35

FINANCIAL MARKET INTEGRATION AND EMU

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I. Introduction

35.1 This chapter discusses the evolution of the market structure in European banking and the level of financial integration in the Eurozone and the interaction with financial regulatory developments. The chapter will address how the creation of the Banking Union's Single Supervisory Mechanism (SSM) has affected banking market integration in the Eurozone. The chapter also raises related issues concerning monetary policy and banking supervision and some of the challenges in discharging these responsibilities within the Banking Union. This chapter also analyses the Capital Markets Union **(CMU)** proposal in respect of its important objective to increase the supply of credit from non-bank financial intermediaries to the economy of the European Union (EU) while also raising important prudential regulatory concerns concerning the risks raised by the shadow banking sector.

II. EU Banking Market Structure

35.2 It has been asserted that increased financial market integration in the European Union leads to a more efficient allocation of capital and enhanced credit intermediation within the Single Market, and to a more effective transmission of monetary policy in the European Monetary Union (EMU).[1] Other commentators emphasize the power of EU legal and institutional

[1] See ECB, 'Financial Integration in Europe' (Frankfurt, April 2010) 1–2 (hereafter ECB, 'Financial Integration in Europe'). Commission, 'Report on Financial Integration' (Brussels, 2009) 2–3 (hereafter Commission, 'Report on Financial Integration').

factors to shape the development of banking markets while influencing the organizational structure and strategy of banking groups,[2] whilst others have analysed the effectiveness of the SSM in terms of whether the right balance has been struck in determining whether the European Central Bank (ECB) should have more influence over prudential rule-making.[3]

35.3 The aftermath of the crisis has posed a host of new questions on the relationship between financial market integration and financial stability, as well as between competition policy and banking regulation. In general, as in other jurisdictions, regulation has lagged behind the process of liberalization of the financial sector. Financial market integration has become an important objective of EU policy-makers and has become linked to other post-crisis policy developments, such as promoting a level regulatory playing field in the design of harmonized bank regulatory standards across the Union.

35.4 After the creation of the European Monetary Union, there was a substantial increase in the growth of the European banking sector as measured by banking sector assets, which grew to 3.5 times the Gross Domestic Product (GDP) of the euro area.[4] Despite the growth of banking sector assets relative to GDP, the share of monetary and financial instruments in the formal banking sector relative to the total assets of financial intermediaries has declined steadily, reflecting the growing competition from nonbank financial firms. The crisis, however, had the effect of curtailing the expansion of banking assets relative to GDP, in particular in countries more affected by the crisis.[5]

35.5 Nevertheless, some studies suggest that Europe may be overbanked[6] and the European banking sector displays overcapacity, even more so after the crisis. As a result, the sector has undergone restructuring with reduced employment and falling branch numbers. For instance, between 2008 and 2016, the number of branches in the euro area dropped by 17 per cent, while employment fell by 12 per cent.[7] Moreover, deregulation and increased competition have led banks to consolidate their operations in order to achieve economies of scale and scope and to try to maintain market power. Although consolidation can lead to larger and more diversified banking groups, it often results in reduced capacity in the branch network—especially when banking networks overlap.

35.6 In addition, market concentration in the banking sector has increased in most EU countries and in all Eurozone countries between 2005 and 2016 (see Figure 35.1). In particular, the banking sectors of the economies which suffered the most post-crisis all underwent major restructurings, which have resulted in greater concentration in the banking industry.

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[2] See Eddy Wymeersch, 'The Single Supervisory Mechanism: Institutional Aspects' in Danny Busch and Guido Ferrarini (eds), *European Banking Union* (OUP 2015) 93–94, 111–12 (hereafter Wymeersch, 'The Single Supervisory Mechanism').

[3] See Guido Ferrarini and Fabio Recine, 'The Single Rulebook and the SSM: Should the ECB Have More Say in Prudential Rulemaking?' in Danny Busch and Guido Ferrarini (eds), *European Banking Union* (OUP 2015) 118–54, 143–51.

[4] This is measured as the value of monetary and financial instruments relative to GDP. See Xavier Vives, *Competition and Stability in Banking: The role of regulation and Competition Policy* (Princeton UP 2016).

[5] Joaquín Maudos and Xavier Vives, 'Competition policy in banking in the European Union' (2019) 54 Review of Industrial Organization 4.

[6] European Systemic Risk Board, 'Is Europe Overbanked?' (2014) Reports of the Advisory Scientific Committee No 4 <http://www.esrb.europa.eu/pub/pdf/asc/Reports_ASC_4_1406.pdf> accessed 10 February 2020.

[7] See ECB, 'Report on Financial Structures' (2017) 81 <http://www.ecb.europa.eu/pub/pdf/other/reportonfinancialstructures201710.en.pdf> accessed 10 February 2020 (hereafter Report on Financial Structures).

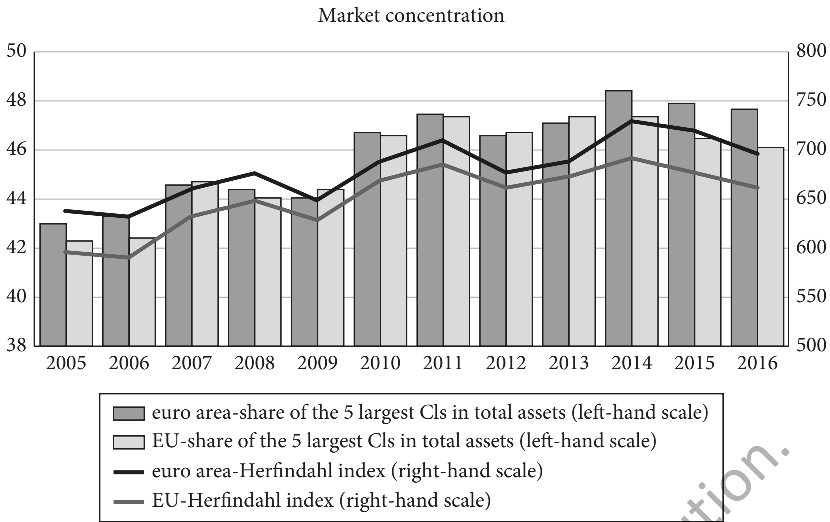

Figure 35.1 European banking market concentration: the Herfindahl index[1]

[1] See Report on Financial Structures (n 7) 31.

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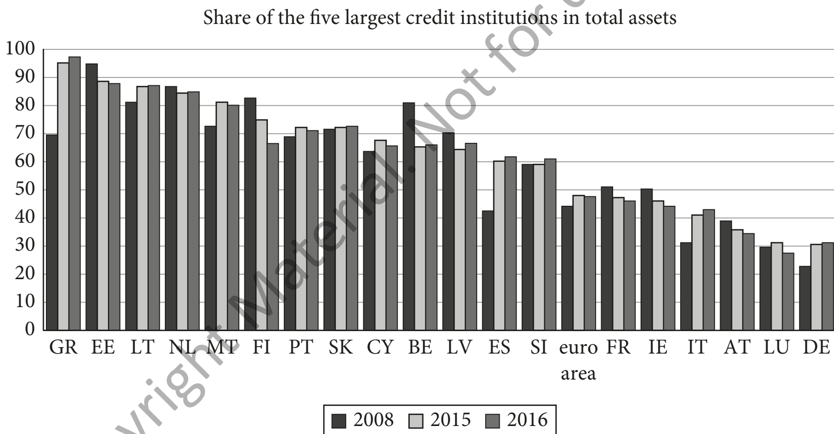

Figure 35.2 Market share of credit institutions by country[1]

[1] Report on Financial Structures (n 7) 32.

