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Summary

Legislation laying down the institutional system of the Banking Union was finalised in April 2014. In accordance with the regulations, non-euro area Member States, including Hungary, may notify the ECB at any time if they wish to participate in the common system even before the euro is adopted. However, in its existing form, the single supervisory and crisis management mechanism has not achieved the initial goal, i.e. the separation of the stability of national banking systems and the fiscal capacity of Member States and the elimination of interdependencies. In addition, close cooperation implies weaker powers than those provided by actual membership, and the separation of central bank and supervisory functions carries risks in non-euro area countries. By contrast, the attraction of Banking Union membership lies in the opportunity to join a uniform European system, a wider analyst base and ultimately, the “ammunition” of the EUR 55 billion available for crisis management in comparison to the contributions coming solely from the Hungarian banking system. In October 2013, a single supervisory system integrated into the central bank was set up in Hungary, and the institutional system of the domestic resolution mechanism will be complete by the end of 2014. Therefore, until the actual launch of the Banking Union and the commencement of payments into the Resolution Fund in 2016, it is reasonable to put the decision to join on hold; indeed, such a decision should be made in light of several factors presented in this study.

JEL: E58, F55, G21, G28, H12, H81
Keywords: Banking Union, close cooperation, SSM, SRM, financial crisis management

Összefoglaló

A Bankunió intézményrendszerének alapjait lefektető jogszabályok 2014 áprilisára nyerték el végleges formájukat. Ezek alapján az eurozónán kívüli EU-tagországok, köztük Magyarország elvben bármikor jelezhetik az EKB felé, ha szoros együttműködéssel az euro bevezetése előtt részesei akarnak lenni a közös rendszernek. A közös felügyeleti és válságkezelési mechanizmus jelen formájában azonban nem teljesíti a kezdetben kitűzött célt, a nemzeti bankrendszerek stabilitásának és a tagországok fiskális teljesítőképességének az elválasztását, a kölcsönös függőségi viszony megszüntetését. Ráadásul a szoros együttműködés gyengébb jogosítványokkal jár a tényleges tagsághoz képest, miközben a jegybanki és felügyeleti funkciók szétválasztása a nem eurozónás országokban kockázatokat is hordoz. A bankuniós tagság vonzerejét ezzel szemben az egységes európai rendszerbe való bekapcsolódás, a szélesebb elemzői bázis és végső soron a válságkezelésre rendelkezésre álló 55 milliárd euro hazai bankrendszerhez viszonyított „tűzereje” adja. Magyarországon 2013 októberében létrejött a jegybankba integrált egységes felügyelet, 2014 végére pedig feláll a hazai szanálási intézményrendszer is. Így a Bankunió tényleges indulásáig, az Egységes Szanálási Alapba történő befizetések 2016-os megindulásáig mindenképpen érdemes várni a csatlakozási döntéssel, melyet számos, a tanulmányban ismertetett tényező mérlegelésével kell majd meghozni.

1 Executive summary

In addition to periphery countries, by the summer of 2012 the fiscal capacity of the Spanish government had been called into question amid the surfacing of significant losses in the banking system. These countries saw the beginning of a self-reinforcing process. Weak banking systems generated potential state liabilities, which increased the financing costs of these governments. The problems of the states took their toll on banks, which found themselves in a significantly costlier financing environment. As a result, despite the single currency system, interest rates diverged inside the currency area. In addition, it was in countries facing a more difficult economic situation where interest rates tended to rise despite the low key policy rate of the ECB. This situation called fundamentally into question both the short-term and long-term sustainability of the institutional system across the euro area. This expedited the deepening of financial integration within the euro area and facilitated the creation of a single supervisory and crisis management mechanism, generally called as the Banking Union.

Legislation laying down the institutional framework of the Banking Union was finalised in April 2014. In accordance with the regulations, non-euro area Member States, including Hungary, may inform the ECB at any time if they wish to participate in the common system even before the euro is adopted. This takes up the form of a so-called close cooperation which, however, implies weaker powers than those provided by actual membership; in addition, from the liquidity side, outside of the scope of the single monetary policy the vulnerability of countries entering into close cooperation may even increase. Therefore, the decision on joining the Banking Union is not straightforward by any measure and should be contemplated not only based on the assessment of the institutional system but also in consideration of specific domestic aspects.

In the first part of our analysis we demonstrate that, in the lack of an actual community fiscal backstop (at the EU/ESM level) on the one hand, and a common deposit guarantee scheme on the other hand, in its existing framework the Banking Union can only partly fulfil its fundamental objective. Since the fiscal background required for the guaranteeing of financial stability must be still provided by the Member States, potential contagion effects between the national governments and the banking sector have not been eliminated. Moreover, it gives cause for concern that the mechanism is extremely cumbersome, time-consuming and bureaucratic even in those phases of crisis management where state funding has not even been used yet.

We examine in detail the Hungarian interests along which the advantages and disadvantages of accession or staying outside may be compared from microprudential, macroprudential and crisis management perspectives. From a microprudential perspective, although the professional reputation of the ECB and the Single Supervisory Mechanism (SSM) clearly rises above national supervisions, by tracking the methodology as closely as possible, the differences may be reduced to a degree perceivable even by external players. In terms of macroprudential policy, the decision-making of the ECB and the SSM is cumbersome, their intervention powers are limited and their role perception is still unknown. Thus, based on currently available information, their potential added value in the reinforcement of financial stability in Hungary is limited. This may remain the case until branch operations and direct, cross-border services activity gain a substantially higher significance. As regards crisis management, the complicated and time-consuming nature of the Banking Union's decision-making process poses a perceptible risk, while the source of finance accumulating in the common fund — which is expected to reach EUR 55 billion by 2024 — can be considered attractive. However, it should be noted that even if Hungary stays outside of the Banking Union, the probability of the emergence of crisis situations can be reduced significantly by a sound macroprudential policy and the appropriate use of supervisory tools, including the so-called early intervention system, and at the same time, the fear that foreign banks will be recapitalised from the payments of Hungarian banks can be dispelled.

Of the 9 EU Member States which can decide freely about joining the system of single supervision, Romania, Denmark and recently, Bulgaria may have intention to join as soon as possible. The United Kingdom and Sweden will definitely stay outside of the Banking Union for the foreseeable future. While the rest of the Member States have not refused the opportunity to join outright, for the time being, they have taken a "wait and see" approach. From the perspective of Hungary, owing to geopolitical and structural reasons, the decision of Poland has a particularly great significance. In our current understanding, Poland has been uncommitted so far; therefore its accession is not expected over the short term.

In view of the above, according to the opinion of the MNB, the decision to initiate close cooperation should be put on hold. In our perception, the “wait and see” approach is warranted by several factors, such as the uncertainty surrounding the outcome and consequences of the Comprehensive Assessment, the rudimentary state of the SSM’s internal systems, delays in the practical preparations for close cooperation and the launch of the Single Resolution Mechanism in 2016. Obviously, the unfolding of new, significant developments may necessitate the review of this position down the line.

