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Funding models of Banks and Corporates

Implications of the Euro Crisis, Banking Union and Bail-in

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures

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Implications of the Euro Crisis, Banking Union and Bail-in

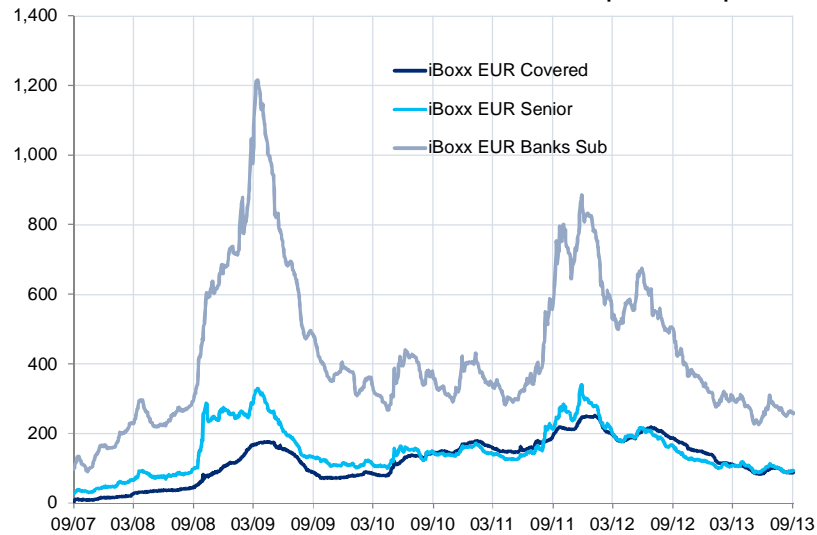
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1. Implications on Banks

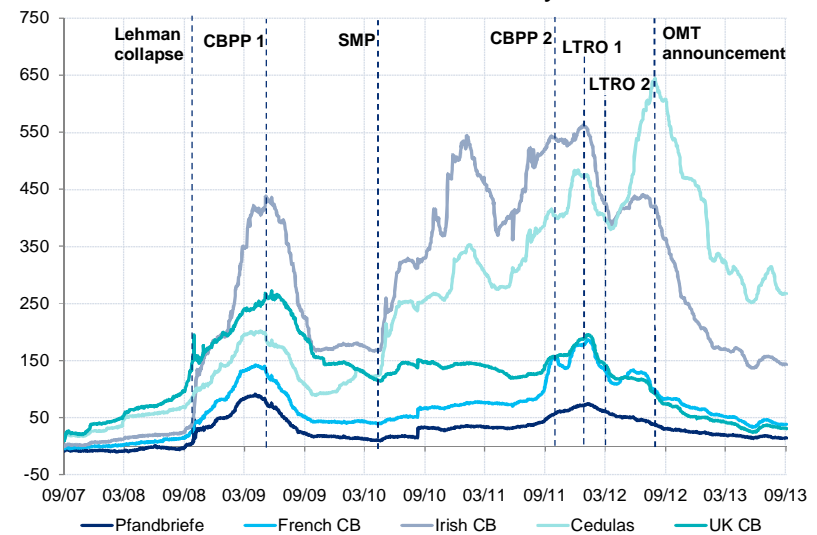
Higher funding costs

During the crisis, distortions in the sovereign markets led to higher funding costs in general. The different depth of the crisis led to a fragmentation in the system. Extraordinary monetary measures counteracted a further distortion.

iBoxx indices, 2007-2013, ASW-Spread, bp

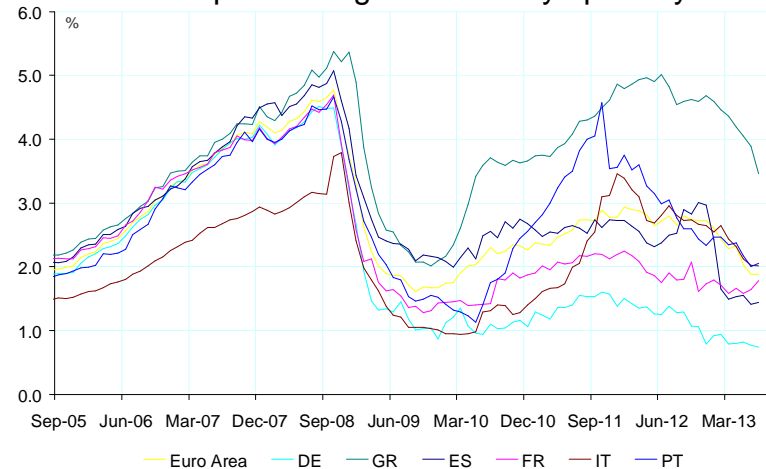


iBoxx covered bond indices & extraordinary measures of the ECB



- Funding costs for high beta sub bank bonds reacted severely in the aftermath of the Lehman collapse, less so to stress in the sovereign markets. Covered and senior funding costs were equally affected by the risk of distortions on the banking system and on the sovereign markets.
- The Gordian knot between bank and sovereign risk led to a generally high spread differentiation between core and peripheral banks during the crisis. Hence, public funding was substituted with retained bond issuance or retail funding.
- Tackling the sovereign crisis (OMT) has so far been the most effective extraordinary measure to ease funding conditions for European banks.

