

BANKING UNION THROUGH HUNGARIAN EYES – ASSESSMENT OF A POSSIBLE CLOSE COOPERATION

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Abstract

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Legislation laying down the first two pillars of 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. The paper aims at summarising the possible pros and cons vis-à-vis the Banking Union from a Hungarian perspective. It highlights the reasons for not opting in at the inception of the new supervisory system and also gives indications about those major milestones that could give rise to the reconsideration of the present position. In its existing form, the single supervisory and crisis management mechanism has not achieved the initial target, 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 98 billion available for crisis management in comparison to the Hungarian banking system. In October 2013, a uniform supervisory system integrated into the central bank was set up in Hungary, and the domestic resolution institutional system was complete by the end of 2014. Therefore, until the finalisation of the Banking Union through the creation of the common deposit insurance fund and a common fiscal backstop, 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.

Keywords: Banking Union, Close Cooperation, Single Supervisory Mechanism, Single Resolution Mechanism, European Deposit Guarantee System, EU Financial Crisis Management

1. EXECUTIVE SUMMARY

In addition to periphery countries of the Eurozone, 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 the Banking Union.

Legislation laying down the first three pillars of the institutional system of the Banking Union was finalised in April 2014. The European Commission

published its proposal for a common deposit guarantee system in November 2015, however, the adoption of the legal text has been stalled and is not expected to be adopted in the near future. 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 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.

The paper first gives an overview about how the regulatory framework behind the Banking Union fits with the original objectives. In the first part of the analysis it is demonstrated that, in the lack of an actual community fiscal backstop (at the EU/ESM level) on the one hand, and an operating common deposit guarantee scheme on the other hand, in its present framework the Banking Union can only partly fulfil its fundamental task. Since the fiscal background required for the guaranteeing of financial stability must be still provided by the nation 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.

In the second part Hungarian interests are examined in detail along the advantages of accession or staying outside. The analysis is completed based on microprudential, macroprudential and crisis management aspects. 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 ambition to act seems to be constrained by several factors. Thus, based on currently available information, their potential added value in the reinforcement of financial stability in Hungary is inconsequential. This may remain the case until branch operations and direct, cross-border services activities 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 resolution 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.

The publication of the EC proposal for a common deposit guarantee fund does not seem to elicit any position change towards the accession. It is still unclear whether it will be able to start collecting gradually mutualised funds or the demand for prior, or at least parallel, risk reduction in the EU banking system will block it for a while. As the common deposit guarantee scheme would be an indispensable complement of the first three pillars, seeing it function could definitely tilt the balance towards joining the Banking Union.

Of the 10 EU Member States which could decide freely about joining the system of single supervision, in the first round Romania, Denmark and Bulgaria indicated their intention to join as soon as possible. However, no information was available about any actual initiation of accession talks until the end of 2016. The United Kingdom, due to the Brexit decision, 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 thus far; therefore its accession is not expected over the short term.

In view of the above, according to the professional opinion of the MNB, the decision to initiate close cooperation should be put on hold. In the Bank's perception, the “wait and see” approach is warranted by several factors, such as the uncertainty surrounding the creation of the common deposit guarantee system, the opacity of the SSM's internal systems, information shortages about the practical preparations for close cooperation and the launch and use test of the Single Resolution Mechanism. 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 first three pillars of the Banking Union ran their course and the precise criteria of their operation were determined. As a result, all non-euro area EU Member States with an option to decide had, in principle, all essential information at their disposal in order to decide whether they wish to join the Banking Union upon its launch in November 2014 or at any later point. The supervisory organisation of the ECB has started to set up and, parallel to this, in order to gauge the status and vulnerability of the euro area banking system, a Comprehensive Assessment (ECB, 2014) was completed, the outcome of which could 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 systems, Member States with free choice on whether they wish to join being aware of these uncertainties had to start considering the pros and cons of the Banking Union

for themselves. This paper presents the major considerations Hungarian decision makers had to bear in mind when their position towards close cooperation was formed.

