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Financial Regulation Outlook

First Quarter 2017 | REGULATION UNIT

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Summary

Finalisation of Basel III

More time is needed. The BCBS has announced that more time is needed to conclude the revision of the BIS III framework, also known in the industry as BIS IV. Among the items that were expected to be approved, the calibration of the output capital floor seems to be the main source of disagreement.

New package of banking reforms

A review of the prudential and resolution frameworks. The European Commission recently presented a legislative package to amend both the current banking prudential and resolution frameworks, implementing international standards in EU law. A legislative proposal to harmonise the creditor hierarchy for senior debt in the EU was also presented. This is only the first step as a long negotiation period can be expected.

TLAC and MREL

A proposal to amend the resolution framework. On November 23 the European Commission released a proposal seeking to amend the EU resolution framework. It introduces TLAC for EU G-SIIs, amending MREL for other financial institutions. The entry into force is not expected before 2019.

SSM publishes its supervisory priorities for 2017

The SSM has streamlined its priorities for 2017 based on the sources of risk identified within the banking sector. They focus on the institutions' business model, credit risk and risk management. For each of these, a number of supervisory initiatives will be implemented, to allow banks to address these risks effectively.

A flawed EDIS proposal

Parliament has proposed amendments. In October, the European Parliament presented a draft report amending the EDIS proposal. It involves a substantial departure from the original text and fails to fulfil the objective of the banking union: to break the sovereign-bank vicious circle by reducing financial fragmentation.

Turning the spotlight on shadow banking

Non-banking entities and activities can help banks to support investments and growth. However, they can also be a source of systemic risk. Therefore, an adequate balance is needed to maximise the benefits while minimising the gloomy consequences of financial instability and regulatory arbitrage.

Geopolitics and Regulation

Increasingly interconnected. 2016 presented some important and unexpected political events. Geopolitics might influence more than ever developments in regulation. The run up of Presidential elections in some European countries might delay the progress on the EU integration. The German G20 Presidency will have to deal with a rise of populisms all over the world. At this stage, there are more questions than answers.

1 Finalisation of Basel III

More time is needed

The Basel Committee on Banking Supervision (BCBS) has announced that more time is needed to conclude the revision of the BIS III framework, also known in the industry as BIS IV, which was supposed to be finished by end-2016. The BCBS has stated that it remains committed to the goal of restoring confidence in risk-weighted capital ratios and that it will continue its work with a view to completing it in the near future. Among the items that were expected to be approved by the Group of Governors and Head of Supervision, the calibration of the output capital floor seems to be the main cause of disagreement within the Committee.

The BCBS started in 2013 a review of the current capital framework with the aim of increasing simplicity, risk- sensitivity and comparability of capital ratios across banks and jurisdictions. This review was targeted at both the standardised and internal model approaches for the main risks incurred by banks: i) credit risk, ii) market risk and iii) operational risk. The BCBS intended to finish this revision by end-2016 and have it endorsed by the GHOS on early January. However, the GHOS meeting has been postponed and, under this new scenario, it seems that the delay will last at least until the end of 1Q17.

Main parts of the review underway

The main items that were expected to be approved by the GHOS included:

- **A revised standardised approach (SA) for credit risk**, aimed at increasing risk sensitivity of risk-weighted assets (RWAs). In a first consultation the BCBS proposed eliminating any reference to credit ratings when determining RW. Nevertheless, in a second consultation, they were reintroduced for certain categories (banks and corporates). This was highly welcomed by the industry although concerns remained regarding calibration and risk sensitivity, given that this SA will be the base for the output floor.
- **A revised internal models approach for credit risk**. The use of internal models is seen as one of the main sources of variability in RWAs and the BCBS is searching to limit their use. The proposal therefore includes a restriction on the use of internal models (foundation and advanced) for certain exposures that would necessarily need to migrate to less advanced methods (SA or F-IRB respectively).
- **A new framework for operational risk**. The BCBS proposed a “standardised measurement approach” (SMA) aimed at combining in one single method the simplicity and comparability that is associated with standard approaches with the risk-sensitivity that comes with the use of internal models. This new SMA is designed to substitute all current methods, including the Advanced Measurement Approach (AMA). Despite the efforts of the BCBS to combine comparability and simplicity with risk sensitivity, the latter is still a key issue for the industry together with the transitional period toward this new SMA.
- **A capital output floor**. This capital floor would substitute the current Basel I floor and is aimed at increasing the comparability of capital ratios and mitigating modelling risk. This floor would set a lower bound for the capital requirements stemming from internal models, thereby limiting the risk-sensitivity of these models and also the capital savings that banks can achieve with their use. The introduction of this

measure has been extensively criticised by the industry, especially in Europe, given that the European banks traditionally rely more on internal models to calculate their capital requirements than their foreign counterparts.

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- **The banking system needs certainty regarding its regulatory framework**. After 9 years of great regulatory activism, the banking system and the markets need to have clarity about the prudential framework that will apply to banks and the sooner the better. Moreover, there is a proliferation of initiatives (both regulatory and supervisory) to achieve the same goal of increasing the comparability of capital ratios. Further understanding is needed of how these different initiatives will interact (for example, the finalisation of this review of BIS III and the TRIM Single Supervisory Mechanism project).
- **Improving RWA comparability is a valid objective that needs to be achieved.** But we have to be aware that in the search for the comparability of capital ratios we may be losing risk sensitivity in our capital framework. It is necessary to preserve the risk-sensitivity of capital requirements and reinforce the use of internal models as a management tool. Restrictions on the use of internal models mean a step backward in the promotion of improvements to risk modelling and advanced risk management associated with the Basel framework.
- **Any revision to the current framework should not further increase capital requirements significantly**. It is necessary to take into account that a global average impact of 10% can mean a much more significant impact on specific regions. After the great regulatory overhaul that the financial system has recently dealt with, we need to avoid putting more pressure on banks, especially in an environment of incipient, fragile recovery and low interest rates that is already exerting a lot of pressure on these entities and the financing of the economy.
- **Calibrating international standards is always challenging but it is necessary to take into account the different characteristics of the jurisdictions** in which these standards will be applied. Especially for emerging markets, where the particular features of their financial systems can result in a greater impact, both for local banks and for global banks with a decentralised model based on subsidiaries in these countries.

