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Doctoral School in Political Sciences

Is the European Banking Union on the right track?

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Bucharest,

2021

Introduction

Analyzing what has been achieved so far, the paper tries to answer the questions: Will the Banking Union be a step forward on the road to integration or will it remain only an incomplete step, necessary to save the European banking system severely affected by the subprime crisis and the sovereign credit crisis ? Will it succeed in achieving its two stated goals, namely breaking ties between states and banks and avoiding the use of taxpayers' money in bail-out processes? Is it important for non-euro states to join the Banking Union and under what conditions?

Although it is a step forward on the road to integration because both the MUS and the MUR represent a transfer of sovereignty, the largest since the introduction of the euro and because the banking sector is the main financier of European economies and both bank supervision and bank resolution pose significant risks to state economies. Although at the theoretical level the states have accepted this cession of sovereignty, in practice it remains an incomplete construction because the states cannot agree on the financing of the resolution part, the proposed solutions will either take long time to implement or are avoided by the them.

As for international relations, in the implementation of the Banking Union we speak of the tension between federalization and intergovernmentalism, between national and international. From a political point of view, we are talking about the legitimacy of the institutions and the way they take decisions. From a social point of view, we are talking about equity and the optimal use of taxpayers' money.

From the 3 pillars, only the Single Supervisory Mechanism is functional, and even that one works suboptimal, because it consists of a set of rules, which focus very much on capital adequacy and less on operational risks, which were in fact the main problem that triggered the financial crisis, and the standardization of banking procedures in risk assessment and guarantees, by overlaping the Single Supervisory Mechanism over the regulations of existing institutions, such as the Basel Committee, ESRB, IFRS, EBA which had prior standardized part of banking regulations. In addition, the MUS regulations have only marginalized the risks associated with extreme events, in general, the offensive of fintechs and cryptocurrencies, which seek to change the banking market and climate change in particular, while for the Single Mechanism Resolution and the Single Resolution Fund did not find a viable solution.

For banks, the Banking Union generated, in addition to an increase in the level of capital, also an increase in the operating volume and an adjustment of expenses for the capital adequacy regulation proposed by MUS. These provisions did not lead to a reversal of lending trend or any improvement in the quality of banks' assets and processes, as evidenced by the ensuing bankruptcies, the precarious balance sheet situations of major banks, and the allegations of money laundering. In contrast, the new capital requirements, together with the ECB's negative interest rate policy, have led to a sharp reduction in banks' profits. As for the resolution part, in the absence of a functional mechanism, the banks bail out remained in the responsibility of the Member States, which continue to use taxpayers' money, contrary to one of the aims of this project. In addition, sovereign exposures did not decrease significantly, breaking the link between the state and banks being another unrealized goal of the Banking Union.

The paper makes an analysis of the feasibility of the organization of the Banking Union with applicability on the situation of Eurozone states and non-euro states. An important part is allocated to the conditions that Romania must meet in order to join the Banking Union.

The work was started in 2014, with the approval of the MUS regulations and was written as things evolved, covering the period 2014-2020.

Research methods

This paper is a top-down approach, starting from the study of the main policies and practices of the EBA and the ECB, trying to synthesize the main rules of the Banking Union, through deductive reasoning, analyze them and try to verify their applicability in two specific situations: the impact on the Eurozone states and the accession of non-euro states to the Banking Union, with a more detailed analysis of Romania's case in relation to the Banking Union.

The first part contains a description of the Banking Union, its pillars and the institutions underlying it. Next, the contributions of these institutions will be operationalized by analyzing the regulations and reports issued by them, so that we can determine their effects. Following the determination of the effects, certain hypotheses will be formulated that will be applied in the second and third part of the paper. Finally, a series of hypotheses will be formulated that will be argued in the form of proposals.

The paper is based on a descriptive area from a normative point of view, analysis based on documents and interpretation of secondary statistical data to argue the conclusions. European legislation in the field of Banking Union, European Union and Eurozone, analysis of data and information from EBA stress-tests, secondary data of Deutsche Bank, Jaques Delors Institut, ECB, Bruegel Institute, EBA, esm.europa.eu, EBF, BNR, PWC synthetically analyzed to argue the conclusions.

