STUDY

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

EGOV

BANKING UNION

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Abstract

We address the role of the Banking Union (BU) in promoting market integration and the lessons it provides for the Capital Markets Union (CMU).

First, we tackle BU's establishment, exploring whether it has achieved its original goals and discussing its main shortcomings. Second, we address market integration in the BU. Third, we advance some proposals to finalise the BU accelerating effective market integration. Fourth, we explore various BU-CMU interconnections, introducing policy-related considerations to support the development of a well-functioning CMU.

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LIST OF ABBREVIATIONS

APSF	Action Plan on Sustainable Finance
AuM	Assets under Management
BRRD	Bank Recovery and Resolution Directive
BU	Banking Union
CMU	Capital Markets Union
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
DGSD	Deposit Guarantee Schemes Directive
DIB	Deposit Insurance Board
DIF	Deposit Insurance Fund
DGS	Deposit Guarantee Schemes
EBA	European Banking Authority
ECB	European Central Bank
EDIS	European Deposit Insurance Scheme
ELA	Emergency Liquidity Assistance
ESCB	European System of Central Banks
ESG	Environmental, Social, Governance
ESMA	European Securities and Markets Authority
ETFs	Exchange Traded Funds
EU	European Union
FOLF	Failing Or Likely to Fail (referring to banks)
GFC	Global Financial Crisis
GBs	Green Bonds

G-SIIs	Global Systemically Important Institutions
LOLR	Lender Of Last Resort
LOOP	Law Of One Price
M&A	Merger and Acquisitions
NCAs	National Competent Authorities
NCBs	National Central Banks
NPLs	Non-Performing Loans
NRAs	National Resolution Authorities
O-SIIs	Other Systemically Important Institutions
PIA	Public Interest Assessment
ROA	Return on Assets
SCV	Single Customer View
SMEs	Small and Medium-sized Enterprises
SRB	Single Resolution Board
SRF	Single Resolution Fund
SRI	Sustainable and Responsible Investment (referring to funds)
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
SVB	Silicon Valley Bank
T2S	Target2-Securities (platform)
TFEU	Treaty on the Function of the European Union
UK	United Kingdom (of Great Britain and Northern Ireland)
US	United States (of America)

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EXECUTIVE SUMMARY

This study investigates how the Banking Union (BU) can foster market integration and to what extent its experience can provide lessons for the development of the Capital Markets Union (CMU). In particular, the original goals of the BU are (re)-analysed to ascertain to what extent they have been achieved and what is still needed. We advance some proposals to support the finalisation of the BU, which are expected to be also instrumental to fostering integration of the banking market. Moreover, we explore the interplays between the BU and the CMU with a view to benefitting from BU's 10-year experience to support the proper creation of the CMU.

More specifically, the paper is divided into five parts.

Part 1 contains the introduction where we spell out the scope and objectives of this study (Section 1.1), we provide an overview of the Banking Union establishment and its objectives (1.2), we underline how the BU harmonised across member states convincingly supervisory – through the very successful implementation of the SSM led by the ECB – and to some extent also crisis management practices – with the creation of the SRM (1.3). However, we also lament the incompleteness of the Banking Union, especially the lack of development of EDIS and the unsatisfactory harmonisation of crisis management practices across the EU (1.4).

Part 2 goes more in depth in assessing the degree of integration of the banking markets after the (partial) completion of the Banking Union. Our view is that the BU has been largely successful, its peaks being reached with the mature and highly regarded SSM-based supervisory system, which has evolved from a backward- to a forward-looking perspective to assess financial and non-financial risks, to considering factors such as business models, board effectiveness, behaviour, and culture. As a result, European banks are now safer and more resilient, even though differences across Member States persist where cross-border activity remains low and the fragmentation of banking markets along national lines remains cause for supervisory concern (Section 2.1). Moreover, the limited degree of market integration within the BU is highlighted by the significant variance in terms of interest rates especially for household loans (2.2). And M&A activity in the Euro Area has slowed down substantially, particularly with regard to large operations, indicating that so far the SSM and the SRM have had little impact on the structure of the banking industry and most recent M&A deals have been domestic rather than cross-border (2.3).

Part 3 discusses ways to enhance the stability of the European banking sector. First, we review a set of possible actions to finalise the BU (3.1), where we focus on remedying the lack of EDIS and centralising emergency liquidity assistance (ELA). In particular, we explain the issues resulting from the lack of EDIS and outline some considerations that might speed up the process to progress the implementation of EDIS if and when related legislation will enter into force (3.2.) Next, after revisiting the criticality of ELA to avoid depleting the value of the banking system in case liquidity crises at some banks could otherwise unduly degenerate into solvency crises (Subsection 3.3.1), we explain why, in practice, ELA has failed to be centralised at BU-level, i.e., because of the existence of ELA national ceilings (3.3.2). On the same line, we stress the inconsistencies of the ELA framework currently in place, advocating in favour of a reinterpretation of the legal framework currently in force (3.3.3).

Part 4 focuses on the Inter-connection between Banking Union and Capital Markets Union. After describing the framework of the BU and CMU (4.1), we advance some policy proposals to advance both the Banking Union and Capital Markets Union (4.2.).

The main lesson to be learnt from the BU experience is that identifying a central EU-level supervisor and entrusting it with an adequate level of power is needed in order to defend the CMU from

competing national interests and promote the various needed standardizations. The most obvious solution would be assigning that role to a strengthened ESMA as suggested directly or indirectly by experts, and by other relevant European institutions or associations. Hence, we propose increasing the powers of the European Securities and Markets Authority (ESMA), to ensure consistent application of rules across member states, e.g., giving ESMA more authority by:

- Creating a Pan-European Capital Markets Regulator
- Enhancing ESMA's Capacity for Data and Digitalization
- Granting ESMA Direct Supervisory Powers Over Key Capital Market Activities and actors
- Strengthening ESMA's Role in Sustainable Finance
- Reinforcing ESMA's Role in Cross-Border Investor Protection
- Increasing ESMA's Budget and Staffing
- Coordinating ESMA with Other European Supervisory Institutions

Finally, before summarising the main thrust of the paper in Section 5, we delve into how sustainability and green finance could reignite the BU-CMU mutual support (4.3). In particular, after underlining that sustainable finance has been for several years now the most dynamic part of finance, we claim that the complementarity of CMU and BU to support the Green Transition is visible already by taking a glimpse at the blueprint of the Action Plan on Sustainable Finance (APSF). Moreover, the fact that BU preceded CMU and that, as mentioned, BU possessed a strong institutional anchor while CMU misses it, concocted a situation in which at times the phasing in of APSF-related regulation related to the APSF seems to have moved more swiftly on banking than on markets or on disclosure. The existence of such a timing mismatch across the various regulations and business practices involved has been identified as a critical point behind the application of APSF by some authors, because of lack of overall consistency or simply lack of data. A final critical point we flesh out is the reliability of ESG data, where the EU could find itself in the inconvenient position of being anchored to the ESG metrics – which have been introduced into EU regulation following the APSF – and yet being dependent on measuring the ESG it uses depending on the services of the global rating agencies which are based in the US, where the ESG metrics may be living a phasing out. This looks like a possible contradiction on which ESMA might be called to ponder. Fortunately, however, the introduction of the EU Green Taxonomy may now be reducing the risk of greenwashing, but that does apply neither to the risk of social washing – where the EU Social Taxonomy is lagging behind – nor to that of governance-washing.

1. INTRODUCTION

1.1. Scope and objectives of this study

This study focuses on the Banking Union, looking at how it can foster market integration, and to what extent its experience can provide lessons for the development of the Capital Markets Union.

In engaging in this analysis, this study, in Part I, deals with the establishment of the Banking Union, exploring whether its original goals have been achieved and to what extent and discussing its main shortcomings. Part 2 focuses on market integration in the Banking Union, while part 3 advances some proposals to finalise the Banking Union project, which are key also to enable effective market integration. Part IV explores the several interconnections between the Banking Union and the Capital Markets Union, introducing policy-related considerations with a view to supporting the development of a well-functioning Capital Markets Union. Part V concludes.

1.2. Overview of the Banking Union establishment and its objectives

The Banking Union (BU) is considered one of the most ambitious European projects since the creation of the single market and, later on, of the single currency.[1] Its conceptual pillars are centralisation at European level of bank supervision and crisis management, on one side, and mutualisation of deposit insurance, on the other side. Through centralisation of oversight functions and mutualisation of financial resources, the ultimate goal is to facilitate the integration and enhancement of the European banking system, while eradicating the vicious link between sovereign(s) and their national banking system(s).[2]

The Banking Union is a key component of the Economic and Monetary Union. It was created as a response to the Global Financial Crisis (GFC) of 2007-2008 and the ensuing Euro Area sovereign debt crisis of 2010-2012 to ensure that the banking sector in participating countries (and the wider EU) is stable, safe and reliable, thus contributing to financial stability. The BU is intended to make the banking system more robust and able to withstand future financial crises, allow the resolution of non-viable banks without using taxpayers' money and with minimal impact on the real economy, and reduce market fragmentation.

Every Euro Area Member State is part of the Banking Union, while non-Euro Area EU Member States can join the Banking Union by entering into close cooperation with the European Central Bank (ECB). This was the case of Bulgaria and Croatia, which joined the BU in 2020.

According to the original project, the three pillars of the Banking Union were meant to be: 1) the Single Supervisory Mechanism (SSM), 2) the Single Resolution Mechanism (SRM), and 3) the European Deposit Insurance Scheme (EDIS). The SSM is a system of banking supervision that comprises the ECB and national supervisors, known as national competent authorities (NCAs), of the participating countries. The SRM is a system of bank crisis management that comprises the SRB and the national resolution

[1] On Banking Union see *ex multis* Moloney, N. (2014). European Banking Union: Assessing its Risks and resilience. Common Market Law Review, 51, 1609-1670; Binder, J. H. (2015). The Banking Union and the governance of credit institutions: a legal perspective. European Business Organization Law Review, 16, 467-490; Nielsen, B. S. (2015). Main Features of the European Banking Union. European Business Law Review, 26, 805-822; Nieto, M. (2015). Banking on Single Supervision in the Eurozone: Skepticism and a Reform Proposal. European Business Organization Law Review, 16, 539-546; Ferrarini, G. (2015). Single supervision and the governance of banking markets: will the SSM deliver the expected benefits? European Business Organization Law Review, 16(3), 513-537.

[2] See Bodellini, (2022). The Banking Union in the Aftermath of the COVID-19 Pandemic: An Incentive to Finalise the Project? in Gimigliano, G., & Catellan, V. (eds.), *Money Law, Capital, and the Changing Identity of the European Union,* Hart Publishing, Oxford, *passim*.

authorities (NRAs) of the participating countries. The EDIS is the proposed centralised deposit guarantee scheme financed by banks established in the participating countries, intended to provide equivalent protection to every depositor regardless of bank location.

The new institutional architecture is built upon the "single rule book", which is a set of harmonised rules applying to credit institutions established in the EU. The most relevant pieces of legislation in this regard are the Capital Requirements Directive (CRD)[3] and Capital Requirements Regulation (CRR)[4] package, the Bank Recovery and Resolution Directive (BRRD)[5] and the Deposit Guarantee Schemes Directive (DGSD).[6]

1.3. Harmonising supervisory and crisis management practices across member states

With the creation of a centralised system of supervision based on close cooperation between the ECB and NCAs, the goal was to ensure consistent supervision of every bank in the BU and tackle the issue of supervisory forbearance ontologically embedded in domestic supervision.

In the new framework, the ECB supervises the banking sector from a European perspective by establishing a common approach, taking harmonised actions and corrective measures and ensuring the consistent application of regulations and policies. This means that the ECB, in cooperation with NCAs, is responsible for ensuring that banking supervision is effective and consistent across the BU. In practical terms, the ECB has the authority to a) conduct supervisory reviews, on-site inspections and investigations, b) grant or withdraw banking licences; c) assess banks' acquisition and disposal of qualifying holdings, d) ensure compliance with EU prudential rules, e) set higher capital requirements (buffers) to counter any financial risks.

To make the system more effective, credit institutions have been grouped into two categories: significant institutions and less significant institutions.[7] The former (over one hundred institutions holding almost 82% of banking assets in the participating countries) are directly supervised by the ECB, while the latter continue to be supervised by their NCAs in close cooperation with the ECB, which can decide at any time to draw them under its direct remit to ensure that supervisory standards are applied consistently.

