I. Financial Union: Integration and Stability

Section prepared by Anna Grochowska and Alexandra Hild

The introduction of Europe’s single currency 20 years ago was an important milestone for the integration of financial markets in the euro area. These markets integrated significantly in the first decade after the launch of the euro, but the integration process came to an abrupt halt with the outburst of the global financial crisis. Since then, the progress of financial and economic integration has slowed down significantly, and concerns about the stability of the overall financial system returned. The weaknesses of the regulatory and supervisory architecture that came to light during the crisis led to calls for comprehensive reforms to stabilise the EU’s financial system and promote its integration. In addition to the ad hoc measures to address the crisis, these reforms included: (i) an overhaul of the regulatory framework for financial markets and institutions; and (ii) the creation of two crucial building blocks for a genuine financial union: the banking union and the capital markets union. These reform measures were very successfully designed, and, while not fully completed yet have contributed to the stabilisation of Europe’s financial sector. However, further efforts are now necessary to reap the full potential of a true financial union. This section presents an overview of how the financial sector and its regulation have developed over the past two decades. It starts with a literature review on financial integration and stability, followed by an overview of trends in financial integration in the euro area. The subsequent chapters elaborate on the regulatory framework established before the crisis, the weaknesses of the financial system which were unveiled by the crisis, and the subsequent policy response. (1)

I.1. Introduction

The adoption of the European single currency initiated a long process of euro-area financial integration. That process of integration has waxed and waned over the past 20 years. In particular, the global financial crisis significantly interrupted the integration process, as can be seen in Graphs I.1 and I.2. Overall, however, the long-term trend towards financial integration has been maintained.

Almost immediately following the introduction of the euro, the financial services action plan (FSAP) became the key component of the EU’s attempt to create a single market for financial services. However, a decade later, the financial crisis exposed several weaknesses in the European financial system and its regulatory and supervisory architecture. The crisis led to calls for more thorough reforms of the regulatory and supervisory framework. In order to achieve a true financial union, these reforms, including the creation of the banking union and the capital markets union (CMU), must be completed.

I.2. Theory and benefits of financial integration

Baele et al. (2004) define a fully integrated market as a market where all market participants face the same relevant characteristics, such as: a single set of rules when dealing with financial instruments and services; equal access to the same set of financial instruments and services; and equal treatment of participants in the market. (2) In other words, full financial integration requires the same access to banks for both investors (the demand side for investment opportunities) and firms (the supply side of investment opportunities), regardless of their region of origin. It also requires the same access to trading, clearing and settlement platforms for investors and firms. Liebscher et al. (2006) show that financial integration can take many forms, including: monetary integration, liberalisation of the capital account, subcontracting abroad of financial services or of financial infrastructure, foreign entry, regulatory convergence, and harmonisation. (3) The concept of financial market integration implies that the law of ‘one price’ holds, which means that assets with

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The economic literature (5) identifies several interrelated benefits of financial integration, including more opportunities for risk sharing and for risk diversification; better allocation of capital among investment opportunities; and the potential for higher growth. Some studies also consider financial development as a beneficial consequence of financial integration.

On risk sharing, Jappelli and Pagano (2008) show that integration into larger markets is beneficial to firms, financial markets and institutions. (6) In particular, financial integration facilitates the investment process. This is because entrepreneurs with little initial capital have access to more intermediaries that can mobilise savings to cover the costs of investment. In addition, the availability of risk-sharing opportunities improves financial markets and permits risk-averse investors to hedge against negative shocks. This allows higher-risk projects (potentially also with high returns) to be financed. Given that integrated financial markets and institutions are better able to handle credit risk, financial integration removes certain forms of credit constraints faced by investors.

An integrated financial market removes impediments to the trading of financial assets and to the flow of capital. This allows investors to allocate their funds to the most productive use, and at low operational cost. Kalemli-Ozcan et al. (2008) show that opening access to foreign markets gives agents a wider range of financing sources and investment opportunities, and permits the creation of deeper and more liquid markets. This allows for information to be pooled and processed more effectively, and for capital to be allocated more efficiently. (7)

The economic literature also indicates a strong link between the development of financial structures and economic growth. (8) In the neoclassical framework, the opening of international capital markets generates flows from capital-abundant countries towards capital-scarce countries, and thus accelerates convergence (it therefore also accelerates medium-term growth) in poorer countries. Productivity may also increase in the countries receiving foreign capital, since capital flows relieve the economy of credit constraints and thus allow agents to make more productive investments. (9) Financial integration may also improve the functioning of domestic financial systems through the intensification of competition and the import of financial services. There is ample evidence in the literature (10) that financial integration leads to higher economic growth.

At the same time, increased cross-border financial activity creates challenges for financial regulators and supervisors seeking to maintain financial stability. Deeper financial integration requires closer regional financial policy cooperation, because shocks spread more widely in an integrated financial system. Sudden market volatility and abrupt reversals in capital flows across integrated markets may provoke financial crises. Appropriate legal frameworks and rules must therefore be put in place to take account of market circumstances where institutions are organised on a Pan-European, cross-sectoral basis. Possible regulatory safeguards to keep pace with new sources of financial risk and contain institutional and systemic risk include capital adequacy for banks and solvency margins for insurance companies.

Researchers have debated at length the extent of Europe’s financial integration — and more specifically the extent of the euro area’s financial integration. Their research is not entirely conclusive, as many researchers stress that even a fully integrated financial market may be subject to frictions. (11) What remains unchallenged is the fact that financial integration has progressed in Europe.

