

PREVIOUS EXPERIENCES ON THE ESTABLISHMENT AND DEVELOPMENT OF THE EUROPEAN BANKING UNION

Zsófia Kenesey¹
László Pataki²

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Abstract: *The De Larosiére report initiating the establishment of the financial system of the European Union was published in the year following the global economic crisis of 2008, on 25 February 2009. Already in June of this year, the European Council accepted a document known as the Single Rulebook, which contains common rules related to the financial sector of the EU, however, the real break-through was achieved with the working paper accepted by the European Committee in December 2012, which initiated the establishment of the institutional system of the banking union. The individual elements of the system constituted by three pillars have been gradually developed, however, it is still not complete. The single banking supervising system started its operation in November 2014, the resolution mechanism in January 2016, however, the single deposit-guarantee system has not yet been established. The purpose of the study is to present the events of the recent 11 years, during which the currently known institutional system of the banking union was established.*

Keywords: *Banking sector, Banking union, Development.*

1. INTRODUCTION

Significant changes have taken place in the fields of banking regulation and banking supervision in the European Union since the financial crisis of 2008. The reforms of the recent 11 years are sufficient reasons to make a retrospection and to sum up what has been really implemented since the original concepts were developed, and what objectives are left to be still achieved by the EU for the safe operation of banks.

Changes have been realised partly through the reorganisation of the system of supervisory institutions affecting the operation of the banks, establishment of new institutions, and partly through the modification and tightening of EU regulations and guidelines. As part of the Economic and Monetary Union, the banking union supplements the work of the previous organisations. The individual elements of the system constituted by three pillars are intended to supervise the prudent operation partly of the euro zone, and partly of the banking systems of all member states to ensure that an event similar to the crisis of 2018 would cause the minimum damages to the financial system.

As a result of the technological development, the banks can more and more easily establish connections with the various financial operators. This has resulted in complicated financial mergers in the background, due to which the activities of the individual operators affect not only the operation of partners connected to them but also the economy as a whole. This process was one of the reasons as a result of which the crisis of 2008 became a world crisis. As a consequence of the phenomenon called by the literature as a contagion effect, the financial problems started in

¹ University of Sopron, Sopron, Bajcsy-Zsilinszky u. 4, 9400 Hungary

² Szent István University, Gödöllő, Péter Károly u. 1, 2100 Hungary

the banking system of the United States readily spread over the world. In addition to the connection between the partners and the complicated system of connections, the increase of the sizes of banks was also observed. Institutions with a vast number of assets were created, the sizes of which exceeded the economic influences of certain countries expressed in gross domestic products. Figure 1 shows the assets of the greatest banks of the European Union at the end of 2018, as compared to the GDPs of the countries in which they are based. Despite the tightened regulations, the sizes of these institutions have not reduced in the recent years. In Spain and the Netherlands, the assets of the greatest banks even exceed the GDPs of these countries, while the two values are almost identical in the United Kingdom and France. Though the United Kingdom exited the EU on 31 January 2020, the operation of its banking system will still significantly affect the financial system of the EU. In the top ten, the three greatest English banks are replaced with institutions such as the Italian UniCredit and Intesa Sanpaolo, and the Spanish BBVA.

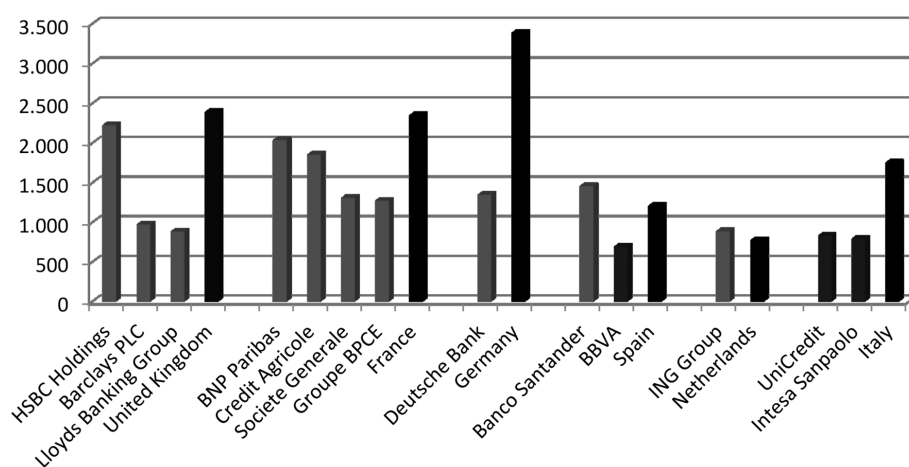


Figure 1. The balance sheet total of the greatest banks of the EU and the GDPs of the countries in which they are based

Source: Own edition on the basis of Cherowbrier (2020) and Clark (2020)

The financial institutions important from the aspect of this systemic risk still represent a significant economic power, the bankruptcy of which would induce another world economic crisis. According to the De Larosi re report published on 25 February 2009, stringent supervision and regulation of such institutions were one of the deficiencies of banking regulation before the crisis, and this is why it is necessary to adopt uniform rules for the banking system of the EU (De Larosi re, 2009). The report highlighted that the banking supervision previously had focused only on certain institutions (microprudential supervision), and this is why the supervision structure had to be reorganised. As a result, the macroprudential supervision of the EU was established with the assistance of the European Central Bank and the national central banks from 1 January 2011. As part of the European System of Financial Supervision, the European Systemic Risk Board performs the macroprudential tasks, while the European Bank Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority are responsible for the microprudential tasks.

