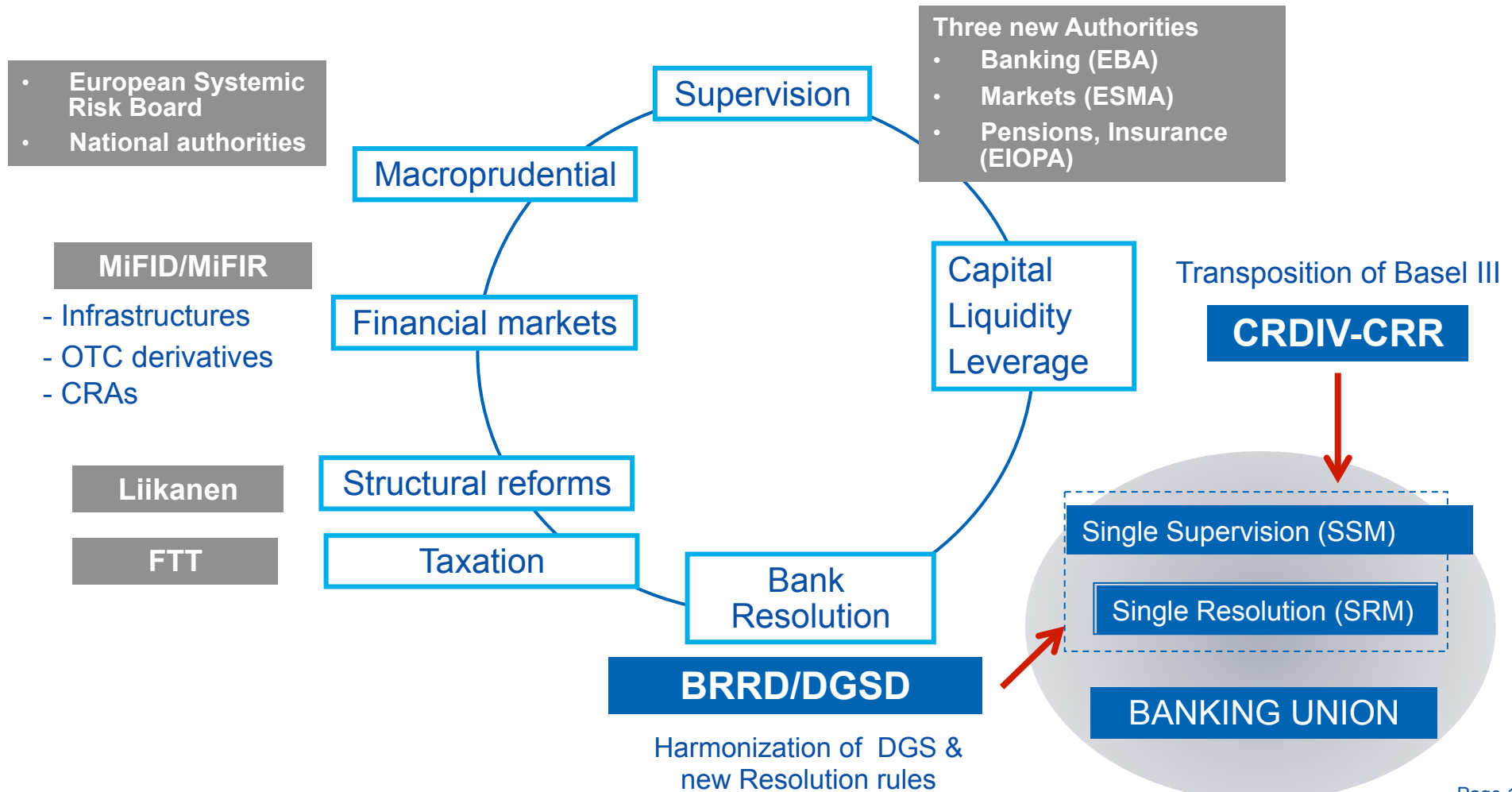
With BU 1.0 we bought time to refine the whole new setting but needs to be done now that we have the time



