THE EUROPEAN COMMISSION'S ANNOUNCEMENT OF 12 SEPTEMBER 2012 IS DESIGNED TO CREATE THE CONDITIONS IN WHICH THE EUROZONE'S CREDITOR MEMBER STATES CAN PROVIDE FINANCIAL ASSISTANCE TO BANKS IN WEAKER MEMBER STATES

THE EUROPEAN BANKING UNION. WHAT WILL IT MEAN IN PRACTICE FOR BANKS?

AS THIS IS NOT IMMEDIATELY OBVIOUS, NOR NECESSARILY CONTAINED IN THE EC'S ANNOUNCEMENT, THIS NOTE SUMMARISES WHAT THESE LATEST REGULATORY CHANGES COULD MEAN IN PRACTICE FOR BANKS.

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Our team would be delighted to explain how we can help you respond to the challenges and opportunities regulatory change in Europe.

PRE- AND IMMEDIATLY POST-IMPLEMENTATION

A big increase in demands on senior executives. For banks currently supervised by a single regulator, the changes will increase the time spent managing regulatory risk. In particular, senior executives will spend more time dealing with regulatory matters as new supervisory teams are created and the ECB consults on its new regime. The fact that national central banks will continue to be responsible for conduct of business and AML supervision compounds this challenge.

A big increase in data requests. We anticipate that the demand for microprudential data will increase markedly over time, with demands for more items of data and new categories of data. This will place significant pressures on finance and risk functions, especially if COREP and FINREP are re-engineered or replaced. There will be a further round of data requests from people involved in macroprudential supervision.

Good and bad news for UK banks. For UK banks, we expect no impact in the near term. As the new arrangements take shape, though, it will become clear that banks with multiple product lines and/or Eurozone operations will have more and more complex, regulatory relationships to manage.

A major challenge for Eurozone banks in London. Those most affected by the changes will be the subsidiaries of Eurozone banks located in London. In one scenario, we see these banks having to manage 7 financial regulatory relationships: The ECB; their home country regulator; the Bank of England; the Financial Conduct Authority; the European Banking Authority; the European Securities Market Authority; and the European Insurance and Occupational Pensions Authority.

LONG TERM EFFECTS

Forward to the past – less regulation, more supervision. The re-emergence of central banks as supervisors in the Eurozone and UK will lead to significant changes in the philosophy and practice of prudential supervision. This will be a mixed blessing for banks. Central bankers' suspicion of rules-based supervision might lead to a push to simplify regulatory regimes – a theme the Bank of England's Andy Haldane explored recently. Conversely, there will be more willingness to interfere in day-to-day business decisions, including the appointment of staff.

Industry structure – expect more consolidation. A number of Eurozone policymakers consider that the Eurozone banking system is excessively fragmented, both within countries and across borders. Indeed, the single market project for financial services has taken a real blow during the crisis, with banks retreating from activities and investments outside their home markets.

IT WILL BECOME CLEAR THAT BANKS WITH MULTIPLE PRODUCT LINES AND/OR EURO-ZONE OPERATIONS WILL HAVE MORE AND MORE COMPLEX, REGULATORY RELATIONSHIPS TO MANAGE

In theory at least, the new regulatory architecture will allow the authorities to address this issue, even if the solutions will ultimately require assent by national governments because of political concerns about the provision of banking services and, separately, on-going State ownership of some banks.

Bank resolution – one route to consolidation. A crude if effective route to secure consolidation will be through the use of bank resolution tools. Although originally designed as a tool of last resort, bank resolution legislation does allow supervisors to address the weakness of individual banks pre-emptively. In some cases these weaknesses are a function of a particular market segment to compete, especially in a world of tougher captal and liquidity requirements. We have already seen this in certain market, for example the UK's mutual sector and the Spanish cajas. We therefore expect to see these tools used to deal with non-viable banks across the Eurozone, with possibly far reaching effects for the shape of the European banking market. In our opinion, this is the key proposal announced by the EC.

Capital and funding – will Basel III/CRD IV be diluted? The question of non-viability of certain banks is not limited to smaller or monoline banks. The Eurozone's growth prospects mean than financial performance will be depressed for many banks, especially those in the Eurozone's periphery. Equally, measures to strengthen banks' balance sheets are already affecting returns. The key concern, however, is whether new prudential requirements are constraining lending in a downturn. The ECB will consider this issue through three lenses now: monetary policy; financial stability; and bank supervision. We therefore expect revisions to the Basel III timetable to be at least debated. It is possible that this will be followed by a discussion of the rules, particularly those on funding. While the EC remains committed to CRD IV, central bank pragmatism might yet assert itself in the resolution of the Eurozone's challenges.

WHAT CAN DO BANKS TO PREPARE FOR THE NEW REGIME?

Building bandwidth to manage demands from regulators, discarding inefficiencies. The creation of new regulators creates work for banks, as does the ensuing regulatory change. We think banks need to consider now whether they are resourced to monitor and respond to the new regulatory architecture in Europe. At the same, and after nearly five years of regulatory change, we think banks should consider whether the compliance and risk infrastructure they have constructed remains fit for purpose. There are undoubtedly opportunities to re-direct resources to activities consistent with the emerging European regulatory regime, and possibly even eliminate inefficiencies which have been introduced into banks in recent years.

Getting recovery and resolution planning right. The banking union proposals will concentrate supervisory power in the ECB. The EC's proposals also argue strongly for the realisation of a single Eurozone banking resolution mechanism. We expect that the ECB will make resolution a priority, and will work closely with the entity which will own the resolution powers (which might yet be the ECB too). This looks similar to the centralisation of supervisory and resolution powers in the Bank of England. The UK experience suggests to us that Eurozone banks will be pushed hard to develop recovery and resolution plans, with priority given to Europe's more vulnerable banks and banking system. We therefore recommend that banks move quickly to develop capability in this area.

Will you have the right risk and compliance architecture? Over time, we expect that the ECB will seek to construct a supervisory philosophy based on substantive observance of key principles rather than narrow compliance with rules. While it may not be in the ECB's gift to re-write the rulebook, it can adjust its supervisory focus. Importantly, it will also be less sympathetic to national traditions and practices than the status quo. For some banks, especially those operating across jurisdictions, this will be familiar territory. For others it will not. We recommend that banks consider what skills they will need to manage multi-national supervision teams in the ECB today; mandated to focus on the fundamentals of banking business rather than observance of banking rules.