Financial Regulation Outlook

THIRD QUARTER 2017 | REGULATION UNIT

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Closing date: **12 July 2017**

Summary

Reflection on the future of the EMU

What needs to be done to strengthen the Eurozone and single currency? The European Commission published a reflection paper on the deepening of the Economic and Monetary Union setting principles and bold proposals to strengthen the Eurozone. The main initiatives are the completion of the Banking Union and strengthening the Capital Markets Union. It also introduces the possibility of a common issuance of a European Safe Asset, and a Eurozone Treasury.

Authors: María Victoria Santillana y Pilar Soler

Reviewing the G-SIBs framework

The turn of the screw. On 30 March, the Basel Committee on Banking Supervision released a consultative document for revisiting the framework for Global Systemically important banks. It proposes seven main changes, and an issue for consultation (closed on the 30th of June) aimed at improving the frame by capturing new sources of systemic risk which are not reflected in its 2013 methodology.

Author: Arturo Fraile

Improving the supervisory regime

The future supervisory framework in the EU. The Commission's consultation is a good opportunity to revise the functioning of the three EU supervising/regulating agencies. However, their proposed rearrangement into a "Twin Peaks" model as opposed to the current sectoral configuration, should be postponed at least until the Banking Union is complete.

Author: Javier García

Assessment of the regulatory framework

After the storm, it is time to reassess the situation. In the wake of the financial crisis, the G20 launched a comprehensive program of financial reforms to make the financial system more resilient by reducing the likelihood and severity of crises. A resilient financial system should support a strong, sustainable and balanced growth. In this context, the Financial Stability Board is working on a framework for evaluating the effects of financial regulation, which was endorsed by the G20 leaders at the Hamburg summit in July 2017.

Author: Javier Villar

CMU mid-term revision

Towards a Capital Market Union 2.0. On 8 June, the European Commission published the Mid Term Review Action Plan for a CMU. A year and a half after the publication of the original Action Plan, this comes at a convenient moment to take stock of what has already been done, analysing future challenges arising from recent events such as the UK decision to leave the EU.

Author: Pilar Soler

US Treasury report

US puts its regulatory framework under revision. On 12 June, the U.S. Treasury published its first report to review its financial regulatory framework. This report covers depository institutions, and responds to president Trump's Executive Order to review financial regulation based on seven core principles.

Author: Santiago Muñoz

Fostering financial innovation

Assessing a new policy framework for financial innovation. On 23 March, the European Commission released a public consultation on Fintech. Its objective was to develop measures and policies to foster the development of technology based innovation for financial services within Europe.

Author: Vanesa Casadas

Resolution: At the moment of truth

Spanish resolution vs Italian liquidation. On 23 June, the ECB declared that Veneto Banca and Banca Popolare di Vicenza were "failing or likely to fail" due to repeatedly breaching capital requirements. The Single Resolution Board determined that these two banks were not to be resolved, as liquidation under Italian law posed no danger for financial stability. The Commission authorised the use of State Aid to support this process. As opposed to this case, Banco Popular was resolved without using any public support just a few weeks before.

Author: Maria Victoria Santillana

1. Reflection on the future of the EMU

What needs to be done to strengthen the Eurozone and single currency?

The European Commission (EC) published a reflection paper on the deepening of the Economic and Monetary Union (EMU). The document sets principles and proposals with bold and innovative solutions in order to strengthen the Eurozone and the common currency. The main initiatives are the completion of the Banking Union and strengthening the Capital Markets Union. It also introduces the possibility of a common issuance of a European Safe Asset, and a Eurozone Treasury. Ultimately, the successful implementation of these measures will depend on political negotiations.

In this paper, the EC identifies four guiding principles for deepening the EMU. These are: i) the pursuit of jobs, growth, social fairness, economic convergence and financial stability; ii) to find the right balance between responsibility and solidarity, i.e. risk reduction and risk-sharing; iii) to include all member states in the forthcoming deepening process; and iv) to make the EMU decision-making process more transparent, democratic and accountable.

To achieve these goals, the EC proposes a reform agenda with a two-phased road-map (2017-2019 and 2020-2025) on three key areas: i) Financial Union; ii) Economic and Fiscal Union and; iii) Strengthening the EMU architecture (political integration). For the first phase, the plan provides details of the actions to be taken, while it sets the strategic lines on which the EU must work in the second phase.

Figure 1.1 Road map on main measures to complete EMU proposed by the commission

Source: BBVA Research

With respect to the Financial Union, the paper sets as top priorities (during the first phase) the **completion of the single rulebook for the banking union, coupled with the creation of a credible backstop for the Single Resolution Fund and the European Deposit Insurance Scheme (EDIS)**. Additionally, it calls for further risk reduction, specifically to reduce banks' non-performing loans, complete measures to enhance the Capital Markets Union (CMU) with a first step towards the creation of a Single European Supervisor for markets and insurance, and the possible **introduction of sovereign bond backed securities (SBBS). The latter does not imply mutualization-** in order to diversify banks' sovereign debt portfolios (previously known as European Safe Bonds - ESBies). In a second phase, the document sets out the possibility of developing a **European Safe Asset (ESA)** that could serve as a benchmark in the financial European market, as an instrument to enhance the development of monetary policy, and as a tool to break the sovereign-bank doom loop. The ESA **would imply a common issuance of debt**. It includes the change in the regulatory treatment of sovereign exposures as an element to complete the financial union.

Regarding the Economic Union, and to favor economic convergence, it proposes to **strengthen the European semester** by focusing on the aggregate euro area dimension and using a multi-annual approach. To encourage structural reforms, it proposes the development of a strong link between reforms, the use of EU structural and investment funds and the access to a potential macroeconomic stabilization function. Finally, it sets specific proposals on the macroeconomic stabilization functions, in order to counter asymmetric shocks across countries. For the second stage, the options proposed are: the creation of an unemployment reinsurance mechanism, an investment protection scheme and/or a rainy day fund. There is not much detail on the funding of these options, but it is mentioned that it could come from the ESM, the EU budget, or designing a new instrument for these specific goals.

On institutional reform and political integration, it makes several proposals around the governance of the EMU. In the first phase, it proposes to integrate the Fiscal Compact and the ESM Treaty into EU law. In the second stage, it proposes to **set up a common Treasury**, supported by the European Fiscal Board, tasked with: (i) issuance of new common debt, (ii) budget execution, (iii) macro stabilizing instruments, and (iv) incorporating the ESM competencies. This Treasury would be led by an EU Finance Minister, who could also be Chair of the Eurogroup/ECOFIN. The decision-making capacity would be attributed to the Eurogroup, while the Treasury would execute them.

