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Presentation of the 9th PwC Report on the Banking Union: "A climate of change"*

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* Translation of the original in Spanish.

Good morning. I should like to begin by thanking PwC for the invitation to present its latest Report on the Banking Union, entitled “A climate of change”.

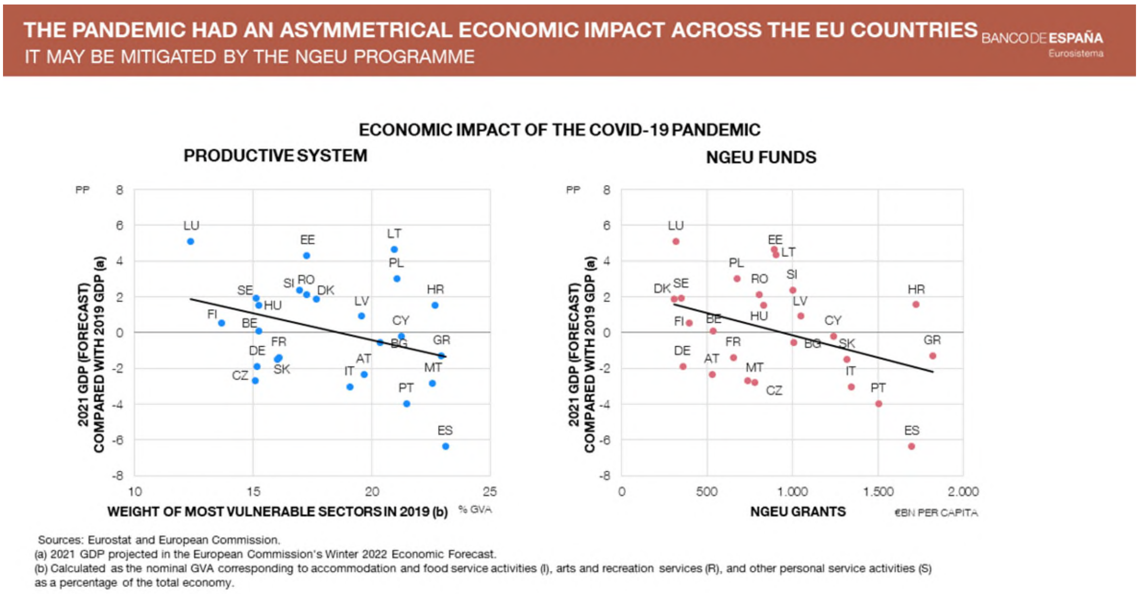
If we have learnt one thing in recent years, it is that we live in an extraordinarily changing environment subject to uncertainties that are often difficult to measure and, of course, to predict.

In this setting, the banking union, another major European project, has not been immune to such changes. While there is no doubt that the terrible conflict in Ukraine affects us all, above all from a humanitarian standpoint, its repercussions can be felt in all spheres (economic, political and social) for various reasons.

Along with expressing my concern for the situation in Ukraine, especially for its people, today I should like to assess the impacts this conflict may have on the key issues and challenges facing the financial system that we have already analysed on previous occasions.

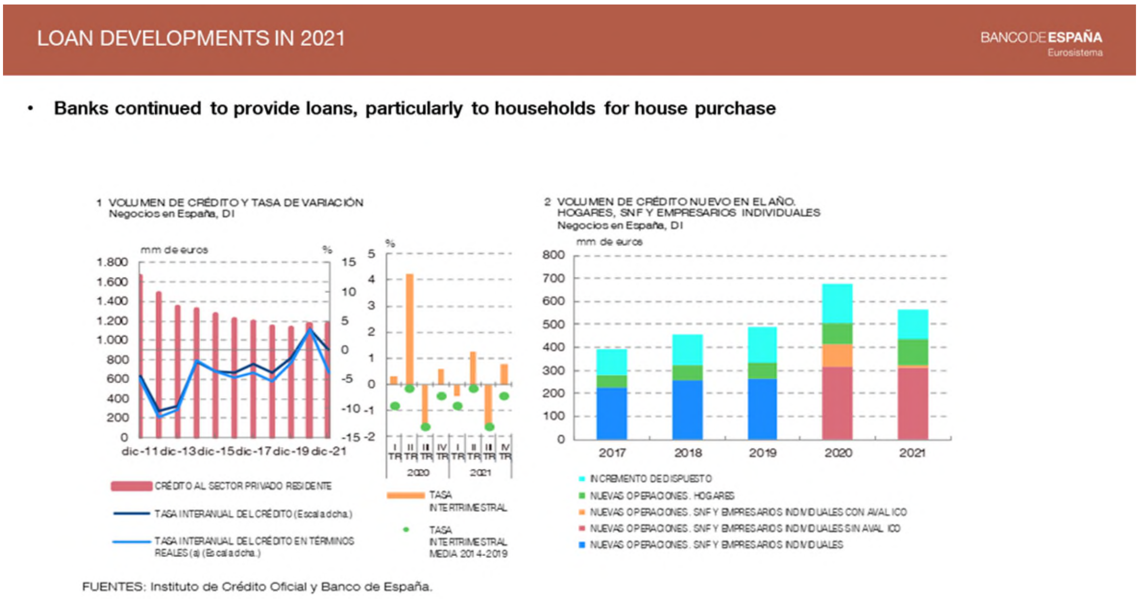
Economic effects of the conflict

First, it should be pointed out that this conflict will undoubtedly impact the post-pandemic economic recovery that was in progress.

