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Implementation rather than new initiatives will lead the regulatory agenda in 2013

The European regulatory agenda in 2013 will be dominated by the implementation of proposals that are already on the table rather than by the crafting of new initiatives. Some items, such as banking union, will receive urgent attention, but as the final year of the European Parliament's term approaches, it is likely that others, such as bank resolution, will fail to find a place in the Parliament's increasingly cramped legislative schedule.

The agenda for the re-regulation of global financial markets was set some years ago during meetings of the G20 – most notably the September 2009 meeting in Pittsburgh – and has been led by the Financial Stability Board (FSB), which in turn has relied on specialised international standard settlers to draft, or help draft, specific proposals. (For example, the Basel Committee for bank regulation, IOSCO for regulations on securities markets.)

The broad lines of the agenda were clear from the start and have changed little over the last three years.

- make banks stronger and less likely to fail (mainly through the package of measures collectively known as Basel 3);
- place additional safeguards on systemically important banks (such as a capital surcharge) and reduce the cost to the tax payer when large banks do actually fail (through bailing in bond-holders, and having clear resolution procedures at the supervisory level and clear resolution plans at bank level);
- regulating and implicitly therefore de-risking bank-like activities that were not properly captured under previous bank regulation ("shadow banking"); and
- reducing the systemic risk associated with the global derivatives market by moving most derivatives trading onto regulated exchanges, requiring most trades to be cleared through regulated clearing houses, and making them transparent by registering them on trade repositories.

Further issues have included reviewing bankers' bonuses, pushing for convergence between international and U.S. accounting standards, and reducing reliance on rating agencies.

The intense regulatory activity that began in 2009 is now abating and one hears talk of "regulatory fatigue" within the FSB and other international bodies. It is unlikely that significant new areas of financial regulation will be initiated at the international level during 2013.

The Three Streams of Financial Sector Regulation within Europe

Within Europe, there have been three streams of regulatory activity. First, the transposition into directives and regulations of the international agenda described above. Examples include CRDIV/CRR in the case of Basel 3 and the European Markets Infrastructure Directive (EMIR) in the case of post-trade market infrastructure.

Second, there have been additional measures, arising largely from the experience of the global financial crisis, that have particular resonance in Europe. Examples include the updated Market In Financial Instruments Directive (MiFiD), which aims to extend

Powers of the single supervisor should not be underestimated

The proposed regulation on banking union agreed by the European Council on 12 December appears to be quite different from the proposals published by the European Commission in September, but in substance, it retains the Commission's vision that the European banking system will operate under the watchful eye of the European Central Bank (ECB) in the foreseeable future.

The Council's proposal includes measures to appease interests in some member states. The much-trumpeted provision that member states, rather than the ECB's new Single Supervisory Mechanism (SSM), will continue to be primarily responsible for supervising banks with assets less than €30bn goes a long way to satisfying the sensitivities of German regional politicians: among the German Sparkassen, only Hamburger Sparkasse, with assets of €38.6bn at the end of 2011, will be overseen directly by the SSM.

The Council has also softened the practical challenges presented by the Commission's proposal, which foresaw the SSM assuming oversight of some banks on 1 January 2013 (sic) and all banks by 1 January 2014. Instead, the Council would have the SSM beginning its work on a single date – 1 March 2014 or twelve months after the regulation enters into force.

To see a copy of the Council's proposed regulation, please see http://register.consilium.europa.eu/pdf/en/12/st17/st17812.en12.pdf. For the Commission's proposal, please refer to Darien Analytics Issue 8, September 2012.

The two key issues in this debate are the scope of the SSM's oversight and when that oversight will take effect. In both cases, the Council's proposals differ little in substance from those of the Commission.

The Council identifies two categories of banks: "significant" and "less significant." Significant banks will be directly overseen by the SSM. National supervisors will retain primary oversight for less significant banks.

In addition to the €30bn threshold, significant banks will include those whose assets are equivalent to more than 20% their national GDP (and have assets in excess of €5bn) and all banks for whom public financial assistance has been requested directly or *indirectly* (my emphasis). This second point would imply that all Greek, Spanish, Irish, Cypriot and, perhaps, Portuguese banks would be considered significant. Furthermore, the three "most significant" banks in all member states will be subject to SSM supervision, unless "particular circumstances" (left undefined) make such supervision unjustified. If "significant" correlates exactly to "biggest," (which it may not) then the SSM could be supervising banks with assets as little as €3bn in the Baltics and Malta.

regulatory oversight and transparency of financial derivatives; and measures to constrain high frequency trading and short selling.

Third, there have been measures to harmonize financial regulation in Europe through the creation of European regulatory bodies, and the transfer to them of regulatory functions previously conducted by regulators in member states. This has been driven by the long-term process of European convergence, and accelerated more recently by the Eurozone crisis.

