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The Single Resolution Mechanism of the European Banking Union: its structure and functioning

The recent financial crisis showed that the institutions of the European Union (EU) and its member states are poorly prepared for solving current problems of banks, which are experiencing financial difficulties in European markets. In order to be able to further provide services for citizens and companies, member states' governments had to support banks with public finances and provide guarantees on an unprecedented scale. It did help to avoid a collapse of banks and a disturbance of the economy, but only by putting the burden on taxpayers and thereby causing deterioration in public finances. An agreement about the right course of action in the face of these difficulties experienced by cross-national banks has not been reached either. The major situation changer should be the European Banking Union (EBU), also called the Integrated Financial System, which is in the process of being created. The foundations for it have been laid during Lithuanian presidency of the Council of the EU in the second half of 2013. For Lithuania and all other EU member states, joining the banking union will mean handing over important national state powers to the European Union institutions.

Struktura i funkcjonowanie jednolitego mechanizmu restrukturyzacji i uporządkowanej likwidacji w europejskiej unii bankowej

Obecny kryzys finansowy pokazał, że instytucje unijne i państwa członkowskie nie są w pełni przygotowane do rozwiązywania problemów banków, które borykają się z trudnościami finansowymi na rynkach europejskich. Aby umożliwić świadczenie usług klientom indywidulanym i korporacyjnym, rządy poszczególnych państw członkowskich udzieliły bankom wsparcia ze środków publicznych. Decyzja o udzieleniu pomocy finansowej pomogła przetrwać instytucjom bankowym i zapobiegła dalszemu pogorszeniu się sytuacji gospodarczej, ale obciążyła podatników, wskutek czego ucierpiały finanse publiczne. Nie rozwiązano również trudności związanych z działalnością banków transgranicznych. Sytuacja ma się zmienić z związku z planowanym utworzeniem Europejskiej Unii Bankowej, czyli tzw. Zintegrowanego Systemu Finansowego – projektu przedstawionego przez Litwę w trakcie jej prezydencji Rady Unii Europejskiej w drugiej połowie 2013 r. Dla Litwy i innych państw członkowskich przystąpienie do unii bankowej będzie oznaczało przekazanie istotnych uprawnień w ręce instytucji unijnych.

Keywords: European Banking Union, Single Supervisory Mechanism, Single Resolution Mechanism, Single Bank Resolution Fund, Single Resolution Board

JEL classification: E5, E6, H6, K4, R5

Introduction

The euro crisis caused by issues in global financial markets impelled the EU institutions and member states to implement reforms of their finance sector. A clear vision of the future of economic and monetary union is needed, and all the necessary reforms and decisions regarding EU institutions and its member states should be guided by this vision. The European Commission (EC) seeks closer cooperation, viewing it as one of the means for overcoming the crisis. The European Banking Union (EBU) has not been established as a legal instrument so far. This is a political vision of deeper EU integration, which will be based on recent consequential actions and aim to tighten the regulations and control of the banking sector. This area also still needs development. Although the recent compromise on EBU is expedient to Lithuanian interests, the above-mentioned problems remain unsolved. Therefore, before making the final decision on Lithuania's membership in the eurozone and in the Banking Union, it is important to find answers to major problematic questions.

The issues regarding the creation of the European Banking Union have not been widely analysed in Lithuanian or international scientific literature so far. In 2013 the Bank of Lithuania carried out a study on the adoption of the euro planned for 2015. The study analyses and makes the quantitative impact assessment of the euro introduction on the national economy [*Euro įvedimo…*, 2013]. The results of this quantitative study show that the euro introduction will have positive long-term effects which will significantly outweight short-term negative consequences, such as the expenditure and size of Lithuania's additional financial contributions. However, this study is not directly concerned with the Banking Union. This subject is rarely analysed in Lithuanian academic research papers. Some aspects of the recently created EBU were analysed by Vytatuas Šenavičius [Šenavičius, 2012, pp. 405–416]. Considering that the Banking Union has only recently gotten under its way, it is understandable that scientific literature on this subject is sparse. Foreign academic papers provide a lot more in-depth analyses of these issues, in particular the Economic and Monetary Union (EMU) reform and the Single Resolution Mechanism (SRM) [Whyte, 2012].

