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Financial Regulation Outlook

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Index

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Summary

Future trends in European banking regulation

Reflections on possible scenarios in the EU regulation roadmap. 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.

Authors: Maria Victoria Santillana

Global regulatory framework

Retrenchment or recalibration? A decade after the beginning of the financial crisis the resilience of the global financial system has been enhanced, and much is due to the implementation of the agreed global regulatory agenda. However, there have recently been some concerns over the impact of regulation on economic growth and market liquidity. After a decade, it seems a good time to evaluate what has been achieved and to make adjustments where necessary.

Authors: Santiago Muñoz

CRD V: state of play

Resumption of negotiations after the summer break. On 23 November 2016, the European Commission presented a new legislative package to amend the current prudential and resolution frameworks for banking. Negotiations in the Council and Parliament are underway but might take longer than expected. Efforts seem to have been made to approve the issues that need fast-tracking: i) transitional agreement for IFRS 9, ii) transitional agreement for large exposures and iii) the bank creditor hierarchy.

Authors: Pilar Soler

Banking Union: barriers and other issues

Halfway there. The Banking Union is one of the tools most relevant to achieving financial integration in the Eurozone and to breaking the doom-loop between sovereigns and banks. Given its importance we need to improve it, as there are barriers to overcome. Furthermore, the project is only half-completed, since some key elements are still missing.

Authors: Victoria Santillana

European initiatives on NPLs

There are several ongoing European initiatives, like the Council conclusions on an action plan to tackle NPLs, which identifies future work streams. Currently, policy options are focused on three areas: (1) Enhanced supervision: e.g. ECB Guidance, (2) reform of insolvency frameworks and, (3) development of secondary markets, e.g. securitisations. In any case, the introduction of a single European regulatory framework or the homogenization of rules among Member States will be crucial to eliminate regulatory uncertainty.

Authors: Ana Rubio

Resolution: lessons learned

The framework needs improvements. The handling of the recent cases shows that, despite having common legal (BRRD) and institutional (Banking Union) frameworks at EU level, bank failures are still not treated in a homogeneous way across Europe. Furthermore, the resolution framework requires improvements as its practical implementation has given rise to new challenges.

Authors: Javier Garcia

CCPs in the post-Brexit era

The future of market infrastructures after the UK departs the EU. The importance of Central Counterparties (CCPs) have become larger since the last financial crisis. In the EU, a substantial volume of euro-denominated trades are cleared in the UK. Brexit is likely to have an impact to the current status-quo. In this regard, the European Commission presented a proposal to grant ESMA and Central Banks additional powers on the supervision and authorization of CCPs.

Authors: Matias Cabrera

Fintech keeps climbing up the political agenda

Financial regulators rekindle the debate. During 2017 financial regulators and supervisors at international and EU level have released a number of public consultations, discussion papers and reports analysing the impact of financial technology (fintech) on the financial sector, as well as the implications for regulatory and supervisory frameworks.

Authors: Lucia Pacheco

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1. Future trends in European banking regulation

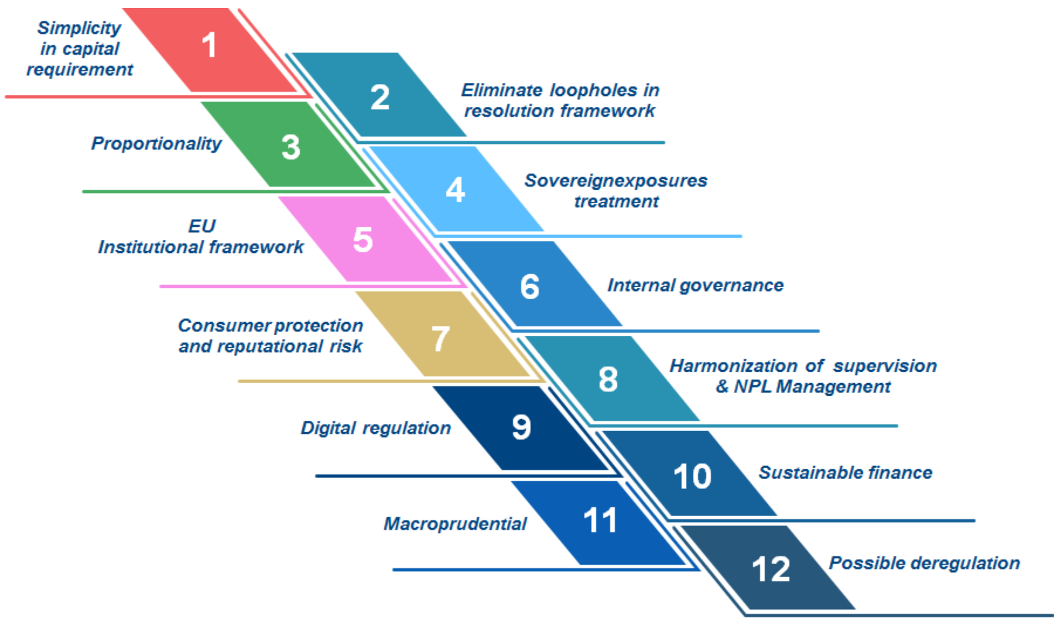
Reflections on possible scenarios in the EU regulation roadmap

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.

- **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.

2. Global regulatory framework

Retrenchment or recalibration?

A decade after the beginning of the financial crisis it can be confidently stated that **the resilience of the global financial system has been enhanced,** and much is due to the implementation of the agreed global regulatory agenda. However, there have recently been some concerns over the impact of regulation on economic growth and market liquidity as the final elements of Basel III reforms are agreed upon while others have already been fully implemented. After a decade, it seems a good time to evaluate what has been achieved with the reforms and to make adjustments where necessary.

