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BBVA's response to the summary terms of reference of the FSB on the evaluation of too-big-to-fail reforms

Main messages

BBVA supports the FSB's initiative to gather evidence on whether the post crisis reforms have put an end to the "too big to fail" (TBTF) issue.

After almost a decade of an intense regulatory agenda including the FSB's policies to tackle TBTF, its is now appropriate to carry out a retrospective analysis in order to determine how the FSB's reforms have been implemented and whether they have achieved their initial objectives.

- The **FSB's objective of ending TBTF is achieved to a significant degree**. Most of G-20 jurisdictions already have a new way to handle banking crises without compromising taxpayers money nor jeopardizing financial stability.

- Banks are now safer as they **have significantly raised their levels of capital** and are **issuing considerable amounts of loss absorbing debt** in order to comply with TLAC/MREL and to make bail-in credible and feasible.

- Since their implementation, **a handful of practical cases have put to test the new framework**, including the failure and resolution of a systemic bank, with non-homogeneous results.

- The main conclusion is that resolution can work, provided there is political will, but several **lessons still need to be learned**. Credible **funding in resolution** mechanisms need to be established in Europe and the focus should be now be on how to set up **special insolvency regimes for banks**.

- But above all, **uneven implementation and gold plating** requirements to the maximum historical levels **should be carefully analyzed** in order to avoid negative consequences to the economy. **Achieving the optimal level of capital and loss absorbing debt** is crucial.

Preliminary remarks

The FSB's policy measures in order to end TBTF included the establishment of resolution regimes to deal with failing financial firms in an orderly way and with the loable goal of ending taxpayers funded bailouts. They also included new resolvability assessments to check whether resolution is feasible, recovery and resolution plans to outline ex-ante the steps to be followed, cross border cooperation agreements which are crucial in the case of large and multinational banks, new loss absorption requirements, and stronger supervisory mandates.

The amount of work carried out by the FSB and by national authorities is remarkable and nowadays, most of the G-20 countries, including most that are home to G-SIBs, have at their disposal a complete new set of tools and plans to handle bank crises in a fair and orderly way. In that sense the **FSB's objective is more or less achieved**. Of course, the implementation of this new framework is not yet fully completed, but is well on track. But this is already an achievement as compared to the pre-crisis era when authorities were faced with two choices: disorderly liquidations or bailouts.

Now, **fine tuning the framework should be the priority**. And for that, the shortcomings identified during the recent cases of practical implementation come in handy to detect what is working and what needs to be improved. These few cases (which however do not include the failure of a G-SIB) reveal the sheer complexity of building a new regime from scratch, covering all foreseeable contingencies.

Finally, the new resolution framework is having clear advantages for banks in going concern in terms of better self-knowledge, responsiveness to deteriorating situations, more agile and efficient structures thanks to legal entity rationalization and preparedness for disaster.

But, **uneven implementation of global TBTF standards and particularly national gold plating should be reviewed**. Accordingly, it is now time to analyze whether capital and loss absorbing requirements have not already surpassed an **optimal level** beyond which overall negative effects to the economy prevail.

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1. To what extent are TBTF reforms achieving their objectives as described in the terms of reference? Are they reducing the systemic and moral hazard risks associated with SIBs? Are they enhancing the ability of authorities to resolve systemic banks in an orderly manner and without exposing taxpayers to loss, while maintaining continuity of their economic functions? What evidence can be cited in support of your assessment?

- A lot has been achieved in a relatively short time frame. Many jurisdictions, including most that are home to G-SIIs, have implemented resolution regimes in the image of the FSB's Key Attributes. The FSB itself, in its Thematic Review on Bank Resolution Planning, indicates that 16 jurisdictions have already established a resolution planning framework. Six of the remaining eight countries are undergoing legislative reforms in order to establish such a framework.

- In 2014, the EU established a common resolution framework, based on the FSB's Key Attributes, with the adoption of the Bank Recovery and Resolution Directive (BRRD), including:

    - The establishment of administrative resolution authorities. For systemic banks in the Eurozone, the SRB is responsible, relying on national authorities.

    - At least once a year, banks have to i) draft a recovery plan to be ready to cope with situations of stress and ii) provide resolution authorities with all the information they need in order for them to draft the resolution plan.

    - To ensure orderly cross-border resolutions, banks need to choose (and authorities need to validate) a resolution strategy based on their business models, risk profile, etc. This is especially relevant for global banks with relevant presence in multiple geographies, such as BBVA.

    - Resolution authorities now have four different tools to manage the failure of a bank: bail-in (shareholders, creditors and certain depositors of a bank are now the first in line to absorb losses instead of the taxpayer), bridge bank, separation of assets and sale of business tool.

- Since 2016 until 2024 (in principle) banks have to contribute ex-ante (and ex-post if needed) to various resolution funds including the single resolution fund or SRF for those in the Eurozone. Resolution funds can be used during resolution processes either to provide liquidity or capital support. However, capital injections are only allowed after losses equivalent to 8% of total liabilities and own funds have been absorbed by shareholders and creditors.

