IN-DEPTH ANALYSIS

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Can Banking Union foster market integration, and what lessons does that hold for capital markets union?

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BANKING UNION

External authors:

Ignazio ANGELONI

Rainer HASELMANN

Florian HEIDER

Loriana PELIZZON

Jonas SCHLEGEL

Tobias H. TRÖGER

Economic Governance and EMU scrutiny Unit (EGOV)
Directorate-General for Internal Policies
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Can Banking Union foster market integration, and what lessons does that hold for capital markets union?

Abstract

Over the past decade, the Single Supervisory Mechanism focused on making banks safer, resulting in stronger banks but limited euro area cross-border integration. We argue that overbanking hinders both cross-border integration for the EU and the development and integration of capital markets. In addition to a common supervisory authority and to attain the strong and integrated financial system Europe needs going forward, the Banking Union and Capital Markets Union need to coexist and complement each other.

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AUTHORS
Ignazio ANGELONI, SAFE and IEP Bocconi
Rainer HASELMANN, Goethe University Frankfurt and SAFE
Florian HEIDER, Goethe University Frankfurt and SAFE
Loriana PELIZZON, Goethe University Frankfurt and SAFE
Jonas SCHLEGEL, SAFE
Tobias H. TRÖGER, Goethe University Frankfurt and SAFE

ADMINISTRATOR RESPONSIBLE
Kai Gereon SPITZER

EDITORIAL ASSISTANT
Donella BOLDI

LINGUISTIC VERSIONS
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To contact Economic Governance and EMU Scrutiny Unit or to subscribe to its newsletter please write to:
Economic Governance and EMU Scrutiny Unit
European Parliament
B-1047 Brussels
E-mail: egov@ep.europa.eu

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LIST OF ABBREVIATIONS

BU	Banking Union
CMDI	European Crisis Management and Deposit Insurance
CMU	Capital Market Union
EA	Euro Area
ECB	European Central Bank
FDIC	Federal Deposit Insurance Corporation
HH	Household
IPS	Institutional Protection Scheme
LSI	Less Significant Institutions
M&A	Merger and Acquisition
NCA	National Competent Authorities
NPL	Non-Performing Loan
SI	Significant Institution
SSM	Single Supervisory Mechanism
SSMR	Single Supervisory Mechanism Regulation

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EXECUTIVE SUMMARY

Over the past decade, the Banking Union (BU) has concentrated on ensuring the prudential stability of banks, with the primary goal of making them safe and sound. This focus has resulted in euro area banks becoming significantly stronger, as evidenced by their resilience during the 2020-2022 pandemic recession and the 2023 banking turmoil. However, this singular focus on safety has come at the expense of cross-border banking integration. Despite ten years of the BU, euro area banking remains fragmented, with national banking markets still operating largely independently.

For the BU to fulfill its broader objectives, it must shift its focus to promoting a genuinely integrated and strong continental banking market. This requires revising EU banking legislation to eliminate outdated provisions that discourage cross-border banking. A critical step is to treat cross-border banking within the BU on the same level as national banking, ensuring that legislation is "country-blind" and supports the internal cohesion of large banking groups across the euro area. Additionally, legal reforms should include structural and prudential criteria for banking groups involved in substantial cross-border business, ensuring they can move capital and liquidity freely within the eurozone.

Furthermore, there is a need to address the differential treatment between smaller and larger banks, which currently undermines market integration. Bringing smaller, but interconnected, banks under direct European Central Bank supervision – more than already implied by the existing criteria for defining "significant institutions" (SIs) – would help level the playing field and enhance competition across borders.

The BU's experience offers lessons for the Capital Markets Union (CMU), which, complementing the BU, aims to integrate and expand Europe's capital markets. It is often argued that CMU requires a common supervisory authority, similar to the BU's Single Supervisory Mechanism (SSM), to ensure consistent regulation and oversight. We agree, but think that more is needed. Overbanking, which hampers cross-border banking, also impedes the natural development of the CMU by limiting the diversification of funding sources. Both challenges stem from the same underlying root cause: resistance to embedding national interests in a broader European view[1]. Without a willingness to redesigning regulatory power according to that view, further progress towards a strong and efficient euro area financial sector remains highly unlikely.

Ultimately, for the European financial system to function effectively, the CMU and BU must coexist and support each other. The CMU can reduce overbanking by providing alternative funding sources, thereby alleviating pressure on banks and promoting cross-border integration. Conversely, a strong BU ensures a stable banking environment, which is crucial for the success of the CMU. Their mutual reinforcement is essential for achieving a truly integrated European financial system.

[1] The opposition which is emerging on Germany, as we write, to the acquisition of significant stakes in Commerzbank by Unicredit is only the most recent example of such resistance.

1. HOW HAS BANKING MARKET INTEGRATION EVOLVED, BEFORE AND DURING THE BANKING UNION?

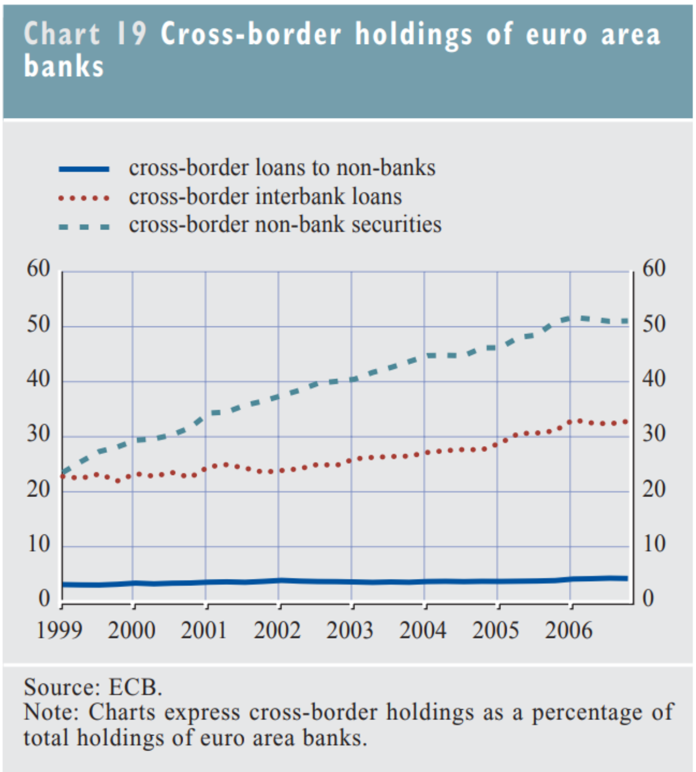
By launching a BU in June 2012, the euro area leaders intended to bring all banks, in the eurozone and potentially in a more distant future in the entire EU, under a single regulatory and supervisory umbrella. The main purpose of this new and ambitious "union" was prudential; this is clear from article 1 of the Regulation establishing the SSM, which states that the ECB is given specific supervisory tasks "... *with a view to contributing to the safety and soundness of credit institutions and the stability of the financial system within the Union and each Member State*...". The prudential concern was paramount at a moment in time in which banking crises in several member countries were threatening to tear the euro apart.