Since the financial crisis there has been a **strong and coordinated effort by global leaders to strengthen financial regulation** to reduce the probability of a future crisis and its impact on the economy. G20 leaders have agreed on a long list of reforms to be implemented simultaneously across jurisdictions, to which end the Financial Stability Board (FSB) has been instrumental. The agenda was broad and ambitious, and included improvements in the quality and quantity of bank capital under a new Basel Committee agreement, liquidity ratios, reforms to the OTC derivatives market, and several tools to facilitate the resolution of systemic banks.

The **United States was among those showing the most interest in advancing the global regulatory agenda,** and pursuing its successful completion in a limited timeframe. However, this has waned since the election of president Trump. In February 2017, a Presidential Executive Order was issued to review US financial regulation and the US Treasury was asked to prepare a thorough report reviewing all financial regulation set in place since the financial crisis. Published in June, the Treasury report included 97 recommendations, some of which suggested postponing already agreed standards such as the net stable funding ratio (NSFR), and the fundamental review of the trading book (FRTB). More recently some countries such as Australia, Hong Kong and Singapore have expressed similar intentions. This has undermined efforts and the consensus achieved by international standard setting bodies, introducing an additional degree of regulatory uncertainty.

On the other hand, some recent studies suggest that new regulation might have had some unintended consequences, such as the fact that **market liquidity** has fallen with respect to levels observed before the financial crisis. Even so, it is hard to tell whether current levels represent a risk to financial stability. The banking industry has been vocal about this concern because its market-making activity has been negatively impacted due to regulations such as the Volcker Rule in the US while global liquidity is also expected to fall as economic conditions worldwide continue to normalise. This is a concern that has been taken so seriously by policy-makers that some Federal Reserve governors have even proposed a review of the Volcker Rule.

Another unintended consequence that has been of concern to policy-makers and banks is a reduction in **correspondent banking**. This is of crucial importance for some emerging markets and developing countries, as it is essential for international payments involving their financial systems. This has been recognised by the FSB and a work plan has been in place since November 2015.

It is important to **finalise the agreed financial global agenda as soon as possible**, so that regulatory uncertainty is reduced. A reversal of regulations should not be the path, but instead an adequate calibration of some regulation so that any unintended consequences are corrected, especially once the whole reform package is fully implemented. The real risk is for international cooperation to diminish and regulatory fragmentation to set in, to the detriment of a level playing field.

3. CRD V: state of play

Resumption of negotiations after the summer break

On 23 November 2016, the European Commission presented a new legislative package aimed at amending the current prudential and resolution frameworks for banking. The proposal is a very ambitious package that covers a significant part of the banking prudential framework. Negotiations in the Council and in the Parliament are underway but might take longer than expected. Efforts seem to have been made to approve the issues that need fast-tracking: i) transitional agreement for IFRS 9, ii) transitional agreement for large exposures and iii) the bank creditor hierarchy.

General overview of the process

Figure 3.1 Milestones in the legislative process of the file so far

Source: BBVA Research

There has been a general delay in negotiation of the file. After the presentation of the proposal by the Commission, both the Parliament and the Council stated their willingness not to delay the negotiation process too much, although they also pointed out that quality was preferred over speed in the process.

- On the one hand, **the Council seems to be advancing faster than the Parliament**. The Estonian Presidency aims to have a final position on the whole Commission proposal by yearend, although this is highly unlikely.

- On the other hand, **the Parliament is focusing on the fast-tracked files** (IFRS 9, large exposures and the creditor hierarchy). The overall report was originally expected for June, but has since been postponed on several occasions.

The focus now is on fast-tracked files. Having reached a general position at both institutions, trilogues for IFRS 9 and Large Exposures are expected to start in late September. Trilogues for creditor hierarchy are expected to start in early October:

- **IFRS 9 transitional period**: ahead of the introduction of the new accounting provisions of IFRS 9 in January 2018, the Commission proposed a transitional period to mitigate the potential impact of the envisaged increase in accounting provisions on banks' own funds. There are two key aspects in the design of this transitional agreement: i) the approach to calculating the amount to phase in and ii) the percentages of the phase-in itself. The main divergences are regarding the envisaged approach. While the Commission has proposed a dynamic approach (which requires recalculating the amount to phase in every year) and the Parliament has backed this, conversely the Council advocates a new "static modified approach"[4].

- **Large exposures**: as the exemption for certain sovereign exposures (those denominated and funded in the currency of any Member State other than that of the issuer) comes to an end, these government bonds will be subject to a non-zero risk weight and will therefore be subject to the large exposures limit. In order to smooth the impact of the introduction of this limit, the Commission has proposed a three-year phase-out. Both the Parliament and the Council have agreed positions that do not differ from the Commission's proposal in terms of content.

As negotiations resume after the summer break, apart from the fast-tracking, the main issues to discuss are:

- **Pillar 2**. The design of the new Pillar 2 is one of the issues subject to most discussion. One of the main concerns is the trade-off between maintaining a certain flexibility for supervisors and aiming for further homogenisation in applying Pillar 2. The microprudential nature of the Pillar 2 included in the Commission's proposal is also being discussed, as is whether targeted amendments to the macroprudential toolbox would be advisable.

- **Market risk**. The main concerns relate to the difficulty of implementing these new standards. Moreover, the US report recommending a delay in the implementation of the new market risk rules has also been raised as a concern. To soften the application of the FRTB, the Commission has proposed a 3-year phase-in, and in addition to this consideration is being given to allowing a little more time for implementation of the rule (beyond the two-year period for the rest of the rules) to ensure that there is enough time for the transition, especially for the new internal models regime.

