BBVA Research

Financial Regulation Outlook

Third Quarter 2018

Regulation Unit

Creating Opportunities

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Index

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1. Finalisation of Basel III: what comes next?

Pilar Soler

With the finalisation of the Basel III framework, global regulatory reform is almost finished, or at least its design phase is. The focus is now on implementation. All major jurisdictions have been clear in their commitment to implementing the latest Basel standards, which are due in 2022, except for the output floor which includes a phase-in until 2027. The European Union is already starting to work on the implementation of the new standards and a legislative proposal can be expected for 1H2020.

The finalisation of the Basel III framework last December is a milestone in global regulatory reform, as it means the beginning of the end, at least in terms of design. Now comes the time for implementation, and major jurisdictions have declared their willingness. This is especially important given that during the last few months doubts have arisen regarding some countries' commitment to global standards, amid strategies that seemed to follow the path of deregulation, for example in the US. A consistent application (both in time and in content) of globally-agreed rules is of the utmost importance to ensure a level playing field between banks and jurisdictions.

Implementation in the European Union

Last February, the European Commission consulted on the main issues of concern for the industry and shortly afterwards issued a call for advice to the EBA in order to conduct an impact assessment. After that, a legislative proposal will follow, with the aim of meeting the January 2022 deadline envisaged by the Basel Committee.

Chart 1.1 Next steps for the implementation of the BIS III framework

Source: BBVA Research

As in every transposition of international standards, the European Commission always seeks to achieve a balance between avoiding deviations from the global agreed rules and respecting the features and specificities of the European financial and banking sector and the real economy. Accordingly, the impact assessment will cover a broad representation of the EU banking sector, including specific business models and small entities. The EBA will try to leverage as much as possible on the Basel III monitoring exercise, but that will not be sufficient to cover the wide range of entities that are intended to take part in the exercise.

The exercise will cover nearly all the new standards published, namely: i) new standardised approach for credit risk, ii) internal models approach for credit risk, iii) new operational risk framework, iv) new Credit Value Adjustment for counterparty credit risk framework and v) output floor. It will not include the targeted changes made to the leverage ratio or the G-SIB add-on, as they are already being implemented through the banking package. It is also envisaged that this report will include an assessment of the Fundamental Review of the Trading Book (FRTB), which is still partly being discussed in Basel.

After this exercise, the European Commission will start to prepare for the legislative proposal. This text can be expected for the first half of 2020 and will have to follow the ordinary legislative process. The final text is likely to include a specific implementation period to allow institutions to adapt to the new rules.

BBVA Research assessment

- **We welcome the impact assessment by the EBA**. The implementation of the latest Basel standards will follow the finalisation of another major legislative text in the European Union, the so-called banking package. It is important then, not only to analyse the impact of the new rules but to put them into context with the recently implemented ones. Some of the novelties in the current review of the European regulatory framework come from the Commission's call for evidence, which sought to analyse the functioning of all the various rules combined.

- **Meeting deadlines can be challenging in the EU**. The EBA's report will not be ready until June 2019 and the legislative proposal is expected for 2020. This would leave only two years before implementation. In practice, the European legislative process can be lengthy and it is likely that the final rules will allow some extra time for entities to adapt to these new standards.

- **National implementation of international standards is always challenging because of national specificities**, but national regulators should keep an international perspective in mind when implementing global rules. Convergence in international financial regulation is key to ensuring a level playing field for entities in different jurisdictions and to avoiding potential extraterritorial effects of national rules.

2. Funding in resolution[1]

Javier García

Both the industry and the authorities agree that one of the most pressing issues that needs an urgent solution is the lack of a clear funding in resolution mechanism in the Euro Zone. One idea for establishing such a mechanism could be for the European Central Bank, backed by guarantees from the Single Resolution Fund, to assume responsibility for providing liquidity for a bank in resolution.

The new resolution regime enshrined in the Bank Recovery and Resolution Directive (BRRD), which requires losses to be absorbed by creditors instead of taxpayers, is incompatible with the "constructive ambiguity" that has traditionally imbued the framework of Lender Of Last Resort (LOLR)[2]. Indeed, the new resolution regime revolves around the idea of recapitalizing a bank by means of a number of tools, prominent among which is the bail-in. However, the need to also ensure enough liquidity to guarantee a smooth and successful resolution process has been neglected so far. Investors, banks, authorities and the public in general demand clarity and a uniform European regime. No matter how much planning is carried out on an ex-ante basis through recovery and resolution plans, a credible public backstop providing liquidity in resolution is needed, as recommended by the FSB[3].

Why is a clear framework for funding in resolution necessary?

The provision of liquidity is crucial for the success of a bank resolution process. Even if a bank is well recapitalised after the implementation of a resolution tool (bail-in, bridge bank or asset separation tool) and can continue operating, it still needs liquidity to pay its debts as they fall due. A lack of liquidity could ultimately lead the bank into a bankruptcy process. The ensuing liquidation of assets and the discontinuation of critical services could put at risk the financial stability of a country, which is exactly what the new resolution regime seeks to avoid.