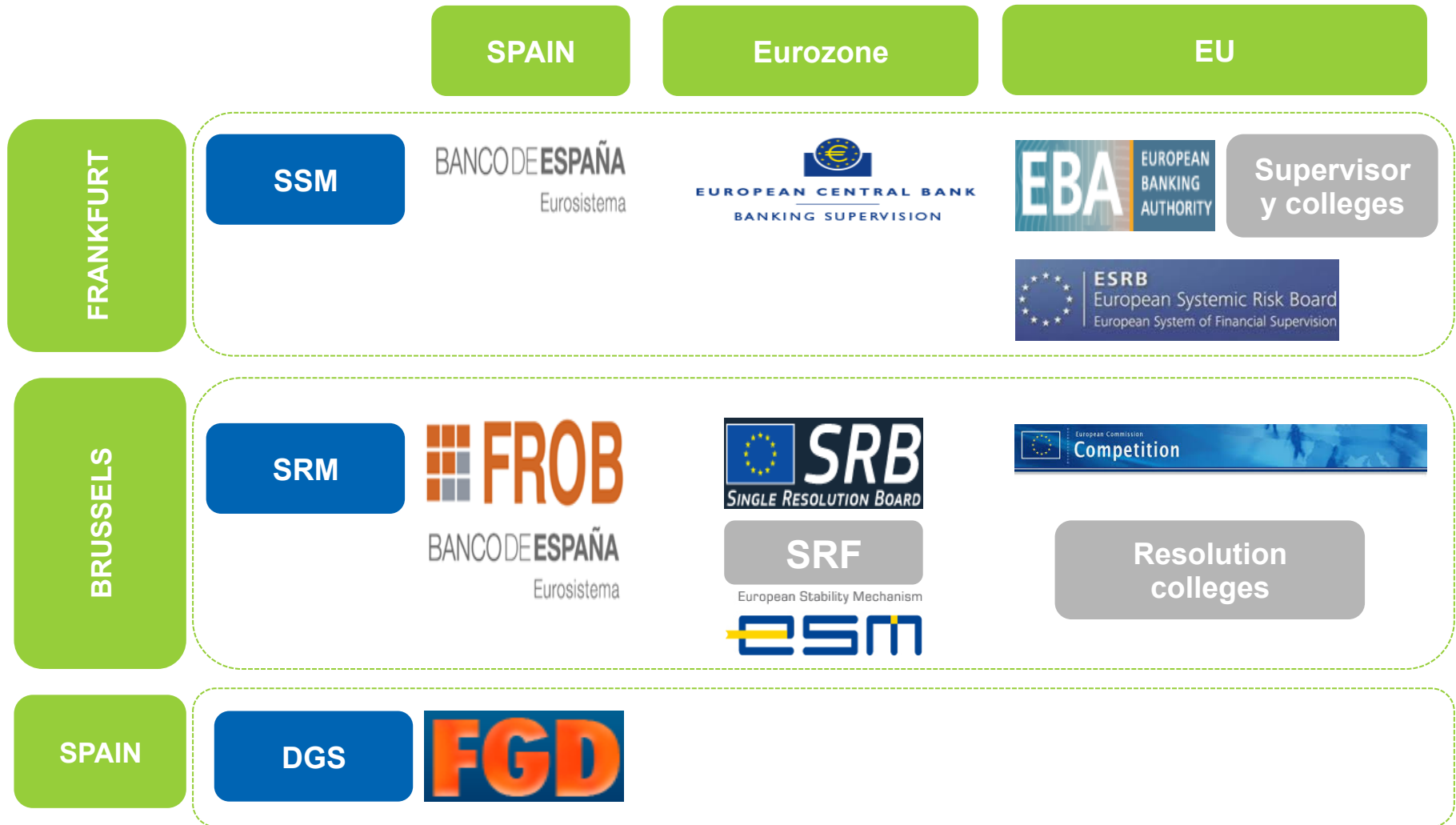
2.- Challenges for the Spanish banking system

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...

