

Banking Union: A New Step towards Completing the Economic and Monetary Union

Marijana Ivanov, Roman Šubić

Abstract—This study analyzes the critical gaps in the architecture of European stability and the expected role of the banking union as the new important step towards completing the Economic and Monetary Union that should enable the creation of safe and sound financial sector for the euro area market. The single rulebook together with the Single Supervisory Mechanism and the Single Resolution Mechanism - as two main pillars of the banking union, should provide a consistent application of common rules and administrative standards for supervision, recovery and resolution of banks – with the final aim of replacing the former bail-out practice with the bail-in system through which possible future bank failures would be resolved by their own funds, i.e. with minimal costs for taxpayers and real economy. In this way, the vicious circle between banks and sovereigns would be broken. It would also reduce the financial fragmentation recorded in the years of crisis as the result of divergent behaviors in risk premium, lending activities and interest rates between the core and the periphery. In addition, it should strengthen the effectiveness of monetary transmission channels, in particular the credit channels and overflows of liquidity on the money market which, due to the fragmentation of the common financial market, has been significantly disabled in period of crisis. However, contrary to all the positive expectations related to the future functioning of the banking union, major findings of this study indicate that characteristics of the economic system in which the banking union will operate should not be ignored. The euro area is an integration of strong and weak entities with large differences in economic development, wealth, assets of banking systems, growth rates and accountability of fiscal policy. The analysis indicates that low and unbalanced economic growth remains a challenge for the maintenance of financial stability and this problem cannot be resolved just by a single supervision. In many countries bank assets exceed their GDP by several times and large banks are still a matter of concern, because of their systemic importance for individual countries and the euro zone as a whole. The creation of the Single Supervisory Mechanism and the Single Resolution Mechanism is a response to the European crisis, which has particularly affected peripheral countries and caused the associated loop between the banking crisis and the sovereign debt crisis, but has also influenced banks' balance sheets in the core countries, as the result of cross-border capital flows. The creation of the SSM and the SRM should prevent the similar episodes to happen again and should also provide a new opportunity for strengthening of economic and financial systems of the peripheral countries. On the other hand, there is a potential threat that future focus of the ECB, resolution mechanism and other relevant institutions will be extremely oriented towards large and significant banks (whereby one half of them operate in the core and most important euro area countries), and therefore it remains questionable to what extent will the common resolution funds will be

used for rescue of less important institutions. Recent geopolitical developments will be the optimal indicator to show whether the previously established mechanisms are sufficient enough to maintain the adequate financial stability in the euro area market.

Keywords—Banking Union, financial integration, single supervisory mechanism (SSM).

1. INTRODUCTION

THE European Union is still incomplete as an Economic and Monetary Union (EMU). Although all EU Member States are formally part of the EMU and coordinate their economic policies for benefits of the EU as a whole, a complete economic integration process is still not finished. First two stages of the EMU have been focused towards achieving freedom of capital transactions between Member States (MS), convergence of MSs' economic policies and cooperation between MSs' national central banks. A third stage is focused on gradual introduction of the euro as a single currency and it is still in progress.

Until 2015, only 19 of the 28 Member States have joined the third stage of EMU. Two Member States, Denmark and the United Kingdom have 'opt-outs' clause from joining in the currency union and they currently have no interest in joining the euro area. Seven Members States with 'derogation' currently have no target dates for adoption of euro because they didn't achieve a high degree of "sustainable convergence" which is necessary for a participation in the system with common monetary policy. On the other hand, the crisis shows large differences in meeting sustainable convergence criteria also inside the euro area characterized by divergent economic developments in core and peripheral countries.

