The Need for a Banking Union

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It is clear that a banking union at the European level is a gain, but it is not a solution for all the problems that have been revealed by the last financial crisis. Although the Single Rulebook uniforms banks' risks management and micro-prudential supervision, the macro-prudential components contained are reduced and academically challenged. The question of Member States outside the Eurozone on the participation within the Single Supervisory Mechanism is when is the right moment and not if, since there is an implicit horizon for joining the Eurozone and thus to the mechanism. For these Member States, where the banking system is dominated by banking groups supervised by the European Central Bank, entering into a close cooperation with the Single Supervisory Mechanism does not appear to be a necessity, given that national supervision authorities are applying the Single Rulebook, and cooperation between national authorities and the European Central Bank is clearly established.

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Background

A banking union at European Union level is necessary because the institutional architecture of Economic and Monetary Union has proven to be insufficient, fiscal rules weak and financial integration occurred amid significant accumulation of imbalances in the private sector (Isărescu, 2013).

A monetary union cannot function in the context of internal restrictions and on the existence of major differences between the capital and financial conditions in the Member States, also being needed to restore proper functioning of the transmission mechanism of monetary policy. In terms of integration of financial markets, financial stability cannot be ensured if the supervision activity remains at national level. The current institutional project intends to tackle these problems by creating a banking union in the euro zone, with the possibility of other non-euro Member States to voluntary adhere to this union.

Banking Union is based on four pillars:

i. Single Rulebook;
ii. Single Supervisory Mechanism;
iii. Single Resolution Mechanism and
iv. Single Deposit Guarantee Scheme.

Harmonization of regulations and banking supervision was necessary because regulatory diversity within the Economic and Monetary Union was counterproductive (Larosière Report, 2009). This blocked the potential of the single market, has distorted the competition, stimulated the regulatory arbitrage that undermined the effectiveness of risk management and capital allocation for cross-border groups and made more difficult the crisis management, especially in case of large cross border banks (Isărescu, 2013). So it was defined a Single Rulebook, but there is enough flexibility for imposing additional requirements at national level, if financial stability would be threaten. In this way it is considered that it would ensure the restoration of confidence depositors and investors and avoid fragmentation of European financial markets.

The Single Rulebook ensures uniform implementation of Basel III across the European Union. This element is not specific to the banking union, since it is applied at the European Union level, but it is one of the pillars that support the banking union.

The second element of banking union is transferring the main supervision responsibilities from the national to the European level, by creating a Single Supervisory Mechanism (SSM). Under this mechanism the European Central Bank (ECB) and national supervisory authorities will function as a system. The task of national supervision authorities will focus on consumer protection, money laundering, the supervision of entities belonging to credit institutions headquartered outside the European Union, as well as conducting on behalf of the European Central Bank the activities related to the supervision of banks. The ECB will take over the authorization of credit institutions, the responsibilities regarding capital adequacy and liquidity requirements for banks and supervision of financial conglomerates on a consolidated basis. By creating a Single Resolution Mechanism for resolving banking crises was intended to introduce common provisions to ensure legal support required to manage bank failures inside the banking union. Implementing a Single Deposit Guarantee Scheme was designed to ensure equal treatment for all EU countries depositors and to boost confidence in the banking system. Some measures have already been implemented, the national deposit guarantee schemes coverage level was harmonized to 100 thousand euro per depositor per credit institution, procedures for deposits repayments were simplified, repayment period was reduced and financing arrangements improved. However, there are major controversies between Member States on the necessity and the implementation of the single deposit guarantee scheme and its building prospects are not very favorable (Isărescu, 2013).

Given that euro zone banks hold three-quarters of total bank assets in Romania and two thirds of the shares, Romania's membership in the banking union appears as a self-evident element (Isărescu, 2013).