The SRM, in turn, is a system of cooperation between the SRB and participating countries' NRAs, whose main purpose is to ensure the efficient resolution of failing or likely to fail (FOLF) banks with minimal cost to taxpayers and to the real economy. The SRB supervises the system and has been given powers allowing it to execute -in close cooperation with NRAs- bank resolution over a weekend. A Single Resolution Fund (SRF), financed through contributions paid by banks, has been created to support

[3] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

[4] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

[5] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms [2014] OJ L 173/190.

[6] Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes.

[7] The criteria to qualify institutions as significant are: a) total value of assets exceeding EUR 30 billion; b) economic importance for the specific country or the EU economy as a whole; c) total value of assets exceeding EUR 5 billion and ratio of cross-border assets/liabilities in more than one other participating Member State to total assets/liabilities above 20%; d) institution has requested or received funding from the European Stability Mechanism or the European Financial Stability Facility; e) an institution can also be considered significant if it is one of the three most significant banks established in a particular country.

resolution measures. The scope of application of the SRM reflects that of the SSM, and the criteria for the distribution of tasks between the SRB and NRAs are also rather similar, with the former in charge of handling crises involving significant and cross-border institutions (and groups), and the latter in charge of less significant institutions (and groups).

The creation of the SRM is closely connected with the adoption of the BRRD, which, by implementing the Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions,[8] has introduced a new administrative procedure, called resolution, to handle a bank crisis when a number of requirements are met.[9]

1.4. The incompleteness of the Banking Union

Yet, over ten years after the establishment of its first component, i.e. the SSM,[10] the BU project is still incomplete, and some important parts are missing. While centralisation of bank supervision has been fully accomplished with the involvement of the ECB within the SSM, crisis management functions have been assigned to a new European agency, the Single Resolution Board (SRB), acting as the central authority of the SRM.[11] However, the SRB is only in charge of the resolution of institutions under its remit, to be executed by the NRAs pursuant to national law.[12] This means that FOLF[13] credit institutions that do not meet the public interest assessment (PIA)[14] for being submitted to resolution will be placed into insolvency proceedings under national laws,[15] which are not harmonised at European level and are managed by the domestic (either administrative or judicial) authorities of the jurisdiction concerned.[16]

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8 Financial Stability Board (2014). Key Attributes of Effective Resolution Regimes for Financial Institutions, 15 October, *passim*.

9 See article 32 paragraph 4 of the Directive 2014/59/EU.

10 The legal foundations of the SSM are Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, and Regulation (EU) No 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities (SSM Framework Regulation) (ECB/2014/17).

11 The legal basis of the SRM is Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010.

12 According to article 2(1)(1) of the BRRD, 'resolution means the application of a resolution tool or a tool referred to in Article 37(9) in order to achieve one or more of the resolution objectives referred to in Article 31(2)'.

13 According to article 32 paragraph 4 of the Directive 2014/59/EU, 'an institution shall be deemed to be failing or likely to fail in one or more of the following circumstances: (a) the institution infringes or there are objective elements to support a determination that the institution will, in the near future, infringe the requirements for continuing authorisation in a way that would justify the withdrawal of the authorisation by the competent authority including but not limited to because the institution has incurred or is likely to incur losses that will deplete all or a significant amount of its own funds; (b) the assets of the institution are or there are objective elements to support a determination that the assets of the institution will, in the near future, be less than its liabilities; (c) the institution is or there are objective elements to support a determination that the institution will, in the near future, be unable to pay its debts or other liabilities as they fall due; (d) extraordinary public financial support is required except' in a few cases.

14 See Bodellini, M. (2019). Impediments to resolvability: critical issues and challenges ahead. Open Review of Management, Banking and Finance, 5 48, where it is underlined that the PIA aims at ascertaining whether the resolution of a failing or likely to fail institution is considered to be needed in the public interest.

15 According to article 32 of the BRRD, 'Member States shall ensure that resolution authorities shall take a resolution action in relation to an institution referred to in point (a) of Article 1(1) only if the resolution authority considers that all of the following conditions are met: (a) the determination that the institution is failing or is likely to fail has been made by the competent authority, after consulting the resolution authority or; subject to the conditions laid down in paragraph 2, by the resolution authority after consulting the competent authority; (b) having regard to timing and other relevant circumstances, there is no reasonable prospect that any alternative private sector measures, including measures by an IPS, or supervisory action, including early intervention measures or the write down or conversion of relevant capital instruments and eligible liabilities in accordance with Article 59(2) taken in respect of the institution, would prevent the failure of the institution within a reasonable timeframe; (c) a resolution action is necessary in the public interest pursuant to paragraph 5'.

16 See Bodellini, M. (2021). The Optional Measures of Deposit Guarantee Schemes: Towards a New Bank Crisis Management Paradigm? European Journal of Legal Studies 13, 341.

The lack of a harmonised regime for bank insolvency remains a crucial issue, further exacerbated by the fact that, under the current regime, the majority of banks, in the event of being FOLF, will likely be subject to liquidation (and not to resolution). In a similar vein, mutualisation of deposit insurance through the establishment of the EDIS has not yet been achieved due to differing positions and views among Member States; therefore, deposit insurance exists only at national level on the grounds of various domestic provisions transposing the DGSD. Crucially, also emergency liquidity assistance is provided by national central banks and not by the European Central Bank.

The incompleteness of the Banking Union causes that the reliability of credit institutions, and thus the safety of deposits, still depend, to a large extent, on the public finances of the Member State(s) where they are based. This also determines that the objectives of removing the vicious link between sovereign(s) and national banking sector(s) and of integrating the European banking sector have not yet been achieved and will not be achieved until a fully-fledged mutualised EDIS becomes operational, the bank insolvency regimes are harmonised and emergency liquidity assistance is provided centrally.

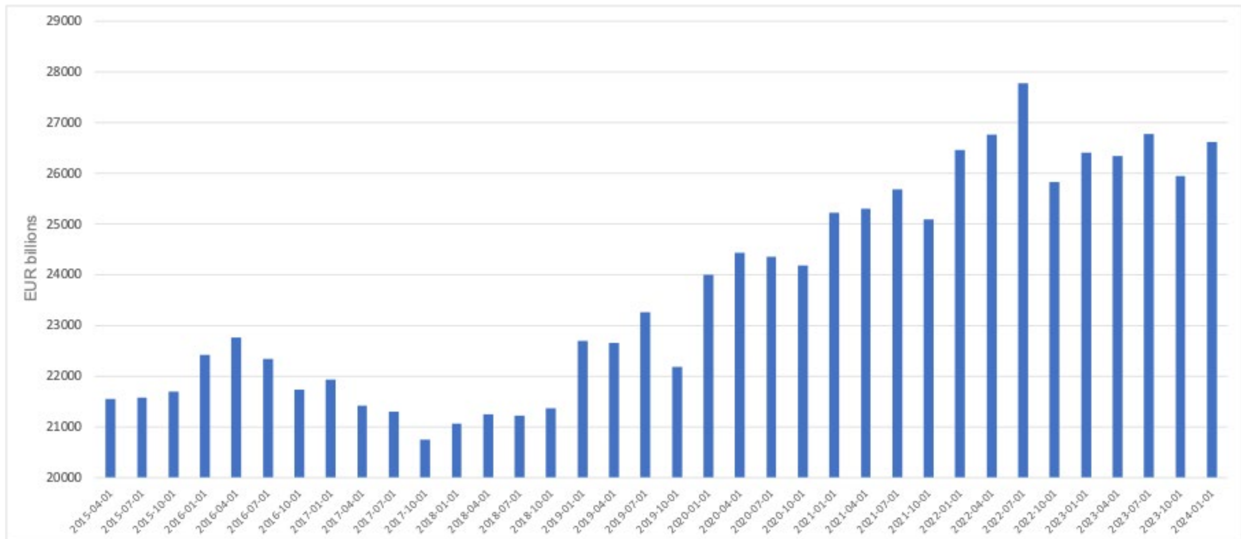
This critical situation is likely to be further exacerbated by the impact of several exogenous forces, such as the long-term effects of the economic crisis provoked by the Covid-19 pandemic, geo-political tensions, rising inflation and the restrictive monetary policy measures implemented by several central banks to tackle it, as well as the risk of recession already materialising in some countries. Such forces are expected to affect, sooner or later, also credit institutions (and the financial system more in general) through, *inter alia*, an increasing stock of non-performing loans and other assets losing their value as well as lower revenues in turn possibly causing banks to suffer losses. In light of these concerns, Member States should try and make the most out of the current situation to strike a meaningful political compromise to bring about completion of the BU.

2. INTEGRATION IN EU BANKING MARKETS

2.1. Market integration in the Banking Union

The Banking Union has been largely successful. Ten years since its inception, the SSM has developed into a mature and highly regarded supervisory system. The approach to banking supervision has also evolved, shifting from a predominantly backward-looking focus towards a more forward-looking perspective that encompasses a comprehensive assessment of both financial and non-financial risks. Increasing attention is now given to factors such as business models, board effectiveness, behaviour, and culture. Additionally, supervision has been enhanced by incorporating various methods, including benchmarking, risk culture assessments, in-depth thematic reviews, interviews, surveys, and questionnaires.

Figure 1: Total banking assets SSM countries (2015 - 2024 Q1)

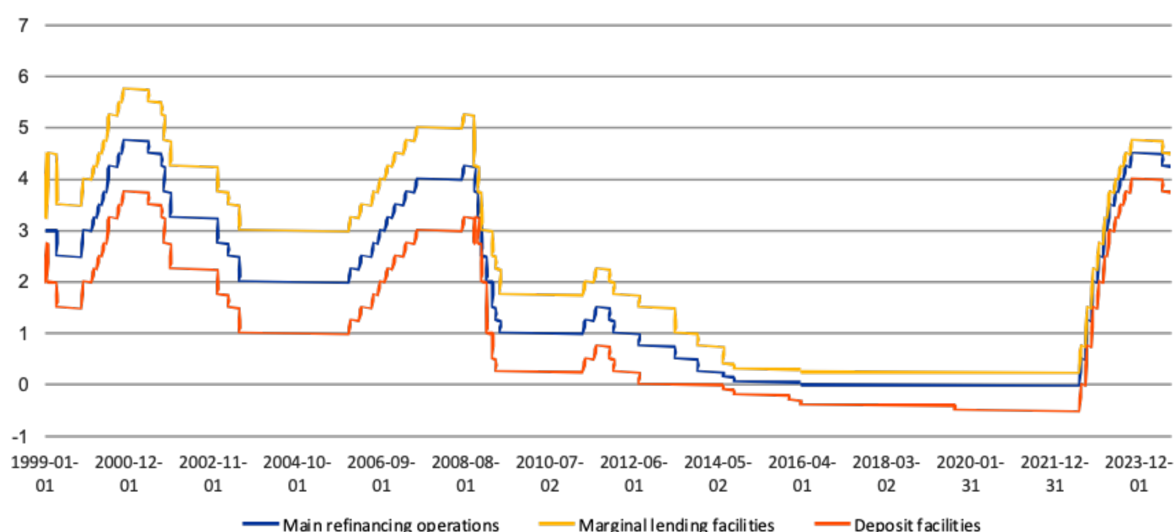


Source: data.ecb.europa.eu

As a result, European banks are now safer and more resilient, even though differences between Member States persist. Supervision has become more uniform and consistently applied, ensuring a level playing field, greater transparency, and enhanced accountability across the banking sector. Despite the resilience during the COVID-19 pandemic and increased geopolitical risks, progress on financial integration in the euro area has been slow.

The size of the euro area financial sector, in terms of total assets, has contracted in the post-pandemic period (see Figure 1), reflecting changes in economic and financial conditions, including decreased borrowing from banks due to interest rates increases and tighter credit standards (see Figure 2).

Figure 2: Key ECB interest rates (1999 - 2024Q1)



Source: data.ecb.europa.eu

Cross-border activity remains low and the fragmentation of banking markets along national lines remains cause for supervisory concern.[17] The volume of cross-border loans or deposits within the euro area, the penetration of foreign banks, and the number of cross-border merger and acquisition operations in the banking industry have not increased much since the creation of the BU.

It is a long-held belief of EU regulators that a well-integrated financial system is necessary to increase the efficiency of the euro area economy by reducing the cost of capital and improving the allocation of financial resources. In addition, greater integration should increase competition and provide borrowers and lenders with a larger set of products and services. Integrated financial markets should also increase opportunities to diversify idiosyncratic risks and therefore contribute to financial stability. For example, a geographically diversified loan book and deposit base can reduce banks' exposure to domestic shocks.