Problems in peripheral euro-area countries are mostly fiscal problems, but also structural problems derived from external imbalances and relatively weak regulation of financial systems in pre-crisis period - especially considering the fact that banks have operated globally, but their supervision and resolution took place only at a national level. In circumstances of integrated financial markets and single currency, exposures of banks from core to peripheral countries more than quintupled between 1999 and 2008 [1]. Thus, current account deficits in most peripheral countries were led by large capital inflows coming from core countries and were intermediated by banks' cross-border financial flows. It enabled excessive credit growth and asset price bubbles in the overheated peripheral countries until 2008, while their other imbalances were further increased in years of recession through growing fiscal deficits and sovereign debt, through deterioration in the asset quality

Marijana Ivanov is with Department of Finance, Faculty of Economics and Business, University of Zagreb, Croatia (corresponding author; phone +385-1-238-3108, e-mail: mivanov@efzg.hr).

Roman Šubić is with Croatian National Bank, Croatia (e-mail: roman.subic@hnb.hr).

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of national banking system and through the different forms of 'the bank-sovereign loops' which linked: 1) banks as holders of bonds with risk of sovereign default; or 2) governments as the expected and actual saviors of troubled banks.

It shall be emphasized that the idea of establishing the banking union was mostly triggered by the presence of instability in the financial system during the economic crisis in the last few years. With the start of the global financial and economic crisis in the summer of 2007 and the intensification of the euro crisis in early 2010, the European Central Bank's roles have been greatly extended beyond its commonly known price stability mandate [2]. Crisis developments pointed out some negative effects of free movement of capital and liberalized schemes of external borrowing which, due to exposure of banks from core to peripheral countries, have become important for the euro area as a whole. However, although there is a general awareness of the risks of international capital flows, further strengthening of financial integrations in the EU and the euro-zone are practically inevitable, because they represent one of basic elements of the single market and principles on which the EMU was developed. Taking all this into account, the creation of the banking union should enable that the future financial integration between euro area members will take place under better monitored conditions. There are four essential components in this process: 1) an adoption of a single set of rules for all banks in the EU, 2) an upgrade of current national supervision authorities to the common supranational supervision for all euro area countries - the Single Supervisory Mechanism, 3) the Single Resolution Mechanism that will be funded by banks and should ensure an orderly resolution of failing banks with minimal cost for taxpayers and for the real economy and 4) a harmonized system of deposit guarantee between all EU Member States.

Start of functioning of the banking union with central position of the European Central Bank within the Single Supervisory Mechanism (SSM) took effect at the beginning of November 2014 and in this moment includes only euro-area members (but there is a possibility of inclusion for all EU Member States).

II. WEAKNESS OF THE CURRENCY UNION – FASTER FINANCIAL THAN REAL INTEGRATION

In recent history six countries of the eurozone were faced with sovereign debt crisis (Greece, Ireland, Italy, Portugal, Spain and Cyprus) combined with extremely high public debt and increase in risk premium and yields on government bonds. However, the level of public debt is also high in many other countries including Belgium and France, while Slovenia has extremely high budget deficit. According to the WB data for 2013 [3] an instability of the banking system is evident in a number of euro-area countries with high level of non-performing loans to total gross loans (including Greece, Cyprus, Ireland, Slovenia, Italy, Portugal and Spain), but also in some future euro-area countries like Lithuania (Table I). The financial crisis has shown that process of the economic integration is not complete inside the euro area due to the

insufficiently effective mechanism for maintaining the sound public finance and supervision of national fiscal policies, as well as due to the lack of a single regulatory framework for integrated financial markets and cross-border activities of banks that enabled an excessive credit expansion and accumulation of the systemic risks in the pre-crisis period.

TABLE I
FINANCIAL STABILITY IN EUROZONE COUNTRIES [3], [4]

| Country | Indicator 1 | Indicator 2 | Indicator 3 |
|-------------|-------------|-------------|-------------|
| Austria | 75.1 | 2.9 | -0.2 |
| Belgium | 105.1 | 3.8 | 48.2 |
| Cyprus | 112.2 | 30.3 | -156.8 |
| Estonia | 10.0 | 1.5 | -47.1 |
| Finland | 58.6 | 0.5 | 8.2 |
| France | 96.6 | 4.3 | -15.6 |
| Germany | 77.3 | 2.9 | 42.9 |
| Greece | 174.1 | 31.3 | -121.1 |
| Ireland | 123.3 | 24.6 | N/A |
| Italy | 135.6 | 15.1 | -30.7 |
| Latvia | 38.2 | 6.4 | -65.1 |
| Lithuania | 40.3 | 12.5 | -46.9 |
| Luxembourg | 22.8 | 0.2 | 216.4 |
| Malta | 75.3 | 9.2 | 49.2 |
| Netherlands | 68.6 | 3.2 | 31.1 |
| Portugal | 132.9 | 11.0 | -116.2 |
| Slovakia | 58.4 | 5.1 | N/A |
| Slovenia | 78.7 | 18.0 | -38.2 |
| Spain | 96.8 | 8.2 | -92.6 |