2 New package of banking reforms in the EU

A review of the prudential and resolution frameworks

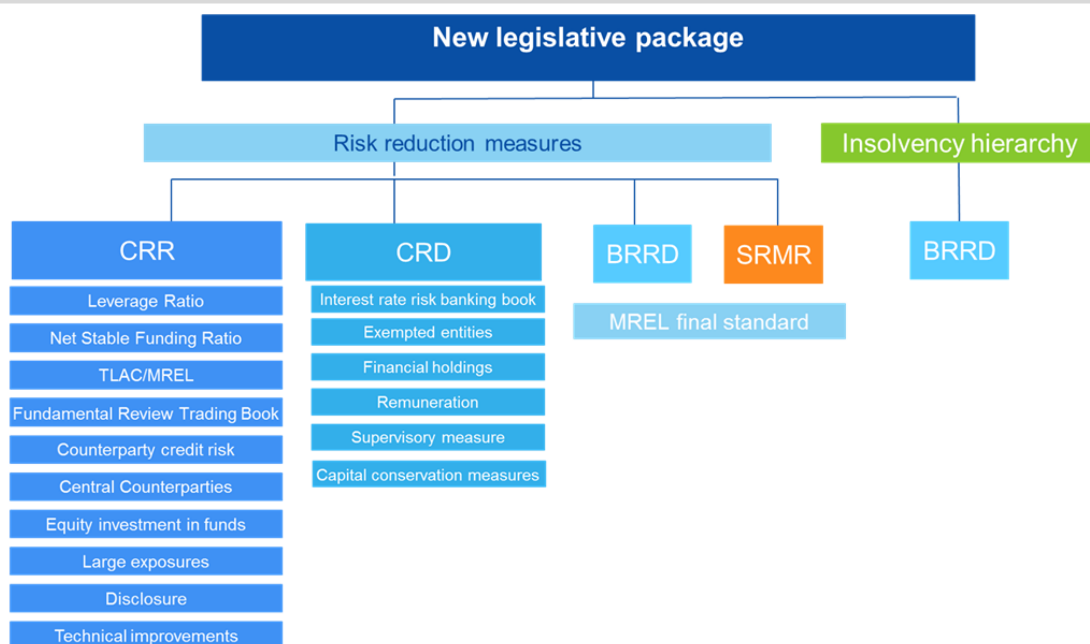
On November 23rd the European Commission presented a new legislative package aimed at amending both the current banking prudential and resolution frameworks. The revision includes the implementation of several international standards in EU law and the introduction of a package of technical improvements. In parallel, a legislative proposal was also released that harmonises the creditor hierarchy for senior debt across the EU. These proposals are only the first step in the EU legislative process. A negotiation period of approximately one year can be expected before a final text is agreed.

Content and timing of the proposal

This package of risk reduction measures includes the implementation of outstanding international standards (some regulatory items adopted by the Basel Committee after 2010 -- but not those that are currently under discussion in Basel -- and the TLAC standard) and at the same time certain amendments to take into account European specificities or unintended consequences identified in the Call For Evidence. The spirit of the Capital Market Union is also present as the Commission wants to ensure that strong banks continue to play a key role in supporting growth and financing the economy.

Figure 1

Commission's legislative package

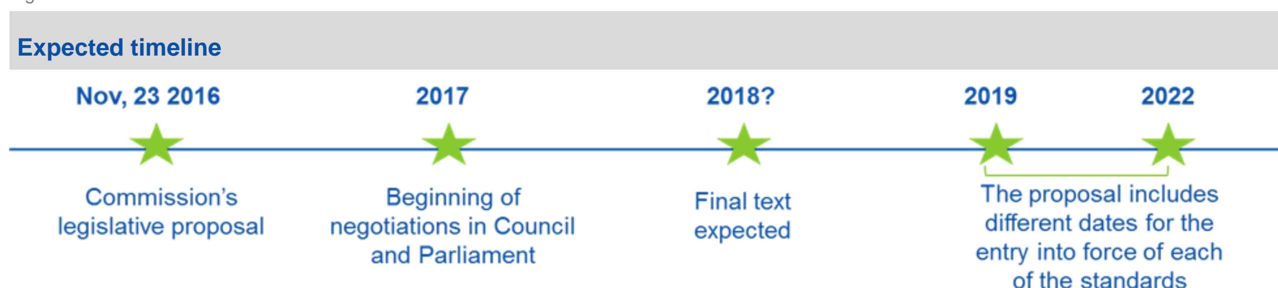


Source: BBVA Research

The Commission's proposal is only the first step in the European legislative process. Negotiations will now begin in the Parliament and the Council, both of which need to reach an internal agreement before trilogues can begin and a final text is agreed. The negotiation process is expected to last approximately one year and after the approval of the final text the different measures included in this review will have a specific date for their entry into force.

Figure 2

Expected timeline



Source: BBVA Research

BBVA Research assessment

- **The Commission's proposals present a wide and comprehensive review that affects both the prudential and resolution frameworks.** The implementation of international standards is positive and the technical improvements are welcome. After three years of application of the current prudential framework, we are in a good position to identify issues that are not working as expected.
- **Clarification of the implementation of international standards was needed and is welcome.** Nevertheless, uncertainty still remains, as European authorities will have to issue a great number of Regulatory Technical Standards. This remaining uncertainty could hinder capital planning for entities.
- **This review poses significant challenges for entities** given the magnitude of the proposed changes. Implementation of the proposed measures is likely to be operationally burdensome and sufficient time should be allowed for transition. Also, the interplay of different regulations can slow down the implementation process and raise potential inconsistencies.
- **The adjustments made to reflect European specificities are welcome.** However, it is also necessary to take into account the specific characteristics of the markets in which European banking groups operate in order not to unduly penalise banking groups with a global footprint.
- **The clarification of the new Pillar 2 framework is very positive.** It is necessary for the markets and institutions to bring certainty to the regulatory framework. Nevertheless, a breach of the MREL requirement should not trigger the activation of the MDA, as this requirement responds to a different nature than the prudential requirements.
- **The regulatory overhaul is still ongoing**. After eight years of designing and implementing new prudential and resolution standards, the review process has not yet ended. With the legislative package just released, the industry and the markets already have an eye on the finalisation of the Basel III framework.