(10) See e.g. Eichengreen, and Wyplosz (2001), Klein and Olivei (2008), and Quinn and Toyoda (2008).
since the Treaty of Rome (1957), which created the basic conditions for the creation of a single European market for financial services.

The adoption of the common currency in 1999 gave a major impetus to financial integration in the euro area. (12) As economists point out, a single currency is an important component of a common financial system and a strong promoter of financial integration. (13)

I.3. Trends in euro-area financial integration

Euro-area financial integration began to increase after the inception of the euro, but stalled during the global financial crisis. Remarkably, integration in prices (where prices for — and returns on — similar investments in different euro-area countries converged) consistently outperformed quantity-based measures of integration (which cover interbank markets and which include the money and banking markets, bond markets and equity markets). After the acute phase of the crisis, the aggregate indicators of euro-area financial integration resumed their upward trend — strongly in the case of prices, but much less strongly in the case of quantities (see Graph I.1).

The main drivers behind the recent progress in price-based indicators of euro-area financial integration, whose level is still to reach pre-crisis levels, have been: (i) the convergence in equity returns; and (ii) the convergence in bond yields along with declining risk premia (see Graph I.2). In contrast, the slight decrease in the quantity-based indicator of integration over the past few years appears to result mainly from a decline in cross-border interbank lending. This decline in cross-border interbank lending may be linked to lower counterparties’ needs to undertake transactions within the euro area money market given the ECB’s loose monetary policy and in particular its sustained liquidity injections into the euro area banking system.

(12) Liebscher et al. (2006), op. cit.
A high level of interest-rate dispersion was also registered in the secured money market. This was linked to high demand for high-quality collateral amid the ongoing public-sector asset purchases by the Eurosystem.

In the securities market, euro area equity market integration, as measured by differences in returns between euro area countries, has recently reached again pre-financial crisis levels. In the sovereign bond segment, sovereign bond yields showed evidence of a return to cross-country convergence, following an increase in the dispersion rate during years 2015-2017. Convergence also continued in non-financial corporate bond yields while the measures of financial integration based on the portfolio structures of euro area securities investors showed mixed trends. The exposures of monetary and financial institutions (MFIs) (14) to euro area sovereign and corporate bonds issued outside their domestic market increased during the first few years following euro inception but the trend reversed during the crisis (for corporate bonds) or even before (for government bonds) – see Graph I.4. More recently, both groups of exposures stabilised at levels exceeding those from approximately 20 years ago.

Graph I.3: Dispersion in euro-area countries' unsecured interbank lending rates

Note: Dispersion is measured using the interquantile range of euro-area countries’ average unsecured interbank lending rates.

Source: GDP

In banking, the convergence of several price-based euro-area banking-market indicators continued. This was partly due to support from the ECB’s non-standard monetary policy measures. The narrowing dispersion in bank bond yields was helped in recent years by the positive market reaction to the resolutions, liquidations and recapitalisations of European banks and by the reduction in the stock of non-performing loans (NPLs — loans where the borrower is unable, or is deemed unlikely to be able, to make scheduled payments) (see Graph I.10).

Meanwhile, interest rates on lending to non-financial corporations and to households have continued to decline since the inception of the euro, amid falling cross-country dispersion. These developments indicate that access to finance improved for households and companies, including for small and medium-sized enterprises (SMEs) (see more details in Box I.1). The results of the bank lending survey (15) show changing trends in credit supply and demand in the euro area over the last two decades. The period immediately following the inception of the euro was marked by significant supply constraints, as well as by weak demand for credit. These weaknesses gradually dissipated, but frictions started to rebuild, especially in stressed countries, during the global financial and euro-area sovereign debt crisis. In recent years, there have

Graph I.4: Share of MFI cross-border holdings of debt securities issued by euro-area and EU corporates and sovereigns

Source: ECB

(14) MFIs constitute one of the most prominent sub-sectors of euro area investors.

(15) The bank lending survey provides information on bank lending conditions in the euro area. It supplements existing statistics with information on the supply of and demand for loans to enterprises and households.
been consistent improvements in both credit supply and demand conditions throughout the euro area (see Graph I.5).

Graph I.5: Credit supply and demand conditions in the euro area

Note: For supply, values correspond to the net percentages of banks contributing to tightening credit standards. For demand, values correspond to the net percentages of banks reporting a positive contribution to demand.

Source: ECB

Despite gradual progress, quantity-based indicators continue to show that there is fragmentation in cross-border and retail banking. The share of outstanding cross-border bank loans provided to non-MFIs is currently at around 5%. The share of cross-border loans to non-financial corporates remains below 10% while the share of cross-border loans to households remains below 1%. However, euro area equity and bond investment funds remained diversified across euro area Member States and beyond. The combined share of their investments in other euro area Member States and outside euro area have been increasing (see Graph I.6).

