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The Importance of Resilience and Integration for the Future European Financial System

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Key Messages

- In times of structural change and periods of upheaval, a resilient financial system plays a key role in the successful transformation of the economy.
- Two of the three pillars of the still unfinished Banking Union have proven to be important elements of financial integration and stability.
- To realize the full potential of the European financial system, the EU should complete the Banking Union and progress the Capital Markets Union.
- The Commission's proposals to strengthen the existing EU bank crisis management framework are a step in the right direction.

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The Importance of Resilience and Integration for the Future European Financial System

*Karlheinz Walch and Benjamin Weigert**

The financial system plays a crucial role in the economy by supporting payments, investing savings, facilitating financing and hedging risk. This enables firms and households to conduct their economic activities efficiently and effectively. To avoid exacerbating economic downturns, the financial system must be resilient. It must be able to withstand a wide range of shocks and continue to perform the above-mentioned functions in order to avoid negative chain reactions. Disruptions in the financial system, nonetheless, can lead to serious economic problems that may affect overall economic development and entail social costs.

The state of the financial system and economic developments are closely linked and influence each other. Despite the recent economic recovery in the Euro area, the macro-financial environment remains challenging and the resilience of the financial system to unexpected events is crucial. While household and corporate balance sheets have proven to be robust, a number of vulnerabilities remain in the financial system. These include sensitivity to developments in housing markets, where the decline in residential real estate prices has recently slowed, although commercial real estate prices continue to fall. In addition, the vulnerabilities in bank balance sheets resulting from the period of low interest rates persist and are only gradually diminishing.[1] Added to this are the challenges posed by the growing importance of the financial non-banking sector, geopolitical tensions and the increasing risk of cyber-attacks (ECB 2024a).

The crises of recent years, such as the Covid-19 pandemic, have underscored the importance of effective supervision and regulation for financial stability. Identifying risks at an early stage and taking appropriate action is crucial to ensuring financial stability. In addition, society and the economy as a whole are facing structural challenges. The transition to a climate friendly economy and the digital transformation requires adap-

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[1] For example, the vulnerability of the German financial system to changes in interest rates increased, and the share of relatively risky firms in banks' loan portfolios rose (Deutsche Bundesbank 2022).

tation and innovation in the financial sector. A competitive and integrated financial system is essential to overcome these challenges and ensure the sustainability of our economy.

To realize the full potential of the European financial system, we should strive for a highly integrated European financial market, with the Banking Union and the Capital Markets Union at its core. This would not only strengthen Europe's resilience, but also increase opportunities for growth. It is therefore of utmost importance that the European institutions and Member States continue to work closely together in this area to achieve the necessary progress.

Supervisory priorities

In times of structural change, a resilient financial system plays a key role in the successful transformation of the economy. Especially in periods of upheaval, we cannot rely on banks' risk management alone.[2] Strong supervision and regulation that safeguard financial stability and give society confidence in the stability of banks are more important than ever. For this reason, supervision at the national and European level focuses not only on annual priorities[3], but also on issues that will emerge as particularly relevant in the medium term.

At the national level, the Deutsche Bundesbank and the Federal Financial Supervisory Authority (BaFin) have set the following medium-term priorities for the supervision of less significant institutions in Germany until 2026: first, ESG risks, especially climate risks. At present, almost two-thirds of German institutions subject to national supervision are only just beginning to implement the supervisory recommendations on sustainability risks and are therefore lagging behind the supervisory requirements. Over the next few years, the supervisory authority will therefore focus on examining how banks are progressing in implementing existing requirements, including the Minimum Requirements for Risk Management (MaRisk).

The second medium-term priority is digital transformation. It is a key success factor for the competitiveness of the German financial sector - but only if digital operational resilience is ensured on an ongoing basis. Third, as we clearly saw during the turmoil in the banking sector in 2023, good governance and an appropriate risk culture are essential.

[2] The terms credit institutions and banks are used synonymously here. Due to the majority of credit institutions, the terms financial services institutions, payment institutions and e-money institutions are not used in the following.