3 TLAC and MREL

European Commission proposal to amend the resolution framework

On November 23 the European Commission published its proposal to amend both the prudential and the resolution frameworks in Europe. Regarding the latter, the proposal seeks to introduce TLAC for EU G-SIIs and amend MREL for other financial institutions. Its entry into force is not expected before 2019.

Main features

The Commission has released its legislative proposal to amend the CRR, CRDIV, BRRD and SRMR[1]. Regarding the changes to the resolution framework, the Commission's main objective is to **introduce TLAC in the EU**. For all entities, MREL will be calculated as **twice the sum of Pillar 1 and the new Pillar 2 Required** (the resolution authority may apply some adjustments), or twice the leverage ratio, whichever is higher. The same formula applies to EU G-SIIs but, in addition, they will have to comply with a minimum level of MREL set at 16% of RWAs or 6% of the leverage ratio exposure (from 2019 on) and 18% of RWAs or 6.75% of the leverage ratio exposure (from 2022 on). On a case-by-case basis, the resolution authority may require EU G-SIIs to comply with an additional "add-on" on top of the minimum requirement. The Commission has also clarified what happens when a **breach of MREL** occurs. In the case of an entity not able to roll over eligible debt, a breach of MREL will trigger MDA restrictions after a 6 month period. Additionally, the **eligibility of instruments** has been modified in the CRR to bring it closer to that of the TLAC Term Sheet. The subordination requirement is mandatory for EU G-SIIs and set by the resolution authority on a case-by-case basis for other entities. In parallel, the Commission has released a proposal to implement **a clear and harmonised creditor hierarchy in Europe for senior debt**. The Commission has opted to mirror the French approach by forcing EU Member States to create a "non-preferred" senior debt class that banks can use in order to issue TLAC/MREL compliant debt. Regarding the level of MREL application, the proposal introduces the **concepts of resolution entities and groups** for the scope of application but some clarification may be needed to make them consistent with both MPE and SPE resolution strategies. Finally, **the Commission reduced the burden of complying with art. 55** by allowing authorities to apply waivers.

From now on, the Council and the Parliament will have to review and approve the Commission's proposals and a final framework is not expected before 2019. Both institutions will also take into account the EBA's MREL final report, which was published recently. Compared to its interim report, the EBA now suggests, among other things, extending the subordination requirement to O-SIIs (with a lower requirement than for G-SIIs).

Assessment

The new legislative package represents a positive step forward in reducing regulatory uncertainty. However, there is still a lot of work to do to finalize the framework through the adoption of rules and the development of level 2 legislation. Also, a fast track transposition of the new subordination scheme is crucial so that banks can start issuing MREL compliant debt.

1: The Commission's proposal seeks to amend those legislative texts, not to release new directives or regulations.

4 SSM supervisory priorities and SREP methodology

SSM priorities for 2017 have a supervisory focus

On the basis of the sources of risk identified within the banking sector, the Single Supervisory Mechanism (SSM) has streamlined its priorities for 2017, focusing on the business model, credit risk and risk management of institutions. For each of these priorities, a number of supervisory initiatives will be implemented, in order to enable banks to address these risks effectively. Apart from that, the SSM has updated the SSM booklet, giving more transparency and clarity to the capital decision for next year.

Overview

During 2016, great progress was made in promoting banking supervisory objectives, strengthening both credit institutions, by contributing to their safety and soundness, and the entire financial system, by bringing stability.

Bearing in mind the economic, political, regulatory and supervisory environment, the Joint Supervisory Teams (JSTs) along with the National Competent Authorities (NCAs) and the support of macro prudential and micro prudential analysis from the European Central Bank (ECB), have identified sources of risk that arise from the banking sector.

By setting the supervisory priorities for 2017 the supervisor sets out the areas of focus for supervision. **2016's key risk areas** and the new challenges and geopolitical uncertainties define the **starting point** for the upcoming supervisory work. Based on this, the **supervisory priorities for 2017** are as follows: i) Business Models and Profitability Drivers; ii) Credit Risk, with a focus on non-performing loans (NPLs) and concentrations; and iii) Risk Management.

Defining these supervisory priorities will mark the path toward coordinated supervisory actions, granting a level playing field for assessing banks in a harmonised and proportionate manner.

2017 supervisory activities

The key risks identified are expected to drive concrete supervisory actions, and for each priority the SSM will carry out a number of related activities.

1) **Business model and profitability risk** remain a priority. The supervisor will continue to drive forward its thematic review as its main supervisory action for facing up to this risk and will perform in-depth examinations throughout the year, with a special focus on any new challenges arising that could impact the banks' business model (i.e., low interest rates, Brexit, the emergence of Fintechs and non-bank competition).

2) **Credit risk** is still a priority, due to the deterioration in the credit quality of loans to corporates and households and a persistently high level of non-performing loans (NPLs). Through an NPL task force, and with the recent publication of the draft guidance on NPLs, the JSTs will continue follow-up actions,

combining on-site and off-site elements. The main supervisory action to address this risk, along with the guidance and supervisory dialogue on NPLs, includes a thematic review of IFRS 9.

