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The Banking Union and the Spanish Financial System

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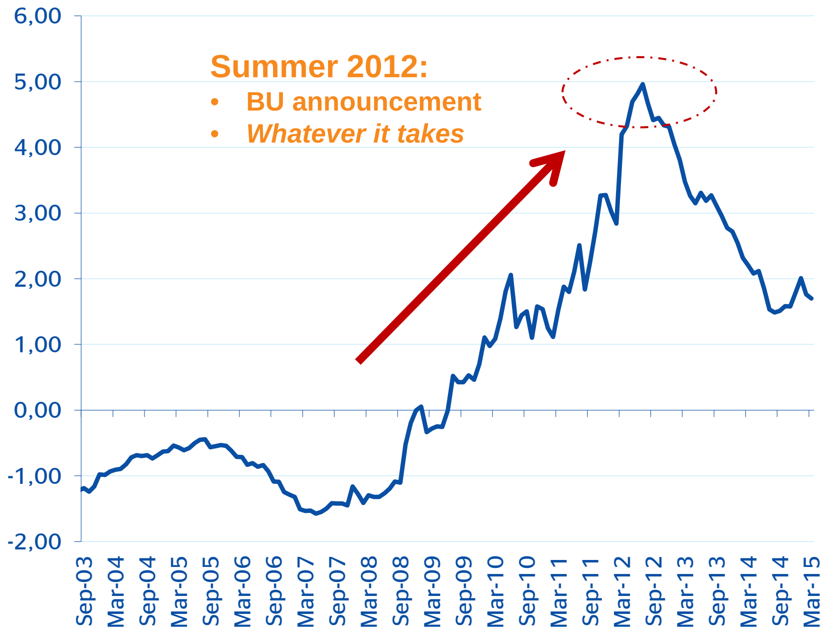
From BU 1.0 to BU 2.0

Why a banking union?

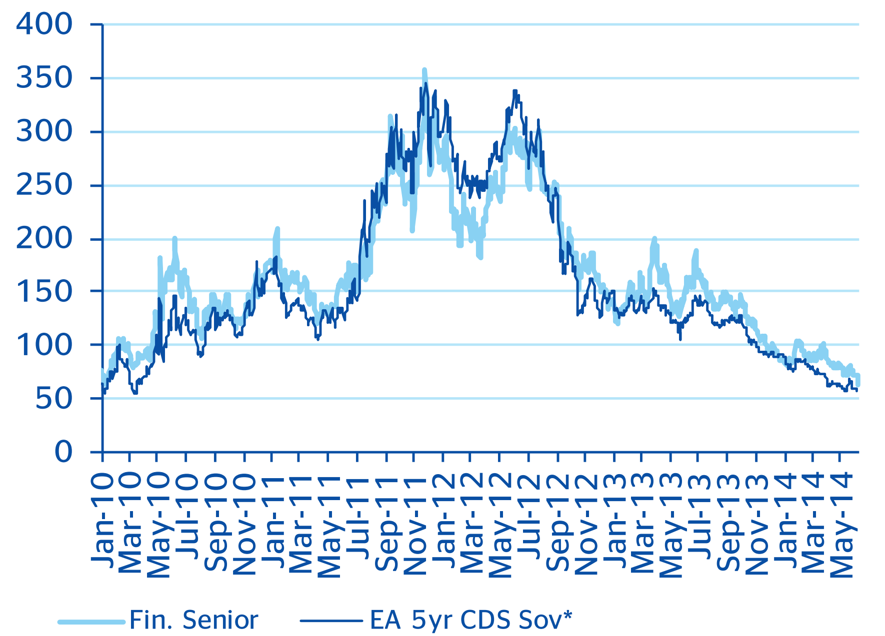
Financial fragmentation

Composite measure of EZ financial fragmentation
Source: BBVA Research and Bloomberg



