UNIVERSITY OF LJUBLJANA
FACULTY OF ECONOMICS

MASTER'S THESIS

ANALYSIS OF CAUSES AND CONSEQUENCES OF FORMING EUROPEAN BANKING UNION

Ljubljana, September 2014 EVA ALJANČIČ

AUTHORSHIP STATEMENT

The undersigned Eva Aljančič a student at the University of Ljubljana, Faculty of Economics, (hereafter: FELU), declare that I am the author of the master's thesis entitled Analysis of Causes and Consequences of forming European Banking Union, written under supervision of prof. dr. Mojmir Mrak.

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INTRODUCTION

The crisis has had serious effects on the financial sector, with an unprecedented loses that started with the end of over confident credit growth period. The crisis started in the United States' real estate sector in 2007 and had initially effected the advanced economies of the United States and Western Europe, but has surprisingly quickly spread around the globe, namely in 2008, after the collapse of the Lehman Brothers. It affected various countries up to different levels. The consequences were also felt in almost every Member State of the European Union (EC, 2013a).

Shortly after the crisis burst, the banking sector became concerned and distrustful. It suddenly became clear that the number of banks, investing in the financial products, which were in many cases overly complicated and very pricey, were not a reliable and a trustworthy partner anymore. Serious liquidity problems occurred, as the interbank market stopped with its normal activities and risk premiums on interbank loans increased (EC, 2009). Fundamental failures in the assessment of risk were exposed. Regulators and supervisors, together with affected financial firms, have failed to properly estimate the appropriate relationship between firms' ability of undertaking risk and holding adequate levels of capital (Larosière et al., 2009).

First calls for the Banking Union have arisen, when it became evident that the financial safety net in the Eurozone has to be improved (Beck, 2012). The main idea has been to try preventing banking crisis and provide appropriate actions to save individual banks, if a crisis occurs. The banking sector would, with the support of a Banking Union, provide good functioning of financial intermediation.

Europe's main reasons for implementing the Banking Union are (Elliot, 2012):

- to deal with the banks weaknesses that have already existed and have had a major impact on the Eurozone crisis,
- to reduce the risk of possible negative contributions of the banking system to the later phases of the crisis,
- to restore the effectiveness of the ECB and its monetary policy
- to reintegrate the banking system of the European Union and,
- to correct and improve the problems that Single market has been dealing with for a long time in the EU.

The Banking Union is planned to be built from three main pillars – supervision, resolution and deposit guarantee scheme. Each of the pillars presents important policies that need to be mutually connected to safeguard the banking sector and to provide robustness and stability (ECB, 2013). Only partially build Banking Union could bring worse results than the current nationally based systems and hence the development of all pillars is important (IMF, 2013b).

Banking Union is evolving in the same direction as the current Europe's economic and monetary systems, especially in the Eurozone. The first major steps have been taken, but improvements are still needed for achieving the goal of preserving the Eurozone's long-term stability.

The purpose of the master thesis is to contribute to the understanding of the process and development of the Banking Union and its effect on the EU as a whole and specifically on the Economic and Monetary Union (EMU), since participation in the Banking Union is mandatory for its members. As there are many organizational matters that need to be discussed, as well as problems that can accrue in any stage of the developing process, it is important to identify what positive and negative consequences the Banking Union could bring. The Banking Union is an important step toward a more interconnected collaboration between banks in the participating countries, but there is still a long way toward the finish line, where all three pillars will be properly implemented.

The goal is to determine through research what the most important reasons for the establishment are and to present in detail the characteristics of individual pillars of the Banking Union, along with the challenges it will bring. In-depth theoretical analysis will expose the elements of the build-up process and help to understand the importance and complexity of this demanding project.

Methods. Master thesis will be composed of detailed theoretical analysis which will be based on technical literature, scientific discussions and articles of mostly foreign experts from the financial and, more specifically, the banking field and main institutions of the European Union. Master thesis will be built from four main chapters; the content will be additionally elaborated upon in sub-chapters.

Content. As the financial crisis in 2007 functioned as a wake-up call and resulted in demands for certain reforms and measures on the insufficiently connected financial markets in the Member States, I will firstly describe the situation that brought to this decision and will continue by elaborating why the Banking Union is necessary. Afterwards, I will provide detailed information on the progress, development and opinions regarding the three main building blocks of the Banking Union which are Single Supervisory Mechanism, Single Resolution Mechanism and Deposit Guarantee Scheme. I will analyze the pillars with the intent to expose the main advantages, disadvantages and finding the main reasons for much needed progressive development, as well as the main obstacles that are standing in the way. Since the third pillar, Deposit Guarantee Scheme, is not developing at the same pace as the other two (so far, there is no plan for a Common Deposit Guarantee Scheme), I have experienced shortages on the appropriate literature for the application of this master thesis. As a result, the last chapter on the Deposit Guarantee Scheme is less comprehensive as the second and third chapters, describing the other two pillars.

After an extensive in-depth analysis of the secondary data, I will manage to accept or reject two hypothesis questions which I set before starting my research. The hypotheses raise the most important issues in the process of creating a Banking Union.

Rapid progress has been made in the direction towards the formation of the Single Supervisory Mechanism, following with the adoption of the Single Resolution Mechanism but there is a clear risk that the EU will not succeed in putting in place the remaining element of the Banking Union, as this would require even more demanding agreements regarding burden-sharing obligations. Transferring only some elements to the European level could result in an uneven system, one that would not be appropriate for ensuring financial stability. I will research this question, which will be based on my first hypothesis: “All three pillars are necessary for a successful Banking Union”**.**

From the crisis onwards, the countries of the euro-area were more structurally vulnerable, which consequently reinforced the banking/sovereign vicious circle. One of the important purposes of the Banking Union creation is that it will help to counteract the so-called feed-back loop between sovereigns and banks. With the second hypothesis: “a Banking Union is the right solution for resolving the sovereign debt crisis of the Eurozone members”, I intend to research, if the establishment of the Banking Union will resolve this serious and still very relevant problem.

1 WHY DO WE NEED A BANKING UNION?

1.1 Financial Crisis in 2007

When looking back and searching for reasons that lead to the financial crisis, we come across high productivity growth and stable inflation, which has proven consistency between the activity and economy’s potential growth. Macroeconomic growth has achieved record levels and created a deception that long-lasting and stable high growth is possible (Larosière et al., 2009). These conditions, together with the low long- and short-term interest rates and low volatility, have surged up asset prices, from stocks to housing prices. In the pursuit for higher yields, together with underestimations of risks, people and institutions wanted to purchase increasingly risky assets (IMF, 2009).

Even though the growth of credit volumes was high, central banks did not action with tightening the monetary policy as the consumer inflation stayed low. As a consequence, the growth of financial and commodity markets was not consistent anymore. Asset prices were rising on the account of excessive liquidity, while that did not happen with prices of goods and services. Excessive liquidity, together with low interest rates, represented one of the most important reasons for the crisis, but it was definitely intensified by innovations in bank funding instruments (Larosière et al., 2009).

While concentrating mostly on inflation and overall activity, central banks have not realized the seriousness of the expanding risk and prevailed optimism led to deterioration of market discipline. Short-term profits encouraged financial sector to take actions with higher risks, while due diligence was performed by credit rating agencies (IMF, 2009). With a help of underpricing the risks by capital markets, the derivatives' markets enabled banks, together with other financial entities, to spread their activities on- and off- balance sheet, regardless of non-equal growth of deposits. These innovative and sophisticated financial products have expanded very quickly (Liikanen et al., 2012). Securitization undercut the credit standards for banks as well as for non-bank lenders and did not encourage the lenders to correctly evaluate borrowers and to increase the loan delinquency rates, but rather to hide increases in actual leverage (Van Rixtel & Gaperini, 2013).

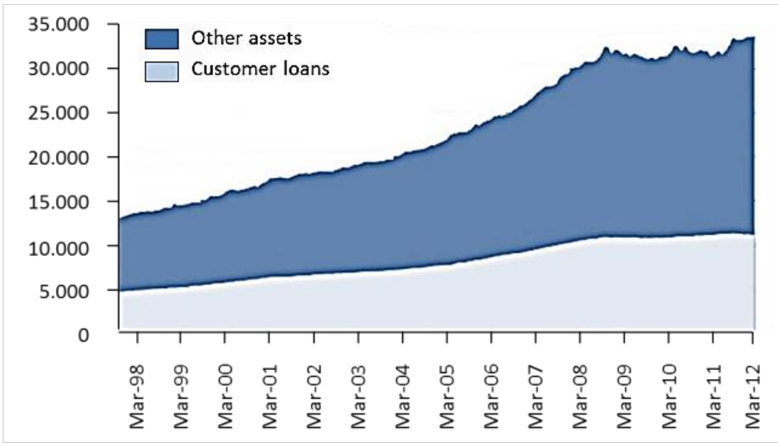
Market fragmentation in the European financial markets was the result of a deep crisis of confidence. Furthermore, incentives by political and regulatory authorities have motivated banks to diminish their foreign activities. As part of the EU state aid procedures, banks have faced stipulations, requiring closures of foreign branch offices (German Council of Economic Experts, 2013).

1.2 The banking sector in the European Union

Through years, banks' activities were modified. Core activities in commercial banking (deposit taking and loan making for individuals and corporations) or investment banking (underwriting stocks and bonds, providing advisory services) have lost its importance. Activities which were complicated to monitor and supervise and have deviated from basic banking services gained more influence, i.e. dealer and market making activities, broker activities for professional investors and hedge funds, and proprietary trading. Intermediation channels between ultimate lenders and ultimate borrowers have, simultaneously with an extension of banks activities, considerately extended. For this reason, interconnectivity and counterparty risk within the banking sector have increased. Very quick growth of institutional money and banks, serving these new institutional clients, accompanied the growth in banks' new activities (Liikanen et al., 2012).

Figure 1 illustrates shifts in focus of operation with shifts in asset structure and Figure 2 illustrates the increased leverage with shifts in funding structures.

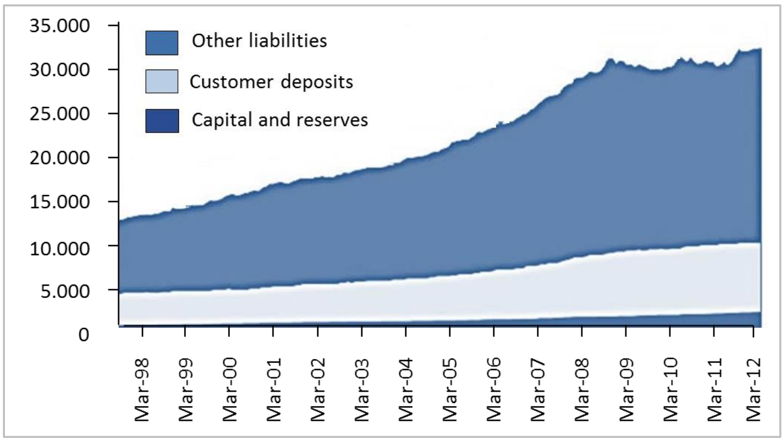
Figure 1: Evolution of assets of MFIs in the EU euro area 1998-2012 (€ billion)



Note: Customer loans are loans to non-monetary financial Institutions, excluding general government.

Source*:* Liikanen, E. et al., *High-level Group on reforming the structure of the EU banking sector,* 2012, p.15.

Figure 2: Evolution of liabilities of MFIs in the euro area 1998-2012 (€ billion)



Note: Customer deposits are deposits of non-monetary financial institutions excluding general government.

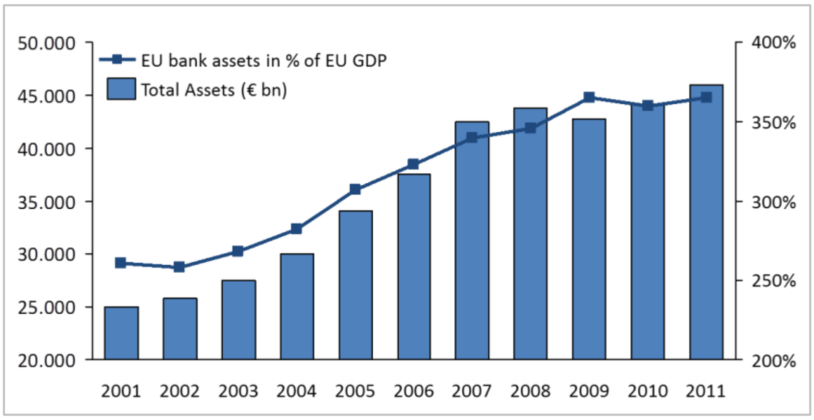
Source*:* Liikanen, *E. et al., High-level Group on reforming the structure of the EU banking sector,* 2012, p.15.

A few years before the crisis, the international business of European banks has expanded. The enhancement was the Single market at the EU level and the euro in the Eurozone. In effect, financial integration of the European financial system increased, more notably within the Eurozone (Liikanen et al., 2012). Integration emerged very quickly and large credits, together with other capital flows have been circling around in the involved countries (Sapir & Wolff, 2013).

Figure 3 demonstrates the growth of the European banking sector, which was the consequence of an increased influence of the financial intermediation. The overall growth of the asset importantly outpaced the EU Gross Domestic Product (GDP) growth, with total assets of MFIs (Monetary Financial Institutions) in the EU reaching €43 trillion by 2008 (€32 trillion in the Eurozone), or approximately around 350 percent of EU GDP.

When the crisis occurred, the stable ratio of GDP to total assets, proved a slowdown in the relative growth of the sector to the EU economy (Liikanen et al., 2012).

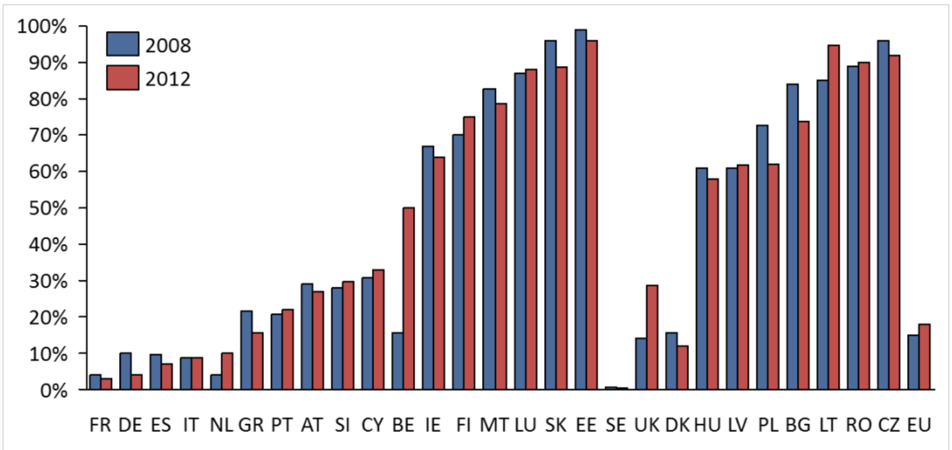
Figure 3: Total assets of MFIs in EU 2001 – 2011



Source: Liikanen, E. et al., *High-level Group on reforming the structure of the EU banking sector*, 2012, p.12.

Figure 4 exhibits the prevalence of foreign financial groups, mostly from Western Europe, in the banking sectors of countries from Central and Eastern Europe. These financial groups have dominated the banking and insurance markets and had centralized risks management functions in their headquarters. In 2009, approximately 70 percent of EU banking assets was owned by 43 banking groups that performed considerable cross-border activities (Larosière et al., 2009).

Figure 4: Percentage of the banking system that is foreign owned



Note: This percentage is calculated as the total assets of foreign owned subsidiaries/branches as % of total banking system assets.

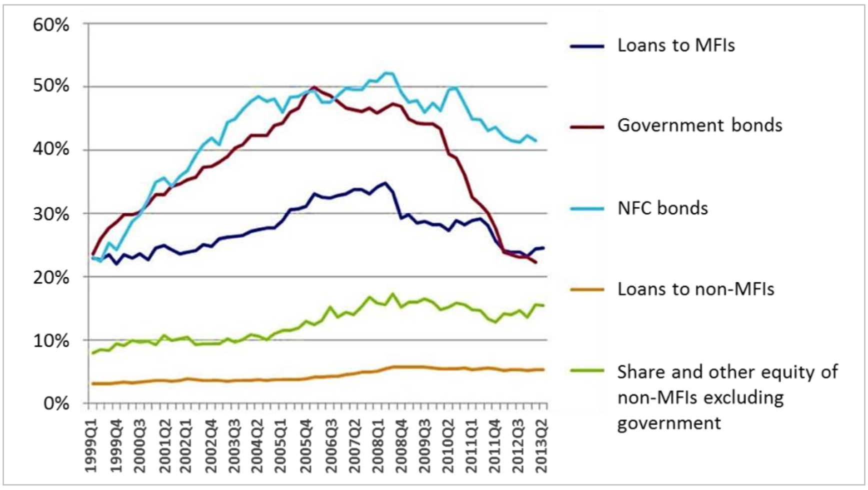
Source: Sapir, A. & Wolff, B. G. *The neglected side of Banking Union: reshaping Europe's financial system,* 2013, p.3.

In spite of the extensive rise in cross-border financial assets and liabilities, the retail banking did not spread much across national borders. Financial assets and liabilities across border reached over 600 percent of GDP on average per Eurozone country and in the UK even over

1000 percent, but the total assets of foreign owned branches and subsidiaries did not contribute a notable share of total assets of the domestic banking system. Smaller Member States and non-euro Member States of Central and Eastern Europe were exceptions as their banking sector has mostly been foreign owned (Sapir & Wolff, 2013).

On the contrary, the integration of the wholesale banking was accelerated in the years before the crisis. But afterwards, the euro area felt a considerable fall in the proportions of cross-border interbank financing. Figure 5 shows that in the observed period (1999-2007) in the Eurozone, the foreign share of loans to MFIs, the share of foreign government bonds and the share of foreign corporate bonds had increased considerately. However, when the crisis started, these percentages lowered considerably. On the contrary, levels of cross-border lending to non-financial corporations - retail banking, were very low throughout EMU in the entire observed period (Sapir & Wolff, 2013).

Figure 5: Share of cross-border holdings of assets of euro-area MFIs in total assets



Note: The lines measure the share of intra-euro area cross-border holdings in total euro-area holdings.

Source: Sapir, A. & Wolff, B. G. *The neglected side of Banking Union: reshaping Europe's financial system,* 2013, p.4.

Because of the unstable and deficient financial system in the Eurozone, some countries had high competitive disadvantages on the account of their location and consequently, companies and households could not obtain credit as the conditions were too expensive. The problem arose when banks became very careful when lending across borders, always requiring a high premium. Additionally, as already mentioned above, cross-border retail banking did not present an important source of credit and therefore could not substitute deteriorated interbank market. The difference in credit conditions across the EU and the Eurozone have arisen. Required funding for companies and households could also not be provided through other financial-intermediation channels (i.e. capital and equity markets) as development was slow and cross-border integration limited. Under those circumstances, the investments were low and economic growth was not vital (Sapir & Wolff, 2013).

Differentiated price and availability of credit across EU countries, especially in the Eurozone, had a negative effect on the important stimulator of growth in Europe, the SMEs (small and medium enterprises). The average interest rates that had to be paid by SMEs in the peripheral countries were much higher than the rates paid by the SMEs in France and Germany, which meant that recovery in peripheral countries would be slower and less strong than in the countries with better lending conditions. Furthermore, these differences were also putting a strain on the already existing disparities in growth rates and living standards among countries (Herring, 2013). ECB boosted its liquidity to the banks in the crisis countries, but that did not solve the problem of diverging rates.

The Outright Monetary Transactions (OMT) program has achieved either stabilization or reinforcements in the cross-border activities. It was announced by Mario Draghi in September 2012 (FT Lexicon, n.d.). OMT program has been provided for preserving the ECB and its monetary policy and to properly transmit the ECB policy actions to the real economy, covering the Eurozone. OMT has enabled the ECB to discuss potential distortions in the government bond markets and has aimed to enforce an efficient backstop (Liikanen et al., 2012).

