January 2014

Special analysis

Banking union as EU´s response to financial crisis

Jan Jedlička, Tomáš Kozelský

EU Office České spořitelny

EU OFFICE
Česká spořitelna, a.s.
Budějovická 1518/13a
140 00 Praha 4
tel.: +420 956 718 012
fax: +420 224 641 301
EU_office@csas.cz
http://www.csas.cz/eu

Jan Jedlička
+420 956 718 014
jjedlicka@csas.cz

Iva Dlouhá
+420 956 718 015
idlouha@csas.cz

Jana Majchráková
+420 956 718 012
jmajchrakova@csas.cz

Tomáš Kozelský
+420 956 718 013
tkozelsky@csas.cz

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Idea and purpose of banking union

The financial crisis, which since 2008 with brief interruptions has impacted developed economies, has several causes. While in some countries, it has mainly taken on the form of a crisis of public finances, elsewhere it has involved excessively high private debt.

The current sign of that is the debt crisis in Europe, which involves excessive indebtedness in both the public and private sectors Banks are its smallest common denominator, where both types of unsustainable indebtedness remain. This situation is putting banks into a vicious cycle (see box).

Vicious cycle

In every economy, banks are among key investors in state bonds. The financial crisis, which has also resulted in reduced performance of the real economy, in structurally weaker economies is also leading to worsening of public finances, which is negatively reflected in the value of state bonds.

The declining value of state bonds is causing investors, including large banks, to incur substantial losses. The most vulnerable banks then need to be rescued from public sources.

This is also leading to further increases in public debt and further declines in the value of state bonds. This development is causing investors in state debt, mainly banks to incur additional and increasingly major losses. Loss-making banks, in order to prevent bankruptcy, are then rescued by public resources, which leads to an increase in public debt.

One of the goals of the banking union is to break this cycle between weak banks and indebted state coffers in some European countries. However, the situation described above affects only some European economies and their banking sectors. The European banking sector as a whole remains strong, robust and trustworthy.

Therefore, we can understand the banking union project as a plan for transferring debt difficulties from national levels, where they are becoming an inescapable problem, to the pan-European level, where in view of the entire European economy's size this is not a task that cannot be accomplished.

Deeper real European Monetary Union and banking union

Most experts agree that the financial and the subsequent debt crisis have uncovered insufficient regulation and oversight (not only) of the European financial sector.

Therefore, since 2010 the Commission has proposed nearly 30 legislative means to ensure that all players on the financial market, all products and all segments of the market are properly regulated and effectively supervised. These means for the basic framework for all 28 EU member states and underscore the properly functioning single market in the area of financial services.

The ongoing debt crisis in the Eurozone has brought an additional dimension - the need to manage the EMU (Economic and Monetary Union) better in combination with the single European currency, the euro, so that functioning and perspective are preserved in the future. Beginning in 2011, a vicious cycle also arose involving certain ailing banks and indebted states (see box on left).

In order to shatter this cycle, it is not enough only to boost the banking sector with capital, but it is also necessary to adopt long-term systematic solutions. That need is stronger in countries that are tied to the euro, and therefore European leaders have adopted the banking union project, which they view as the best solution.

It first began taking shape in June 2012, when the banking union project was joined by heads of government and states at the European Council level.

That vision was further processed by the Commission, which in November 2012 came up with the Blueprint for a Deep and Genuine Economic and Monetary Union – see image below.

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			Blueprint for a Deep and Genuine Economic and Monetary Union Start of European Discussion	Second. law	Contract amend.
ENTIRE PROCESS	short-term horizon	Next 18 months	1. Complete implementation of the European Semester and the package of 6 legal acts and the quick agreement regarding the package of two legal acts and its form	✓	
			2. Banking union: financial regulation and supervision: quick agreement on the proposed Single Rulebook and the Single Supervision Mechanism	✓	
			3. Banking union: Single Supervision Mechanism	✓	
			4. Quick decision about the next multi-year financial framework	✓	
			5. Previous coordination of major reforms and creation of a means for convergence and competitiveness	✓	
			6. Support for investments in the Eurozone in accordance with the Pact on Stability and Growth	✓	
			7. External representation of the Eurozone	✓	
	mid-term horizon	18 months – 5 years	1. Boosting of budget and economic integration	✓	✓
			2. Proper budget capacity of the Eurozone based on the means for convergence and cooperation	✓	✓
			3. Fund for amortisation of debt		✓
			4. European cash vouchers		✓
	long-term horizon	Over 5 years	1. Compete Banking union		✓
			2. Complete budget and economic union		✓
			Political union: reasonable progress in relation to democratic legitimacy and responsibility	✓	✓

Reform of regulation and supervision over financial services

When the financial crisis began in 2008, the EU had 27 different regulatory systems for the banking sector, which were based mainly on national rules and national rescue mechanisms. Nonetheless, some pan-European minimum rules and coordination mechanisms already existed. The "pre-crisis" regulatory framework, however, in the light of the financial crisis proved to be insufficient, and some potential risks (such as processes in the event of the collapse of large cross-border banks) were not covered at all.