The mode of collecting the information used in the paper are: the mode based on the authority of the source that includes regulations, procedures, market research studies, information from the websites of public authorities and regulatory and supervisory institutions; the rational mode based on logic critically analyzes the documents listed above, states a conclusion and proposes an alternative; the research method based on the study of reality is used because the European Banking Union is a very new field, which is still being built at the time of this presentation and includes besides the financial-banking approach and a macroeconomic approach, a political approach, a managerial approach, a legal approach, an ethical approach, a public administration approach and an integration approach.

The mode based on the authority of the source that includes regulations, includes:

a. the governing institutions of the European Union: the European Council, the Council of the European Union, the European Commission, the European Parliament;

b. Regulatory institutions: European Central Bank (ECB), European Investment Bank (EIB), European Economic and Social Committee (EESC), European Court of Auditors (ECA), European Committee of the Regions (CoR), European Action Service External Affairs (EEAS), European Economic and Social Committee (EESC), European Ombudsman, European Data Protection Supervisor (EDPS);

c. the institutions of the European Banking Union:

c1. Single Supervisory Mechanism (SSM): Board of Governors, ECB Supervisory Board, Steering Committee, European Systemic Risk Board (ESRB), European System of Financial Supervisors (ESFS) - European Banking Authority (EBA), European Securities Authority and Markets (ESMA), the European Insurance and Occupational Pensions Authority (EIOPA), the Joint Committee of National and European Supervisory Authorities, the Basel Committee, the European System of Central Banks;

c2. Single Resolution Mechanism (SRM): Directive for the recovery and resolution of credit institutions and investment firms (BRRD), Minimum eligible own funds and liabilities requirements (MREL), Total loss absorption capacity (TLAC), Single Committee on Resolution (SRB), European Deposit Insurance Scheme (EDIS), Single Resolution Fund.

d. Reports issued by various supervisory institutions: “Six Packs”, “Two Packs”, “ECB Bank lending survey”, “ECB Annual Report”, “EBA Comprehensive Assessment”, “EBA Guidelines on Credit Risk Management”, “Capital Requirements Regulation ”, CRD IV, Exchange Rate Mechanism - ERM 2, documents issued by the Basel Committee, BNR, ASF.

e. heads of institutions, professors, authors and scientists known in the field.

BANKING UNION: INSTRUMENTS AND INSTITUTIONS

The first part talks about the pillars of the Banking Union and examines the following issues: whether it is good for the Banking Union to have a single supervisor and whether it is good that this functionality to be performed by ECB and whether another one of the ECB's roles can also be the lender of last resort. The Single Supervisory Mechanism, the Single Resolution Mechanism, EBA, their legislative support and their organization and the institutions with which they cooperate are analyzed.

The Banking Union is part of a broader reform package of the European Union that also contains incentives to increase fiscal discipline, such as the excessive deficit procedure, the excessive imbalance procedure, a budget discipline assessment package in the form of the European Semester, a crisis management framework and related preventive measures for the actions of the Commission and the Council and the strengthening of public institutions gathered in the so-called "Six Pack", as well as a package of budgetary surveillance and financial assistance from the European Emergency Fund called "Two Pack" . In addition, for the reform of the EU and for increasing convergence, the "Report of the Five Presidents" has been added with reforms, among others, in the banking sector, in order to guarantee the support of the economy by the banks.

Following the Report of the five Presidents, the Commission issued a document providing options for the further development of Economic and Monetary Union, "Deepening EMU" by