In addition to the reorganisation of the system of institutions, the EU regulation and guidelines (CRD regulation, CRR guideline) on banking regulation were also updated on the basis of the Basel regulation (Sz eles et al., 2016). The rules focus on the tightening of capital rules, reducing excessive risk-taking by the banks, and the requirements demanding increased capital give priority to safe operation.

After the crisis, the EU became committed to make its banking system more resistant to the negative economic events. The crisis affecting the whole world has shown that the countries are not able to individually manage the problems, and a comprehensive solution is necessary. Interconnection between the financial operators within the member states of the euro zone is particularly true due to the common currency, and therefore a more stringent supervision of such institutions is necessary. In September 2012, the European Commission announced the importance of the creation of a banking union in a communication, and in December 2012, report “Towards a genuine Economic and Monetary Union” was adopted, which contained already actual proposals in connection with the implementation of the banking union. Based on this, the uniform regulatory package on the banking system of the European Union was divided into three pillars, i.e. the uniform banking supervision mechanism, the single resolution mechanism, and the single deposit guarantee system.

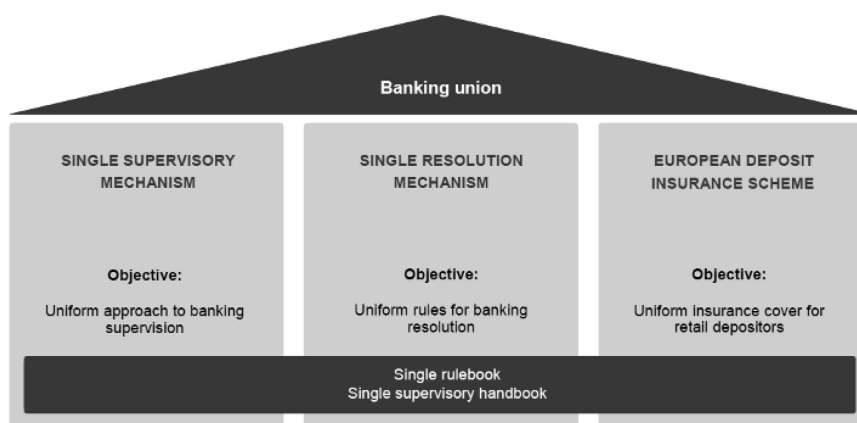


Figure 2. Pillars of the Banking Union

Source: European Banking Federation

<https://www.ebf.eu/priorities/banking-supervision/banking-union/>

The Single Rulebook serving as a basis for the banking union was released already in 2009, and was intended to eliminate the regulatory differences to ensure that identical requirements are set for the member states, and thereby the operation of the bank system becomes more transparent (EBA). The rulebook created with the assistance of the European Bank Authority (EBA) contains rules on capital requirements, protection of depositors and prevention of crisis, which are valid for nearly 8,300 banks of the EU. The common banking supervision within the bank union currently applies to 19 member states of the euro zone, however, other member states may also apply for admission.

Already at the beginning, it was clear that the deadlines specified for the introduction of the banking union could not be met, they tried to urge decision-makers, and this was confirmed also in practice. There follows a description of how the individual elements of the banking union have changed after the initial concepts, and which measures have been effectively implemented in order to protect the banking system and the economy.

2. SINGLE SUPERVISORY MECHANISM (SSM)

Decision-makers gave priority to the establishment of the banking supervision considered as the basis and core element of the system, and therefore first the banking supervision mechanism started its operation under the aegis of the European Central Bank on 4 November 2014.

To have an accurate picture of the status of the banks of the EU, the ECB examined the quality of their assets and their level of resilience to crisis via stress tests for one favourable and one unfavourable economic event. In cooperation with the ECB, the European Bank Authority tests the resilience of the banks every two years, considering the performance not only of the big banks of the euro zone, but also of those of the other member states of the EU. Based on the data, 87 controlled banks proved to be more resilient against economic shocks in 2018 as compared to the results of the test of 2016. The rate of the Common Equity Tier 1 (CET1) considered as the key capital element of banks increased from 8.8% to 10.1% within all assets (ECB, 2019).

The ECB supervises those banks of the euro zone member states:

- which possess assets with a value above euro 30 billion,
- the value of the assets of the bank exceeds 20% of the GDP of the country where it is based,
- they operate in at least two countries, and have significant external exposures.

If none of the conditions is met (e.g. Slovakia, Lithuania), the first three credit institutions with the highest values of assets are controlled. Since the beginning of the operation of the SSM in 2014, on 1 January 2015 Lithuania became the 19th member state of the euro zone, and thereby its first three big banks automatically come under control of the banking supervision system of the EU. Based on the list published by the European Central Bank, 117 banks of the euro zone were under direct control of the SSM on 1 January 2020. These institutions possess more than 80% of the bank assets of the euro zone (ECB, 2020).