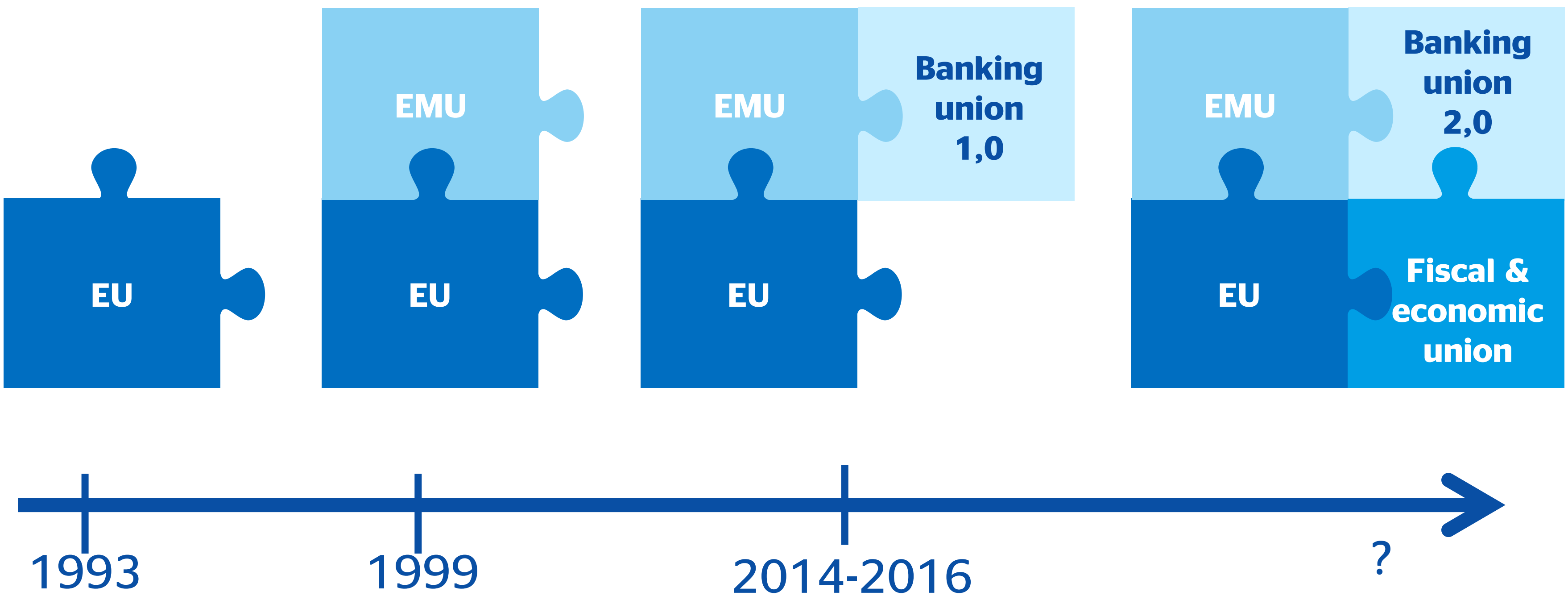
Why fragmentation? Sovereign-bank doom loop

Bank and sovereign spreads in the eurozone (bp)
Source: Bloomberg and BBVA Research



High fragmentation levels and sovereign-bank loop where incompatible with EMU

Banking union is the key for completion of the euro project



Banking union 1.0 was built up in record time

2014-2015
SINGLE RULEBOOK

Common rules

(CRDIV, BRRD, DGS)

2014
SINGLE SUPERVISOR (SSM)

Since Nov 2014

2015-2016
SINGLE RESOLUTION (SRM)

2015: preventive

2016: full powers

Private Fund (SRF): increasingly funded and mutualized (100% in 2023)