However, the BU was also supposed to help establish a single banking market; the Single Supervisory Mechanism Regulation (SSMR) mentions this purpose as well, though in a much more nuanced way. After the words just quoted, the same article 1 continues as follows: "... *with full regard and duty of care for the unity and integrity of the internal market based on equal treatment of credit institutions with a view to preventing regulatory arbitrage*." This rather vague formulation was intended mainly to sooth the concerns of countries which had decided not to participate in the scheme – first and foremost the UK – which feared the SSM would become a new "fortress eurozone". At the same time, however, many among the architects of the BU believed that the scheme being set up would also contribute to build a single, well-integrated banking market within the eurozone; a goal that had eluded all repeated attempts since the 1980s. Same legislation, same EBA standards, same supervisor in the ECB, same resolution authority in Brussels, and of course same currency: these elements combined would, in their mind, produce that result almost as a matter of course.

Unfortunately, that turned out not to be the case, as documented over the years in the ECB annual (lately, biannual) reports on Financial Integration in Europe.

The early issues of this report show that interbank market made significant progress in its cross-border integration after the start of the single currency. By contrast, the client deposit and loan markets remained essentially national, and in some cases, even regional or local (see Figure 1, reproduced from the ECB's Financial integration report of 2007).

Figure 1: Cross-border holdings of euro area banks

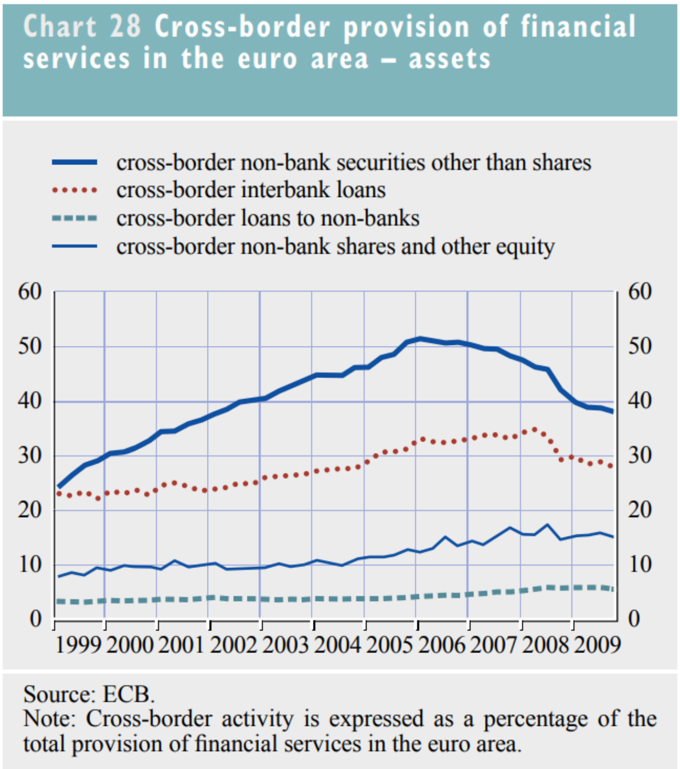


Source: ECB (2007)

In the same report, the ECB (2007) noted that the value of cross-border mergers and acquisitions (M&As) had been increasing somewhat in the years after the launch of the euro. The increase in value (but not in the number of cross-border operations) was essentially due to a few high-profile operations, such as the acquisition of Hypovereinsbank (Germany) by Unicredit (Italy) or of BNL (Italy) by BNP Paribas (France). Arguably, these were rather specific cases, unlikely to represent the onset of a new trend.

Be that as it may, even these limited positive signs of cross-border activity ended abruptly with the financial and euro crisis (see Figure 2, reproduced from the ECB's Financial Integration in Europe report of 2010).

Figure 2: Cross-border provision of financial services in the euro area - assets



Source: ECB (2010)

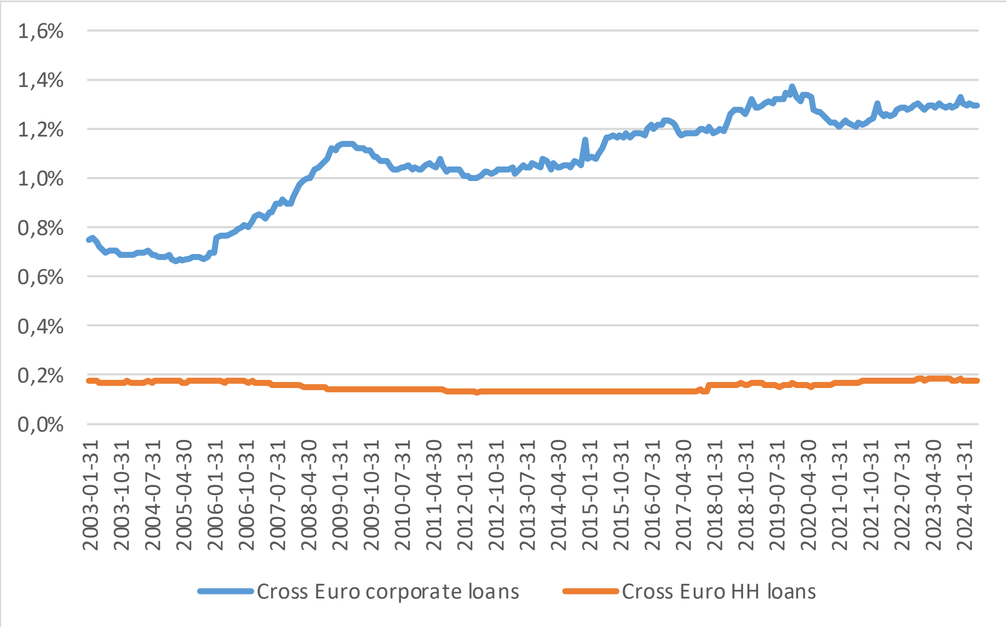
Emter et al. (2019) document the "great retrenchment" of cross-border integration in banking after the crisis in some detail, trying also to determine the causes of it by means of econometric estimates. They find that the retrenchment affected all markets, but in particular the market for loans, both interbank and toward non-bank clients. Overall, EU banks' overall cross border exposures declined by 25%, and cross border interbank loan exposures alone by as much as 40%, pointing to an increased home bias in bank exposures as a result of the crisis. Their econometric estimates suggest that the main driver of the reduction was the increase in non-performing loans (NPLs). According to their interpretation, "*A high NPL ratio can create deleveraging pressures, for instance as a result of higher risk weights. Similarly, weakened bank profitability leads to slower capital accumulation, thereby impeding banks' capacity to leverage, which – coupled with tighter regulation – may reduce banks' willingness to engage in risk-taking across borders*" (ibid., page 7).