The aim of this paper is to point out the key issues of eurozone and to identify the main elements of the Single Resolution Mechanism for the European Banking Union. However, the question of the other pillar of the Integrated Financial System – namely the Single Supervisory Mechanism (SSM) – is not among the issues analysed by the authors in detail. This paper discusses the subject of the SSM in only few words, as it is so complex that it could be the object of another research.

The methods implemented to conduct the research include the analytical method and analysis of the research literature, documents, and statistical data.

1. The main provisions of the Single Bank Resolution Mechanism

The key issue of European banks' financial sector is closely connected to the state support for national banking sector. Charles B. Blankart notices that the latter accounted for a large portion of the country's GDP [Blankart, 2011, p. 4]. State intervention aimed at rescuing the banking sector began in the years 2008–2009 along with the global financial crisis. According to the latest Eurostat data, it has reached undoubtedly dramatic proportions [Baciulis, 2013, pp. 1–4]. First and foremost, these actions took by the EU member states had a negative impact on their public finances. EU-27 governments are often criticized for financing the banks restructurization with taxpayers' money, which fundamentally opposes the state public policy. It has also triggered a moral hazard – depositors and other parties (investors), seeing their states spending money on bank restructurizations, took excessive risks, hoping that they would not go bankrupt thanks to the active state aid instruments [Krimminger, 2006, pp. 1–2]. This clearly demostrates the complexity of the situation. Likewise, the supervision over the banks and their integration must be conducted on the European Union level. It is impossible to implement such an effective supervision and ruling mechanism only by using national instruments.

The Banking Union will be based on a full and comprehensive single set of rules for financial services. The European Banking Union is aimed at developing integrated financial system, which will ensure the financial stability and reduce the cost of a possible bank collapse, as it has been repeatedly emphasized by Herman Van Rompuy, the president of the European Council [Van Rompuy, 2012, pp. 4–8]. These objectives were aproved by the European Council in 2012, on June 28–29 and December 13–14. The European Council placed the legislators (European Commission and European Parliament) under an obligation to develop appropriate legal acts [EC, 2012]. Firstly, the Single Supervisory Mechanism for European banks must be established, followed by the creation of the Single Resolution Mechanism. The EU member states have already reached an agreement about the SSM [CR, 2013]. The SSM operation will be based on current national bank supervisory procedures and institutions. The European Parliament and the Council have reached a provisional agreement on the procedures of the Single Resolution Mechanism for the Banking Union proposed by the Commission. It complements the Single Supervisory Mechanism which, once fully operational in late 2014, will be applied for the major and systemically most important euro area banks. The European Central Bank (ECB) will then directly supervise 130 of the biggest (among 6000 operating) eurozone banks. Other banks, which do not meet the set criteria, will remain under national supervision; nonetheless, the ECB will have the authority to step in if it sees it necessary. For this reason it is essential emphasize one very simple and practical matter: the member states hand over their power to the ECB, but they do not create any new institution. The ECB has enough quality experts, which are well-acquainted with the current EU economic and financial situation. The accumulation of functions in a single institution will ensure the unity of the monetary policy of the EU and make it easier to reach an agreement on a joint action.

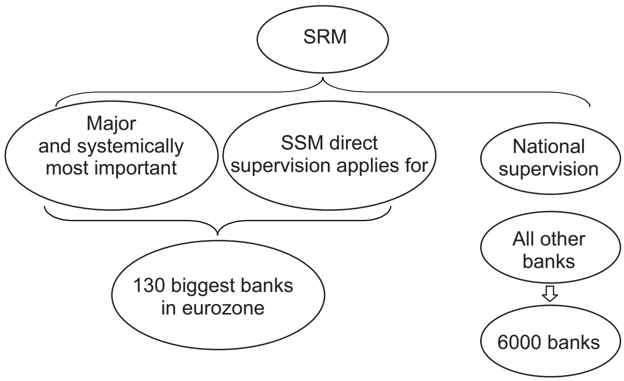

Figure 1. The application of the Single Resolution Mechanism in the European Banking Union

Source: Own elaboration.

