Reflections from the banking Union towards deeper Capital Markets

I would like to thank you for the kind invitation to this conference organised by BETTER FINANCE and CFA Institute and for giving me the opportunity to open the discussion this afternoon on the issue of the Capital Market Union (CMU).

We are in the middle of the road when it comes to the creation of integrated Financial Markets in Europe. Although we have already made some progress in the functioning of capital markets, it is also true that we are still far from reaching their full potential. Deep and liquid financial markets that can allocate capital efficiently and allow for cross-border private risk sharing constitute a key element for the resilience and growth of our economies. Such financial markets will complement the progress made in the banking union and ensure we have the financial markets we need for the future. My intention here is to provide some reflections on how far we have come in the banking union, which I hope will help in provide some light on how to progress in the deepening for financial markets in Europe.

The need for collective action

The economy faces a range of significant challenges in the coming years, including lower economic growth, technological disruption, and climate change.

First, growth in the global economy, as the World Economic Outlook highlights is “steady but slow”. While economic performance is soft landing from the interest increases of the last years, five-year
economic growth forecast is lower than ever. Trade tensions, political unrest, and rising war threats are among the factors contributing to instability.

Technological disruption is another significant challenge facing the economy in the coming years. The rise of Artificial Intelligence (AI), and financial innovations are transforming the way we live and work. While these technologies offer new opportunities for innovation and growth, they also pose significant risks to economic stability.

Finally, climate change, sustainability and the need to transition to greener economies is without doubt the most existential challenge the economy is facing not only in the long term but also in more immediate terms. The EU is committed to this transition and to lead the world in this process as needed to ensure a sustainable transition.

Given the structural long-term challenges our economy faces, and the transformation needed, efficient financial markets are essential to facilitate proper risk management, capital allocation and to ensure access to the large amount of new financing that is needed.

The public sector will need to provide some financial support and ensure a proper regulatory framework. Financial entities are called upon to play a decisive role in making market-based funding opportunities more widely and readily available across Europe. Of course, when we think about the financial sector, we think of the banking sector as a crucially important player to confront these challenges. The sector is critical in providing credit to households and businesses, assessing and managing risks, providing stable funding to the real economy, facilitating payments and transactions, and capturing savings.

This important role of banks should however not be at the expense of other financial companies, but rather complementary. Equity financing at all stages of a company’s development, long-term funding, active management, corporate restructuring, asset allocation, and insurance are essential financial activities that fall beyond traditional banking services. A bigger role for financial markets also implies more and better opportunities for banks to perform their activities.

The Eurogroup has in March identified priority areas for action to improve the functioning of European capital markets. These include developing a competitive, streamlined and smart regulatory system, allowing funds to be better channelled into innovative EU businesses, with greater liquidity, risk taking and risk sharing. Create better opportunities for EU citizens to increase direct and indirect retail participation in financing and provide profitable investment opportunities for them. The Letta report further elaborates on some of these ideas with some more concrete proposals, including areas for direct supranational supervision and the development of an auto-enrollment EU long term savings product, and I expect the Draghi report to elaborate further on these themes.

**Lessons from the construction of the Banking Union**

The European Union has made strong progress in the last decade in the construction of a banking union. The work done has served to create a more resilient banking sector and to better integrate
the banking sector in the EU. Although the job is far from finished, tangible progress has been observed and weaknesses remain. I think that there are lessons that can be extracted from that experience that can help in building more robust and deeper capital markets in the EU.

Let me elaborate in some of those lessons.

Construction of the banking union was an explicit policy agenda to address the challenges from the global financial crisis of 2008-2010, and then more specific, the Euro area crisis of 2010-2012. At the time, the assessment at the global level was that financial activity had grown too big. Banks were involved in too many activities, too complex and interconnected, without proper risk management, and with too much leverage. To put it simply: there was too much banking activity, too interconnected, and too risky. Furthermore, at the European level financial integration through the single market and the creation of the euro was not consistent with national supervisory and resolution regimes. The banking-sovereign loop proved pervasive.