Figure 35.1 uses the Herfindahl index to measure market concentration in the EU and euro area banking industry.[8]

35.7 If the Herfindahl index's market concentration measure is applied to the banking markets in Greece and Spain (see Figure 35.2), it will demonstrate a highly concentrated banking market. Based on ECB measures of the Herfindahl index in the EU banking sector, as of 2016 there are significant differences in the degree of concentration in the banking sectors of different EU Member States. Figure 35.2 also shows that market concentration (measured

[8] See Commission, 'European Financial Stability and Integration Review (Commission Staff Working Document)' SWD (2015) 98 final, 166–67.

by share of assets held by the five largest banks) ranged from 97 per cent in Greece to about 31 per cent in Germany and 28 per cent in Luxembourg.[9] This data depicts structural factors in EU banking markets, including that banking sectors in some of the larger countries are more fragmented because they include competitive savings and cooperatives banks, thereby reducing concentration levels. In contrast, banking sectors in smaller Eurozone economies tend to be more concentrated and less fragmented with the exception of Austria and Luxembourg.[10] In Austria, the less concentration in structure of the banking sector is due to its similarity with some larger EU countries, such as Germany, while the lesser concentration in structure of Luxembourg's sector is due to the presence of a large number of foreign banks.[11]

35.8 As a matter of competition policy, it should be mentioned that measuring an appropriate concentration for the European banking industry involves a determination of the relevant market for banking services, but determining the relevant market in banking presents a number of challenges, as the market for banking services consists of a number of multiple products and geographical markets. Aggregate measures provide an imperfect indication of the concentration in the relevant markets.

35.9 As discussed below, the financial crisis has inhibited further cross-border mergers in the Eurozone. In comparison, although bank mergers in the United States increased dramatically in the late 1990s because of the Inter-State Banking Act of 1994, they fell sharply after the 2007–08 crisis.[12] The long period of low interest rates in the Eurozone, as a response to the crisis and the subsequent sovereign debt crisis, has put further pressure on bank margins and profitability, and has provided further incentives for banks to consolidate. If economic recovery in the Eurozone returns to pre-crisis levels, the number of bank mergers and acquisitions—both on a domestic and cross-border basis—may increase again to pre-crisis levels.

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III. Financial Market Integration in the EU and Eurozone

35.10 A widespread view holds that the level and evolution of the degree of financial integration is relevant since the more integrated a market is, the lower the barriers to entry and the greater capital formation and enhanced credit intermediation.[13] A vast literature has documented the level of integration in European financial markets.[14] Following adoption of the euro, the Eurozone experienced significant convergence between 2001 and 2008 in interest rate differentials in the wholesale banking and inter-bank markets.[15] Wholesale markets have a higher level of financial integration than retail. Up until the crisis in 2008, there was

[9] See Report on Financial Structures (n 7) 32.
[10] Report on Financial Structures (n 7) 31.
[11] Report on Financial Structures (n 7) 32.
[12] See Robert Armstrong and Laura Noonan, '$66 bn US bank merger ups ante on others to consolidate' *Financial Times* (New York, 8 February 2019), citing chart showing US bank mergers and acquisitions from 1980 to 2018.
[13] ECB, 'Financial Integration in Europe' (n 1). See also Commission, 'Report on Financial Integration' (n 1) 3.
[14] See Tullio Jappelli and Marco Pagano, 'Financial Market Integration Under EMU' (2009) CEPR Discussion Paper No DP7091.
[15] Ibid.

increasing integration in both interbank (wholesale) and non-interbank (retail) markets, with greater integration occurring in interbank (wholesale) markets. This pattern was also shown when monitoring the evolution of the differences in interest rates of bank loans between Eurozone countries. ECB data show that from 2003 to 2008, there was increased convergence in interest rates on bank loans between countries, which suggests an increase in integration in the interbank loan market. Moreover, the cost of capital for equity and debt issuance underwent significant convergence pre-crisis across EU states, while the composition of asset classes in most regulated investment funds **became** less home-biased towards the domestic market.[16]

35.11 Notwithstanding, the impact of the crisis led to a reversal of cross-border bank lending and investment flows between countries.[17] The outbreak of the crisis in 2007 and 2008 and its intensification by the Eurozone sovereign debt crisis between 2010 and 2013 also resulted in sharp increases in the differences in interest rates between Eurozone countries, which is largely explained by the impact of the different sovereign risk premiums. The ECB observed that post-crisis '[f]oreign branches lost market share to domestic institutions, and there was a pronounced decline in cross-border M&As as banks shifted their focus from pursuing growth opportunities to repairing their balance sheets'.[18] Moreover, the market segments that had experienced the highest degree of integration pre-crisis were most heavily impacted by the crisis, and in many cases saw a sharp reversal of the integration trend. For example, this occurred in the unsecured wholesale money markets, government bond markets and equity markets.[19]

35.12 The ECB's proposals for a Banking Union in 2012 had the effect of reversing this trend by leading in 2013 to a significant reduction in the difference in interest rates between Eurozone countries, returning in some cases to pre-crisis levels. Despite reduced differences in interest rates generally between Eurozone countries, differences remain much higher for consumer loans than for other loans (loans to companies and home mortgage loans). In fact, the high differences in interest rates for consumer loans between Eurozone and EU countries are much higher than the differences that existed before the crisis.[20]

35.13 EU policy-makers and regulators had expressed concerns well before the 2007–08 crisis as to whether the banking liberalization process was adequate to promote integration of the EU banking sector. Of particular concern is that retail banking remains regional despite the inroads made by online banking. Retail banking remains fragmented essentially because local banks have proximity to clients, soft information, and long-term relationships, all of which remain important factors in a successful retail banking strategy. Regarding cross-border banking, European banks continue to rely more on using subsidiaries in other EU jurisdictions to establish more retail and wholesale business. This approach has been reinforced by the crisis.

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[16] Ibid.
[17] ECB, 'EU Banking Structures' (September 2010) 21–22.
[18] Ibid, 22.
[19] Commission, 'European Financial Integration Report 2009 (Commission Staff Working Document)' (2009) SEC (2009) 1702 final.
[20] ECB, 'Financial Integration in Europe' (May 2017) 101 <http://www.ecb.europa.eu/pub/pdf/other/ecb.financialintegrationineurope201705.en.pdf> accessed 10 February 2020 (hereafter ECB, 'Financial integration in Europe 2017').

35.14 In some EU countries almost 100 per cent of the banking business is in the hands of foreign banks and that this co-exists with other EU countries where the market share of foreign EU-based banks is less than 10 per cent. Since 2008, the market share of foreign banks has been reduced in many countries.[21] Another measure of banking sector integration is the market share of EU-based banks in the markets of other Member States. Based on this measure, the market share has fallen since 2008 in many countries, which is evidence of the negative impact that the crisis has had on financial integration.[22] The financial crisis has produced a negative effect on financial integration, particularly in the euro area, which has suffered more deeply from the effects of the sovereign debt crisis that started with Greece in May 2010 and spread to other Eurozone states. Most retail and wholesale banking indicators show deterioration in financial integration post-crisis.