Some fiscal **backstop** by 2023

?
SINGLE DGS

Dropped from agenda

Pillar I	Pillar II	Pillar III	Pillar IV

A lot has already been achieved with BU 1.0

A new genuinely European institutional setup

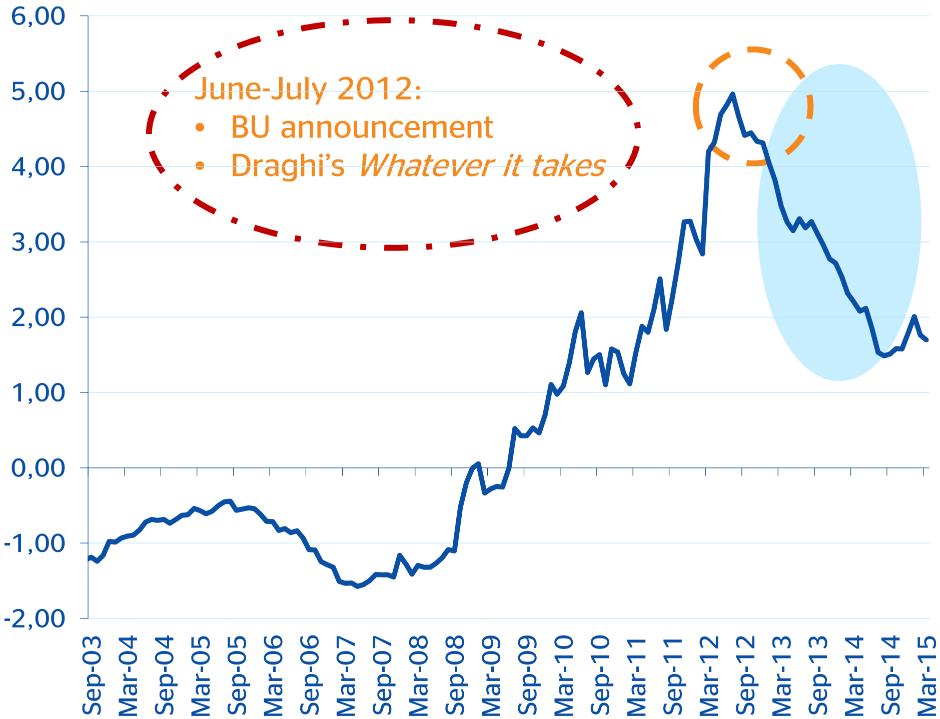
1. Single Rulebook	Better regulation Level playing field: CRDIV BRRD, DGS
2. Single Supervision	Single interpretation of CRDIV No supervisory ring-fencing Confidence in banking sector
3. Single Resolution	Single interpretation of BRRD Predictability in resolution Cross border resolution Resolution costs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

Still, complex setting and further harmonization in key concepts still required: RWA, NPL, national discretionalities, model validation, etc

Fragmentation is certainly down…

Composite measure of EZ financial fragmentation

Source: BBVA Research and Bloomberg



ECB provided the anchor to the BU process

Financial fragmentation has gone down but the problem still persists

?

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

- The banking union has helped moderating the contagion of banking crises (Greece)
- Fragmentation has considerably eased but credit conditions still depend on location

Additional elements are needed to break bank-sovereign doom loop

Banking union 2.0

- **Further harmonization** (e.g soft capital)
- **Completion of BU 1.0** with EMU safety net (Single DGS and Common public backstop)
- **Main hurdle:** requires fiscal union and common insolvency law

Fiscal and economic union

- Back to original **Four President's roadmap.** Will the new 4PReport stick to the original integrative spirit? Not sure...
- **Main hurdle:** no political will for fiscal union right now and Treaty change required

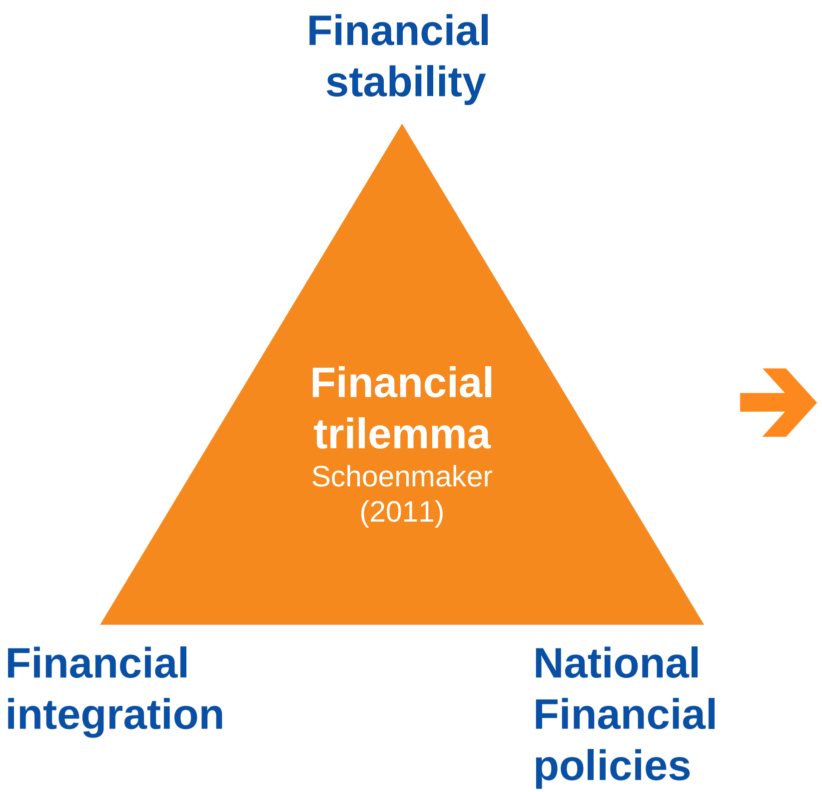
Hand in hand

- Capital Markets Union is the New Commision EU-28 **flagship** project that may enhance progress towards Banking Union