On the basis of the experiences of the period since its beginning in 2016, the Council initiated the modification of the rules of the banking union, based on which the capital requirements were tightened. As a result, the capital reserves of the banks have increased in the recent years, and their compliance with the short- and long-term liquidity requirements has made the operation of the institutions safer. In general, the uniform banking supervision performs the banking supervisory work previously belonging to the national scope and performed by central banks in the member states concerned, but it still closely cooperates with them.

3. SINGLE RESOLUTION MECHANISM (SRM)

Resolution is an activity performed to restore the operation a financial institution that becomes or has become insolvent, with the main purpose to preserve economic stability. After the crisis, the member states spent significant amounts to save failed banks to avoid an even deeper recession of their economy. As a result, the state debts of the countries increased, the consequences of which are still seen in Island, Ireland and Spain. A common EU fund was established to avoid the use of the money of taxpayers for the bail-in of banks.

In July 2014, Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms was adopted, based on which national resolution funds are created in the member states. In the process of the resolution, first the national authority indicates if a bank has become or is becoming insolvent, and in cooperation with the resolution body they jointly make a decision on the necessary measures. The means of resolution include the sale of assets, use of a bridge institution or recapitalisation by creditors. If these are not sufficient, then the assets of the single resolution fund are used. The fund is filled up from the payments of all member states during an eight-year period until the end of 2025, its scheduled amount is euro 55 billion, which will be foreseeably 1% of the guaranteed deposits.

The single resolution authority started its operation on 1 January 2016. Its purpose is to avoid the bankruptcy of the banks by using the resolution means, and to ensure their further operation with reorganisation without the depositors feeling the problem.

In 2017, the previous directive (2017/2399/EU) was modified, it requires the global systematically important banks to have sufficient resources and general loss protection (Total Loss-Absorbing Capacity, TLAC) to ensure their resolution in the case of bankruptcy.

Resolution has already taken place in one case. Via the resolution of the Cooperative Bank of Peloponnese, the further recession of the Greek economy already in difficulty could be avoided.

4. EUROPEAN DEPOSIT INSURANCE SCHEME (EDIS)

The deposit guarantee is intended to compensate the depositors of the insolvent institution, if the resolution of the institution is not possible any more, and its liquidation is unavoidable.

Directive 2014/49/EU of the Council was adopted on the uniform deposit guarantee in 2014, in which the creation of a common fund was also specified. The International Association of Deposit Insurers (IADI) and the European Forum of Deposit Insurers (EFDI) have contributed to the establishment of a single deposit guarantee system with their work. The directive provides that at least one deposit guarantee scheme must be operated in each member-state, which can guarantee the protection of the depositors in case of bankruptcy. Payments into the funds must be affected in advance (ex ante), on the basis of the banks' risk-based fee payment. The purpose is to ensure that the coverage index of the national funds reaches 0.8% of the guaranteed deposits by 2024. The guarantee limit is euro 100,000 in each member state from 2011. The period available for compensation must be gradually reduced from the previous 20 days (to 15 days from 2019, to 10 days from 2020, and to 7 days from 2024).

The member states were able to implement the above requirements partly already in practice; however, a single fund is still to be established. In the sense of Article 19(5) of the directive, the Commission must give a recommendation on the organisation of the single EU deposit guarantee fund by 3 July 2019. Unfortunately, the establishment of the system is hindered by the differences between the deposit guarantee systems of the member states (more than one funds operate in certain countries), and the conflict between the northern and southern member states. Some western countries fear that they have to fund a potential bankruptcy of the banks of South-European countries having recessed economies. The review of the directive has been started, but currently it is not accepted between the member states. According to the idea, a single deposit guarantee would represent an extra safety net behind the deposit guarantee systems of the member states, which offers help to the national deposit guarantors for the payment of the injured parties if necessary. Hopefully, the way of its implementation in practice and the time when the different viewpoints of the member states will approach each other will become clear in the near future.

CONCLUSION

In general, we can state that all regulatory and systemic reorganisations related to the banking system of the EU were intended to ensure safer operation of the banking system, to eliminate the so-called vicious circle, which caused the deepening of the crisis.

“The reform of the regulation has achieved its aims from several aspects, while its true efficiency and practical implementation are doubtful in other fields. Coordination and simplification of the extremely complex regulation and provision of its competition-neutral nature serve the basic interests of both the banking sector and of the general public.” (Móra, 2019)

The supervision and resolution mechanism of the banking union has a key role in the prevention of any crisis, while the single deposit guarantee is in place when the bankruptcy of the failed institution is unavoidable. According to the current status, the system tried to get prepared for the management of a negative situation caused by another economic shock, however, its functioning in the case of a severe problem is doubtful. According to certain forecasts, Europe may face a severe crisis in the near future, which may even worse than that in 2008. Its signs may appear in the slow-down of the European economy and further recession in the South-European countries, mainly in Italy.

The future task and challenge for the European Union will be to further control the EU banking supervision and resolution activities and to establish a single deposit guarantee system in order to implement a single monetary union.

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