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The neglected side of banking union: reshaping Europe's financial system

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Prior to the crisis, the European Union financial system became increasingly integrated, especially within the euro area. However, integration is far from complete. In the euro area, the interbank market rapidly became highly integrated after the introduction of the single currency, but retail banking remains largely fragmented along national lines, with bank mergers predominantly between institutions of the same country. And in the EU in general, corporate bond markets and equity markets also remain fragmented along national lines despite some progress with integration. The financial crisis undid financial integration where it had been most successful, in the interbank market. Overall, the state of financial integration in Europe is unsatisfactory, with markedly different financing conditions in different countries, which undermines the necessary convergence of their economic and employment conditions.

The reform agenda should include three essential elements in order to end the fragmentation of financial markets, to give households and corporations greater access to finance, and to ensure financial stability: (1) The newly created Single Supervisory Mechanism will soon start an Asset Quality Review. This should be a tough assessment of the assets held by banks. Based on this review, viable banks should be recapitalised from private sources. Public recapitalisation should be the exception and should not amount to bail-outs of shareholders or bank management. (2) For non-viable banks, there should be restructuring and resolution by a Single Resolution Mechanism capable of implementing economically sensible cross-border bank sales and mergers. More integrated retail banking would help to credibly break the vicious circle linking banks and sovereigns because it would mean less exposure to debtors, including the government, located in each bank's home country. (3) Finally, the EU and in particular the euro area, need to develop a genuine cross-border equity and corporate bond market, in part to be able to absorb shocks. The development of these markets will require further harmonisation of corporate governance, insolvency legislation and taxation. This would reduce the heavy reliance of the EU economy on bank funding and improve economic stability thanks to better financial risk sharing.

The timing of policy measures is paramount. Because the European economy is so dependent on bank credit, the priority must be to solve the banking sector problems. But policymakers need to be aware that restructuring and merger decisions taken now will undermine eventual financial stability if they are done without allowing for sensible cross-border mergers. The second priority is to start a European reform process to develop capital markets. This is unlikely to quickly provide a partial substitute for bank credit but it is a crucial element in the medium-run to put Europe's monetary union on a sound basis. The eventual introduction of strict limits on bank exposure to sovereign borrowers, or risk weights attached to government bonds, are also important for reducing the link between banks and sovereigns.

1) Introduction¹

Prior to the crisis, the EU financial system became increasingly integrated, especially within the euro area. However, integration is far from complete. In the euro area, the interbank market rapidly became highly integrated after the introduction of the single currency, but retail banking remains largely fragmented along national lines, with bank mergers taking place predominantly between institutions in the same country. Europe is heavily dependent on bank credit, much in contrast to the US, whether other forms of financial intermediation play a more important role.² At the same time, EU corporate bond markets and equity markets remain fragmented along national lines despite some progress with integration. The financial crisis undid financial integration where it had been most successful, in the interbank market. Incidentally, the financial crisis therefore undid financial integration in exactly the area in which cross-border integration was most successful.

The euro-area financial system is now in an unsatisfactory state. Banks do not lend to each other across borders without asking for a significant premium. In the larger euro-area countries, cross-border retail banking plays a negligible role and therefore cannot serve as a meaningful source of credit that could compensate for the dysfunctional interbank market. The combination of these two factors leads to significant differences in credit conditions across the euro area and the EU. As a consequence, corporations in some countries are at a competitive disadvantage merely because of their location, and households cannot borrow at reasonable terms. As a result, investment remains subdued and economic growth remains anaemic. Alternative financial-intermediation channels, such as capital and equity markets, cannot play a meaningful role in stabilising the different economies and providing sufficient funding for business and households because of their comparatively low degree of development and their limited cross-border integration.

This situation calls for bold policies, the timing of which is paramount. As the European economy is so dependent on bank credit, the priority must be to solve the banking sector's problems. But decisions taken now in this area will shape the future of Europe's financial system, not least in terms of its stability. For example, bank mergers could lead to more cross-border integration of retail banking thereby reducing financial fragmentation and increasing stability. To be successful along those lines, the implementation of banking union will therefore have to be accompanied by acceptance by governments that they will be less involved in banks. Banks will have to become European. Similarly, insufficient re-capitalisation would result in structurally weak banks that do not provide sufficient credit. At the same time, capital market integration has been identified as one of the key channels for risk sharing in monetary unions³. To increase the stability of EMU, it therefore is advisable to develop further the capital markets and to foster their cross-border integration: in other words to complete the single market for capital. Against this background, we review a number of stylised facts about Europe's financial system, and review the upcoming policy agenda.

¹ Excellent research assistance by Giuseppe Daluiso, Carlos de Sousa and Erkki Vihriälä is gratefully acknowledged.

² According to the Eurostat financial accounts, loans represented 87.5 percent of the total debt liabilities (loans over loans plus securities other than shares) of non-financial corporations in the EU27 and 89.7 percent for the EA17 at the end of 2011. By contrast, the Federal Reserve reported that loans accounted for only 26.1 percent of the total debt liabilities (loans over loans plus debt securities) of non-financial corporate business in the United States at the end of 2012, a share that, unlike in Europe, has been moving downward from a peak of 41.6 percent in 2007.