IV. Strengthening Banking Integration and ECB Banking Supervision

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35.15 The European Banking Union (EBU) was designed to restore the financial health and stability of the European banking system and to sever as a link between weak euro area banking systems and fragile sovereign debt finances.[23] The Banking Union consists of three pillars: the Single Supervisory Mechanism (SSM), Single Resolution Mechanism (SRM), and the European Deposit Insurance System (EDIS). The SSM was implemented first, taking effect in 2014, with a view to enhancing the supervision of the European banking sector and to promoting banking stability following the financial crisis of 2007–09 and the euro area sovereign debt crisis of 2010–12. The SSM forms the supervisory pillar of the European Banking Union and empowers the ECB to carry out prudential supervision of credit institutions and certain financial holding companies that are established in participating Member States. In addition, the SSM allocates supervisory responsibilities to the national competent authorities of participating Member States for less significant institutions.[24]

35.16 The other two pillars of the EBU consist of the Single Resolution Mechanism (SRM) and the European Deposit Insurance System (EDIS). The SRM applies the Bank Recovery and Resolution Directive 2014 (BRRD)[25] in the Banking Union jurisdictions. The SRM took effect in 2016 and operates through the Single Resolution Board, which has authority to take a bank or systemically important investment firms into resolution and to utilize resolution tools to restructure or recapitalize the institution, if necessary, to prevent a crisis and to

[21] ECB, 'Financial Integration in Europe' (n 1) 9.

[22] Ibid.

[23] Council Regulation (EU) 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions [2013] OJ L287/63 (hereafter SSM Regulation); European Parliament and Council Regulation (EU) 806/2014 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) 1093/2010 [2014] OJ L225/1 (hereafter SRM Regulation).

[24] Article 6 SSM Regulation.

[25] European Parliament and Council Directive 2014/59/EU of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) 1093/2010 and (EU) 648/2012 of the European Parliament and of the Council [2014] OJ L173/190.

avoid a taxpayer funded bailout. The SRB can draw on a Single Resolution Fund, which can be tapped to help wind down a systemically important institution. The third pillar, known as EDIS, represents a common scheme to insure bank deposits across the Banking Union, but is still under negotiation as it faces strong political opposition in Germany and other countries.[26]

35.17 The SSM provides the main pillar of the Banking Union and consists of the ECB and the national competent authorities of participating Member States. Its overriding objectives are to ensure safety and soundness of the European banking system and to ensure the unity and integrity of the EU internal market. All euro area Member States are automatically members, while non-euro area members can decide to participate in the SSM through a procedure involving the national competent authority entering into a 'close co-operation' with the ECB.[27] For the other non-participating Member States, the ECB has adopted a memorandum of understanding with the relevant national competent authority that explains how the ECB will cooperate with the NCA in performing their respective supervisory tasks.[28] The ECB will also conclude memoranda of understanding with each competent authority of a systemically important financial institution in EU Member States.[29] The ECB's bank supervisory powers are conducted through an executive board—the Supervisory Board (SB)—that is responsible for supervising 'significant' banks (ie large cross-border euro area banks), which constitute about 85 per cent of banking assets in the euro area[30]—and indirectly responsible for overseeing the supervisory actions of national competent authorities responsible for supervising small and medium sized (less systemically important) banks in participating Member States.[31] The ECB has ultimate discretionary authority to decide whether to intervene and to take supervisory decisions that could supersede the decisions of national competent authorities with respect to smaller credit institutions which the ECB does not directly supervise.

35.18 The SSM acting through the ECB only has jurisdiction to apply and enforce EU prudential banking law and regulatory requirements against 'credit institutions' under EU law.[32] For instance, financial institutions that do not accept retail deposits are not defined as 'credit institutions' under EU law and therefore are not subject to SSM jurisdiction. Similarly, a

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[26] The EDIS would eventually mean customer bank deposits under 100,000 euro guaranteed by Eurozone taxpayer money.

[27] Article 7(1) and (2)(a)–(c) SSM Regulation providing the legal requirements for ECB cooperation with national competent authorities that enter 'close co-operation' with the SSM, including rules that apply directly to banks established in participating countries.

[28] Article 8 SSM Regulation.

[29] Article 6(7)(b) SSM Regulation.

[30] The criteria used to define a bank as significant are: total value of assets, whether it is one of the top three largest banks in its home Member State; its importance to the economy of its home state or the EU as a whole; and whether it has requested or received direct public financial assistance from the European Stability Mechanism (ESM) or the European Financial Stability Facility (ESFS). See also Article 6(4)(i)–(iii) SSM Regulation.

[31] Article 4(1) SSM Regulation.

[32] 'Credit institution' is defined as a firm which accepts deposits from the public that are insured by the EU Deposit Guarantee Scheme Directive. See Capital Requirements Directive IV (CRD IV Package): European Parliament and Council Directive 2013/36/EU 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 [2013] OJ L176/338 (including the Capital Requirements Directive (CRD) and Capital Requirements Regulation (CRR)), entered into force 1 January 2014. The Capital Requirements Directive IV transposes into European law the prudential capital requirements for credit institutions and investment firms which are based on the internationally-agreed Basel Capital Accord (Basel III agreement).

'credit institution' subject to SSM jurisdiction for carrying on activities governed by EU prudential banking law is not subject to SSM jurisdiction for activities not subject to EU prudential banking law, such as brokering and dealing securities or the marketing and sale of retail financial products. For such non-prudential activities, the bank would be subject to other EU banking and financial law requirements, such as conduct of business rules, which are the sole responsibility of national competent authorities to monitor and enforce.[33] As discussed below, another limitation of the SSM framework is that it applies only to banking institutions that are legally defined as 'credit institutions' under EU law—that is, banks that perform traditional intermediary functions of taking retail deposits and providing credit through commercial and retail lending.[34]

A. SSM governance structure

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35.19 The ECB acts through the Supervisory Board,[35] **which** is responsible for supervising the euro area's largest cross-border banks and the top three banks by size in each participating Member State. The SB is also responsible for overseeing the supervisory actions of participating national competent authorities who directly supervise small- and medium-sized credit institutions in the SSM regime.[36] The ECB/SB has ultimate discretion to decide whether to intervene and take direct oversight of small and medium sized institutions that are ordinarily subject to direct supervisory control by national competent authorities.[37]

35.20 The ECB/SB is primarily responsible for the licensing of all banks in the Eurozone or participating Member States, as well as for the monitoring and enforcing of various prudential regulations, such as capital adequacy requirements, liquidity buffers and leverage limits, against certain *significant* Eurozone/participating banks under its direct supervision.[38] Among those tasks, the ECB/SB is empowered to approve bank recovery plans[39] or make use of supervisory measures that aim to address systemic risks at the level of individual banks.[40] For banks not significant enough to fall under the direct supervision of the ECB, these tasks will be exercised by national competent authorities (NCAs), nonetheless

[33] The SSM does not apply to most conduct of business rules that govern a credit institution's capital market activity—such as prospectus requirements, insider dealing and market abuse rules, or mis-selling of retail financial products. These are subject to other areas of EU and national law and are regulated by that country's national competent authority (not the ECB).

[34] See Article 4.1(1) of European Parliament and Council Regulation (EU) 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) 648/2012 [2013] OJ L176/1.

[35] Article 26 SSM Regulation ('planning and execution of the tasks conferred on the ECB shall be fully undertaken by an internal body composed of its Chair and Vice Chair').

[36] Article 6(7)(a)–(c) SSM Regulation. See also Article 25(8) (SB shall adopt 'draft decisions' 'to be transmitted to the national competent authorities of the Member States concerned').

[37] Article 6(5)(b) SSM Regulation, 'when necessary to ensure consistent application of high supervisory standards, the ECB may at any time, or on its own initiative after consulting with national competent authorities or upon request by a national competent authority, decide to exercise directly itself all the relevant powers for one or more credit institutions'.

[38] Article 4(1)(b), (d)–(i) and Article 6(4)–(6) *a contrario* SSM Regulation.

