Banking sector

The Eurozone banking system has continued to strengthen itself during 2015, in a context characterised by periods of volatility in the financial markets. The sector has improved in loss absorption capacity, as well as in solvency and profitability, but it is still facing significant challenges related to the weak macroeconomic recovery in a low interest rate environment.

This analysis coincides with the conclusions of exercises in banking transparency published at the end of November by the European Banking Authority (EBA). The objective of this exercise is to raise the level of understanding of European banking, permitting the comparisons of the positioning of individual institutions as well as banking sectors by country via multiple homogenous indicators. It should be noted that this is the second exercise in transparency published by the EBA, which covers 105 banking groups of 21 EU countries (in addition to Norway), almost 70% of the total banking assets in the EU, according to information dated June 2015. The results show that, in general, EU banks have continued to strengthen their capital positions throughout the last year (CET1 ratio has grown from 12.1% to 12.6%), mainly due to capital increases and locking in profit, instead of a reduction in risk weighted assets. The quality of assets and the levels of profitability also improved, although from low levels. For value added, the study shows that leverage in Spanish banking is lower than the European average, and that there is greater coverage of impaired assets, efficiency and profitability. However, levels of NPL's and solvency are worse.

In 2015 work has continued on the Banking Union process and on the construction of capital markets in Europe, topics which are detailed below.

Regulatory environment

Banking Union

The euro crisis has proved that to guarantee long term sustainability of the Monetary Union it a truly integrated banking system is necessary. With this aim, in 2014 the process to create Banking Union was started, which is based on three pillars:

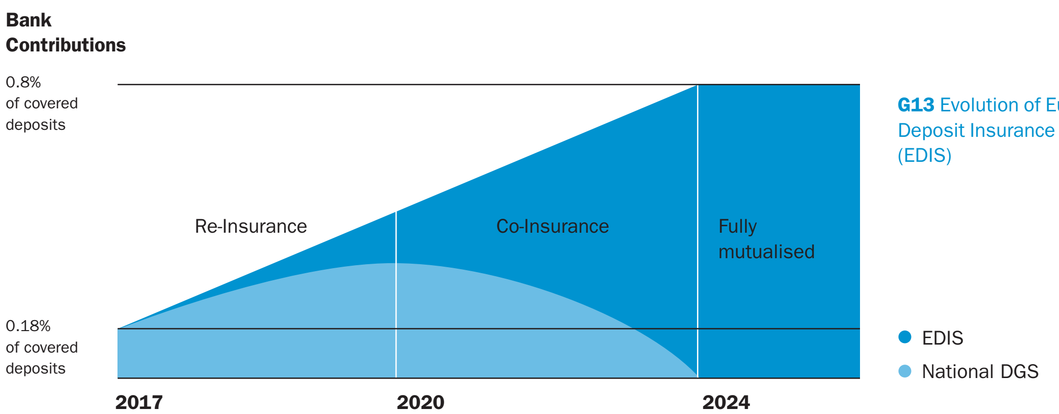
— Single Supervisory Mechanism (SSM), by which all institutions are subject to the same level of supervision.
— Single Resolution Mechanism (SRM), and its corresponding Resolution Fund, which dictates how to manage institutions in difficulty.
— European Deposit Guarantee Mechanism (EDIS – European Deposit Insurance Scheme), which should equally guarantee deposits from all institutions, independently of their country of origin.

Pillar 1 of Banking Union, SSM, has been fully effective since November 2014, whereas Pillar 2, SRM, will become fully effective from 1 January 2016. Pillar 3, the Single Deposits Mechanism, has gained relevance due to the European Commission's new proposal for its creation.

In this respect, the European Commission maintains that whilst Deposit Guarantee Funds (DGF) continue to be national, the Banking Union's ultimate objective to break the link between banking and sovereign risk cannot be achieved. The objective is that the security of deposits should not depend on the country where the bank's headquarters are located, and should depend on the management and solidity of the institution. Therefore, this proposal represents a very significant step forward in completing Banking Union. However, it should be noted that the proposal faces opposition from Germany, who does not consider the mutualisation of more risks to be appropriate, without the countries financial systems first having fully recovered.

The European Commission's proposal on the European Deposit Guarantee Scheme consists of three phases:

— "Re-insurance" phase (2017-2019), in which national Deposit Guarantee Funds can only access common European funds when they have exhausted their own resources, and only up to 20% of the funds required will be covered.



G13 Evolution of European Deposit Insurance Scheme (EDIS)

Macroprudential policy has gained relevance.

— "Co-insurance" phase (2020-2023), in which, when a bank requires funds, the funds will be shared by the European and national funds, instead of firstly using national funds (the contribution from the European fund will progressively increase, from 36% in the first year, to 84% in the fourth year).
— "Fully mutualised" phase, from 2024 onwards, when the European fund will pay 100% of the deposits guaranteed by national Deposit Guarantee Funds.

If the proposal is maintained, the funding of the European Deposit Insurance Scheme will be private. It will be funded ex-ante by contributions from the participating banks. This contribution will not result in any additional costs for participants as it will be deducted from their contributions to national DGFs. Over a period of seven years (2017-2024) the target funding level is equivalent to 0.8% of the guaranteed deposits (close to 43 million euros, according to balance sheet data taken from the banks for 2011) (G13).