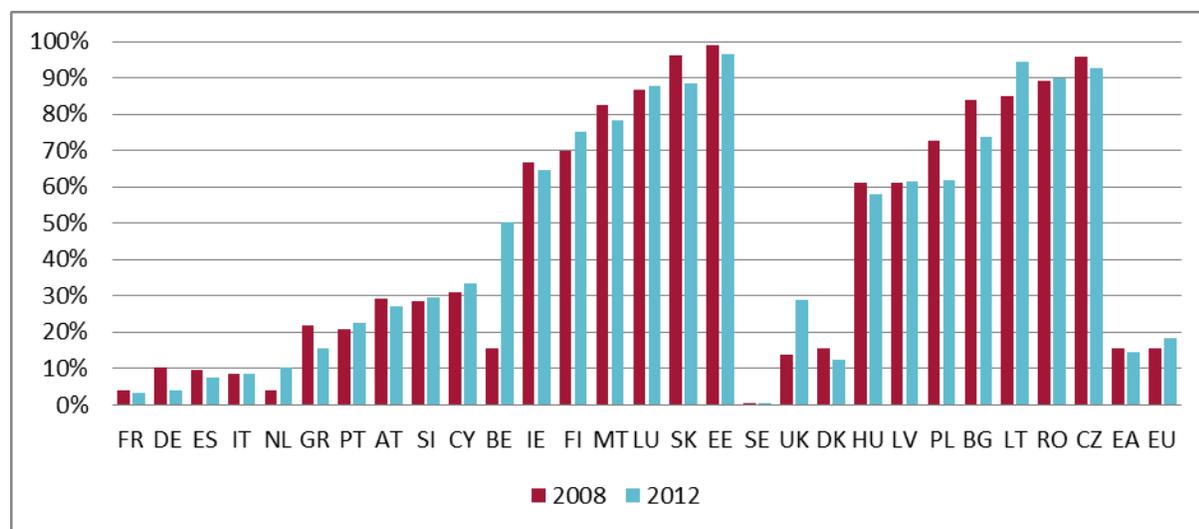
³ Asdrubali, Pierfederico, Bent E. Sorensen and Oved Yosha (1996) 'Channels of Interstate Risk Sharing: United States 1963-1990', The Quarterly Journal of Economics, MIT Press, 111(4): 1081-1110

2) The changing financial landscape of Europe

The financial system in the EU and other advanced economies has grown relative to GDP, and has become more interconnected across borders. Cross-border financial assets and liabilities have increased very substantially to reach more than 600 percent of GDP on average per euro-area country. In the UK, the figure is over 1000 percent.

However, retail banking is generally still constrained by national borders, though small countries make an important exception. The total assets of foreign owned branches and subsidiaries generally constitute only a small part of the total assets of the domestic banking system (see Figure 1). Only in the smaller member states and the non-euro area member states of central and Eastern Europe is a significant part of the banking system foreign-owned. The share of foreign asset ownership has somewhat fallen in the euro area, while it has increased somewhat outside the euro area.

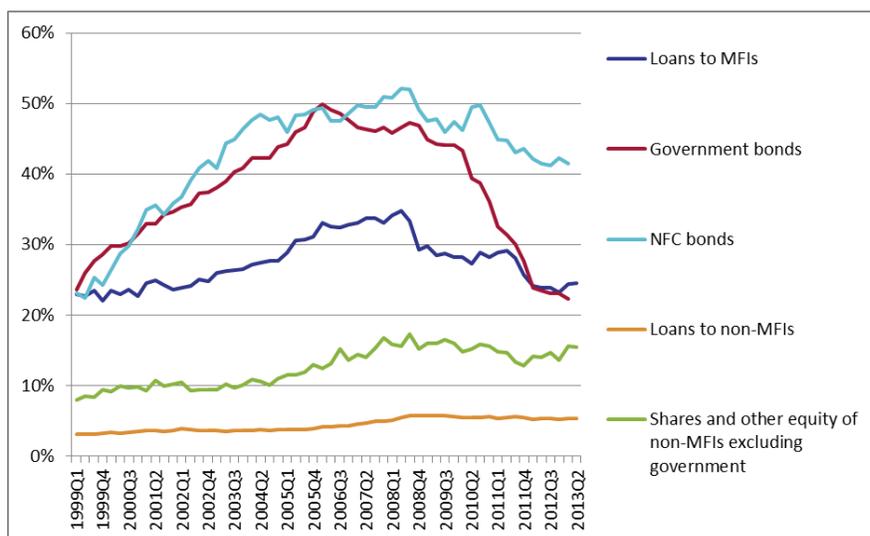
Figure 1: Percentage of the banking system that is foreign owned



Note: This percentage is calculated as the total assets of foreign owned subsidiaries/branches as % of total banking system assets
 Source: Bruegel based on ECB data

Wholesale banking, by contrast, became highly integrated before the crisis. Since then, the share of cross-border interbank financing has fallen substantially in the euro area. Between 1999 and 2007 in the euro area, the foreign share of loans to Monetary and Financial Institutions (MFIs), the share of foreign government bonds and the share of foreign corporate bonds had increased by 23 and 28 percentage points, reaching 47 percent and 51 percent of the total holdings of government and corporate bonds, respectively. Since the beginning of the crisis, the shares have fallen 24 and 10 percentage points, standing at 22 percent and 41 percent respectively (Figure 2). In contrast, cross-border lending to non-financial corporations, i.e. retail banking, has been at a very low level throughout EMU (Figure 2).