- **Proportionality**. This is also a key issue in the negotiation of the file. The Commission proposal already included several features to increase proportionality, which have been met with a high degree of acceptance. The discussion mainly focuses on the thresholds to determine which entities can benefit from this proportionality. The main areas affected by these proposals are: i) disclosure requirements, ii) reporting requirements and iii) targeted remuneration rules.

Next steps

After the summer break, negotiations are resuming in both the Parliament and the Council. Even though the priority is to have the fast-tracking ready for yearend, the rest of the file needs to keep up momentum. The Parliament is expected to issue its report in September.

4: The static modified approach is based on a static approach that requires one only calculation of the amount to be phased-in at the time of implementation of the new standards. Only if macroeconomic circumstances envisage an increase in expected loss, could the amount to be phased-in be increased up to a fixed level.

4. Banking Union: barriers and other issues

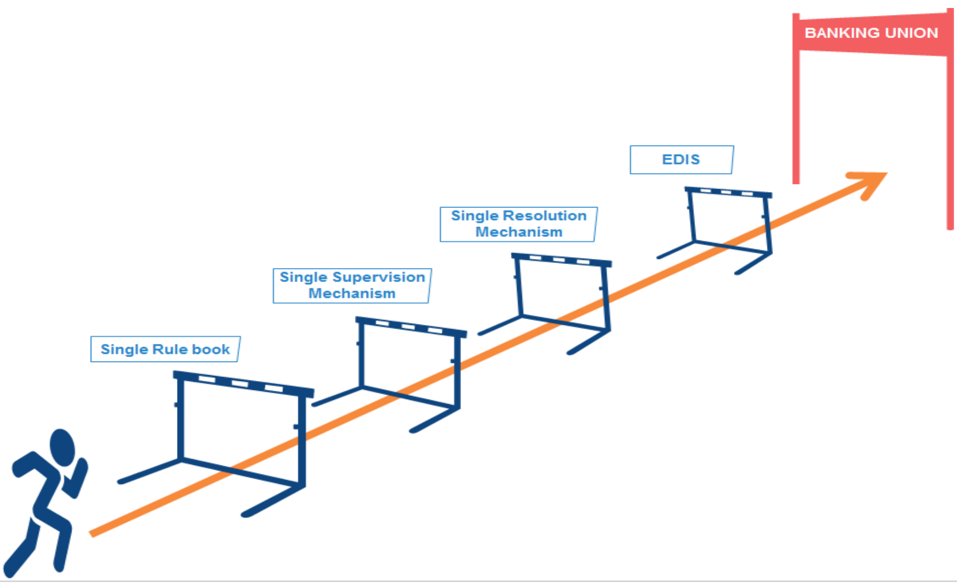
Banking Union: halfway there

The Banking Union (BU) is one of the tools most relevant to achieving financial integration in the Eurozone and to breaking the doom-loop between sovereigns and banks. Given its importance we need to improve it, as there are barriers to overcome. Furthermore, the project is only half-completed, since some key elements are still missing.

Since its launch in June 2012, the BU has shaped up to be the most significant transformation caused by the financial crisis in Europe, not only regarding economic structure, but also from a political perspective. It marks a sea change in the nature of European integration and the balance between Member States and European institutions.

This new institutional architecture has been successfully launched in record time. A key structure of the Banking Union was put in place with the creation of a new single supervisor in the European Central Bank (ECB), known as the Single Supervisory Mechanism (SSM), and the Single Resolution Mechanism (SRM) for resolution and recovery tasks. Nevertheless, after three years in existence the BU is not progressing as expected and remains mid-stream. Among the main elements of the BU (Single Rulebook, SSM, SRM and a single deposit guarantee scheme), only the first three are operational with some drawbacks still to overcome, as the recent resolution cases in Spain and Italy have shown. The last pillar of the BU, the European Deposit Insurance Scheme (EDIS) is still missing and the time is ripe for the EU authorities to finish this off.

Figure 4.1 Banking Union: Halfway there



Source: BBVA Research

A **quick and comprehensive review must be conducted of the barriers currently preventing the smooth functioning of the various different pillars. These are hampering efforts to further progress** as regards the BU, which calls for re-examination of how the BU is being effectively implemented.

In this regard, the main barriers standing in the way of smooth functioning of the different pillars are:

1. The Single Rule Book must be truly "single". The European Commission has to guarantee harmonised application of EU law in all member states, and to improve some of the current procedures.

2. Supervision. A lot of progress has been made on supervision, promoting a unique culture for supervision via the SSM. Yet **domestic divergences and discretionary action must be avoided if we want to consolidate the supervisory framework in place. This relates to the first issue.**

3. The resolution framework must eliminate loopholes that do not respect its spirit, in order to consolidate the idea that taxpayers should not bear the cost of a crisis. Additionally, it would be advisable to buttress the financial resources of the Single Resolution Fund (SRF) by creating a public backstop.

4. The BU will remain fragile unless real steps are taken to include a common fiscal backstop for the SRF and to create an EDIS.

As the BU is a key project for the future of the EMU that cannot be taken for granted, its development will require stamina and leadership from several key players. There is an urgent need to close the loopholes in the Single Rulebook and in supervision without holding up progress on resolution and EDIS, where much remains to be done.

The SSM and SRB will need to be exemplary in terms of effectiveness, fairness, transparency and accountability, not to mention in their technical competence and integrity, and be able to navigate political constraints skilfully, without compromising their basic policy principles.

