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EUROPEAN BANKING UNION: EFFECTS AND CHALLENGES

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Abstract: *This paper analyzes impact of new banking structure on different countries. Analysis include banking sectors of both: European Union members and non-European Union member's countries. For the purpose of analysis, data from these banking and financial sectors for period 2008-2014 were used. European banking sector as well as entire financial sector integration is necessary. This necessity is deduced from the problems in this banking sector. Namely, widespread connection between banks and sovereigns which was detected by analysis of these two types of debts. Fragmentation of the Eurozone credit markets was, mainly, caused by sovereign debt crisis due their extremely high correlation. Analysis has shown that this was especially emphasized in peripheral countries of Eurozone. This was disclosed through correlation analysis of sovereign and bank Credit Default Risk premium. Therefore, banking union with good absorbing shock mechanism at union level, credible discipline on state level as well as with central regulatory mechanism should resulted in reduction of this correlation and its complete elimination in the long run. However, potential benefits of this new structure will be unequally distributed. Actually, effects will depend on number and size of banks which are located in certain country.*

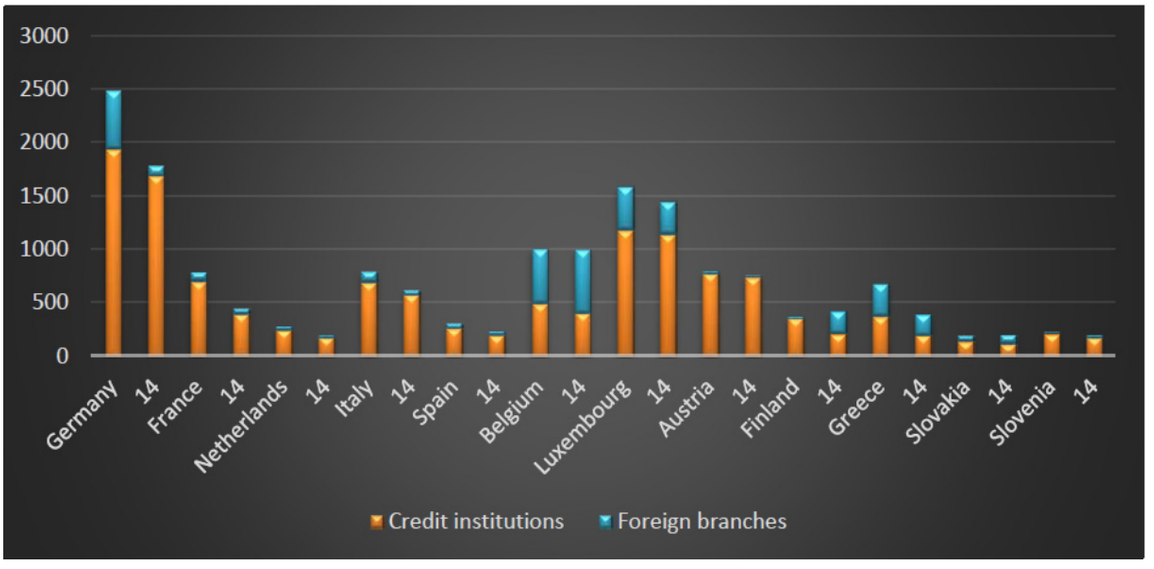
Keywords: *correlation, Eurozone, banking union, bank, sovereign*

JEL Classification: *E44, E58, G21*

Introduction

Eurozone financial sector asset – including banks, insurance companies, ICPFs (pension funds) and so called „banking from shadow" have almost double during last decade and reached level of 57 trillion euros in 2014th. From the beginning of the crisis 2008th Eurozone banking sector has pass through rationalization process that resulted in decrease of credit institutions. This banking sector consolidation is connected with pressures on cost reduce, deleveraging and restructuring. At the end of 2014th total number of credit institutions (including foreign branches) was 5.948 and it was reduced from 6.100 at the beginning of 2014th. By comparison, this number at the end of 2008th was 6.690. Developments over time resulted in decrease of 742 credit institutions since then to 2014th, what represents decrease of around 11, 1%.

