IMPLEMENTING SINGLE RESOLUTION MECHANISM – ADVANTAGES AND CHALLENGES

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Abstract:

Banking system of European Union was unsettled by present economic and financial crisis, and also both principle *and* effectiveness *of Banking Union of EU. In effect, Banking Union confronts with risk aversion, bank run and financial disintegration, which explains why it was decided, for EU's Banking Union, to build European Banking Union (EBU), as key element of European Monetary Union (EMU).*

EBU must be a comunitary tool for monitoring and harmonising banking system of EU, with three main components; implementin gespecially one of these, Single ResolutionMechanism (SRM), is most important, but very difficult. Why? Firstly, implementing SRM requires several measures under taken by EU, in order to override defend of sovereignty, for allowing a better functioning of Single Market.

This may not be interpreted simply as complementary action of national prudential supervision, but as acts which are about to confer to European Commission supplementary powers. On the other side, an existent SRM is likely to induce at least appearance of difficulties or flaws in what concerns the other economies, namely the key economies from Euro-zone area (Germany, UK, etc.). And, in addition, SRM will have to adjust *itself with and for the existent European Stability Mechanism (ESM).*

Key words: *banking union, banking system, Single Resolution Mechanism*

JEL Classification: *E50, E58, G20, F30*

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1. Introduction

Present economic and financial crisis – still under way, now, in fall of 2014 – caused, in 2008, in general, to the economy of European Union (EU) many a difficulty, and none too few damages. One of most important components of this economy which took quite some damage in this manner is *banking system* of European Union.

That is, EU's banking system faced – and, in part, still faces – a number of issues, most important of them being:

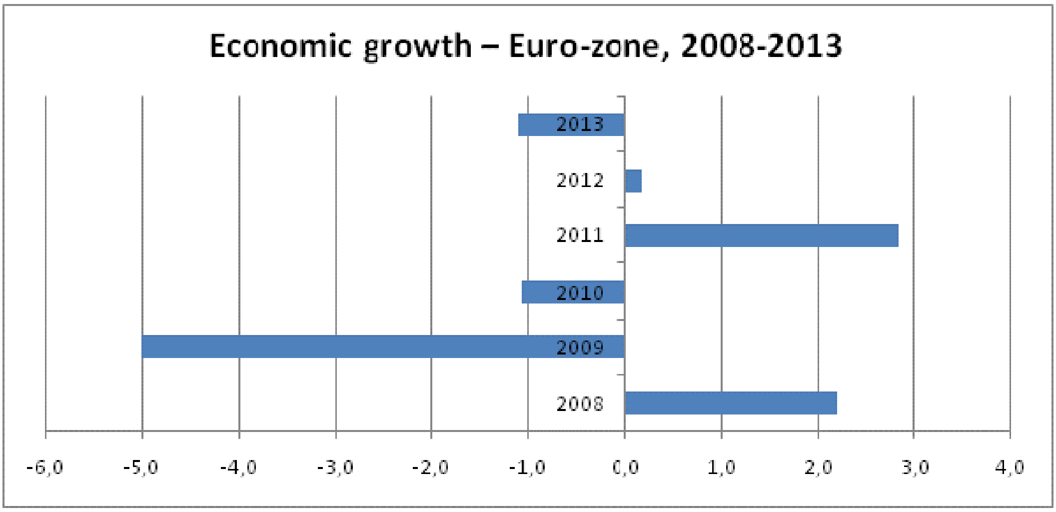
1. Rise in amplitude of non-performing loans portfolio;
2. Existence of a *very large* size of banking sector in small economies inside *Euro-zone*;
3. Extensive interconnection of banking system at European level;
4. Insufficient adaptation of banking sector at *Euro-zone* periphery;
5. Size of public debt;
6. Hesitant feature of reform of banking system, at European level.

2. Content

Reforms assigned to *banking union* in EU, adopted lately, form one of biggest achievements since introduction of single currency, but all these problems are plagued by a (somewhat) lack of sound design. Essential problem member states of EU face led to a under-than-useful reaction as involves banks' legacy assets, not to mention the lack of a standard market, as essential as it can get for bank environment and especially more so given this *single* currency does exists – to a best a level as EU was able to make it to be.