[39] Article 4(1)(i) SSM Regulation.

[40] Article 97(1)(b) Capital Requirements Directive IV, discussing the review of systemic risks affecting the Member State's financial system, and Articles 104–105, and the subsequent imposition of specific capital, liquidity, operational or governance requirements addressing those risks.

following the regulations, guidelines and general instructions issued by the ECB to that effect.[41]

35.21 The SSM regulatory system is complex because of its federal structure, which needs to incentivize information sharing among national regulators and the central coordinating regulator (as well as the interaction with the countries outside the Eurozone). The shift towards ECB supervision represents a toughening of enforcement, since national regulators had incentives to be more lenient with their national banks. By comparison, the enforcement of competition policy by the European Commission is likewise perceived to be tougher than enforcement by national authorities.

35.22 The European Banking Authority (EBA) at the EU level has had similar problems in coordinating the implementation and application of harmonized technical and regulatory standards for banking supervision. The problems of coordination among decentralized regulators and supervisors within the EU are acute. Indeed, a supervisor based in another EU state is less likely to consider the consequences (systemic or not) for domestic residents of failure, or restructuring of a local branch or subsidiary, but only the consequences in terms of systemic stability at home. For example, a consequence of the 2007–08 crisis was that host Member State regulators have limited or even forbidden the local subsidiaries of EU/EEA-based banks from transferring liquidity across jurisdictions.[42]

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B. ECB monetary policy and banking supervision[43]

35.23 The ECB's role as a bank supervisor, however, might bring it into conflict with its main treaty objective of price stability.[44] According to this view, the ECB might be tempted to lower interest rates or to loosen conditions for bank access to liquidity in order to stabilize the banking sector, but this might lead to easier terms of credit thereby conflicting with its price stability objective.[45] This is why supervisory mandates for central banks tend to be controversial.[46] In general, the price stability mandate of central banks is obstructed by short-term goals, eg avoiding high interest rates and unemployment due to electoral and political pressures—hence the need for central banks to be independent so that they are immune from these pressures. Accordingly, a central bank receiving explicit or implicit employment or economic growth mandates will face the same conflict. A supervisory mandate thus potentially results in lenient monetary policies to prevent bank illiquidity and insolvency; central

[41] Article 6(4)–(6) SSM Regulation.

[42] See Sharlene Goff and Elaine Moore, 'Bank of Cyprus seeks FSA cover for UK savers' *Financial Times* (London, 6 June 2012). Sharlene Goff, 'Santander seeks cover from pain in Spain' *Financial Times* (London, 29 October 2010).

[43] The following paragraphs are based on Kern Alexander, 'The European Central Bank and Banking Supervision: The Regulatory Limits of the Single Supervisory Mechanism' (2016) 13 The European Central Bank and Banking Supervision 488–90 (hereafter Alexander, 'The European Central Bank and Banking Supervision').

[44] Art 127(6) TFEU provides that 'price stability' is the primary objective of the European System of Central Banks. In relation to the ECB's primary objective of 'price stability', a 'financial stability' objective is mentioned incidentally in Art 127(5) TFEU as follows: 'The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system.'

[45] This is why Principle 2 of the Basel Core Principles for Effective Banking Supervision recommends that the functions of the bank supervisor and monetary policymaker be independent from one another.

[46] See Charles Goodhart and others, *Financial Regulation: Why, How, Where Now?* (Routledge 2013).

banks also enjoy easier 'bureaucratic entrenchment' than a supervision-only agency would, making them less accountable for the moral hazard they create. The optimal governance architecture needed for such a double mandate is unclear: lawmakers struggle to combine an efficient relationship between the monetary and supervisory sides, whilst nevertheless ensuring adequate accountability. Other governance issues are both external (especially towards national resolution authorities) and internal, such as the transparency of central bank policies: while excessive transparency may potentially damage the credibility of central banks, eg when responding to temporary market disturbance, empirical evidence shows that higher transparency in forecasts is associated with lower average inflation, and to some extent both less inflation persistence as well as reduced inflation volatility.[47]

35.24 The SSM Regulation attempts to address the potential conflict in dual central bank mandates by requiring that bank supervision decisions and monetary policy be strictly separated by creating a Supervisory Board which would have separate staff to work solely on banking supervision matters and not to have links with staff involved with monetary policy.[48] To reinforce the independence of the Board, ECB President Mario Draghi set forth conditions that were added as an amendment to the SSM, which he argued were necessary to make the plan work and protect the ECB's reputation for maintaining and achieving its monetary policy objective of price stability. It is an important policy objective for the ECB, therefore, that supervision and monetary policy are 'rigorously separated', and the SB governance structure allows national supervisors to play a significant role in any supervisory plan for participating states. Under Article 25 SSM Regulation, the Board's organizational structure and operational functions will be separate from the ECB's monetary policy operations and related functions.[49] For instance, the SSM tasks are further prohibited from interfering with or being determined by the ECB's other mandates, whether in relation to the European Systemic Risk Board or to the solvency monitoring of monetary policy counterparties.[50]

35.25 As mentioned above, the separation between monetary policy and supervisory tasks within the ECB is reinforced by a requirement to ensure the organizational separation of both the staff involved and their reporting lines.[51] Beyond the separation of the staff involved on both sides of these firewalls, the Regulation requires the ECB to ensure an operational separation for the Governing Council itself as regards monetary and supervisory functions, eg through separated meetings and agendas.[52] The procedure for appointing the Chair and Vice Chair of the Supervisory Board also reflects this separation: rather than having the ECB Governing Council elect a member of the Supervisory Board as was proposed in the draft Regulation, the Chair is now appointed by the Ecofin and cannot be a member of the ECB Governing Council.[53] But the Vice Chair is also appointed by Ecofin,

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[47] Ibid.

[48] Germany insisted on separation of the ECB's supervisory functions from its monetary policy functions in order to protect ECB monetary policy from being influenced by the pursuit of banking supervision mandates. See Peter Mülbert, Presentation at European Company and Financial Law Conference (Berlin, 7 November 2014) (on file with author).

[49] Article 25 SSM Regulation ('Separation from monetary policy function'). Article 25(2) states: '[t]he ECB shall carry out the tasks conferred on it by this Regulation without prejudice to and separately from its tasks relating to monetary policy and any other tasks'.

[50] Article 18(2)(1) of 19 March 2013 tripartite agreement ('March compromise').

[51] Article 25(2) SSM Regulation.

[52] Article 18(3a) March compromise.

[53] Art 26(3) March compromise.

but only from among the members of the Executive Board of the ECB, which person must also be a member of the Governing Council, according to Article 283(1) of the Treaty on the Functioning of the European Union (TFEU). This demonstrates that the SB's oversight of the SSM is ultimately accountable to the ECB's Governing Council, whose strong form of independence is guaranteed by the Treaty and whose overriding mandate is to maintain price stability, which under the Treaty arguably takes precedence over the ECB's banking supervision mandate. However, the Governing Council's dual oversight of monetary policy and banking supervision will be subject to separate agendas that rely on separate groups of staff and reporting channels respectively to maintain a semblance of independence for the Council whilst making decisions on monetary policy and banking supervision. **To reinforce this**, the Council's oversight of these dual areas is subject to the 'separation' requirement in Article 18(3a) SSM Regulation, which requires that Council decision-making is based on separate agendas that rely on separate staff and reporting channels.

