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Banking Union- Present Stage and its Perspectives

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Abstract: Banking Union is very important for financial stability of EU, for preventing any future crisis, for improving corporate governance in the banking sector, for completing the single market for financial services and for the strengthening of monetary union, for opening the way to fiscal union and to political union. There is not enough theoretical research in the field of banking union, but there are many recent contributions on behalf of foreign and Romanian experts and analysts, which refer mainly to the three components/pillars of EU banking union: a Single Supervision Mechanism (SSM), a Single Resolution Mechanism (SRM) and an harmonized system of deposit guarantee schemes. Some micro studies and surveys carried out by prestigious institutions, like Deutsche Bank, Brookings Institution, CEPS have been run over and analyzed together with the positions and opinions of different European officials, and also with the content of EU secondary legislation. An empirical research was made with the aim to identify all essential aspects relating to EU banking union, which may concern the academics, researchers and business community. The paper is based on a previous research study coordinated by author and contains his own conclusions focused on the main arguments in favour of banking union.

Keywords: bank; supervision; resolution; legislation; institutions

JEL Classification: G01, G18, G21

1. Introduction

EU Banking Union is a new and ambitious project based on a better European supervision and regulation framework established after the crisis and involves a legislative and institutional building up under the direct guidance of European Council. While Single Supervisory Mechanism is more advanced in materializing due to a new regulation adopted by EU Council and due to activity of Supervisory Board of ECB, European Commission and European Banking Authority, it will take some time to create and implement a Single Resolution Mechanism and it is not clear what will happen with the funding of Deposit Guarantee Schemes at European level. Romania and other non–euro Member States will participate to banking union in order to remove the structural vulnerabilities and fragmentation of banking sector, to improve its performance and contribution to economic growth.

2. Important Steps Recorded in the Formation of Banking Union

When in 1961 Bela Balassa defined the five stages of economic integration- free trade area, custom union, common market, economic and monetary union, total economic union- European integration process was in the first years after Rome Treaty, but in the second stage, that of creating a custom union for the six member states of European Community which was finally achieved in the mid 1968 together with a common market for agricultural products. The liberal vision of Rome Treaty, see the four fundamental freedoms, was in stark contrast with the national interventionism inspired by Keynes

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ideas and focused on achieving the welfare state, although the regulation activity at super-national (European) level was also a kind of new interventionism and involved a large transfer of sovereignty from national level (positive integration).

After more than half a century European Community was able to establish an economic union based mainly on a single market and also a monetary union based on a single currency, but the single market is not complete and the monetary union covers only 20 member states of European Union. Due to liberal economic policies implemented in the last decades and because the way the monetary union was made and consolidated, see the failures in implementing the Growth and Stability Pact, European Union proved extremely vulnerable to the effects of financial and economic crisis. But the main culprit of the recent crisis, and also of debt crisis in the Eurozone, was the banking sector that took full advantage of liberalization and deregulation and threw itself into reckless lending in the real estate sector, in doing huge and uninspired speculations with derivative products and in buying a lot of treasury bonds. The second culprit was the bad governance in the countries from Southern Europe, where the governments run into huge debts, bore with high macroeconomic deficits and imbalances and tolerated a damaging corruption and a large fiscal evasion. European Governments and Central Banks were forced to bail out the banking sector using a lot of public money and increasing to a large extend the public debt in order to avoid the repetition of the Great Depression (1929-1933) scenario when many banks had failed and when the crisis had badly hit most people in USA and Europe and it took almost two decades for starting a true economic recovery in Europe.

The response of EU to crisis effects was to undertake a large reform of European economic governance in order to consolidate the role played by the Stability and Growth Pact in coordinating and supervising the macroeconomic policies, especially the fiscal and budgetary policy of the Member States. The main instruments introduced are: European Stability Mechanism, European Semester, Six Package, Two Package, Treaty on Stability, Coordination and Governance(Fiscal Compact), the second and the third ones sustaining the Excessive Deficit Procedure (EDP) applied to Member States with public debt in excess of 60% of GDP and also the Macroeconomic Imbalance Procedure (MIP) based on Scoreboard Indicators (11) which broadens the EU economic governance framework to include the surveillance of macroeconomic trends.