2 Introduction

On 15 April 2014, the procedures surrounding the establishment of the Banking Union ran their course and the precise criteria of its operation were determined. As a result, all non-euro area EU Member States with an option to decide have, in principle, all essential information at their disposal in order to decide whether they wish to join the Banking Union at its launch in November 2014 or at any later point. On the other hand, for the time being, the supervisory organisation of the ECB has not been fully set up and, parallel to this, in order to evaluate the status and vulnerability of the euro area banking system, a Comprehensive Assessment[1] is in progress, the outcome of which may have a key significance in respect of the European Union's financial stability and the future of the institutional system intended to guarantee it. Therefore, from the perspective of their own financial stability, Member States with a free choice on whether they wish to join will only proceed with due caution if they carefully consider and weigh these uncertainties.

In making the decision, a special aspect arises in respect of Hungary. Drawing the conclusions from the deficiencies of the former supervisory system, in October 2013 the Hungarian government integrated the supervisory authority into the central bank and, upon setting up the new structure, it was mindful of the uniform European rules entering into force as of 2014–2015 and the structure of the Banking Union. To the highest possible extent, the MNB's financial stability decision-making mechanism and instruments map, and in some cases, even outpace[2] the structure of the Banking Union. Thus, in the case of Hungary, the question arises even more definitely, whether it is worth abandoning a brand new structure — the setting up of which claimed heavy sacrifices — to replace it with a still rudimentary structure whose functioning is yet to prove itself in practice.

The largest attraction of the Banking Union is the bank stability fund which, accumulating from the payments of the European continent's banks is expected to be in the range of EUR 55 billion by 2024, but even access to the fund cannot justify the decision to join in itself. Since the basis of payment is uniform for each Member State — it depends on the size and riskiness of banks —, proportionately Hungary cannot expect to receive any more from this fund than the HUF 90 billion collectible, based on the same principles, into the Hungarian fund. In extreme cases, when, for example, a major European bank is in distress, as part the Banking Union even Hungary's contribution may have to go towards the bailing out of another country's bank.

[1] Comprehensive Assessment : http://www.ecb.europa.eu/ssm/assessment/html/index.hu.html

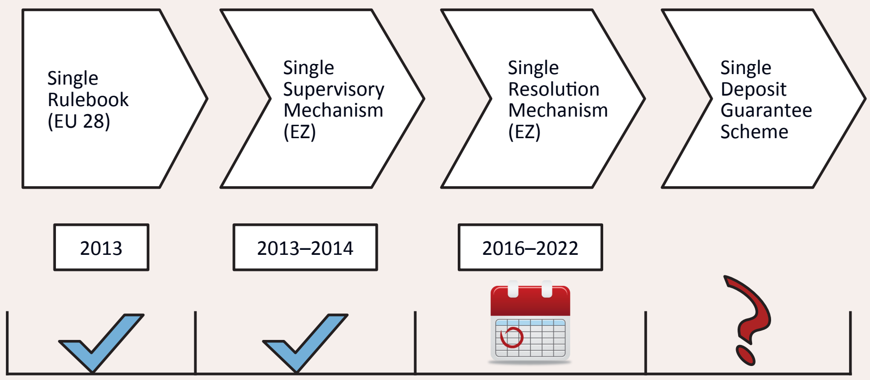
[2] For example, micro and macroprudential decisions have been delegated to a single decision-making forum, the Financial Stability Board, where both professional fields have due representation. By contrast, macroprudential decisions in the SSM will be made by the Supervisory Board, which gives rise to concern from numerous aspects. (Presented in detail below).

3 The original goals of the establishment of the Banking Union versus the implemented system

As a result of the European sovereign debt crisis, economic cycles began to diverge among individual Member States. In addition, the same process severely impaired the uniform transmission of monetary policy within the euro area. Owing to the vicious circle emerging between banking systems and sovereigns, the same central bank base rate increasingly implied completely different cost of funds for economic participants in Germany and, for example, in Portugal. This process fundamentally called into question the sustainability of the institutional background of the single currency and revealed that only a far more centralised fiscal policy, supervision and resolution scheme can save the currency.

The notion of a Banking Union is not new; indeed, the need arose much earlier to have a central supervisory authority to oversee the European banking system which, dominated by a cross-border banking groups, constitutes an integral part of the EU's Single Market. Nevertheless, partly due to sovereignty considerations and partly owing to unresolved crisis management and loss-bearing issues, until now the intention to centralise has not realised. The turning point arrived with the emergence of a pile of problems, which exacerbated the bank crisis to become a sovereign debt crisis and became nearly uncontrollable at the national level, and that the promise of an EU level bank bailout was associated by "net contributors" with the need for single, unbiased supervisory control. Consequently, in the summer of 2012 a decision was made to establish a Banking Union with the goals of separating the stability of the banking system from national fiscal capacity and eliminating interdependencies. However, "net contributors" argued that before the ECB commenced its central supervisory activity, problem banks had to be identified, and the necessary measures for restructuring them had to be arranged to ensure that the credibility of the ECB and the common crisis management mechanisms are no longer burdened by previously committed supervisory errors (legacy assets). This dual target, i.e. the necessity of addressing existing problems and the need for an efficient, well-functioning, stable central supervisory and crisis management system, continuously hindered the creation of a coherent system, and the end result was a fragmented, cumbersomely established structure, which continued to rely on the financial commitment of individual Member States.

Chart 1
Key building blocks of a Banking Union



Source: BBVA (2013).

In respect of the individual elements of the system, initial ideas and the final outcome are compared in the tables below:

Table 1
Pillar 1: Single Rulebook

Plan	Implementation
Uniform prudential rules at the EU level	• The Capital Requirements Regulation entered into force on 1 January 2014 and, due to its regulation form, it is directly effective in all Member States of the EU. The CRR lays down the foundations of the prudent operation of credit institutions and investment firms with a uniform content for all EU Member States. Nevertheless, it only defines general principles concerning several issues, letting the Technical Standards of the European Bank Authority (EBA) define specific rules of conduct and operational criteria, which will take at least another 3 years to be developed. • The Capital Requirements Directive sets forth, in a directive form, the rules applicable to the supervision of banks and investment firms and a part of the rules applied for macroprudential purposes. Since the directive comes into effect via national implementation, in practice, 28 national laws define the key parameters of supervisory work. Similarly, the accounting rules are defined by the national implementations of EU directives and as such, are composed of 28 different systems.