35.26 Eurozone national authorities haves recognized that the institutional challenges about the management of conflicts of interest by the ECB, which arise from having the Governing Council approve all substantive decisions of the SB, creates a conflict of interest within the ECB. For example, a Bundesbank official expressed doubt about the effectiveness of the governance structure, and suggested limiting the Governing Council's involvement in many supervision decisions.[54] In addition, despite the SSM's focus on independence and separation between the monetary policy function and banking supervisory mandate, it is submitted that the broader post-crisis focus of macro-prudential supervision and regulation requires some degree of coordination between monetary policy and banking supervision. Indeed, much of the literature justifying the separation of monetary policy from banking supervision arose in a period when monetary policy was seen to be independent from banking supervision and that the use of monetary policy instruments to increase bank lending in certain sectors of the economy were considered not to be within the central bank's mandate.[55]

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35.27 Since the crisis of 2007–09, however, central banks have adopted extraordinary measures of monetary policy (ie the ECB's Long-Term Refinancing Operation (LTRO) and Outright Monetary Transactions (OMT) and the Bank of England's quantitative easing and funding for lending schemes) that necessarily involve central banks in assessing the healthiness and viability of bank balance sheets in order to have a better understanding of whether the central bank is achieving its monetary policy objectives (ie price stability). This has particularly been the case in the euro area where the European Central Bank has adopted an array of monetary policy measures, including its role as the main purchaser of asset-backed securities issued by banks and bonds issued by non-bank corporates, in order to increase bank lending with an overall view of achieving the ECB's price stability objective of 2 per cent inflation.[56]

[54] See Andreas Dombret, 'Plan B—where is the banking union heading?' (Banken- und Unternehmensabend at the Deutsche Bundesbank's Regional Office, Munich, 1 April 2018) <http://www.bundesbank.de/en/press/speeches/plan-b---where-is-the-banking-union-heading--732316> accessed 10 February 2020.

[55] Alexander, 'The European Central Bank and Banking Supervision' (n 43) 490–91.

[56] See discussion of ECB's unconventional monetary policy in Chapter 22.

35.28 It is debateable whether the use of such broad measures of monetary policy requires the central bank to have more information and an opinion about the healthiness and ability of individual banks or groups of banks to lend in the broader economy. In a financial system where the central bank's use of monetary policy measures has grown to play such an important role in affecting bank lending and banking regulation, it calls into question the utility of the strict separation between monetary policy and the supervision of individual banking institutions. Therefore, the strict separation between the ECB's monetary policy function and its banking supervision mandate in the SSM should be given more consideration.

C. ECB's macroprudential tools

35.29 The SSM Regulation also included additional powers for the ECB to exercise certain macroprudential powers in limited situations. The SSM's macroprudential tasks are set forth in Article 5 SSM Regulation, entitled 'Macroprudential tasks and tools', which include the discretion to impose stricter prudential requirements, including higher capital buffers, on individual banks based on macroprudential factors in the country where the bank is based. Although the exercise of these macroprudential tools rests primarily with the NCAs,[57] the ECB may intervene and utilize these tools 'if deemed necessary'.[58] In adopting a particular measure, the ECB is then required to take the specific circumstances of the Member State's financial and economic situation into account,[59] as well as to 'duly consider' any objection of a Eurozone national competent authority that seeks to address a macroprudential risk on its own.[60] Moreover, under the Single Resolution Mechanism, the ECB will have limited macroprudential powers, merely allowing it to cooperate with the SRM's Single Resolution Board in conducting an *assessment* of the extent to which banks and groups under its direct supervision are resolvable without the assumption of extraordinary public financial support,[61] and to notify the SRB of a supervised entity requiring resolution.[62]

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35.30 From a macroprudential perspective, the SSM should help to mitigate systemic risks at the level of the individual credit institution. However, the ECB/SSM will only have competence to supervise individual banks or 'credit institutions' as defined under EU law.[63] As a result, the ECB/SSM will have only limited authority to impose regulations aimed at reducing systemic risks, involving, for example, imposing higher capital and liquidity requirements on individual banks. It will not have competence to regulate non-bank financial intermediaries—such as shadow banks—even though the CMU envisages the EU non-banking financial sector to channel a growing amount of credit and leverage to the European economy.[64] In other words, the ECB will have very limited authority to address

[57] Article 5(1) SSM Regulation.
[58] Article 5(2) SSM Regulation.
[59] Article 5(5) SSM Regulation.
[60] Article 5(4) SSM Regulation.
[61] Article 8(1) Commission, 'Proposal of 10 July 2013 for a Regulation of the European Parliament and of the Council 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 Bank Resolution Fund and amending Regulation (EU) 1093/2010 of the European Parliament and of the Council' COM (2013) 520 final.
[62] Article 16(1) COM (2013) 520 final.
[63] See Article 4.1(1) Regulation (EU) 575/2013.
[64] Article 5 SSM Regulation.

macro-prudential systemic risks that can arise in the broader financial system where non-bank financial intermediation is growing along with increased trading and clearing of leveraged-linked risky financial instruments.

35.31 Five years after the SSM became operational in 2014, some Eurozone Member State regulators have developed the view that the SSM has proven itself to be an effective supervisory network that has functioned smoothly and has supported the stability and resilience of the European banking system.[65] For instance, the German Federal Financial Supervisory Authority (the 'BaFin') has observed that '[i]t now plays an important role in safeguarding long-term financial stability and advancing financial market integration'.[66] Another view, however, asserts that the SSM supervision has led to duplication of responsibilities and uncoordinated reporting with national competent authorities and increased operational costs for NCAs so that they can comply with the SSM regime.[67] Furthermore, it is claimed that increased compliance costs for banks have hindered their capacity to support the Eurozone's post-crisis economic recovery.

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D. Remaining challenges: mergers

35.32 In considering the extent of EU bank mergers on banking sector integration, there is a diversity of arrangements in different countries in terms of merger control and in terms of how the bank supervisor weighs regulatory factors (eg financial stability) in reviewing a proposed bank merger. In this regard, it is necessary to distinguish between domestic mergers and cross-border cases.

35.33 In most Member States, governments can grant mergers even though the relevant competition authority may have objections to the merger. This occurred in the United Kingdom in October 2008, when the British Prime Minister Gordon Brown and the Chancellor of the Exchequer Alistair Darling waived through the acquisition of the ailing Halifax Bank of Scotland (HBOS) by Lloyds Bank plc even though the merger had been questioned by the UK competition authority as leading to increased concentration in the UK banking industry.[68] Similarly, bank supervisory authorities in some EU jurisdictions can reject a bank merger proposal even if it has been approved by the competition authority if the supervisory authority concludes that the merger conflicts or undermines supervisory objectives, such as depositor protection or financial stability. For instance, in the Netherlands, the Minister for Economic Affairs can overturn a merger decision of the competition authority if this

[65] German Federal Ministry of Finance, 'The Single Supervisory Mechanism: Lessons learned after the first three years' (German Federal Ministry of Finance's Monthly Report, January 2018) <http://www.bundesfinanzministerium.de/Content/EN/Downloads/2018-01-26-SSM.pdf> accessed 10 February 2020.

[66] Ibid.

[67] See Commission, 'Report from the Commission to the European Parliament and the Council on the Single Supervisory Mechanism established pursuant to Regulation (EU) No 1024/13' COM (2017) 591 final, 30.