Nonetheless, integrated financial markets can transmit shocks and volatility and internationally active financial institutions need to be supervised and regulated more comprehensively, through common risk monitoring, risk prevention and risk mutualisation.

2.2. Measuring financial integration

Financial integration is a broad concept, and the literature puts forward several definitions. The measurement of integration is of significant policy relevance. A number of studies rely on *de jure* measures of integration, that is, the legal and regulatory changes to promote the flow of capital, goods and services cross-borders. Other studies consider *de facto* measures of integration, based either on quantities (for example, the size of foreign investments) or prices (the degree of synchronisation of asset prices across different markets).

[17] Enria, A. (2023). The integration of the EU banking sector and the challenges of global competition. https://www.bankingsupervision.europa.eu/press/interviews/date/2023/html/ssm.in230913~d990592ae3.en.html.

In this context, an integrated financial market can be defined as a market where participants with the same relevant characteristics: (a) face a single set of rules; (b) have equal access to financial instruments and/or services; and (c) are treated equally when they are active in the market.[18] The above definition of financial integration is closely related to the law of one price (LOOP), which states that if assets have identical risks and returns, then they should be priced identically, regardless of where they are traded. Based on the law of one price, it is possible to derive measures of integration. For example, the cross-sectional dispersion of relevant variables (such as interest rate spreads or asset return differentials) is often used as an indicator of integration.[19]

Traditionally, reporting on EU financial integration has considered (i) quantity-based; (ii) price-based and (iii) news-based measures of convergence. Quantity-based measures consider the actual cross-border banking flows and cross-border banking consolidation. Price-based models consider variables such as interest rates. Finally, news-based measures are based on the view that under full financial integration, asset prices should react to the same news, for example monetary policy announcements.

Early works on integration consider the cross-border operation of retail banks, the convergence of retail interest rates for mortgages and personal loans, and cross-border mergers. Convergence methodologies are then applied (Phillips and Sul, 2007; Rughoo and Sarantis, 2012).

Building on the LOOP, Gropp and Kashyap (2010) develop a test of integration based on convergence in bank profitability, proxied by the return on assets (ROA), and emphasise the role of an active market for corporate control and of competition for retail banking markets integration.

Hoffmann et al. (2020) develop composite indicators of financial integration within the euro area for both price-based and quantity-based indicators covering money, bond, equity and banking markets. For money, bond and banking markets, each price-based indicator is built by invoking the law of one price. They find an increase in financial integration in Europe between 1995 and 2007, followed by a drop due to the global financial crisis. The trend reversed in 2012, with integration recovering more strongly when measured by price indicators. They also find that intra-EU financial integration is (on average) positively associated with economic growth across the currency union. The effect is economically significant, with an increase of 0.1 in the composite indicator implying 0.35% higher annual growth on average.

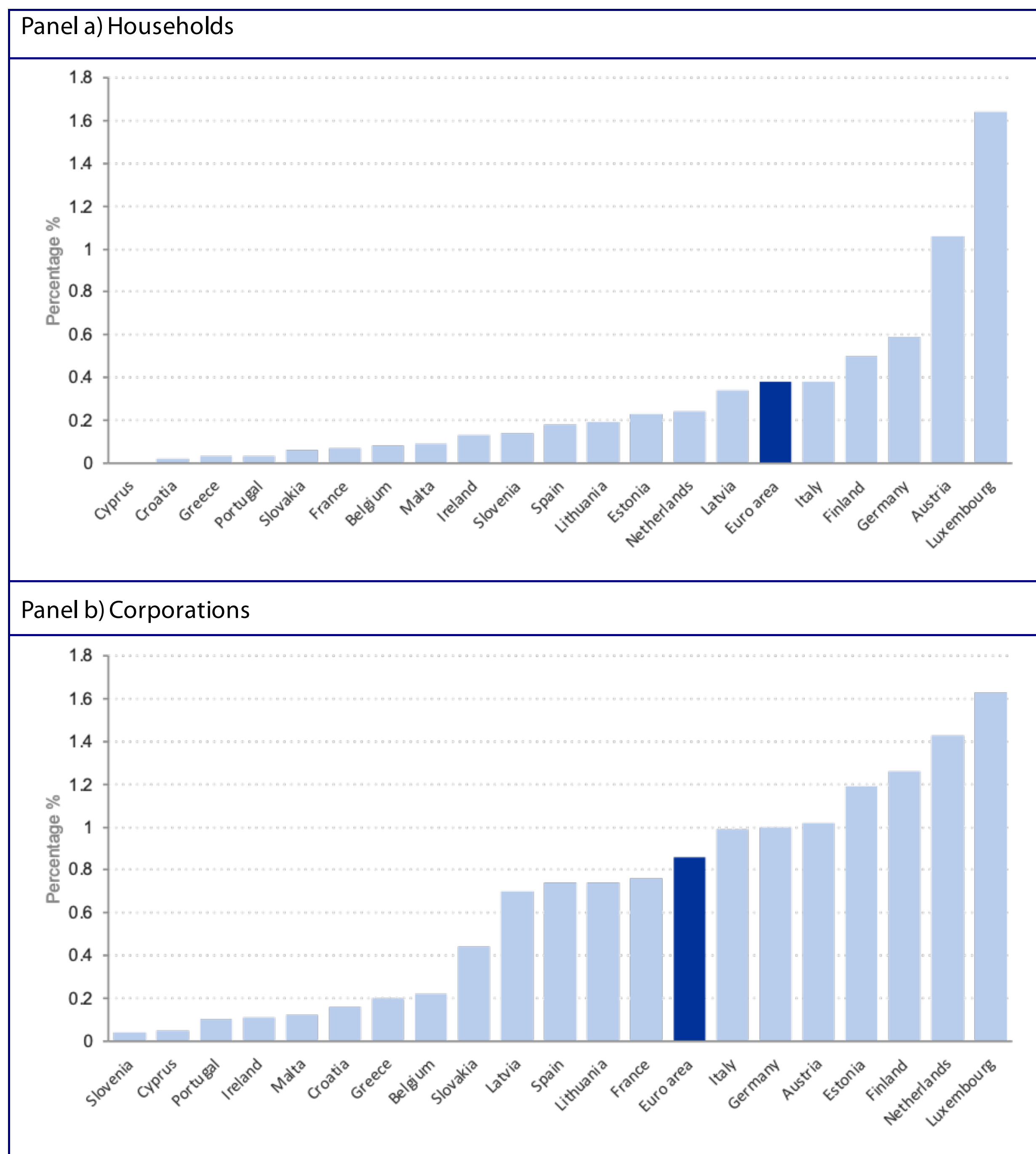
Kleimeier and Sander (2022) investigate retail banking markets integration before, during and after the eurozone financial crisis by employing bi-directions Granger causality indicators for heterogeneous banking markets. They show that the damage of the crisis to deep European integration has been long lasting. The authors conclude that their results support the view that creating a full Banking Union is vital to achieving financial integration.

For banking markets, integration measures typically consider the cross-country dispersion of bank lending rates and deposit rates to households and corporates. Figure 3 illustrates the spread of deposit rates to households and corporations as per June 2024, using data from the ECB. The average EU overnight deposit rate for households is 0.38% (ranging from 0% in Cyprus to 1.64% in Luxemburg) and 0.86% for corporations (ranging from 0.04 in Slovenia to 1.63 in Luxemburg).

[18] European Central Bank, 2008, Financial integration in Europe, April.

[19] See Baele, L., Ferrando, A., Hördahl, P., Krylova, E., & Monnet, C. (2004). Measuring financial integration in the euro area (No. 14). ECB occasional paper. See Donadelli, Gulfer and Paradiso (2024) for a review of the literature on financial integration.

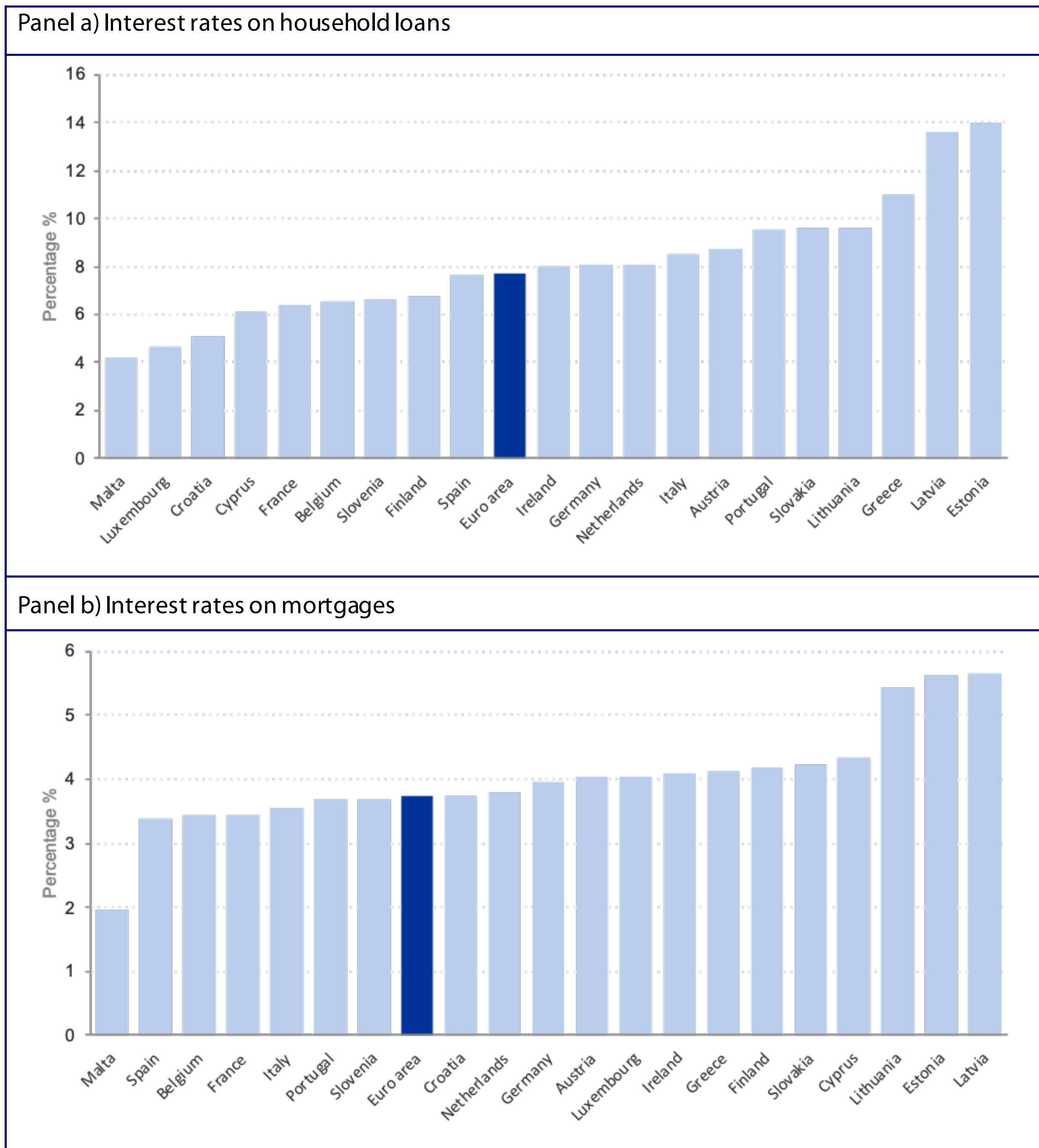
Figure 3: Overnight deposit interest rates (June 2024)



Source: data.ecb.europa.eu

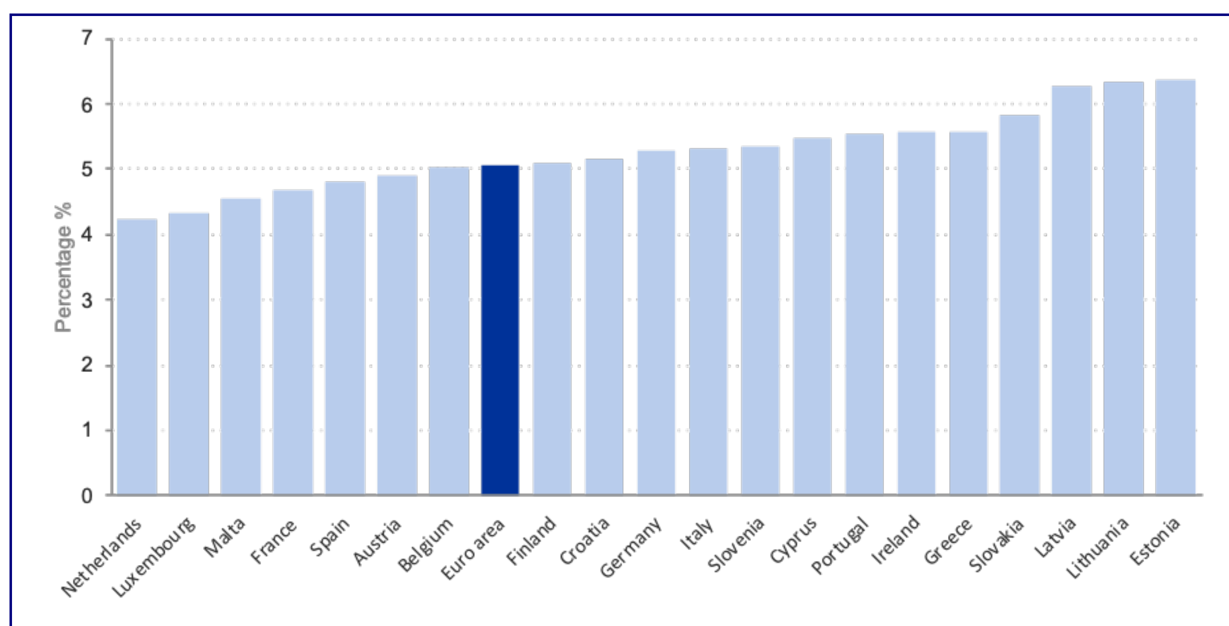
Notable variation exists in the cost of household loans (Figure 4, panel a); whereas there is more convergence in terms of mortgage rates (with the exception of Estonia, Lithuania and Latvia) (Figure 5, panel b) and in the composite cost of borrowing for corporates (Figure 5).

