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BRIEF CONSIDERATIONS REGARDING THE ESTABLISHMENT OF A BANKING UNION IN THE EUROPEAN UNION

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Abstract: *This paper analyzes whether the recent trends regarding the European financial supervisory system are able to establish a better strong decision-making center. Nevertheless an European Banking Union has its own advantages and disadvantages, but the question is if by empowering the ECB to supervise banks, will it have a greater and more benefic impact in case of a new crisis? After all, both the Central Bank and national supervisors must continue to work closely together in order to provide a better transparency and connection between them. The reform of the European Banking Union is one of the greatest challenges for the Member States. In what follows, I will try to present both the positive and less positive sides of it, related to various official arguments in the economical literature.*

Key words: banking union, Single Supervisory Mechanism, financial trilemma, Monetary Policy, independence, European Central Bank, financial supervision, European Banking Authority

During the 2007-2009 financial crisis, the European Central Bank (ECB) was the only European institution effectively able to fight against the jeopardy that threatened the inter-bank market. In spite of holding a strong leadership and a financial stability of the Euro Area[1], the potential bank failures were handled by national authorities and this led to inefficient global results.

The lack of a competent cross-border resolution framework was emphasized at the same time with the events regarding *Lehman Brothers*, *Fortis* and the *Icelandic Banks* in 2007-2009. This financial crisis highlighted how the absence of a suitable management system can damage the financial institutions.

Although over the past years the ECB played a positive role in the economical recovery throughout the bank crises, the present financial reforms are not sufficient to counteract the risks that might jeopardize the Euro Area, in case of new financial issues. Whereas further steps are needed against this problem, the Commission has called for a Banking Union in order to boost the confidence in Euro and improve the banking domain's footing[2]. The mechanism through which, the ECB shall assume more responsibilities related to the financial stability of all Euro Area banks, was proposed by the European Commission in order to strengthen the Economic and Monetary Union on 12th of September, 2012[3].

The Single Supervisory Mechanism represents the first pillar of the banking union. Nevertheless, the banking union also consists of the next three integral parts:

- *The establishment of a common Deposit Protection*;
- *The Single RuleBook for banking regulation*, in order to improve both transparency and enforcement; [4]
- *New rules for Bank recovery and resolution,* based on the idea of a single and harmonized framework for resolution.

One step in the first package's purpose is to adopt the legislative proposal on deposit guarantee schemes, by providing a harmonized framework.

Regarding the second building block of the Banking Union, it appears as a mandatory requirement in order to remove the danger of divergent national rules. In order to succeed in this, regulation will be directly applicable and also will establish a single set of capital rules. Moreover, the Internal Market Commissioner Michel Barnier said that in order to not be forced to feel again the consequences of a new financial crisis, the above mentioned proposal shall be adopted for a stronger and more responsible banking sector.[5]

The goal of the third proposal is to consider both the **directive** - regarding the access to deposit-taking activities - and the **regulation** - consisting of prudential requirements credit institutions and investment firms - as a package in pursuance of a safer financial system.

The Banking Union also implies a wider Consumer Protection and Confidence in the Financial Service. This element's purpose is to develop a better coverage which now includes not only small, medium and large companies but also all currencies. Moreover, it is expected that this component ensures a better provision of information in the benefit of the bank account holders as well as a long-term and responsible financing.[6]

Following these steps, even if the banks may confront with future problems, the public will gain confidence in banks. Moreover, in this case, the costs for the taxpayer will also be minimized.

In order to succeed in this process, (i) more severe and prudential requirements for banks have been proposed; (ii) the coverage of national Deposit Guarantee Schemes (DGS) has already been raised to a harmonised level of €100,000 per depositor, per institution since 31st of December, 2010[7]; (iii) the Commission's proposal on recovery and resolution tools for banks in crisis is meant to streghten Europe's banking system.

The task of applying these rules in the same way in EU rests upon national supervisors and the ECB. In a similar manner, The Commission has also proposed that the European Banking Authority (EBA) develop a Single Supervisory Handbook to "preserve the integrity of the single market and ensure coherence in banking supervision for all 27 EU countries".[8] The EBA has a decisive role in achieving its goal, especially thanks to the instruments and powers delivered by its founding regulation. Therefore, the proposal regarding the Single Supervisory Handbook is looking to standardize the different approaches between the Member States because of the potential fragmentation of the Single Market. [9]

The Single Market for financial services is based on common rules which ensure that in accordance to the Treaty, banks and other financial institutions not only benefit of free establishment and provision of services, but they are also subject of the same rules. In the proposal's view, the creation of the Banking Union must not affect the integrity of the Single Market.

Mr. Vives, Professor of Economics and Finance at IESE Business School in Barcelona, made an extremely relevant point of view round Europe's Regulatory "Chaos"[10]. According to his opinion, "*in the euro zone there is one common currency but many national supervisory authorities. So the responsibilities for financial stability remain in national hands*." As for the proposal above, he emphasizes the benefits of empowering committees for banking, insurance and security with specific tasks related to macroprudential supervision of credit institutions. Professor Mr. Vives also presents the current situation of the financial system in Netherlands. To sum it up, this system implies that powers and supervision are separated, so that this ensures "*economies of scale in information gathering, a single authority in a crisis and no interference with transparency requirements and investor protector issues.*" Yet, he states that applying the Netherlands financial system to the EU level may be difficult due to the lack of integration. However, Prof. Vives claims that EU could only reach its purpose depending on the right implementation of a both single supervisor for large cross-border groups and a burden-sharing procedure in crisis[11].