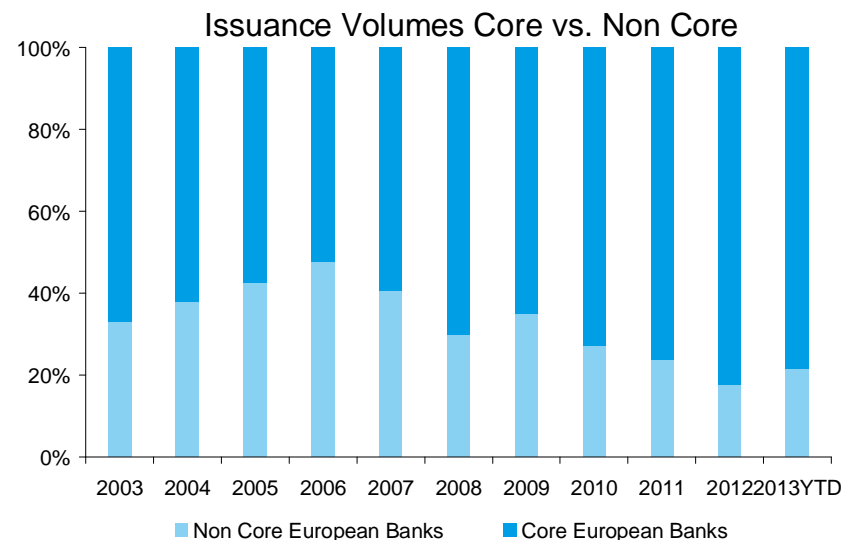
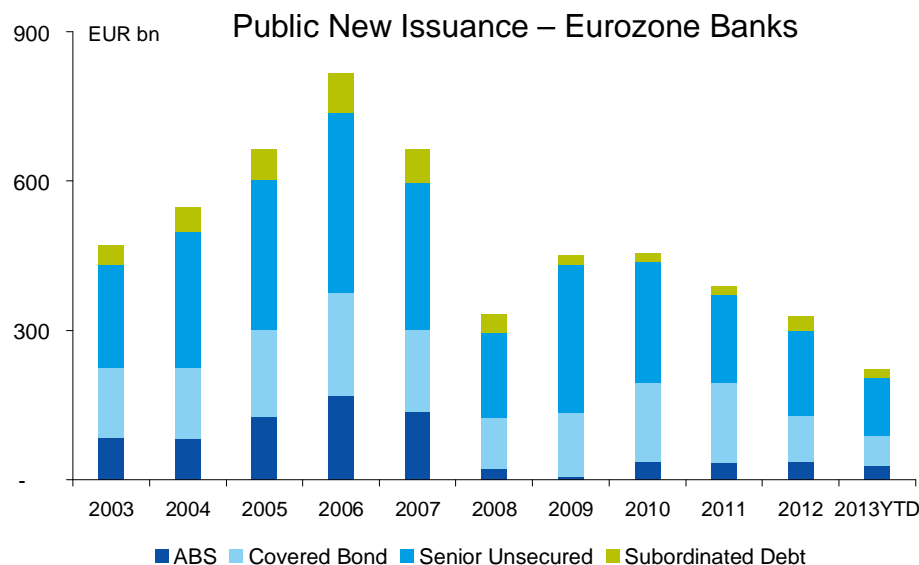
Cost of Deposits – Agreed Maturity up to 1 year



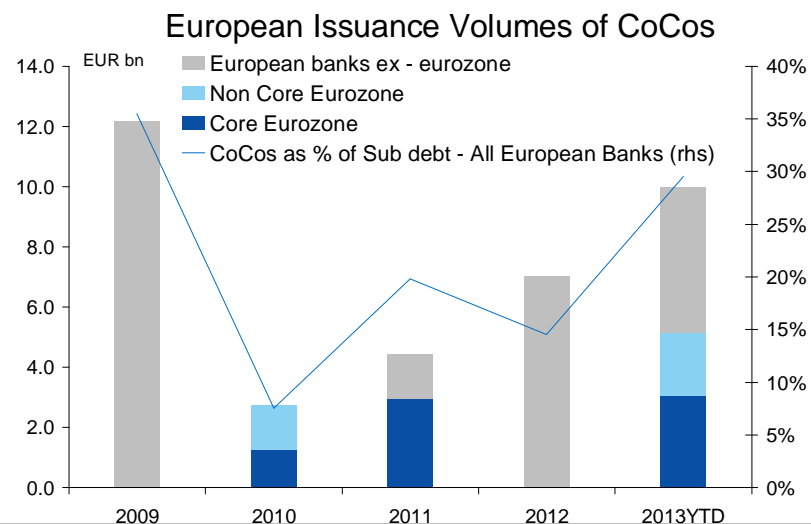
Source: Bloomberg, Markit, ECB, Citi Research, BBVA GMR.

Lower total funding volumes but a clear preference for CoCos

The higher funding costs have also represented lower funding volumes in public markets. According to the Dealogic, the average volume in the period 2008-2012 dropped by 40% to EUR391 billion from EUR633 billion in 2003-2007. However, the current environment remains supportive for the issuance of CoCo bonds.



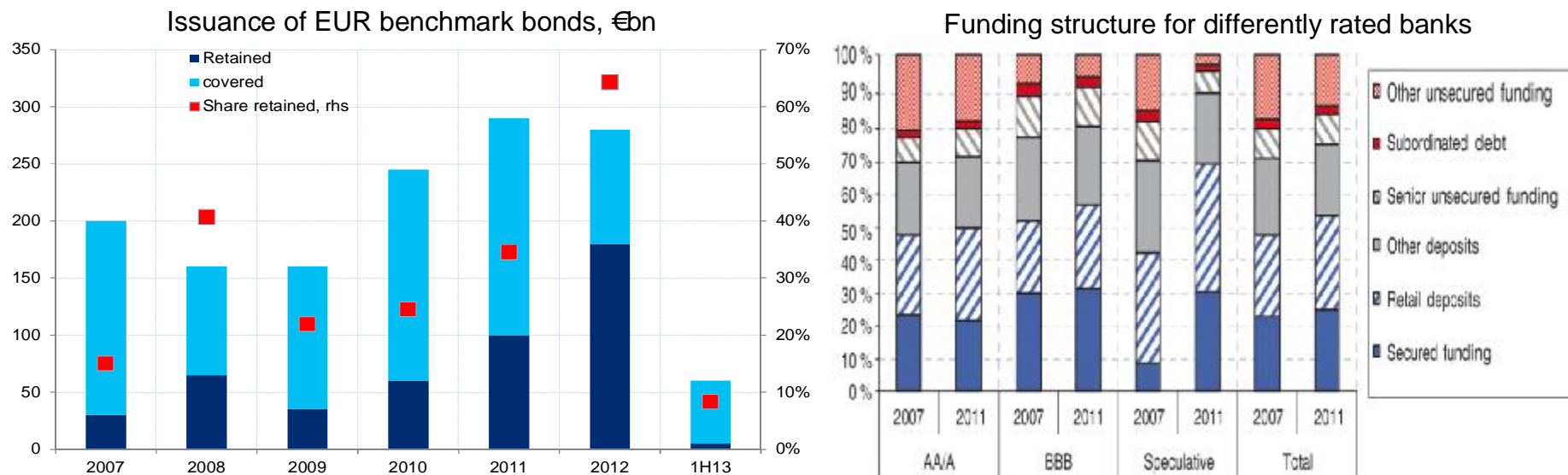
- Since the beginning of the crisis, ABS issuance has declined notably. ABS funding represented almost 20% of the total bond funding in 2003-2007 but it fell to just 7% in 2008-2012.
- Also, the participation of financials in peripheral countries in bond markets has declined from 40% in 2003-2007 to 27% in 2008-2012 due to concerns on asset quality and capital adequacy.
- However, issuance of contingent convertible bonds have soared since 2010. In 2013YTD, European banks have launched a total of approx. EUR10.0 billion which represents 30% of the total subordinated funding versus only 15% in 2012.