In short, to complete the BU there are key issues pending, such as a backstop for the SRF and EDIS. Nonetheless, we need not only to finish off what we started, but also to consolidate the framework we have developed so far.

5. European initiatives on NPLs

There are several ongoing European initiatives on tackling the high level of non-performing loans (NPLs) in Europe. One of them is the Council's conclusions in an action plan for NPLs, which identifies future work-streams, their deadlines and the European authorities in charge of them. Current policy options focus on three areas:

1. Enhanced supervision

The EBA has worked towards a common EU definition of NPLs, and the ECB has published a "Guidance to banks on tackling non-performing loans", which is applicable to all significant institutions under the Single Supervisory Mechanism (SSM).

The Council action plan invites the European Commission to interpret existing supervisory powers as regards banks' provisioning policies (to ensure immediate action if necessary) and to consider introducing prudential backstops to new loans in the ongoing review of the CRR/CRD IV (possibly deductions from own funds).

Additionally, the ESRB has been mandated by the Council to develop macroprudential approaches to prevent system-wide NPL problems by the end of 2018.

2. Loan enforcement

In 2016 the Commission proposed a directive on insolvency frameworks aiming to facilitate debt restructuring and to give potential buyers of NPLs better information on insolvency outcomes (average recovery values, timing and cost of proceeding, etc.). Both the Parliament and the Council have started their work on this proposal. In particular, the Council action plan invites the European Commission to publish the results of the benchmarking exercise on national loan enforcement, and Member States to consider carrying out peer-reviews on insolvency regimes in the EU.

In July 2017 the Commission launched a public consultation that considers the introduction of an 'accelerated loan security', which is a swift, out-of-court power procedure that would entitle the bank to acquire ownership of firms' encumbered assets with a view to selling them off.

3. Development of secondary markets for NPLs:

Direct sales of impaired assets to an outside investor can be a quick way to reduce the NPL stock. However, currently the bid-ask spread in the market is wide and trading volume is low.

The aforementioned ongoing Commission consultation includes initiatives on this issue, aiming at fostering the transfer of loans, the functioning of third party servicers and removing other constraints.

In this regard, on January 2017, the EBA presented its proposal for an EU-wide asset management company (AMC or "bad bank"). Some of the arguments raised against this alternative are: the heterogeneity of national assets and procedures, the short-term costs for banks, and the mutualisation of risks that it would entail. More recently, the idea of a single European AMC seems to have been discarded and the Council action plan invites the European Commission to develop a blueprint for national AMCs by the end of 2017.

Transparency could foster the development of the market. In the Council action plan the EBA, ECB and European Commission are invited to propose initiatives on this issue, including the setting-up of centralised NPL data platforms to make access to such information easier, provide a single point of contact for potential investors and facilitate the packaging of assets from different banks.

NPL securitisation and sale may additionally be an appropriate tool to remove more granular SME loans or unsecured loans (credit cards, consumer loans) from bank balance sheets.

One of the main obstacles for a secondary market are the high transaction costs, which include taxes (like stamp duty) and register costs. In the short term, bringing down such costs could incentivise banks to participate in secondary markets.

In any case, the introduction of a single European regulatory framework or the homogenisation of rules among Member States (or even across regions in one country) will be crucial to eliminating regulatory uncertainty.

6. Resolution: lessons learned

The framework needs improvements

The handling of the recent cases shows that, despite having common legal (BRRD) and institutional (Banking Union) frameworks at EU level, bank failures are still not treated in a homogeneous way across Europe. Furthermore, the resolution framework requires improvements as its practical implementation has given rise to new challenges.

Now that we have seen how the new regime works in practice (last June Banco Popular was resolved, two Veneto banks were liquidated, and Monte dei Paschi was subjected to a preventive recapitalisation), it is time to draw some conclusions. Legal loopholes and practical implementation challenges show that there is a need to amend the framework to make it more credible and guarantee the new post-crisis paradigm whereby private shareholders and debt holders must absorb losses first without taxpayers' money being committed. In fact, there are several opportunities to do just that: i) following the mandate of article 129 of the BRRD, when the Commission carries out its first revision of implementation of the BRRD at the end of 2018, and ii) in the course of current negotiations of the banking reform package ("CRDV"). So what can be done to improve it?

1. Minimise the loopholes in current legislation

It is crucial to stress the fundamental importance of ensuring that the resolution framework is applied uniformly across the EU so that all bank shareholders, creditors and depositors are guaranteed equal treatment under resolution. One way to ensure this is by restricting the use of preventive recapitalisations once the resolution framework is complete (i.e. once banks have their MREL buffers fully built-up, provided that the problem of retail investors holding "bailinable" liabilities other than common stock is solved in a standard way). Moreover, the 2013 Commission's State Aid Communication should now be aligned with the BRRD (which was approved at a later stage) in terms of burden-sharing.

2. Harmonise bank liquidation regimes in the EU

This is necessary, not only to avoid better treatment in liquidation than in resolution, but also to ensure compliance with the fundamental principle of "no creditor worse off than in liquidation" (NCWO) that is enshrined in the BRRD. Accordingly, it is necessary to achieve a minimum of harmonisation among national insolvency laws and at the same time align them to the EU resolution framework.

