EU BANKING UNION

Introductory thoughts on the current situation

The decision adopted by the 28 European Union (EU) Member States in June 2012 on the establishment of the banking union expresses clear political support to the idea of common Europe. Is such a pretentious EU project an important historic step towards further integration, particularly in terms of the financial sector? Will the banking union reconsolidate the connections within the economic and monetary union and create better conditions for economic growth? After three decades of deregulation of monetary policy, which has taken the European financial situation to the verge of a precipice, it is above all important to take precautions to avoid in the future any destructive developments similar to those that occurred in the years after 2008.[1]

From the very beginning, one democratic principle has to be clear: until the political union has not been fully developed, the parliaments of the Member States within the Community should have the right to adopt final decisions concerning payments to be made directly from the budgets of the Member States to partner countries in trouble. The no-bail-out principle established in Article 125 of the Lisbon Treaty (TFEU[2]) according to which neither single Member States nor the Community as a whole shall be responsible for or take over commitments of other Member States, has fundamental significance without general high-level political responsibility. It is not possible to explain to citizens in an understandable manner why their country and thus under certain circumstances also they themselves as taxpayers should bear the financial risks caused by either foreign, international or domestic banks with their irresponsible transactions which are primarily profit-oriented. This particularly applies to old debts taken in the past when only domestic bodies were responsible for the supervision. Risk-taking and liability, also financial liability are inseparable in the conditions of the free social system. Banks should not be allowed to consider themselves as absolutely essential for the functioning of the system and to expect therefore the state and eventually the taxpayer to help them. As we saw, this would induce them to take higher risks (moral hazard – change in risk perception if it is known beforehand that someone else will bear the possible losses), and the crisis sensitivity of the whole system would increase.

The banking union which will have to increase the security of the European financial system, achieve clear success in the application of the responsibility principle and thus protect the taxpayer against unjustified risks and financial burdens caused by banks, assumes

[1] Particularly in Ireland, Spain and Cyprus. After the national banking supervision agencies had failed to perform their duties, these three countries had to request EU support for rescuing their banks.

[2] Treaty on the Functioning of the European Union.

→ joint strict supervision over the financial sector;
→ comprehensive measures both for the liquidation of bankrupt banks and restructuring of the still viable banks;
→ sufficient and individually sized equity reserves for each bank; and
→ clear rules of liability.

The issue is whether the decision adopted by three parties – the European Parliament, Council of Ministers of Finance and the European Commission – i.e., the tripartite decision on the creation of the banking union conforms to the above-mentioned requirements.

The euro zone banking union is based on the three main columns:

1) Single Supervisory Mechanism (SSM). Globalisation of financial markets requires supranationally organised banking supervision. Proceeding from that idea, the European Central Bank (ECP) will receive an additional task on 4 November 2014 to analyse regularly the balance sheets of the major banks of the euro zone countries (Asset Quality Review, AQR). The objective is to discover any latent risks, above all hidden losses, in the balance sheets, and if gaps in capitalization are detected, the banks should be induced to cover them by adding new equity. Such balance sheet audits are supplemented by stress tests, and results of both regulatory inspections will be joined up. These audits will include also assessment of credit guarantees and practical measures applied for the prevention of risks. It will be performed on the basis of the EU definition of non-performing loans and also according to the fixed criteria of the risk analysis of main accounting records. It is absolutely important in this respect – we learnt it during the financial crisis – that updated information and reports should be promptly available. Investments in information technology would considerably save time. The banking supervision mechanism would help to restore the lost confidence in the European banking system.

2) The European Single Resolution Mechanism (SRM) that will be created for the 18 eurozone countries will become the core of the banking union. It will be based on common rules for the controlled liquidation of banks with unsustainable business conceptions and restructuring of banks which have encountered difficulties. The mechanism will consist of two components. One of them is the crisis management agency which will establish the further procedure on the initiative of the European Central Bank[3] and monitor the subsequent process. It is important for the crisis management agency and the European Central Bank to have close cooperation as supervision and crisis management should be in the same hands. According to political discussions, however, the opinions are very different in this respect. The second component of the mechanism is the crisis management

[3] The European Commission can review the result of the crisis management agency and make objections in case of doubts, which will be then settled by the Council of Ministers.

fund. The fund should ensure that the banks will bear the mutual financial burden and prevent the eventual responsibility of the taxpayer again. By the end of the creation stage the total amount of the fund planned will be 55 billion euros.

3) The third column will consist in internal liability in the form of a cascading liability. Allocations from the crisis management fund (restructuring fund) can be used for recapitalization only after shareholders and creditors have assumed their part of liability arising from the basic principle of market economy (bail-in).