3) **Risk management**: remaining elements from 2016 have been combined (risk governance, capital adequacy and liquidity) highlighting the aspects to be addressed through a series of initiatives including: **i) compliance with the Basel principles for effective risk data aggregation and risk reporting (i.e., BCBS 239).** Sound risk management and adequate capital controls must be preceded by obtaining accurate risk information, which must be backed up by high data quality. Banks must exercise prudent risk management and during the coming year the supervisor will finalise its thematic review as the main supervisory action; **ii) targeted review of internal models (TRIM).** Supervisors will roll out a multi-year targeted review of internal models, together with on-site inspections connected with this exercise. This supervisory action aims at enhancing the credibility of the banks' risk management, assessing and confirming the adequacy and appropriateness of approved Pillar 1 internal models; **iii) Internal Capital Adequacy Assessment Process (ICAAP) and Internal Liquidity Adequacy Assessment Process (ILAAP).** These processes are key tools that allow banks to manage their capital and liquidity. As part of the SREP, the supervisor seeks to enhance their ICAAPs and ILAAPs, verifying that banks have put in place adequate processes to assess and maintain their capital and liquidity adequacy; **iv) outsourcing.** New risks connected with outsourcing are emerging, leading the supervisor to launch a thematic review to take stock of the banks' outsourced activities and scrutinise how they are managing associated risks.

SREP decision for 2017 and beyond

Apart from its supervisory priorities, the SSM has also published an updated version of the SREP booklet. This initiative tries to give more colours to the rationale behind the capital decision for next year.

According to the SSM, the SREP for 2016 revealed that the distribution of risks in the system remains broadly stable. Therefore, the SREP CET1 demand for 2017 has remained at the same level as last year. However, for individual banks the level may have altered due to changes in the risk profile of the corresponding financial institution.

In addition to this, the MDA (Maximum Distributable Amount) trigger decreased, from an average of 10.2% to 8.3% mainly due to: i) a shift of capital from the 2015 Pillar 2 to the newly introduced non-MDA relevant Pillar 2 Guidance (P2G) reflecting mainly the outcome of the stress tests; and ii) the exclusion of the non-phased-in part of the capital conservation buffer (CCB) in Pillar 2.

Assessment

Both initiatives, the publication of the SSM priorities and the updated version of the SSM booklet should be welcomed as they represent a clear commitment by the SSM to increased transparency. It is worth noting that Pillar 2 has been split into two parts, a requirement and guidance. This gives more flexibility to financial institutions as the Pillar 2 Guidance does not affect the MDA trigger and at the same time gives more clarity to financial markets for computing the distance to the MDA of each financial institution.

5 A flawed EDIS proposal

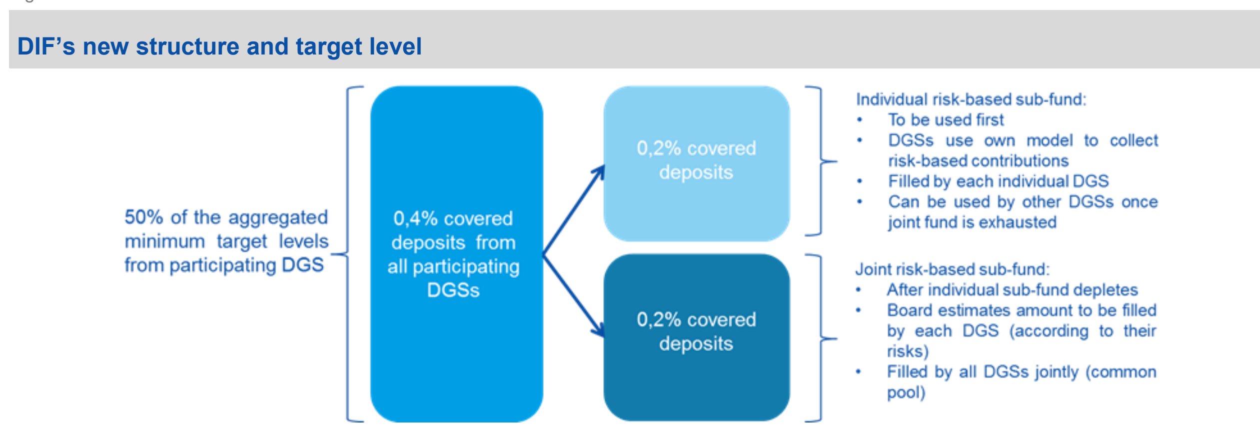
Parliament proposed amendments

In October, the European Parliament presented a draft report amending the European Deposit Insurance Scheme proposal. It involves a substantial departure from the original text and fails to fulfil the objective of the banking union: to break the sovereign-bank vicious circle and reduce financial fragmentation.

Under the proposed structure EDIS has two stages: reinsurance and insurance. The first phase would start in 2019, covering an increasing proportion of liquidity shortfall. During this stage EDIS provides only liquidity, but no loss coverage and no risk mutualisation. Progress to the next stage is conditioned by the implementation of a series of risk reduction measures (despite warnings from the ECB[2]), starting no earlier than 2024. Among the risk reduction measures, the harmonisation of the insolvency regime seems to be an unattainable objective in the near future, unnecessarily delaying progress. In the insurance phase, EDIS covers the liquidity shortfall in full and an increasing proportion of the excess loss. A strong national component remains: EDIS covers the excess loss to the level of funds that national DGSs should theoretically have. The proposal modifies the structure and target level of the Deposit Insurance Fund. National DGSs will have a target level of 0.4% of their covered deposits, and the DIF will have a target level of 0.4% of the covered deposits of all participating DGSs. This fund is divided into two sub-funds. In a trigger event, if national DGS funds are not sufficient, the DIF's individual sub-fund is used. When this is depleted, the joint sub-fund is used. After that, the individual sub-funds of other member states can be used. Finally, the risk-based contributions of the joint sub-fund would be calculated based on the aggregate level of risk of each DGS.

Figure 1

DIF's new structure and target level



Source: BBVA Research

Given the strong national component in the payment process (first, national DGS funds and individual sub-funds, then mutualisation), the structure of the DIF and the way contributions are calculated (estimating risks at the DGS-level rather than at the bank-level), the proposed amendments will certainly do little to help to break the sovereign-bank doom-loop. In that regard, the Commission's proposal was better suited.

2: On April 2016, the ECB released a document firmly supporting the creation of EDIS stating that: "Progress on other measures needs to be achieved in parallel …a solution that makes the transition from one phase to the next dependent on the progress with regard to risk reduction could cause delays."

