9th BANKING INDUSTRY MEETING

BANKING: BEYOND THE CRISIS

Madrid, December 12, 2013

ACADEMIC SUMMARY

IESE Business School University of Navarra | CIF

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IX ENCUENTRO DEL SECTOR BANCARIO
LA BANCA: MÁS ALLÁ DE LA CRISIS

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José Miguel Andrés, President, EY. Prof. Juan José Toribio. President, IESE-CIF (Center for International Finance)

OVERVIEW

The 9th Banking Industry Meeting, organized by IESE Business School and EY, was held on December 12, 2013 under the theme "Banking: Beyond the Crisis." The meeting analyzed some of the main challenges that banking institutions face after a period of rapid on-going change over the last years.

The outline of this academic summary[1] aims to provide a comprehensive view of the distinct viewpoints and debates that arose during the meeting. Without wishing to detract from the importance of the speakers, the summary centers mainly on capturing the concepts and ideas that were generated rather than their specific source. Moreover, in some cases the contributions made by the various speakers complemented supplementary information that were presented to enhance the meeting, such as sectorial sources and reports.

INTRODUCTION

The previous Banking Industry Meeting (2012) emphasized the important restructuring process that had taken place in the Spanish financial system to create a smaller and more robust system. One of the challenges in the mid-term entailed the banking union, a critical step for the monetary union – as well as the recession in Spain, which wasn't expected to change in the short term.

Important changes have taken place since then, and not limited the global economic situation. Progress has been made toward a single supervisory mechanism as a first step to establish a banking union. In addition, the monetary union seems stronger, although fragmentation remains a problem in euro zone markets.

Today we must look to the future, examine the opportunities present in a truly European banking sector and reflect on the role of the Spanish banking system in this new context. The 9th Banking Industry Meeting provides a unique platform to study these issues in-depth and suggest avenues of strategic action.

Professor Juan José Toribio, Academic Director

1 Supervised by Prof. Juan José Toribio, Banking Meeting Academic Director, and prepared by Júlia Gifra, Research Associate in IESE's Industry Meetings Department. Our thanks to Francisco de Asís and Carlos Mérida for their contrubutionscontributions.

CURRENT STATE OF AFFAIRS: REGULATION, SUPERVISION AND RISKS

Since the outbreak of the global financial crisis, the international banking system hasn't been the same. Industry analysts agree on the importance that should be given to the supervision and regulation of the banking sector.

The current international normative framework outlined in the Basel III accords will address some of the shortcomings that came to light during the crisis and strengthen the regulation, supervision and risk management in the banking sector. At this time, the priority of the Basel Committee on Banking Supervision is not to incorporate new regulations, but rather continuously implement the agenda and existing norms. In other words, Basel III doesn't seek to enlarge the existing framework, but instead aims to complete and update the regulation and ensure its full implementation.

The main priorities of Basel III are to improve the capacity of the banking sector to absorb shocks, optimize risk management and establish solid bank governance, as well as achieve greater transparency and improvement in disseminating information. The economic crisis has demonstrated how the problems in one bank can spread to others, affect deposits and investments, and ultimately impact the entire economy. For this reason, the breadth of the regulation is dual and complementary: on one hand, it targets banks on an individual basis to bolster their strengths and resilience in periods of economic tension; and on the other hand, it seeks to avoid the systematic risks accumulated in the banking sector as whole and on society.

The content of this regulation comprises distinct facets, including the increase in required capital;

Jaime Caruana, General Manager, Bank for International Settlements (BIS).

Prof. Juan José Toribio, IESE-CIF (Center for International Finance) the introduction of a leverage ratio and standard liquidity; the improvement in risk management, the supervisory process and market discipline; systemic institutions; the elimination of aberrant "too big to fail" incentives; derivative markets, and the management and monitoring of shadow banks, among others.

With regard to reflections by industry experts on the normative framework, their overall assessment hasn't been negative, although some have noted that the regulatory response was qualitatively correct but intentionally uncoordinated and quantitatively underdeveloped. They indicate that the new regulation should strike a better balance between efficiency and stability, since long-term stability can only be achieved through an efficient financial system that fulfills its social function in the economy.

Others go on to underscore that the reforms aimed at increasing capital requirements shouldn't be the sole solution to the problem, but rather part of the solution, since in their view, it's important not just to increase available capital but to also improve the quality of assets and a true assessment of their inherent risks.

The latter aim of this normative framework strives for an international convergence of measures and norms in the banking system, since divergences between national and supervisory regulations generate inconsistencies that ultimately undermine confidence, not only in individual countries but the region as a whole. By way of example, experts cite the lack of a common criterion to calculate risk-weighted assets and its ensuing confusion, which impedes effectively comparing entities across different countries.