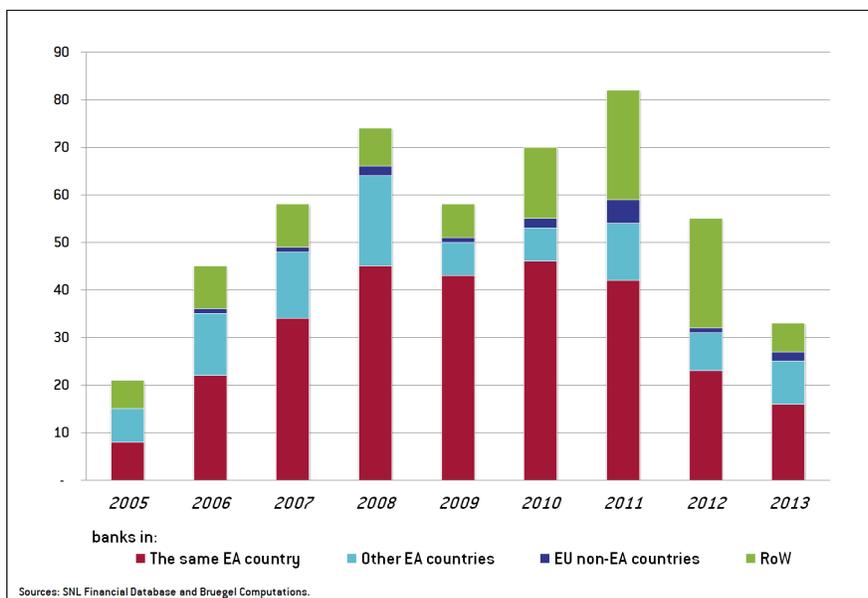
Figure 2: Share of cross-border holdings of assets of euro-area MFIs in total assets



Note: The lines measure the share of intra-euro area cross-border holdings in total euro-area holdings.
Source: Bruegel based on ECB data.

The counterpart to the low degree of retail banking integration is the low number of cross-border bank mergers and acquisitions (Figure 3). Bank mergers and acquisitions in the euro area happen predominantly within national borders. In the US, the average number of bank mergers and acquisitions per year from 2005-12 was 343, while in Europe the yearly average only amounted to 58⁴. The percentage of cross-border mergers in Europe is low. Data for all 28 EU countries is presented in the annex. Since mergers and acquisitions are mostly domestic, the percentage of subsidiaries and branches that are foreign-owned is correspondingly low measured in assets.

Figure 3: Total number of EA17 banks being bought by banks in E

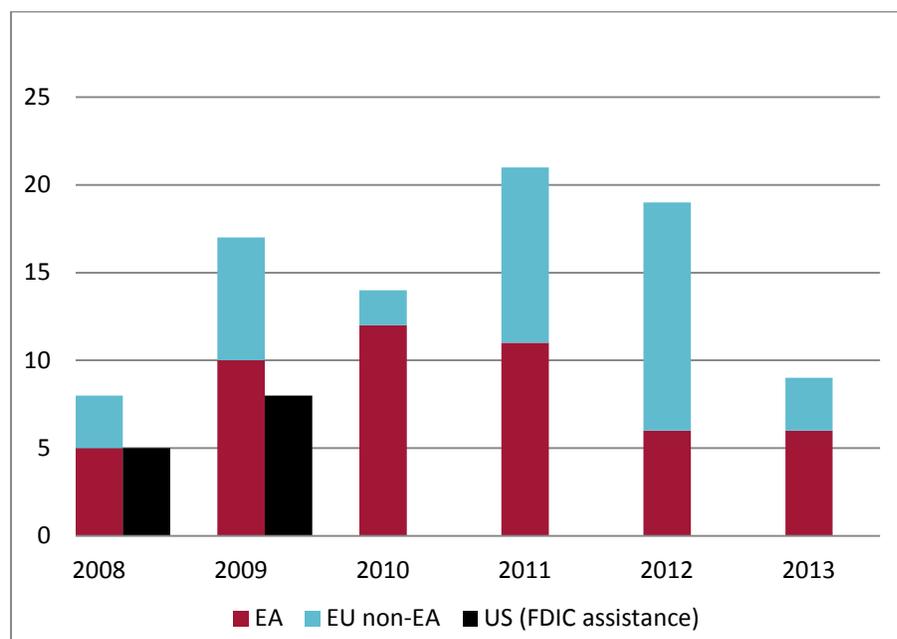


⁴ These numbers include only banks located in the euro area respectively in the US that have been targets. Acquisitions outside are not counted.

As a consequence of the impaired wholesale banking market and the absent cross-border retail banking market, the price and availability of credit for non-financial corporations is dramatically different in different countries. Standard measures (see the annex and the European Central Bank’s financial stability report) indicate very significant differences in interest rates in different countries. Furthermore, in terms of quantity restrictions, several indicators show that the likelihood of receiving a credit differs substantially across the common currency area – in contrast to the pre-crisis period⁵. In response to this divergence, ECB liquidity was increasingly directed towards banks located in crisis countries, but liquidity provision could not stop rates from diverging. Since the announcement of the OMT programme (Outright Monetary Transactions), cross-border activity has either stabilised or has slightly rebounded. Overall, the fragmentation of lending conditions is a significant disadvantage for corporations in affected countries, and is ultimately not sustainable.

The crisis has resulted in numerous bank-support programmes in the euro area, which have so far failed to solve the problem of financial fragmentation. In contrast to the US, the EU has had many support programmes but very few bank closures (Figure 4). Federal Deposit Insurance Corporation (FDIC) numbers show that since 2008, 13 banks received FDIC government support, while in the euro area and the rest of the EU, DG Competition counts 50 instances of state aid cases for euro-area banks, and 38 cases of state aid for banks for the rest of the EU. Since 2010, the FDIC has not started a new support programme for any bank. The FDIC reports that 494 banks failed in the US between 2008-July 2013. In Europe, there is no official data source collecting the number of bank failures, but a data collection project by Open Economics resulted in an estimate of 49 in the euro area and 64 in the rest of the EU⁶.

Figure 4: Number state aid bank support cases (other than just guarantees)



Note: state aid cases that only comprise guarantees as an aid instrument were excluded as we don’t include bank guarantees given by the TARP program. Some state aid cases consist of national bank support schemes, therefore the number of banks that benefit from this state aid cases is largely underestimated by the bars.

