The Banking Union and the Spanish Financial System

May 2015
Colegio de Economistas. Valencia

Santiago Fernández de Lis
Chief Economist of Financial Systems and Regulation
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

- **Summer 2012:**
  - BU announcement
  - Whatever it takes

**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**
  - Since Nov 2014
  - Common rules (CRDIV, BRRD, DGS)

- **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**
  - **2014-2015 SINGLE SUPERVISOR (SSM)**

- **Pillar II**
  - **2015-2016 SINGLE RESOLUTION (SRM)**

- **Pillar III**
  - **SINGLE DGS**

- **Pillar IV**

- **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 discretionary, model validation, etc.
Fragmentation is certainly down...

**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.

- 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

- **Capital Markets Union** is the New Commission 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

1. EUROZONE +
2. BANKS
3. CENTRALIZATION: regulatory driven
4. Break fiscal-bank doomloop through unified bank rules and supervision
   • Restore confidence in European banks

### Capital Markets Union

1. EU 28
2. ALL FINANCIAL ACTIVITIES EXCEPT BANK CREDIT INTERMEDIATION
   (includes all other bank activities too)
3. HARMONIZATION: mostly market-driven
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

<table>
<thead>
<tr>
<th>Short-term agenda</th>
<th>Long-term agenda</th>
</tr>
</thead>
<tbody>
<tr>
<td>Some quick-wins in finance for growth</td>
<td>Structural shift in EU funding pattern towards more market finance</td>
</tr>
</tbody>
</table>

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

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

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

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

Credit stock
123% GDP
(EMU 94% GDP)

+6.2% yoy 1Q15

-6.2% yoy Feb-15

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

SMEs

Corporates

Housing

Consumer

- ECB official rate
- Spread 12 months
- Spread EMU
- Spread sovereign
- Firms default rate
- Up to 1 million
- Method Change Jun-10
- Seasonality
- Consumer credit
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