2025. Current issues highlighted in the report such as the marginal growth of the economy, rising unemployment, rising public and private debt, anti-Union movements have affected the socio-political structure. The low economic integration, the lack of confidence and solidarity of the states and the lack of a clearly accepted vision have led the Commission to look for options. If so far the reforms have been investment-oriented, budgetary policies and structural reforms, all supported by bank financing and accompanied by a slow and non-transparent decision-making process, by intermediate bodies used to alleviate mistrust and vision, the proposed reforms focuses on people, job creation, economic convergence and social equity, solidarity. The same document also provides for the completion of the Banking Union, the financing of a common budget protection mechanism for the FUR and EDIS with a 2025 operability term, together with a financial protection mechanism, which will be used as a back-up if the FUR will not cover the necessary financing, in case of resolution of several banks. It will be activated quickly, without national costs and institutional architecture, being financed either by an ESM credit line to the FUR or by a simultaneous loan to the FUR by all states. After Brexit, the Capital Markets Union became a priority as an additional source of funding by promoting sovereign bond securities, SBBS. In addition, in order to strengthen the governance of the Eurozone, the idea of a treasury to oversee it from a budgetary point of view has emerged, to be supported by the budgetary council, with the main function of macroeconomic stabilization. To all this will be added a European Monetary Fund needed to increase the autonomy of the Eurozone and which will be based on the ESM.

An important chapter is the analysis of the banking system supervision, with the emphasis on the analysis of EBA stress tests, the EBA guide on credit risk management and the single book of regulations. The analysis concludes that although many expected these tests to be the foundation of a new economic and financial paradigm, they turned out to be just a simple check of how the legislation is applied in the banking system, anyway continuously supervised until then by national supervisors. The tests showed gaps in purpose, method and consistency.

The guide on credit risk management, which requires the application of risk provisions according to proportionality and materiality, has taken over part of the burden of the new legulation on the shoulders of small financial institutions. The single book of regulations arose from the need for the single banking market to be subject to a regulation and not to the 28 regulations belonging to each state. But this single regulation is hit by asynchronous business cycles in the European Union. However, a single set of rules reduces regulatory arbitrage and smooths out the legislative advantages that distorted competition.

Next, we analyze the current problems of the Banking Union, which must be addressed, such as: speculative operations, denomination risk, lack of structural reforms, delaying the implementation of SRF and EDIS, due to lack of acceptance of mutualizations, suboptimality of the Eurozone without a common treasury and common fiscal policy, which can't be resolved only by the fiscal discipline promoted by the Fiscal Pact nor by the mitigation of the imbalances in the Six Pack or Two Pack, or by the creation of the Banking Union. To these are added the highly fragmented financial market and the banking systems of Eastern Europe dominated by Western banks and the euro. All these problems and reforms must be supported by democratic mechanisms and not only by administrative acts because they will lead to an accentuation of Euroscepticism. In addition, external challenges such as globalization, rapid technological change and their impact on the population, migration must be taken into account.

The first part ends with a series of questions and ambiguities that still do not have a clear answer. Things like supranational oversight and recapitalization and resolution at the national level are not very clear, and can cause problems. The ECB as a lender of last resort is poorly equipped for this, has limited information and limited intervention authority. In the long run, the recapitalization of the banks by the European Financial Stabilty Facility and the European Stability Mechanism, will generate debt for national governments. Another question arises from the opportunity for non-euro states to join the Banking Union, but also for the inclusion in the Banking Union of small banks, for which the ECB must play the role of lender of last resort. There is also the issue of excess sovereign credit not only in the banking market but also in the capital market. In addition, it is still unclear why the cheap money with which the ECB flooded the banking market, instead of being directed to lending to companies and legal entities, could be used to buy sovereign bonds, opening a new spiral that will have to refinanced when these securities mature.

BANKING UNION IN THE EURO AREA

The second part focuses on the analysis of the impact of the Banking Union on the banking system of the Eurozone. The outbreak of the crisis in 2008 showed that the European institutional architecture is too weak and the euro has created an integrated interbank market but not a real cross-border integration, because cross-border financing does not work. These, together with the lack of predictable rules and ring-fenced practices, have increased the fragmentation of the financial market and the financing costs of banks have become dependent on their states, strengthening the link between states and banks. After the crisis started in 2008, a significant part of integration was lost, reaching almost the same as before the introduction of the euro, but the sense of urgency, doubled by political will, contributed to the legislative process of the Banking Union in less than three years. However, in the meantime, implementation has slowed down due to a lack of political will regarding risk pooling and fiscal pooling.