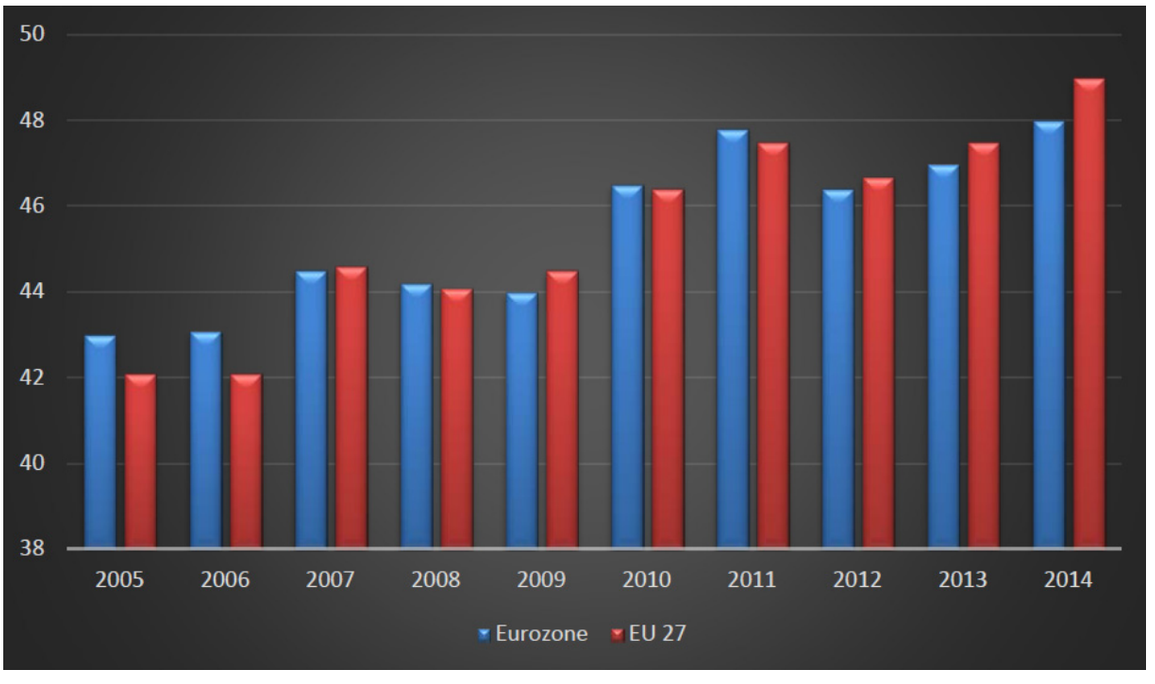
Graph 1: Number of credit institutions and foreign branches 2008 vs 2014



Source: Banking Structure Report, 2015

Market concentration measured by total asset hold by five greatest credit institutions or by Herfindahl index has increased in Eurozone as well as at European Union level from 2010th and further compared with the period before the crisis. This indicator recorded a high value in 2011th, after that it has decreased in 2012th and again recover in 2013th and 2014th, but in any case, remaining above the level before the crisis period.

Graph 2: Market concentration



Source: Banking Structure Report, 2015

A modest increase in 2014th was mostly caused by developments during the crisis in countries where big banks were affected by consolidation by parent banks decisions what was especially noticeable in Cyprus, Greece and Spain. If we compare those indices between different countries, we will notice a huge number of structural factors. Therefore, banking system in big countries such as Germany and Italy are much more fragmented with bigger amount of savings and more cooperative banking sector. On the other hand, banking systems in smaller countries are much more concentrated with exception of Austria and Luxembourg. At the end of 2014th market concentration has reached level of near 95% in Greece and at the Germany and Luxembourg a little bit above 30%. According to current situation development during period 2008-2014, it is expected that over time the banking structures have become much more concentrated in most countries.

Literature review

Since problematic that this paper considers is most recent problem in European banking sector, a few papers had the subject of this issue. Namely, idea of new banking sector structure have occurred a few years ago and together with that new researches occurred. First disclosed paper gives a first legal and technical analysis new banking structure proposals, referring also to some of the discussions that have already sprung up and identifying a few of the controversial points. (Wytmeersch, 2012) Further, researches have analyzed a number of euro-area countries that have been affected by a lethal negative feedback loop between banking and sovereign risk, followed by disintegration of the financial system, real economic fragmentation and the exposure of the European Central Bank. (Pisani-Ferry & Wolff, 2012) Following paper have shown that it was much easier to endorse the concept of a banking union than it is to design and implement one. Banks are central to the European financial system, supplying about three quarters of all credit, and are therefore critical to the functioning of the wider economy in Europe. Their supervision is not just a technical issue, but it requires many subjective judgments that have serious implications for credit provision, economic growth and jobs. (Elliott, 2012) The following paper have investigated the role of "Europeanisation" for bank recovery and resolution that will be managed nationally based on EU law. A first evaluation indicates that the potential benefits of solving bank problems via the resolution mechanism of a new European banking union would be distributed unequally between the member countries of the Euro area. Germany would be the biggest loser, Spain and the Netherlands the biggest winners. Of the non-euro countries, the UK and Sweden have the most to gain, but Poland would lose. The country-specific gains of European banking union depend on the number and size of banks which are located in a country. It is, however, not yet clear whether the goal of macroeconomic stabilizing of bank resolutions would be better achieved when executed via the Single regulation mechanism or with the ESM, both for the countries affected and for the Euro area as a whole. (Breuss, 2013) Further, authors have analyzed role of SRM. The central body of the SRM should be either the European Commission, or a new authority. This legislative effort should not be taken as an excuse to delay decisive action on the management and resolution of the current European banking fragility, which imposes a major drag on Europe's growth and employment. (Veron & Wolff, 2013) Further, it was proven that 2014 handover, and a subsequent change in the European treaties that will establish the robust legal basis needed for a sustainable banking union, together define the policy sequence as a bridge that can allow Europe to cross the choppy waters that separate it from a steady-state banking policy framework. (Veron, A realistic bridge towards European banking union, 2013)