This third stream began, quite uncontroversially, with the creation of three European regulatory bodies (the EBA for banks, ESMA for capital markets and EIOPA for investments and pensions) and the ESRB, which oversees systemic financial risk. (Note that the three regulators make rules for all 27 E.U. states, not just the Eurozone 17.) The process has continued, more controversially, with proposals to create a banking union, comprising centralised bank supervision, bad-bank resolution and deposit insurance.

More broadly, there is discussion of the structure and role of banks, centered around the Liikanen Report to the European Commission, but also including national initiatives such as the U.K.'s Vickers' report, the French *Projet de Loi* and references to the U.S. Volcker Rule. (More detail on these initiatives is available in a separate Client Annex.)

Time is running out for new proposals

The term of the European Parliament will end in June 2014, and there are indications that the Parliament will not be willing to accept new proposals for legislation after May 2013. The approach of German federal elections, due in the autumn, will also reduce the willingness of German politicians to push new or controversial measures.

Proposals for the ECB's Single Supervisory Mechanism (SSM) are sufficiently well advanced, and have sufficient political momentum, to enable them to meet the Parliament's implied deadline and to be passed into law; but it is much less likely that proposals on bank recovery and resolution, and on deposit insurance will be ready in time.

In the statement issued after its December meeting, the European Council urged the Commission and the Parliament to reach agreement on legislation on bank resolution and deposit insurance, but this seems ambitious in view of the amount of work which still needs to be done on recovery and resolution and the political controversies which continue to surround a joint European deposit insurance scheme. As a result, these two areas are likely to remain subject to member state, rather than European, regulation, for the foreseeable future.

As for the High Level Expert Group on the structure of European banking (the "Liikanen Report") the Council's statement commented simply that the Council, "looks forward to the Commission's rapid follow up" to the group's proposals. Few believe that legislation on this complex matter will be brought forward during the current Parliament.

Practical Implications of Banking Union

The Basel Committee's decision, earlier this month, to lighten the conditions of its Liquidity Coverage Ratio and to delay its implementation opens the way for the European Parliament to pass CRDIV/CRR. (French banks in particular were lobbying for a delay/alteration to the LCR, which makes long-term dollar funding expensive for Euro-denominated banks; but it was always going to be difficult to have a European directive that differed from international norms.) Compliance with CRDIV/CRR will provide the main regulatory focus for banks during 2013.

Over the longer term, the practical implications of having a single supervisor will become increasingly important, particularly for foreign (that is, non-European) banks that have some degree of choice over their domicile. Two factors will be crucial in determining the supervisory atmosphere within which banks will operate.

The first will be the tone set by the head of the SSM, widely expected to be Danièle Nouy, the Secretary General of the French banking supervisor, the Autorité de contrôle prudential. (Outgoing Eurogroup President Jean-Claude Juncker told the European Parliament on 10 January that he would be nominating a French woman.) The second factor will be the relationship that national supervisors will develop with the SSM staff. The SSM cannot possibly take a close supervisory interest in all the banks within the Eurozone, let alone those within the E.U. 27, in the foreseeable future. It will therefore focus its attention on those banking systems where it is less comfortable with the quality of national supervisors.

As banks think about their long-term strategies for Europe, the extent to which the head of the SSM takes a *dirigiste* line, and the extent to which their national regulator enjoys the trust of the SSM will be key. ■

Pace the question of whether the banking systems of bail-out countries will be incorporated into the SSM *in toto*, the definitions described above (appearing in Article 5, Section 4 of the proposed regulation) imply that 150 – 200 banks will be directly supervised by the SSM.

Yet beyond these narrow definitions – so important to the public presentation of the Council's proposals – the regulation would give the ECB/SSM almost unlimited power to exercise its authority over all banks and banking systems within the Eurozone.

Article 5, paragraph 5(b) states that, "When necessary to ensure consistent application of high supervisory standards, the ECB may *at any time, on its own initiative* (my emphasis)…decide to exercise directly itself all relevant power for one or more credit institutions…" *Consultation* with national authorities is required when taking such a step; national authorities' *agreement* is not.

Furthermore, paragraph 5(a) of Article 5 empowers the ECB to, "Issue regulations, guidelines or general instructions to national competent authorities," specifying that such instructions may refer to the specific powers mentioned in Article 13(b), paragraph 2. That paragraph empowers the ECB to require institutions to hold capital in excess of formal requirements such as CRDIV and to interfere in a range of internal matters such as provisioning policy, business strategy, risk appetite and bonus payments.

The Council proposes that this will take effect in March 2014, just beyond the date when the Commission was proposing that the SSM acquire oversight of all Eurozone banks.

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Darien Middle East advises clients on international financial regulation and best practices in risk management and corporate governance. The firm was founded in 2010 by Andrew Cunningham and is based in London. The firm publishes regular briefings on financial markets under the title, Darien Analytics.

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