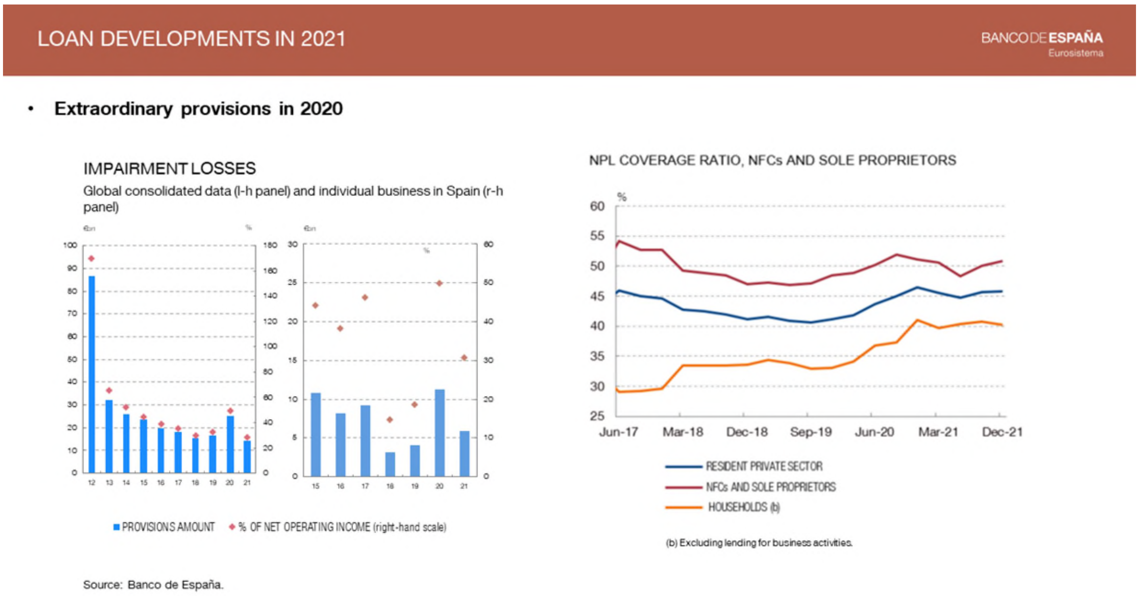


The pace of this recovery was proving uneven across economies, sectors and even population groups. As can be seen in the chart, the economy has not yet returned to its 2019 levels in those countries (such as Spain) where the sectors most vulnerable to the pandemic have a higher weight.

Also accompanying this recovery was an upsurge in inflation that has turned out to be sharper and longer-lasting than initially expected. This was being fuelled by factors both on the demand side (such as the robust economic recovery after the collapse in 2020) and on the supply side (for instance, production chain disruptions).



Against this backdrop, in 2021 Spanish banks continued to provide financing, chiefly to households, with new loans for house purchase seeing strong growth. Conversely, the stock of credit to non-financial corporations and sole proprietors stabilised at the levels of the previous year, when such loans saw very significant growth on account of the ICO guarantee programmes.



In this respect, in recent months we have been reiterating the need for prudence when managing credit portfolios and, specifically, with the provisions made in the wake of the pandemic, especially those recorded in 2020.

As we have mentioned, the economy remains shrouded in much uncertainty, which is now being stoked by the crisis in Ukraine. We must therefore be watchful of loan developments, even more so now that the payment holidays of the ICO-backed loans are beginning to expire, pending any measures approved by the Council of Ministers today. We are about to enter April, a month that represents a watershed moment precisely because firms will see their debt burden increase as principal payments on these loans start to fall due. ICO loans whose payment holiday is set to end in Q2 account for 80.2% of the total amount of such credit, and this will increase by a further 6.8% in Q3.

