BBVA | RESEARCH

Regulation Outlook

January 2015
Financial Systems and Regulation Area

- Regulation 2015: Taking stock and priorities
- Solvency Regulation for Banks: Much has been achieved but work remains unfinished
- Resolution: Making Banks Resolvable
- Systemically Important Financial Institutions (SIFIs): Addressing *too big to fail*
- Shadow Banking: The oversight and regulation of shadow banking
- Derivatives reforms: A global challenge
- Macro-prudential Regulation: Art and Science
- The new liquidity framework: A decisive step to avoid further financial crises
- The digital revolution: A regulatory challenge

Index

Summary

Regulation 2015: Taking Stock and Priorities

Mission (almost) accomplished, but new tasks ahead. After seven years of intensive work on the regulatory front, the G20 Brisbane Summit, held in November 2014, marked the shift to a new phase in the regulatory agenda. Now it is the time for implementation, assessing effectiveness, and possibly revisiting calibration so that the financial industry can play its role in society and finance economic growth.

Solvency Regulation for Banks

Much has been achieved but work remains unfinished. After seven years, the Basel Committee on Banking Supervision has already done much of the work demanded by the post-crisis agenda to strengthen banking solvency regulation and restore confidence. Banks are now more capitalised and this higher loss-absorbency, alongside their stronger liquidity positions, makes them more resilient to shocks. Nevertheless, the solvency regulatory overhaul has some issues still under discussion. This is the case for the final calibration of the leverage ratio and the revision of the capital framework to address current concerns of excessive variability of risk weighted assets, that can undermine investors' confidence in disclosed capital ratios.

Resolution: Making Banks Resolvable

Defining the loss-absorbing requirement and implementing the EU resolution regime at national level. 2015 will be the "loss-absorbing year" when authorities will clarify the principles and features of the new TLAC and MREL ratios. This new prudential ratios have potentially similar impacts on the banking industry to Basel III in terms of capital and funding management, banking risk and profitability. In Europe, member states will have to transpose the BRRD into their laws and start carrying out some resolution tasks: resolution fund contributions, recovery plan and resolvability assessments.

Systemically Important Financial Institutions (SIFIs)

Addressing too big to fail. The design of a complete framework to deal with systemic risk has been one of the pillars of the regulatory reform. On a global basis, the framework for banks and insurers is already finished and agreed by global standard setters but the one related to non-bank non insurers is still pending, and will require much concentrated work during this year. On a domestic basis, the Domestic Systemic Important Bank framework has been defined in some geographies but still remains to be finalised in others, as is the case for many European countries. A key challenge will be to ensure consistency between both frameworks in order to provide a level playing field, especially in local markets. In any case, starting in January 2016 most systemic banks will face an extra regulatory burden

Shadow Banking

The oversight and regulation of shadow banking. The "shadow banking" system, described as "credit intermediation involving entities and activities outside the regular banking system", can be considered as an important complement of the traditional banking channels that can facilitate access to credit, enable maturity transformation, support risk sharing and, more importantly, provide market liquidity. However, the shadow banking system can also become a source of systemic risk through its interconnectedness with various participants of the financial markets (in particular the banking sector) or undermine the level playing field through regulatory arbitrage. At the G-20's November 2010 Summit in Seoul, the FSB was requested to develop recommendations to increase the solidity of the shadow banking system and to strengthen the associated oversight and regulation.

Derivatives Reforms

A global challenge. More than five years have passed since the G-20 meeting in Pittsburgh, in which the main features of the new OTC derivatives contracts were agreed upon, to increase the transparency of the over-the-counter ("OTC") derivatives markets and to reduce the associated generation of systemic risk. Despite all the steps that have been taken in these years, as of today, the reform of the OTC derivatives markets is partially incomplete The legislation associated to mandatory margins for non-cleared derivatives needs to be finalised and we still need further progress on achieving recognition of the respective legislation between some of the jurisdictions home of the largest players in these markets. Finally, the development of an orderly recovery and resolution framework for Central Counterparty will be on the agenda this year.

Macro-prudential Regulation: Art and Science

Learning *and* doing. Macro-prudential policies aim at increasing the resilience and fostering the structure of the financial system. Currently there are three challenging issues: a clear governance, a specific hierarchy of objectives - leading by stability - and the spillover effects of macro-prudential policies with other policies. In that sense, macro-prudential policies should be clear, easy and transparent, to allow agents a full understanding.

The New Liquidity Framework

A decisive step to avoid further financial crises. As an immediate response to the recent financial crisis, regulators have developed a new framework to enhance the liquidity conditions of financial institutions. At the core of this framework stand the two ratios that financial institutions must fulfil in the coming future (LCR, or short-term liquidity risk, and NSFR, or structural liquidity risk). This new framework should ensure global consistency in the supervision of liquidity conditions.

The Digital Revolution

A regulatory challenge. Society is transforming itself into being digitally-based, fuelled by the rapid improvements in technology. By contrast, it takes too much time to introduce and implement the necessary new legislation to enable these services to develop and to tackle the main threats and risks that the shift to digital may bring.

1 Regulation 2015: Taking Stock and Priorities

Mission (almost) accomplished, but new tasks ahead

After seven years of intensive work on the regulatory front, the G20 Brisbane Summit, held in November 2014, marked the shift to a new phase in the regulatory agenda. Now it is the time for implementation, assessing effectiveness, and possibly revisiting calibration so that the financial industry can play its role in society and finance economic growth.

Until now the most significant advances have been produced on: i) enhancing the resilience and robustness of banks' balance sheets; ii) ending the 'too big to fail' problem and developing a new paradigm for banking resolution based on bail-in; iii) increasing transparency in OTC derivatives markets and centralising its clearing through central counterparties, and iv) shedding light on the shadow banking system (although this is the issue which has progressed the least). Additionally, v) principles for effective supervision, which is a necessary condition for the regulation to be successful, have been enhanced.

