The Banking Union - The Solution To Reduce The European Banking System Risks?

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Abstract: - The banking union has been seen as "a panacea" for solving the system risks of the EU banking system. This paper objectives are to find out if is the banking union, with is strong and week sides, will be right answer to solve the actual issues that EU banking system has as: the fragmentation in the EU single market, the deterioration in asset quality, the need for recapitalization and the quality of banks' loan portfolios. According with most of the experts the banking union will strength the process of economic integration. On the other side, the non-euro area member states are questioning about "equal rights and obligations for all Member States" inside the banking union. But, with all pros and cons of the banking union, the ECB's making decisions and tasks can be questioned, although its role of supervisor can not be disputed. The most important thing is that the banking union breaks the vicious circle between banks and sovereign debts, and ends "to big to fail".

Key-Words: - Banking union, risks, integration, supervision, regulations, institutions

JEL Classification: **-** *E5, E52, E58, G, G2*

1. Introduction

The recent international financial crisis that has began in 2008, led the European Commission to take a number of measures in the EU to create a safer financial and banking sector and to strengthen financial supervision. Therefore, EU has established new European supervisory authorities (ESA), operational since January 2011, as: the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA).

To intensify the European integration process and to increase mutual accountability in the financial banking sector between Member States, during the European Council and Summit for Euro zone, which took place in late June 2012, the Heads of State and Government of the EU member states have decided to create a banking union, in order to complete the Economic and Monetary Union (EMU). The Banking Union is based on three pillars: the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM) and the Deposit Guarantee Schemes

The European Commission's main objective is to improve the financial market efficiency, integrity and transparency in order to ensure the funds available for financing the real economy and society development, by the instrumentality of the banking union.

2. The major risks of the European banking system

The European Banking Authority in its reports on "Risk Assessment of the European Banking System" analysis the EBA key risk indicators (KRI), which are a set of 53 indicators collected on a quarterly basis by national supervisors, from a sample of 57 European banks in 20 EEA countries from 2009 onwards. The banks in the sample cover at least 50 % of the total assets of each national banking sector.

The EBA Risk Assessment Report published in July 2013, has presented evidence of the **fragmentation in the EU single market.** In this report, the EBA experts show that "the risks of further

fragmentation of the EU single market are evident through the increasing national retrenchment of assets and liabilities, home bias and reduced banks' cross-border financial activity". In 2013 EBA's report is shown that "this trend was mainly driven by banks' revised business strategies, changes in risk appetite, higher funding costs and the challenging macro environment, but it was also exacerbated by uncoordinated national policy measures, including ring-fencing of local bank capital and liquidity".

Furthermore, in EBA 2014 report on "Risk Assessment of the European Banking System", EBA underlines that "EU banks' **income and profitability** has continued to be faced with significant headwinds, which are unlikely to dissipate in 2014 with the looming redress costs related to conduct issues a key concern. The **deterioration in asset quality** not only influences earnings and capital strength of the EU banks but also casts a shadow over near future economic performance. According with EBA in 2013, the total operating income declined 10 billion euro (after a decline of 39 billion euro in 2012) and, in the last quarter of 2013, the annual flow of profits declined by 58% (54 billion euro). Over the course of 2013, EU banks' capital positions have continued to maintain an important increasing trend. In 2013, for example, the euro area banks raised over 80 billion euro in capital and, in 2014, they will raise over 60 billion euro according to some market estimates. EBA identifies as a risk that **the quality of banks' loan portfolios** continued to decline in 2013 and in first months of 2014 and remains a concern, harmfully contributing to the continuation of elevated risk premium levels on European banks. Furthermore, the EBA's key risk indicators show that a positive market sentiment and confidence are strengthening; however, the signs of recovery remain modest and fragile."

According to the EBA (2014) assessment of risks "a coordinated policy action remains fundamental for the coherence of the single market. Initiatives such as the asset quality reviews (AQR), common definitions on "nonperforming exposures" and "debt forbearance" form part of broader policy actions aimed at addressing the current situation in the EU by restoring stability and confidence in the markets. Moreover, new regulatory requirements for banks (e.g. the CRD IV-CRR and the Bank Recovery and Resolution Directive BRRD) are fundamental for the ongoing repair of the EU banking system. The sovereign bank linkage persists and there is evidence of disparities in funding conditions and funding costs between banks domiciled in financially strong and financially stressed sovereigns. EBA experts recommend that "the institutional reforms at EU level are crucial in breaking this pernicious linkage, more specifically in the establishment of the banking union, including the implementation of a more integrated framework for bank resolution and an appropriate single deposit guarantee system scheme."