Sovereign debt crisis and great difficulties faced by banks in Eurozone have revealed not only the major weaknesses of corporate governance in the banking sector but also demonstrated that financial stability cannot be insured at national level because of the vicious circle created between banks and governments (shocks transmitted from the banks to the government and from the government to the banks) and therefore the need to break it by establishing a banking union within EU. But there are two other important reasons for the creation of a banking union: the first one would be the completion of single market for financial services, that is the free movement of capital, the second one would be the strengthening of monetary union, especially the role of single currency. Both mentioned processes aim at a rapid transition to a fully economic union and a federal political union, the last stages of European integration.

Starting with 2010 a new institutional framework was created for a better supervision and regulation of financial sector: the European Systemic Risk Board (ESRB), in charge with macro-prudential surveillance under EU Regulation no.1092/2010, European Banking Authority (EBA), based on EU Regulation no.1093/2010, The European Insurance and Occupational Pensions Authority(EIOPA), established under EU Regulation 1094/2010 and The European Securities and Markets Authority (ESMA) established under EU Regulation 1095/2010 (see figure 1). All these authorities are in charge with macro-prudential supervision and especially with monitoring and preventing the systemic risk at EU level and also with issuing of warnings and recommendations for financial sector from EU. It is also European Central Bank(ECB) involved in monetary policy and macro-prudential supervision of banking sector while at the national level there are specialized authorities in charge with micro-prudential supervision, but also with some macro-prudential functions (like Central Banks) which interact with European Authorities.

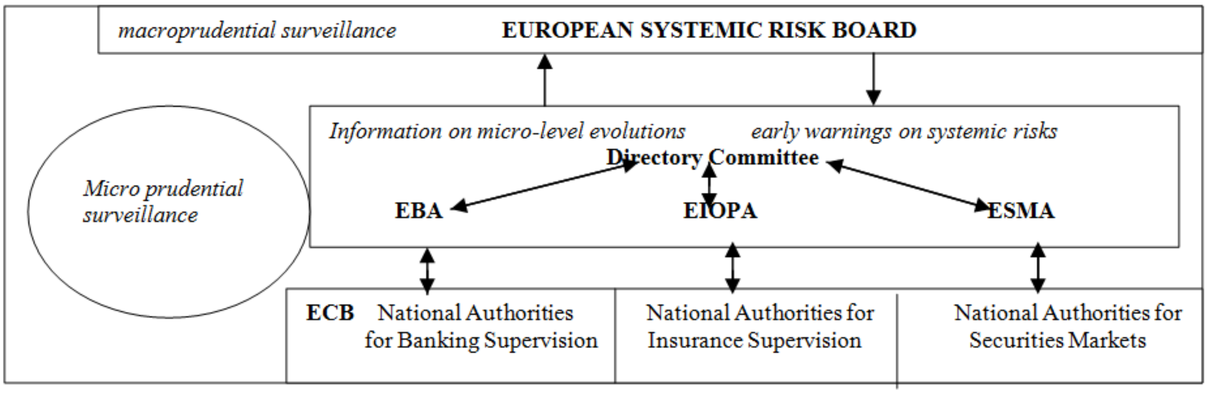

Figure 1. The structure of European System of Financial Supervision

Source: Made by the author after some sources

Based on this system banking union was defined as having three main pillars: a Single Supervision Mechanism (SSM), a Single Resolution Mechanism (SRM) and an harmonized system of deposit guarantee schemes. On 29 June 2012, European Council decided the creation of a banking union, focusing initially on the establishment of a single supervisory mechanism that involves European Central Bank on the basis of Article 127 (6) of the Treaty on the Functioning of the EU (TFEU). After Larosière Report, which underlay the financial supervision at European level, European Commission published the Communication "*Roadmap to banking union"* on 12 September 2012 which examined the issues of legislative and institutional framework of the banking union. This Communication was followed by Liikanen Report on 2 October 2012 that reviewed the banking sector, proposed some major reforms and recommended actions in 5 domains.

Starting with October 2012 European Council has reviewed the issues of banking union at every summit, ECOFIN and European Parliament adopted some legislative acts, European Commission submitted its proposals for the needed secondary legislation and strongly cooperated with ECB and EBA for establishing a functional banking union within EU.