1 General government gross debt (% of GDP) Q1 2014

2 Bank nonperforming loans to total gross loans in % Q4 2013

3 Net international investment position in % of GDP Q1 2013

Since the Maastricht criteria does not imply the limits on the external debt (financial integration and capital flows across the monetary union are the part of convergence), while the existence of a common currency cancels the exchange rate risk for external borrowing in the euro zone, many Member States have accumulated high level of the external debt accompanied with permanent current account deficit. Net international investment positions of the core countries in relation to emerging and peripheral parts of euro-area have a divergent behavior in last fifteen years. According to Eurostat data [5] Luxembourg, Belgium, Germany and the Netherlands permanently record positive positions, while negative net international investment positions are typical for Greece, Portugal, Cyprus, Ireland, Spain and Italy, as well as for European emerging markets. Despite strong growth in cross-border bank borrowing (inside and outside of the euro area), as well as the huge rise in private and public sector debt in peripheral countries until 2008, all of this was not considered as a problem in stable period. Even more, financial markets have equally treated the risk of borrowers in peripheral and core euro area countries. In absence of macro-prudential tools to offset the effects of large capital inflows, there were no strong limits on banks' leverage and lending activities which resulted in credit boom and housing bubbles in peripheral countries during the period of higher economic growth and optimistic expectations.

The liquidity risk of banks (particularly in terms of significant maturity mismatches between banks' assets and liabilities) was undervalued and it represented one of the vulnerabilities of the pre-crisis regulation Basel II. A regulatory capital of banks was prescribed on minimal levels without additional capital conservation buffers, countercyclical capital buffers and/or capital requirements for the systemic risk. (As a part of macro-prudential measures it was later incorporated in the Basel III regulation and the single rulebook for all banks in the EU). Additionally, regulation on credit risk management treated claims to government as risk-free investments of banks, unwisely stimulating the significant increase in their placements to public sector - particularly at the beginning of the recession when loans to the private sector recorded a significant drop. Thus, the main part of today external, financial and fiscal imbalances in the euro area was created in the decade prior to the crisis [6], while fiscal balances and bank positions deteriorated further during the crisis.

Today's EU and the currency union should not necessarily be a fiscal union, although it is expected that a deeper level of fiscal integration will be developed in the near future [7], [8], but the EU in general needs a financial union which will contribute to the stability of the financial system of all members, and which will be able to adjust unbalanced economic conditions across countries. Defining new fiscal rules, a single rulebook for banks, and a creation of the banking union are structural mechanisms that should correct imbalances caused by negative consequences of financial liberalizations and financial integrations in pre-crisis period [9]. The creation of a new financial stability framework in euro area should serve as a basis for future integration with centralized body in banking supervision and resolution, and a common system of deposit guarantee schemes. It has to reduce the financial fragmentation recorded in the years of crisis as the result of divergent behaviors in risk premium, lending activities, and interest rates (on loans and deposits) between the core and the periphery. In addition, it should be strengthened the effectiveness of monetary transmission channels, in particular the credit channels and overflows of liquidity on the euro-area money market (from banks with liquidity surplus to banks with liquidity shortage) which, due to the fragmentation of the common financial market, were significantly disabled in period of crisis.