1.3 Supervisory and regulatory actions before the crisis

Creation of the European Single market has enforced the financial supervision and regulation at the European level. In the 1980s, fundamentals of the EU internal financial supervision (free capital movement within EU territories, mutual recognition of regulation and the supervisory responsibility of the host country) were enacted and cross-border financial transactions have been increasing. But holes have constantly been pointed out in the financial supervision. Large banks have operated beyond its borders, which resulted in a series of inconsistency problems as financial activities were taking place over integrated European Single market and supervisory authorities were limited inside national boundaries (KIEP, 2013).

The nationally based supervisors had several deficiencies, despite the progress made in integration of financial markets and raising importance of cross-border entities. National supervisors were still fragmented along national lines and had different levels of powers, both in respect of what were their duties as supervisors and what was their scope of enforcement actions (including sanctions) open to them, when a firm would be in violation of duties. There was a need for a framework which would execute actions on the basis of an extensive understanding of financial markets and institutions’ development (Larosière et al., 2009). For this reason, demands for reforming the financial supervision and regulation were increasing.

Frameworks of EU supervision have not been one of the crucial reasons for the beginning of the financial crisis, but it has to be noted that serious supervisory failures have been made, both from macro- and micro- prudential standpoint. Not only financial firms, but also supervisory and regulatory institutions have made radical mistakes in their risk assessments. They were overestimating the abilities of financial firms managing their risk and underestimating the levels of capital the firms should hold accordingly (Larosière et al., 2009).

Supervisors and regulators did not monitor the systemic risk, as they were focused too much on the observed entity itself. The biggest failures were made, when policymakers did not work outside the regulatory area and were not able to recognize the moral hazard placed in too-big-to fail companies as well as the external impacts of the too inter-connected-to fail companies (IMF, 2009). There was too much focus on the micro-prudential supervision and insufficient focus on the macro-systemic risks of possible contagion of connected shocks.

Micro- and macro- prudential supervision should have an impact on each other. Financial stability of individuals cannot be properly protected, if it does not consider developments of the macroeconomic environment. By supervising only individual institutions and clients, micro prudential supervision did not always include into its scope the overall financial system and its threatening risks. Nevertheless, as the goal of the micro prudential supervisors was to limit the individual failures of institutions and clients, they simultaneously attempted to alleviate also the risk of contagion and negative consequences in the field of confidence in the financial system as a whole. On the other hand, purpose of macro prudential supervisors was to reducing distress of the overall financial system and hence preventing serious losses in real output of the economy. Macro prudential supervision has to have an impact on micro prudential supervision (Larosière et al., 2009).

Financial institutions were competing against each other which tighten up the situation and consequently the national regulators and supervisors were not willing to cooperate in unilateral actions. As the crisis was evolving, supervisors in the Member States did not participate in discussions with an appropriate honesty at the early vulnerable stages of financial institutions which they supervised. Information exchange was very modest and led to deterioration of mutual confidence among supervisors.

Formal contract of understanding was missing for a successful collaboration between national supervisors and regulators. They could manage without it in their normal everyday activities as the mechanisms for information sharing and assessments for joint risk assessments were working well enough. But when the crisis occurred, every country got concerned because there were no ex-ante rules that would specify how the cross-border resolution or burden sharing should be governed. Countries were dealing with different types of risks and different resolution tools and safety nets. Small risks that were threatening to large foreign banks could cause extensive losses to the host country. For this reason, national supervisors minimized liabilities to non-residents and maximized their control of assets (IMF, 2009).

Subprime risk affected financial institutions to different degrees. It was difficult to assess the extent of exposure to excessed leveraging. EU supervisors failed to recognize the levels to which many of the EU financial institutions collected financial assets that was of exceptionally high exposure or highly complex, often in off balance-sheet constructions and later became illiquid. EU supervisors sometimes did not have all the relevant information or were even not persistent enough to get it and information was often obtained too late. Furthermore, they did not entirely comprehend the size of the risks and had inadequate skills for appropriate evaluations. The situation was even worsened because the Member States had different national systems of supervision and did not want to properly exchange information (Larosière et al., 2009).

Investment banks, mortgage brokers/originators, hedge funds, securitization, vehicles and other private asset pools belong to a category called shadow banking system. This system has not been appropriately regulated by agencies and not supervised effectively, which caused a believe that just deposit taking institutions need to be strictly regulated and supervised, in order to give the possibility to financial innovations of succeeding under the regime of market discipline. Consequences have brought failure of the market discipline and effective regulation, as banks have been avoiding their capital requirements by moving risks to connected entities in the shadow system on who's the regulators and supervisors had very little information. The shadow banking system has grown on a high scale and was big as the formal banking system which indicated that failures were not a possibility. These brought additional obligations to taxpayers that were caused by the moral hazard costs (IMF, 2009).

1.4 Measures taken

Discussions about required measures in the financial system have speeded up during 2009. Newly created Financial Stability Board (FSB) and the Basel Committee on Banking Supervision have taken the leading role. Their collaborative work soon led to a draft of new rules for trading, capital and liquidity (named Basel 3), which was published in September 2010 (Liikanen et al., 2012).

The Larosiere group (2009) defended the necessity of the harmonized set of core rules to provide an efficient Single market. In their opinion, the most relevant concern has been that the single financial market cannot operate as it should, if national rules and regulations have significantly differentiated from country to country. That kind of diversification was causing competitive distortions among financial institutions and has encouraged regulatory arbitrage. European regulatory framework was not cohesive enough. Member States had too many options when enforcing common directives, which later brought diversification of various national transpositions connected to local traditions, legislation and practice. Additionally, regulatory diversity for cross-border groups has not been efficient and in events of failing institutions, crisis management created much more problems with interference in cross-border situations.

From October 2008 until the end of 2010, EU countries used a sum of €1.6 trillion state aids (13.1 percent of EU 27 GDP) for supporting the banking institutions, in the form of guarantees and liquidity support (€1.2 trillion), recapitalization (€288 billion) and asset relief measures (121 billion). Situation was serious and perception was that the intervention by the governments was urgently needed; otherwise the consequences of this systemic crisis could be enormous for the economy. Besides the governmental state aids, the ECB and the central banks of the Member States have contributed large amounts of liquidity support to banking institutions. Situation improved by the end of 2010 and banks' positions in relation to the ECB returned to levels before the crisis. Unfortunately, problems of sovereign debt started increasing at the end of summer 2011 and Eurozone banks started once more intensively relying on the Eurosystem liquidity (Liikanen et al., 2012).

Term implicit subsidies refers to the benefits that banks or creditors received, even if they did not get any kind of explicit state aid or liquidity support. Expectations that governments will perform as the guarantors of last resort during the financial crisis, brought implicit gains to the banks. Subsidies are named implicit as there is not a contractual agreement that would specify the amount or conditions of governmental support. To the extent that banks and creditors did not pay for this guarantee, an implicit subsidy can be considered for banks that are "too systemic to fail". Evaluation of the implicit subsidy is very problematic as it depends on several factors. It becomes higher in crisis times and is connected to the strength of the sovereigns supporting the banks, the country's resolution arrangements, the banks' size and systemic importance, etc. The evidence available has shown that the transfer of resources from the government to the banking system via implicit subsidies is significant, which has caused several types of distortion (competitive distortions, excessive risk-taking, misallocation of resources to the banking sector…) (Liikanen et al., 2012).

The recovery for the real economy started in 2010, but the sovereign debt levels were becoming more critical concern for the European Union. It was assumed by the majority of institutional investors that the balance sheet of EU banks are saturated with big portfolios of government debt and consequently, there was no more trust in the EU banking system which caused that equity prices were different from banks in the other parts of the world and debt capital markets slowly, but steadily closed for most European financial institutions.

As already pointed out above, important deficiencies were exposed during the 2007/2008 financial crisis, from the structure and functioning of national supervisors to the overall financial system. Integrated and interconnected EU financial markets have proven to be unsuitable for effective functioning of nationally based supervisory systems. Weaknesses were revealed in the risks management of numerous financial institutions operating internationally. In May 2009, the European Commission (EC) proposed a number of reforms for a new institutional system of supervision. A new supervisory system, the European Financial Stability Facility (EFSF), came into effect in January 2011. Furthermore, there has been a sequence of initiatives realized to improve banking supervision and regulation. A European system set up the supervision of the financial sector and has comprised of three supervisory authorities: the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), and the European Securities and Markets Authority (ESMA) (Giuseppe et al., 2014). Additionally, the system included the European Systemic Risk Board (ESRB), operating in connection with the European Central Bank (ECB) as well as the Joint Committee of the European Supervisory Authorities and the national supervisory authorities (Algemene Rekennkamer, n.d.).

Introduction of the banking regulation Basel III modified the capital requirements in December 2010. These standards have been serving as a base for the new Capital Requirement Regulation (CRR) and Capital Requirement Directive (CRD IV), published by the European Commission in June 2013. New rules had to be applied from 1 January 2014, with the complete implementation by financial institutions on 1 January 2019 (Giuseppe et al., 2014).

Revision and reinforcement of the old Stability and Growth Pact was performed, by developing a Fiscal Compact to reinforce the surveillance and monitoring of public deficits by the EU authorities, to improve the coordination of fiscal policies and to limit the size of deficits (European Council, 2012). Simultaneously, the ECB initiated structural changes with easing the monetary conditions in countries in crisis, with a purpose of mitigating their recession, keeping inflation from negative rates, easing liquidity and funding problems faced by the banks, and making it easier and cheaper for governments to borrow. In the period following directly the financial crisis, the ECB lending rate was down to almost zero and has remained very low.

Long Term Refinancing Operations (LTRO) have been used to make banks more independent from the capital markets. Through an aggressive collateral policy, a redistribution of refinancing credit has relocated funds from those Member States with an excess, mainly in northern Europe, to those with a shortage, mainly in the south, through the bailout of banks and their sovereigns with public international credit. Lastly, the ECB announced the usage of Outright Monetary Transactions (OMT) to buy the public debt of euro area members which have been receiving assistance from the European Stability Mechanism (ESM) programs in the secondary markets under certain conditions and in potentially unlimited amounts. It achieved the desired effect of calming markets down and lowering yields on the debt of the financially weak euro area sovereigns by offering to investors insurance, similar to CDS and free of charge, when buying government bonds (Giuseppe et al., 2014).

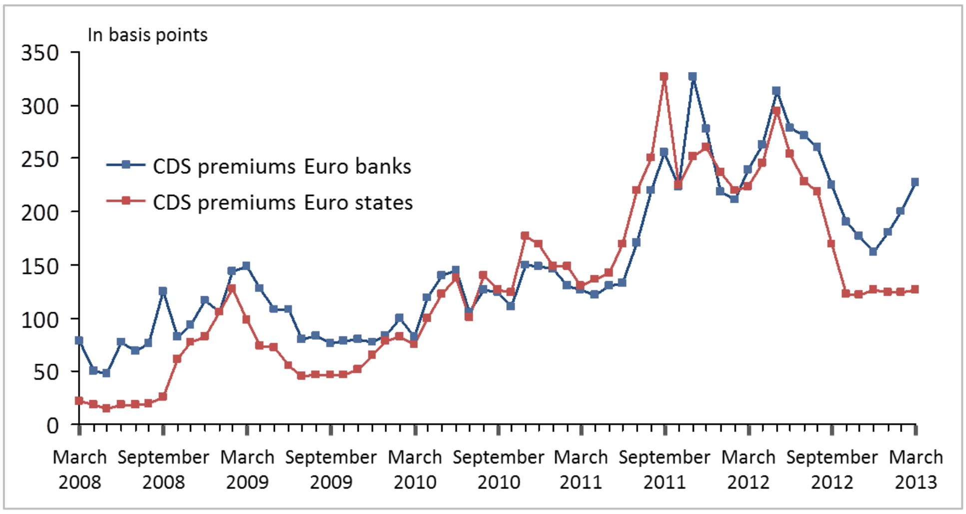
1.5 Sovereign debt crisis in 2010 encourages the creation of the Banking Union

Initial effects of the Eurozone's financial sovereign debt crisis were felt in the beginning of 2010. It started when markets stopped believing that public finances of the Member States were sustainable. This distrust came too soon and a lot of European banks did not have enough time to remove the impaired assets from their balance sheets, which were the result of the 2007-2009 financial crisis. Even the strongest and biggest banks had significant troubles with their costs and availability of funds. Hence, banking crisis came as a result of the sovereign stress and had a negative influence on economic growth and competitiveness (Van Rixtel & Gaperini, 2013).

The crisis has emphasized a strong interconnection between the weak euro-area banking and weak sovereigns and their toxic interaction has become painfully obvious. Banks have tended to hold large concentrations of claims on the home governments as it has been easy to use bonds as collateral. Political pressures from home governments were one of the negative factors as they wished to sell their bonds at least possible costs. These bonds had zero risk-weights in the calculation of risk-weighted assets, but its value declined as soon as the home country's creditworthiness did. This has caused losses to all debt holders, including the banks. Furthermore, growth and profitability expectations of the country and its companies have lowered together with the declining country's creditworthiness. Consequently, the loan losses were expected to rise and creating an additional burden on the capital positions of banks in the affected country (Herring, 2013).

The joint riskiness of banks and public debt has been obvious in the premiums for tradable credit default swaps (CDS). As seen in the Figure 6, the premiums for CDS from bank bonds and government bonds change practically uniformly (Demary, 2013).

Figure 6: Shared risk on bank debt and public debt



Source: Demary, M., *European Banking Union Status of Implementation and the need for Improvement,* 2013, p8.

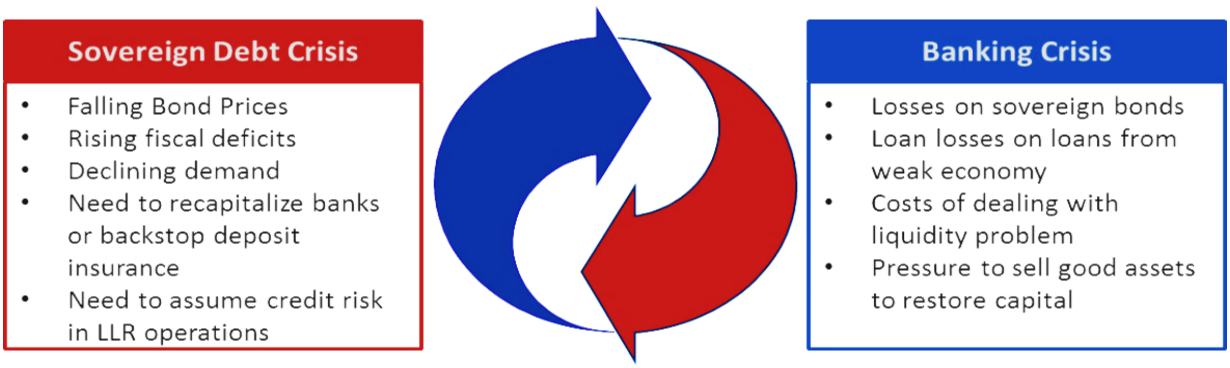
Sovereign debt crisis led to the segmentation of banking systems within the Eurozone in summer 2011. The return of the capital inside the countries' borders minimized the degree of integration of government bond markets, interbank markets and deposits, which had been increasing constantly since the start-up of the euro. Cross-border lending between Eurozone banks have reached the peak at nearly 7 percent in June 2008, but fell back to 4.1 percent of bank assets at the end of 2012, a level inferior to the one prevailing just after the euro's introduction (5.1 percent in March 1999) (Quignon, 2013).

Majority of continental Eurozone banks had still held in their portfolios large sizes of their domestic government bonds, although the diversification trend was present since the introduction of the euro. These percentages were much higher compared to UK or the US, where government bonds were not sold to banks in such volumes. For this reason, sovereign solvency problems had an immediate effect on banks. Especially the euro crisis has shown how both sides can be impaired because of this interconnection between sovereigns and banks. Since 2007, the increasing structural vulnerability reinforced the sovereign/banking crisis vicious circle. Furthermore, the EMU was weakened as well. Countries with rising concerns about its solvency saw a switch from the stable increase of the share of government debt held by non-residents (Portugal, Ireland, Spain, Greece and Italia). Germany was the only country that experienced an increase in the share held by non-residents. Consequently, national banks have become even larger creditors of its own sovereigns in the period when sovereigns were under enormous pressure (Merler & Pisani-Ferry, 2012a).

The European sovereign debt crisis has shown that creating a Single market for capital within the European Union (EU) has remained an uncompleted project. The EU Single market was based on the idea of uniform regulations at the European level, while leaving responsibility for implementing them to the national levels. On the contrary, banks' cross-border activities have called for a pan-European supervisor and central authority to intervene in crisis situations. Otherwise, bank distress could have negative external effects for other countries, without being possible for anyone to intervene as swiftly as it is necessary in a crisis (German Council of Economic Experts, 2013).

The vicious circle between banks and their sovereigns has proven how Eurozone banks and sovereigns are inseparably tied together and how its specific features make the whole system fragile. Distress in the banking institutions was spilled over to sovereigns when the governments have taken responsibility for saving their national banking systems as there has been no supranational banking resolution framework. Because the banking systems in the Eurozone have been very large in their size, high fiscal consequences have affected the country during the rescuing of a bank (Spain, Ireland). Despite the fact that the Eurozone countries have achieved strong degree of integration within the EMU, they still had responsibility of saving the banks under their control. These recapitalization costs can be enormous amounts, notably for countries with large banks and with important cross-border activities. Looking from the other side, domestic banks have held large amounts of their domestic government debt. Vice versa, the doubts about sovereign solvency have had an immediate effect on the domestic banks (Greece) (Merler & Pisani-Ferry, 2012b).

Figure 7: Toxic Interactions between Banks & Their Sovereigns



Source*:* Herring, J. R., *The Danger of Building a Banking Union on a One-Legged Stool*, 2013, p. 12.

In order to break this link between private and public debt, the banking system has to be more strongly regulated, properly capitalized, rigidly supervised and also restructured in debt. To prevent spill-overs, an appropriate recovery and resolution is needed, which will include a financing authority with adequate backstop ability. What were we able to see during the crisis is that high sovereign debts quickly emerge as a consequence of high private debts. Banks got refinancing help by the governments and that same banks were substantially investing in government bonds, depending very much on them for solvency and liquidity reasons. As soon as the level of confidence in the financial system lowered, the governments and its taxpayers became the ultimate guarantors (Wymeersch, 2014).

Two possible outcomes could resolve this problem – Eurosystem's degree of socialization would be recoded or central control would be enhanced. The first one would imply a return to the system of harder budget constraints intended by the Maastricht Treaty where ECB would stop bailing out banks and their sovereigns with cheap refinancing credit, collateralized with below-investment grade government bonds. TARGET2[1] balances would be settled in such a way that the differences in the interest rates would emerge and would reflect the differences in bankruptcy probabilities, and markets would be responsible for the allocation of capital to rivalling risky assets. There would also be a possibility of eliminating risk premia in interest with the policy of undercutting market conditions, but constraints would be imposed on banks and their sovereigns for preventing moral hazard, ensuring prudent lending and borrowing, and steering the allocation of scarce capital to rivalling uses. But the euro area countries have rather chosen to go forward with the second option. Continuing as a lender of last resort, the ECB will also act as a single regulator and supervisor (Giuseppe et al., 2014). In order to reimburse the trust in the banks and the Euro currency, it has been clear that the connection between banks and their sovereigns has to be broken. Policymakers have concluded that an extensive strategy was needed to tackle this problem (Deloitte, 2013).

As reasoning behind the European decision to introduce a Banking Union was the decision made by the ECB Council to act as a lender of last resort to troubled banks in the euro area. TARGET2 balances accumulated and as a result they peaked at 1,000 billion euros in summer 2012, in the GIPSIC countries. When the crisis came, the ECB bailed out the banks and their sovereigns to avoid the bankruptcy, even though it was not intended as a lender of last resort, not by its own statutes and or by the Maastricht Treaty. Thus, ECB wants to supervise the banks, keeping in mind the minimization of its own investment risk (Giuseppe et al., 2014).

