Finance for Europe

Creating an integrated Financing Union for the EU

The important role of Banking and Capital Markets Unions

Association for Financial Markets in Europe
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1. The important role of Banking and Capital Markets Unions

The benefits of **financial integration** in the EU are well known and include making both the financial system, and the wider economy, more resilient, which in turn supports growth.

One of the mechanisms to improve **financial integration** is to encourage **cross-country risk sharing**, as this dampens the impact of country-specific shocks on consumption and economic growth. However, such risk sharing remains relatively low in the EU[1]. There is therefore **scope for cross-border banking and capital markets** to play a much larger role in levelling shocks across the European economy than they do today. Moreover, building these forms of private risk sharing can help reduce the potential need for public risk sharing, for instance in the form of fiscal transfers, and will reinforce the risk reduction measures and crisis prevention tools that have been implemented over the past decade.

Cross-border risk sharing remains relatively low in the EU

The **capital market channel** contributes to risk sharing to a much greater extent in the US than in the EU.
Source: "Risk sharing in the euro area", ECB Economic Bulletin, Issue 3, 2018.

Promoting Banking and Capital Markets Unions jointly is therefore one of the ways to move beyond the risk reduction/ risk sharing debate which has weighed down European political discourse over recent years. It is important that these projects be pursued and completed to create a more robust, efficient and **truly integrated financing market** for the benefit of the EU in the longer term[2]:

- **A resilient and integrated European banking market where transfers of capital and liquidity are not restricted along national lines will support banks' cross-border lending and capital markets activities.** Such activities include helping governments and corporates access capital and funding and connecting investors with savers. It also means that banks can continue to play their important market-making role, ensuring that securities are bought and sold at the best price and in the most cost-effective and timely manner. The provision of liquidity by market makers reduces price volatility and increases markets' ability to withstand shocks. Finally, secondary markets liquidity also facilitates primary issuances of equity and debt by providing confidence that securities will be tradeable once issued.

- **More developed and integrated capital markets in the EU will ensure we build up the availability of, and access to, risk capital, which is much needed to support innovative, high growth businesses.** Integrated markets will also help investors access diversified portfolios of cross-country assets, thus promoting private risk sharing across borders. In such an environment, banks themselves can diversify their own exposures through increased holding of cross-border assets and will also be more resilient.

1 ECB Economic Bulletin, Issue 3, 2018

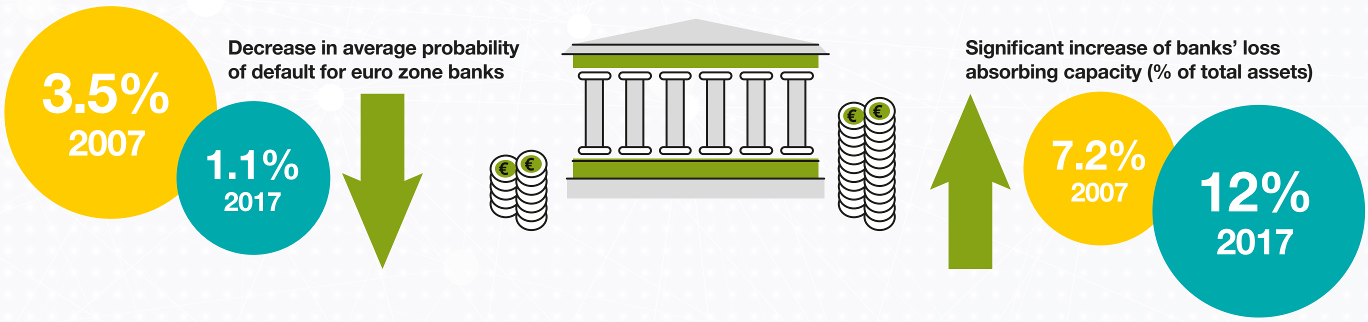
2 See for instance ECB Vice President Luis de Guindos's speech of 14 December 2018

Financing Union: The virtuous circle of integrated banking and capital markets supporting each other

Banking and Capital Market Unions are therefore **complementary** and **mutually reinforcing**, each supporting the other by broadening the financing options available to end users and avoiding the withdrawal of funding particularly in the event of economic downturns. From a policy perspective it is important they be considered jointly with a view to creating a more balanced, and resilient financing landscape, or a **Financing Union** in the EU.

2. Moving forward

The banking system is more resilient and resolvable due to larger capital buffers and the new resolution framework



Source: "Is taxpayers' money better protected now? An assessment of banking regulatory reforms ten years after the global financial crisis", ECB Macroprudential Bulletin, March 2019

While the post crisis reform programme is nearly fully implemented and has unambiguously improved the safety of the European banking system[3], there is still some work to do before we can achieve a truly integrated European financial market. This includes:

Building trust: While it is natural that an individual jurisdiction may be comforted by ring fencing capital and liquidity locally to protect its taxpayers and market in a crisis, if other countries adopt the same approach, this becomes ineffective. All jurisdictions will be worse-off, with the net result that the entire system becomes more fragile and the provision of finance more expensive. Continuing to strengthen cross-border supervisory cooperation and resolution planning and making use of the tools which have been put in place is key to fostering integration. This would be further strengthened through the implementation of the EDIS roadmap to ensure depositor confidence and build trust between Member States.

3 See for instance the Monitoring Report on Risk Reduction Indicators of the European Commission, European Central Bank and Single Resolution Board (November 2018) or the ECB Macroprudential Bulletin, 27 March 2019

Removing regulatory and supervisory obstacles to facilitate cross-border banking activities and consolidation: This is necessary, particularly in a sector that is described as overbanked and suffering from low profitability. As exposures become more diversified across borders and the EU becomes a genuine single market, the persisting home bias of European banks will also reduce. The European regulatory framework should allow capital and liquidity to flow as freely as possible within European banking groups and supervisory authorities should implement the regulatory framework in a way that achieves this outcome. Options and national discretions which serve to perpetuate fragmentation and supervisory divergences should be addressed. The supervisory framework needs to be kept under review to ensure it is efficient and effective.

Work to harmonise insolvency frameworks: This should be pursued to foster integration of banking and capital markets. Continuing differences in national approaches are an on-going drag on cross-border investment and finance which require more timely corporate restructurings and settlement of claims. Well organised judicial systems and/or the availability of out-of-court workout solutions are also required to support efficient insolvency frameworks.

Ensuring the overall supply of credit and liquidity is stable: While regulatory reform has given rise to intended adjustments in banks' business models and balance sheets, including reduction in their exposures to capital market activities, it is important to continue monitoring possible overcorrections and the stability of the broader financial system. As the non-bank sector has grown to provide capacity, authorities must continue to examine the emergence of risks in this sector and its ability to withstand shocks.

Supporting open markets: To benefit from access to global capital and liquidity pools, EU markets need to be connected with those in other jurisdictions. To ensure these connections can occur while preserving market integrity, well-functioning equivalence regimes and strong global supervisory cooperation must be encouraged.

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