Figure 4: Interest rates on loans to households and corporates (June 2024)



These differences highlight the lack of a truly integrated EU banking market. Dermine (2006) points out that interest rate convergence might be misleading if the underlying lending risks in countries differ. Essentially, a lack of integration can be inferred if disparities in lending risks arise due to divergent national legal systems, even if regulatory standards are harmonised across the eurozone.

Figure 5: Composite cost of borrowing for corporates



Source: data.ecb.europa.eu

2.3. Bank M&As in the Euro Area

Regulators often consider bank M&As as an option for reducing overcapacity but also as a driver for financial integration. The literature indicates that consolidation can improve diversification, increase banks' access to international capital markets and decrease their cost of funding and facilitate the build-up of loss absorption capacity. Nonetheless, M&A activity in the Euro Area has slowed down substantially, particularly with regard to large operations.[20] Evidence to date indicates that the SSM and the SRM have had little impact on the structure of the banking industry and most recent M&A deals have been domestic rather than cross-border.

The literature on cross-border M&As relates mostly to studies of the 1990s and early 2000s (Berger, DeYoung, Genay and Udell, 2000; Focarelli and Pozzolo, 2001; Beck, Demirguc-Kunt and Maksimovic, 2004) and finds that banks engaged in M&A activities as acquirers tend to be more profitable banks. DeYoung, Evanoff and Molyneux (2009) present a review of the post 2000 literature and find that European bank mergers resulted in efficiency gains and increased shareholder value. A comprehensive review of the more recent literature can be found in Chiaramonte, Dreassi, Pisera' and Khan (2023). While evidence of the aggregate effect of M&As on bank performance yields mixed results, when M&As operations leverage strategic similarities, they can foster efficiency gains, including scale and scope efficiencies.

There are several obstacles to further consolidation. The first relates to the industry structure. Most Euro Area banks, including those designated as 'significant' and directly supervised by the ECB within the SSM, are not listed companies. There is still a large presence of mutual and savings banks that cannot be taken over though ordinary M&A transactions, thereby reducing the potential for further consolidation.

[20] ECB (2021) Financial Stability Report.

The second issue relates to national regulation. Banks cannot leverage the benefits of cross-border consolidation if national supervisors continue to ring-fence liquidity and capital at the domestic level (Schoenmaker and Veron, 2016). Banks looking to expand cross-border still need to deal with a vast array of different domestic regulations in host countries (for example state aid rules), as well as with very diverse tax and insolvency regimes. Harmonisation on these fronts would foster bank integration.

In addition, some features of the current regulatory regime can create disincentives for cross-border mergers. For example, buffer requirements for global systemically important institutions (G-SIIs) and other systemically important institutions (O-SIIs) in the Capital Requirement Directive (CRD), designed to improve financial stability, could have unintended consequences.

As O-SIIs are determined as a function of a bank's systemic relevance, as captured by the O-SII score, compared to the domestic banking sector,[21] the O-SII buffer requirement for a merged bank can vary significantly, depending on the location of the bank's head office. The buffer size may be affected by country-specific heterogenous buffer settings and surcharges for cross-border exposure within the BU[22].

3. ENHANCING THE STABILITY OF THE EUROPEAN BANKING SECTOR

3.1. Actions needed to finalise the BU

The finalisation of the BU original project needs, on one side, centralisation at European level of some crucial functions, such as deposit insurance and provision of emergency liquidity assistance, and harmonisation of the bank insolvency regime, on the other side. The completion of the Banking Union is expected to enhance the stability of the European Banking system and to further integrate it, also through more numerous cross-border M&A transactions. This assumption rests on some main arguments. From a theoretical perspective, for a banking market to be integrated, the scope of its safety-net should match the scope of the market to integrate. This aspect was highlighted by Dirk Shoenmaker who coined the expression "financial trilemma" to refer to the situation where the European banking system and its institutional architecture found themselves before the creation of the Banking Union. In Shoenmaker's opinion, in a complex jurisdictional domain, such as the EU, financial stability, an integrated banking and financial market and national supervision cannot co-exist. Since financial stability is considered a public good of primary importance and an integrated banking and financial market is deemed instrumental to supporting economic growth and development, a decision had to be made to centralise the safety-net components at European level through the involvement and empowerment of European bodies.

While centralisation has been fully achieved with regard to bank supervision and partially with regard to crisis management, this has not been the case so far with regard to deposit insurance, emergency liquidity assistance and bank liquidation. Decentralisation at national level of those key functions hampers the finalisation of the BU and thereby the integration of the banking market. Particularly, the lack of a centralised and mutualised deposit insurance system renders banks located in member states with less solid fiscal positions weaker than institutions based in member states which are stronger in that respect. Going forward, in a currency union this might give incentives to (the most sophisticated)

[21] Guidelines on the criteria to determine the conditions of application of Article 131(3) of Directive 2013/36/EU (CRD) in relation to the assessment of other systemically important institutions (O-SIIs) (EBA/GL/2014/10), European Banking Authority, December 2014.

[22] European Central Bank (2021). Bank mergers and acquisitions in the euro area: drivers and implications for bank performance, Financial Stability Review, November.

depositors to move deposits to banks located in the strongest member states, thereby negatively affecting banks located in less solid member states. The latter might thus end up becoming targets for take-over operations rather than being involved in market-driven cross-border mergers and acquisitions. Such a situation is at odds with the goal to foster market integration.

The argument concerning centralisation of ELA provision is, to a certain extent, similar, as banks located in economically and fiscally solid member states can benefit more from their NCB's ability to provide them with liquidity support to the detriment of banks located in member states finding themselves in more difficult positions.

Such misalignments among member states could be effectively tackled through centralisation of the related functions to be exercised by European bodies. This in turn would further support market integration removing national inefficiencies and levelling the playing field.

While a discussion on harmonisation of bank insolvency regimes can be found in Avgouleas et alii (2023) in the following sections we focus on EDIS and on emergency liquidity assistance.

3.2. European Deposit Insurance Scheme

In 2015, the European Commission made a proposal for a regulation to create a European Deposit Insurance Scheme (EDIS), a deposit insurance board (DIB) and a deposit insurance fund (DIF) to guarantee deposits in the EU. According to this proposal, EDIS would replace national deposit guarantee schemes (DGS) progressively. In 2017, the Commission called for the completion of all parts of the banking union by 2018 to deliver its full potential to ensure stability and resilience to shocks. In December 2022 a joint declaration by the EU institutions confirmed the need to reach an agreement on EDIS. That agreement has not been reached yet.

Deposit insurance in the EU is regulated under the DGS Directive of 2014 . The Directive requires EU Member States to have a deposit insurance scheme to which all banks must join to guarantee a harmonised level of deposit protection. The directive has introduced a harmonised level of coverage of 100.000 Euro for the aggregate deposits of a depositor in the same bank; it also regulates the types of protected deposits, period of repayment in the event of bank failure (up to seven business days applicable as of January 2024), the financing of the DSG by the bank themselves depending on their business models and risk profiles (a target level of 0.8% of total deposits covered by the DGS by 3 July 2024), the use of funds available to DGS, and information available to depositors on annual basis.

During the 2007-08 financial crisis, as was showed by Ayadi and Lastra (2010), several EU authorities provided unlimited guarantees to depositors to avoid the contagion effect, while others increased the deposit coverage limits from 20.000 Euro to 100.000 Euro, a limit that was later on set by the 2014 DGS directive. However, it was evident that these actions neither succeeded to calm market disquiet nor prevented bank runs. Governments had to resort to massive liquidity injections, coupled with fiscal stimulus and quantitative easing to restore confidence.

The recent collapse of Silicon Valley Bank (SVB) in the US and other mid-sized banks shows that the US authorities had to provide unlimited insurance to depositors and other emergency liquidity injections to calm markets and to avoid contagion in the US and across the Atlantic.

Despite the limitations of national deposit insurance schemes in face of a contagious systemic crisis, it is of paramount importance to have in the BU an explicit, well-designed and harmonised deposit insurance scheme to maintain market confidence and enhance the resilience of the financial system. There is however no certainty that a well-designed and funded deposit insurance would prevent bank runs in the event of a systemic banking crisis, as was shown in previous episodes. That is the reason

why it is important to design a single Eurozone DGS within a coherent comprehensive framework of crisis management, LOLR and ELA.

In their paper, Ayadi and Lastra (2010) proposed a precise set of reforms for explicit deposit guarantee schemes in Europe and accordingly backed the shift to an EU-wide institutional arrangement for deposit insurance that is fully aligned with the framework of crisis management and resolution. This deposit insurance system must be properly designed and coupled with effective bank supervision.

The 2015 European Commission proposal on EDIS establishing a single deposit insurance scheme for the Euro zone, centralised under the Single Resolution Board (SRB) via the Deposit Insurance Board (DIB), tasked with expanded powers, if implemented will be the third, missing pillar of the banking union. However, several questions remain as to whether this new structure will be enough, particularly in terms of design, human resources and funding to solve a systemic banking crisis without public intervention to bail out failing banks.

The European Commission proposed a roadmap for EDIS to be implemented in three phases: first the provision of a reinsurance facility to Eurozone DGS, second the move to a co-insurance phase of the protected amounts and third the full transformation into a protection scheme that is based on full mutualisation. The 2014 DGS Directive will continue to serve as the basis for the determination of what EDIS would cover and amounts.

Yet, the introduction of EDIS will create a multi-tiered system of DGSs in the Eurozone and the EU, not least because of the breakdown between significant versus less significant credit institutions and other institutions that are outside the BU. A process of coherent integration must start as soon as the regulation of EDIS will enter into force, to avoid fragmentation between the countries that apply EDIS and others that apply national DGSs. Essentially, for EDIS to work, the DIB must be equipped with the necessary human resources and funding and closely connected with the supervisory and regulatory environment. Moreover, close cooperation and coordination schemes must be designed with third country jurisdictions (such as US, UK and Switzerland) to make sure that protection levels and all arrangements are equivalent.

3.3. Emergency liquidity assistance (ELA)

ELA is one of the tools that central banks are empowered to deploy in performing their function as lenders of last resort (LOLR).[23] Lending of last resort is central bank's assistance which can be either provided to avoid contagious effects that would endanger the overall financial stability of the banking system or granted to help out individual banks experiencing liquidity issues.[24]

The LOLR credit approach refers to the supply of liquidity to individual banks; this type of central bank's intervention is commonly known as ELA.[25] ELA is one of the most important instruments at central banks' disposal to fight liquidity shortage and emergency situations at individual level and was used in

[23] On lending of last resort and ELA, see Hofmann, C. (2018). Reconsidering central bank lending of last resort. European Business Organization Law Review, 19, 883-922, *passim*; Steinbach, A. (2016). The Lender of Last Resort in the Eurozone, Common Market Law Review, 53, 361–384; Garicano, L., & Lastra, R. M. (2010). Towards a new architecture for financial stability: Seven principles. Journal of International Economic Law, 13(3), 597-621.