In June 2012, the Presidents of the European Council, European Commission, Eurogroup[2] and European Central Bank published a joint report "Towards a Genuine Economic and Monetary Union " that is defining relevant and necessary future parts of the EMU: the Banking Union,

[1] TARGET stands for Trans-European Automated Real-time Gross settlement Express Transfer system. It is an interbank payment system for the real-time processing of cross-border transfers throughout the European Union. It can serve as a barometer of cash flows and imbalances within and among the various member countries. (Höfert, 2012).

[2] Finance ministers of countries whose currency is the euro.

the Fiscal Union, a Competitiveness Union and a Political Union (Wymeersch, 2014). These building blocks would integrate financial, budgetary, economic policy framework and empower democratic legitimacy and responsibility. European Council asked for a specific plan which would help to achieve such genuine Economic and Monetary Union and for addressing the negative feedback loops between the sovereign crisis and banking sector, EU financial fragmentation, and macroeconomic imbalances. As the first step, which has been followed by a specific call from the Euro Area Summit on 12 September 2012, the European Commission presented legislative proposals for the establishment of a Single Supervisory Mechanism (SSM) in Europe, with a vision of succeeding with further progress on the Banking Union (Liikanen et al., 2012).

2 SINGLE SUPERVISORY MECHANISM

2.1 Concept and progress

The prime objective of supervision is to provide a proper implementation of the rules which are relevant for the financial sector for preserving financial stability and thus ensuring the overall confidence in the financial system and sufficiently protecting customers, using financial services. One of the important supervisors' functions is also to identify issues so quickly that there is still a possibility of preventing the crisis from occurring. We can say with certainty that there will be occasional missteps, but then it will be essential for supervisors to manage the crisis in an effective way to prevent the damage for a wider economy and overall society (Larosière et al., 2009).

Traditional argument for centralized supervision lies in the difficulties of coordinating single financial market and strength of the financial stability, while supervision is decentralized and executed at the national level. It presents a triangle of incompatibilities known as a financial trilemma (Quignon, 2013). During its growth, the EU banking sector also became integrated to a greater extent. Cross-border activities were formed by numerous banks and were soon outgrown by their home markets.

Move to an integrated system was considered necessary, since the coordination of national banking supervision, especially for the euro area was no longer an option. Given the joined monetary responsibilities and tighter financial integration, there has been a specific risk in the Eurozone in terms of cross borders spill-over effects in the case of a troubled banking system (EC, 2012b). The problems occurred when it was clear that supervisory and regulatory authorities of the banking system were vulnerable. Under those circumstances, financial stability could not be protected, as financial institutions did not have enough capital of good quality and quantity. Furthermore, to preserve financial stability, many banking sectors needed help which had to be provided by the governments (EC, 2013a).

Supervisory arrangements have differed substantially across Europe and have been very much fragmented. Numerous reasons exist: different economic and financial system, legal reasons, different bureaucracy and politics, history influences, missing optimal supervisory structure, etc. Despite the effort of increasing integration over the years, diversity in the economic and financial systems across EU still existed. Biggest concerns of the small nations were that differences between countries will not be taken under consideration when implementing centralized supervision as it is possible that some supervisory measures would be good for Germany but not for Slovenia and the other way around (Elliot, 2012).

Functioning of the national supervisory regimes was the result of implementing detailed harmonized EU rules at the level of national supervisory agency. As a result, despite the harmonized EU rules, the individual supervisory systems had important differences regarding supervisory strictness, methodology and authority. Not only has this caused high diversification among the countries which led to distortion in banking groups, operating in several countries, it also prevented a comprehensive view on the overall EU banking sector. The risk of contagion was increasing and was preventing realization of the internal financial market. Furthermore, the old regimes created problems to banks that were operating in several countries as they operated under non-harmonized rules of the national supervisors which brought high administrative burden and costs (Wymeersch, 2014). Crisis has indicated how supervision has, structured along national lines, been setting back the aim towards robust and coherent supervisory model for supporting the financial integration in the European Union (ECB, 2013).

The establishment of the Single Supervisory Mechanism represents the first major decision which is leading towards formation of the Banking Union. The goal is creation of an integrated framework for the financial sector, as written in the report »Towards a genuine Economic and Monetary Union«, (ECB, 2013). The purpose of supervision is to ensure bank soundness by verifying and enforcing prudential rules and providing discretionary powers to control risk taking (IMF, 2013b). The decision for creating SSM aims at terminating the diversity by establishing a centralizing prudential supervision under single authority that will pursue the goal of ensuring the common rules are enforced in all situations and in the same manner.

SSM will build more functional banking supervision and will be committed to provide an integrated internal market for financial services. It will prevent financial institutions of individual countries to take advantages of their own differentiated supervisory regimes and will provide better conditions for more effective cross-border activities. Despite the fact that functionality of the banking supervision and banking market integration in the Eurozone will definitely be improved, it will not be enough to build a fully integrated market for financial services. Numerous factors will still have an effect and will continue enhancing differences in national markets, i.e. differences in financial techniques and traditions (comparing mortgage markets, legal regimes in terms of the company law, tax differences, etc.) (Wymeersch, 2014).

Legislative proposal of the EC in September 2012 was presenting the next step from the approved agreement to create SSM by the euro-area leaders in June. The proposal was drawn up by two pieces of legislation. The first one was a Regulation, which included the establishment of SSM based on the Article 127(6) of the Treaty on the Functioning of the EU (TFEU) which defined the required unanimity between Member States in the Council for confirmation of Regulation. The second one was a Regulation, dealing with modification of voting rights in the EBA which has been the central body of the European Union that was handling supervision of individual banks. Normal EU legislative procedure was required for the adoption of this Regulation, which involved an agreement between the Council and the EU Parliament (Verhelst, 2013).

Proposals have been an important step in reinforcing the EMU. Unanimous agreement was reached in the December 2012 meeting of Finance Ministers (ECOFIN), followed by trilogue agreement in March 2013. On 18 April 2013, the Council of the European Union and the European Parliament (EP) reached an agreement on the establishment of the SSM and on 25 April 2013, the Council of the EU published the final compromise texts (Huber, von Pföstl, 2013). The Parliament gave its final approval in September 2013 (Deloitte, 2013). The Regulation has been adopted by the Council on 15 October 2013 and it has been one of the most significant steps in creating internal market for financial services (Wymeersch, 2014). The Regulation on the SSM came into force on 3 November 2013 and the ECB will take over its full supervisory tasks from 4 November 2014 onwards, meaning 12 months after Regulation entered into force.

ECB will take over the responsibility of ensuring consistent SSM operations and keeping system’s effectiveness at the high level. SSM will consist of ECB and the national supervisory authorities of the Eurozone. Non-euro countries will have the possibility of cooperation through creation of close collaboration with the ECB (Council of the EU, 2012). There are number of reasons that give a green light to the implementation of a unified supervisory system. The most importantly needed achievement is to gain back public confidence in the financial markets which has seriously been damaged by the crisis and has on one hand been the reason for the created huge loses in the banking sector and has on the other hand undermined confidence in sovereigns. Overall, it has been creating negative feedback loops in the banking sector and endangering the common currency (Wymeersch, 2014).

The main goal of an efficient supervisor is not organizing actions which would ensure that no bank would ever fail or preventing banks from taking risk. Better solution would be to create an appropriate balance between risks and rewards in the private sector, particularly for owners and managers of the banks. If banks would not be able to take risks at higher levels, then innovation growth would be limited. Bankers, together with their investors, would have to accept the consequences if any risk investment would be unsuccessful. Even if the ECB would do its job in the best possible way as the single supervisor, there would still be bank failures (Gros & Schoenmaker, 2013).

2.2 European Banking Authority

The European Banking Authority has been formed at the start of 2011, under the impact of the financial crisis and has been responsible for grouping the banks' supervisors of all the Member States. It is a coordination body of the EU bank supervisors and contributes to regulatory and supervisory standard setting of the EU. Its tasks cover issuance of technical standards in regulatory and supervisory fields and contribution to the consistent application of EU legislation in regulation and supervision. EBA tasks cover planning and organization of peer review analyses of authorities responsible, which also covers issuance of guidelines, together with recommendations and identification of the most successful practices in order to promote supervisory integration. It is responsible also for addressing breaches of EU law and coordinating and ensuring high quality of the EU stress tests execution. Furthermore, it also has the role or ensuring smooth functioning of supervisory colleges[3], including by mediating disagreements. Additionally, it is expected of EBA to be prepared on providing banking consultation to EU institutions, as well as on payments and e-money regulation, corporate governance, auditing, and financial reporting. It also has a back-up enforcement authority in specific cases and under strict conditions and safeguards (IMF, 2013b).

2.2.1 Single Rulebook

As the Banking Union represents a major shift in the institutional set up, it calls for a higher degree of ambition. The European Banking Authority will retain its current role but will additionally exercise its powers and missions for the ECB. In particular, it will continue to develop the Single Rulebook, a truly uniform and integrated set of rules for banks in the whole Single market. If the national discretions were to remain, they would complicate enormously the task of the SSM, which would then be required to enforce different rules for banks falling under its responsibility.

The Single Rulebook is a very simple idea at the core of the reform advised by the Larosière report, which led to the establishment of the EBA. It enforces technical rules, adopted through the EU Regulations and applies in all the EU Member States and give no space for national choices. The EBA is responsible for the key parts in the design of technical standards (Enria, 2013).

During the crisis, financial institutions' reactions have been very different. Some were strong enough to process all the market shocks and have shown their resilience. Others have not been successful when trying to resolve their situation. The most important disparities were in the areas of the liquidity management, capital levels and their effectiveness of internal and corporate governance. This has been good enough reason for updating the Basel agreement and providing new regulatory rules. The overall purpose has been to enable better rules that will be providing more sustainability to banking institutions of the EU, which will enable

[3] Colleges are a mechanism for the exchange of information between home and host authorities, for the planning and performance of key supervisory tasks in a coordinated manner or jointly, including all aspects of ongoing supervision, and also for the preparation for and the handling of emergency situations (EBA, n.d.).

them to react better when absorbing economic shocks and help them to maintain economic activity and growth (EC, 2013a).

Single rulebook is provided for the banking sector through the introduction of the CRD IV, based on the new bank liquidity and capital requirements, established by the Basel Committee (Basel III). The Basel Committee issued specific instructions of new global regulatory standards on bank capital adequacy and liquidity called Basel III, in December 2010.The legislative package CDR IV was adopted by the European Commission on 20 July 2011 (Quignon, 2013). It applies from the 1 January 2014.

At least two reasons exist why Basel III could not be simply copied and pasted into the EU legislations. Firstly, Basel III is not a law, but an evolving set of internationally agreed standards. Secondly, the Basel capital adequacy agreements take into consideration only internationally active banks, but all the banks are, together with the investment banks, in the scope of the EU legislation (EC, 2013a).

New framework is now dividing the old CRD into two legislative parts. The first part is a CRD, a directive which is responsible for accessing deposit-taking activities. The second part is CRR, a regulation that provides prudential rules that have to be respected by the institutions. The directive has to be incorporated into individual laws by the Member States, but the regulation is directly applied and it has an instant effect, in the same way as a national instrument. This speeds up regulatory processes and as national differences are eliminated, reactions to differentiated market conditions are easier and more successful. CRD IV is the backbone of the single rulebook and they form, along with harmonized deposit protection schemes and a European recovery and resolution framework, essential parts of a stronger financial framework that applies to all the EU members. The goal of the single rulebook will be to pursue an pan-EU banking sector which will reflect resilience, transparency and efficiency (EC, 2013a).

Respecting unique rules by all the banking institutions competing in the European market, is a prerequisite for the integration of the single rulebook, which already exists in a substantial way and aims to provide support for the effective SSM (ECB, 2013). According to the SSM regulation, national law will remain relevant for those matters that are governed by the EU Directives or where the ECB has no relevant powers and instructs national authorities to act in accordance with national law. Thus, the wider the span of the Single Rulebook application, the less heterogeneous will be the rules that the ECB applies to banks in different Member States. Nonetheless, it would be very difficult to justify that a supervisory authority does not apply same rules to two, otherwise identical, banks under its jurisdiction, just because banks' headquarters are located in different countries. Single Rulebook is also required to provide a common view on banks operating in all Member States, irrespective of whether they participate in the SSM or not. Single Rulebook also has a central role in underpinning market discipline in the EU. Data of the European banks were not truly comparable and consistent. Since its establishment, the EBA has put a lot of emphasis in enhancing the quality and comparability of bank disclosures. The first step was accomplished by the 2011 stress test, where around 3,400 data points for each bank participating in the exercise were published (Enria, 2013).

2.2.2 Changes in the voting procedure

The update in the EBA voting procedure is the so-called double majority voting that will be required for different formats of decisions (breaches of EU law, binding meditation). Double majority will ensure that certain decisions will be accepted by both sides – by majority of SSM members and by majority of non-SSM members. The novelty was considered necessary as EBA decisions were agreed by all the national supervisors of the Member States and these decisions could be, with the SSM establishment, easily overruled by the members of the SSM, even if only euro-area members would be included, as they would hold the simple majority. Consequently, the above mentioned safeguard had to be incorporated into the agreement to protect the interest of the non-SSM members (Verhelst, 2013). For regulatory decisions of horizontal nature (e.g., draft technical standards, guidelines, recommendation) the principle of qualified majority is also combined with a requirement for a double simple majority. After the plenary vote in the Parliament, the Council compromise has been accepted on 22 October 2013. The relevance of these changes is somewhat uncertain because the votes of the EMU members present the majority in the EBA voting today, if the voting is unified (EU Monitor, 2013). This voting agreement enables normal functioning of the EBA, but only until large number of non-euro countries will not be participating as member of the SSM (Verhelst, 2013).

Additionally, the EBA has to take up a new role in safeguarding the integrity of the Single market. When looking at the data, EBA has been monitoring 43 large EU cross-border groups in 2013, but just five of them were operating only within the Eurozone. More than 60 percent of banking groups with headquarters in the Eurozone have important market shares in the rest of the Members States and the same share of non-euro groups do an important part of their business in the Eurozone. This means that the EBA will have to start playing a new role in ensuring that the SSM and the other competent supervisory authorities in the EU develop unified supervisory methodology and practice, which can support stricter cooperation in supervisory colleges and the possibility to efficiently predict and deal with the crisis of a cross-border group. The Single Rulebook is definitely also an essential ingredient in the repair of the Single market (Enria, 2013).

2.3 European Central Bank as the Single Supervisory Authority

The role of the responsible single supervisor of the largest banks in the SSM will be taken over by the ECB. Under the discussion, a few members of the EU Parliament have suggested creating a special body that would be in charge of the banking supervision, but in terms of legal reasons, changes would have to be made in the Treaty, which is normally a very lengthy process that would not be feasible in the short term and would spend a lot of time and energy, generating different rivalries and wishes that could have negative consequences for the financial market. ECB is the only institution that can execute interventions without changes in the law, as specific provision in the Treaty enable ECB to execute prudential responsibilities. The important characteristic is also the ECB reputation. Despite these facts, the decision has generated certain concerns, specifically focused on the facts that too much responsibility will be in hands of one institution, consequently the accountability will have to be strengthened and awareness about the potential conflict will have to be raised. Overall, it is also important that the monetary function should stay under the protection of strong independent safeguards and should not be connected to the functioning of the supervision (Wymeersch, 2014).

Some gave an opinion that prudential supervision should be under the responsibility of the EBA, as it has already started its activities in 2011 and its responsibility has been to provide soundness, effectiveness and consistency to regulation and supervision. But under the EU Treaty, it is not allowed that discretionary decisions are delegated to independent bodies and there are also additional obstacles for placing the EBA at the top of the SSM as it coordinates and provides cooperation for 28 national regulators, not only for the 18 Eurozone authorities, and furthermore, its activities are in majority focused on regulation and standard settings, not to supervision, while the ECB’s role is to provide an independent supervision. It is expected that the EBA will continue with its functioning and will ensure that the regulation remains equally accepted by all the EU Members (Wymeersch, 2014).

The decision of choosing the ECB as the single supervisor was the best fit. There is a possibility of risk when giving too much power to the single institution, as well as possibility of increased conflicts due to different objectives about price stability and financial stability. Nevertheless, the advantages are that the ECB is a well-established independent and credible institution in the Eurozone. Furthermore, the role of supervisor will be a great support to its lender of last resort function and will also strengthen its bonds with central banks that already have the function of supervisors in the euro system (Silicia et al., 2013). It will also receive help from national supervisory authorities as they have several years of experience in supervision. This collaboration includes assistance with regular daily assessments of banking situation and related inspections (Council of the EU, 2012).

The institutions with which the ECB will also be closely cooperating are (Wymeersch, 2014):

- Supervisory Agencies at the EU level - EBA, EIOPA, ESMA; the ESRB and the national supervisors which are all the part of the European System of Financial Supervision (ESFS);
- with present or future authorities responsible for banking recovery and resolution plans at the national level, and later at the European level as well;
- the EFSF and the European Stability Mechanism (ESM), particularly in regards to granting financial assistance as the latter will trigger direct ECB supervision.

2.3.1 Scope of ECB supervision and its tasks

Supervisory tasks performed by the ECB, will be covering the banking system or more accurately, the “credit institutions” that are by definition businesses, which focus on receiving deposits or other repayable public funds and granting credits for their own accounts (EUR-Lex, 2013). But the Treaty in its Article 127 (6) enables the possibility for other financial institutions, which are not covered by SSM, to be included under the SSM responsibility. Argument on specificity has excluded insurances from the Treaty. Supervisory tasks of banking and insurance systems are becoming increasingly compliant and together with their systemic significance, there is a high probability of possible further supervisory integration. Supervisory tasks on non-banking activities under national supervision will also be of SSM concern as these activities will repeatedly have a direct effect on the risk profiles of different banking groups (Wymeersch, 2014).

Should SSM cover all banks, not taking into account their size, complexity and cross-border reach? Considering that there are 5000-6000 institutions in the Eurozone and many have not significantly affected the financial status of the Eurozone, the argument has been made for restricting the ECB’s role and suggesting supervision at the national level. Looking from another perspective, often mentioned examples, Northern Rock and the Spanish cajas, have demonstrated how can small institutions have a contagion effect on the entire financial system and consequently cause a crisis that is much more expanded compared to the size of institutions involved (IMF, 2013b).

The Spanish cajas (regional savings banks) have been at the center of the Spanish real estate crisis, which has driven the financial crisis in Spain. Unlisted regional savings banks were for years controlled by a mixture of local politicians and depositors and were operated in many cases “by regional barons as development banks that could further their political purposes.” These banks were closely held and were lacking independent shareholders, which resulted in improper corporate governance and virtually non-existent risk management. Consequently, these banks financially supported local real estate growth, unfeasible on the long run. Many of the cajas lost huge amounts of money after Spain's property bubble burst in 2008 and left them seriously damaged or actually insolvent. As a rescue plan, the Bank of Spain had chosen to merge this cajas with other banks. Bankia was one of the creations of seven cajas, merging in December 2010. All of them had serious financial difficulties and there was high risk of bankruptcy on account of failed property loans, if the merger would not been executed. In May 2012, largest bailout in the Spanish history, in the amount of €19 billion, has been applied by Bankia. There were also other unsuccessful mergers – Caja Unnimm Caixa Catalunya and Nova Galicia Caixa. Data of the International Monetary Fund (IMF) have shown that over 50 percent of Spain’s large and medium-sized banks have partly or fully been depending on the help of the state (Coppola, 2012).