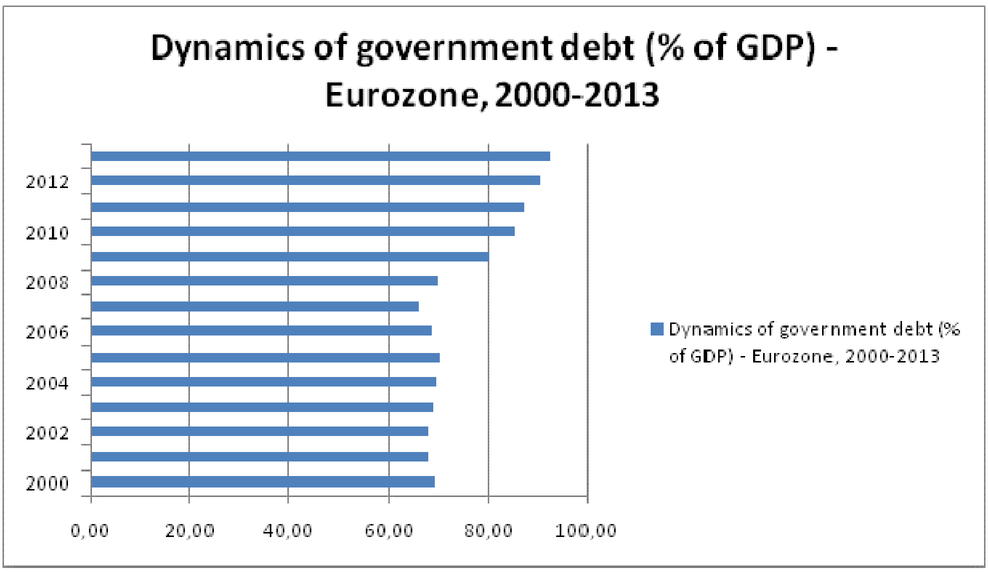
These reforms are all the more important, as general economic conditions that prevail in European Union these days are hardly glorious: in the first place, economic growth was, *exempli gratia* in period 2008-2013, anything but constant; if fact, it was, as anyone knows it today, *the* period of greatest economic and financial crisis in almost 40 years.

Recorded levels of economic growth, in Euro Zone, prove assertion stated above crystal clearly, so to speak – as figure below shows it:



Source: authors' own computations, based on data from http://epp.eurostat.ec.europa.eu

Likewise, dynamics of government debt fared, in Euro Zone, almost as bad, and, of course, it couldn't have been far better anyhow, given the state of EU's banking union around 2008, and even before 2000. The following figure helps assembling a proper picture of the *background* of designing and implementing Single Resolution Mechanism in European Union:



Source: authors' own computations, based on data from http://epp.eurostat.ec.europa.eu

As a result, banking union faces (at least) three possible 'market defaults':

1. risk aversion;
2. bank *run*;
3. financial collapse.

This dynamics can be, perhaps, better symbolized using the following summary table:

Drawbacks	**Causes**	**Effects**	**Behavior**	**EU'scures**	**EU Dimension**
Risk aversion	Public guarantees	Asset bubbles	Banks' moral hazard	SRM and SSM	Single Market
Bank run	Lack of trust	Lack of liquidity / insolvency	Avoidance of deposit losses	SRM and DGS	Single Market
Absorbtion deferral of legacy losses	Capital migration	Financial collapse	Governments' moral hazard	SRM	Single Currency

Source: Diego Valiante "Framing Banking Union in the Euro Area: Some EmpiricalEvidence" CEPS Working Document, No.388/February 2014, p.12

If first two drawbacks – risk aversion and bank run – are simply shortcomings that characterize any market, in what concerns economic mechanisms of money and banking system (Diamond and Dybvig, 1983, Akerlof and Romer, 1993, Stiglitz, 1993), the third issue – which brings about financial collapse due to governments' moral hazard– is a market mishap brought forth by the mechanisms of single currency.

In an usualfinancial system public intervention is necessary, so that bank location (and *not* bank assets) does **not** affect lending and financing costs of the government – at least, in, let's say, normal circumstances. In this respect, prohibiting use of state aid funds (blamed for distorting and destabilizing EU's financial systems) will not be credible if financial help is also missing.

