Financial Regulatory Divergences between EU and US

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Divergences between the EU and the US are evident. In some cases convergence is not possible. In others it just must happen, but how?

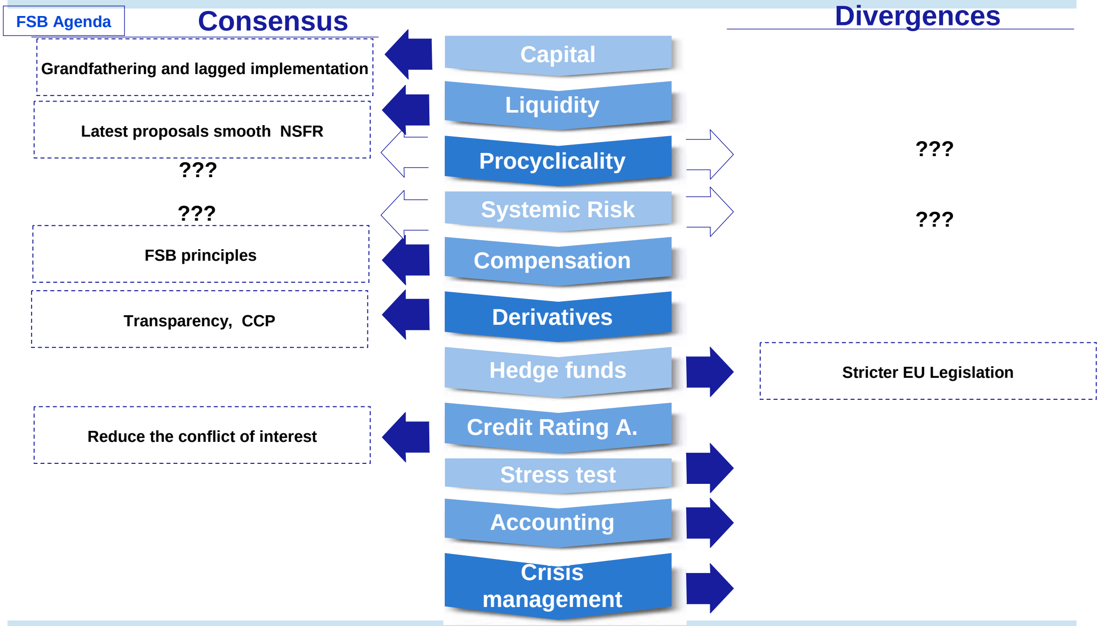
- **Public disclosure** of stress test results is necessary in Europe though **not sufficient**. Results must be **credible** in order to provide **triage** among banks. Moreover, a **public backstop facility must be put in place** to prevent panic reactions in case of a dire outcome. Biggest **challenge for EU** authorities will be to ensure **credibility**.
- **Move from rhetorical convergence** between FASB and the IASB, to real convergence. The European mix model should prevail.
- **Avoid patch work effects** by focusing only in one stage (in Europe **bank levy**) and develop a **comprehensive an effective crisis management framework** (prevention, early intervention, resolution and liquidation)
- Establish **a benchmark in supervisory practices** to provide homogeneous micro-prudential supervision**.** We welcome that In Europe **Macro-prudential** to be carried out **in close cooperation with central banks. Better information sharing mechanisms.**

Global governance: diverging forces seem to be gaining ground…

- Initial spirit of cooperation and global collaboration
- Real commitment to make the G20 the central forum for coordinated financial regulatory reform
- Divergences appear when specific issues are addressed
- Political pressure in the US and sovereign debt crisis in Europe incentive unilateral solutions
- US financial reform approved
- Fiscal consolidation will be the main issue
- Financial debate will center on bank levy, where there is total lack of consensus: EU wants a bank levy, emerging economies oppose bank levy and the US would most probably favor an ex-post bank levy

Section I

Main messages



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Transparency: Stress testing in Europe

1 EU leaders agree to publish STRESS TESTING results by mid july

Stress Testing
- Stress tests results and methodology must be published
- Triage only granted if individual results are also published
- They should be rigorous and credible
- They are only a first step

Financial backstop facility
- Allows for a prompt recapitalization of ailing entities
- Avoids a negative market reaction to stress test results
- EU governments should be clear on this point

Strong conditionality
- Facilitates an appropriate cleaning-up of the financial sector, avoiding current distortions