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THE BANKING UNION IN THE EUROZONE UNION

The proposal of the European Commission to create a banking union as the first step toward economic and fiscal integration in the long term suggests moving in this same direction to achieve greater homogeneity and convergence in the banking sector's measures and regulations within the specific ambit of the European Union (EU). The reform of the banking sector is currently a critical issue on the European agenda, and there seems to be consensus that a banking union is fundamental to reduce European financial fragmentation[2]. In particular, both national and international analysts underscore the fact that the banking union should contribute toward impeding the interaction and dependency between sovereign risk and bank risk.

This banking union comprises four main pillars: common European norms; a sole banking supervisory authority for the EU, with the power to directly supervise banks operating in different countries; common mechanisms and resolution instruments to prevent bank failures and intervene when a bank suffers from financial difficulties; and a single system to guarantee deposits.

Several measures have been adopted to date, among them the creation of three European supervisory authorities: the European Banking Authority (EMA), the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA). In addition, the Commission has expedited the application process in the EU for rules pertaining to bank capital approved in Basel III, specifically related to increase in capital requirements. This process has been applied to 8,000 banks thus far, which represent 53% of worldwide assets. On the other hand, other proposals are still being negotiated and debated among the European member states, including the creation of a single resolution fund for the entire EU.

2 See also: *High-Level Expert Group on Reforming the Structure of the EU Banking Sector*, presided by Erkki Liikanen, Brussels, October 2, 2012.

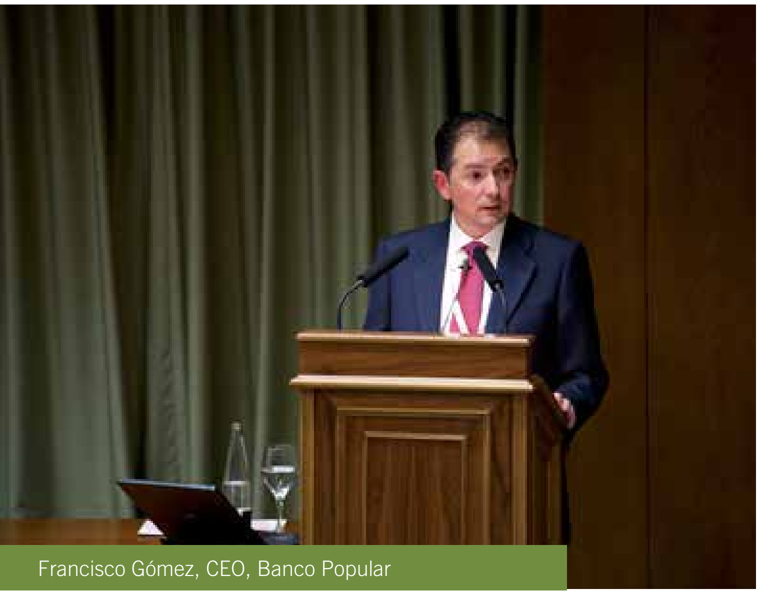
THE SPANISH BANKING SECTOR: MOVING PAST THE RECESSION

The economic and financial crisis has revealed the vulnerability of the banking sector in many countries. In the case of Spain, the impact of the crisis on the banking sectors has perhaps been greater, since the country's economic growth mainly depended on investment and rising prices in the housing market and in the fluidity of the interbank market.

Restructuring the current financial system in Spain has been incredibly challenging. The processes of recapitalization and financial restructuring have led to a significant decrease in the number of offices and employees, as well as a reassessment of the responsibilities of supervisory bodies and improvements in the regulatory framework. The banking system has accumulated €240 billion for provisions and €80 billion in capitalizations. It has 17% fewer offices and 40,000 fewer employees.

Financial support from the European Financial Stability Facility and European Stability Mechanism has adapted to the established timetable, and bank supervision on behalf of the EU is being carried out according to the conditions agreed upon. This stage of financial restructuring has witnessed an intense process of bank consolidation. In fact, before the crisis 51 banking entities held 91% of the assets, whereas now this percentage is held by 13 entities. Some experts feel that the realignment of the Spanish banking system, while painful, perhaps adapts better to the economic reality of the country, and they concur in the banking system's ability to bounce


José Ignacio Goirigolzarri, President, Bankia


Francisco Gómez, CEO, Banco Popular


Josep Oliu, President, Banc Sabadell

bank and overcome the current challenges. The overhaul of the Spanish banking landscape has upended banking entities and put them at different points of departure and in a completely new environment.

Bankia, for instance, is currently in the process of implementing its financial restructuring plan imposed by the European Commission. Among the measures adopted to date are cutbacks in the number of offices and employees, as well as a decrease in the number of external advisers on the administrative boards by more than 800 members. The reduction in the number of offices and employees, the de-politicization and the incorporation of independent advisers in the area of corporate governance are among the first decisions to be adopted by the new management board. The fast speed at which all of these measures were executed has been the linchpin to ensure that 2014 is a year of normalization.