DEFAULT DEVELOPMENTS IN 2021

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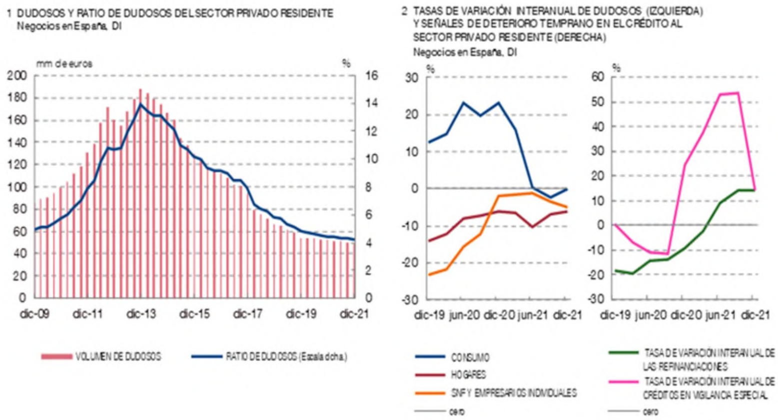
- **Default rates continued to decline, although refinanced credit and Stage 2 loans increased**



Turning to default rates, in 2021 the volume of non-performing loans continued its downward trend of recent years, albeit at a much slower rate than had been observed before the pandemic.

Another factor well worth bearing in mind is the highly significant increase in both refinanced credit and Stage 2 loans. Despite moderating in 2021 H2, growth in Stage 2 loans remains at double-digit rates. Unsurprisingly, this growth has been concentrated in the sectors hit hardest by the pandemic, namely, as has been mentioned on other occasions, hospitality and transport.

These two aspects are the first warning signs of a potential worsening of the quality of loan portfolios.

In this context, we have to analyse the impact that the Russian invasion of Ukraine may have on the economy and, by extension, its repercussions for the financial system. While the direct impacts seem limited, the consequences for the economic recovery are likely to be significant as they will spread through various channels.

First, inflation is expected to be higher on account of the impact of rising prices of some commodities and, especially, of energy. In its latest forecasts, the European Central Bank (ECB) projects euro area inflation of 5.1% for 2022, which may reach 7.1% under the severe scenario. Second, the conflict could also influence supply chains, which have already been disrupted in the wake of the pandemic, and act as a drag on growth. The ECB has revised its growth forecast downwards by 0.5 percentage points, to 3.7% and, under the severe scenario, to 2.3%.

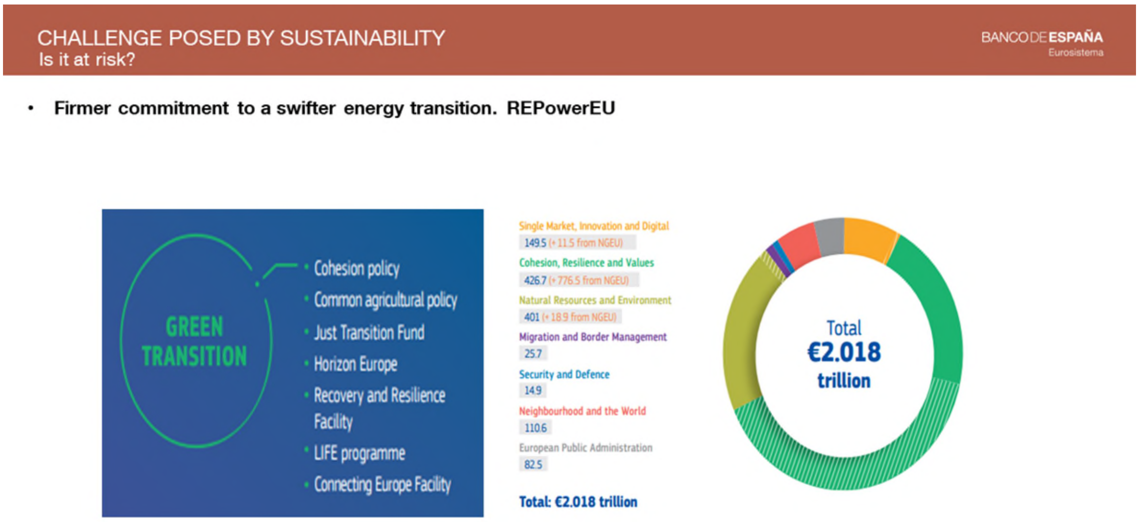
Moreover, although, from a financial standpoint, European, and particularly Spanish, banks' direct exposures to Russia and Ukraine are low, the potential consequences on the financial and stock markets of the greater volatility prompted by this crisis need to be monitored. For example, capital market financing costs for financial and non-financial corporations have risen recently. The potential future consequences of shutting the Russian economy out of international financial channels also need to be considered. Lastly, the conflict also has a negative effect on economic agents' confidence, impacting on consumption and investment decisions.

This combination of higher inflation and lower economic growth forecasts will undoubtedly affect monetary policy. In its latest decision, the ECB Governing Council[1] agreed to scale down the volumes of the Asset Purchase Programme (APP), and it clarified that any adjustments to interest rates will take place "some time after" the end of the purchases under the APP. This suggests a commitment to gradual interest rate adjustments, avoiding any type of abrupt movement. For banks, this is particularly significant, as they must combine the positive effects of an interest rate rise on net interest income with the potential negative consequences of higher borrowing costs on firm and household default rates.