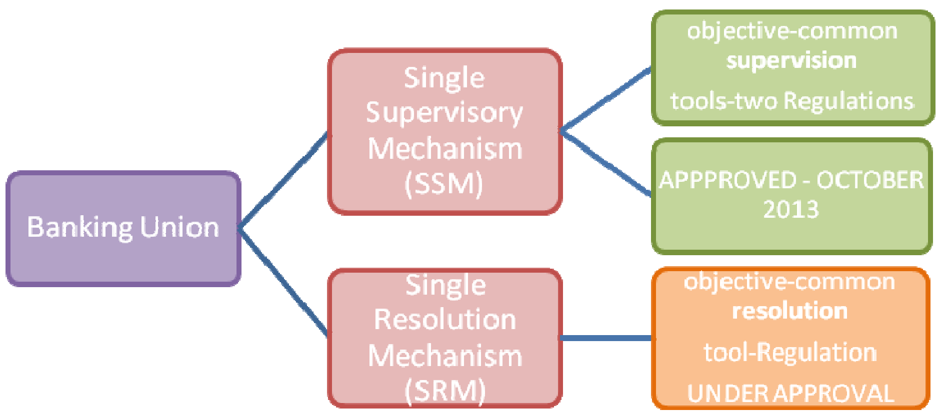
At EU level, a prudent and institutional design of financial support gives European institution many an option, such as access to European Stability Mechanism (ESM), which is able tohelp institutions which (e.g. desperately) need unrestricted financing, ***when*** public financial or private resources are insufficient, whenever supplied (only) by open markets.

In order to make right, both these issues, and other issues that might come about – in other words, not only those with which governments confront with now, as consequences of *present* crisis –,in European Union it was decided to put together European Banking Union (EBU), as essential component of European Monetary Union (EMU).

EBU is meant to be an EU tool for monitoring and **harmonizing** banking system of European Union, tool composed of three components:

1. *Single Surveillance Mechanism* (SSM);
2. *Single Resolution Mechanism* (SRM);
3. *Single Deposit guarantee Mechanism* (SDM).

The present structure of EBU is described best by figure below:



Source: made by authors

EBU is, though, a thing of the future, so to speak; for the present, European Central Bank (ECB) does exists, and so anyone in need of ECB' services must do whatever needs to be done in order to really benefit from them: this is because, whilst recapitalization of banks from *Euro zone* cannot be practically achieved without intermediation being carried out by (national) governments and political institutions – both deeply involved in bank governance, one way or another –, everywhere *inside* European Union, ECB will soon become responsible for supervision of most of European banks. This is indeed the case, considering lately one can observe with ease a rise in importance of banking union for *Euro zone*' financial system.

Firstly, is should be noted that, as early as the beginning of financial crisis, that is in 2008, European Commission put forth a number of proposals for reforming banking system and for reviewing and updating legislation, so that, by end of June, 2012 the first set of guidelines was issued, as concerns setting up a banking union, first step of which is *Report of Four Presidents*[2] (of Central European Bank, European Council, European Commission and Eurogroup); the second step was a more detailed communication of the Commission, in September[3] of same year.

After this communication, in order to complete common procedures proposed before through Directive from June 6th, 2012, as completion regarding G20 Committee for crisis management, a unique supervision of European banks was proposed, and likewise the idea of existence of a Single Resolution Mechanism (SRM). Through second Report of the *Four Presidents*, implementation of single resolution authority at European level was proposed, but, from the moment of proposal until moment of approval, in March 2013, banking crisis developed in Cyprus, this requiring for a corrective intervention in whole of European Union, intervention which involved bail-in of depositors.

Fear that situation in Cyprus would led to disasters in financial markets also in the realm of lending costs concerning banks and governments alike led to stepping up negotiations for building up of SRM[4]. European Commission offered in July 10th, 2013 the proposal of constituting a Single Resolution Board (SRB), for governing bank resolution in member states of EU, as component of a Single Supervisory Mechanism[5] (SSM).

First component, SSM, is fully functional – at least on paper, anyway – from fall of this year (2014). But, on the other hand, what can be said about SDM is that, for the time being, its core already exists from December 2010, when it enacted existence of Deposit Guarantee Fund for all depositors, guarantee amounting to100, 000 EUR per person/bank.

But, in terms of establishing SRM, technical difficulties of calibrating this tool so as to be as effective in present day Euro-Zone are significantly higher, matching amplitude of the disagreement between Euro-zone member states in this perspective – which is, to say this much, strong enough. Or, in this paper, our intention is to outline real ways in which SRM, and so EBU can be materialized.