Schoenmaker (2012) draws attention to the rise of interest in micro-prudential supervision through the creation of the Single Supervisory Mechanism and relatively low interest on implementing sound macro prudential policies at European Union level. He argues that macro trends, such as the sharp rise in residential house prices were underpinning the economic crisis, requiring placing the macro-prudential policy at the European Central Bank, separated from micro-prudential supervisory function, with the national central banks help when necessary. Thus, he considers that focusing on the stability and soundness of individual banks may lead to missing the imbalances in the financial system, Europe needing an integrated financial architecture, monetary stability, financial stability (macro) and financial supervision (micro).

This is not anymore valid since a macro-prudential mandate was given to the European Systemic Risk Board, which is responsible for setting the national institutional framework in order to have a common approach on implementing macro-prudential tools across European Union. Although the European Systemic Risk Board recommended a set of tools that can be

implemented at national level, it made a statement that those tools must be adopted carefully since their effects are not entirely known.
We will try to evaluate this new banking arhitecture at the European Union level so as to see how it will work, and to identify if there is a short term necesity for non-euro Member States to voluntary enter into a close cooperation with the Single Supervision Mechanism.

Banking Union Strenghthening the Economic and Monetray Union or Remedy to Crisis?

European Commission says it has made efforts to understand the lessons from the crisis that started in 2008 and has taken big steps to strengthen the financial system. The measures taken have had regard regulation, supervision and the governance of the financial system, so that in the future the mistakes made by banks will not be borne by taxpayers. Most of these measures are already implemented or under implementation.

Commission pursued the following tasks to create a financial system more robust and secure:

i) strengthening capitalization and liquidity position;
ii) increasing the efficiency of the banking system supervision;
iii) common rules on supervision and resolution;
iv) creating an efficient resolution mechanism to protect depositors;
v) eliminating the risks of institutions deemed too big to fail;
vi) creating a financial system safer and more transparent;
vii) reducing the importance of ratings issued by rating agencies;
viii) reducing the risks posed by the shadow banking system;
ix) prevention and punishment of abusive behavior.

As the crisis evolved and turned into euro area sovereign debt crisis, it became clear at European level that, in particular, Eurozone Member States have to adopt more extensive measures. They were necessary in the context in which it was created a vicious circle between banks and financial situation of the states. The negative influence was mutual, the aid granted to banks weakened financial capacity of States, which were perceived as being more risky and were borrowed more expensive, and on the other hand banks were the main holders of government bonds, affecting them also. Greece is an example where the public sector has negatively influenced the banking sector and Ireland and Cyprus are the states where the banking system status adversely affected the public sector.

Thus, in 2012, euro area Member States have decided to create a banking union, completing the Economic and Monetary Union, enabling centralized enforcement of European regulations on the Eurozone banks. Subsequently, the proposals were updated to accept in banking union any non-euro Member State wishing voluntary to adhere. In its initial form, banking union was strictly designed to be a remedy for the Eurozone problems. Therefore, since the creation this mechanism was not intended to include non-euro Member States.

It is estimated that the banking union will help to break the links between banks and sovereign debt:

i) banks will become stronger and more immune to shocks. Joint supervision would ensure more effective implementation of new prudential rules for banks, which requires maintaining adequate capital reserves and liquidity buffers. This will make the European Union banks stronger, enhancing their ability to manage the risks they are facing and to absorb losses;

ii) banks that are no longer viable will be liquidated without the taxpayers contributions, leading to mitigate the negative effects on the financial situation of states. The liquidation of banks will be funded first by shareholders and creditors and only after by the resolution fund, which will be also funded by the banking industry. Banks will not be saved with government aid and the fiscal positions of the states will no more be affected;

iii) banks will no longer be ”European in life but national in death”, as they will be supervised by an European mechanism and any bankruptcy will also be managed by an European mechanism.

Together with the new European regulatory framework of the financial sector, completing the banking union is an important step towards economic and monetary integration of the European Union. It is believed that the banking union will end the period in which banks were rescued with taxpayers' money and will help restore financial stability. This will create conditions for the financial system to start lending to the real economy, stimulating the economic recovery and job creation.

Due to some national responses that were not harmonized and uneven, when large banking groups faced difficulties, in some cases resorting to withholding funds within national borders and due to the high interdependence between banks and their home Member States, the single market was fragmented in terms of lending and fund raising. This fragmentation was harmful, particularly in the euro area, hindering lending to the real economy and thus economic growth.