The document opens a debate on what is needed to deepen integration in the EMU, focusing on banking union and fiscal policy. Nevertheless, it does not offer many clues on issues related to regulatory treatment of sovereign debt, nor it does commit to the mutualization of sovereign debt (Eurobonds). **The successful implementation of the measures included in this proposal will rely on political negotiations among Eurozone Member States, where divergent views on the priorities and timing of reforms still exist.**

Work on existing proposals, and the necessary public and political support are key to moving forward. Nevertheless, as these proposals are complex reforms to implement, discussions are expected at a legal, institutional and mostly political level. In this vein, the steps ahead will be focused on further mutualization of debts and further control of policies, which in turn reflects the tension between risk control and risk sharing. For these reasons, an expert group that prepares the "White Paper on second-stage EMU reform" should be convened as soon as possible.

2. Reviewing the G-SIBs framework

The turn of the screw

On 30 March 2017, the Basel Committee on Banking Supervision (BCBS) released its consultative document for revisiting the assessment frame for the Global Systemically important banks (G-SIBs)[1]. It proposes seven main changes, and an issue for consultation (closed on the 30th of June) aimed at improving the frame capturing new sources of systemic risk which are not reflected in its 2013 methodology.

What would the new proposed methodology be?

Figure 2.1 The new proposed methodology compared to current methodology

Changes vs the current methodology		Weight in % Current		Weight in % NEW	
Size	Total exposures cum insurance*	20	20	20	20
Interconnectedness (affected by insurance*)	Intra-financial system assets	6.6	20	5	20
	Intra-financ system liabilites	6.6		5	
	Securities outstanding	6.6		5	
	New STWF**			5	
Substitutability/financ institution infrastructure	Payment activity	6.6	20	6.6	20
	Assets under custody	6.6		6.6	
	Underwritten transactions in debt & equity markets	6.6		3.3	
	Trading volume in fixed income & equity and other securities***			3.3	
Complexity (affected by insurance*)	Notional amount of OTC derivat	6.6	20		
	Trading and AFS** securities	6.6			
	Level 3 assets	6.6			
CJ activity (derivatives at consolidated level)	Cross-jurisdictional claims	10	20		
	Cross-jurisdictional liabilities	10			
		100	100	100	100

Sample

The largest 75 banks as determined by the leverage ratio exposure measure + any banks that were designated as a G-SIB in t-1 list but are not the top 75

Indicator score (bps)

$$\frac{\text{Bank indicator}}{\text{Sample total}} \times 10{,}000$$

*Inclusion of exposures under insurance subsidiaries in the scope of consolidation. **All sources of a bank's wholesale funding with a maturity of less than six months(based on data used to compute the NSFR). ***=0.5*[FI/SUM(FI)] +0.5*[EOS/SUM(EOS)]

Source: BBVA Research based on BCBS

1: The BCBS revisits its G-SIBs framework every three years. The previous assessment methodology was released in 2013.

The seven key planned changes:

- **Dismissing of the 500 bps cap on the substitutability category**. It is aimed at disincentivizing payments, custody and underwriting activities as they can weaken financial markets and can be hard to replace if a bank fails.

- **Including the exposure under insurance subsidiaries** of banking groups in the consolidation perimeter for G-SIBs. This seeks to achieve consistency in the appraisal of the entities across jurisdictions, since some of them have insurance subsidiaries while others do not. It will impact the size, interconnectivity and complexity categories.

- **Reformulating the definition of cross-jurisdictional indicators**. The cross-jurisdictional liabilities derivatives can now be calculated on a consolidated basis[2] (and derivatives can also be included in cross-jurisdictional claims). Going a bit further, it should be noted that the BCBS' amendment to this definition: **i) does not** contemplate the advantages of diversification as a risk mitigation tool, **ii)** neither does it exclude local claims and local liabilities of foreign subsidiaries or the activities funded by an affiliate in its home country and currency[3].

- **Adding a new indicator of trading volume[4]** within the substitutability and financial institution infrastructure category. The BCBS considers trading activity could disturb market liquidity, pressure market agents' balance sheets and induce negative systemic consequences that could themselves be feedback in.

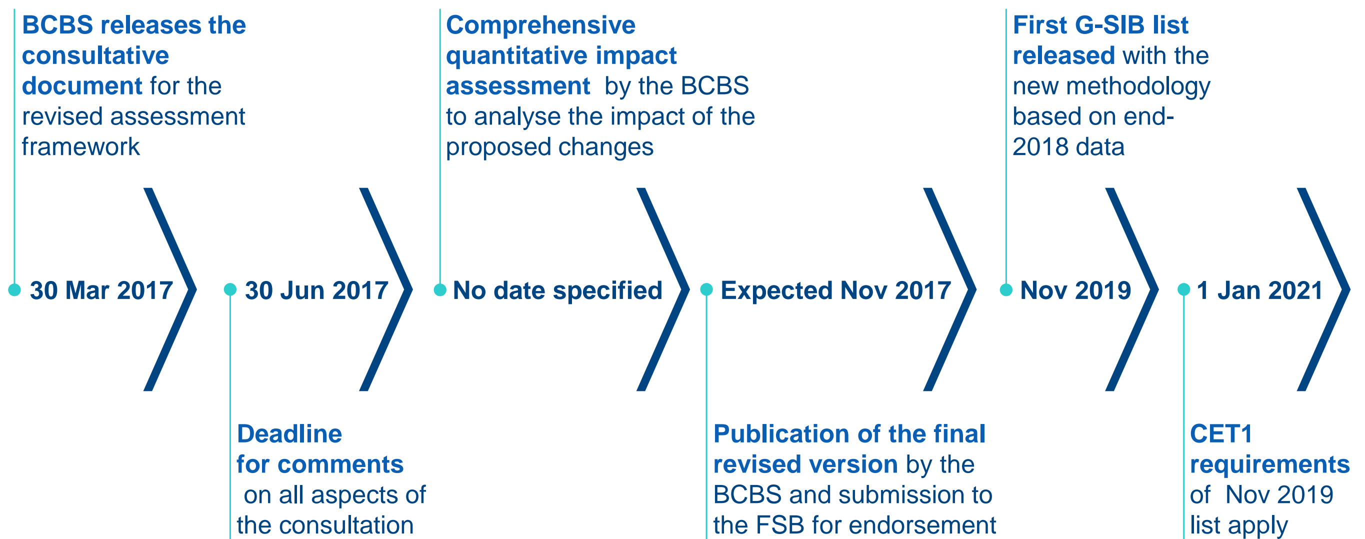
- **Reviewing the disclosure requirements** for entities, to bring their twelve publicly disclosed indicators up to date, the latter being used for calculating their quantitative score in case they vary from those that have been released earlier[5]. This proposal aims at being consistent with the Pillar 3 disclosure requirements[6].