However, the focus of this paper is another important pillar of the Banking Union – the Single Resolution Mechanism. They will functionally complement each other, as already mentioned above. It will be a second step on the road to the creation of the EBU. This system will facilitate the cooperation between national institutions in cases of a cross-border banking groups collapse. The main principle of the SRM is very simple: "Bail in", and it is essentially intended to ensure that in case of its bankruptcy, the bank would not pose a bigger threat to the state in which it oprerates nor to the whole economy of eurozone. In case of bank crisis, the SRM will enforce an effective reorganization at the lowest cost possible – for taxpayers and for the real economy. Although the Single Resolution Mechanism will apply only to the banks in the activity zone of the SSM, the rest of the smaller banks will have to obey its rules if their international activity crosses the border ("neighbourhood effect"). National resolution authorities would be responsible for executing bank resolution plans under the supervision of the Single Resolution Board. Should a national authority neglect to comply with its decision, the board could direct the executive orders straight to the collapsing bank. The European Banking Union is open to incorporate countries which do not belong to the eurozone, too. In case of a positive scenario, these provisions should ensure a sustainable transition from “Bail out” to “Bail in” (banks covering their losses by themselves) and the bank supervision would be supplemented by a strong and integrated system, devoted to saving the collapsing banks.

The SRM was divided into two separate documents in 2013: the European Commission proposal on European Parliament and Council regulation and the EU intergovernmental agreement. The EU regulation will have to set a single resolution mechanism for banks in the EU [EC, 2013]. The EU intergovernmental agreement identifies the priciples of collecting financial contributions from national financial institutions of the member states participating in the European Banking Union. It also determines that these contributions are to be transferred to the Single Bank Resolution Fund. The SRM will be formed by two main constituents essential for its operation: the Single Resolution Fund (SRF) and its use of funds rules, and the Single Resolution Board, which participates in making decisions regarding the collapsing bank. The main objective of the European Commission’s proposed regulation is to enforce the implementation of the directive dedicated to the banking sector rearrangement. This regulation should be enforced according to the centralized rules of the EU, with participation of the EU institutions and by applying the specific EU level procedures to the rearrangement of troubled financial institutions. The issue of their centralized funding is also an important subject matter of this regulation. The Single Resolution Mechanism should be implemented through the Single Supervisory Mechanism. When the EU member states join the SSM – they must also apply the SRM. The negotiations about the SRM took place during the Lithuanian presidency of the Council of the EU at the end of 2013. The ministers of the EU member states agreed on the shape of the main Banking Union directives and SRM provisions.

2. The role of the Single Resolution Fund in providing single financing for the bank resolution

As already mentioned, the Single Resolution Fund is a key element of the SRM, without which it could not function properly. Different national funding systems would distort the single bank resolution rules in the internal market. The Fund should help to ensure a single administrative resolution of financing practice. The SRF should not allow any obstacles for exercising fundamental freedoms or distortions of the competition within the internal market due to a different national practice. The SRF should be directly funded by the banks and its finances should be concentrated at the Union level, in order to evenly distribute the resources among all the member states, thus making it possible to improve the financial stability and limit the connection between the envisaged fiscal condition among the individual member states and the expenditures for their banks and enterprises. The same funds, also financed by ex ante contributions of national banks, will be established in all the eurozone member states (national Bank Resolution Funds).