The response was more and better regulation at the international level jointly with more intrusive supervision. The work of the financial stability board and the Basle Committee have been essential in this front. The Basel III framework sets out global standards for bank capital adequacy, liquidity, and risk management. The work at the EU level in the implementation and to establish the Single Rulebook has greatly contributed to the sector’s strength.

Supervisory intensity and scrutiny has also improved within the EU. The establishment of the Single Supervisory Mechanism with the ECB at its core has been quintessential in this process. Also key has been the work on recovery and resolution and the enhanced supervisory convergence across all the EU member states.

Finally, but not least important, banks have also enhanced their governance, risk management and business model assessments to improve their sustainability. Governance and control functions have been enhanced, efficiency has also improved.

Let’s briefly describe some of the positive developments. Despite facing numerous challenges in recent years, the EU banking sector has remained resilient. No major instability was observed since the global financial crisis (GFC), and no significant impact from the 2023 banking turmoil. This resilience can be attributed to a range of factors, including strong capital and liquidity positions, good profitability, and high credit quality.

Despite the significant progresses made in establishing the Banking Union, challenges remain. These challenges are particularly relevant when we think about the need for better, deeper financial markets in Europe.

First, cross border movement of capital and liquidity within banking groups remains fragmented. Banks operating in the EU continue to confront difficulties when allocating capital, liquidity, and some of their operational facilities within the different member states. Concerns over a fully integrated banking union being compatible with ensuring financial stability in each of the member states in case of financial disruptions prevent further integration. Furthermore, member states are...
concerned about the potential fiscal costs (or to their Deposit guarantee schemes) of banks from other member states entering into resolution.

Therefore, a more integrated banking union also means that the failure of a bank must dealt with according to a coherent set of rules across the Union, that guarantees financial stability throughout the EU and provides similar treatment to depositors. Here, we are looking forward to the new DGSD and encourage lawmakers to conclude the negotiations of the Crisis Management and Deposit Insurance framework promptly. In the long run, we should not lose sight of the aim to complete the banking union through the establishment of a single European deposit insurance scheme.

Second, cross-border provision of banking services at the retail level remains limited. Differences in legal structure, consumer protection, taxation, insolvency procedures, and other cultural and competitive dynamics continue to limit cross-border provision of services.

Third, and partially as a result of the previous two, the banking union has not resulted so far on any significant cross-border integration of banks in the European union. In fact, the market share of cross border activity performed by EU banking groups has declined over time.

**Reflexions for a deepening of EU financial markets**

I think that the establishment of the Banking Union supports and complements the deepening of financial markets and aims to further strengthen overall the financial services sector in the Union. Furthermore, I hope it will help us in better identify the best way to progress going forward. Let me provide some reflections in this regard.

Let me start with the two key elements that defined the policy action for the creation of the banking union at the time: there was a financial crisis and there was too much banking activity and regulatory failures.

Are we building the capital markets in response to a crisis, or do we view it as an opportunity? As is well known, Jean Monnet, a founding father of the EU, said “Europe will be forged in crisis, and will be the sum of the solutions adopted for those crises”.

The Capital Markets Union is not new. The project was now launched almost 10 years ago, at the time with the aim of improving the financing of the EU economy, reducing its reliance on bank funding, and enhancing financial stability. Not too different from the goals today.

However, there has never been so far the same sense of momentum to progress as there was in 2012 for the banking union and I will argue because there has never been the immediacy of a crisis that needed to be solved. Even after Brexit, when the EU lost its largest financial centre, there was not the sense of crisis needed to serve as a catalyst. It has all been about potential opportunities. I hope we can build in the next months the sense of momentum that will make Europe move swiftly.
The second difference is the perception, when creating the banking union, that a regulatory (and supervisory) failure at the global level, with specificities in the euro area, were at the core of the problem.

Here again the situation is different. Capital markets union is not a solution to a global problem, is a European specific issue. Is also not seen as a solution to a regulatory failure. We do sense that more homogeneous regulation, and supervisory intensity may contribute to better and deeper capital markets. Again is good to have but we are not desperate for it, it is not challenging our existence.