- A new loss absorption requirement: MREL, calculated on a case by case basis.

- Regulatory stays on certain derivatives and other liabilities in order to avoid counterparties disorderly unwinding their positions once resolution is declared.

- New ways to coordinate and cooperate between authorities from different countries in order to ensure the feasibility of cross-border resolutions by agreeing ex-ante the steps to be taken in case a large multinational bank fails.

- Authorities now have a complete set of tools and a new legislative framework in order to deal with banking crises in an orderly way, without affecting taxpayers and without compromising financial stability.

- **Rating agencies** recognize that the new resolution frameworks provide authorities with powers to impose losses on creditors and consequently remove the government support uplifts in their ratings of bailinable instruments[1]. This in turn affects the pricing of these securities and hence reduces moral hazard risks. It is safe to expect that, once MREL/TLAC buffers are fully built up, moral hazard risk will be anecdotal.

- The ECB (Carmassi et al., 2019) acknowledges that "post-crisis reforms on bank capital and loss absorbing capacity have reduced the average probability of default of banks from 3.5% in 2007 to 1.1% in 2017, less than a third of its pre-crisis value".

[1] There are multiple examples. See Moody's note on 3 Aug 2018 downgrading senior unsecured debt instruments of 14 German banks following change in bank insolvency law (downgrade of 1 notch owing to the reduction of government support assumptions for these securities to low from moderate previously); or Moody's note of 17 March 2015 stating that its ratings will reflect declining probability of government support for European banks under the EU's BRRD.

- The establishment of a common recovery and resolution framework in the EU represents a great leap forward. However the framework is ever evolving. On the one hand, the authorities, as they learn and accumulate experience, increase their requirements (in both quantity and quality). And on the other hand, the legal framework is still not stable, as evidenced by the fact that at this moment, and only 4 years after its establishment, the framework is being subject to a comprehensive reform (BRRD2). **After a long period of regulatory activity banks need legal certainty**. Therefore, BBVA welcomes this consultation as it is now appropriate to check whether the reforms are working well in order to deal with unintended consequences.

2. Which types of TBTF policies (e.g. higher loss absorbency, more intensive supervision, resolution and resolvability, other) have had an impact on SIBs and how? What evidence can be cited in support of your assessment?

- **Banks have made and continue to make considerable efforts** in order to put an end to TBTF and to ensure the switch to a new bail-in paradigm. Complying with the new requirements is transforming the way banks are managed. According to Bolton et al. (2019), these reforms represent "the most important institutional transformation of international finance coming out of the recent global financial crisis":

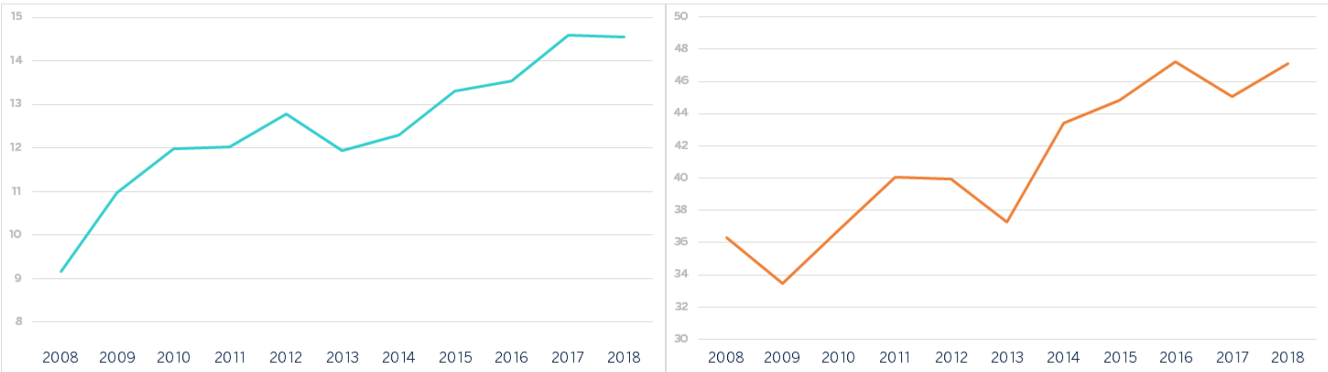
    - A general belief still persists that financial institutions have been recapitalized by way of public interventions only. But that is far from the truth as, in some countries, the **private sector also contributed to the recapitalization** of failing entities via disbursements to the deposit guarantee schemes (DGS) or by purchasing failing banks and assuming all their critical functions. For example, in Spain[2], between 2008

[2] Spain was one of the first countries to setup a resolution framework incorporating many of the FSB's Key Attributes in advance of the transposition of the BRRD1. This was done in 2012, in the context of the signature of the Memorandum of Understanding with the EU Commission and included a regime for the restructuring and resolution of financial entities (Ley 9/2012), a sort of pre-BRRD with an obligation of burden sharing to subordinated creditors (a pre-bailin); the establishment of a private-public asset management company to

and 2016, the national DGSs have contributed around **20bn EUR** (one third of the effort) in the restructuring of the financial system, mainly the sector of savings banks or *cajas de ahorro*. Indeed, solvent banks that did not need public money throughout the crisis were interested in contributing to addressing problems in the banking system i) in order to guarantee financial stability, ii) to safeguard clients' resources (depositors and employees) and iii) to avoid generalized shortages of funding.

