IN-DEPTH ANALYSIS

Requested by the ECON committee

Can the Banking Union foster market integration, and what lessons does this hold for Capital Markets Union?

EGOV

BANKING UNION

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PE 760.259 - September 2024

EN

Can the Banking Union foster market integration, and what lessons does this hold for Capital Markets Union?

Abstract

We discuss the contribution of the Banking Union in its current form to market integration in the euro area. While the introduction of single supervision has fostered banking integration, limited progress in single resolution and the absence of a European deposit insurance scheme undermine further advancements. We argue that a significant obstacle to financial integration lies in the persistence of national interests in regulation, supervision, and politics. We also explore the lessons that can be learned from ten years of the Banking Union for the development of the Capital Markets Union and the integration of capital markets. The successes of the Banking Union in common supervision and rule-setting can provide a path forward.

This document was provided by Economic Governance Support Unit at the request of the ECON Committee.

This document was requested by the European Parliament's Committee on Economic and Monetary Affairs.

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LINGUISTIC VERSIONS
Original: EN

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Manuscript completed in September 2024

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CONTENTS

LIST OF ABBREVIATIONS

BRRD	Bank Recovery and Resolution Directive
BU	Banking Union
CMDI	Crisis Management and Deposit Insurance
CMU	Capital Market Union
EA	Euro Area
EAFCs	Euro area Financial centres
EC	European Commission
ECB	European Central Bank
EDIS	Deposit Insurance Scheme
EMU	Economic and Monetary Union
ESMA	European Securities and Markets Authority
EU	European Union
NFC	Non-financial corporations
NPLs	Non-Performing Loans
SRB	Systemic Risk Board
SSM	Single Supervisory Mechanism

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EXECUTIVE SUMMARY

This paper discusses the contribution of single supervision and resolution to market integration in the euro area (EA), including across different segments of the banking market. It also discusses whether and to what extent the Banking Union (BU) experience may provide lessons to foster the capital market union (CMU) project.

Aggregate price- and quantity-based measures of financial integration have only partially increased since the inception of the BU in 2014, reaching levels similar to those observed since the start of the Economic and Monetary Union (EMU) in 1999. However, financial integration remains non-uniform across segments and countries in Europe.

Regarding banking integration, quantity indicators of cross-border exposures have increased primarily due to interbank activities, rather than retail lending and lending to large corporates. Cross-border corporate lending has prevailed over cross-border retail lending and has been concentrated in large banks from European central countries. Conversely, price indicators show a reduction in dispersion across the EA in lending and deposit rates, indicating an increase in financial integration along the price dimension. This may be supported by the low interest rate environment that has prevailed until very recently, along with competition from non-bank financial institutions and fintech/big tech.

Did the BU contribute to financial integration, and how? Do further steps need to be taken to achieve more integrated banking markets?

On the positive side, the introduction of a single supervisor and a single rulebook has determined the application of uniform rules across the EA and the more homogeneous implementation of local regulations. This has helped level the playing field and enhance transparency and comparability. Moreover, capitalisation and risk management practices have also improved, as demonstrated by increased risk-based capital ratios and a reduction in non-performing loans (NPLs). More transparent and sound bank balance sheets are better able to attract depositors and investors. As a result, a large share of unsecured debt securities issued by EA banks is now held outside the banking sector and even outside Europe, contributing to risk-sharing across financial segments and geographies.

On the other hand, two types of obstacles to greater financial integration are still present.

The first obstacle lies in the limitations of the European Union (EU) regulatory framework and the incompleteness of the BU. The current functioning of the BU faces challenges due to impediments in capital and liquidity mobility across borders within cross-border banking groups. These restrictions are partly due to local supervisors' attitude that tends to protect their national champions, and EU banking legislation, which allows capital waivers within the same country but not across borders. National authorities also impose additional restrictions, leading to inefficiencies in resource allocation and higher costs for cross-border consolidation. Another issue is the severity of the BU's bank resolution framework, established by the Bank Recovery and Resolution Directive (BRRD), which limits its actual application and leads to divergent national practices and an uneven playing field. Finally, the lack of a European Deposit Insurance Scheme (EDIS) is the most significant gap in the BU that reduces depositor protection, discourage cross-border banking, and amplify the tendency of countries to retain financial resources locally.

The second relevant barrier to completing the BU and achieving a truly integrated European banking market is national politics, which impede decisive steps toward harmonization in several key policy areas (such as tax regimes and national legislation on competition, credit, consumer protection). Unless

national governments are willing to take a backseat with regard to their banking systems, only limited progress seems feasible.

Recently, European authorities have taken additional steps to enhance financial integration. These include the ECB's 2021 guide on the prudential treatment of mergers and acquisitions and the 2023 European Commission (EC) proposal to reform the crisis management scheme. More importantly, there has been increased debate on how to improve banks' cross-border consolidation. Proposals range from better utilization of the existing freedoms embedded in EU regulation (see Enria, 2021) to more ambitious projects involving changes in the framework to favor the establishment of a few pan-European banks under new, separate rules (Angeloni, 2024).

Although incomplete, the BU experience may provide some valuable lessons for the CMU project. The successes of the BU in supervision and rule-setting can provide a path forward. A stronger supranational supervisor and better coordination among European financial authorities are essential. Harmonisation of relevant legislations must be promoted, as differences in insolvency laws, accounting practices, and tax regimes continue to create frictions, impeding capital movements and investment diversification.

To reignite interest in the CMU project, policymakers could emphasize the challenges the EU faces in progressing with digitalization and climate transition, which require substantial funding that only frictionless financial markets can mobilize.

Overall, achieving the goal of healthy and sustainable integration requires effort from various parties, with greater commitment from individual governments also necessary.

1. INTRODUCTION

The experiences of the global financial and euro debt crises led to the political decision to establish a BU in 2012. The immediate objectives of the BU were to sever the vicious link between bank and sovereign fragility, which had dominated the EA sovereign debt crisis, re-establish private liability, and minimize the risk of taxpayer-funded bailouts of failing banks. There was also a related goal to reinforce the regulatory framework for an integrated banking system in the EA (Buch, 2024).

While significant steps have been taken, including the establishment of the Single Supervisory Mechanism (SSM), the Single Resolution Board, and the Single Resolution Fund, the BU cannot yet be considered a truly integrated market.

In fact, when considering its three original objectives, progress appears limited. First, although not an immediate concern, home bias in sovereign debt holdings persists across the EA banking system (ECB, 2022 and 2024). Second, bank failures are still primarily managed at the national level, sometimes involving precautionary recapitalization, which undermines the principle of private liability; for banks failing the public interest test, discretion by either national or central authorities may lead to debatable decisions (see the Tercas case).[1] This situation risks inefficient solutions and a renewed bank-sovereign fragility doom loop during crises. Third, and partly as a consequence of the previous two points, little progress has been made in financial integration, as discussed below.

Indicators of financial integration show that business operations remain segmented along national lines. We identify two types of obstacles to further integration. The first lies in the absence of a genuinely European safety net—primarily a common deposit insurance scheme—and existing regulatory barriers. As noted by Enria and Fernandez-Bollo (2020), following the collapse of Lehman Brothers and throughout the sovereign debt crisis, numerous cross-border coordination difficulties arose in managing crises within international groups. As a result, we have inherited a significant legacy of ring-fencing measures and a lack of trust between national authorities, which affect the way banks operate even during normal times.

The second obstacle is the barrier that national interests pose to further financial integration. These national interests exist at different levels—within the banking system, regulatory and supervisory authorities, and party politics. This is evident in the lack of progress in completing the BU, from difficulties encountered in advancing a common deposit insurance scheme to obstacles in cross-border consolidation in the banking industry, as well as in pushing forward the necessary reforms for a CMU.

While national authorities may resist cross-border consolidation to prevent oligopolistic behavior and moral hazard from too-big-to-fail banks, it is important to emphasize that the ambition of the BU is to foster "healthy financial integration," without the excessive risk-taking associated with more integrated markets, as seen in the years leading up to the global financial crisis.

[1] In 2012, the failing Italian Cassa di Risparmio della Provincia di Teramo (Tercas) was placed under extraordinary administration by the Italian government and subsequently sold to Banca Popolare di Bari (BPB). This sale was contingent on the Italian deposit guarantee scheme (Fondo Interbancario di Tutela dei Depositi, or FITD) absorbing the acquiror's losses. However, three years later, the EC declared the FITD’s intervention unlawful, arguing it constituted unapproved state aid, and requiring the amount provided by scheme to returned to it. Remarkably, the EU General Court, in its March 2019 judgment, annulled the Commission's decision, ruling that the FITD's support for Banca Tercas was legitimate and compatible with the internal market. On March 2, 2021, the EU Court of Justice dismissed the Commission's appeal against the General Court's ruling. Finally, on September 21, 2023, the Commission reassessed the case in light of these rulings and concluded that the FITD's support for Banca Tercas was not attributable to Italy and did not constitute unlawful state aid. The case sparked significant debate over the damages inflicted on Italian savers and the banks directly and indirectly affected by the erroneous decision. As argued, had the FITD’s actions not been deemed unlawful state aid, the subsequent burden-sharing operation to rescue four regional banks (Etruria, CariChieti, CariFerrara, and Marche) would have been handled differently, and the rights of subordinated creditors would not have been compromised.