[3] The 2024 National Supervisory Program (NSP) focuses on the following four areas: (i) economic environment and inflation, (ii) interest rate developments, (iii) IT security and (iv) the commercial real estate market.

The latter ensure integrity and transparency and reduce the risk of mismanagement, misconduct and fraud.[4]

At the European level, the Single Supervisory Mechanism (SSM) sets the priorities for the supervision of significant institutions. The national supervisory program is closely linked to these priorities. The SSM has outlined the following priorities for a three-year planning horizon: first, to strengthen the resilience of the financial sector to macroeconomic and geopolitical shocks; second, to accelerate the effective resolution of structural deficiencies in governance and climate risk management and, third, to make further progress in digital transformation and operational resilience (ECB 2024b).

These medium-term supervisory priorities at the national and European level are based on the risks that supervised institutions are most exposed to in the current macro-financial and geopolitical environment. They strengthen the resilience of the financial sector to the risks arising from structural change.

Completing the Banking Union

The idea of a Banking Union in the European Union (EU) emerged in the aftermath of the global financial crisis and the sovereign debt crisis. With the SSM and the Single Resolution Mechanism, two of the three pillars of the Banking Union have already been implemented. Today, they are important elements of financial integration and stability. Political agreement has not yet been reached on the third pillar, the European Deposit Insurance Scheme (EDIS).

The aim of EDIS is to strengthen confidence in deposits across Europe and to limit the impact of potential national banking crises, for example if confidence in national deposit guarantees were to be lost. EDIS could reduce contagion between banks and banking systems in the event of a crisis. Depositors' confidence in functioning deposit protection could be enhanced beyond the performance of the national deposit guarantee scheme and could thereby reduce the risk of bank runs. EDIS would also alleviate the burden on governments: They would have to intervene less often with public funds to safeguard domestic financial stability through support measures. The EU as a whole could become more resilient and thus contribute to financial stability in Member States.

EDIS is ultimately about jointly shouldering certain risks within the EU. However, as the European Economic Area is not a fiscal union and there are institutional peculiarities in

[4] In a widely cited study, researchers at the ifo Institute showed that German banks with competent supervisory and management boards suffered lower average losses during the financial crisis (Hau et al. 2024).

the national banking systems,[5] the concrete design is challenging. In any case, eliminating false incentives in the existing legal framework and avoiding them for the future is a prerequisite for political agreement.

In the Bundesbank's view, the first step must therefore be to strengthen the existing EU bank crisis management and deposit insurance (CMDI) framework. In April 2023, the European Commission published legislative proposals to this effect (European Commission 2023), thus giving the go-ahead for the negotiations currently underway. The importance of an effective crisis management framework was also demonstrated by the banking turmoil in the US and Switzerland in 2023.

It is also important to avoid disincentives due to a mismatch between liability and risk (Deutsche Bundesbank 2015). Risks must be adequately limited, especially those that can be directly influenced by individual Member States. At present, this primarily concerns sovereign solvency risks and the resulting sovereign-bank doom loop.

Government bonds are currently not subject to the usual capital requirements or large exposure limits. Reducing these regulatory privileges for government liabilities on bank balance sheets would be the ideal solution, but the political backing to push this through won't be there for the foreseeable future. To move forward, however, one idea to consider might be using concentration limits to effectively restrict the amount of government bonds held on banks' balance sheets. Such a cap would be technically relatively easy to implement. Concentration surcharges could also be an option, which would apply if a bank's share of bonds and loans to a government exceeded certain thresholds.

The more EDIS is expected not only to provide liquidity but also to absorb losses, the more important it is to mitigate the sovereign-bank doom loop at the same time. Thus, the specific design of EDIS as a whole matters. Various approaches are conceivable, ranging from a decentralized model to a hybrid, partially centralized model to a fully centralized model at the European level. These numerous design options provide scope for political agreement on the introduction of an EDIS. The institutional protection schemes can be integrated into different EDIS designs.