Source: BBVA GMR; Left graph: Dealogic; upper right graph: Dealogic; bottom right graph: BBVA GMR.

Funding diversity – leaving the wholesale path

During the crisis, market access diminished for several banks. Hence, using retained bonds for repo operations increased with severe effects on asset encumbrance. Also, the decreasing volume of wholesale funding increased the importance of deposits.

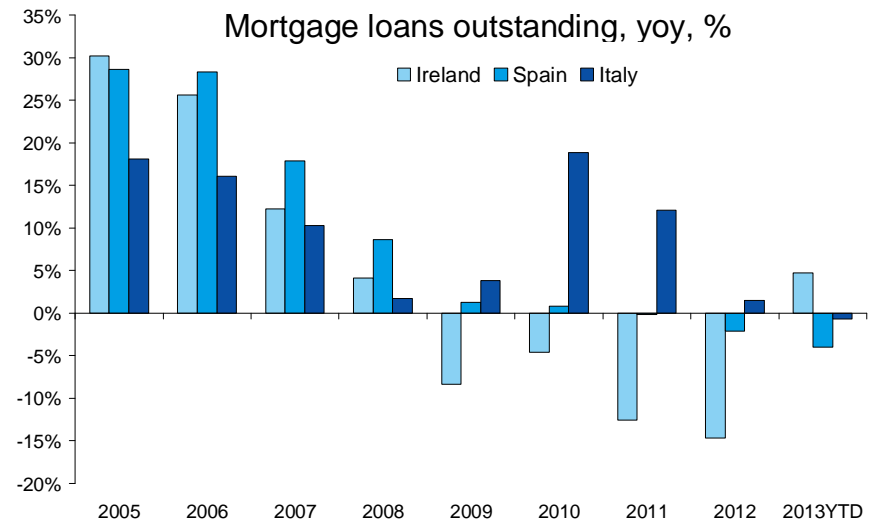
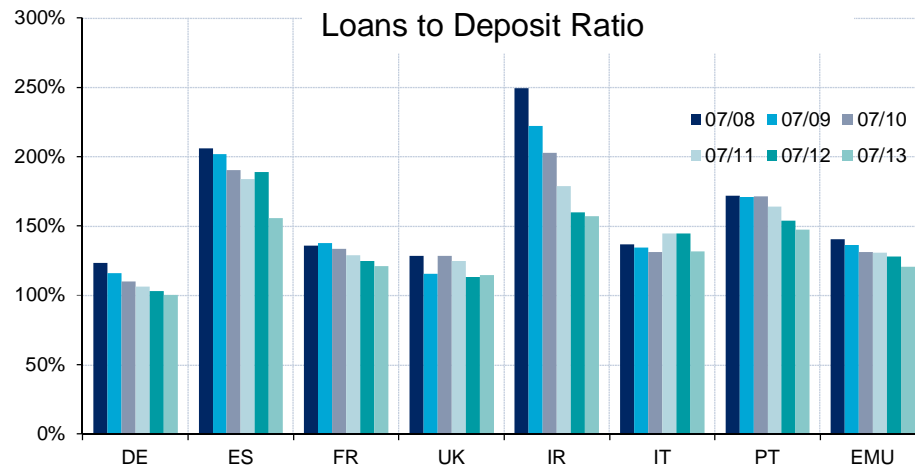


- Own issued securities are usually not eligible for repo operations with the ECB - exception: covered bonds. Hence, the usage increased substantially during the crisis. This trend hasn't been ongoing in 2013: on the one hand because of a lack of collateral, on the other hand because regained market access in 2013. Moreover, the recent change of the ECB to the collateral framework recently made retained covered bond issuance less attractive.
- Secured (retained) funding has become significantly more important for sub-investment-grade banks during the crisis; in total retail deposits and secured funding gained funding share while senior and other unsecured funding lost importance.

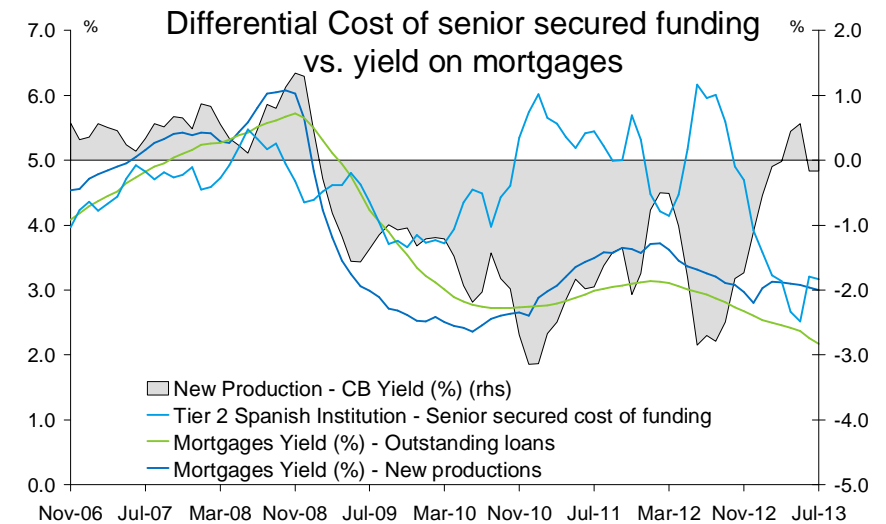
Source: ECBC, ESRB, Citi Research; right upper graph: Coverage: 12 banks (AA/A), 6 banks (BBB), 11 banks (speculative rating), 29 banks (total). Note: In order to ensure consistent comparison, the same sample of banks was used for both end-2007 and end-2011 data.