6 Turning the spotlight on shadow banking

Pros and cons of the darkness

Non-banking entities and activities, such as crowd-funding and peer-to-peer lending, can be a helpful complement to the banking sector to support investment and economic growth. However, they can also be a source of systemic risk if not properly supervised and regulated. Therefore, an adequate balance is needed to maximise the benefits while at the same time minimising the gloomy consequences of financial instability and regulatory arbitrage.

Light on the shadow

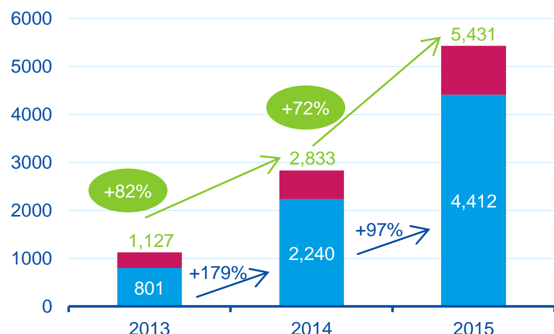
The concept and the metrics for shadow banking are still pending. Shadow banking is generally defined as "credit intermediation that involves entities and activities fully or partially outside the regular banking system"[3]. In 2015, the Financial Stability Board (FSB) proposed a more accurate definition considering five economic functions and their contributions to financial stability risks[4]. In addition to that, a group of economists from the International Monetary Fund (IMF) proposed an alternative definition based on the sources of funding and whether or not they are "non-core liabilities[5]. They consider that the previous definitions are short-sighted because they "miss significant non-traditional banking activities carried out by banks themselves, thus leading to an incomplete picture of [shadow banking] and of the potential vulnerabilities associated with it".

The FSB estimated that non-bank financial intermediation totalled EUR 102.2 trillion[6] at the end of 2014 (40% of total financial system assets) and EUR 29.6 thousand billion using the narrow definition. **In the EU, at the end of 2015**, the European Systemic Risk Board (ESRB) calculated EUR 37 million trillion[7] in terms of total assets (36% of total EU financial sector assets) using the broad definition. **Focusing on the online sector, by the end of 2015**, the total for alternative finance in the Asia-Pacific region was approximately EUR 95.6 billion, EUR 33.6 billion for the Americas, and EUR 5.4 billion (+92% YoY) in Europe. The data show that the European market is still small when compared to the other two regions. In Europe, the United Kingdom is the largest market by a considerable margin[8].

3 Source: ESRB. EU Shadow Banking Monitor No 1 / July 2016 Page 6.
4 Source: *A measure of shadow banking based on economic functions* (sect.2.) FSB 2015 Global Shadow Banking Monitoring Report.
5 Core liabilities are issued only by banks and non-core liabilities can be issued by banks, money market funds and other financial intermediaries. Explanation can be found in *Shedding Light on Shadow Banking* Artak Harutyunyan et al. IMF WP. Jan 2016.
6 10^12. Source: FSB's 2015 Global Shadow Banking Monitoring Report for more. Exchange rates 1.21410 USD/EUR. Source: BCBS.
7 10^18
8 Source: Sustaining momentum: the 2nd European alternative finance industry report.University of Cambridge & KPMG. 2016

Figure 1

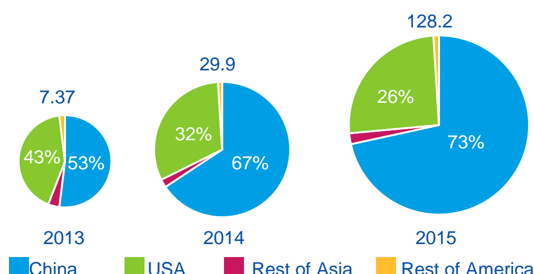
European Online Alternative Finance Market Volumes 2013-2015 (in EUR million)



Source: BBVA Research based on University of Cambridge & KPMG

Figure 2

Asia-America Online Alternative Finance Market Volumes 2013-2015 (in EUR billion)



Source: BBVA Research based on University of Cambridge & KPMG

Digital shadow banking

With the emergence of new technologies, digital finance platforms have expanded rapidly. **They facilitate millions of transactions every day for individuals and businesses** and play a significant role in the provision of a viable 'alternative' to traditional sources of financing. A variety of online platform-based models exist, such as donation-, reward- and equity-based crowd-funding, peer-to-peer consumer and business lending, invoice trading and debt-based securities.

In Europe, funding for businesses has increased considerably since 2014, becoming an important source of finance for entrepreneurs, start-ups and small & medium-sized enterprises (SMEs). In 2015, EUR 536 million of business finance was raised through online alternative funding models, providing capital to 9,442 businesses. It is providing early stage investments to start-ups and growth capital to SMEs, stimulating regional economies and funding worthwhile causes. It should also be noted that, according to the European Commission, in recent years, access to financing has become overall the least important problem for SMEs, while in 2009 it was the second most urgent one. **The alternative business funding market has probably been a relevant variable in explaining that improvement.**

At this point, we would like to highlight that one of the largest lending platforms is applying for a banking licence in the UK. It will become the first *P2P banking company* under the scrutiny of the Financial Conduct and Prudential Regulation Authorities. Business diversification, synergies and consumer protection seem to be the main drivers of that strategy: deposits raised from the bank would fund P2P loans. Last, but not least, the platform will also bring protection for its consumers' deposits, given the fact that they will be included under the umbrella of the Financial Compensation Scheme, not extended to "pure" P2P depositors.

There are different possible explanations for the increase in alternative business funding platforms, one of them being the **financial crisis**: with near-zero interest rates, as investors entered these new markets, searching for the higher rates available due to P2P assets exposure. For potential borrowers, there is a wider range of credit options, as regulation has become stricter and a lack of trust in the traditional banks has expanded. Another reason that explains the expansion of alternative finance could be linked to the **nature of the traditional banking market**, where high entry barriers make it difficult for new banks to

emerge. Financial intermediary costs have remained stable for years, while **the new online lender players face lower costs due to their lack of branches and lower administrative burden.**

Yet another possible explanation for this boom could be that finally **digitisation is mature enough in society** for the public to use on-line channels to perform financial transactions. But the most important driver is probably the **rise of new technologies**, which has enabled the rapid entry of new players into the financial markets.