Recently, European authorities have taken additional steps to enhance financial integration. These include the ECB's 2021 guide on the prudential treatment of mergers and acquisitions and the 2023 EC's proposal to reform the crisis management and deposit insurance (CMDI) scheme. More importantly, the debate on how to improve banks' cross-border consolidation has intensified at different levels.

Proposals range from better utilization of the existing freedoms embedded in EU regulation (see Enria, 2021) to more ambitious projects involving changes in the framework to favor the establishment of pan-European banks under new and specific regulations (Angeloni, 2024). These proposals all call for greater involvement of market participants (banks in the first place) and cooperation with national and supranational supervisors. As suggested by Enria (2021), market participants could better leverage the progress made since the EMU and fully exploit the opportunities already embedded in the current institutional framework. The idea is that a mutually reinforcing approach, where increased risk-sharing initiatives from the private sector (e.g., utilizing opportunities in the recent Cross-Border Merger Directive or setting up intragroup agreements), could ease the pressure on public risk-sharing mechanisms. This could help complete and establish a truly European safety net in a smoother and faster manner.

Although incomplete, the BU experience may provide valuable lessons for the CMU project. The successes of the BU in supervision and rule-setting can provide a path forward. A stronger supranational supervisor and better coordination among European financial authorities are essential. Harmonization of relevant legislation must be promoted, as differences in insolvency laws, accounting practices, and tax regimes continue to create friction, impeding capital movements and investment diversification. These improvements are also needed because trading and post-trading systems in the EU are highly fragmented across numerous platforms.

Integration and harmonization in insolvency laws and regulatory frameworks for equity investments are particularly desirable, especially in EU countries where inefficient insolvency frameworks may pose political risks for foreign investors. Strengthening the institutional framework would also benefit the banking market, particularly in how banks manage problem loans, which may require either efficient loan recovery or restructuring. Addressing the debt-equity bias in taxation is also important as it can improve certainty for investors, reduce costs, and facilitate cross-border investments while making risk capital more attractive and accessible to companies.

More generally, policy efforts should focus on harmonizing the interpretation of European rules and standards. Fragmentation arises from differing national interpretations of directives and regulations, despite a unified European framework.

The long-term benefits of an integrated financial system (both in banking and capital markets) accrue to economies and societies at large, while short-term losses are more concentrated, giving rise to strong lobbying from these groups. But, while the euro debt crisis and the direct risk to the survival of the EA as a common currency area resulted in swift and decisive actions, such pressure is currently missing for further reforms. To reignite interest in the CMU, it is important to leverage the need for substantial private investment in Europe's climate and digital transition to accelerate the necessary reforms toward truly integrated financial markets, where participants with similar characteristics have equal market access, face the same rules, and are treated equally, regardless of their location.

Overall, achieving the goal of healthy and sustainable integration requires effort from various parties, with greater commitment from national governments particularly necessary.

The remainder of the paper is structured as follows. The next section describes the state of financial integration. Section 3 discusses the effects of the BU reforms on financial integration and Section 4 focuses on the lessons for the necessary reforms for the establishment of a CMU. Section 5 concludes.

2. FINANCIAL INTEGRATION: DEFINITION AND CURRENT STATE

2.1. The definition and benefits of financial integration

Financial integration can be broadly defined as interdependence and interconnectedness of financial systems and markets (including both capital and banking markets) across different countries and is often seen as facilitating the flow of capital, investments, and financial services across national borders. Integrated financial markets imply the law of one price, e.g., securities with the same risk and identical cash flows should have the same price in different locations. Financial integration would also imply that capital flows to the project with the highest risk-adjusted return no matter where – within the integrated area – the investor sits and where the project is located. Going from the conceptual level to the more practical level, financial integration can also mean that customers of financial services should have access to products and providers from anywhere in the integrated areas and should pay the same price for the same service. This, however, requires a common institutional, regulatory and supervisory framework.

Why do policymakers care about financial integration? Integrated banking and capital markets provide ex-ante private mechanisms for risk-sharing that help smooth the asymmetric shocks affecting a single monetary area. In fact, when a country is hit by a negative shock, different channels may come into play to mitigate its impact on disposable income and consumption: the capital markets channel, the credit channel, and the fiscal channel (Cimadoro et al., 2022). The first two channels are predominantly private, while the latter is public in nature. The private channels involve cross-border capital flows where, for example, financial income from abroad is primarily generated by firms and households investing in foreign companies, which constitutes the 'capital market channel'. By holding geographically diversified portfolios of financial asset, corporates and households could withstand local shocks without sudden contractions of consumption and investment. In addition, households and firms in a country affected by an adverse shock may protect their consumption by resorting to savings or by obtaining credit from other countries, which constitutes the 'credit channel.' This mainly includes credit from private financial (foreign) intermediaries. These channels can operate internationally (across countries) or between states or regions within a federation, as seen in the United States. The greater the cross-country financial integration, the stronger this private channel becomes. On the contrary, when private mechanisms for risk-sharing do not work efficiently, the burden falls entirely on the public fiscal channel, which is likely to reignite contentious political debates. Cross-border risk-sharing is therefore of utmost importance in a currency union like the EA, where a common monetary policy is implemented across countries with different economic conditions and where, commonly, financially healthy countries are less willing to share risks with financially weaker ones.

2.2. Financial integration in the Euro Area

The ECB defines financial integration as "the market for a given set of financial instruments or services to be fully integrated when all potential market participants in such a market (i) are subject to a single set of rules when they decide to deal with those financial instruments or services, (ii) have equal access to this set of financial instruments or services, and (iii) are treated equally when they operate in the market" (ECB, 2007). Based on this definition, the ECB has developed a price- and a quantity-based measure of financial integration that captures different segments of the financial market. [2] The price-based composite measures aggregate indicators for money, bond, equity, and retail banking markets. The quantity-based composite measures aggregate indicators for the same market segments, except for retail banking.

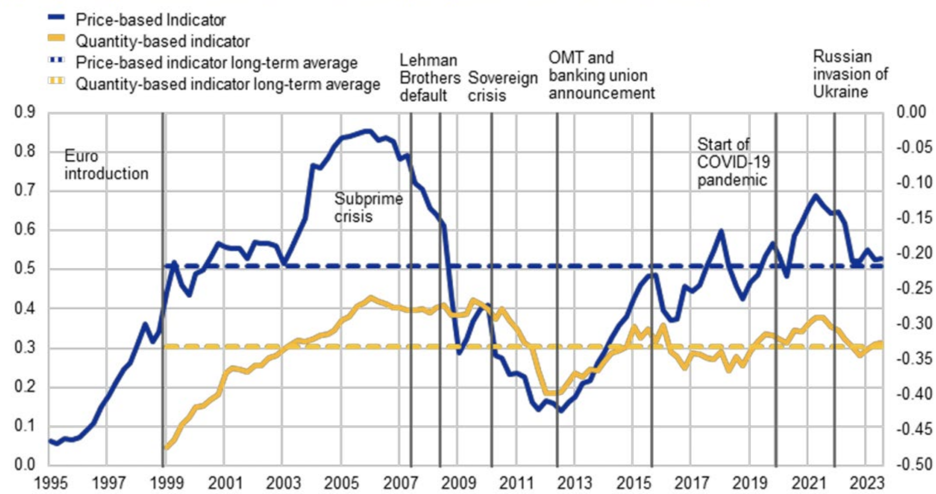
The former indicators invoke the law of one price, the latter use intra-euro area cross-border holdings, expressed as a percentage of total holdings for the EA. They assume that in a perfectly integrated market, all agents invest in the market portfolio, implying that all investors should hold a portfolio with assets proportional to the total supply of assets in the economy. Both indicators range from zero (full fragmentation) to one (full integration). Hence, increases in the indicators signal greater financial integration.

The EA is far from being an integrated financial system, as recently documented by the ECB's Financial Integration Report (ECB, 2024). Figure 1 shows the trend of financial integration from the start of the Economic and Monetary Union (EMU) in 1999 to recent years. At first glance, there has been no significant increase in financial integration indicators (especially when considering the price-based measure) since the inception of the EMU. Financial integration peaked just before the global financial crisis, dropped in the post-crisis years, and has since risen since the inception of the BU in 2014 to levels more or less similar to those in 1999.

Figure 1: Financial integration indicators over past 30 years

Price-based and quantity-based financial integration composite indicators

(quarterly data; price-based indicator: Q1 1995-Q4 2023; quantity-based indicator: Q1 1999-Q3 2023)



Sources: ECB and ECB calculations.
Notes: The price-based composite indicator aggregates ten indicators for money, bond, equity and retail banking markets; the quantity-based composite indicator aggregates five indicators for the same market segments except retail banking. The indicators are bounded between zero (full fragmentation) and one (full integration). Increases in the indicators signal greater financial integration. From January 2018 onwards the behaviour of the price-based indicator may have changed due to the transition from EONIA to €STR interest rates in the money market component. OMT stands for Outright Monetary Transactions. For a detailed description of the indicators and their input data, see the Statistical Web Annex to this report and Hoffmann, P., Kremer, M. and Zaharia, S., "Financial integration in Europe through the lens of composite indicators", *Working Paper Series*, No 2319, ECB, Frankfurt am Main, September 2019.