[24] See Dietz, S. E. (2019). The ECB as Lender of Last Resort in the Eurozone? An analysis of an optimal institutional design of Emergency Liquidity Assistance competence within the context of the Banking Union. Maastricht Journal of European and Comparative Law, 26(5), 628-668.

[25] See Tucker, P. (2014). The lender of last resort and modern central banking: principles and reconstruction, BIS Papers No. 79, 15, https://www.bis.org/publ/bppdf/bispap79b_rh.pdf.

the EU during the global financial crisis, mainly in order to keep financial stability.[26] It constitutes a lending function of central banks in cases where institutions can no longer raise funding from the market. Therefore, it is one of the first lines of defence in a crisis. In order for ELA to be granted by the central bank, a number of conditions have to be met. According to the so-called Bagehot model,[27] the requirements for receiving ELA are:

1) banks must be solvent, despite facing liquidity issues;
2) illiquid banks must give adequate collateral to the central bank;
3) interest rates are typically (although not necessarily) higher than those of monetary policy operations;
4) liquidity is to be provided on a case-by-case basis only to specific institutions;
5) liquidity assistance is to be given on a temporary basis;
6) the central bank needs to be given discretion in deciding on whether to extend liquidity or not (so-called principle of constructive ambiguity).[28]

These requirements aim at achieving two main goals, namely protecting the central bank from losses and mitigating moral hazard.[29] On the one hand, limiting access to ELA to solvent institutions makes sure that only those institutions which have more assets than liabilities and that still comply with capital requirements can be helped by the central bank. Those banks are regarded as able, at least in principle, to pay back the loan to the central bank also in that they have assets to offer to the central bank as collateral. These elements should protect the central bank from the risk of suffering losses resulting from the bank's inability to repay the loan.[30] On the other hand, allowing the central bank to decide on whether to grant ELA on a case-by-case basis, giving it full discretion in this regard and ensuring that the support can be given only temporarily are key elements to counter moral hazard. If those elements were missing, banks could base their lending operations on the expectation that should they face liquidity tensions they would be able to rely unconditionally upon the central bank's support. This certainty would affect banks' risk management policies as they would have an incentive to exploit the maturity mismatch between their assets and liabilities with a view to increasing their profits. This would arise from longer-term assets being typically more remunerative than short-term assets.

3.3.1. Critical aspects of ELA and the rationale for vesting central banks with ELA functions

Against this backdrop, one of the most critical aspects in providing ELA relates to the difficulty in distinguishing between (in)solvency and (il)liquidity. The dividing line between (in)solvency and (il)liquidity in the banking sector can be very thin and often it is just a timeline.[31] While in corporate law, solvency is typically referred to as the situation where a firm has more assets than liabilities (insolvency test), in banking, solvency typically refers to the bank's compliance with the capital requirements set

[26] See Dietz, S. E. (2019). The ECB as Lender of Last Resort in the Eurozone? An analysis of an optimal institutional design of Emergency Liquidity Assistance competence within the context of the Banking Union. Maastricht Journal of European and Comparative Law, 26(5), 628-668.

[27] On the so-called Bagehot model see Lastra, R.M. (2015). International Financial and Monetary Law, Oxford, 151.

[28] See Tucker, P. (2014). The lender of last resort and modern central banking: principles and reconstruction, BIS Papers No. 79, 15, https://www.bis.org/publ/bppdf/bispap79b_rh.pdf.

[29] See Krugman, P. (2008). The Return of Depression Economics and the Crisis of 2008, Penguin, London, 63, who defines moral hazard as 'any situation in which one person makes the decision about how much risk to take, while someone else bears the cost if things go badly'.

[30] Bodellini, M. (2024). The Financing of Problem Banks: Critical Issues and Challenges Ahead. In Bodellini, M., Gimigliano, G., & Singh, D. (eds.) Commercial Banking in Transition: A Cross-Country Analysis. Cham: Springer International Publishing, 127-148., *passim*.

[31] See Lastra, R. M., Russo, C. A., & Bodellini, M. (2019). Stock Take of the SRB's activities over the past years: What to Improve and Focus On? Study Requested by the ECOM Committee of the European Parliament, 11, <https://www.europarl.europa.eu/RegData/etudes/STUD/2019/634392/IPOL_STU(2019)634392_EN.pdf>.

out in the banking regulation.[32] Liquidity, on the other hand, is typically referred to as the capability to pay debts as they fall due. Still, in banking, liquidity has peculiar connotations in that banks perform a key function in maturity transformation, which makes liquidity tensions rather common, despite often being only temporary and thus manageable.

By matching (in)solvency and (il)liquidity, a bank can end up in four different situations:

1) a bank that is solvent and liquid;
2) a bank that is solvent but illiquid;
3) a bank that is insolvent but still liquid;
4) a bank that is insolvent and illiquid.

In the first scenario (bank solvent and liquid), the bank is sound and does not need any assistance. The second scenario (bank solvent but illiquid) is the typical situation where ELA plays a significant function to allow such a bank to face its temporary liquidity issues. The third scenario (bank insolvent but still liquid) is rather uncommon in practice as it would need the bank to have short-term assets and long-term liabilities, which is exactly the opposite of what a commercial bank balance sheet typically looks like. The fourth scenario (bank both insolvent and illiquid) is when ELA is no longer enough and either a recapitalization takes place, or the bank has to be submitted to either resolution or liquidation.[33]

Even if in theory, illiquidity and insolvency are different concepts, in practice often a bank that is illiquid sooner or later might end up being also insolvent. This can happen due to the fact that a bank that needs to meet significant withdrawals might have to fire-sell its assets, thereby suffering proportional losses. Such losses can in turn cause it to become insolvent. That is the reason why ELA is so important to prevent banks from fire-selling their assets and central banks play a pivotal role in keeping solvent but illiquid banks alive.

On the other hand, the rationale for providing central banks with the function and associated powers to provide ELA to illiquid banks lies on the synergies existing between exercising such a task and safeguarding the stability of both the payment system and the financial system as a whole. Last-resort lending is incorporated in the instruments used to satisfy the policy objective of safeguarding financial stability.[34] Also, central banks typically have the power of printing money, therefore by definition they are in a position to be always able to provide banks with the liquidity they need to face a temporary crisis.

3.3.2. Central banking in the Euro-Area and ELA provision in the Banking Union

The European System of Central Banks (ESCB) has the task of defining, conducting and implementing the monetary policy of the Eurozone and has 'price stability' as its primary objective according to the Treaty on the Function of the European Union (TFEU).[35] The ESCB is composed of the ECB and the NCBs.[36]

[32] See Bodellini, M. (2019). The long 'journey' of banks from Basel I to Basel IV: has the banking system become more sound and resilient than it used to be? ERA Forum, 20, 81-97.

[33] Bodellini, M. (2024). The Financing of Problem Banks: Critical Issues and Challenges Ahead. In Bodellini, M., Gimigliano, G., & Singh, D. (eds.) Commercial Banking in Transition: A Cross-Country Analysis. Cham: Springer International Publishing, 127-148, *passim*.

[34] See Lastra, R.M. (2015). International Financial and Monetary Law, Oxford, 151, *passim*.

[35] See Amtenbrink, F. (2010). Central Bank Challenges in the Global Economy. In European Yearbook of International Economic Law 2011 (pp. 19-42). Berlin, Heidelberg: Springer Berlin Heidelberg, where it is said that 'a clear monetary policy objective geared towards the combating of inflation has become the dominant feature of central banks'.

[36] See Hinarejos, A. (2023). Economic and Monetary Union. in Barnard, C., & Peers, S. (eds). European Union Law. Oxford University Press, 4th edition; Fabbrini, F. (2016). Economic governance in Europe: Comparative paradoxes and constitutional challenges. Oxford University Press.

The decision-making process is centralised at the Euro-Area level within the ECB bodies. In the adoption of monetary policy measures, NCBs are included indirectly as part of the ECB bodies and thereby take part in the decision-making process. Implementation is decentralised with the NCBs executing the monetary policy measures adopted by the ESCB. NCBs, as the national authorities, implement the ESCB's policies. NCBs have a double function: 1) they act as agents within the ESCB fulfilling tasks at the European level and according to EU law; and 2) they act in their capacity as national authorities, within their own responsibility according to national law.[37]

Given that neither the Treaties (Treaty of the European Union (TEU) and TFEU) nor the ESCB Statute contain any explicit provisions on last resort lending two alternative views have emerged as to how to perform such a function. While the first view is the so-called decentralised approach under which this task should be carried out by the NCBs, the second view is the so-called centralised approach under which the ECB should be in charge to provide ELA.[38]

On the basis of article 14.4. of the ESCB Statute, the decentralised approach has been backed by the ECB itself. Article 14.4. of the ESCB Statute states that 'National central banks may perform functions other than those specified in this Statute unless the Governing Council finds, by a majority of two thirds of the votes cast, that these interfere with the objectives and tasks of the ESCB. Such functions shall be performed on the responsibility and liability of national central banks and shall not be regarded as being part of the functions of the ESCB'. The ECB has so far provided a restrictive interpretation of article 14.4 of the ESCB Statute according to which ELA provision is a task to be fulfilled by NCBs. The main reason for such a restrictive interpretation seems to be connected to the fact that ELA is considered a tool aimed at keeping financial stability. Financial stability in turn is not the first objective that the ECB/ESCB is meant to achieve, this being price stability under article 127(1) TFEU (exclusive competence). Accordingly, the financial stability mandate in the setting of the Treaties is only a secondary objective under article 127(5) TFEU (contributory competence).

The ECB restrictive interpretation of article 14.4 has been reaffirmed in the ELA Agreement 2017 that sets out the procedure to provide ELA, even though the latter is not a legally binding act. According to the ELA Agreement 2017, ELA occurs when '(a) a Eurosystem NCB provides central bank money and/or (b) any other assistance that may lead to an increase in central bank money to a financial institution or a group of financial institutions facing liquidity problems, where, in either case, such operation is not part of the single monetary policy'. ELA is thus provided under the main responsibility of the NCB concerned. As a result, the provision of such assistance is at the sole discretion of NCBs, on the condition that the ECB has not prohibited it. Hence, it is not the ECB itself that provides ELA and the eventual losses arising from the bank defaulting on paying back the credit line will appear on the NCB's balance sheet. As a result, ELA remains the responsibility of the NCBs, at their own cost, but with the necessary authorisation of the ECB that has a veto power.[39]

In order to benefit from ELA, banks facing a liquidity tension, have to be assessed as solvent. Interestingly, now such an evaluation is to be made by the ECB for significant banks. The ELA Agreement 2017 provides explicitly that a credit institution is considered solvent for ELA purposes if either of the following conditions is met:

[37] See Lastra, R.M. (2015). International Financial and Monetary Law, Oxford, 151, *passim*.

[38] On the two opposite views see Dietz, S. E. (2019). The ECB as Lender of Last Resort in the Eurozone? An analysis of an optimal institutional design of Emergency Liquidity Assistance competence within the context of the Banking Union. Maastricht Journal of European and Comparative Law, 26(5), 628-668.

[39] For example, in 2013 the ECB decided that emergency liquidity assistance to credit institutions in Cyprus could only be considered if an EU/IMF programme was in place to ensure the solvency of the concerned credit institutions.

(a) Its Common Equity Tier 1, Tier 1 and total capital ratios, as reported under the CRR on an individual and consolidated basis, comply with the minimum regulatory capital levels (namely 4.5%, 6% or 8%, respectively).

(b) If the above condition is not met, there is a credible prospect of recapitalisation by which the above minimum regulatory capital levels would be restored within 24 weeks after the end of the reference quarter of the data that showed that the bank does not comply with these standards; in duly justified, exceptional cases the GC may decide to prolong the above-mentioned 'grace period'.

About the duration, the ELA Agreement 2017 stipulates that the provision of ELA may only exceed 12 months following a non-objection by the Governing Council requested by the Governor of the NCB concerned at the latest once the provision of ELA exceeds 10 months. If any provision of ELA exceeds 12 months, the Governor of the NCB concerned must justify the further provision of ELA in a letter to the President of the ECB on a monthly basis, and the Governing Council may impose additional requirements and conditions.