Transparency: Stress testing

	Sample	Methodology	Disclosure	Backstop facilities
In the **US**, the American SCAP was a resounding policy success which stabilized the financial system.	19 largest banks covering 2/3 of the banking sector assets	Public, though important details lacking. Private sector could not replicate exercise. Combined both top down and Bottom up approaches.	Yes, firm-by firm	Yes, Treasury established Capital Assistance Program (CAP): $700 billion from TARP funds
In **Europe**, the 2010 test started in March and is about to get finalized. It is a follow-up of the one performed by CEBS in 2009	25 large cross-border banks representing (60% of the banking sector assets	Not published. National supervisors have the ultimate responsibility for Individual results. CEBS agglutinates national figures and publishes aggregated data. Only top-down approach.	Not published in 2009 Will be published in 2010, though not clear how results will be displayed.	Not explicitly, but most countries have recapitalization programs.
Can Europe replicate the success of the American experience? Significant doubts arise…	• **Focus on size** specially **misleading** for Europe, where in countries like Spain or Germany the biggest threat comes from smallest but weak and interconnected entities.	• **Credibility of results not guaranteed:** 27 different, opaque, methodologies, with a low degree of interaction and iteration. Private sector should be able to replicate the exercise.	• **Publication of individual, detailed**, results is crucial in order to provide triage and enhance trust.	• Most European **recap programs are due to expire in June.** Will/could they be prolonged still?

Transparency: Stress testing

What are the main risks associated to disclosure of the stress tests results?

TWO RISK SCENARIOS

SCENARIO A

Most banks pass the test or show very low capital needs:

- Results not credible. No triage
- Uncertainty exacerbates crisis

SCENARIO B

Some or most banks are much worse than expected:

- If backstop facility: OK
- If no backstop facility: panic

Most likely

Potential size of national backstop facilities: recapitalization amounts approved for general aid and ad hoc programs in the EU

	PUBLIC RECAPITALISATION PROGRAMS			AD HOC PUBLIC RECAPITALISATIONS
	Expiry date	Number of times prolongued	Maximum amount (billion €)	Amounts approved (billion €)
Austria	30/06/2010	2	15	0,5
France	expired 2009	0	24	62,2
Germany	30/06/2010	2	80	107,6
Italy	31/12/2009	1	20	0
Portugal	30/06/2010	1	4	0,5
Spain	30/06/2010	0	99	0
Sweden	expired feb 2010	1	4,8	0,5
UK	expired feb 2010	3	63	405,6
US (CAP)	expired 2009	0	700	

Source: European Commission and BBVA Research

- **Most countries have "backstop facilities" or are likely to put them in place (France).**
- On average, less than 30% of the amounts approved (€338 bn) have been used.
- Adding up capital used to ad hoc recapitalizations gives a total sum of €240bn.
- This shows that there is room for pouring more money into the sector, but programs are set to expire soon, could they be prolonged still?
- If not, create new programs or resort to the EFSF €440bn as the US did with the TARP funds?

Transparency: Accounting Standards

1 **Rhetorical convergence, but divergences de facto…**

3 Stages

3 Stages	EU	US
CLASSIFICATION & MEASUREMENT	**Mixed Model** Promoting the use of amortized cost	**Fair Value**
IMPAIRMENT METHODOLOGY	**Expected Loss**	**Rather Undefined** Present value of management's current estimates
HEDGE ACCOUNTING	**Due**	

Section II

Transparency: Accounting Standards

2 **Need for a convergence to realistic fair countercyclical standards…**

CONVERGENCE IASB/FASB	Doubtful FASB's convergence to common framework	Divergences US and EU leading to: • Playing Field Fragmentation • Unfair Competition	June 2011: G-20 deadline for CONVERGENCE
ACCOUNTING ROLE	Should not dampen a sound prudential regulation and must ensure good management practices	Standards must: • Remain relevant, realistic and informative • Avoid imposing unnecessary burdens	Need for more realistic valuation Approach: Amortized cost & Dynamic provisioning model
FAIR VALUE vs. AMORTIZED COST	Procyclical nature of fair value accounting	Considered as a driver of the past crisis (collapse in current value of asset-backed securities)	
IMPAIRMENT METHODOLOGY	Procyclical nature of incurred loss methodology	Need for: • Countercyclical buffers • Smooth of banks' benefits	

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Moral Hazard & Crisis management framework

Moral Hazard + Crisis Management

Need to develop the completed diagram, no individual phases

EU

- **EP: Radical Proposals**
- **Council: Approval proposal, following the scheduled times**
- **Lack of consensus on**
- **Focus in Europe**
- **Lack of consensus**
- **National Legislation**

Prevention (Supervision)

Early Intervention (Living Will & CoCos)

Resolution (Bank Levy & Resolution Fund)

Liquidation

US

- **Sprints for Finance Reforms led by G.20. House will vote 29 June. Expect approval before July 4**
- **Us approach more development than EU**
- **Sprints for Finance Reforms led by G.20. House will vote 29 June. Expect approval before July 4**
- **National legislation**

Moral Hazard & Crisis management framework

Prevention : Micro Supervision

EU

- **New Supervisory Authorities (ESAs) in banking, securities and insurances and pension funds**
- **ESAs will be observers in colleges of supervisors**