According to the Commission, 75% of small and medium enterprises located in Germany, who applied for funding have received this funding, while in the South European countries the percentage drops to 50%, while reaching 25% in Greece.

Banking Union is expected to lead to an increased confidence in all banks given that are supervised by the same authority and are subject to the same regime and resolution authority. The credibility of the banking system will depend only on their specific risk profile and increasingly less of the financial stability of the Member State where they are established. This should lead to access resources under the same conditions for all the Member States' banks that will lead to an increase in loans to companies and individuals. Banking union should ensure that the common set of rules would be implemented consistently across the Eurozone. It is estimated that will be rare cases where banks will fall, given the tighter supervision, and if this will still happen the Single Resolution Mechanism - SRM will efficiently manage the resolution of banks concerned. This mechanism will be led by one governing body, the Single Resolution Board - SRB and will manage the funds accumulated into a single Resolution Single Fund - SRF. Thus, the Commission believes that if a bank falls, Single Resolution Mechanism, that has clear rules regarding the liquidation of cross border banks and experienced staff will be more effective in accomplishing the resolution process than a chain of national resolution authorities.

It is believed that after the crisis, appropriate measures were taken in order to efficiently manage the banking risks, as follows:

i) increasing the resilience of the banking system (crisis prevention);
ii) ensuring that if banks are facing problems, supervisors can intervene and take corrective measures (early intervention);
iii) if the bank situation however worsens, ensuring that there are adequate tools for proper crisis management.

Banking Union Pillars

Single Rulebook

Banking Union is based primarily on a single regulatory framework, which establishes common rules for banks in all Member States. The common set of rules is designed primarily to prevent banking crises and if some banks get into difficulty, however, there is a common set of rules to govern these kind of situations, including that they are orderly wound down (Directive on Recovery and Resolution Bank - BRRD). CRD IV package on capital requirements for banks, consisting of Capital Requirements Directive IV and the Capital Requirements Regulation, implemented at European level the new global standards on capital requirements, known as Basel III. The new rules in force since January 2014 ensure that banks hold enough capital both in terms of quality and in terms of quantity.

This common set of rules also sets that all depositors always have guaranteed deposits amounting to 100 thousand euro per bank anywhere in Europe (Directive on Deposit Guarantee Scheme). The European Commission states that have initiated 28 legislative proposals covering all products and financial market actors so that the financial sector to be better regulated, supervised and managed (all of them forming the single rulebook). These form the supervisory single rulebook and banks should adjust their activity according to this set of rules throughout the Single Market. This will ensure that there are equal and tighter regulations in the European Union without flaws and differences, so as to secure equal conditions for conducting banking activity and thus a single market. The benefit will be common, for banks, financial sector as a whole and for citizens.

A strict regulatory framework in what concerns the situations when banks enter into difficulty now covers the financial sector at European level. The recovery and resolution framework lays the banks to formalize recovery plans describing the steps it would take to remain viable if their financial situation would deteriorate and resolution plans for an orderly exit from the market if they are no longer viable.

In the banking union, the authority vested with bank resolution responsibilities is the Single Resolution Board, while in other Member States are established independent national authorities. Resolution plans should present resolution options and the specific measures that should be applied, such as transferring assets to a bridge bank, writing down capital instruments or other specific liabilities in a bail-in procedure etc., as well as how to be maintained critical functions of the bank.

The Commission states that for cases when problems arise clear rules have been defined to allow rapid intervention and application of timely corrective actions - early intervention. Supervisors have now greater powers to intervene at an early stage when a bank encounters financial difficulties, for example when breaches or is about to breach minimum capital requirements, but before problems become critical and financial situation irreparably damaged. The measures are laid down in the recovery plans and include the possibility of changing the management structures and replace them with a temporary administrator, convening shareholders to adopt urgent measures, including blocking the distribution of dividends or bonuses. Other measures that may be imposed by supervisors may refer to the bank's request to reduce certain exposures, and to increase capital or to modify the legal and operational structure.