Funding through deleveraging

Another form of funding stems from deleveraging, i.e. decreasing the loan book. In addition, the market conditions made it uneconomical for certain banks in the periphery to continue making loans.



- Another measure to decrease wholesale funding needs is the decrease in lending. By shrinking the loan book, funding increases as loans are repaid.
- Troika aid premises demand banks to delever resulting in higher asset quality and advantageous funding refinancing requirements.
- Also, we highlight that higher funding costs for banks reduced sharply their margins to the extent that it was uneconomical to continue with their lending activities.



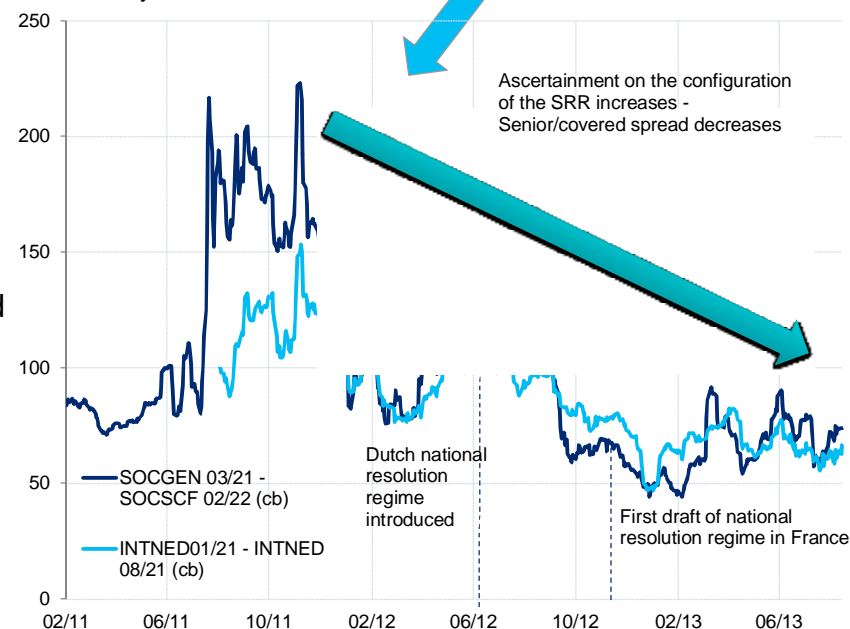
Source: BBVA GMR, Eurostat, Citi Research, Markit iBoxx

European resolution regime and bail-in

The Single Resolution Regime (SRR) for European banks will not lead to a harmonized winding-up approach. While covered bonds will be excluded from bail-ins, senior bonds should suffer a haircut. However, national discretions remain high. Hence, relative funding costs within the capital structure might differ between countries.

The bail-in ranking		The exclusions		Does the current law foresee bail-in of senior debt?		Senior debt sovereign uplift for S&P	
Shareholder		Covered deposits		FR	No	+1	
Unsecured bondholder		Secured liabilities including covered bonds		DE	Yes	+2	
Large depositors (i.e. >100k)		Liabilities to employees		IRL	Yes	+1/+2	
Eligible Deposits		Fixed salary		ITL	No	0	
- from natural persons		Pension benefits		NED	Yes	+1/+2	
- micro enterprises		Commercial claims		ES	No	0	
- small and medium sized entities		for daily functioning of the institution		UK	Yes	+2/+3	
- liabilities to the European Investment Bank		Inter-bank liabilities					
		with an original maturity of less than 7 days					

- Remaining uncertainties:
 - Several degrees of freedom for national regulators to deviate from SRR. No harmonized transitional solution until the introduction in 2018.
 - Fiscal or ESM support can be utilized if 8% of the bank's total liabilities (incl. own funds) have been bailed in and if this contribution is capped at 5% of the bank's total liabilities.
 - No clarity on treatment of voluntary overcollateralization in covered bond programs.
 - Implications of the new credit events in the subordinated CDS for financials.
- The SRR proposal helps to break the link between sovereign and banks. Important impact on the rating of banks' senior debt as the sovereign uplift rating in senior debt could be removed.
- In theory, the funding advantage of covered bonds vs senior bonds should increase, while funding levels between sub-debt and senior debt should narrow.



Source: European Union, Citi Research; Graph: ASW-Spread, bp

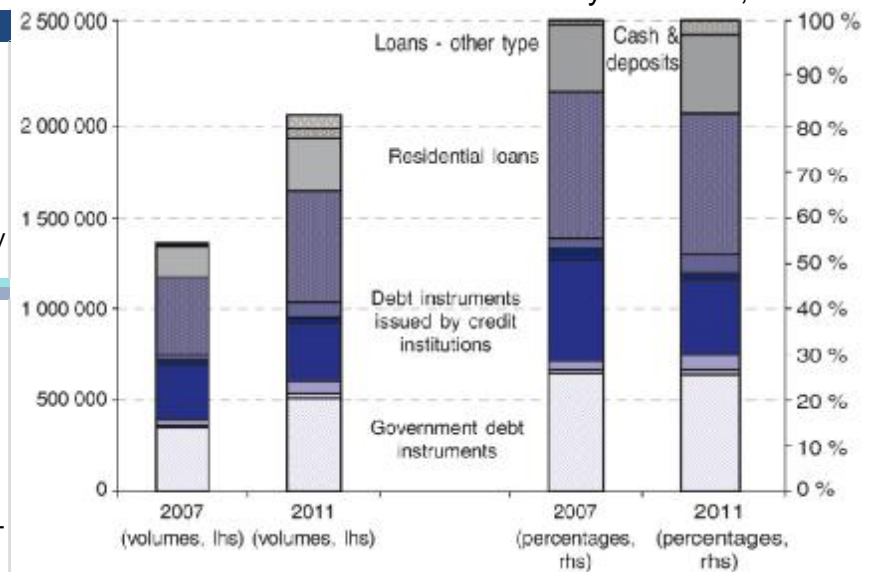
The European Banking Union – harmonization ahead?