In making the decision, a special aspect emerged in respect of Hungary. Drawing 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 the structure of the Banking Union. This is the case, for example, with regard to the common decision making forum responsible for micro and macroprudential decisions, the Financial Stability Board, where both professional fields have due representation. By contrast, macroprudential decisions in the SSM are made by the Supervisory Board, which gives rise to concern from numerous aspects (presented in detail below). Thus, in the case of Hungary, the question has arisen even more emphatically, whether it is worth abandoning a brand new structure — the setting up of which demanded weighty 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 was the bank stability fund which, to be accumulated 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 could not justify the decision to join in itself. Since the basis of payment is uniform for each Member State — it depends on the size and exposure of banks —, proportionately Hungary cannot expect to receive any more from this fund than the EUR 300 million collectible, based on the same principles, from the Hungarian fund. In extreme cases, when, for example, a major European bank is in distress, as part of the Banking Union even Hungary's contribution may have to go towards the bailing out of another country's bank.

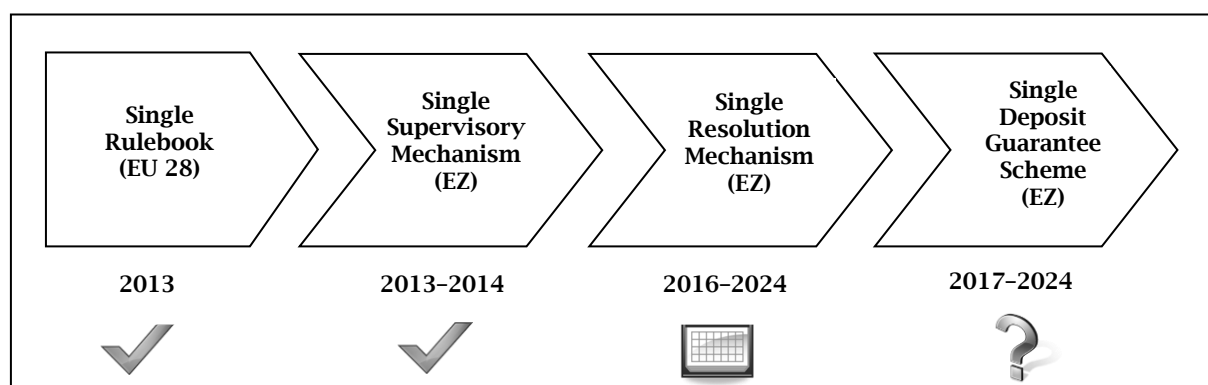
3. THE ORIGINAL GOALS OF THE ESTABLISHMENT OF THE BANKING UNION VERSUS THE IMPLEMENTED SYSTEM

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 countries, 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 justification for a 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 cross-border banking groups, constitutes an integral part of the EU's Single Market. Nevertheless, partly due to sovereign considerations and partly to unresolved crisis management and loss-bearing issues, until recently the centralisation intention has not come to fruition. The turning point arrived with the emergence of an accumulation of problems, which exacerbated the bank crisis to become a sovereign debt crisis and became nearly uncontrollable at the national level, given 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 necessary measures taken for resuscitating them in order to ensure that the credibility of the ECB and the common crisis management mechanisms would no longer be 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, clumsily established structure, which continued to rely on the financial commitment of individual member states.

Figure 1. Key building blocks of a Banking Union



Source: BBVA (2013), MNB

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	<ul style="list-style-type: none"> - The Capital Requirements Regulation entered into force on 1 January 2014, and due to its regulation form 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 takes several years to develop and become operational. - 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 prescribes national implementation, in practice 28 national laws define the key parameters of supervisory work. Similarly, the rules pertaining to accounting records were defined by the national implementations of EU directives and as such, are composed of 28 different systems until the introduction of IFRS9 in 2018.