- Banks have **raised their capital levels**, in both quantity and quality. It is undeniable that the banking system today is more robust and healthy than in the past. Between the period 2008-2018, the Tier 1 ratio of current and former G-SIBs has increased by almost 60% from 9.16% to 14.55% (See Graph 1[3]).

Graph 1. Tier 1 ratio of G-SIBs (% RWAs) / Graph 2. Total Assets for G-SIBs (trn EUR) 2008-2018



Source: BBVA based on Orbisdata

- Banks have **raised a significant amount of bail-inable liabilities** including a new class of debt dubbed "senior non preferred" (SNP) in order to comply with TLAC and/or MREL. During the period 2018-2019, European and Canadian banks have raised an equivalent of **65 bn USD of SNP** and American, Irish, Dutch, English and

manage the real estate non performing exposures; a reform to the legislative framework of the cajas; a comprehensive asset review exercise and a recapitalization line of 100 bn EUR (although only 39 bn were used) with European funds.

[3] Includes G-SIBs that are or were on the FSB's G-SIB list since its first publication.

a Spanish bank have raised an equivalent of **67 bn USD of senior debt from their holding** companies ("senior HoldCo" which is structurally subordinated)[4].

- As of May 2019, the spread between SNP and senior preferred (SP) issued with the standard maturity of 5 years is **44 bps** and the spread between SP and Senior HoldCo is **19 bps**[5]. That means that, at prevailing funding spreads, the increase in banks' annual funding costs for issuing bailinable instruments are representing around **420 mn USD**.

  - But, these incremental costs **represent nowadays a bare minimum** and could be much higher in the near future because:

    - Funding **conditions are extremely favorable** and could most likely deteriorate once Central Banks start normalizing their respective monetary policies.
    - This estimate takes into account the rollover of SP for SNP or Senior HoldCo but **many banks won't have access to these markets** and will have to rely on more subordinated (hence more expensive) instruments. For example, the current spread between Tier 2 and SP is **262 bps**[6]. Additionally, some banks currently do not hold SP and they will have to **substitute cheaper funding instruments such as covered bonds** (or deposits even) by more expensive bailinable debt in order to comply with MREL/TLAC.
    - So far, **only the largest, most systemic banks are issuing debt**, once medium-small banks get clarity on their requirements, they will

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[4] Bloomberg
[5] Bloomberg
[6] Bloomberg

have to start issuing more debt. The increase in the offer will surely have an impact on the pricing of these instruments.

- Therefore, banks are facing increasing costs as a result of the establishment of resolution frameworks:

    - Higher funding costs.
    - Contributions to resolution funds, DGSs and resolution authorities budget (which in the case of the Single Resolution Board is fully financed by the private sector).
    - Together, in the case of BBVA, these costs represent the non negligible sum of around **10% of the annual net income** of the consolidated group

- BBVA is fully committed to making this new resolution regime work. Indeed, planning for a hypothetical resolution is a useful exercise and is proving beneficial for the day-to-day management of the business in terms of better self-knowledge, simpler and more efficient structures, etc. BBVA is or has:

    - Adapting its wholesale medium and long term funding programs by issuing bailinable instruments in order to comply on a continuous basis with its MREL requirement. According to the latest funding plan and subject to market conditions, it expects to issue €2.5-3.5bn of SNP and to roll over non-capital wholesale funding maturities into MREL eligible instruments.
    - Already set up a resolution office that is the point of contact with resolution authorities and that is in charge of managing and coordinating all the information requests by these authorities in order to draft the resolution plans. Furthermore, the resolution office coordinates the work of different internal working groups in order to respond to the priorities identified by the SRB in order to enhance the resolvability of the group.
    - Already involved the senior management in all the planning process both in recovery and resolution.

- Working to ensure the separability of the different points of entry and working on how to improve the applicability of the resolution tools.
- Simplifying its legal and operational structure.
- Reviewing and amending its contracts with internal and external providers of shared services in order to guarantee the continuity of its critical services in resolution.
- Improving its IT systems in order to reduce the time to generate the required information.
- Together with the industry, developing a bail-in execution manual with the steps to be taken by banks and authorities.
- Complying with MREL at all times.
- Inserting bail-in and stay clauses in issuances under English law (and third country law) in order to strengthen the bailinability of those instruments following brexit.

