BBVA | RESEARCH

Trends in international banking and regulatory challenges

Santiago Fernández de Lis

Chief Economist for Financial Systems and Regulation

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Section 1

Regulation and global banking

The strengthening of regulation is necessary, but its wide scope creates uncertainty on the overall impact . Challenging environment for global banks

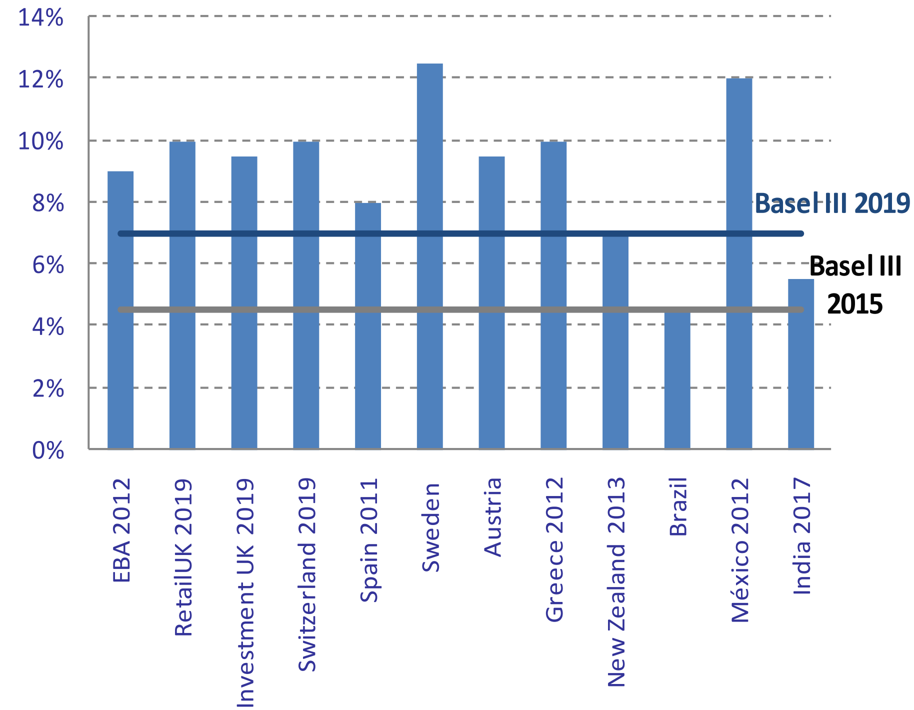
	Increase banks solvency	Mitigate system's complexity/risks	Minimize taxpayers' fiscal burden
Basel III	●	●	
SIFIs	●	●	
Crisis Management		●	●
Structural reforms		●	●
Effective supervision		●	●
Macroprudential		●	●
OTC derivatives	●	●	
Shadow banking		●	
Rating Agencies			●
Financial taxation			●

Regulation and global banking

- Basel harmonization based on minimum levels …
- … only works in the good times, when there is a race to the bottom in regulation…
- … but not in the bad times, when there is a race to the top
- Risk of exacerbating pro-cyclicality
- Asymmetric market discipline and gold-plating

Core capital ratio (%)

Source: BBVA Research based on BIS



Regulation and global banking: Impact on EMEs

- EMEs affected by reform in home and host countries-
- Retrenchment of global banks → risks for **financial inclusion** in EMEs

Capital Requirements

- Could worsen deleveraging and increase the costs of global banks that operate in EMEs
- Trade finance is penalized by Basel III

Liquidity Requirements

- Liquidity ratios particularly difficult to implement in EMEs
- Credit rating could penalize sovereign debt of EMEs in consolidated requirements

SIBs Regulation (domestic and global)

- Could penalize the subsidiary model vs. branch model
- Coherence between global and local frameworks is not ensured

Volker Rule (US)