   In principle, banks should first of all back their debt obligations prudently with sufficient equity. Sufficient means that the equity should be sufficient to enable each bank to fulfil its payment obligations for at least 30 days in a crisis situation without involving external funds. In order to achieve that, the equity base should be measured according to the risks related to each obligation and taking into account all balance sheet and off-balance sheet commitments (leverage ratio). Considering the amount of total assets, the currently mandatory three per cent is clearly too low; it should be at least eight per cent. – Thus, the liability of shareholders is backed first of all by the retained earnings which they financially own but which will not be distributed to them. In addition, shareholders will have to bear with their shareholder rights the costs of restructuring or controlled liquidation of the bankrupt banks. Both of these components are a 'strong core capital'.

   Creditors of the bank are at the next stage of liability, namely first of all junior creditors with subordinated loans, followed by senior creditors with primary rights. And finally the distribution of the financial burden reaches also depositors as holders of claims against the bank. With respect to their deposits, EU Member States agreed for the purposes of distribution policy to establish regulations which are analogous with the German Deposit Guarantee and Investor Compensation Act. According to this Act, deposits of up to 100,000 euros will not be subject to the liability requirements.[4]

☛ The future will show whether the banking union established will meet the expectations and is able to restore the confidence of the financial sector. The purpose of the supervisory mechanism is to discover weaknesses of the financial sector. Therefore banks should be obliged to declare clearly their off-balance sheet financial activities. In addition, all risks arising from financing performed through security brokers, insurance companies and trusts should be recorded.

Different bodies will be performing banking supervision in the future. While the 120 major banks of the eurozone countries, the banks essential for the system, will be subjected to the single supervisory mechanism (SSM) of the European Central

[4] This specifically means the following: EU Member States took the commitment of establishing a national fund for the insurance of bank deposits to secure deposits of up to 100,000 euros per bank client.

Bank, approximately 5800 banks declared to be of less importance will remain – at least at first – under the supervision of national agencies. Such differentiation leads to the question – why should the European major banks assume only 85% of the costs of the new banking supervision of the European Central Bank and the other banks will have to cover the remaining 15%.

By dividing this extremely important task in the manner described, the fact that there are close mutual connections and relations in the banking sector is ignored. Also not very big banks perform partly risky transactions at their own risk (trading under their own name). Liquid assets are also often invested in presumably secure government bonds which are generally considered to be free of problems or at least not so risky. However, according to the experience gained from the years of crisis, such assessments are arbitrary and do not often take into account the often observed interconnection between national debts and banking crises. For instance, if a country is threatened by insolvency, the related risk of losses may be transferred to the bank depending on the amount of bonds deposited with the bank.

The banking sector is represented not only by globally operating banks. As operators of the financial sector are closely networking, no definite separation line can be drawn between banks that are important or less important for the system. There are no criteria that could be used for that in practice. The amount of total assets over 30 billion euros or 20% of the economic capacity of the country are not sufficient bases for that. Therefore **all** banks without exception should be subjected to central control. This would be the only way to achieve effective pan-European supervision within the EU. It is important to perform risk assessments, verify the quality of loans issued and other assets, and perform also stress tests proceeding from common positions (e.g., on the basis of definite crisis scenarios).

The more regulated are the activities of banks, the more interested will be the actors in the financial market in going over to the areas not subject to the strict banking supervision mechanism, such as hedge funds, private equity funds, special-purpose investment funds (conduits), structured investment vehicles. Consequently, a solution should be found to subject such shadow banks to analogous supervision.

At any rate, banking supervision – as planned within the framework of the banking union – is a tremendous task. It can be achieved only with a significant number of employees who need to have the required knowledge and skills to be able to assess extremely complex derivative instruments (derivatives), their underlying securities and residual risks. It is questionable whether the European Central Bank is prepared for that, bearing in mind the organisation and the required staff. And therefore the question arises about whether the Central Bank is the right institution to take that mandate.

☛ Considering the fact that since the start of the financial crisis the countries have had to invest more than 1.5 trillion euros[5] to rescue from collapse the banks that are important for the system[6], the 55 billion euros intended for the liquidation fund is quite insufficient. Also the German Monopolies Commission considers the amount insufficient, bearing in mind the size of certain banks. The German Commerzbank alone needed assistance to the extent of more than 18 billion euros from the state during the years of crisis. If the system should fall into crisis again, the financial resources of the fund would be exhausted every soon. Also the regulation that in each case the fund can allocate financial resources after the bail-in to the extent of five per cent as a maximum of the total assets of the bank does not change anything. It would hardly be possible to strengthen the financial system of the eurozone with the assistance of a fund of such modest size and to protect the taxpayer as the last instance for unjustified burdens.[7]

In order to keep the contributions for setting up the liquidation fund within reasonable limits for banks, the possibility for extending the creation phase to ten years from 2015 was discussed at first. Finally the duration of the phase of 8 years was agreed upon. This is still not a long period, considering that the funds contributed during the period will become common assets only gradually. It is not certain at all that no new banking crises will emerge during the accumulation phase and whether the funds gathered by that time would be sufficient.