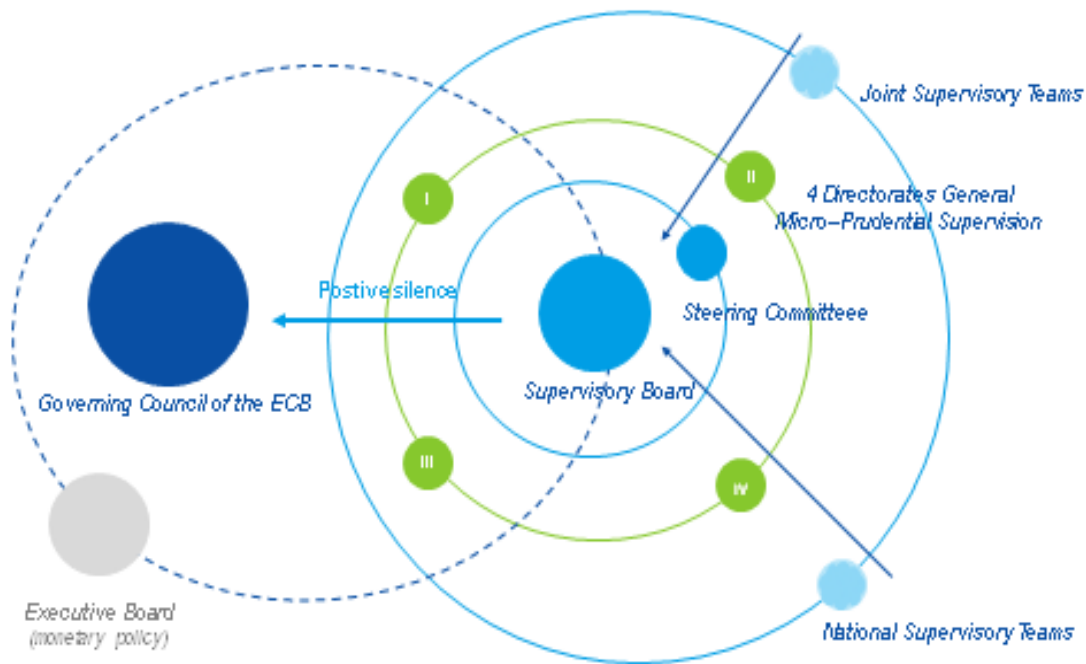


... with a new institutional complexity



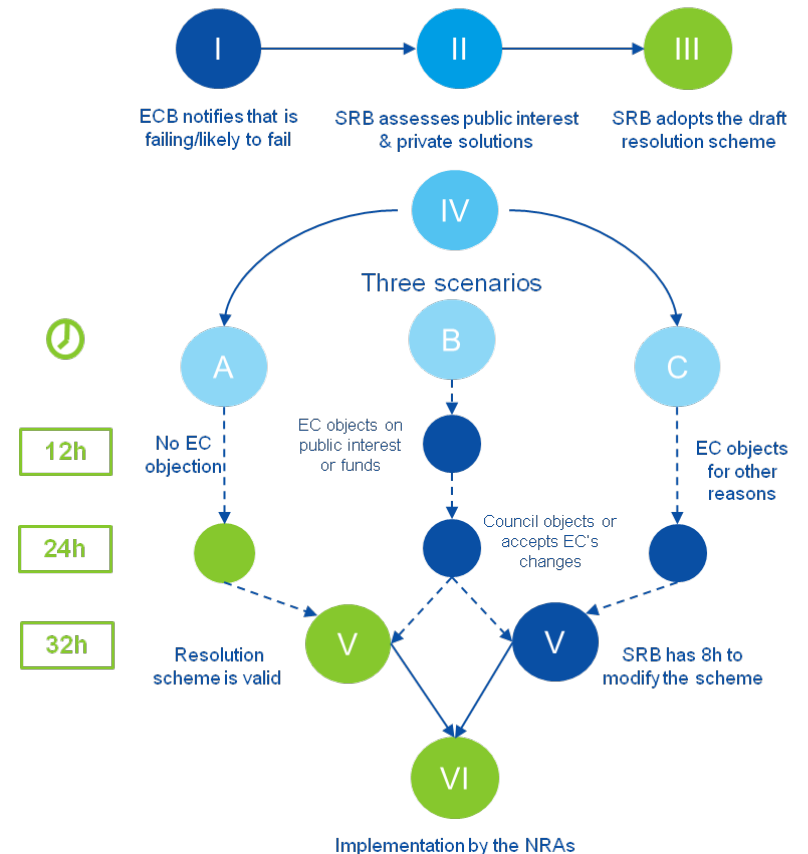
These new animals have complex internal structures and governance