- **Increasing guidance in case of bucket migration** and the capital surcharge required (CET1 / RWAs). In case an entity moves to a lower bucket, the BCBS proposes allowing the bank to immediately gain a benefit for that in terms of capital (without having to wait 14 months as is currently the case). If an entity adheres to a higher bucket, the 14 months period will be kept for the entity, so it has enough time to abide by the more stringent capital requirement.

- **Proposed timeline**. The revised version is expected to be released next November, and it will be effective in the 2019 list - prepared with end of 2018 data. Therefore, for the 2019 list, capital requirements will be fully applicable on 1 January 2021.

2: As of today, derivatives liabilities in the cross-jurisdictional liability indicator are calculated at solo level (considering local accounting rules) adding branches and subsidiaries positions and deducting intragroup positions.
3: Local claims and local liabilities of foreign subsidiaries or the activities performed by an affiliate in its home country in local currency are not purely cross-jurisdictional activities. In case the BCBS keeps taking into consideration local claims and local liabilities of foreign subsidiaries for the cross-jurisdictional indicator, it could evaluate local claims net of local liabilities.
4: The BCBS would not consider central bank and central government instruments in the trading volume indicator
5: On an annual basis, entities have to disclose at least the 12 indicators as of financial year-end data and remark that numbers can be updated; indicate if the data have changed from the prior disclosure; disclose the newest numbers in the financial quarter just after the BCBS 's G-SIB score calculation. Last but not least, disclosures have to be compliant with Pillar 3 reporting requirements and timelines.
6: Restatements are only necessary if considered so by the national authority, or on voluntary basis.

Figure 2.2 Timeline



Source: BBVA Research based on BCBS

An issue for consultation

Adding a new short-term wholesale funding indicator in the interconnectedness category. Proposes adding this indicator, thus including all wholesale funding items with a maturity of less than 6M according to NSFR data.

Some concluding remarks

On the one hand, the BCBS revision on the G-SIBs revised assessment framework is positive, because systemic risk is dynamic and it evolves over time. **On the other, the methodology should only impact and disincentivize the banks' activities that could be a source of systemic risk**. It should not penalize those activities that contribute to risk mitigation through diversification, or that do not imply systemic risk (such as those previously commented on in the amendment to the definition of the cross-jurisdictional amendment).

Since 2013, there have been significant improvements towards the mitigation of banks' systemic risk that might be considered by the new proposed methodology: more and better capital, a non-negligible amount of debt that can directly absorb losses - Total Loss Absorbing Capacity Requirements-, and resolution plans based on the *FSB's Key Attributes of Effective Resolution Regimes*. They are all aimed at minimizing the disruption of the whole financial system and of the real economy in case a G-SIB fails to bring order.

Non-banking activities may be a source of systemic risk if not properly supervised and regulated through interconnections with a few players from the financial system, especially the banking sector. **Cyber risk** should be given especial attention. Attacks can come from any location worldwide, affect any part of the organization, and can be launched by players of any size, from individual hacktivists to organized crime and even states.

3. Improving the supervisory regime

The future supervisory framework in the EU

The Commission's consultation is a good opportunity to revise the functioning of the three EU supervising/regulating agencies enhancing some of their current powers. However, their proposed rearrangement into a "Twin Peaks" model as opposed to the current sectoral configuration, should be postponed at least until the Banking Union is complete.

The role of the ESAs has been and will continue to be crucial. The ESAs were established during the fallout of the worst global financial crisis in recent history and amid an extremely critical time for the European project. Since their inception in 2011, they have managed to deliver on material demands with limited resources. However, in light of several important events which have taken place since the birth of the ESAs, such as the establishment of the Banking Union - where the ECB acts as the single supervisor for the significant banks in the Euro area - and the "Brexit" vote, it is time to examine how to improve the EU supervisory framework.

Recently, the EU Commission published a consultation on the operations of the European Supervisory Authorities (ESAs): the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA). The basis for this consultation can be found in the review clauses included in their founding Regulations[7]. The objective is to help the Commission prepare its report on the operations of the ESAs with a view to presenting it to the European Parliament and to the Council of the EU. Based on its conclusions, the Commission could draft a proposal to amend the aforementioned regulations[8]. The topics covered in this consultation (which are also based, among others, on the 2014 Commission's report, which identified several areas for improvement) are supervisory convergence, consumer/investor protection, internal governance, funding arrangements and structural changes.

We have identified several areas to improve the functioning of ESAs:

- **Regulatory development:** ESAs should:
  - have a more prominent role in the development of level 1 legislation (regulations and directives), by, for example, participating as an observer on the negotiations with the co-legislators,
  - have more independence and more time when drafting level 2 legislation (technical standards), and
  - be more transparent when drafting level 3 texts (Q&As, guidelines and recommendations) by, for example, organizing public consultations prior to their approval.

7: According to article 81 of each of the EBA, EIOPA and ESMA Regulations, by the 2nd of January, 2014 and every three years thereafter, the Commission shall publish a general report on the operation of the ESAs.
8: In fact, on June 13th, the EU Commission, based on the responses to this consultation, published a proposal to give powers to ESMA to supervise both EU and non-EU CCPs, including the possibility to force the latter to relocate their business inside the EU.

- **Focus on regulatory convergence**: After a long period of lawmaking, the ESAs' work should focus on regulatory harmonization to ensure that supervisory practices converge towards the most efficient and effective configuration.

- **ESAs' restructuring**. The priority should now be to complete the Banking Union (establish a common deposit insurance across the EU and create a public backstop to the Single Resolution Fund). Therefore, the most pressing task for the time being should be to find new headquarters for the EBA, forced to relocate because of the UK vote to leave the EU. Meanwhile, the current sectoral configuration of the ESAs should be maintained. More time is needed to analyze other more profound structural changes such as a the Twin Peaks model, because that model is for supervision purposes only, not for regulation (ESAs, although their name suggests otherwise, are both supervisors and regulators). Furthermore, given the complexity of the current EU supervisory landscape (for instance with different levels of supervision in the banking sector with the ECB and the National Competent Authorities), any potential change of regime should be carefully assessed.

What is the "Twin Peaks" model?