These two differences explain the ambition of the work done so far in the Capital Markets Initiative. Progress has been made. A number of milestones have been achieved, including the adoption of the Prospectus Regulation, the Securitisation Regulation, and the Covered Bond Directive. These regulations aim to improve access to financing for businesses and households, enhance transparency and investor protection, and promote cross-border investment.

However, we sense that as supportive as this is, it may not be enough. Other aspects, dealing with industry competitive structure, sources of saving, specialized human capital, clusters of activity, and deeper societal attitudes towards risk aversion and risk attitude remain important.

An example in this respect is the progress to create a more integrated and liquid market for securitised products. The introduction in 2019 of the Securitisation Regulation, as well as the Simple, Transparent and Standardised (STS) framework which has a preferential prudential treatment under CRR, represented an important step forward. However, the framework has not produced the expected results.

The work to enhance the securitisation framework is ongoing. EBA has published together with the other ESAs in Dec 2022 a review of the prudential framework for securitisation to improve its efficiency and risk sensitiveness. It is acknowledged that the lack of revival of the EU securitisation market should be found in the interplay between demand and supply, and that no simple regulatory solution is identifiable. Only a holistic and comprehensive review of the current framework could have the hoped effects.

In the meantime, the EU securitisation market is a fraction of what it was. Securitisations volume amounted to EUR 2tn in 2010 and was at around EUR 500bn at the end of 2022. In contrast, the outstanding volumes of securitization in the US in 2022 were well above the levels prior to the global financial crisis.

A third aspect relates to the lessons that can be learned from the persistence of fragmentation in the banking union. As I mentioned before, financial stability concerns by member states and possible mutualization of risks in cases of bank failures and resolution have been at the core of the reluctance to further progress towards European integration in the banking sector.

Here I am more optimistic for the prospects of European integration in capital markets. The economies of scale in capital market activity, the rationale for concentration of market activity,
create deep liquidity pools, and specialized knowledge in financial markets are clear. It is also clear that Europe has too many (national) markets in a number of financial products (equity, derivatives or fixed income) all of them too small. The case for consolidation and specialization is clear. At the same time, the concerns that concentration may impact financial stability at the level of a member state or possible risks from mutualization in case of failure are much less relevant.

A fourth lesson that I would like to extract has to do with the creation of pan European financial firms. The creation of the banking union has led to some consolidation of banking services across the EU. Most of these consolidations has taken place along national borders. However, cross border consolidation of banking groups has been quite limited, despite the creation of the single rulebook and single supervision. Banks executives consistently argue that the economics for cross border consolidation do not currently exist in the EU. There are however certain segments of banking activity were cross border provision of services by consolidated groups has been increasing. This is happening precisely in those areas more closely related to capital market activity and corporate banking (investment banking, trading, corporate lending and similar activities). In this aspect, I see potential for the creation of larger pan European financial players in the capital markets if the conditions were favorable.

A fifth reflexion has to do with the effective provision of cross-border retail financial services in the EU. The experience from the establishment of the banking union shows that progress here is difficult. Most of the retail lending and banking services provided to EU citizens and SMEs remain within national borders. Cross-border provisions of such services, with the notable exception of payments, remains very low. A large number of well identified differences across member states of very different nature (insolvency regulations, fiscal treatment, and cultural) make the expectation of developing truly European products through sequential regulatory harmonization and supervisory convergence difficult. A truly big bang approach will be needed if progress were to be made in this front.

Conclusions

Let me conclude. I do believe that deeper capital markets in Europe will help us in addressing some of our challenges. I think the experience from banking integration can help us in better achieve this goal. On the negative side, I fear that we lack the sense of urgency, and existential crisis, to make progress. We need to be convinced that deeper capital markets are not just nice to have or good for the financial sector. They are existential for the future of our citizens. On the positive side, financial stability concerns on financial stability that have slowed integration within the banking union are much less significant in capital markets while the economic benefits from specialization and economies of scale larger. This should drive faster integration if the conditions proved adequate.

Thank you for your attention