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

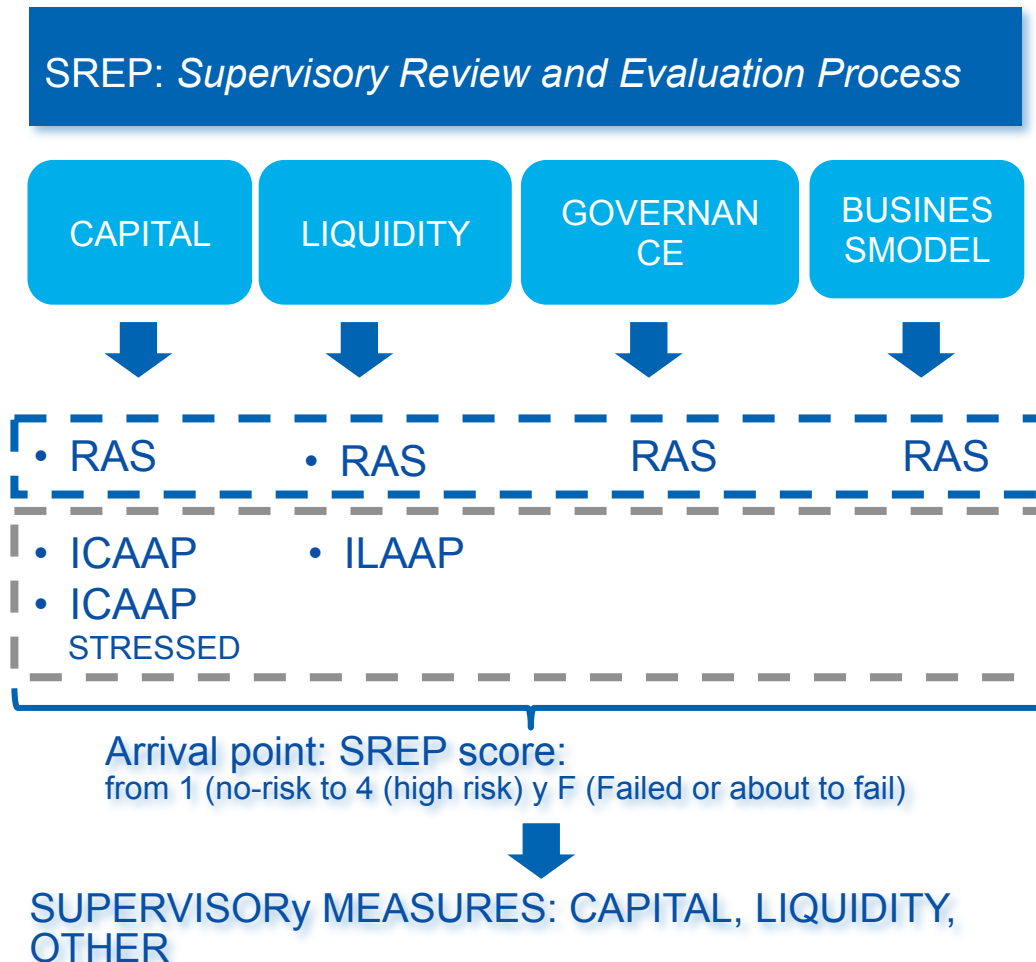
- **Less supervisory judgement** than for most NCAs
- More **emphasis on rules**
- Especially for **non-significant** banks

PROCEDURAL AND TRANSPARENT

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



The new SREP



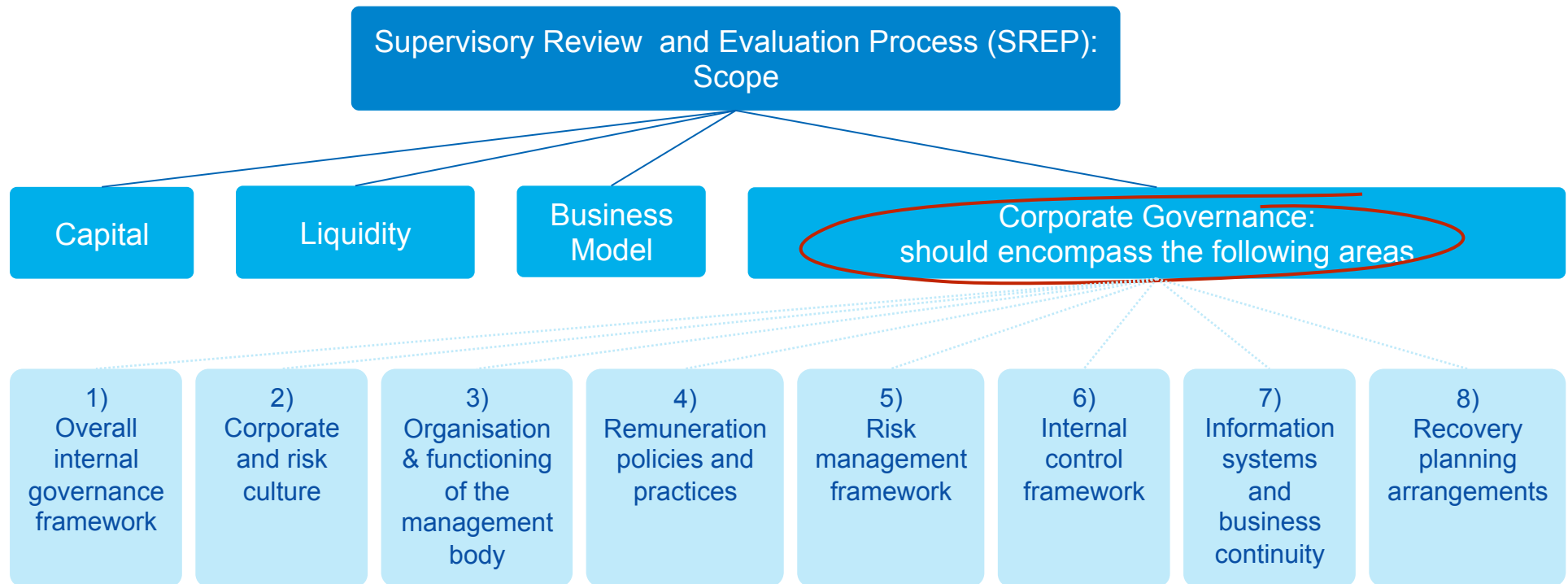
New key concepts: **SREP, ICAAP/ILAAP, RAS**

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



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

Quantitative approach together with more **transparency** and **disclosure** generates lots of data requests

Data must be **gathered** and **managed**

Update **systems** and **processes**

CULTIVATE GOOD RELATIONSHIP

Develop a good work environment with new authorities (SSM, BoS, ESRB, EBA, SRB/FROB)

Get them to understand the bank's **business model**

Macroprudential: who to address to and for what?