Currently, in the Euro Zone there is no clarity on the provision of funding to a bank in resolution, and no credible public sector backstop, contrary to what is recommended by the FSB. This is not the case in other jurisdictions such as the **UK, USA or Canada where clear frameworks for the provision of liquidity are in place.**

The link between ELA and funding in resolution

Another aspect that is often overlooked and that should also be clarified is the link between funding in resolution and funding before resolution. In most cases, before reaching resolution, a bank has a considerable exposure vis-à-vis central banks, through regular monetary operations in normal times, and through LOLR facilities such as Emergency Liquidity Assistance (ELA) when market-based funding dries up or there is a bank run. The establishment of a funding in resolution mechanism needs to take into account this connection and must clarify the role of the central bank before and during resolution. Indeed, both frameworks have been discussed so far as if they were totally separate, due to the fact that in theory ELA is for banks with a liquidity problem, and funding in resolution is for banks with a solvency problem. But this distinction is artificial for several reasons:

- **Most banking crises lie in a grey area between liquidity and solvency problems**. When the authorities take a decision on whether or not to intervene they normally do not have full information about the solvency situation. Very often the trigger for intervention is a liquidity problem, as the bank loses access to funding when rumours of solvency problems spread.

1: A more detailed note can be found here
2: The lender of last resort function is a concept developed in the 19th century (Bagehot dictum) and is one of the crucial roles assumed by central banks in order to protect financial stability.
3: Guiding principles on the temporary funding needed to support the orderly resolution of a global systemically important bank ("G-SIB"). 2016. FSB.

- Very **often, when a bank enters resolution it has significant positions in ELA vis-à-vis the central bank**. In these situations, the first problem of funding in resolution is not who should lend ex novo to the entity in resolution and how, but how to renew the existing ELA positions to maintain market confidence during the delicate period immediately after resolution, so as to recover market access as soon as possible. This transition is complicated by the fact that most central banks are prohibited from lending to insolvent banks[4].

- In a liquidity crisis it is crucial to have sufficient ammunition to stop a speculative attack or a bank run. The **central bank is the only institution with this firepower**. Even though the institution in charge of funding in resolution is not usually the central bank, the central bank acts as a backstop. In this regard, again, the Euro Zone is an exception due to its peculiar institutional configuration.

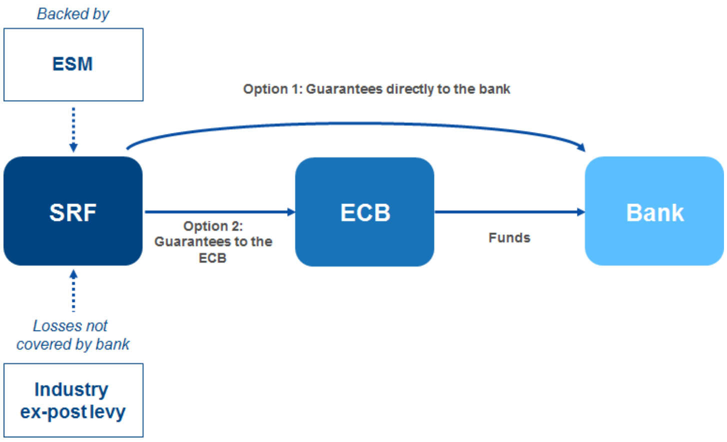
Some ideas for setting a funding in resolution mechanism in the Euro Zone

A mechanism could be designed where ECB's liquidity support, which is necessarily temporary, is gradually taken over by the institution responsible for resolution **(the Single Resolution Board, SRB, which manages the Single Resolution Fund, SRF, with support from the European Stability Mechanism, ESM)** until the entity regains access to the markets. The **central bank could continue providing the funds** because it is the most appropriate institution to commit potentially large amounts of money in a timely matter. However, **the risk could be assumed by the SRF by providing guarantees either i) directly to the bank (which could use them as collateral against funds from the central bank) or ii) to the central bank**. Consequently, the **central bank would not be exposed to losses and would act merely as a provider of funds**. This could also solve the problem of the bank not being able to access ELA because it has run out of eligible collateral, which is very likely to happen during a resolution process. The central bank would have absolute discretion to decide when to provide the funds, how much is necessary, and for how long.

The mechanism would be fiscally neutral because the SRF has access to **ex-post contributions from the financial sector** if the entity in resolution is unable to reimburse its funding. The ultimate losses would be absorbed by the private sector, thereby respecting the main principle of the resolution framework: to put an end to bailouts. However, the ex-post contributions should be calibrated in a flexible manner to avoid excessive pro-cyclical effects.

In order to minimise the possible losses, any funding from this mechanism could have a **"super priority"** in the creditor hierarchy of national insolvency regimes. However, the benefits of super priority funding should be measured against its possible unintended consequences in terms of accelerating bank runs. Indeed, other creditors might be encouraged to run before any funding in resolution with super priority is granted, in order to avoid being subordinated in the creditor hierarchy (which would reduce the probability of their being repaid).

Figure 2.1 An idea for a funding in resolution mechanism



Source: BBVA Research

4: This is certainly the case of the ECB, although some flexibility has been introduced recently with the ELA framework.

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3. Regulation is coming: pending issues

Ana Rubio

The regulatory reform that started with the international financial crisis is well advanced, and in fact we are entering the implementation phase. However, some important pieces of regulation are still pending. We welcome advances made towards finishing the regulatory reform. Now it is crucial to move forward with the implementation phase, the impact assessment of the new regulation, and the completion of the European financial architecture.

We are entering a new phase of the regulatory tsunami

Ten years after the start of the international financial crisis, the design phase of the regulatory tsunami has almost finished. We have started the implementation phase, and the debate has become more detailed and more European. Regarding implementation, it is crucial to ensure the convergence of national financial regulations in order to ensure a level playing field for entities in different jurisdictions and to avoid extraterritorial effects of national rules. However, there are still important regulatory packages to be finalized, tested and implemented. In particular in Europe, the end of the Bulgarian presidency and the changes in the Parliament and the Commission seem to be speeding up the process, which is mainly composed of three blocks: prudential issues, capital markets, and the banking union.