With respect to the importance of banks in the financial systems of continental Europe, the banking union is an important step along this way and even more if we take into account that the assets of the banking sector accounted over 300 percent of the euro-zone gross domestic product in 2013 [10] (see more in Fig. 1). In comparison, due to the US regulators who have influenced on the regulation of banks and consequently on the development of the financial markets, the impact of the total banking assets to GDP is only around 80%. However, contrary to all the positive expectations related to the future functioning of the banking union and relatively good results of the 2014 comprehensive assessment, as well as expected contributions of the higher financial stability on

future economic growth, characteristics of the economic system in which the banking union will operate should not be ignored. The EU and the euro area are integrations of strong and weak entities, as well as rich and poor countries with a large difference in economic development, wealth and growth rates. In the last ten years, real GDP growth rates were the highest in new members including Slovakia (4.2%), Lithuania (4.2%), Latvia (3.75%) and Estonia (3.6%), - as current or forthcoming participants in the single currency union, while high growth rates were also recorded in Poland (4.0%), Romania (3.5%), Bulgaria (3.3%) and Czech Republic (2.6%) - as non-euro area members of the EU. However, all of these data concerns relatively poor countries with the GDP per capita twenty to fifty percent lower than the European average and significantly lower than in the core euro area countries like Germany, Belgium, Luxembourg (160% higher from EU average), the Netherlands, Austria, France and Finland - what include the Member States with average low real growth rate between 0.9% to 2.1% in last ten years [11].

The euro area does not meet some of the criteria for the Optimal Currency Area (OCA, according to theoretical model defined by Robert A. Mundell [12], Peter Kenen and Ronald McKinnon). One of the reasons is an imperfect mobility of the labour market including language and cultural barriers as well as an imperfect price and wage flexibility across the currency union. It also supports the significant differences in the gross labour costs per hour between members ranging them from 6.3 euros in Latvia to 38 euros in Belgium [13]. In addition, between Member States there are significant differences in amount of rates and bases for calculation of income tax, value-added tax and other forms of taxation, differences in welfare-state politics that affect national fiscal revenues and public debt, as well as differences in national inflation rates and purchasing powers of one single unit of euro.

Disparities of key economic indicators between euro area members are also evident through the high foreign trade surplus and increase of productivity in the German economy whose pace cannot be caught up with other countries. The opposite extreme is an uncompetitive economy of Greece faced with the problem of over-indebtedness and questionable ability to service high public debt as well as with liquidity disorder in banking system which can turn into a problem of bank insolvency. Therefore, possible Greek exit from the currency union is not just a question of respect common fiscal rules, but also an avoidance of common burden by other members in case of Greek banks' rescue.

In spite of the high level of monetary, financial and economic integration, the euro area is neither a fiscal nor a political union, while citizens in the core countries are not ready for larger fiscal transfers between members as the replacement for a missing flexible exchange rate. On the other hand, a fixed nominal exchange rate in combination with the availability of cheaper external borrowing create the real appreciation pressures and reduce the competitive position of peripheral and other euro-area countries with lower productivity and higher national inflation pressures, as well as with a tendency to higher growth in public spending (and the

tax burden), wages and living standards in relation to the real fundamentals of their economies. All of these show an incomplete understanding of the fragility of a currency union in normal periods, but also under crisis conditions when national fiscal policies were used as a main tool for countercyclical macroeconomic activities and when the national differences in potential for economic growth have become more visible. These and many other problems of a currency union were pointed out in research papers published before the introduction of the euro, and Obstfeld described them in the article with the metaphorical title “Europe's Gamble” [14].