3. Clarify the provision of liquidity

The latest ECB policy on Emergency Liquidity Assistance[5] seems to cover the case of an entity in resolution needing liquidity. However, more clarity is needed to include the cases where a bank is past the point of non viability but before

5: https://www.ecb.europa.eu/mopo/ela/html/index.en.html the application of resolution/liquidation. That is, allowing the lender of last resort to provide sufficient liquidity while plans to create a bridge bank, recapitalise the entity or liquidate it are put into effect. Furthermore, the EU should adopt the FSB's principles on funding in resolution which should be further clarified[6]. Finally, a public backstop should be created to reinforce the credibility of the Single Resolution Fund.

4. Adopt a common approach to retail investors holding "bailinable" liabilities

Authorities at EU level should come up with a common solution to this problem to guarantee a level playing field at European level, by either prohibiting or seriously limiting the sale of bailinable (other than common stock) instruments to retail investors.

5. Improve the recovery phase

The recent resolution cases highlight the shortcomings of the recovery phase which must be revised and, if needed, authorities should have more instruments at their disposal (or the ability to use the existing ones without any interferences). But, the proposed pre-resolution moratorium tools are not a solution: their effect would be counterproductive as they would exacerbate bank runs at an even earlier stage than the PONV[7]. Their mere existence might deter investors and depositors and force a run at the first sign of deterioration. Furthermore, if the provision of liquidity is clarified as suggested in point 3, then these moratorium tools would not be needed.

6: http://www.fsb.org/2016/08/guiding-principles-on-the-temporary-funding-needed-to-support-the-orderly-resolution-of-a-global-systemically-important-bank-g-sib/
7: The Point of non viability (PONV) is already a vague concept, and authorities have ample discretion to activate it.

7. CCPs in the post-Brexit era

The future of market infrastructures after the UK departs from the EU

The importance of Central Counterparties (CCPs) has become greater since the last financial crisis. In the EU, a substantial volume of euro-denominated trades are cleared in the UK. Brexit is likely to have an impact on the current status-quo. In this regard, the European Commission (EC) has presented a proposal to grant ESMA and Central Banks, additional powers in the supervision and authorization of CCPs.

CCPs play an important role in the economy. They become the counterparty to each sides of an operation, and by netting the positions of multiple trades across agents and collecting collateral they are able to reduce counterparty and systemic risk. Nearly 62% of all OTC contracts are centrally cleared (75% for interest rates derivatives) [8].

In the EU, the European Market Infrastructure Regulation (EMIR) oversees the registration and supervision process for CCPs. After the implementation of this regulation, the clearing of some asset classes was mandatory. For the case of CCPs located in third countries, there are two requirements: first, that the third country's legal framework is granted equivalence for EMIR, and second, that the corresponding CCP is authorised and registered by ESMA. If otherwise, EU agents cannot use these CCPs services for regulatory purposes.

Currently, a substantial volume of trades in the EU is conducted through CCPs located in the UK (particularly, euro-denominated derivative transactions). Once the UK ceases to be a Member State, it will become a third country. Then, unless the EU and the UK are able to secure a transitional period, in March 2019 CCPs located in the UK will no longer be able to provide services to EU clients. Under the current situation, the UK will need to go through the third country equivalence process, and CCPs will need to be authorized by ESMA.

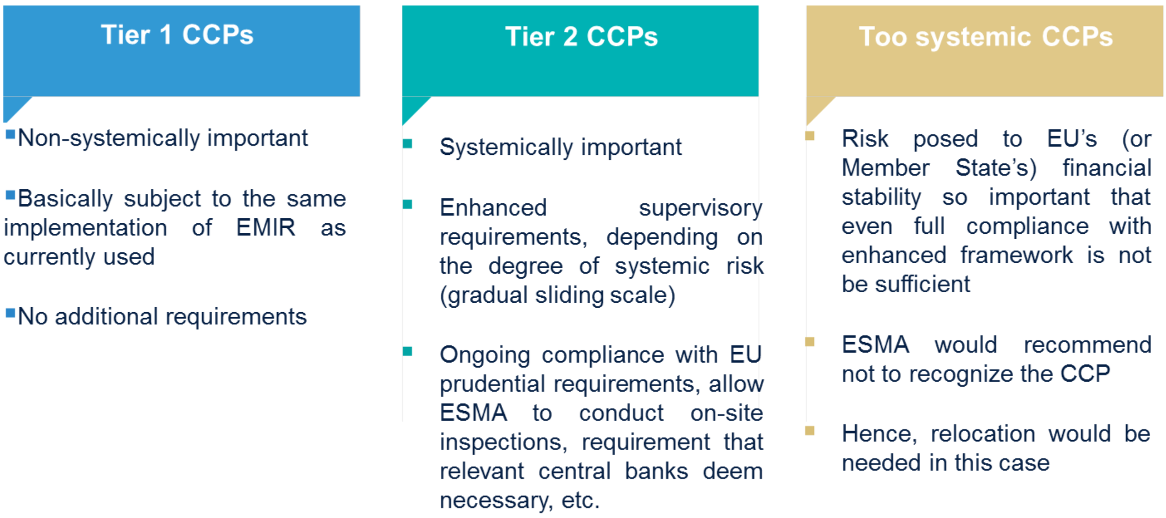
Considering that until now the UK has been a full member of the EU, and henceforth it has applied all of the EU regulations and directives, the equivalence process for EMIR should not pose a major difficulty from a technical perspective. Nevertheless, if the UK decides to modify its regulatory/supervisory framework, equivalence could be revoked. Considering the sheer volume of EU-based clients using UK-based CCPs, we would expect close scrutiny by EU authorities and this solution might not be a long term alternative.