During a past conference at the London School of Economics, there were debated the consequences of implementing the third element of the Banking Union. In the presentation sustained[12], there were made a few noticeable remarks with regard to the benefits of a European Banking Union: if its components are being prudentially and carefully implemented, the positive effects, such as: (i) standards consistently being applied across the UE; (ii) intern conflicts of interest being avoided or (iii) national fragmentation of financial market being reduced, may positively be seen in the next future[13].

On one hand, it is precisely presented the importance of adopting common rules and institutional arrangements and it is also highlighted the positive idea of incorporation of bail-in instruments.

On the other hand, the presentation shows that if the directive's requirements for bank recovery and resolution are not implemented at the same time as the SSM, it may cause uncertainty on the EU background.

Beyond the institutional arrangements, the directive is not clear with regard to cooperation between the ECB and the Resolution Authority[14].

Due to the both positive and insecure consequences caused by a wider supervision of the ECB, at the London School of Economics conference was sustained the following relevant idea: by empowering the ECB to sign a *resolution contract* with *each member state*, it will be easier to obtain a ***greater recapitalization of the banks***.

At the Council meeting on 12th of December, 2012, the EU finance ministers agreed on the general approach on the legislative package regarding the SSM. This mechanism represents a key element in the EU's plan to establish a banking union. Therefore, its purpose is to "*restore confidence in the banking industry. Such a development will enable the vicious circle between and sovereigns to be broken*", said Vassos Shiarly, Cyprus' minister of finance. Moreover, the non-euro area Member States will also be able to participate in this mechanism.

The Single Supervisory Mechanism consists of empowering the ECB to have the ultimate responsibility for specific supervisory tasks in the financial domain but also of allowing national central banks to play an important role in daily activities and implement the ECB's decisions. The SSM will operate as a "*strong decision making center*", a very much decentralised one, where the ECB will be assisted by national supervisory authorities. Both this mechanism and other measures, such as creating a common system of deposit protection, are essential elements of banking union process[15]. The President of the European Commission, José Barosso also concluded in a debate at the European Policy Centre that "*this is the best, and indeed the only way forward that can give our citizens the prosperity, our businesses the opportunities, and our young people the futures that they all deserve*".

One of the main objectives in establishing the SSM is to approach the "financial trilemma" issue. The so-called financial trilemma states that financial stability, financial integration and national financial policies are incompatible[16]. Any two of the three objectives can be combined, but not all three. This goal is the more desirable as the current financial crisis brought to light the fact that one country's financial system can rapidly threaten the stability of the whole euro area banking system. Moreover, the spillover effects between banks and sovereigns would be diminished by establishing the SSM.

Regarding the Supervisory board, the ECB's monetary and supervisory tasks will be strictly separated, in order to avoid any potential conflicts of interest between the objective of monetary policy and banking supervision. However, contrary opinions have been brought to the economic literature on this issue, even if supervision and monetary policy are completely different on many aspects[17]. In accordance to them, coordination is more desirable instead of separation, due to the fact that during a crisis, major decisions on individual banks are very frequently taken. Therefore, it may appear as a must that the two components should not be separated exactly because the stability of the financial system represents the biggest threat to a monetary policy[18]. Moreover, due to the fact that most bank crisis are explosive and sometimes threaten to affect the whole financial system, decisions must be made in a short time. As a consequence, the supervisors must always be ready and perfectly informed[19]. Even if, such organizational problems do exist, a Central Bank will feel that it needs to be in continuous contact with the supervisory body, however that may be organized[20].

The legislative proposal on the SSM also contains one regulation which is about to modify the existing regulation on the EBA. The changes to the EBA are mainly related to procedural matters and its goal is to ensure an effective decision making process regarding the single market.

One of the greatest advantages of involving the central bank in bank regulation and supervision is the crisis resolution. If the central bank has supervisory powers, it may be able to act more effectively through the banking system in times of crisis. Furthermore, on the basis on the information received, the ECB may decide whether it is necessary to exercise directly supervision on one or more credit institutions[21]. Yet, the economic literature is not unanimous on this issue. There have been emphasized arguments on the disadvantages of combining monetary policy and supervision. According to them, this could result not only in conflicts of objectives but also it would decrease the credibility of the central bank as a prudential supervisor[22].

As a response to these, Mr. Vítor Constâncio, Vice-President of the ECB stated that there are some "true" risks but also some "false" risks.

If the Central Bank gets to be responsible for both price stability and bank supervision, any negative event may affect its reputation. "*…supervision is an area that can never be perfect as it lacks the resources to see everything, meaning that accidents are always possible*", said Mr. Constâncio.