A hybrid model, in which national deposit guarantee schemes would continue to exist while being complemented at the European level, seems to offer particular advantages. The European part could, for example, provide support when national funds are exhausted, thereby strengthening confidence in the national deposit guarantee scheme. For Germany, for instance, a hybrid model would have the advantage over a centralized, purely European one in that the autonomy of the institutional protection schemes and

[5] For example, national banking systems differ in the structure of institutional protection schemes, where they exist.

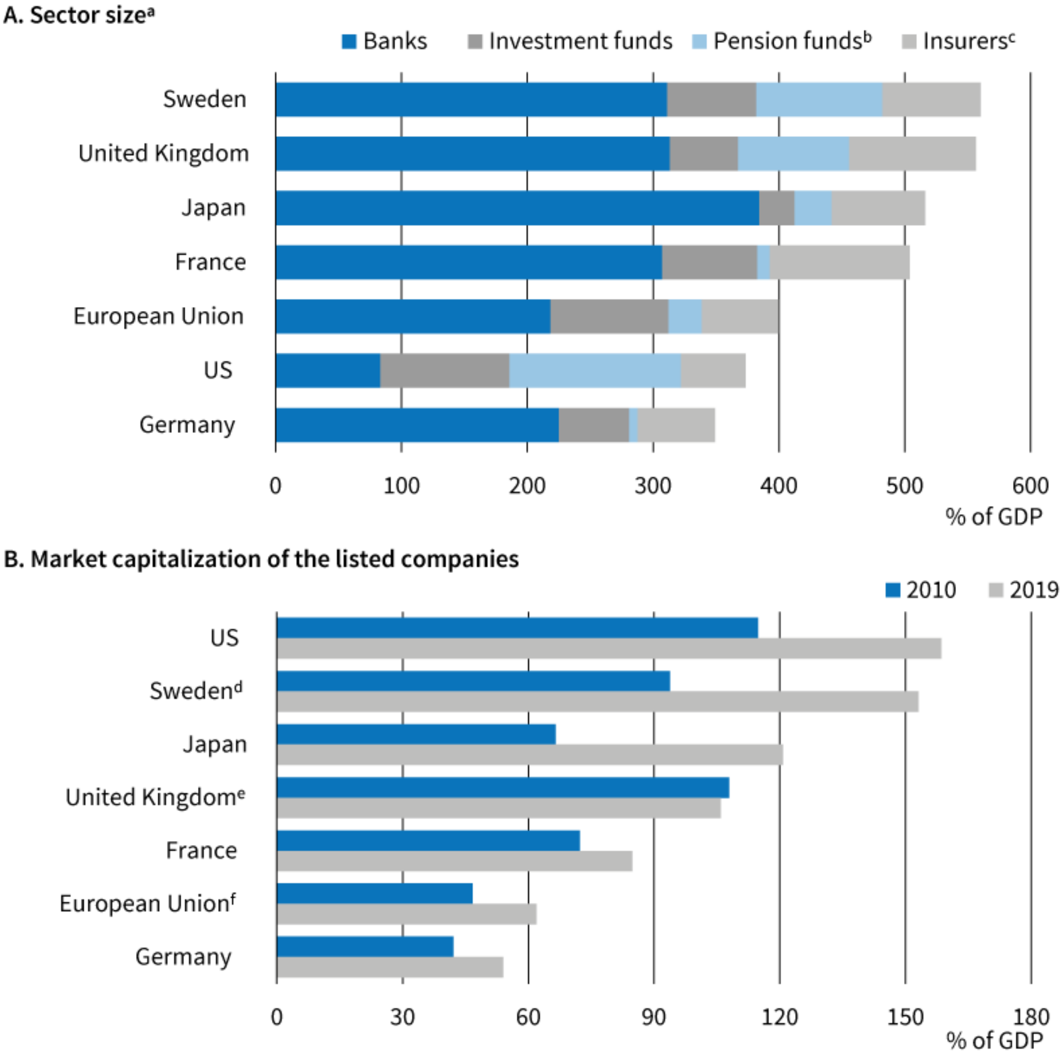
their deposit guarantee schemes could be better ensured. Moreover, the national level would remain directly responsible as the individual Member States would continue to have an influence on the health of their national banking sector.