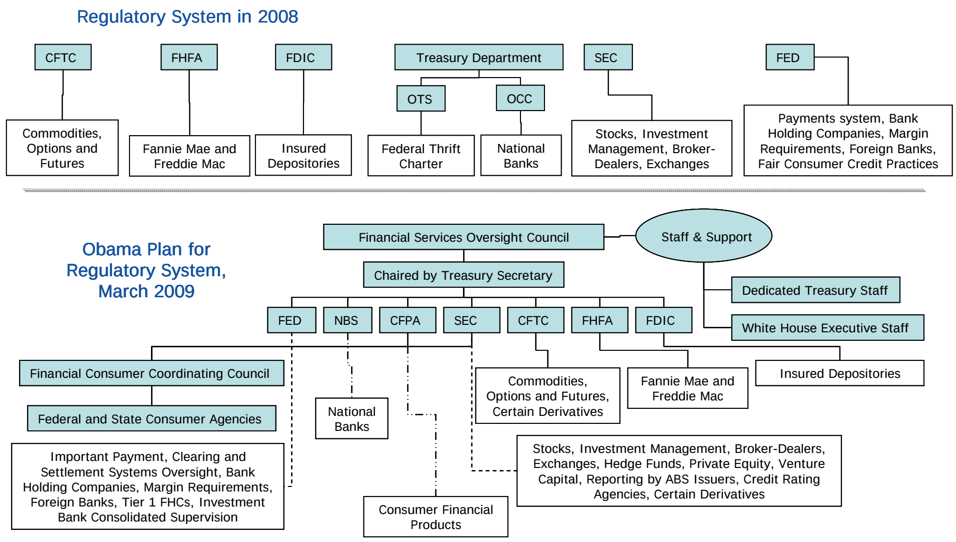
US

Simplification of the former system but still too many supervisor feed regulatory arbitrage

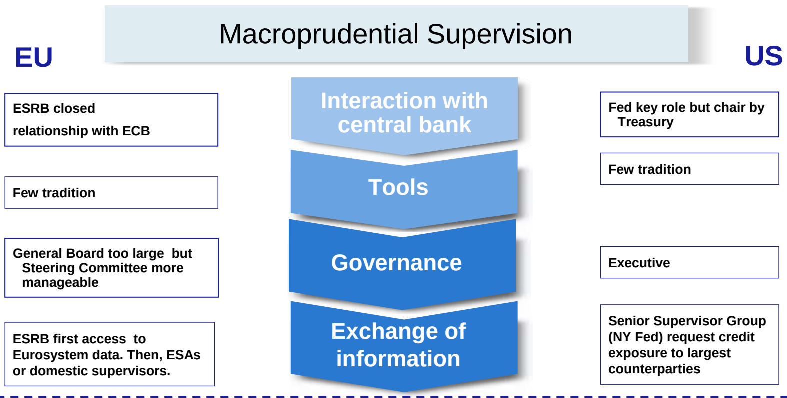
- Unfortunately “**twin peaks**” model is rather the exception
- Despite being a critical issue, not too much attention in the G 20
- Need for convergence of supervisory practices in order to avoid regulatory arbitrage
- Benchmark of supervisory practices to avoid competitive disadvantages Vs competitors
- ESAs will set a single rule book only in a learning by doing basis
- European single supervisor: may be good in the LT but no in the ST.
- Colleges of supervisors can play a key role to reduce discretionality of the home supervisor but is subject to: confidentiality, high level representation…

Moral Hazard & Crisis management framework

Reform Structure Before the Crisis and the White House's Proposal



Moral Hazard & Crisis management framework



- Main doubt**: 1) assesment, 2) large gap between assesment and decision making capacity, 3) tools: Asian experience should be taken carefully.** Control of credit may be prove inefficient in more developed, deep and sophisticated markets
- Close cooperation with central bank is key: expertise and link between monetary policy and financial stability Governance has to be operative
- Information channels:Need to better capture global risk.
- Room for improvement in collecting information of payment system, counterparties and network exposures

Section III

Moral Hazard & Crisis management framework

Macroprudential instruments cited by CGFS survey respondents

Type of instrument	Examples	Economies that have used the instrument	
		Advanced	EME
Measures targeting credit growth			
Limits calibrated to borrower risk characteristics	LTV caps, DTI limits, foreign currency lending limits	2	9
Absolute limits	Aggregate or sectoral credit growth ceilings, limits on exposures by instrument		4
Measures targeting size and composition of bank balance sheets			
Measures to limit interconnectedness			
Limits on leverage	Size-dependent leverage limits or asset risk weights, capital surcharges for systemically important institutions	2	2
Financial system concentration limits	Limits on interbank exposures	1	2
Measures to limit procyclicality			
Capital	Time-varying capital requirements, restrictions on profit distribution	1	1
Provisioning	Countercyclical/dynamic provisioning	1	5
Measures to address specific financial risks			
Liquidity risk	Loan-to-deposit limits, core funding ratios, reserve requirements	1	8
Currency risk	Limits on open currency positions or on derivatives transactions		8