The current degree of uncertainty is therefore of such a magnitude that it warrants additional prudence when managing portfolios, default rates and the coverage needed. This is not a case of supervisors being excessively pessimistic, as the report presented today might seem to suggest. Rather, we consider that the current circumstances call for a prudent approach. Moreover, against this backdrop, banks should undertake a complementary exercise to assess the sectors that may potentially be more affected by the conflict in Ukraine on account of rising commodity and energy prices.

Sustainability

The second challenge facing European banks relates to the transition of our economy towards a more sustainable model, and their role in financing this transformation.



[1] https://www.ecb.europa.eu/press/pressconf/shared/pdf/ecb.ds220310~c4c5a52570.en.pdf

Around one-third of the €2 trillion[2] in the Next Generation EU funds and of the regular 7-year Multiannual Financial Framework will be earmarked for combating climate change. This forms part of a plan called Green Deal,[3] which aims to achieve net zero greenhouse gas emissions by 2050, with an intermediate target of reducing these emissions by 55% by 2030, compared to 1990 levels.

Sustainability targets are present in all European projects, but two take centre stage in this area. The first is the Cohesion and Resilience projects, which include the pandemic-response REACT-EU funds to strengthen the economy and make it more digital, sustainable and resilient. These have been allocated over €426.7 billion, plus a further €776.5 billion in NGEU funds. The second largest sustainability-related item is the funds for Natural Resources and Environment.

This unprecedented mobilisation of funds will be carried out through projects combining public resources (from both the EU and national authorities) with private funds and investments.

How might the conflict in Ukraine affect this challenge? The European Commission has been clear and it has launched a plan dubbed REPowerEU[4] to reduce Europe's reliance on Russian gas and to promote the use of renewable energies. This plan comprises three clear measures: urgent action on energy prices, a plan to replenish gas reserves before next winter and, the one of most interest to us today, reducing Europe's reliance on Russian gas. This plan is explicit in this respect, as it gives impetus to the use of renewables and the decarbonisation of industry.

So, the EU's commitment to transforming the economy is both clear and firm. Banks will therefore have to continue getting ready to manage climate risk appropriately which, as you all know, includes the risk arising from the transition towards more sustainable models. In this respect, the ECB has recently published[5] an assessment of the quality of banks' disclosures on climate and environmental risks.

[2] https://op.europa.eu/en/publication-detail/-/publication/d3e77637-a963-11eb-9585-01aa75ed71a1/language-en

[3] https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal_en

[4] https://ec.europa.eu/commission/presscorner/detail/en/ip_22_1511

[5] https://www.bankingsupervision.europa.eu/press/pr/date/2022/html/ssm.pr220314~37303fd463.en.html

CHALLENGE POSED BY SUSTAINABILITY
Supervisory activity

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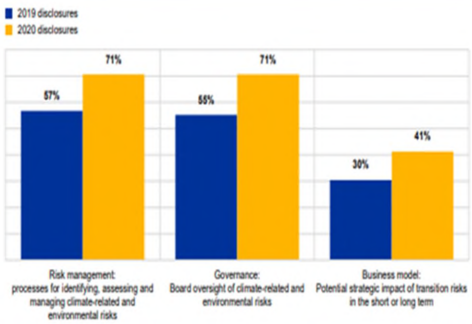
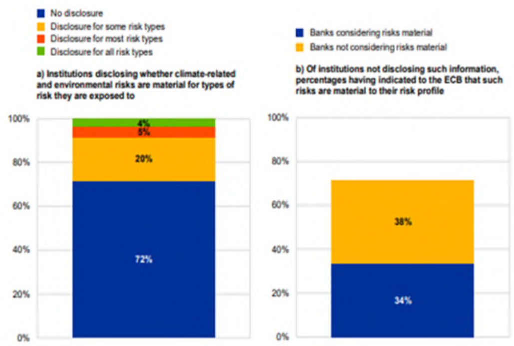
- **Stress test, thematic review of climate disclosures**

Overview of the progress made by institutions on describing selected indicators in their public disclosures



Source: Supervisory assessment based on institutions' disclosures with a reference date of end-2019 (2019 disclosures) and end-2020 or later when available (2020 disclosures).

Transparency on the materiality of climate-related and environmental risks



Source: ECB.
Note: Panel b) is based on institutions' views on materiality expressed in the context of the 2021 ECB supervisory assessment.

The conclusion it draws is clear: despite the progress made since previous assessments, banks do not yet meet the supervisory expectations on this matter. This report contains some striking data that I would like to highlight: for instance, 72% of banks do not disclose whether climate-related risks are material for the types of risk they are exposed to, even though, of those, nearly half acknowledge that the impact of climate risk is material. On the positive side, in addition to the progress being made in the right direction, 71% of banks disclose their organisational processes for identifying, assessing and managing climate-related risks.

The major challenge in managing this risk is undoubtedly the absence of data with sufficient historical depth and the need to use uniform definitions. Although the regulation in this area is adapting very quickly, the results have yet to be seen.

