BBVA Research

Financial Regulation Outlook

SECOND QUARTER 2018 | REGULATION UNIT

Index

Closing date: **05 April 2018**

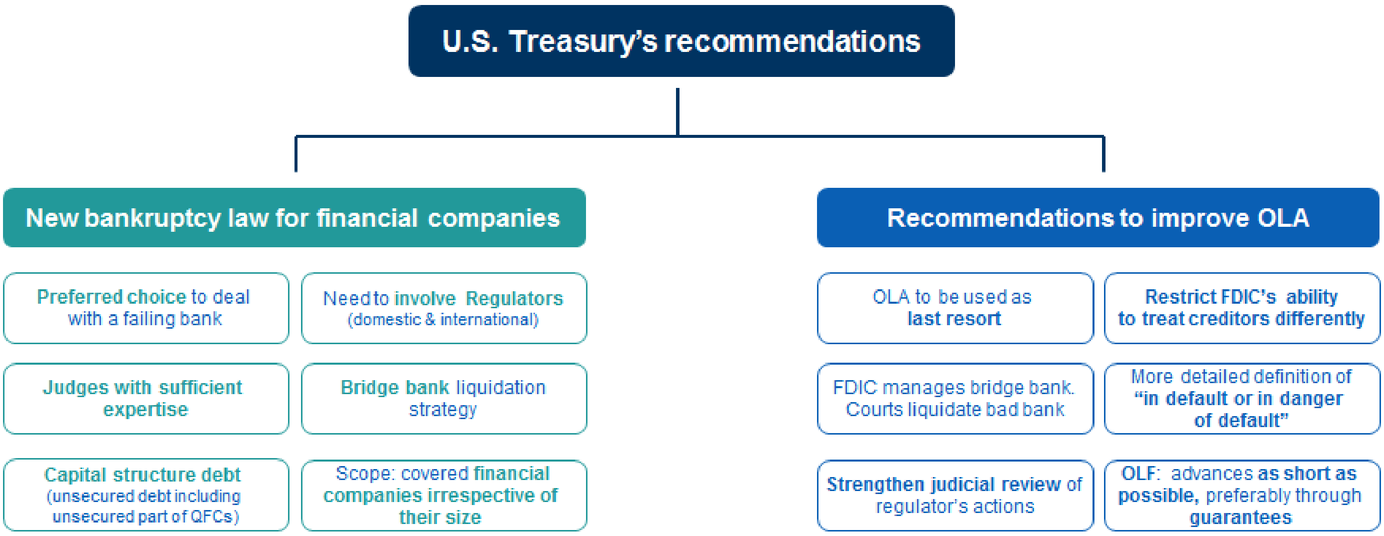
1. US Treasury's review of the Orderly Liquidation Authority and Bankruptcy Reform

Javier Garcia

The U.S. Treasury report does not recommend repealing the existing resolution framework, nor does it represent a move towards deregulation. On the contrary, the Treasury recommends enhancements to the existing regulatory framework as well as the establishment of a new bankruptcy regime for financial firms only. Now, it is up to the U.S authorities, regulators and Congress to enact the report's recommendations.

In response to a Presidential Memorandum issued in April 2017, the Treasury published a report[1] in February on the Orderly Liquidation Authority (OLA) and Bankruptcy Reform[2]. The report, which is part of a broader review of the U.S. financial regulatory framework, includes several recommendations revolving around two main ideas: i) to establish a new bankruptcy process for financial entities (dubbed "Chapter 14"[3]) and ii) to improve the existing regime**.**

Figure 1.1 U.S. Treasury's main recommendations



Source: BBVA Research based on U.S. Treasury's report on "Orderly Liquidation Authority and Bankruptcy Reform

The report states that Chapter 14 should be the preferred path to deal with failing banks instead of the OLA. This is consistent with the already existing obligation under the Dodd-Frank Act to use Title I (existing bankruptcy system for all companies, not only banks) as the first option to deal with a failing bank. Chapter 14 would replace the current

[1] The publication can be found here.
[2] The OLA is the U.S. resolution regime created by Title II of the Dodd-Frank Act in 2010.
[3] A concept which is not completely new as it has been already proposed in a Senate bill based on work from the Hoover Institution.

bankruptcy regime which, according to the Treasury, contains several limitations that hinder its applicability to banks with significant derivatives activity and short-term funding. All financial companies irrespective of their size would fall within the scope of Chapter 14. A similar mechanism that is currently applicable under OLA would be introduced during bankruptcy: the transfer of most assets and part of the liabilities of a failing bank to a new figure, a bridge bank (which would continue operating). Shareholders and *capital structure debt*[4] holders would be left behind and would assume losses. The process would be led by judges with sufficient expertise and regulators, both national and international, would be able to participate in the process.

A resolution mechanism under OLA could still be invoked as a last resort, if Chapter 14 fails. Nonetheless, several amendments must be introduced according to the report. Among others, the ability of the FDIC to treat creditors of the same class in a different manner should be restricted and only applicable to ensure the continuity of critical functions. Also, a bankruptcy court, rather than the FDIC, should be responsible for the administration of the claims of those left behind in the receivership. The report also recommends confining the authority's discretion when declaring a firm as "in default or in danger of default" by limiting its discretional judgment as to what the health of the bank would be during the next 90 days, but not beyond. Finally, in order to reinforce existing taxpayer protections, the use of the Orderly Liquidation Fund (OLF)[5] would be restricted in terms of duration (as short as possible), instruments (guarantees instead of lending), collateral (on a secured basis only) and ex-post contributions from the industry (activated as soon as possible and before the current five year deadline).