3. Single Supervision Mechanism

When the idea of banking union took shape the establishment of a Single Supervisory Mechanism(SSM) has shown to be essential and European Commission proposal was based on the transfer at EU level from national level of specific surveillance tasks for large banks from eurozone. SSM, composed of the ECB and national supervision authorities, constitutes a consistent and effective supervision structure in the eurozone meant to insure financial stability in Europe and it is based on indisputable and strong authority of ECB and also on the specific and long expertise of national authorities which shall insure that banking sector supervision remains anchored in national/local conditions and traditions, at least for medium and small banks. At the same time European Commission proposed a mechanism for connecting to the Member States which have not adopted the euro but wish to participate in SSM. This mechanism is based on a memorandum of understanding describing in general terms the cooperation framework.

In 15 October 2013 ECOFIN Council adopted the Regulation no.1024/2013 conferring specific tasks on ECB concerning policies relating to the prudential supervision of credit institutions, having regard to the opinion of European Parliament and the opinion of ECB. The regulation makes several references to the banking union and its structure and clearly establishes the role of ECB in it. ECB should be able to exercise supervisory tasks in relation to all credit institutions authorized in, and branches established in, participating Member States and should take into account the diversity of credit institutions and their size and business models. Credit institutions must internalise all costs caused by their activities in order to avoid moral hazard and the excessive risk taking arising from it. The Supervisory Board will be an essential body in the exercise of supervisory tasks by the ECB, and will have a Chair, a Vice Chair and will include representatives from the ECB and from national competent authorities.

It is the ECB through the new institutional component –Supervisory Board- that will be involved in assessing through audits and stress tests the participation of 128 banks to SSM (see figure 2). Danièle Nouy, the appointed Board Chair, said that the banks should make reserves to cover sovereign assets that can not be regarded as risk-free assets and the banks failing the stress tests will not get any help and they have no future. The ECB had already begun in early 2014 checking the quality of assets resistance for the first 128 largest banks in the euro area, followed in September 2014 to set the final list, which is reviewed annually, with banks directly supervised (from November 2014), especially their line and acquisitions of assets. EBA supports activities ECB technically on line supervision, testing the resilience, mediation and establishing technical standards

ECB has already released the guidelines (a 285 page manual) for asset quality review (AQR) by which €3,700 billion worth of assets (out of 30,700 billion total assets) will be evaluated until August 2014. Sabine Lautenchlaeger, Board Vice Chair, pointed to the need for capital improving and there were estimates for banks ‘capital shortfall ranging from € 280 billion to €770 billion. Soon after performing AQR unprecented stress/shock scenarios would be implemented having in mind that stress tests made in 2010 and 2011 and conducted by the EBA and its predecessors were useless: they didn’t properly assess banks’ ability to withstand sovereign defaults and to fully reveal banks’ macroeconomic vulnerabilities. Banks will have to reflect the results of AQR and stress test in their 2014 accounts.

Collateral in its diverse form will be correctly evaluated by external experts based mainly on independent market valuations because collateral valuations are an important source of uncertainty for banks in some countries (e.g. Italy). Besides loans, a broad group of assets difficult to value will be assessed (“level 3 assets”) for 29 banks with material exposures, including derivatives, real estate holdings, participation in private equity deals, special investment vehicles.