Consistent with this interpretation, one may have expected to see cross-border exposures rising again once the crisis was overcome and the incidence of NPLs declined markedly (especially in countries where NPLs had previously been higher, for which the ECB's stricter supervisory standards constituted a turning point).

It is therefore important to verify whether in the last decade – with the ECB supervision in force, the euro area economy recovering (except in the pandemic) and bank NPLs falling drastically, cross-border banking integration has progressed. The rest of this section brings some evidence on this. In synthesis, the answer to the question is: yes, but not much and not enough.

Figure 3 shows the development of cross border lending to non-bank borrowers, distinguished between the corporate and the household sector. As one can appreciate from the vertical scale, the size of this type of exposure is minimal – well below 2% of total bank assets for the corporate component, and 0.2% for the household component. Therefore, any increase that is observed in the later part of the period is also minimal. Nonetheless it is interesting that cross-border corporate exposures did in fact resume somewhat after the crisis, and are now near their a historical high. Even the pandemic shock and recession had a limited and short-lived effect on this type of cross-border exposures.

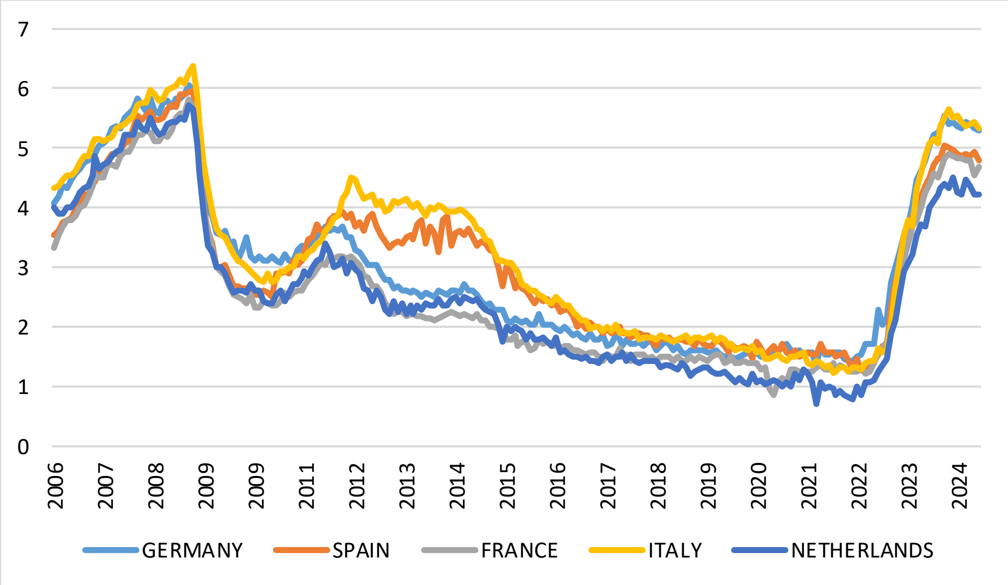
Figure 3: Loans to the private sector as percentage of total assets



Sources: ECB, own calculations.

The message is reinforced by looking at bank lending interest rates. Figure 4 shows the cost of borrowing for corporations from banks, in the largest 5 eurozone countries – Germany, France, Italy, Spain and Netherlands. The figure clearly shows the major increase in the dispersion of interest rates during the euro banking and sovereign crisis (2011-2013), concentrated in the two riskier countries: Spain and Italy. This contrasts with the period of the global financial crisis (2008-2010), in which corporate borrowing costs had risen more or less in line in the five countries. Starting in 2014, interest rates decline in their level and converge again. However, they never converged fully, or even more than in the pre-crisis years. Remarkably, interest rates did not diverge appreciably during the pandemic (2020-2022), a sign that the ECB policy, on both the monetary and supervisory sides, was quite successful in preserving the cohesion of the euro area in times of a major crisis. Subsequently, when interest rates started rising, borrowing costs rose sharply, but the divergence among the five countries did not increase much. All in all, these data suggest that there seems to be a "structural bound" beyond which convergence cannot go, even in the most favourable times from the macroeconomic and financial stability viewpoints.

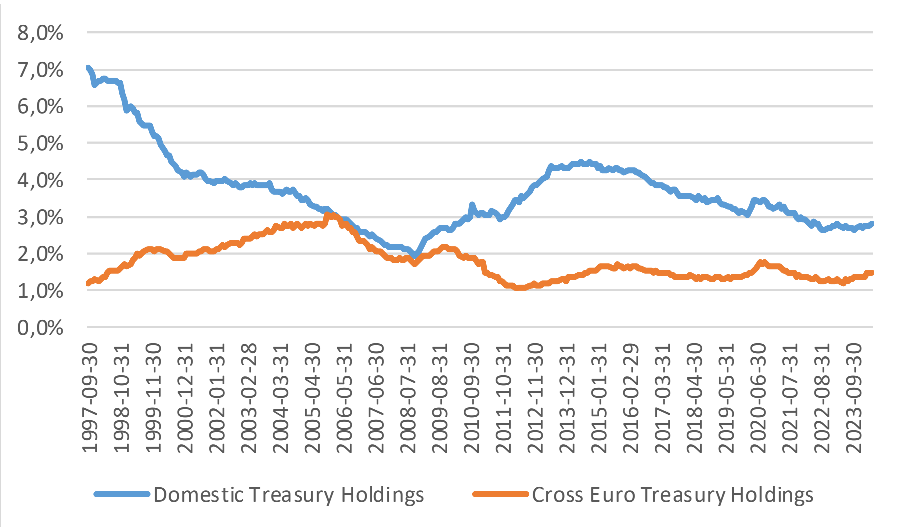
Figure 4: Cost of borrowing for corporations (percent per annum)



Sources: ECB Data Portal

Completing the picture, Figure 5 shows the holdings of Treasury securities by eurozone banks, still as percent of assets, broken down between domestic and cross-border. Again, one can observe a sharp increase in cross-border integration before the crisis (the global and especially the euro area one), and a big retrenchment afterwards. The euro crisis marked a big increase in domestic holdings of sovereigns, which continued afterwards and peaked in 2014 – the start of ECB supervision. After that, cross border holdings of Treasury paper did not recover, rather remained stagnant at the post-crisis levels. By contrast, domestic holdings dropped significantly, coming close to the pre-crisis level. This development may have benefited from the recovery of Treasury markets of highly-indebted countries, partly as a result of the monetary policy enacted by the ECB (QE and negative central bank rates) and possibly also due to informal ECB suasions on the banks, discouraging an excessive concentration on high-risk domestic Treasury exposures.