Sources: DG Competition and FDIC

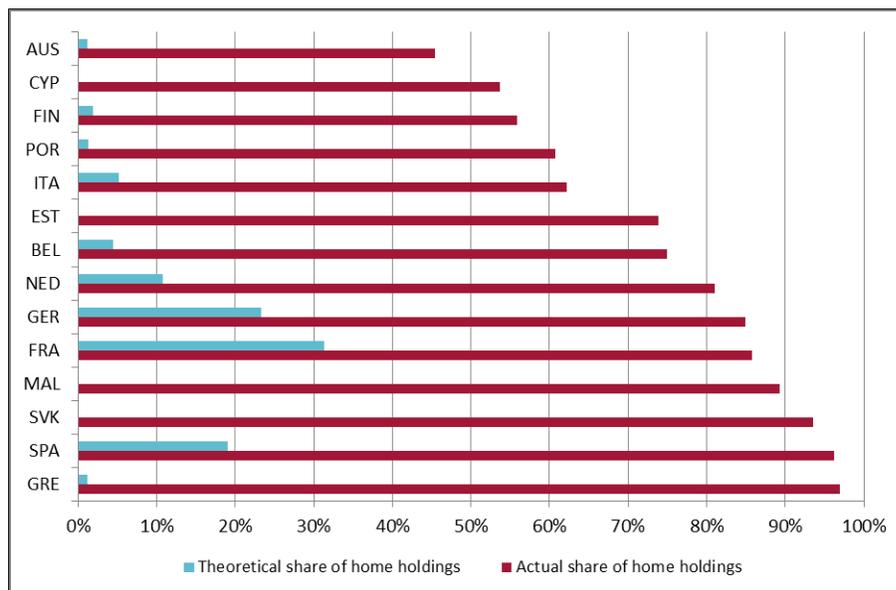
⁵ OECD (2013) Financing SMEs and Entrepreneurs 2013: An OECD Scoreboard. Final Report

⁶ Data downloaded in August 21 2013 from <http://openeconomics.net/failed-bank-tracker/>

Compared to the US, the European banking sector has somewhat lower equity levels and a low return on equity (Figure A2-4 in the annex). Non-risk weighted average tangible equity in the nine Global Systemically Important Banks (G-SIBs) of the euro-area was 3.05 percent of tangible assets as of second quarter 2012, while in the US, the same ratio for its eight G-BIBs stood at 3.66 percent⁷. The return on equity has been comparatively low, standing at 1.7 percent at the end of 2012, compared to 8.9 percent in the US for the largest 10 banks with available data in each region⁸. Low market-to-book values (54.9 percent in the top 10 euro-area banks compared to 97.5 percent in the top 10 US banks) further suggest that markets still believe that significant problems lurk in the balance sheets of euro-area banks.

Other forms of financial intermediation in the euro area remain underdeveloped and there is comparatively little cross-border financial intermediation that could help reduce financial fragmentation. For example, equity markets remain characterised by a strong home bias. The ownership of listed companies remains predominantly national (Figure 5). The percentages are significantly lower than would be expected in a fully integrated market, in which investors would spread their portfolio across the entire euro area⁹. ECB data corroborates this result and shows that ownership by MFIs of foreign shares and other corporate equity is very limited in the euro area (Figure 2). As a consequence, the effects of a shock that reduces the value of shares in one country will mostly be felt domestically because ownership is concentrated domestically. Risk is not shared across borders and access to new finance – because it remains national – remains constrained by the negative situation in the particular country.

Figure 5: Proportion of equity held in euro-area countries that is of domestic origin, 2010



Note: Theoretical share of home holdings is equal to the share of domestic market capitalisation of total euro-area stock market capitalisation. Source: Bruegel based on World Bank data on stock market capitalisation and IMF CPIS data on cross-border holdings following the methodology of Balta and Delgado (2009).

⁷ The adjusted tangible equity to adjusted tangible assets ratio figures were taken from the FDIC website: Capitalization Ratios For Global Systemically Important Banks (G-SIBs) table http://www.fdic.gov/about/learn/board/hoenig/CapitalizationRatios_SIBs_Table1_v1.pdf

⁸ The figures for the top 10 euro area and US banks were compiled using SNL data services; banks included are: BNP Paribas, Crédit Agricole, Société Générale, Natixis, Deutsche Bank, Commerzbank, UniCredit, Intesa Sanpaolo, Banco Santander, Banco Bilbao Vizcaya Argentaria, (Dutch Banks were not included because of lack of data) in the euro area and JPMorgan Chase & Co., Bank of America Corporation, Citigroup Inc., Wells Fargo & Company, Bank of New York Mellon Corporation, U.S. Bancorp, Capital One Financial Corporation, PNC Financial Services Group Inc., State Street Corporation, BB&T Corporation in the US.

⁹ Balta and Delgado (2009), "Home Bias and Market Integration in the EU," CESifo Economic Studies, CESifo, vol. 55(1), pages 110-144, March.

Overall, the euro-area banking and capital market system remains highly national. Efficiency gains are feasible. Relatively low market-to-book values and low return rates in combination with predominantly national merger activities suggest that the consolidation of the European banking sector still has not happened. This is in contrast to the US, where significant mergers and the absence of governmental support indicate that the banking system has returned to comparatively high stability. The situation is also unsatisfactory because euro-area financial markets remain highly fragmented, meaning that financial conditions remain very unfavourable in some countries. With the creation of a banking union, with the first step being the single supervisory mechanism (SSM), the euro area's banking system could now be restructured. In terms of the capital markets, the low cross-border ownership of equity and the underdeveloped cross-border corporate bond markets also reduce the efficiency of capital allocation, and prevent meaningful risk-sharing across borders.