- Extraterritoriality
- Effects on liquidity of non-US sovereign debt,

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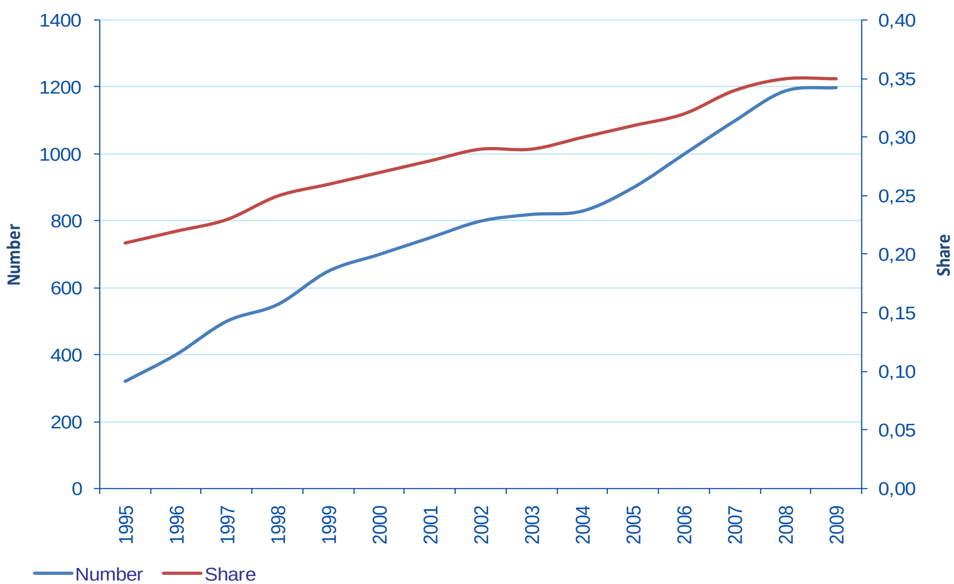
The trend towards fragmentation

- **Last decade: increase of globalization.** Internationally active foreign banks gained importance, especially in LATAM and Eastern Europe …
- … but recent signs of a **reversal of this trend**, partly as a result of the perception of public support and the cost of banking crises: temporary or structural? Regional differences

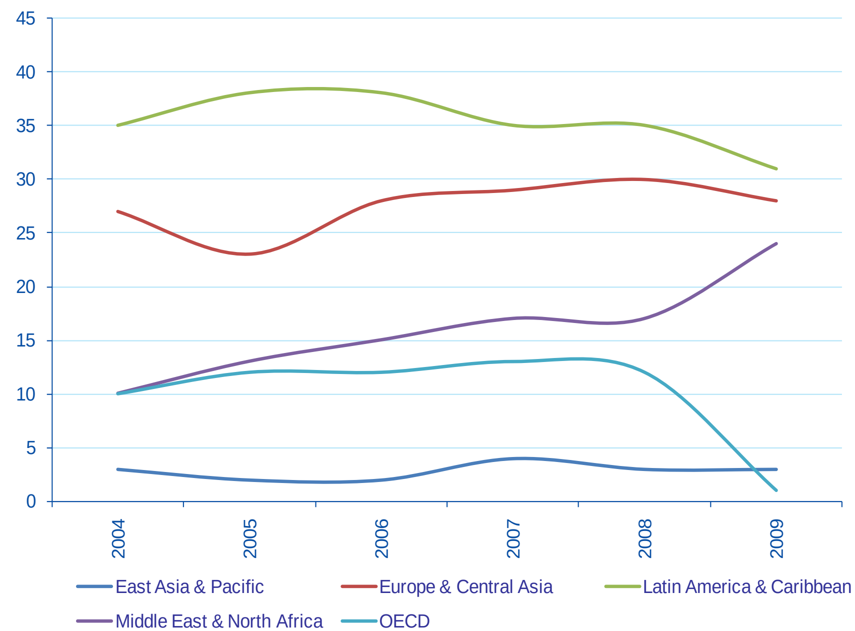
Market share of foreign banks

Source: IMF



Asset share of foreign banks *

Source: IMF



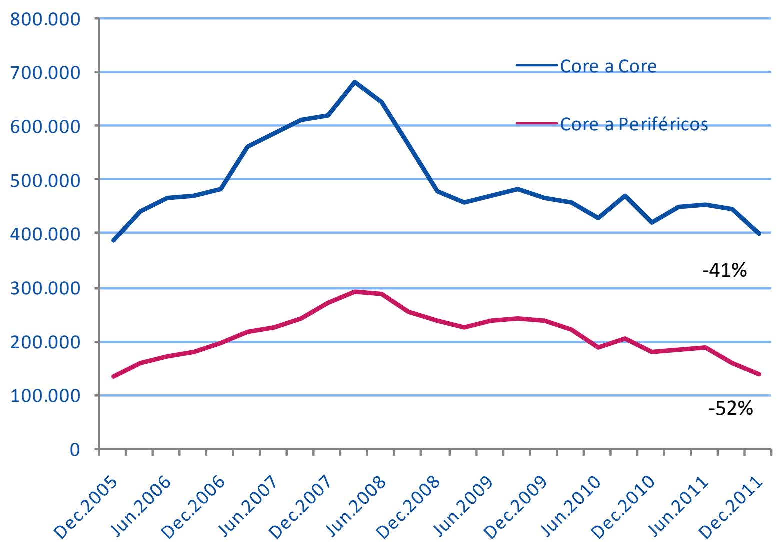
* Claessens, S. and van Horen, N. (2012), "Foreign Banks: Trends, Impact and Financial Stability", IMF Working Paper No.12/10