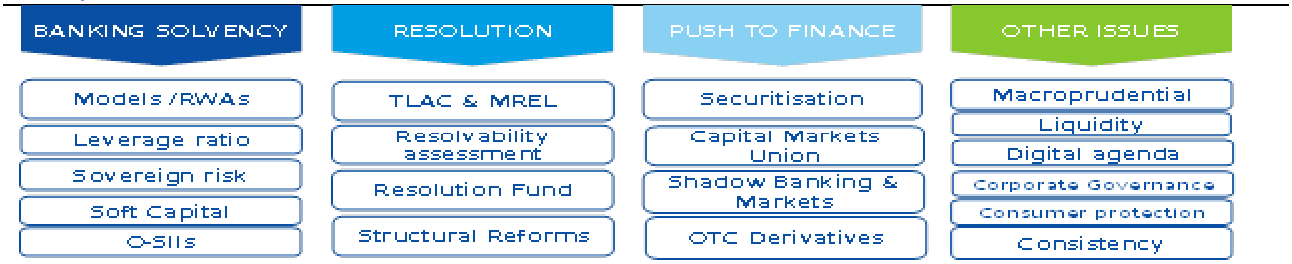
New phase for regulation

Looking forward, the authorities will work to produce a coordinated implementation of the whole regulatory tsunami, as this is the key to ensure a level playing field in a globalised world. More cooperation and mutual recognition will ultimately determine the effectiveness of the approved regulation. Peer reviews are valuable tools to assess the consistency of implementation across countries. The FSB will indeed publish an annual report on implementation. On the other hand, having much of the reforms approved and in its way to implementation, it is more important than ever to carry out a cumulative impact analysis of the whole reform, with a view to refining those global standards which have generated unintended consequences. This should not be the moment to rush into new regulations, especially when the focus is on consolidating the economic recovery and growth.

Where will be the focus in 2015?

- **Prudential policy**: Basel III implies a significant change in the numerator of capital. Now there are several proposals under consultation, focused on the denominator of capital (revision of standardised model, capital floors for IRB banks, the treatment of sovereign risk, the fundamental review of trading book…) which might well be considered as a new Basel IV.
- **Resolution**: Huge work on resolvability assessment and establishing TLAC/MREL is expected. 2015 will be a key year to implement practical issues to ensure that we have resolvable banking entities. In Europe, the banking structural reform aimed at imposing certain constraints on the structure of the banks, will also be a hot topic. Finally, we expect intensive work on the framework for systemically important non-bank non-insurers, which is still pending.
- **Push to finance**: Progress of the shadow banking reform and finalisation of the derivatives reform is expected.
- **Digital agenda**: Regulators have recently been including, little by little, the digital issues on their agenda. We expect an increasing focus on issues such as: big data, privacy, cloud computing or payments systems.

Figure 1
Hot Topics for 2015



Source: BBVA Research

2 Solvency Regulation for Banks

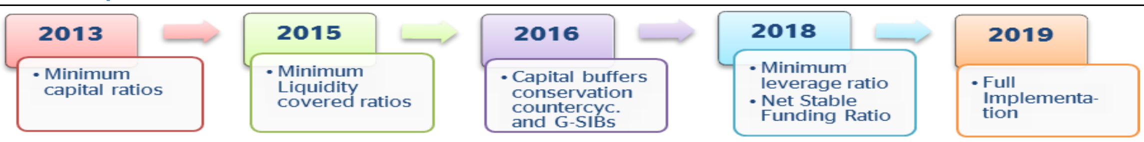
Much has been achieved but work remains unfinished

Much has been achieved but work remains unfinished. After seven years, the Basel Committee on Banking Supervision has already completed much of the work demanded by the post-crisis agenda to strengthen the banking solvency regulation and restore confidence. Banks are now better capitalised and their higher loss-absorbency capacity alongside with stronger liquidity positions make them more resilient to shocks. Nevertheless, the solvency regulatory overhaul has some issues still under discussion. This is the case for the final calibration of the leverage ratio and of the ambitious revision of the capital framework to address current concerns of excessive variability of risk-weighted assets.

Basel III: the new post-crisis banking solvency framework

The first revision of the Basel II framework, known as Basel 2.5, was done as soon as 2009, to deal mainly with trading book and securitisation related weaknesses uncovered by the financial crisis. Shortly after, banking regulators reached an agreement on **a comprehensive reform package, known as Basel III,** issued in 2010. Basel III combines a reinforcement of the microprudential regulation, to raise the resilience of individual banking institutions to periods of stress, with a macro-prudential focus to address system-wide risks. This framework includes: i) an increase in the level and quality of the capital required to cover risks; ii) new macro-prudential measures ranging from G-SIB surcharges to the countercyclical capital buffers; iii) new liquidity requirements, and iv) a new leverage ratio as a backstop to the risk-based requirements. Given the depth of the reform a gradual implementation was recommended. **Most relevant jurisdictions have already implemented Basel III, starting in 2014 in the case of Europe and USA.**

Figure 1
Basel III implementation calendar



Source: BBVA Research

Additional policy measures to complete and/or improve Basel III have been approved since 2010, and will have to be implemented in the following four years. This is the case of: i) investments in the equity of funds (by 2017); ii) counterparty credit risk (by 2017); iii) exposures to central counterparties (by 2017); iv) revised securitisation framework (by 2018), v) a large exposure regime (by 2019) and vi) Pillar III (by end 2016).

The effects of a full implementation of Basel III have been largely anticipated, having contributed to the effect of the demanding capital requirements associated to **stress testing exercises**, in both Europe and USA.

Towards Basel IV?

Several policy measures are currently under consultation or to be finalised. With the aim of reducing the variability of regulatory capital ratios, improve comparability and reduce reliance on credit ratings, a **revision of the standardised approaches** to calculate requirements is underway, and **changes in internal models-based approaches are also to be expected shortly**. New **capital floors** are being proposed to limit the reduction of capital requirements achievable with the use of internal models. Additionally, a comprehensive review of the Trading book and Pillar III are also underway.

Besides the difficulty of assessing the overall impact and the cost for the industry of implementing so many changes, it is a concern that **regulatory uncertainty could be prolonged even further**. Considering the ample scope of the on-going revision of the Basel III framework relative to the calculation of risk-weighted assets**, the revision should be done the sooner the better in order to avoid regulatory uncertainty and to restore confidence in capital ratios**.