Further, there are signs that euro-area financial integration is becoming more resilient to shocks. This trend can be illustrated by foreign equity investments gaining ground over foreign debt investments, and by foreign direct investments strengthening relative to portfolio investments (see Graph I.7). Moreover, cross-border bank lending to retail customers has slowly increased over time in comparison to cross-border interbank lending. (16)

Graph I.6: MFI loans to non-MFIs: outstanding amounts by residency of counterparty

Source: ECB

Graph I.7: Euro area cross-border equity holdings

Source: ECB

Overall, cross-border, private financial risk sharing, which refers to attempts by households and firms to smooth out their consumption streams against fluctuations in the business cycle of their country resulting from economic shocks, is still fairly limited. (17) ECB calculations show that, as of 2017, almost 80% of the idiosyncratic shocks to a country’s GDP growth remain unsmoothed. According to the literature, better integration of capital and credit markets could make much larger contributions to risk sharing. (18)


(17) Idem.

Box I.1: Developments in access to finance based on SAFE data

More than 10 years after the onset of the global financial crisis, the availability of bank financing has become a much less significant problem for firms within the euro-area. In particular, the results of the EU’s survey on the access to finance of enterprises (SAFE) make it clear that the availability of external bank financing has improved greatly since 2010 in 11 euro-area countries for which data coverage remains comparable. Indeed, as of mid-2018, only 5.7% of sampled firms were deemed to be credit constrained, down from a peak of 13.8% in late 2011 (Graph 1a). Moreover, although credit constraints have eased for all firms, they continue to be much more significant for smaller firms, affecting nearly 7.2% of micro-sized firms in mid-2018 as opposed to 2.9% of larger firms in the same period (Graph 1b).

Graph 1. Credit-constrained* firms (% of sampled firms)

(a) by financial market conditions ** (b) by firm size ***

Source: Survey on the access to finance of enterprises (SAFE); European Commission.

Notes: Figures aggregate the share of firms facing problems in accessing bank loans or credit lines. *Credit-constrained firms are those firms that received less than 75% of the original amount sought, including a full rejection, or those that refused the bank’s offer. **The EA-11 countries that have not experienced severe financial market stress are identified as Austria, Belgium, Finland, France, Germany, and the Netherlands. The stressed EA-11 countries are Greece, Ireland, Italy, Portugal, and Spain. *** Micro enterprises are enterprises with 1-9 employees, small- and medium-sized enterprises (SMEs) are those with 10-249 employees, and large enterprises have 250 or more employees.

The figures also make it clear that the availability of bank financing continues to be more difficult for firms in countries that have experienced a severe episode of financial market stress. This is especially the case for Greece (country-specific data are not shown here), where 17.1% of firms are credit constrained, and 31.3% of firms say that access to finance is their most pressing problem. A deeper analysis reveals that most of this cross-country variability can be explained by: (i) changes in business outlook (i.e. sales and profitability); (ii) future growth expectations; (iii) credit history; and (iv) financial and macro-economic conditions.

An arguably less positive development has been the declining share of firms that seek bank financing. As of mid-2018, 67.5% of all sampled firms have refrained from seeking financing, a percentage which has been continuously increasing since the beginning of the survey (Graph 2a).

(Continued on the next page)
I.4. From euro inception until the crisis

The first decade which elapsed since euro inception can be characterised by a significant growth of cross-border banking groups in Europe. (19) While some general factors, such as the globalisation of financial markets fostered this process, also EU-specific drivers boosted cross-border financial activity. In particular, the legal and regulatory convergence observed in the 1990s (20) and the elimination of the exchange rate risk through the introduction of the euro are two important factors that pushed cross-border financial activity. (21)


(20) One milestone in this regard was the Second Banking Directive (No 89/646) which entered into force in January 1993 and introduced the Single Banking Licence.


The figures also reveal that the share of firms not needing bank financing is much greater in countries that have not faced severe financial market stress. This tendency holds for micro-sized firms and SMEs (Graph 2b). However, larger firms appear to have been more likely to seek bank financing since late 2015, which may be a direct result of the ECB’s expanded asset purchase programme. An empirical analysis reveals that an improving business outlook, and the corresponding ability of a firm to generate the needed funds internally, help to explain a relatively small part of the cross-country and intertemporal variability. The data do not highlight any increased use of alternative non-bank financing. Put together, these findings suggest that declining credit demand may be driven by reasons other than internal fund generation or alternative funding sources. These other reasons may include high levels of debt, economic and political uncertainty, and so on.

Graph 2. Firms that did not apply* for bank financing (% of sampled firms)

(a) by financial market conditions **                                    (b) by firm size ***
In order to strengthen the emerging single market for financial services in Europe, the FSAP was the key action plan guiding the EU’s attempt to create a single market for financial services. The plan was issued in May 1999 and it tackled three strategic objectives: (i) the creation of a single market for wholesale financial services; (ii) ensuring open and secure retail financial markets; and (iii) ensuring modern prudential rules and supervision. (22)

In order to complete the single wholesale market, the FSAP called for:

- the removal of outstanding barriers to raising capital (an update to the Directives on reporting requirements and prospectuses);
- a common legal framework for integrated securities and derivatives markets (amendment of the Investment Services Directive; Directive on market manipulation; and the Communication on clarification of protection rules for sophisticated and retail investors);
- a single set of financial statements for listed companies, and legal security to underpin cross-border securities trades (amendments to financial collateral arrangements);
- a secure and transparent environment for cross-border restructuring (agreement on proposals for a European company statute and takeover-bids directive; proposals for directives on cross-border mergers and transfers of company headquarters; requirement for disclosure of objective and stable criteria for the authorisation of restructuring in the banking sector);
- a sound framework for asset managers to optimise the performance of their portfolios in the interests of their investors (proposals for directives on: (i) prudential supervision of — and tax arrangements for — supplementary pensions; and (ii) closed-end collective investment funds).