Prudential regulation is fundamental, but has taken a long time

Regarding **prudential regulation**, the process has been much longer than expected, but we seem to be entering the delivery phase. In fact, the finalisation of Basel III will not come until its impact analysis is finished by mid-2019 and the final Commission text is published in 2020, while the final CRR-CRD V text is expected for end-2018, with a two-year implementation period.

This final CRD V text will include some measures regarding **resolution**, which are currently under discussion. In this regard, the revision of the Banking Recovery and Resolution Directive (BRRD III) is expected for year-end, as the BRRD I has a revision clause due in December 2018. There is still one missing piece in the process, which is funding in resolution, so the market expects a mechanism to solve this problem during 2018.

Finally, the CRR-CRD package includes **macroprudential** measures, such as the revision of the caps of some buffers and a new methodology to calculate how systemic banks are on a global level (G-SIBs).

The Capital Markets Union is an ambitious project, likely to be delayed

The **Capital Markets Union** project, which was launched in 2015, is due for 2019, although that deadline seems to be too ambitious.

In this framework, the Regulation on Simple, Transparent and Standardised (STS) securitisations will enter into force in 2019, in an attempt to revitalise the market, while a significant amount of level 2 legislation is still pending.

In the same vein, a Directive and a Regulation on Covered Bonds are on their way to try to standardise this significant source of long-term finance throughout the EU. The proposal will be discussed by the European Parliament and the Council. Once adopted, an implementation period of 12 months is envisaged before the new regime starts to apply.

The Banking Union is advanced, but not yet completed

There is more uncertainty on the changes expected in the **European institutional architecture.** In this month's European summits there could be limited advances regarding the backstop to the Single Resolution Fund and in the European Deposit Insurance Scheme (EDIS), thus coming very slightly closer to the finalisation of the Banking Union. However, uncertainty on the final outcome is high, as some countries are in favour of more risk reduction (mainly in terms of non-performing loans) before any advance in risk sharing (particularly on EDIS). At the same time, the current framework is being adjusted, as the powers of the **European Supervisory Authorities** are under review.

BBVA Research assessment

- **We welcome advances made towards completing regulatory reform**. A decade after the start of the crisis it is now time to close this chapter and finish the big lines of the new regulation. Banks need certainty on the rules to be applied to them, so that they can focus on their business and on supporting the economic recovery.

- **Starting the implementation phase and measuring the impact of new regulation is crucial.** Major international authorities are adapting their priorities to focus on implementation, supervision and impact assessment. Once we have measured the impact of the new rules and the interaction among them it may be necessary to make some adjustments.

- **The new regulatory framework should be implemented uniformly in the various countries.** In a globalised world, in particular after the entry of digital banking businesses, a global level playing field has to be pursued. Having said that, the simpler and more principles-based global standards are, the easier it will be to implement them without generating conflicts with national regulation.

4. New STS securitisations in Europe

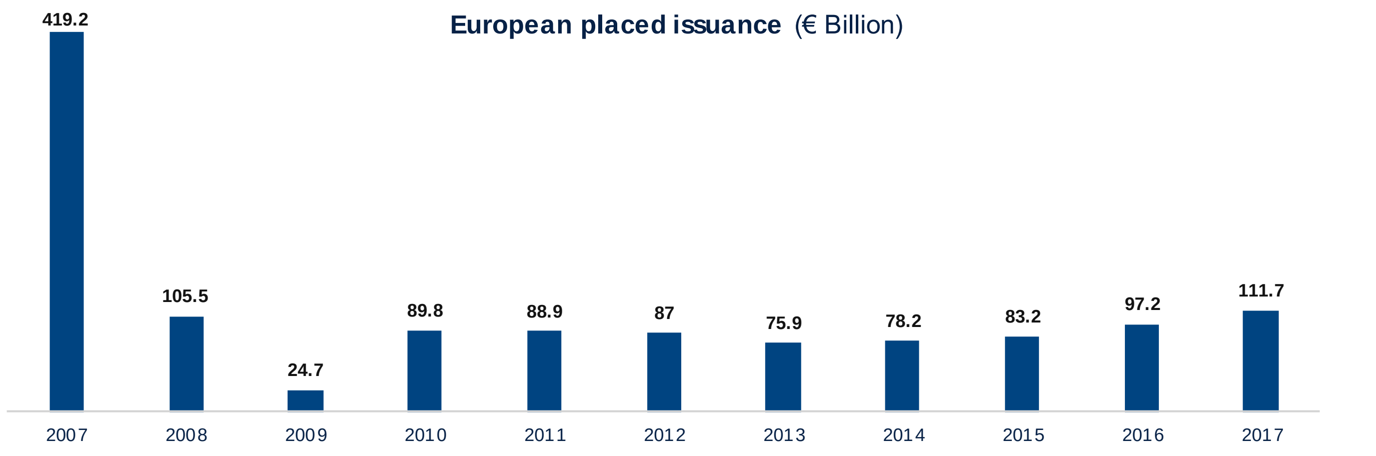
Javier Garcia, Álvaro Romero

The development of a Simple, Transparent and Standardised (STS) securitisation market seeks to restart high quality securitisations, without repeating the mistakes made before the financial crisis. The essential point of this regulation is to create a "simple, transparent and standardised" label to promote this market, improving transparency, and restoring the reputation of this instrument. It will have the potential to generate additional funding, and allow banks to diversify risks.