Table 2
Pillar 2: Single Supervisory Mechanism

Plan	Implementation
A central supervisory authority should oversee euro area banks.	• The supervisory body of the Banking Union will be the ECB (Single Supervisory Mechanism – SSM); however, it will not perform its supervisory activity independently but in cooperation with local supervisions; consequently, information sharing and coordination channels gain special significance. Although in principle, the 120 largest banks are supervised directly by the ECB, even in the case of these banks, local supervisors are involved in on-site inspections. In theory, the ECB may impose its direct supervision on any one of the 6,000 euro area banks in case of more severe problems; therefore, it has set up a separate directorate for the “indirect” supervision of these 6,000 banks, doubling, as it were, the supervisory capacity for the banks concerned. • For the sustainability of the single market, non-euro area Member States have a possibility to enter into close cooperation with the SSM. Since, however, the ECB’s decisions are not directly applicable to the banks of these countries, formally, all decisions remain to be made by the local supervision, which implies a loss of time relative to euro area banks. In addition, they also raise the issue of liability, given that banks concerned will contest the local supervisor’s decision in case of a disagreement. • Supervisory decisions are made in a two-step procedure: draft decisions are proposed by the Supervisory Board comprising all members (including representatives of the supervisions of countries in close cooperation), while the Governing Council — whose membership is limited to euro area central bank governors — either adopts or objects to the decisions within 10 days.

Table 3
Pillar 3: Single Crisis Management

Plan	Implementation
In case of a crisis affecting the banks participating in the SSM, a central resolution authority takes action. The financing of resolution actions fundamentally relies on banks; however, the system is backed by a EU-level, credible fiscal support — presumably, the ESM —, which can provide loans to the resolution fund. Since instalments of these loans are made from banks’ payments, from a fiscal perspective the system is neutral over the medium term.	• According to the original plans, the resolution authority would have been the Single Resolution Board (SRB), which would have had its own organisation and a management composed of the heads of participating Member States’ resolution authorities. Due to legal and political reasons, however, final decisions are made by the European Commission; however, the ECOFIN Council also has a say in the Commission’s decisions. • The source of financing for resolution will be the Resolution Fund to be established from the pooling of national resolution funds within 8 years (with funds worth EUR 55 billion after 8 years); however, no solution has been made in respect of the fiscal backstop behind the Fund. • Until the sufficient level of the national resolution funds is built up and the contributions collected retrospectively from the banking system are received, Member States will be forced to contribute — after uninsured depositors and capital holders — actively to bank bailouts from taxpayers’ funds.

Table 4
Pillar 4: Single Deposit Guarantee Scheme

Plan	Implementation
A single deposit guarantee scheme needs to be established with a view to maintaining confidence in the financial system. As an alternative solution, a collaboration network of state-level deposit guarantee schemes is also conceivable with loans and cross-guarantees granted to one another.	• In December 2013 a political agreement was reached on the recast of the Deposit Guarantee Scheme Directive. Accordingly, there will be national-level deposit insurance schemes; the Directive reaffirmed the EUR 100,000 insurance limit for deposits applicable since 2011 (per person and per bank); set the target level of national deposit guarantee funds at 0.5–0.8 per cent of covered deposits to be raised by banks based on their specific risk profiles; 30 per cent of the funds can be available in the form of payment obligation and the existing payout period of 20 working days is to be shortened gradually to seven days by 2024. • There is no mutualization.

3.1 MACROPRUDENTIAL OVERSIGHT

The conduct of a macroprudential policy, i.e. the early recognition and possible mitigation of the financial system's risks was given a peculiar framework inside the Banking Union. Upon developing the CRR/CRD system, from the initial framework defined merely in terms of a countercyclical capital buffer, it took a long time to reach a macroprudential intervention tool system that is based on several kinds of capital buffer and a wide range of flexibility options and even this new system is admittedly inadequate,[3] and will be reviewed by the European Commission in the near future[4]. This spectacular increase in the powers of national macroprudential authorities can be attributed to the fact that legislators recognised that the specificities of national financial systems, the different product structure, macroeconomic background, various levels of consumer awareness, development, etc. give rise to several different kinds of potential systemic risks which, until the single market is actually achieved, may require different modes of management at the national level.

Somewhat contradicting to this, macroprudential decision-making is also centralised in the Banking Union with the semi-solution of empowering the ECB to overrule the decisions of national designated authorities — including the decision of non-intervention — with an intention of tightening. What is more, this is based on the opinion of the Supervisory Board, which consists of the leaders of microprudential supervisions [5].

Box 1
Competences of the SSM in macroprudential issues

The single European prudential regulation (CRR/CRD) defines a narrow group of tools, in respect of which national macroprudential authorities (designated authorities) may set stricter requirements over and above the microprudential minimum, based on systemic risk considerations. These tools are the following: (i) the level of own funds; (ii) requirements for large exposures; (iii) public disclosure requirements; (iv) capital conservation buffer; (v) liquidity rules (LCR, NSFR), (vi) leverage rules; (vii) risk weights of loans secured by residential and commercial property; (viii) credit risk weights within the financial sector. They also include the (ix) countercyclical capital buffer defined in the Basel III standards for the national level; and the (x) systemic risk buffer rate that can be also set, up to 3 per cent, at the national level.

The macroprudential authorities of Member States joining the SSM must inform the ECB of any steps scheduled to be taken in respect of any of the tools above 10 working days before decision is made. In case of disagreement, the ECB must produce a written response with justification within 5 working days. The authority of the Member State concerned must consider the ECB's written opinion in making its final decision.

[3] For example, it lacks PTI and LTV rules and so far, no single tool has been dedicated to the management of systemic liquidity risks.
[4] Pursuant to Article 513 of the CRR.
[5] Decisions proposed by the Supervisory Board are approved, without an option for change, by the Governing Council whose membership is limited to euro area members. (The decision-making procedure is described in detail in Box 2).

At the same time, the ECB has an option to set stricter rules than the domestic regulations in respect of the tools specified above. In such cases, the ECB also must inform the national authority about the contemplated measure 10 working days before it comes into effect. The national authority may voice its disagreement, along with a justification, in a written opinion. The ECB must make its final decision in consideration of these justifications.

It should be noted that, apart from the ten tools mentioned above, the macroprudential tools established by national legislation (e.g. LTV regulations, loan-to-deposit ratios, etc.) will still be controlled by the national authorities, and the ECB will have no access to them.

The Supervisory Board is the body responsible for the ECB's preparatory work in respect of macroprudential decisions, while formal decisions are made — without an option for change — by the Governing Council. The decision-making procedure of the Supervisory Board and the Governing Council, as well as the special procedures of countries in close cooperation are presented in Box 2.

So far, the ECB has not communicated anything on its views on managing the macroprudential policy. In view of the competences, the final result could become a duplicate structure burdened by numerous redundancies where the main decision-making powers remain at the local level. In the worst-case scenario, the mixture of responsibilities may lead to an obscure structure where placing blame on the one hand, and the insensitivity of centralised risk-analysis on the other hand, gives rise to the risk of inaction-bias.