CHALLENGE POSED BY SUSTAINABILITY
Regulation

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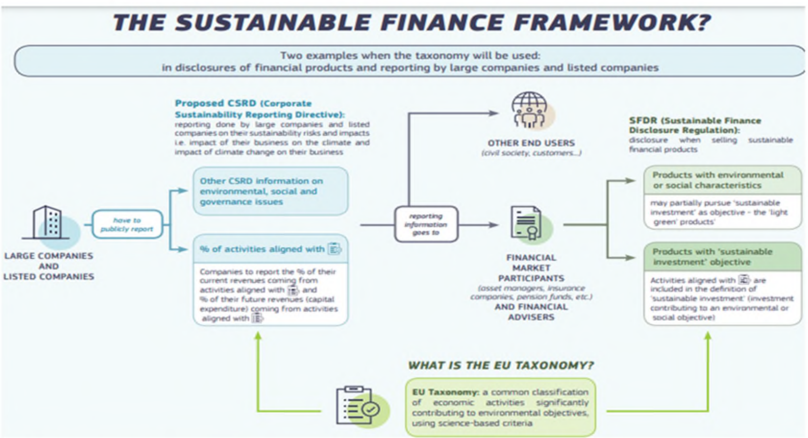
- **Problem with the data. Regulation in process**



Source: European Commission.

This slide summarises how the existing and upcoming regulation for constructing the sustainability framework fit together.

As I have mentioned, obtaining reliable information on sustainability is paramount. To this end, the Non-Financial Reporting Directive (NFRD) was approved[6] in 2014. The NFRD affects non-financial corporations of a certain size with non-financial reporting obligations, and it has been transposed into Spanish law through Law 11/2018. It is currently undergoing a revision (the so-called proposal for a Corporate Sustainability Reporting Directive, or CSRD).[7] The CSRD seeks to expand the scope of firms subject to non-financial reporting obligations, introduce more reporting requirements and require that such information is machine-readable and subject to third-party assurance.

Another key pillar is the Taxonomy Regulation,[8] which sets out the six environmental sustainability objectives. This regulation is supplemented by delegated acts, which define the activities considered to be aligned with these objectives. This taxonomy remains incomplete, as there are still many sectors to be classified according to these objectives.

Added to this is the proposal for a Directive on due diligence,[9] requiring firms of a certain size to review their activity and see how it impacts sustainability.

In the case of banks, the regulation is completed with the Directive on sustainability-related disclosures on financial products[10] and the EBA's final draft ITS[11] on Pillar 3 sustainability disclosures. These draft ITS provide ambitious support for managing climate risk appropriately, in terms of both the amount of quantitative and qualitative information included and the type of disclosures (environmental, social and governance).

Will these regulations suffice to construct a solid framework for managing sustainability and, in particular, climate risk? While the EU is a pioneer in this field, the international agenda is still at an early stage of regulatory development. Given that climate risk has a global impact on all geographical areas, the need for robust coordination between authorities in this field is particularly noteworthy.

Work is being carried out in parallel across all fields, including reporting, impact analysis, scenarios and forward-looking methodologies. But it is essential that sufficient, reliable and comparable data with historical depth are available. For this reason, this is where the greatest emphasis needs to be placed, starting off by laying down clear and standardised definitions, so that sound databases for appropriately managing this risk can begin to be constructed.

Meanwhile, we also find ourselves in an as yet very incipient debate and analysis about the prudential treatment of these risks. This would not be a matter of penalising the banks that are today most exposed to climate risks, but rather encouraging the appropriate management of such risks by nurturing an orderly transition of the economy towards more

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[6] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0095

[7] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0189

[8] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32020R0852

[9] https://ec.europa.eu/info/publications/proposal-directive-corporate-sustainable-due-diligence-and-annex_en

[10] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32019R2088

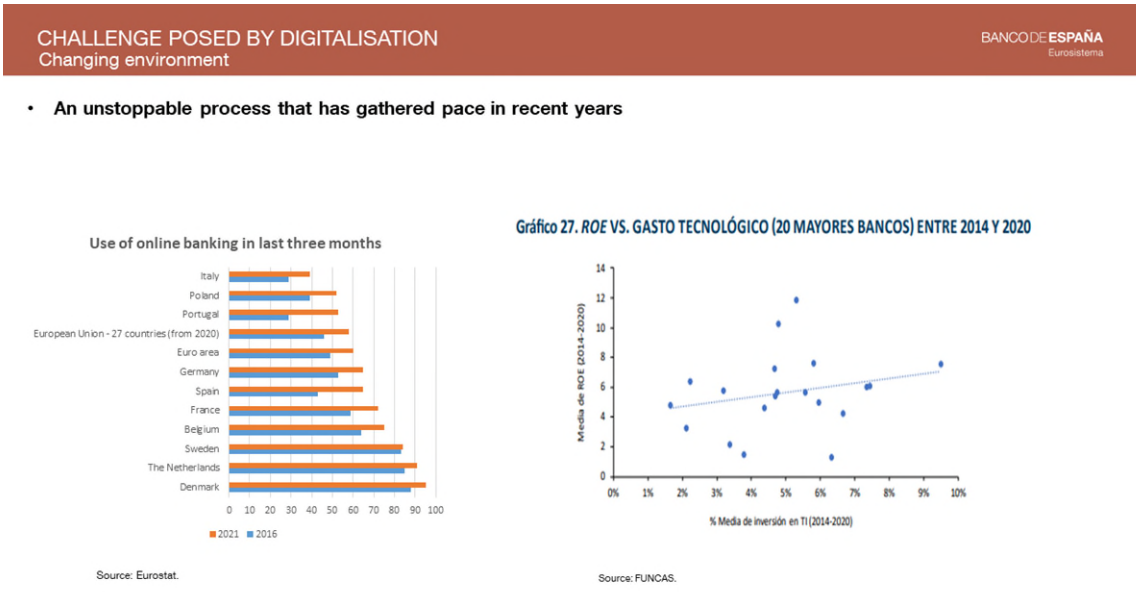
[11] https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Draft%20Technical%20Standards/2022/1026171/EBA%20draft%20ITS%20on%20Pillar%203%20disclosures%20on%20ESG%20risks.pdf