Source: ECB (2024)

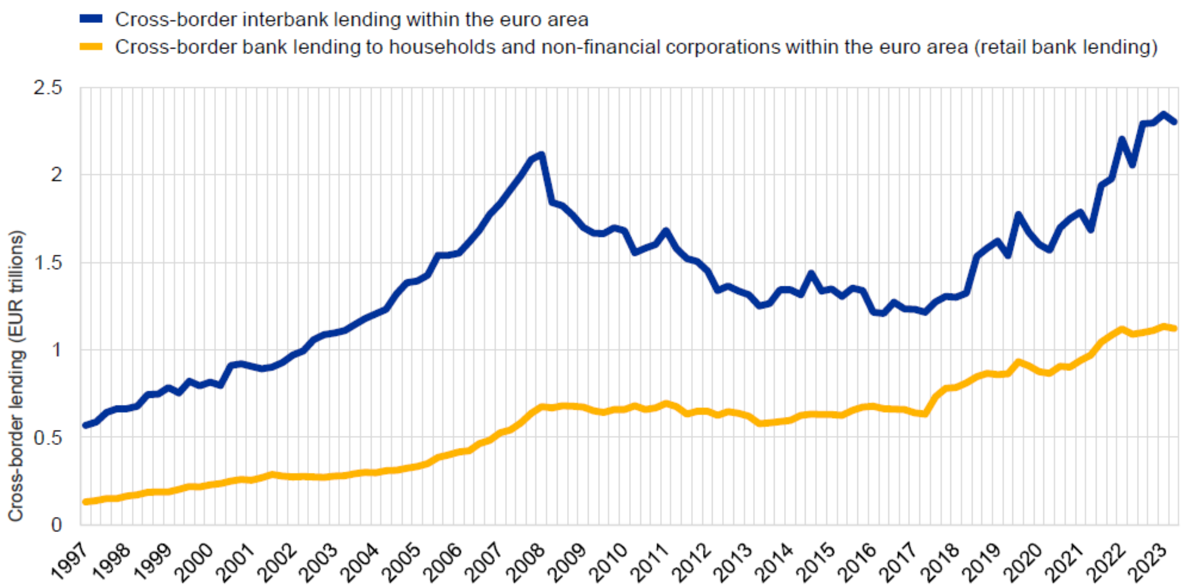
[2] The price-based financial integration composite indicator measures price dispersion across countries, with higher values of price dispersion indicating a lower degree of financial integration, where price dispersion is considered for money, bond, and equity and banking markets. The quantity based composite indicator measures intra-euro area cross-border holdings expressed as a percentage of total holdings for the EA (assuming that in a perfectly integrated market all agents invest in the market portfolio), across interbank markets (which include the money and banking markets), bond markets and equity markets. See ECB (2024).

More granular analysis reveals that some segments of the European financial system are more integrated than others. In the following sub-sections, we will build on the ECB's report (see ECB, 2024 and related Statistical Annex) to discuss specific segments of financial markets that we consider more relevant in light of the purpose of this note.

2.2.1. Banking market integration

In the loan market, cross-border exposures have increased over time but integration is driven by the interbank market, while cross-border lending to household and firms (retail lending) is still limited (Figure 2). This is a source of concern from a policy makers' viewpoint, as retail banking integration is particularly important for achieving risk-sharing. Banks with geographically diversified portfolios can offset losses in one region with gains in another. As such, these banks could continue providing credit to high-quality cross-border borrowers even in the event of a local recession, rather than indiscriminately cutting back lending to all borrowers.

Figure 2: Cross-border lending in the EA: interbank lending vs. retail bank lending

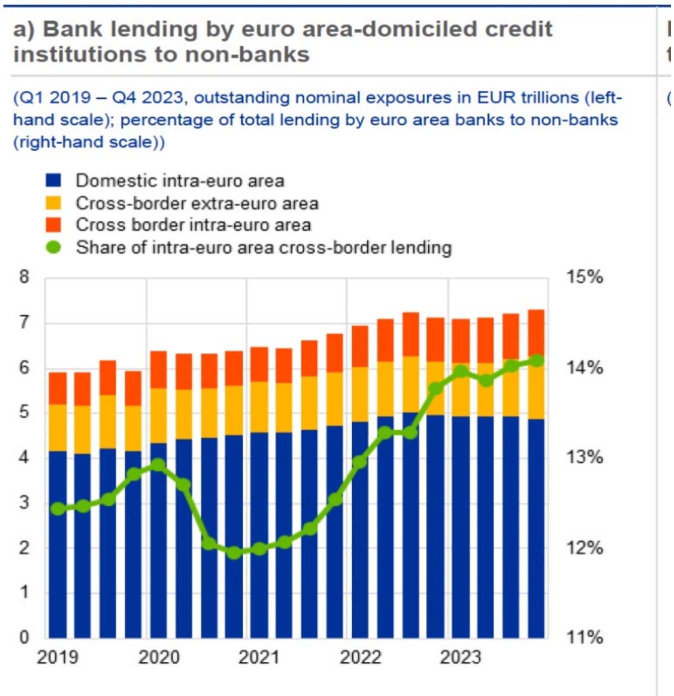


Source: ECB (2024)

Cross-border bank lending can follow either a direct or an indirect model. In direct lending, a lender based in one EA country provides funds to a borrower in another country in the area. In the indirect model, a banking group headquartered in one EA country extends credit to a borrower in another EA country through a branch or subsidiary located in the borrower's country.

At the end of 2023, direct cross-border intra-euro area lending amounted to €1.03 trillion, or 14.1% of EA bank lending to non-banks (Figure 3). Summing direct and indirect cross-border lending adds up to 1.7 trillion total cross-border lending. Direct cross-border lending is primarily undertaken by large German and French banks to large non-financial corporations in real estate, manufacturing, professional and scientific activities, and wholesale and retail trade (Lenoci and Monitor, 2024). Cross-border retail lending remains limited, accounting for 7% of total retail lending. Surprisingly, the share of retail lending to extra-EA borrowers is higher, accounting for 11% of the total (Buch, 2024).

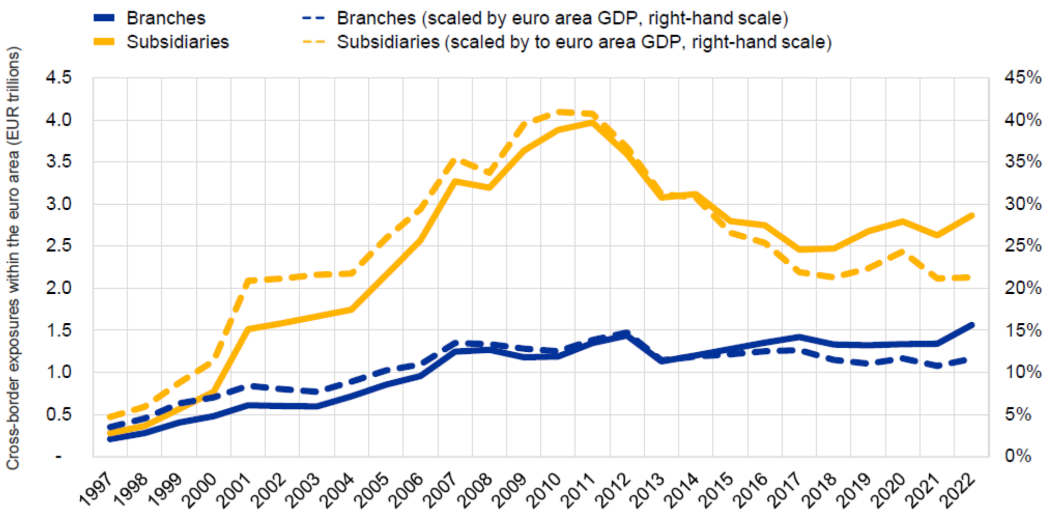
Figure 3: Banking market integration over past 30 years



Source: ECB (2024)

Focusing on indirect cross-border lending, there are signs of increased activity in the recent past, although the consolidation process has not developed as expected. Regarding the prevalent strategy, cross-border exposures through subsidiaries remain more important than those through cross-border branches, although they have been reducing starting with 2010 (Figure 4).