To develop open and secure markets for retail financial services, the FSAP promoted better information, transparency and security for the cross-border provision of retail financial services (Directive on distance selling of financial services; Recommendation on mortgage credit information; proposal for a directive on insurance intermediaries; action plan to prevent counterfeiting and fraud in payment systems). The FSAP also proposed the speedier resolution of consumer disputes through effective extra-judicial procedures (Communication on out-of-court settlements) and the balanced application of local consumer-protection rules.

To ensure the continued stability of EU financial markets, the FSAP proposed to bring banking, insurance and securities prudential legislation up to the highest standards. It proposed to do this via:

- the adoption of a directive on the winding-up and liquidation of banks and insurance companies;
- the adoption of a directive on electronic money;
- amendments to the Money Laundering Directive;
- proposals to amend the capital framework for banks and investment firms; and
- proposals to amend solvency margins for insurance companies.

The FSAP also proposed: (i) a directive on the prudential supervision of financial conglomerates; and (ii) specific arrangements to increase cross-sectoral discussion and cooperation between authorities on issues of common concern (creation of a securities advisory committee).

On mutual funds, several successive directives on undertakings for collective investment in transferable securities (UCITS) (23) were adopted. Finally, the FSAP addressed broader issues on an optimal single financial market, including the elimination of tax obstacles and distortions. (24)

To support the development of the proposals and policies outlined above, the ‘Lamfalussy process’ was designed in March 2001. This process was composed of four ‘levels’, each focusing on a

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specific stage of the implementation of legislation. At the first level, the European Parliament and Council adopted a piece of legislation, setting out the core values of a law and building guidelines on its implementation. The law then progressed to the second level, where sector-specific committees and regulators advised on technical details. At the third level, national regulators worked on coordinating new regulations with other countries. The fourth level involved compliance with — and enforcement of — the new rules and laws. The Lamfalussy process was a significant catalyst in delivering successful agreements on four key measures of the FSAP: the Market Abuse Directive, adopted on 3 December 2002; the Prospectus Directive, adopted on 15 July 2003; the Markets in Financial Instruments Directive (MiFID), adopted on 27 April 2004; and the Transparency Directive, adopted in 2004.

The Lamfalussy process strengthened the role, legal status and political accountability of what were known as Level 3 committees. These committees subsequently evolved into the three supervisory authorities constituting the European system of financial supervision: the European Banking Authority (EBA); the European Insurance and Occupational Pensions Authority (EIOPA); and the European Securities and Markets Authority (ESMA). These reforms set the ground for subsequent supervisory convergence at euro-area and EU level.

The Commission’s White Paper on Financial Services Policy 2005-2010 (25) presented the Commission’s financial-services policy priorities for the period after the FSAP. The main objectives of the White Paper were:

- to strengthen the achievements made under the FSAP;
- to remove remaining inconsistencies in the regulatory framework;
- to further improve the supervisory architecture;
- to create more competition between financial services providers;
- to bolster the EU’s position in global capital markets.

The FSAP was largely completed by its 2004 deadline (39 of the 42 measures adopted) and two further measures were adopted in 2005. Member States made considerable efforts to transpose FSAP directives into national law, albeit at different speeds. Still, the plan left a number of significant fiscal and legal obstacles to creating a truly Single Market in financial services unaddressed, for example as regards the treatment of pensions across Member States. An important remaining challenge was the even and full implementation and enforcement of the newly adopted rules and regulations.

During the first decade of the euro’s existence, the financial services industry was actively involved in the rule-setting process. In particular, the Giovannini Group (26) produced reports on: (i) the re-denomination of bond markets into euro (1997); (ii) the EU repo market (1999); and (iii) coordinated issuance of euro-area government bonds (2000). The role of the Group was essential in the area of post-trading, where in 2001 (27) it identified 15 barriers to efficient cross-border clearing and settlement. It categorised these barriers under three headings: (i) national differences in technical requirements/market practices (10 barriers); (ii) national differences in tax procedures (2 barriers); and (iii) legal certainty (3 barriers). In the subsequent report (2003) (28) the Group proposed actions to remedy the identified problems. These actions took the form of a set of technical standards, market conventions, rules, regulations, and laws that are consistent with a barrier-free environment for the provision of post-trading services. As a follow-up to these efforts, European securities exchanges, clearing houses and central securities depositories signed on 7 November 2006 the code of conduct on clearing and settlement. However, the scope and implementation of this code of conduct turned out to be insufficient.


I.5. The crisis unveiled weaknesses

In the years preceding the global financial and economic crisis, the European financial sector experienced a boom. The financial system grew significantly in size during these years (see Graph I.8), and the operations of large financial institutions expanded, including across borders. These pre-crisis years also saw financial markets become increasingly integrated internationally. As mentioned at the beginning of section 4, this rapid growth of global banking groups, including those with headquarters in the EU, was fuelled by the introduction of the euro. However, other factors also played a role in this growth, such as the EU’s enlargement, the US financial market boom, and the low interest-rate environment. (29)

Graph I.8: Total assets of euro-area MFIs

Source: ECB SDW, Eurostat

The global financial and economic crisis, which started in 2007-2008 in the US, exposed weaknesses in the European — and in particular the euro-area — financial system. Many challenges were imported, or reinforced, by financial imbalances elsewhere, and the FSAP had only addressed some of the financial stability challenges of the system. The large scale of banking losses globally and the failure of leading investment banks such as Lehman Brothers spurred uncertainty in the market and prevented banks from lending to each other restricting liquidity provision across financial markets and to the broader economy. The described problems in the banking system, coupled with existing vulnerabilities of some euro-area Member States led to significant financial-sector disruptions and to the sovereign debt crisis in 2010.