3. Non Euro zone Member states official's positions on banking union

The Romanian National Bank Governor, Mugur Isărescu supports that the project of creating a banking union will be applicable to the member states that are not in the Euro zone. He underlines that the voluntary participation of non-euro states in the Union Banking could mean EU single market fragmentation in participating countries and non-participating. In his opinion, the Banking Union means strengthening the competitive neutrality, by applying principle the "same deal and the same rules." Isărescu (2014) point of view is "that Romania should be part of all three pillars of the Banking Union – despite the sequenced manner in which they will inevitably come into being; all of them are required for the Banking Union to function effectively". Isărescu (2014) believes that European project will strengthen financial stability, further increasing confidence in the national banking sector (through the harmonization of supervisory practices and deposit guarantee schemes), as well as fostering sustainable lending and economic growth (by reducing fragmentation of European financial markets).

The former Swedish Minister of Finance Anders Borg, point out that the idea of an institution supervising the countries outside the euro area, that would have no right to vote, can not be accepted. Furthermore he is concerned about the provision that stipulates the independence of the European Central Bank. In his opinion, this means that in the event of a dispute, the ECB will not be subject to the decisions of the European Banking Authority (EBA). Or, the ECB, in its role of supervision, has just designed to enforce the rules decided by EBA.

A special case is Estonia, a Euro zone member, as its whole banking sector is in Swedish bankers hands. But Sweden is outside the Euro zone, so Estonia will be in the banking union, but its banks will remain under national supervision from Sweden.

Poland's central bank governor Marek Belka criticized Europe's plans for a banking union, saying that non-Euro zone countries that join would be at a disadvantage and have little influence over key decisions. In his

view, a problematic solution of the banking union is if will be a common macro prudential policy, or very much coordinated, for the Euro zone countries with others. Similarly, Poland along with Hungary seeking voting rights in the ECB and equal rights and obligations for all Member States. Meanwhile, Hungary has many questions about the proposal from the Commission and shall not be given until it will clear all obligations and rights that states will join the banking union.

The Czech authorities have their doubts concerning the Banking Union. It is believed that could affect the financial stability of the country in condition that the Czech banking system is consider being a very stable one. Other Czech experts are in favor. According to Andreas Treichl, the CEO of Erste Group, countries such as the Czech Republic should join the emerging European banking union. "Even though joining this union is not a question for the Czech Republic to resolve for the coming two to three years, but eventually it will be necessary", is the opinion of Andreas Treichl, the CEO of Erste, the owner of Ceska Sporitelna, the largest bank in the country. At the beginning of 2014, he has reveled that joining the banking union means "to decide whether you want to be part of Europe or not." Treichl (2014) underlines that therefore also have to bear the costs, and even states not using the euro will be able to join the euro zone's banking union. He underlies that in that case, however, countries such as the Czech Republic would have to participate in bailing out banks and deposits in Spain or Italy, or in other countries that would get in trouble.

Initially, the Bulgarian officials have considered that will not be in the interest of the country, because the banking union will involve a significant transfer of a part of national sovereignty to Brussels, without much benefit. But on July 2014, the president Rosen Plevneliev said "there is full consensus for an immediate start of procedures for Bulgaria's entry into the Single Supervisory System of the European Union as a first step to joining the EU's banking union". Bulgarian officials have decided to join the a new EU set of rules known as the 'banking union' after poor bank supervision led to the collapse of its fourth-biggest lender bank Corporate Commercial Bank (CCB).

The Bankers and UK officials are worried that the new supervisory power of the Central European Bank could affect UK banks, in condition that the banks with headquarters in the UK that have subsidiaries in the Euro area will not escape the new regime for the supervision of ECB. The British analysts fear that the international banks may prefer to establish headquarters in EU at the expense of London, if the UK will be disadvantaged by the Banking Union reglementation. The British Bankers Association has also expressed fears about the future of the single market. Officials and representatives of the British banking industry fear that the EU will use the crisis to seize more power, for moving European financial center from London. On the other side, George Osborne, British chancellor of the Exchequer and Second Lord of the Treasury since 2010, has argued for single market protections for non-euro members to be written into the EU treaties. He appreciates that "access to the single market in financial services and the free movement of capital provides significant benefits for the UK financial services industry and for consumers".