The Twin Peaks model has gained attention and interest in the years following the 2008 financial crisis. Focused on the premise of regulation by objectives, the Twin Peaks model, as opposed to the sectoral model, is a framework in which two supervisors co-exists: one for **prudential matters**, and a different one for **conduct issues**. These supervisors, which are the same across sectors (i.e. banking, insurance or markets), look after different problems in financial supervision: **financial institutions' stability and consumer protection**. From a theoretical perspective, one of the main advantages of this supervisory model, is that both supervisors are on an equal footing, so that micro-prudential concerns do not override conduct concerns or vice versa[9].

For example the EU, the Netherlands and the United Kingdom have adopted a Twin Peaks model. In the former, the prudential supervisor is the "De Nederlandsche Bank" (DNB), while the conduct authority is the Authority for Financial Markets (AFM). In the latter, the supervisors are the Prudential Regulatory Authority (the PRA is part of the Bank of England) and the Financial Conduct Authority (FCA).

9: Nevertheless, macro-prudential concerns should always have priority over micro-prudential or conduct of business concerns.

4. Assessing financial regulation

After the storm, it is time to reassess the situation

In the wake of the financial crisis, the G20 launched a comprehensive program of financial reforms to make the financial system more resilient by reducing the likelihood and severity of crises. A resilient financial system should support strong, sustainable and balanced growth. In this context, the Financial Stability Board (FSB) is working on a framework for evaluating the effects of financial regulation. A first version of the framework was endorsed by the G20 leaders at the Hamburg summit in July 2017. This initiative follows the European Commission call for evidence and similar exercises in Japan, the US and other jurisdictions.

This "fitness check" aims at assessing the effects of the reform, and whether it is working as intended. Undertaking an evaluation has become even more important because of two main issues: the high complexity of the financial sector, and the many reforms that have been undertaken in a short time span. Moreover, there are others in the pipeline (e.g. Basel IV) and the risk of being implemented before knowing what is working and what needs fixing.

The financial sector is complex because of the wide variety of agents (banks, insurers, broker dealers, market infrastructures, clearinghouses, investment funds, asset managers, credit rating agencies, and so on) as well as products and services (e.g. loans and credits, issuance of securities, overwriting of insurance policies, trading with derivatives, foreign exchange and commodities, hedging activities, financial advice, and so on). The digital transformation and the continuous process of innovation, add other layers of complexity. Moreover, multiple connections and interactions among agents and products make the financial sector even more intricate to understand, regulate and supervise. Regulating such a complex environment is intrinsically complex and is not exempted of unintended consequences.

Given the global reach of the financial sector, the regulatory reform was coordinated at G20 level through the FSB. Although formal or informal international economic coordination is not new (e.g. at the OECD, the G7 and the Basel Committee on Banking Supervision), such a wide geographical scope and depth of reforms is a novelty which adds yet another layer of complexity.

The regulatory reform has targeted banks, insurance companies, financial markets and other sectors. Such a complex regulatory effort requires a systematic evaluation framework, so that the consistency among regulations, possible unintended consequences and the overall coherence of financial regulation can be properly assessed. Agreeing on such an evaluation framework is the first step, which is expected to be approved in Hamburg in July. It will start to be applied soon afterwards.

Besides the substantial difficulty of disentangling the effects of individual reforms and their interactions, the evaluation of the regulatory framework for financial services will confront two important challenges. On the one hand, while coordination at G20 is a major step, financial markets are global and many countries remain outside the regulatory

perimeter of the G20, not least many fiscal heavens and offshore centers. On the other hand, the emergency and pressure prompted by the outbreak of the crisis is being left behind. Increasing risks of fragmentation among G20 have emerged in the last two years. The coordination role of the FSB has been put into question in the US Senate. Following the abandonment by the new US administration of the Paris climate agreement, it cannot be discarded that US will implement changes in its financial regulation unilaterally without an attempt to coordinate this with other jurisdictions. Similarly, one of the aims of Brexit is to dodge European coordination. Moreover, given the risk that the City may lose its role as a financial center, there is a potential risk of regulatory and tax competition, rather than coordination, with the possible negative impact for public accounts and financial stability.

We should keep in mind that there will always be the next crisis. Financial regulation should make the financial sector more resilient so that it can support the real economy. Regulatory competition and isolationism seems, not only to reduce the efficiency of the financial sector, but also to throw to the winds important lessons learned during the crisis.

5. CMU mid-term review

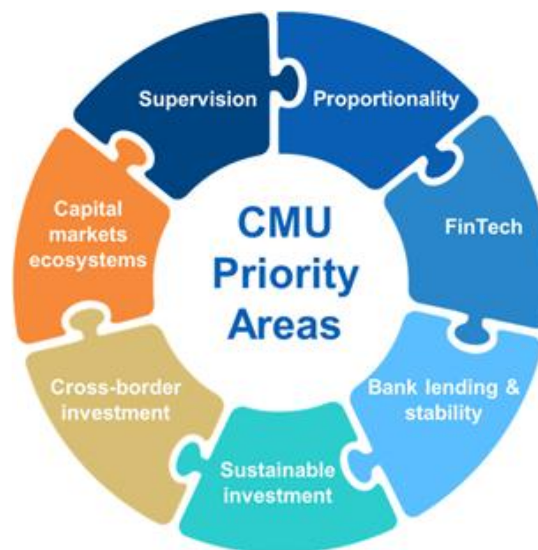
Towards a Capital Market Union 2.0

On 8 June, the European Commission (EC) published the Mid Term Review (MTR) Action Plan for a Capital Markets Union. A year and a half after the publication of the original Action Plan, this comes at a convenient moment to take stock of what has been done, and analyze future challenges arising from recent events such as the UK decision to leave the EU (Brexit). The CMU is still one of the main priorities of the EC, as was highlighted in the recently released Reflection Paper on the Deepening of Economic and Monetary Union.

Based on the responses to the recent consultation, and taking into account the new challenges that are arising, the MTR re-examines the CMU agenda and sets out new priority actions for a Capital Markets Union 2.0.

New priority initiatives for the European Commission

Figure 5.1 CMU priority areas



Source: BBVA Research based on the European Commission's Mid Term Review of the Capital Markets Union Action Plan

- **Strengthening the effectiveness of supervision to accelerate market integration**. To this end, the EC will propose amendments to the functioning of the ESAs, with a focus on ESMA, in order to promote regulatory harmonization and convergence with a view to removing barriers to cross-border investment.

- **Enhancing the proportionality of rules to support initial public offerings and investment firms**. The EC will assess possible modifications to currently existing rules to achieve a more proportionate environment for SMEs. Moreover, it will issue a legislative proposal for a revision of the current regulatory framework for investment firms.