[68] See Office of Fair Trading, 'Anticipated acquisition by Lloyds TSB plc of HBOS plc: Report to the Secretary of State for Business Enterprise and Regulatory Reform' (UK Government Publishing Service, 24 October 2008) <http://assets.publishing.service.gov.uk/media/5592bba440f0b6156400000c/LLloydstsb.pdf_jsessionid_4EBCDA0A4B36535AF8355B90D18E00A2.pdf> accessed 10 February 2020. See also Louise Smith, 'The Lloyds-TSB and HBOS Merger: Competition Issues' (Standard Note SN/BT/4097, House of Commons Library, 15 December 2008) <http://researchbriefings.files.parliament.uk/documents/SN04907/SN04907.pdf> accessed 10 February 2020.

conflicts with the one of the supervisory authority.[69] The situation is similar in Germany, where the Minister of Economy may overturn a blocking decision by the Cartel Office for reasons of general welfare (upon consultation with the Monopoly Commission).[70] In the UK, as mentioned above, the government may approve a merger against the advice of the competition authority on financial stability grounds.[71] In Italy, until the 2005 reform the competition authority was only requested to issue an opinion on a proposed merger or acquisition with the supervisor in charge for merger review. In France, bank merger reviews have been integrated in common competition law since 2003 and in 2008 exclusively under the Competition Authority (which is required to consult the relevant regulator). In Portugal, the banking system has been subject to merger control since 2003, although with a delay of five years relative to the other sectors.[72]

35.34 Some domestic mergers have led to significant competitive concerns or have been blocked, withdrawn, or subjected to remedies by the competition authority of the EU. Cross-border mergers typically do not entail substantial anticompetitive effects, but they have been subject to domestic regulatory and supervisory obstacles.[73] Factors other than competition have played an important role with some Member States using the merger regulation to block a foreign bank entering the local market on financial stability grounds. For instance, the European Commission has intervened in checking the misuse of national supervisory powers to prevent cross-border mergers when trying to protect national champions. The Commission can request all relevant information from the national supervisory authorities in mergers in the banking sector that have a Community dimension, but according to Article 21(3) of the European Merger Regulation[74] Member States may block a merger to protect financial stability, which is considered a 'legitimate interest' in the domestic market.[75]

35.35 The SSM regime designates the ECB, in close cooperation with competent national authorities, the role of assessing the applications for the acquisition and disposal of qualifying holdings.[76] The removal of artificial obstacles to mergers, and the single supervisory framework in the Eurozone, should facilitate consolidation in the sector extending beyond domestic mergers to include cross-border regional consolidations that are based first on geographic and cultural affinity, and then on broader international mergers. An important objective of the Banking Union was to contribute to the integration of the banking sector.

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[69] Article 47(1) Dutch Competition Act (DCA).
[70] §42(1) Gesetz gegen Wettbewerbsbeschränkungen.
[71] Section 42(2) Enterprise Act 2002.
[72] See Elena Carletti and Philipp Hartmann, 'Competition and stability: What's special about banking?' in Paul Mizen (ed), *Monetary History, Exchange Rates and Financial Markets: Essays in Honour of Charles Goodhart* (Edward Elgar Publishing 2003); Elena Carletti, Philipp Hartmann, and Steven Ongena, 'The Economic Impact of Merger Control Legislation' (2015) 42 International Review of Law and Economics 6.
[73] Article 21 Council Regulation (EC) 139/2004 of 20 January 2004 on the control of concentrations between undertakings [2004] OJ L24/1 (hereafter (EC) Merger Regulation).
[74] (EC) Merger Regulation.
[75] See generally Elena Carletti and Xavier Vives, 'Regulation and Competition Policy in Banking' in Xavier Vives (ed), *Competition Policy in the EU: Fifty Years On from the Treaty of Rome* (OUP 2009), discussing cases in Member States where governments blocked bank mergers approved by competition authorities on the grounds of 'legitimate interest'.
[76] Article 14(1)(c) SSM Regulation.

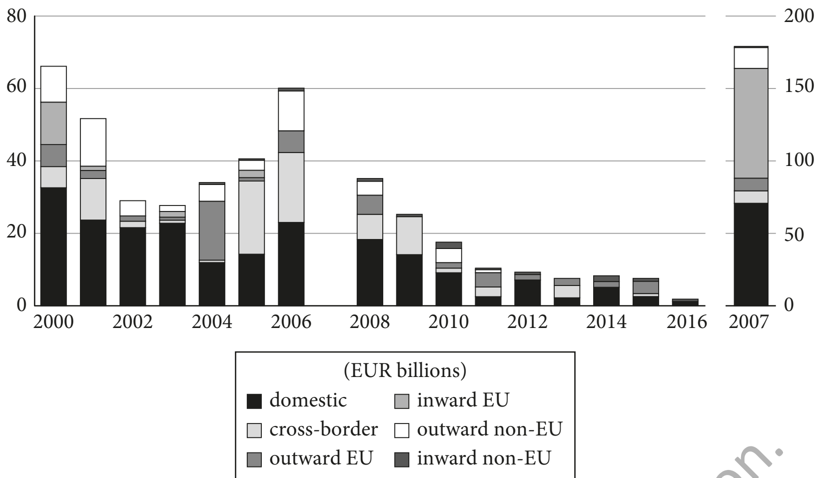

Figure 35.3 Bank M&As involving euro area banks – value of transactions

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35.36 Nevertheless, mergers and acquisitions (M&A), including cross-border M&A, in the Eurozone and EU have substantially decreased since the SSM became effective in November 2014. Figure 35.3 above illustrates the low volume of M&As within the euro area, which reached its lowest level in 2016.[77] It should be noted, however, that worldwide M&As in banking were significantly lower in 2017 as well, with a volume of $79.6 billion compared to $359 billion in 2008.[78] Therefore, it cannot be ruled out that the decline in bank M&A in the Eurozone may have been caused by other factors in global financial markets unrelated to creation of SSM.

35.37 There is speculation about future M&A activity in the Eurozone banking sector.[79] One industry commentator stated that 'those calling for cross-border bank consolidation are getting things the wrong way around. It is not cross-border M&A that will create an integrated single market, but an integrated single market that will drive cross-border M&A. And that does not look likely any time soon.'[80]

35.38 Moreover, the decrease in banking M&A in the Eurozone has also been attributed to the extra costs of higher regulatory capital requirements for merged banks that have grown in size and thus constitute significantly important institutions that require additional capital and liquidity. Indeed, any significant bank considering a merger with another significant institution should weigh the cost of moving up the scale of systemic importance, which brings with it extra capital and liquidity requirements.[81]

[77] ECB, 'Financial integration in Europe 2017' (n 20).
[78] Martin Arnold, Patrick Jenkins, and Laura Noonan, 'Banking M&A: the quest to create a European champion' *Financial Times* (London, 11 July 2018) (hereafter Arnold, Jenkins, and Noonan, 'Banking M&A').
[79] Ibid.
[80] Vicente Vázquez Bouza, 'Cross-border Bank M&A? Europe Is Not Ready' (*Oliver Wyman Insights*, 8 November 2017) <http://www.oliverwyman.com/our-expertise/insights/2017/nov/cross-border-bank-m-and-a-europe-is-not-ready.html> accessed 10 February 2020.
[81] Arnold, Jenkins, and Noonan, 'Banking M&A' (n 77).

E. Market structures

35.39 Generally speaking, the above discussion suggests that the banking market in the Eurozone is 'fragmented', which can be inter alia seen in the fact that 'there is one bank for about every 50,000 citizens in the Eurozone'.[82] 'Since 2008, the number of banks in the euro area has declined by about 20 per cent, to around 5,000. And the number of bank employees has fallen by about 300,000, to 1.9 million. Total assets of the euro area banking sector peaked in 2012 at about 340 per cent of GDP. Since then, they have fallen back to about 280 per cent of GDP.'[83] The reduction in bank assets to GDP can also be attributed to the low interest rate environment in which bank customers have increasingly been buying more bank-issued financial products, in which the bank distributes the clients' funds off balance sheet (rather than lending the clients' funds on balance sheet to a borrower).