In order to ensure that ELA operations do not interfere with the single monetary policy of the Eurosystem, the ECB would have to be informed or consulted. This information is to be provided by the NCB and should allow a smooth sterilisation of any undesired liquidity effects and an assessment of any systemic implications.

ELA to credit institutions established in euro area member states was repeatedly activated during the Global Financial Crisis. In the 2010-2013 period, ELA was provided in Ireland, Greece, and Cyprus. In 2014, ELA was provided in Portugal. In 2015, ELA was provided again in Greece. In 2017, ELA was provided in Spain.[40]

However, the ECB also exercised its veto power under article 14.4 of the ESCB Statute in June 2015 when the economic and financial situation in Greece was escalating, because the Eurogroup decided not to prolong the existing rescue program after the announcement of a bailout referendum. The Greek banks were in urgent need of liquidity, but the ECB objected to increasing the ELA ceiling.[41]

3.3.3. The inconsistencies of the framework currently in place

Before the creation of the Banking Union, prudential supervision was conducted at the national level; in that context, it was allegedly coherent to assume that national authorities had the adequate expertise and information to assess the problems of banks within their jurisdictions. It was therefore understandable that ELA was a function to be performed by NCBs on the basis of the adage that assistance on a rainy day requires supervision on a sunny day.[42]

However, as supervision has been centralised at European level and the ECB has become the main banking supervisor within the SSM, *i.e.*, the first pillar of the BU, the current ELA framework presents a number of shortcomings and should be reconsidered. On these grounds, it has been defined as the fourth missing pillar of the BU,[43] and it has been pointed out that the ECB should be at all effects the

[40] See Dietz, S. E. (2019). The ECB as Lender of Last Resort in the Eurozone? An analysis of an optimal institutional design of Emergency Liquidity Assistance competence within the context of the Banking Union. Maastricht Journal of European and Comparative Law, 26(5), 628-668.

[41] See Bank of Greece, Press Releases, Bank of Greece (2019). https://www.bankofgreece.gr/pages/en/bank/news/press releases/DispItem.aspx?Item_ID.5055&List_ID.1af869f3-57fb-4de6-b9ae-bdfd83c66c95&Filter_by.DT.

[42] See Hallerberg, M., & Lastra, R. (2017). The Single Monetary Policy and Decentralisation: An Assessment. In-Depth Analysis – European Parliament – Directorate General for Internal Policies Policy, September, 8.

[43] See Lastra, R. M. (2015). Reflections on Banking Union, lender of last resort and supervisory discretion, From Monetary Union to Banking Union, on the way to Capital Markets Union New opportunities for European integration, ECB Legal Conference 2015, December, 154.

lender of last resort for all those institutions under its supervision.[44] By doing so, ELA would link monetary policy and supervision.[45]

This position has been grounded in a number of legal considerations. Firstly, granting the ECB a clear LOLR function would not require a Treaty change. A mere reinterpretation of Article 14.4 of the ESCB Statute would be sufficient in light of the rationale under article 18.1 of the ESCB Statute (general liquidity provision) and of new circumstances (namely the creation of the Banking Union). This reading of the TFEU would also be aligned with the principle of subsidiarity.[46] Also, times have changed, and now financial stability has become in practice a key objective also for the ECB/ESCB, even though the Treaties have remained unaltered.[47] At the very least, such a (re)interpretation of TFEU would be required for significant institutions.

4. INTER-CONNECTION BETWEEN BANKING UNION AND CAPITAL MARKETS UNION

4.1. The framework of the Banking Union and Capital Markets Union

The Banking Union (BU) and the Capital Markets Union (CMU) are two interconnected pillars of the European Union's strategy to create a more resilient and integrated financial system. While the BU primarily focuses on ensuring the stability and soundness of the banking sector, its finalisation is essential to the development and success of the CMU. A strong and well-regulated banking system provides the necessary foundation for deepening capital markets, fostering investor confidence, and enabling cross-border financial activities. The key components of the Banking Union—ranging from the SSM and SRM to risk reduction measures and cross-border integration—are essential to advancing the Capital Markets Union. These elements create the stability, confidence, and regulatory coherence necessary for the development of deep, integrated, and efficient capital markets across the European Union. By reinforcing these foundations, the Banking Union helps pave the way for a more resilient financial system where capital markets can thrive alongside a robust banking sector.

Additionally, a sound capital and liquidity framework ensures that banks are well-capitalised and able to withstand financial shocks. The related measures introduced to implement the Basel Accords have reduced the likelihood of bank failures and promoted financial stability, which in turn contributed to fostering a more resilient environment for capital markets. Well-capitalised banks are better positioned to support capital markets through lending, underwriting, and market-making activities.

Equally, macroprudential supervision, which monitors and addresses systemic risks in the banking sector, helps prevent financial shocks that could destabilise capital markets. By reducing the risk of systemic crises, macroprudential supervision supports a stable environment for investment and growth in the capital markets, contributing to the success of the CMU.

[44] See Dietz, S. E. (2019). The ECB as Lender of Last Resort in the Eurozone? An analysis of an optimal institutional design of Emergency Liquidity Assistance competence within the context of the Banking Union. Maastricht Journal of European and Comparative Law, 26(5), 628-668.

[45] Bodellini, M. (2024). The Financing of Problem Banks: Critical Issues and Challenges Ahead. In Bodellini, M., Gimigliano, G., & Singh, D. (eds.) Commercial Banking in Transition: A Cross-Country Analysis. Cham: Springer International Publishing, 127-148, *passim*.

[46] See Lastra, R.M. (2015). International Financial and Monetary Law, Oxford, 151, *passim*.

[47] See Lastra, R. M., & Alexander, K. (2020). The ECB Mandate: Perspectives on Sustainability and Solidarity, In-Depth Analysis Requested by the ECON committee of the European Parliament, Monetary Dialogue Papers, June, 8.

Banks play a crucial role in developing capital markets by acting as intermediaries and participants in bond and equity markets. A strong and stable banking sector is necessary for the development of deep and liquid bond and equity markets, which are a key component of the CMU. Encouraging banks to participate in bond and equity markets and securitization enhances the availability of credit and improves market liquidity.

When banks are solid and well-regulated, they are more likely to participate in capital markets themselves, for example, through securitization or by supporting clients in issuing bonds and equity. A sound BU creates a conducive environment for banks to act as intermediaries and facilitators of capital markets, rather than just providers of loans.

Furthermore, advancing the BU through regulatory harmonisation (such as unified supervisory mechanisms and resolution frameworks) helps create a more consistent regulatory environment across the EU. This is vital for the CMU, as a fragmented regulatory landscape is a significant barrier to cross-border capital flows and integration of capital markets. On these grounds, the alignment of banking regulations with capital markets rules can reduce legal and operational barriers to cross-border investments. For example, harmonised rules on financial reporting, prudential requirements, and insolvency can make it easier for banks and capital markets to work together seamlessly across different EU countries.

As banks become more stable, they are in a better position to distribute risks through the capital markets, for instance by issuing bonds or securitizing loans. This, in turn, can help to create more liquidity and depth in the capital markets, a key goal of the CMU.

Advancing the BU can also support the development of innovation financing and green finance, as we will detail in 4.4. Stable and well-regulated banks can partner with institutional investors to finance innovative projects, particularly in technology and sustainable industries, thereby aligning with the CMU's goals of supporting the green and digital transitions in Europe.

Finally, one of the goals of the BU is to reduce the so-called "sovereign-bank nexus," where banks are overly exposed to their own country's sovereign debt, creating vulnerabilities. By reducing this nexus, banks become more resilient, and the overall financial system is less prone to shocks that can affect both the banking sector and capital markets. A more resilient banking sector helps create a stable environment for capital markets to function effectively.

Accelerating the CMU requires both policy reforms and greater political commitment across member states. While the EU has made progress in certain areas, further efforts are needed to overcome remaining barriers and achieve the goals of a fully integrated and efficient capital market.

4.2. Some specific lessons from the Banking Union for the Capital Markets Union

The Capital Markets Union (CMU) was launched in 2015 to accompany the Banking Union (BU) towards increased financial market integration. While some authors viewed BU and CMU as complements,[48] several (perhaps many more) experts deemed that financial markets development was needed (also) to reduce the allegedly excessive bank dependency of financing supporting European firms.[49] Thus,

[48] See, e.g., Braun, B., Gabor, D., & Hübner, M. (2018). Governing Through Financial Markets: Towards a Critical Political Economy of Capital Markets Union. Competition & Change 22(2), 101–116.

[49] See, e.g., from inside the banking industry itself Kaya, O. (2015). Capital Markets Union. Deutsche Bank Research. EU Monitor. Frankfurt am Main; and from a more academic / policy consulting-oriented perspective Schoenmaker, D. (2015). From Banking Union to Capital Markets

the complementarity vs substitutability view seems to have twisted the balance towards the latter at the origin of the CMU. However, subsequent evolutions have restated the case for complementarity between integrating banking markets and capital markets.[50] Interestingly, Braun-Munzinger et al. (2021)[51] argue that banking integration and capital market integration are complements suggesting that BU and CMU would be promoting each other.[52] In their view, the reciprocal support of BU and CMU would unfold in two ways. In one way, by intensifying the diversification of risks, CMU reduces output and income variability, thereby attenuating banking risks and favouring the functioning of the BU. On the other hand, a better functioning and integrated banking system – thanks to the BU – backs the smooth functioning and further integration of capital markets. In spite of those potential benefits from its joint progress with BU, as suggested by Högenauer, Howarth and Quaglia,[53] the support for CMU dwindled subsequently because of two main reasons. First, Brexit took off stage the UK, which had been the most vocal advocate of CMU, given the advantage the country enjoyed vis-à-vis the rest of Europe in terms of capital markets development. Second, support for the CMU fell at various national governments whose domestic financial markets were disadvantaged.[54]

In turn, while the Banking Union managed to gain a strong institutional anchor – as discussed above, the EDIS is undeveloped but the SRM has been established, and SSM is in the safe hands of the European Central Bank – the CMU seemed to be left in a no man's land whereby strong institutional support is lacking. In other terms, the CMU ended up 'stalled by design' because of competing interests as argued by Piroska and Epstein: "Capital Markets Union sought to make raising funds across borders easier, but its supervision remained at the national level making that difficult in practice." (p.182).[55]

One could imagine a different scenario, though, in which a stronger ESMA might have been able to provide decisive institutional support to expand and deepen the CMU. Under the present circumstances, to exemplify, as advocated by the European Securities and Markets Authority itself,56 the CMU could be accelerated by reinforcing the institutional anchor it can offer. Indeed, ESMA, as the EU's regulator for securities markets, is well-positioned to play a more prominent role in fostering

Union. The European Capital Markets Union: A Viable Concept and a Real Goal. Duisenberg school of finance, VU University Amsterdam, 28 April, where Schoenmaker invokes as a possible justification of CMU the idea that Europe was overbanked, referring to the views of top experts like Pagano, M., Langfield, S., Acharya, V., Boot, A., Brunnermeier, M., Buch, C., Hellwig, M., Sapir, A., & van den Burg, I. (2014). Is Europe overbanked? Report no. 4 of the European Systemic Risk Board's Advisory Scientific Committee, Frankfurt, and also Langfield, S., & Pagano, M. (2016). Bank bias in Europe: effects on systemic risk and growth. Economic Policy, 31(85), 51-106. On the idea that capital markets may develop to substitute banking financing see also, the US history, which is called to have a bearing on the CMU: Gordon, J. N., & Judge, K. (2019). The origins of a capital market union in the United States. In Allen, F., Faia, E., Haliassos, M., & Langenbucher, K. (eds). Capital markets union and beyond. MIT Press.

50 See, e.g., Acharya, V. V., & Steffen, S. (2017). The importance of a banking union and fiscal union for a capital markets union. Publications Office of the European Union; Hoffmann, M., Maslov, E., Sørensen, B. E., & Stewen, I. (2018). Are banking and capital markets union complements? Evidence from channels of risk sharing in the eurozone, Working Paper, No. 311, University of Zurich, Department of Economics, Zurich; Sapir, A., Véron, N., Wolff, G. B. (2018). Making a reality of Europe's Capital Markets Union, Bruegel Policy Contribution, No. 2018/07, Bruegel, Brussels.

51 See, Braun-Munzinger, K., Carmassi, J., Kastelein, W., Lambert, C., & Pires, F. (2021). From Deadlocks to Breakthroughs: How We Can Complete the Banking Union and Why It Matters to All of Us. In: Caetano, J., Vieira, I., & Caleiro, A. (eds) New Challenges for the Eurozone Governance. Springer, Cham. https://doi.org/10.1007/978-3-030-62372-.