SET UP GOOD PROCEDURES & DOCUMENTATION

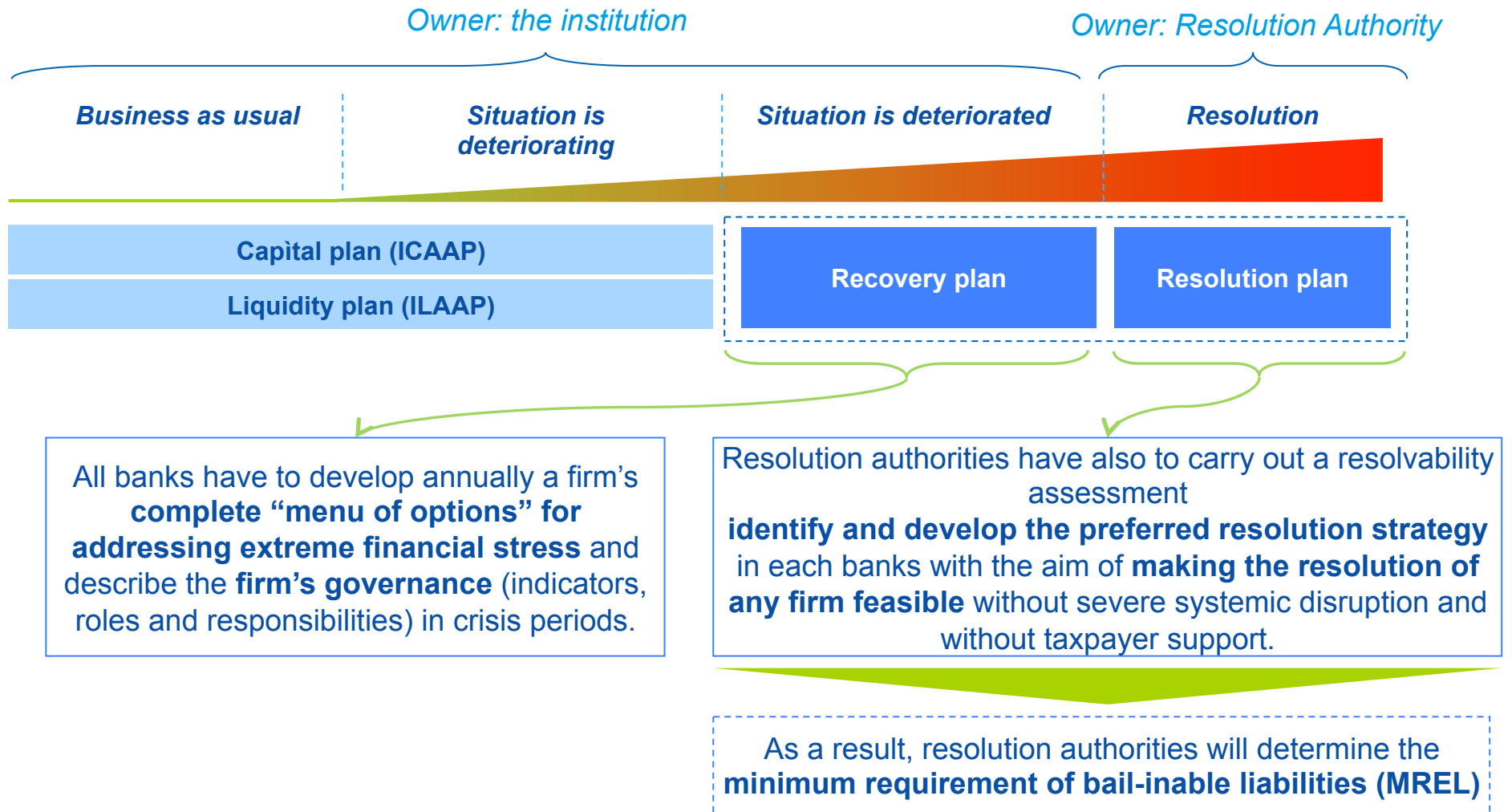
Communicate efficiently data, **business plans**, **governance**, **internal control procedures**, etc

All **decisions** must be properly **documented** and ready to be shown to the supervisor