Overall, this led to a return to fragmentation along national borders, first appearing in the banking sector and subsequently spreading to the sovereign sector. Some of the divergences resulting in fragmentation, were driven by country-specific differences in fundamentals and other factors (e.g. debt/GDP ratio, relative size of the financial sector, banking sector openness, national ring-fencing of financial markets).

At the peak of the financial crisis, the euro-area banking system became fragile. Stricter funding conditions meant that the flow of interbank funding decreased, and in some cases even came to a halt. This was particularly the case for cross-border, and unsecured, borrowing. This was because foreign lenders started charging larger premia or ceased lending altogether. At the same time, banks had limited ability to absorb losses, given their often-large expansion of balance sheets without provisioning sufficiently for the level of risk taken. Banks had also come to rely on relatively short-term wholesale funding to finance their balance sheets, and this wholesale funding proved unstable in the crisis. The resulting maturity mismatch between these short-term liabilities and longer-term loans or other assets, made them vulnerable to liquidity shocks. These liquidity shocks, combined with the solvency problems of some banks, led to calls for unprecedented state aid to support the euro-area banking system.

As a consequence of the financial crisis, bank lending to the economy dropped sharply. The heavy reliance on banks as a source of funding, and the relatively limited role of other sources of financing (such as equity markets) aggravated the problem. This seriously hampered the economic growth of the euro area. The financing conditions faced by companies very much depended on their geographical location.

The disproportionate growth of assets in the financial sector in the years preceding the crisis was accompanied by the accumulation of excessive levels of private- and public-sector debt (see Graph I.9). The low level of sovereign-bond yields created an environment in which governments were no longer subject to market pressure. The build-up of high levels of private (and public) debt hindered economic recovery, in particular in vulnerable Member States. At the same time, these

high debt levels exacerbated problems in the banking sector. The share of NPLs on the balance sheets of certain European banks increased significantly, as private-sector borrowers faced debt-servicing problems in the weak economic environment (see Graph I.10). The increased NPL levels diminished the capital position of many banks, and in some cases, reduced their profitability, thus hampering their ability to provide financing to the real economy. (30)

The sovereign debt crisis also illustrated the risks emerging from banks’ exposure to sovereign debt. In particular, it illustrated the systemic risk that can arise from banks’ disproportionately large exposure to the sovereign debt of their ‘home’ sovereigns (i.e. the countries in which the bank conducted most of its business), referred to as the ‘home bias’ (see Graph I.11). The adverse bank-sovereign loop transmitted the turmoil on sovereign debt markets into bank funding markets. This in turn affected lending conditions to the real economy. As a consequence, the single market for banking services once more fragmented along national borders. (31)

Another development observed since the global financial crisis is the retrenchment of cross-border banking in the EU. European banks cut down their cross-border bank claims by approximatively 25%. In particular, intra-EU claims were sharply reduced, and also commercial presence in other Member States was reduced. This led to geographically little diversified balance sheets,
making banks more vulnerable to domestic shocks. (31)

There were many causes of the crisis, and these causes were all intertwined. (32) Although many factors — both European and global — played an important role, two of the key issues in the crisis were: (i) the inadequate supervisory and regulatory framework; and (ii) the absence of a framework to facilitate an orderly winding down of financial institutions. Rectifying these flaws was at the centre of reform efforts in the years following the crisis.

I.6. Policy response to the crisis and remaining factors that hinder financial integration

Given the weaknesses of the regulatory and supervisory framework, and the lack of crisis management tools available, the initial policy response to the crisis was based on ad hoc (and in some cases unconventional) measures to address the particularly urgent situation. To safeguard financial stability, Member States took timely and coordinated action at national level, and provided unprecedented public support to their banking sector within the EU State aid framework. That framework ensured an orderly and coordinated process to rescue certain banks. Overall, the total volume of State aid increased significantly in response to the financial crisis. In 2008, aid provided in the form of cash expenditure represented €671 billion or 5.4% of the EU GDP and €1.3 trillion or 10.3% of the EU GDP for contingent exposures. (33) At the same time, the central banks of major economies coordinated their liquidity interventions, and the European Central Bank took a range of additional — in some cases novel — monetary policy measures, including the measure known as quantitative easing.

Although the 1999 legislative programme had been largely completed (34) before mid-2007, the ad hoc measures taken during the crisis were not sufficient to resolve all the implications of the financial crisis or to prevent future similar crises from happening. A fundamental overhaul of the regulatory and supervisory framework in the financial sector was therefore necessary. (35) Consequently, significant reform measures were taken or launched to stabilise Europe’s financial system and to restore the confidence of markets and the general public (36). More concretely, since the start of the crisis, the Commission proposed more than 50 legislative and non-legislative measures (37) to build a safe, responsible and growth-enhancing financial sector in Europe.