- **Harnessing the potential of FinTechs**. Based on the findings from a recent consultation, the EC will gauge the viability of developing an EU licensing and passporting framework for FinTech activities.
- **Using capital markets to strengthen bank lending and stability**. Non-performing loans (NPL) are a challenge for some national systems. To help overcome this, the EC will seek to reinforce secondary markets for NPL.
- **Strengthening the EU's leadership on sustainable investment**. It will decide on specific follow-up actions to the High-level Expert Group's recommendations. Specifically, efforts will be made to improve disclosure and to build sustainability into rating methodologies and supervisory processes.
- **Cross-border investment**. The EC will work on providing guidance about applying EU rules on how to treat cross-border investments and on amicable resolution of investment disputes. Moreover, it will weigh up the options for a legislative proposal to facilitate cross-border distribution and supervision of funds.
- **Support the development of local ecosystems**. Based on the Vienna initiative's Working Group, it proposes a strategy to support regional market development, especially in Central, Eastern and South-Eastern Europe.

BBVA Research assessment

- **This MTR is well-timed to take stock of what has already been done, and to take into account and adapt the CMU agenda to new challenges.** This project needs a final boost towards its completion in 2019, especially after some of the more recent events, such as Brexit which, far from diminishing the significance of this project, has increased the need to develop a genuine CMU for the European Union. Nevertheless, the envisaged timeline for specific actions seems ambitious and will require a substantial effort to put all the measures in place.
- **Supervisory convergence is key to the success of the CMU**. The need to harmonize supervisory and regulatory practices for capital markets is greater after Brexit, because the relocation that this event will give rise to is not likely to play out *en masse* or be towards only one Member State, but rather to several different jurisdictions. In this context, regulatory and supervisory convergence will play a key role in avoiding an uneven playing field and helping to address fragmentation issues while maintaining high regulatory and supervisory standards.
- **Banks will still play a major role in the CMU**. Promoting alternative funding sources for SMEs and facilitating their access to capital markets is a positive goal, but we must not forget that banks play (and will continue to play) a significant role, both as intermediaries in capital markets and as providers of funds for the real economy. Here, it is important to have certainty about the regulatory framework and to avoid piling pressure on banks in the context of incipient economic recovery.
- **The focus on cross-border investment and private risk-sharing is also positive**. Nevertheless, involvement and commitment from Member States is necessary to harmonize policies, which persist on a national level and are still seen as a major barrier to cross-border investments, such as tax rules.

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6. US Treasury report

US puts its regulatory framework under revision

On 12 June, the U.S. Treasury published its first report of a series to review the U.S. financial regulatory framework. This report covers depository institutions, and responds to president Trump's Executive Order to review financial regulation based on seven core principles[10]. Three more reports are to follow regarding capital markets, asset managers and insurance, and non-bank financial institutions and financial technology.

The report includes over 100 recommendations, based on extensive consultation with stakeholders[11]. It does not cover, however, two subsequent Presidential Memoranda to the Secretary of Treasury[12], which called for the review of the Orderly Liquidation Authority (OLA), and the process by which the Financial Stability Oversight Council (FSOC) determines that a non-bank financial entity can pose a financial stability threat to the United States. The corresponding reports on these issues are expected to be submitted to the President in October.

Some of the most important recommendations included in the report are:

Regulatory Structure

- Improve the coordination among federal and state financial regulators, and allow the FSOC to appoint a lead regulator for any issue on which multiple agencies have conflicting or overlapping jurisdictions;
- Reduce the independence of the Consumer Financial Protection Bureau (CFPB), and remove the Federal Deposit Insurance Corporation (FDIC) from the living wills assessment process;

Capital and Liquidity

- Revisit many of the prudential requirements on US GSIBs that are more demanding than what has been agreed upon by international standards (i.e. eliminate gold-plating):
  - US GSIB capital surcharge;
  - Mandatory minimum debt ratio included in the Federal Reserve's total loss absorbing capacity (TLAC) and minimum debt rule;
  - Calibration of the enhanced supplementary leverage ratio (eSLR);
- Revise the threshold for the application of enhanced prudential standards to a value of assets, yet to be defined, but above $50 billion;

10: U.S. Presidential Executive Order 13772 on Core Principles for Regulating the United States Financial System, 3 February, 2017.
11: Including financial firms, consumer and advocacy groups, trade groups, academics, experts, rating agencies, investors and investment strategists, among many other experts or with deep knowledge of the sector.
12: U.S. Presidential Memoranda to the Secretary of Treasury, 21 April 2017: OLA and FSOC.

- Apply enhanced prudential standards to foreign bank organizations according to their US risk profile and not on global consolidated assets;
- Allow for an off-ramp exemption from Dodd-Frank prudential standards (stress tests and Basel III requirements) for any bank that elects to maintain a sufficiently high level of capital as measured by a simple leverage ratio of 10% as included in the proposed Financial CHOICE Act;
- Reduce the scope of the liquidity coverage ratio (LCR) to apply only to internationally active banks;
- Delay the adoption of two internationally agreed standards: the Net Stable Funding Ratio (NSFR) and the Fundamental Review of the Trading Book (FRTB);

Stress tests

- Raise total assets threshold for company run Dodd-Frank Act Stress Testing (DFAST) to $50 billion so that smaller and less complex banks are excluded from the requirement, and simplify the process so as to reduce the regulatory burden of larger banks;[13]
- Raise the Federal Reserve asset threshold for the Comprehensive Capital Analysis and Review (CCAR) process to match the revised threshold for enhanced prudential standards;
- Improve transparency of Federal Reserve stress-testing and capital planning review frameworks by making them subject to public notice and comment, including its models, economic scenarios, parameters and methodologies;

Volcker Rule

- Simplify the definition of proprietary trading so that the complexity of the Volcker Rule is reduced and compliance is less burdensome for medium and large banks;
- Exempt entities with less than $10 billion in assets from the Volcker Rule.

Assessment

The report is a clear guideline for the Administration's deregulatory agenda, and sets a work plan to follow for those who will be nominated by Trump as the terms of federal agency directors' end in 2017 and 2018. Many of the recommendations can be achieved by changes in regulation without the need of Congressional approval. However, some of the more structural changes, such as reducing the independence of the CFPB or removing the FDIC from the living wills process would require the support of at least eight democratic senators, which for now is highly unlikely. The report shows a clear shift in US policy as the calibration, simplification, modification of definitions and delays of certain measures gains importance, especially the elimination of gold plated elements of capital and liquidity requirements for US GSIBs. Since the financial crisis the US has lead by implementing internationally agreed financial reforms promptly, and in general, more severely for its largest banks. Going forward, it is expected that US financial regulation will no longer gold-plate internationally agreed reforms. This will set a new example that other jurisdictions might follow.