Table 2. Pillar 2: Single Supervisory Mechanism

Plan	Implementation
A central supervisory authority should oversee euro area banks.	<ul style="list-style-type: none"> - The supervisory body of the Banking Union belongs to the ECB (Single Supervisory Mechanism – SSM); however, it is not performing its supervisory activity independently but in cooperation with local supervisions; consequently, information sharing and coordination channels gain special significance. Although, in principle, the 129 largest banks are supervised directly by the ECB, even in the case of these banks, local supervisions are involved in on-site inspections. In theory, the ECB may impose its direct supervision on any 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 of the banks concerned. - For the sustainability of the single market, non-euro area Member States have the 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 can 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 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
<p>In case of a crisis affecting the banks participating in the SSM, a central resolution authority takes action. The financing of resolutions fundamentally relies on banks; however, the system is backed by an 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.</p>	<ul style="list-style-type: none"> - 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 leaders 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 formulated in respect of the fiscal support behind the Fund. - Until a sufficient level of 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 uncovered deposit holders and owners of capital — actively to bank bailouts from taxpayers' funds.

Table 4. Pillar 4: Single Deposit Guarantee Scheme

Plan	Implementation
<p>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.</p>	<ul style="list-style-type: none"> - In December 2013, a political agreement was reached on the recast of the Deposit Guarantee Scheme Directive. Accordingly, national-level deposit insurance schemes were harmonised; 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 may 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. No access to other member states' funds was granted. - On 24 November 2015, the European Commission published its draft regulation in order to establish a European Deposit Insurance Scheme (EDIS). The proposal relies on the gradual mutualisation scheme applied for the SRF and intends to set up a fully operation DGS applicable for the members of the Banking Union by the end of 2024. Being regarded as a further step towards risk mutualisation among BU member states the idea is heavily criticised by the major "net contributors" of the Eurozone and its support is made conditional on significant "risk reduction" measures. These measures would embrace several kinds of legal measures in the area of bank prudential regulation and liquidation, but the cornerstone is constraining sovereign debt holdings of banks. As the latter would also require global regulatory consensus, as well as full support from EU governments and MEPs, the breakthrough is not highly probable in the foreseeable future.

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 system that is based on several kinds of capital buffers and a wide range of flexibility options. However, in its first review by the European Commission in 2016 (EC 2016) the regulatory body itself shed light on areas where the system would benefit from being improved or complemented. 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 contradictory 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.

However, centralised decision making applies only for the harmonised set of instruments of the Single Rulebook, which the CRR/CRD recognises.

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 may also be set, up to 3 per cent, at the national level. At the same time, apart from the ten tools mentioned above, the macroprudential tools established by national legislation (e.g. LTV regulations, loan-to-deposit ratios, etc.) are still to be controlled by the national authorities, and the ECB has no access to them.

Another peculiarity is that ECB decision is based on the opinion of the Supervisory Board, which consists of the leaders of microprudential supervisions, while formal decisions are made — without an option for change — by the Governing Council.

Countries in close cooperation have an option to inform the Governing Council in case they disapprove a draft decision proposed by the Supervisory Board. If the Governing Council approves the draft in any case, the Member State is 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 disapproval, 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, the ECB may decide to terminate the close cooperation after having carefully considered its potential implications.

So far, the ECB has not initiated any macroprudential measures of its own and communication about macroprudential policy considerations was also modest. 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, medium-sized and small banks with either domestic or foreign, non-EU ownership 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 competition-neutral environment in accordance with uniform supervisory aspects, also bearing in mind macroprudential and monetary policy objectives. This goal was achieved by the integration of the Hungarian Financial Supervisory Authority (HFSA) into the MNB; however, the establishment of the Banking Union could 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 are subject to the group-level supervision of the ECB, while their individual-level supervision remained 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 supervised locally 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, a Hungarian based banking group active in Central- and Eastern Europe, 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 group and two other 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, the question may be posed 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.