Figure 5: Treasury holdings as a percentage of total assets



Sources: ECB, own calculations.

All in all, the data just shown supports three conclusions:

1. Neither the introduction of the euro in 1999 nor the single ECB supervision in 2014 were sufficient to attain full cross-border integration of euro area banking, although each of them contributed significantly at different stages.
2. The Treasury segments tend to integrate more easily and quickly, but are vulnerable to retrenchments in crisis situations. Other segments evolve more slowly, but progress, when attained, is more structural and robust.
3. Clearly, the limited progress in eurozone banking integration so far cannot be blamed on currency segmentation, removed in 1999 with the introduction of the euro, or on supervisory segmentation, eliminated in 2014 with the SSM. More and different policy action is needed, if higher levels of banking integration are to be achieved in the euro area.

2. POTENTIAL REASONS FOR LIMITED INTEGRATION OF THE EURO AREA BANKING MARKETS

The previous section demonstrated that cross-border banking in Europe has not progressed as anticipated (Emter et al. (2019)). Banking markets remain predominantly controlled by national banks, which can be particularly disadvantageous for large European corporations operating extensively within the Euro area (Langfield and Pagano (2016)). This section explores potential reasons for the limited cross-border integration in the banking market.

2.1. Overbanked Europe

We begin by examining the structure of European banking markets. A common assertion is that Europe is "overbanked" (Pagano et al. (2014)). What does this mean? Essentially, it refers to an oversupply of banking services surpassing the demand for such services. A commonly used measure to evaluate banking markets in this respect is whether the amount of banking assets relative to the size of the real economy is disproportionately higher than compared to other banking markets.

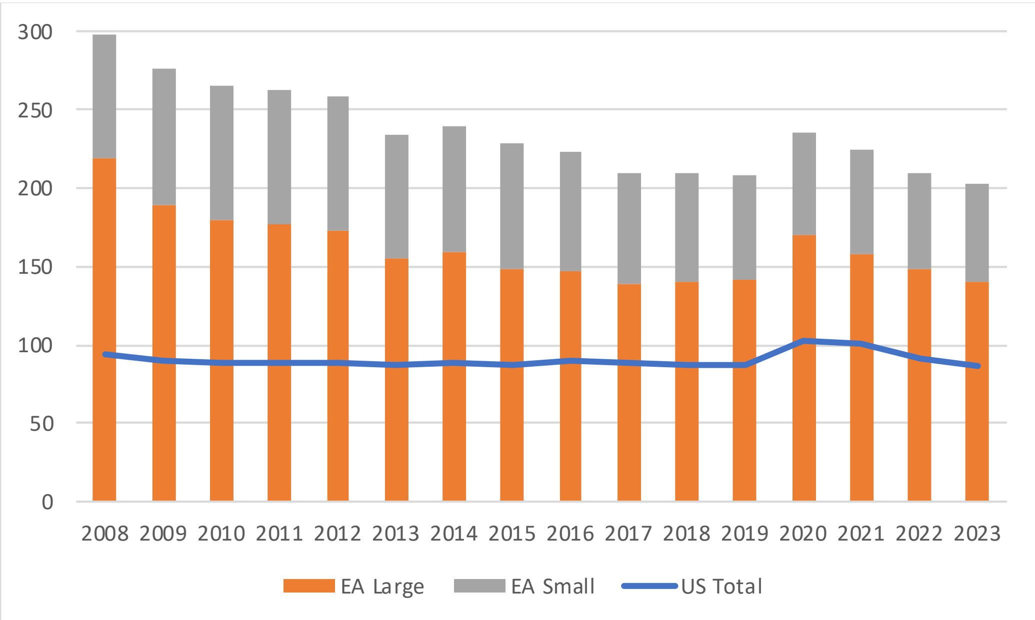
In competitive markets, it is unlikely to have an equilibrium where the supply of banking services is higher than the demand. In practice, however, implicit as well as explicit government guarantees and other frictions can result in an outcome where a market remains overbanked for an extended period. In an overbanked market, banks find fewer business opportunities than in markets with a lower ratio of banking assets relative to the economy. Fewer business opportunities mean lower profitability in the banking sector. The empirical evidence in studies by Feng and Wang (2018) and Di Vito et al. (2023) corroborates this intuition. Lower profitability of banks has several drawbacks, such as banks resorting to riskier business opportunities or being unable to build up sufficient capital and liquidity buffers from earnings. Importantly, while banks are less profitable in overbanked markets, this does not mean that consumers and corporate borrowers benefit from more favourable prices for financial services. To the contrary, less profitable institutions cannot afford to offer low-cost services and high deposit rates to their customers or low interest rates to the corporate sector. Therefore, ultimately, consumers are likely to pay for the inefficiencies associated with an overbanked market. The presence of asymmetric information and the strong stickiness of bank-client relationships make it particularly difficult for new entrants to penetrate the market without an established branch network.

To illustrate this point, we compare the euro area with the United States, using GDP to measure market size. It is important to note, however, that the structure of financial markets differs between these two economies. While the predominant source of external finance for businesses in most euro area countries is bank funding (i.e. bank-based economies), U.S. enterprises are more likely to access capital markets instead of asking for a bank loan (i.e. market-based economy). The observed differences in financial market structures are disadvantageous for economic development per se (Levine (2002)). Yet, most advanced economies see an increase in market-based financial instruments over time, while Europe's financial market structure stands out and became even more bank-based since the 2000s (Pagano et al. (2014)).

Against this background, it is not surprising that Figure 6 shows that the size of the euro area banking sector is drastically larger compared to the US. While the relative size of the euro area banking sector has decreased from 260% of GDP in 2012 to about 200% of GDP in 2023, the relative size of the US banking sector has remained relatively stable at around 90% of GDP, with a temporary increase caused by deposit inflows (see, e.g., Li et al. (2020)) at the onset of the pandemic in 2020 and 2021. These numbers suggest that overbanking in Europe is a problem on the decline.