3 Resolution: Making Banks Resolvable

Defining the loss-absorbing requirement and making the BRRD operational at national level

2015 will be the "loss-absorbing year", when authorities will clarify the principles and features of the new loss-absorbing ratios. These new prudential ratios have potentially similar impacts on the banking industry to Basel III in terms of capital and funding management, banking risk and profitability. In Europe, Member States will have to transpose the BRRD into their' laws and start carrying out some resolution tasks: resolution fund contributions, recovery plan and resolvability assessments.

Since the beginning of the crisis, the authorities have been searching for the optimal regulatory formula for dealing with failed banks. Achieving an effective resolution regime to resolve them quickly, avoiding disturbances to the financial system, minimising the use of public funds – thus protecting taxpayers – and continuing the critical financial services is one of the **main goals in the current regulatory reform**.

In 2011, the FSB outlined the general principles of a new resolution framework. Its central premise is that any banking rescue will have to be supported in the first instance by shareholders and private creditors through the bail-in tool. In order for this new banking rescue philosophy to be effective, banks must, at all times, have enough liabilities to absorb losses.

Last November 2014, the FSB published the consultation paper on the principles and features of the **total loss-absorbing capacity (TLAC)** requirement (consultation ends on 4 February 2015). Then a comprehensive Quantitative Impact Study will be carried out in the first half of 2015 with four dimensions: i) banks' impact assessment; ii) historical losses back-testing; iii) market impact study, and iv) macro- and micro-economic analysis. The final TLAC requirement and the QIS outcomes are not expected until the end of 2015. Developing a **TLAC business model-neutral approach** is the main challenge for the FSB.

At a European level, the EBA also released a consultation paper in November 2014 on the criteria for determining the **minimum requirement for eligible liabilities (MREL),** which could be seen as the TLAC's transposition to Europe. Despite seeking the same purpose, the two ratios have different characteristics; in particular that MREL applies to all banks (not only GSIBs) and is determined on a case-by-case basis.

On 1 January 2015, the new **Bank Recovery and Resolution Directive (BRRD) entered into force.** At the Eurozone level, the Single Resolution Mechanism (including the new single resolution authority and fund) will not be operational until January 2016. During 2015, European Member States will be focusing on transposing the BRRD into their national laws and adapting their institutional frameworks (e.g. creating resolution authorities, launching national resolution funds), where needed. Additionally, they will have to carry out the first resolvability assessment. In parallel, banks will have to start contributing to the resolution fund and developing a recovery plan.

- **Resolution fund contributions**: From 2015, all banks in Europe will have to make contributions to a private resolution fund, which will partially provide temporary support (capital and liquidity) to institutions under resolution.[1] Each bank's contribution will be calculated by the resolution authority, based on the relative size of uncovered liabilities and the risk profile of each bank.
- **Recovery plan:** European institutions will be required in 2015 to draw up a recovery plan setting out arrangements and measures to enable them to take early actions to restore their long-term viability in the event of a material deterioration of their financial situation. The supervisor, the SSM at Eurozone level, will be responsible for assessing it.
- **Resolvability assessment**: European resolution authorities are required to evaluate the feasibility of resolution strategies, and their credibility in light of the likely impact of the firm's failure on both the financial system and the overall economy. As a result, authorities may impose legal, organisational, financial and corporate governance changes to remove or reduce barriers to resolution.

[1] This support is subject to a minimum bail-in requirement of the 8% of total liabilities, and it is also capped to 5% of total liabilities

4 Systemically Important Financial Institutions (SIFIs)

Addressing *too big to fail*

The design of a complete framework to deal with systemic risk has been one of the pillars of the regulatory reform. On a global basis, the framework for banks and insurers is already finished and agreed by global standard setters but the one related to non-bank non-insurers is still pending, and will require much concentrated work during this year. On a domestic basis, the Domestic Systemic Important Bank framework has been defined in some geographies but still remains to be finalised in others, as is the case for many European countries. A key challenge will be to ensure consistency between both frameworks in order to provide a level playing field, especially in local markets. In any case, starting in January 2016 most systemic banks will face an extra regulatory burden.

What has been done? Banks and Insurers

In November 2011, the FSB/BCBS proposed a **multi-pronged framework** for Global Systemically Important Banks (G-SIBs). In late 2012, they also proposed guidelines for a framework for domestic systemic banks but implementation here has been poor, with few countries having passed their final laws.

The **methodology** to identify the G-SIBs follows an indicator-based measurement approach, which calculates a systemic score for each bank. For those in the list, the higher the systemic score the higher the bucket, and the higher the capital surcharge required. The G-SIB buffer ranges from 1% (bucket 1) to 3.5% (bucket 5). The first G–SIB list was issued in 2011 and it gets updated each November. In the last update (November 2014), 30 G-SIBs were identified.

Starting in January 2016, G-SIBs will face extra capital **requirements** on top of their regular Basel III ones, following the same phase-in profile as the conservation buffer and becoming fully loaded by 2019. G-SIBs are also bound by higher supervisory requirements, and to stricter requirements on the resolution front. Some policymakers want to go further and cut the size of SIFIs by limiting or banning certain activities. Even acknowledging that the effectiveness of the SIFI measures will not be tested until the next crisis occurs, imposing such an extra regulatory burden seems excessive and potentially counterproductive.

- **Not all G-SIBs' business models are equally resilient.** The decentralised model with stand-alone subsidiaries posed less systemic risk during the crisis by limiting contagion across banking groups, which was in part due to the existence of natural firewalls. More intrusive measures should be limited to more complex and interconnected business models. Regulation should reward, or at least not penalise, those business models which are inherently more resilient and resolvable.
- **Dynamic revision.** Systemic risk should be controlled with a dynamic perspective as the systemic level of banks evolves through time.
- **Global vs. national competition**. A financial entity considered to be systemic on a global basis competes with local players that may well have higher local market shares but are not affected by the SIFIs regulation. This situation erodes fair competition and market discipline. In that vein, both global and domestic methodologies should be consistent, in order to set an effective systemic risk policy.
- **Additional regulatory burden.** The crisis has proved that even small and apparently simple entities may be systemic, so the G-SIB label should not be used to impose additional regulatory requirements, as is the case with TLAC or structural reforms.

