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The neglected side of banking union: reshaping Europe's financial system

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Prior to the crisis, the European Union financial system became increasingly integrated, especially within the euro area. However, integration is far from complete. In the euro area, the interbank market rapidly became highly integrated after the introduction of the single currency, but retail banking remains largely fragmented along national lines, with bank mergers predominantly between institutions of the same country. And in the EU in general, corporate bond markets and equity markets also remain fragmented along national lines despite some progress with integration. The financial crisis undid financial integration where it had been most successful, in the interbank market. Overall, the state of financial integration in Europe is unsatisfactory, with markedly different financing conditions in different countries, which undermines the necessary convergence of their economic and employment conditions.

The reform agenda should include three essential ele ή n ص p

1) **Introduction**[1]

Prior to the crisis, the EU financial system became increasingly integrated, especially within the euro area. However, integration is far from complete. In the euro area, the interbank market rapidly became highly integrated after the introduction of the single currency, but retail banking remains largely fragmented along national lines, with bank mergers taking place predominantly between institutions in the same country. Europe is heavily dependent on bank credit, much in contrast to the US, wheter other forms of financial intermediation play a more important role.[2] At the same time, EU corporate bond markets and equity markets remain fragmented along national lines despite some progress with integration. The financial crisis undid f

bonds, respectively. Since the beginning of the crisis, the shares have fallen 9, 24 and 10 percentage points, standing at 24, 22

the entire euro area[9]. ECB data corroborates this result and shows that ownership by MFIs of foreign now be restructured. In terms of the capital markets, the low cross-border ownership of equity and the underdeveloped cross-border corporate bond markets also reduce the efficiency of capital allocation, and prevent meaningful risk-sharing across borders.

3) Options for Europe's financial system

The crisis has revealed three problems with Europe's financial system. The first is that cross-border financial intermediation happened largely through debt-based wholesale banking market integration. This increased vulnerability to shocks and led to sudden-stop problems[10]. More and better integrated equity markets would have allowed capital markets to absorb the massive shocks with which the euro shareholders and convertible debt holders are unwilling or unable to put up more money. The discussion

Treasury provides a line of credit to the FDIC, which it repays over time. The FDIC experience suggests that such an approach would involve comparatively low levels of public resources and would lead to the greater involvement of private creditors and more bank closures.

Cross-border mergers would not only increase efficiency, but would also enhance financial stability by reducing the strong interconnection between banks, sovereigns and national economies, which currently plagues many EU countries. Certainly, the foreign ownership of banks in central and eastern European countries has contributed to stability when crises had domestic origins in these countries. When, on the contrary, crises started in the home country of foreign banks, as was the case in 2008, then foreign ownership was a source of problems for recipient countries[16]. But the problem was a result of the absence of a proper pan-European mechanism. This absence encouraged home-country supervisors to demand that their banks take action that favoured home-national champion banks is incompatible with a true European banking union[20]. One way to weaken this link would be to impose limits on the exposure of banks to any sovereign, in particular their own[21].

The second set of issues that European policymakers will need to address concerns financial activities outside of banking. European equity markets are much smaller than US markets and are still fragmented along national lines. Cross-border ownership of corporate bonds is also underdeveloped in the EU. As a result, European capital markets provide far less opportunity for risk sharing between European countries than is the case between US states[22]. Better integrated European capital markets would also provide European non-financial corporations with a source of funding other than bank borrowing. Policymakers cannot neglect any longer the barriers that continue to hinder the integration of European capital markets more than 20 years after the alleged completion of the single market and the liberalisation of EU capital movement. Key elements in fostering the integration of European equity markets include harmonisation of and improvements to corporate transparency standards, harmonisation of corporate governance standards and harmonisation of insolvency legislation. There is evidence that differences in legal enforcement affect private equity. While private markets can find solutions for differences across countries, this can only be a partial remedy, *inter alia* because of higher transaction costs[23]. Taxation reform would also be crucial. Empirical evidence shows that differences in taxation can lead to reductions in the valuation of equity, making it more difficult to raise new capital across borders[24]. Similarly, it would be important to take steps to improve the financing of high growth potential firms by adopting transparency and insolvency regulation[25]. This reform agenda would be greatly beneficial as an underpinning for improved financing conditions of non-financial corporations, and would increase the stability of the financial system. This is, of course, a long-term agenda that cannot be seen as a substitute for the pressing need to resolve current banking problems.

Europe, and the euro area in particular, would greatly benefit from having fully integrated financial markets – not only in banking s o 2f K *“to be self-reinforcing and unleash virtuous dynamics”* as envisaged by the ECB[26]. The following sequencing would seem appropriate:

The first step, the SSM, is already programmed, with the AQR due to start later this year and end in March 2014. The second step will be the choice that governments make on how to handle the outcome of the AQR if some banks, as is likely, are under-capitalised and unable to raise sufficient capital from private sources. This will be a crucial choice for two reasons. First, governments will have to ensure not only that all under-capitalised viable banks are recapitalised, but also that all non-viable banks fail. Second, and equally important, governments will have to agree whether or not they accept cross-border consolidation of European banks to deal with non-viable banks. This two-dimensional crucial choice will be closely related to governments' willingness to accept the creation of a meaningful SRM. Without European resolution, the banking system would remain fragmented along national lines thereby problems of monetary union – the vulnerability to shocks affecting individual countries – and would contribute to the stability of the EU more broadly. Decisions taken now – on the relative importance of banking versus capital markets, on the number and size of banks and on cross-border integration of banking – will shape Europe’s financial system for years to come. The complex choice requires careful consideration because it might be difficult to reverse.