- **Main hurdle:** resistance to hand over sovereignty on insolvency law, tax law, corporate governance law, etc.

Rationale for a complete banking union 2.0

The *financial trilemma:* financial stability, financial integration and national financial policies are incompatible



Centralization of banking powers for EMU+

How does CMU fit with Banking Union?

CMU and BU are different in nature and scope but mutually reinforcing

- BU is a vital asset for CMU to advance further towards free flow of capital
- CMU will also help underpin integration and financial stability

Banking Union	Capital Markets Union
1 EUROZONE +	1 EU 28
2 BANKS	2 ALL FINANCIAL ACTIVITIES EXCEPT BANK CREDIT INTERMEDIATION (includes all other bank activities too)
3 CENTRALIZATION: regulatory driven	3 HARMONIZATION: mostly market-driven
4 • **Break fiscal-bank doomloop** through unified bank rules and supervision • **Restore confidence in European banks**	4 Broader and deeper EU capital markets • ⬇ barriers to **free movement of capital** • ⬆ **investment** in the EU and from abroad • ⬆ **market finance** in the EU economy

Capital Markets Union: the new EU flagship project

Main goal: to achieve a deeper, broader and more integrated EU Capital markets

Short-term agenda
Some quick-wins in finance for growth

1. **Lift regulatory barriers to bank lending:** high quality securitization
2. **Develop standard EU instruments**
3. **Improve access to finance** for SME, infrastructures

Long-term agenda
Structural shift in EU funding pattern towards more market finance

1. **Diversify supply:** attract institutional, retail and international investors
2. **Better access to finance:** promote new ways of funding (crowd funding, P2P, etc.)
3. **Remove barriers:** improve market infrastructure, legal harmonization (insolvency, corporate governance, taxation, securities law)

The macroprudential dimension

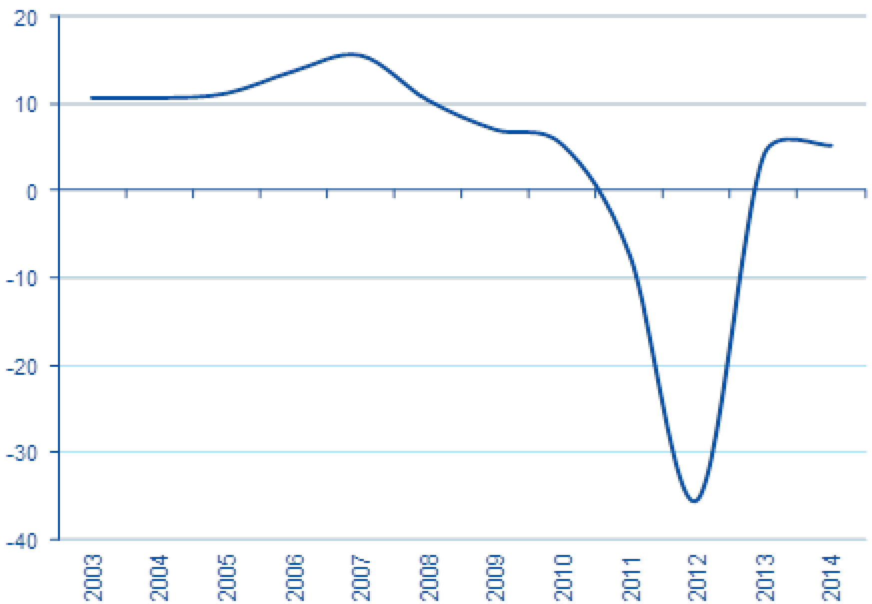
- **Macroprudential policies need to complement monetary policy.** Decisions must be taken at the same level of financial stability and integration objectives **(back to financial trilemma)**
- **The ECB has a key role to play** (complementarities) but **MS will still keep the control**
- **Coordination between the SSM, the CB and MS** will be key in the transition

