

Regulation Flash

Madrid, 6 March 2014
Economic Analysis

Recovery & Resolution
Policies Unit

Jose Carlos Pardo
Josecarlos.pardo@bbva.com

Victoria Santillana
mvictoria.santillana@bbva.com

Pilar Mirat
mariapilar.mirat@bbva.com

Resolution Directive and Bail-in:

Removing Government Support in Credit Ratings

On Tuesday – 4 March, 2014 –, Standard & Poor's (S&P) released a report warning of **potential downgrades for European banks** due to the review of the government support criteria in the context of the Bank Recovery and Resolution Directive (BRRD). The S&P review is likely to be completed by the end of April and could result in a gradual downgrade by one or two notches in the next two years – the bail-in will come into force in 2016.

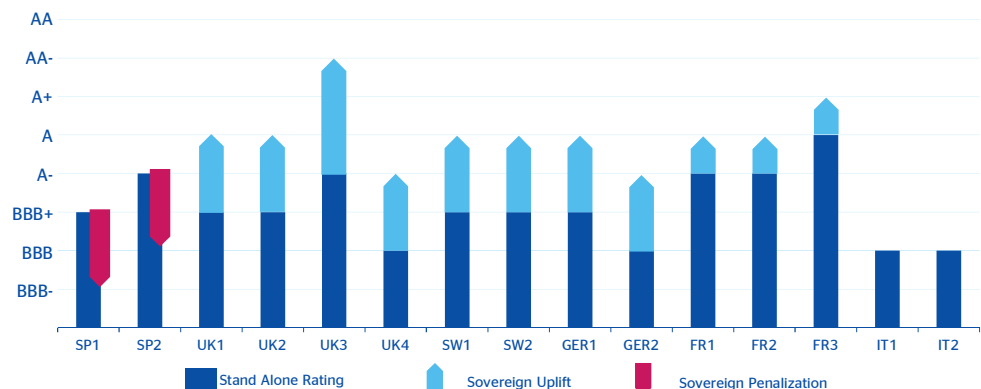
The BRRD and, in particular, the bail-in tool reflect a **new paradigm in dealing with ailing banks –avoiding bail-outs by using bail-ins**. Removing the sovereign “uplift” reveals two effects: i) resolution regimes are credible and predictable, and ii) the bail-in of creditors could become a common practice in case of bank failure. Whether the elimination of parent support will be total or partial will depend on the degree of flexibility that the government retains.

In case of the US, these rating developments have already had a significant impact. In November 2013, **Moody's removed US sovereign support for the eight largest US bank holding companies**. A review of the methodology has shown the progress the Fed and FDIC have made in devising a credible mechanism to implement the US Orderly Liquidation regime.

Removing government support in the bank credit rating would have the following considerations:

- **A positive step forward towards eliminating fragmentation in the European financial sector.** The recent crisis has shown the pernicious effects of the sovereign/banking loop on the European economy. This vicious circle has been reinforced by credit rating methodologies. Chart 1 illustrates this phenomenon, highlighting the different outcomes that sovereign uplifts and/or downgrades provoke on final bank ratings between core and non-core European banks.

Chart 1
S&P Big European banks rating as of December 2013



Source: BBVA Research

- **Each bank's fundamentals and liability structures will become more relevant under the new resolution regimes.** The use of a sovereign rating as the measure of available support and also as the ceiling for a bank rating, regardless of its inherent fundamentals, may create misclassifications across European banks. As a result of the removal of the sovereign rating link, bank creditors should exert more efforts in monitoring their stand-alone credit quality, thus reducing moral hazard and enhancing market discipline.

DISCLAIMER

This document has been prepared by BBVA Research Department, it is provided for information purposes only and expresses data, opinions or estimations regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

Estimations this document may contain have been undertaken according to generally accepted methodologies and should be considered as forecasts or projections. Results obtained in the past, either positive or negative, are no guarantee of future performance.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

In regard to investment in financial assets related to economic variables this document may cover, readers should be aware that under no circumstances should they base their investment decisions in the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

The content of this document is protected by intellectual property laws. It is forbidden its reproduction, transformation, distribution, public communication, making available, extraction, reuse, forwarding or use of any nature by any means or process, except in cases where it is legally permitted or expressly authorized by BBVA.