Therefore, it is worth underlying materialization of these tools can, however, gain momentum only if it *based on* an (inter-)institutional analysis of

[2] European Council, 2012a
[3] European Commission, 2012b
[4] Legal basis-Treaty on theFunctionning of the European Union (TFEU), article 114
[5] Legal basis-Treaty on theFunctionning of the European Union (TFEU), article 127.6

this issue, inclusively in terms of monetary and banking dynamics of money, in particular, and of economic dynamics, in general – at the European Union level. And this is, because dynamics to which we refer are, at least to some extent, simultaneously the cause and the effect for which, existence of EBU – and therefore SRM – proves to be necessary.

An institutional analysis of sorts has been carried out: European Commission presented a legislative proposal for introducing SRM from July 10^{th}, 2013, to the effect SRM will function as a complement to SSM. In respect of this, SRM is designed to have two main functions:

1. "connection" to it of all states participating in SSM (i.e., all member states of Euro-Zone, to which can be added any state asking for it) for the supervision and management of the European banking system, so as it will/would reach the same ('European') level;
2. "connection" to it of all banks operating in countries participating in the SSM.

The central concept, i.e. SRM central utility, resides in calibration of banks resolution so this will be transferred to European level, unlike current situation, in which these operations take place within each state.

In order to attain this goal, projected structure of SRM comprises the following components:

1. European Central Bank (ECB);
2. Single Resolution Board (SRB) – in other words, a *new* agency of European Union, which comprises representatives of ECB, European Commission and relevant national authorities, all these specialists being entrusted with putting through process of *bank resolution*;
3. Single Bank Resolution Fund (SBRF) – this fund will be controlled by SRB in order to submit a medium term finance support, as a component of the process of bank restructuring.

It must be observed SBRF is, too, as well as the other components of SRM, to replace funds of this type that, in the present, exist at national level, in European Union, and, respectively, to amount to more or less 1% of total value of all insured deposits existing in all functioning banks in the space covered by SBRF.

What is worth mentioning here, though, is the fact until SRM will eventually materialize a long way must be tramped. First of all, it must be underlined the fact that, legally speaking, SRM *can* be materialized: according to European Commission, legal basis for SRM is Article no. 114 of TFEU, which gives the possibility to take action in order to better adapt existent national regulations so as to allow a better performance of internal market.

In respect of this, SRM is a tool designed specifically for sustaining performance, at high levels, of internal (bank) market. But in this point there is a major difference between SSM and SRM: on one side, SSM – respectively, SSM Directive – is meant to work, using a *single set of rules*, which, in its turn, is designed to work together with the one and only SBRF – and *vice versa*.

On the other side, SSM – and, respectively, SSM Directive – has as goal reaching a high level of *harmonization*, but this *on the background of maintaining flexibility level*, in other words *tolerating a certain degree of fragmentation of EMU management approach* through actions undertaken in this sense, independently, by each state in turn.

SRM focuses on getting rid of competitive *disadvantage* as regards banks comprised in SSM, and which belong to member States of euro-zone, as compared to banks that function is states which are *not* members of euro-zone. But, all these reforms must be approved by European Parliament, and here opinions are split, if anything.

Objections brought against SRM are rational, and, more than that, mostly objective. For example, German authorities consider SRM, once instated, will confer to European Commission supplementary powers, as compared to powers it already has, through implementing EU Treaties. If the latter will remain unchanged in order for SRM to aquire a *legal* existence *strict sensu*, German authorities are of the opinion only cooperation between states, in *Euro-zone*, is able to replace SRM tool.

And management of German banks also shares this vision, in this case due to economic and financial rationale as well: in other words, 'Europeanization' of banking resolution through SRM *would be a bit too costly* for banks from states with a sound banking system, such as Germany itself, especially when these banks would have to support, within the framework of EBU – and, as such, of SRM –, banks which simultaneously are in distress and also in states whose banking systems are, at least comparatively, poorly structured and poorly led.

Resolution of banks, i.e. the sum of all measures taken, procedures enforced and applied for the benefit of banks in distress is, must be underlined, already a reality, but not – not yet, that is! – a reality of SSM type. More specifically, in European Union, finance ministers of all states members of EU – that is, ECOFIN – decided, in June 27th, 2013 to adopt a common position for this matter, by proposing a European Directive for a proper and legal regulation of this common position.