	BEFORE THE BU	**BU 1.0**	**BU 2.0 + fiscal/economic union**
National	**National mandates and tools**	**National mandates. EU tools** (CRDIV)+**national tools** (eg LTV)	
EU	**ESRB** *(comply or explain)*	• **ESRB** *(comply or explain)* • **ECB (SSM)** can toughen some CRDIV tools (asymmetry) Enough?	• **SSM: Eurozone mandate** • **Authority: ECB/ESRB?** • **Tools: CRDIV+ SSM**

2 Impact on the financial system

Spanish banks have pretty much recovered, but profitability remains low

Return on Equity (%, Profit after taxes)
Source: BBVA Research based on Bank of Spain



Average profitability will not return to the pre-crisis levels

Balance-sheet cleaning: Accumulated bad loans provisions have been €193bn in 2008-14. The cost of risk (provisions/credit) has decreased from 4% in 2012 to 0.8% in 2014

Expenses have been reduced by 12% between 2008 and 2014

Environment with challenges and opportunities

Banks

Challenges

- Regulatory burden
- Competition of shadow banking
- New framework of supervision and resolution

Opportunities

- More resilience: Markets will request lower profitability (lower cost of capital)
- Less fragmentation: Better funding conditions for banks and therefore for clients
- Capital Markets Union: Alternative finance, as a complement to bank credit

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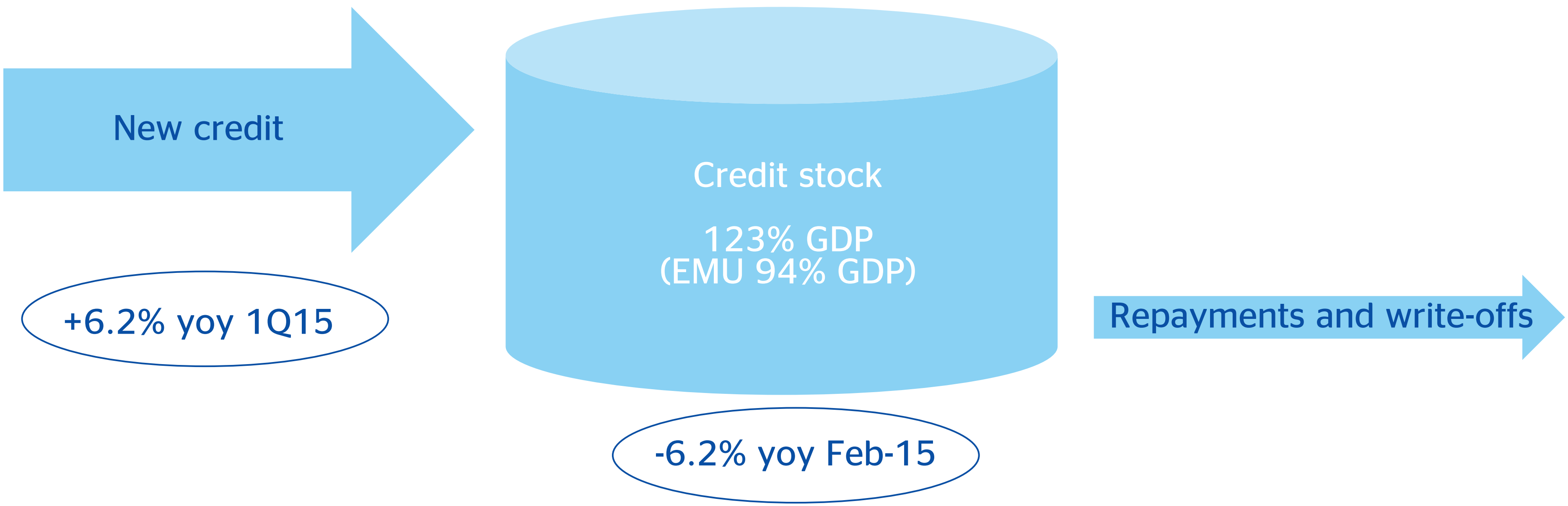
The deleverage has to continue, but it must be compatible with new credit