The FSB methodology for Global Systemically Important Insurers (G-SIIs), developed by the IAIS, follows the same spirit as that for G-SIBs while accounting for the specificities of the insurance business. The IAIS has committed to include reinsurance activity and to further develop the methodology by November 2015. Meanwhile, the last G-SIIs list (November 2014) incorporated the same nine insurance companies as in 2013.

What is next? Non-bank, non-insurers

During 2015 it is also expected that the FSB will finalise the methodology for identifying non-bank, non-insurer global systemically important financial institutions (NBNI G-SIFIs), whose first outline was subject to consultation in January 2014. It extends the SIFI framework that currently covers banks and insurers to all other financial institutions. It therefore includes a methodology for identification and proposed regulatory measures for: i) finance companies; ii) market intermediaries (securities broker-dealers), and iii) investment funds (including hedge funds).

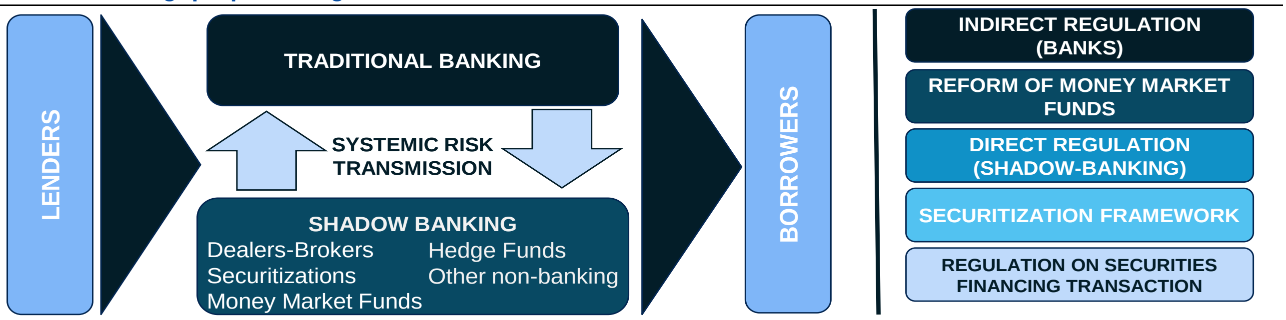
5 Shadow Banking

The oversight and regulation of Shadow Banking

The "shadow banking" system, described as "credit intermediation involving entities and activities outside the regular banking system", can be considered to be an important complement of the traditional banking channels that can facilitate access to credit, enable maturity transformation, support risk sharing and, more importantly, provide market liquidity. However, the shadow banking system can also become a source of systemic risk through its interconnectedness with various participants of the financial markets (in particular the banking sector) or undermine the level playing field through regulatory arbitrage.

At the G-20 November 2010 Seoul Summit, the FSB was requested to strengthen the associated oversight and regulation of the shadow banking system. The FSB has adopted a two-tiered approach: first, authorities worldwide have started **to gather data** on the activities – and associated risks – where shadow banking systemic risk can arise and second, once it has identified the macro areas where risks are estimated to be systemic, to **undertake focused actions** to limit the effects of the creation of systemic risks and reduce the potential regulatory arbitrage generated by the banking regulation.

Figure 1
Shadow banking: proposed regulation



Source: BBVA

In a more practical approach, regulators have decided to take measures that can be broken down to five main areas: i) indirect regulation by regulating the banking sector and its interactions with the shadow banking system (capital charges, limits to relationship, more information flows); ii) reforms of the Money Market Funds ("MMFs"), reducing the susceptibility of "runs" (rules issued and proposed by the US SEC and EU); iii) direct regulation of the shadow banking entities, increasing the information gathering on activities and entities operating in the shadow banking space; iv) strengthening the regulatory framework for the securitisations, aligning the incentives of the various actors in the securitisation markets (retention rules), and v) direct regulation of the securities lending and repos measures on margins and minimum haircuts and obligations of transparency (various proposals are under discussion). The identification of shadow banking activities made so far has been backward-looking but the activities that will pose a threat in the future are more difficult to identify.

What's next?

The process of transforming the shadow banking system into a solid and stable component is still ongoing. Some of the most relevant changes that will be occurring during the course of 2015 are: i) monitoring of the shadow banking system, associated risks and interconnectedness with the traditional banking sector by the FSB will be complemented by an IOSCO global analysis of the hedge fund sector; ii) guidance for the scope of consolidation for bank prudential regulation; iii) proposed application of numerical floors and calculation methodologies for haircuts associated with securities financing transactions ("SFTs") will be included in the currently proposed regulations. Finally, iv) more efficient data monitoring systems will be needed to fully understand the dynamics of the complex relationship with the traditional banking system and, v) globally harmonised regulatory frameworks will have to be implemented to avoid potential regulatory arbitrages in cross-border transactions or a spill-over effect from the more-regulated banking sector to the shadow banking.

6 Derivatives reforms

A global challenge

More than five years have passed since the G-20 meeting in Pittsburgh, in which the main features of the new OTC derivatives contracts were agreed upon to increase transparency of the over-the-counter ("OTC") derivatives markets and to reduce the associated systemic risk generation. Despite all the steps that have been taken in these years, as of today, the reform of the OTC derivatives markets is partially incomplete.

> **"…**_All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements_..."

With these words the leaders at G-20 in Pittsburgh (2009) aimed at a fundamental change in the structure of the OTC derivatives markets, impacting the business model, the legal entity structures, the profitability, the operation and IT architecture of its actors. All the participants of the financial industry are now familiar with the US legislation "Dodd-Frank Wall Street Reform and Consumer Protection Act" ("DFA") (Title VII) or with the corresponding "EMIR" and Markets in Financial Instruments Directive/Regulation "MiFID2-MiFIR" on the European side, legislations that in part are already approved and implemented and – for some of the associated technical standards – still under discussion. All the changes in the OTC regulatory framework have contributed to change the business model of many of the market participants that had to reorganise their geographical focus and asset classes in which they operate.