Figure 4: Indirect cross-border lending: subsidiaries vs. branches

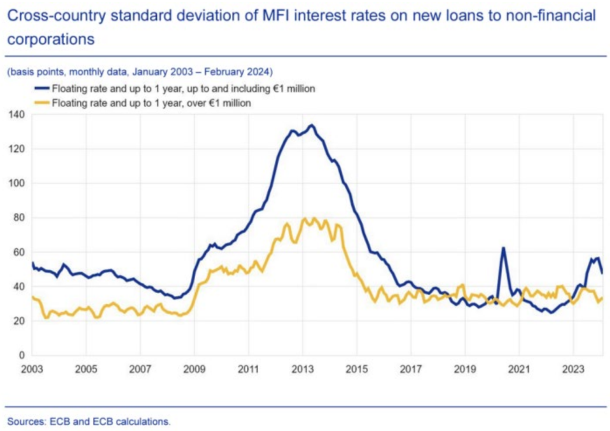


Source: ECB Structural financial indicators and ECB calculations.

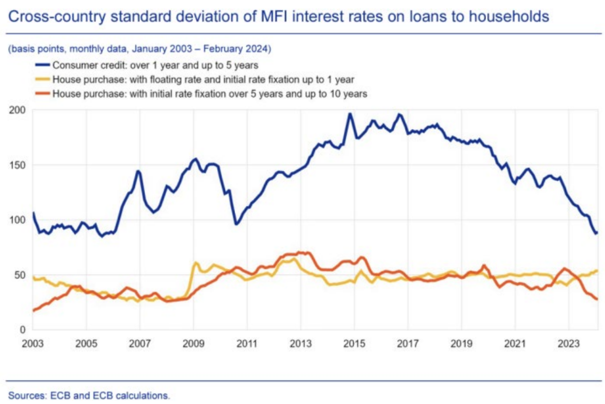
Turning to price integration, bank interest rates for new loans to non-financial corporations (NFC) have not diverged significantly over the past year, in spite of the recent rate hikes (Figure 5-Panel A). However, this holds more for larger loans (and thus most likely larger NFCs) than smaller loans (and thus most likely smaller NFCs). Dispersion in lending rates to households has declined, especially for consumer loans and with the exception of floating housing loans (Figure 6-Panel A). The decline in dispersion of housing loans with longer fixation period over the past few years is surprising, given the vast difference in mortgage finance systems across Europe.

Figure 5: Interest rate dispersion on loans

Panel A: New loans to NFC



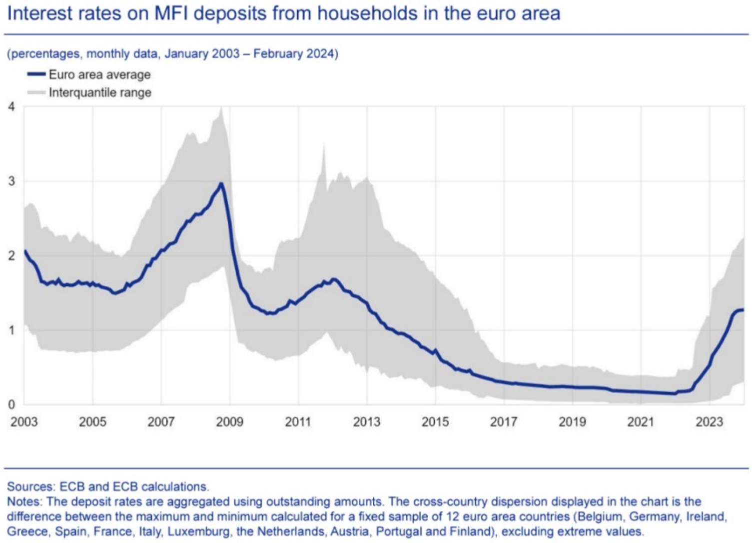
Panel B: Loans to households



Source: ECB (2024)

Finally, while deposit interest rates have recently not only increased but also shown rising dispersion, this dispersion is far lower than during the euro debt crisis (Figure 6).

Figure 6: Interest rate dispersion on deposit interest rates for households

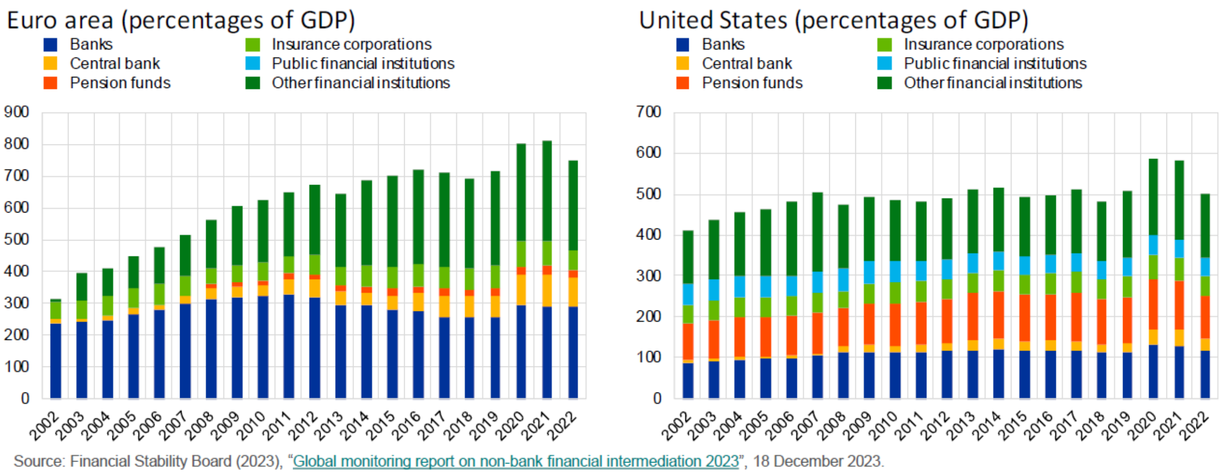


Source: ECB (2024)

2.2.2. Financial integration in the investment industry and the role of EAFCs

Since early 2000 financial markets in the EA have increased from around three times the EA GDP to about eight times nowadays. In comparison, financial assets in the United States amount to nearly five time the US GDP (Figure 7). Such a growth reflects the increased relevance of the non-bank financial institutions category, in particular money market funds, hedge funds and investment funds.

Figure 7: Financial intermediation in the EA vs. the US



Source: ECB (2024)

As mentioned, financial integration is non-uniform across segments and countries in Europe. Beck and Schmitz (2024) show that the substantial growth in EA cross-border financial positions since 1990 has been largely driven by transactions in three small countries: Luxembourg, Ireland, and the Netherlands. These are labelled as "euro area financial centres" (EAFCs) due to their pivotal roles as major hubs for the investment fund industry and securities issuance by foreign company affiliates. More precisely, investment funds based in Luxembourg and Ireland hold approximately 40% of the EA cross-border equity and debt securities, while 33% of all intra-euro area cross-border corporate bond holdings are in securities issued within EAFCs.

Examining the dual role of EAFCs as hubs for investment funds and securities issuance offers a more nuanced understanding of EA financial integration and portfolio exposures.

To shed light on the geography of capital allocation in the EA, Beck et al. (2024) provide new estimates of EA countries' bilateral portfolio investments that look through both roles, attributing the wealth held via investment funds to the underlying holders and linking securities issuance to the ultimate parent firms. They uncover that the EA is even less financially integrated than it appears, both within the currency union and vis-à-vis the rest of the world. This is largely because a significant portion of fund holdings in Luxembourg and Ireland belong, in fact, to non-euro area residents. Since these investments are held on behalf of investors outside the EA, they do not represent economically meaningful exposure for the EA itself. To the extent that investors from the rest of the world primarily invest in non-euro area countries through funds in Luxembourg and Ireland, these positions function as a pass-through via the EAFCs. In addition, the authors provide insights on home bias in equity and bond portfolio. They show that while official data suggests a sharp decline in portfolio home bias for EA countries relative to other developed economies following the introduction of the euro, this pattern only remains true for bond portfolios. Bonds issued in EAFCs are more widely held by other EA investors than those issued in domestic capital markets. As such, companies that raise capital through EAFCs better align with the policy goal of a CMU, as their bonds are more broadly distributed among EA investors. At the same time, the dominant role of EAFCs may exaggerate the actual level of financial integration within the EA and with the rest of the world, especially in the case of equity investments. Moreover, since establishing EAFC financing affiliates involves fixed costs, this approach may disproportionately benefit the largest, most productive, and most sophisticated firms, potentially skewing financial integration in their favor.

The overall experience of EAFCs, however, suggests that European firms use financing structures in these advanced financial centers to overcome some of the challenges in cross-border financial integration. These challenges often stem from differences in the legal systems across the EU, which can be particularly problematic for firms in southern EU Member States. For example, the EBA (2020) reports that national loan enforcement regimes vary significantly across EU member states in terms of the range of enforcement processes available to creditors, the scope and consistency of rule application, and the efficiency of court systems. For comparison, southern countries such as Italy, Greece, and Portugal rank at the bottom for recovery rate and time to recovery, while Luxembourg and the Netherlands perform above average across all the indicators considered (recovery rate, time to recovery, cost of judicial procedures).[3]

Overall, this broad analysis of price- and quantity- indicators in the EA has shown that financial integration has increased since the global financial crisis but also that financial markets are certainly not fully integrated, with differences across segments and countries. At a first sight, capital markets appear more integrated than banking markets, but this achievement is driven by particular segments

[3] More generally, due to the divergence in national European insolvency regimes, creditors, administrators, and stakeholders can expect different rights, obligations, protections, and outcomes depending on the European jurisdiction in which the insolvency proceeding is conducted. This creates uncertainty for cross-border investments, making it harder for investors to assess credit risk and reducing the benefits of pan-European economic integration (Simmons et al., 2016).