The first attempts of harmonizing the European banking system to ease the introduction of SSR revealed several challenges: asset encumbrance, covered bond laws, reporting standards. However, homogenous legislation seems very improbable while improving transparency is reachable.

The Structure of the European Banking Union

	Supervision	Restructuring	Financing
European Level	Microprudential: - issuance of banking licenses - early intervention Macroprudential: - identification of systemic risks - specification of additional capital buffers	Restructuring and resolution if stability of the financial system is at risk	European restructuring fund: - financing of bank restructuring and bank resolution - funded by European bank levy - fiscal backstop provided by ESM
National Level	- Ongoing microprudential supervision in the context of European supervision - early intervention in coordination with the European supervisor	- Restructuring and resolution by order of the European authorities - restructuring and resolution if national financial stability is at risk	National deposit insurance: - Compensation of depositors in the context of a) resolution by European and/or national restructuring authorities and b) of an insolvency procedure - funded by harmonized, risk-based insurance premia

Breakdown of encumbered assets by collateral, €mn



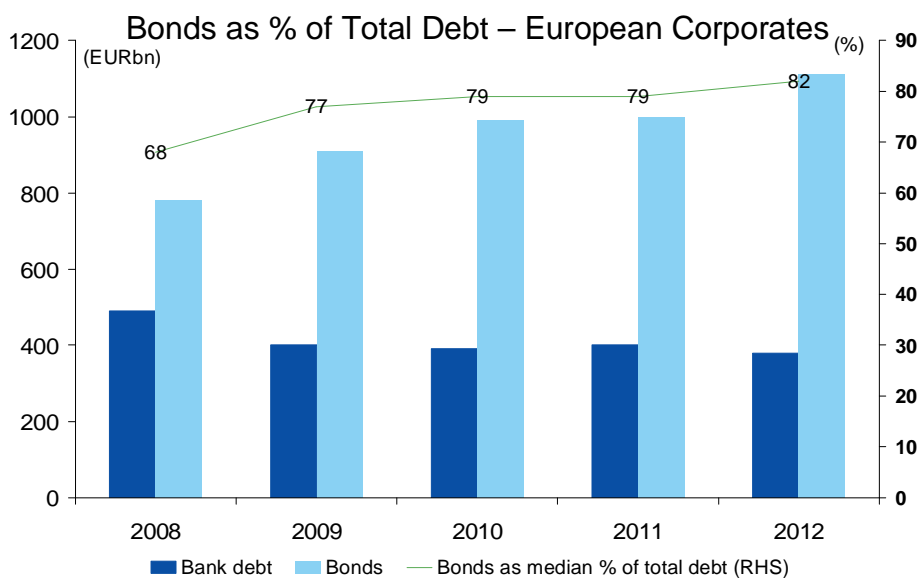
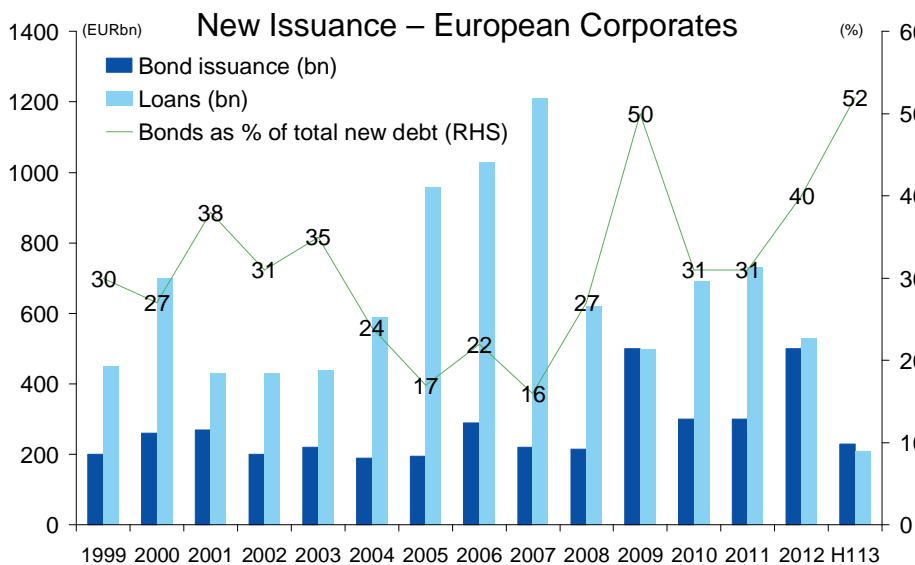
- Challenges for European-wide binding SSM: the scope of a deposit guarantee scheme, redefinition of central bank powers, restoring trust after Cyprus, technical harmonization (reporting standards).
- Asset encumbrance will be an even more pivotal topic in the future and needs to be harmonized with respect to a common definition and the technical supervision: Higher repo haircuts from central banks, more collateral posting for non-CCP cleared derivatives under EMIR, higher reliance on secured funding, fulfillment of LCR ↔ Share of high quality assets has been decreasing steadily since the beginning of the crisis.
- Harmonization of covered bond markets remains challenging:
 - CRR demands for disclosure of certain cover pool data → improving transparency and narrowing asset eligibility criteria
 - Covered bond laws mostly are the interface of national insolvency laws and mortgage laws → harmonization of covered bond laws might contradict to national legal environment while bankruptcy remoteness of covered bonds is highly diversified