4 Hungarian interests in light of the Banking Union

The Hungarian banking market is fairly diversified, with competing groups often overlapping in terms of ownership background, customer base and activity. The key players of the market include the OTP, a Hungarian-controlled retail bank, large and medium-sized foreign banks with a strong corporate and retail market presence and an ownership structure largely subject to the Banking Union, mixed-activity small banks and the cooperative bank integration. The interests of customers and Hungarian financial stability would be best served if these players pursued their activities in a level playing field environment in accordance with uniform supervisory aspects, also bearing in mind macroprudential and monetary policy objectives. This goal was temporarily achieved by the integration of the Hungarian Financial Supervisory Authority (HFSA) into the MNB; however, the establishment of the Banking Union may have a significant impact on the domestic banking market and, in a wider sense, on the operating environment of financial intermediation and on the attainment of a uniform supervisory attitude.

Through their groups, large banks with a foreign ownership background will be subject to the group-level supervision of the ECB, while their individual-level supervision will remain within the competence of the MNB. In this regard, Hungary's accession would not bring about too many changes as, being small banks by EU standards, at the individual level they would remain to be supervised locally[6] despite a potential close cooperation. Therefore, in making the decision on Hungary's accession, it needs to be considered whether the supervision of the OTP group should be taken over by the ECB from a supervisory perspective, and whether in case of a potential resolution situation Hungary would be better off in terms of time and cost efficiency by joining the European resolution mechanism or not.

4.1 MICROPRUDENTIAL SUPERVISORY CONSIDERATIONS

As described above, the single European rulebook (CRR/CRD) serves as the basis for microprudential oversight which, besides, adopting the rules of Basel III, rearranges the relationship between the supervisor and the bank to a great extent. On the part of the supervisor, it expects a more proactive and conscious attitude; a more consistent representation of financial stability considerations; and the understanding of — and even challenging, where appropriate — the business model as a whole. Accordingly, it implies, on the one hand, standardisation; on the other hand, an institutional focus and a requirement system scaled to size, activity and complexity.

From a financial stability perspective, the most important question is whether it would strengthen the stability of the Hungarian system if OTP Bank and a few[7] foreign-owned large banks were directly supervised by the ECB, while the ECB defined certain aspects for the supervision of the remaining banks? Since actual supervisory work will be presumably performed by the same experts of Hungarian supervision, we may also pose the question as follows: can the Single Supervisory Mechanism (SSM) improve the efficiency and effectiveness of Hungarian supervisory work?

From the point of view of market participants, investors and credit rating agencies, the greatest added value of the SSM is the **ECB's reputation,** and specifically, a new, **uniform methodology** and a **series of internal controls** which ensure that supervisory interventions are free from external influence.

[6] At the time being, it cannot be determined exactly which large banks would be supervised directly by the ECB on the basis of the "three largest banks" principle. From a legal perspective, the ECB supervises banking groups; therefore, the two largest domestic banks after the OTP could be the FHB — incorporated in Hungary — and Takarékbank (the savings bank). In its communication to the supervisions, however, the ECB indicated that it may also supervise major subsidiaries independently which, based on 2014 Q2 data, may warrant the direct supervision of K&H Bank and Erstebank as well.

[7] See the preceding footnote.

In weighing the decision on Hungary's accession it can be established generally that the **professional reputation of the MNB** lags behind that of the ECB; however, it should be stressed that extremely strong firewalls will be put in place between the ECB's organisation responsible for monetary policy and its supervisory organisation which, in principle, excludes all forms of cooperation. In other words, the SSM will have to build its own credibility, and the most important steps in this process will be the Asset Quality Review (AQR) and the Stress Test. Since their results are expected to be released at the end of October 2014, until then it remains to be seen whether all, or at least a few weak banks will fail to pass the ECB's Comprehensive Assessment, and whether a sufficient number of non-performing portfolio elements will be written off to meet the heightened expectations. Since, looking at the other side, the legal background of resolution will only be in place by the beginning of 2015 with the institutional system lagging far behind, and the chance of capital injections by the state is restrained by competition law and a vulnerable fiscal position, in respect of banks which would fall through the cracks due to their weak position and a disability to tap sufficient funds from the market, the ECB may be "tempted" to give in to the pressure anyway and set a lower capital requirement.

Indeed, the supervisory credibility of the MNB will need to pass the same test. In this context the MNB has launched, in accordance with the ECB's methodology, the Asset Quality Review (AQR) of the largest Hungarian banking group, in which — as is the case with the ECB — an external consultant has also been involved. In addition, the MNB is participating actively in the EU Stress Test. On the other hand, since the MNB also receives information on the comprehensive assessment pertaining to foreign-owned subsidiaries operating in Hungary, in its supervisory capacity it can take the steps that may become necessary. And since the legal background for including the shareholders in loss-sharing was established in July 2014[8], and the resolution mechanism will be set up by the end of the year, it can be demonstrated with credibility that the MNB, as a supervisory authority, need not make compromises in assessing portfolio quality as it has all crisis management tools at its disposal which are designed to either retire undercapitalised banks from the market or restructure them.

In the course of 2014–2015 a series of EBA technical standards will come into force intended to facilitate the application of the uniform European methodology; in addition, the MNB will also have an opportunity to adopt the **ECB's supervisory methodology** and apply it to domestic actors.

The key question is, then, how will the ECB function in terms of **internal controls** and the **efficiency of decision-making**, and how will the MNB fare in comparison? The ECB will organise its activities around banking groups, where on- and off-site national supervisors and ECB employees will be coordinated by local managers and ECB managers. Most operative issues, such as the content and approval of the annual audit plan, will be decided at the ECB's directorates. The decision-preparation forum of key issues is the Supervisory Board, which consists of four delegates from the ECB and leaders of the local supervisions; actual decisions, however, will be made — without an option for change — by the Governing Council composed of euro area central bank governors.

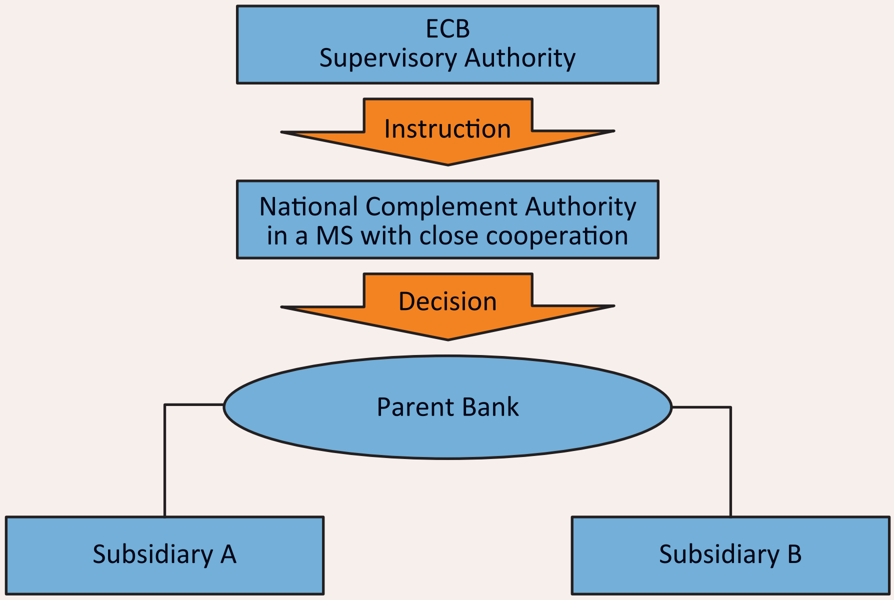
Box 2
Decision-making procedures of the SSM in micro and macroprudential issues