13: Adopting a two year cycle review, reduce stress scenarios to two from three, and eliminate the possibility of failing stress tests from the qualitative assessment.

7. Fostering financial innovation

Assessing a new policy framework for financial innovation

On 23 March, the European Commission (EC) released a public consultation which ended on 15 June, regarding the creation of measures and policies to foster the development of technology based innovation for financial services (FinTechs) within Europe. The objective of the consultation is "**to create an enabling environment where innovative financial service solutions take off at a brisk pace all over the EU, while ensuring financial stability, financial integrity and safety for consumers, firms and investors alike**". Basically, it keeps the momentum initiated with the public-private high-level dialogue with the EC during 2016, which resulted in the creation of the Fintech Task Force.

For the purpose of this consultation, the EC's definition of FinTechs is inclusive: "**technology-enabled innovation in financial services, regardless of the nature or size of the provider of the services**". Moreover, the consultation understands that this new generation of solutions help to improve the quality and variety of banking services, complete the single market and improve efficiency. Nevertheless, it also observes some **core principles which are same-activity-same-regulation, proportionality and the promotion of market transparency avoiding the creation of new risks**. However, in order to obtain the most benefit of FinTech, a **technology-agnostic principle should also be included**, which means that regulations focus on the effects rather than in the technology itself, as this could create barriers for future developments which are currently unknown.

The consultation itself was structured in four parts, and **focused on the use and impact of technologies and on the measures that the authorities can apply to foster the development of Fintech**:

- Analysis of new means to **improve the access to financial services** to banked, under-banked and unbanked consumers, for example by using artificial intelligence for automation, or providing credit through crowdfunding.
- How to **reduce operational risks and increase efficiency** by introducing new technologies such as Distributed Ledgers (DLT), cloud computing or RegTech.
- What kind of **barriers should be lowered to foster the introduction of FinTech,** including the type of policies that authorities should establish (e.g. regulatory sandboxes, innovation academy, narrow FinTech licenses), and how to encourage the industry to achieve common standards.
- Finally, the consultation echoes the current debate on **how to balance data sharing and security with protection needs,** gathering the opinion about the free flow of data for the development of a Digital Single Market, the use of DLT for information storage or cybersecurity concerns.

Finally, this consultation clears the path for a **new generation of inclusive innovation policies that prioritize FinTech in regulators' agendas while enabling an open and continuous conversation among all stakeholders**, in order to create an efficient, competitive, collaborative and safe ecosystem for the benefit of all, without over-regulating or creating unnecessary barriers.

8. Resolution: At the moment of truth

Spanish resolution vs Italian liquidation

On 23 June, the ECB declared that Veneto Banca and Banca Popolare di Vicenza were "failing or likely to fail" due to repeatedly breaching capital requirements. The Single Resolution Board (SRB) determined that these banks were not to be resolved, as they did not perform critical functions, and liquidation posed no danger for financial stability. Nevertheless, the European Commission (EC) authorized the use of State Aid under the Italian insolvency law, to support the sale of parts of these banks according to the local legislation. As opposed to this case, Banco Popular was resolved without using any public support just a few weeks before.

The Italian Council of Ministers published a Decree Law to liquidate these banks. The winding up will use a tool to separate banks' businesses into a good and a bad bank (that will hold NPLs and doubtful assets). Even though this is a tool envisaged in the BRRD (and therefore to be used in resolution), Italian law allows its use for liquidation as well. The good bank will be sold to Intesa Sanpaolo for €1, with the Italian state granting government aid and guarantees. The state provides Intesa with €4.7bn by way of **cash advances**, in order to prevent Intesa from having to increase its capital (to maintain its CET1 ratio), or having to alter its dividend policy. Furthermore, a set of **state guarantees** are in place: €1.5bn to shield Intesa against losses from impaired assets and litigation risk, and up to €12bn for the bad bank. The Italian state would shoulder the merge-in costs (4,000 layoffs are expected). All-in-all the bill for the public treasury could reach €17bn (1.1 of Italian GDP). European authorities (SSM and EC) had approved the move, explaining that it does not constitute an infringement of state aid rules. In order to comply with these, shareholders (including the Atlante Fund) and subordinated debt holders absorbed losses -**burden sharing**-. However, retail junior creditors might be reimbursed (with most of the burden on the government) in case of mis-selling.

On the other hand, on 6 June, the ECB declared Banco Popular "failing or likely to fail" because it was unlikely to pay its debts (presumably a liquidity problem). The SRB declared the bank was to be resolved based on: i) ECB's decision, ii) lack of private alternatives (not a capital increase, nor a purchase before resolution), and iii) public interest to ensure the continuity of critical functions, preventing adverse effects on financial stability. The process was executed by the Spanish executive resolution authority: the FROB. In this case, the SRB applied only one resolution tool: the "**sale of business tool**" (sold to Santander for €1). The bail-in tool, under art. 43 of the BRRD, was not applied. This means that senior creditors and depositors were spared. However, the SRB executed art. 59, similar to a "bail-in" but with a narrower scope. This allows resolution authorities to write down or convert capital instruments (up until Tier 2), either before resolution (as opposed to bail-in, which can be applied only in resolution), or in combination with a resolution tool. In this case, the latter occurred before the entity was sold to Santander.

As a result, CET1, AT1 and T2 holders were completely wiped out (the loss absorption level reached 5.4% of total assets). In order to recapitalize the bank to a sustainable level, Santander has to raise €7bn of equity.

	BANCO POPULAR	VENETO BANCA & BANCA POPOLARE DI VICENZA
Rationale for decision "Failing or likely to fail"	Unlikely to pay debts (accelerated by **liquidity problems**, and **solvency problems** – 4th worse in stress test)	Breaching **capital requirements** & no private solutions (although Intesa is finally involved)
SRB decision	Resolution: Systemic entity (D-SIB)	Liquidation: No systemic entities
Law applied	BRRD	Italian Decree Law to liquidate banks & Italian insolvency law
Tools used	**Write down + Sale of Business**	**Asset separation tool**: split businesses into a good bank and a bad bank
Buyer	Santander bought Popular (including toxic assets) for €1	Intesa will buy the good bank for €1. Italian government keeps the bad bank
Public Support	**No** **Santander will raise €7bn** of new equity to keep its capital ratio	**Yes - Italian state provides:** i) Intesa with **€4.7bn** of **cash advance** to avoid the need to increase capital to keep its CET1 ratio or having to modify its dividend policy ii) Guarantees for **€1.5bn** to shield against **asset impairment losses and litigation risk** iii) Guarantees up to **€12bn on the bad bank**, to be funded via an Intesa loan
Cost for public Treasury	**None**	It could reach **€17bn**
Who will absorb losses?	CET1, AT1 and T2 completely wiped out	Taxpayers, shareholders and junior creditors. In case of mis-selling, retail junior creditors (€200M) will be compensated using public funds (80%) and Intesa's funds (20%)

Even though there is a common framework to deal with resolutions, the recent experience shows that there is still flexibility when it comes to the use of public funds to support the financial sector. Additionally, it highlights the need to further harmonize the process when banks go through a liquidation process, rather than a resolution process. Fixing these issues is necessary to guarantee that all stakeholders are treated equally when banks are either resolved or liquidated.