Source: Sachverständigenrat, ESRB

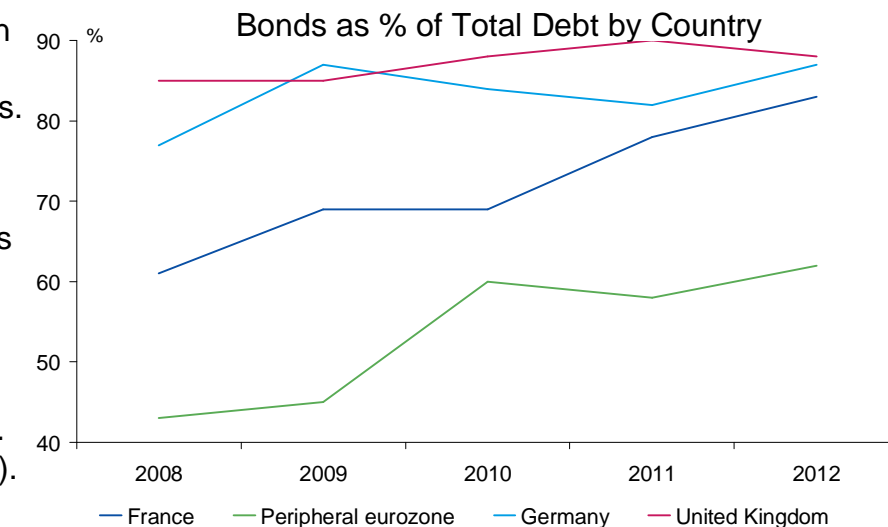
2. Implications on Corporates

Strong bank disintermediation process

Since the beginning of the crisis, the disintermediation trend in Europe has occurred virtually across all industries as banks continue to reduce leverage in their balance sheet.



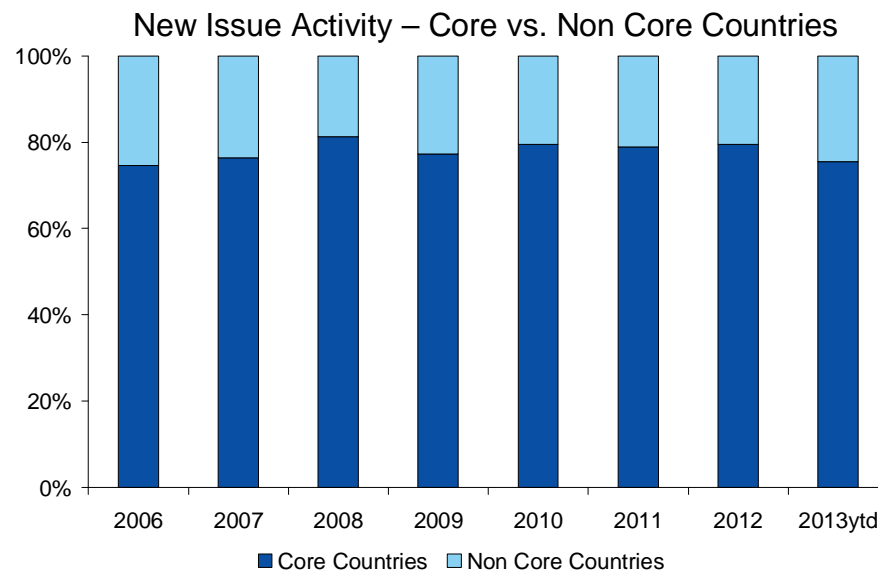
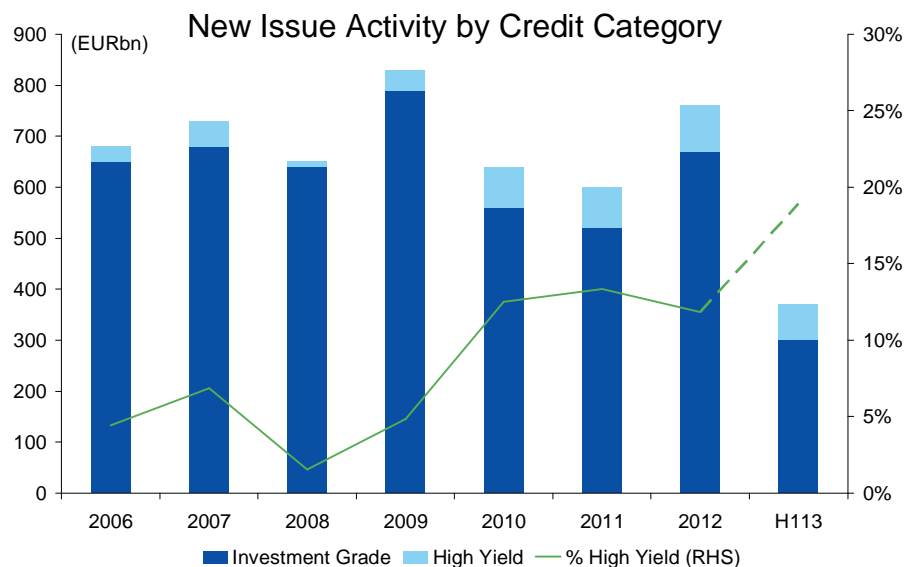
- According to Dealogic, the amount of cash raised by European corporates through bonds in 1H13 was higher for the first time in more than a decade than the funding obtained through loans. In this period, bonds represented 52% of the total new debt, well above the average of 30% since 1999.
- The increasing preference for bonds over loans in recent years has led to a much bigger weight of bonds in the capital structure. According to Fitch, bonds represented 82% in the total debt structure of European corporates in 2012 compared to only 68% in 2008. The proportion of bonds in the total debt has risen very sharply in peripheral countries (62% in 2012 vs. 43% in 2008) and France (82% vs. 61% over the same period).