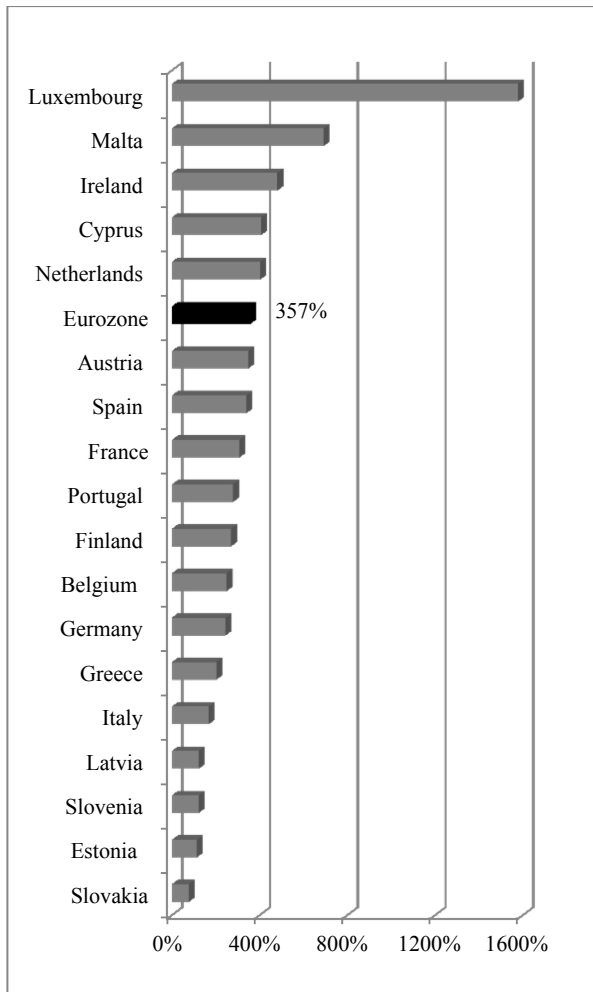


Fig. 1 Total banking assets to country's GDP [10]

III. THREE INTERLOCKING CRISES IN THE EURO AREA

As a result of expansionary monetary condition in the period from 2003 to 2005 and innovations in bank funding instruments, until 2007 banking sector assets recorded significant growth both in core and peripheral countries, while simultaneously relying on the significant use of leverage and short-term sources of funding through cross-border borrowing on regional and global level. Such activities created a vicious

circle of financial interconnectedness of banks' balance sheets in the core and the periphery. The development of liquidity crisis in 2007 affected the European largest banks with high level of foreign debt liabilities cumulated on global markets, including banks in Belgium, France, Germany and the Netherlands, but consequently caused funding liquidity problems for banks in peripheral countries. More expensive and less accessible sources of funding as well as a lack of confidence (evident in the global financial markets since October 2008) opened a Pandora's Box of systemic risk that was accumulated for years at both national and regional levels.

In period 2009-2013 the euro area has faced three interlocking crises:

1. sovereign debt crisis in peripheral countries faced with rising bond yields due to growing market concerns about the sustainability of their public finance;
2. banking crisis reflected in undercapitalized banks, liquidity problems, significant increase of non-performing loans, and negative spillover effects of the sovereign debt crisis on banks (as creditors) resulting in the positive correlation between sovereign and bank CDS spreads [15]; and
3. growth crisis caused by slow and unequally distributed growth across the currency union.

Problems of weak banks and high sovereign debt become mutually reinforcing: a) on the one side in the case when banks failure bankrupted the sovereigns as they tried to support banks, and b) on the other side in situation when high sovereign default risk affected the banks with sizable sovereign debt holding [16]. Actually, both of this was exacerbated by weak growth, but with reversible further effect on economic slowdown due to deterioration of banks' assets, reduction of lending activities, weak creditworthiness of potential borrowers and fall in prices of assets used as collateral for lending.

The development of crisis has shown and confirmed many weaknesses in the banking system of euro-area countries among which can be emphasized the following:

- a liquidity risk was significantly undervalued in the pre-crisis period;
- banks operated with a relatively low capital base, high leverage and unstable sources of financing, as well as significant mismatch in maturity (and currency structure) of their liabilities and assets;
- real estate and other property used as a collateral was overvalued in many countries leading to greater credit and systemic risk in the years of the recession and the decline in the value of assets used as a collateral;
- the depositors' confidence can be significantly reduced in case of plenty of bad information on banks and/or over-indebted countries (for example in the case of higher deposit outflows in Greece, Portugal and Spain accompanied by the simultaneous higher inflows in Germany and the Netherlands during 2012);
- all government securities cannot be considered as risk-free investments because the risk premium is distinguished between core and peripheral countries;

- sovereign crisis lead to the fragmentation of euro-area money markets and disabled effective reallocation of liquidity from euro-area banks with a liquidity surplus to euro-area banks with liquidity needs deepening the differences in financial conditions between the core and the periphery [17];
- the largest banks are much larger in proportion to their home economies due to which deposit insurance and bank resolution require coordinated actions between all euro-area members; and
- keeping supervision at the national level (in both creditor and debtor countries) contributed to the large imbalances and fragmentations of the common financial market due to which the creation of the banking union is a necessary institutional response.