(i.e., investment funds) and even jurisdictions (namely, the EAFCs). Within capital markets, bond markets seems to be more integrated than equity markets.

As for banking integration, quantity indicators on cross-board exposures have increased primarily due to interbank activities, as opposed to lending to large corporates and retail lending. Cross-border corporate lending has prevailed over cross-border retail lending and has been concentrated at large banks from central-Europe countries. On the other hand, price-indicators show a reduction in dispersion across the EA in lending and deposit rates, which points to an increase in financial integration along the price dimension. As suggested by Buch (2024), plausible drivers of increased price convergence in the lending market may be the low interest rate environment that has been in place until very recently, along with competition from non-bank financial institutions and fintech and bigtech, and to a lower extent the entry of non-domestic institutions.

Finally, Figure 1 shows that financial integration has increased since the significant drop in the post-crisis years, following the inception of the BU in 2014. Although it is difficult to distinguish the BU's effect on financial integration from other concomitant initiatives (primarily the Outright Monetary Transactions), the following section aims to elaborate on the aspects of the BU project that may have contributed to more integrated markets.

3. THE EFFECT OF THE BANKING UNION ON FINANCIAL INTEGRATION

The BU, as conceived more than a decade ago, had three interconnected main objectives. The first two—reducing the likelihood of taxpayer money being used to rescue failing banks, and severing the link between bank and sovereign fragility—were directly related to the experiences during the global financial crisis and the euro debt crisis. The third objective — fostering banking sector integration, which is the focus of this note — could be considered a desirable and expected consequence of progress made on the other two goals of the BU project.

In fact, the BU was viewed as a necessary, albeit not sufficient, condition for market integration in the banking sector. First, by establishing a level playing field not only in regulation but also in supervision, the BU aimed to promote healthy competition among safe banks. Centralized supervision was intended to prevent national ring-fencing, both during normal times and in situations of turmoil. This should enable more efficient capital and liquidity allocation within cross-border banking groups, thereby fostering intra-euro area consolidation. Second, enabling bank resolution at the supranational rather than the national level should offer more private and industry-funded options for resolution authorities, further incentivizing banking integration. Third, the creation of a supranational safety net in the form of deposit insurance should guarantee financial stability and establish a proper level playing field for banks, regardless of their location

On these premises, the roadmap to the BU envisioned three key steps: expanding the ECB's mandate to include banking supervision; establishing a separate resolution authority; and introducing a BU-wide deposit insurance scheme. The legal framework for these reforms was based on two key pieces of European legislation: the Capital Requirements Regulation (directly enforceable on banks) and the Capital Requirements Directive (which requires incorporation into national law by each member country to be effective).

Despite these objectives, the BU in its current form remains incomplete. It has a single rulebook in place, a strong supervisory pillar, a limited resolution pillar, and no deposit insurance pillar. Yet, the BU brought some progress in particular concerning the safety of the EA banking system, but important actions remain to be done. In the following sections, we will gauge the progress achieved, keeping in mind the three prerequisites for integrated financial markets outlined in the previous section: markets whose participants (i) are subject to a single set of rules, (ii) have equal access to financial instruments or services, and (iii) are treated equally (ECB, 2007).

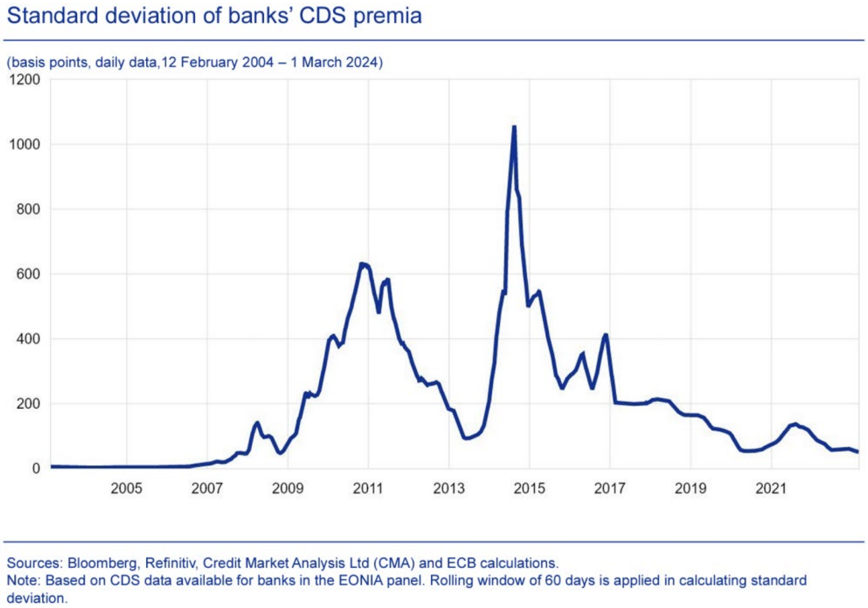
3.1. The progress made toward greater financial integration

The introduction of a single supervisor and a single rulebook represents a significant improvement achieved since the start of the BU. The application of uniform rules across the EA and the more homogeneous implementation of local regulations have helped level the playing field. This, along with consistent bank supervision, has increased transparency and ability to benchmark more easily across banks. European oversight of smaller banks (Less Significant Institutions, LSIs) has been equally beneficial (Buch, 2024). All this has enhanced the confidence of investors and depositors. Moreover, stringent and consistent supervision, including the initial Comprehensive Assessment with Asset

Quality Review and stress tests, has significantly contributed to a more stable banking sector across the EA over the past ten years, as evidenced by several recent studies[4].

The increased soundness of EA banks since the SSM inception is reflected in a significant reduction in the dispersion of bank risk, as suggested by the evolution of credit default swap rates over the last two decades (Figure 8).

Figure 8: Dispersion of banks' default risk



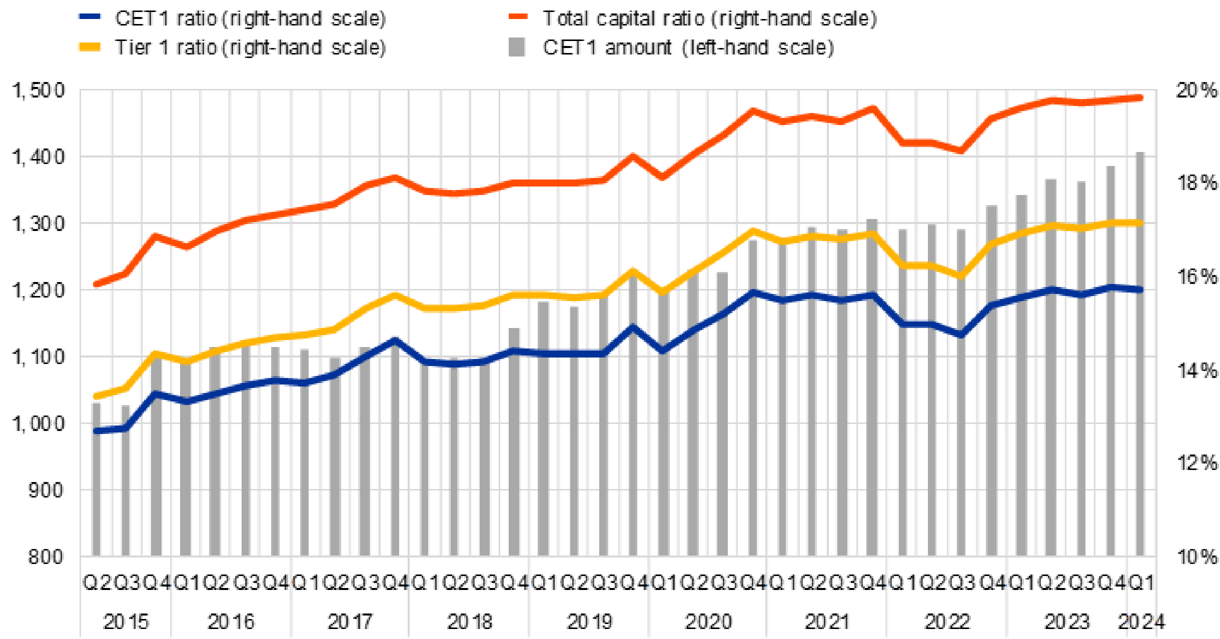
Source: ECB (2024)

A plausible reason of reduced default risk is that the SSM's strict and consistent supervision have strengthened bank balance sheets by promoting higher and better quality capitalization along with enhanced risk management practices, as reflected in Figure 9 and Figure 10.

Figure 9 shows that the aggregate common equity tier 1 (CET1) ratio of significant institutions has increased from 12.7% in 2015 to 15.7% in 2024.