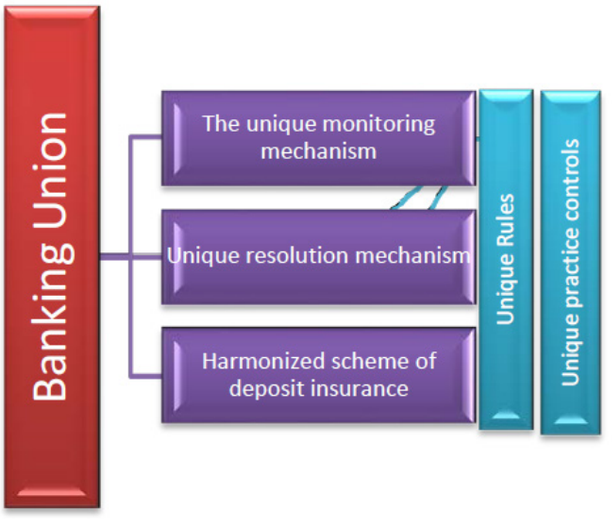
Banking Union

From the beginning of crisis 2008th, European Commission has worked hard to discover the lessons from the crisis in order to create a safe and stable financial sector. Commission has suggest 28 new rules for better regulation, supervision and financial sector management so that in the future, taxpayers will not pay full price for the mistakes of banks. Most of the rules are now in force or are nearing completion. Since financial crisis develop and transform to debt crisis in Eurozone 2010/11, it was clear that for these countries with together currency need to work harder in order to break the vicious circle between banks and public finances. Therefore, in June 2012 the Heads of State and Government decided to create a banking union, exclusively economic and monetary union in order to enable a centralized application for all banks in the euro area (as well as for those countries that are not EU members, but that they wanted to join). Therefore, the objectives of the introduction of this new structure could be defined as:

- strengthening of bank capital and liquidity,
- "Single rule book" including rules about salaries,
- an effective resolution regime that protects depositors,
- effective control and supervision,
- suppression paradigm "too big to fail",
- safer and more transparent financial markets,
- reducing reliance on credit ratings,
- identifying risks posed by "banking from the shadows" and
- prevention and punishment of market abuse.

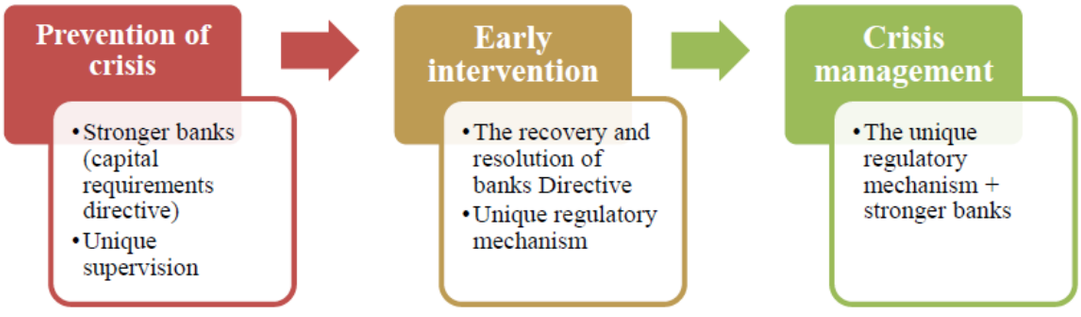
This new regulatory framework with equal rules for all banks in 28 member countries, listed in one rule book is basis of banking union. Uniform Rules will primarily help preventing a banking crisis and if banks get into difficulty a common framework for the management of the process including the means to mitigate them in the right way is defined. This uniform rules will also ensure that all EU deponents their deposits up to 100.000 euro will be secure at anytime and anywhere in Europe. Banking union ensure uniform implementation of these rules in Eurozone. New banking structure could be presented as follows.