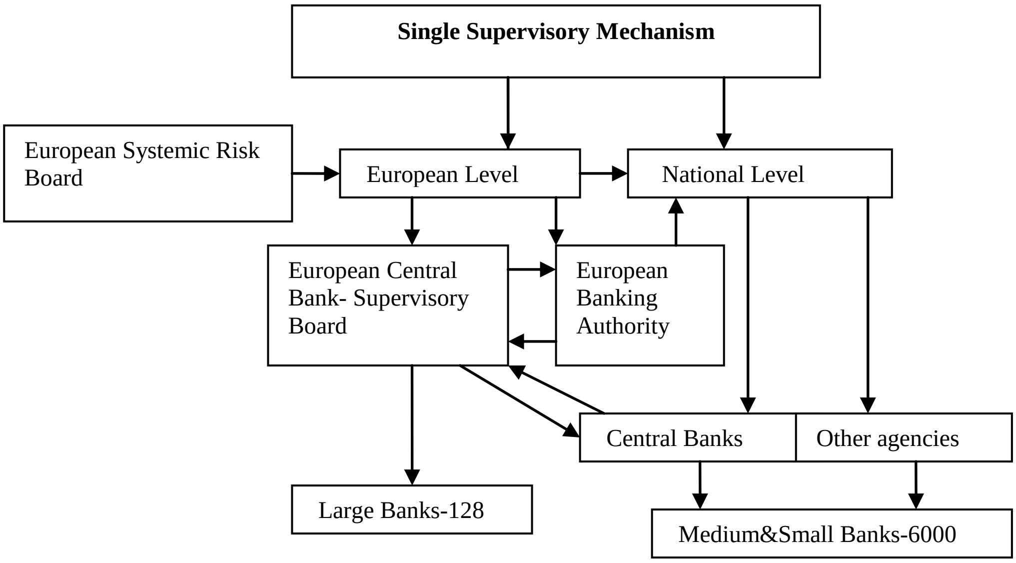

Figure 2. The framework of banking macro and micro-prudential supervision in EU

Source: Made by the author

Similar to Danièle Nouy, prestigious analysts, like Daniel Gros, CEPS director, think that banks' investments in government bonds is not risk free and as they have a huge debt exposure on sovereign debt it will be necessary to drastically reduce it (under the provisions of Large Exposure Directive banks should not hold government bonds over 25% of their own capital). European banks hold €1750 billion worth of assets in government bonds representing only 5.7% of total banking assets but a large part of their capital.

4. Single Resolution Mechanism

The second major component of banking union is represented by the Single Resolution Mechanism (see figure 3) based on the provisions of the Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010. The aim of this directive is to create adequate instruments at EU level for dealing with unsound or failing credit institutions and to involve shareholders and creditors, rather than taxpayers, in bearing the banks losses. A harmonized resolution regime is necessary because Member States have different insolvency procedures applied to commercial banks. Each member state will have to create a national resolution authority responsible for banking resolution process. All the credit institutions and investment firms which are governed by the provisions of Capital Requirements Directive will enter under the rules of this directive and will prepare a full recovery plan offering valuable information for resolution authorities which may require proper self-imposed measures for restoring the financial soundness or for reorganizing bank's business. Resolution authorities will be in charge with resolution plans based on different scenarios including systemic instability, which will provide resolution instruments and ways for banks survival.

Resolution activity is strongly linked to banks supervision, as supervisors may intervene in the case of evident difficulties and may require the implementation of recovery plans and improvements in bank's management or even the replacement of managers by a special manager having all legal powers and asking for capital increase, assets decrease, reorganization or a takeover by another bank. If the early intervention process is not successful and a bank is in danger of failing then the resolution authority may implement resolution actions based on its investigation related to capital requirements, assets, liabilities, financial position and prospects and aiming at promoting the public interest and avoiding the dissemination of systemic risks. The main resolution measures or tools would include: a)sale of some business; b)setting up a bridge institution (temporary transfer of banking assets to a public controlled entity); c) separation of assets (transfer of impaired assets to a vehicle asset management); d) bail-in measures (the imposition of losses, with an order of seniority, to the shareholders and non-insured creditors). Some liabilities, like insured deposits, may be excluded from bail-in.

Regulatory technical standards supporting Single Resolution Mechanism are going to be developed by the European Banking Authority and adopted by the European Commission. The date proposed for the implementation of this Directive is 1 January 2015, except for the bail-in tools, which may not be applied by Resolution authorities until 1 January 2018.