IV. THE ELEMENTS OF THE BANKING UNION

The global financial crisis that emerged in 2008 and turned into the debt and banking crises in eurozone has stimulated a creation of a common set of rules stipulated in the Capital Requirements Regulation and the Capital Requirements Directive (CRR/CRD IV) or so-called single rulebook that all banks in the EU must comply with. Many elements of CRR are derived from the Basel III standards and correspond with technical standards developed by the European Banking Authority (EBA) to ensure effective and consistent prudential regulation and supervision across the European banking sector. On the first place they include stronger prudential requirements for capital and liquidity of banks to make them stronger and more immune to shocks – including an additional capital conservation buffer, a countercyclical capital buffer and a systemic risk buffer for global and other systemically important institutions relative to their size, complexity, cross-border activities and importance for the economy of the Union and the relevant Member State.

The single rulebook correspond with many other financial reforms in the EU whereby the most important are: 1) an improved system of deposit protection with harmonized level of protected deposits up to €100,000 per depositor, per institution in all EU Member States (Deposit Guarantee Schemes - DGSs) and 2) common rules for prevention and management of bank failures (Banking Recovery and Resolution Directive – BRRD) with the aim that „in future taxpayers will not foot the bill when banks make mistakes“ [18]. With fully implementation of the Banking Recovery and Resolution Directive as of 1st January 2015, a former practice of the bail-out should be replaced with the bail-in system through which bank failures will be resolved by their own funds including the money of their shareholders and creditors, and when they take up these opportunities through national resolution funds financed by banking industry. In the case of euro-area members (which currently only participate in the banking union), their national resolution funds set up under the BRRD as of 2015 will be replaced by the Single Resolution Fund that will be pooled together gradually as of 1st January 2016 – with contribution of each credit institution in proportion to its size and its risk profile.

The creation of a Single Supervisory Mechanism (SSM) with a particularly important role of the European Central Bank as the central prudential supervisor for large and systemically important banks should increase transparency of the banking system in the euro area and restore confidence that have been disturbed during the depression. The cooperation between national competent authorities and the ECB will reduce the risk of discretion or moral hazard in national banking supervision activities. It will enable a better overview of the banks' balance sheets and their cross-border transactions in terms of leveraging, lending, risky investments, collection of foreign deposits and different factors of the systemic risk development. Complement to this, a Single Resolution Mechanism (SRM) with the Single Resolution Board (SRB) and the future Single Resolution Fund (SRF) will enable that serious difficulties of banks will be resolved more effectively with minimal costs for taxpayers and real economy. In this way, the vicious circle between banks and sovereigns, also known as the 'doom loop' should be broken [8], while banks will no longer be “European in life but national in death” [18].

With the establishment of the SRM and centralize key competences and resources for managing the failure of any bank in the euro zone, a system will be more capable of preventing bank runs and a potential spreading of instability from a failing institution to other solvent banks or from one country to other eurozone members. Additionally, if some significant credit institution (significant for the euro area or a relevant member states) would be unable to meet capital requirement, the European Stability Mechanism will provide an opportunity to recapitalize them directly. This can be a significant contribution to a financial stability in the forthcoming years and especially until the Single Resolution Fund does not achieve its target level of €55 billion. On the other hand, due to the limited financial resources in coming years, there is a potential threat that future focus of the ECB, resolution mechanism and other relevant institutions will be extremely oriented to the large and significant banks (whereby one half of them operate in the core and most important euro area countries), while it is questionable to what extent the common resolution funds will be used for rescue of less important institutions.