The Supervisory Board is the competent body in micro and macroprudential issues under the SSM. Composed of a Chair and a Vice-Chair, four delegates of the ECB and high-level representatives of the national competent authorities, the Supervisory Board will make its decisions by a simple majority; in case of a draw, the Chair will have the casting vote. In the legal sense, decisions of the Supervisory Board will become legally binding if they are also approved by the ECB's Governing Council. The Governing Council has maximum 10 working days for the approval of decisions. It has no option for change; it either adopts or objects to the decisions. Countries in close cooperation will have an option to inform the Governing Council in case they dislike a draft decision proposed by the Supervisory Board. If the Governing Council approves the draft in any case, the Member State will be entitled to exit the Banking Union with immediate effect. Likewise, the close cooperation may be terminated if the draft decision of the Supervisory Board is rejected by the Governing Council, but a non-euro area Member State informs the Governing Council of its dissatisfaction, yet the Governing Council is still unwilling to adopt the decision. In such cases the Member State is entitled to declare that it does not consider binding to itself the draft recast by the Supervisory Board and eventually approved by the Governing Council. In this case, may decide to terminate the close cooperation after having carefully considered its potential implications.

[8] As of August 2013, pursuant to the competition law of the EU, the state may provide a capital injection to distressed banks only after junior capital owners (owners of Common Equity Tier 1 capital and subordinated capital and loan capital) have been included in loss-sharing. The Hungarian resolution law adopted in June 2014 permits both junior and senior (creditor's) recapitalisation; therefore, this cannot present an obstacle in the management of a potential individual-level bank crisis.

Being a non-euro area Member State, in the case of Hungary decision-making would not conclude upon the approval of the Governing Council. Since the decisions of the Governing Council are not directly applicable to credit institutions incorporated in non-euro area Member States, in a legal sense these decisions would be deemed as recommendations only. In order to adopt them as supervisory decisions, the decision-making body of the MNB, i.e. the Financial Stability Board, would also have to put them on the agenda and approve them repeatedly as if they were the MNB's decisions.

Chart 2
Consolidated supervisory decisions in case of close cooperation



Source: ECB.

The organisation of the SSM is still evolving, and only fragmentary information[9] is available on its expected functioning. The situation is even worse in respect of the availability of information regarding the expected methods of conflict management and the special procedures applicable to emergencies.

By contrast, after the HFSA-MNB integration in the autumn of 2013, the institutions and internal procedures were, for the most part, established in Hungary, decision-making competences are straightforward, and — with the involvement of the NGM —, the decision-making forum of micro- and macroprudential measures is functioning adequately.

Overall, the MNB is one year ahead in the processes aimed at laying down the groundwork for and operating critical functions and establishing the required internal cooperation mechanisms. And if the MNB can offer a real and viable alternative to the common banking supervision, the government will have the advantage of being able to wait in making its decision on joining the Banking Union until it has proved itself in practice, and has faced crisis management a few times; i.e. when it has demonstrated whether the community mechanisms described above are truly functional.

4.2 MACROPRUDENTIAL POLICY CONSIDERATIONS

Macroprudential policy brought to life in Hungary in response to the crisis, as in the EU, is still a work in progress. Besides the supervisory integration, the new MNB Act adopted in October 2013 laid down the institutional system and tool set of macroprudential policy. By doing so, essentially, it beat the deadline specified in the recommendation of the European Systemic Risk Board laying down the common EU standards and hence, outpaced most EU Member States[10].

[9] http://www.ecb.europa.eu/ssm/orga/html/index.en.html
[10] See http://www.esrb.europa.eu/pub/pdf/recommendations/2014/ESRB_2014.en.pdf?a6589dd2349be909e0007e3817f17b00 for more details.

The losses suffered in Hungary on foreign currency lending emphatically underpin the importance of the timely recognition of systemic risks and the execution of adequate interventions as early as possible. In theory, the broad analysis base and independent experts of the ECB can look at the Hungarian banking sector more objectively and free from bias, which may contribute to the timely recognition of structural and cyclical risks alike. For the time being, however, we do not know how this will work in practice, and cannot be sure that the problems of smaller, non-euro area Member States will be taken as seriously as those of key Banking Union members with a more significant banking sector.

Regarding the interventions following the detection of risks, in countries acceding to the Banking Union the responsibility for financial stability is shared between national designated authorities and, in case of the measures envisaged in the CRR/CRD, the ECB. From the perspective of Hungary, joining the SSM would be an option worth considering if we thought that we needed the ECB's option for stricter requirements as a disciplinary effect in order to ensure that the MNB takes the necessary steps of intervention in time, or if we believed that for the harmonisation of national macroprudential policies, there was a need, in addition to the European Systemic Risk Board (ESRB), for the closer cooperation offered by the SSM.

We cannot give an objective answer to the first question; however, based on the functioning of the FSB since October 2013 we may conclude, that it pursues an active macroprudential policy, effectively operating the macroprudential tools of the MNB based on the detected systemic risks and in accordance with the appropriate legal procedures. Since the ESRB, which relies on the analysis base of the ECB, is entitled to issue recommendations at any time if it perceives inadequately handled systemic risks in Hungary, external control over the MNB would be ensured in any case.

The harmonisation of macroprudential policies is important for Hungary in order to ensure that the measures taken by the MNB are followed by the macroprudential authorities of countries with activities directed to Hungary. In a legal sense, this so-called reciprocity gains relevance in the case of branches and direct cross-border activities, as the subsidiaries operate in Hungarian jurisdiction. As long as the activity of and thus the level of systemic risks generated directly by branches are limited, Hungary is not in need of close coordination. Even so, it can still rely on the ESRB, the scope of which covers the entire EU, not only Member States participating in the Banking Union.

At this point, we should also mention of those institutions, which operate in a subsidiary form and are important for Hungary from a systemic risk perspective. If we joined the Banking Union and, based on the legal approach, these institutions would be covered by the direct supervision of the ECB and their banking group, which is built on the parent company, would constitute the basis of the ECB's supervision in the future, this would call into question the MNB's ability to set extra requirements for these institutions as a macroprudential authority, and to verify their compliance.

4.3 CRISIS MANAGEMENT, MONETARY POLICY EFFECTS

One of the main goals of supervisory activity is to avoid individual bank crises. Having said that, if a systemically important bank would be hit by a crisis due to unexpected shocks, external effects or systemic disturbances, competent authorities should be able to manage the crisis efficiently and effectively for the mitigation of damages and the fast resolution of the situation. Depending on the size and nature of the crisis, the smooth cooperation between the central bank, the supervision, the resolution authority and, in case of the use of public funds, the Government, may become critical.