[4] Fiordelisi et al. (2017) show that banks that expected to come under the supervision of the SSM reduced their lending activities and increased their capital ratios in comparison with banks below the asset threshold for supervision by the SSM. Eber and Minoiu (2016) show that SSM-supervised banks reduced their asset size and reliance on wholesale debt over the period 2012-15, compared with banks that did not fall under the supervision of the SSM, while Altavilla et al. (2020) show that supranational supervision reduces credit supply to firms with very high ex-ante and ex-post credit risk, while stimulating credit supply to firms without loan delinquencies.

Figure 9: Trends in capital ratios of significant institutions

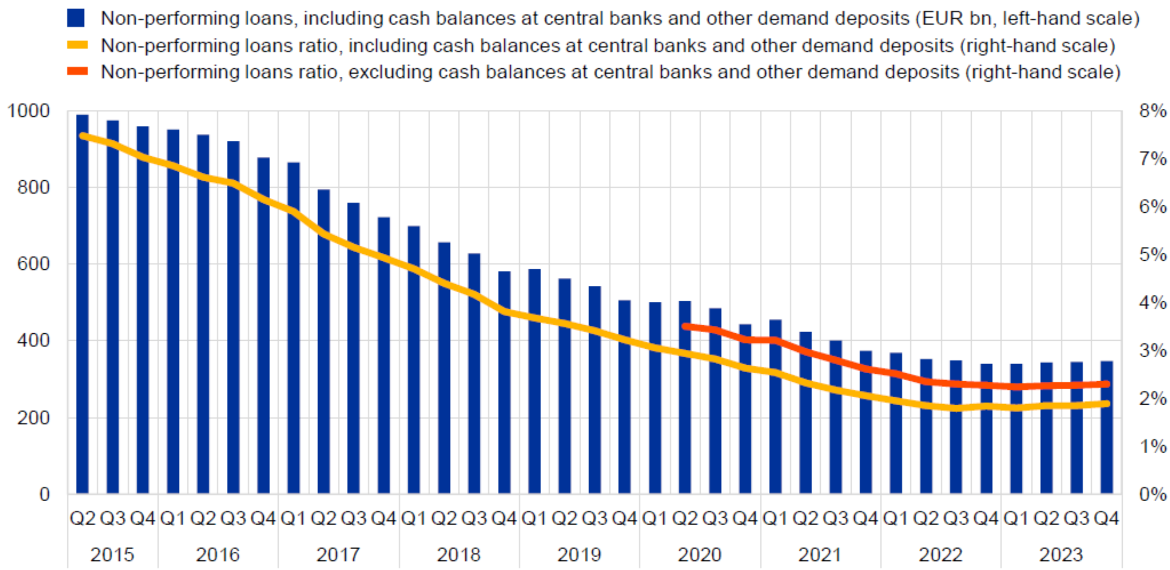


Source: ECB, supervisory banking statistics on significant institutions for Q1 2024

Regarding risk management practices, a notable achievement of the single supervisor has been the reduction of high non-performing loans (NPLs), which were a consequence of two consecutive crises for many banks and countries in Europe.[5] NPLs (in terms of stock and ratio of total loans) have declined significantly over the first decade of the BU (Figure 10) and risk sharing has improved as a vast amount of NPLs have been transferred out of the banking system to non-bank financial institutions specializing in NPL recovery and resolution.

[5] The common supervisor has taken decisive actions to help banks address NPLs; these actions have included the harmonization of NPL classification, along with common guidance on how to measure, manage, and provision for increased credit risk.

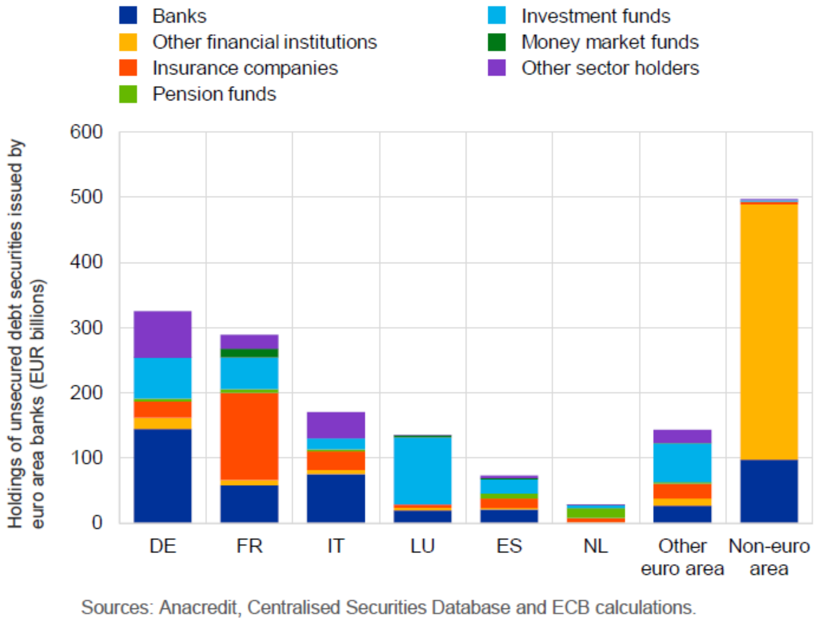
Figure 10: Trends in NPLs over the decade of the Banking Union



Source: ECB Supervisory banking statistics. Significant institutions, evolution of non-performing loans.

There are several reasons why a sound banking system is important for achieving greater financial integration. Greater resilience at the individual bank level protects customers in both normal and adverse times. This reinforces private risk-sharing mechanisms, allowing potentially unexpected losses during tough times or triggered by unpredictable events to be better absorbed at the bank level, thereby reducing the need for public intervention. At the same time, stronger banks are less likely to be exposed to the sovereign-bank risk nexus, as they have less incentive for 'risk-taking and gambling for resurrection' practices (a mechanism behind the accumulation of risky sovereign bonds during the Euro sovereign crisis, see Altavilla et al., 2017) and a better ability to manage increased credit risk. As such, the two mechanisms behind increased sovereign-banking risk—such as Greek banks holding large amounts of domestic, high-risk government bonds and Irish banks burdened with high-risk loans—can be alleviated by sounder, better-capitalized banks with enhanced risk management procedures. This should initiate a virtuous cycle that attracts debt and equity investors, both domestic and foreign. In fact, a large share of unsecured debt securities issued by EA banks is currently held outside the banking sector and even outside Europe, contributing to risk-sharing across financial segments and geographies (Figure 11).

Figure 11: Holders of unsecured debt securities at EA banks



Source: Buch (2024)

3.2. What is missing and what can be done to advance financial integration

In integrated financial markets with a common regulatory and supervisory framework, customers should have equal access to financial services; implicit in this is the cross-border offering of all services. This could be achieved in various ways. Since 1992, European banks have had the freedom to operate throughout the EU by providing financial services through digital platforms, branches, and subsidiaries. However, stylised facts from the previous sections show that banking integration—particularly in retail banking—remains limited. Despite the freedom granted to authorised institutions, cross-border banking, whether in the form of direct provision of services, cross-border establishments, or mergers and acquisitions, has not significantly increased. In addition, operating through subsidiaries is generally preferred over branch-based solutions, as shown in Figure 4.

In the following sections, we will discuss how to further foster integration by addressing the remaining weaknesses in the system. Greater integration would help make the recent increases in bank profitability more sustainable. The timing is favorable now because bank profits have improved with the return of interest rates to more normal levels, making cross-border expansion, in principle, easier.

3.2.1. (Some of) the reasons behind limited financial integration

There are two types of obstacles to cross-border integration. The most important one is related to limits embedded in the European regulatory framework.

The first concerns some aspects of the current functioning of the BU and the elements that are still missing. To start with, cross-border banks are not permitted to move capital and liquidity freely within their groups, even within the BU. This is due to the attitude of local supervisors and the limitations of EU banking legislation, which allows intragroup capital waivers only for subsidiaries within the same member state but not across borders. In addition, member countries have the legal option to impose restrictions on liquidity waiver or "to implement other measures in national law designed to enhance the resilience of the financial system", over and beyond common macro-prudential requirements (Enria, 2021). These restrictions tend to limit the practical application of cross-border capital and liquidity waivers, making cross-border consolidation more costly and, potentially, resource allocation less efficient.

Interestingly, the rationale behind capital and liquidity ring-fencing is the fear that, during crises or potential resolutions, cross-border banks might exit local markets, disrupting the availability of essential banking services. Consequently, certain countries tend to exercise their legal options and discretion to ring-fence liquidity, capital, and collateral within their own markets even in normal times. For the same reasons, they also typically use persuasive tactics to encourage pan-European banks to operate through subsidiaries rather than branches (Constâncio, 2024).