With regard to the new Basel III regulatory framework it is to mention that it is not comprises an enhanced set of macro-prudential instruments (countercyclical capital requirements), and focuses on micro-prudential supervision. The definition of macro-prudential policy tools is national prerogative of the Member States, so the overall financial system stability and financial stability depends primarily on their efficiency. It is obvious that it is essential to strengthen the resilience of the financial system by increasing capital and liquidity requirements, but this doesn't include the macro-prudential perspective. Shin (2011), believes that Basel III is almost exclusively micro-prudential, focusing more on individual capital adequacy of banks than on system resilience. Focusing on a greater capacity to absorb losses, it does not directly control excessive credit growth in boom periods and may lose sight signals on vulnerabilities of banks' balance sheets related to volatile short-term funding and short-term liabilities in foreign currency. Giese et al. (2011), analyzing the historical performance indicator on the evolution of credit to GDP in the case of England for the last 50 years, to be used in the capital countercyclical, notes that it would have functioned properly, but it does not guarantee that in the future it would work the same way, given the complexity of the financial system, the trend of evolution and innovation, time differences between production of risks and their identification, being proposed other complementary indicators to be monitored. Repullo and Saurina (2012) criticizes taking into account, when establishing the counter cyclical capital requirements, the deviation of credit in relation to GDP trends and developments, indicator proposed by Borio et al. in 2010. They argue that in some countries the difference between credit and GDP tends to be negatively correlated with GDP growth. Periods of expansion and recession differ between the economic cycles and the credit or financial cycles and economic cycles are not the same. In addition, in periods of boom, credit grows faster than GDP and in normal times or in crisis, the credit increases less or decreases less than GDP.

Since European Systemic Risk Board recommends a carefully application of the newly established macro-prudential tools, it means that serious questions can be putted on efficiency and effects of these tools. The recent financial crisis showed that the macro-prudential policy was best positioned to prevent systemic risk accumulation. If macro-prudential policy is still under question micro-prudential supervision must do a lot of the work.

Single Supervisory Mechanism

Through the Single Supervisory Mechanism the European Central Bank takes fully responsibility for supervising all banks in the Eurozone and all banks in the Member States participating in the mechanism.

Supervision provided by the European Central Bank is considered to be truly independent, not to be influenced in order to protect national interests. Single Supervisory Mechanism will enforce adequate supervision ensuring by that the stability of the European banking system. It also ensures that the single rulebook is applied consistently and coherently across the Eurozone. Thus, in November 2014, the European Central Bank becomes supervisor of the 5.500 Eurozone banks through the Single Supervisory Mechanism - SSM. Prior to that, because the European Central Bank wanted to have a clear picture of the situation of banks which were to come into direct supervision of it, it was conducted an extensive asset quality review on these banks. The transfer from the national to the European level of the main responsibilities for supervision, creating a Single Supervisory Mechanism, will require to European Central Bank and the national banking supervisory authorities to function as a system. The tasks of national authorities will focus on consumer protection, money laundering, the supervision of entities belonging to credit institutions headquartered outside the European Union, as well as conducting on behalf of the European Central Bank, activities related to credit institutions supervision, while the European Central Bank will take over the authorization of credit institutions, the capital adequacy requirements and liquidity for banks and supervision of financial conglomerates on a consolidated basis. Single Supervisory Mechanism changes the way in which banks located in the Eurozone are supervised. But from the perspective of non-euro Member States that are host countries for branches or subsidiaries of banking groups now supervised by the European Central Bank things do not differ substantially. The colleges of supervisors for cross border banking groups are now chaired by the European Central Bank and the joint supervisory teams are made up of representatives of the European Central Bank, the national supervisory authority of the home country of the group and representatives of national supervision authority of the host countries. Thus, for non-euro area Member States, entering into a close cooperation with the Single Supervisory Mechanism does not appear to be a must. Also, decisions on capital adequacy and liquidity for each cross border group entities are adopted by joint decision of all authorities involved.