Figure 1: Banking Union



Since November 2014th ECB has become supervisor for 6.000 banks in Eurozone in the context of the single supervisory mechanism. In order to ensure that ECB has clear insight into banks that are under its control, a comprehensive assessment of the financial condition of each bank conducted. In case of bank meltdown despite strong supervision, unique new resolution mechanism will enable the efficient resolution of problems in banks through Unique-resolution committee and the Single-resolution fund. If the bank still suffers meltdown unique regulatory mechanism will with clear rules for decision-making for internationally active banks a ton more effectively solve problems than the existing framework of national resolution. Together with the new EU regulatory framework for the financial sector, the creation of a banking union is a big step in the economic and monetary integration in the European Union. This should lead to increase in financial stability. Thus, financial sector should now be able to lend to real sector, thereby supporting economic recovery and job creation.

Figure 2: Steps in the implementation of new banking structure



European Commission has prepared suggestions of 28 legal requirements that covers all financial participants in order to better manage financial sector. These proposals constitute a single rulebook. Therefore, it's important to ensure strong pervasive regulation, without gaps, in order to be able to guarantee equal conditions for all banks that enable formulation of unique financial services market. A unique supervisory mechanism gives the European Central Bank responsibility for supervising banks in the Eurozone. Therefore, ECB is charged to ensure real European supervisory mechanism which is not intended to protect national interests but the weakening of the link between banks and public finances taking into account the risk to financial stability. Package capital requirements for banks and the regulation of capital requirements created by a new global standard for banking capital (known as the Basel III framework) in the legal framework of the European Union. The new rules have been in force since 01 January 2014 and, as such, allow banks to keep a sufficient level of capital both in terms of quality and in terms of quantity. The financial sector and the whole European Union is now based on a strong basis in the event that some of the banks will encounter difficulty. These resolutions require banks to present their recovery plans describing the measures that would be taken in the event of entering into unwanted financial situation and plans for changes to existing plans if they are no longer applicable. Banking supervisors have expanded their powers to be able to intervene in the event that an institution gets into financial difficulties, but before the problem becomes critical and while its financial position has not become irreversible. In banking union, if is considered that viability of banks in danger, ECB is only supervisory authority that will supervise early intervention in coordination with relevant resolution authorities.

Advantages and Disadvantages

From the conceptual point of view unified supranational banking supervision should help to strengthen the single European financial market. Also, as positive aspect of these new structure it should be considered unique rule book and fact that implementation of new banking union could help in raising cross-border comparability of de jure and de facto control of the banking sector in the euro area and the EU. The unique regulation of the banking sector as well as coordination will support the simplification and harmonization of critical areas such as stress tests or taxation of the banking sector. Concentration of banking sector supervision in one supranational body should also improve banking regulation management. Also, form practical point of view, supranational banking supervision should increase regulator independency from political parties, while it will also significantly help improve the banking as well as the capacity to manage the financial crisis. However, increased regulation of the banking sector and international cooperation in itself does not end there. A unique supranational regulatory body of the banking sector in Europe should ensure the achievement of the ultimate goal of regulation of the banking sector - financial stability. Mostly on a voluntary basis based participation of non-EU countries in supranational banking union should help in avoidance of excessive remuneration of national and / or additional uncoordinated local regulations. Such practices could literally eat profitability internationally active banks in non-EU countries, what potentially could lead to higher market risk at aggregate level some big banking groups from West Europe that operate in those countries. For larger internationally active banks to maintain and manage liquidity and capital buffers at the aggregate level will be much more effective than holding too much liquidity and capital buffers to each local market.

Banking union will contribute to the termination of the links between banks and the state on following way:

- **Banks will be stronger and more immune to shocks -** unified supervision will ensure the effective implementation of prudential requirements for banks, requiring them to keep an adequate level of reserves and liquidity. This will make the EU stronger banks, strengthen their capital in order to adequately manage the risks associated with their activities and absorb any losses;
- **The problematic banks will be resolved without taxpayer money, limiting negative effects on government fiscal position -** troubled banks will be solved by financing shareholders of the bank, its creditors and the decision of the Fund to finance industry. Banks should get out of trouble while the fiscal position of the country should not be weakened;
- **Banks will no longer be "European in life but national in death" -** since it will be watched truly European mechanism so will any destruction be supervised these same mechanisms.