Furthermore, this is of paramount importance to preserve the credibility of the resolution framework, the Banking Union and the Single Market itself. If the rules already in place (or the essence in which they are based) are perceived to be different across geographies, we risk jeopardizing future advancements in the integration process, fueling fragmentation.

Main regulatory actions around the world over the last months

	Recent issues	Upcoming issues
GLOBAL	**On April 4,** BIS issues final guidance on the prudential treatment of problem assets **On April 11, FSB** consults on framework for evaluation of the effects of regulatory reforms **On April 12, BIS** publishes report on repo market functioning **On April 25, BIS** publishes the work program for 2017-2018 **On April 25, BIS** publishes twelfth progress report on Basel regulatory framework **On April 28, FSB** publishes thematic peer review on Corporate Governance (CG) **On April 28, FSB** publishes responses to consultation on resolution of CCPs **On May 10. FSB publishes** Global Shadow Banking monitoring report 2016 **On May 22, FSB & BIS** publish FinTech credit report **On May 23, FSB** issues recommendations to strengthen governance and mitigate misconduct risks **On May 25, Global Foreign Exchange Committee (GFXC)** publishes code of conduct **On June 7, BIS** publishes final revision to correspondent banking annex **On June 13, IOSCO Task Force** issues report on regulation of wholesale market conduct **On June 19, IOSCO** issues report on order routing incentives as part of effort to protect investors **On June 22, BCBS** publishes report on countercyclical capital buffer practices **On June 20, FSB** issues consultation on the use of compensation tools to address misconduct **On June 27, BIS & IOSCO** consult on harmonization of OTC derivatives data elements **On June 29, FSB** issues reports on OTC derivative market reforms **On June 29, FSB Task Force on Climate-related Financial Disclosures** releases final recommendations **On June 27, FSB** issues report on the financial stability implications of FinTech **On June 29, BCBS** consults on a simplified alternative to market risk standardized approach	
EUROPE	**On April 6, EC** published for consultation a draft DR supplementing MiFIR as regards the exemption of certain third countries' central banks in their performance of monetary, foreign exchange and financial stability policies from pre- and post-trade transparency requirements. **On April 7, EC** launched a consultation on conflict of laws rules for third party effects of transactions in securities and claims **On April 5, EP** adopted amendments to the proposed regulation on money market funds (MMFs) **On April 5, EP** adopted the new Prospectus Regulation **On April 4, EU Council** adopted Directive on shareholders' rights in EU companies **On April 24, Council of the EU** has adopted new rules to better protect EU finances **On April 29, the Special European Council** (Article 50), in an EU 27 format, adopted the guidelines for the Brexit negotiations **On April 3, EBA** updated Risk Dashboard confirms that elevated NPLs and low profitability are the main challenges for the EU banking sector **On April 5, EBA** provided guidance on bail-in under the BRRD **On April 4, ESAs** consult on draft Guidelines to prevent terrorist financing and money laundering in electronic fund transfers **On May 7, EBA** issues amended technical standards on supervisory reporting for EU institutions **On April 11, EBA** finds German waiver on covered bonds justified **On April 11, EBA** finds Polish waiver on covered bonds justified **On April 11, EBA** outlines roadmap of its plan to update 2017-2018 SREP **On April 11, EBA** finds supervisory authorities have implemented robust IT systems and processes for supervisory reporting **On May 20, ESAs** highlight main risks for the EU financial system **On April 4, ESMA** has published a consultation paper (CP) on updating its Guidelines on the application of the endorsement regime under the CRA (Credit Rating Agencies) Regulation	

On April 5, ESMA has issued detailed guidance regarding the implementation of the Markets in Financial Instruments Directive (MiFID II) and Regulation (MiFIR)
On April 6, ESMA has issued the final report on the Guidelines regarding the calibration of circuit breakers and the publication of the trading halts under the Markets in Financial Instruments Directive (MiFID II)
On April 18, ESMA has established a Memorandum of Understanding (MoU) under the European Markets Infrastructure Regulation (EMIR) with Reserve Bank of New Zealand and Financial Markets Authority of New Zealand
On May 3, EC published a Recommendation for a Council Decision authorising the Commission to open negotiations on an agreement with the UK on its withdrawal from the EU
On May 24, EC published a proposal on targeted reforms to the European Market Infrastructure Regulation (EMIR), which are intended to improve the functioning of the derivatives market in the EU and provide simpler and more proportionate rules for OTC derivatives
On May 10, EC published its mid-term review of its Digital Single Market strategy
On May 24, EC launched a public consultation on the Database Directive in order better to understand how the Directive is used, to evaluate its impact on users and to identify potential needs for adjustment
On May 31, EC published a reflection paper on the deepening of the EMU
On May 31, EC adopted DR on objective criteria for applying preferential liquidity outflow or inflow rates
On May 31, EC published a reflection paper on deepening the economic and monetary union (EMU)
On May 31, EP ECON Committee publishes draft report on action plan on retail financial services
On May 30, EU Council and EP have reached political agreement at trilogue negotiations on rules governing investment funds in relation to venture capital and social enterprises
On May 30, EU Council and EP have reached political agreement in trilogue negotiations on a package of proposals for simple, transparent and standardised (STS) securitisation
On May 2, the Presidency of the EU Council has published a compromise text on the proposal for a regulation on a framework for the recovery and resolution of central counterparties (CCPs)
On May 16, EU Council adopted the Money Market Funds (MMF) Regulation, which lays down rules and common standards on the structure of money market funds, their credit quality and liquidity
On May 16, EU Council adopted the new Prospectus Regulation
On May 22, EU Council, in EU27 format, has adopted a decision authorising the opening of Brexit negotiations with the UK and negotiating directives for the talks
On May 25, EU Council published a compromise text on the proposal for a Directive to amend the BRRD as regards the ranking of unsecured debt instruments in insolvency hierarchy
On May 31, EU Council Presidency published compromise texts on proposed amendments to BRRD and CRR
On May 4, EBA amended RTS on benchmarking of internal approaches
On May 5, EBA publishes final draft Technical Standards under the Payment Accounts Directive to enhance transparency and comparison of payment account fees
On May 8, EBA launches public consultation on draft standards on the eligibility criteria for granting simplified obligations for recovery and resolution planning
On May 11, EBA publishes final guidelines to assess ICT risk
On May 12, EBA publishes final Guidelines on credit institutions credit risk management practices and accounting for expected credit losses
On May 18, EBA consults on its guidance for the use of cloud computing
On May 23, EBA updates on monitoring of CET1 instruments
On May 23, EBA publishes final technical standards on valuation in resolution
On May 31, EBA publishes Opinion on EU Commission consultation on the operation of the ESAs
On May 30, ESMA published its response to the EC consultation on the operation of the ESAs