The obstacles for achieving banking union are large and numerous. Countries like Sweden, Hungary, Poland, and Czech Republic are dissatisfied that Commission proposal do not offer favorable conditions for those who choose not to enter banking union and weak guarantees towards the supervision authority. Apart from Great Britain states, there are not objections in principle against the banking union, but non Euro zone member states want more influence capacity. The deepening of the integration of financial (economic) by making banking union is so evident, but there are dangers of the divisions of the EU. The making decisions process and the tasks of the ECB can be questioned, although its role of supervisor can not be disputed.

4. Pros and cons of the banking union

Douglas Elliott (2012) underlines that a single supervisory regime for Europe would be good, but only if it has the right governance structure, so that all concerned can defend their viewpoints and their interests. Elliot (2012) highlights that having a euro zone entity effectively dictate overall EU policy is not appropriate and would ratchet up tensions with the U.K, especially given the often quite divergent views of finance and its regulation that are espoused by the U.K. as compared to the continent. In his opinion, in the worst case, tensions of this nature could help push the U.K. to exit the entire EU.

Elliott (2012) appreciates the commission's proposal attempts to ameliorate this issue by cementing the EBA's legal position as the overseer of the supervisory framework for banking in Europe (particularly by making it the author of a "single supervisory handbook" that would bind the ECB and all other supervisors in the EU) and by offering a new voting structure in the EBA to protect non-members of the banking union. Elliott

(2012) comments that the intentions are laudable, but it is not clear that either step will be very effective or there is no obviously superior answer, given the U.K.'s unwillingness to join the banking union or the euro zone.

Elliott (2012) considers that creating a banking union would have pros and cons with regard to macro prudential policy. He appreciates that "would make it distinctly easier to deal with credit bubbles or crunches that were broader than in a single country, but might make it somewhat more difficult for national authorities to tackle homegrown problems, if too little flexibility is provided for national responses".

One critical question is whether the banking union should be "just" for the Euro zone or for the whole EU. Thorsten Beck (2012) has analyzed the risks and the challenges of the banking for EU. Beck (2012) argues that the need for a banking union is stronger within a currency union, as it is here where the close link between monetary and financial stability plays out strongest and where the link between government and banking fragility is exacerbated as national governments lack policy tools that countries with an independent monetary policy have available.

Jeromin Zettelmeyer, Erik Berglöf and Ralph de Haas (2012) notice that emerging European countries are concerned about insufficient influence on the proposed Single Supervisory Mechanism and the prospect of fiscal responsibility for crises elsewhere. Some countries outside the Euro zone also worry that exclusion from potential access to the European Stability Mechanism might tilt the playing field against local banks. On the other hand, they argue that non-Euro zone countries should be allowed to opt into the banking union but, if they do so, must be given a say in the governance and access to euro liquidity through swap lines with the ECB. They propose that apart from full membership, intermediate options could be considered which would extend. (Jeromin Zettelmeyer, Erik Berglöf and Ralph de Haas, 2012)

Charles Wyplosz (2014) sees the banking union as crisis management tool. He underlines that ECB is to fulfill its role of lender of last resort to all banks, it also needs the authority to supervise and resolve all banks. It is essential to understand that a partial banking union is no better than no banking union at all, and possibly worse. (Wyplosz, 2012). In his opinion a banking union is politically difficult to achieve, because it involves a transfer of competence from national to Euro zone authorities, it entails apparent income redistribution among countries, and it requires the setting up of new institutions. Wyplosz (2012) concludes that "the banking union is need is only apparent at crisis time, even though its existence is bound to change incentives of both banks and governments and the consequences of these changing incentives are unpalatable to banks in quiet times inasmuch as they result in less risk-taking and less profits".

Luis Garicano (2012) has analyzed the Spanish financial crisis, and diagnosed has been a "crisis of the *caja* (savings and loan) sector". As the example of Spain shows, in systemic crisis the problems do not necessarily have to affect large institutions, but may instead impact a lot of small institutions. In his review, the small institutions may play "the role of the canary in the mine" in anticipating the systemic problems. The supervisor should have all the relevant information and that requires covering (essentially) the entire banking system, as in the European Commission's Single Supervisory Mechanism proposal (COM 2012 511). (Garicano, 2012).