Assessment

- The U.S. Treasury report does not recommend repealing the existing resolution framework, nor does it represent a move towards deregulation.
- Many of the recommendations could be adopted quickly as they would only need to be approved by the Treasury or by the FDIC. However, Congressional approval is needed to establish the new Chapter 14.
- It is positive news that the OLA, including the OLF, is maintained (as previous rumours indicated a possible repeal)[6]. The fact that the U.S. would not revoke recently adopted global rules should provide comfort to foreign authorities.
- The OLF is crucial when dealing with the failure of a systemic bank, because it can provide the necessary liquidity that would otherwise not be available from other sources under a bankruptcy procedure. A similar mechanism could be introduced in countries where there is no clarity on how a bank would access funding in resolution.
- Also, other jurisdictions should consider whether a special bankruptcy process for financial companies only would be a positive addition[7] to their legal frameworks as a complement to, not a substitute of their resolution regimes. A specific bank liquidation regime could increase the transparency of the decisions as well as reduce the possibilities of infringing the no-creditor-worse-off-than-in-liquidation principle.

[4] Long-term debt held at holding company level including all unsecured debt plus the uncollateralized part of QFCs (Qualified Financial Contracts - mainly derivatives and repos).
[5] Contrary to what its name suggests it can only be used during a resolution, not a bankruptcy procedure. More importantly, the fund has access to a public backstop: it can borrow from the Treasury under certain conditions. Unlike in the EU, it is funded ex post.
[6] Repealing the OLA would have represented a return to a pre-crisis situation where the failure of systemic banks was impossible to manage in an orderly way and the only alternative was to bail them out in order to preserve financial stability.
[7] F. Restoy in a speech mentions the report as an example to follow for other authorities: " ... *the recent proposal by the US Treasury to develop a new Chapter 14 of the US bankruptcy code for financial institutions that meet a set of specific criteria merits consideration*."

2. IFRS 9: Supervisory practices, behavioural impacts and regulatory interactions

María Rocamora

In the aftermath of the crisis, the G20 urged the improvement of accounting standards regarding valuation and provisioning. The new accounting standard is a tool to strengthen financial stability through greater buffers of provisions to cover expected losses. However, an increase in required provisions poses some risks on traditional banking practices (e.g. lending, forbearance, price, collateralization, etc.). The IASB issued the final version of this standard in July 2014 and it came into force on 1st January 2018.

A new era of accounting under IFRS 9

IFRS 9 represents a major change for banking accounting and balance sheet structure. Firstly, the classification and measurement of financial instruments is performed considering business models and cash flow characteristics. Secondly, the new impairment model introduces the forward-looking approach, implementing the lifetime expected credit losses (ECLs) for financial instruments classified either in Stage 2 (if the credit risk increases significantly and is not considered low) or Stage 3 (defaulted). Finally, it overhauls hedge accounting in order to establish a linkage between accounting and business management.

The accounting standard impacts European banks' capital ratios. Therefore, the SSM performed a Thematic Review on IFRS 9 and disclosed the quantitative impact on CET1 (40 bps for significant institutions, and 59 bps for less significant institutions, according to the SSM thematic review on IFRS 9, 2017). Moreover, the SSM has included IFRS 9 as one of the priorities for supervision purposes for 2018. More recently, in January 2018, the EBA launched the EU-wide stress test, including IFRS 9 assumptions for the first time[8].

Strategic issues deriving from Expected Credit Loss approach

The implementation of the ECL approach could trigger impacts on banks' strategic decisions related to lending (e.g. price, duration, forbearance, collateralization or underwriting practices). Firstly, higher provisioning may lead to higher loan rates for certain kind of loans. Indeed, several respondents to the EBA survey[9] envisaged an impact on the rates and the duration of products (as a longer term implies higher expected losses over the whole life of the loan). Secondly, regarding underwriting practices, a number of studies[10] have established the impact of bank capitalization on lending behaviour, suggesting that as provisions reduce capital, subsequent lending practices could be negatively affected. Moreover, since performing and non-performing forborne exposures are subject to lifetime ECLs under IFRS

[8] For IFRS 9 reporting banks as of Q3 2018, EU-wide stress test takes the impact of the introduction of IFRS 9 into account in starting point data, as of Q42017.
[9] EBA (2017): "EBA Report on results from the second impact assessment of IFRS 9".
[10] Cohen B. and Scatigna M. (2016): "Banks and capital requirements: channels of adjustment". Gambacorta and Shin (2016): "Why bank capital matters for monetary policy".

9, banks could be disincentivized from granting forbearance measures. We can observe this effect in Spain with the entry into force of Circular 4/2016 which led to a drop in performing forborne exposures (Stage 2)[11].

Thirdly, at the early stages of an economic downturn, a greater volume of loans is eligible to be transferred from Stage 1 to Stage 2, with negative effects on regulatory capital[12]. Analogously, IFRS 9 implies an earlier recognition of losses in downturns, undermining capital at the early stages of a crisis, thus resulting in lower lending[13].

Regulatory treatment of IFRS 9 provisions, what's next?

The European prudential regime was amended to introduce a phase-in treatment in order to mitigate the impact of IFRS 9[14]. This is an interim approach until the BCBS decides on a long-term treatment for accounting provisions. For this purpose, the BCBS issued a discussion paper including different policy options[15].

Under the current prudential treatment, regulatory provisions are calculated with 12-month forward-looking parameters, representing the cushion to cover unexpected losses likely to arise in that period. This regulatory capital expected-loss approach acted as a complement to the incurred loss approach of accounting provisions (backward looking). Moreover, any excess of accounting provisions over regulatory provisions is added back to Tier 2 capital, subject to an overall limit related to risk-weighted assets.

Apart from the negative impact on capital due to higher provisions, the entry into force of IFRS 9 would further erode capital ratios if the current limits on Tier 2 capital related to risk-weighted assets remain unchanged. This stems from the fact that accounting provisions (lifetime approach in Stage 2 and Stage 3) will always exceed regulatory provisions (12-month approach) and it will become even more important than nowadays to incorporate this difference in Tier 2. Otherwise we may face a paradox in which banks appear to be less solvent (with lower regulatory capital) while they have higher cushions to face expected and unexpected losses. With this in mind, regulators should consider an increase in the overall limits to account for excess provisions in Tier 2 capital. Alternatively they could modify the methodology for calculating prudential provisions. In this regard, banks would face implementation costs related to the adjustment of current 12-month through-the-cycle parameters, validation methods and internal audit processes.