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 correlation. In other words, the SSM will have to build its own credibility, and the most important steps in this process began with the Asset Quality Review (AQR) and Stress Tests, while the time-to-time evolving specific issues, such as ability and willingness to handle the NPL problem of European banks can weaken or strengthen it. According to the Brueghel assessment of the first eighteen months (Schoemaker, Veron et. al. 2016), when it comes to significant banks ECB supervision has proven to be fair, tough and effective, while it also makes mistakes and eventually has not yet broken the bank-sovereign vicious circle. Since, looking at the other side, the legal background of resolution has only become effective in 2016 with the institutional system lagging behind, and the chance of capital injections by the state is restrained by competition law and a vulnerable fiscal position for the most exposed Eurozone countries, in respect of banks which would fall through the cracks due to their weak position and a disability to borrow 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 needs 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 Tests. On the other hand, since the MNB also received information on the comprehensive assessment pertaining to foreign-owned subsidiaries operating in Hungary, in its supervisory capacity it could take the steps that became necessary. And since the legal background for including the owners of capital in loss-sharing was already established by July 2014, and the resolution mechanism was already tested via the

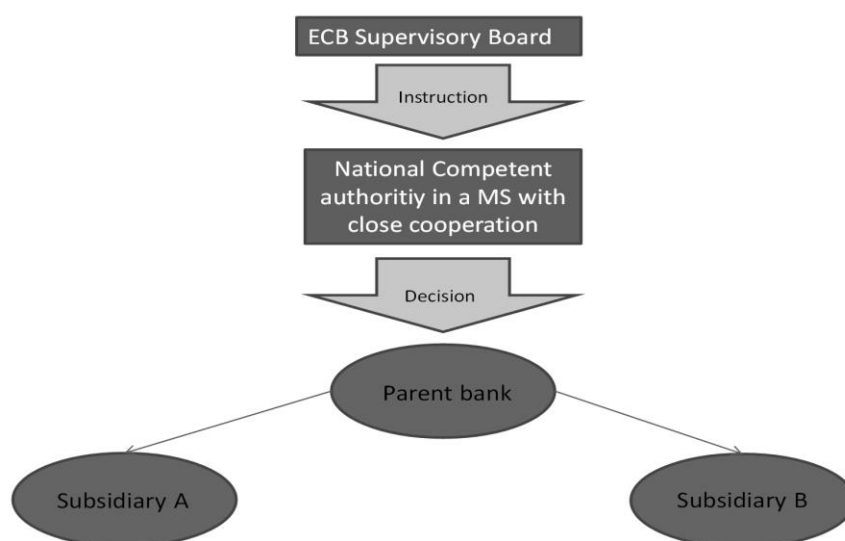
successful resolution and sale of MKB Bank in 2016, it can be demonstrated with credibility that the MNB, as a supervisory authority, need not make compromises in assessing portfolio quality and handling evolving bank viability challenges as it has all crisis management tools at its disposal which are designed to either remove undercapitalised banks from the market or resolve them.

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

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

Being a non-euro area Member State, as 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.

Figure 2. Consolidated supervisory decisions in case of close cooperation



Source: ECB

The organisation of the SSM continues to evolve, and only fragmentary information is available on the modalities of its function (ECA, 2016). The situation is even worse in respect of the availability of information regarding the 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 established in Hungary, decision making competences are straightforward, and — with the involvement of the NGM —, the decision making forum of 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

The macroprudential policy brought to life in Hungary in response to the crisis, as in the EU, has taken shape gradually. 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, it essentially 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 (ESRB, 2014).

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, it cannot be known how this could work in practice, nor 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 competent and designated authorities and, in case of the measures enlisted in the CRR/CRD, the ECB. From the perspective of Hungary, joining the SSM would be an option worth considering if the general public would consider 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 it were justified for the harmonisation of national macroprudential policies there was a need, in addition to the coordination completed by the

European Systemic Risk Board (ESRB), for the closer cooperation offered by the SSM.

An objective answer to the first question cannot be given; however, based on the functioning of the FSB since October 2013, it can be concluded 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 (MNB, 2016). Since the ESRB, which relies on the analytical support 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 is 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 at Hungary. In a legal sense, this so-called reciprocity gains relevance in the case of branch offices and direct cross-border activities, as the subsidiaries operate in Hungarian jurisdiction. As long as branch office activity and thus the level of systemic risks generated directly by branches originated in the Eurozone are limited, Hungary is not in need of close coordination. Even so, it may 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, one should also mention those institutions, which operate in a subsidiary form and are important for Hungary from a systemic risk perspective. If Hungary would join 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, 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 enforce 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 be drawn up and implemented**, so 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, in the case of Northern Rock (See, for example, Bruni, Llewellyn, 2009), 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.