A classification of the European banking sector as "too" large is ultimately difficult because it is hard to find a scientifically robust benchmark. However, Pagano et al. (2014) show a transformation of the European banking sector before the financial crisis towards rapid growth in bank size. A potential explanation for this development is the implementation of Basel II, introducing model-based capital adequacy requirements which generally only benefited large banks that adopted the model based approach. This regulatory innovation led to relatively lower capital requirements for large banks compared to smaller ones, as one key advantage of model-based regulation has been a proportional reduction in capital requirements. This allowed particularly the largest European banks to increase their balance sheets without raising their capital base and implied higher concentration and leverage, with a potential negative impact on economic growth in the euro area. Figure 6 shows that this trend has been somewhat reversed during recent years, but, euro area banking markets remain enormous in size, particularly in comparison to the US.

Figure 6: Banks' market share expressed as total assets over GDP



Sources: ECB, FDIC, FED, own calculations.

Notes: The ECB defines the cut-off for the large banking groups in their [CBD] (consolidated banking data) documentation as "greater than 0.5% of total consolidated assets of EU banks". Small and medium-size banking groups below the threshold are lumped together in this illustration. The data here is scaled to GDP, to enable a comparison of euro area and US data.

What does an overbanked financial sector mean for cross-border integration of banking markets? The scarcity of profitable business opportunities in overbanked markets dampens, among other things, the appetite for acquiring other banks or entering foreign markets. At the margin, this leads to fewer cross-border mergers and acquisitions deals in the banking sector and limited provision of cross-border banking services, as discussed in the previous section. Our hypothesis is consistent with a non-trivial domestic M&A activity in the banking sector, because such transactions are frequently reorganizations of ailing institutions where supervisory and resolution authorities and politicians push transfer strategies (purchase and assumption/sale of business) or induce such reorganizations outside of resolution by moral suasion. If European countries were willing to restructure their banking sectors and solve the issue of overbanking, we would likely see more cross-border market integration. Such an integration should result in more favourable conditions for banks' corporate and retail clients.

2.2. European banking politics

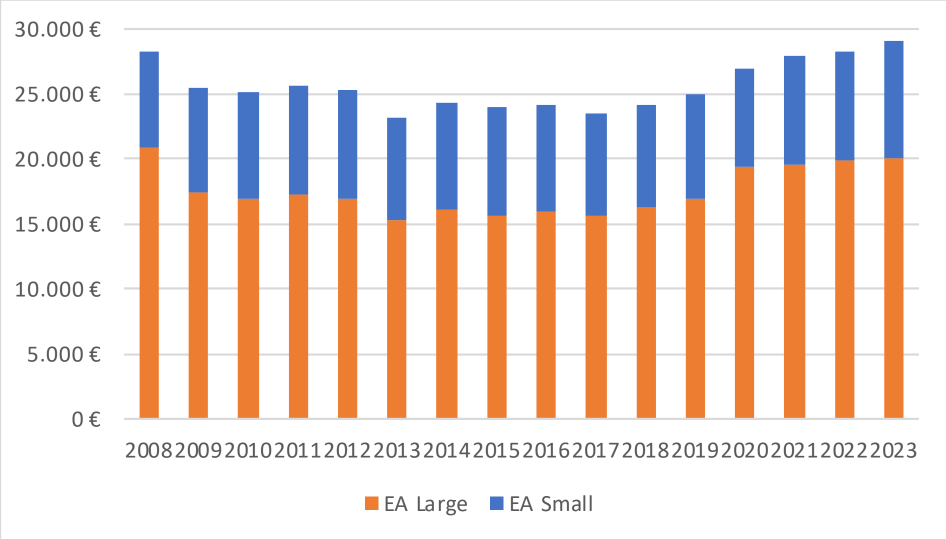
Many European member states' governments support their banking system by providing direct or indirect guarantees for their domestic banks. Pagano et al. (2014) argue that far fewer EU banks failed since 2008 compared with the number of banks that have been resolved by the US authorities, suggesting a higher degree of regulatory forbearance in Europe around this time.

Several studies have argued that the latter resulted from strong ties between politics and banking in several euro area member states. Langfield and Pagano (2016) point out that every euro area country aims to maintain a large internationally active bank, often referred to as a national champion. Haselmann et al. (2022) show that national regulators tend to vote against specific regulatory initiatives by the Basel Committee when these initiatives are likely to impact their national champions negatively. Given the size of the euro area economy, each country supporting a national champion already means a considerably higher number of large banks compared to the US.

2.3. The prevalence of regional banks

Small, primarily regional banks continue to play a significant role in the euro area banking sector and even dominate in some countries. Figure 7 provides evidence of these regional banks' substantial presence and influence.

Figure 7: Total bank assets in the Euro Area (in EUR Billions)



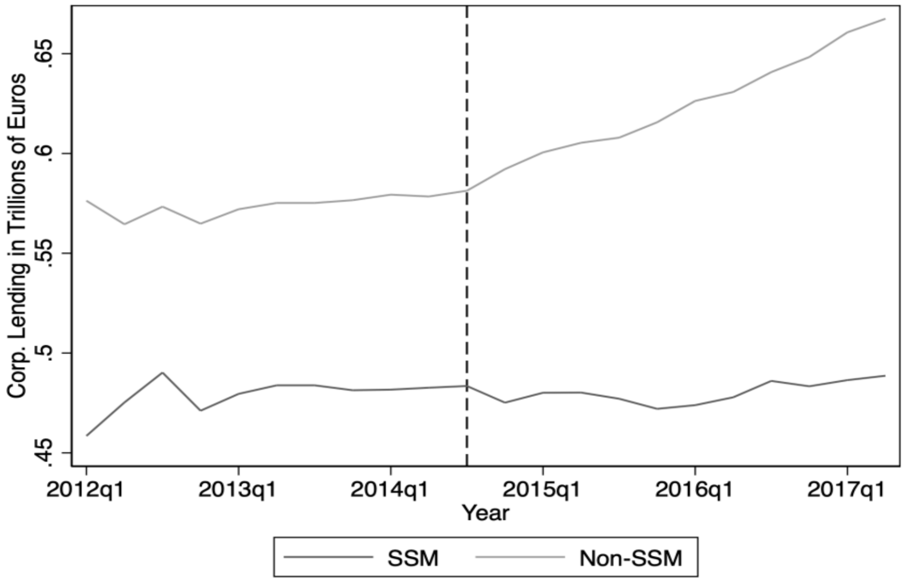
Sources: ECB, own calculations.

Notes: The ECB defines the cut-off for the large banking groups in their CBD (consolidated banking data) documentation as "greater than 0.5% of total consolidated assets of EU banks". Small and medium-size banking groups below the threshold are lumped together in this illustration. The large banks in the EA have been largely stable in size since 2012, with a persistent uptick in 2020. The EA small banks were similarly stable from 2012 to 2019. In 2020 they lost about 5% of total assets, before then increasing in size by 20%.