In conclusion, the solution of divergences across different regulation frameworks can be reached with a stronger coordination between accounting and prudential regulators[16].

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[11] Plata García C., Rocamora M., Villar J. (2017): "Transition to IFRS 9: Impact on forbearance practices: are there some risks?" BBVA Research.
[12] Abad J. and Suarez J. (2017): "Assessing the cyclical implications of IFRS 9 – A recursive model".
[13] Cohen B. and Edwards G. (2017): "The new era of expected credit loss provisioning".
[14] Regulation (EU) of the European Parliament and of the Council of amending Regulation (EU) No 575/2013.
[15] Basel Committee on Banking Supervision (2016): "Consultative document: Regulatory treatment of accounting provisions –discussion document".
[16] As a sign of this commitment of improving interaction, the IFRS Foundation and the Basel Committee on Banking Supervision signed a Memorandum of Understanding in September 2017.

3. Brexit negotiations: still a long, uncertain way ahead

Matias Cabrera

Major steps have been taken to finalise the Withdrawal Agreement, particularly on the transition period (where the UK accepted EU's conditions), but there are still areas of divergence. While these achievements should be taken with caution (nothing is agreed until everything is agreed), they are welcomed as they bring clarity. Furthermore, the European Council adopted the guidelines to set the framework for the future relationship with the UK, starting a new phase of the negotiation. This process will be hard, particularly given the UK's red lines, and will have important implications for the financial sector.

From the withdrawal agreement to the new relationship

Decisive steps have recently been taken towards the finalisation of the Withdrawal Agreement that will set the conditions for an orderly departure of the UK. The document presented by the Commission's negotiating team on 19 March highlights this situation. Full agreement has been reached on the citizens' rights and financial settlement issues. Nevertheless, there are other areas of divergence such as the Ireland and Northern Ireland issue, in which there is not yet a solution. The UK has to come up with a technical proposal to overcome the apparent contradiction of avoiding a physical border between both Irelands while leaving the UK (and therefore Northern Ireland) outside the customs union.

Another important step was the agreement on the transition period requested by the UK, that would last for 21 months until December 2020. During this period there will be little change to the status quo, with the UK having access to the Single Market (but being excluded from decision making bodies). This transition will grant additional time for firms (and governments) to adapt to the new situation, serving as a bridge towards the new EU-UK relationship. Nevertheless, it is not legally binding yet. The whole Withdrawal Agreement needs to be ratified by the EU and the UK for the transition to be certain (presumably during the last quarter of the 2018): "*nothing is agreed until everything is agreed*"[17]. This means that the current pending issues need to be resolved. It is unclear how the Ireland situation can be solved in an acceptable way for both parties. Thus, even though the agreement on the transition is welcomed, there is still uncertainty over its practical implications.

The main source of uncertainty concerns the final shape of the EU-UK relationship, which is still far from certain. In this regard, the European Council approved the guidelines that will set the framework to define the future partnership with the UK, giving the Commission's negotiating team a mandate to start discussions on this issue[18]. The goal is to agree the broad lines of the future relationship by October 2018 in order to allow the legal processes and ratification to take place before the end of March 2019. Currently, the agreement would seek to cover (among other issues): trade in goods for all sectors, some sort of customs cooperation, a framework for voluntary cooperation on the regulatory front, and trade in services to allow for market access under host rules (but considering that the UK will not share a common regulatory and supervisory framework). Furthermore, it states that EU financial stability should be safeguarded, and that any agreement should respect its regulatory and supervisory standards.

[17] Michel Barnier, press statement following the latest round of Article 50 negotiations (19 March 2018).
[18] The guidelines were adopted by the European Council (Art.50) on 23 March 2018.

The guidelines recognise that the red lines set by the UK (controlling EU immigration, no ECJ jurisdiction, regulatory autonomy, independent trade policy) will limit the extent of the future relationship, since there should be a balance between rights and obligations (a third country cannot have the same rights as a member state with full obligations). However, if the UK modifies its position the conditions for the new relationship will evolve accordingly.

All these factors (coupled with the short period of time available to negotiate any agreement) seem to complicate the negotiations on the future partnership. The UK's red lines (such as the control of immigration, or freedom to deviate from EU's regulation) conflict with its desire to include financial services in the new relationship, as the EU has repeatedly stated: "*no 'cherry picking' through participation in the Single Market based on a sector-by-sector approach*"[19]. Unless some of the positions are relaxed, it will be hard to reach an agreement in time to implement after the transition (considering that the Withdrawal Agreement is effectively signed).

There is still a great deal of uncertainty regarding what the final outcome will be, particularly for financial services. It is very likely that a potential agreement will fall short of the passport for financial services from which UK firms (and EU firms as well) currently benefit. This will have adverse consequences, particularly for UK-based agents, but also for EU-based agents, which rely on the passport to do business.

Time to revise the equivalence regime?

Considering the uncertainty surrounding the outcome of the negotiations, and the fact that following Brexit the UK will be a third country with no passport for financial services, an alternative to temper the negative consequences and dissipate some uncertainty could be the equivalence regime (a system that recognizes the third country's regulatory and supervisory framework as equivalent, granting a series of advantages, and in some cases market access). But this is not a long term solution: not only it is a piecemeal approach, but it does not provide certainty in the long run as it can be withdrawn at any moment. Additionally, the approach to granting equivalence could be deemed as too rigid. Finally, this alternative could mean that an important proportion of EU business is supervised by foreign authorities, which could imply an excessive reliance on the third country framework.