3) Options for Europe's financial system

The crisis has revealed three problems with Europe's financial system. The first is that cross-border financial intermediation happened largely through debt-based wholesale banking market integration. This increased vulnerability to shocks and led to sudden-stop problems¹⁰. More and better integrated equity markets would have allowed capital markets to absorb the massive shocks with which the euro area was confronted. The second problem is the high exposure to risk relative to the loss-absorbing capital and debt in the banking system. This translated into increasing demands for bail-outs and numerous public assistance programmes. The third problem is the contrast between the high degree of (wholesale) banking market integration that prevailed before the crisis and the absence of a European system for financial stability. This has delayed the resolution of bank difficulties and dragged down the EU economy for a full five years¹¹.

The European banking union is meant to address the third problem¹². At the same time, the creation of the banking union raises a number of issues that policymakers will need to face.

The first set of issues concerns banking itself. Here the most pressing matter is the upcoming Asset Quality Review (AQR), which the ECB – acting as the single banking supervisor – will shortly start carry out to determine the true quality of the assets on the balance sheets of those banks that it will directly supervise from late 2014. The ECB has a clear interest in establishing itself as a tough regulator by conducting a thorough review. After all, it does not want to be liable for problems that pre-date its supervisory responsibility. Moreover, only a tough AQR (together with a credible stress test) will restore confidence in the European banking system and thereby overcome the dysfunctional interbank market and reduce the fragmentation of euro-area credit conditions.

¹⁰ Merler and Pisani-Ferry (2012), "Sudden stops in the euro area", Bruegel policy contribution 2012/6.

¹¹ Darvas, Pisani-Ferry, Wolff (2013), "Europe's growth problem (and what to do about it)", Bruegel Policy Brief 2013/03.

¹² The ECB has repeatedly emphasized that a true European banking union requires three pillars: the Single Supervisory Mechanism (SSM); the Single Resolution Mechanism (SRM); and a common system of deposit protection. It has also argued that the SSM and the SRM are indispensable complements that have to proceed in parallel, whereas a common system of deposit protection can be added later. Also see Pisani-Ferry, Sapir, Véron, Wolff (2012), "What kind of European banking union", Bruegel Policy Contribution 2012/12; Pisani-Ferry and Wolff (2012), "The fiscal implications of banking union", Bruegel Policy Brief; Véron and Wolff (2013), "From supervision to resolution: next steps on the road to banking union", Bruegel Policy Contribution 2013/4; Véron (2013), "A realistic bridge towards European banking union", Bruegel Policy Contribution 2013/9.

However, a tough AQR will increase the likelihood of bank recapitalisation, which could involve the use of public money for publicly-owned banks, or also in case of privately-owned banks if private shareholders and convertible debt holders are unwilling or unable to put up more money. The discussion on this matter has generally been focused on whether the European Stability Mechanism (ESM) would be able to recapitalise banks in ESM member countries in which the government *“is unable to provide financial assistance to the institutions in full without very adverse effects on its own fiscal sustainability”*¹³. The more important question, however, is if other avenues should be pursued for a bank that is under-capitalised and *“unable to attract sufficient capital from private sources or other means in order to resolve its capital problems”*¹⁴. This is where the issue of resolution, whether through merger or termination, comes into play.

Policymakers should consider a number of issues regarding the resolution of failing banks. The first is regulatory forbearance. It is important that the resolution of banking problems is not further delayed. Second, a European resolution framework is needed for a number of reasons. First, it is a way of protecting the ECB from pressure to delay triggering resolution and to keep insolvent banks with liquidity and ELA afloat. Second, a European resolution authority is essential to ensure that bank failures do not result in major disruption in the European banking system. The FDIC has achieved such resolution without major disturbances in the United States¹⁵. Third, in case of a resolution, a European rather than a national solution is desirable to keep the financial market integrated. In particular, if a cross-border rather than purely national merger would make sense from a business perspective, it should not be prevented by the fragmentation of resolution authorities along national lines. As we have argued, the low level of cross-border retail banking integration combined with the low profitability of the sector suggests that there is ample scope to increase efficiency in European banking, including through cross-border mergers.

How could a European resolution framework be constructed? In the new system, the ECB holds the key to triggering resolution processes. The first important step is to create harmonised rules for all countries, as spelled out in the Bank Recovery and Resolution Directive. The clear spelling-out of a pecking order and rules for bail-in are essential in this regard. But this is not sufficient. A Single Resolution Mechanism (SRM) with a Single Resolution Authority (SRA) must be established as soon as possible to operate in tandem with the SSM. The main advantage of an SRA would be that it would offer the most credible route towards a European approach to resolution, which is desirable, as we have outlined. Other ways of organising resolution are possible, but the key is to achieve as much centralisation as possible in order to avoid the further fragmentation of banking along national lines.

The SRA should be, like the ECB, an independent institution. It should be able to quickly make decisions, which would ensure the continuation of those parts of business that are central for financial stability, while coming to an agreement between creditors about burden sharing based on clearly-defined rules. The FDIC, which combines bank resolution and deposit insurance, might serve as a good model. The FDIC is funded entirely by fees from member banks but is guaranteed by taxpayers, which means that the US Treasury provides a line of credit to the FDIC, which it repays over time. The FDIC experience suggests that such an approach would involve comparatively low levels of public resources and would lead to the greater involvement of private creditors and more bank closures.

¹³ Eurogroup, “ESM direct bank recapitalisation instrument”, 20 June 2013, Luxembourg.

¹⁴ Ibid.

¹⁵ In this respect, it is striking to compare the handling of two bank failures of roughly the same size: IndyMac bank, a Californian bank with \$32 billion in assets, which was taken over by FDIC in 2008 and sold in 2009; and the Bank of Cyprus, with €37 billion in assets. The fact that only few readers will have heard of IndyMac speaks for itself.