With the introduction of the SSM in 2014, a two-tier supervisory system was introduced in the euro area. Significant banks became subject to direct ECB supervision, while less significant, particularly small regional banks remained under national direct supervision (essentially, the ECB supervises not the banks directly, but the way national authorities supervise their own "less significant" banks). Haselmann et al. (2023) show that direct ECB supervision has been considerably stricter than supervision of National Competent Authorities (NCAs). Exploiting loan level data that allows to compare the treatment of the same corporate borrowers by the ECB and NCAs respectively, they demonstrate that the ECB requires banks under its direct supervision to hold significantly more regulatory capital against the same exposures than NCAs. This unequal treatment provides a competitive edge for small regional banks vis-à-vis large banks in lending markets. Although their study focuses on German data, their findings go beyond a specific member state. Altavilla et al. (2024) also identify national "leniency" towards powerful local banks compared to the supervisory standards of the SSM.

How do these differences in the regulatory treatment of significant and less significant institutions affect banking markets and their cross-border integration? Smaller banks have a competitive advantage over large ones if they need to hold less regulatory capital. Their marginal costs of extending a loan are lower in relative terms compared to banks under the SSM supervision. Figure 8 (taken from Haselmann et al. (2023)) shows that the *relative* market share of aggregate lending by banks under direct ECB supervision and those under NCA oversight has shifted considerably since the introduction of the SSM. While the lending volume of ECB supervised banks did not grow since the start of the SSM, the pattern for banks under NCA supervision is different. Banks remaining under national supervision maintained stable lending volumes before the SSM's introduction but significantly increased their lending afterwards by taking over particularly risky lending business from banks under direct ECB supervision.

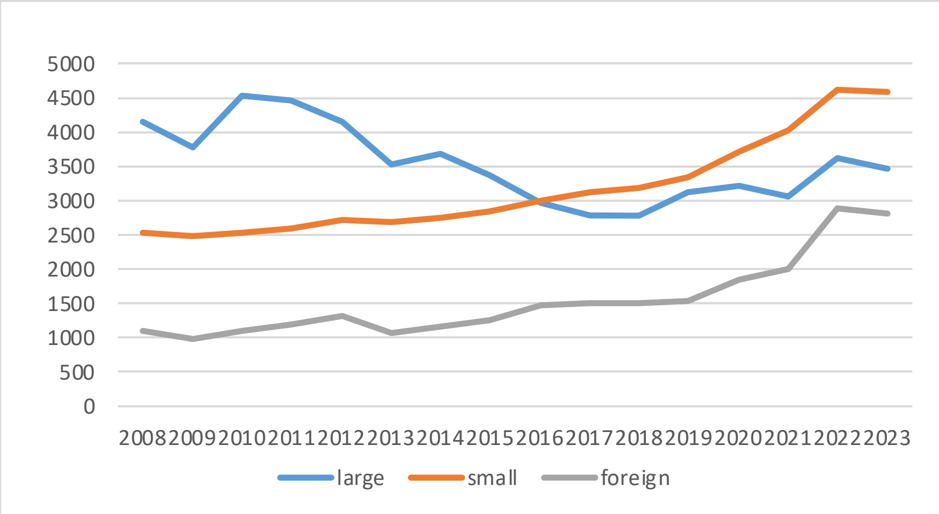
Figure 8: Aggregate Lending around the SSM implementation



Source: Haselmann et al. (2023) Figure 2.

Figure 9 illustrates a related trend for Germany. Large banks decreased their total assets after 2014, whereas small and foreign banks grew in size following the SSM's implementation.

Figure 9: Total Assets by banking groups in Germany (in EUR Billions)



Source: Bundesbank

Notes: The differentiation is done according to the specifications of Bundesbank, grouping together the Savings banks with credit cooperatives and regional banks (Small), as well as big banks with the Landesbanken, the regional institutions of credit cooperatives and mortgage banks (Large). The foreign banks consist of independent foreign banks or local branches of foreign banks.

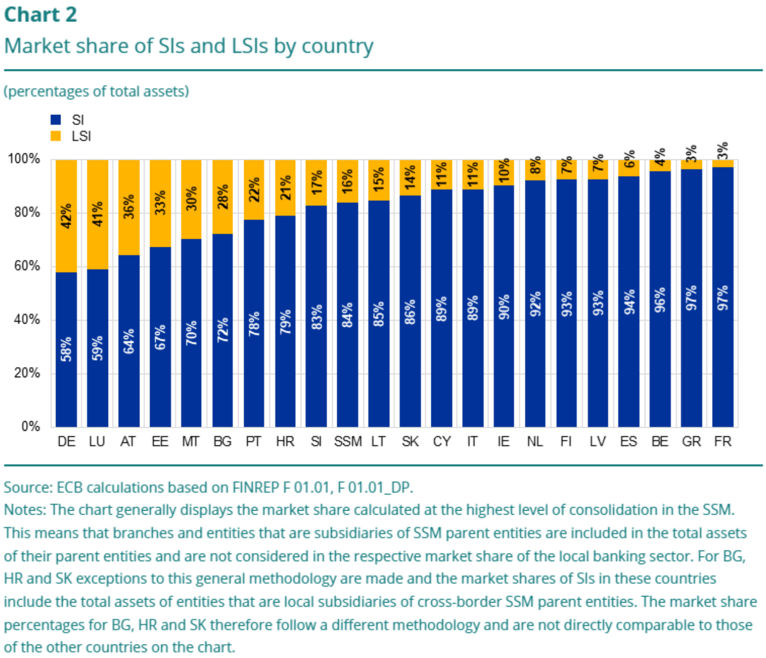
Similarly, Altavilla et al. (2020) and Altavilla et al. (2024) show that, compared to national supervision, supranational oversight reduces risk-taking by decreasing credit supply to high-risk firms, while promoting lending to low-risk firms.

In essence, the competitive edge of less significant banks and the consequential growth of their market share after the advent of the SSM has adverse effects on cross-border market integration. First, smaller banks typically pursue regionally focused business strategies; some are even compelled to do so by law.[2] They are thus relatively reluctant to expand across borders. Second, these institutions are typically very well-networked in domestic politics and thus benefit from preferential treatments by national governments, further incentivizing them to retain their local DNA. Third, distressed M&A transactions to reorganize failing smaller banks typically occur within the sector and thus nationally, clogging the potential for cross-border consolidation. Fourth, the heightened competitive pressure on large banks arguably reduces large banks' capacities and incentives to invest in risky cross-border expansion further.