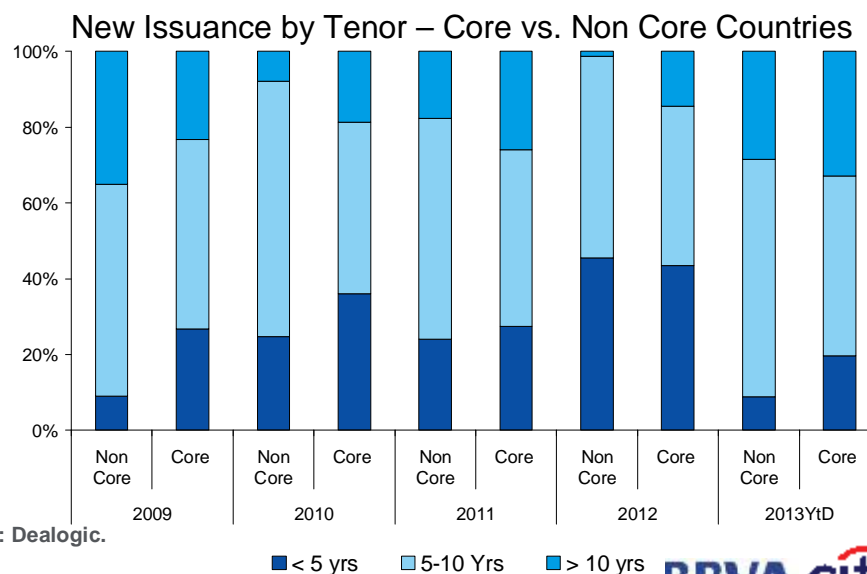
Source: BBVA GMR; Left graph: Dealogic; right graph: Fitch.

Disintermediation more acute in HY

The impact of the disintermediation process on highly-rated investment grade companies is minimal as banks continue to provide lending at attractive rates for these issuers.



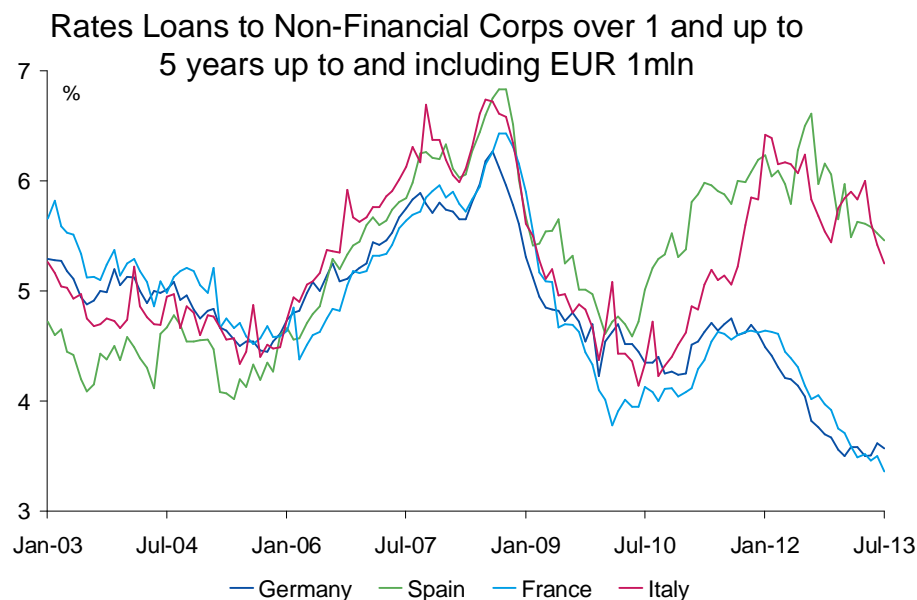
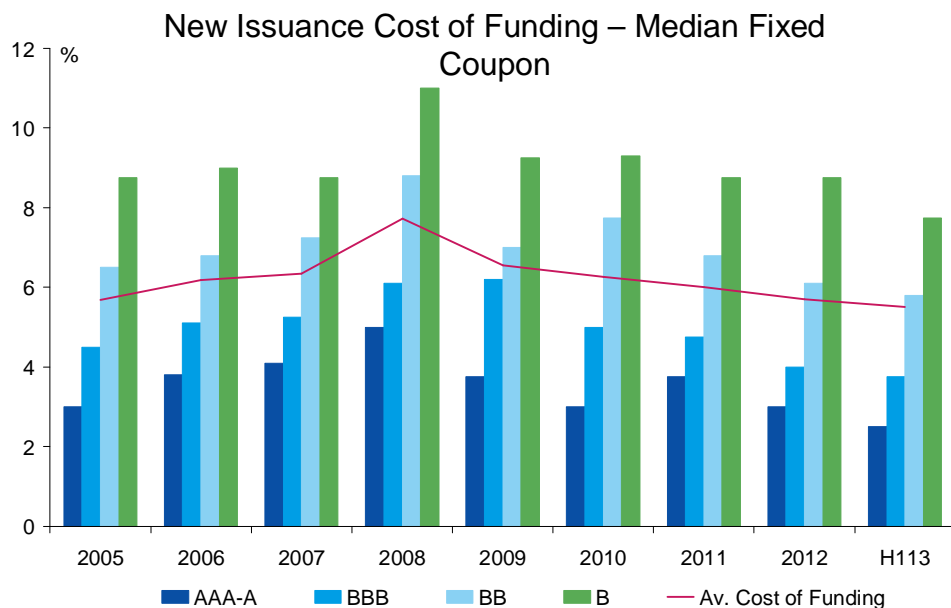
- We think the disintermediation is much stronger for high yield issuers than for those in investment grade as evidenced by the record issuance volumes of the former over the last three years. The new issues in HY represented an all-time high of 18% of the total issuance in 1H13.
- However, we have no significant evidence of signs of fragmentation for non-financial bond issuers in Europe. The participation of peripheral countries in the new-issue market has remained broadly stable at around 28% on average since 2006.
- Taking advantage of a healthy investors' appetite towards corporates, issuers have extended their debt-maturity profile to reduce reliance on bond markets in the short term.