- All the work undergone by banks to raise their levels of capital and loss absorbing debt should now be the focus of a thorough analysis. The **analysis should go beyond TLAC and MREL requirements and take into account that bail-in has a much larger scope** as well as the fact that bail in is already in full force since 2016[7]. Indeed, loss absorption should not only be measured in terms of MREL / TLAC buffers but in terms of bail-in. Once MREL / TLAC buffers are depleted, authorities can continue bailing in other liabilities. In the case of BBVA, 50% of its liabilities are in the scope of the bail-in tool.

- Also, **resolution funds have increased the loss absorbing capacity** of the entire system. That should also be taken into account.

[7] According to BRRD1 "it is desirable that bail-in can be applied to as wide a range of the unsecured liabilities of a failing institution as possible".

- Carmassi et al., 2019 acknowledge these and conclude that the **ability to absorb losses while minimising taxpayers' costs between 2007-2017 has increased 12-fold** as 55.5% of total assets are now under the scope of the bail-in tool.

- The level of 18% was selected as "sufficient to achieve the objectives of TLAC" by the FSB, after a careful comprehensive impact assessment including an evaluation of historical losses and recapitalisation needs of large banks. In fact, that same report indicates that 25% of RWAs was the maximum loss and recapitalisation needs of a particular bank during the recent crisis. However, the first MREL decisions in the Eurozone are averaging exactly that level according to the SRB, and some banks' requirements are even higher (and this is notwisthstanding that the real loss absorption capacity is even higher because of the larger scope of bail-in, as explained in the previous point). In practice this means that loss absorption requirements are already at the very upper end of what the authorities' recommend. Further increases and/or tightening eligibility criteria are therefore unsupported by the authorities, and could negatively affect economic growth, certainly putting European banks at a disadvantage compared to non-European peers.

- Therefore, it is now time to **evaluate whether gold plating international standards and setting requirements at the top of the range of historical losses does not entail unintended consequences, unlevel playing field issues and overall negative effects to the general economy**. According to Bolton et al. (2019), capital and/or liquidity requirements could be set at 100% but at that level no bank would be profitable. Additionally, and more importantly, that "narrow bank model" does not "*eliminate liquidity transformation and financial fragility, it merely displaces it*" (to the uncovered and unregulated banking sector) according to Bolton et al. (2019)[8]. Finally, "*imposing capital requirements when banks and the economy are weak would be counterproductive since banks will then shed assets instead of raising capital*".

[8] Bolton et al. (2019) also state that they do not know whether current levels of capital are enough and they believe that it is better to err on the high side. As the authors also recognise, we should analyze whether loss absorbing requirements (and not just capital requirements) are sufficiently high, or even beyond some optimal level from where the social costs start to outweigh the potential benefits. This is particularly relevant in a moment in which some jurisdictions are starting to revise and recalibrate some of the newest regulations, a situation that might lead to an unlevel playing field hampering growth in some regions.

- Concerning the **optimal level of capital** (and loss absorbing debt). There is no consensus in the literature on the optimal level of capital. Ideally, any model to estimate this should take into account both benefits and costs, in order to identify whether a tipping point exists, a sort of a Laffer-curve, with an optimal capital requirement, beyond which the negative effects to the economy prevail over the benefits of minimizing the probability of bank failures. According to a recent paper from the ECB (Mendicino, et al., 2019), it is necessary to take into account the short run costs of higher capital requirements (undue costs to the real economy during the transition to the higher level of capital). But it should be noted that the long term costs which surely arise with higher requirements are important as well. Indeed, if bank funding costs rise (capital is the most expensive type of funding[9]), then surely banks will try to optimize their assets' returns by either investing in riskier assets (which is contrary to the objective of the regulation itself) or raising their lending spreads (both of which have negative effects in the real economy in terms of less credit and less GDP growth). This analysis of the tipping point is even more important in jurisdictions opting to gold plate international standards and setting loss absorbing requirements at the highest (or even beyond) levels than those recommended by authorities. See our responses below.

- An argument to support that gone concern requirements should now be the gauge instead of capital requirements is that bank debt can absorb losses, provided there is political will, as observed in recent cases (Banco Popular, Veneto banks, Monte dei Paschi), as well as past cases (Denmark was one of the pioneers of applying bail-in to senior debt, in Cyprus bail-in reached non covered deposits, etc).

- Other interesting papers defending that higher capital requirements result in a reduction of bank's lending volume:

[9] The paper considers that increased levels of capital reduce the cost of funding for debt issuances but up to a certain point. However the paper analyzes these costs in aggregate, without taking into account the different business models of banks. Banks which rely more heavily on deposits and less on debt for their funding benefit less from higher levels of capital as deposit costs cannot go lower than 0%.