Digital Regulation

As a result of the expansion of the alternative finance market, governments **have started to issue local regulations with different approaches**, ranging from more restrictive ones in countries such as the US, Germany or France, versus less restraining norms in the UK and New Zealand.

In Europe, **the lack of a common legal framework may be hampering the development of online-based platforms,** as it implies major risks to both consumers and investors and does not ensure a level playing field between financial and non-financial institutions.

Recently, **fraud incidents regarding crowd-funding platforms have proved that some regulation is needed for these entities**. One of the most significant cases is related to the biggest Chinese P2P lending platform Ezu Bao, which collected 50 billion Yuan ($7.6 billion) in less than two years. Investigations revealed that top executives used investors' money to enrich themselves. After this, China issued a regulation to toughen its control of peer-to-peer lending companies.

Some of these new entrants (Lending Club, Prosper, Kabbage) favour the use of other terms, such as "market-based financing", instead of "shadow banking" to define their business. In any case, issues such as **insufficient understanding on the part of consumers, the collapse of platforms, loan defaults, cyber-attacks and credit and/or investment protection must be addressed by the authorities in regard to these players**; regulation is therefore becoming another key driver for the adoption of these alternative finance solutions.

Conclusions

Shadow banking can be a useful tool for helping the banking sector in the provision of credit, especially in Europe, where approximately two-thirds of funding depends on banks[9]. Non-banking funding can also contribute to facilitating market liquidity and risk sharing and to fostering competition and innovation through the support of new ideas and projects. In particular, digital-based platforms have grown dramatically in size and scale over the past few years. On the other hand, if not adequately supervised and regulated, non-bank funding can contribute to an increase in systemic risk through interconnections with a few players from the financial system, especially the banking sector. Besides, non-bank funding might weaken the level-playing-field as a consequence of regulatory arbitrage due to undeserved advantages. The setbacks relating to fraud and cyber security attacks suffered by some P2P need to be addressed by the regulators, providing a comprehensive framework for the development of these shadow banking activities, and allowing the development of instruments that can contribute to maximizing the advantages of digital shadow banking while minimizing its inconveniences. Consumers could take advantage of gains in efficiency and have access to wider and more competitive services and, last but not least, financial entities would have the possibility of bolstering their innovation projects and learning faster.

9: Source: ECB's "Shadow banking in the euro area: risks and vulnerabilities in the investment fund sector" No 174. July 16. Point 2.2

7 Geopolitics and Regulation

Increasingly interconnected: More surprises to come?

2016 was characterised by some important and unexpected political events, such as Brexit and Trump's election. The expectation is that geopolitics could influence any development in regulation on both sides of the Atlantic more than ever before. In addition to this, the run up to the Presidential elections in several European countries may delay the progress of the European integration process, especially of the banking union. Finally, the German presidency of the G20 will have to deal with a rise in populism all over the world.

Geopolitics is growing in importance for all kind of matters and financial regulation is no exception. At this stage there are more questions than answers, but certainly political analysts should be in the loop to better anticipate changes or impacts in regulation.

- **Brexit.** Political negotiations for the UK's exit from the EU remain very complex and there is huge uncertainty about the final outcome. The main issues of the negotiation are the future of the UK's participation in the single market, the UK's immigration policy and contributions to the EU budget. In the event of a "Hard Brexit", the UK will lose its passport rights, which will have devastating effects on the City as this means that financial firms located in the UK will need authorisation from the host country to operate across the EU. An alternative to the passport is "third-country equivalence". A case in point in the new political situation is that the European Commission has included a provision in the banking package reform published in November 2016, by which foreign banks with a significant presence in Europe will be obliged to establish an intermediate holding company in Europe. This has been deemed to be retaliation for the US Foreign Organisation Act, but the Brexit dimension should not be neglected.
- **US**. There is still a huge uncertainty about Trump's plans for the financial regulation agenda. He is expected to show a softer stance towards regulation, if not deregulation itself, and a protectionist bias. Indeed, the million dollar question is to what extent will the new Administration dismantle the Dodd Frank Act as announced in the campaign? Many observers think that he will only modify some parts of the rule. Besides, clarification on what role the new government will play in international fora such as the G20 or the Basel Committee is critical for shedding some light on the US's commitment to agreed international standards. Finally, another unknown is whether the Financial Choice Act proposed by Jeb Hansarling, Chairman of the Financial Services Committee, will gain traction. This initiative establishes that banks holding a Leverage Ratio of at least 10% will not be subject to any other regulation.
- **EU**. Presidential elections during 2017 in some European Countries, such as the Netherlands, France, Germany and potentially Italy, might well influence the discussion on the future of Europe, the speed of integration, the creation of a European Deposit Guarantee Scheme, not to mention a fiscal union. Any significant change in the European architecture is not likely to happen before those elections.
- **Global**. The goal of Germany's presidency of the G20 will be to ensure that globalisation benefits everyone as a key tool for fighting global challenges, such as populism, terrorism, nationalism and refugee movements. A top priority will be the stability of the global economy and also improving future viability and accepting responsibility, especially for Africa.