But, in this case too, according to Article 116 TFEU, for all this it is required a majority vote in European Council, in other words a favorable vote given – in majority – by European Parliament. And, according to European Commissar for Internal Market, Michel Barnier (2013), it may be considered ECOFIN understanding from June 27th, 2013 is 'the first step' of SRM' materialization.

Moreover, the consequences economy of European Union records even today (2014) due to the still unfinished economic and financial crisis are reasons more than enough to analyze further this dilemma, whether national approaches *or* EBU – and, therefore, SRM – mechanisms are *better* able to stabilize a banking system in (great) distress, especially, and an economy in recession, in general. This problem must be solved quickly, given concrete examples showing us this *is* indeed the case, in the midst of European Union, respectively *Euro-zone*, such as Greece, Cyprus and Spain.

But, on the other side, the dilemma mentioned above must transform itself, so to speak, into a *clear* answer, at least in order to prevent appearance of difficulties or flaws in what concerns *the other* economies, namely key economies from *Euro-zone* area.

All these dynamics and mechanisms must be analyzed, though, inclusively from the perspective, or in other words in the environment in which these dynamics and mechanisms exist and work: which means it can be observed, thus, the fact EMU and SRM, whether they *will* exist, will have to adjust, for a properly function of *whole* macro-mechanism, along with existent European Stability Mechanism (ESM).

ESM is a permanent mechanism of clearing out crisis resolution, designed for states part of *Euro-zone*, mechanism funded at February 2nd, 2012 and dedicated at October 8th, 2012; through issue of debt instruments, ESM finances loans, mainly, as well as other forms of financial assistance for these states.

Or, it is put forward, whether, given the fact through use of ESM, costs of operations used in banks' salvage will be borne *not* by banks themselves, but by the very states *in* which these banks work, if a 'pure' ESM solution would not be more efficient – e.g. cheaper, in long term – than SRM solution.

It must not be forgotten, however, the fact SRM has, among others, the major advantage of functioning so as to break the link between banks and states, or, in other words, between lenders and the *sovereign debts* this lenders made possible in the first place. And, there is one more benefit: lessening of cost *per* state of 'mending' the banking system of a state through the fact *all* states from *Euro-zone* which are and, respectively, will be included in EMU and SRM will defray the respective (total) costs.

Thus, we are able to conclude *proposal* of instituting these two main components of Banking Union (SRM and SSM) was effected in last two years, respectively that lack of seamless understanding of problematic of banking system can bring about, through contagion, a disaster at European level.

In spite of repeated action adopted by European Central Bank in order to avoid dysfunctional dynamics occurring in market, and of two official reports of presidents of European Central Bank, European Council, European Commission and Eurogroup with the goal of establishing reforms in *Euro-zone*, initiatives of EU institutions taken in order to build up a *banking union* intend to assure cohesion of Single Market through tools made ready by EU treaties.

3. Conclusions

Today's frame of Banking Union denies *Euro-zone* of support and demands national salvage plans as last available means. That is to say, interest rates will reflect rather bank location than monetary policy of European Central Bank. A resolution fund, if a credible common backup is blatantly lacking, seems too much like a deposit guarantee scheme usable whenever bank resolution might endanger protected deposits – of 100,000 € or less.

Given the fact of existence of a Single Market Mandate, the steps needed for achieving a banking union possess nearly form of a ***conclusion***, and not necessarily for financial integration, steps materialized in a credible common recapitalization, on one hand, and resources furnished by banks with great support from states themselves.

In fact, it is really difficult to justify these situations, whilst an 'umbrella' of Single Market does exist, given fact national banking systems *outside* Euro-zone act as marketing institutions EU-wide, but act accordingly to national monetary policy and credible aid which, in long run, are at the disposal of national governments sustained by their own central banks. In this context, maintain national aid near reasonable level makes its best to avoid indirect cession of sovereignty of fiscal and monetary policies to EU institutions.

We can underline, as a conclusion, that measures undertaken by EU in order to override defend of sovereignty through means of a more encompassing support and supervision framework at European Union level may not be interpreted as complementary action of national prudential supervision so as to allow a better functioning of Single Market.

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