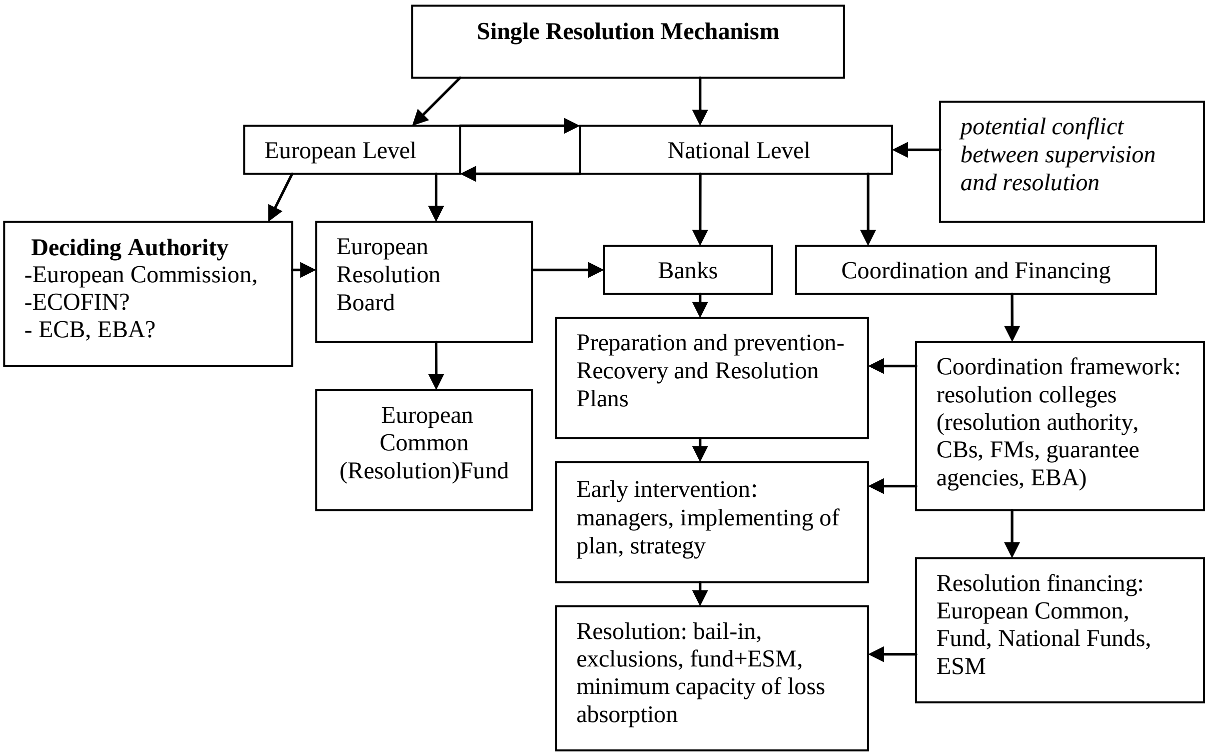

Figure 3. The framework of Single Resolution Mechanism in EU

Source: Made by the author

On 10 July 2013 European Commission has proposed the Single Resolution Mechanism (see figure 3), including the European Resolution Board (with a staff of 300 people) and in the second part of 2013 ECOFIN Council and European Parliament have debated on the Recovery and Resolution Directive. European Council, which is the supreme decision factor within EU, has asked during the last December Summit (2013) to EU legislative bodies to adopt SRM before the end of the current European legislature (May 2014). However some divergencies have persisted between ECOFIN Council and European Parliament on the final decision body in the resolution process.

The Single Resolution Mechanism will work as follows: the ECB, the supervisor of the most important banks (128) from the banking system, will indicate when a bank passes through severe financial difficulties and has to be resolved by the Single Resolution Board (SRB) supported by the ECB; European Commission and the relevant national authority will prepare the proper solution for its solving, SRB having powers to investigate and define the proper way of resolution, what tools will be used and how the European Resolution Fund will be involved; on the basis of the recommendation of the Single Resolution Board or on its initiative the European Commission will decide if and when will place a bank in a resolution position and will determine the framework for using the resolution tools and the implication of the European Resolution Fund; under the supervision of the Single Resolution Board national resolution authority will be in charge with the implementation of resolution plan; the Single Resolution Board will supervise the resolution, will monitor the implementation of the plan at the national level by the national authority and if such an authority does not conform to its decision it will be able to directly address executive orders to the banks. The European Commission's role is to trigger a bank resolution and a decision for its framework, ensuring consistency with the rules of the internal market and state aid, defending thus the independence and responsibility of the entire mechanism.