Measures for better supervision

However, regulation itself would be worthless without effective supervision. Therefore, the Commission resorted to reforming the supervision of the financial sector.

As of 1st January 2011, three new organisations were established within the European System of Financial Supervision:

- the European Banking Authority (EBA) – ensuring harmonised supervision and regulation of the banking sector
- the European Securities and Markets Authority (ESMA) – ensuring harmonised supervision and regulation of the securities market and direct supervision over rating agencies and registers of trade repositories.
- The European Insurance and Occupational Pensions Authority (EIOPA) – ensuring harmonised supervision and regulation of insurance and occupational pension coverage

These three institutions include representatives of national supervisory bodies. The institutions' role is to contribute to the development of rules for harmonised regulation in Europe, eliminate created risks and help restore confidence in the financial sector.

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In addition, the European Systemic Risk Board (ESRB) was established for the purpose of monitoring and evaluating potential risks to financial stability, which could result from macro-economic development and development of the financial system as a whole (macro supervision). The Board manages a system of timely warnings regarding systemic risks and if necessary issues recommendations for their elimination.

Single Rulebook and harmonised regulation

In response to the financial and debt crisis, in June 2009 the Board issued a recommendation for creation of a Single Rulebook), which would apply to all financial institutions in the EU's internal market. The Rulebook is a set of legislative texts that cover all financial sectors and products and which require banks to comply with a single set of rules. This is intended to ensure the same rules of the game for all banking institutions and to create a single financial services market.

A key part of the Single Rulebook is a legislative package regarding bank's capital requirements known as CRD IV, which through regulations and directives took effect in July 2013. The purpose of the package is to strengthen banks' capital and liquid reserves and to reform corporate governance practices.

An important legislative element is the boosting of insurance of deposits up to 100,000 euros per depositor in the event of bank failures and shortening of the amount of time for refunding deposits to 7 days from the original 20 days. Something no less important is the Bank Recovery and Resolution Directive, which defines the rules for handling banks that have found themselves in existential difficulties.

Other important elements of the Single Rulebook, which have already taken effect, include:

- Stricter rules for hedge funds
- Stricter rules for short selling and credit default swaps (CDS)
- A comprehensive set of rules for financial derivatives
- Guidelines for rating agencies

Other important elements of the Single Rulebook, which should be approved in the next year:

- Audit sector reform
- Reform of guidelines against market manipulation
- Revision of existing rules for functioning of markets through financial instruments and investment funds
- Regulation of shadow banking, including the currency and securities markets
- Revision of management of Libor reference rates
- Structural reforms of the banking market based on recommendations from the expert committee headed by Erkki Liikanen

Main pillars of the banking union

Based on initial expectations, the banking union will have four pillars. The first and least controversial pillar is common rules for the banking union's functioning in the EU. These rules most often take the form of harmonisation directives and regulations continuously adopted and implemented in practice - see chapter “Single Rulebook and harmonised regulation”.

Contrastingly, the most controversial pillar is the single pan-European deposit insurance system. That step currently seems too ambitious and not feasible. Therefore, the European Commission is currently focusing on ensuring that at national levels there is enough financial coverage to enable national deposit insurance plans to function.

Therefore, the proposal for creating a single pan-European deposit insurance plan is not currently on the agenda.

Besides joint bank rules, two other key and much more significant pillars have already been approved (or are pending final approval):

- the Single Supervisory Mechanism (SSM)
- the Single Resolution Mechanism (SRM)

Single Supervisory Mechanism

The Single Supervisory Mechanism is one of the pillars for creating the banking union. It is intended to ensure that EU policy regarding supervision over lending institutions is implemented fairly and effectively, so that the single set of rules for financial services is applied in the same way to lending institutions in all involved member states.

The SSM is designed to be in harmony with the functioning of the financial services internal market and with free movement of capital and to ensure timely discovery of failures and adoption of measures to boost financial institutions that encounter problems. It should also contribute to interrupting ties between member states' budgets and some of their banks. A functioning SSM is essential for the European Stability Mechanism, which is the Eurozone's permanent rescue fund, to perform direct re-capitalisation of banks as agreed upon by leading Eurozone officials in June 2012.

Eurozone states will participate in the SSM automatically. Member states outside of the Eurozone can also decide to participate in the SSM through closer cooperation between their national bodies and the European Central Bank.

How time has flown with the SSM

Also due to the need for financial stability in the Eurozone, in June 2012 it was decided to create the SSM for banks. The ECB was assigned special supervision tasks. In the summer of that same year, the Commission presented proposals for directives and disclosures related to the creation of the SSM. ECOFIN (EU ministers of economy and finance) unanimously expressed agreement with the European Commission's proposal at the turn of 2012. In March 2013, the Council of the EU, the European Commission and the European Parliament reached an agreement regarding establishment of the SSM, which the Council of the EU confirmed on 18th April 2013.

In September of last year, the European Parliament adopted the Commission's proposals for the creation of the SSM, and ECB Governor Mario Draghi and European Parliament Chairman Martin Schulz signed a declaration, in which both institutions pledged to officially enter into an inter-institutional agreement regarding practical issues related to the application of democratic responsibility and supervision over the performance of tasks, with which the ECB was entrusted as part of the SSM.