Furthermore, the EC has recently issued a proposal to modify, among other issues, the authorisation and recognition process for third-country CCPs. The EC recognizes there is the "*risk that changes to the CCP...regulatory framework in a third-country could negatively affect regulatory or supervisory outcomes,...creating scope for regulatory...arbitrage*". In order to cope with this issue, the ESMA would be empowered to set additional requirements for third country CCPs, depending on their systemic importance (as measured by objective criteria such as size, complexity, membership structure, or the effect that failure would have on the EU).

8: Bank for International Settlements (2016). OTC derivatives statistics at end-June 2016.

Non-systemically important CCPs (Tier 1 CCPs) would be subject to the same implementation of EMIR equivalence that is currently used. But systemically important CCPs (Tier 2 CCPs) would be subject to enhanced supervisory requirements (depending on the degree of systemic risk). These additional requirements include, among other aspects, ongoing compliance with prudential requirements for EU-CCPs, the ability of the ESMA to conduct on-site inspections upon request, or any other requirement that relevant central banks deem necessary to guarantee the correct implementation of their monetary policy tasks. Additionally, there might be cases in which ESMA determines that the risks posed by a specific non-EU CCP to the financial stability of the EU (or one of its Member States) are so significant that even full oversight and compliance with the enhanced framework would not be sufficient to reduce such risks. In such cases, the ESMA would recommend that the EC should not to recognise the CCP. If such a CCP decides to service EU clients, it would need to be established and authorised in one Member State[9].

Figure 7.1 The European Commission's proposal



Source: BBVA Research

Given the importance of CCPs to the financial network, stronger supervision seems to be a reasonable approach. It is important to recognise as well, that if a location policy is enforced, and UK-based CCPs have to settle in a Member State, there might be a fragmentation of the liquidity pool, thus increasing the cost of using these CCPs. Nevertheless, EU's financial stability must prevail over other objectives. During periods of financial stress, rules in third countries might change in adapting to the new environment, but such rules might not be fully compatible with EU goals. Finally, it is worth mentioning that, whatever the outcome of this proposed reform (and the Brexit negotiations), a sufficiently long transition period is needed to allow firms to adapt their structures to the new environment. Given the complexity and the high interdependencies of CCPs, time is key to adapt positions to suit a different set of conditions; unravelling positions in a short period of time could lead to serious problems for the industry, as well as overall stability.

9: In 2011 the ECB tried to impose a location policy on CCPs with a high exposure to euro-denominated products, which would have forced CCPs located in the UK to relocate to a Euro Member State. The UK opposed this measures, and took it to the General Court of the EU, which ruled in 2015 that the "*ECB does not have the competence necessary to impose such a requirement on CCPs*".

8. Fintech keeps climbing up the political agenda

Financial regulators rekindle the debate

During 2017 financial regulators and supervisors at international and EU level have released a number of public consultations, discussion papers and reports analysing the impact of financial technology (fintech) on the financial sector, as well as the implications for regulatory and supervisory frameworks.

The **European Banking Authority** (EBA) has stepped into the Fintech debate by issuing a **discussion paper inviting comments on its approach to fintech**. Published on August 4, the document takes stock of a mapping exercise carried out by the EBA in the spring of 2017 which collected data from national competent authorities on the number, nature and regulatory status of fintech firms in the EU. Based on this exercise, the EBA has identified that a significant proportion of these firms (31% of the sample[10]) are not subject to any regulatory regime, or are only subject to a national authorisation or registration regime (14% of the sample), which raises concerns about the emergence of divergences among Member States and uncovered risks.

As a result, the **EBA has identified six areas where follow-up work may be necessary**: (i) authorisation and sandboxing regimes, (ii) prudential risks for credit institutions, payment institutions and electronic money institutions; (iii) the impact of fintech on the business models of these institutions, (iv) consumer protection and retail conduct in relation to business issues, (v) the impact of fintech on the resolution of financial firms, and (vi) the impact on AML/CFT. This consultation, for which feedback will be received up until November 6, will guide the EBA's work in the months to come.

At a global level, the **Basel Committee on Banking Supervision** (BCBS) has produced a **Sound Practices paper** analysing the current and potential future environment for banks and bank supervisors in light of recent developments in financial innovation. In this consultation, open until October 31, the BCBS acknowledges that the nature and scope of financial risks may change over time as a result of fintech and responds by outlining **10 recommendations which seek to guide the financial sector in the quest for striking a balance between innovation and safety**. These recommendations lie in four areas:

1. **Banks and bank supervisors** must ensure the **safety and soundness** of the system without unnecessarily **inhibiting innovation.**

2. **Banks** should have **adequate governance, risk management and IT structures** in place to manage and monitor new risks and take advantage of the opportunities arising from fintech, including those relating to the use of new enabling technologies and the increasing reliance on third parties, by either outsourcing or partnering.

10: The EBA identified over 1,500 fintech firms in the EU, although it only has detailed information on a sample of 282 firms.

3. **Bank supervisors** should enhance **cooperation**, including both across sectors and internationally, update their **skill-set** and **explore** the opportunities of new technologies to improve supervisory practices.

4. **Supervisors and regulators** should review and update the **regulatory, supervisory and licensing regimes in place** in the face of new innovation, and explore regulatory initiatives **(i.e. regulatory sandboxes or innovation hubs)** to spur the latter.

Further work is yet to come

Besides the work by the EBA and the BCBS, other regulators across the globe have shared their views on fintech in recent months. For instance, the **European Commission** launched a public consultation last March with the aim of assessing a new policy framework for financial innovation. The **European Parliament** also passed a resolution last May on fintech and the influence of technology on the future of the financial sector. In June, the **Financial Stability Board (FSB)** published a report analysing the consequences of fintech on financial stability. All of these efforts are welcome, since they **contribute to enhancing the understanding of new developments** in the financial sector by policy-makers and market participants.