From a crisis management perspective, the interests of financial stability would demand that, in due course following the detection of the crisis, **an effective crisis management scenario is drawn up and implemented,** that the **funds** required for addressing the situation are available, and that crisis management itself has the **fewest possible adverse effects.** The literature basically distinguishes between two types of crisis: liquidity and solvency crises, which may take on diverse forms.

Invariably, resolving liquidity crises is assumed by central banks which, in the case of Hungary, imposes an exclusive responsibility on the MNB. A recent British example, the case of Northern Rock[11] demonstrates that a lack of close cooperation between the supervisory authority and the central bank and the failure of the competent authority to provide adequate information to the central bank on the current situation of the financial institution may render the extraordinary central bank loan unrecoverable, and the liquidity crisis may become a full-fledged solvency crisis.

[11] See, for example, Bruni, Llewellyn (2009).

Therefore, a possible accession to the Banking Union would expose the MNB to the liquidity oversight performed by the ECB, and in case of any inefficiencies the costs incurred would be borne by Hungarian taxpayers. Likewise, in the case of systemic liquidity crises, the Hungarian monetary authority would heavily rely on the quality of the ECB's monitoring and early warning systems, as well as suitably fast and efficient supervisory interventions. In their absence, the escalation of the crisis may reach a point where the intervention of the monetary policy would be required in order to maintain financial stability. These ad hoc interventions, however, would deter the conduct of monetary policy geared to price stability, as it would have to use the interest rate instrument with a view to achieving two different policy goals at the same time, which may lead to inconsistencies and overload the monetary policy. The ideal case would be to have a single institution to control both the monetary policy and financial supervision. This, precisely, was one of the objectives of the creation of the Banking Union for euro area countries.

Until recently, only state aid was available to handle solvency crises. However, the EU Bank Recovery and Resolution Directive[12] designed to minimise the necessity of recourse to state funds with the introduction of new tools and financial resources will come into effect in the territory of the European Union from 1 January 2015. The directive expects each Member State to establish its own resolution authority and resolution fund from the resources of its banking sector.

For members of the Banking Union this authority will be the Single Resolution Mechanism (SRM), and the resolution fund will be pooled from individual national resolution funds within 8 years. Hungary needs to consider whether it is the SRM — in the case of banks settled down in Hungary — or the designated resolution authority, the MNB, that **can execute a more effective and more efficient resolution intervention, and whether the HUF 90 billion that can be collected from local banks in 10 years' time is sufficient to address domestic cases, or access to the common EU fund is absolutely necessary.**

In Hungary, the Act on Resolutions was adopted on 4 July 2014, which means that a viable resolution institutional system may be set up by the autumn of 2014. This can only be expected for 2016 in the case of the Single Resolution Mechanism. The resolution authorities must assess systemically important banks and investment firms at times of peace, prepare, in conjunction with the institutions, a resolution plan that serves as a script for conducting a potential resolution, and if they perceive any obstacles in the activity or organisational structure of the institution that would impair the implementation of the resolution plan, they must enforce the necessary changes. The MNB will need to perform all this in case of a potential accession as well; as an important difference, however, inside the Banking Union these plans would be drawn up by the SRB in the case of large banks.

The real difference would materialise in case of a resolution event. In case of staying outside and provided that taxpayers' funds are not used, the updated resolution script — which is based on the resolution plan — will be approved by the Financial Stability Board, and its implementation may begin immediately. In case of participating in the Banking Union, after the decision of the FSB, the planned measure must be presented to the SRB and, depending on the size of the bank and the amount to be used for the financing of the resolution from the Single Resolution Fund (SRF) to be set up by 2024, a multi-player decision-making procedure will be launched with the participation of the Executive Board and plenary body of the SRB, the European Commission and the European Council. Since the speed of administrative intervention in case of a crisis situation is a key issue and there have been no practical examples to show how long it takes for the respective decision-makers of this manifold body to reach a consensus, we deem this to be a risk by any measure.

In contrast with the complicated and time consuming decision-making of the SRM, the attraction of the Banking Union lies in the common resolution fund, which pools EUR 55 billion from the European banking sector in 8 years. We must stress, however, that the use of these funds for the recapitalisation of distressed banks is limited; it is paid from the funds of owners, creditors, the local deposit guarantee fund and, in the form of nationalization, local taxpayers' funds[13]. Moreover, after utilisation the funds thus used must be replenished, over the medium term, from the extra taxes levied on the banking sector.

Relying solely on Hungarian funds would clearly imply a competitive disadvantage. This competitive disadvantage, however, may be significantly reduced by the capital buffers expected from owners[14], by maintaining a sufficient level of bail-inable

[12] Bank Recovery and Resolution Directive, BRRD, http://eur-lex.europa.eu/legal-content/HU/TXT/HTML/?uri=CELEX:32014L0059&from=EN

[13] Capital shortfall potentially detected in the course of the AQR reviews in 2014 may be covered by public resources on one occasion, in the form of precautionary recapitalisation.

[14] The so-called O-SII buffer imposed on systemically important banks.

funds[15] that can be involved in loss management, by carefully prepared intra-group financing and loss-sharing plans in case of subsidiaries, by a risk-sensitive and efficient supervision, and by the efficient and effective application of the so-called early intervention tools that were added to the supervisory tool set after the implementation of the BRRD. These issues, however, are partly within the competence of the Hungarian legislator, and are partly determined by the MNB.

In some cases, however, even these resources are insufficient to resolve the predicament of a bank properly. In such cases, in the interest of maintaining financial stability, the last resort is to take recourse to public funds. This is called the **fiscal support** or backstop which, although rarely used, must be in place for maintaining investor confidence in the highly leveraged banking sectors[16]. Since the fundamental idea behind the creation of the Banking Union was precisely the elimination of the debtor-creditor relationship between sovereigns and banks, this proved to be a particularly sensitive issue at the time of designing the system. So much so, that a mere months before the system is launched, this topic is not even on the agenda yet; official negotiations on the subject will commence only after the implementation of the SRM, around 2016. Ideally, in case of euro area countries, the source for this could be the financial fund maintained by the European Stability Mechanism (ESM), which is intended to provide temporary assistance to individual governments in case they face financial difficulties. Since, however, non-euro area Member States did not join, these countries has no access to the funds accumulated under the ESM, not even in case of a state or a bank failure. Consequently, only the subsequently commenced negotiations will reveal whether the EU is capable of setting up a fiscal backstop that offers a level playing-field both to euro area countries and non-euro area Member States opting for close cooperation. Ultimately, this will be the last building block of the Banking Union which, however, fundamentally defines the entire structure.

[15] MREL–Conditions and authorisations are set by the BRRD.
[16] See, for example, Schoenmaker, D. (2014).