Single Resolution Mechanism

Within the Banking Union, if a bank viability is threatened the European Central Bank as the sole supervision authority will oversee the implementation of early intervention measures in coordination with the relevant resolution authorities. For cases where the banks situation irreparably deteriorates have been defined crisis mechanisms which will be applied to protect depositors and taxpayers. Repeated measures of capitalization of banks increased external debt and imposed a heavy tax burden on taxpayers in the Eurozone. The Commission has estimated that state aid granted in the form of recapitalizations and asset purchases between October 2008 and December 2012 amounted to 591.9 billion euros, representing 4.6% of EU GDP in 2012. If are included the guarantees given, the amount would be 1.6 trillion euros, representing 13% of EU GDP in the period 2008-2010.

If the financial condition of a bank is irreparably damaged, Bank Recovery and Resolution Directive - BRRD ensures that shareholders and creditors will pay their share of losses through bail-in operation.

Single Resolution Mechanism provides centralized and efficient implementation of these rules at EU level. It provides that complex decisions to be taken when there is a bank failure, especially cross border banks, are adopted quickly and with binding effect on all Member States of the banking union.

Single Resolution Mechanism is based on a solid decision structure, Single Resolution Board that has permanent members, the European Commission, the Council, the European Central Bank and national authorities for resolution. In most cases, when a bank in the Eurozone or in participating member states in banking union should be closed, European Central Bank shall notify the Single Resolution Board, the Commission and the relevant national resolution authorities. The decision-making was calibrated so as to permit the adoption of a resolution over the weekend.

To avoid contributions from taxpayers, all banks in the European Union should contribute to establish the resolution fund. In the banking union these funds are pooled gradually. This means that if additional resources are needed to provide liquidity to banks to operate in the medium term, while restructuring is undergo, they will be provided by the Single Resolution Fund. All banks in banking union countries will have to contribute to the fund since 2016, its estimated level for the year 2024 is 55 billion.

The bail-in procedure (mechanism of internal capitalization) is a recapitalization by writing down liabilities and/or their conversion into capital, which will allow the bank to continue to function. The operation can avoid creating turbulence in the market caused by a bank failure or interruption in ensuring critical financial services and provide time for authorities to reorganize or close certain parts of the bank under difficulties in an orderly manner. If a bank has to resort to bail-in procedure, the authorities will first erase debts to shareholders and will then follow a clear mechanism to clear other liabilities. Shareholders and other holders of equity as convertible bonds and subordinated bonds will be the first whose debts will be erased to cover losses. Deposits under 100 thousand-euro values will not be included in this mechanism being always protected. To the fullest extent the possible liability to cover bank losses will revert investors in banks and the banking system as a whole and not taxpayers.

It is estimated that once all components of the banking union will become functional, in most cases, taxpayers will not be called any more to support liquidate banks or to enable them to continue functioning, if they are viable. However, in exceptional cases the Commission accepts that might be necessary public funds, and arrangements for these cases must be clearly defined, especially about the limits and sources of aid. Public aid that will be used must be neutral in the medium term in terms of fiscal burden of states and the banking industry must reimburse those aids by imposing additional fees. The regulatory framework of the Single Resolution Mechanism provides that the Single Resolution Board, in cooperation with Member States, should contract credit lines to increase the lending capacity of the fund. The regulation does not yet provide which will be the source to increase the fund capacity; this will be determined in the coming years.

The scheme is not yet operational and it will be an accumulation period of 10 years for the resolution fund. On long-term it is unlikely that the fund could support the resolution of several large banks with no other support mechanisms. Using the amounts of single resolution fund will be subject to intergovernmental agreements, thus, there will probably several stages of negotiations before a single resolution scheme to be completed (Mircea, 2015).

As a general rule, banks need to raise capital from the market or from private sources. If it will not be enough, national public funds can be used, but under strict conditions and in accordance with the state aid rules. Subsequently, if national funds are not sufficient, then will be used instruments defined at European level, including the use of funds from the European Stability Mechanism (ESM). If banks will not be viable, resolution measures will be applied according to national regulations.