Cross-border mergers would not only increase efficiency, but would also enhance financial stability by reducing the strong interconnection between banks, sovereigns and national economies, which currently plagues many EU countries. Certainly, the foreign ownership of banks in central and eastern European countries has contributed to stability when crises had domestic origins in these countries. When, on the contrary, crises started in the home country of foreign banks, as was the case in 2008, then foreign ownership was a source of problems for recipient countries¹⁶. But the problem was a result of the absence of a proper pan-European mechanism. This absence encouraged home-country supervisors to demand that their banks take action that favoured home-country borrowers at the expense of host countries. The Vienna Initiative successfully reversed this situation. A more durable way to ensure stability in central and eastern European countries, where banking systems are dominated by western European institutions, would be to include them in the banking union¹⁷.

This raises a central question on which Europe needs to make up its mind, and rather soon as far as non-viable banks are concerned. Governments will have to decide if consolidation of European banks will be allowed to happen across borders, thereby creating truly pan-European banks, which would improve financial stability¹⁸. This would also reduce the close relationship between governments and banks, which pervades both sides of bank balance sheets, and which is perhaps Europe's greatest financial problem¹⁹.

On the asset side, this close relationship translates into a bias towards bank lending to governments (partly encouraged by government regulation that assigns zero risk weights to government debt), or towards providing funds for politically-motivated projects with low, or even negative, financial returns. On the liability side, banks receive implicit and explicit guarantees from governments that amount to subsidies in the form of reduced funding costs. This relationship between national governments and national champion banks is incompatible with a true European banking union²⁰. One way to weaken this link would be to impose limits on the exposure of banks to any sovereign, in particular their own²¹.

The second set of issues that European policymakers will need to address concerns financial activities outside of banking. European equity markets are much smaller than US markets and are still fragmented along national lines. Cross-border ownership of corporate bonds is also underdeveloped in the EU. As a result, European capital markets provide far less opportunity for risk sharing between European countries than is the case between US states²². Better integrated European capital markets would also provide European non-financial corporations with a source of funding

¹⁶ See Franklin Allen, Krzysztof Jackowicz and Oskar Kowalewski. 2012. "The effects of foreign and government ownership on bank lending behavior during a crisis in Central and Eastern Europe". Mimeo.

¹⁷ See Erik Berglöf, Ralph De Haas and Jeromin Zettelmeyer. "Banking union: The view from emerging Europe". Vox EU, 16 October 2012. Zsolt Darvas and Guntram Wolff (2013), "Should non-euro area countries join the single supervisory mechanism?", Bruegel Policy Contribution 2013/6.

¹⁸ Compared to the United States, bank concentration is high in individual EU member states but low for the EU as a whole. The share of the three largest banks in the total of all banks is roughly 50 percent in each of the six largest EU countries (France, Germany, Italy, Poland, Spain and United Kingdom) but only slightly over 10 percent for the EU as a whole. By contrast it about 30 percent for the US. See Michiel Bijlsma and Gijsbert Zwart. 2013. "The Changing Landscape of Financial Markets in Europe, the United States and Japan". Bruegel Working Paper 2013/2. Brussels: Bruegel.

¹⁹ See, for instance, Anat Admati and Martin Hellwig. 2013. *The Bankers' New Clothes: What's Wrong with Banking and What to Do about It*. Princeton and New York: Princeton University Press.

²⁰ See Charles Goodhart. 2012. "Funding arrangements and burden sharing in banking resolution". In Thorsten Beck (ed.), *Banking Union for Europe: Risks and Challenges*. A VoxEU.org Book. London: CEPR.

²¹ See also Viral Acharya. 2012. "Banking union in Europe and other reforms. In Thorsten Beck (ed.), *Banking Union for Europe: Risks and Challenges*. A VoxEU.org Book. London: CEPR; and Daniel Gros. 2013. "Banking Union with a Sovereign Virus: The self-serving regulatory treatment of sovereign debt in the euro area". CEPS Policy Brief No. 289. Brussels: CEPS.

²² See Mathias Hoffmann and Bent E. Sorensen, "Don't expect too much from EZ fiscal union – and complete the unfinished integration of European capital markets!", VoxEU.org, 9 November 2012 and Wolff (2012), "A budget for Europe's monetary union", Bruegel Policy Contribution 2012/22..

other than bank borrowing. Policymakers cannot neglect any longer the barriers that continue to hinder the integration of European capital markets more than 20 years after the alleged completion of the single market and the liberalisation of EU capital movement. Key elements in fostering the integration of European equity markets include harmonisation of and improvements to corporate transparency standards, harmonisation of corporate governance standards and harmonisation of insolvency legislation. There is evidence that differences in legal enforcement affect private equity. While private markets can find solutions for differences across countries, this can only be a partial remedy, *inter alia* because of higher transaction costs²³. Taxation reform would also be crucial. Empirical evidence shows that differences in taxation can lead to reductions in the valuation of equity, making it more difficult to raise new capital across borders²⁴. Similarly, it would be important to take steps to improve the financing of high growth potential firms by adopting transparency and insolvency regulation²⁵. This reform agenda would be greatly beneficial as an underpinning for improved financing conditions of non-financial corporations, and would increase the stability of the financial system. This is, of course, a long-term agenda that cannot be seen as a substitute for the pressing need to resolve current banking problems.