	On May 30, ESMA has updated its list of recognised central counterparties (CCPs) based in third countries **On June 1, EC** sets out amendments to EBA draft RTS on PSD2 strong customer authentication **On June 8, EC** adopted a mid-term review of its 2015 Capital Markets Union action plan **On June 13, EC** adopted a proposal for a regulation amending the EMIR as regards the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs **On June 22, EC** published an inception impact assessment on an initiative to develop a secondary market for non-performing loans (NPLs) **On June 27, EP** (ECON) published a draft report on the EU Commission's proposal for a Directive to amend the Bank Recovery and Resolution Directive (BRRD) as regards the ranking of unsecured debt instruments in insolvency hierarchy **On June 27, EP** (ECON) has published an own-initiative report on creating a pan-European covered bonds framework under the Capital Requirements Regulation (CRR) **On June 8, EU Council** adopts new rules improving portability of digital services across the EU **On June 1, ESMA** opened a public consultation on future guidelines, which further clarify provisions stemming from the European Market Infrastructure Regulation (EMIR) **On June 1, ESMA** has issued final Implementing Technical Standards (ITS) regarding the application of the Market Abuse Regulation (MAR) **On June 19, ESMA** has published a consultation paper regarding its draft technical standards specifying the trading obligation for derivatives under the Markets in Financial Instruments Regulation (MiFIR) **On June 26, the Joint Committee of the ESAs** published its final Guidelines on anti-money laundering and countering the financing of terrorism (AML/CFT) **On June 27, ESMA** has issued its final guidelines on trading halts under the Markets in Financial Instruments Directive (MiFID II) **On June 7, EBA** issues 2018 EU-wide stress test methodology for discussion **On June 21, EBA** publishes draft amending technical standards on CVA proxy spread **On June 26, ESAs** publish central contact point standards in fight against financial crime **On June 26, ESAs** publish AML/CFT guidelines	
MEXICO	**On 14 April CNBV** amended its mutual fund rules to allow for differentiated fees for customers with portfolios over 10 million UDIS (2.8 million Euro), levelling their regulatory treatment with institutional investors and pension funds. **On 27 April, the CNBV** adjusted its definition of bank capital and capital requirements for SMEs, aligning them to international standards. Also, minor adjustments were made in order to incorporate the new Mexican indexed unit of account (UMA) to the market risk methodology. **On 29 May, Banco de México** required that dollar-denominated transfers and credits made to the accounts of legal persons residing in the country be made through its Interbank Dollar Payment System (SPID), or by other electronic payment systems authorized by it.	The Fintech law draft, which was made public in April, is being adjusted by the Secretariat of Finance (SHCP) and is expected to be presented to Congress during its next session (September-December).
LATAM	**Argentina:** **On 28 April 2017, BCRA** raised de maximum global net position in foreign currency for banks from 25 % a 30. **On the same date,** the Central Bank allowed the use of dollar denominated deposits to finance external importers of goods and services produced in Argentina Income from repo operations between financial entities and the Central bank will be exempt from Gross Revenues Tax in the City of Buenos Aires as of June 16, 2017 **Colombia:** The Financial Conglomerates Law was approved. It allows the Financial Superintendence to demand an adequate level of capital to support all the risks assumed by the conglomerate and creates a new resolution mechanism to protect public resources. **Peru:** **The Central Bank** removed the daily limits on banks' derivatives operations and it increased the cap for weekly and monthly ones. For weekly operations, the cap was increased from USD 250 million to USD 400 million; for monthly operations, the cap is now USD 1,2 billion, up from USD 1,0 billion.	

	In April, the Central Bank cut reserve requirements in foreign currency (both average and marginal rates) from 46% to 42%. **The Central Bank** raised the limit of private pension funds' holdings in foreign assets from 42% to 44% (as of June, 1st).
USA	**On May 21, FRB** announced final amendments to the check collection and return provisions in Regulation CC. The amendments create a framework for electronic check collection and return and create new warranties for electronic checks. **On June 8, the House of Representatives** passed the Financial CHOICE (Creating Hope and Opportunity for Investors, Consumers and Entrepreneurs) Act. **On June 12, the Department of the Treasury** published the first report on core principles of financial regulation. **On June 22, representatives from the Federal Reserve**, FDIC and the Office of the Comptroller of the Currency testified in front of the Senate Banking Committee. They expressed support for actions to simplify some banking regulations. **On June 22, FRB** released the results of supervisory bank stress tests. All banks passed.
TURKEY	FX lending criteria for the private sector: One of the options to contain FX borrowing is to put a condition like having an FX position of 20% lower/higher than equity like there is for banks. The tax cuts on white goods and furniture will be extended until the end of September. A new tax restructuring opportunity will be created for tradesmen. The total impact of tax cuts on the budget until the end of September will be around TL 800 Mn. In addition, Moreover, it has been worked on extending the restructuring of debt to the public as of March 2017, which was previously June 2016. Restructuring of public receivables: The law on the restructuring of public receivables and re-activation of Emlakbank was published in the Official Gazette. **CBRT** increased late liquidity window (LLW) rate by 50bps to 12.25% from 11.75%.
ASIA	**On 7 April, China's CBRC** issued the guiding opinions on improving the quality and efficiency of the banking industry in serving the real economy. **On 10 April, China's CBRC** issued the guiding opinions on risk prevention and control of banking industry to implement the decisions of the State Council, further strengthen financial supervision and prevent risks. **On 8 May, China Securities Depository and Clearing corporation Limited (CSDC)** announced a plan to tighten requirements for using corporate bonds as collateral. **On 16 May, China's CBRC** required that banks report the underlying assets and liabilities of their WMPs, as well as all layers of investment schemes on a weekly basis. **On 22 Jun, China's CBRC** instructed several local banks to conduct financial reviews on selected companies, e.g. Wanda, Fosun, HNA etc.

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