In order to prevent bearing of the burden by the taxpayer again during such accumulation phase, it will be made possible to use the resources of the European Stability Mechanism (ESM) in an emergency if the respective eurozone country files an application for direct recapitalization of banks. Thus ESM will remain the safety net ('backstop') for less capable Member States as it is now. However, it can only be used if specific requirements have been met.[8]

[5] These are financial resources which public budgets lack to reconstruct infrastructure, develop the educational system, support scientific research and innovation.

[6] The total assets of which exceed the gross domestic product of some average EU Member State. – The order of magnitude of only Deutsche Bank is comparable to ca 60% of the economic performance of whole Germany.

[7] Although in such a problematic situation ESM may apply for additional support for direct recapitalisation of the bank to a limited extent after the national government has already allocated its financial support.

[8] Firstly, according to the principle of internal responsibility, the losses of banks with problems should be borne by shareholders and creditors of banks (bail-in). In addition, for the use of ESM, national bank deposit protection funds (restructuring funds) have to be exhausted first. Banks have no direct access to ESM. The funds can only be used on the basis of an application of the national government and only if the state is not able to fill the remaining financial gaps from the national budget (national backstop is meant here). At any rate, it would increase the national debt of the applying country and the intention was to prevent that, considering the reduced confidence during the euro crisis.

☛ The discussions also include the issue of the bases of determination of the amount of the contributions of each bank to the European restructuring fund. In principle, contributions to the restructuring fund should consist of two components: firstly, the basic amount calculated on the basis of total assets, independently of risks, therefore proceeding from the bank size (a certain percentage of total liabilities); secondly, an amount derived from the risk profile of the bank, so that large banks with higher risk exposure would tend to pay more. Such a combination would allow little variation in the size of payments over time. This in its turn would favour more consistent development of the fund.

Should exceptions, reduction of the amount used for the calculation of the payment, and other limits or thresholds be allowed in the determination of the size of payments – particularly, considering the risk prevention provisions of the Basel III Agreement, for instance, if it is required by the bank size or importance of the fields of activities; but this issue should still be discussed with the participation of all countries. It is necessary to consider that above all medium-sized enterprises rely on high performance smaller and medium-sized banks for the financing of their credit-based investments, often only on the regional banks.

According to tax law, contributions of banks to the fund should be regulated in similar manner in all countries. This is important for the prevention of distortions of competition in the European banking sector. It should also not be possible to deduct such payments from taxable income as it would reduce the tax revenues of countries. It would sooner or later increase the tax burden of taxpayers again if it becomes necessary to adjust the state budget revenues to the development of expenditures. Consequently, taxpayers would be indirectly involved in the financing of the fund anyway.

☛ Internal liability has been limited to 8% of the total assets of the insolvent bank. According to the responsibility principle of market economy, such a limitation is quite incomprehensible. Outside the banking community, shareholders and creditors take full responsibility for the insolvency of a company. The issue is about why internal liability has been limited in the banking sector and why does it have to be eight per cent. Thus, most bail-in resources would not be used for covering the debts.

☛ It should certainly be absolutely clear at the very beginning that without the liability of owners and creditors, preventive recapitalisation by the state, i.e. preventive state aid is excluded. The same should apply also to emergency situations when a risk of systemic crisis in the financial market emerges. Otherwise, the principle of internal liability is eliminated and an opportunity is created for avoiding the rules.

The banking union is a step in the right direction. The three columns described have, however, also some weaknesses. This applies particularly to the size of the liquidation fund that will be created. It is simply ridiculously small considering the experience of the years of crises. Different competencies of the European Central Bank and bodies of the Member States in banking supervision raise doubts of whether such a fundamental task would be solved according to common criteria. Besides, it is not understandable why the internal liability of an insolvent bank is limited to 8% of the amount of its total assets[9]. Such a limit violates the central principle of market economy. This limit facilitates access to the fund and reduces the disciplining effect of internal liability. In general it is really questionable whether the banking union will fulfil its objectives in the currently planned form.

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[9] The same applies to the possible use of the European Stabilisation Fund (ESM) resources during the liquidation fund creation phase of eight years.