52 To support this claim, Braun-Munzinger et al. (2021) cite two papers that were already available in 2015 [Demirgüç-Kunt, A., & Maksimovic, V. (1996). Stock market development and financing choices of firms. The World Bank Economic Review, 10(2), 341-369.; Song, F., & Thakor, A. V. (2010). Financial system architecture and the co-evolution of banks and capital markets. The Economic Journal, 120(547), 1021-1055] and an additional one published later [Hoffmann, M., Maslov, E., Sørensen, B. E., & Stewen, I. (2019). Channels of risk sharing in the Eurozone: what can banking and capital market union achieve? IMF Economic Review, 67, 443-495].

53 Anna-Lena Högenauer, David Howarth & Lucia Quaglia (2023) Introduction to the special issue: the persistent challenges to European Banking Union, Journal of European Integration, 45:1, 1-14, DOI: 10.1080/07036337.2023.2183390.

54 See also Epstein, R., & Rhodes, M. (2018). From governance to government: Banking union, capital markets union and the new EU. Competition & Change, 22(2), 205-224.

55 See Piroska, D., & Epstein, R. A. (2023). Stalled by design: New paradoxes in the European Union's single financial market. Journal of European integration, 45(1), 181-201.

56 https://www.esma.europa.eu/sites/default/files/2024-05/ESMA24-45054445 2-2130_Position_paper_Building_more_effective_and_attractive_capital_markets_in_the_EU.pdf.

integration, transparency, and efficiency in capital markets across Europe. The following proposals aim to strengthen ESMA's role and institutional framework to drive progress on the CMU:

- *Create a Pan-European Capital Markets Regulator*

While ESMA plays a coordinating role among national regulators, the actual supervision of capital markets is decentralised across EU member states, which can result in regulatory divergence and inefficiencies. Over time, ESMA could evolve into a more centralised pan-European capital markets regulator. This would involve transitioning more powers from national authorities to ESMA, particularly for cross-border market participants and products. A centralised regulator would facilitate more uniform and predictable enforcement, reduce the complexity of cross-border investments, and support the development of a single EU capital market.

- *Enhance ESMA's Capacity for Data and Digitalization*

As capital markets become increasingly digitised, data plays a crucial role in market supervision, particularly in areas such as high-frequency trading, algorithmic trading, and fintech. ESMA should be equipped with greater technological capacity and resources to monitor and analyse large datasets related to capital markets. This includes enhancing its capabilities to supervise digital financial services, detect systemic risks, and address issues like market manipulation in real-time. Additionally, ESMA could oversee a consolidated tape for real-time market data across the EU, improving transparency and reducing market fragmentation.

- *Grant ESMA Direct Supervisory Powers Over Key Capital Market Activities and actors*

ESMA currently has limited direct supervisory powers, which are primarily focused on credit rating agencies and trade repositories. Most supervisory functions for capital markets remain in the hands of national authorities, leading to fragmentation and inconsistencies in enforcement. ESMA should be granted direct supervisory powers over more key capital market activities and actors, such as cross-border issuance of securities, financial market infrastructures (e.g., clearinghouses), and certain large institutional market participants. This would harmonise supervision across the EU, reduce regulatory arbitrage, and ensure a consistent application of rules that are critical to the CMU's goal of deeper market integration.

- *Strengthen ESMA's Role in Sustainable Finance*

Sustainable finance is a growing segment of the capital markets, and ESMA has an important role in promoting transparency and consistency in this area. However, regulatory oversight and enforcement in sustainable finance are still fragmented and the risk for greenwashing is growing. ESMA should be given enhanced authority to oversee the implementation of the EU taxonomy for sustainable finance, including monitoring compliance with environmental, social, and governance (ESG) reporting requirements. This would not only ensure that investors have consistent and reliable information but also accelerate the growth of sustainable finance within the CMU by providing clear and enforceable standards.

- *Reinforce ESMA's Role in Cross-Border Investor Protection*

Investor protection standards can vary significantly across EU member states, which undermines confidence in cross-border investments. ESMA should be empowered to set and enforce uniform investor protection rules across the EU. This would include more consistent enforcement of regulations related to investor disclosures, product transparency, and the resolution of investor disputes and redress procedures (such as collective action clauses). Strengthening investor protection will increase confidence in EU capital markets, encouraging more cross-border participation.

- *Increase ESMA's Budget and Staffing*

Despite its crucial role, ESMA's resources remain limited compared to its expanded responsibilities. Inadequate staffing and budget constraints can hinder its ability to effectively carry out its mandate. ESMA's budget and staffing levels should be increased significantly to reflect its expanding role in the CMU. This would allow ESMA to enhance its capacity to supervise more market participants, develop new regulatory technologies, and maintain effective oversight of capital markets. Ensuring ESMA has the necessary resources is critical to accelerating progress on the CMU. The budget should be shared between the EU and the market participants.

- *Coordinate with Other European Supervisory Institutions*

ESMA should strengthen its cooperation with other European supervisory authorities to ensure a more coherent approach to the regulation of financial markets. This could involve joint supervision efforts, streamlined decision-making processes, and more coordinated enforcement actions to ensure that the broader financial sector, including banking and insurance, is well-aligned with capital market regulation.

In a nutshell, reinforcing ESMA's institutional framework is critical to accelerating the CMU's progress. By expanding ESMA's supervisory powers, increasing its capacity for data and digitalization, and enhancing coordination with national and European authorities, the EU can foster a more integrated, transparent, and efficient capital market. These reforms would reduce fragmentation, enhance investor protection, and create a level playing field for market participants across the EU, helping to achieve the goals of the CMU.

The large potential benefits which could result for the EU by speeding up the CMU creation have been highlighted in a recent important paper by Martinez, Philippon and Sihvonen.[57] The authors "compare risk sharing in response to demand and supply shocks in four types of currency unions: segmented markets; a money market union;[58] a capital market union; and complete financial markets" and show through a numerical exercise that "the welfare gain of moving from segmented markets to a money market union is of roughly similar magnitude to that of moving from a money market to a capital market union." (p.1).

On these grounds, the main lesson to be learnt from the experience of the Banking Union is that the success of the Capital Markets Union requires identifying a central EU-level supervisor and entrusting it with an adequate level of power in order to defend the CMU from competing national interests and promote the various needed standardizations. The most obvious solution would be assigning that role to a strengthened ESMA as suggested directly or indirectly by experts,[59] and by other relevant European level institutions or associations.[60]

[57] See Martinez, J., Philippon, T., & Sihvonen, M. (2022). Does a currency union need a capital market union? Journal of International Economics, 139, 103675.

[58] "A key feature of the banking union is the creation of what we call a money market union: a currency union in which country-specific borrowing rates are invariant to country-specific shocks such as private and public deleveraging shocks". Martinez, J., Philippon, T., & Sihvonen, M. (2022), page 2.

[59] Among the various authors concurring in this sense, see Demertzis, M., Domínguez-Jiménez, M., & Guetta-Jeanrenaud, L. (2021). Europe should not neglect its Capital Markets Union. Policy Contribution 13/2021, Bruegel; ● Gortsos, C. (2022). The foundation of the European Capital Markets Union (CMU): From the 2015 to the 2020 CMU Action Plan and Their Implementation. January 9. Available at SSRN: https://ssrn.com/abstract=4005259.

[60] To exemplify, on its part, the European Court of Auditors devoted a special report [ECA (2020). Capital Markets Union – Slow start towards an ambitious goal] to the issue of the inadequate results obtained by the CMU and observed repeatedly that ESMA was not funded and/or pressured enough by the EU Commission to pursue key passages of the CMU, e.g., regarding the European Single Access Point.

4.3. Sustainability and Green Finance can reignite the BU-CMU mutual support

The sustainable transition, perhaps the most distinctive set of policies in which the European Union holds a world leading role, bestows important ramifications that could reignite the mutual support between the Banking Union and the Capital Markets Union. Indeed, lately sustainable finance has been possibly the most dynamic part of overall banking and finance, especially in advanced economies and even more so in Europe. While the EU has long been the forerunner of the sustainable transition, the fact that banking and finance must play the keystone role for the transition has become clear with the introduction of the Action Plan on Sustainable Finance (APSF – March 2018). One year later, the announcement of the challenging objective of decarbonization by 2050 contained in the EU Green Deal highlighted the reality that sustainable finance should provide the bulk of the needed funding. Recently, the Commission has estimated a financing gap to pursue the Twin – Digital and Green – Transition of about €500 billion per year.[61] Concurrently, the ECB has estimated the Green Transition financing gap to be covered with private funding at above €400 billion per year over the period 2025-2031 (Figure 6) and places completing CMU and BU at the top of the Menu of options to address additional investment needs in the EU (Figure 7).[62]

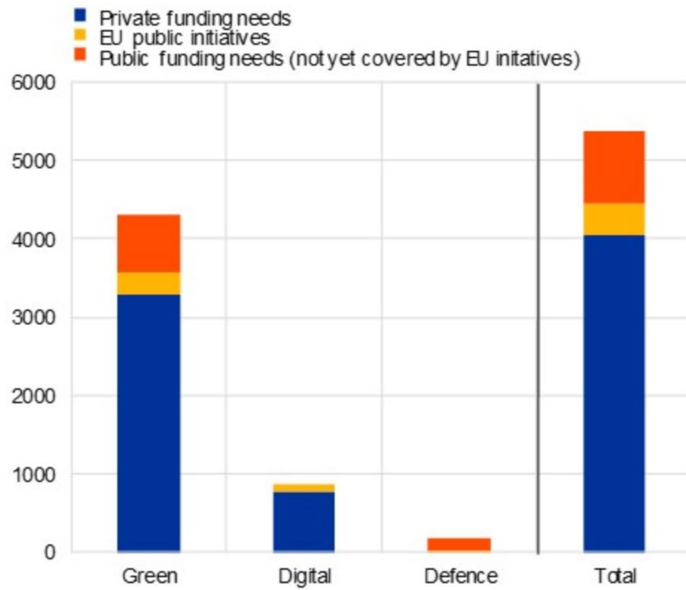
[61] See McGuinness, M. (2024). Financing the transition – Green and Digital. Speech by EU Commissioner McGuinness at the Global Economic Summit, Killarney, 20 May.

[62] These two Figures are taken from Bouabdallah, O., Dorrucci, E., Hoendervangers, L., & Nerlich, C. (2024). Mind the gap: Europe's strategic investment needs and how to support them. ECB Blog, 20 May. https://www.ecb.europa.eu/press/blog/date/2024/html/ecb.blog240627~2e939aa430.en.html.

Figure 6: Estimated funding needs for the Green, Digital and Defence Transition

Additional cumulated EU private and public investment needs and its funding: Estimates for green-digital transitions and defence spending

(2025-2031; by funding entities and in billions of euro)



Source: ECB (2023) https://www.ecb.europa.eu/press/blog/date/2024/html/ecb.blog240627~2e939aa430.en.html

Figure 7: How to cover the financing gap to support the Green, Digital and Defence Transition

Menu of options to address additional investment needs in the European Union

	Initiatives supporting private investment	Initiatives supporting public investment
EU Level	❑ Complete capital markets & banking unions ❑ Enhance EU internal market ❑ 28th regime for corporate law, to which firms in the EU could opt in(*) ❑ Single EU platform for education, innovation and research ("5th freedom") (*) ❑ Enhancing EIB\EBRD role	➢ Investment-friendly EU fiscal rules ➢ Maximise the positive impact of NGEU, REPowerEU ➢ Reprioritise EU budget ➢ Increase EU own resources ➢ Joint debt issuance to fund investment in genuine European public goods
National level	✓ Improve framework conditions for doing business ✓ Lower regulatory burden ✓ More investment-friendly corporate taxation	• Build fiscal space for investment in multi-year fiscal-structural plans • Enhance administrative capacity and adopt best practices for high-quality public investment • Reprioritise public expenditure and improve quality of public finance

Source: ECB (2023) https://www.ecb.europa.eu/press/blog/date/2024/html/ecb.blog240627~2e939aa430.en.html

Sustainable finance has largely taken the shape of financial markets finance. One of the key tools of sustainable finance is the Green Bonds (GBs) market – including the associated Social Bonds, Sustainability Linked Bonds and other sustainability bonds. This market was initiated in 2007 by the Climate Awareness Bond launched by the European Investment Bank. Since then, initially with the key involvement of multilateral organisations, but later with increasing roles of the private sector and governments, the GBs market has grown to over $1,100 billion of issuance in 2021 and even the 2022 setback, connected to the conflict in Ukraine and the rise in interest rates, has been overcome already in 2023. Europe's primacy in GBs' issuance is rather visible: in the first half of 2023 (but the shares are rather stable over time), Europe issued 54% of the total, followed by Asia-Pacific (22%), America (16%), Japan (5%) and Africa/Middle East (3%). In spite of this boom of sustainable bonds – GBs, Social Bonds and Sustainability Bonds – the much larger growth of sustainable finance in terms of quantity is given by Sustainable and Responsible Investment Funds, called SRI Funds, investment instruments characterised by a particular "sustainable and responsible" investment approach defined by Eurosif as «a long-term oriented investment approach that integrates ESG factors in the research, analysis process and selection of securities within an investment portfolio. It combines fundamental analysis and

engagement with an assessment of ESG factors in order to better capture long-term returns for investors and for the benefit of society by influencing the behaviour of companies». Assessing the precise size of the SRI funds market is difficult, as official statistics are lacking. However, it reaches a considerable size. For example, Eurosif (2022) reports that at the end of March 2022, SRI funds constituted 31.5% of the total offered in Europe with Assets under Management of €4.18 trillion, equal to 45.6% of the total AuM, with the dominant part (27.9% of the number of funds and 40.7% of the AuM) of SRI art. 8 and the smallest part (3.6% of the number of funds and 4.9% of the AuM) of SRI art. 9.