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 inefficiency 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 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 its instruments, including Emergency Liquidity Assistance (ELA) provision 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 Resolution Directive (BRRD) designed to minimise the necessity of recourse to state funds with the introduction of new tools and financial resources came 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 is the Single Resolution Mechanism (SRM), and the resolution fund is going to 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 in Hungary — or the designated resolution authority, the MNB, that **can execute a more effective and more efficient resolution intervention, and whether the EUR 300 million 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. In addition, the MNB has already demonstrated that its institutional setup is operational and tested by the resolution of a systemically important credit institution, the MKB Bank in 2015. This is not the case for 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 the instance 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 (excluding recapitalisation), 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, one can 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. One 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 exceptional cases, when capital shortfall is detected in stress tests, in the form of precautionary recapitalisation from local taxpayers' funds. Moreover, after utilisation the funds thus used must be replenished, over the medium term, from the extra taxes levied on the banking sector.

The latest element of the Banking Union framework is the Commission proposal for a European Deposit Guarantee System (EDIS), with a capacity of approximately EUR 43 billion. The date of effectiveness and the gradual mutualisation embedded into the system mirrors that of the SRF. Overall, the EDIS is an indispensable pillar of an EU-wide supervisory and crisis management framework that aims at dismantling the bank-sovereign loop and its realisation could become a major pro-accession argument for countries in doubt of BU-membership. The only risk in this case is whether it will come into effect in any foreseeable future, given the political burden that it carries. At present, some major Eurozone countries have been blocking the adoption process at the Council demanding that risk mutualisation must go — at least — parallel with risk reduction, i.e. with limiting the uncontrollable bank-sovereign interdependence in the form of high proportion of home country sovereign debt holdings of banks. However, this latter case lies on the table of global regulatory negotiations, where not only EU-members, but major players like the USA, Japan and

Canada also must be convinced about not only strengthening the favourable sovereign bond treatment in the credit risk framework, but also working out the exact calibration with the necessary impact assessment as well. Since according to original plans the consultation process only starts in spring 2017, the date of any agreement is not expected in the near future. Should global regulators agree on any risk-based treatment of sovereign bonds, EU-level discussions about its adoption must resolve further delicate issues. Given the somewhat more unfavourable credit-rating and the relatively significant exposure in the banking system towards own-country sovereign debt risk, an agreement about restrictions based on either concentration or credit quality has the potential to put further significant burden on non-Eurozone countries. Since the banks of these countries are by definition worse off in their capacity to diversify sovereign investment compared to counterparts in the single currency area, the adoption of any proposal in this direction would have the potential to harm single market principles, such as levelling the playing field. And EDIS can only come after that. In summary, the common DGS as a factor for BU accession is not tangible for decision makers of today.

Relying solely on Hungarian funds would clearly imply a competitive disadvantage. This competitive disadvantage, however, may be significantly reduced by the capital buffers expected of owners of systemically important banks, by maintaining a sufficient level of creditors' funds in the form of MREL that can be included 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, therefore, are partly within the competence of the Hungarian legislator, and are partly covered by the MNB.

In some cases, however, even these resources are insufficient to properly resolve the predicament of a bank. In such cases, in the interest of maintaining financial stability, the last resort is to take recourse with public funds. This is called the **fiscal support** or backstop which, although rarely used, must be in place for maintaining investor confidence in highly leveraged banking sectors (Schoenmaker, 2014). 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. 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. Along this line, the ESM Board of Governors agreed on 8 December 2014, that they are ready to provide such support with the maximum capacity of EUR 60 billion on condition that the initiating country's fiscal sustainability in danger, bail-in of 8 per cent, has already been exercised and the recapitalisation measures bear the unanimous support of the Board

of Governors (ESM, 2014). Since, however, non-euro area Member States did not join, these countries have no access to the funds accumulated under the ESM, not even in case of a state or bank failure. Overall, both euro and non-euro area countries deem the current administration as overly restrictive and unjust, so official negotiations are about to start at the beginning of 2017, aiming for a really suitable fiscal backstop. Consequently, only the subsequently commencing 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.