Due to the fact that the ECB's monetary and supervisory tasks will be strictly separated, the argument regarding the conflicts of interest between the ECB's functions cannot be taken in consideration. According to Mr. Constâncio, the clear goal of price stability will not be compromised in the future, as well as it was not compromised in the past either. In addition to this, the "**full inclusiveness**" of the SSM, is guaranteed by the main feature given to the ECB of having access to the data referring to all credit institutions[23].

Another important element of the SSM regulation is represented by the macro-prudential tasks given to the ECB. It exposes not only the Member States' aptitude to "deepen European integration"[24], but also the ECB's ability to apply higher requirements and take more prudential measures.

Having a single European supervisor may increase the probability that the applicable rules would be more uniform in the financial sector of the EU Member States[25].

One of the most important advantages for Romania, is definitely its integration into an area covered by rules. In spite of this, due to the fact that the National Romanian Bank is a key element in keeping a balance in the economic domain, being part of a banking union may negatively affect this balance. Similarly, according to Mr. Mugur Isărescu, Governor of the National Bank of Romania, if the Single RuleBook is being implemented, this may not have positive effects on Romania's financial system. Moreover, the local subsidiaries of the states that have not adhered at the banking union, may be able to not apply the more prohibitive legislation.

In order to sustain the previous idea, Mircea Cosea, Professor of Economy, stated that due to the fact that approximately 80 % of the banking system in Romania is coordinated by foreign banks and have subsidiaries in Romania, they still need to obey the rules imposed by the National Bank of Romania. In this way, the national bank would lose her position regarding the monetary policy. However, I consider that a banking union is required in order to strengthen the European banking system and consequently, this can only have a positive impact even on the national authorities.

In conclusion, a few remarks may be done with regard to the arguments presented above:

The implementation of the SSM is a must in order to rise up the probability of a better management in crisis situations. Even if the national authorities of the Member States might take some good decisions on financial issues, an overlook at a higher scale is required. Although some procedural and functional aspects, such as coordination or separation of the monetary policy and banking supervision are not unanimous yet, the banking union represents one of the goals that should promptly be taken in consideration and transposed into substance.

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[1] Schoenmaker, Dirk (2011), *Banking Supervision and Resolution: The European Dimension*, p.1 (via SSRN)

[2] Communication from the Commission to the European Parliament and the Council: *A Roadmap towards a Banking Union*, Brussels, 12th September, 2012, COM(2012) 510 final.

[3] The proposal is based on the article 127 (6) of the Treaty of Lisbon, according to which: "The Council, acting by means of regulations in accordance with a special legislative procedure, *may unanimously*, and after consulting the European Parliament and the European Central Bank, *confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions* with the exception of insurance undertakings".

[4] European Commission (2011), Press Release: *Commission wants stronger and more responsible banks in Europe*, 20th July, 2011 (available at http://europa.eu/rapid/press-release_IP-11-915_en.htm?locale=en).

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[6] European Commission (2010), Press Release: *Commission proposes package to boost consumer protection and confidence in financial services*, Brussels, 12th July, 2010 (available at http://europa.eu/rapid/press-release_IP-10-918_en.htm?locale=en).

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[8] European Commission (2012), Press Release: *Commission proposes new ECB powers for banking supervision as part of a banking union*, Brussels/Strasbourg, 12th September, 2012 (available at http://europa.eu/rapid/press-release_IP-12-953_en.htm).

[9] Idem.

[10] Vives, Xavier (2009), *Europe's Regulatory Chaos*, The Wall Street Journal [Internet] 18th March, 2009. (available at http://online.wsj.com/article/SB123733224322763155.html)

[11] Idem.

[12] European Shadow Financial Regulatory Commitee (2012), *Resolution and recovery in a European Banking Union*, Statement No. 36, London, 22nd October, 2012 (available at http://www2.lse.ac.uk/fmg/events/conferences/past-conferences/2012/European_Banking_Union/ESFRC-Statement.pdf).

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[15] Communication from the Commission to the European Parliament and the Council: *A Roadmap towards a Banking Union*, Brussels, 12th September, 2012, COM(2012) 510 final.

[16] The classical monetary trilemma is built on the Mundell-Fleming model of an open economy under capital mobility.

[17] For example, they are different on their implementation, the nature of the decisions being taken or the professional terms required for the staff.

[18] Beck, Thorsten and Gros, Daniel (2012), *Monetary Policy and Banking Supervision*: Coordination instead of separation, No. 286, 12 December 2012 (via SSRN).

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[21] Constâncio Vítor, *Establishing the Single Supervisory Mechanism*, at the BAFT-ISA 2013 Bank-to-Bank Forum, 29th January 2013 (available at http://www.ecb.europa.eu/press/key/date/2013/html/ sp130129_1.en.html).

[22] Beck, Thorsten and Gros, Daniel (2012)*, Monetary Policy and Banking Supervision*: Coordination instead of separation, No. 286, 12 December 2012, pp.6-7 (via SSRN).

[23] Constâncio Vítor, *Establishing the Single Supervisory Mechanism*, at the BAFT-ISA 2013 Bank-to-Bank Forum, 29th January 2013 (available at http://www.ecb.europa.eu/press/key/date/2013/html/ sp130129_1.en.html).

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