The economic performance of the Eurozone is directly linked to the performance of the banking system, which finances three quarters of companies and nine out of ten households, twice as much as in the US, and the size of the banking system exceeds 2.7 times the European economy. The European banking system is currently facing the ECB's negative interest rate policy and banks' reluctance to finance for fear of a new crisis. In the banks' view, the new supervisory regulations put pressure on the profitability of the entire banking system. Banks still rely on ECB financing but still keep a large stock of non-performing loans in their balance sheets. The causes identified in the banking system are the low interest rates that eat from profitability and the pace of implementation for the new regulatory and resolution procedures, which decreases the profitability of banks, affects their ability to raise capital and finance. Also, the reduced interest rates will affect for a long time the remuneration of the capitals, whose cost will increase, but also on the clients of the banks whose indebtedness will increase at the same time with the interests. In addition, the long period of delevereging, due to austerity budgetary policies, has led to lower stock prices of European banks. At the same time, they do not want a quick clean-up of non-performing loans in the balance sheets, because a recognition of them can lead to the insolvency of some banks, and if governments try to buy them back, they will come into conflict with MUR.

The macroeconomic risk and banking system risks are expressed by the EBA in the report "Risk Assessment of the European Banking System". An important step was taken in

December 2020 when the Eurogroup approved the reform of the European Stability Mechanism to support the FUR. This is a precautionary measure given the economic management of the Covid crisis and the likelihood of a banking crisis. There is also a proposal for a European deposit insurance and the creation of a single European bond, ideas rejected by the Nordic countries, which insists that risk-sharing be done only after diversifying banks' sovereign exposures, while southern states do not want to give up their dependence on their own banks without having a true third pillar of the Banking Union.

In addition to reforming the ESM, the Covid crisis has accelerated the merger of the ESM, the EFSF and the EIB to issue secure European assets, which will improve the European Union's financial situation but also improve the euro's international position and replace national bonds, reducing the link between banks and weakening the vulnerability of the private sector to public demotion. The novelty is that for the first time the European Union will borrow to finance budget expenditures and the loan will be guaranteed by all EU member states.

The analysis ends with the argumentation of the need for risk sharing and the need for risk reduction for the implementation of a single deposit insurance.

BANKING UNION AND NON-EURO AREA. THE SITUATION OF THE ROMANIAN BANKING SYSTEM

The third part analyzes the situation of non-euro area Eastern states, non-euro states. They have the option of establishing close cooperation with the ECB or joining the Banking Union after examining the banking system. The question that still arises is whether it is better for non-euro states to join the Banking Union or directly in the Eurozone. Although they are 60-70% dependent on the Eurozone banking system, non-euro states have not had to allocate budgetary resources to save banks, non-performing loans have declined naturally and not through quantitative easing programs and have a low degree of indebtedness. The performance is remarkable if we consider that, unlike the Eurozone states, non-euro states have neither access to economic power and capitalization of Western firms nor access to ECB funds, which makes it difficult to resume lending, economic development and non-performing loans reduction.

In order to come under the governance of the Eurozone, the eastern states must, in addition to the nominal accession criteria, reach a structural compatibility from which the convergence of revenues will result. Economic robustness, which is measured by the degree of total indebtedness, the size of the budget deficit, the trade and current account balance, the level of fiscal revenues, will more easily cope with asymmetric shocks. The obvious benefits, such as increased financial stability, access to ECB and ESM facilities, are useful to non-euro states in the long run, but due to lower interest rates, the cost of financing is no longer an immediate benefit. In addition, non-euro states do not want to bear the costs of the sovereign debt crisis and resolution mechanisms, which weren't generated by themselves.

Politically, non-euro states are caught between the two camps of the southern states, which want a flexible fiscal policy, risk-sharing in the banking system and more tax transfers, and the Nordic states, whose economic policy is based on individual responsibility, strict observance of fiscal rules and integration of capital markets. In addition, Britain's exit from the EU mainly affects them from a political point of view, tilting the balance decisively towards the Eurozone.

Although the banking system has shrunk in number of units and employees, deposits and loans have risen above 2012. But the main problem remains profitability due to ECB policy.