EFFICIENT INTERNAL COORDINATION

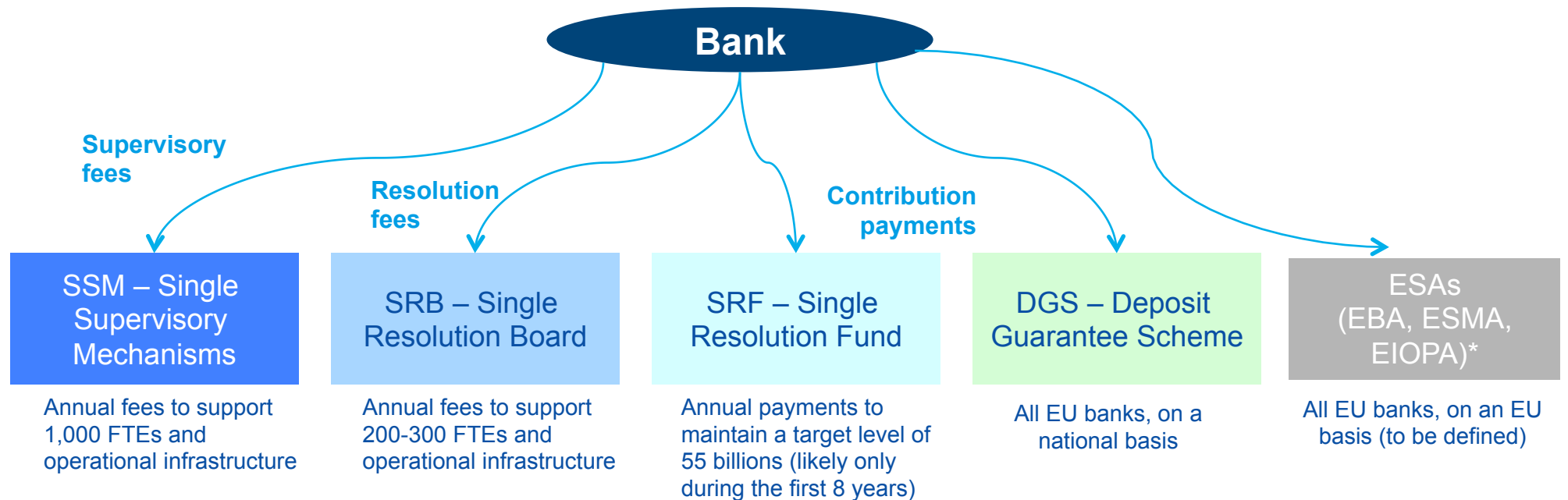
Strong internal coordination will be required to collaborate in the ICAAp, ILAAP, RRP, RAF, etc

Main challenges in resolution



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.