The weight of the competition argument in explaining the shortcomings in cross border integration of euro area banking markets depends on the relative share of banks under NCA supervision. ECB (2022) highlights the strong country heterogeneity in Figure 10. The Less Significant Institution (LSI) sector has a market share of more than 30% in several countries (DE at the top with 42%, as well as LU, AT, EE, MT, and BG close but below), while making up only less than 5% of the banking sector in total assets in other large markets (FR with 3% at the bottom, together with GR, BE, and ES slightly above, at 6%).

[2] German cooperative banks (Genossenschaftsbanken) and savings and loans (Sparkassen) are a prominent example of this statutorily enshrined limitations, Haselmann et al. (2022).

Figure 10: Market share of SIs and LSIs by country



Source: ECB (2022)

3. CAPITAL MARKET UNION: LESSONS FROM THE BANKING UNION

Like the BU, the Capital Markets Union (CMU) is essential for Europe as it aims to create a more integrated and efficient financial market across EU member states. By harmonizing regulations and removing barriers to cross-border investments, the CMU aims to facilitate easier access to funding for businesses, particularly small and medium-sized enterprises (SMEs). A well-functioning CMU will enhance financial stability, diversify funding sources, and increase investment opportunities, ultimately strengthening Europe's global competitiveness and economic resilience.

The previous chapters have highlighted both the achievements of the BU and its remaining weaknesses, along with recommendations for addressing these challenges. This naturally leads to the question: to what extent can the CMU learn from the BU's experiences? How does BU impact CMU?

First and foremost, the BU cannot serve as a perfect blueprint for the CMU as both not just cover different markets, but also different targets. The BU primarily focuses on ensuring the stability and resilience of the banking sector by centralizing supervision, managing bank resolutions, and protecting depositors across member states. It mainly targets the banking market to address the potential negative externalities an unstable banking sector exerts on the entire economy. The BU therefore aimed at preventing financial crises and enhancing trust in the banking system, without which the maturity transformation by banks cannot work. In contrast, the CMU is supposed to broaden and deepen Europe's capital markets by integrating them into a single, more accessible market. It covers a wider array of financial markets, including equities, bonds and other investment vehicles, with the goal of diversifying funding sources, increasing investment opportunities, and fostering economic growth across the EU. While the BU strengthened the banking sector's stability, the CMU, when enacted, will enhance the overall financial ecosystem by promoting investment and innovation.

Despite these differences, we can draw two important lessons and one common denominator from the BU for the CMU:

3.1. Overbanking

Overbanking is not just a problem for bank integration (see section 2) but also hinders the development of the CMU. Overbanking in Europe significantly impacts the demand for capital market instruments by redirecting firms toward bank credit rather than the bond market or equity markets. Firms tend to rely heavily on banks for financing, which diminishes the demand for capital raised through bonds or equity. As a chicken or egg story, this reliance is partly due to the underdeveloped nature of the equity markets, where there is a lack of sufficient capital funds. As a result, firms opt for the more readily available bank loans, stifling the growth and development of a broader and more robust capital market ecosystem. The vicious cycle has as a result that the dominance of bank credit creates an environment where firms have limited incentives to explore or expand into alternative financing avenues, such as bonds or equity offerings circle reinforcing the need for bank funding.

On the supply side, overbanking constrains the development of capital markets by providing investors with access to capital market instruments primarily through banks. Banks, leveraging their close relationships with depositors, engage in low competition in the investment industry in Europe[3]. Additionally, the rents extracted by banks from mutual funds further restrain the growth of the European investment industry. These practices restrict the development of a competitive and transparent investment environment, thereby preventing the capital markets from expanding and maturing as they have in other regions, such as the United States.

Fee structures are often overlooked but are crucial for savings because of the impact of compounding interest over time.[4] A well-established CMU can help improve competition in the investment industry, reduce its dependence on the banking sector, and lower these fees, thereby reducing costs and potentially increasing household stock market participation. In this way, it would also potentially reduce wealth and income inequality, contributing to the mitigation of the pension gap in Europe.

3.2. Common supervisory authority

The experience of the Banking Union, and particularly the establishment of the SSM, demonstrates the critical need for a common supervisory authority within the CMU. The SSM provided a unified framework that addressed regulatory inconsistencies and enhanced the stability of the banking sector across the Eurozone. Similarly, the CMU would benefit from a centralized supervisory body to ensure consistent regulation and oversight across member states.

Based on Heider et al. (2024), there are several ideas on how a supervisory authority could be established. First, the new supervisory structure could be established as a centralized European Securities and Exchange Commission (Krahnen and Pelizzon (2020), Lagarde (2023)). Second, the ECB

[3] According to the Investment Company Institute (2023), since 2021, the asset-weighted average ongoing charge for an equity UCITS fund (1.21 percent) was more than double the asset-weighted average expense ratio for a US-registered equity mutual fund (0.47 percent) . This evidence is not so different from the EFAMA (2011)'s survey that suggests that the average European-domiciled retail equity mutual fund has a total expense ratio of 1.75% whereas a U.S. retail equity mutual fund has a total expense ratio of 0.95%.

[4] Two investors save EUR 10,000 per year for their pension. Investor A invests in an ETF with 0.08% annual fees, investor B invests in a mutual fund via its bank with 2% annual fees. Both investment products return 8% per year. After 40 years, investor's A retirement portfolio is at EUR 2.5 million, while investor's B is only at EUR 1.5 million, therefore short of EUR 1 million only due to its fee structure.

could also be considered as a supervisory authority by adding a new responsibility for overseeing capital markets, similar to its role in the SSM for banking (Friedrich and Thiemann (2017))[5].

An alternative approach to achieving market integration is through regulatory competition. This can lead to outcomes similar to those of a supervisory authority by allowing EU member states to compete in offering favorable regulatory environments, thereby promoting the harmonization of rules and practices across jurisdictions. This competitive dynamic encourages the development of efficient, investor-friendly markets, where the most effective regulatory frameworks naturally gain prominence, leading to a de facto standardization and integration of capital markets across the EU (Heider et al., (2024)).

The lesson from the Banking Union is clear: effective supervision demands a unified approach to overcome national disparities and achieve genuine financial integration. Therefore, the priority for authorities should be to finally reach a consensus on a single supervisory solution, as the success of the CMU depends more on establishing a common framework than on the specific choice among the three proposed options.

3.3. The common denominator: national interests as a barrier to financial market integration

National interests significantly hamper market integration within both the BU and CMU. In the BU, countries frequently protect their national bank champions, prioritizing domestic agendas over the broader goal of European financial integration. This protectionism creates obstacles to cross-border mergers, acquisitions, and the necessary consolidation for a truly unified banking market. Additionally, national interests influence resolution processes by often prioritizing the protection of domestic financial institutions, reducing the likelihood of cross-border resolution mechanisms.