Main regulatory actions around the world over the last months

	Recent issues	Upcoming issues
GLOBAL	**On 3 October, IOSCO** published report on corporate governance framework **On 11 October, BIS** on regulatory treatment of accounting provisions **On 12 October, BIS** publishes definitive standard on TLAC Holdings **On 17 October, ISDA** report on key trends in clearing for small derivatives users **On 19 October, FSB** publishes methodology for assessing the implementation of its Key Attributes **On 19 October, BIS** progress report on adoption of Basel regulatory framework **On 28 October, IOSCO** reports on implementation of G20/FSB measures to strengthen securities markets **On 8 November, BIS-CPMI** report on fast payment services **On 21 November, FSB** releases 2016 list of G-SIBs and G-SIIs list **On 29 November, FSB** publishes responses to CCP resolution consultation **On 15 December, IOSCO** on the implementation and disclosure of the IFRS standards **On 16 December FSB** on proposed guidance to support resolution and resolvability **On 19 December, FSB** publishes progress report on correspondent banking **On 21 December, IOSCO** publishes documents with the aim of protecting investors **On 3 January, BCBS** announces delay on the finalisation of BIS III	
EUROPE	**On 12 October, EC** Implementing Regulations laying down ITS on assessments of external credit assessment institutions regarding credit risk and securitisation positions **On 19 October , EC** published final report on the feasibility of alternatives to credit ratings and the state of the credit rating market **On 24 October, EC** adopted Delegated Regulation on RTS for benchmarking portfolio assessment standards and sharing procedures under CRD IV **On 11 October, EP ECON** published draft report on a motion for a resolution on an annual report on the Banking Union in 2016 **On 31 October, EC** adopted a draft Delegated Regulation on RTS for additional liquidity outflows **On 9 November, EC** proposed a 1 year extension on the application of the Regulation on key information documents for PRIIPs Regulation **On 22 November, EC** issued a proposal for a Directive on preventive restructuring frameworks **On 22 November, EC** launched the Start-up and Scale-up Initiative **On 23 November, EC** proposed amendments to CRD IV, BRRD and SRM Regulation **On 23 November, EC** published results of its September 2015 call for evidence **On 23 November, EC** has published the findings of its review on EMIR **On 28 November, EC** published a proposal for a Regulation on a framework for the recovery and resolution of CCPs **On 24 October, Council of the EU** published compromise text on a proposal for Regulation amending the Regulation EuVECA and the Regulation on EuSEF **On 3 October, EBA** published final Guidelines on implicit support for securitisation transactions **On 11 October, EBA** published final guidelines on corrections to modified duration for debt instruments **On 20 October, EBA** recommends that only GSIIs and OSIIs investment firms are subject to the full CRDIV/CRR **On 3 November, EBA** published final guidelines on ICAAP and ILAAP **On 4 November, EBA** on new prudential regime for investment firms **On 4 November, EBA** issues recommendations on the implementation of new counterparty and market risk frameworks **On 10 November, EBA** provides its views on IFRS 9 and its impact on banks **On 16 November, ESAs** provide guidance on anti-money laundering and counter-terrorist financing supervision **On 21 November, EBA** provides overview on the application of remuneration requirements across the EU **On 22 November, EBA** publishes final standards on assessment methodology to validate market risk models **On 24 November, EBA** launches 2nd impact assessment of IFRS 9 **On 30 November, EBA** amends supervisory reporting standards due to IFRS 9 **On 1 December, EBA** updates list of CET1 instruments **On 14 December, EBA** recommendations to strengthen loss-absorbing capacity **On 14 December, EBA** published guidelines on Pillar 3 disclosures requirement **On 20 December, EBA** recommends a harmonised EU-wide framework for covered bonds **On 4 October, ESMA** issued report on securities financing transactions (SFTs), leverage and pro-cyclicality in the EU's financial markets **On 10 October, ESMA** issued final Guidelines regarding the implementation of the transaction reporting regime under MiFID II / MiFIR	

	On 14 October, ESMA published Guidelines on Sound Remuneration under UCITS and on Sound Remuneration under the AIFMD **On 10 November, ESMA** published a Public Statement on IFRS 9 issues **On 14 November, ESMA** published final report on the application of the clearing obligation for some financial counterparties under EMIR **On 15 November, ESMA** published Final Report on Guidelines on the validation and review of Credit Rating Agencies' (CRAs) methodologies **On 16 December, ESMA** agrees with the MAR accepted market practice on liquidity contracts proposed by Spanish regulator CNMV	
MEXICO	**On Nov 15, CNBV** adjusted its Securities Issuers' handbook simplifying listing requirements in terms of minimum stockholders and capital placed **On Nov 17, CNBV** modified rules on investment funds to address adhesion contracts for distribution of shares, increasing transparency for investors **On Dec 16, CNBV** ratified its list of D-SIBs	**The Fintech law project** has yet to be presented by the Secretariat of Finance. **CNBV's proposal** for dealing with identity theft through on-line ID validations by banks.
LATAM	**On 27 October, BCRA** raised the ceiling on banks' global FX position to allow for the increase in dollar-denominated deposits **On 25 November**, **BCRA** permitted part of the excess dollar lending capacity to be used to buy Treasury bonds **On 14 November, BCRA created DEBIN**, an online payment system to debit/credit bank accounts with prior client authorization **Colombia:** tax reform under discussion in Congress to reduce taxes on businesses and increases them to individuals	**Argentina**: A bill reforming the Capital Markets Law was sent to the congress to eliminate "double taxing" on dividends and enable the operation of "closed" investment funds **Peru:** tax reform under discussion, to allow payment of mortgage interest to be discounted on the income tax **Colombia:** Financial Conglomerates Bill approved in the second debate, but discussions in the House of Representatives to continue during 2017
USA	**On 5 October, CFPB** finalized rules to protect prepaid account consumers **On 15 November, FDIC** final rule establishing recordkeeping requirements for FDIC-insured institutions with a large number of deposit accounts **On 2 December, OCC** announced it "will move forward" with plans to provide special-purpose national bank charters to financial technology firms. **On 10 December, agencies** issued interagency final rules increasing the number of small banks eligible for an 18-month examination **On 15 December, Fed** finalized rules on how much TLAC US G-SIBs are required to hold **On 19 December, Fed** approved a rule requiring large banking organizations publicly disclose certain quantitative liquidity risk metrics **On 28 December, OCC** finalized a rule prohibiting national banks from dealing or investing in industrial and commercial metals	**CFPB** continues to establish its nonbank supervisory authority by defining larger participants of certain markets for consumer financial products and services. It is in the process of reviewing comments on the proposed rulemaking concerning the use of arbitration clauses in consumer financial agreements; it is also reviewing comments on its proposed rulemaking to address consumer harms from practices related to payday loans, vehicle title loans, and other similar credit products. It is also engaged in developing proposed rules to regulate debt collection practices
TURKEY	**CBRT** adjusted the ROM mechanism allowing for the use of scrap and processed gold up to 5% for TL liabilities and with a coefficient of 1. Reserve option coefficient for the first tranche of the FX facility of Reserve Option Mechanism remains unchanged, while the other tranches have been reduced General provisions for SME loans were reduced from 0.5% to 0% and general provisions for commercial loans were lowered from 1% to 0.5% **IFRS-9 process** postponed by one year for banks that are not ready Treasury's guarantee has been extended through the Credit Guarantee Fund **CBRT** lowered interest rates for the credit card borrowings affecting overdrafts Implementation of limits for FX collateral deposits: Banks' limits will be applied as four times the limits allocated before 17 July 2016	Possible abolishment of banking and insurance transaction tax for derivatives There will be a 7.5% interest rate cap on public deposits at state banks **The Bank Association of Turkey** is working on a draft regulation: GLLP amount which is not reflected in net income or not included in core capital due to the upper limit 1.25% of credit risk might be included in core capital. **SME** loan definition to be extended for loans with nominal value below TL125 M
ASIA	**On 16 December, CBRC** published guidelines for commercial banks' collateral management in order to mitigate risks **On 23 November, CBRC** announced new risk management guidelines for commercial banks' off-balance sheet business **On 16 December, CSRC** announced new guidelines for securities and futures investors, which will be implemented on July 1, 2017	