STS Regulation

This proposal was launched in September 2015, when the European Commission proposed new rules on securitisations as a component of the Capital Markets Union (CMU) Action Plan. The idea of the Commission was to revive the securitisation market, which has not yet recovered from the financial crisis (see chart 4.1). For this reason, the Commission proposed a European securitisation regulation and the corresponding amendments to the Capital Requirements Regulation (CRR).

Figure 4.1 Evolution of the securitisation market since the financial crisis



Source: AFME - Securitisation Data Snapshot 2018

The new regulation came into force on 1 January 2018, but banks and authorities have until 1 January 2019 to adapt to all the changes, and to consult on technical issues. Meanwhile during this transition year the EBA and ESMA will develop technical standards and guidelines to ensure a homogeneous application in the EU of the technical aspects of the new regime.

STS criteria and requirements

To be considered as STS, a securitisation will have to meet several criteria:

i) **Simplicity**: Only a securitisation in which the ownership of the underlying exposures is transferred or effectively assigned to an SSPE (Securitisation Special Purpose Entity) will be considered as STS. Securitised assets must be homogeneous. At the time of transfer into the SSPE, no loans should be in default or constitute exposures to credit-impaired obligors and at least one payment must have been made.

ii) **Transparency**: The Regulation requires certain information to be reported to repositories. Originators, sponsors and SSPEs must provide historical data on default and loss performance to investors. Originators and sponsors will be responsible for verifying that they comply with the new criteria and they must notify ESMA of all related information.

iii) **Standardised**: Templates issued by the originator, and the information disclosed must be standard and detailed to facilitate the task of the repositories and the due diligence of investors.

The third party verification is a new requirement of this regulation, which states that the role of the third party is to ensure and verify the compliance of the securitisation with the STS criteria. The third party cannot be a regulated institution or a credit rating agency (CRA), and it must not provide any form of advisory or equivalent services to the agents involved in the securitisation process.

Key aspects of the regulation

- Risk retention requirement remains at 5%, in line with the existing international standards[5].
- Creation of a securitisation data repository system to ensure market transparency. This repository will keep certain information that is needed to fulfil regulatory requirements (disclosures), it will verify completeness and consistency of the information received, and will be supervised by ESMA.
- STS certification process is the authorisation by third parties that verify compliance with STS securitisation requirements to prevent conflicts of interest.
- Ban on re-securitisation (securitisations backed by other securitised exposures).
- Grandfathering: Legacy securitisations will be grandfathered, so they will be eligible to use the STS designation after 1 January 2019.

Next steps

Authorities have been very active in consulting the industry on new regulation. In fact, the EBA issued consultations on risk retention and homogeneity of underlying exposures, and ESMA consultations on STS templates, disclosure and operational standards and third party verification servicers. The EBA has recently launched a consultation on STS criteria for ABCP (Asset-Backed Commercial Paper) and Non-ABCP, and last week the EBA also issued a consultation on K-IRB in relation to purchased receivables (capital charge of the underlying pool according to the IRB approach). More consultations are expected during this year, related to the cooperation between competent authorities and the ESAs, among others. Therefore, 2018 will probably be a busy year for the securitisation industry.

BBVA Research assessment

We welcome advances made towards improving the securitisations framework. A revamp of the market would be useful in terms of funding and of risk management for banks. However, given the limited size of the market and its reputational issues during the crisis, banks should be active in pursuing a diversified funding mix and an appropriate risk management framework per se.

5: See EBA/CP/2017/22 for further detail on the different approaches to calculate the retention requirement.

5. Strengthening the Banking Union

Victoria Santillana

European positions on the EMU are highly polarised. Some countries emphasise that there are no conditions for what they see as "enforced solidarity". On the other hand peripheral countries insist on the idea that completing the Banking Union should be a priority. On 28-28 June (Euro Summit) the Heads of State of the countries will discuss ways to improve the functioning of the euro area.

EDIS is the main challenge for a credible Banking Union

European countries are preparing June's Euro Summit discussions on the development of the Economic and Monetary Union (EMU), where they will try to reach agreement on the completion of the Banking Union and the future role of the European Stability Mechanism (ESM).

Currently there are highly polarised positions. Some countries do not want to advance further towards risk sharing without first making progress on risk reduction measures. Peripheral countries prioritise the completion of the Banking Union with a common backstop for the Single Resolution Fund (SRF) and the creation of a European Deposit Insurance Scheme (EDIS).

In a sort of halfway point in this debate, the Spanish Government published a position paper in April in favour of strengthening the EMU, aiming at agreeing by June the next steps to be taken in order to unblock the current legislative stoppage, and move ahead in the field of risk sharing.

The main priority highlighted in the **Spanish report is the need to advance in financial integration by completing the Banking Union** and the Capital Markets Union, as this greater economic union will pave the way for new fiscal instruments. The document stresses the need for the June Euro Summit to issue a clear mandate for scheduling the entry into force of a fully-fledged EDIS, fully mutualised and with a common backstop. This final date would be conditional on the EU institutions' assessing that no material non-provisioned exposures pre-dating the Banking Union remain on their balance sheets.

Spain also calls for a common fiscal backstop (for EDIS and the SRF) to strengthen its credibility by ensuring sufficient resources are available with (i) a size commensurate with the estimated needs of a potential systemic banking crisis in the Banking Union; and (ii) non-discretionary activation rules.