Under the SSM, the ECB is responsible for supervision over banks in the Eurozone.

The ECB particularly:

- Ensures harmonised application of the Single Rulebook in the Eurozone;
- Will in cooperation with national supervision bodies directly supervise banks that have assets of more than 30 billion euros or whose share of assets represents at least 20% of GDP or who have requested or received direct public financial assistance from the EFSF (European Financial Stability Facility), or ESM (European Stability Mechanism). This is believed to involve about the 130 largest banks in the Eurozone of the approximately 6,000.
- Will monitor supervision by national supervision bodies at less important banks. The ECB may at any time decide to supervise directly one or more of these lending institutions, in order to ensure harmonised application of supervision standards.

The ECB's supervision tasks will be separated from tasks related to the monetary area, in order to prevent potential conflicts of interest between monetary policy and supervision. Therefore, a supervisory board will be set up in the ECB, which will be responsible for various supervision tasks. Non-Eurozone member states with representatives in that board will have full and equal voting rights. Unless the Board of Governors rejects the decision, it will be considered adopted.

In October 2013, the Council of the EU adopted the regulation regarding the SSM. The legislative proposal itself for creation of the SSM consists of two regulations:

- the first places supervision powers in the hands of the ECB (Council Regulation (EU) NO. 1024/2013),
- the second amends the current regulation regarding the European Body for Banking (Regulation of the EP and Council (EU) No. 1022/2013).

These regulations took effect on 29th October 2013, the fifth day after their announcement in the European Union Official Bulletin. The European Central Bank therefore will fully assume its responsibilities in the area of supervision on 3rd November 2014, 12 months after the regulations took effect.

Single Resolution Mechanism

Another pillar of the planned banking union is the SRM, which will consist of:

- a single committee for solving problems - a single decision-making body, which will prepare cases for problem solving,
- a single fund for problem solving - it will finance restructuring of problem banks.

The SRM is intended to complement the SSM, which after its implementation in 2014 will ensure that the ECB directly supervises banks in the Eurozone and other member states that decide to join the banking union. If a bank that is subject to the SSM has serious problems even despite the stronger supervision, the SRM would enable management of problem solving effectively with minimum costs for taxpayers and the real economy. An important system is the "bail in" system, ensuring that if a bank encounters problems, small depositors and taxpayers will not be the first in line to cover the bank's losses.

In the event of a bank's failure, the procedure followed will be based on a pre-set sequence: first shareholders and then other creditors who have invested into the bank's capital. Small depositors' funds will be fully protected up to 100,000 euros. Individuals' and small and mid-sized companies' deposits above 100,000 will be handled in a manner that ensures that they are affected as little as possible.

This proposal by the Commission was preceded by the Council's recognition in December 2012 of the need to establish a single mechanism. The SRM will apply to Eurozone countries belonging to the SSM, intended for supervision over banks, and to those countries that are not in the Eurozone, but which have decided to participate in the mechanism.

The SRM (from the Commission's press release) should be prepared as follows:

- The ECB as a supervisory body will point out that a certain bank in the Eurozone or a bank with its registered seat in a member state participating in the banking union is experiencing serious financial difficulties, which need to be resolved.
- The newly created committee for solving problems consisting of representatives from the ECB, the Commission and relevant national bodies (from the countries where the bank has its headquarters, branches and/or subsidiaries) will prepare proposals for solving the bank's problems. It will have extensive powers for analysis and definition of the approach to solving the bank's problems; it can determine what means to use and how the European fund should get involved in problem solving. National bodies responsible for resolution would also be intensively involved.
- Based on the recommendations by the committee for solving problems or from its own initiative, the Commission will decide whether to commence the process of solving problems at the particular bank and will set a framework for the use of means to solve the bank's problems and for a fund. For legal reasons, this committee must not have the last word.
- A single fund will be set up for solving banks' problems under the supervision of the single committee for solving problems, in order to ensure the availability of financial support during restructuring of banks. It will be financed from contributions from lending institutions amounting to 1% of the value of their deposits; it is expected that at the end of the 10-year transitional period, the fund will reach the value of approximately 55 billion euros.

EU finance ministers agreed on the form of the SRM in Brussels on 18th December 2013. It final form still needs to be confirmed by the Council of the EU and the EP. The SRM itself should take effect on 1st January 2015, and by the end of January 2016, the "bail in" system will take effect.

Conclusion

As a reaction to the financial crisis and the ongoing debt problems, negotiations have been and are still being held and steps are being implemented that will lead to the creation of the banking union, the characteristics of which began becoming clear in 2012.

The banking union is intended to prevent not only turbulence in the banking sector, which affected the EU mainly after the financial crisis following 2008, but also to end the unhealthy relationships between weak banks and indebted states. The individual pillars of the banking union are intended to help alleviate this situation. For example The SSM, which will supervise approximately 130 European banks, and the SRM were discussed a couple of weeks ago.

The banking union should include all Eurozone states, in view of the close ties and interaction among member states that use the euro. In the interest of maintaining deepening of the internal market, to the extent possible the banking union should also be open to participation by EU states outside of the Eurozone.