What has been done so far?

Huge steps have been taken to strengthen the resilience and transparency of the OTC derivatives markets and of the institutions operating in such sector. In particular, on the **post-transparency** side, new entities have appeared on the market, the "Data Repositories" data warehouses that collect all the main features of the closed and existing derivatives trades between counterparties of a jurisdiction. On the **pre-transparency** side the first mandatory trades passing through **electronic platforms** have seen the light in the course of 2014 giving additional transparency to the price formation of standardised derivatives. **Mandatory clearing** has already started in the US and will start in the following months in Europe, reducing drastically the counterparty credit risk associated with standardised bilateral trades. In parallel, the adoption of the proposed **capital regulation** (BCBS standards) have imposed a higher capital charge on the OTC derivatives that will not be cleared, de-facto pushing OTC derivatives – where available – to pass through the Central Counterparty framework ("clearing").

What still needs to be done?

First and foremost the legislation associated to **mandatory margins for non-cleared derivatives** needs to be finalised and, more importantly, harmonised between various regulatory regimes. This is crucial for the well-functioning of the derivatives and financial markets since the collateral to be used as margin will be of the highest quality and its proper management will have a deep impact on the structure of the liquidity of the financial sector if rules are not properly balanced. Additionally, while **mandatory clearing** is implemented or will be implemented in the short term, there is still a lack of harmonisation and recognition of the respective legislation between some of the jurisdictions home of the largest players in these markets. If **recognition and harmonisation** will not be achieved in the short term, a potential disruption of certain markets is inevitable. Mandatory clearing has also raised an additional concern related to the **solidity of the Central Counterparties** ("CCPs"). Being central to the OTC derivatives system, plans for recovery and resolutions of these actors will have to be implemented by the Regulators to avoid the potential collapse of entities that are central to the global systemic risk management. Therefore rules on the **orderly recovery and resolution** of such entities will be key for the solidity of the financial system at global level. Finally the **extraterritorial impact** of the various legislations associated to trading in the OTC space will have to be carefully weighted in order **to avoid potential legislative loopholes or regulatory arbitrage**, in particular, if affected entities are not subject to the more stringent banking regulation (see also shadow banking).

7 Macro-prudential Regulation: Art and Science

Learning *and* doing

Macro-prudential policies aim at increasing the resilience and enhancing stability of the financial system.' Among others, there are currently three challenging issues: a clear governance, a specific hierarchy of objectives led by stability, and analysing and calibrating the synergies and potential conflicts of macro-prudential policies with other policies. Macro-prudential policies should be clear, easy and transparent to allow agents a full understanding to achieve the desired objectives.

An overview

The last global crisis highlighted that a global, integrated, multidisciplinary and dynamic approach is a necessary condition to achieve financial stability. Monetary, fiscal and micro-prudential policies were not enough to safeguard the stability of the financial and the economic systems. Therefore, most countries have designated new macro-prudential authorities as guardians of financial stability.

In 2011, the European Systemic Risk Board (ESRB) was created as part of the European System of Financial Supervision (ESFS) and the Financial Stability Oversight Council (FSOC) was established in the United States. The Financial Stability Board (FSB) has facilitated coordination at a global level since 2009. The three aforementioned authorities focus on the stability of the financial system as a whole, because as stated by Mr. Tucker[2]: "If stability is to be preserved, finance needs to be regulated as a system, not as a series of notionally independent parts".

In Europe, there has been much progress over the past year towards a comprehensive framework:

- In March 2014, the ESRB released its *Handbook on Operationalising Macro-Prudential Policy in the Banking Sector*, offering a first overview about the new EU common policy framework.
- Since 4 November 2014, the ECB via the Single Supervisory Mechanism (SSM) has assumed a key role as *macro-prudential watchdog.* National authorities have to notify the ECB of their intention to apply requirements for capital buffers or any other measures according to EU law. The ECB can tighten – not soften – capital buffers or any other measures. In that sense, central banks are expected to have a key role given the interaction between macro-prudential and monetary policies. Indeed, it is the option chosen by most of EU Member States (17 of 28).
- National authorities are still empowered to adopt macro-prudential decisions on particular instruments regulated in their national laws and this can cause regulatory inconsistencies.

Lessons to be learnt

The discussion on the efficiency of macro-prudential instruments is still in an incipient phase but some lessons can be highlighted. **Clear communication is of the utmost importance to enhance the predictability of macro-prudential policies**. We should evolve towards a more forward-looking and rule-based framework. Having said this, the main difficulty is calibrating the cycle ex-ante.

Despite the absence of consensus on whether price instruments (provisions, capital buffers) **are more effective than instruments based on quantities** (Loan-to-value; LTV), empirical evidence suggests that quantity measures are most effective although intrusive instrument. Furthermore, macro-prudential instruments are not mutually exclusive and can be used in combination to achieve more efficient results.

Macro-prudential policies should pay special attention to the shadow banking sector risks, as they are increasing credit-intermediation and maturity transformation activities. Risks associated with exposures to the less regulated shadow banking sector must be properly monitored and adequately regulated.

In Europe, there is intense debate about the adequate level of coordination between national and European authorities (national authorities might be reluctant to transfer some of their competences).

2 2014. *Macroprudentialism.* Edited by Dirk Schoenmaker *The political economy of macroprudential regimes*; Paul Tucker.

8 The New Liquidity Framework

A decisive step to avoid further financial crises

As an immediate response to the recent financial crisis, regulators have developed a new framework to enhance the liquidity conditions of financial institutions. At the core of this framework stand the two ratios that financial institutions must fulfill in the coming future (LCR, or short term liquidity risk. and NSFR, or structural liquidity risk). This new framework would ensure global consistency in the supervision of liquidity conditions, but certain aspects of the framework must be improved.

Rationale of the new liquidity framework

During the worst years of the last financial crisis some financial institutions, despite meeting the existing capital requirements, experienced serious difficulties due to their inability to manage liquidity under severe circumstances. In addition, these liquidity difficulties turned, in some cases, into solvency problems. This stressful situation forced central banks, all over the world, to take immediate action to ensure the proper functioning of money markets under extreme situations, but also to implement measures focused on some institutions that were facing liquidity constraints.