Source: BBVA Research

Abbreviations

AIFMD	Alternative Investment Fund Managers Directive	**FSB**	Financial Stability Board
AMC	Company for the Management of Assets proceeding from Restructuring of the Banking System (Bad bank)	**FTT**	Financial Transactions Tax
AQR	Asset Quality Review	**G-SIB**	Global Systemically Important Bank
BCBS	Basel Committee on Banking Supervision	**G-SIFI**	Global Systemically Important Financial Institution
BIS	Bank for International Settlements	**IAIS**	International Association of Insurance Supervisors
BoE	Bank of England	**IASB**	International Accounting Standards Board
BoS	Bank of Spain	**IHC**	Intermediate Holding Company
BRRD	Bank Recovery and Resolution Directive	**IIF**	Institute of International Finance
CCAR	Comprehensive Capital Analysis and Review	**IMF**	International Monetary Fund
CCB	Counter Cyclical Buffer	**IOSCO**	International Organization of Securities Commissions
CCP	Central Counterparty	**ISDA**	International Swaps and Derivatives Association
CET1	Common Equity Tier 1	**ITS**	Implementing Technical Standard
CFTC	Commodity Futures Trading Commission	**Joint Forum**	International group bringing together IOSCO, BCBS and IAIS
CNMV	Comisión Nacional de Mercados de Valores (Spanish Securities and Exchange Commission)	**LCR**	Liquidity Coverage Ratio
COREPER	Committee of Permanent Representatives to the Council of the European Union	**LEI**	Legal Entity Identifier
CPSS	Committee on Payment and Settlement Systems	**MAD**	Market Abuse Directive
CRA	Credit Rating Agency	**MiFID**	Markets in Financial Instruments Directive
CRD IV	Capital Requirements Directive IV	**MiFIR**	Markets in Financial Instruments Regulation
CRR	Capital Requirements Regulation	**MMFs**	Money Market Funds
CSD	Central Securities Depository	**MoU**	Memorandum of Understanding
DFA	The Dodd–Frank Wall Street Reform and Consumer Protection Act	**MPE**	Multiple Point of Entry
DGSD	Deposit Guarantee Schemes Directive	**MREL**	Minimum Requirement on Eligible Liabilities and own Funds
EBA	European Bank Authority	**MS**	Member States
EC	European Commission	**NRAs**	National Resolution Authorities
ECB	European Central Bank	**NSAs**	National Supervision Authorities
ECOFIN	Economic and Financial Affairs Council	**NSFR**	Net Stable Funding Ratio
ECON	Economic and Monetary Affairs Committee of the European Parliament	**OJEU**	Official Journal of the European Union
EDIS	European Deposit Insurance Scheme	**OTC**	Over-The-Counter (Derivatives)
EIOPA	European Insurance and Occupational Pensions Authority	**PRA**	Prudential Regulation Authority
EMIR	European Market Infrastructure Regulation	**QIS**	Quantitative Impact Study
EP	European Parliament	**RRPs**	Recovery and Resolution Plans
ESA	European Supervisory Authority	**RTS**	Regulatory Technical Standards
ESFS	European System of Financial Supervisors	**SCAP**	Supervisory Capital Assessment Program
ESM	European Stability Mechanism	**SEC**	Securities and Exchange Commission
ESMA	European Securities and Markets Authority	**SIB (G-SIB, D-SIB)**	Global-Systemically Important Bank, Domestic-Systemically Important Bank
ESRB	European Systemic Risk Board	**SIFI (G-SIFI, D-SIFI)**	Global-Systemically Important Financial Institution, Domestic-Systemically Financial Institution
EU	European Union	**SII (G-SII, D-SII)**	Systemically Important Insurance
EZ	Eurozone	**SPE**	Single Point of Entry
FASB	Financial Accounting Standards Board	**SRB**	Single Resolution Board
FBO	Foreign Bank Organisations	**SREP**	Supervisory Review and Evaluation Process
FCA	Financial Conduct Authority	**SRF**	Single Resolution Fund
FDIC	Federal Deposit Insurance Corporation	**SRM**	Single Resolution Mechanism
Fed	Federal Reserve	**SSM**	Single Supervisory Mechanism
FPC	Financial Policy Committee	**TLAC**	Total Loss Absorbing Capacity
FROB	Spanish Fund for Orderly Bank Restructuring	**UCITS**	Undertakings for Collective Investment in Transferrable Securities Directive
FSAP	Financial Sector Assessment Program		

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