5 Should Hungary join immediately the Banking Union?

Based on the ECB's communication, Member States wishing to enter into close cooperation — if they wanted to participate in the Banking Union from the start — had an opportunity to declare their intention to join 5 months before the launch of the SSM in November 2014, i.e. in June 2014 at the latest. During these 5 months, the banking sector of the joining country must be thoroughly assessed, access to data required by the ECB for the purposes of supervision must be ensured, and the cooperation obligation with the ECB must be enshrined in national legislation. In addition, on 15 April 2014 the European Parliament adopted the resolution directive and the regulation defining the Single Resolution Mechanism (SRM); consequently, all decision-making actions for the current phase of the Banking Union have been formally concluded and therefore, apart from the fiscal backstop, all information required for the decision on accession is, in theory, available.

Following June 2014, the position on close cooperation may be formally reviewed in the context of the following:

Table 5
Possible dates of Hungary's accession to the Banking Union

Event	Date of announcing the intention to join
Publication of AQR and ST results, the first credibility test of the SSM	1 November 2014
5 months before the actual setting up of the SRM–SRF in January 2016	31 July 2015
After the establishment of final fiscal backstops	Conclusion of negotiations to be launched in 2016
A significant increase in the "ammunition" of the SRF	
A wave of entries – the group of outsiders narrows down significantly	
Adoption of the euro	

As has been shown earlier, the institutional structure and operation of the Banking Union significantly differs, in several respects, from the very objectives that warranted its establishment, the most important of which include the following:

1. There was a failure to establish a truly centralised supervisory authority even for the euro area; supervisory responsibilities are shared between the national competent authorities and the ECB, in a manner that relatively lacks transparency.

2. Only limited participation of non-euro area Member States is permitted in supervisory and macroprudential decision-making (with decisions being made by the Governing Council).

3. The new crisis management mechanism is slow, ponderous and bureaucratic; its practical applicability within the required extremely limited timeframe is questionable.

4. The system is not backed by a true, European-level fiscal backstop, forcing members to keep contributing to banks' crisis management from their own financial resources. Separation between a Member State's fiscal capacity and the operation of banks located on its territory failed.

5. It is unclear whether national supervisory responsibilities and the burdens of crisis management incurred by Member States will be proportionate.

6. The mutualization of the deposit guarantee scheme failed to materialise, which may impose further costs on Member States in case of a possible crisis situation.

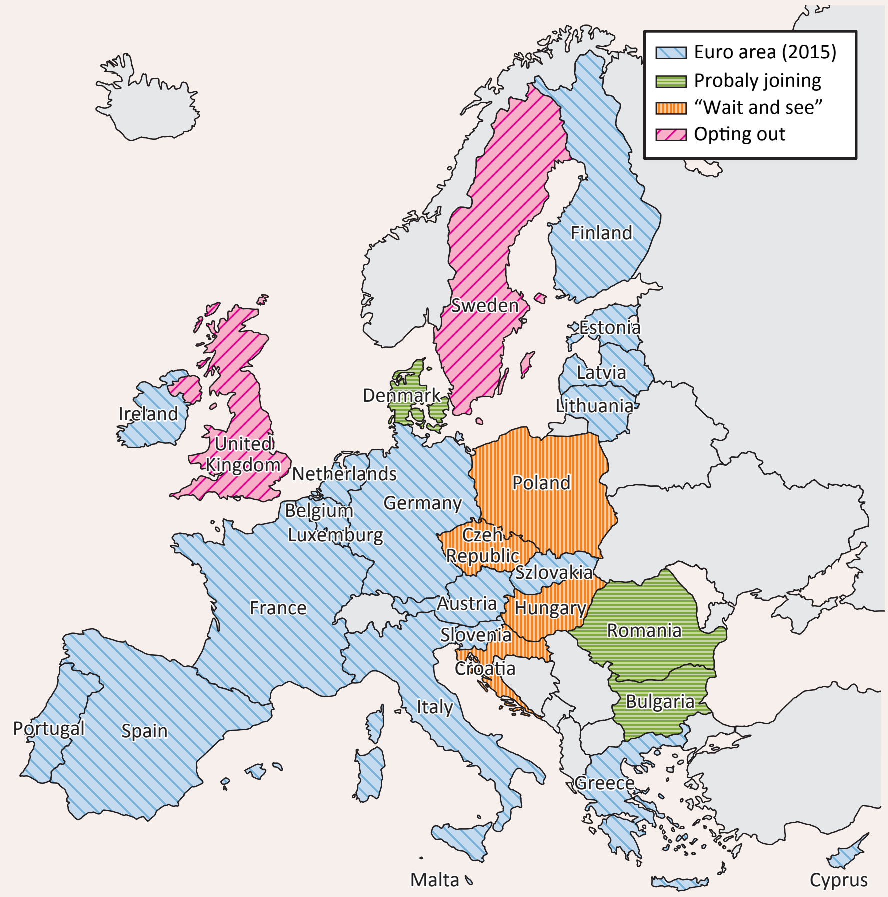
5.1 MEMBER STATE POSITIONS

Of the 10 EU Member States that have not adopted the euro so far, the United Kingdom has indicated from the start of the Banking Union negotiations, that due to the significant weight of its banking sector in the national economy and the potential risks associated with it, it will definitely keep supervisory powers and responsibilities within national competence. Over time, a similar position was taken by Sweden as well, especially after it has been revealed that euro area and non-euro area members will not be treated equally in supervisory decision-making. The attitude of Denmark is cautious, but it has issued statements favouring accession[17].

As regards Central and Eastern European countries, Romania is clearly in favour of joining and, in the face of the run on banks in June 2014, Bulgaria declared an intention to join the ECB oversight. At the same time, Poland and Hungary expressed reservations. The rest of the Member States expressed a position in between the two extremes, but fundamentally leaning toward accession.

Hungary's decision to join is influenced by the decision of other Member States through two channels. The significance of a potential accession of Central and Eastern European countries lies mainly in investor sentiment. Since accession is expected to elicit positive market reactions owing to the superior professional reputation of the ECB compared to national authorities, if the majority of these states decide to join, outsiders will be left with a clear competitive disadvantage, while banks operating in these Member States will face an increasingly difficult financing position.

Chart 3
Relationship of EU Member States to the Banking Union



Source: Press releases.

[17] The Danish Parliament has appointed the Bruegel Institute to produce an analysis for its preparations for the decision on accession. Also relying on several features of the Hungarian banking sector, the analysis identified more arguments in favour of the accession than opposing it: Darvas – Wolff (2013).

By European standards, compared to the 19 euro area countries and the ECB, the ability of the remaining 9 countries to enforce their interests in financial regulation and oversight issues is limited as it is. If the number of outsiders diminishes, those on the outside may face a further loss of significance and possibly, isolation, which may warrant the reconsideration of the arguments in favour of opting out. Although the opting out of the United Kingdom and Sweden is a foregone conclusion for the time being, the possibility of enforcing those Hungarian interests which do not concern them and are linked to the special, host country status would be weakened significantly by a potential accession of the remaining countries in the region.