Financial regulators and standard-setters have nonetheless taken **different approaches** in this endeavour. On one hand, the BCBS has issued a Sound Practices document, which constitutes a first attempt at exploring this phenomenon and is not intended to set regulatory standards. On the other hand, the EBA analysis is more grounded on the EU's landscape today, and is therefore more specific as regards the regulatory consequences of fintech. All in all, it is clear that fintech is increasingly seeping into the minds of regulators and supervisors. The financial sector should thus not be surprised to see **more regulatory action on this front in the months to come.**

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Main regulatory actions around the world over the last months

	Recent issues	Upcoming issues
GLOBAL	**On July 3 FSB** published assessment of shadow banking activities. **On July 3 FSB** published documents in preparation for G20 Hamburg 2017 Summit **On July 4 BCBS** published Basel standards implementation report and RCAP for LCR. **On July 5 FSB, CPMI, IOSCO and BCBS** published documents on CCP recovery and resolution. **On July 6 FSB** issued resolution planning guidance and report on implementation of reforms **On July 6 BCBS** issued two consultations on simple, transparent and comparable securitisation. **On July 14 CPMI & IOSCO** published update of implementation monitoring of PFMI **On July 17 FSB** welcomed the new insurance accounting standard IFRS 17 **On July 27 IOSCO** published review of Client Asset Protection Recommendations **On August 14 IOSCO** consulted on recommendations to improve transparency of corporate bond markets **On August 31 BCBS** consulted on the implications of FinTech for the financial sector **On September 5 BCBS** announced cooperation agreement with IFRS Foundation **On September 7 FSB** included a new key standard for sound financial systems **On September 12 BCBS** published Basel III Monitoring report **On September 18 ISDA** issued recommendations for CCP recovery and resolution **On September 18 ISDA** published white paper on the harmonization of regulatory regimes for derivatives **On September 21 FSB** and IMF published 2nd progress report on G20 Data Gaps Initiative **On September 28 CPMI-IOSCO** issued guidance on Harmonisation of the Unique Product Identifier **On September 28 CPMI** issued consultation document regarding wholesale payments frauds.	
EUROPE	**On July 4, EP** adopted a resolution on a pan-European covered bonds framework under the CRR **On September 11, ECON** approved a five year phase-in period for the IFRS 9 **On September 14, ECON** has published a report setting out proposed amendments to the EU Commission's proposal for a regulation amending the CRR **On September 14, EP** voted to approve the text of the proposed regulation amending the European Venture Capital Funds (EuVECA) Regulation and the European Social Entrepreneurship Funds (EuSEF) Regulation. **On September 27, ECON** published a draft report setting out amendments to the proposed regulation on a framework for the recovery and resolution of CCPs **On July 4, EBA** updated Risk Dashboard that shows stable capital levels amidst efforts to improve banks asset quality and profitability **On July 6, EBA** launched supplementary data collection to support the new prudential framework for investment firms **On July 7, EBA** published Final Guidelines on Professional Indemnity Insurance under PSD2 **On July 11, EBA** enhanced transparency on Deposit Guarantee Schemes in the EU	

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	On July 11, EBA published final Guidelines on authorisation and registration under PSD2 **On July 13, EBA** updated on the impact of IFRS 9 on banks across the EU and highlights current implementation issues **On July 14, EBA** published final standards specifying information requirements for the authorisation of credit institutions **On July 18, EBA** amended Decision on the quality of unsolicited credit assessments of certain ECAIs for the assignment of risk weights **On July 27, EBA** published Final Guidelines on major incident reporting under PSD2 **On July 28, ESAs** advised on Packaged Retail and Insurance-Based Investment Products with environmental or social objectives **On August 1, EBA** issued Opinion on measures to address macroprudential risk **On August 4, EBA** published a Discussion Paper on its approach to FinTech **On August 11, EBA** updated data used for the identification ofG-SIIs **On August 14, EBA** updated list of public sector entities for the calculation of capital requirements **On September 5, EBA** published final technical standards on MREL reporting by resolution authorities **On September 11, EBA** issued revised list of ITS validation rules **On September 22, ESAs** provided guidance to prevent terrorist financing and money laundering in electronic fund transfers **On September 26, EBA** published guidance to further harmonise EU banks internal governance **On September 26, EBA and ESMA** provided guidance to assess the suitability of management body members and key function holders **On July 6, ESMA** updated opinion on MiFID II's ancillary test for commodity derivatives **On July 6, ESMA** published three Consultation Papers on the Prospectus Regulation **On July 10, ESMA** issued final RTS regarding the aggregation and publication of derivatives data by trade repositories **On July 11, ESMA** published guidelines regarding the cooperation between authorities under the Central Securities Depositories Regulation (CSDR) **On July 20, ESMA** published opinion to the EC, the Council and the Parliament under Article 34 of the ESMA Regulation **On August 8, ESMA** updated Guidelines on transaction reporting, order record keeping and clock synchronisation under MiFID II **On August 10**, ESMA published three opinions on position limits regarding commodity derivatives under MiFID II/MIFIR **On August 24**, ESMA issued final guidelines on data transfer between Trade Repositories authorised under EMIR **On September 11**, ESMA updated transitional transparency calculations for non-equity instruments in relation to the implementation of MiFID II/ MiFIR **On September 15**, ESMA issued procedure under MiFIR laying out the steps for trading venues to temporarily opt-out from access provisions for ETDs **On September 26**, EBA and ESMA published joint Guidelines to assess the suitability of members of management bodies and key function holders **On September 28**, ESMA, and national competent authorities, updated work plan for the opinions on pre-trade transparency waivers and position limits that must be issued under MiFID II and MiFIR **On September 28**, ESMA published Guidelines for the management body of market operators and data reporting services providers.
MEXICO	**On July 21, CNBV** amended its Issuer Handbook to adopt OECD and G20 recommendations on gender discrimination. It requires issuers to disclose the gender composition of their boards and directors, and the existence or lack thereof of gender inclusive policies. It eases requirements for subsequent offerings if restricted to institutional and qualified investors. **On August 29, CNBV** published rules to combat identity theft, defining accepted identification methods for entering into of contracts, requesting means of payment, and for cash withdrawals and transfers. It establishes verification measures, especially biometric validation and consultation against the National Electoral Institute's database. Provides for the possibility of remote identification (digital onboarding). **On September 19, Fintech law** was formally presented for public review. The project is expected to pass through Congress in the current session.