UK experienced a visible bank-run in August 2007, after 100 years. Medium-sized bank Northern Rock experienced a £3 billion deposit withdrawal. The deposit run started as soon as it became public that the Bank of England provided liquidity aid for the bank and it was confirmed by the regulators that the bank was solvent. The run stopped, when the authorities promised 100 percent deposit guarantee for Northern Rock and other possible distressed UK banks. In 2008, it was nationalized by the British Government. The breakdown of the

Northern Rock was partly a misstep of UK regulatory and partly a failure of their mechanisms and has caused a severe hit to the financial system stability and credibility of financial regulatory and supervisory systems. Shortcomings of the UK system, when dealing with distressed banks, have been disclosed. Difficulties were the consequence of the weak deposit insurance guarantee structure, regulatory oversight and legal structure regulating failures of the banks (Bruni & Llewellyn, 2009).

From the political perspective, the restrictions were very much supported in Germany where numerous small local banks have been located and their political support has been important. Even from the technical point of view it does not seem possible that 5000-6000 banking institutions could be supervised from a single location. A large number of supervisors would be needed, which would bring cultural and language differences, together with inefficiency and huge costs (Wymeersch, 2014).

Despite the high number of banks, only the biggest 150 present approximately 80 percent of banking system assets which has required clarification regarding the degree of delegation. ECB's supervisory tasks will be focused on banking institutions and groups that belong to the category of "significant" entities. Determination of those entities has been one of the important tasks as it specifies also the labor distribution between the ECB and national supervisors. Under the adopted agreement, a bank is considered to be significant, when it fulfills at least one of the following criterions (Verhelst, 2013):

1. If the amount of the bank's assets is more than €30 billion. This criterion enables that the biggest banks of the SSM members are directly supervised by the ECB.
2. If the amount of the bank's assets is more than €5 billion and 20 percent of the SSM member's GDP. The precondition of 20 percent of GDP involves only the SSM members with a GDP lower than €150 billion.
3. If the bank is one of the three most important banks of the SSM members.
4. If the bank has extensive cross-border activities.
5. If the bank gets help from the euro-area bailout fund.

The category of "less-significant" banks is represented by approximately 98 percent of euro-area banks. This category will still be supervised nationally by SSM members, with the ECB being the final responsible supervisor under the SSM structure (Verhelst, 2013).

Methodology "Framework Regulation", prepared by the ECB, will provide results that will enable the banks' segmentation. The analysis in a specific SSM member state should be consolidated at the highest level and should include the parent company, the financial holding company or mixed financial holding company. An exemption of "special circumstances" in this methodology enables the ECB to decide that a specific entity should stay nationally supervised (Wymeersch, 2014).

The supervisory responsibilities of the ECB will include these tasks (EC, 2013b):

- Empowerment or withdrawal of the authorized persons in all Eurozone credit institutions,

- Assessment of acquisitions and disposals of the bank's holdings,
- Ensuring compliance with required EU banking rules and setting more prudential requirement if needed for protection of financial stability,
- Implementation of supervisory stress tests to properly deal with the review of the supervision and carrying out supervisory tasks on a consolidated basis – this will be executed beside the EBA stress tests,
- Close cooperation with the national authorities,
- Carrying out complementary supervisory tasks in credit institutions in financial conglomerates,
- Applying prerequisites to credit institutions (having robust governance processes and mechanisms and adequate internal capital assessment processes),
- Carrying out supervision, in connection to promptly interventions, when the viability of banks' existence is at risk.

2.3.2 Responsibilities of national supervisors

Functions of national supervision by the authorities in the SSM member will stay at the important level. National supervision will be responsible for all the tasks that are not specified in the SSM regulation. These involves supervision of credit institutions from the third countries, the establishment of a branch or ensuring cross-border actions in the EU, supervision of payment of services, imposing financial penalties when EU legal perspective would be breached (exceptions are breaches of the ECB law). Supervision at the national level will also include daily supervisory tasks of "less-significant" banks. Generally speaking, a lot of daily tasks, which include actions of verifying, preparing and implementing ECB's acts, could be performed by the national supervisory authorities (EC, 2013b).

Nonetheless, ECB has the ultimate responsibility to provide efficient and coherent activities for the entire SSM and the relationship, formed by the ECB and the national supervisors can be defined as cooperation between different degrees of supervision. However, national supervisory tasks should not be underrated. National supervisors will form, together with the ECB, cooperating teams. The national supervisory members are needed to ensure linguistic and cultural support and also to provide knowledge and expertise from their past supervisory experiences.

National supervisors will take part in the implementation and enforcement phase - they will also investigate, inspect, gather information for possible sanctions and provide assistance to the ECB when authorization by the court is needed for on-site inspections. Ultimately, national supervisors will also participate in the Supervisory Board. The ECB responsibility will be to provide guidelines, regulations or general instructions and will require from national supervisors to ensure regular information regarding supervisory materials, to create evaluations and/or forward ECB draft decisions. Whenever necessary, the ECB can, on its own or after talking with the national supervisors, take over direct supervision, to retain the quality of requirements (Council of the EU, 2012).

2.4 Supervisory decision-making authorities

The decision making in the SSM consists of the following ECB bodies: first is the new Supervisory Board, mainly represented by national supervisory authorities and the second is the already existing Governing Council, the most important decision-making body of the ECB. Supervisory Board is the main body and its responsibilities cover the supervisory functions of the SSM. It is also the main decision-making body, even if an individual decision is formally and finally adopted by the Governing Council of the ECB. When defining the responsibilities of the Governing Council, it cannot change the decision of the Supervisory Board, but only prevent their entry into force with exercising its power of veto, but only if strongly supported with facts, e.g. by monetary policy reasons (Hakkarainen, 2013). However, this power will not be frequently used. Normal ECB supervisory operations will give the main decision-making responsibility to the Supervisory Board. Its voting participants are (Verhelst, 2013):

- Chair, elected by the Council of Ministers,
- Vice-chair, chosen among the members of the ECB's Executive Board,
- Four Representatives of the ECB, who will be assigned by the ECB's Governing Council and will not have the right to carry out tasks, connected to monetary policy,
- Representatives of individual national supervisors of SSM members,
- In addition, the EC will participate as a non–voting observer.

The Chair (Danièle Nouy from December 16, 2013) will be an important independent figure. She has been chosen for this five-year function based on her experience in banking and financial matters, with no possibility of renewal, which insures her independence. She cannot be a member of the Governing council or the national supervisor.

Supervisory Board will decide by a simple majority. In a situation where the voting would result in a draw, the Chair's vote concludes the voting. Exceptions to this general rule will be required for the ECB regulation and should be modified in accordance with the Union law. Decisions about important regulations will have to be confirmed with the qualified majority voting, giving larger weights to the biggest Member States. The activities of the Supervisory Board will be backed by a Steering Committee, which will be responsible for preparation of the meetings, but will legally not have any decision-making powers.

Only possible intervention of the Governing Council is a blockade of a Supervisory Boards' decision and could be used in exceptional cases. The Governing Council has the following structure:

- The governors of individual central banks in the euro-area
- ECB Executive Board members. The Executive Board is dealing with ECB's operational tasks. It consists of six members and includes the President and Vice-President of the ECB, who are chosen by the presidents or prime ministers of the Eurozone members.

Mediation Panel is a body that is activated when the Governing Council has objections to the draft decision of the Supervisory Board. Mediation Panel is active in the areas where the draft decision is negotiated. Individual SSM Member States can appoint one member of the Supervisory Board or the Governing Council. Simple majority is a condition for confirmation of the agreement and each member has one vote. The mediation time period is not specified in the SSM regulation (Buch et al., 2013).

The structure of the Governing Council does not include participants of all the EU members. The countries left out are the non-euro countries. This group is not automatically entitled to be a part of the Governing Councils' meetings. If deemed necessary, ECB's Rules of Procedure allow the invitation of external people. Given these points, the problem are the voting rights as the Treaty states that non-euro countries cannot vote in the final decision-making body of the ECB and are not obliged to take into consideration decisions made by the ECB (Verhelst, 2013).

Consequently, the non-euro Member States do not have a possibility of becoming an equal member of the Banking Union when talking about equal rights and duties as euro-area countries. Therefore, a special type of cooperation had to be planned for the non-euro Member States, named "close cooperation agreement". If decided by the non-euro country to enter in this voluntary agreement, it needs to take into consideration three applicable requirements that are also relevant for the euro-area countries (Verhelst, 2013):

1. All banks should be included in the SSM,
2. When referring to information sharing with the SSM, the country should be cooperative in all aspects,
3. The Member State should obey the ECB decisions regarding supervision.

Termination of the cooperation agreement between the SSM and the non-euro area member is possible by the member state, three years from joining the SSM. Termination is also possible if the non-euro area member does not approve the draft decision of the Supervisory Board. The cooperation agreement can be again signed after a three-year period. ECB also has the right to terminate or suspend the member if the evidence has shown that it does not take into consideration the cooperation rules, if it declined incorporation of supervisory rules called by the ECB or if it does not agree with the Governing Council opinion about the draft decision of the Supervisory Board (Buch et al., 2013).

A visible characteristic that is different between banking institutions based in the euro- area and the ones that are not, is the fact that the ECB cannot ask from the non-euro member to directly take into account its decision, but it has to firstly forward it to the national competent authority which is later responsible for banks' implementation of these rules (Verhelst, 2013). The proposal states that each participating country has the right of one seat in the Supervisory Board. This seat can be represented by the national central bank or some other competent national institution. In more than 50 percent of Eurozone countries, central banks deal also with the supervisory activity, which ultimately means that Supervisory Board will in majority have the same members that have already been dominating in the Governing Council, i.e. the national central banks (NCBs). Prevalence of the NCBs in the Board and Council could be reduced by full cooperation of the non-euro area members (Beck & Gros, 2012).

Regulation mentions very little on how to cooperate with the third countries, whose banking institutions cooperate across the border with the countries of the EU. National rules still apply here and where appropriate, the European directives. SSM scope of operation only includes banks headquartered in the euro area and banks of non-euro members. Therefore, the ECB could only contact the third countries, trying to agree on certain administrative agreements with its supervisors, but could not seriously influence on any activity or impose any legal obligations for these countries (Wymeersch, 2014).

According to the SSM Regulation, the ECB will be obliged to be fully accountable to the EP and the Council. It should also prepare reports on an annual basis which include descriptions and justifications of its supervisory tasks and responsibilities. It will be provided for the EP, the Council, the Eurogroup and the EC and will be submitted to the national parliaments of the SSM members (Buch et al., 2013).

2.4.1 Separating monetary and supervisory functions

Different authors could not completely agree on the separation of the supervisory and monetary policy which is in the hands of the ECB. Even though the formal separation of monetary policy and banking supervision exists, many experts see possibilities of functions conflicting each other within the ECB. Some are concerned that the ECB could be in the way in case of the resolution of a bank operating transnationally, when cross-border contagion has affected other banks, leading to a systemic banking crisis and preventing the ECB from implementing its monetary policy. According to Verhelst (2013), there are two facts that can confirm this matter. The first one takes into consideration a problem of supervisory and monetary activities being incompatible. For illustration, a troubled bank would receive liquidity assistance that could provide stabilization for the financial system but would at the same time cause higher rates of inflation. ECB, as the supervisory authority, could take that kind of consequences into consideration when executing its monetary tasks. The second one mentions the possibility of supervisory misjudgments having an effect on the overall ECB reputation. In either case, supervisory misjudgments cannot be entirely prevented, as they depend on the decisions of the decision makers.

On the other hand, Beck & Gros (2012) support the fact that absolute separation of supervisory and monetary activities does not make sense in difficult financial circumstances as maintaining stability of the financial system in that times has a big negative effect on the monetary policy, which purpose is to provide low, but stable inflation rates and has to be prepared to correctly react when there is a possibility of high medium-long term inflation and short-medium term deflation.

Involvement of the ECB in the SSM is beneficial. Supervisory data support monetary activities and its responsibilities of the lender of last resort. Nonetheless, both functions could not be working successfully, if managed from the same house as it could possibly cause difficulties between the trade-offs, i.e. monetary activities could affect the solvency of the banks or liquidity help for troubled banks would be required for maintaining financial stability. Another problem could also be the conflict of interest, when the ECB as a supervisory authority would be obliged to take away the bank's license and start a resolution process, which would cause losses for bank customers (IMF, 2013a).

To prevent the two-sided influence, the legislation has been focused on completely separating the two functions. The SSM regulation has enabled shields that are important for minimizing the possible negative interactions between the monetary and supervisory function (Council of the EU, 2012). According to the Council Agreement, a strict division of people employed will take place as well as the already mentioned process in the decision-making. Supervisory decisions are prepared by the Supervisory Board which is not included in the other ECB activities. Even though, the measures for separation are taken, the separation will never be completed, neither on European or national level. Most of the NCBs have a role of national supervisory authorities and are members of the Governing Council that is in charge of monetary activities. Additionally, Governing Council also participates in both, monetary and supervisory activities (Verhelst, 2013).

2.4.2 Financing the SSM

The ECB will need to collect the funds that will provide effective decision-making and successful management of the SSM. The funds should be provided by the banks as they represent involved entities (EC, 2013b). Separate supervisory fee will ensure the financing of the ECB's supervisory activity, accounted directly by the ECB. The ECB fee will be depending on its expenditure related to its responsibilities under the SSM, together with the size and the seriousness of the exposed risks. Expenditures will be covered by supervised banks, including branches with the location in the non-SSM Member States. At the same time, the national supervisory authorities will still be able to impose charges for their own activities that will not be in connection to the ECB's instructions. Coordination of both has been published for the public consult and will take into consideration the analysis of costs and benefits (Wymeersch, 2014).

The ECB made a rough estimation that the SSM will spend around €260 million in 2015. Fees will be collected from November 2014 onwards and until then, the ECB will cover any costs by itself. ECB is planning to charge up to €15 million per year in supervisory fees. Banks which will be the subject of direct supervision will be paying between €0.7 and 2 million. Banks that will not the under direct supervision will be paying between €2,000 and €200,000 (national fees are not included) (Gordon & Randow, 2014).

2.5 Comprehensive Assessment

SSM will be responsible for 120 banks that hold assets worth 250 percent of the euro area's GDP and their capital is equivalent to only 4 percent of their assets' value. Overall, they have not made any profit over the period of last four years (2009-2013) (Gros, 2013).

Before the ECB will officially take over the supervisory responsibility of the majority of the banking system, comprehensive assessment of banks' balance sheets has been executed. These assessment results will provide the basis for negotiations and restructuring plans for the entities which have had too low levels of capital (Véron, 2013). The balance sheet assessment is the key element in rebuilding the confidence, where the potential weaknesses in banks' balance sheets will be addressed (Hakkarainen, 2013).

The comprehensive assessment quality review will be very important as it counts as a beginning test, which will uncover how credible the ECB is in its supervisory activities. Under the Article 27(4) of the SSM Regulation, the ECB is given a direct access to information and this information are very important for the high quality assessment which will provide a division of examined banks into three groups: banks with adequate levels of capital, banks with capital needs that can be fulfilled and banks that are significantly undercapitalized or insolvent and call for public intervention instead of insolvency procedures (Véron, 2013).

This first ECB test is almost entirely dealing with the logistic and technical aspects that ECB has to complete. It requires capabilities to efficiently decide on the required capital needs of the banking institutions, involved in the evaluation. The enormous extent of this challenge is exacerbated with the complexity of different EU banking structures and missing knowledge as well as experiences of the ECB regarding supervision. The second test presents the possibility of a mismatch of stimulations among the ECB and some Member States which will still be in charge for the resolution processes and will be responsible for any public funding. Strong connections between the reputation of the ECB supervisory and monetary functions push the ECB to execute the assessment with qualitative and strict actions (Véron, 2013).

The comprehensive assessment will be very relevant for the credible start of the SSM. It is a project, which would make sure that all major problems in asset quality are well-known and properly dealt with, before the SSM starts with its operations (Hakkarainen, 2013).

The comprehensive assessment will involve three elements (Ernst & Young, 2013):

- A supervisory risk assessment – it will cover key risks, including liquidity, leverage and funding risk. Backward and forward looking quantitative analysis will be accompanied with the assessment of a bank's position compared to its peers and its vulnerability to outside factors. A new risk assessment system is being developed by the ECB and national supervisory authorities and will be the SSM key tool in the future.

- An asset quality review (AQR) – the review will report on credit and market risk exposures, together with the qualitative and quantitative review of hard-to-value assets and on- and off-balance-sheet positions. It will also take into consideration non-performing assets and forbearance.
- A stress test – it will complete the AQR by ensuring a future view of a bank's loss-absorbing capacity in the stressful economic and financial situation. The test gives insight into the banks' ability to absorb various shocks and will be performed in collaboration with the EBA (Giuseppe et al., 2014).

EBA released its stress tests methodology and macroeconomic scenarios on 29 April 2014. It will be used by all EU supervisory authorities to ensure that the leading EU banks are all appropriately assessed against the common definitions, assumptions and approaches (EBA, 2014).

Occasionally some assets of a bank are overvalued, which is why an evaluation will be provided by the ECB and if the true value of all assets in the bank's balance sheets is not so high than it was provided in the book, then the bank will be instructed to increase its capital to cover the accounting losses. However, it can also happen that banks lose money on their current operations. In that case only a deep restructuring of the bank itself could help (Gros, 2013).

2.6 Membership of the non-euro countries

The Eurozone needs the Banking Union as financial market has been too fragmented, stressed and deposit flights in the common currency area were endangering economic growth. Banking Union will substantially secure the financial system and encourage cooperation which will result in beneficial effects in the entire EU Single market (IMF, 2013a).

Despite mentioning the EU Single market in the preceding paragraph, intentions of the SSM are not to be a European supervisor. Not all the countries will be joining. For members of the euro-area, membership in SSM in required. Other members have an open possibility to join, but it has been seen so far that some of the non-euro countries do not possess enough political will and are not satisfied with the legal limitations that not allow an equal role in the SSM. UK and Sweden have announced with certainty that they do not wish to become SSM members, while some other countries are eager to join, but are waiting the final outcome of the legislative negotiations (Verhelst, 2013).

Non-euro Member States will be equally treated in the Supervisory Board, which is accountable also for preparation of the supervisory decisions. In this sense, they will be treated equally with the euro-area Member States. If the non-euro members will join the SSM, than the SSM procedures will also apply to non-euro area banks. Cross-border banks would receive a lot of benefits with that kind of unified supervisory procedures. Non-euro area countries would receive a special status when it comes to the system of decision-making. If the Council prevents a decision from entering into force, which would result in a possible change of the decision, than the non-euro area country can express its disagreement. If the Council’s decision prevails in any case, then the non-euro area country has the possibility of not accepting the decision on its side and the ECB could start the procedure of ending the agreed close cooperation (Hakkarainen, 2013).

It is assumed that additional pillars of the Banking Union will also enable the possibility for non-euro area members to participate. The strategic question for these countries is if and when to join the developing Banking Union. As soon as the SSM starts with its operation, these countries will have to make a decision if they wish to participate, without being entirely certain how the other elements of the Banking Union would look like. SSM is only the first pillar and cannot provide all the benefits, but it will bring a lot of advantages. Particularly, it will improve the cross-border supervision and supervisory activities and therefore contribute to the improvement of the financial integration (Darvas & Wolff, 2013).

There are currently only 18 of the 28 EU countries in the Eurozone and additional 7 countries have signed treaty commitments to join the euro area once they fulfill all the required conditions. The UK, Denmark and Sweden have special agreements, which allow them not to enter the common currency zone. ECB is responsible for the monetary policy of the current 18 euro members and has also been providing large amounts of liquidity for the banking institutions of these countries. In the countries without euro, these tasks are executed nationally. Thus, enlargement of the Banking Union beyond the euro area will cause also additional complexity and organizational issues (Elliot, 2012).

Banking rules for the entire EU are intended for fostering the Single market and are monitored from Brussels. These rules were proposed by the EC and revised and accepted by the EP and the Council. The coordination point is the EBA. An additional problem presents the matter that the most important financial center is in London – situated in a non-member state.

Commissions’ proposal that the Eurozone countries should join the Banking Union and that other members of the EU have the possibility of joining is currently the best possible choice. Certainly, it would make much more sense and would create opportunities to have a Banking Union that would include all the EU countries which would contribute to the further integration of the Single market in financial activities. But under these circumstances, it is currently not possible to carry out actions in such cope. The first goal of the Banking Union will be to assist in solving the euro crisis. At least giving an option to the non-euro Member States to join the Banking Union is a step to the wanted result on the long run (Elliot, 2012).