sustainable models. The methodology as to how to incorporate, in one way or another, this risk into capital requirements is still under discussion.

In conclusion, the EU's political commitment to a sustainable transition appears to have been bolstered by the Ukraine crisis. Consequently, banks must continue preparing to take on a key leading role in this much-needed economic transformation. In this respect, the climate risk stress test exercise currently under way will serve as a learning experience for banks and supervisors alike.

Digitalisation

The third challenge I would like to highlight today is the transformation of the banking business, in which digitalisation has a particularly key role to play.



Digitalisation is nothing new, nor does it affect the banking sector only, though it is perhaps one of the sectors where industry has had to work fastest to adapt to the new customer demands in this regard.

For example, according to Eurostat,[12] in 2021, 65% of Spanish citizens used online banking in the three months leading up to the survey, compared with an average of 60% in the euro area. This figure stood at 43% in 2016, as compared with 49% in the euro area.

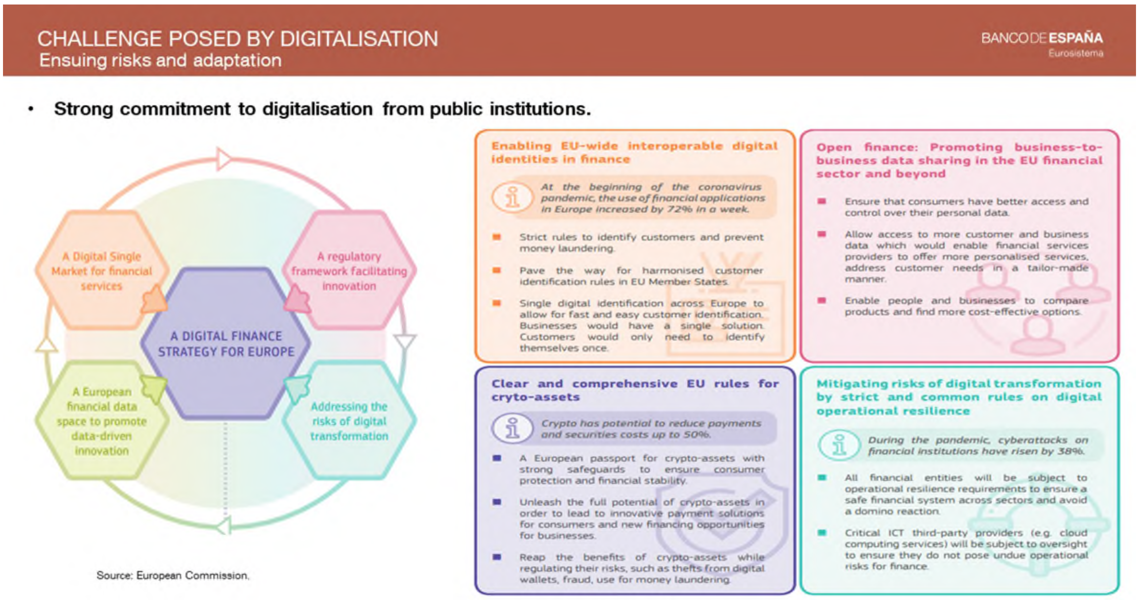
Digitalisation calls for a major investment in resources. According to recent research,[13] technological investment by Spain's top ten banks is estimated to have increased by almost 62%, from €2,615 million in 2015 to €4,233 million by end-2020. Moreover, there is every sign that this trend is set to continue in the coming years. Nonetheless, by cutting costs and

[12] https://ec.europa.eu/eurostat/databrowser/view/tin00099/default/table?lang=en

[13] https://www.funcas.es/odf/el-esfuerzo-tecnologico-de-los-bancos-espanoles/

boosting profitability, while also spurring competition, such investment will bear fruit in the medium term.