New obligations in the banking union



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

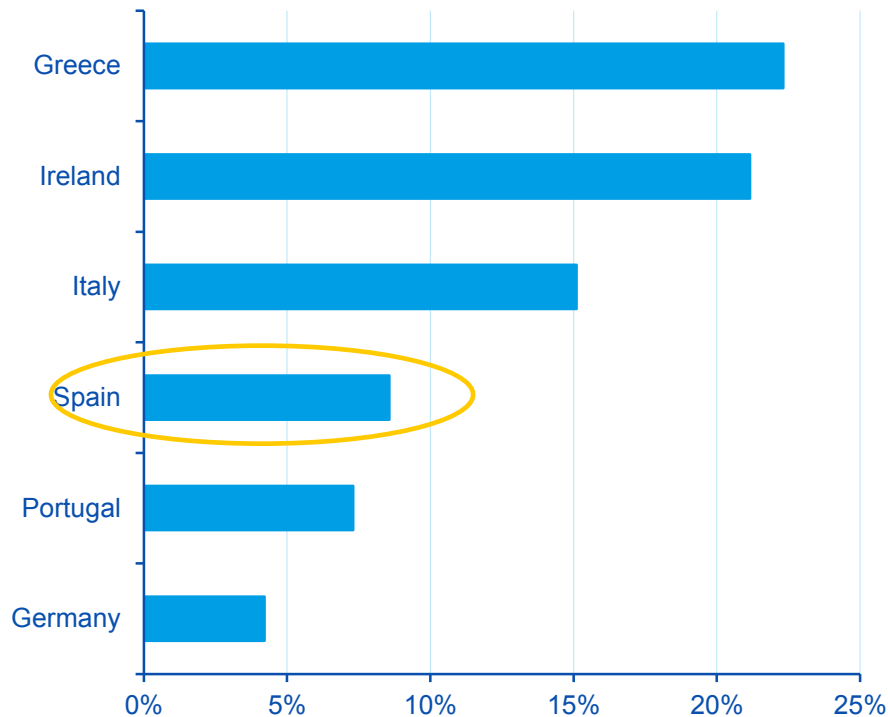


Low profitability, unlikely to return to pre-crisis levels

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



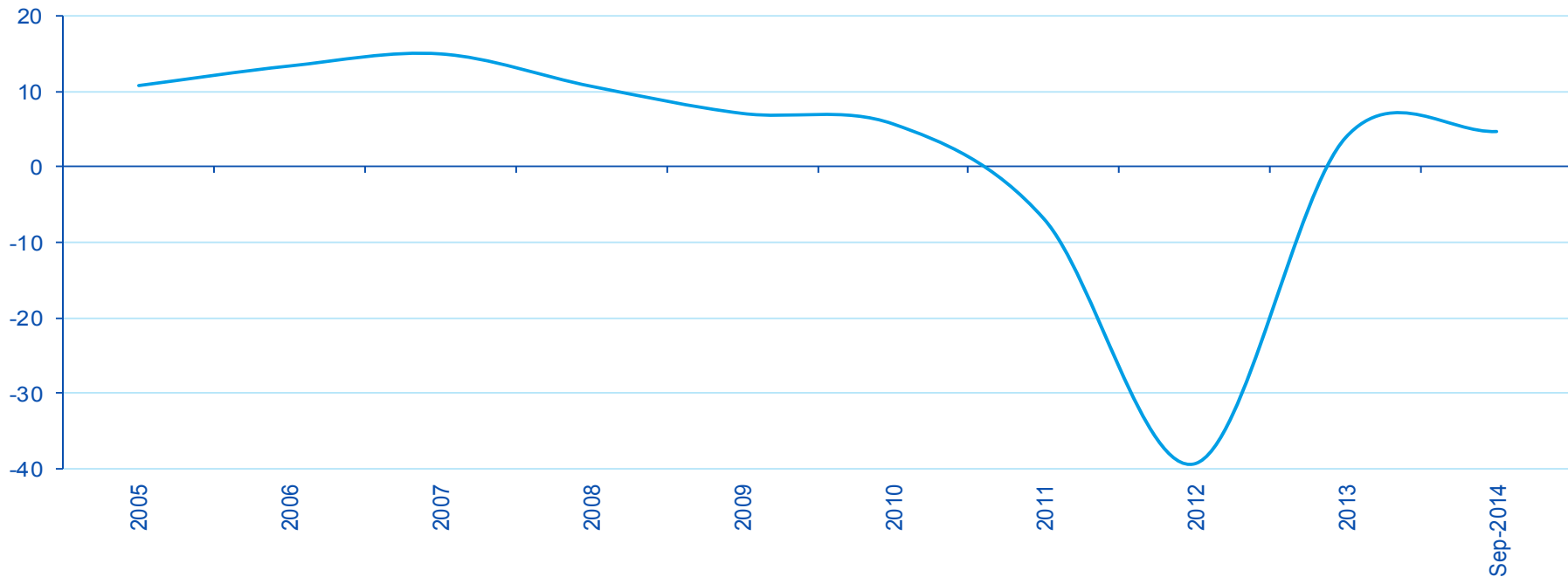
Spanish banks have a lower burden of legacy assets than other European banking systems, as they have gone through the cleaning of the balance-sheets

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

Return on Equity* (%)

*Profit after tax
Source: BBVA Research based on Bank of Spain and Bloomberg

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



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



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

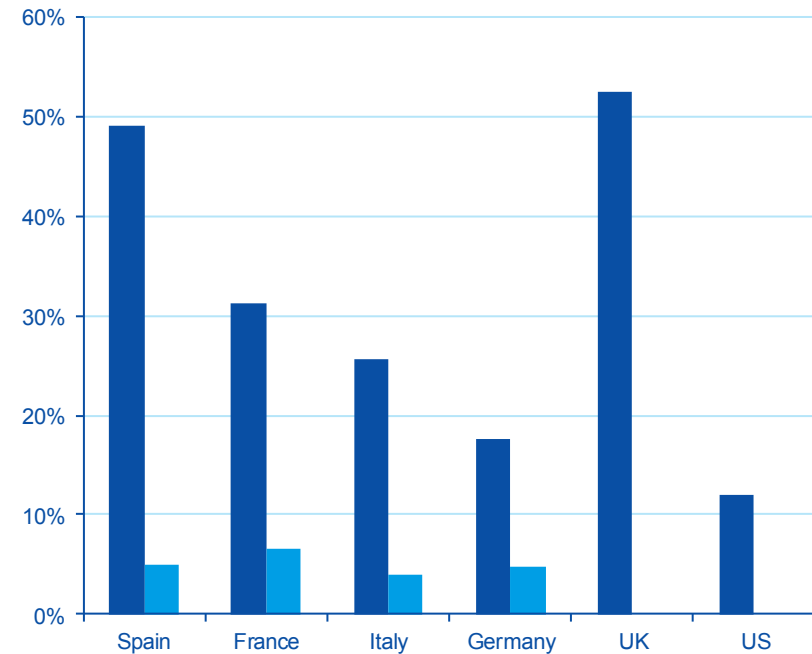
Concentration, first domestic and second cross border, searching for profitability. Concentration is still far from generating competitive distortions