However, the gradual formation of the Eurozone threatens the integrity of the EU and its Single market for at least two reasons. Firstly, a Banking Union would create a more integrated core in which Eurozone members might develop policy together, which could lead to forming a caucus inside the EU, potentially dictating policy to the rest of the EU. EU countries that did not belong to the Eurozone would become policy-takers, rather than policymakers. Secondly, a tighter Eurozone core could call into question the sanctity of the four freedoms of movement between ins and outs (Whyte, 2012).

There are numerous reasons for the non-euro states to join the SSM. Non-euro Member States host important foreign banks that are headquartered in the Eurozone and would gain a lot from improved interdependencies within the Banking Union. Different benefits would appear for banking groups with the activities in the SSM area, from simplification of operations to cost saving and also reputational advantages. A supervisory regime that is not affected by national bias will have a better position and will be preferred by the markets which could lead to more favorable interest rates, credit ratings and equity prices (Ferran, 2014).

Differentiated approach to Member States outside the Eurozone could widen EU integration by serving as intermediate point for adoption of the euro. On the opposite side, integration beyond the Eurozone could influence on the remaining countries outside the Banking Union and increased their marginalization within the EU and the unity of the Single market could be in danger.

3 SINGLE RESOLUTION MECHANISM

3.1 Concept and progress

Resolution by definition deals with restructuring of institutions, with a goal of providing on-going activities and restoring the healthiness of all parts of the institutions. It is crucially important to provide a clear and comprehensive bank resolution regime (EC, 2012a). The primary objective is to maintain financial stability and taking actions to prevent large financial crisis, as the one we have just witnessed. The second critical goal is to minimize losses for society, especially for taxpayers and simultaneously trying to provide the same conditions for normal insolvency proceedings with assigning losses to shareholders and creditors. The third relevant goal is fair-play and will be very important when coming to the topic of loss distribution across the members of the Banking Union.

Resolution protects certain critical shareholders and functions and aims to provide continuing operations, but may on the other hand, not fix the elements which are not of key importance to the financial stability. Shareholders and debt holders will have to be aware of the fact that they will need to carry some losses on their shoulders in case that the banking institution fails and will have to undertake an appropriate price to this risk. The intention is to avoid moral hazard and prevent spending taxpayers' money on a troubled bank (Elliot, 2012).

Specific European factors are negatively supporting the introduction of an efficient banking resolution regime: EU states' banking systems have been systematically fragile and have caused institutional uncertainties. Furthermore, banks have been prevailing in the countries' financial systems. Not least, the insolvency and fiscal frameworks have been operating inside the national borders and policy makers, together with the investors have almost had no experiences with bank resolutions as resolutions were dealt mostly through public bailouts and/or nationalizations (Goldstein & Véron, 2011).

Bank resolution framework has been established on national levels and has in many situations not been suited for winding down large and systemic banks. A lot of EU countries have only been depending on corporate insolvency procedures when dealing with banking failures, which was an approach that could be very complex, long, costly and inefficient. Although several countries (e.g., Germany, UK and Ireland), have strengthened their bank resolution frameworks with enhanced tools to facilitate a quick resolution of failing banks in line with international best practices – "Key Attributes" (IMF, 2013b).

In 2011, the Key Attributes of Effective Resolution Regimes for Financial Institution (the "Key Attributes") have set the basic fundamentals that have been considered necessary by the Financial Stability Board (FSB[4]) for efficient resolution model. The introduction enabled the authorities to resolve financial institutions in trouble without exposing taxpayers to losses and at the same time maintaining stability of healthy economic functions. Not all of the resolution powers, written in Key Attributes, have been appropriate for all the companies and situations. FSB has continually been working with its members and have had an open mind to adjustments to different legal systems and market environments as well as for other specific considerations (e.g. insurances, financial markets, infrastructure…) (FSB, 2011).

A lot of banks that were considered "too big to fail" have received high amounts of public funds during the financial crisis. These amounts have been unprecedented. IMF estimations show that European banks incurred crisis-related losses that came near to €1 trillion or 8 percent of the EU GDP in the 2007-2010 period. The very much exposed fact during the crisis was that there was no appropriate instrument or system implemented that would be able to deal with failed banks, operating also across the borders. The increasing financial integration and interconnection between institutions from several countries have needed to be supported by a strong framework with intervention powers and rules (EC, 2012a).

Before a crisis occurs, governments can ensure to the public without hesitation that they will close the insolvent banks, if necessary. It can also provide guarantees to the shareholders, creditors and depositors that it will ensure financial injections which will cover the losses but also emphasizes it has the right of replacing the banks' management board, if there is an involvement of the public sector. With these statements, the governments wish to minimize public costs and avoid moral hazard. Although these statements may not apply in crisis times, but statements about introducing losses on shareholders, creditors and depositors could result in government unpopularity. Additionally, it might be difficult in a systemic crisis to impose losses on the banks without unnecessarily destroying the banks' value. Announcements of a bail-in of the bank's shareholders, large depositor and creditors could result in pulling out the

[4] Financial Stability Board (FSB): international body, monitoring and preparing recommendations regarding the global financial system. It was set up in after the G-20 London summit in April 2009.

funds from the bank. Consequently, bank failures are worsened by bank runs (Gandrud & Hallerberg, 2013).

The bank resolution mechanism should be structured in a way to make it clear and possible that creditors would be bearing the losses when their bank would be in trouble and persuade them not to take any risky actions, thus taking care of the market discipline. It should also be recognized that the consequence of the crisis could be very serious or the resolution mechanism could have certain defects, which would enable the creditors not to pay for all the losses and consequently the taxpayers would be bearing the losses (Elliot, 2012).

The Cyprus financial crisis has emphasized the need for quick and decisive actions, which have been supported by EU financing plans to prevent nationally formed banking resolution, with an enormous effect on the real economy and simultaneously stemming uncertainty and preventing contagions to other Eurozone countries and the Single market (EC, 2014b).

The Commission prepared a proposal for Bank Recovery and Resolution Directive (BRRD) that made a starting progress with the use of recommendations of the Financial Stability Board, with respect to key attributes for resolution regimes, in June 2012. When implemented, the BRRD would harmonize resolution tools across all EU Member States (Huertas, 2013). The Commission has also proposed a regulation for setting up a European Single Resolution Mechanism (SRM) and a Single Resolution Fund (SRF) in July 2013. While standalone BRRD presents a system, which is based mostly on national authorities, the BRRD, together with the Single Resolution Mechanism presents cooperation of all the European institutions and is at the moment the most supranational option (Gandrud & Hallerberg, 2013).

All things considered, the BRRD is as a net of national authorities and resolution funds, an important step towards minimizing differences in national approaches and EU fragmentation, but is not specific enough for the countries with the common currency or members of the SSM (EC, 2014b).

3.2 Bank Recovery and Resolution Directive

3.2.1 Structure and scope

The Bank Recovery and Resolution Directive fits within the extended commitments made by the G20, following the collapse of the Lehman Brothers, with a purpose to set into place an orderly resolution of non-viable banks and to prevent the contagion effect of failing financial institutions (IMF, 2013b). The agreement was reached on 12 December 2013, between the EP, EU Member States and the EC. It was officially adopted by the Parliament, together with the Single Resolution Mechanism on 15 April 2014.

According to the BRRD, banks would become a candidate for a resolution process if (EC, 2012a):

- The level of distress presents such a concern that there are no sensible ways of recovery in a suitable time period,
- All intervention measure have already been executed,
- Normal solvency proceedings would only increase the uncertainty and lengthen the problems of financial stability.

The directive includes a complete package of measures, which have intended to provide that (EC, 2012a):

- Countries have an appropriate equipment to react with interventions in a bank to prevent the evolving problems as quickly as possible, when problems are still at an early stage
- Companies and authorities adequately prepare for the crisis,
- Resolution tools and powers are harmonized for national authorities, which enables them to execute efficient measures when a bank breakdown cannot be prevented,
- Cooperation between authorities is effective when handling a collapse of a cross-border bank.

Member States must implement this directive into their national laws by 1 January 2015 at the latest, with the exception of measures that relate to bail-in tools, which must be transposed into law by 1 January 2018 (Quignon, 2013). This directive will be implementing three parts for managing and resolving EU banking crises in the future: prevention and preparation, early intervention and resolution.

- Prevention and preparation: Banking and investment institutions will be obliged to put together strong recovery systems, on company and group levels. If obstacles towards resolvability will be identified by the authorities in the middle of the planning phase, than necessary actions will be taken and will include also some adjustment for corporate and legal structures, to provide resolvability with currently available tools and at the same time being careful not to endanger financial stability and create costs for taxpayers (EC, 2012a).
- Early Intervention: The authorities will have more competences for intervention in early stages of the problems, before the situation is very serious and the bank is on the edge of breaching regulatory capital requirements. Directive gives the possibility to the national resolution authorities to designate a manager that will be responsible for restoring financial status of the institution and improving business administration. These managers have an option to work along with or replace the people responsible in the institution and get all the needed rights for decision-making (International Law Office, 2013).
- Resolution tools: With an objective to minimize the costs that the governments and taxpayers need to pay and to ensure that shareholders and creditors cover the required amount of losses, these tools also aim towards protecting the important functions, without a bailout of the institution (EC, 2012a). National resolution authorities will, in a resolution situation, have the possibility of choosing one of below mentioned tools:

- The Sale of Business Tool – this tool gives to the national resolution authority the possibility to conduct a sales process of the entire institution or only a part of it. The sales would be performed on commercial terms and without including common procedural requirements.
- Bridge Institution Tool – with this tool, the national resolution authority can move asset and liabilities of the troubled institution to a provisional institution, controlled by the public. The wanted result of this tool is that eventually the moved asset and liabilities will be sold back to the private sector. Before that happens, the institution can even continue with its business activities.
- Asset Separation Tool – this tool may be used for transferring the problematic assets from the institution to an asset management instrument where common insolvency procedures would have an unfavorable effect on the financial markets.
- Bail-in Tool – this tool is the most contentious and gives an opportunity to the national resolution authorities of restructuring liabilities of troubled institutions. Restructuring actions include reducing the amount of unsecured debt or reapplying it into equity. It should be used where an institution is in a bad shape, with an intention to restore its healthy activities (International Law Office, 2013).

3.2.2 Bail – in tool

On 27 June 2013, the Council of the finance ministers agreed on the "bail-in" procedure (Council of the EU, 2013). This deal introduced different rules of bearing the costs in the banking crises – big amount of costs have been introduced to creditors (i.e., bail-ins), while still enabling the national governments to have some flexibility which is according to Kirkergaard (2013b), a common agreement between single centralized rules and national discretion. This mechanism has been approved for stabilization of distressed institutions so that they can carry on with their fundamental services, without public interventions. It pursues the goals of minimizing the spent amount of public money and harmonizing EU processes. Unfortunately, it can also negatively influence the market by growing cost of senior debt or moving funds from senior debt to deposits. The BRRD has also determined that some liabilities will not be considered when imposing losses on creditors, i.e., covered deposits under €100,000. The scale for absorbing losses is the following: shares, hybrid instruments, junior debt, senior debt and non-covered corporate deposits, non-covered deposits of SMEs and households and liabilities of the European Investment Banks and the deposit guarantee scheme (Silicia et al., 2013).

Based on several reasons, the national authorities will have the right to eliminate or partly eliminate some bank liabilities with their own assessment. These individual decisions can have a significant effect and can create big differences in how national authorities deal with the failed banks. Consequently, critical challenges remain for the unified Single Resolution Mechanism for banks in the Member States that share different opinions regarding the role of the creditors in the event of a banking crisis (Kirkergaard, 2013b). At the same time, bail-in has become one of the relevant parts of EU bank resolution processes and presents a big step forward.

3.2.3 EBA role and Cross Border Resolution

EBA will be equipped with precise and decisive responsibilities in areas, where harmonization and compatibility of rules and practices is very important and will at the same time avoid duplications of everyday tasks, implemented by national authorities (EC, 2012a). The EBA role will be to ensure the coordination of the different resolution authorities and will write the regulations applicable to the system. The national supervisor receives the Recovery and Resolution Plan, makes amendments through discussions with the bank and transmits it to the EBA (Quignon, 2013). The EBA is intended to be a strict coordinator during the prevention and early intervention stages, especially when resolution planning and facilitating would have to take cooperative decisions with respect to cross-border companies that are going through the resolution process.

Sound governance will be crucial for ensuring early actions and effective resolution decisions. Specifically, conflicts of interest may arise during the phase of preparation of the recovery and resolution plans, or during early intervention and resolution for cross-border systemically important financial institutions, given that ownership structures remain national, while assets and liabilities go across borders. It would have to prevent the unnecessary political interference and long negotiations that could hold up decisions of the resolution authority.

The Directive includes standards for early intervention and resolution of cross-border banking institutions, i.e. liquidity provision within cross-border groups, and establishes resolution colleges for development of non-binding mechanisms for crisis planning and resolution (with the EBA in a mediating role). However, it does not include the required coordination of resolution measures before they are executed by home and host authorities. Consequently, no specific resolution mechanism for cross-border banks exists. Conflicts of interest and intentional integration inside the borders have already affected the cross-border crisis management and will still be integrated in the current framework (IMF, 2013b).

3.2.4 Financing of Resolution in BRRD

Without any exceptions, all EU countries will be obliged to start with the implementation of the national resolution funds (if not yet existing). The needed amount of funds will be collected through levies on banks, which will be calculated through their liabilities and levels of risk (EU Monitor, 2013). Banks' contributions will be based on their share of liabilities, compared to the total size of the national financial sector, what will enable the biggest contributors to have the best benefits, if entering into resolution. Financing should be organized ex-ante. Contributions that will be collected from banks should be raised at least once a year, to reach a target funding level in the amount of 1% of covered deposit through a 10-year transitional period. If this ex-ante funding would not be sufficient, additional ex-post contributions would have to be raised to properly handle the resolution process. There will also be a possibility of borrowing between countries' national financing schemes, if needed (EC, 2012a). BRRD also considers the use of the available funds in the 28 Deposit Guarantee Schemes (DGS). If an institution would have to be resolved, the DGS would have to contribute funds which would be in the same amount as is normal insolvency procedures and new resolution funds would be spent for the needs of the resolution process. Resolution funds will only be spent if at least 8 percent of liabilities have already been covered through bail-in, and would have the limit of maximum 5 percent of the bank's liabilities (EU Monitor, 2013).

3.3 Single Resolution Mechanism

The EC blueprint that set out the Commission's vision for future euro area integration, published on 27 November 2012, announced that a proposal for a Single Resolution Mechanism will be put forth in the months following the adoption of the SSM. The December 2012 EU Council agreement reaffirmed that SRM with adequate powers and tools is required, to make the SSM more effective. The SRM is based on contributions from the financial sector and backstops that repay taxpayers contributions over the medium term (IMF, 2013b). The SRM most important responsibility will be the resolution of banks, participating in the Banking Union.

The SRM Regulation legal base is the Article 114 of the TFEU and allows adoption of measures for converging national regulation, with a purpose of establishing and functioning of the Single market.

SRM will offer essential benefits through a powerful central decision-making body and SRF (EC, 2014b):

- Resolution decision will be taken rapidly and effectively, without problems of uncoordinated actions, due to the strong central decision-making,
- Central body will have the possibility of resolving banks more efficiently and limiting the effect of tax payers, due to its wide knowledge and experiences,
- Taxpayers will have better protection as the Single Resolution Fund will be allowed and responsible to use a significant amount of resources from banks' contributions and simultaneously allowing an active playing field for banks in the Member States.

The SRM aims toward safeguarding the integrity and encouraging the development of the Single market. Potential obstacles of free movement of capital, freedom to provide services and freedom of establishment, will be recovered and possible to pass through significant distortions of competitors (EC, 2014b).

SRM is referring to the principles of the BRRD and apart from the aspect of recovery plans and intra-group financial support, the SRM has included key instruments, provided in the BRRD. The first one is the establishment of resolution plans by authorities, including assessments of resolvability and setting of individual bail-in debt ratios. The second one is the implementation of resolution through the use of resolution tools and lastly, the support for the resolution tools through financial arrangements, based on contributions from the banking industry (Wolters et al., 2014).

Véron & Wolff (2013) have claimed that the resolution mechanism for the European Banking Union should also include a centralized and autonomous decision-making authority for the banks that are members of the SSM. The goal is to reach higher degrees of centralization for many reasons. During the resolution process, high-risk decisions have to be made very quickly and under serious pressure. The topics covered in the decision-making process would in most cases be liquidations of banks, assumptions of risky assets in the public-sector balance sheet, authorizations of emergency sale of assets or activities to third parties. These actions demand a high degree of centralized authority.

3.3.1 Single Resolution Authority

A common resolution authority for the euro area should seek to maximize recovery value in resolution and minimize the overall cost of the resolution and losses to creditors. Establishing a strong and autonomous resolution authority will ensure that home-host concerns are internalized within the euro area, but the cost and stability impact on other jurisdictions (in the EU or outside) will have to be taken into account. The resolution authority should endeavor toward financial stability and provide cohesion for financial services and functions which are of systemic importance, while also offering protection to depositors and other beneficiaries (IMF, 2013b).

Not only should the common resolution authority comply with the best international practices, but it should also be designed in a way that it addresses concerns, arising specifically from the multi-country setting of the euro area. Having a single, fully centralized, supranational resolution authority would set the right incentives, correct externalities and coordination issues, provide a mechanism for swift decision making and avoid duplication at national levels. It would also ensure that individual countries are not forced to internalize all the resolution costs and spillovers to others at enormous cost for itself, as was the case for Ireland and that could in theory, be the case for any of the Member States. Issues related to burden sharing, governance, accountability and interaction with the SSM need to be properly addressed (IMF, 2013b).

Nevada and Ireland were in similar troubles, but had different solutions when dealing with their banking problems, as the US managed to solve it already at the federal level, but in the euro area, the responsibilities for taking care of the banking losses remained at the national level. Most banks in Nevada were experiencing large losses and consequently, many became insolvent, but the Federal Deposit Insurance Corporation (FDIC) took care of the losses and relocated operations to other banks that were stronger at that time. Over a two-year period, from 2008-09, the FDIC was responsible for closing 11 banks, located in Nevada, with an asset of over €40 billion or about 30 percent of Nevada's GDP. The losses of rescuing and restructuring operations, summed up to only €4 billion. If the similar system would be used in Europe than the outcome of Ireland (and Spain) would possibly be different (Gros, 2012).

According to Elliot (2012), there have been several adequate candidates, which could form the Single Resolution Authority (SRA) for Europe. As the ECB will already be responsible for the SSM, it would bring positive effects if it would be also dealing with the resolutions of failing banks. As the lender of last resort, it would already have an important data on individual banks and would systematically lead the resolution process with good understanding of its consequences. Nevertheless, there are also important arguments which do not support this decision. The resolution process is occupied by solving problems that occurred in the institutions past periods and have sometimes been neglected by supervisors. If supervision and resolution would be under the same roof, this could lead to situations where the supervisors would wait with the signal that the bank resolution is required and would also try to adjust the resolution processes, to minimize discovered supervisory mistakes. The resolution process can also require taxpayer's money, which could obscure the line between the ECB and the fiscal authorities and possibly endanger the ECB's independence, which is one of the most important prerequisite for successfully managed monetary policy.

In theory, the overall supervisor EBA might be a sensible choice for managing the resolution mechanism. On the other hand, there would also be some disadvantages. The EBA is an EU-wide institution and would be functioning within the Banking Union, which has a really little possibility of including all the EU Member States. It has also been working only from 2011 and has not yet gain much power, which could bring difficulties, when defending and enforcing difficult decisions that resolution authority is responsible for. It also shares the same problem with the ECB that supervisory decisions can blur the right decisions.