Europe, and the euro area in particular, would greatly benefit from having fully integrated financial markets – not only in banking but also for bonds and equity. This requires a financial stability framework for banking, such as envisaged in the banking union, and appropriate measures to foster capital market integration. Not all policies would need to be implemented at the same time to achieve the desired goal, but it is crucial that progress be made simultaneously on both the integration and stability fronts in order “*to be self-reinforcing and unleash virtuous dynamics*” as envisaged by the ECB²⁶. The following sequencing would seem appropriate:

The first step, the SSM, is already programmed, with the AQR due to start later this year and end in March 2014. The second step will be the choice that governments make on how to handle the outcome of the AQR if some banks, as is likely, are under-capitalised and unable to raise sufficient capital from private sources. This will be a crucial choice for two reasons. First, governments will have to ensure not only that all under-capitalised viable banks are recapitalised, but also that all non-viable banks fail. Second, and equally important, governments will have to agree whether or not they accept cross-border consolidation of European banks to deal with non-viable banks. This two-dimensional crucial choice will be closely related to governments' willingness to accept the creation of a meaningful SRM. Without European resolution, the banking system would remain fragmented along national lines thereby endangering financial stability and hampering growth. Eventually, further steps should be taken to reduce the exposure of banks to sovereign debt. This could come in the form of exposure limits or the introduction of risk weights for sovereign debt.

The next step would be the adoption of measures to make significant progress in the integration of European capital markets, both for corporate bonds and for equity. Here European legislators will have to tackle issues that have long eluded them, in particular differences between EU countries in areas such corporate governance, insolvency laws and even tax treatment of certain assets and liabilities. Creating a truly *Societas europaea* subject to a single European insolvency law and taxation with a single European corporate governance structure would be a formidable step in the creation of a pan-European, fully integrated capital market.

²³ Josh Lerner and Antoinette Schoar (2005), “Does legal enforcement affect financial transactions? The contractual channel in private equity”, *Quarterly Journal of Economics*, 120(1), pp. 223-246.

²⁴ Harry Huizinga, Johannes Voget and Wolf Wagner (2012), “Who bears the burden of international taxation? Evidence from cross-border M&As,” *Journal of International Economics*, 88(1), pp. 186-197

²⁵ Philippon, Thomas and Nicolas Véron (2008), *Financing Europe's fast movers*, Bruegel Policy Brief 2008/01.

²⁶ Benoit Coeuré, “The way back to financial integration”, speech prepared for the Conference on International Financial Integration and Fragmentation”, Banco de España and the Reinventing Bretton Woods Committee, Madrid, 12 March 2013.

4) Conclusions

The European financial system could be significantly reshaped in the coming years as a consequence of the creation of the banking union and the need to find additional sources of financing. This may lead to a fundamentally different banking and capital market landscape, with implications for the availability of finance for corporations and households, economic growth and the stability of the financial system. We have highlighted two central aspects in this regard.

The first aspect concerns the banking system. Cross-border mergers have been in a minority and retail banking integration has been limited. More retail banking integration would help to de-link the availability and conditions of credit from country-specific shocks and sovereign distress. But achieving increased integration in banking will also mean accepting less industrial policy in banking.

The second aspect is the creation of integrated bond and equity markets. More cross-border ownership would be a formidable tool for the sharing of risk and for harmonising access to finance across the EU. Completing the single market in the capital market would thereby help overcome one of the central problems of monetary union – the vulnerability to shocks affecting individual countries – and would contribute to the stability of the EU more broadly. Decisions taken now – on the relative importance of banking versus capital markets, on the number and size of banks and on cross-border integration of banking – will shape Europe's financial system for years to come. The complex choice requires careful consideration because it might be difficult to reverse.

Annex

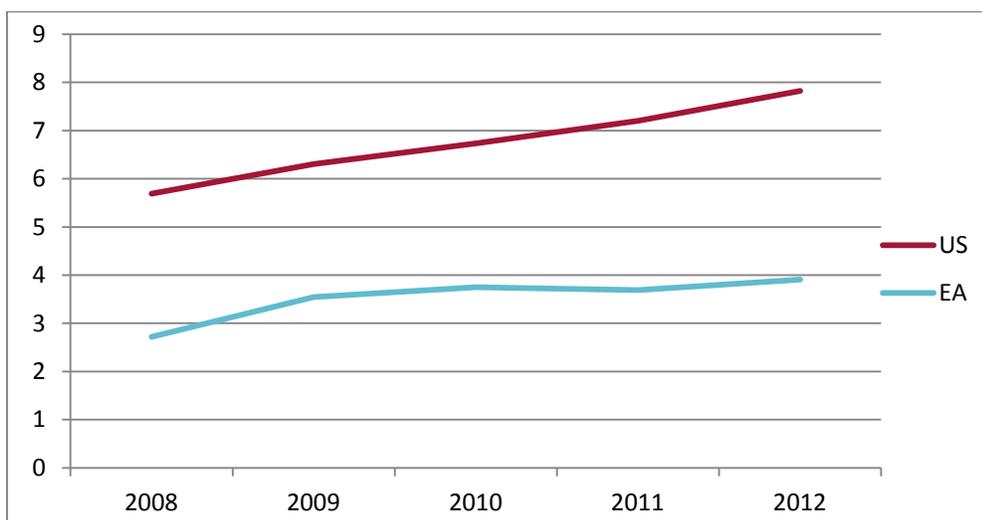
Figure A1: Coefficients of variation for MFI interest rates on new euro-denominated loans to euro area non-financial corporations (EA changing composition)