LATAM	**Brazil:** **On August 16, Central Bank of Brazil** issued a public consultation on the simplification of prudential requirements for financial institutions with a lower risk profile. **On August 30, Central Bank of Brazil** issued a public consultations on the establishment and the operation of credit fintechs. **On September 19, Central Bank of Brazil** issued a public consultations on a resolution about cyber security policies and on the requirements on the processing and storage of data and computing in the cloud. **Colombia:** **On September 21, President of the Republic** sanctioned Law for the regulation of Financial Conglomerates (Law 1870 of 2017). It seeks to regulate the creation, circulation, acceptance, endorsement and other exchange acts on electronic security. The bill is in the third of four debates. **Peru:** **Central Bank** raised the limit of private pension funds' holdings in foreign assets from 44% to 46% as of August, 1st. **In August, Central Bank** cut reserve requirements in foreign currency (both average and marginal rates) from 42% to 41% (as of September, 1st). In September, it was cut again from 41% to 40% (as of October, 1st).	**Argentina**, as of January 2018 banks will be required to present and calculate the NSFR **Peru:** An influential congressman announces that he will present a bill to fix ceilings on interest rates of the financial system.
USA	**On July 19, Federal banking agencies** issued notice of proposed rulemaking to exempt commercial real estate transactions of $400,000 or less from appraisal requirements. **On July 21, Federal regulatory agencies** announced coordination of reviews for certain foreign funds under "Volcker Rule" **On July 24, FRB** announced guidelines for banking entities seeking an extension to conform certain "seeding" investments in hedge funds or private equity funds to requirements of Volcker Rule **On August 3, FRB** invited public comment on two proposals: corporate governance (improved effectiveness of board of directors) and rating system for large financial institutions. **On August 22, Federal banking agencies** proposed extension of certain capital rule transitions (mortgage servicing assets, certain deferred tax assets, investments in the capital instruments of unconsolidated financial institutions, and minority interests). **On September 1, OCC and FDIC** issued a notice of proposed rulemaking to shorten the standard settlement cycle for securities purchased or sold by national banks, federal savings associations, and FDIC-supervised institutions **On September 6, FRB** published "Strategies for Improving the U.S. Payment System: Federal Reserve Next Steps in the Payments Improvement Journey" - steps for payment system improvement. **On September 13, Agencies** proposed amending CRA regulations to conform to HMDA regulation changes. **On September 27, FDIC** adopted a final rule to enhance the resilience and safety and soundness of state savings associations and banks supervised by the FDIC that are affiliated with systemically important U.S. and foreign banking organizations. **On September 27, Agencies** proposed simplifying regulatory capital rules (mortgage servicing assets, certain deferred tax assets, investments in the capital instruments of unconsolidated financial institutions, and minority interests).	

TURKEY	**BRSA** published draft amendment according to which banks will be allowed to book 100% of required reserves as liquid assets. Currently, only 50% are booked as liquid assets. The impact of the draft amendment is expected to be positive on banks' liquidity ratios. **Official Gazette** published amendment according to which if a consumer loan is classified as a NPL, other consumer loans belonging to the same customer may be classified as other than the Group I. **Official Gazette** published new definition for SME under Banks' LCR regulation: "Entities that have revenue under the amount that has been determined by BRSA". Interest rates and financing costs of exporters via Turkish Eximbank were reduced. The interest rates of rediscount FX loans lowered by 10 bps. In addition, an additional TL 2.5 Bn loan will be provided for exporter SMEs. **BRSA**, allowed state banks to sell NPLs, according to an amendment published in the Official Gazette.	The regulatory changes related to the transition to IFRS9 were published in the Official Gazette and new reporting standards were set. Accordingly, banks will start to report their provisioning burden details with the new concept of "expected loss." IFRS 9 introduces an expected credit loss (ECL) model which requires the making of robust estimates related to customers. Additional disclosure requirements will also be necessary related to bond portfolio and loan risks. The new amendments will be valid starting from 2018. Medium term Program Decisions: Corporate tax for the finance sector will be increased to 22% from 20% to be effective from January 1, yet 2017 year-end cumulative income will also subject to 22% corporate tax ratio.
ASIA	**On July 15, China's authorities** held its once-in-five-year central financial working conference and announced the establishment of a financial stability committee to lead and coordinate different regulators. **On September 4, China** bans companies from raising money through initial coin offerings (ICO), asking local regulators to inspect 60 major platforms for trading cryptocurrencies. **On September 8, China's central bank** removed a 20% reserve requirement for trading foreign currency forwards in a bid to slow the pace of RMB appreciation.	

Source: BBVA Research

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