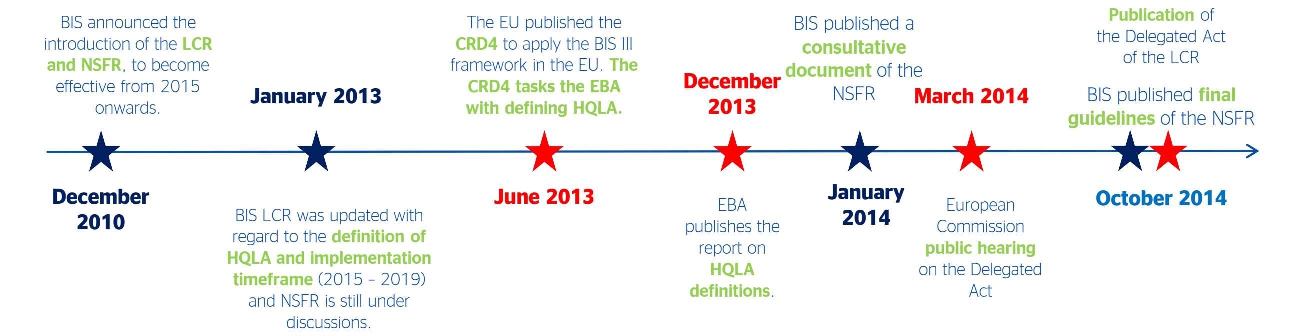
Apart from these non-standard monetary policy measures by central banks, regulators tried to build a prudential framework to avoid future liquidity crises. For instance, the Basel Committee in 2008 published "Principles for Sound Liquidity Risk Management and Supervision" as the foundation of its liquidity framework. This framework was transposed by domestic regulators such as the European Union (i.e. CRDIV and CRR developed these pillars).

Two main pillars of the liquidity framework: LCR and NSFR

The Basel Committee developed two minimum standards for funding and liquidity risk:

- First, the LCR (Liquidity Coverage Ratio) ensures the liquidity capacity of financial institutions under a situation of severe stress. To be more precise, it obliges financial institutions to have short-term resilience in terms of sufficient high-quality liquid assets (HQLA) to survive a significant 30-day stressed scenario. In the European Union, according to the recently published Delegated Act, the LCR will be mandatory, on a consolidated basis, from October 2015 (i.e. at 60%), which is later than expected, but with a phase-in period finishing by January 2018 (i.e. at 100%).
- Second, the NSFR (Net Stable Funding Ration) requests financial institutions to maintain a stable funding profile (i.e. avoiding an over-reliance on unstable funding sources such as short-term wholesale funding). In other words, this ratio tries to reduce funding risk over a longer time horizon (i.e. one year). This ratio will become mandatory by January 2018, with no phase-in period.

Figure 1
Liquidity framework timeline



Source: BBVA Research based on Basel and European Commission reports

Assessment

In a nutshell, regulators have taken a decisive step to avoid liquidity crises in the future. Now, regulators should assess the final impact on the real economy (i.e. GDP, credit, etc.) of the whole regulatory package, with the liquidity framework being one of its cornerstones. In this regard, some official impact assessment reports do not foresee a dramatic change from a macro standpoint. However, a more focus on long term funding and the need to build a solid liquidity buffer will certainly affect the way banks act in the financial markets and therefore some spill over effects should to be expected.

9 The Digital Revolution

A regulatory challenge

Society is transforming itself into being digitally-based, fuelled by the rapid improvements in technology. By contrast, it takes too much time to introduce and implement the necessary new legislation to enable these services to develop and to tackle the main threats and risks that the shift to digital may bring.

New players in banking sector

Financial services are not exempt from the shift to digital, in which innovations in several areas of the value chain such as payments or lending are being introduced by players outside the financial sector. These players are very nimble to capitalize on new technologies to improve consumers' experience but in many cases, they do not offer adequate levels of security and protection to the consumer. Being concerned about the new opportunities, but also the new risks, that are emerging in the digital world, regulators have started to include these issues in their agendas, and several legislative processes that started during recent years will see the light during 2015.

- **Related to payments**, the European Commission submitted a proposal (PSD2) in July 2013 to update the current Payment Services Directive, with the aim of enhancing the level playing field for all players. It is expected to be approved during the first part of 2015.
- Disruption in payments is also being highlighted by **virtual currencies** and the businesses that are flourishing around them. Regulators from all over the world are exploring whether and how to regulate them. The first attempts to regulate certain virtual currencies as Money Transmitters are being led by US regulators, and will probably be followed by other geographies.
- **Lending** is also being disintermediated by new entrants that are offering loans, or other products, as part of their service. Peer-to-peer lending and crowd-funding have emerged as innovative mechanisms for financing, and the first steps have been taken to regulate them across the world. In Europe, several countries have taken regulatory actions locally, and the European Commission has announced a number of steps that it will endeavour to take by 2015 in order to explore the potential of crowd-funding and to discuss the obstacles to convergence of national regulations on financial return models.
- **Payments Account Directive** 2014/92/EU *on the transparency and comparability of payment account fees, payment account switching and access to a basic* payment account was finally adopted in 2014 in Europe. By 18 September 2016, Member States will have to transpose it into their national legislation, and shall apply the measures imposed from the same date.

European regulators are tackling the big challenges involved in unleashing the potential of new technologies such as "Big Data" or cloud computing while, at the same time, ensuring security, privacy and consumer protection.

- **"Big Data" and Privacy:** Europe has been working on data protection reform since the Commission's proposal of 25 January 2012, but there is still much debate needed before equilibrium can be reached between those who claim that privacy must be zealously protected and others who advocate a flexible environment that will boost innovation and enable the development of data-based businesses. The US Congress has also proposed new laws to empower consumers to decide how companies can use "Big Data" techniques to gather and/or sell data collected from the digital footprints that consumers leave online.
- **Cloud Computing**: There is also much debate in the European Commission about how to increase the use of cloud computing across all economic sectors, by promoting the development of certification schemes and privacy seals that could allow cloud service companies to provide guarantees for the safety and control of information processed.
- **eIDAS Regulation:** The Regulation (EU) nº910/2014 *on electronic identification and trust services for electronic transactions in the internal market* was adopted on 23 July 2014. It will provide a predictable regulatory environment to enable secure and seamless electronic interactions between businesses, citizens and public authorities. In 2015, we will see much activity between public authorities and private sector on how to implement electronic Identities (eID) in Europe.