On 20 March 2014 ECOFIN Council and European Parliament have reached an agreement on SRM from the Banking Union project that, in 2016, will allow avoiding situations in which taxpayers bear the cost of banks liquidation, in the event of further crises. The setting-up period of an (Common) European Resolution Fund of €55 billion for banks facing serious difficulties has been reduced as a result of the negotiations from ten to eight years. The European Parliament would have wished that the European Fund should become fully operational within three years, but there was a fierce opposition on behalf of Germany. At the same time, there remains a sensitive issue to be solved, namely the method of calculating the banks' contributions to European Fund, which concern in particular France and Germany. European Central Bank will trigger the process that will determine whether a bank is failing and the European Resolution Board will coordinate the orderly liquidation or recovery of the bank concerned. All decisions on the resolution process must be validated by the European Commission.

5. Deposit-Insurance Schemes

The third component of banking union will be the harmonization/improvement of national deposit insurance schemes. Directive 94/19/EC on Deposit Guarantee Schemes was firstly improved in 2008, when in 15 October 2008 the European Commission proposed a revision to EU rules on deposit guarantee schemes that put into action the commitments made by ECOFIN on 7 October 2008. The new rules were designed to improve depositor protection and to maintain the confidence of depositors in the financial safety net, the ceiling for a person deposit being increased from €20,000 to €50,000. In July 2010 European Commission made a new proposal for improving this directive aiming at simplification and harmonization, reduction of the time limit for paying out depositors and better access for DGS to information about banks, sound, credible and sufficiently financed DGSs, mutual borrowing between DGSs. Starting with 31 December 2010, Member States were supposed to ensure the coverage for the aggregate deposits of each depositor set at €100,000 in the event of deposits being unavailable.

After more than three years of stop-start negotiations, ECOFIN Council and the European Parliament agreed in 2013 on reforms to make available funds of up to 0.8 per cent of the banking sector's insured deposits for payouts. The revision to the deposit guarantee scheme directive is one of reforms that EU was aiming to close until the end of 2013. In December 2013 preliminary approval was given to national rules on bank failure, which will require governments to impose fees on banks equivalent to 1 per cent of insured deposits, which will go towards the costs of resolving or rescuing banks. While the EU deposit guarantee of €100,000 will remain the same, the rules will coordinate better the way governments arrange for that insurance to be paid. At present many countries have poorly funded or unfunded deposit guarantee schemes, which may ask for industry contributions after a payout is made. The deadline for payouts will be gradually reduced from 20 to 7 working days by 2024 and at least 70 per cent of this payment must be made in cash, the remainder can be deferred for a year.

The capacity of the national deposit guarantee schemes (DGS) to cover the guaranteed deposits is under question. DGSs funded at the EU level or at euro area level may provide an external loss absorption mechanism, which may be considered independent on the solvency of the sovereign entities. Such an external loss absorption mechanism may be important, especially during a financial crisis. Banks bailing out or resolution during the financial crisis was made with taxpayers money (financed by governments and central banks) and practically saved all deposits (insured and non-insured), but the bail out will be replaced by bail in (shareholders and large creditors ‘money). But an European Fund for covering the needs of national deposit guarantee schemes has not been accepted so far, also a Common European Fund for banks resolution and for deposit guarantee schemes, both financed through banks own contributions, due to financial constraints and losses recorded by banking sector. Firstly, banks will have to increase their capital due to the fact that Basel 3 agreement introduced the reserves requirements for macro-prudential risks and those for an increased liquidity, while increasing coverage level with capital of the risks, improving the quality of their own funds and returning to capping the banks deleveraging. Secondly, banks will have to contribute to European Resolution Fund and to national resolution funds. Thirdly, banks will have to supplement their contribution to national deposit guarantee funds.

6. Conclusions

Daniel Dăianu, first Deputy Chairman of the Financial Supervisory Authority from Romania, observed the impact of financial integration, of the complexity and risks of financial operations/innovations, including the failure of the regulatory and supervisory systems, corporate governance deficiencies, manipulation of markets and chase after big profits but associated with high risks rapidly propagated into the system (Dăianu, 2013). He combats the great illusion that price stability (low inflation) would ensure financial stability on the basis of efficient markets hypothesis. For a healthy economic growth we need more robust financial systems, as in the last two decades their robustness and resilience dropped dramatically, they became more vulnerable to systemic shocks while the financial situation turned out more fragile and destabilising for the whole economy (Dăianu, 2014). Mugur Isărescu, the Governor of NBR, believes that mortgage loans and derivatives have boosted moral hazard in the banking sector, the banks should finance mainly the most dynamic economic sectors which draw economic growth, and this requires the review of the orientation of commercial bank policies to finance the productive activities (Isărescu,2013).