Other banks, like Banco Popular, have adopted a strategy to complement their vocation as a retailer bank by concentrating on small- and medium-size enterprises and putting internationalization on the back burner until the medium- to long-term. Moreover, the integration of other entities, such as Banco Pastor, has been a strategic focus and a clear model of success.

On the other hand, entities like Banc Sabadell, which adopted a strategy of absorbing smaller banks or those at risk of bankruptcy such as Caixa Penedès or Caixa Galicia, currently have a greater presence in Spanish territory. From their position as a corporate bank, they aimed to have a larger international presence, using BBVA or Santander as benchmarks, which were able to weather the recession better thanks to their well-timed processes of international expansion.

Prof. José Manuel Campa, IESE Business School

Juan Rodríguez Inciarte, Member of the Board and Executive Vice-President of Strategy and Asia, Banco Santander

Alberto Placencia, Managing Partner of Financial Services, EY

Miguel Martín, President, Spanish Banking Association

Indeed, internationalization has been the strategy for quite some time for some of the Spanish banking institutions such as Santander and BBVA, whose wider market diversification allowed them to weather the crisis through other tools. In the case of BBVA, the presence and leadership position in already-consolidated markets, especially Latin America, has encouraged it to set sights on expanding to other markets, like China. By 2015, this Asian giant is predicted to be the second-largest global market in retail banking. The Chinese population and income per capita are the main yardsticks to assess the appeal of this market, which has a burgeoning middle class with disposable income and strong desire to spend it.

Although Spanish banks have adopted diverse strategies to overcome the recession and adapt to the new financial landscape, they face the same challenges and changes. Experts advise that the current situation is still fragile in light of sovereign debt, regulatory changes and the sale of real-estate assets, but see the sector in a new context of moving beyond the crisis and before new challenges. For example some indicate that the onset of the first phases of the aforementioned banking union will impose a very challenging timetable for the Spanish banking system. Furthermore, the recovery of cred, the adjustments of the regulatory framework and the adaption of new business models also pose challenges for the system.

CREDIT RECOVERY

With the expected recovery of the Spanish economy in 2014, analysts point to an increase and recovery of credit. Nonetheless, this recovery won't be immediate, nor will it follow the same pattern as before. Based on experiences from previous financial crises, credit supply recovers more slowly than other indicators such as exports, employment, and investment in machinery and equipment.

In addition, the deleveraging of the private sector is moving forward, and according to experts should continue to avoid excesses from earlier stages, which were significantly higher than the European Monetary Union (EMU) and based primarily on mortgages and credit to real-estate businesses. Experts also note that this decline may be consistent with a new flow of credit to other sectors. Moreover, deleveraging should avoid damaging the productive fabric that Spain is constructing, primarily through small- and medium-sized enterprises.


Prof. Jorge Soley, IESE Business School

FINANCIAL SERVICES: A NEW ENVIRONMENT

The current context in which banking institutions must offer their financial services is in a state of flux and introduces new elements.


Gonzalo Gortázar, CFO, CaixaBank

The so-called service bank offers transactions that are typically related to payment systems, such as transfers, [direct-debit] billing and credit cards, and the impact of new regulation on these services is evident. By way of example, the new ways of measuring capital established in Basel III and scheduled to come into effect in 2014 will generate very significant changes in the profit margins of banking institutions. Some of the consequences that these changes may unleash could include a waning interest in the mortgage business, a possible return to massive securitization of specific markets, a decline in the public-debt business financed by repos or LTROs (*Long-Term Refinancing Operations*, which are long-term financing operations) and the possible growth in commission-based businesses.


Prof. José Manuel González-Páramo, IESE Business School

Other relevant changes could arise after the definitive implantation of SEPA (Single Euro Payments Area), which should take place in 2014. This initiative responds to the need of creating a single market to make payments in euros to offer citizens and businesses a safe and easy way to make payments to all European countries from any account, just as they do within their own country. To this end, a single account and single set of homogenous payment instruments are used.

In addition, the draft of the new payment directive introduces significant innovations, such as the recognition of the figure of third-party payment service suppliers, in other words, businesses that act between the company and the managing body of the account and allow making payments without using traditional credit cards. Currently, there are already companies that act as intermediaries between businesses and banks, offering primarily online payment services.

NEW CUSTOMER RELATIONSHIP MODELS

The declining use of credit cards, the emergence of new players and the incorporation of new mobile-based payment models demand a shift in the financial services offered until now in order to satisfy changing customer needs and new customer-relationship models. It is not a matter of merely offering different methods and services, but rather of delivering them through channels already available – offices, cash machines, Internet, cell phones, iPads – as well as adapting them to specific client segments, whether they are companies, institutions, SMEs or individuals.