35.40 The SSM has also resulted in an increase of cross-border branches instead of subsidiaries. In general, it is not clear why this has occurred, as it is too early to attribute the effect to any single cause. Wymeersch, however, predicted that conversions of cross-border owned subsidiaries into branches would grow in number, not necessarily because of the Banking Union, but because of 'the massive deleveraging' of banks or their 'withdrawal from certain regional markets or from certain activities considered to represent less core activities, where the more stringent capital requirements, and later the structural measures, may have more far-reaching consequences'.[84] Although the SSM Regulation states that it is neutral as to the choice of a bank's form (branch or subsidiary), Wymeersch observes that many banks may be reluctant to change their form from subsidiary into branch 'in order to preserve their local brand, to preserve the relations with their employees, for tax purposes' or other strategic reasons.[85] But the European Commission has estimated that the impact of state bailouts of the banking sector and the desire of stronger home country scrutiny of cross-border operations has influenced banks in opting for more cross-border branches as opposed to subsidiaries.[86]

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35.41 Other concerns are that there are not enough pan-European banks. If one defines pan-European banks as consisting of branches or subsidiaries in at least three EU states, there are only two pan-European banks in Europe: BNP Paribas, (France, Italy, and Benelux) and UniCredit, (Italy, Germany, and Austria). According to this view, regulation should support the creation of more pan-European banks to support the European economy.[87]

35.42 ECB officials believe that creating a few pan-European champions would reduce the reliance on US banks providing credit and trading support operations in Europe. Danièle

[82] Ibid.

[83] Danièle Nouy, 'Too much of a good thing? The need for consolidation in the European banking sector' (VIII Financial Forum, Madrid, 27 September 2017) <http://www.bankingsupervision.europa.eu/press/speeches/date/2017/html/ssm.sp170927.en.html> accessed 10 February 2020.

[84] Wymeersch, 'The Single Supervisory Mechanism' (n 2) 111–12.

[85] Ibid.

[86] COM (2017) 591 final, 5.

[87] Arnold, Jenkins, and Noonan, 'Banking M&A' (n 77). See also Patrick Jenkins, Rachel Sanderson, and David Keohane, 'UniCredit seeks merger with SocGen' *Financial Times* (London, 3 June 2018).

Nouy, former chair of the ECB's supervisory board, stated that: 'In my opinion, cross-border mergers within the euro area are the way forward.' Moreover, '[w]hile the ECB would not reduce capital requirements for merged entities, officials indicate it could use its powers to help in other ways'. This could include, for example, measures allowing banks to offset more of their biggest exposures to individual clients across borders or increasing their flexibility to move capital and liquidity between countries.[88]

35.43 More generally, there appears to be growing optimism in the ECB's role as a tough but fair regulator that has had a positive effect on bank performance. For example, the ECB has taken control of the non-performing loan problem that has bedevilled Eurozone banks whose assets (unlike US banks) are dominated by on-balance sheet lending. At the height of the Eurozone crisis in 2012, non-performing loans (NPLs) at Eurozone banks exceeded 7 per cent of the value of total on balance sheet loans. Since 2015, NPLs have begun to decline, most recently with NPL levels falling to 3.4 per cent of on-balance lending in 2018.

35.44 Despite progress on many fronts, the average European bank had a return on equity (ROE) of less than 6 per cent in 2017, much less than the average of nearly 10 per cent ROE for US banks. Also, Eurozone bank ROE remains less than the cost of capital. This is an important concern because it limits the ability of banks to raise capital when necessary, especially during market downturns. The ROE also limits the ability of European banks to compete effectively on global stage with US and Japanese banks.

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35.45 The SSM framework must also contend with persistent weak bank performance in some European countries, such as Italy, Portugal, Cyprus, and Greece. In Italy, the fourth largest European national economy, the combination of a populist Eurosceptic government and a persistently weak banking system has revised the so-called 'doom loop' where banking sector fragility spreads to sovereign debt finances and can spiral downward into an economic crisis. Banks are increasing their sovereign debt exposure to their home country governments without having to hold regulatory capital against these assets. Bank exposures to sovereign debt are growing and the banks' ability to raise capital sustainably is diminishing.[89]

35.46 Since becoming operational in November 2014, the ECB has been credited with helping the European banking system address some of its most pressing challenges. The ECB's Single Supervisory Mechanism (along with monetary policy) has stabilized the euro area banking sector in the face of the Eurozone sovereign debt crisis and oversaw implementation of post-crisis regulatory reforms, such as Basel III capital and liquidity requirements and bank governance standards. Nevertheless, as discussed below, despite having an overall positive effect on banking sector performance, the SSM has serious challenges in stabilizing the Eurozone banking sector and overseeing its return to a sustainable financial position.

[88] Arnold, Jenkins, and Noonan, 'Banking M&A' (n 77).
[89] Unicredit in 2018 issued five year bonds that required an 8 per cent coupon rate. See Robert Smith, 'UniCredit chief defends steep price for new $3bn bond' *Financial Times* (London, 28 November 2018).

V. Strengthening Capital Market Integration and Capital Markets Union

35.47 An important objective of the Capital Markets Union is to strengthen and complement the European Monetary and Banking Union's institutional framework. EU legislation to promote a Capital Markets Union (CMU) across the **twenty-seven** EU Member States attempts to address structural challenges and barriers to the efficient financing of companies in EU capital markets. Some of the main challenges include, among others, the heavy reliance of EU-based firms on bank finance, significantly different financing terms for firms across EU states, inadequate access to capital markets for many small and medium-sized firms, segmented national markets for shareholders and buyers of corporate debt, and differing rules and market practices between EU states for products like securitized instruments and private placements.[90]

35.48 The CMU's objectives include establishing a genuine single capital market in the EU where investors are able to invest their funds without hindrance across borders, and businesses can raise capital from a diverse range of sources, irrespective of their location.[91] It aims to develop a more diversified financial system complementing bank financing with deeper and more developed capital markets that facilitate the cross-border flow of capital to its most productive use.

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35.49 The CMU, in contrast, addresses the issue of how to create a single market for the provision of capital—both credit and equity—and financial services by non-bank intermediaries with the main objective of rejuvenating European economic growth, which has stalled in the aftermath of the financial crisis. Indeed, the Commission's Green Paper[92] attributed inadequate economic growth in Europe to a financial system that overly relies on bank intermediation for the external funding of non-financial and medium-sized firms. In comparison to the United States, which has shown signs of economic recovery post-crisis, Europe has experienced extremely subdued growth and outright contraction in many countries in the Eurozone. The relative economic success of the US has been attributed to a better balance in firm funding between banks and the capital markets, whilst the European Union's overreliance on the universal banking model for most of its non-financial firm funding has hindered its post-crisis recovery. The Commission's initiative therefore to reduce barriers between savers and investors in the provision of non-bank financial services and capital aims to enhance the future sustainability of the European economy by facilitating the creation of more diverse sources of business finance.

35.50 The EU legislation to create a capital markets union aims to reduce cross-border barriers to capital and trade in financial services in order to increase financial integration in the EU internal market. By removing institutional and regulatory barriers so that savers, investors and borrowers can allocate capital to its most productive use, European policy-makers hope to revitalize the EU economy and to enhance economic growth and global competitiveness.

[90] Commission, 'Completing the Capital Markets Union by 2019 – time to accelerate delivery' COM (2018) 114 final, 5–6.