Mugur Isarescu, the Governor of NBR, recently said that the absence of fiscal union and of banking union has flawed the Monetary Union and imposed a high cost on financing the public debt due to market perceptions, noting a major paradigm shift, for ensuring the continuity of critical financial services through a combination of preventive actions with corrective solutions. He thinks that the banking regulations, although they have an increasing macro-prudential orientation are not sufficient to prevent the build-up of systemic vulnerabilities, the other components of the mix of macro-economic policies should avoid ample variations in the demand for credit, particularly through the promotion of a non-cyclical policies of revenues (Isărescu, 2013).

The arguments in favor of banking union are much more solid, more logical and better theoretical grounded than the counter-arguments. It is ridiculous to talk about over-regulation and its costs in the case of a banking union when the deregulation and liberalisation of financial markets have led to the explosion of mortgage credit, financial derivatives and speculations, with the direct result of a severe financial crisis. Banking Union concept has been imposed to prevent systemic risks and resolve in an appropriate manner the delicate situation of the distressed banks, but also to ensure the protection of small depositors and to preclude a new financial crisis. Banking Union will combat the fragmentation of EU banking sector and facilitate lending/financing of the private sector, potentiating its investment capacity with beneficial effects on economic growth (Tolosa, 2014). Banks should promote a new business model, to pass from the transaction banking to relationship banking, that is to solutions tailored to customer needs (Dănilă, 2014).

Banking Union construction is meant to break the vicious circle between banks and sovereign entities, because banks will have to reduce their high exposure on the sovereign debts, which no longer can be considered without risk. Poor governance at national level may affect local banks, and on its turn a poor credit institution may affect the credibility of local government and may require financial support, with consequences on the level of public debt (Tolosa, 2014). That's why the Banking Union must be accompanied by a Fiscal Union to prevent moral hazard and to break the vicious circles, to strengthen public finances and budgetary discipline within EU, to create new instruments for intervention at EU level.

Banking Union issues may be integrated into the new economic governance framework (reformed) of EU, by imposing a tight fiscal discipline through Fiscal Compact and the Excessive Deficit Procedure based on Scoreboard Indicators(11), by implementing the provisions of Basel agreements and by creating a possible fiscal union.

Progresses on the implementation of the Banking Union are significant and have resulted in the adoption of an important regulation and the proposals for some directives, in evaluations and stress tests designed to be completed in the first part of the year 2014, in the political will displayed by the European Council to fulfill the objectives set in 2012, in the actions undertaken by legislators (ECOFIN and EP), and in the intense activity carried out by the European Commission, the ECB and EBA. One can say that there has been a rapid progress for establishing the Banking Union on behalf of European institutions, which have worked effectively and almost without breaks for the adoption of secondary legislation and also for the institutional biding required to accomplish the three components of the Union: supervision, resolution and deposit guaranteeing. At the end of March 2014 there was in force the Regulation no.1024/2013 for SSM adopted by ECOFIN and also the Supervisory Board within ECB, The Directive for SRM was in the final stage of adoption, there was made an agreement between ECOFIN and EP on the revision of the Deposit Guarantee Scheme Directive, it has been started the assets evaluation for the banks supervised by Supervisory Board, and SSM would have become operational in November 2014, EBA has published final draft Technical Standards on liquidity requirements and final draft Technical Standards on additional collateral outflows, and also has announced the key components of the forthcoming 2014 EU-wide stress test that will be conducted on a wide sample of EU banks.

5) Romania will enter the Banking Union because banking sector in our country is overwhelming dominated by European banks from the euro area and because National Bank of Romania and Romanian Banking Association support this project useful for the financial stability of EU and for the consolidation of the single currency and monetary union. Romania does not have to wait for the adoption of the single currency to enter the Banking Union, instead adhering to this union is an advantage in getting ready the economy for its entry into the euro area. Of course, it may occur several important requirements for the banks related to the management of capital, liquidity, assets, risks, to their contributions to various new funds, but fears of banking capital flowing towards stock exchanges due to big investors panic and those relating to the restriction of lending, especially for SMEs, are not justified and may be tackled fairly easy.

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