Action plan on a Capital Markets Union

The creation of a Capital Markets Union (CMU) has also continued to progress, due to the European Commission's publication of an Action Plan (30 September), which specifies measures to be implemented until 2017.

The CMU aims to establish a single capital market for all twenty eight EU Member States. The main objective is to widen the range of non-banking sources of financing, including capital markets, capital risk, crowd funding and the asset management industry, with the objective of providing financing for companies, especially SMEs and start-ups, thus fostering their investments and employment creation.

One of the first actions included in the Action Plan highlights the initiatives that aim to encourage the highest quality securitisation processes, as well as channelling investments from insurance companies towards infrastructure projects. Specifically, the European Commission has proposed a new regulatory framework for simple, transparent and standardised securitisations, by which it will modify their treatment in favour of solvency. In the insurance industry, the European Commission aims to eliminate prudential obstacles in order for insurance companies to play a greater role in the financing of infrastructure projects. For this purpose, the creation of a category of infrastructure assets has been proposed, as well as reducing the amount of capital that insurance companies should maintain with respect to debt and capital in these projects.

Lastly, the European Commission has also announced its own legislation proposal to simplify the preparation process for the issue of fixed and variable interest securities. The main objective is to lower costs for SMEs so that they can raise capital from stock markets or issue debt securities. For this purpose, the Commission proposes to lengthen the list of exceptions for companies so that they are either not obliged to publish a European issue prospectus, or so they can do so in a more simplified manner. It also includes the possibility of creating an express and simplified route for frequent issuers of debt securities and shares, so they face less bureaucratic obstacles when accessing the market.

Macro-prudential policy

In the prudential area, it is worth nothing the ECB's new responsibilities (since November 2014), which it shares with national authorities on macro-prudential policy. Macro-prudential policy has been a relevant line of work in the Eurozone in 2015, as it is considered key to correcting imbalances that may accumulate at national level within the Monetary Union and contain systemic risks. In fact, in 2015, several Member States have implemented macro-prudential measures, mainly focused on requiring additional capital 'buffers' for the banks of systemic importance at national level, and counter-cyclical capital 'buffers' or measures to contain risks in certain sectors, such as the real estate market.

New implementation, calibration and harmonisation phase of the regulatory framework.

Regulatory framework

In 2015 work has continued in the regulatory field to increase solvency in the financial system. After several years of intensive preparation of new regulations, a new implementation phase of measures, evaluation of their efficiency and potential re-estimation of parameters is taking place. The objective is not only to ensure the resilience of the banking sector in adverse situations, yet also for the latter to fully develop its role in society and support economic growth.

In the context of resolution, in mid-November the Financial Stability Board provided information on its final proposal on TLAC (total loss absorbing capacity), which should be incorporated by the thirty banks considered to be globally systemic (with capital equivalent to 16% of their risk weighted assets or 6% of leverage exposure, the denominator of the leverage ratio), starting from 1 January 2019. In Europe, starting from 2016, an agreement on own funds and eligible liabilities has been established (MREL due to its initials Minimum Requirement for own funds and Eligible Liabilities), for each institution according to its risk profile and other specific characteristics, with a minimum level of 8% of the balance sheet. The objective of both requirements is to ensure that banks, especially those which are systemically important, have sufficient own funds and eligible liabilities to absorb losses in order to adequately recapitalise themselves in a situation of resolution. It is expected that the new resolution regulations will have a substantial impact on the cost and financing structure of the banking sector.

Outlook for 2016

In 2016, the global economy is expected to maintain modest, yet fragile growth. Economic growth will be capped by the deleveraging process of emerging economies and less dynamism in international trade in a complicated financial environment. On the other hand, inflation is not expected to rise, and continues to be far from the objective of central banks in the main developed economies. In this context, monetary authorities will foreseeably maintain relatively accommodating policies.

By country, in the USA the growth of the economy is expected to stay close to its potential rate. In the Eurozone, the ECB's policy will help to counteract the loss of momentum in activities due to the situation in emerging economies. In Spain, the economy is expected to show reasonably high growth, yet lower than in 2015, given the complexity of the external environment and the lower positive impact of certain events that have been supporting recent activity (for example, the Euro, tax cuts…). In the United Kingdom, the political environment will take centre stage. Specifically, uncertainty regarding the referendum on whether the United Kingdom will leave or remain in the EU, which will be held in June 2016.

In emerging economies it is expected that the structural slowdown in China will continue, which is necessary for it to move towards a more efficient and sustainable growth model. Latin America is a particularly vulnerable region. Lastly, in Eastern Europe, the risks are political (Turkey) and/or geopolitical (Russia).

In the regulatory environment, the implementation and specification of Basel III requirements will continue, which will contribute to strengthening balance sheets in terms of solvency and liquidity. Increased regulatory pressure will continue to push banking activities into non banking or insurance sectors. In European construction, the second pillar of Banking Union, Single Supervisory Mechanism, will become effective. Lastly, following the European Commission's proposal in November 2015, the implementation of the Single Deposit Guarantee Scheme will be discussed.