- A paper from the Dutch Central Bank (DNB) concludes that an increase in capital requirements by one percentage point forces banks to cut their total lending in the short run by 1.2-4.5% or reduce credit growth by 1.2-4.6 percentage points.
- The ECB (Maurin et al., 2012) finds that the impact of an increase of 1p.p in capital ratios results in a decrease of lending volumes of 2.15%.
- In the same vein, Aiyar et al. (2014) conclude that the accumulated reduction on banking lending growth of an increase of 1p.p in capital requirements is between 6.5 and 7.2 percentage points.
- The Bank of England finds that higher equity requirements increase the overall funding costs for banks and that this increase is likely to be translated into a higher cost of capital for the real economy, reducing household expenditure, business investment and potential economic output in the long term. This same report includes an analysis that suggests that the optimal equity requirement for the UK financial system is about 4% lower than previous estimates due to, among others, the fact that the UK has an effective **resolution arrangement, which reduces both the probability and cost of financial crisis**.
- The EU Commision states that increases in minimum capital requirements carry the potential to significantly constrain bank lending over the period of transition to higher capital ratios which can noticeably impair growth and investment levels in the short run.
- TBTF requirement should also be analyzed in the light of other new requirements such as stress tests. The US Fed finds that, for large US banks, larger stress-test capital buffers lead to material reductions in bank commercial and industrial lending. In particular, a 1 percentage point larger capital buffer results in a roughly 2 percentage point lower (four-quarter) growth rate of utilized loans and a 11/2 percentage point lower growth rate of committed loans.

- Finally, **some additional counterarguments responding to the literature defending that capital levels are still not high enough**:

  - In practice the Modigliani-Miller Theorem (which is commonly used as an argument to claim that the equity/debt composition should not affect the value of a firm) does not hold for banks, so both the cost of equity and the WACC change as capital is accumulated.

- ROE is actually the metric used by investors to gauge banks' profitability, and lower ROE due to higher capital requirements might make it more difficult for banks to raise capital when needed.
- Most of the arguments that seek stricter capital rules focus on the liabilities side. While it is true that more equity makes banks stronger by increasing the buffer against unexpected shocks, the arguments overlook the fact that risks arise on the assets side.
- Authors claiming that banks should hold significantly higher amounts of capital fail to provide an indication of the price (interest rate) that banks should charge on new lending in order to generate revenues to keep ROE above COE, i.e. remain profitable and going concern, given the unprecedented increase in shareholders' equity that this idea might produce assuming that the new shareholders will demand a sufficient return on their investment.

3. Is there any evidence that the effects of these reforms differ by type of bank (e.g. global vs domestic SIBs)? If so, what might explain these differences?

- Regarding the FSB's G-SII designation, the evolution since 2011 shows that, in general, the number of entities and their corresponding capital surcharge requirements have been stable (see Table1). No entity has been moved up to the maximum 3.5% bucket.

Table 1 G-SIBs list from 2011 to 2018

	Capital Surcharge (% of CET1/RWAs)								
Entities	2011*	2012	2013	2014	2015	2016	2017	2018	
JP Morgan	*	2.5	2.5	2.5	2.5	2.5	2.5	2.5	
Citigroup	*	2.5	2	2	2	2.5	2	2	
HSBC	*	2.5	2.5	2.5	2.5	2	2	2	
Deutsche Bank	*	2.5	2	2	2	2	2	2	
Bank of America	*	1.5	1.5	1.5	1.5	2	2	1.5	▼
Barclays	*	2	2	2	2	1.5	1.5	1.5	
BNP Paribas	*	2	2	2	2	2	1.5	1.5	
Goldman Sachs	*	1.5	1.5	1.5	1.5	1.5	1.5	1.5	
Mitsubishi	*	1.5	1.5	1.5	1.5	1.5	1.5	1.5	
ICBC			1	1	1	1.5	1.5	1.5	
Wells Fargo	*	1	1	1	1	1.5	1.5	1.5	
Bank of China	*	1	1	1	1	1	1.5	1.5	
China Construction Bank					1	1	1.5	1	▼
Agricultural Bank of China				1	1	1	1	1	
Bank of NY Mellon	*	1.5	1	1	1	1	1	1	
Crédit Agricole	*	1	1.5	1	1	1	1	1	
Crédit Suisse	*	1.5	1.5	1.5	1.5	1.5	1	1	
ING	*	1	1	1	1	1	1	1	
Morgan Stanley	*	1.5	1.5	1.5	1.5	1	1	1	
Mizuho	*	1	1	1	1	1	1	1	
Nordea	*	1	1	1	1	1	1	OUT	
Royal Bank of Canada							1	1	
RBS	*	1.5	1.5	1.5	1	1	1	OUT	
Santander	*	1	1	1	1	1	1	1	
Société Générale	*	1	1	1	1	1	1	1	
Standard Chartered		1	1	1	1	1	1	1	
State Street	*	1	1	1	1	1	1	1	
Sumitomo	*	1	1	1	1	1	1	1	
UBS	*	1.5	1.5	1	1	1	1	1	
Unicredit	*	1	1	1	1	1	1	1	
BBVA		1	1	1	OUT				
BPCE	*	1	1	1	1	1	OUT	1	IN
Commerzbank	*								
Dexia	*								
Lloyds	*								
Total entities	29	28	29	30	30	30	30	29	