Note: The includes all maturities and all amounts of loans

Source: ECB

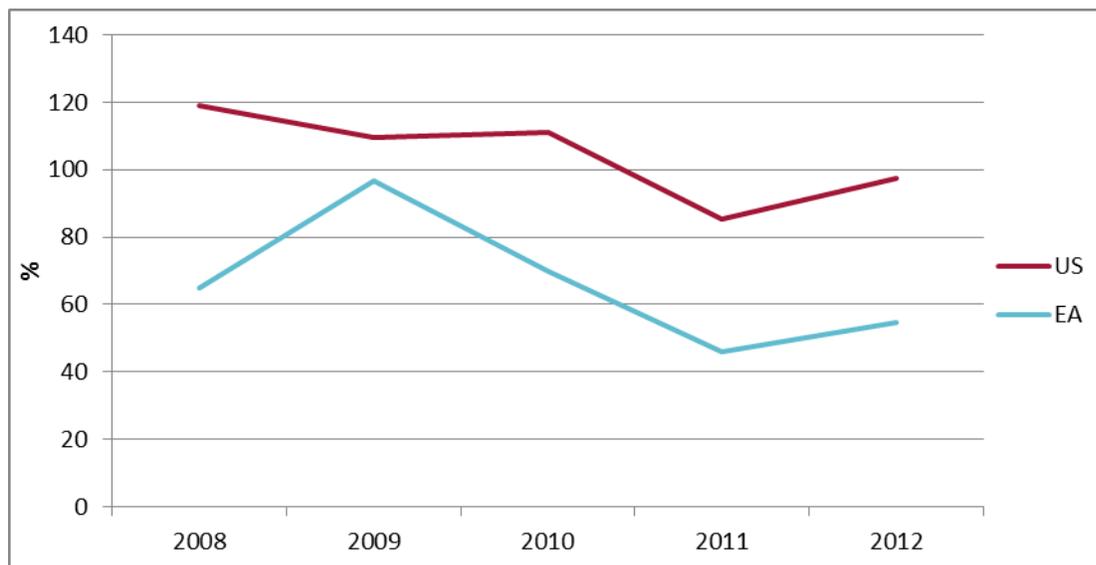
Figure A2: Tangible Equity to tangible assets ratio (%)



Note: The levels are not strictly comparable as in the US total assets are reported according to Generally Accepted Accounting Principles while in Europe they are reported according to International Financial Reporting Standards.

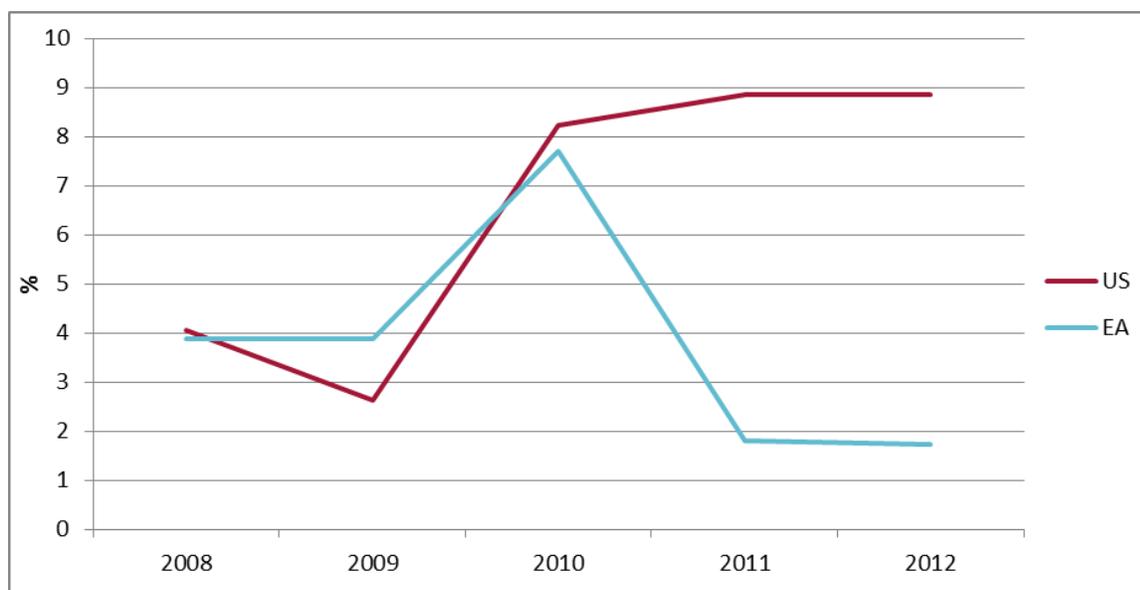
Source: SNL

Figure A3: Price/ Book (%)



Source: SNL

Figure A4: Return on average equity



Source: SNL

List of banks included:

EA: BNP Paribas SA, Crédit Agricole SA, Société Générale SA, Natixis, Deutsche Bank AG, Commerzbank AG, UniCredit SpA, Intesa Sanpaolo SpA, Banco Santander SA, Banco Bilbao Vizcaya Argentaria, SA (Dutch Banks were not included because of lack of data)

USA: JPMorgan Chase & Co., Bank of America Corporation, Citigroup Inc., Wells Fargo & Company, Bank of New York Mellon Corporation, U.S. Bancorp, Capital One Financial Corporation, PNC Financial Services Group Inc., State Street Corporation, BB&T Corporation

Merger and Acquisitions data

The main source adopted is the SNL Financial Database series, in particular the SNL Mergers and Acquisitions database, and the SNL Companies database.

We consider a sub-set of the SNL Mergers and Acquisitions database involving deals completed in the period 01/01/2005 to 23/08/2013 and in which either buyer or seller were located in the USA and Europe (both Developed and Emerging). The sub-set comprises a total of 4,503 deals.

For some of the deals, only name and geographic location of the subsidiary/branch being bought is reported; therefore the need of crossing the SNL Merges and Acquisitions database with the SNL Companies database which reports the banks' ownership structure. We consider a sub-set of the SNL Companies database entailing 5,329 banks, their ultimate parent bank and relative geographic location of both. Hence, we could update the first database with the second and so have a more realistic picture of the M&A decisions by holding banking groups instead of subsidiaries.

After the update, it results that 2,922 deals (67% of the total 4,503) involve banks having ultimate parent based in the US being acquired, 496 deals (11%) in the EA17, 235 (5%) in the rest of EU28 and 850 (19%) in the rest of Europe.

Note: The number of domestic banks buying other domestic banks in the negative semi-axis is omitted to avoid redundancy.