That notwithstanding, the principles of the SRF composition are not fully clear. During the Lithuanian presidency of the Council of the EU it was agreed that in the initial build-up phase of the fund, bridge financing will be provided by national sources backed by bank levies or by the European Stability Mechanism (ESM). The SRF is to be formed out of national compartments, yet it remains unclear whether the financial contributions to the fund would be made only by systemic banks, or would other smaller banks and credit unions have to pay, too. Lending money among the national compartments would also be a valid option. During this transitional stage, a common backstop will be developed, which would become fully operational in 8 years at the latest. The backstop would facilitate borrowings by the Fund. Finances accumulated in national funds would be directed to the SRF. At the initial stage, these finances could only be used for rescuing national banks of the state which paid the contribution to the SRF. For example, in the transitional period, it would not be possible to finance Estonian or Latvian bank resolution with finances from the Lithuanian resolution fund. Accordingly, the German resolution fund assets would be allocated only to saving its national troubled banks. Each country will have to save its national banks using its own finances. However, each year a national responsibility will decline and the EU responsibility will increase. When the 8-year transitional period is over, national compartments will be combined and pooled into the Single EU Resolution Fund. A gradually increasing part of each member state's financial contribution will thus end up in the SRF, which will become responsible for the resolution of all the eurozone banks.

The Bank Recovery and the Resolution Directive also require banks to contribute an equivalent of 1% of covered deposits for defraying the costs of saving or shuttering lenders. Collected money will be used for saving all the EU main systemic banks. EUR 55 bn should be collected to the Single Resolution Fund by 2026, however there is a serious possibility that this sum might be not enough. For example, even after the collapse of the medium size Anglo Irish Bank in Ireland, solving the succeeding crisis required EUR 30 bn [*Irische Pleitbanker…*, 2013]. Therefore, another way of financing the bank resolution was necessary, namely the above-mentioned European Stability Mechanism. The ESM is a EUR 700 bn worth fund created by 18 eurozone member states. Each eurozone member contributes a certain part of its capital, according to the size of its national GDP. The ESM provides about EUR 60 bn of additional funding to be used if necessary for saving the EU main systematic banks [Hartmann-Wendels, 2013, p. 429]. However, there is no agreement among the EU member states on the ways of using the ESM assets. The ESM was created for the purpose of being able to provide loans for the eurozone countries facing financial problems.

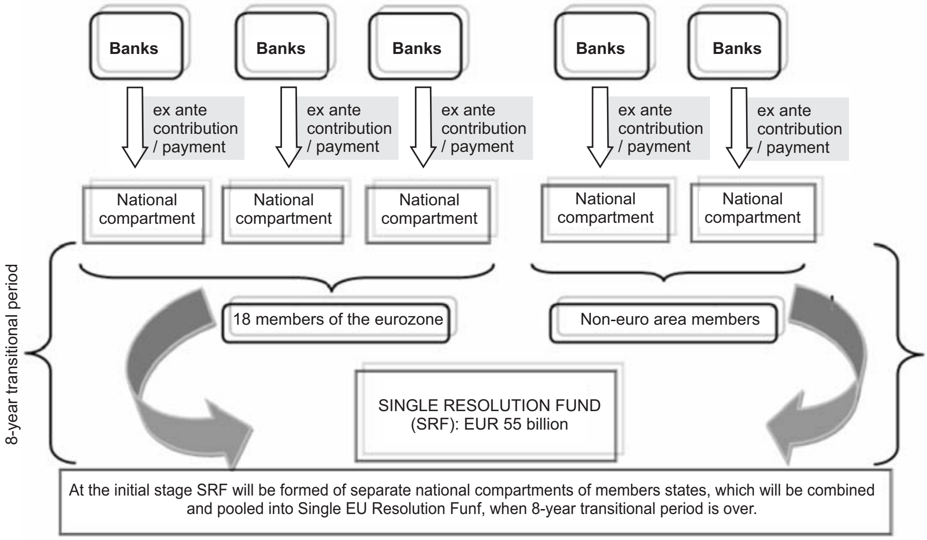

Figure 2. The Single Resolution Fund
Source: Own elaboration.