The single rulebook together with the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) – as two main pillars of banking union, represent important steps towards completing the Economic and Monetary Union and the creation of safe and sound financial sector for the single market. They should bring to the consistent applying of “common rules and administrative standards for supervision, recovery and resolution of banks, by treating national and cross-border banking activities equally and by delinking the financial health of banks from the countries in which they are located, as well as intervening early if banks face problems in order to help prevent them from failing, and – if necessary – by resolving banks efficiently” [19]. Since the creation of the completed banking union cannot be achieved through just one single step, it could

be vividly described that it is a process of creating firstly 'timber-framed' banking union which will be later replaced with 'steel-framed' banking union [20]. This 'timber-framed' union was started with the establishment of SSM.

V. CREATION OF SSM AS ONE PART OF THE FUTURE BANKING UNION

Apart from the above mentioned problems regarding the economic crisis which led ECB to engage actively in solving the situation, other important issues were the effects of globalisation and increasing growth of international cross-border banking relations that consequently required the appropriate development of banking supervision and overall coordination. Another important incentive was the need for adequate level of supervisory transparency which, in comparison to the US supervisory system, was very weak. It seems logical that the increased level of transparency and uniform reporting standards would increase customer confidence and therefore the health of the financial system in general. Recent research has shown that American investors are rediscovering European banks because of the role of ECB which will enable them to have greater faith in claims about the health of the banking sector because books were checked in a systematic fashion [21].

Regarding the scope of the banking sector, there are about 8,200 banks in the EU out of which 6,000 of them are doing business in the eurozone. Due to complexity of the credit institutions system, several institutions have been established with the purpose of ensuring financial stability. The list is not exhaustive and it depends on the scope of monitoring. The Financial Stability Board (FSB) was established in April 2009 as a successor of the Financial Stability Forum (FSF). Its key role was promotion of the reform of international financial regulation. Another institution is European Systemic Risk Board (ESRB) which was established in December 2010 as a response to the ongoing financial crisis. This body is responsible for the macro-prudential oversight of the financial system within the Union. Regulatory agency of the European Union headquartered in London and established in January 2011 is European Banking Authority (EBA) whose role is to ensure effective prudential regulation and its activities including conduction of stress tests in European banks. EBA took over the responsibilities and tasks of the Committee of European Banking Supervisors (CEBS) established in 2004. The role of all this institutions is to ensure the financial stability of the European banks and to minimize the potential risks of financial crisis in the future. However, considering the volume of international business and cross-border activities of European banks, EU finance ministers agreed on the idea of establishing joint banking supervision which will monitor the systemically important banks of the eurozone countries. Due to increased importance of banks in financing the economies of the eurozone, the establishment of the joint body was essential. About three quarters of total financing of the economies in the eurozone is provided by banks while only one fifth is financed from this sources in the US [22].

Except its primary role as the guardian of price stability in the euro area, the ECB's roles have been greatly extended to the other areas during the crisis [2]. One of the new roles is responsibility for the prudential supervision of the banks in eurozone countries. Some of the authors criticize ECB's potential conflict of interest due to responsibility for both important areas but, on the other hand, the fact that the monetary policy and supervision role is under the responsibility of one institution produces a lot of advantages and synergy effects. Additionally, there already exist a lot of examples where the banking supervision is established within the central bank: out of 18 national central banks of the Eurosystem, 15 are deeply involved in bank supervision (partially from [23]).

Prior to the establishment of the SSM, ECB has conducted balance sheet assessment of systemically relevant credit institutions in eurozone countries. Comprehensive assessment of the quality of banks' business was scheduled for the period from November 2013 to the October 2014 with the final aim of stress-test calculation which derived from the asset quality review results. The assessment was conducted among the banks which were deemed to be enough significant at the national level or at the level of the entire eurozone. 130 institutions were selected and included in the comprehensive assessment primarily from the most important eurozone countries: Germany (24 institutions), Spain (16 institutions), Italy (15 institutions), France (13 institutions). Significant banks' assets of 22.0 trillion euro account for 81.6% of total banking assets in the eurozone area. Overall, the comprehensive assessment identified a capital shortfall of 24.6 billion euro across 25 participating banks after comparing these projected solvency ratios against the thresholds defined for the exercise [24]. Thereby, the highest number of banks with capital shortfall was found in Italy: out of 15 banks included in comprehensive assessment, there were 9 undercapitalised banks.