To join, countries such as Poland, the Czech Republic and Hungary are awaiting political decisions. On the other hand, Bulgaria and Croatia have been accepted in EMR II and will enter the Banking Union through the Eurozone, even though Bulgaria still has unresolved issues in the area of justice and corruption, and Croatia has a strong euro area and delays in state companies' privatization.

As arguments against joining the Banking Union, in addition to the political and economic structure, the technical ones were highlighted: non-euro states will not be part of the decisions of the Board of Governors; lack of access to ECB and ESM liquidity, the SSM may be tempted to carry out general supervision of the banking system, excluding specific problems, with systemic risk in the country but unrepresentative in the European Union; liquidity management will generate transfers of funds from east to west to meet the indicators at group level; treating branches separately during the resolution, which would generate an additional need for funds to which non-euro states do not have access; compliance with standard conditions, not properly calibrated at the same time as the impossibility to propose other solutions not being in MUS; decision-making processes in MUS and MUR take place over long periods and can jeopardize resolution processes.

The main arguments for joining the Banking Union are: banking systems are made up mostly of Eurozone banks; The Banking Union has an overview, unaffected by local or political interests, which generates stability; the intermediation relationship with the Eurozone banks is improved; The Banking Union also has an overview of large, systemically risk banks; MUS contributes to increasing confidence in local banking systems; attracting enough capital to join the Banking Union will make banks more attractive; will increase the discipline of supervision and strengthen the capacity to absorb shocks; increasing the degree of cooperation with Eurozone authorities when problems arise with cross-border banks.

The Romanian banking system recovered quickly after the disintermediation period, following the crisis of 2008 due to the micro and macro prudential measures taken by the NBR. In 2015, the banking system returned to profit after years of loss, determined by the recognition of provisions, and in 2018 it reached the level of business that they had before crisis. But profitability is asymmetric, being concentrated in large banks. The Romanian banking system has contracted, but, at the same time, it has changed its balance sheet structure, diminishing its currency risk, orienting lending to the mortgage segment, in parallel with the tightening of lending conditions, and moving towards lending public administration, its solvency improved by a prudent dividend policy and the additional capital required of shareholders. The banking system has overcome the crises caused by banks in Greece and Cyprus. One problem they face, however, is the low degree of intermediation and financial inclusion. Also, other problems are the volume of bank arrears is at 10% of GDP and the phenomenon of insolvencies, both expected to be exacerbated by the Covid crisis, and, as in other non-euro states, the demographic crisis.

The stress test performed by the NBR for the period 2018-202, unlike the EBA tests, was applied top-down and resulted a healthy banking system and with the risk that the small banks being the most affected in the event of a negative scenario.

For Romania's access to the Banking Union, the following measures have been proposed: sustainable entry into the mechanism of close cooperation with the ECB; avoiding laws that could affect the process of removing non-performing loans from the balance sheet of banks or would force the unsustainable growth of the banking sector; avoiding increasing the exposure of the banking system to the state; avoidance of granting high-risk loans in the long run; low external and budgetary deficits; capitalization of state-owned banks by listing on the stock exchange; resolving structural imbalances at the level of companies; investments in infrastructure, health, technology and public services.

Romania can enter the Banking Union directly or by adopting the euro, which means joining EMR II. The question is not whether to enter but when. Croatia and Bulgaria have shown us that the road is through EMR II, and it will help us test the economy's ability to absorb shocks.

What to do next?

Given the close relationship between the financial sector and the Eurozone economy, the sustainability of the European banking system should be one of the main concerns of policy makers. Economic dependence on the banking system means that it is critical for it to be stimulated and to create a framework in which it can be credited safely. Although banks are better capitalized, the size of debt affects their balance sheets.

From an economic point of view, a significant recovery process has been taking place in the Eurozone for several years, but the main risks remain, as the Banking Union is incomplete and the Eurozone is not as robust when it comes to policy instruments and arrangements. This has been acknowledged by top European officials including the Five Presidents ’Report of 2015 and the European Commission’s Reflection Paper of 2017.