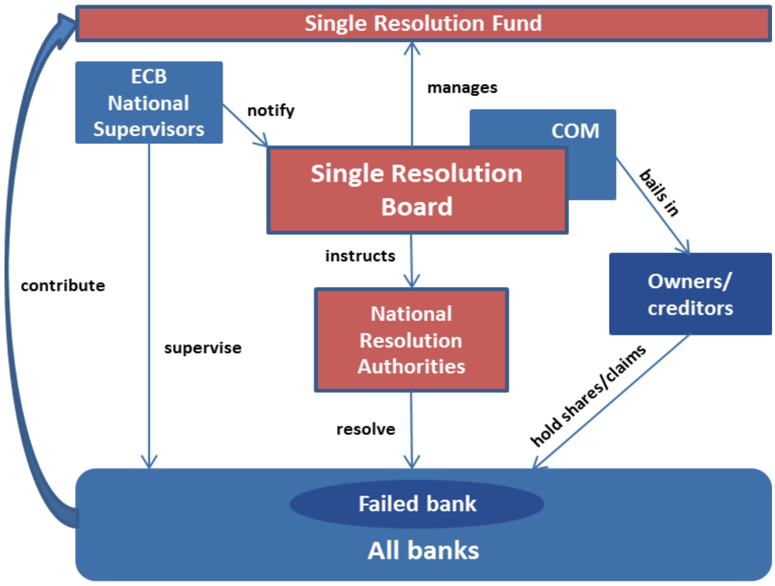
The ESM has been established to handle the sovereigns in trouble and has also been authorized to cooperate in recapitalizations and other rescue operations for banks as it purpose is to preserve the credit of the sovereigns. So far, it is a suitable candidate for being in charge of the banking resolution. It is also active only in the euro-area, which is a very good match for the Banking Union scope. Nonetheless, its decision-making is built in a way to always be available to national governments and it is not protected from political influence. It is also very focused on systemic issues that could result in too high priorities on avoiding bank failures or events that would bring high costs for creditors by neglecting other goals.

There is a good option for merging the management functions of the resolution authority and deposit guarantee fund, taking the US FDIC as an example. Roles of protecting the guarantee fund and taking over distressed banks and handling them to limit their further losses and further damages are quite similar. Problems would occur, when decisions on limiting deposit losses would lead to larger overall losses or to interventions, which would not necessarily happen, if the authority would be more patient.

One of the last alternatives is to establish a new resolution authority. This would bring the advantages of non-bias organizational focus and the possibility of designing it from the beginning, without any inappropriate structural characteristics. It would also eliminate many potential sources of conflicts of interest. However, inefficiencies and risks in creating a new, unproven authority would have to be considered.

3.3.2 The Board

Figure 8: The resolution process in the Single Resolution Mechanism



Source: Tornese, *A Single Resolution Mechanism For the Banking Union,* 2014, p. 35.

Based on the approved proposal, the role of the SRA will be assumed by a Single Resolution Board (hereinafter the Board). It will be set up to prepare and monitor resolution decisions centrally and will take care that the resolution process is of high quality and impartial. The resolution process will be proposed by the European Commission (Giuseppe et al., 2014).

The Board's division of tasks will be similar to the one under the SSM. The Board will be directly responsible for the institutions, which will be under direct supervision of the ECB and for cross-border groups, meanwhile the national resolution authorities will be in charge for all other institutions, with exceptions of the institutions that have to be under SRF, according to the resolution scheme and regardless of their size. Member States can also make a decision where the Board will be responsible for all the important tasks in their entities. Board also has the right to implement all the relevant Regulation powers, to issue general instructions or advice to national resolution authorities (EC, 2014b).

The Board will take its general decisions by majority voting. Its main tasks, performed partly in co-operation with national resolution authorities and other bodies will be (Wolters et al., 2014):

- Drawing up resolution plans and assessing how banks can be resolved, including the power of determining individual minimum requirements of own funds and entitled liabilities for banks (bail-in),
- Implementation of bank resolution schemes, and
- Administration of the SRF, for the support of the application of the resolution tools.

Board will be composed of a Chairman, a Vice Chair, related national authorities and four permanent members. ECB representatives and the EC will participate in the process as permanent observers. The Board will be accountable to the EP and the Council for any approved decision. The parliaments of the participating Member States would receive information about the Board's operations (EC, 2014b).

The ECB presents the main triggering authority as it declares a bank's likeliness to fail, whereas the Board has to determine that no other solution than resolution would be appropriate. The resolution scheme will set the troubled institution under resolution and decide on the use of certain resolution tools or the SRF, to support the resolution actions.

After the resolution is adopted, the Board will communicate it to the Commission. The Commission either supports the plan or has objectives to it with regards to the optimal view of the resolution scheme, in a timeframe of 12 hours. Therefore, the Commission may advise to the Council to object the resolution plan, due to non-fulfilment of the public interest criterion or to object to the amount of the funds, provided for the resolution plan. The plan may only be approved, if there are no such comments by the Commission or the Council in the 24-hour period, after its transmission by the Board. In cases of objection, the resolution scheme shall be modified by the Board, taking into account the reasons for the objection, as expressed by the Commission. The Board has 8 hours to modify the plan. National resolution authorities shall take required actions, after the resolution scheme becomes operative, based on their powers under national law (Wolters et al., 2014). This plan is tight, with very short deadlines, in the total period of 32 hours, in order to allow resolution of a bank over the weekend (EC, 2014b).

The Board will make decisions in two types of sessions – executive and plenary. In the executive session, the Board will take over the most important preparatory and operational decisions for providing resolution plans for individual banks (including the resolution fund) and addressing national authorities to introduce the measures. Most decisions will be taken by the Board in its executive sessions. If the resolution plan requires usage of more than €5bn from the Resolution Fund, plenary session will take place (where all the countries have a vote). In this calculation, money used for liquidity purposes will only count for half of its value, therefore, up to €10bn for liquidity purposes, the decision would be made by the executive session (Abascal et al., 2014).

The Board's role is to carefully monitor the implementation of the resolution scheme and it may also issue instructions regarding any aspects of the resolution to the national resolution authority. If not applied, the Board may issue certain instructions directly to the institution. Furthermore, the Board has investigation powers and is authorized to request information, explanations, interviews and to conduct on-site inspections. It also has sanctioning powers which enable it to impose fines on an institution that has breached certain instructions (Wolters et al., 2014).

National resolution authorities assist the Board and are also responsible for implementation of resolution solutions, while taking into consideration the national company and insolvency law. Furthermore, the Board will control the implementation, done by the national resolution authorities and will provide special orders to the distressed banks, if the NRA will not comply with its decision.

Three conditions have to be met for a bank to be a candidate for a resolution: (1) a bank is failing or likely to fail, (2) no private alternatives are available, (3) resolution measurements are required for the benefit of the public (IMF, 2013a).

For the cross-border resolution, carried out in the participating and non-participating Member States of the SSM, resolution colleges and other procedures provided by the BRRD will apply. The Board will be the representative of the national authorities of the participating Member States in the resolution college, but national authorities will have the possibility of attending as observers. The Board will be authorized to collaborate with the non-participating Member States at the most important stages of the process, i.e. with preparation of comprehensive recovery and resolution plans (EC, 2014b).

3.3.3 Burden Sharing

The Board will be centrally preparing and monitoring the resolution decisions. Moreover, its important role will also be to establish the SRF and providing the main elements. SRF has been proposed so that any type of costs, acquired through the resolution mechanism and not through shareholders and creditors of the entity under resolution, will be a responsibility of the financial industry. The Commission is trying to highlight that there are no intentions of using the Fund as a bailout fund and that it exists only to provide capital to an institution that is being resolved. Existence of a fund that will be able to provide a back-stop for dealing with failed institutions, will remove the danger of contagion from one institution to another. Pooling resources in the fund allows much bigger funds, while providing better insurance. The main point is to enable financial assistance in the form of guarantees/loans in the short to medium time period and to provide healthy functions in the restructured banks as they are very important for ensuring the financial stability, also for the whole economy. The fund is not intended for achieving replacement of private investors in absorbing losses and providing new capital (EC, 2014b).

The size that is assumed to be achieved is equal to 1 percent of the covered deposits of all the banking institution participating in the Banking Union. The funds will be collecting over the period of 8 years, but it may be prolonged to 12 years, if the fund has expenditure, exceeding half of the target size of the fund. Therefore, the banking industry contribution will be around 12.5 percent of the target amount per year. SRM will supposedly have a fund of €55 billion by 2024 and it will be progressively built up by taxing banks through the years. Until then, private resources, together with those provided by the new bail-in rules and complemented by the ESM would provide an important cushion in the event of bank failures. Before 2024, the resources will partially be divided into national compartments, with national authorities still partly responsible for recapitalizing their banks. Mutualization of costs will be completed in eight years – 40 percent in first year, 20 percent in second year and increasing by 6.6 percent annually (Abascal et al., 2014). This could become a problem as bank failures could put solvency of states at risk once again. Furthermore, according to the EBA, size and scale of the euro area in the banking sector was close to €30 trillion in late 2013. The possible problem could be that these resources would almost certainly not be sufficient in the event of a systemic banking crisis (Pickford et al., 2014).

Financial sources will contain two different categories: ex-ante contributions, made on a regular basis, and extraordinary ex-post contributions. Ex-ante contributions are calculated by the Board for each institution individually, consisting of a flat contribution and a proportional risk adjusted contribution. Ex-post contributions become relevant if SRF or the national compartments of SRF cannot cover its expenditure during the transitional period. These funds will not be more than three times of the amount of contributions that institutions have to make annually (Wolters et al., 2014).

In a situation where neither the SRF funds nor the extraordinary ex-post contributions will be sufficient, the Board may exercise its power to contract borrowings or other forms of support to the SRF. The SRF will be able to rely on a private loan facility to borrow funds when needed, starting in 2016. The details will be provided by the Council and the Board by January 2016 at the latest. There will be no public guarantee or support for the time being in terms of collateral, so it is assumed that the SRF will be borrowing funds and using as collateral the bank’s future contributions (Abascal et al., 2014). Additionally, the Board may issue temporary transfers between the compartments, according to the procedure laid down in the Intergovernmental Agreement. Participating Member States may also request to the Board to make a temporary use of financial means available in the compartments of the SRF that are not yet mutualized. Decision would be taken upon by a simple majority and may be subject to the objection by any of the contracting parties, for whose compartment the transfer has been made (Wolters et al., 2014).

One of the most questionable elements has been the degree to which the costs of resolving a failing institution are shared across the euro area. The problematic is the period before the sufficient financial resources will be accumulated through industry levies as countries are unwilling to commit budgetary resources without sufficient control over the decision about which institution should be resolved. It will be very hard to break the feedback loop between sovereign and banking debt, completing the Single market in financial services and ensuring that countries are not exposed to sudden stops, before a common fiscal backstop for resolving banks and guaranteeing deposits is in place (Pickford et al., 2014). What if SRF will not be enough, even after the build-up period of 2016 – 2024? It is planned that during the collecting period, national sources that will be backed by levies on banks or the ESM will provide the financing (Giuseppe et al., 2014).

Before the BRRD and the SRM come into force, the banking crisis will be dealt by countries itself. But these national regimes are very closely associated with the already confirmed rules of resolution, specially the division of bank losses to shareholders and creditors, not to taxpayers. The SRM Regulation will be used from 2016, together with the bail-in rules, set up by the BRRD. Some exceptions exist: from the 1 January 2015, the cooperative relationship between the Board and the national resolution authorities for preparing the resolution plan will already apply (EC, 2014b).

The establishment of the SRF was the most controversial issue for the Eurozone members in the SRM negotiations, mostly because Germany did not agree with the centralization of control and mutualization of financial responsibilities for bank failure. Uneasily, the compromise was reached to treat the requirements of banks contributions as an obligation that remains with Member States, and afterwards the Member States are obliged to transfer contributions, raised at the national level, into the SRF in accordance with the Intergovernmental agreement (IGA) between Member States participating in the Banking Union (Ferran, 2014).

3.3.4 Intergovernmental agreement

The necessity for secure resolution funding in the form of the SRF, gave a rise to legal complications as well as some political sensitivity that could only be resolved by applying an IGA outside the EU law (Ferran, 2014).

The SRM established the SRF as well as methods for its use (laying down general criteria for determination of fixing and calculating the contributions of credit institutions as well as the obligation of the Member States to levy them on national level), but the Member States remain competent to transfer the collected contributions to the SRF. The obligations of the Member States to do so are in the IGA on the SRF, concluded by the participating Member States (Wolters et al., 2014).

IGA complements the SRM Regulation and was ratified by the Member States as a political commitment for preventing delays in setting up the SRM. Its field of work is very narrow, covering the transfer of the funds collected by national resolution authorities to national compartments of the Single Fund, mutualizing the funds available in the national compartments, dealing with the order in which the financial funds are collected, for taking care of resolution costs, lending inside the national department on a temporary basis and dealing with bail-in conditionality. All other issues are dealt in the Regulation (EC, 2014b).

From 2015 onwards, the banking institutions will start with the collections of contributions under the BRRD. The IGA plans to transfer the contributions raised in 2015 to the Fund. SRM will start raising contributions of the national resolution authorities when it enters into force, in January 2016 (EC, 2014b).

3.3.5 Winners of the Banking Union

Schhoenmaker & Siegmann (2013) have provided a model for calculation of costs and benefits if an individual country is participating in the Banking Union. The purpose has been to compare the long-term benefits vs. costs occurred. Assumption has been that the possibility of bank failures is equal across the observed group. They have focused on the largest banks in the EU, as this group of banks is the least domestically oriented and would be affected the most by coordination problems in the case of a bailout. They have chosen 25 top banks (in 10 different EU countries), with an average asset of €985 billion and a capital of €40 billion, which has provided a solid coverage of the European banking system, as their assets amount to approximately 71 percent of the total cross-border EU assets. This fact is significant as resolution of cross-border banks divides the participating countries into net receivers and net payers.

They have chosen the equity's value as the cost of resolution. This choice was encouraged by the fact that equity indicates very well the unexpected losses that could arise by the banks and the consequent public bailout costs. The results have shown that increased stability, due to supranational approach, is beneficial for all the countries when the members of the Banking Union are collectively paying for the development of joint resolution mechanism. Home countries prosper as the resolution process of the parent bank becomes more effective. The same countries also prosper from the more qualitative resolution of their banks and have an immediate positive effect from being a part in providing funds for the bailouts of its (cross-border) banks, as they have to contribute just one part of the needed funds under burden sharing. Additionally, supranational approach breaks the interlacement between solvency of countries and banks.

Net benefits for individual countries were calculated by using a baseline of the ECB capital key, which serves for cost allocation. The outcomes of the net effect, inside the Eurozone, show Spain and the Netherlands as the net beneficiaries with 11 and 3 percent. Germany, France and Italy are all net contributors, providing 7, 3 and 4 percent. Even though these members have large banks, the banks are not that big than their economic influence. Generally, the Eurozone is the net contributor with 10 percent and the non-euro area is the net benefiter with 10 percent. Despite their unwillingness to participate, the UK and Sweden are the main receivers (13 and 9 percent), but Poland would become the main contributor for CEE countries with 5 percent, due to its size. It is perceived that countries with large and active cross-border banking system would benefit the most from the upgraded resolution regime.

Under the assumption that the average costs of recapitalization are the same size as the bank's equity, it was calculated that overall amount of the new resolution regime would be €766 billion if resolution of 25 banks would be executed. That is a cumulative improvement, under the assumption that all banks need to be fixed. If the probability of a banking failure is lowered to only 5 percent, than the number lowers to €38 million. Overall, the change from national to common resolution process brings an average improvement of 63 percent for the top 25 banks. This figure represents the total effect, as it is clear than banks would almost certainly not fail simultaneously and need the entire change of equity. However, during the financial crisis, 9 banks from these group needed state aid and some received amounts that exceeded their pre-crisis equity levels.

3.4 European Stability Mechanism recapitalization

The main goal of the ESM recapitalization of domestic and systemically important banks that are under the restructuring phase has been to focus on removing the residual risk from the sovereigns' balance sheet. Non-systemic banks should have to close their doors with minimal costs, but systemic banks should have to be revitalized by shareholders, creditors, the sovereign and the ESM. By delinking the sovereigns from the losses that can occur unexpectedly in banks, the ESM recapitalization would succeed by removing future tail risks from the sovereigns' balance sheets and would at the same time ensure a trustworthy owner to the bank with good financial strength, which would improve banks' funding conditions. Before ESM could get involved, a mechanism would examine whether the troubled bank presents a systemic risk and is too big to be resolved by the sovereign itself (IMF, 2013a). ESM direct recapitalization will be considered when other solution could endanger the continuous access to markets of the requesting ESM member (ESM, 2013).

In June 2012, the Eurozone leaders decided that the direct recapitalization will be possible only "when an effective single supervisory mechanism is established" (Euro Area Summit Statement, 29 June 2012). Fully operational SSM is a precondition for direct bank recapitalization by the ESM (IMF, 2013a). ESM became effective on 8 October 2012, after its founding treaty was ratified on 27 September by the Member States, representing at least 90 percent of its capital requirements. The fund has authorized capital of €700bn, contributed by the Member States, including €80bn of paid in capital and €620bn in callable capital. It has a financing capacity of €500bn and a safely invested capital reserve of €200bn in liquidities, to ensure ESM always has a top quality credit rating. The fund provides five different types of programs of financial support. Member States in financial difficulties, complying with a principle of conditionality, can receive direct loans, primary market support, secondary market support, or precautionary financial assistance through bank-up credit lines in case of having troubles in accessing the market. The recapitalization programs aim to provide lower cost of financing via ESM, to recapitalize their banking system (Quignon, 2013).

The most reliable countries in the euro-area have pushed for three limitations regarding the direct recapitalization. The first one is to find a way to eliminate difficulties from the past. The common responsibility for past problems will probably have limitations and the country of bank's headquarters will stay responsible for the majority part or even for the entire amount of potential losses. The second concern is the general risk-sharing in direct recapitalization activities. A similar decision will probably be accepted - again the country in which the bank is located will be responsible for the majority part of the losses in comparison to other Eurozone countries. The third issue is the limitation of the funds available for the ESM direct recapitalization, since the operations can quickly empty the available ESM funding capacities (Verhelst, 2013).

The Eurogroup has reached a first agreement on details of the direct recapitalization by the ESM of ailing banks in stresses countries in the middle of June 2013. A €60bn cap has been imposed over the ESM recapitalization ability, but it can be increased at the discretion of the ESM Board, under exceptional circumstances. Capital shortfalls would be identified through a stress test, under the guidance of the ESM and after applying appropriate bail-in criteria (BBVA Research, 2013). Direct recapitalization by the ESM will be considered only if private capital resources are being engaged first. In line with the principles of the BRRD and EU state-aid rules, an appropriate level of bail-in will have to be applied before the ESM recapitalization (ESM, 2013).

Several restrictions have been placed on the direct recapitalization instrument. Besides the already mentioned maximum amount of €60bn, two types of national government co-financing are planned. First, the national government will have to inject sufficient capital to get the beneficiary institution up to the legally required minimum of 4.5% CET1 (Common Equity Tier 1) in a stress test established by the Basel III framework. Afterwards, the ESM would do the rest, until reaching the ECB required ratio (equivalent to current EBA 9%) (Kirkergaard, 2013a). Second, for banks with capital ratio at/above 4.5% CET1, but below the ECB required levels, the Member State would have to contribute a 10-20% share and then the ESM would cover the rest (BBVA Research, 2013). In order to ensure transparency and flexibility in the recapitalization operations, the ESM will establish a subsidiary in the member state and become a shareholder in the beneficiary institution (ESM, 2013). The Eurozone's bailout fund could directly invest in a troubled bank from 2015 onwards, after 8 percent of the bank's total liabilities are written off by a bail-in and the use of national resolution funds, up to 2015 target levels. Once the BRRD is fully in force from 2016, not only the bank's shareholders, but also bondholders and even large depositors would have to lose money before government or Eurozone money could be used to save a bank. Direct investment of the Eurozone bailout fund in a troubled bank, would be a last-resort measure after all other options have been exhausted (Roche, 2014).