The complementarity of CMU and BU to support the Green Transition is visible already by taking a glimpse at the blueprint of the Action Plan on Sustainable Finance (APSF) (Figure 8).The Action Plan prescribed a set of ten actions grouped into three subsets: I. Reorienting capital flows towards a more sustainable economy; II. Mainstreaming sustainability into risk management; III. Fostering transparency and long-termism.[63] While the direct impact of most of the actions is on financial markets for subset I, on banking and insurance for subset II, and on corporations for subset III, the 10 actions are strongly interconnected through indirect linkages. In a sense, this holistic interconnection network matches the systemic character of dealing with the sustainable transition. And this traces a first level of intimate interconnection between the CMU and the BU which is originating from the boom of Sustainable Finance.

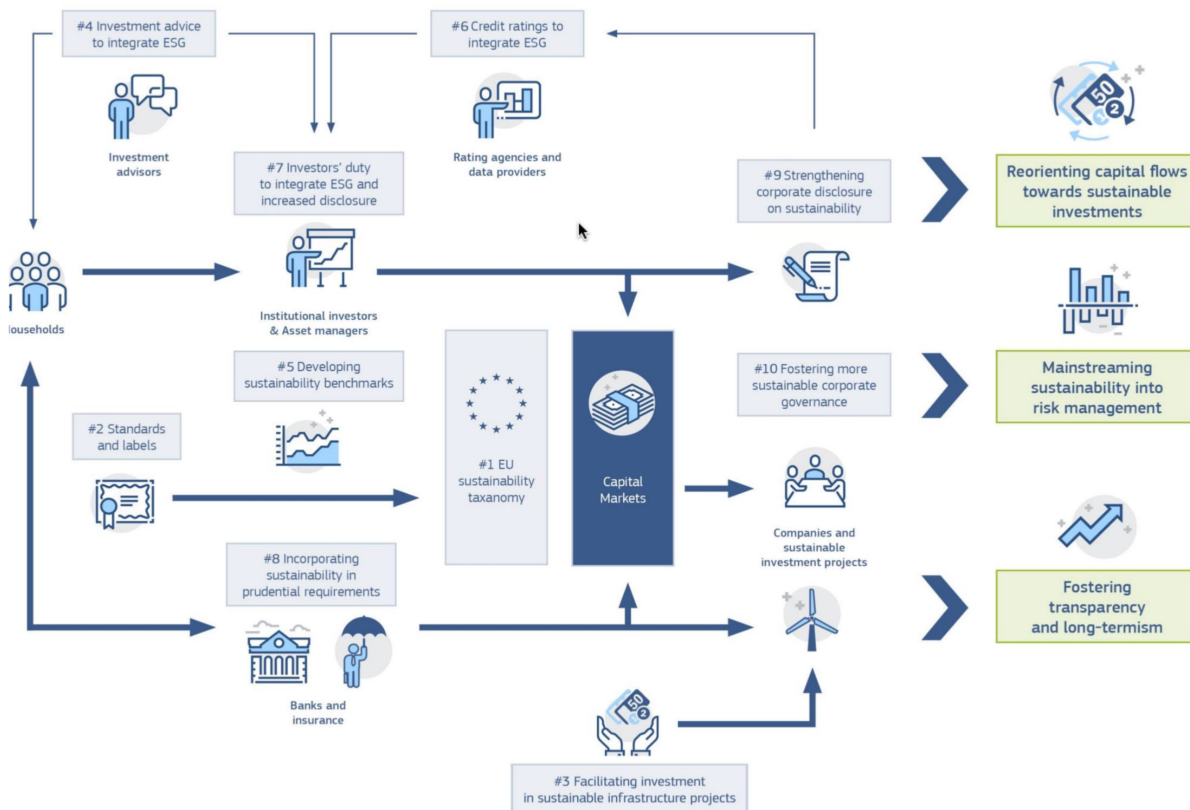
[63] For the reader's convenience, the 10 actions broken down in the three subsets runs as follows.

I. Reorienting capital flows towards a more sustainable economy: 1. Establishing a clear and detailed EU taxonomy, a classification system for sustainable activities; 2. Creating an EU Green Bond Standard and labels for green financial products; 3. Fostering investment in sustainable projects; 4. Incorporating sustainability in financial advice; 5. Developing sustainability benchmarks.

II. Mainstreaming sustainability into risk management: 6. Better integrating sustainability in ratings and market research; 7. Clarifying asset managers' and institutional investors' duties regarding sustainability; 8. Introducing a 'green supporting factor' in the EU prudential rules for banks and insurance companies.

III. Fostering transparency and long-termism: 9. Strengthening sustainability disclosure and accounting rule-making; 10. Fostering sustainable corporate governance and attenuating short-termism in capital markets.

Figure 8: Blueprint of the Action Plan on Sustainable Finance



Source: European Commission.

https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018DC0097

Moreover, the fact that the Banking Union preceded the Capital Markets Union and that, as mentioned, BU possessed a strong institutional anchor while CMU does not have it, concocted a situation in which at times the phasing in of APSF-related regulation seems to have moved more swiftly on banking than on markets or on disclosure. The existence of such a timing mismatch across the various regulations and business practices involved has been identified as a critical point behind the implementation of the APSF by some authors, because of lack of overall consistency or simply lack of data.[64]

A critical issue at this juncture is the reliability of the ESG (Environmental, Social, Governance) metrics, which has become very popular in the sustainable finance community. In particular, the validity of ESG ratings is often questioned. In particular, attracted by the benefits of sustainable finance, issuing companies may be tempted by green- or social- or governance-washing by declaring themselves more sustainable than they actually are and, perhaps, rating agencies may be misled and grant excessive ESG ratings. Several scholars have identified some recurring characteristics of the phenomenon. For example, Drempetic, Klein and Zwergel (2020) raise the question of whether the way in which ESG ratings measure corporate sustainability gives an advantage to large companies with more resources

[64] See, e.g., Zetzsche, D. A., & Anker-Sørensen, L. (2022). Regulating sustainable finance in the dark. European Business Organization Law Review, 23(1), 47-85; Ahlström, H., & Monciardini, D. (2021). The regulatory dynamics of sustainable finance: Paradoxical success and limitations of EU reforms. Journal of Business Ethics, 1-20.

without offering SRI investors the information needed to choose based on their own orientations.[65] In the same vein, Doyle clearly shows that the average level of ESG ratings increases by 40% (from 46 to 64 out of a maximum of 100) from micro- to mega-cap companies.[66] And again, La Bella, Sullivan, Russell and Novikov (2019) show that ESG ratings bias in favour of larger market capitalization issuers, albeit to varying degrees, is present everywhere across three of the major ESG rating agencies.[67] The problem of the quality of ESG ratings is then aggravated by the fact that there is often low consistency between the various agencies in issuing ESG ratings to the same company, as revealed by the limited correlation between the different agencies, something that has been labelled "aggregate confusion by Berg, Koelbel and Rigobon.[68] This problem may be further aggravated by the fact that the independent ESG rating agencies, some of them originated in Europe, were over time acquired by the US-based mega credit rating agencies. S&P's bought UK-based Trucost – a provider of carbon and environmental data and risk analysis – and in November 2019 the ESG rating business from Swiss-based RobecoSAM. Moody's has made a few acquisitions, too, including France-UK-based Vigeo Eiris, a global leader in ESG assessments, California-based Four Twenty Seven, a publisher and provider of market intelligence on the economic risk of climate change, and SynTao Green Finance, a provider of ESG data and analytics-based in and serving China.[69] Although, strictly speaking, this might not pose formal problems, the apparent contradiction stems from the following reasoning. In reality, the ESG metrics comes from the US, where it was first introduced,[70] but in recent years, under political pressures,[71] more and more US-based investment holdings seem inclined to abandon those metrics. Thus, the EU could find itself in the inconvenient position of being anchored to the ESG metrics – which have been introduced into EU regulation following the APSF – and yet being dependent on measuring the ESG it uses depending on the services of the global rating agencies which are based in the US, where the ESG metrics may be living a phasing out. This looks like a possible contradiction on which ESMA might be called to ponder. Fortunately, however, the introduction of the EU Green Taxonomy may now be reducing the risk of greenwashing,[72] but that does apply neither to the risk of social washing – where the EU Social Taxonomy is lagging behind – nor to that of governance-washing.

All in all, although with bright sides and shadows, Sustainable finance seems to open up new possible ways to revive the mutual support between the Banking Union and the Capital Markets Union.

[65] See Drempetic, S., Klein, C., & Zwergel, B. (2020). The influence of firm size on the ESG score: Corporate sustainability ratings under review. Journal of business ethics, 167(2), 333-360.

[66] See Doyle T. M. (2018), Ratings that don't rate: the subjective world of ESG ratings agencies, American Council for Capital Formation.

[67] See La Bella, M. J., Sullivan, L., Russell, J., & Novikov, D. (2019). The devil is in the details: the divergence in ESG data and implications for responsible investing, QS Investors, New York.

[68] See Berg, F., Koelbel, J. F., & Rigobon R. (2022). Aggregate confusion: The divergence of ESG ratings, Review of Finance, 26(6), 1315-1344.

[69] See Tillier, N. (2021). ESG and credit rating agencies: The pressure accelerates, 22 February, retrieved on 25 August 2024 from: https://think.ing.com/articles/esg-and-credit-ratings-the-pressure-has-accelerated/.

[70] See, e.g., Krantz, T. (2024). The history of ESG: A journey towards sustainable investing, 8 February, retrieved on 25 August 2024 from: https://www.ibm.com/think/topics/environmental-social-and-governance-history#:~:text=It%20refers%20to%20a%20set,been%20around%20for%20much%20longer.

[71] See, e.g., Jessop, S., Binnie, I., & Kerber, R. (2024). Leading U.S. banks leave ESG project finance group, 6 March, retrieved on 25 August 2024 from: https://www.reuters.com/business/finance/jpmorgan-citi-wells-boa-are-no-longer-signatories-equator-principles-website-2024-03-05/.

[72] The Taxonomy Regulation was published in the Official Journal of the European Union on 22 June 2020 and entered into force on 12 July 2020.

5. CONCLUSION

This study has investigated how the Banking Union can foster market integration and to what extent its experience can provide lessons for the development of the Capital Markets Union. Particularly, the original goals of the Banking Union have been (re)-analysed to ascertain to what extent they have been achieved and what is still needed. Some proposals to support the finalisation of the Banking Union have been advanced, which are expected to be also instrumental to fostering integration of the banking market. Moreover, the interplays between the Banking Union and the Capital Markets Union have been explored with a view to benefitting from the Banking Union 10-year experience to support the proper creation of the Capital Markets Union.

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We address the Banking Union (BU) in promoting market integration and the lessons it provides for the Capital Markets Union (CMU).
First, we tackle BU's establishment, exploring whether it achieved its original goals and discussing its main shortcomings. Second, we address market integration in the BU. Third, we advance some proposals to finalise the BU project accelerating effective market integration. Fourth, we explore various interconnections between BU and CMU, introducing policy-related considerations to support the development of a well-functioning CMU.
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