Similarly, within the CMU, national authorities resist transferring regulatory power to a centralized European body, driven by a desire to maintain control over their domestic markets and to safeguard national financial systems, and EU member states do not accept the loss of sovereignty that follows from a true unified capital market (Heider et al., (2024)). These national agendas prevent the full realization of a cohesive and efficient financial system across Europe, undermining efforts to create a level playing field and limiting the potential benefits of deeper economic and financial integration.

4. CONCLUSIONS AND POLICY RECOMMENDATIONS

Banking Union policies over the last 10 years have been focused on the prudential side, driven by a paramount goal: making banks safe and sound. Many analyses have provided evidence that euro area banks are now much stronger (for example, Angeloni, 2020; Véron, 2024) than they were before the advent of the Banking Union. This is a reason why they sailed virtually unscathed through the pandemic recession of 2020-2022 and the 2023 banking turmoil (Angeloni et al, (2024)).

However, Banking Union's unidimensional focus on making large banks safe had a down-side as cross-border banking integration has not progressed. Ten years into the banking union, eurozone banking is still a loosely connected collection of national banking markets; its geographical structure is not much more united than before 2014. Even the euro area's supposed continental banking "champions" remain essentially national, and as a result small by international standards.

[5] While we favour the first idea, the second could be seen as an intermediate step. The ECB could use its reputation and credibility to establish an arm, separated from the SSM, which could become fully independent after the introductory phase.

Banking integration is a key component of the EU single market and a pivotal policy objective of the Banking Union. Lack of it prevents continental banks from growing and developing their full potential. This is a serious problem, especially now: the structural transformations that Europe is committed to (green, digital, strategic) cannot happen without the support of strong banks. Banking Union policy, therefore, has to refocus to propel a genuine, strong and continentally integrated banking market, albeit without compromising on Banking Union's prudential objectives.

Unblocking banking integration will involve concerted efforts from many sides, involving the regulatory, supervisory and resolution authorities. A precondition of all that, however, is to amend EU banking legislation to remove provisions, largely inherited from earlier legislation and never repealed, which prevent or discourage cross-border banking.

Angeloni (2024a) contains detailed suggestions on the legislative amendments needed. It also argues that cross-border banking in the Banking Union must be treated on the same footing as national banking today, so that legislation is "country-blind" for banks belonging to the Banking Union. This would strengthen the internal cohesion of large cross-border banking groups, ensuring intra-group support under stress and avoiding that subsidiaries in distress are "renationalized" and wound down using national taxpayer resources.

We share the main proposals presented in Angeloni (2024a). Critical elements are:

• Defining a set of structural and prudential criteria that need to be satisfied by the euro area banking groups that conduct, or realistically aspire to conduct, substantial cross-border business;

• Repealing or waiving the legal provisions that prohibit the free movement of capital, liquidity and other prudential resources within the banking groups belonging to this category;

• In parallel, strengthening the provisions that govern the internal support within those groups, making them mandatory and enforceable and prescribing that they should be activated, in case of distress, both before and after the entity reaches the point of non-viability;

• Establishing that these groups and/or the entities thereof, if declared failing-or-likely-to-fail by the supervisor, are resolved by the European resolution authority under the European Crisis Management and Deposit Insurance (CMDI) framework, not liquidated nationally;

• Prescribing that the deposit insurance function for these groups is performed by a dedicated scheme, industry-funded by the groups themselves, whereas the existing deposit insurance schemes retain their functions for banks having a predominantly national business focus.

These legal amendments have a clear conceptual goal: making the rules for cross-border euro area banks "country blind" and really European. Angeloni (2024b) argues that a European-integrated banking sector is an important precondition for establishing the CMU as well.

We propose one additional legislative reform that tackles the differential treatment of smaller (less significant) and large (significant) banks and its negative effect on market integration we identify in section 2. Submitting at least those banks that are linked through contractual or statutory arrangements that provide, inter alia, for mutual liquidity and solvency support, such as institutional protection schemes (IPS) to direct ECB supervison would critically level the playing field for euro area banks and reduce anti-competitive hurdles to cross-border banking we identify. Such a treatment of small, but connected banks as significant also aligns with the banking union's prudential objectives. The lessons from the US savings and loan crisis during the 1980s and 1990s and the banking turmoil of 2023 illustrate that uniform business models and risk taking decisions in a large fraction of small banks can also imperil financial stability.

What lessons can we draw from the BU for the CMU? It needs to be noted that the CMU has a distinct objective from the BU because it addresses a different aspect of the financial system. While the BU focuses on stabilizing the banking sector to prevent crises and protect depositors, the CMU aims to integrate and expand Europe’s capital markets. Its goal is not just to enhance stability but to foster a more diversified and innovative financial environment. By broadening access to various funding sources like equities and bonds, the CMU seeks to drive economic growth and competitiveness across the EU, which requires a different approach than the banking-centric focus of the BU.

Nevertheless, there are important similarities from which lessons can be learned:

- The CMU needs a **common supervisory authority** as the SSM for the BU. Authorities must prioritize reaching a consensus on a single supervisory solution, as the success of the CMU hinges more on finally establishing a common framework than on selecting among the proposed options.
- **Overbanking** does not just hinder cross-border bank integration, but also prevents the CMU from developing naturally.

The challenges of overbanking and the absence of a unified supervisory authority both stem from the same underlying root cause: national interests. Without a willingness to transfer national regulatory power, further progress in banking integration and the development of a true CMU remain highly unlikely.

Finally, it needs to be recognized that for the European financial system to function fully and efficiently, the CMU and the BU must coexist and support each other. The CMU plays a critical role in reducing overbanking by providing alternative funding sources outside of traditional bank credit, which helps to diversify and deepen financial markets. This reduction in overbanking is essential for the BU, as it alleviates the pressure on banks, allowing them to operate more sustainably, which makes cross-border integration more profitable and therefore more likely. Conversely, a strong BU is necessary for the CMU to thrive (Angeloni, 2024b), as it creates a stable banking environment that underpins the securitization of loans and other capital market activities, creating a virtuous cycle. In conclusion, the success of one depends on the success of the other, making their coexistence not just beneficial but essential for a truly integrated European financial system.

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Over the past decade, Banking Union (BU) regulators focused on making banks safer, resulting in stronger banks but limited euro area cross-border integration. To attain the strong and integrated financial system Europe needs going forward, BU authorities must now broaden their focus, promoting cross-border banking by removing legislative barriers that prevent or discourage it. That goal requires reducing overbanking and limiting the national authorities' regulatory power further. It also necessitates a Capital Markets Union (CMU) under a unified supervisory control. We argue that BU and CMU are complements in a strong and integrated European financial system, and that a successful launch of CMU presupposes progress towards an integrated BU
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