1. Future trends in European banking regulation

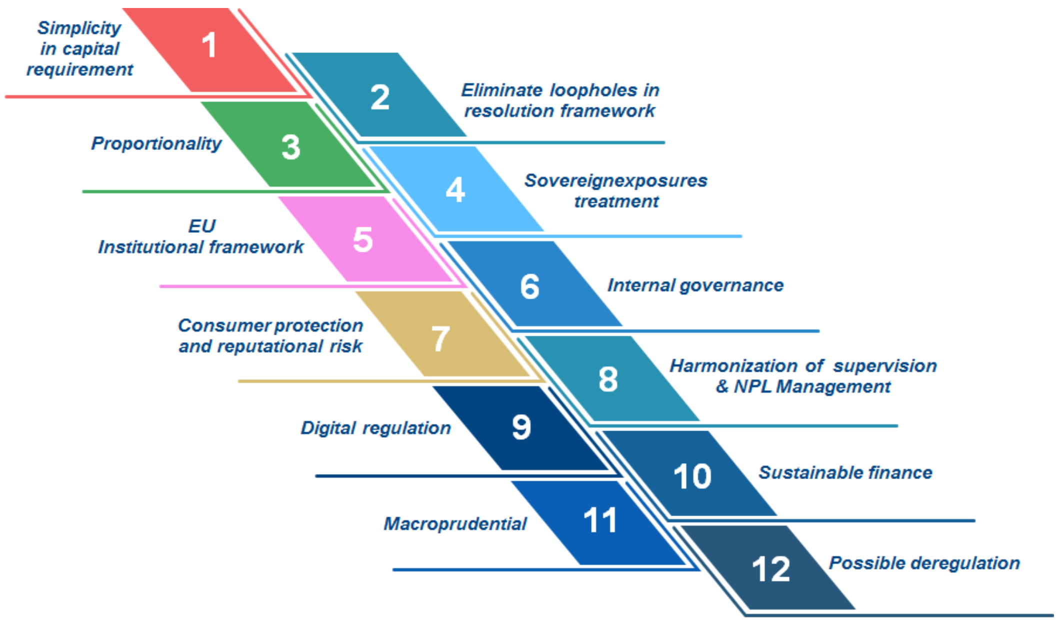
Reflections on possible scenarios in the EU regulation roadmap

A view on future trends in European banking regulation requires an understanding of the current regulatory framework, and debate on the EU's future in the aftermath of Brexit. Generally, there are wide-ranging questions in Europe over the course and pace that regulators will choose in the next 5-10 years, and banks must weigh up potential trends to anticipate future changes. This analysis seeks to stimulate discussion on potential trends.

This kind of exercise requires predicting how the market will react to new regulatory constraints and trying to anticipate what the future goals of regulators might be. The article summarises expected medium and long term trends in European financial regulation, while identifying new potential regulatory developments.[1]

From an overall standpoint the study identifies twelve main trends that may impact the EU banking system in the medium term across a variety of topics, namely capital, resolution, proportionality, sovereign exposures, the equivalence framework, internal governance, consumer protection, supervision, digital regulation, sustainable finance, macroprudential regulation and the tendency toward deregulation (see Figure 1 below).

Figure 1.1 Future trends in EU banking regulation



Source: BBVA Research

1: The analysis and trends described in this article should not be considered as certain. They are the product of the expert, yet subjective judgement of BBVA Research's regulation team. This exercise should instead be regarded as an initial foray into assessing both potential regulatory trends and their consequences for the industry that is designed to foster debate on the future of regulation.

- **Increased simplicity in capital requirements, with consequent reduced risk sensitivity in prudential frameworks.** The work underway in the BCBS for the finalization of the Basel III framework can point to a future prudential framework characterized by a quest for simplicity and comparability for capital ratios. The introduction of risk-sensitive capital requirements and internal models for them have been milestones in the evolution of the prudential framework. Nevertheless, doubts have recently emerged regarding the complexity of internal models and the lack of comparability of capital ratios among entities that use them. Specifically, within the EU it has been suggested that national decisions on authorising and supervising these models have exacerbated complexity and comparability shortcomings of this kind. It is therefore likely that this trend may materialise.

- **Modification of the resolution framework to eliminate current loopholes.** Recent resolution cases in Europe have evidenced that the current framework needs to be revised to build on the idea that taxpayers should not shoulder the cost of any crisis. Furthermore, the rules on liquidity and state aid are very likely to be reviewed for resolution cases, and some aspects of the G-SIB framework might be extended to D-SIBs.

- **Greater proportionality in financial regulation and supervision, and convergence with accounting practices.** Regulatory requirements in the fields of reporting and disclosing standards will take into account the size and complexity of the entities. Additionally, we should expect greater convergence between the regulatory/supervisory and the accounting framework given the increasing importance of the latter, accompanied by a review of the stress test framework.

- **Changes in the treatment of sovereign exposures.** There is an ongoing debate at European level on whether sovereign exposures should continue to enjoy privileged treatment (0% risk weight, exemption from large exposure limitations, and top-tier, high-quality asset status for the purposes of liquidity regulation). Alternatives range from applying a positive risk weight for sovereigns, to the application of large exposure limits, or a combination of both. Nevertheless, such a change is not very likely to take place in Europe within the next five years. Furthermore, even were it to be approved, such a measure would need domestic legislative implementation in the EU accompanied by a long transitional period to allow banks to manage their exposures.