On the reform of the ESM, Spain believes it to be a key instrument in the euro area for preserving financial stability, requiring a strong mandate for crisis management that enables it: (1) to provide conditional financial assistance to Member States with impaired market access and, (2) to support the stability of the banking sector by providing the common backstop to the Banking Union and by increasing the flexibility of the Direct Bank Recapitalisation Instrument.

These last two measures (the backstop and the reform of the ESM) have been agreed between German Chancellor Angela Merkel and French President Emmanuel Macron, as first reported on 19 June, but the two sides failed to agree on the EDIS. They only remarked that the work on a roadmap for beginning political negotiations on EDIS could start after the European Council in June. An agreement between Berlin and Paris is not enough for a final pact in the whole European Union, but it could have an impact on the negotiations and delay the EDIS discussion for longer than previously expected. On the other hand the new Spanish finance minister appears to dial down Spain's ambitions for an Eurozone reform even more than the April report. Apparently the new Spanish Government sees the Franco-German roadmap as a good starting point for discussions.

BBVA Research assessment

- It is crucial to complete the Banking Union with an EDIS to avoid market fragmentation and reversal of the progress made. It is necessary to recognise how much progress has been made so far in risk reduction measures and to continue advancing in them (especially in the case of non-performing loans) in parallel with measures aimed at mutualising risks.

- There is still work to be done, as the EMU is an ongoing project that will continue during the next few years with the objective of making the euro area more robust. Nevertheless in the short term, the priority is completing the Banking Union and it is essential that next week in the June Summit, the Heads of State agree a concrete roadmap to develop the backstop to the resolution fund, the implementation of the EDIS and the redefinition of the role of the ESM.

6. Adapting the organisation to the digital era

Lucia Pacheco and Maria Villar Ochoa

Financial institutions are transforming their organisations in order to acquire the knowledge and skills to face the challenges of the digital era. This restructuring process should not be confined to financial institutions, but should also be undertaken by financial supervisors and regulators, as several financial authorities around the world have already acknowledged.

A challenge for banks and regulators alike

Over the past years, most industries have witnessed the effects of a digital revolution that has come fast and with an unprecedented reach, and the financial industry is no exception to this. This digital revolution has led many banks and other financial institutions to embark on a transformation journey to ensure that they remain competitive in facing these changes. This process of digital transformation implies not only the adaption of their IT and the widening of the range of products and services delivered to their customers, but also a significant effort to adapt their culture and their organisation. As the whole industry is being transformed, banks have realised the importance of creating a solid base of digital skills and professionals with the right capabilities and expertise. In fact, recent evidence shows that EU banks have increased recruitment of technology specialists more than tenfold in the past three years[6].

In this context of transformation of the financial services industry, it becomes evident that new skills are necessary not only for financial institutions but also for financial regulators and supervisors, as recognised by the Basel Committee[7]. As financial institutions rely on new enabling technologies and new business models spread across the industry, financial regulators and supervisors need to make similar efforts as private actors to make sure they have the relevant skill sets and approaches to regulation and supervision to keep up with the changes. As the digital revolution might give rise to new or evolving risks, regulators and supervisors relying on traditional knowledge and tools might not have any previous experience to call upon, and therefore might face difficulties in maintaining the same high standards of regulation and supervision.

Recognising these challenges, several regulatory and supervisory authorities around the world have already undergone some changes to adapt their internal organisations or have adopted targeted recruitment policies or training programmes for their staff. Those that have gone further in this endeavour have undertaken modifications in their structures, by setting up new dedicated departments or units within their institutions. In this regard, the UK's Financial Conduct Authority (FCA) can be seen as a pioneer in view of the launch in 2014 of Project Innovate, a new initiative within the Authority intended to serve as a driver of innovation in financial services, which resulted in the creation of the world's first financial regulatory sandbox in 2016. The FCA has endowed Project Innovate with a full team working on innovation across the different segments under the FCA's oversight. Authorities in other countries such as Singapore and Hong Kong have followed similar steps, incorporating Fintech Offices into their main regulatory bodies, serving as facilitators for innovation and leading to the creation of regulatory sandboxes. Furthermore, the Monetary Authority of Singapore has made a remarkable effort to upgrade the skills and broaden the fields of expertise of its staff. In Spain, the National Securities Market Commission (CNMV in the Spanish abbreviation) and Banco de España, the central bank, have respectively set up a sub-group and a general directorate to deal with innovation issues and cybersecurity. This has also been the case in Mexico, where the National Banking and Securities Commission (CNBV) announced in March 2018 that it was embarking on a process of organisational restructuring in response to the recently passed Fintech Law.

Although the number of regulatory bodies that acknowledge the need to undergo transformations such as the ones just described is undoubtedly growing, the broad majority of authorities are not yet there. Nevertheless, many authorities have instead opted for the creation of groups or initiatives to foster dialogue among national regulatory

6: According to an analysis carried out by LinkedIn between 2015 and 2018. For further information, please refer to: Megaw, N. (2018) Banks seek tech talent for digital shift, Financial Times.
7: Basel Committee on Banking Supervision (2018) Implications of Fintech developments for banks and bank supervisors

bodies, in order to facilitate the sharing of knowledge and information. For instance, the European Commission in late 2016 set up an internal task force on fintech, co-chaired by the general directorates responsible for the financial sector (DG FISMA) and the digital single market (DG CONNECT), and also bringing together experts from competition and consumer protection areas. Furthermore, these measures have often been accompanied by additional measures to create spaces for interaction between the private sector and the authorities. These spaces are intended to facilitate the mutual understanding of needs and concerns and to foster the identification of best practices and the understanding of the most recent developments. These types of forums have been established, in different forms and with varying degrees of reach, by authorities in Latin America (for instance in Mexico by the CNBV, in Colombia by the Superintendencia Financiera and in Brazil and Argentina by their respective Central Banks), in several European countries (for instance in Spain, through the CNMV and Banco de España; in the UK through the Financial Conduct Authority), and in Asia. Furthermore, at the European level both the European Commission and the European Banking Authority have recently announced the launch of forums of this kind (the EU Fintech Lab and the EU Knowledge Hub)[8], which intend to foster dialogue among national and European authorities, financial services providers and even technology vendors.