Some voices have argued for "*broad global standards of equivalence*"[20] to relax the rigidity of the regime. A broader approach to assess whether the regulatory/supervisory framework of a third country is equivalent could be a step in the right direction if done properly. Nevertheless, although this is a very valuable idea on its own merits, any potential revision of the equivalence framework to provide for more clarity should not be limited to dealing with the threats posed by Brexit, but it should help to tackle current existing issues with all geographies. Such a revision should seek to benefit EU financial stability and go beyond market access issues.

[19] European Council (Art. 50) guidelines on the framework for the future EU-UK relationship, 23 March 2018.
[20] Andrew Bailey speech at the Economic Council Financial Markets Policy Conference (Jan 2017), "Free trade in financial services and global regulatory standards: friends not rivals".

4. On the way to a common low-risk asset for the euro zone?

Pilar Soler

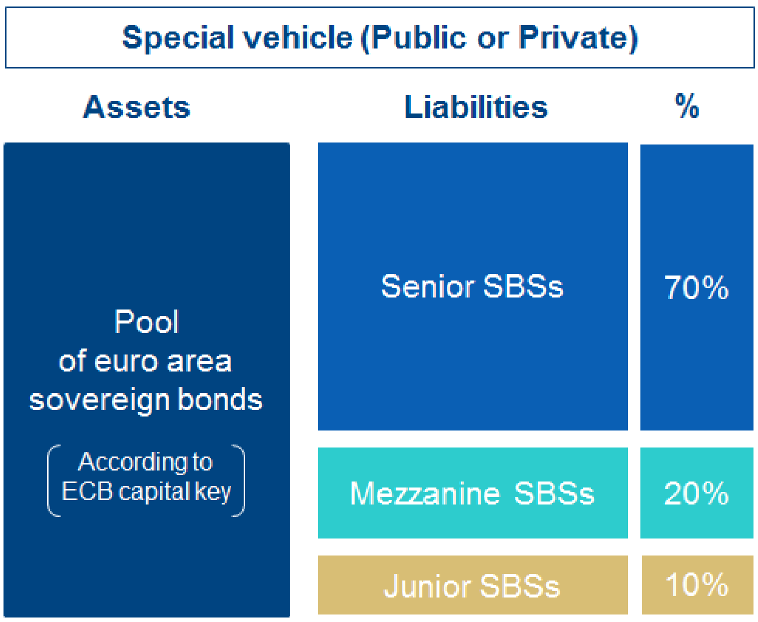
The idea of a euro-denominated low-risk security has emerged from the academic field and is now being analysed from a regulatory point of view. After several months of work, the ESRB's High Level Task force on safe assets has released a feasibility study on Sovereign Bond-Backed Securities (SBBS), and the European Commission has expressed its intention to introduce these new assets in the regulatory framework. Since the first academic proposal, SBBS have evolved, but uncertainty remains on important aspects of the proposal.

The idea of a euro-denominated low-risk asset was first introduced in 2016[21], with the so-called ESBies (European Safe Bonds). Since that first academic proposal, the idea of that euro-denominated common asset has evolved into Sovereign Bond-Backed Securities. SBBS are seen as a way of enhancing diversification in sovereign portfolios in the banking sector. The key feature of this kind of assets is that no mutualisation is needed, as each participating Member State remains responsible for the repayment of its bonds.

Sovereign Bond Backed Securities

Sovereign Bond-Backed Securities are defined by the ESRB as securities with different levels of seniority and which are backed by a diversified portfolio of euro-area sovereign bonds. SBBS would be structured as follows:

Figure 4.1 Overview of the structure of sovereign bond-backed securities



Source: BBVA Research based on ESRB report on Sovereign bond-backed securities

[21] Brunnermeier et al (2016):"ESBies: Safety in the tranches".

- The composition of the sovereign bond pool would be established according to the ECB capital key.
- The design of the structure would result in three different tranches of SBBS: i) a 70%-thick senior tranche, mainly targeted at banks, ii) a 20%-thick mezzanine tranche targeted at institutional investors, such as investment or pension funds and iii) a 10%-thick junior tranche, which would be the riskiest security. With this structure, the ESRB finds that senior SBBS would have expected and unexpected loss rates similar to those of German sovereign bonds.
- The creation of SBBS would be demand-led. SBBS would be issued only when investors demanded them. The ESRB is not clear about whether it should be a private of public issuer, and includes both possibilities.

European Commission

Last January the European Commission issued a roadmap for introducing SBBS in the current securitisation regulation. The Commission considers that this new kind of assets can help to enhance the Banking Union, but that they need a specific regulatory framework to be successful. With that aim, a legislative proposal was announced for the second quarter of 2018, with some specific measures considered necessary to boost the issuance of SBBS.

The amendments to the current securitisation framework would include:

- A definition of the concrete characteristics that a securitisation must comply with to be considered SBBS and consequently, to benefit from the specific regulatory treatment. The Commission considers that SBBS should be privately produced, something that the ESRB was not clear about (the report does not show a preference for a public or private issuer).
- A specific regulatory treatment for SBBS that takes into account the specificities of this kind of assets and that ensures consistent treatment of the SBBS and the underlying assets.

Assessment

- **The development of SBBS would present both significant benefits and important challenges**. On the one hand, SBBS could help to reduce systemic risk and financial fragmentation, strengthening financial stability and breaking the sovereign-bank loop. On the other hand, there are also significant challenges associated with the project. Political support for SBBS, which is key for their success, is not forthcoming at the moment, given the uncertain impacts that the issuance of SBBS could have on national sovereign bond markets.
- **We welcome the ESRB report and the clarification of some important aspects that were not clear in previous proposals**. Specifically, the composition of the sovereign-bond pool according to the ECB capital key, and the seniority structure of the issuance. Regarding this last point, we find it positive that the junior tranche is divided to include a mezzanine tranche, as this will act as an extra protection layer for holders of senior SBBS.
- **Nevertheless, there are other specific aspects of the proposal which are not yet clear.** For example, the ESRB report does not show a preference for a public or private issuer (although, in its roadmap, the Commission refers to privately produced SBBS). Finally, the demand for the most junior tranche is not clear, nor is its behaviour in times of stress, especially given that the issuance of the instrument is supposed to be demand-led.