[91] Commission, 'Action Plan on Building Capital Markets Union (Communication)' COM (2015) 468 final providing short overview of CMU initiatives.

[92] Commission, 'Green Paper-Building a Capital Market Union' COM (2015) 63 final.

This should lead to a rise in risk-adjusted returns for investors, if an adequate level of competition is maintained. The CMU proposal is designed primarily to achieve two overriding objectives: First ensure alternative sources of credit intermediation for European non-financial firms and less reliance on the provision of credit by universal banks, and second greater efficiency in the provision of capital and a diversity of financial products for investors in capital markets.

35.51 The Commission's philosophy, rationale and objectives for CMU have been largely endorsed across Member States and constitute an important step in the development of robust and resilient EU financial markets that aim to increase financial integration in EU capital markets. Nevertheless, important gaps in the Commission's proposal have yet to be addressed, especially regarding the way in which the expansion of capital markets and the Commission's express goal of generating more capital and funding from the non-bank financial sector for the broader economy can be achieved without undermining financial regulatory—and in particular macro-prudential regulatory—objectives. Indeed, it is suggested that although the Commission's goal of a more balanced provision of funding between the banking and non-bank financial sector is important, and should be supported, inadequate attention has been given to the effects of such a change in the structure of EU financial markets has on regulatory objectives—and in particular on the stability of the financial system.

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35.52 The CMU aims for non-banks to take on a growing and significant role through bank disintermediation in providing credit to the European economy. That is, non-bank financial intermediaries should play a greater role—as they already do in the US and the UK—in aggregating savings and then allocating funds to firms to engage in productive economic activity. This type of bank disintermediation—involving non-bank financial firms 'borrowing short and lending long'—is also known as 'shadow banking', a loosely defined term that refers to the process of disintermediation. The size of the shadow-banking sector—which includes securitization, money-market mutual funds, hedge funds, securities lending, asset-backed commercial paper ('ABCP') conduits, structured investment vehicles ('SIVs'), and repo financing—is estimated at nearly $70 trillion worldwide.[93] Shadow banking raises an important new source of systemic risk, because it involves the provision of high levels of leverage or debt through informal financial channels outside the scope of prudential regulation, such as bank capital and liquidity requirements. Indeed, the failure of financial regulation prior to the crisis to adequately address the build-up of leverage and liquidity risks across the financial system and, in particular, to detect excessive leverage and risk-taking in the shadow banking sector contributed substantially to the severity and duration of the crisis and its ongoing effect on the European economy.[94]

[93] Philipp Halstrick, 'Tighter Bank Rules Give Fillip to Shadow Banks' (*Reuters*, 20 December 2011) <http://www.reuters.com/article/uk-regulation-shadow-banking/tighter-bank-rules-give-fillip-to-shadow-banks-idUSLNE7BJ00T20111220> accessed 10 February. See also Financial Stability Board, 'Global Shadow Banking Monitoring Report 2012' (18 November 2012) <http://www.fsb.org/2012/11/r_121118c/> accessed 10 February 2020 (estimating shadow banking's worldwide assets as $67 trillion in 2011).

[94] Indeed, Anabtawi and Schwarcz observed that shadow banking 'is widely believed to have contributed to the buildup of risks in the financial system in the period leading up to' the global financial crisis. See Iman Anabtawi and Steven L Schwarcz, 'Regulating Ex Post: How Law Can Address the Inevitability of Financial Failure' (2013) 92 Texas Law Review 75. See also Ben S Bernanke, 'Some Reflections on the Crisis and the Policy Response' (Russell Sage Foundation and The Century Foundation Conference on Rethinking Finance, New York, 13 April 2012) <http://www.federalreserve.gov/newsevents/speech/bernanke20120413a.htm> accessed 10 February 2020, arguing that mortgage lending through shadow-banking firms encouraged risky lending practices that contributed to the financial crisis.

35.53 The CMU addresses some of the issues related to the financial stability risks associated with the increased provision of credit to non-financial firms. It provides however for only limited regulatory controls to address the huge gap in the Banking Union regime that allows credit intermediation to be provided by non-bank financial firms outside the coverage of prudential supervision. It is argued that the Commission has further work to do to ensure that the CMU addresses the macro-prudential financial risks posed by bank disintermediation and the related systemic risks in the structured finance markets. It is this type of non-bank credit intermediation and related trading of credit instruments that the CMU is designed to promote throughout the EU internal market with a view to increasing alternative sources of credit and equity investment in European firms. In comparison with the US, Europe has less-developed wholesale capital markets; therefore, it is an important goal of CMU to create the conditions where non-financial firms can access adequate sources of alternative funding outside the traditional banking sector.

35.54 Notwithstanding the Commission's emphasis on shadow banking for the EU economy, bank credit intermediation remains essential to the European financial system, supplying about three-quarters of all credit.[95] With the continued growth of shadow banking, however, as envisioned by CMU, this will likely change. Although a vibrant, well-regulated shadow banking industry should be encouraged, it nonetheless should be subject to regulatory controls that meet macro-prudential objectives of controlling systemic risk across the financial system. Moreover, regulatory controls against systemic risk should be broad enough in scope to prevent excessively risky bank lending and trading from migrating from the traditional banking sector to the wholesale capital markets, where non-bank financial intermediation is increasingly providing more funding for the economy. Although the CMU proposal offers the potential for a more balanced and efficient provision of credit in EU capital markets, it nonetheless introduces certain regulatory risks that raise serious challenges for the EU policy makers plan to regulate the shadow banking sector, which, if not adequately addressed, could limit the effectiveness of the CMU project.

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VI. Conclusion

35.55 Post-crisis, the EU banking market is undergoing some consolidation, as overcapacity in the EU banking system is corrected through a number of mergers and acquisitions, encouraged in some cases by regulators. However, banking margins remain under pressure and credit growth inhibited. Also, financial integration across the EU financial services sectors and, in particular, in the banking industry has become more fragmented. The Banking Union has attempted to reverse this phenomenon by creating a single supervisor across the nineteen Member States of the euro, which is open to other non-euro Member States to join.

35.56 Since becoming operational in 2014, the ECB's Single Supervisory Mechanism has been credited with helping the European banking system to address some of its most pressing challenges. The SSM oversaw the implementation of Basel III through the Capital

[95] European Systemic Risk Board, 'Flagship Report on Macroprudential Policy in the Banking Sector' (March 2014) <http://www.esrb.europa.eu/pub/pdf/other/140303_flagship_report.pdf?d0f12e526e9b00e7c4a137f97776b96c> accessed 10 February 2020.

Requirements Directive IV, which resulted in significantly higher capital and liquidity buffers and enhanced oversight of bank risk management and corporate governance. Despite SSM reforms to Eurozone banking supervision, there is more room to improve regulation so that it can achieve macroprudential objectives. This potentially involves enhanced co-ordination between the SSM and ECB monetary policy.

35.57 Although banking mergers and consolidation have increased significantly since the early 1990s, the Eurozone and EU cannot expect further integration of retail banking or the consolidation of wholesale banking without the completion of Banking Union with a common deposit insurance fund and an effective resolution framework. However, the SSM's regulation of credit institutions does not cover the growing number of non-bank financial intermediaries and structured entities that are not defined as 'credit institutions' under EU law. These non-bank financial intermediaries or 'shadow banks' are playing an increasingly important role in the maturity transformation process—borrowing short and lending long—outside the formal banking sector in the European economy and without being subject to prudential regulatory controls. This creates a tension with the objectives of the CMU that is designed to promote the increased provision of non-bank sources of credit that would support the internal market and European economy.

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