An example of ring-fencing occurred during the pandemic when both the ECB and the European Systemic Risk Board recommended payout restrictions for banks within the EA and the EU, respectively. These restrictions were intended to be implemented at the bank holding level rather than at the subsidiary level, to maintain the flow of capital within banking groups in the single market. However, several national authorities requested that all banks within their jurisdictions—including subsidiaries of EU cross-border banks—suspend payouts. This was motivated by financial stability concerns and as part of broader national policy packages aimed at ensuring stable funding for the real economy in those countries. In some cases, this led to restrictions being imposed on subsidiaries of foreign banks that already had sufficient capital buffers. These national-level restrictions effectively constituted supervisory ring-fencing. While these restrictions were lifted by the end of 2021, they set a risky precedent for ring-fencing actions during future crises.

A second aspect of the current BU architecture limiting integration concerns bank resolution. The policy changes implemented through the BRRD were supposed to prevent bank bailouts by national governments, (i) by making banking fragility less likely (including through additional loss-absorbing capacity), (ii) by permitting national bailouts only in exceptional circumstances, and (iii) by ensuring that failed banks could be resolved without fiscal support and without creating a financial disaster.

This regulation has raised numerous concerns (Constâncio, 2024). For example, the minimum requirement that 8% of a bank's total liabilities must be used for bail-in purposes seem to have limited the application of the BRRD. While only a few banks have been resolved (Banco Popular Español in June 2017, and the Croatian and Slovenian subsidiaries of Sberbank Europe in March 2022), several others have been gone through precautionary recapitalization or liquidation procedures. Importantly, these procedures foresee a larger involvement of national banking authorities and governments with the consequence of divergent national practices and uneven level playing field (Beck et al., 2022).

Finally, reaching a political agreement on the BU's third pillar (EDIS), is crucial as this is the (truly) missing piece needed for further integration. The benefits of a common deposit insurance scheme for greater integration are numerous (Buch, 2024). European deposit insurance would ensure a more uniform level of protection for depositors, potentially stimulating cross-border demand for deposits. This would benefit retail banking integration. In this respect, empirical evidence on the Portuguese banking sector shows that the lack of a common deposit insurance scheme influences depositors' behaviour and that credibility of deposit insurance matters (Bonfim and Santos, 2023). Depositors responded to foreign banks' decision to convert their subsidiaries into branches; by relocating their deposits into these newly formed branches during a period of sovereign distress, depositors became insured by a deposit insurance scheme with a stronger fiscal backstop rather than their national one.

National heterogeneity in deposit insurance credibility can thus reinforce a sovereign-bank vicious link.[6]

On the contrary, with a common, more credible deposit mechanism, host jurisdictions' concerns about the national costs of bank distress would be alleviated, reducing incentives to retain capital and liquidity resources locally. For banks, cross-border management of capital and liquidity would become easier, potentially increasing incentives to expand abroad. Progress with EDIS could also unlock political will to amend the single rulebook, providing more flexibility for cross-border liquidity waivers and permitting cross-border capital waivers. Additionally, a more integrated deposit insurance framework would bolster ex-ante confidence in the European crisis management framework.

The second type of obstacle to financial integration extends beyond the limitations embedded in the current European regulatory framework and the incompleteness of the BU. It includes the lack of harmonization in other policy areas, such as divergent tax regimes and national legislation on competition, credit, and consumer protection, as well as the behaviour of national governments. In this last regard, anecdotal evidence shows that national politics still loom large and act as an impediment to cross-border mergers or the establishment of a common deposit scheme for reasons that extend beyond the protection of local banking market stability.

A notable example of this 'banking-nationalist' approach is the German government's attempt, only a few years ago, to engineer a merger between the country's first and second-largest banks (FT, 2019). Conversely, French President Macron recently stated that he would not oppose a major French bank being taken over by another large bank from a different European country (FT, 2024). However, it remains to be seen whether this would truly be the case.[7]

In fact, we will only have arrived at a single market in banking, when we no longer refer to French, German or Italian banks (or national champions) but European banks. The current wave of nationalist parties taking political power or getting close to it will certainly not help in such a push for a truly European banking system.

It remains also to be seen what would happen should a large European bank go in distress. It seems rather naïve to think that the failure management process (such as a resolution process) would be strictly undertaken on the European level; rather a process such as in the case of Credit Suisse, with central bank, supervisory authority and Ministry of Finance agreeing on a (re)solution is more likely. While in the case of a large bank based in a member state, the resolution would be under BRRD and there would certainly be an involvement of SRB and Commission, the failure management of a top-three bank in a large member state would likely be primarily driven by national authorities (with heavy involvement of the government, as in the case of Switzerland and Credit Suisse) and attempts to avoid applying the strict rules of the BRRD.

It is important to outline that the wave of "protectionism" along the national boundaries goes beyond the fear of excessive concentration and oligopolistic behaviour, or moral hazard in too-big-to-fail banks. The ambition of the BU is, in fact, to foster "healthy financial integration, bringing with it the benefits of integrated markets such as greater risk-sharing and welfare-improving competition" (Buch, 2024). For comparison, financial integration indicators—both price and quantitative—showed greater financial integration in the years leading up to the global financial crisis (see Figure 4). However, during

[6] The authors, however, are not certain about the effect of a full-fledged BU, writing that "*it is unclear whether depositors would still behave the way they did during the euro area sovereign debt crisis in the presence of a complete Banking Union*".

[7] Constâncio (2024) illustrates examples of impediments to the idea of a centralised deposit scheme—which would, by definition, involve a form of risk-sharing, even if only through private funds—motivated more by cultural bias than by sound reasoning.

those years, cross-border consolidation and asset price convergence went hand in hand with increased risk-taking. Moreover, strong interbank integration and highly interconnected markets became a source of instability when highly risky assets (such as subprime-based structured products) were spread across financial markets and institutions worldwide. Likewise, measures adopted by national governments in response to the GFC led to the "repatriation" of many assets previously held in local subsidiaries of cross-border groups.

In sum, to promote *healthy* and *sustainable* integration there is an urgent need to complete the union along the three designed dimensions. This, however, requires cooperation at various levels, including among individual governments and market participants. We will discuss these aspects further in the next section.

3.2.2. Recent steps to foster integration

Recently, European authorities have taken additional steps to enhance financial integration. In January 2021, the ECB published a guide on the prudential treatment of mergers and acquisitions, clarifying that cross-border mergers within the EA would be assessed and treated in the same manner as domestic mergers. Regarding steps taken on the second pillar of the BU, the recent CMDI reform package, put forward in 2023 by the Commission and broadly endorsed by the Parliament, foresees a stronger role for the deposit guarantee funds in financing resolution cases, as well as a wider application of resolution techniques by enlarging the public interest definition also to regional economic interests, and by introducing the same priority for all deposits, including the ones paid out by deposit guarantee funds. Importantly, it broadens the options available to European authorities for managing the resolution of medium-sized banks, addressing the issue of the stringent 8% limit for smaller banks. The reform proposal has entered trilogue negotiations (between European Parliament, Commission and Council), but the counter-proposal by the Council goes against some of the original ideas put forward by the Commission.[8]

Regarding cross-border consolidation, the discussion is vibrant, with several concrete and feasible proposals. There also appears to be a willingness on the part of central supervisors to facilitate cross-border consolidation wherever possible—not only to scrutinize but also to support the entire process.

For example, to sustain the use of branches (an underutilized expansion strategy at the moment), the European banking authorities (see, for example, Buch, 2024 and Enria, 2021) have emphasized that converting subsidiaries into branches is a viable option, well-supported by the supervisory framework. In this context, the cross-border reorganization of Nordea may serve as an example, among others, of a complex process that successfully leveraged the opportunities for corporate reorganisation and mobility provided by the recent Cross-Border Merger Directive, along with the freedom of establishment under the European Treaty.

Additionally, banks operating across borders through subsidiaries can request liquidity waivers, enabling liquidity to be pooled across legal entities. To address potential concerns from host country authorities regarding the local costs of bank distress, Enria (2021) made concrete proposals with limited legislative intervention required to reduce national risk and, therefore, the need for ring-fencing.[9]

[8] For example, the Council proposal is much less willing to consider financing by deposit guarantee funds in the resolution process, goes against treating all deposits with the same priority, and reintroduces a 'super-preference status' for DGS-protected depositors.

[9] Enria (2021) illustrates the advantages and disadvantages of expansion through subsidiaries versus branches, citing several cases (including that of Nordea) of reorganizations that exploit the full potential and freedom already permitted by the existing institutional framework.

More recently, Angeloni (2024) has put forward an ambitious proposal, suggesting the creation of a separate jurisdiction for a limited number of sizable banks that already have a European cross-border presence or the potential to develop one. For these banks, the overarching goal is to create a single jurisdiction in the area covered by the BU, "country blind" from the regulatory, supervisory and crisis management viewpoints. To this end, a new legislation could be passed to "repeal or waive the legal provisions that prohibit the free movement of capital, liquidity, and other prudential resources within the banking groups belonging to this category" (Angeloni, 2024, p. 8).