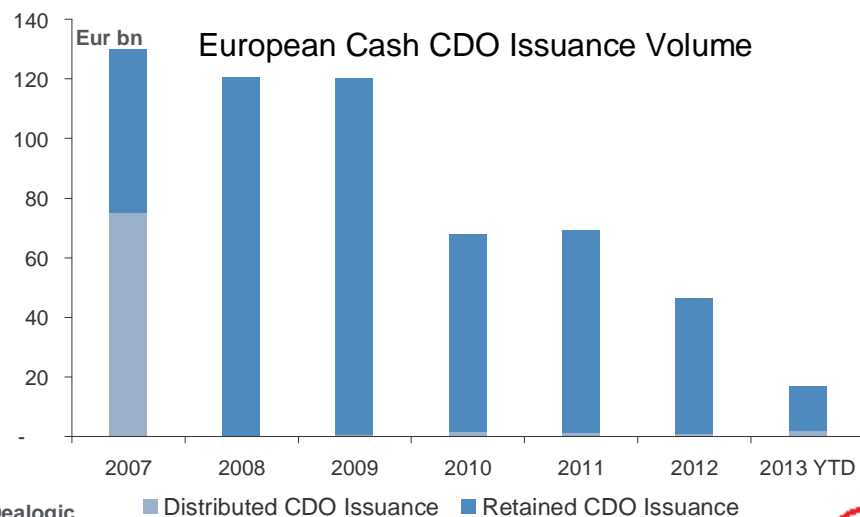
Source: BBVA GMR; Left graph: Dealogic, Fitch; upper right graph: Fitch; bottom right graph: Dealogic.

Bifurcation in the funding costs for corporates

For large corporates, the all-in funding costs remain at historically low levels as interest rates have offset wider credit spreads. However, for SMEs in peripheral countries the cost of funding have soared.



- Funding costs in bond markets for large corporates have been supportive for credit quality as major central banks across the world have kept interest rates at all-time lows. The highly-accommodative monetary policy have compensated the wider credit spreads witnessed in different European countries.
- However, the crisis has sharply eroded the funding ability of SMEs in peripheral countries. As shown in the chart above (RHS), the lending rates, according to the ECB, in Italy and Spain show a large divergence compared to those in Germany and France. For instance, for loans up to EUR1 million and a maturity between 1 and 5 years the gap between these countries stands at around 2 percentage points (approx. 5.5% vs. 3.5%).

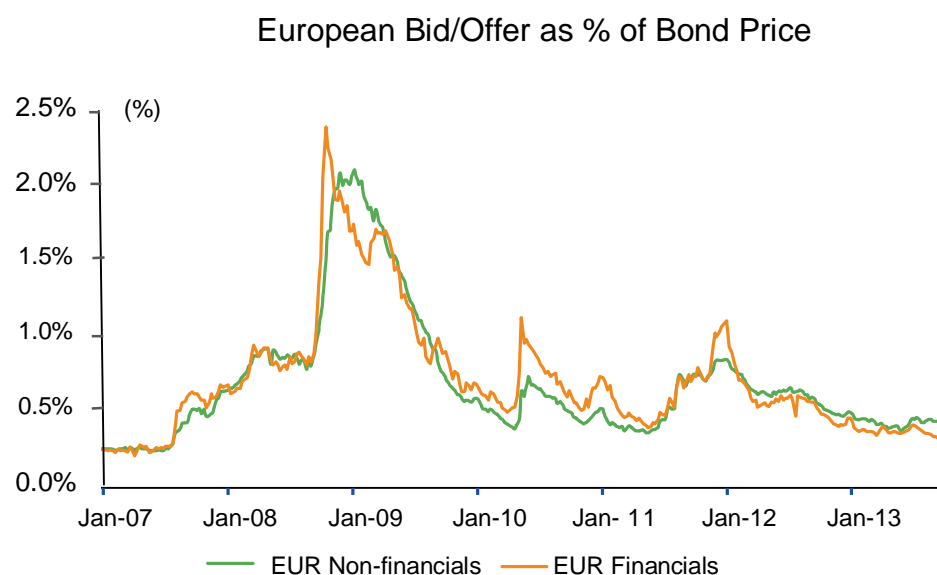


Source: BBVA GMR; Left graph: Dealogic, Fitch; Upper right graph: ECB; Lower right graph: Dealogic

■ Distributed CDO Issuance ■ Retained CDO Issuance

New regulation for banks introduces volatility in secondary pricing

New capital, liquidity and leverage rules for banks are making it expensive to carry inventory in bonds. Banks have less capacity to take principal risk reducing significantly market liquidity in secondary markets. The additional volatility in credit spreads have negative consequences for corporate issuers, in our view.



- The introduction of the so-called Basel 2.5 has forced dealers to hold more capital against trading assets through the use of a 10-day value at risk, a stressed VAR calculation and an incremental risk charge. Separately, the Volcker rule in the US has also restricted proprietary trading activities. US Commercial banks now follow an *agency* model. As a result, primary dealer holdings of corporate bonds have plummeted.
- Also, the liquidity coverage ratio in Basel III only includes corporate bonds with a minimum rating of AA- for a 15% haircut. For corporate bonds rated between A+ and BBB- the haircut climbs to 50% and up to a certain limit.
- In addition, Solvency II directive on insurance companies forces insurers to account for the risk of their investments as a cost. This cost could be greater than the yield on the bonds especially for those rated BBB or lower making them unattractive.
- Lower liquidity in secondary markets make pricing discovery for issuers more challenging and probably more costly as well.
- Also, in the medium and long term, institutional investors may perceive the corporate bond asset class as less attractive due to the lack of transparency and the higher trading costs.

Source: BBVA GMR; MarketAxess, Markit iBoxx.

Topics for discussion

The funding models of European banks and non-financial corporates have changed in a significant way as a result of the new capital and liquidity rules. The introduction of these regulations pose uncertainty going forward.

1. Evolution of market fragmentation. Have we reached fair levels?
2. Impact of stress test and AQR for bank funding strategy and securities holdings of banks.
3. Is another VLTRO necessary? Implications.
4. Senior debt is now subject to bail-in although ESM funds could be used before a haircut is applied. Covered bonds are safe under the new framework. Implications on pricing and funding. Key thresholds to consider.
5. Higher issuance of bonds in relative terms (disintermediation) in an environment where banks have less capacity to take principal risk (agency model). Is this the recipe for structurally higher volatility and higher costs in secondary markets? Is it necessary to create new trading platforms?