Finally, one year later, after the introduction of the regulation concerning the new Single Supervisory Mechanism (SSM), in November 2014 ECB was assigned to take the responsibility over supervision of 120 systemically most important banks which represent around 85% of total banking assets in the euro area. Apart from those significant banks directly supervised by ECB, national supervisors continue to play an important role in day-to-day supervision for less significant banks, under the overall oversight of the ECB [25]. National competent authorities will be directly responsible for all other 3,500 banks and the role of the ECB will be to monitor the supervisory standards. Among 120 banking banks (1,200 supervised entities) that are considered as significant, one half derive from four most important countries (Germany, Spain, Italy and France) and the rest refers to the remaining 14 countries.

Referring to the organisational structure, the ECB has established four directorates general (DGs) to perform the supervision of significant and less significant banks from the eurozone. While DG1 and DG2 are responsible for the direct supervision of significant institutions, DG3 is responsible only

for the oversight of supervision performed by national supervisors. DG4 is responsible for providing a specialised expertise on specific aspects of supervision [26].

Following the establishment of a single supervisory body, banking union still depends on the development of other two components: a single resolution mechanism and an integrated scheme of deposit insurance. Upon the implementation of these two components, it will be possible to quantify the real effects of setting up of the new institution and to measure the level of financial stability in eurozone countries.

VI. CONCLUSION

Problems in peripheral euro area countries are mostly fiscal problems, but also structural problems derived from external imbalances and relatively weak regulation of financial systems in pre-crisis period - especially considering the fact that banks have operated globally, but their supervision and resolution took place only at a national level. The creation of the banking union should enable that the future financial integration between euro area members will take place under better monitored conditions with centralized body in banking supervision and resolution, and a common system of deposit guarantee schemes. The creation of a Single Supervisory Mechanism (SSM), with the European Central Bank as the central prudential supervisor for large and systemically important banks, should increase transparency of the banking system in the euro area and restore confidence that have been disturbed during the depression. Complement to this, the harmonized Deposit Guarantee Schemes and the Single Resolution Mechanism should enable that serious difficulties of banks will be resolved more effectively with minimal costs for taxpayers and real economy, preventing bank runs or spillover banking crisis from one country to another. On the other hand, more stringent requirements for capital and liquidity, ex ante system of collecting the premium for DGSs and contributions of banks for the SRF and the SSM will increase operating costs of banking industry with possible effects on costs of banks services, while the bail-in systems could reduce interest of creditors and shareholders to invest in banking sector. Additionally, due to limited financial sources that could be implemented for managing the failure of credit institutions in short period of time, especially until the Single Resolution Fund does not achieve its target level of €55 billion, there is a potential threat that future focus of the ECB, resolution mechanism and other relevant institutions will be extremely oriented to the large and significant banks operating in the core and most important countries, while it is questionable to what extent the common resolution funds will be used for rescue of less important institutions.

Additionally, contrary to the positive expectations related to the future functioning of the banking union, major findings of this study indicate that characteristics of the economic system in which the banking union will operate should not be ignored. The euro area is an integration of strong and weak entities with large differences in economic development, wealth, assets of banking systems, growth rates and welfare-state politics that affect national fiscal revenues and public

debt. The analysis indicates that low and unbalanced economic growth rates remain a challenge for the maintenance of financial stability and this problem cannot be resolved just by a single supervision and resolution and especially not in the case of non-compliance with the common fiscal rules by several Member States. The next step of the euro area integration will therefore likely to be a creation of the fiscal union - with adherence to uniform fiscal rules and policies, and after the implementation of fiscal equalization between developed and less developed regions.

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