The role of new technologies is having – and will continue to have – a major impact on how clients interact with their banks. The digital transformation is a fact that affects all sectors in one way or another, and while the impact may vary according to the age group or type of clientele, all segments are in any case immersed in change. The ease and convenience of making payments in real time from wherever one might be, with no need to go to a bank office, is without a doubt the most obvious.

Ángel Cano, President & COO, BBVA

Luis M. Linde, Governor, Bank of Spain

Based on this premise, experts highlight two fundamental issues above others: First, the importance of having a digital strategy that entails a true transformation of the business, while allowing it nonetheless to preserve its essential values and principles. In other words, the digital transformation shouldn't imply a complication in the language of the services that are offered, nor should it affect the perception of security or guarantees for clients. Much less will mean the disappearance of bank offices that, in any case, will adapt to new concepts. In fact, recent studies confirm that bank offices remain a key component to the commercial banking model in Spain, although they require significant changes to adapt to new technologies and respond to consumer needs and behavior. These findings are included in the research study *Bank Offices and the Ongoing Restructuring Process*, carried out by A.T. Kearney and IESE's Center for International Finance.[3]

Second, the adaptation must be very carefully calibrated to the speed of change of each institution, since the costs could be very high if it is implemented too fast, and conversely, clients could disappear if the change is too slow.

In addition to these considerations, there are other more concrete matters such as the importance of ensuring accessibility of bank data from any medium, the simplicity of digital products, which in general should be easy to use, and the challenge of balancing the advantages and risk of big data, among other related topics.

In conclusion, overcoming the recession has led to a major restructuring of the Spanish banking system, and while the new composition of the sector and the challenges it faces remain uncertain, the outlook is positive within a framework of caution.

3 Mateache, P., M. García-Ramos, A. Rahnema, y J. Soley: *Bank Offices and the Ongoing Restructuring Process: Closing Offices Is Inevitable, but It Shouldn't Be the First Option*, CIF-Center for International Finance & A.T. Kearney, July 2012.

APPENDICES

PROGRAM

Thursday, December 12, 2013

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- José Miguel Andrés, President, EY
- Prof. Juan José Toribio, President, IESE-CIF (Center for International Finance)

Regulation, Supervision and Risks: The Situation Today
- Jaime Caruana, General Manager, Bank for International Settlements (BIS)

The Spanish Financial System: From Restructuring to Lending
- Prof. José Manuel González-Páramo, IESE Business School

Banking and Financial Services: The New Context
- Gonzalo Gortázar, CFO, CaixaBank
- Prof. Jorge Soley, IESE Business School

Turnaround
- José Ignacio Goirigolzarri, Chairman, Bankia

Moderator: Alberto Placencia, Managing Partner of Financial Services, EY

The Spanish Banking Industry: Opportunities and Threats
- Miguel Martin, President, Spanish Banking Association (AEB)

Moderator: Alberto Placencia, Partner Director Financial Services, EY

The Banking Business: Overcoming the Recession
- Josep Oliu, Chairman, Banco Sabadell

Moderator: Prof. José Luis Suárez, IESE Business School

The Banking Industry looking to the Future
- Francisco Gómez Martín, CEO, Banco Popular

Moderator: Prof. Juan José Toribio, IESE Business School

Structural Financial Reforms
- Juan Rodríguez Inciarte, Member of the Board and SEVP, Strategy & Asia, Banco Santander
- Prof. José Manuel Campa, IESE Business School

New Trends and Clients Relation Models
- Ángel Cano, President & COO, BBVA

Moderator: Prof. Juan José Toribio, President, IESE-CIF (Center for International Finance)

Closing
- Luis M. Linde, Governor, Bank of Spain

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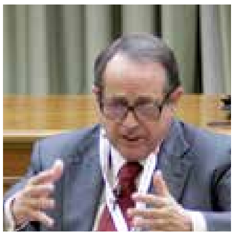
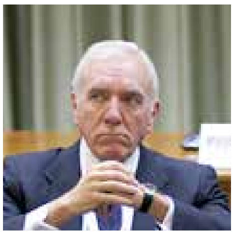


PROF. JUAN JOSÉ TORIBIO
President
IESE-CIF (Center for International Finance)

SPEAKERS



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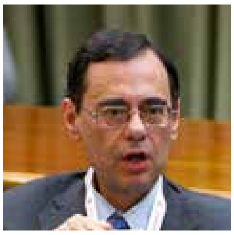

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General Manager
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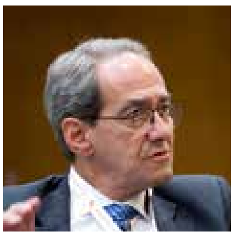

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