5. SHOULD HUNGARY JOIN 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 preserved 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 EDIS and the real long term 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 major milestones explained in Table 5.

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.

If cannot be foreseen exactly when the mutualisation of the deposit guarantee scheme may

materialise, but by no means before 2024. Until that date member states have to bear the costs in case of a possible crisis situation.

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

Event	Date of announcing 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 launched for 2017
SRF funds became fully mutualized	31 July 2023
Completion of the BU with the adoption of EDIS proposal	Regulation on EDIS takes effect and DGS funds have been mutualised - 31 July 2023 or later
A wave of entries - the group of outsiders narrows down significantly	
Adoption of the euro	

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, it will definitely keep supervisory powers and responsibilities within national competence. The Brexit referendum in June 2016 renders this position to remain unchanged. 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, although it has issued statements favouring accession, no official negotiations over the accession had begun until the end of 2016.

As regards Central and Eastern European countries, from the beginning Romania has clearly been in favour of joining and, in the face of the run on banks in June 2014, Bulgaria has already declared an intention to join the ECB oversight. However, no progress by any of these countries has been achieved in the first two years of the Banking Union. At the same time, Poland and Hungary expressed reservations from the outset. The Czech Republic reemphasised its abstention from euro adoption or Banking Union membership year after year, in December 2016 for the last time (MoF - CNB, 2016). Croatia also has taken the "wait-and-see" approach until all three pillars are in place (CNB 2016).

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 Member States will face an increasingly difficult financing position.

By European standards, compared to the 19 euro area countries and the ECB, the ability of the

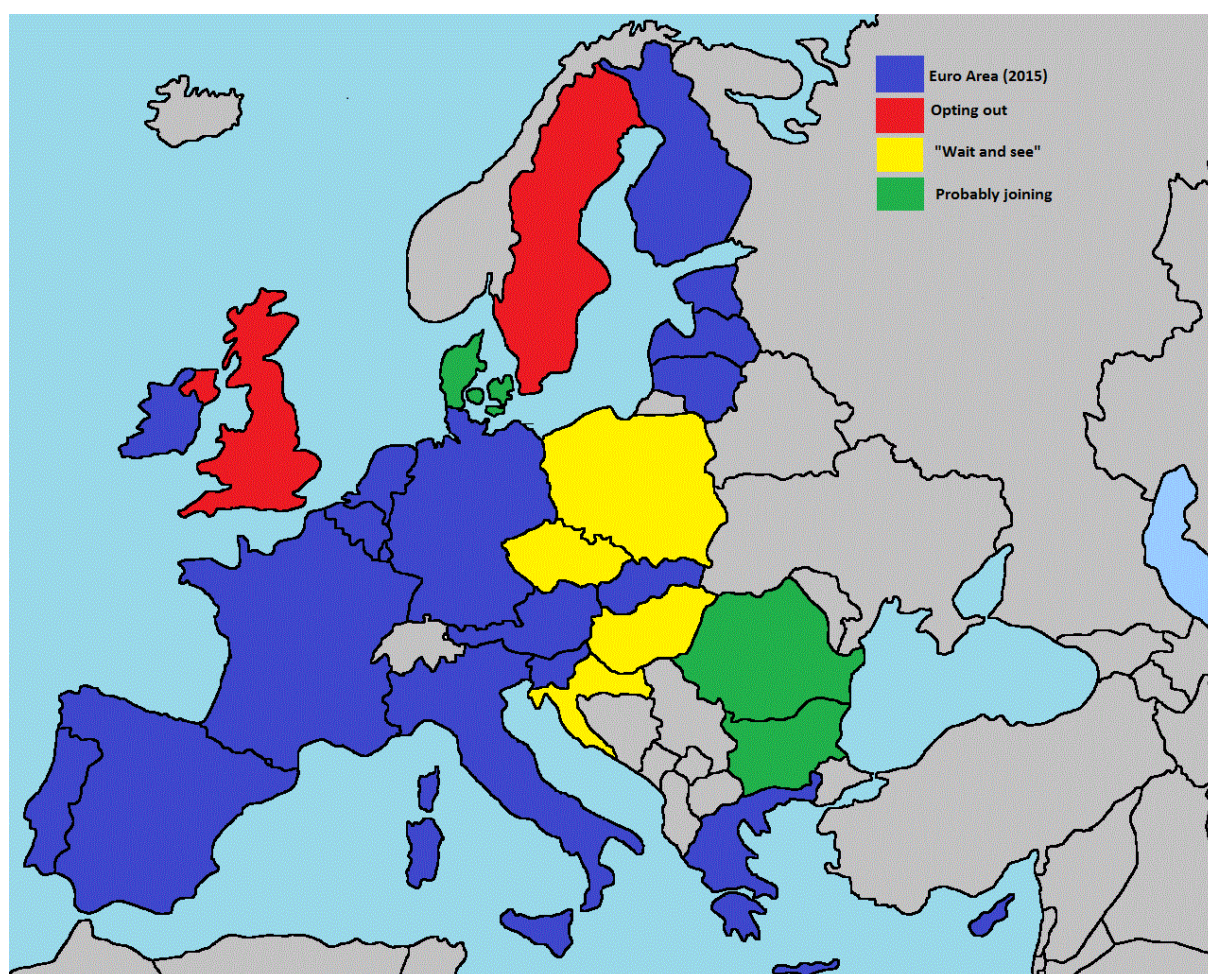
remaining 9 countries to enforce their interests in financial regulation and oversight issues is limited as it is. If the number of outsiders diminishes, those on the outside may face a further loss of significance and possibly, isolation, which may warrant the reconsideration of the arguments in favour of opting out. Although the opting out of the United Kingdom and Sweden is a foregone conclusion for different reasons, the possibility of enforcing those Hungarian interests which do not concern them and are linked to 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 resolution 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. The possibility to become part of the future EDIS would also count as positive, especially with the opportunity to be able to directly influence its final details.