International collaboration is needed

In the digital world, national boundaries are being eroded and markets are increasingly linked by international connections. Global regulations, or at least international collaboration in the development of global rules that cover the issues to which we have referred, are absolutely necessary to set the incentives to enhance the digital society and the innovation behind it, while avoiding new risks.

Main regulatory actions around the world over the last month

	Recent issues	Upcoming issues
GLOBAL	On **11 Dec BCBS and IOSCO** launched a consultation on criteria to identify **simple, transparent and comparable securitisations** On **23 Dec CPMI and IOSCO** issued the assessment methodology for oversight expectations applicable to **critical service providers** On **23 Jan BCBS** published its **Work Programme** for the years 2015 and 2016 On **23 Jan BCBS** published a report on progress in adopting principles for effective **risk data aggregation and risk reporting** On **26 Jan ISDA** proposed a framework on **CCP recovery and continuity** On **28 Jan BCBS** published a revision on **Pillar III disclosure requirements**	**FSB** will review its **representation structure** to better capture emerging market and developing economies
EUROPE	On **19 Dec EBA** published **RTS and guidelines on resolution planning** and launched a consultation on notification in resolution On **19 Dec EBA** published final **guidelines on the SREP** methodology On **19 Dec ESMA** published final report and launched a consultation o**n implementing MiFID/MiFIR** On **23 Dec** EBA published final guidelines on **disclosure requirements** for EU banks On **01 Jan Lithuania** became the 19th EU member to adopt the Euro On **01 Jan Latvia** initiated its six-month rotation **Presidency of the Council** On **01 Jan** the **Bank Recovery and Resolution Directive** become applicable in the EU and the **Single Resolution Board** became operational On **09 Jan CE** adopted two ITS with regard to **supervisory reporting** of institutions under the CRR On **12 Jan EU and US** financial market regulators **met to discuss regulatory developments** On **14 Jan EBA** launched a **consultation on the "resolution information pack"** On **14 Jan the CJEU** gave its initial support to the **ECB's OMT program** On **15 Jan EBA** published a report on the **assessment of the effects of LCR** for EU banks On **15 Jan ECON** published amendments to draft report on the proposal to **reform EU banking structures** and on reporting and transparency of **SFTs** On **23 Jan EBA** published final Implementing Technical Standards on **prudent valuation** On **29 Jan ECB** announced a revision on **variable remuneration** and recommended **prudent dividend policy** In **Jan the Council** approved compromise texts on **interchange fees** for card-based transactions and **indices used as benchmarks** In **Jan** the **OJEU** published the legal texts on **disclosure requirements** for structured finance instruments, **LCR, leverage ratio and ex ante contributions to Single Resolution Fund**	In **1Q 2015** EC will launch a **consultation** on the proposal for a **Capital Markets Union** In **1H2015** several legislative proposals are expected to be adopted: MMFs, indices used as benchmarks, payment services directive, long-term shareholder engagement, reporting and transparency of SFTs and a revision of general data protection regulation
MEXICO	On **31 Dec** Financial Authorities issued rules on the **assessment of banks' contribution to economic development**, **financial conglomerates**, changes to banks' capital requirements in order to fill gaps identified in the RCAP and comply with BCBS, **money laundering and LCR.**	Upcoming CNBV regulation includes **"Ring-fencing", Recovery Planning and changes to the capital regime** as a result of the BIS RCAP findings. Various **regulatory projects are** expected to complete the Financial Reform's secondary regulation in 2014.

Continued on next page

cont.	Recent issues	Upcoming issues
LATAM	On **18 Dec Brazil's** National Monetary Council adopted rules on management of **credit, market, operational and liquidity risks as well as of capital** On **8 Jan** the **Argentinian** Central Bank imposed an additional capital requirement of 1% of RWAs for banks classified as **locally systemic important** On **21 Jan** the President of **Venezuela** outlined **new forex policies**. Further details are expected to be provided soon	
USA	On 09 Dec Fed announced a rule to impose a **larger capital surcharge for the largest US based G-SIBs** On **18 Dec Fed** extended the conformance period of the **Volcker rule** until 21 Jul 2016 On **10 Jan Fed** released public sections of **banks' resolution plans** The **CFPB** finalized a rule to **decrease the reporting burden of financial institutions** in communicating their privacy policies with consumers.	Regulators and internal risk managers will **review the validity of capital models** within financial institutions **Higher scrutiny of mortgage originators and services** is expected, according to the Federal Housing Finance Agency
TURKEY	On **29 Dec BRSA** announced that the liquidity coverage ratio (LCR) limits will be %60 from January 2015. A 10% increase will be applied starting from 01/01/2016 to 01/01/2019 for each year. On **03 Jan** the Central Bank revised reserve requirement ratios of **foreign exchange denominated liabilities** of banks and financing companies	
ASIA	On **12 Dec** China announced a **protection fund** aimed at supporting **trust firms** On **12 Dec China**'s securities regulator confirmed it will inspect **brokerages** to determine if their higher-risk margin trading businesses comply with rules. On **30 Dec China**'s Administration of Foreign Exchange released new rules to ease **limits on banks' foreign exchange trading** practices. On **01 Jan People's Bank of China** started to implement a **deposit insurance scheme** covering up to 500,000 Chinese yuan of a bank account.	