Troubled economies have been corrected by implementing programs to reduce spending and rebalance external balances. But all this has been done with internal costs such as rising unemployment and internalizing imbalances putting pressure on social structures and the internal political configuration. At the same time, the current economic recovery is highly dependent on the ECB's non-standard policies, very low interest rates and sovereign bonds, which have a cyclical component. If before the creation of the Eurozone external imbalances were corrected, mainly through exchange rate adjustments and budget cuts, adjustments during the current crisis took place through internal devaluations at a not necessarily lower cost.

Eurozone reforms have two approaches. The first approach focuses on discipline and fiscal rules, with balanced budget executions throughout the year and rules that do not allow uncontrollable public or private imbalances. However, the financial crisis has not only been attributed to financial budgetary constraints, but also to the allocation of resources in an economy with large development gaps that can lead to unpredictable bubbles. The second approach refers to risk sharing, but in an area with heterogeneous economies, unable to absorb shocks.

A fear of creditor nations is that Eurozone reforms will lead to systematic transfers to certain countries, transfers that will be labeled as financially assisted countries and should be differentiated from transfers that help repair asymmetric shocks and move economic performance gaps.

Considering the bailing scheme, which the creditors and the associates are involved in the sharing of losses and debt reductions, is ideal because it protects taxpayers from the costs of resolution but, at the same time, more difficult to implement due to political interference and the fact that if not done with care can generate contagion at the economic level, at the same time, bail-out schemes being banned by the European treaties these situations can generate a blockage. The ECB has been forced to take on the role of lender of last resort and therefore bail-outs should not be ruled out in exceptional circumstances to avoid contagion.

If banks diversify their government bond portfolio and at the same time no longer have a risk-free rating, capital will be directed to performing economies while weaker economies will attract hedge funds. These discriminations will further affect weak economies and if economic divergences are not leveled, when they reach maturity they will further weaken peripheral economies. The absence of adequate risk-sharing schemes would only reinforce such dangerous dynamics.

To reduce the spiral banks - sovereign loans was brought into question a single European asset. Until now, Eurobonds have been considered as risk-combining assets in the Eurozone, but the idea of risk pooling is rejected by creditor nations. This is why the proposal for a synthetic financial asset, sovereign bond-backed securities - SBBS, appeared, comprising bonds from strong savings, a tranche of bonds from medium savings and a tranche from weak savings at risk of losses. This asset will be more attractive to banks and should replace medium- and long-term sovereign bonds. However, in times of crisis the demand will be for bonds related to strong economies while for bonds related to weak economies the demand will be zero and the realization of a derivative of these sovereign bonds would be even more difficult. However, in addition to functioning in the market, SBBS should benefit from the

Eurozone a package of measures comprising: liquidity assistance in times of market stress, asymmetric shock repair schemes, the restructuring of sovereign loans should not be started automatically, the adjustment imbalances can not be pro-cyclical, the macroeconomic imbalance procedure should work symmetrically, both for countries with external deficits and for surplus countries, a macroeconomic policy at the level of the Eurozone, investment programs should include economic convergence.

Financial integration through the Banking Union in the Eurozone raises a fundamental issue, namely whether the Banking Union can solve the problem of fragmentation and economic divergences in the absence of fiscal arrangements that will resolve asymmetric shocks and lead to economic convergence.

A disconnect between a banking union, in which "risk-sharing" works, and real savings is hard to imagine. If economies continue to evolve divergently and risk-sharing does not apply to them, this would further undermine the Eurozone.

In conclusion, solving the problems in the Eurozone lies in the political area because it involves more than an institutional cooperation to manage fiscal integration, which needs common institutions and a significant budget at the Eurozone level, but strong political and constitutional constraints. But there can be no integration in a single market at the same time as an autonomous economic policy and democratic accountability at national level. The lack of political will to relinquish sovereignty and combat divergence consumes economic and social resources and fuels populism, Euroscepticism and extremism. This requires a reconciliation of rules and discipline on the one hand and risk-sharing (public and private) on the other so as to reduce moral hazard. Otherwise the Eurozone will remain a very rigid construction and exposed to recurring tensions and crises. A new economic recession will again be felt quite painfully in the Eurozone if the right policy arrangements are not put in place.

After solving the political dissensions and working together, the EU states will make Banking Union a step forward on the road to integration, the largest since the introduction of the euro.