* No bucket released for the 2011 list. CET1: Core Equity Tier 1 Capital. RWAs: Risk Weighted Assets.
Source: BBVA Research based on FSB

Source: BBVA Research based on FSB

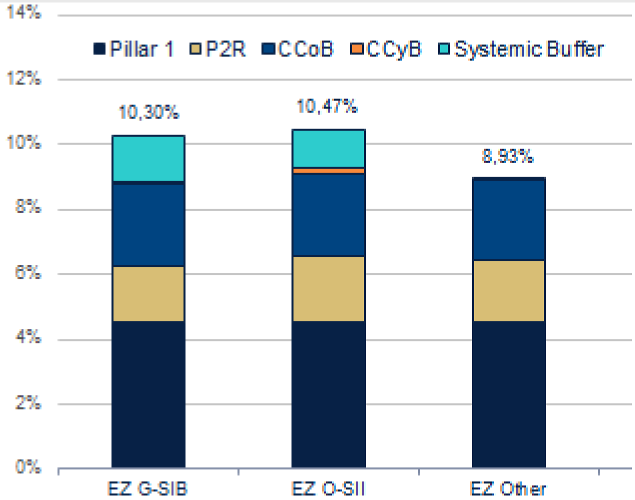
- BBVA was in the G-SIB list from 2011 until 2015, not because it reached the numerical thresholds but because of the supervisor's criteria. However, ever since its exit from the list, BBVA's overall capital requirements have not gone down significantly. Our bank has ever since been classified as a D-SIB and hence has had to comply with a D-SIB buffer which in numerical terms has been more or less equivalent. Therefore, BBVA is not on the G-SIB list anymore but, because of its size, international exposure, etc. has to **comply with similar requirements as it if were a G-SIB**.

- Furthermore, the **intensity of supervisory reporting requirements for BBVA has not gone down since its exit from the G-SIB** list. BBVA continues reporting to its supervisor, on a weekly basis, the same granular data on large exposures with several counterparties and, on a monthly basis, information on liabilities as it had to report when it was designed as a G-SIB.

- Finally, and although the consultation clearly states that the G-SIB designation methodology will not be reviewed, several observations must be pointed out:

    - The **methodology considers that the universe of systemic risk for the whole financial system is constant in absolute terms** (10,000 basis points), therefore it does not allow the possibility to consider a possible reduction after the measures adopted since the crisis.
    - Whereas that should provide some stability to the designation, that is not always the case as there is a particular bank that, since 2011, has been in and out of the list throughout a three year period.
    - In the EU, the upcoming **CRR2 will allow national competent authorities to reduce the indicator of cross-border exposure**.
    - Therefore, it is now time to also **analyze the divergences in the G-SIB methodology as compared to the D-SIB methodology** applied by the different national authorities in order to determine why in some jurisdictions D-SIBs end up with higher requirements than G-SIBs (which is counterintuitive). Indeed, the FSB leaves ample room for national authorities to define the D-SIB framework. In the Eurozone, O-SIIs have slightly lower systemic buffers (the higher of either G-SII, O-SII or systemic risk buffers) than G-SIBs, however that is more than compensated by higher Pillar 2 requirements for O-SIIs, resulting in an overall level of CET1 requirements which is 17bps higher than those of G-SIIs (Graph 3).

Graph 3 2018 CET1 SREP requirements in the Eurozone (EZ)



Source: BBVA Research

4. What have been the broader effects of these reforms on financial system resilience and structure, the functioning of financial markets, global financial integration, or the cost and availability of financing? What evidence can be cited in support of your assessment?

See previous responses.

5. Have there been any material unintended consequences from the implementation of these reforms to date? What evidence is available to substantiate this?

- **Uneven implementation of FSB's standards coupled with national gold-plating**. According to the latest FSB's thematic review on resolution planning, seven jurisdictions have already implemented loss absorbing requirements (Canada, Japan, Switzerland, UK, USA, Hong Kong and the EU). However, more work remains to be done concerning internal TLAC, disclosure requirements and deductions for TLAC holdings.