- **Advances in EU Institutional framework reform and political integration.** As stated in the European Commission’s reflection paper on the deepening of the EMU, steps are likely to be taken within the next few years to enshrine the Fiscal Compact and the ESM in EU Law. Over a longer time-frame we can expect a little progress in setting up a common Treasury, which could be tasked with issuance of the new common debt instrument. Nevertheless, for these institutional projects to be matured, two European regulatory projects must be seen through to completion: the Banking Union (Backstop and EDIS) and the Capital Markets Union.

- **Increasing the importance of internal governance for decision-making and the alignment of compensation incentives**. Regulators are increasingly turning their focus to internal governance arrangements, with decision-making processes coming under supervisory surveillance. There are already examples in this field, i.e. regulatory requirements for some employees to prove they are suited to carrying out their tasks. Additionally, there are further regulatory changes expected on compensation regimes (setting up remuneration and salaries), reflecting the tendency to align monetary incentives (such as bonuses) with non-monetary objectives (such as promoting stability or sustainable growth). Finally, senior management positions are likely to become increasingly accountable for their actions. All these changes could lead to reputational gains insofar as institutions become more trustworthy.

- **More focus on topics relating to consumer protection and reputational risk.** There is a trend towards concentrating on the protection of retail customers and stepping up financial education in all regulatory frameworks. Regulatory changes aimed at protecting consumers, coupled with changes in internal governance and compensation schemes (as commented before) are likely to have effects on the reputational risk of banks.

- **Harmonisation of supervision & NPL management.** There is scope for further homogenisation of supervisory practices in the coming years. Although options and discretions (O&D) in the current framework grant national authorities flexibility to deal with different situations, they lead to an unlevel playing field.[2] The ECB is making significant efforts to address this issue so, going forward, we are very likely to move towards a more harmonised system.[3] Moreover, in the coming years Member States are likely to start incorporating new tools and strategies to deal with NPL management and to develop secondary markets for these assets.
- **More focus on digital regulatory frameworks.** A drive to extend the regulatory and supervisory boundaries to currently unregulated activities is expected. Supervisors will prioritise FinTech and coordinate national initiatives to promote innovation and strengthen cybersecurity while always being conscious of technological innovation.

- **Development of sustainable finance.** Future legislation will promote sustainable finance, while ensuring financial stability. Regulators will consider environmental, social and governance-related factors and risks.

- **Centralisation of macroprudential regulation and an increasing focus on systemic entities**. Macroprudential regulation and supervision is expected to take on increasing importance, featuring EU-wide homogenization and centralisation through a more effective European Systemic Risk Board.

- **Possible deregulation.** The possibility of deregulation in Europe should not be discarded if third countries go along such a path. An intensive deregulation process in the USA or in the UK as a consequence of Brexit could trigger similar moves in the EU, although such a course would not be desirable.

2: For example, there are O&Ds regarding rules for capital instruments or the method to calculate own funds and liquidity requirements.
3: The banking union would greatly benefit from a more harmonised insolvency framework as it would facilitate many decisions and processes when banks are failing or likely to fail.

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BBVA Research

This report has been produced by the Regulation Unit:

Chief Economist for Financial Systems & Regulation

Santiago Fernández de Lis
sfernandezdelis@bbva.com

Maria Abascal
Maria.abascal@bbva.com

Santiago Muñoz
santiago.munoz.trujillo@bbva.com

Arturo Fraile
arturo.fraile@bbva.com

Victoria Santillana
mvictoria.santillana@bbva.com

Matías Daniel Cabrera
matiasdaniel.cabrera@bbva.com

Pilar Soler
pilar.soler.vaquer@bbva.com

Javier García Tolonen
javierpablo.garcia@bbva.com

Álvaro Romero Mateu
alvaro.romero.mateu@bbva.com

With the contribution of:

Financial Systems

Ana Rubio
arubiog@bbva.com

Digital Regulation team

Lucia Pacheco Rodriguez
lucia.pacheco@bbva.com

BBVA Research

Economista Jefe Grupo BBVA

Jorge Sicilia Serrano

Macroeconomic Analysis
Rafael Doménech
r.domenech@bbva.com

Global Economic Situations
Miguel Jiménez
mjimenezg@bbva.com

Global Financial Markets
Sonsoles Castillo
s.castillo@bbva.com

Long term Global Modelling and Analysis
J. Julián Cubero
juan.cubero@bbva.com

Innovation and Processes
Oscar de las Peñas
oscar.delaspenas@bbva.com

Financial Systems And Regulation
Santiago Fernández de Lis
sfernandezdelis@bbva.com

International Coordination
Olga Cerqueira
olga.gouveia@bbva.com

Digital Regulation
Álvaro Martín
alvaro.martin@bbva.com

Regulation
María Abascal
maria.abascal@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Financial Inclusion
David Tuesta
david.tuesta@bbva.com

Spain and Portugal
Miguel Cardoso
miguel.cardoso@bbva.com

United States
Nathaniel Karp
Nathaniel.Karp@bbva.com

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Middle East, Asia and Geopolitical
Álvaro Ortiz
Alvaro.ortiz@bbva.com

Turkey
Álvaro Ortiz
alvaro.ortiz@bbva.com

Asia
Le Xia
le.xia@bbva.com

South America
Juan Manuel Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@bbva.com

Venezuela
Julio Pineda
juliocesar.pineda@bbva.com

CONTACT DETAILS: BBVA Research: Azul Street. 4. La Vela Building – 4th and 5th floor. 28050 Madrid (Spain). Tel.:+34 91 374 60 00 and +34 91 537 70 00 / Fax:+34 91 374 30 25 - bbvaresearch@bbva.com www.bbvaresearch.com