3.5 Differences between BRRD and SRM

BRRD and SRM share common characteristics, but they also have their differences. The BRRD goal has been to form a framework that will take care of the banking resolution at the national level and in all EU Member States. It is not a pan-EU resolution regime, but aims towards minimum standards for the EU banking resolution. As these standards also present the basis of the SRM structure, the SRM and BRRD are very connected. Content wise, the BRRD is covering three points of recovery and resolution regime – preparatory and preventive arrangements, early intervention and resolution (EU Monitor, 2013).

Three key differences between two possibilities are:

1. Who determines resolution plan,
2. How it is monitored afterwards,
3. What is the source of funds for public assistance.

The plan is prepared by the “executive” section of the Resolution Board in European approach, with great inputs and efforts from the Commission. In the next step, it authorizes the national resolution authorities to carry out the plan. The SRF takes care of the fund and the Board controls the process of implementation. In the system with Member States in charge, the NRA forms a plan and also executes it. During this process, they use the national resolution funds.

The Board is not responsible for the implementation of the resolution plan, but it hands it over to the relevant NRA and only oversees its execution. It is important to mention that the SRM regulation will have immediate influence, after it comes into force. This will mean more power over the process of implementation by the EU institutions. The SRM empowers the Board to directly carry out the agreed plan, if the NRA does not comply with the plan as it was instructed. EU institutions prepare the resolution process, but they are depending on the individual members for its implementation.

The SRM Regulation builds on the main concepts of the BRRD, but additionally introduces a centralized institutional resolution approach with a centralized resolution fund, compared to decentralized approach in the BRRD. The SRM does not replace the BRRD, which continues with providing the framework for recovery and resolution within the EU, in particular for Member States that are not a part of the Banking Union.

Timelines are varying as national laws and regulations implementing the BRRD, include those related to the establishment of national resolution funds and will apply from January 2015. The rules for SRF will be in principle applicable from 1 January 2016; however, the contracting parties of the IGA have committed to transfer to SRF the contributions they have raised by virtue of national laws, implementing the BRRD (Wolters et al., 2014).

4 DEPOSIT GUARANTEE SCHEME

4.1 Concept

Deposit guarantee provides insurance, usually state institutions to depositors. In most cases, these guarantees are offered against the risk of a bank failure and its connected losses. Generally, deposit guarantees have two main functions: protecting costumers and enhancing stability of the financial markets. Deposit guarantee is a powerful tool in preventing deposit runs, but on the opposite side, the guaranteed depositors have no incentive to monitor bank risk-taking. Market discipline is limited, because banks do not have motivation to behave prudently. This moral risk is the most dangerous when all the deposits are covered (Burke, 2013).

The Deposit Guarantee Scheme (DGS) should complement, support and strengthen the protective function of the other components of the Banking Union. The DGS should fulfill five key functions (Bernet & Walter, 2009):

- Confidence function – DGS, with its implementation and credible instruments for handling the financial crisis, assures high confidence levels with depositors,
- Protection function – it offers protection to the depositors when a crisis occurs, to ensure their amounts of the covered deposits and also to the institutions in case of a deposit run,
- Security function – DGS keeps the covered deposits save from the grip of the rest of the bank stakeholders,
- Financing function – it provides sufficient financing of the needed capital to handle the protective actions and security functions to provide enough liquidity to protect the insured deposit credibility,
- Support function – is represented by other institutions, supported by the DGS, which provide financial safety and are dealing with the topics of securing and providing improvements to the financial system's stability.

DGS reacts quickly if there is a case for a claim and ensures the entire amount of the covered deposits, while it provides structured liquidation or resolution process of financial institutions that are endangered by the insolvency, or have already become insolvent. With its applicable actions, it prevents the breakdown of illiquid, but more importantly still solvent financial institutions.

There are also negative aspects of a DGS. Bank's managers and shareholders are basically ready to accept large risks with intentions of reaching their goal of higher profits. On the other hand, the depositor's purpose is to find a bank with strong stability and security because they do not expect high profits, but only the agreed interest rates. As they can lose their assets in a bank failure situation, its motivation is to supervise the hazardous attitude of the managers and react by early withdrawal of the deposits, if necessary. Motivation of taking these actions against high-risk behavior is lower if deposits are protected, even though that kind of behavior would possibly boost the instability. As a consequence, a highly-developed DGS can even lower the strength of the overall deposit guarantee system. This risky behavior has been highlighted in almost all the crises in recent history as states have extended the deposit protection. Market participants have assumed that the government will take the role of the lender of last resort every time and the consequently, assumptions of even higher protection have been expected on the basis of the existing protection (Bernet & Walter, 2009).

4.2 Development of the Deposit Guarantee before the crisis

In 1986, the European Commission issued, in the European Community at that time, the recommendation on insurance protection, which was the milestone in the development of the deposit guarantee. It tried to set more concrete fundamentals for the already existed insurance schemes. It was also an encouragement for the countries that did not have an appropriate deposit scheme to use (Bernet & Walter, 2009). The recommendations were very general and variation of deposit guarantee schemes emerged as a result.

The Directive on Deposit Guarantee Scheme (94/19/EC) in 1994, created the first framework that was aiming toward harmonization of the DGS in the EU Member States. The main goal was to speed up the integration of retail banking, by determining minimum grounds for deposit protection. Unfortunately, the harmonization was not sufficient. A number of deposit guarantee schemes were preserved and were widely variating in coverage levels, deposit/depositor responsibilities, legal statutes, governances, payout procedures and funding mechanisms. This Directive has not been changed for approximately 15 years; nevertheless, the financial markets have importantly changed during that period of time (EC, 2014c).

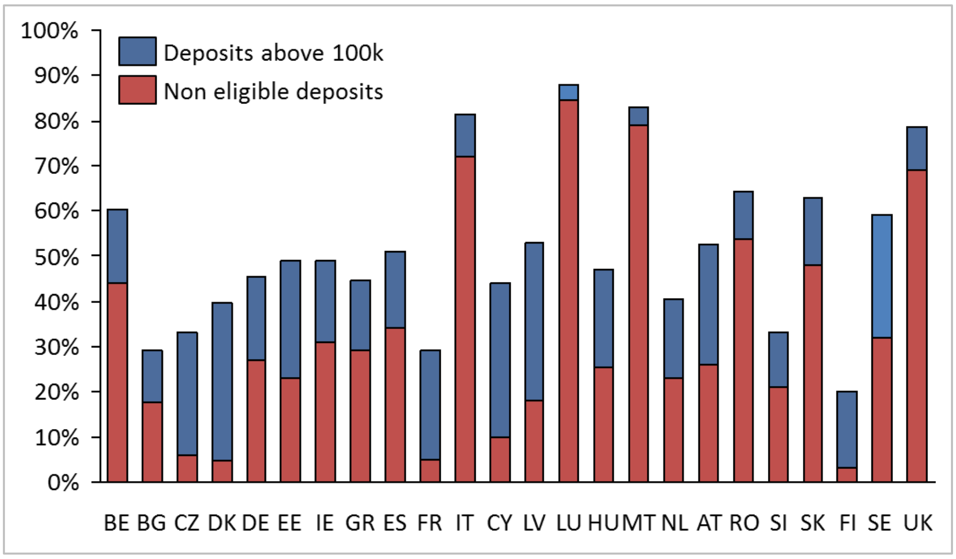
The Commission has already defined the importance of modernization and wider-reaching harmonization and raised the awareness about differences and flaws in the review of guidelines in 2006. But the crucial weaknesses were revealed in the financial crisis and almost all states started with the implementation of significantly renewed deposit guarantee schemes, partly as a response to the necessary state guarantees and rescue measures (Bernet & Walter, 2009). A report, published by the Commission in 2008 (EC, 2008), concluded that deposit guarantee scheme significantly varied among individual Member States.

National deposits most differ in terms of coverage, mandate, payout and funding arrangements. One of the crucial findings has been that many national deposit guarantee schemes were only able to cover the insolvency of the smallest banks. The coverage levels in Member States have varied between amounts of €50,000 to €103,291 in Italy, to an unlimited amounts of coverage in other Member States. In some cases, mandatory schemes have been supplemented by voluntary schemes. Many national DGS have had limited prefunding and have relied on ex-post funding mechanisms. In 22 Member States, contributions to DGS have included a regular prefunding mechanism where however, the ratios of prefunding to eligible deposits remained very low. For example, the funds available for payouts of the French Fonds de Garantie des Depors reached about €2 billion at the end of 2010, about 0.1 percent of insured deposits. Some countries such as Austria and the Netherlands have relied exclusively on ex-post funding (IMF, 2013b).

Numerous banks of the EU have received their considerable amounts of funds by non-deposit liabilities or uninsured deposits. These amounts were not protected explicitly by deposit insurances and had a tendency to evaporate when market participants became concerned about the healthiness of their bank. These liquidity pressures forced banks to sell their assets in order to be able to pay the cash to the funders, as they wished to remove their funds when their uninsured bank deposits of non-deposit liabilities matured.

When the banks' liquidity reserves are spend and the possibility of refinancing by the ECB is no longer an option, than the banks' only possible choice is to sell its illiquid assets to illiquid markets and bearing the losses that incurred from the sale, which additionally deteriorates the capital levels. ECB has the possibility of providing urgent liquidity help, but it has to be processed by through the national central bank which has to obtain the transaction credit risks and add it to the national debt burden (Herring, 2013).

Figure 9: Percentage of large and uninsured deposits in the EU countries (in percent as from 2007)



Source: Herring, J.R., *The Danger of Building a Banking Union on a One-Legged Stool*, 2013, p. 12.

4.3 Measures taken after 2007

Due to the financial crisis, the trust in the financial market was seriously undermined. A lot of people realized that number of deposit protection systems coexisted at that time in the EU, with different levels and forms, but for almost 20 years they have been told that the Single market is in place. After the bank run in Northern Rock in September 2007 (already exposed in chapter 3), it was realized that EU deposit protection systems did not operate properly (Gerhardt & Lannoo, 2011). An important effect of the banking crisis has been the transfer of considerable deposits from the most vulnerable countries (Greece in 2011 and Spain in 2012) to stronger centers. The fragile banking sector pushed depositors to react to the perceived threat of losing their deposits, taking their money out to other banking institutions (Papadopoulou, 2014).

An extensive proposal has been issued in March 2009 (Directive 2009/14/EC), for adjusting and extending the already existing Directive (Bernet & Walter, 2009). The EU moved quickly to harmonize minimum levels of deposit insurance and maximum payout periods. The level of coverage was increased to €50,000 by mid-2009 and to €100,000 per depositor per bank by the end of 2010, and the maximum payout period was shortened and set to 20 working days. The 2009 Directive introduced an obligation to explore further possibilities of harmonizing DGS, but did not set any timeline for its implementation.

More importantly, a proposal was presented by the Commission in 2010, to recast the 1994 Directive and has been drafted as a response to the crisis and to the recommendations by the experts in the Larosière report (Gerhardt & Lannoo, 2011). A comprehensive review of the DGS Directive is aiming to harmonize and simplify the Directive with protection improvement of the deposits, maintenance of depositor confidence and strengthening the safety net. It has proposed harmonization in the scope of coverage (type of deposits), the introduction of common standards in financing, a target fund size, the introduction of risk-based contributions, shorter payout periods, a clarification of responsibilities to improve insurance payments for cross-border banks and limited cross-border borrowing arrangements between various national DGS (IMF, 2013c).

DGS will be capable of meeting its duties towards depositors, having faster approach to deposits after a bank failure, stabilizing the confidence of depositors and ensuring financial stability (EC, 2014c). Harmonization is determined by the statutory DG. Other protection in the Member States, that is allowed to offer extra deposit protection on a voluntary or contractual basis, is outside of the scope of the Directive.

The 2010 Directive was under discussion for some time. In 2011, co-legislators failed to reach a compromise agreement as requested by the Council, mainly because disagreeing about Member States potential usage of DGS funds for resolution purposes in the context of the proposed BRRD. In July 2012, Member States expressed their willingness to continue the DGS negotiations, in parallel with those in the BRRD (IMF, 2013c). The modified DGS Directive was adopted by the European Parliament, together with the BRRD and Single Resolution Mechanism 15 on April 2014 (EC, 2013d).

The new directive ensures that depositors are acquainted with the most important facts of the protection of their deposits by DGS, i.e. when depositing funds at a bank, the depositors would be required to sign a standardized information list, which includes all the key information regarding the coverage of the deposits by the DGS. On the other side, banks would have to provide information to depositors about the DGS protection and the statements of the account (EC, 2014a). Certain restrictions will also exist on advertisement of deposit products, by limiting it to basic information, excluding the phrases such as unlimited protection, etc.

Coverage limitation of €100,000 covers all the aggregated accounts at the same bank. Depositors that hold deposits in the same bank, but under different brand name, will not have separately covered deposits. Deposits of individual financial companies and authorities will not be protected, since they can easily access other sources of financing. This harmonization will bring much more clarity for the depositors and will provide quicker verification process of claims by the DGS and consequently quicker reimbursement in the event of a bank failure. The Deposit Guarantee reform provides a faster payment with a deadline, which would be progressively lowered from 20 to 7 working days. The number of days will be reduced gradually, to 15 working days in 2019, 10 working days in 2021 and 7 working days in 2024 (EC, 2014c).

4.4 Financing of DGS

For effective operation, DGS needs the required financial capacities. The capital base presents a very essential indicator when assessing the insurance credibility. DGS can be financed for future payments in advance or provide a financial model which would organize a distribution of the claimed amounts over the insured institution, after a claim or payment occurs. It is called ex-ante and ex-post financing. Ex-ante financing covers the baseline for the payments in the future, intended for insured banks and/or depositors and increases public confidence, smoothens premium payments and reduces moral hazard. However, it is not easy to create a fund of an adequate size, properly calculate premiums and to account for the administrative complexity. The contribution has to include enough funds to cover the individual risk of default on covered deposits and also the systemic risk for the insured deposits of the institutions (Bernet & Walter, 2009).

Financing of the deposit guarantee schemes is very important as it needs to assure appropriate funding and credibility of the scheme. According to the 1994 Directive, funding was not harmonized and many were either ex-ante, ex-post or both. National DGS have not all been able to cover similar bank failures (Gerhardt & Lannoo, 2011).

The target level from the 2010 Directive for ex-ante funds of DGS is 0.8% (Member States have the right of setting higher target levels) for their covered deposits to be reached within 10 years. In extreme situations, Member States can prolong the initially determined period of time for a maximum of 4 years. If required, banks will have to pay additional contributions, which will be aiming at avoidance of pro-cyclicality and worsening financial status of healthy banks. If that would still not be enough, DGS would have an option of borrowing funds from each other on a voluntary basis and up to a certain limit or using extra funding source such as loans from public or private third parties as a last resort. The new financing requirements provide enough funds that schemes will be able to deal with small and medium-sized bank failures (EC, 2014c).

The riskier banks will have to contribute more to DGS as the amount will be depending on the amount of covered deposits and the level of risk acquired by the individual member. EBA will be responsible for providing the guidelines that will be used for the calculation of contributions to DGS. Guidelines will contain specific factors, information how to make calculations and will divide participants to different risk classes and will provide other necessary elements. Simultaneously, DGS also has the right to handle the procedures with its own risk-methods for calculating the amounts of contribution, but each method will have to be approved by a competent authority and the EBA has to be informed about it. EBA will carry out guidelines review on risk-based methods 3 years after it enters into force and also on every 5 years afterwards (EC, 2014c).

According to the proposal of the EC, the collected DGS funds will be mostly spend for depositors' claims. Member States are allowed to spend the collected funds for other purposes, with intention of avoiding banking failures. The exact regulation rules on spending the funds are left to the judgments of the individual Member State (Gerhardt & Lannoo, 2011). DGS could use its funds for early intervention, but some conditions would have to be met, e.g. that DGS has applicable systems for selection and implementation of alternative measures and also for controlling connected risks, that costs of measures are not larger, compared to the costs required for the fulfillment of the statutory of contractual mandate of the DGS, that the resolution authority has not taken any resolution actions, etc. Early intervention can be successful in rescuing a troubled bank, but is an action without a guarantee that failure will be prevented because of the intervention. That is why some DGS funds have to be reserved for the payout (EC, 2014c).

If Commission approves, Member States can set a target level lower, but not under 0.5 percent of covered deposits. This will be a possibility for banking sectors, where there will be small chances of bank liquidation, but rather resolution, what makes triggering of the DGS less likely. Nowadays, approximately half of the Member States achieved higher levels than prescribed or are relatively close and in one third, the funds collected for DGS are higher than 1 percent and in a few even beyond 2 percent or 3 percent (EC, 2014c).

Cross-border challenges have been exposed in the Commission's proposal. In order to arrange an easier path, the Commission has proposed that the hosting country acts with its DGS as a 'single point of contact' for depositors at branches in other Member States. If there is a failure of a bank with cross-border activity, the branch customers from other countries do not need to get in contact with several DGS, but only with their national deposit insurer. Insurer will directly reimburse the depositors, on behalf of the DGS that is actually responsible and the home scheme will provide refunding for the host country insurer later. The Commission proposed that Member States will guarantee exchange of information between deposit insurers, but the details about the procedure have not been provided. That raises a question of whether the exchange of information between different European schemes would be enough for a successful cooperation. The information has to be available to DGS in order to be able to provide one-week payout period. If the information exchange would remain non-standardized across EU, relevant obstacles would still remain (Gerhardt & Lannoo, 2011).

4.5 Towards a Common Deposit Guarantee Scheme?

Even though there has also been a strong desire for the harmonization and creation of a common deposit guarantee scheme, little progress has been made towards its establishment. It has proven to be very difficult to reach an agreement where potentially large fiscal consequences are involved. Despite the fact that from January 2015, common ex-ante financing arrangements will be introduced, there will still be no binding mutualization of depositors' protection across countries (Pickford et al., 2014). A number of solutions have already been proposed in the academic circle.

Europe policy makers suggest a common, centralized deposit guarantee system and harmonized across the Eurozone, to build a form of a fiscal union. There is a major acceptance of the general existence of such a system, but there are different theories that are dealing with specific details of what such a system should hold (Burke, 2013). When thinking about pan-European DGS, a lot of advantages can be listed, but also disadvantages occur. However, advantages, such as improved credibility, international solidarity, simplified failure resolution and payout, reduction of adverse selection/moral hazard, inspire confidence in international investors and thus reduce the risks of a bank run affecting several countries. However, there are also some disadvantages like requirements of international supervising authorities and political obstacles with administrative and operative complexity (Bernet & Walter, 2009).

Although resolution and deposit protection are treated as separate sections, these functions have often been combined in practice. FDIC has initially had resolution powers over smaller banks and the Dodd-Frank Act assigned it resolution powers for the large entities as well in 2010. The Japan Deposit Insurance Corporation (DIC) has resolution power as well. One of the proposals in this direction was made by Schoenmaker and Gross (2012). They argue that there is a need for a European Deposit Insurance and Resolution Authority (EDIRA), which would be a new institution and should remain separate from the supervision. It would stabilize the retail deposit base and resolve troubled cross-border bank. Gerhardt and Lannoo (2011) also suggest combining the two functions within some European equivalent of the American FDIC. The combination would bring deposit insurance with resolution powers, allowing swift decision making. The EDIRA would be financed with risk-based deposit insurance premium provided by banks whose customers would have benefits from its protection, i.e. EU banks. Banks that would fall under this regime would be all banks from the euro are that are subject of the EBA stress test.

Pisani-Ferry et al. (2012), provide three options. Firstly, the national DGS would support itself, but a part would also be reinsured by the European deposit reinsurance fund. The national tax payers would continue to support the deposit guarantee system of its country and in the event that the national DGS would not suffice, it would get help from the supranational guarantee fund and national fiscal resources. Secondly, they have proposed a supranational guarantee fund, prefunded by the Member States with annual contributions, making it dependent on previous drawings of the re-insurance scheme. The third option centralizes the entire DGS into one single federal system and takes the U.S. case for its example (Burke, 2013).