5. Sustainability: the New Normal in Finance

Arturo Fraile

Sustainability has evolved from a reputational issue into a long-term macro-financial lever for stable economic growth. In economic terms, sustainability improves the aggregate social welfare function. The financial sector has a key role to play in this field, while markets need a clear, solid pathway. Supervision and regulation are helpful in designing a proper framework and an adequate incentives system.

Embedding sustainable finance into the core of the financial system

There has been a significant change of paradigm around sustainability. **From a reputational matter, it has evolved into a long-term macro-financial lever** for achieving (sustainable) economic growth. Indeed, it improves people's aggregate social welfare function. Two milestones are worth noting in the evolution of this concept: M. Carney's speech about *Breaking the tragedy of the horizon – climate change and financial stability*[22] (September 2015) and the signing of the Paris Agreement[23] (November 2016).

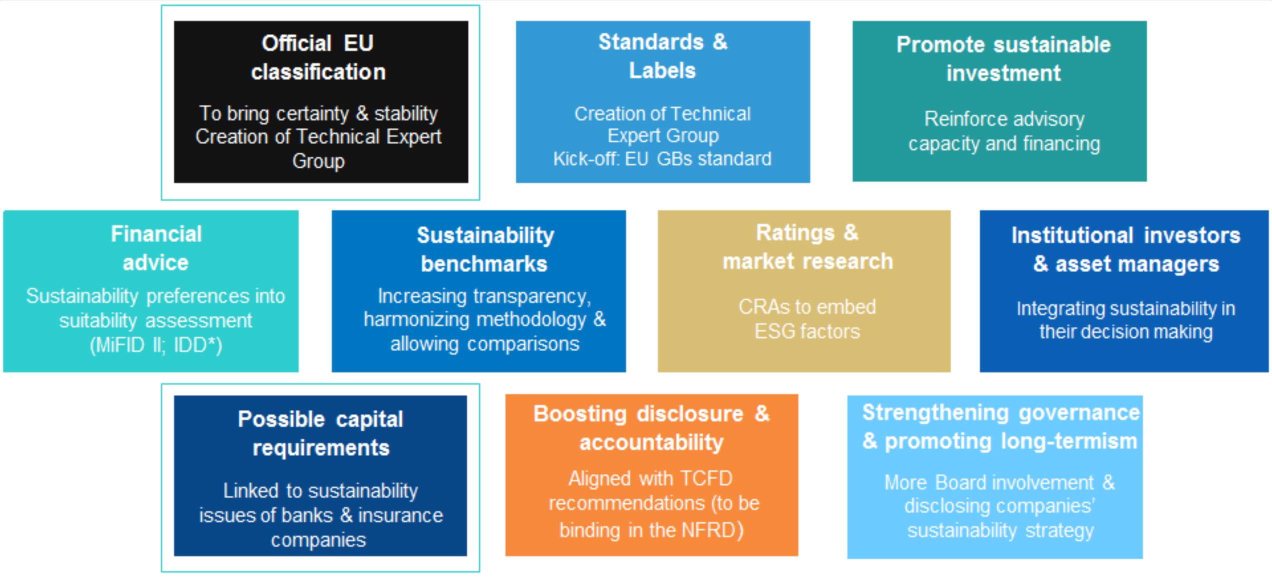
A strong commitment among all players should be highlighted. Financial markets, companies, investors, supervisors, regulators, standard setters, and international bodies are pulling in the same direction to fully integrate sustainability in their business as usual. Two relevant examples are the Inaugural Meeting of the Eight Central Banks and Supervisors Network for Greening the Financial System (NGFS) held on 24 January 2018, and the High-Level Conference (HLC) on Sustainable Finance for *Financing Sustainable Growth* held by the European Commission (EC) on 22 March 2018.

The NGFS is currently composed of eight institutions - Banco de México, Bank of England, Banque de France / Autorité de Contrôle Prudentiel et de Résolution (ACPR), De Nederlandsche Bank, Deutsche Bundesbank, Finansinspektionen (Swedish FSA), Monetary Authority of Singapore and the People's Bank of China. Broadly, their three main goals are creating a governance framework, bolstering experience sharing and identifying best practices on the supervisory and macro-financial dimensions of climate-related and environmental risks. Their next meeting focused on climate-risk management and supervision will be held on 6 April. It will analyse the role of supervisors and the European Supervisory Agencies will provide their respective views.

The HLC brought together a representative sample of the most prominent actors from both the private and the public sectors, who reaffirmed their irreversible commitment to sustainability. The need to do more and faster and *not to rest on our laurels* was emphasized. The key issues of the EC's Action Plan for Financing Sustainable Growth released on 8 March were also analysed:

[22] Once climate change has become a risk to financial stability it could be late to mitigate it.
[23] The 195 signatory countries made a legally binding commitment to hold growth in global average temperature to less than 2ºC above the levels of the pre-industrial age. It allowed for multiple speeds and obligations for emerging and developed countries subject to their capacities.

Figure 5.1 The 10 Priorities of the EC's Action Plan for 2018-2020



*Insurance Distribution Directive

Source: BBVA Research based on ESRB report on Sovereign bond-backed securities

More to be done: some of the main challenges

It seems to be the consensus that the financial sector is a key part of the solution to achieve long-term stable economic growth, and therefore in contributing to value creation for society. A challenge of the utmost importance would be progressively changing the current short-term behaviour of financial markets into a long-term perspective that includes environmental, social and governance (ESG) issues and is aligned with (financial) sustainability.