In the context of the 1999 legislative programme, most EU financial market legislation had taken the form of directives, which had to be transposed into national law. To address some of the shortcomings of that approach, the Commission released a set of harmonised prudential rules in what was called the ‘single rulebook’ (38), initiated in 2009 (39). The Commission also ensured the consistent application of the regulatory banking framework across the EU. This completed the single market in financial services and ensured the uniform application of the Basel rules in all EU Member States.

(32) The causes of the crisis have been assessed in various publications. See, for example, European Commission (2009) Economic crisis in Europe: causes, consequences, and responses, European Economy No 7, September 2009; High-level Group on Financial Supervision in the EU (2009); Claessens et al (2014); Reinhart and Rogoff (2009); Acharya and Richardson (2009); Acharya et al (2009); Roubini and Mihm (2010); Lo (2012); Gorton (2010); and Gorton and Merrick (2012).
(34) One exception was the Directive on insurance supervision (Solvency II). The proposal was only tabled in July 2007 and adopted in 2009. See Directive 2009/138/EC.
(38) The most relevant legal acts of the Single Rulebook are the Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD IV); the Bank Recovery and Resolution Directive (BRRD); and the amended Directive on Deposit Guarantee Schemes (DGSD). Other acts include the Payment Services Directive (PSD2); the Mortgage Credit Directive (MCD); the corresponding technical standards developed by the European Banking Authority (EBA) and adopted by the European Commission (RTS and ITS); and the EBA Guidelines.
Policy efforts in the banking sector were complemented by reforms of the regulatory framework for selected financial institutions and parts of the financial infrastructure. One notable example was the revision of the Regulation on credit rating agencies (CRAs) \(^{40}\). In the period leading up to the financial and sovereign debt crises, CRAs failed to properly appreciate the risks in certain categories of financial instruments. In response, the Commission strengthened the regulatory and supervisory framework for CRAs. Another example is the strengthening of post-trade infrastructure. In this area, new rules were adopted in 2012 that required certain over-the-counter (OTC) derivative contracts to be cleared through central counterparties (CCPs). The aim of this reform was to mitigate some of the risks posed by the credit default swap market and other derivatives markets that were revealed by the crisis. In addition, the EU adopted in 2014 a regulation on central securities depositories \(^{41}\) to strengthen, harmonise and streamline the settlement process across borders. Finally, the Securities Financing Transactions Regulation was adopted in 2015 to increase transparency and reduce risk around transactions in securities used by investors and firms to fund their activities.

Building and preserving financial stability in the euro area had been underway for more than 10 years. It had been significantly supported by the Lamfalussy process and the de Larosière report. However, some remaining gaps were identified and solutions had to be developed. Thus, two crucial building blocks were proposed to help achieve full financial integration within the euro area: the banking union and the CMU. The banking union was launched to further weaken the connection between banks and the governments of their home countries, thus strengthening the resilience of the European banking sector and ensuring that banks in difficulty are not ‘saved’ by taxpayers’ money. It also aimed at strengthening the crisis management and resolution framework. The CMU aimed to promote private risk sharing and improve access to funding by offering companies more diversified sources of funding.

All of these reforms were complemented by the adoption of: (i) an action plan on fintech in the financial sector to harness the potential of financial technology, both for companies and for investors; and (ii) the sustainable finance action plan, to redirect capital flows towards sustainable investment and to manage financial risks stemming from environmental degradation and social issues (see more details below).

**The banking sector and the banking union**

The regulatory and supervisory framework for the financial sector was overhauled to safeguard financial stability and enable the EU banking sector to recover \(^{42}\). The following measures have all helped to create a more resilient banking sector in the EU:

- higher capital requirements;
- the introduction of liquidity requirements;
- the introduction of a macro-prudential dimension to bank regulation and supervision;
- reforms to remuneration rules to curb excessive risk-taking;
- rules to curb moral hazard in securitisation; and
- the creation of bank resolution frameworks to address the too-big-to-fail problem.

In addition, a new architecture was put in place for the supervision and resolution of large or systemic credit institutions in the euro area. The first two pillars of the banking union — the single supervisory mechanism \(^{43}\) and the single resolution mechanism (SRM) \(^{44}\) — have already been implemented and are operational. However, work remains ongoing on a common European deposit insurance scheme (EDIS) \(^{45}\) and the implementation of a common backstop to the single resolution fund (SRF). The creation of the banking union was preceded by the establishment of the European system of financial supervision,

\(^{40}\) The latest legislative package on CRAs consists of Regulation (EU) No 462/2013 and Directive 2013/14/EU.

\(^{41}\) Regulation (EU) No 909/2014.

\(^{42}\) These reforms originated from reform efforts initiated at a global G20 level.

\(^{43}\) The SSM performs prudential supervision of credit institutions in the banking union.

\(^{44}\) The SRM ensures consistent implementation of the rules for orderly recovery and resolution of banks in the banking union that are failing or likely to fail. The SRF, which the SRB has at its disposal, has €24.9 billion in contributions from banks.

\(^{45}\) The Commission made a legislative proposal on EDIS in 2015.
which is a network of micro- and macro-prudential authorities supervising the implementation of financial regulations. The European system of financial supervision is now centred on the three European supervisory authorities (ESAs) the EBA; the EIOPA; and the ESMA), along with the European Systemic Risk Board (ESRB) and national banking supervisors.