Source: BIS

Section III

Moral Hazard & Crisis management framework: Early intervention

Early intervention

EU

- Insignificant notarial document
- It is no international consensus about the use and effectiveness of contingent capital

Living Will

CoCos

US

- Tools have been applied later than in the EU, but the US application proves to be more managed and resolved..
- Agrees to impose contingency capital requirements

Bottom line

- **Living Will:** To be useful is necessary a consensus on the way to elaborate a living will, the coordination among supervisor in their approval and implementation
- **Cocos:** To include some kind of contingent capital could provide several benefits for financial stability and ease crisis management due to its anti-cyclical character

Resolution

EU

- European Commission: Proposes an **ex-ante** resolution fund (funded by a levy

Bank Tax & Resolution Fund

US

- Financial Crisis Responsibility Fee: the tax attempts to recoup TARP losses
- Offers to create and ex-post fee

Year	US	
	Failed Banks	Bailed out
2010	83	
2009	140	
2008	25	
Total	248	828

Bottom line

- **US new proposed resolution scheme:** could have a very inadequate effect on future financial crisis, which is unfortunate given the once-in a lifetime reform environment.
- An fund with ex-ante collection of levies is a better tool for crisis management

Resolution

	US FCRF	US New Proposal	UK BANK TAX	EC Resolution fund
Purpose	The plan aims to recover for the taxpayer the billons spent in governments funds to bail out the big lenders	Ex-post fee on financial firms	Revenue cost to Pubic Budget, without predifined objective	Establish a resolution fund to facolitate an orderly failure
Amount targeted	90 billons in 10 years (0.7 percent of GDP)		It will raise 1.15 billion pounds in 2011, 2.32 in 2012, rising to 2.4 billon pounds in 2014.	Not defined.
Covered Entities	Financial institutions with more than $50 bn in consolidated assets	Financial institutions with more than $50bn	To Britain banks and building societies with assets of 20 billons pounds or more.	All banks
Tax	0.15 percent of covered liabilities		In the first year the levy will be set at 0.04 percent, after it will raise to 0.07 percent.	Not defined
Minimization of probability of default	NO	NO	NO	NO
Minimization of cost of default	NO	NO	NO	YES

Resolution

Bottom line

- Taxation would generate financial disturbances and not solve the current main financial problems
- Concerns about a bank tax not addressed to Resolution Fund, but addressed to Public Budget
- European Resolution Fund:
  - Doubtful combination with the existing national Deposits' Guarantee Funds
  - The burden-sharing problem has not been solved at a European level
  - Europe has not advanced regarding the harmonization of national Funds
  - Important of calibration through cumulative impact analysis

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SYSTEMIC RISK

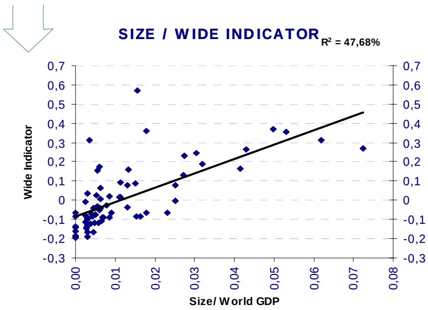
Little progress in measuring the risk factors of individual entities and the quantification of their relative weight.

Rankings: Institution interconnectivity and size

	Ranking		
Institution Name	**Wide Indicator**	**Narrow Indicator**	**Size**
Dexia	1	19	17
BNP Paribas	2	2	4
Credit Suisse Group AG	3	1	15
Deutsche Bank AG	4	8	3
LBB Holding AG-Landesbank	5	36	51
Barclays Plc	6	5	2
Royal Bank of Scotland Gro	7	4	1
Crédit Agricole Group-Créd	8	3	5
UBS AG	9	9	8
BPCE	10	6	9
ING Groep NV	11	13	7
Crédit Industriel et Comme	12	14	37
HSBC Holdings Plc	13	7	6
Natixis	14	11	20
Deutsche Postbank AG	15	40	39

Wide indicator: Size, index of interconnectivity,supervision, market to book and leverage
Narrow Indicator:size, deposits and trading securities
Size: total assets weighted by the world-wide GDP
Source: BBVA research

Too much emphasis on subjects such as size rather than others such as interconnectivity. If the ranking uses the criterion of interconnectivity, many institutions change their risk position significantly.



Soucer: Bankscope / BBVA Research