From a markets perspective, agents need a clear and a consistent pathway that includes financial long-term indicators and variables, jointly with forward-looking analytical tools. Those pointers and tools should include, as basics, (financial) metrics such as prices, expected returns, risks (market and credit risks), liquidity and uniformity of sustainable products and activity. Investors need to be able to measure and to add valuable information to their decision making. In a broad sense, price formation has to cover the costs and risks of climate change towards the internalization of the externalities[24]. In that vein, developing sustainable financial markets, and splitting them from non-sustainable ones could be useful for comparing their relative performances.

Jointly, supervision and regulation can be valuable by creating a solid and a crystal-clear common framework. It has to allow for long-term financial stability that includes a proper incentive system. That is, agents should pay a proper price for the risks they bring to the financial system; and investors should receive an adequate return associated with the (financial) risks they are taking. Sustainable investments need to be economically viable and positively correlated with (financial) profitability. In that vein, a consistent and a dynamic (over time) classification of sustainable products and activities is a necessary condition to generate data that enable performance measurement and comparison before including sustainable risks into prudential legislation.

[24] A clear example of that would be a sufficiently higher carbon price. Some experts are considering US$100 per metric ton of CO_2.

6. EU proposal for Covered Bonds: a challenge for the Spanish market

Victoria Santillana

In March, the European Commission published a proposed Directive and Regulation[25] on covered bonds, which will establish common definitions and standards for this product, and address prudential concerns. This package was expected by the market and in line with the EBA's best practices recommendations. With these new rules, the Commission aims to promote covered bond markets as a source of funding for banks, thereby increasing lending to the economy.

The Commission has taken a major step towards the Capital Markets Union (CMU) by promoting three proposals: (i) the initiative for an integrated covered bond framework; (ii) a regulation to facilitate cross-border distributions of collective investment funds, and (iii) a law applicable to cross-border transactions in claims and securities. These proposals will boost the cross-border market for investment funds, promote the EU market for covered bonds as a source of long-term financing and ensure greater certainty for investors in the context of cross-border transactions of securities and claims.

The covered bonds initiative has been broadly welcomed by the industry, thus recognizing the EU efforts to provide legal support to this market through a Directive of "principles", targeted at "harmonizing" and not at regulating prescriptively.

The proposed Directive (i) provides a common definition of covered bonds (replacing the current definition of the Undertakings for Collective Investment in Transferable Securities - UCITS), which will represent a consistent reference for prudential regulation purposes; (ii) defines the structural features of the instrument (dual recourse, high quality of the assets backing the covered bond, liquidity and transparency requirements, etc.); (iii) establishes the tasks and responsibilities for the supervision of covered bonds; and (iv) sets out the conditions to be fulfilled in order to use the "European Covered Bonds" label.

One of the main features is that the Directive incorporates the requirement of a cover pool liquidity buffer to address risks of liquidity shortage, estimated to cover the net liquidity outflows of the covered bond programme of the first 180 days (except for the first 30 days, which are covered by the LCR ratio). However, its monitoring remains an option for the Members States, which is at odds with preserving the EU level playing field.

The proposed Regulation also amends Article 129 of the Capital Requirements Regulation (CRR), hardening the conditions for granting a preferential capital treatment. Further requirements are included, like overcollateralization, soft LTV limits, grandfathering, and timing.

The Commission has launched an 8-week period to collect the views of the industry that finalizes on 16 of May, in parallel with the legislative process for adopting the proposal by the European Parliament and the Council. A rapid

[25] Proposal for a Directive of the European Parliament and of the Council on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EC and Directive 2014/59/EU and Regulation of the European Parliament and of the Council on amending Regulation (EU) No 575/2013 as regards exposures in the form of covered bonds.

“trilogue” process is expected, so that the Directive should be ready by early 2019, followed by a 12-month period for transposition into national legislation.

The main challenge for the future will be how to adopt this European legal framework in the national jurisdictions, a process that will necessarily involve rethinking the Spanish framework of ‘cédulas hipotecarias’. In any event, close attention should be paid to the European legislative process, since new rules could harm Spanish covered bonds.

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Main regulatory actions around the world over the last months