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Table 2 Uneven implementation of loss absorbing requirements reveals gold-plating practices

	USA	EU	Canada	Switzerland	Japan
Loss absorbing requirement	TLAC	MREL	TLAC	TLAC	TLAC
Scope	G-SIBs (8)	All banks (+4,000)	G-SIB & D-SIBs (6)	G-SIBs & D-SIBs (4)	G-SIBs & D-SIB (4)
Calibration ("fully loaded")	18% RWAs / 9% Total Assets	Case-by-case but on average 25% RWAs	21,5% RWAs (but includes buffers) / 6,75% LR	18,5% - 28,6% RWAs / 6,5% - 10 %LR	18% RWAs / 6,75% LR
Subordination	-	▪ 14 / 16 % RWAs (BRRD1) ▪ Max 8% TLOF or 2(P1+P2R) + CBR (BRRD2)	-	-	3.5% DGS allowance
Entry into force	1 Jan. 2019	1 Jan. 2019 (G-SIBs), case-by-case (rest)	1 Nov. 2021	1 Jan. 2019	31 Mar. 2022 / 2024
Goldplating vs FSB's TLAC	▪ **Higher long term debt requirement** ▪ **Higher calibration in terms of total assets** ▪ **No phase-in period** ▪ **Stricter eligibility**	▪ **Significantly larger scope** ▪ **Higher calibration** ▪ **Higher subordination** ▪ **Stricter eligibility**	▪ **Larger scope (D-SIBs)**	▪ **Larger scope (D-SIBs)** ▪ **Higher calibration (G-SIBs)** ▪ **Higher AT1 requirements**	▪ **Larger scope (D-SIBs)**

Source: BBVA

- But looking at the way these jurisdictions have implemented the 2015 FSB's TLAC Term Sheet (see Table 1), most of them have opted to increase the minimum recommended requirements. This **gold-plating of TLAC** is particularly relevant in the European Union.

- In terms of calibration, MREL is set on a case by case basis with an absolute minimum level equal to TLAC for G-SIIs but with a higher "Pillar 2" requirement based on a rigid formula applicable to all banks without taking into full consideration banks' specificities or their efforts to ensure that they are resolvable. One idea would be to **provide incentives to resolvability by way of reductions to the recapitalization amount**. That is, banks should be offered carrots, not only sticks.

- Divergent implementations coupled with national gold platings, especially when some jurisdictions are undergoing a deregulation process, should be analyzed to see whether they hamper competition between banks from different countries.

- **Pro-cyclicality**. The pro-cyclicality of regulatory requirements is one area that merits further analysis. Pro-cyclicality is an undesired consequence as it increases requirements for banks at a moment where they are less able to cope with them. One example is in the area of new requirements for loan loss provisions. Although this is beyond TBTF reforms, G-SIIs, systemic and in general *larger and better capitalized bank*s are the ones most affected by the pro-cyclicality of new loan loss provisions, especially in the euro area according to the ECB and CEPR (Huizinga et al., 2018). However, many other requirements directly related to TBTF reforms also increase pro-cyclicality. RWAs tend to increase when a bank's situation deteriorates, aggravating in turn all requirements based on RWAs (prudential requirements but also loss absorption ratios).

- **Extraterritoriality.** Sometimes, regulations have undesired extra-territorial issues and force subsidiaries of MPE banks in third countries to comply with home country law. Thankfully, the CRR 2 will include a specificity for MPE banks to compute local issuances in the consolidated capital requirements provided they comply with local requirements if those are as strict as the European ones.

- **TBTF reforms hamper consolidation**. In the EU, many authorities encourage more mergers between banks, particularly cross-border operations. However, TBTF requirements run counter to this objective. Indeed, merging two banks will drive up the G-SII score as well as the capital and loss absorbing requirements of the resulting entity, thus disincentivizing consolidation.

6. Are there other issues relating to the effects of TBTF reforms that are not covered in the questions above and on which you would like to provide your views? Please substantiate your comments with evidence.

- **Practical cases: lessons to be learned**. Since their establishment, resolution regimes **have been put to test on a limited number of occasions**, particularly in the Eurozone with the resolution and liquidation of banks in several countries. Although we have not yet experienced the handling of a failing G-SIB or let alone a more systemic crisis with multiple banking failures, we can already extract some lessons from these cases.

- The most striking one is that each case has revealed **new and unforeseen problems** and that they have been dealt with differently depending on the country of origin of the bank, despite sharing the same legal resolution regime. In fact, using all the flexibilities and loopholes of the current legislation as soon as the first case arises undermined the credibility of the BRRD, the SRB, the Banking Union and the EU Commission.

- The resolution of Banco Popular and its sale to Banco Santander proves that the **EU resolution regime can work, provided there is political will**: risky securities of the failing bank ended up assuming heavy losses; non-risky securities ended up intact; Popular's critical functions did not stop; retail depositors were protected; and taxpayer money was not needed during the process.

- However, the case of Popular was a success in part because there was a willing buyer but several improvements are needed for future references:

    - In the EU, an idea, in line with the opinion of international organizations such as the International Monetary Fund or the Bank for International Payments and that of European authorities such as the Single Resolution Board (SRB), would be to establish a single insolvency regime for banks in the EU. This framework could be led by an administrative authority (the SRB itself in the Eurozone), with the participation of judicial authorities. It should include a toolbox similar to that available in resolution processes (bridge bank, asset separation, etc.) and a common and unique hierarchy of creditors. Insolvency proceedings should be agile and efficient, guaranteeing market unity.
    - But it would also be necessary to **review the principle of universal succession** by which the buyer in an insolvency process (also applicable in resolution) would avoid inheriting legal contingencies from the bankrupt bank. It is not fair that entities that have nothing to do with actions that are, or that may become subject to litigation, committed by third parties become responsible for the mere fact of buying their business, especially taking into account that the decision to buy is usually taken with limited information and time. On the contrary, the purchase of bankrupt banks should be incentivized, in order to guarantee the success of future resolution processes, protect financial stability and minimize the use of public resources.