The banking package, a set of measures proposed by the Commission back in 2016, introduced key amendments to the single rulebook’s prudential and resolution provisions. It revised the rules on capital requirements (now laid down in CRR II/CRD V) and resolution (BRRD/SRM), strengthened the prudential framework; and increased banks’ ability to absorb losses in times of crisis. The banking package is — and will remain — an important milestone in the reduction of risks in the banking sector. It should also pave the way for further progress in the completion of the banking union. A political agreement on the banking package was reached in December 2018.

The Deposit Guarantee Scheme Directive, adopted in 2014, improved protection for depositors based on harmonised rules applicable to: (i) the funding of national deposit-guarantee schemes; and (ii) the level of guarantee that national deposit-guarantee schemes offer to depositors.

The adoption of International Financial Reporting Standard (IFRS) 9 improved the accounting treatment and valuation of financial assets and liabilities. This included improvements to the rules applicable to the impairment of financial assets, which is relevant for banks’ non-performing exposures.

The Commission also proposed a package of measures to address remaining stocks of NPLs and prevent their possible build-up in the future. The package included:

(i) a proposal for a regulation amending the capital requirement regulation and introducing common minimum coverage levels for newly originated loans that become non-performing;
(ii) a proposal for a directive on credit servicers, credit purchasers and the recovery of collateral; and

(iii) a Commission staff working document containing a blueprint for Member States that choose to set up national asset management companies (AMCs).

This package played an important role in reducing risks in the banking sector. It aims to preserve the banking sector’s ability to lend and finance the economy even in difficult times. In December 2018, the European Parliament and Council agreed on the prudential backstop regulation, which introduces minimum levels of coverage for future NPLs arising from newly originated loans. However, the proposal for a directive on credit servicers, credit purchasers and the recovery of collateral is still under negotiation. Data suggest that measures taken by banks and by national and European policymakers, supported by the economic recovery, are delivering results. The latest figures for end-2018 indicate a further drop in the NPL ratio to 3.3% for the EU at large.

Footnotes:
(46) The ESAs are responsible for micro-prudential supervision, and work primarily on harmonising financial supervision in the EU.
(47) The ESRB, established in 2010, is a body responsible for macro-prudential oversight at EU level. It provides a coordination platform, monitors risk, and gives guidance to national authorities.
(48) Academics have also extensively studied the various elements of national deposit-guarantee schemes; and (ii) the questions raised by the evolution of the banking sector and its implications for prudential regulations.
(51) Directive 2014/49/EU.
(52) Directive 2014/49/EU.
(53) Directive 2014/49/EU.
(54) Regulation (EC) No 1126/2008 codifies IFRS as adopted by the EU.
(56) SWD(2018) 72 final.
(57) Regulation (EU) No 1126/2008 codifies IFRS as adopted by the EU.
(61) SWD(2018) 72 final.
(63) EU total gross non-performing loans and advances, in % of total gross loans and advances.
compared to 6.7% since the end of 2014 (see Graph I.10).

The Commission also took action to tackle the bank-sovereign loop by proposing a regulation for an enabling framework for the securities known as sovereign bond-backed securities (SBBS) (59). SBBS are instruments that can be issued by private market participants. They entail two fundamental features: first, bundling of bonds issued by different euro area sovereigns in a single portfolio according to a pre-defined key; and, second, issuing two or more tranches against this portfolio with different seniority. SBBS could help banks diversify their sovereign exposures and weaken the bank-sovereign nexus and associated systemic risk. The European Parliament voted in favour of the proposal in April 2019, but the Council has not yet agreed on a common position.

Today, the EU banking sector is in much better shape than during or even before the financial crisis. Overall, banks are less leveraged and better capitalised and are thus better prepared to withstand economic shocks. In addition, liquidity provisions, which were a key issue during the crisis, have also improved materially. Today, the EU’s large banks hold an average core capital ratio of 13%, which is a rise of 2.8 percentage points since the establishment of the banking union. The strengthening of capital positions is also reflected in higher leverage ratios, which improved from 4.0% at the end of 2014 to 5.3% at the end of 2018. (60)

Nevertheless, some weaknesses and vulnerabilities remain. For example, the ring fencing of regulatory capital and liquidity to protect the domestic assets of a bank from cross-border contagion, by regulators turned out to bear some risks. While during the crisis, supervisors aimed at securing domestic financial stability, they neglected potential negative effects on other EU Member States. (61) More importantly, the architecture of the banking union is not yet complete. Progress on the banking union is essential to guarantee that the overall framework is sufficiently robust in future episodes of financial stress. This progress requires: (i) the establishment of an effective and functional common backstop for the SRF to reinforce the credibility of the bank resolution framework within the banking union; and (ii) the setting up of a common European deposit insurance scheme (EDIS), which would equally and effectively protect depositors in the banking union from large financial shocks and thus reduce sovereign-bank links. The EDIS should also facilitate cross-border banking activities which play an important role in reducing risks through private risk sharing, and support continued improvements to the EU crisis-management framework, in particular for less significant financial institutions. The issue of euro-area banks still holding substantial amounts of sovereign bonds on their balance sheets, in particular sovereign bonds of their ‘home country’, continues to pose a barrier to financial sector integration and a risk to financial stability. (62) If a problem arises in either area, both public finances and the banking sector could be destabilised.