	Recent issues	Upcoming issues
GLOBAL	**On Jan 2,** FSB published governance arrangements and implementation plan for the UTI. **On Jan 5,** IOSCO issued statement on Matters to consider in the use of financial benchmarks. **On Jan 16,** FSB issued fourth annual report**.** **On Jan 18,** IOSCO issued communication on concerns related to ICOs. **On Feb 1,** IOSCO issued recommendation to improve liquidity risk management for investment funds. **On Feb 13,** IOSCO consulted on measures to protect investors of OTC leveraged products. **On Feb 19,** BCBS published Sound practices: implications of Fintech for banks. **On Feb 21,** IOSCO consulted on guidance to address conflict of interest in the equity capital raising process. **On Feb 27,** BCBS consulted on Pillar 3 disclosure requirements. **On Mar 5,** FSB published Securities Financing Transactions: Reporting guidelines. **On Mar 5,** FSB published Global Shadow Banking monitoring report. **On Mar 6,** BCBS published Basel III monitoring report. **On Mar 7,** IOSCO consulted to help trading venues (TV) manage extreme volatility. **On Mar 9,** FSB published Supplementary Guidance on Sound Compensation Practices. **On Mar 12,** BCBS published Regulatory Consistency Assessment Programme (RCAP) handbook. **On Mar 16,** FSB published reports on correspondent banking & recommendations on remittances. **On Mar 22,** BCBS consulted on market risk capital requirements. **On Mar 22,** BCBS consulted on Pillar 3 requirements technical amendment.	
EUROPE	**On 4 Jan,** ECB has published a recommendation on dividend distribution policies. **On 9 Jan,** ESMA published a public register of those derivative contracts that are subject to the trading obligation under MiFIR. **On 12 Jan,** EBA published guidelines on disclosure requirements of IFRS 9 transitional arrangements. **On 23 Jan,** EU Council updated the list of non-cooperative jurisdictions for tax purposes. **On 23 Jan,** European Commission (EC) published an inception impact assessment on enabling a regulatory framework for the development of sovereign bond-backed securities. **On 24 Jan,** EC published a draft Delegated Act amending Delegated Regulation (EU) 2015/61 on the Liquidity Coverage Ratio (LCR). **On 24 Jan,** EC adopted a delegated regulation setting out RTS for procedures for excluding transactions with non-financial counterparties established in a third country from the own funds requirements for credit valuation adjustment (CVA) risk under the Capital Requirements Regulation (CRR). **On 29 Jan,** EU Council adopted supplementing negotiating directives on the transition period following Brexit. **On 31 Jan,** EC published the final report of the High Level Expert Group on Sustainable Finance. **On 31 Jan,** European Parliament (EP) - ECON published its report on the proposal for a regulation on a framework for the recovery and resolution of CCPs. **On 2 Feb**, PE - ECON published a draft own-initiative report on sustainable finance. **On 5 Feb**, ESMA published updated Q&As regarding the implementation of the Benchmarks Regulation (BMR). **On 5 Feb**, ESMA has issued an update of its Q&A on the EMIR. **On 6 Feb**, ESMA issued final ITS on the application of Market Abuse Regulation. **On 6 Feb**, ESMA published an update of Q&As regarding the implementation of the Central Securities Depository Regulation (CSDR). **On 6 Feb**, Official Journal publication: Commission Delegated Regulation (EU) 2018/171, which sets out RTS on the conditions for setting the materiality threshold for credit obligations past due for the purposes of identifying a default under the CRR. **On 7 Feb**, ESMA updated Q&A on transparency issues under MiFID II and MiFIR. **On 7 Feb**, ESMA issued final guidelines on the management of conflict of interests for CCPs. **On 20 Feb**, EU Council Presidency has published compromise texts on the legislative proposals forming the banking reform package: BRRD, SRMR, CRR2 and CRD 5. **On 27 Feb**, Official Journal publication: Commission Implementing Regulation (2018/292) on ITS with regard to exchange of information and assistance between competent authorities under the Market Abuse Regulation. **On 1 Mar**, EC adopted non-legislative resolution on its Banking Union annual report for 2017.	

On 2 Mar, Official Journal published: Commission Implementing Regulation (2018/308) laying down ITS with regard to formats, templates and definitions for the identification and transmission of information by resolution authorities to the EBA on MREL under the BRRD.
On 6 Mar, EBA CRDIV-CRR/Basel III monitoring exercise shows further improvement of EU banks capital leverage and liquidity ratios.
On 8 Mar, EBA launched consultation on how to manage non-performing exposures.
On 8 Mar, EC published an action plan on financing sustainable growth as part of the Capital Markets Union (CMU).
On 8 Mar, EC published the Fintech action plan.
On 12 Mar, EC adopted proposal for a directive on covered bonds, laying down the conditions that these bonds have to respect in order to be recognised under EU law.
On 12 Mar, EC adopted legislative proposals for a regulation and a directive on the cross-border distribution of investment funds as part of the CMU action plan.
On 12 Mar, EC adopted a proposal for a regulation on the law applicable to the third-party effects of assignments of claims, which is part of the CMU action plan.
On 13 Mar, Official Journal published: Commission Delegated Regulation (EU) 2018/389 setting out RTS for strong customer authentication and common and secure open standards of communication.
On 13 Mar, EU Council reached agreement on a proposal intended to strengthen tax transparency to combat aggressive cross-border tax planning.
On 14 Mar, EC adopted a Delegated Regulation supplementing the CRR with regard to the specification of the assessment methodology under which competent authorities permit institutions to use Advanced Measurement Approaches for operational risk.
On 14 Mar, EC published its second progress report on the reduction of NPLs.
On 14 Mar, EC adopted two legislative proposals, a Directive and a Regulation, intended to create an EU-wide legal framework to encourage the resolution of NPLs.
On 14 Mar, EBA advised European Commission on the use of prudential backstops to prevent the building up of new NPLs.
On 15 Mar, EBA published its Roadmap on FinTech.
On 15 Mar, The Joint Committee of the ESAs has published its final report on Big Data analysing its impact on consumers and financial firms.
On 15 Mar, ECB published an addendum to its guidance to banks on NPLs.
On 16 Mar, ECB published a supervisory manual on the organisational set-up of the Single Supervisory Mechanism (SSM).
On 16 Mar, EC published a consultation paper on the finalisation of Basel III, which considers the amendments to current banking regulations required, in particular to the CRR, following implementation of this agreement.
On 19 Mar, Official Journal published: Directive (EU) 2018/411, which postpones the transposition and application dates of the Insurance Distribution Directive (IDD).
On 21 Mar, EC issued proposals on the way digital business activities are taxed.
On 22 Mar, EBA updated list of public sector entities for the calculation of capital requirements.
On 23 Mar, Official Journal published: Commission Delegated Regulation (EU) 2018/480 with regard to RTS on financial derivative instruments solely serving hedging purposes, sufficient length for the life of the European long-term investment funds (ELTIFs).
On 23 Mar, ESMA updated its Q&A on investor protection and intermediaries' topics under MiFID2 and MiFIR.
On 23 Mar, ESMA updated its Q&A on the Market Abuse Regulation.
On 23 Mar, ESMA published updated Q&As regarding the implementation of the Benchmarks Regulation.
On 23 Mar, ESMA published updated Q&A on the implementation of the Central Securities Depositories Regulation (CSDR).
On 23 Mar, ESMA published its guidelines for position calculations in derivatives by trade repositories (TRs) under EMIR, with regard to the time of calculations, the scope of the data used in calculations and the calculation methodologies.
On 27 Mar, ESMA updated Q&As on commodity derivatives topics under MiFID2/MiFIR.
On 28 Mar, EC published proposal for a regulation amending Regulation (EC) No 924/2009 as regards certain charges on cross-border payments in the EU and currency conversion charges.
On 28 Mar, ESMA updated Q&As on market structures and transparency topics under MiFID2 and MiFIR.