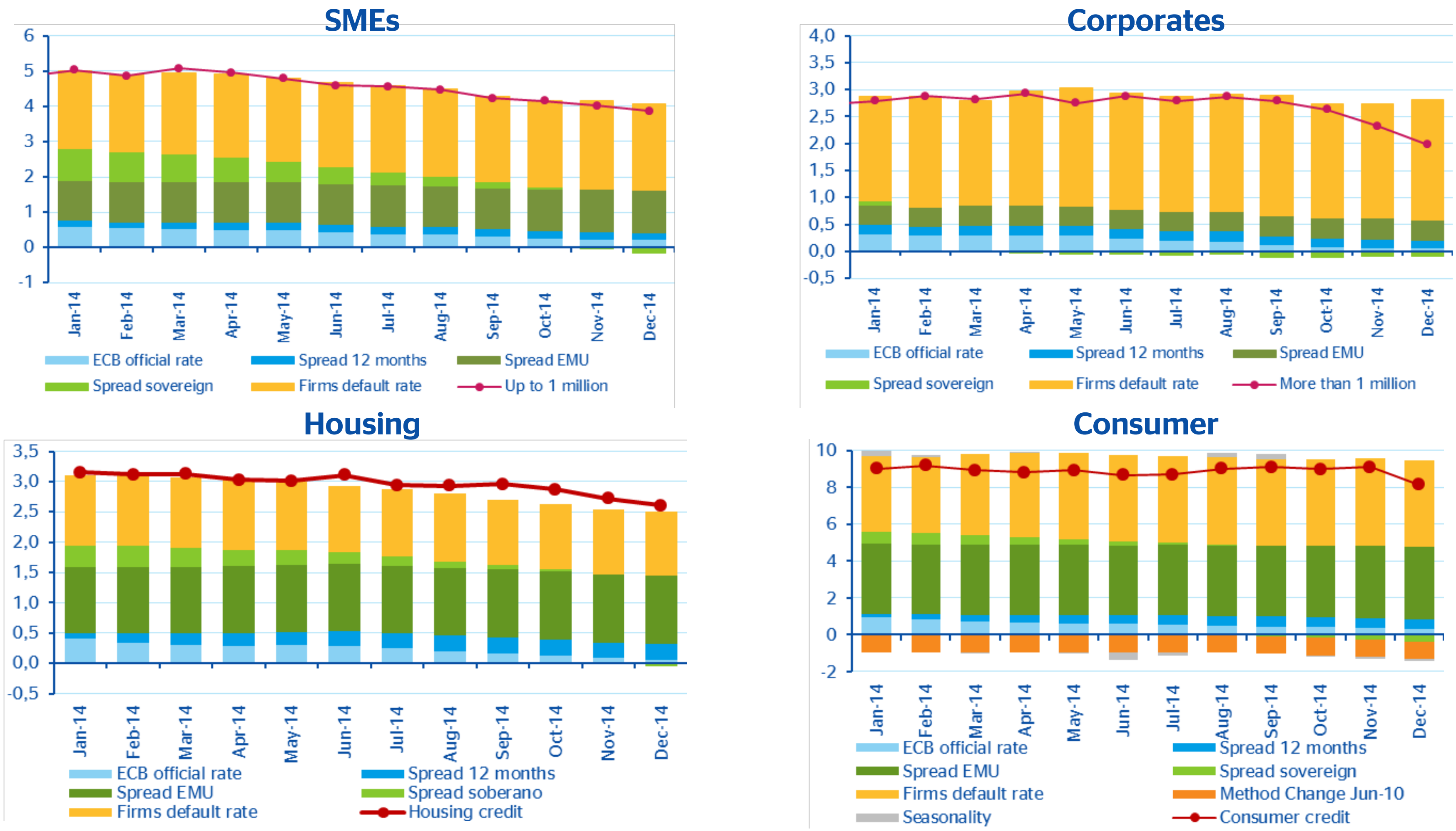
Deleveraging has to continue in over-indebted companies and sectors

New lending will exceed repayments and write-offs until end-2015

Credit conditions normalizing as sovereign risk (1st) and bad loans (later) went down

Spain. Interest rates on new bank lending (%)

Source: BBVA Research based on ECB



3 Concluding remarks

Concluding remarks

Banking union has been crucial in reverting fragmentation

Additional progress needs to be done: Deposit Guarantee Schemes and fiscal union

Capital Markets Union is an additional element that would foster integration

Bank lending positively affected by savings banks restructuring, banking union and ECB policies. New credit is growing and interest rates spreads are going down