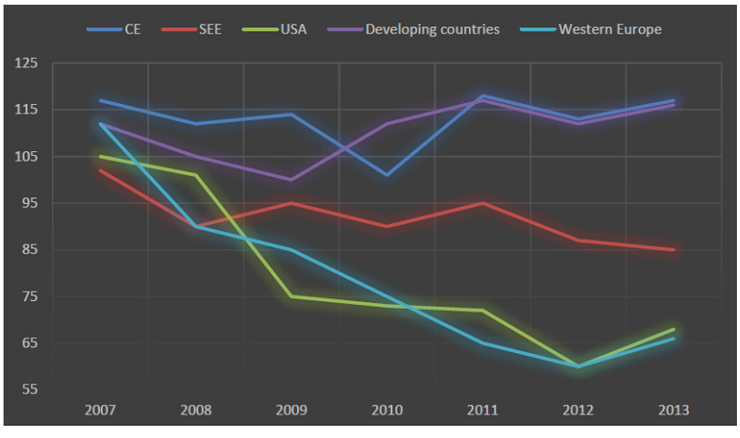
Besides advantages of these centralized and unified supranational banking sector, supervision and regulation by the banking union is carried ECB can cause a lot of nontrivial overflow, for EU countries and also for non-EU countries. Since non-EU countries are small markets, they won't be standards market at the EU level as well as at the global level, but they will be its followers. For example, central banks of these countries have very limited de jure and de facto presence in the relevant international bodies and forums (such as the BIS, the ECB or G7 / G20 forum). The experience of European integration has shown that at some stage, banking union may suffer from some problems in the community, or more precisely, it was easier to create it, but to manage it. In addition, the marginal costs of cooperation are growing with the

growth of the number of members of the community as the banking union. Therefore, policies to achieve the greatest possible number of voluntary members of the Union may be called into question. Furthermore, policy makers at the EU should be aware of the risk that voluntary entry into the banking union could mean entering the euro zone in particular non-EU countries. Also, as in the euro zone there is no option of voluntary leaving and the banking union the same option does not exist because it is not feasible from a practical point of view.

The effect on Member States

Inevitably there will be many demanding tasks in terms of implementation of new parts improved banking regulation in the years to come. Consistent implementation countercyclical capital protection will be a major challenge for both the EU Member States and to other countries and, as such, will require close co-ordination and co-operation. The implementation of the new requirements will be especially difficult for developing countries. In some of these countries there is still considerable scope for financial deepening. Therefore, the gap in the ratio of loans / GDP is significant in these countries, which per se does not have to result in financial stability. On the other hand, a fairly consistent implementation of additional capital requirements, particularly in the European Union and banking union, can definitely stimulate regulatory arbitrage. All in all, a consistent implementation of anti-cyclical policy and capital protection throughout the European banking market will definitely be a challenge in the future.
A recent upgrade of regulations is definitely put emphasis on the fact that the Bank of Western Europe and reduce the risk of borrowing in an unstable economic environment with disappointing low level of GDP growth. In this regard it is worth mentioning that there is empirical evidence that even the application of Basel I in countries whose economies are not bank-based, such as the United States, had a significant impact on credit growth. Therefore, it's not surprise that there is very weak credit growth in Eurozone. From the perspective of the private sector should be emphasized that the deleveraging in non-EU countries was gradually and that definitely can be classified in one of the toughest on the European banking market. Therefore, it should be noted that the recent strengthening of the regulation is definitely the most impact on the less profitable business lines and markets. Therefore, the bank became even more challenging to implement long-term strategies and make a profit at low interest rates.

Graph 3: Total cross-border claims of European banks



Source: *http://www.rbinternational.com/eBusiness/01_template1/829189266947841370-829189181316930732-829189181316930732-NA-2-EN.html*

Conclusion

Regardless of the foregoing, the fact is that the supranational control under the control of the ECB met with resistance from the competent national authorities since new structure take away some of the powers that until then had control of the banks. Large European banks must still work with their supervisors in their daily regulatory programs. This is especially true for banks that operate outside the euro zone markets.

Consistent and supranational banking sector supervision in entire Europe will, unquestionably, become one of the main factors for strengthening of cooperation in banking sector and strengthening of financial stability in west as well as in central and east Europe. Political initiator to coordination, harmonization and simplification of regulation and supervision of banking sector is, also, good thing for CEE countries. Namely, banking markets at this region are highly integrated with banking sector of west Europe. Ideally speaking, unique supranational supervision could help to reduce overall IT costs, direct and indirect, as well as supervisory who control the private sector.

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