Under crisis conditions, the member states were rescuing their banks, which were facing solvency issues, making decisions in order to reduce risks for their financial systems. However, their actions not only had an impact on the national public finances, but also, as already mentioned above, caused a moral hazard. It is worth noticing that a moral hazard could be caused by member states' activity and actions in the Banking Union, too. National governments will seek that their banks, which stimulate the economy, serve only the national interests, demanding that they provide generous credits for their national enterprises. And when the risk of bank insolvency increases – they will try to cover the losses with SRF and ESM assets from all the Banking Union countries. With regard to this, a question arises whether the ESM funds should be used to stabilize the eurozone banks, as it could cause a new moral hazard. Irresponsible states could even cause a crisis and try to solve it with the help of the financial SRF and ESM contributions of other member states.

3. The Single Resolution Board

In addition to the establishment of the Single Bank Resolution Fund, another important and much debated issue is: which institution would administer the bank resolution process at the European Union level and could make the final decision in particular situations? Before answering this question it is important to make a distinction between executive and supervisory institutions. In order to reduce the risk to the national financial system in the USA in 2010, a so-called Wall Street Reform and Consumer Protection Act, better known as the Dodd–Frank Act, was adopted. This legal act brought about the most significant changes in the US financial regulation system since the Great Depression. It tightened the supervision of systemically important financial institutions. The US Federal Deposit Insurance Corporation (FDIC) deals with banks at risk and is responsible for the resolution of the troubled banks. The FDIC's organizational structure could be suitable for Europe, too. This federal agency was created in 1933, during the presidency of F.D. Roosevelt (the Glass–Steagall Act), and aimed at insuring the bank deposits. The FDIC operates effectively. During the 5-year period since 2008 financial crisis, it has successfully restructured about 500 American banks [Grosse, 2013, p. 12–13]. Europe is seeking to create a similar type of institution within the European Union. In the European Commission's proposal on the European Parliament and Council regulation an important role is given to a newly established agency, the Single Resolution Board (SRB), which becomes the main constituent of the SRM. Corresponding agencies responsible for bank resolution will have to be created on the national level in all the member states of the European Banking Union. Such EU agencies are bodies distinct from the EU institutions – they are separate legal entities set up to perform specific tasks under the EU law. There are over 40 agencies of this type divided into 4 groups: decentralised agencies, executive agencies, EURATOM agencies, and the European Institute of Innovation and Technology (EIT) [*Agencies…*, 2014]. Dealing with issues of the establishment of a new agency, the Single Resolution Board, it should be noted that such agencies contribute to regulation and administration of any assigned to them sector at the European level. They also play a role in the implementation of specific EU policy, covering different areas. Some of these agencies can make binding decisions. As it can be observed, it is necessary to cope with a difficult task of keeping balance between the functional benefit and the autonomy of agencies. Such agencies in the European Union may be created on the basis of provisions for creation and functioning of domestic market [JC, 2006].

After the entry into force of the Treaty on the Functioning of the European Union (TFEU) on December 1, 2009, the proposed regulations and the European SRB regulation gained a new legal base in Article 114 TFEU. The transfer of decision-making authority from the competent national governing institutions to the Single Resolution Board assured by said Article cannot be associated with a wider range of activity than the coordination of the internal market [JC, 2014].

This newly created agency should guide the bank resolution process at the EU level. The SRB and the European Commision, together with institutions of participating member states, will implement the SRM rules and procedures.