European Commission changed the rules on State aid since August 2013. The main change was to strengthen the principle of burden-sharing, that banks are required to underpin a rigorous plan for their restructuring or orderly winding down before receiving public aid consisting of capitalization or asset protection. There have also been strengthened requirements for burden sharing, so if banks have capital shortfall and no longer meet the minimum capital requirements, shareholders and unsecured creditors will be required to contribute primarily to the capitalization, before granting any aid.

On bail-in procedure it is to say that introduces a new concept, of allocating losses to depositors and unsecured creditors of banks. This concept emphasizes, once again, given the financial crisis, that the banking system no longer meets the basic role it had since the beginnings, which is the entrusted preserver, returning the values entrusted to the owner, on demand. States have found that their finances can be seriously affected by losses arising from real estate bubbles or any other nature. The conclusion was that those that have the capacity to cover losses of a bubble are those who actually are exposed to risks, meaning the creditors and the depositors. This conclusion seems justified; those who have liquidities and place them on banks are the ones who bear the risks. But they do not participate in risks taking activity, but banks do. At the same time, the shareholders are better repaid for their investments; they received the profits both for their own resources and for the resources borrowed from creditors and depositors. The shareholders revenues versus those of the creditors and depositors are superior, yet all of them are subject to the same risk in case of bankruptcy. This model of losses distribution can be considered unfair.

In my opinion, this new structure of the banking system is only an intermediate step toward a system in which creditors and depositors will hold both the risks and the profits in the banking system (Mircea, 2015).
This intermediate stage can still lead to significant risk - taking by banks given that:

i) the shareholders will try an accelerated recovery of the capital so that, in the situation of difficulties and possible bail-in procedures, the capital would be recovered in full, without making further efforts to conserve the franchise value;
ii) an incentive will be created by the fact that the remaining losses will be covered by the creditors and depositors; and
iii) contribution to the resolution fund will fuel the belief that using this safety net is justified in case of difficulties.

Single Deposit Guarantee Scheme

This objective is not achieved yet. What it was achieved it was only a harmonized deposit scheme. Bank deposits in all Member States will be guaranteed up to 100 thousand euros per depositor per bank. This warranty will give depositors a sense of security and reasons for them to no longer rush to withdraw, with an accelerated rhythm, the resources placed with banks, thus preventing negative effects that can affect the economy.

Also, depositors will get their money back faster, respectively in 7 days, versus 20 days, as it was prior. The national guarantee schemes will be better funded to cover warranties and, in particular by ex-ante contributions of banks, by which it is, estimated that 0.8% of covered deposits will be collected from banks during 10 years. If the funds collected ex-ante turn out to be insufficient, the deposit guarantee schemes will make immediately ex-post collections from banks and ultimately, will access various funding schemes such as loans from public or private sector. Also, there will be a voluntary mechanism for lending between guarantee funds in different Member States.

According to the Bank Recovery and Resolution Directive (BRRD), individuals and very small businesses with deposits exceeding 100 thousand euro will benefit of preferential treatment. This means that it will be the last to be included in a bail-in procedure, meaning that they will not bear losses before other unsecured creditor classes suffer losses. Furthermore, Member States may choose for their total exclusion from a bail-in procedure.

Regarding finalizing the single guarantee scheme it is to be noted that this is subject to interstate agreements, unification is far from over. Without the single guarantee scheme it is questioned the existence and effectiveness of the banking union.

Conclusions

Banking Union creates reasonable premise that banks in the Eurozone will be regulated and supervised in an equal manner. This is also ensured for non-euro Member States banks. Thus, entering into a close cooperation agreement with the Single Supervisory Mechanism is not a must. European Central Bank may provide an overview on financial performances of banks operating in the Banking Union, but financial stability is ensured by implementing effective national macro-prudential tools, taking into account national specificities and risks identified. Creating a Single Resolution Mechanism is beneficial in managing bankruptcies of cross border banking groups, but the success of this mechanism depends on the unification of resolution funds and of the guarantee schemes, for which interstate agreements are needed.

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