Source: BBVA Research

Abbreviations

AIFMD	Alternative Investment Fund Managers Directive
AQR	Asset Quality Review
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
BoE	Bank of England
BoS	Bank of Spain
BRRD	Bank Recovery and Resolution Directive
CCAR	Comprehensive Capital Analysis and Review
CCP	Central Counterparty
CET	Common Equity Tier
CFTC	Commodity Futures Trading Commission
AMC	Company for the Management of Assets proceeding from Restructuring of the Banking System (Bad bank)
CNMV	Comisión Nacional de Mercados de Valores (Spanish Securities and Exchange Commission)
COREPER	Committee of Permanent Representatives to the Council of the European Union
CPSS	Committee on Payment and Settlement Systems
CRA	Credit Rating Agency
CRD IV	Capital Requirements Directive IV
CRR	Capital Requirements Regulation
CSD	Central Securities Depository
DGSD	Deposit Guarantee Schemes Directive
DFA	The Dodd–Frank Wall Street Reform and Consumer Protection Act
EBA	European Bank Authority
EC	European Commission
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs Council
ECON	Economic and Monetary Affairs Committee of the European Parliament
EFSF	European Financial Stability Facility
EIOPA	European Insurance and Occupational Pensions Authority
EMIR	European Market Infrastructure Regulation
EP	European Parliament
ESA	European Supervisory Authority
ESFS	European System of Financial Supervisors
ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
EZ	Eurozone
FASB	Financial Accounting Standards Board
FBO	Foreign Bank Organisations
FCA	Financial Conduct Authority
FDIC	Federal Deposit Insurance Corporation
Fed	Federal Reserve
FPC	Financial Policy Committee
FROB	Spanish Fund for Orderly Bank Restructuring
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FTT	Financial Transactions Tax
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
IHC	Intermediate Holding Company
IIF	Institute of International Finance
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
ISDA	International Swaps and Derivatives Association
ITS	Implementing Technical Standard
Joint Forum	International group bringing together IOSCO, BCBS and IAIS
LCR	Liquidity Coverage Ratio
LEI	Legal Entity Identifier
MAD	Market Abuse Directive
MiFID	Markets in Financial Instruments Directive
MiFIR	Markets in Financial Instruments Regulation
MMFs	Money Market Funds
MoU	Memorandum of Understanding
MPE	Multiple Point of Entry
MS	Member States
NRAs	National Resolution Authorities
NSAs	National Supervision Authorities
NSFR	Net Stable Funding Ratio
OJ	Official Journal of the European Union
OTC	Over-The-Counter (Derivatives)
PRA	Prudential Regulation Authority
QIS	Quantitative Impact Study
RRPs	Recovery and Resolution Plans
RTS	Regulatory Technical Standards
SCAP	Supervisory Capital Assessment Program
SEC	Securities and Exchange Commission
SIB (G-SIB, D-SIB)	Global-Systemically Important Bank, Domestic-Systemically Important Bank
SIFI (G-SIFI, D-SIFI)	Global-Systemically Important Financial Institution, Domestic-Systemically Financial Institution
SII (G-SII, D-SII)	Systemically Important Insurance
SPE	Single Point of Entry
SRB	Single Resolution Board
SREP	Supervisory Review and Evaluation Process
SRF	Single Resolution Fund
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
UCITS	Undertakings for Collective Investment in Transferrable Securities Directive

DISCLAIMER

This report has been produced by:

Chief Economist for Financial Systems & Regulation
Santiago Fernández de Lis
+34 91 5379852
sfernandezdelis@bbva.com

Chief Economist for Regulation and Public Policy
Maria Abascal
maria.abascal@bbva.com

Tatiana Alonso
tatiana.alonso@bbva.com

Arturo Fraile
arturo.fraile@bbva.com

Rosa Gómez Churruca
Rosa.gómez@bbva.com

Lucía Pacheco
lucia.pacheco@bbva.com

Chief Economist for Recovery and Resolution Policy
José Carlos Pardo
josecarlos.pardo@bbva.com

Victoria Santillana
mvictoria.santillana@bbva.com

Guillermo Martín
gmartin@bbva.com

Head of Supervisory and Regulatory Affairs-Frankfurt Office
Matías Viola
matias.viola@bbva.com

Chief Economist for Financial Inclusion
David Tuesta
david.tuesta@bbva.com

Head of Regulation CIB
Graziano Crema
graziano.crema@bbva.com

BBVA Research

Group Chief Economist
Jorge Sicilia Serrano

Developed Economies Area
Rafael Doménech Vilariño
r.domenech@bbva.com

Spain
Miguel Cardoso Lecourtois
miguel.cardoso@bbva.com
Europe
Miguel Jiménez González-Anleo
mjimenezg@bbva.com
US
Nathaniel Karp
Nathaniel.Karp@bbva.com

Emerging Markets Area
Alicia García-Herrero
alicia.garcia-herrero@bbva.com

Cross-Country Emerging Markets Analysis
Alvaro Ortiz Vidal-Abarca
alvaro.ortiz@bbva.com
Asia
Le Xia
le.xia@bbva.com
Mexico
Carlos Serrano Herrera
carlos.serranoh@bbva.com
LATAM Coordination
Juan Manuel Ruiz Pérez
juan.ruiz@bbva.com
Argentina
Gloria Sorensen
gsorensen@bbva.com
Chile
Jorge Selaive Carrasco
jselaive@bbva.com
Colombia
Juana Téllez Corredor
juana.tellez@bbva.com
Peru
Hugo Perea Flores
hperea@bbva.com
Venezuela
Oswaldo López Meza
oswaldo.lopez@bbva.com

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

Financial Systems
Ana Rubio
arubiog@bbva.com
Financial Inclusion
David Tuesta
david.tuesta@bbva.com
Regulation and Public Policy
María Abascal
maria.abascal@bbva.com
Recovery and Resolution Strategy
José Carlos Pardo
josecarlos.pardo@bbva.com
Supervisory and Regulatory Affairs Frankfurt Office
Matías Viola
matias.viola@bbva.com

Global Areas

Economic Scenarios
Julián Cubero Calvo
juan.cubero@bbva.com
Financial Scenarios
Sonsoles Castillo Delgado
s.castillo@bbva.com
Innovation & Processes
Oscar de las Peñas Sánchez
oscar.delaspenas@bbva.com

Contact details

BBVA Research
Paseo Castellana, 81 – 7th floor
28046 Madrid (Spain)
Tel.: +34 91 374 60 00 and +34 91 537 70 00
Fax: +34 91 374 30 25
bbvaresearch@bbva.com
www.bbvaresearch.com