According with Schoenmaker, D. and T. Peek (2014) "the main challenge of the banking union is to counter the fragmentation of the European banking market". Firstly, they recommend that the Central and Eastern European member states countries may exercise their option to join Banking Union at some point in the future, as their financial system is much dependent on the Western-European banks, which are mostly covered by the Banking Union. Secondly, they recommendation that Central and Eastern Europe policy-makers would thus get a seat at the ECB's Supervisory Board and contribute to the supervisory assessment and decision-making on these large European banks. Thirdly, the recommendation is that a strong and decisive recapitalization is needed to get the banking sector back in the good equilibrium, in which they contribute to economic growth. (Schoenmaker, D. and T. Peek, 2014)

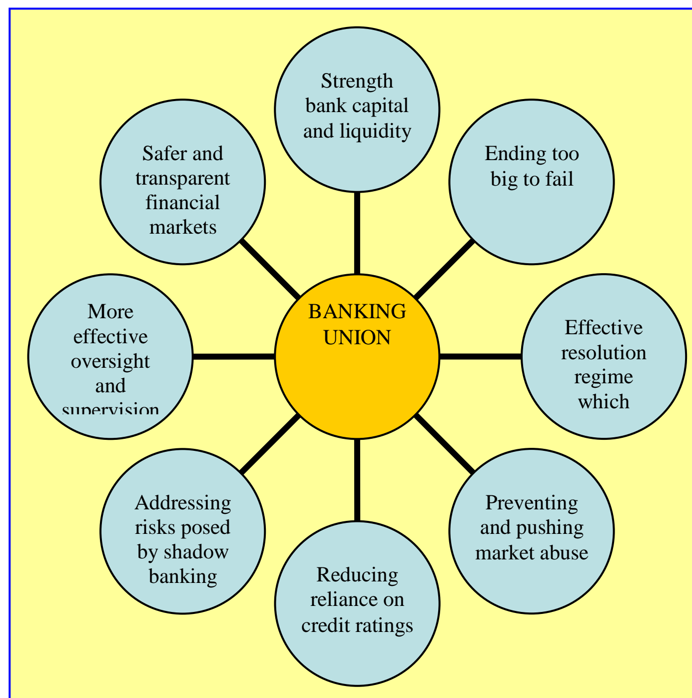
5. Conclusions

In the KLMG (2014) study on "Evolving Banking Regulation", has been highlighted that many risks remain in the European banking system, "the most important of which relate to liquidity, the leverage ratio, and risk-weighted assets". According with KLMG experts, "a higher minimum leverage ratio would become the binding constraint for a larger number of banks. It would therefore increasingly become a 'front stop' rather than a 'back stop' requirement." In this report is underlined that since one key rationale for making the ECB

responsible for banking supervision across the banking union was to move away from the perceived weaknesses of some national supervisors, it would be reasonable to expect the ECB to adopt a generally tough and intensive supervisory approach. KLMG appreciates that the strengthening the supervision role of the ECB by the banking union, “moves towards greater consistency in how banks calibrate their internal risk models; in the definition and treatment of non-performing exposures, provisioning and forbearance; and in the use of macro-prudential tools”.

European Commission sees the banking union as solution to break the link between the banks and sovereigns, by which the banks will become stronger and immune to shocks and will have a better capacity to manage adequate risks linked to their activities and absorb losses. The banking union is based on three steps solution: crisis prevention (safer banks), early intervention (banks supervision), and the last, but not the least crisis management (banks resolutions and depositors protection).

Figure 1: The role of the EU banking union in solving the banking system risks



Source: Information from European Commission (2014). Banking Union: Restoring financial stability in the Euro zone,
Memo 14/294, 15 April 2014;

Danailă (2014) shows that both banks and the euro area in the medium term are preparing for an increase in costs with reserves between 2014-2016, in order to implement the provisions of the Banking Union and is obvious that we will see the decrease of interest in the emerging EU. Danăilă (2014) underlines that European banking crisis is the result of macroeconomic imbalances and excessive credit expansion. He recommends for Romania that it is necessary to achieve a nationally effective combination between a prudent management of each bank (an effective banking supervision system) together with deepening fiscal and structural reforms.

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