These steps to promote public-private dialogue and information sharing are much welcomed, as they might help improve the authorities' understanding of new technologies and business models. However, these steps should be accompanied by other actions on the part of regulators and supervisors to update the knowledge, skills and tools of their staff, either through training or a targeted recruitment policy. Furthermore, similarly to the steps already followed by financial institutions, supervisors and regulators, including at the European level, should consider adapting their organisational structures to incorporate digital experts.

8: See: Pacheco, L. 2018. A new roadmap for European FinTech: Have we gone far enough? BBVA Research Watch.

7. U.S. financial regulation: relief and recalibration

Matias Cabrera[9]

The U.S. has recently embarked on a path to ease its regulatory framework. The process includes not just a revision of certain rules by regulators, but also a major legislative change that provides relief for the industry. Overall, these changes are aimed at improving the framework and making it more efficient. Nevertheless, the process should respect global standards to preserve financial stability and the level playing field (within the U.S. and globally).

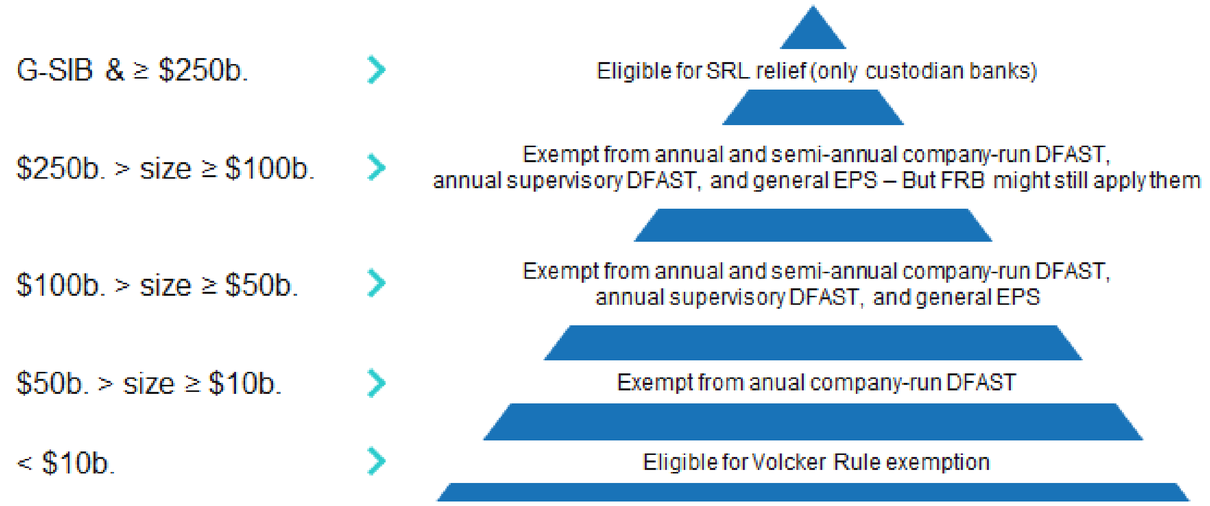
Legislative changes

In May 2018 the U.S. Congress passed a legislative Act (S.2155) that represents the first major step to ease the rules imposed after the financial crisis. It does not represent an overhaul of the Dodd-Frank Act, but rather a process to make the regulation more proportional and less burdensome.

Among many other changes, it increases the threshold of assets that determines which banks are subject to Enhanced Prudential Standards (EPS)[10]. Additionally, the proposal raises the threshold for mandatory stress tests (DFAST). The extent to which these changes affect foreign banks will depend on how the regulators interpret them, i.e. by measuring total assets on a global consolidated basis or only U.S. assets.

There are also changes to the leverage ratio (e.g. funds deposited in a central bank are excluded from the computation for the purpose of the supplementary leverage ratio *for custodial banks*) and to the Liquidity Coverage Ratio LCR (regarding the use of municipal bonds as high quality liquid assets). Additionally, the Act exempts banks with less than $10 billion in assets from the Volcker Rule. It also includes provisions regarding mortgage loans, relaxing some requirements for smaller and regional banks.

Figure 7.1 Senate Bill: How will these changes affect banks?



Source: BBVA Research

Note: the list of changes is not comprehensive, but rather to illustrate how these changes will affect banks depending on their size. There are many measures not considered here that will likely affect most of the banking sector.

9: I'm grateful for all the comments and suggestions from Filip Blazheski, Mike Carlson and Julián Sanchez. A more detailed version of the article can be found here.

10: Banks under this framework are subject, among other things, to contingent capital requirements, resolution planning and limits on credit granted to a single counterparty.