- In the Eurozone, the **lack of a credible funding in resolution mechanism** and an effective public sector backstop[10] could have derailed the resolution process. In a 2018 note BBVA provides some ideas on how to achieve a credible and robust funding in mechanism through a possible arrangement where the European Central Bank (ECB), backed by guarantees (which could be considered as eligible collateral) from the Single Resolution Fund (SRF), assumes the responsibility to also provide the liquidity for a bank in resolution. Indeed, as stated by Bolton et al. (2019) "only the credible backstop of a lender of last resort can provide that assurance."
- **Moratorium is not the correct answer.** First of all this is another example of gold-plating the FSB's standards[11] and is counterproductive as it may lead to contagion to other institutions and trigger flights of deposits in more vulnerable financial systems, especially if the deposit insurance is kept at national level. With current technology allowing instantaneous transfers of deposits to any country, the moratorium is not an appropriate tool for confronting a liquidity crisis, as flows can continue during the 'weekend of resolution'. The central banks were created precisely to offer loans of last resort and avoid banking panics. It is paradoxical that Europe, due to its inability to establish a coherent framework for the supply of liquidity in resolution, should now be looking at resorting to the moratorium as a normal tool for crisis management. If a few days need to be gained in the resolution process, the reasonable way of doing this would be with the support of liquidity, not by imposing limits on the withdrawal of deposits.
- **State aid rules, which date from 2013, prior to the approval of the BRRD1 should be reviewed**. Particularly the burden sharing requirements should be in line with those of the BRRD1 so as to avoid cases where creditors are better off in liquidation than in resolution. This is crucial in order to guarantee a level playing field for banks in the EU.

[10] The FSB considers, in its "Guiding principles on the temporary funding needed to support the orderly resolution of a global systemically important bank", that resolution funds can be the public backstop. But the EU resolution funds including the SRF are not up to the task because of their lack of operational readiness and lack of sufficient resources to give confidence ex-ante to the markets.

[11] The BRRD1 already included the stays clauses for up to two working days, as recommended by the FSB. However the BRRD2 will include this mechanism by which even covered deposits can be "freezed" for a period of up to two days.

- **Multiple point of Entry (MPE) resolution strategy**. Authorities are slowly realizing the benefits of the MPE model:

    - **It is easier to supervise and to resolve**. Host authorities have control over the subsidiaries both in business as usual and in resolution. It requires less cooperation/coordination between home and host authorities. This is true for solvency matters but even more so in terms of liquidity supervision as MPE banks are mainly funded with local deposits in local currency and protected by the host's deposit guarantee scheme in its local currency. Also, MPE banks are more easily separable which facilitates not only resolution but also the prior recovery phase.
    - **It is less risky and avoids the risk of contagion**. Given the absence of cross-financing, in the event that any of the group's subsidiaries had solvency/liquidity/operational problems, the rest of the subsidiaries should be safe and, in extreme cases, authorities could liquidate/resolve them without affecting the rest of the banking group. The risk to the parent company would be limited to the value of the investment in the subsidiary.
    - **It is more resilient.** The literature and international organizations have repeatedly indicated its resilience and highlighted its stabilizing role during crises both in the home and in the host countries.
    - **It fosters the development of local markets** where local subsidiaries of MPE banks are often pioneers in developing new products and opening new/deeper markets.
    - **It creates incentives for local subsidiaries self-sufficiency.** Having to rely on their own strength, local subsidiaries develop the capabilities to be sustainable without benefiting from cross-subsidies inside the group, while at the same time enjoying the groups' internal risk and control culture, synergies and strategies.
    - It is a simple and straightforward strategy and is more adapted to a world of fragmentation and ring fencing.

- This is being reflected, among others, in the changes introduced in the BRRD2 to accommodate banks with this strategy. In addition, the SRB is currently setting the MREL requirement on a sub-consolidated basis, something recommended by the FSB and inherent to the MPE strategy. However, there is still room for improvement in terms of regulatory treatment.

- In this sense, it would be advisable to **revisit the FSB's TLAC deductions regime** applicable to exposures from a G-SIB parent entity to TLAC instruments of other resolution groups within the same banking group[12]. Applying total deductions to those exposures is rather penalizing because it does not take into account the benefits of diversification. The current full deduction regime is similar to assuming that all resolution groups of an MPE bank will fail at the same time once one of them (the parent entity) enters resolution, an extremely unlikely event. An alternative, more sensible approach, would be to apply an add-on to the risk weight of these exposures.

[12] Item 3 in the TLAC Term Sheet

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