With an early 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.

Figure 3. Relationship of EU Member States to the Banking Union

Source: Press releases

An early accession would increase the chances of Hungarian experts and possibly, leaders, being employed in the SSM so that they may 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 new, uniform oversight and crisis management methods. By gaining a vote right in the Supervisory Board, it may participate in supervisory decision making and have a direct, “parent-bank level” influence in the decisions of the supervisory college 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. 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 European forums as well, in addition to those domestically.

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, all 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 were both set up. On top of that, with the completion of the resolution of a systemic bank in 2016, the Hungarian system has proven to be tested and effective. 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, Hungary 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 countries that have already joined the Banking Union in order to see whether the actual added value of the ECB's oversight is limited to euro area members.

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 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 the previous analysis it was 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 outsider 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 productively end 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 of 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, Hungary may have to reconsider its position in respect of joining in

order to become a part of the ECB's internal decision-preparation forums. In this way Hungary may also increase its chances of seeking out internal allies.

4. **Severe infringement of interests resulting from further fragmentation of the single market:** it may happen that the lack of a level competitive playing field infringes upon the interests of clients, 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.

7. CONCLUSIONS

The paper aims at summarising the possible pros and cons vis-à-vis the Banking Union from a Hungarian perspective. The major conclusions can be drawn from the views presented as follows:

The objectives, the mandates and the actual formation of the newly established supervisory and resolution system, the two already existing pillars of the Banking Union differ from the original plans resulting in more complexity and more obscure liability structure. 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. The possible benefits are more of an intangible nature, such as better and harmonised supervisory standards, wider analytical base or more proximity to decisions regarding the EU-wide banking groups prepared for the Supervisory Board. As a result non-Eurozone countries seem to take a precarious approach, the majority of them either stay away from membership or postpone it until the completion of the three pillars. Overall, in certain cases when current power balance is expected to tilt towards membership it might be advisable to reconsider the present position.

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Appendix. 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
ECA – European Court of Auditors
ECB – European Central Bank
EDIS – European Deposit Guarantee System
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