Regulatory changes

Regulatory agencies have been actively promoting a set of measures to simplify regulation as well. For instance, the FED proposed a simplification of capital rules by integrating them with the results from the stress tests. It would introduce a new risk-sensitive firm-specific "Stress Capital Buffer" (SCB) to replace the static capital conservation buffer. This SCB would include among other items the reduction in capital arising from the severely adverse scenario of the stress test for each specific bank. Additionally, the proposal seeks to relax some stringent requirements of the FED stress test.

In a different proposal, the FED jointly with the Office of the Comptroller of the Currency (OCC) seek to modify the enhanced supplementary leverage ratio that affects G-SIBs, by making it more risk sensitive. Currently the surcharge is a static figure, and the objective is to make it dependent on the corresponding bank's G-SIB surcharge (which varies from bank to bank depending on how systemic each bank is).

Finally, the Fed has released a proposal to amend the Volcker Rule[11]. The objective is to better tailor the compliance requirements that the rule implies. Particularly, it seeks to reduce the burden for banks with limited trading activities and to create presumptions of compliance for certain activities in certain banks.

BBVA Research Assessment

- **The reforms proposed in the U.S. seem to tackle the objective of better tailoring regulation.** The process, so far, does not imply a major overhaul of financial regulation, but rather an effort to make it less burdensome and more efficient. While there are changes that will provide relief to the whole industry (including the largest banks), the reform seems to make the framework more proportional, significantly reducing the burden for regional, smaller and mid-sized institutions.

- While the objective of improving regulation and making it more efficient is commendable, we should be **cautious with a process that dismantles the regulatory framework.** High standards should prevail, and global rules must be respected in order to preserve financial stability and a level playing field.

11: Any final change in Volcker needs the agreement of 5 regulatory agencies: FED, FDIC, OCC, CFTC and SEC.

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Main regulatory actions around the world over the last months

	Recent issues	Upcoming issues
GLOBAL	**On April 5,** IOSCO issues recommendations to improve transparency in corporate bond markets **On April 9**, CPMI-IOSCO issue guide to harmonise critical OTC derivatives data elements **On April 10,** CPMI-IOSCO issue guideline for CCP stress testing **On April 20,** FSB publishes toolkit to mitigate misconduct risk **On April 23**, BCBS publishes progress report on adoption of Basel regulatory framework **On April 26**, FSB issues consultation on unique product identifier (UPI) governance **On May 7**, FSB publicly consults on recommendations for compensation data reporting to address misconduct risk **On May 8**, CPMI issues finalised strategy to improve wholesale payments security **On May 14**, BCBS-IOSCO publish criteria for identification and standards for capital treatment for STC securitisations **On May 30**, IOSCO publishes report on the use of behavioural sciences and financial literacy. **On June 4**, FSB publishes a thematic peer review on bank resolution planning **On June 6**, FSB consults on implementation of TLAC standard	
EUROPE	**On April 10, the EC** adopted a Delegated Regulation amending and supplementing the Money Market Funds (MMF) Regulation in relation to simple, transparent and standardised (STS) securitisations and asset-backed commercial papers (ABCPs) **On April 4, the EP (ECON)** published a draft own-initiative report on relationships between the EU and third countries concerning financial services regulation and supervision **On April 11, the EP (ECON)** published its draft reports (I & II) on the legislative proposals to amend the current EU prudential rules for investment firms **On April 19, the EP** plenary has adopted the fifth Anti-Money Laundering Directive (AMLD5) following agreement in trilogue negotiations with the EU Council **On April 12, EU financial regulators** warn against risks for EU financial markets, Brexit, asset repricing and cyber-attacks key risks **On April 20, EBA** consulted on its guidelines interpreting the STS criteria in securitisation **On April 27, EBA** consulted on Guidelines on disclosure of non-performing and forborne exposures **On April 27, the ESAs** conclude a multilateral Memorandum of Understanding with the EFTA Surveillance Authority **On April 10, the ECB** has launched a consultation on draft cyber resilience oversight expectations (CROE) for financial market infrastructures (FMIs) O**n May 07, the EC** adopts RTS on criteria for appointment of central contact points for electronic money issuers and payment service providers (AMLD) **On May 24, EC** adopted legislative package and consults on MiFID2 and IDD sustainability requirements **On May 24, EC** adopted legislative proposal on SME financing **On May 24, EC** published a proposal for a regulation on sovereign bond-backed securities (SBBSs) **On May 29, EC** published legislative proposals on depositary safekeeping duties under AIFMD and UCITS Directive (29/05/2018) **On May 16, the EP (ECON)** published an own-initiative report on sustainable finance **On May 16, the EP (ECON)** has voted to adopt its draft reports on two proposals (I & II) for regulations to amend the European Market Infrastructure Regulation (EMIR) **On May 25, ECON** Committee publishes report on EMIR REFIT proposal **On May 25, ECON** Committee publishes report on CCP supervision proposal **On May 29, EP** adopts own-initiative resolution on sustainable finance **On May 14, EU Council** adopted fifth Anti-Money Laundering Directive (AMLD5) **On May 15, Presidency** published compromise text on proposed PEPP Regulation **On May 25, EU Council** reaches political agreement on the Banking reform package	