MEXICO	**On 27 Dec 2017,** CNBV suppressed restriction to locally-unlisted banks that placed a 400 million UDIs limit on capital instrument recognition. Now eligible capital instruments can be included as AT 1 if they do not exceed 50% of CET 1 as a whole. It includes additional provisions for Tier 1 and Tier 2 recognition. **On 22 Jan,** CNBV adjusted floors and ceilings of the operational risk capital requirements transitional regime for "small banks" (average monthly loan portfolio below 30 billion UDIS, i.e. € 7,8 billion approximately). **On 9 Mar,** Fintech Law passed. It creates two types of Fintech Institutions (crowd funders and e-money issuers), introduces virtual assets, mandatory API use, and regulatory sandboxes for financial institutions and start-ups.	Wide-ranging secondary regulation of the Fintech Law: prudential and accounting standards, financial reporting, auditing, capital requirements, risk disclosure, virtual asset requirements, API standards, sandbox rules, etc.
LATAM	**Argentina:** **On Jan,** creation of 7 day Central Bank bills (LELIQ) exclusively for banks, to be issued and traded daily, which can be used in Repo operations. **On Feb,** change in capital requirements, public sector financing, risk breakdown, foreign currency position, etc. due to IFRS regulations. **Brazil:** **On Jan 25,** Monetary National Council approved resolution allowing micro-entrepreneurs to open and close banking accounts remotely, through electronic channels. **On Feb 22,** the Central Bank of Brazil opened a public consultation regarding the local application of IFRS9 accounting rules. **Colombia:** **Financial Regulation Unit**, released rules on Conglomerates Law regarding: capital, exposition limits, and exclusion of the conglomerate. Some gaps on the Basel III recommendations were seen in the decree on conglomerate's capital. **Peru:** **In Feb,** Central Bank cut reserve requirements in foreign currency (both average and marginal rates) from 38% to 37% (as of 1 March). **In Feb,** Central Bank modified the way to set the limits after which lending in foreign currency is subject to additional reserves requirements. **In Mar**, the Central Bank cut again the reserve requirements in foreign currency from 37% to 36% (1 April). **Central Bank** raised the limit of private pension funds' holdings in foreign assets from 46% to 48% (as of 1 May).	
USA	**On 4 Jan,** FRB requested comments on proposed guidance to clarify the supervisory expectations on risk management for large financial institutions. **On 12 Jan**, FRB announced it has finalized a rule adjusting the Board's maximum civil money penalties. **On 29 Jan**, regulatory agencies completed assessment of resolution plans of 19 foreign-based banks. **On 25 Jan**, CFPB finalized changes to prepaid accounts rule. **On 2 Feb**, FRB released scenarios for 2018 Comprehensive Capital Analysis and Review (CCAR) and Dodd-Frank Act stress test exercises, and issued instructions to firms participating in CCAR. **On 5 Feb**, regulatory agencies sought comments on proposed amendments to swap margin rule. **On 21 Feb**, Department of the Treasury released Report To The President On Orderly Liquidation Authority. **On 6 Mar**, FRB requested comments on amendments to simplify Regulation J and make it conform more closely with Regulation CC. **On 14 Mar**, Senate passed the Economic Growth, Regulatory Relief, and Consumer Protection Act that contains measures providing regulatory relief to smaller financial institutions. The bill has to be reconciled with a version already passed in the House. The reconciled version would have to be passed by both chambers and signed by the president.	Issuance of a rule by federal banking agencies to exempt commercial real estate transactions of $500,000 or less from appraisal requirements. Reconciliation of Senate and House versions of the Economic Growth, Regulatory Relief, and Consumer Protection Act. Pick-up in activities for modernization of the Community Reinvestment Act.

TURKEY	**CGF,** raises limits on loans so there will be additional limit of TL 55 Bn. in CGF loans for the sector. With the repayments of CGF loans amounting ~ TL 90 Bn, CGF may provide TL130 Bn-TL140 Bn collateral to the sector in 2018. New limits started to be used on February. **Official Gazette** publishes amendments so that loans with a total size of less than USD15 Mn. will not be provided to companies that do not have FX revenues with some exemptions. **BRSA**, issued regulation change on Regulatory Capital and Calculation of Risk Weighted Assets. From 2020 Stage 1 and Stage 2 provisions will be deducted from exposure and will not be included under Tier II capital.
ASIA	**On 2 Jan**, PBoC raised the RRR of Third-Party Payment institutions to 50% from the current 20%. **On 3 Jan**, PBoC, CBRC, CSRC and CIRC banned the practice of using other institutions' accounts to participate in bond trading to avoid regulatory arbitrage and putting limits on repo and reverse repo business for financial institutions. **On 5 Jan**, CBRC stipulated bank's maximum exposure for a single client: outstanding loan<=10% of total capital etc. **On 5 Jan**, CBRC clamped down on connected transactions between commercial banks and their major shareholders. **On 6 Jan**, CBRC clamped down irregularities of entrust loan business (company-to-company loan with a bank as the monitor). **On 27 Feb**, PBoC encouraged banks to issue CoCos to supplement capital ahead of tighter international regulatory standards of TLAC (from 1 Jan 2019). **On 28 Feb**, CBRC eased rules requiring lenders to set aside provisions against losses on bad loans: reduced minimum NPL coverage ratio from 150% to 120%,and reduced minimum LLR cover of total loans from 2.5% to 1.5%. **On 22 Mar**, China proposed to merge its banking and insurance regulator in a move to plug regulatory loopholes that enabled risky forms of shadow banking.

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