Section 2

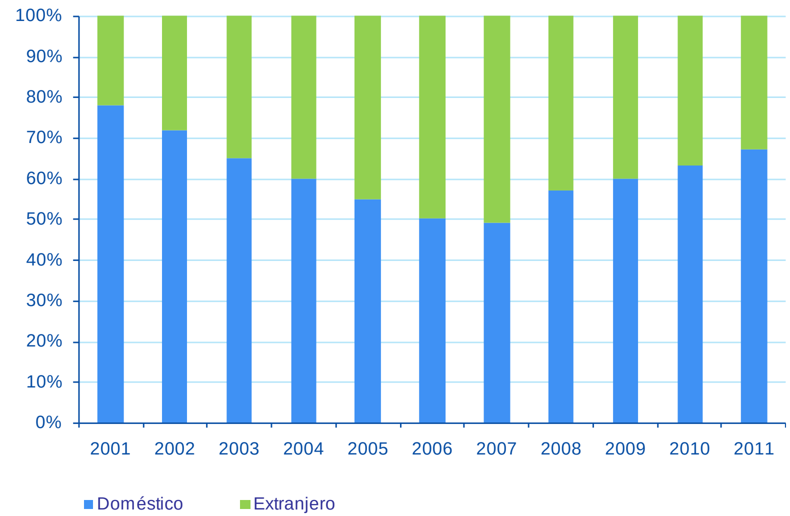
The trend towards fragmentation

The fragmentation is **more worrying in the Eurozone:** re-nationalization of financial markets puts at risk the euro

European Banks: Average exposures to EU members (dollars)
Source: BIS



Collateral used in credit operations (Euro system) (%)
Source: ECB



3 Triggers

1. Market-driven segmentation
2. Rating agencies
3. Regulation (mostly moral suasion)

After LTRO, rise in domestic interbank transactions but drop in cross-border

Section 2

The trend towards fragmentation

Two tings need to be fixed for global banks to recover their role:

1. Macro prudential policies available to protect EMEs from bubbles originated from excess capital inflows

2. Cross border resolution mechanisms that permit to deal with the failure of global SIBs

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Section 3

Macroprudential policies and capital controls

- Recent focus of regulatory debates, but **more solid analytical framework** is needed to design adequate policies
- More interesting experience in EMEs

  - **Asia: successful** (but intrusive) **macroprudential policies**
  - **Eastern Europe: mixed results.** Late response by the authorities in some cases
  - **Latam:** more recent experience, results to be seen

Eastern Europe: vast increase in credit growth

- Massive foreign lending through banking system
- Mostly channeled to the real estate sector.
- Increasing external indebtedness
- Foreign banks relying on centralized funding by parent institution played a key role
- FX mortgages particularly risky. Several measures adopted, but in some countries too late

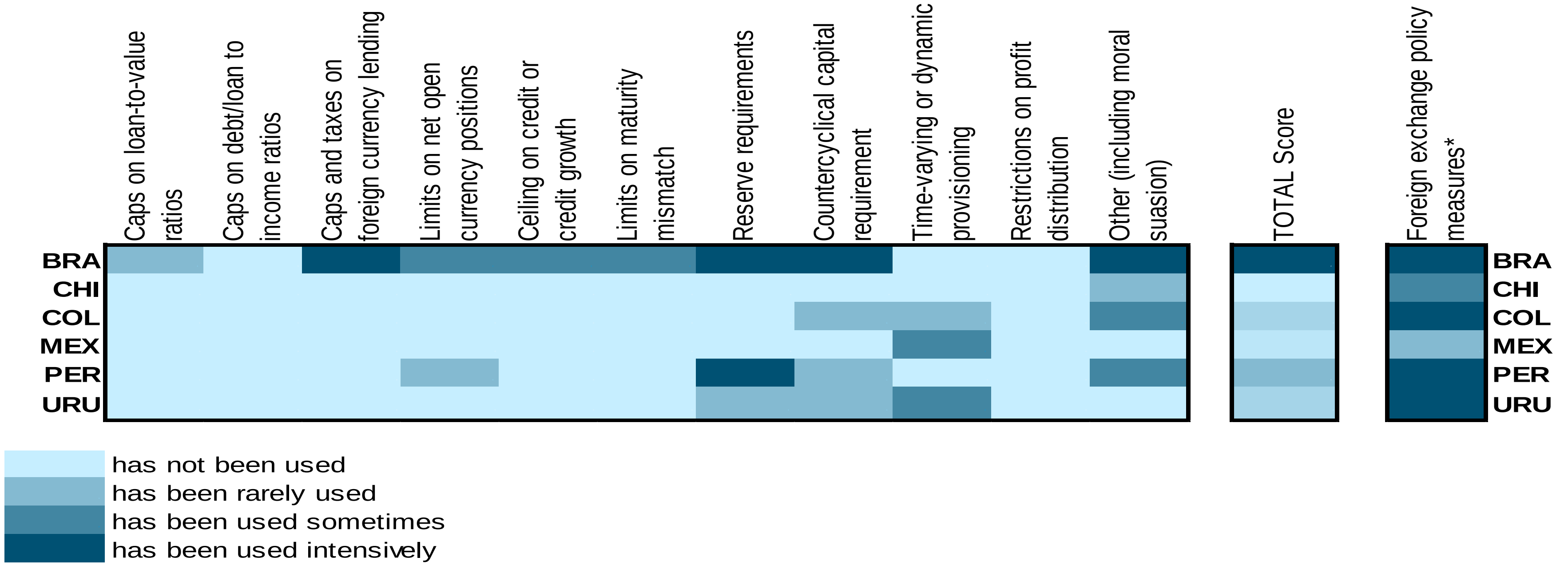
Asia: successful macoprudential policies:

- LTV and DTI limits used to limit housing booms
- Countercyclical buffers
- Dynamic provisions
- Consistency of the overall policy setting (monetary, fiscal and macroprudential
- No reliance on foreign indetedness
- Lessons from Asian crisis.were learned

Section 3

Macroprudential policies and capital controls

Latam: very active use of macroprudential policies in recent years. Results to be seen



* Includes, for example, FX intervention, limits to foreign investment by pension funds, limits to foreign currency purchase by pension funds, etc.

- Macroprudential policies are necessary to deal with credit bubbles
- Important (but difficult) to distinguish some macroprudential policies from capital controls
- Right calibration and early adoption are key

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Resolution is key

- **Recent cases of cross-border banking crises raise concerns and provide a justification for cross-border barriers …**
- **… especially when huge public funds are injected**

Lehman Brothers	• Highly **complex** structure and **interconnectedness**. Difficulties is disentangling trades • **No substitutability**. Loss of access to key services, such as payment and settlement services	**Disorderly bankruptcies must be avoided** because they can trigger systemic crises
Icelandic Banks	• Problems in **foreign branches** exceed their **home country's capacity to offer support**	Need for international clarification & coordination on **creditors preference, bail in and the limits of DGS**
Fortis	• No rules for coordination and **burden sharing in big cross-border banks** (not even in the EU)	Specific mechanisms to deal with **cross border resolution in the EU**

Resolution is key

- **Cross- border resolution seen as too complicated. No agreed burden-sharing mechanisms**
- **Need to clarify rules for resolution of SIBs**
  - **Coordination between home-host supervisors and burden sharing agreements**
  - **Supervisory Colleges and Crisis Managements Groups**
- **Recent progress:**
  - **Towards a resolution framework. Bail in instead of taxpayers money**
  - **Recovery and resolution plans (RRPs)**
  - **Recent FSB paper: significant progress towards an operational resolution framework. Two models:**
    - **Single Point of Entry (SPE)**
    - **Multiple Point of Entry (MPE)**
  - **Decentralized model of stand-alone subsidiaries more resilient and less prone to contagion (Latam vs CEE).**

Key Messages

- The ongoing **regulatory reform is necessary** to avoid a repeat of the international financial crisis. The **proliferation of reforms and the decreasing harmonization in implementation creates, however, uncertainty over the overall impact**.
- Although designed as a **gradual** process, the market pressure is introducing a bias towards **frontloading adoption**. This can have **unintended procyclical effects** in a context of vulnerability in significant segments of the global financial system.
- **Emerging markets** are subject to the combined impact of reforms in home and host countries which implies a **risk for the progress in financial inclusion**.
- The **crisis and the reform are leading to a fragmentation** of global financial systems, although with different regional impact. This fragmentation is **particularly worrying for the Eurozone**.
- This environment is challenging for **global banks**. For them to continue playing a role, **progress is necessary in two areas**:
  - Sound **macroprudential policies** should protect national financial systems from bubbles, in particular those resulting from huge capital inflows. It is important to **distinguish** these policies from others unduly **limiting international capital flows**.
  - Progress in **cross-border resolution** of international banks is key to limit contagion and for a fair burden sharing of international crises. The **decentralized model** of stand alone subsidiaries has proven **more resilient** from the point of view of global financial stability.

Thanks!

Santiago Fernández de Lis

Chief Economist for Financial Systems and Regulation

sfernandezdelis@bbva.com

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