Overall, in light of the above-mentioned discussion, there are steps that require policy makers' interventions, while others call for banks themselves to be more active to further exploit the opportunities offered by the current institutional framework. This includes leveraging opportunities for corporate reorganization and mobility provided by the recent cross-border merger directive, as well as the freedom of establishment under the well-established European Treaty. The freedom to provide financial services within the EU should be facilitated by the increasing digitalization of banking services. Digitalisation could also contribute to simplified organisational structures, particularly in the retail segment.

4. LESSONS FOR THE CAPITAL MARKET UNION

A diverse financial system consists of several financial intermediaries and markets, providing firms, households and governments with a number of different investment and funding options and a variety of risk management services and products. Cross-country comparisons have shown that as financial systems deepen, the relative importance of the banking system declines and that of non-bank financial intermediaries and markets increases (De la Torre et al., 2013). Such cross-country comparisions have also shown that European financial systems are bank-based if not bank-biased (Langfield and Pagano, 2016), with negative implications for growth and stability.

Europe thus urgently needs to diversify away from a bank-based or bank-biased financial system towards a stronger role for non-banks and capital markets, to support the green, digital and demographic transition as well as foster innovation and growth. Even the necessary funding for strengthening European defence can benefit from efficient financial markets.

This was at the core of the CMU project launched in 2014/15. While some progress has been made (e.g., in the area of securitisation and green bond standards), Europe is far away from having a Single Capital Market or a Savings and Investment Union as the recent Letta report called for (Letta, 2024). How does the CMU project relate to the BU project? And what lessons can be learnt from the BU for the CMU project?

The concept of both 'unions' is closely connected. Capital markets cannot function without efficient banks, which are important players in these markets. A thriving capital market, in turn, can help banks by allowing them to raise funds more easily, securitise assets, and sell off non-performing assets, as well as facilitate an easier resolution and exit process for failing banks. Ultimately, a strong European banking system, where large banks are no longer tied to specific sovereigns and operate within a unified capital market, can not only provide the necessary efficiency and scale for financial services in Europe but also reduce dependency on large US investment banks

On the other hand, unlike the BU, which focuses on a specific segment of the financial sector, namely banking, the CMU concerns a large variety of different institutions and markets, ranging from public debt and equity markets to contractual savings institutions (such as insurance companies and pension funds) and private equity and private debt funds. It is thus difficult to point to a similar structured approach as in the case of the three pillars of the BU. Nevertheless, the success of the BU in single supervision (and, relatedly, in greater coordination across national authorities under the single supervisor's aegis) along with common rule-setting, can provide a path forward.

Specific challenges contribute to the lack of a single capital market in Europe. One important element is the limited cross-border investment in investment funds, particularly by retail investors, combined with fragmentation in trading and post-trading systems, which also entails diverse rules and standards. [10] Different taxation rules, including withholding tax regimes, in particular, are a strong disincentive to cross-border activities. The fact that the majority of management companies of investment funds are owned by banks introduces another home bias and undermines competition.

The lack of harmonisation in insolvency laws and regulatory frameworks for equity investments is another impediment to free flows of capital within the EA, especially in those countries where inefficient insolvency frameworks may pose political risks for foreign investors. In this respect, the EBA (2020) reports significant disparities that may increase home bias or reduce the attractiveness for non-domestic investors.

Another important element is the weak enforcement by market authorities. Only if investors can trust governance and enforcement of rules, will they be willing to invest and with possibly lower returns. Some observers pointed out that the current structure of European and Market Authority (ESMA) is not conducive in this respect, as its board is dominated by national competent authorities and its enforcement powers are too weak.

A further important barrier (an obstacle for both the BU and CMU projects) is the absence of a true euro-wide safe asset. Issuance of a common safe bond to fund EU environmental and defence investment projects can be helpful in this context by also providing a backbone for the CMU. At the same time, it can help fill the gap of missing safe assets for European banks.

As has happened in the construction of the BU, many necessary reforms require supranational structures and decision-making processes. However, national interests, including those of domestic banks, often conflict with the goal of establishing a single capital market. It is therefore crucial for national governments to understand what is at stake and to support harmonisation and integration.

However, the lack of obvious urgency in the absence of a financial crisis (which, as discussed above, led to the creation of the BU) is somewhat of an impediment to decisive actions toward market integration. In fact, even as Europe faces existential threats to its socio-economic model, the need to enhance the scale and efficiency of non-bank financial intermediation is not perceived as urgent.

While there is no immediate and visible cost to not having a CMU, the cost lies in missed opportunities for investment and sustainable growth. To reignite interest for integrated capital markets and speed up the necessary reforms, one option would be to link the CMU to the transition processes mentioned above, 'learning' from the US experience where the financing of railway construction with bonds helped boost capital market development. In fact, placing a strategic emphasis on achieving the green and digital transitions might catalyse the necessary political momentum to progress in the CMU project. This would require more developed capital markets, and equity financing in particular, as equity by its nature plays a more important role than debt in funding innovation. A well-functioning equity "ecosystem for innovative companies" that includes venture capital and access to public equity markets is therefore a crucial complement to public investment in delivering the green and digital transition.

[10] Trading and post-trading systems are highly fragmented in Europe. There are 35 listing exchanges and 41 trading exchanges, along with 18 clearing and 21 settlement markets, primarily owned by national stock exchanges. This contrasts with the U.S., where each of the two markets is served by a single company, both mutually owned by the utility-like Depository Trust and Clearing Corporation. (Letta, 2024).

In addition, there is certainly a need for a stronger role for ESMA, both in supervising an increasing number of specific market segments and in pushing for the integration of European capital markets more generally. In this context, the successful experience of common supervision in the BU, and the way it cooperates with national central banks, may indicate the direction to take.

Relatedly, another significant stumbling block appears to be the location of a common capital market. After Brexit, major cities in the EU tried to attract as much financial sector business as possible; this contributed to excessive and unnecessary fragmentation in certain segments of the securities market (e.g., clearing and settlement). Because agreeing on a single location seems unrealistic, a hub model—where different market segments are based in different cities but are closely connected and supervised by one authority—might be a politically feasible solution.

5. CONCLUDING REMARKS

After a decade, the BU is widely recognized for enhancing banking stability, mainly due to its common and rigorous supervisory framework. However, true banking integration—where financial services are uniformly accessible across the EU—remains incomplete.

This is partly due to the partial implementation of the second pillar and the absence of the third pillar. The recent crisis management proposal, aimed at strengthening regulatory certainty and reducing reliance on public funds for resolving bank distress, is a step in the right direction, although its complexity may require additional data and simulations for a thorough assessment (see Constâncio, 2024).

Cross-border integration is also limited by deep-rooted obstacles like cultural and language differences, varying legal systems, and overall nationalistic approaches to bank bailouts and recapitalization. Addressing these issues is important, but some barriers are more amendable than others. Positive developments include the Cross-Border Merger Directive and ongoing debates on best practices (e.g., Enria, 2021) and "challenging but feasible" proposals (e.g., Angeloni, 2024). Achieving effective progress requires both policymakers and market participants to leverage technological innovations and collaborate with central supervisors.

The successes of the BU, particularly in supervision and rule-setting, provide valuable lessons for the CMU project. More integrated trading and post-trading systems, a stronger supranational supervisor, and better coordination among European financial authorities are essential. Differences in insolvency legislation, accounting, and tax regimes continue to create frictions, impeding capital movements and investment diversification. For foreign investors, political risk and weaker institutional frameworks in some countries remain concerns.

Harmonising insolvency regimes could reduce administrative costs and enhance cross-border investment. This could be beneficial for the CMU and BU alike. For example, reinforced insolvency regimes and bankruptcy procedures could assist institutions in the secondary loan market to recover defaulted positions more efficiently or restructure loans to return them to performing status. For banks, this would further strengthen their balance sheets and mitigate one of the two potential feedback loops of the sovereign-banking nexus, particularly the risk of collapsing banks affecting sovereign bonds, as observed in the post-2008 Irish banking crisis.

Overall, addressing national short-sightedness could benefit both the CMU and the stability of the banking sector. At the same time, as suggested by Enria (2021), reinforcing private risk-sharing mechanisms and encouraging market participant initiatives within the whole perimeter of the current framework could also alleviate pressure on public risk-sharing and, thus, help promote more national action toward integrated financial markets.

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We discuss the contribution of the Banking Union in its current form to market integration in the euro area. While the introduction of single supervision has fostered banking integration, limited progress in single resolution and the absence of a European deposit insurance scheme undermine further advancements. We argue that a significant obstacle to financial integration lies in the persistence of national interests in regulation, supervision, and politics. We also explore the lessons that can be learned from ten years of the Banking Union for the development of the Capital Markets Union and the integration of capital markets. The successes of the Banking Union in common supervision and rule-setting can provide a path forward.
This document was provided by Economic Governance Support Unit at the request of the ECON Committee.

PE 760.259
IP/A/ECON-BU/FWC/2020-003/LOT1/C3/SC5

Print ISBN 978-92-848-2289-8 | doi: 10.2861/7098976 | QA-01-24-032-EN-C
PDF ISBN 978-92-848-2288-1 | doi: 10.2861/0243764 | QA-01-24-032-EN-N