Commission in its proposal proposes three models to establish an EU-wide deposit guarantee scheme:

- Introducing a single European DGS instead of national deposit guarantee schemes – this solution integrates individual national DGS. The pan-European DGS would assume the previous functions of the national protection systems,
- Adding additional 28th scheme that would complemented the 27 schemes of the Member States and
- System build out of existing DGS that could give credit to each other – it would create a supporting agreement with the required formal coordination, rules of building elements and specific agreements of cooperation.

According to European Parliament (2013), Member States should harmonize all relevant dimensions of coverage (type of deposit/depositor covered and up to which amount), funding standards (particularly the relationship between ex-ante and ex-post funding), a target ex-ante fund size, payout periods, delegation of responsibilities… Common DGS would imply burden sharing and deposit holders would have equal protection regardless of the country in which they have their deposits. Competitive distortions would be minimized and disturbing cross-border differences in consumer protection would not exist.

Deposit Guarantee System can be presented as a final and urgent goal in the Banking Union construction. The Commission proposal for DGS Directive has been a positive step to increase the insured values of deposits, but the proposal for the common authority is still missing (Hodula, 2013). The feasibility of a common European DGS in the near future is hindered by mostly political reasons. When a common single resolution fund will be set up, the lack of common insurance deposit scheme will create an incentive for the Single Resolution Board to shift the responsibility for resolving banks back to countries, in order to minimize the impact of the European fund. Consequently, vicious circle between sovereign and banking risks would remain (Pickford et al., 2014).

Schoenmaker & Gros (2012) claim that if the resolution and deposit insurance would remain at the national level, serious conflicts would arise with the ECB. The ECB could consider a need for a bank to be shut down, while national authorities could have an opinion that the bank could be saved. The second possibility could be that the ECB would allow a bank to take too much risk and consequently push the fiscal cost of such a problem on the national authorities.

The deposit insurance institution cannot be represented as a box from where you can get money for jeopardized deposits, but it is an important part of an integrated safety network, intended for stabilization of the financial system. In case of a financial crisis, its role and competencies should be very clear and not connected to the other functions of other security network elements (Bernet & Walter, 2009).

Steps should be taken toward establishing a common funding of deposit insurance. It presents a critical element of the Banking Union, as it ensures that funds are available to resolve individual bank failures and covers payouts to depositors in the event of bank failures and does not endanger sovereigns or monetary stability (IMF, 2013c).

CONCLUSION

Financial crisis has shown that the systems of national supervisors, resolution mechanisms and deposit guarantees are not able to provide the needed financial stability in the euro area and the entire EU. The connection between sovereign and banking risk has been revealed by situations that have damaged the financial system and have negatively affected the European economies. In order to stabilize the financial system, to reverse the process of financial market fragmentation and to weaken the destabilizing link between banks and sovereigns, substantial changes and upgrades were needed.

In June 2012, the report Towards a Genuine Economic and Monetary Union was presented and gave guidelines for future desired and needed development of the Eurozone. The Banking Union was one of the four main parts (besides Monetary, Fiscal and Political union), playing an important part in the future development.

The process of forming a Banking Union is based on three pillars: a Single Supervisory Mechanism (SSM), a Single Resolution Mechanism (SRM) and a Common Deposit Guarantee Scheme (DGS). All three pillars are backed by the Single Rulebook, a set of harmonized and prudential rules that serve as a legal basis. While the first two pillars have already been adopted, the third one is still far from becoming a reality.

With an objective to provide certainty on banks' real conditions, the first adopted pillar SSM will enter into operation in November 2014 and will, through its main supervisor European Central Bank (ECB), provide supervision for all the banks in the euro area and in any other Member States that would want to be included. Most significant banks, which are defined with specific criteria, will be under its direct supervision and represent approximately 85 percent of the banking assets in the Eurozone. Supervision over less significant banks will still be performed by the national supervisory authorities on the basis of their national legislation, while considering the guidelines and instructions issued by the ECB. The ECB scope will not include the huge losses, occurred during the crisis years. The ECB is currently dealing with assessment of the strengths of the banks' balance sheets, for which it will be responsible later. If banks will prove to be undercapitalized but viable, then they will be forced to raise additional equity, while the non-viable will be wound down.

SRM represents the second step in the process of building a banking union and will have the powers to make a decision on how to deal with non-viable banks. The legal base is provided by the Bank Recovery and Resolution Directive (BRRD). A very important new bail-in procedure has been established, where creditors and shareholders assume losses in the event of difficulties. The center of the SRM will be a new EU agency, the Single Resolution Board, which will become fully functional from 1 January 2016. It will be responsible for resolution of significant banks and cross border groups, but the national resolution authorities will be responsible for carrying out the resolution. The Board will work closely together with the ECB to come to a decision on whether to put a bank into resolution. The European Commission and the Council will also have responsibilities in resolution decisions. Single Resolution Fund (SRF) will raise its target level of €55 billion with banks' contributions in no more than 8 years. It will be first divided to national compartments but will gradually be mutualized.

The third pillar's aim is to safeguard bank deposits. Due to a number of euro area country opponents, the Common Deposit Guarantee Scheme has not yet been developed, as countries do not want to share bank deposit risks. Instead, harmonization of European deposit schemes took place with a directive, standardizing minimum required coverage for guaranteed deposits at €100.000. It also determined the time objectives for disbursement of deposits and contributions for the national funds. Nevertheless, differences have always existed between various deposit schemes and can potentially generate competitive advantages or weaknesses.

Overall, the Banking Union will take care of the urgently needed further integration of the banking industry. Its integration will connect firstly the Eurozone countries and will further move in the direction of completing the Single market. The Banking Union will have to deal with the problems by implementing the required institutional and operational reforms to enable completion of the European integration. Consequently, several challenges are waiting in the near future.

A particularly emphasized problem is the uneven progress in the development of the main elements of the entire process, which presents a risk of an unfinished banking union. All three pillars that were scheduled to become a part of the Banking union are very much important for its proper functioning. Numerous connections exist between the three pillars and require each other's mutual support. The first hypothesis “All the three pillars are necessary for a successful Banking Union” is referring to this topic. Through the master thesis, it became apparent that this hypothesis can be accepted.

Certain concerns exist that the Banking Union is, due to its incompleteness, only a partial success. The design of SSM and common regulatory regime was very much accepted in 2012, while already the proposal on SRM that followed seemed more controversial and faced much greater opposition and the plan for establishment seemed distant. It was said that this could bring only a half-finalized Banking Union. If only the SSM would exist and supervise the large banks, without having the resolution authority or a deposit scheme, public debt restructuring would lead to bank failures and the ECB would incur write-off losses from lending to local banks without having the possibility of constraining these banks’ actions (Giuseppe et al., 2014). Furthermore, the SSM creates a system of equal rights and obligations regarding the supervision and thus also has an influence on diminishing the risk of forbearance, while the SRM provides restructuring at the least cost in case of a bank failure and ensures that funding can be allocated and used most productively.

Similar information is required from banks for the supervision and resolution authority. Their correlation is obvious as the SSM’s competences of taking appropriate action in connection to the troubled banks, depends on the ability of SRM to resolve the particular bank effectively, without troublesome spillovers to the rest of the financial system. Close coordination with the DGS is also important. If its interest would not be taken into account by the SSM and SRM, it would probably result in delayed interventions and unfairly increasing costs that would have to be taken over by the DGS. Without all three pillars, the Banking Union would stay incomplete. Some other countries have already recognized their interdependence and have placed the resolution powers with the deposit guarantor (e.g. US).

The fact that the creation of the Common DGS is not very likely in the near future does not mean that it is not important for the completion of the Banking Union. DGS present a key factor for the stability, since it largely prevents the typical fears, brought by a banking crisis.

DGS Fund could absorb the losses that occurred in the banking crisis, irrespective of the solvency of the country in which the losses occurred. Together with the SRM fund, also financed by the banks' contributions, it would create a proper baseline of guarantees and additionally strengthen the Banking Union.

Supporters of the Banking union believe that the connection between sovereign debt crisis and banking crisis can be broken by European level supervision, resolution and deposit guarantee schemes and by general encouragement of banks to diversify across Europe.

But the second hypothesis of this thesis, stating that “a Banking Union is the right solution for resolving sovereign debt crisis of the Eurozone members”, cannot provide a clear decision, as more reasons have been found that do not enable the Banking Union to completely break the link between sovereigns and banks. Eurozone leaders have planned to stop this self-reinforcing negative feedback loop by more direct interventions into the banking sector, which is also one of the main purposes of creating the Banking Union.

To properly cope with the vicious link between sovereign and banking risk, the authorities' plan has been to suppress or at least limit the usage of public funds that was caused by the crisis situations in the banking sector and represented a huge spending of taxpayers’ money. The SRM is particularly oriented toward ensuring that taxpayers will not take part in the event of a bank failure. Shareholders and creditors have to be the first in line. The SRM will also have to provide a proper procedure for banks without a feasible business model to enable them to properly exit the market. This would have a positive effect on enhanced banks' credit monitoring and moderating banks' risk appetites. The long transitional period of resolution costs mutualization delays the separation of the banking sector from the public finances. Separation would reduce the possibilities of sovereigns selling the debt they owe to their home banking sector and prevent the possibility of resolution with international fiscal transfer schemes, which would be aiming toward stabilization of insolvent states.

One of the main issues is that sovereign bonds would have to be risk-weighted the same as the private assets and the exposure to the individual sovereign debt should be limited. There should also be a limit of how many government bonds can a bank own. Risk weighting of sovereign bonds would make sovereign banks more resilient, if the fiscal position of the particular sovereign would get worse. The case of non-diversification is also of concern, as the European banks usually hold bonds only from their home country. Undiversified exposure increases the sovereign systemic importance.

When government financial health would be put into question, then the depositors would doubt the government's ability to guarantee deposits, if it would still stay under national jurisdictions. This could lead to a potential bank run. Hence, the national deposit guarantees would not break the negative feedback loop.

Although the Banking Union presents quite a complex system that is still incomplete, it definitely contributes to the stability and consistency of the financial system. In the long run, the effectiveness of the Banking Union will depend upon the operational efficiency of all its components and deliverables that should be able to provide a safe and trustworthy financial environment. A safe banking sector is surely contributing to the prosperity of European citizens.

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APPENDIXES

TABLE OF APPENDIXES

Appendix A: List of Abbreviations

- AQR – Asset Quality Review
- BRRD – Bank Recovery and Resolution Directive
- CRD – Capital Requirements Directive
- CRR – Capital Requirements Regulation
- EBA – European Banking Authority
- EC – European Commission
- ECB – European Central Bank
- EFSF – European Financial Stability Facility
- EIOPA – European Insurance and Occupational Pension Authority
- EMU – Economic and Monetary Union
- EP – European Parliament
- ESM – European Stability Mechanism
- ESMA – European Securities and Markets Authority
- ESRB – European Systemic Risk Board
- EU – European Union
- FDIC - Federal Deposit Insurance Corporation
- FSB – Financial Stability Board
- GDP – Gross Domestic Product
- IGA – Intergovernmental Agreement
- IMF – International Monetary Fund
- MFI – Monetary Financial Institutions
- NCBs - National Central Banks
- NRA - National Resolution Authorities
- OMT - Outright Monetary Transactions
- SRM – Single Resolution Mechanism
- SRF – Single Resolution Fund
- SMEs – Small and Medium Enterprises
- SSM – Single Supervisory Mechanism
- TFEU – Treaty on the Functioning of the European Union

Appendix B: Summary in Slovene

Nekaj let pred izbruhom finančne krize je bil evropski finančni sistem zelo povezan, še posebno v evro območju (Sapir & Wolff, 2013). Finančna integracija je bila intenzivna in hitra ter je spodbujala velike kredite in druge kapitalske tokove med državami. Banke so znatno razširile svoje aktivnosti. Niso se ukvarjale samo s komercialnim bančništvom, ampak tudi z bolj zapletenimi posli, ki jih je bilo težko spremljati in nadzirati (Liikannen et al., 2012).

Usodne napake so bile storjene pri ocenah tveganj, tako v finančnih podjetjih, kot tudi v institucijah, ki so jih spremljale in nadzorovale. Posledice so bile precenitev sposobnosti finančnih podjetij glede sposobnosti prevzemanja tveganja in podcenjevanje višine kapitala, ki bi ga morale imeti v lasti (Larosière et al., 2009).

Od oktobra 2008 in do konca leta 2010, so evropske države porabile €1.6 triliona državnih pomoči, da so pomagale bančnemu sektorju. Če vlade ne bi ponudile interventne pomoči, bi prevladala resna sistemska kriza, z veliki posledicami za ekonomijo. Ob koncu leta 2010 so se pogoji izboljšali, vendar pa je dolžniška kriza prinesla svoj davek in skupaj z bančno krizo ustvarila prepleteno zanko (Liikannen et al., 2012).

Junija 2012 so predsedniki Evropskega sveta, Evropska Komisija, Evroskupina in Evropska Centralna Banka (ECB) izdali poročilo »Na poti k pravi ekonomski in monetarni uniji« in zastavili 4 glavne stebre, ki naj bi oblikovali prihodnost monetarne unije. Bančna unija predstavlja enega izmed najpomembnejših stebrov in katere razvoj se je najhitreje začel odvijati.

Glavni cilj Bančne unije je vzpostavitev integriranega finančnega okvirja, ki bo varoval finančno stabilnost in okrepil banke ter čim bolj omejil stroške propada bank. Z utrditvijo bančnega sektorja je namen tudi rešiti problem prepletenosti bančne in dolžniške krize ter preprečiti ponoven nastanek kriz. Za članice evro območja je članstvo obvezno, medtem ko se ne-evrske države lahko za vstop odločijo prostovoljno.

Razvoj bančne unije temelji na treh stebrih: enotnem nadzoru (SSM), enotnem okviru za reševanje bank (SRM) in enotnem okviru jamstev za denarne vloge (DGS) (Mekina, 2013). Ustrezno podlago za razvoj pa bodo zagotavljala celovita in enotna pravila za finančne storitve, za katere je odgovorna Evropska bančna avtoriteta (EBA). Medtem, ko so pravila in postopki za prva dva stebra že sprejeti, razvoj tretjega stebra zaostaja.

Prvi steber, enotni nadzorni mehanizem, bo prispeval k ohranjanju finančne stabilnosti in pravočasnem odkrivanju tveganj preživetja bank. Glavni nadzornik bo Evropska centralna banka, ki bo nadzorovala 120 največjih in sistemskih bank, katerih seznam je določen s specifičnimi kriteriji. Za nadzor preostalih bank bodo poskrbele že obstoječe nacionalne nadzorne institucije.

Enotni nadzorni mehanizem bo začel delovati v novembru 2014, pred tem pa bo ECB opravila temeljit pregled in skupaj z EBA izvedla stresne teste največjih bank. Rezultati bodo pripeljali do ugotovitev možnih kapitalskih lukenj, za katere bodo banke morale same poiskati denar za financiranje (Kleva Kekuš, 2013).

Drugi steber, enotni mehanizem za reševanje bank je ključno dopolnilo k prvemu in vključuje že dogovorjena pravila za urejeno sanacijo ali likvidacijo bank. Pravno podlago zagotavlja Direktiva o reševanju in likvidaciji bank. Zelo pomemben dosežek je dogovor o tako imenovanem bail-in postopku, kjer bodo v primeru težav bank, izgubo pokrili najprej lastniki in delničarji, nato upniki ter kot zadnji veliki varčevalci z več kot €100.000 na računu. Manjše vloge bodo nedotakljive in popolnoma zavarovane (Kleva Klekuš, 2013). Dogovor vsebuje tudi vzpostavitev enotnega organa, ki bo nadziral izvajanje teh pravil in sklad, ki bo sestavljen iz prispevkov bank (Dnevnik, 2013). Enotni organ bo deloval od Januarja 2016.

Sklad bo najprej temeljil na nacionalnih razdelkih in se nato po osmih letih združil v enotni sklad. V osmih letih naj bi bilo na voljo 55 milijard evrov, vendar bi si lahko dodatna sredstva zagotovili z izposojo denarja na trgih ali iz Evropskega mehanizma za stabilnost (ESM). Če bi v tem prehodnem obdobju države članice potrebovale pomoč, imajo možnost premostitvenega financiranja iz nacionalnih skladov drugih članic ali pa v izjemnem primeru lahko zaprosijo za pomoč ESM (Mekina, 2013).

Tretji steber predstavlja enotni sistem varovanja vlog, ki pa še ni v fazi razvoja, saj zaenkrat države članice niso pripravljene deliti tveganja depozitnih vlog. Do sedaj je bila sprejeta le direktiva, ki je uskladila sheme držav članic z določitvijo minimalnega kritja depozitov v znesku €100.000. Poenotena je tudi doba izplačevanja depozitov in določitev, da morajo banke prispevati v nacionalne sklade, iz katerih se bo lahko izplačevalo varčevalcem.

Dve pomembni vprašanji sta bili izpostavljeni skozi celotno magistrsko nalogo. Prvo se je nanašalo na problematiko neenakomernega razvoja Bančne unije in kako so vsi trije stebri pomembni za medsebojno podporo in zagotavljanje ustreznega delovanja, drugo pa je zajemalo pomisleke ali bo Bančna Unija zagotovila pretrganje zanke bančne in dolžniške krize.

Oblikovanje enotnega nadzornega mehanizma je bilo močno podprto, vendar takojšnje enotne podpore ni dobil drugi steber za reševanje bank, saj se je državam, ki so mu nasprotovale, zdel mnogo bolj kompleksen in dolgotrajen proces. Po zahtevnih pogajanjih so države članice prišle do dogovora, vendar pa se to ni zgodilo pri oblikovanju zajamčenih vlog. Pri tem projektu države članice zaenkrat še niso našle skupnega jezika in bo verjetno še nekaj časa tako ostalo.

Enotni mehanizem za nadzor, kot tudi za reševanje bank potrebujeta podobne bančne informacije, ki spadajo pod njuno delovanje. Njuna korelacija je očitna, saj je sposobnost SSM, da pravilno reagira glede banke v težavah odvisna tudi od načina reševanja SRM, kako bo banko razrešil učinkovito, brez negativnega priliva v preostali finančni sistem. Bližnja koordinacija z DGS je tudi zelo pomembna. DGS predstavlja pomemben faktor stabilnosti, saj v veliki večini prepreči strahove, ki jih prinesejo bančne krize.

Podporniki Bančne unije verjamejo, da bo z vzpostavitvijo mehanizmov pretrgana vez med bančno in dolžniško krizo, vendar pa obstaja kar nekaj razlogov, ki tega z gotovostjo ne potrjujejo. SRM je specifično usmerjen k cilju, ki zagotavlja, da javnih sredstev davkoplačevalcev ne bo treba uporabiti v primeru reševanja bank. Vez pa bo ostala, če bodo državne obveznice na voljo še vedno kot naložbe brez tveganja in če banke ne bodo povečale razpršenosti svojih naložb, saj imajo največkrat v lasti samo obveznice domačih držav. Premajhna razpršenost pa poveča sistemski pomen države in če bo jamčenje depozitov ostalo samo na državni ravni, potem lahko hitro pride do množičnega dvigovanja vlog, kadar bi bilo finančno stanje države vprašljivo in zanka tako ne bi bila pretrgana.

Bančna unija bo poskrbela za nujno integracijo finančnega sistema in še bolj specifično, bančnega sektorja. Najprej bo povezala države evro območja in nadaljevala proti dokončnemu uresničevanju enotnega trga. Čeprav bančna unija predstavlja precej zapleten sistem, ki še vedno ni dokončan, bo zagotovo prispevala k stabilnosti in skladnosti finančnega sistema. Na dolgi rok bo njena učinkovitost odvisna od operativne uspešnosti vseh stebrov in rezultatov, ki jih bo uspela zagotoviti.