Therefore, as outlined in the Commission’s 2017 reflection paper on deepening European monetary union (63) as well as the 2019 Communication (64), further measures could be considered in the medium-to-long-term to strengthen and deepen the financial union. For example, a joint political agreement could be taken on changing the regulatory treatment of sovereign exposures and introducing a European safe asset.

\[\text{(62) Also academics cite the bank-sovereign vicious circle as one of the main issues that need to be addressed. See e.g. A. Bénassy-Quéré, M. K. Brunenmeier, H. Enderlein, E. Farhi, M. Fratzscher, C. Fuert, P.-O. Gourinchas, P. Martin, F. Pisani, H. Rey, N. Véron, B. Weder di Mauro, J. Zettelmeyer (2018) Reconciling risk sharing with market discipline: A constructive approach to euro area reform, CEPR Policy Insight No 91.}\]
The capital markets union (CMU)

As a continuation of the reform effort, and to better develop and integrate euro-area capital markets, the CMU action plan was launched in 2015. The CMU seeks to make progress on the functioning of the single market by ensuring that companies, in particular SMEs, from all Member States have better and equal access to capital markets across the EU. CMU improves private risk sharing and helps mitigate economic shocks in the euro area and beyond. More cross-border risk-sharing, bigger, deeper, more liquid and more competitive capital markets, a greater diversification of funding sources towards capital market funding, together with the progress and efforts made in the context of the Banking Union, should deepen the integration of financial markets and EMU at large and make the euro area more resilient and robust to shocks.

The Juncker Commission has presented 13 CMU legislative initiatives, of which 10 have been agreed on by the European Parliament and the Council. These include measures that:

(i) make it easier for start-ups and SMEs to access market finance and thus to diversify their funding sources, such as via the new prospectus regime;

(ii) make it more attractive for institutional and retail investors to invest long-term and in a more cross-border way in the EU economy, such as the Regulation for a personal pension product;

(iii) increase the integration of capital markets by strengthening the coordination role of the European supervisory authorities and by strengthening the supervisory framework in the area of anti-money laundering.

Another important policy objective is sustainable finance, for which a dedicated action plan was adopted in March 2018. This action plan lays the ground for redirecting capital flows towards sustainable investments, and also aims to improve the handling of climate change risks in the financial sector. As part of the action plan, three legislative proposals have been tabled on:

- developing an EU-wide taxonomy for sustainable economic activities in order to better identify how ‘green’ given investments or portfolios actually are.
- disclosure requirements for asset managers, institutional investors and financial advisers;
- giving investors the tools to measure the carbon footprint of an investment strategy, by using financial benchmarks.

The disclosures and benchmarks proposal have been agreed by the European Parliament and the Council. On taxonomy, the European Parliament has already adopted its negotiation position.

As part of the European Commission’s efforts to build a CMU, the European Commission also adopted an action plan on fintech to foster a more competitive and innovative European financial sector. Under the fintech action plan, the European Commission intends to take 19 measures to:

- boost innovative business models at EU level;
- support the uptake of new technologies, such as blockchain, artificial intelligence and cloud services in the financial sector;
- increase the integration of capital markets by strengthening the coordination role of the European supervisory authorities and by strengthening the supervisory framework in the area of anti-money laundering.

cybersecurity and the integrity of the financial system. (7)

The launched CMU initiatives now need to be followed up in order to ensure that they achieve their purpose. In particular, a further development of market-based financing possibilities for SMEs need to be ensured. Also, challenges relating to the green transition, digitalisation and changing trade patterns need to be addressed.

Fostering euro-area financial integration and stability via country-specific recommendations

In 2010, the European semester (72) was set up to improve economic governance and policy coordination between EU Member States. As part of the European semester, the European Commission presents and addresses country-specific recommendations (CSRs) for each EU Member State, which cover a broad scope of policies.

Some of these recommendations relate specifically to each country’s financial sector, a sector that was of particular importance in the aftermath of the financial crisis. At that time, CSRs on the financial sector focused mainly on measures to stabilise the financial system in general. They targeted the restructuring and recapitalisation needs of the banking system or the quality of banking supervision. This emphasis has recently shifted more towards recommendations addressing some of the legacy issues of the financial crisis, such as the high levels of NPLs on banks’ balance sheets, as well as access to finance for companies.

Overall, the CSRs related to the financial sector have contributed to improved financial-sector stability and to greater resilience of the banking sectors of EU Member States (73). For example, Member States made progress — albeit to varying degrees — in: (i) addressing structural weaknesses in their banking systems; (ii) tackling high levels of NPLs and shortcomings of national insolvency frameworks; and (iii) improving access to finance for companies, including SMEs. Nevertheless, the implementation of key reforms on financial markets/sectors must advance further and remain a priority.

I.7. Conclusion

The euro-area financial system has completed a long path towards greater integration and stability since the introduction of the single currency. While the full potential of financial integration has yet to be realised, this goal is within reach if the effort continues. Although the past two decades have seen many difficulties, most of these difficulties have been turned into opportunities to thoroughly reform and improve the functioning of the system. The recent times are bringing new economic, environmental, technological and geopolitical challenges for the system. To name a few examples, the confirmation of growth concerns got amplified by mounting trade tensions; cyber-attacks increased in frequency and become more sophisticated; non-bank credit intermediation opened new channels for propagating systemic stress. All these issues should be carefully monitored and, if needed, followed with adequate policy responses. More importantly, the initiated projects such as the banking and capital markets union need to be completed so as to yield all their benefits for euro area financial integration and stability. Two important milestones in this context would be to reach an agreement on EDIS and further ease market-based financing possibilities for SMEs.