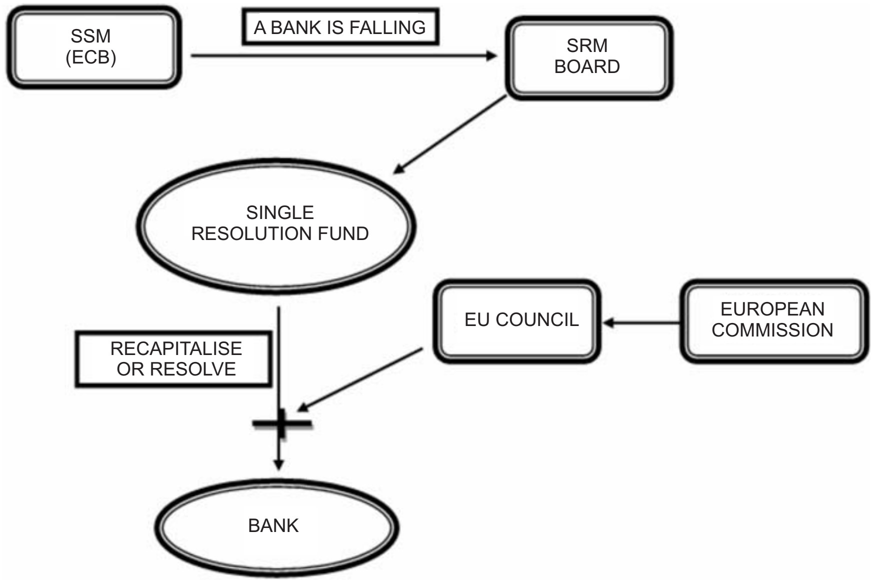

Figure 3. The Single Resolution Board
Source: Own elaboration.

The EC should participate in the implementation of the Single Resolution Mechanism only to the extent necessary for executing specific regulation tasks and supervising the process following the state aid rules. The SRM board would consist of the ECB, the European Commision, executive director, four appointed members, and representatives of the national resolution authorities of all the participating countries. It would exercise its tasks in either a plenary or executive format. The executive format is composed only of the executive director and the appointed members, with the representatives of member states concerned with a particular bank or bank group resolution decision, while the plenary format would be responsible for decisions that involve: liquidity support exceeding 20% of capital paid into the fund, bank recapitalisations exceeding 10% of funds, and access to the fund once a total of EUR 5 bn has been used in a given calendar year. The plenary session, voting by simple majority, would also have the right to oppose decisions made by the executive session that authorise the SRM board to borrow funds. To guarantee the sovereignty of the members, the regulation prohibits decisions that would require a member to provide extraordinary public support without its prior approval under national budgetary procedures.

The SRM board should have the authority to analyse and identify the ways for bank resolution. The board should also observe how bank resolution institutions implement their decisions on the national level. It could provide executive decrees for troubled banks in case national bank resolution authorities would not enact the SRM board decisions. The national bank resolution authorities would be actively involved in this process.

However, this decision-making procedure proposed by the EU Council is too cumbersome and complicated. It gets a lot of criticism for this reason and takes a lot of time, because too many interests are involved in the decision- making process. Therefore, it becomes almost impossible to make a rapid decision. The Financial Times, modeling banking resolution process, concluded that for its succesful outcome the EU would have to synchronize the work of nine commissions and committees, and organize approximately 140 votes at different levels [Мануков, 2013; Barker, Spiegel, 2013]. There are serious doubts about the efficiency of this system during a crisis.

Conclusions

The analysis provided by this paper shows that the supervision and integration of banks in the eurozone during a crisis situation must be implemented at the European Union level. It is impossible to administer and govern them using only national crisis management tools. There are several different bank regulating systems in the EU, such as the supervisory mechanism, crisis management, or resolution mechanism, which makes it difficult to perform an early intervention. The situation can become even more complex due to the very strong links between the supersiving institutions and the regulated ones. Within the Economic and Monetary Union it is impossible to locally solve problems of the financial sector of one member state. These issues transcend the national borders, harming and posing threat to the stability of the eurozone as a whole, thus creating the need for a universal banking system.

The main pillar of the European Banking Union is the Single Resolution Mechanism. It will complement the Single Supervisory Mechanism and be a second step on the path to creating the EBU. This system will facilitate the cooperation between national institutions in case of the collapse of cross-border banking groups. The SRM's main principle is: “Bail in”. Its essence is very simple: to ensure that, in case of bankruptcy, banks would not pose a threat neither to the state in which they oprerate nor to the whole economy of the eurozone. The SRM should guarantee that in case of bank crisis, which might occure despite the enhanced supervision, the resolution of troubled banks would be effective and performed at the lowest cost possible, as for taxpayers, as for the real economy.

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