Higher profitability

Assets of the main domestic player
(2013, %GDP)

Source: BBVA Research based on IMF, AEB and entities' annual accounts



■ Assets/Domestic GDP ■ Assets/EMU GDP

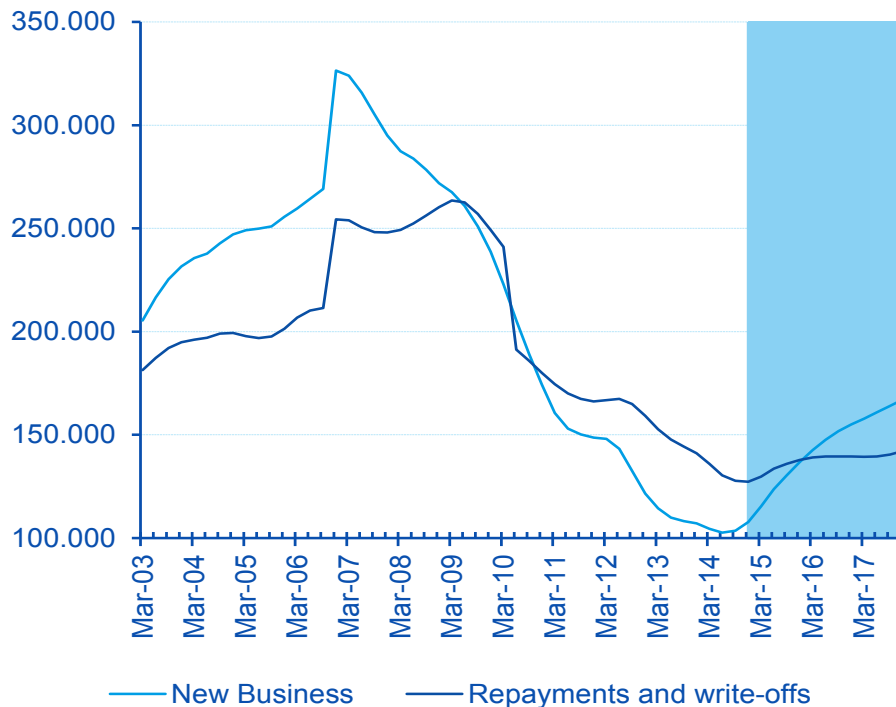
The size of European financial institutions is not excessive, and even less so when compared to the euro area economy

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?

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 |

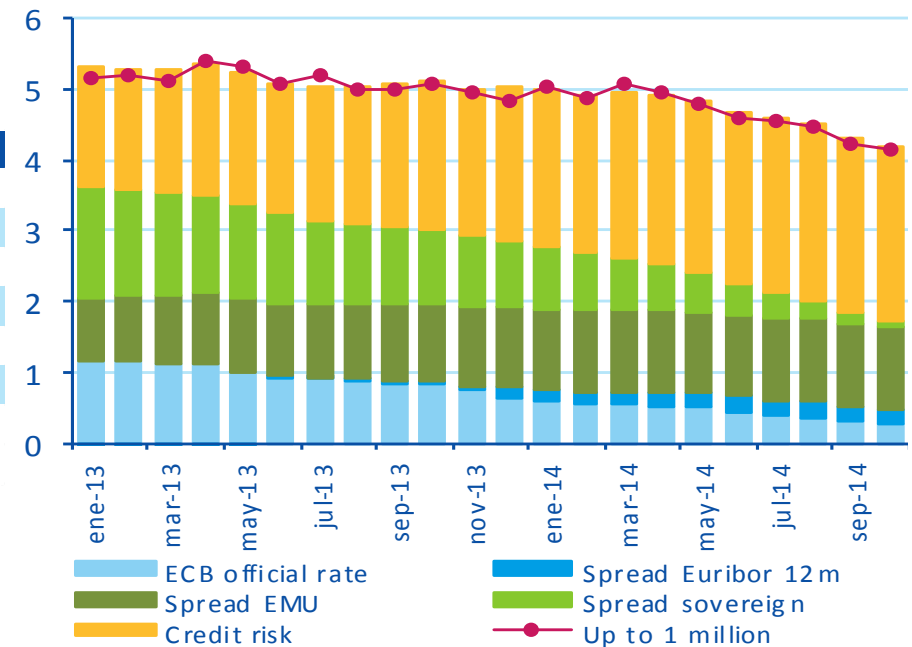
-- Does not differ significantly from zero

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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RESEARCH

Thank you!