5.2 FACTORS INFLUENCING HUNGARY'S POSITION

5.2.1 Possible advantages of immediate accession

Among the arguments favouring accession, access to the EUR 55 billion crisis management fund is the strongest and most tangible factor to consider. Although no decision has been made so far in respect of the fiscal backstop required for this, the ESM funds that can be used inside the euro area may imply, albeit indirectly, a further stabilising force through parent banks.

With an immediate accession Hungary could demonstrate its confidence in the new European supervisory mechanism and the ECB. The broad analysis base and independent experts of the ECB can look at the Hungarian banking sector more objectively and free from bias, which may contribute to the timely recognition of structural and cyclical risks alike. Both analysts and investors consider this an important value. The positive investor sentiment surrounding the Banking Union may have an impact on domestic banks' access to external funds, the high reputation of the ECB's oversight may reduce the cost of funds, and credit rating agencies may find potential bank bailouts less probable which, in turn, may improve the country's credit rating.

An early accession would increase the chances of Hungarian experts and possibly, leaders, of being employed in the SSM in larger numbers so that they can represent Hungarian interests in a wider sense and convey the special intelligence required for the oversight of the domestic banking sector. Hungary may get closer to the mainstream of European integration and the application of the new, uniform oversight and crisis management methods. By gaining a voting right in the Supervisory Board, it can participate in supervisory decision-making and have a direct, "parent-bank level" influence in the decisions of the colleges of supervisors that also include Hungarian banks.

5.2.2 What are the risks?

The main risks of an immediate accession include, primarily, an incomplete organisational structure, untested mechanisms — in particular, the lack of transparency in preparing the decisions to be made at least annually at the level of banking groups (on capital, liquidity, etc.) –, and the uncertainty surrounding the management of crisis situations. At this time, we cannot predict the outcome of the Asset Quality Review, which was intended to be thorough, and the stress test, which is stricter than any other stress tests conducted in the past. If several large banks – including some with a presence in Hungary — prove to be in need of a capital injection, significant market uncertainty may ensue. In situations characterised by such, often exaggerated investor behaviour and an abrupt rise in risk aversion, it is particularly important to have well-functioning monitoring mechanisms that cover the domestic system as a whole, and to take the required supervisory and central bank measures in a concerted and timely manner.

Since the community funds for crisis management are not yet available, in extreme cases it may happen that the costs of a bank crisis are paid by domestic taxpayers anyway, while the decision is made much later than justified because, on the one hand, there is a delay in detecting the problem and, on the other hand, the resolution decision must take its course at the European forums as well, in addition to the domestic ones.

5.2.3 Does Hungary need immediate accession?

In Hungary, supervision was successfully integrated into the central bank in October 2013. The new organisational structure has been put in place and by now, most internal cooperation mechanisms have been developed, positions have been filled and the IT system is functioning properly. In addition, the Hungarian resolution regulations were adopted on 4 July 2014, and by the end of the year the supporting organisation and the resolution fund that pools banks' resources can be both set up. Overall, Hungary has an approximately 1 year head start on the Banking Union in terms of both oversight and crisis management. As long as these Hungarian institutions can function in a credible manner we can demonstrate that the country is capable of capturing the institutional system of the Banking Union within its own borders, while the methodology of oversight and resolution is determined by the same common European rules as those governing the SSM and the SRM. Consequently, the government has an option to wait until the European institutions and mechanisms are in place and their functioning is tested in practice. Meanwhile, the materialisation of the previously described advantages and disadvantages in the day-to-day functioning of the Banking Union must be reassessed on a continuous basis, and Hungary needs to consult with non-euro area countries that joined the Banking Union already in order to see whether there is added value of the ECB's oversight in these Member States.

6 Possible aspects and events that may turn around Hungary's position

In the Treaty of Accession to the European Union Hungary committed to the adoption of the euro once it has met the Maastricht criteria. This step will automatically imply Hungary's entry into the Banking Union, as the fundamental goal of the Banking Union is to strengthen the monetary and financial union. In theory, therefore, between the launch of the single supervision at the end of 2014 and the adoption of the euro, Hungary may request to join at any time. In our analysis we demonstrated that, for the time being, Hungary would benefit from a strategy of wait and see. That notwithstanding, until the introduction of the euro certain events or external circumstances may prompt domestic decision-makers to reconsider Hungary's position, of which, in our current understanding, the following list represents the most important factors:

1. **Changes in power positions – a wave of entries:** if more than one of the currently undecided 4 Member States decide to join, market pressure on Hungary to join as well may increase. In this regard, the attitude of Poland bears special significance.

2. **Establishment of a true community backstop:** if negotiations begin after the launch of the SRM on the establishment of a community fiscal backstop and, from the perspective of non-euro Member States, the ammunition of and burdens associated with the resulting mechanism will be comparable to those of the ESM and to euro area Member States, the Banking Union may become more attractive, even despite its remaining institutional deficiencies.

3. **Impossibility of the enforcement of interests (EBA, ESRB, regulatory policy, etc.):** if Hungary is on the opinion that, under the uniform European single market regulations, Member States inside the Banking Union and the ECB act in a concerted manner in all cases, and this uniform position marginalises Hungarian interests in all EU organisations or renders the enforcement of opinions dissenting from those of the ECB impossible, we may have to reconsider our position in respect of joining in order to become a part of the ECB's internal decision-preparation forums. In this way we may also increase our chances of seeking out internal allies.

4. **Severe infringement of interests resulting from the further fragmentation of the single market:** it may happen that the lack of a level playing field infringes upon the interests of customers, rather than those of Hungarian policy. If financing conditions become drastically different for Banking Union members and for outsiders, or domestic credit institutions have to face significant competitive disadvantage in relation to other interbank transactions while their oversight-related costs are roughly the same, they may exert an institutional pressure on Hungarian decision-makers to reconsider their position.

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8 Annex

Abbreviations used in the study:
AQR – Asset Quality Review
BRRD – Bank Recovery and Resolution Directive
CRD – Capital Requirements Directive
CRR – Capital Requirements Regulation
EBA – European Banking Authority
ECOFIN – Economic and Financial affairs Council
ECB – European Central Bank
ESM – European Stability Mechanism
ESRB – European Systemic Risk Board
EU – European Union
EZ – Eurozone
LCR – Liquidity Coverage Ratio
LTV – Loan - to - Value
MNB – Magyar Nemzeti Bank
MREL – Minimum Requirement of Eligible Liabilities
NGM – Ministry of National Resources
NSFR – Net Stable Funding Requirement
OTP – OTP Bank
FSB – Financial Stability Board
HFSA – Hungarian Financial Supervisory Authority
SRB – Single Resolution Board
SRF – Single Resolution Fund
SRM – Single Resolution Mechanism
SSM – Single Supervisory Mechanism
ST – Stress test

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