	On May 28, ESMA issued final guidelines on anti-procyclicality margin measures for central counterparties (CCPs) under the European Market Infrastructure Regulation (EMIR) **On May 30, EBA and ESMA** have published a joint statement encouraging institutions, market and resolution authorities to properly consider retail holders of debt financial instruments subject to the Bank Recovery and Resolution Directive (BRRD) when carrying out their respective tasks **On May 2, ECB** publishes EU framework for testing financial sector resilience to cyber attacks **On June 1, EC** adopted Delegated Regulation on regulatory capital requirements for STS securitisations held by insurance undertakings **On June 1, EBA** publishes final draft amending ITS on supervisory disclosure **On June 1, EU Council Presidency** published compromise texts on cross-border distribution of collective investment funds **On June 4, EU Official Journal** published extension to transitional periods related to own funds requirements for exposures to CCPs **On June 4, SRB** publishes critical functions policy **On June 6, ECB** publishes MoU with SRB on cooperation and information exchange **On June 12, EU Council Presidency** publishes progress report on Banking Unión **On June 14, EU Council Presidency** publishes compromise text on EMIR 2.2 **On June 15, EU Council Presidency** publishes final compromise texts on cross-border distribution of collective investment funds **On June 19, EU Official Journal** published AMLD5 **On June 19, EP (ECON)** agrees Risk Reduction Package (CRR2/CRD5/BRRD2/SRMR2) negotiating stance	
MEXICO	**On April 26 the CNBV** issued a new handbook for external audit which compiles all applicable regulations in a single document. **On May 11 the CNBV** recognised A.M. Best and DBRS as rating agencies in its banking handbook.	Regulations stemming from the Fintech Law published in March should be presented in the coming months. Although no tentative date exists, the rules are expected before the end of the current Federal Administration on December 1st. According to announcements made in November 2017, the IFRS 9 Methodology for banks is expected mid-2018.
LATAM	**Brazil - On April 24th the Central Bank of Brazil (BCB)** issued two resolutions to regulate and stimulate credit Fintechs. **Brazil - On April 24th the BCB** established a new regulation regarding cyber security policy. **Brazil - On May 7th the BCB** launched a virtual laboratory to foster technological innovation within the financial system. **Colombia - URF** released the decree that specifies the capital level of the financial conglomerates, and a draft decree to converger to Basel III in solvency of the Colombian financial system. **Colombia - The Financial Superintendence** published a new version of the liquidity risk indicator, introduced new requirements to manage the cybersecurity risk, and presented innovasfc, the supervisor's Fintech space (including Sandbox and regtech). **Peru - The Central Bank raised** the limit of private pension funds' holdings in foreign assets from 48% to 49% (as of July, 1st).	**Colombia: URF** will issue two decrees: on exposure limits and conflicts of interest in financial conglomerates, and the solvency required in the financial system.

USA	**On April 2, Federal banking agencies** issued final rule to exempt commercial real estate transactions of $500,000 or less from appraisal requirements **On April 3, the U.S. Department of the Treasury** released recommendations to modernize the Community Reinvestment Act (CRA). The recommendations were issued to the primary CRA regulators **On April 11, the Federal Reserve and OCC** proposed a rule to tailor 'enhanced supplementary leverage ratio' requirements to the business activities and risk profiles of the largest domestic firms **On April 17, the federal banking agencies** proposed a revision to their regulatory capital rules to address and provide an option to phase in the regulatory capital effects of the new accounting standard for credit losses, known as the "Current Expected Credit Losses" (CECL) methodology **On May 7, the Federal Reserve** Board announced the approval of final amendments to its Regulation A, which governs extensions of credit by Federal Reserve Banks, to make certain technical adjustments. **On May 30, the Federal Reserve Board** asked for comment on a proposed rule to simplify and tailor compliance requirements relating to the "Volcker rule." **On June 1, the OCC and FDIC** issued a final rule to shorten the standard settlement cycle for securities purchased or sold by OCC-supervised and FDIC-supervised institutions **On June 21, the Federal Reserve Board** released the results of supervisory bank stress tests
TURKEY	**On May 2**, there were new exceptions to FX borrowing for resident companies without FX income. In addition, companies that start exporting would be able to take out FX loans if they provide the related documents on their possible FX incomes. **On May 7, the CBRT** lowered the upper limit for its reserve requirement mechanism (ROM) for FX maintenance facility within the ROM from 55% to 45%. **On May 9, the CBRT** disclosed new arrangements on FX liquidity management. **On May 18, the Parliament** passed the article of the draft bill on the restructuring of taxes and certain debts, which includes the capital repatriation arrangement. Accordingly, natural and legal persons abroad, who inform banks or brokerage houses in Turkey about their assets by 30 Nov, will be able to freely bring them to Turkey.
ASIA	**On April 28,** the Reserve Bank of India withdrew an investment cap that bars foreign portfolio investors (FPIs) from investing in Indian bonds with less than three-year maturity. **On May 1,** PBoC raised the daily quota threefold between the mainland and HK to further improve the stock market connectivity. **On June 12,** the PBoC and SAFE released capital account reform: 1) lift the 20% cap of QFII monthly fund remittance;.2) cancel the QFII and RQFII principal lock period requirements;3) allow QFII and RQFII investors to hedge their exchange rate risks. **On June 30,** the following measures will be implemented to lift ownership restrictions: 1) remove the foreign ownership cap for banks and AMCs;2) raise the cap to 51% for securities, fund, futures companies, and life insurers;3) no longer require jointly funded securities companies to have at least one local securities company as a shareholder. **On June 30,** the following measures will be implemented to expand market access: 1) allow foreign banks to set up branches and subsidiaries;2) allow eligible foreign investors to provide insurance aent and loss adjuster services;3) lift restrictions on the business scope of foreign-invested insurance brokerage companies.

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