Against this backdrop, the EU has also made a very firm commitment to digitalisation. In September 2020 the European Commission unveiled[14] its digital finance package, aimed at adapting the regulatory and supervisory framework to the new business models, including FinTech and BigTech, with a view to ensuring a level playing field and addressing the new risks posed by digitalisation.



The EU's digital finance strategy has four priorities:

1) Removing fragmentation in the Digital Single Market.
2) Ensuring the regulatory framework facilitates digital innovation, including a framework enabling the uptake of distributed ledger technology (DLT) and crypto-assets in the financial sector. It must also address the risks associated with these technologies and promote the use of cloud computing infrastructure and artificial intelligence.
3) Promoting data-driven innovation in finance by establishing a common financial data space, with real-time digital access, promoting business-to-business data sharing in the EU financial sector and beyond (open finance).
4) Lastly, addressing the challenges and risks associated with digital transformation. The ultimate aim here is to safeguard financial stability and protect investors and consumers, based on the "same activity, same risk, same rules" principle.

This last point is one I would like to stress, since one of the red flags raised in the wake of the Russian invasion is the risk of massive cyberattacks potentially targeting key agencies, institutions and infrastructures.

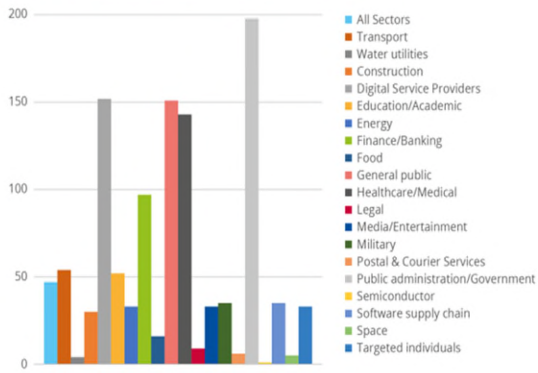
[14] https://ec.europa.eu/info/publications/200924-digital-finance-proposals_en

- **Focus on risks: cyber attacks and other incidents**

Figure 1: ENISA Threat Landscape 2021 - Prime threats

Source: ENISA.

Figure 4: Targeted sectors per number of incidents (April 2020-July 2021)



Source: ENISA.

While fewer cyberattacks have been registered in the conflict to date than might have been anticipated, given the current circumstances it is impossible to predict how things might develop with any degree of certainty. The leading cybersecurity agencies are warning businesses and institutions to remain on high alert in the face of possible cyberattacks.

Within the financial sector, European authorities such as the ECB and the European Banking Authority have issued statements[15] stressing the importance of cooperation and information sharing to boost cyber resilience and warning of possible Russian-sponsored cyberattacks. Indeed, the European Union Agency for Cybersecurity (ENISA)[16] notes that cyberattacks against critical European sectors have doubled, pointing to the Russian crisis as one of the most likely causes.

Digitalisation and operational resilience in the financial sector are two sides of same coin. Digital or information and communication technologies (ICTs) entail both opportunities and risks, which must be properly understood and managed, above all in times as troubled as these.

Against this backdrop, the Proposal for a Regulation on digital operational resilience for the financial sector[17] (DORA) is an ambitious initiative that will enhance digital technology risk management, establish technology system testing requirements, increase supervisors' awareness of cyber risks and empower financial supervisors to oversee the risks stemming from dependency on third parties.

Banks must therefore be ready to detect, withstand and respond to possible cyberattacks and set in place a robust operational resilience framework that enables them to continue providing critical services should such incidents (including cyberattacks) interfere with their activities.

Lastly, as regards digitalisation, I would like to touch on the subject of crypto-assets.

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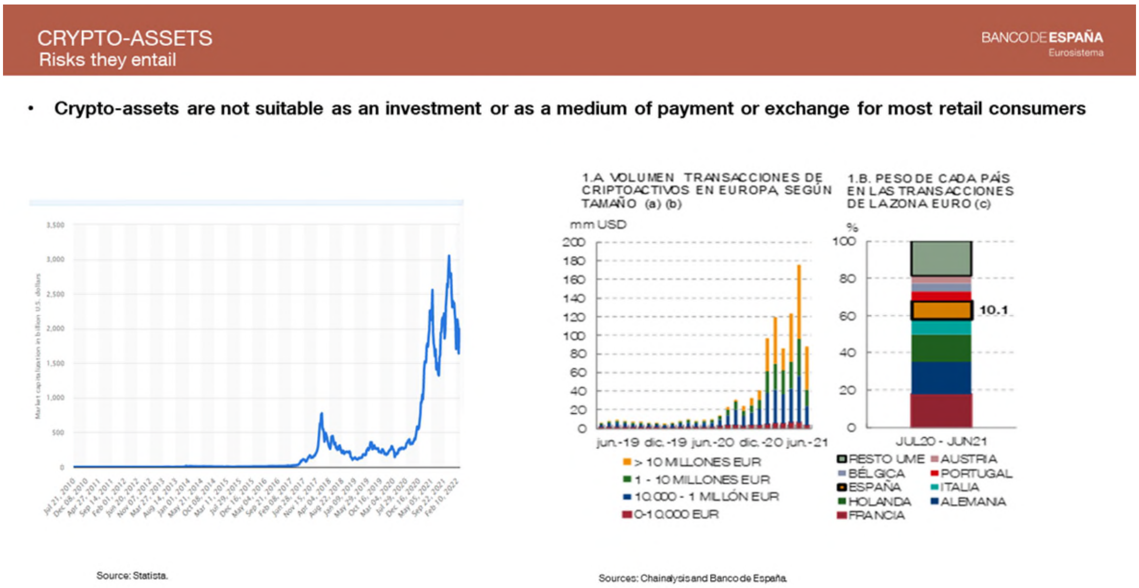
[15] https://www.eba.europa.eu/cyber-attack-european-banking-authority

[16] https://www.enisa.europa.eu/publications/enisa-threat-landscape-2021

[17] https://eur-lex.europa.eu/legal-content/ES/TXT/PDF/?uri=CELEX:52020PC0595&from=EN

Crypto-assets



If not properly regulated[18] and supervised, the widespread use of crypto-assets may? pose risks to financial stability, and they should therefore be analysed and monitored.

The risks they pose are numerous. The first of these is a general ignorance of their basic features and implications. Second, the high volatility of these assets may spill over into other markets, if panic or overreaction spreads to other trading environments. This is particularly relevant in the case of stablecoins. Moreover, the opacity linked to certain segments of crypto-assets, such as those traded through decentralised finance (DeFi) networks, may increase agent's leverage and make default more likely. The technology underpinning crypto-assets also poses extremely high operational risks worth bearing in mind. Lastly, the risks stemming from the use of such assets for unlawful activities (including money laundering) are very significant. Clearly, the list of risks is a long one.

As far as banks are concerned, crypto-assets represent a new source of competition in terms of the associated services and, in the case of stablecoins, in terms also of deposit-taking, such assets being considered a store of value. The banking sector's (direct and indirect) exposure to the crypto-assets business brings with it a very substantial increase in its financial and reputational risks.

News has emerged in recent weeks that points to the crypto-assets' potential for circumventing the sanctions imposed on Russia. Nonetheless, research carried out by both the authorities and the banking industry[19] casts doubt on crypto-assets' capacity for moving large sums of money without due oversight.

[18] The European Commission is already working on a Regulation on Markets in Crypto-Assets (MICA), setting out various obligations for crypto-asset issuers (depending on the type of asset) and related service providers.

[19] https://cryptonews.com/news/crypto-exchanges-facing-fork-road-over-russia-sanctions-london-stock-exchange-group-ceo.htm

I would like to take this opportunity to once again note that investing in these assets involves enormous risks, which should be understood and analysed. In Spain, the only current legislation on the subject is the CNMV Circular[20] on the advertising of crypto-assets and the obligation to register with the Banco de España, applicable to the providers of certain services (exchange of crypto-assets for legal tender and digital wallet custody), which must have in place suitable anti-money laundering measures and procedures.[21]

This activity is not subject to supervision, nor are there any mechanisms in place to protect customers.

We have once again been reminded of this fact in a recent statement from the European Supervisory Authorities[22] warning of the risky and speculative nature of this activity.

Such messages are necessary, since some surveys[23] estimate that 12% of Spanish adults own crypto-assets. It remains to be seen whether such investors are fully aware of the risks they bear or have simply been lured by the prospect of extremely high returns.

Conclusions

Allow me to finish my speech by noting that the challenges facing the banking system have only been further confirmed in the wake of the invasion of Ukraine.

Additional economic uncertainties. A firm commitment to sustainability. The digitalisation-related threats that lie ahead. These are the three aspects I wanted to address in this presentation, without overlooking the crypto-assets boom.

The regulatory and supervisory authorities are hard at work in all these areas, with the aim of strengthening the framework in which banks operate, making it more robust and transparent and as harmonised as possible at international level. In a global context, cooperation between international organisations is ever more necessary.

The report presented today takes a detailed, thorough look at these challenges, which are without doubt set to shape the near future of Europe's banking sector. Allow me to congratulate its authors.

I will finish by expressing my most heartfelt wish for an end to the war in Ukraine as soon as possible, putting a stop to so much futile and unjust suffering.

[20] https://www.boe.es/diario_boe/txt.php?id=BOE-A-2022-666

[21] https://www.boe.es/diario_boe/txt.php?id=BOE-A-2021-6872

[22] https://www.esma.europa.eu/sites/default/files/library/esa_2022_15_joint_esas_warning_on_crypto-assets.pdf

[23] https://dvh1deh6tagwk.cloudfront.net/finder-us/wp-uploads/sites/5/2021/06/Crypto_Adoption_final-compressed-1.pdf