Leveraging the Benefits of a Capital Markets Union

In addition to the Banking Union, progress on the Capital Markets Union (CMU) is another important factor for the future development of the European financial system. The European financial market has traditionally been, and will continue to be, more bank-based than the US financial market (see Figure 1) (SVR 2023). The size of the European banking sector is comparable to that of the insurers, pension funds and investment funds combined. The lower importance of capital markets is also reflected in the market capitalization of companies. Although it has grown over the past decade, it is less than half the size of that of the US in terms of GDP.

The EU's capital market remains fragmented, making it more difficult for businesses to raise finance. However, a broader range of financing options is essential in order to address the structural challenges facing the economy. Financing beyond traditional bank loans is particularly important for the green transformation of the economy. This is linked to the ability of capital markets to reallocate resources to growth industries and to finance the introduction of productivity-enhancing technologies. Increased capital market financing could thus contribute to reducing the ecological footprint of the economy (De Haas and Popov 2019).

Figure 1
Importance of the Banking Market



[a] Value of respective assets in relation to GDP. Average values for the years 2010 to 2020. [b] European Union: Without values for Cyprus. [c] European Union: Without values for Luxembourg. [d] Data for 2011 instead of 2010. [e] Data for 2018 instead of 2019. [f] Data for 2010 excluding Denmark, Estonia, Latvia, Lithuania, Sweden and the Czech Republic.
Source: German Council of Economic Experts. Data source: BoJ; CEIC; ECB; Fed; World Bank.
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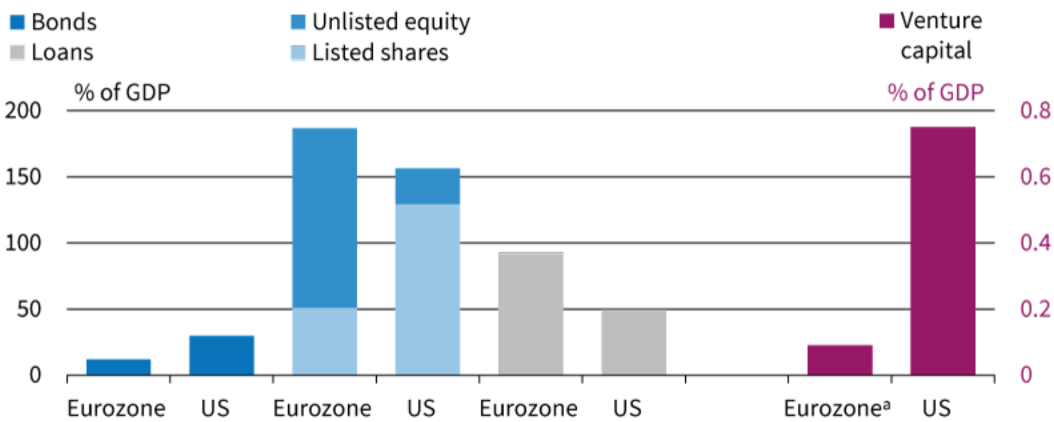
The Bundesbank sees progress on the Capital Markets Union as an opportunity to support innovation in the European economy and strengthen its growth. Greater capital markets integration would promote competition and improve the availability of financial services. Private capital can be mobilized more easily if there is a deep and liquid capital market. The level of capital market financing can also have a positive impact on economic dynamics in developed economies (Demirguc-Kunt et al. 2013).

Innovative young companies, which are often start-ups and smaller enterprises, often need venture capital to strengthen their innovative capacity and make a significant contribution to economic growth (SVR 2023). The venture capital market remains extremely small compared to the US (see Figure 2). Facilitating access to capital, including across national boundaries, would help companies obtain the capital they need.

Figure 2

Financing Instruments of Non-financial Companies in the Eurozone and the US in 2022



[a] Excluding Malta and Cyprus.

Source: German Council of Economic Experts. Data source: ECB; OECD.

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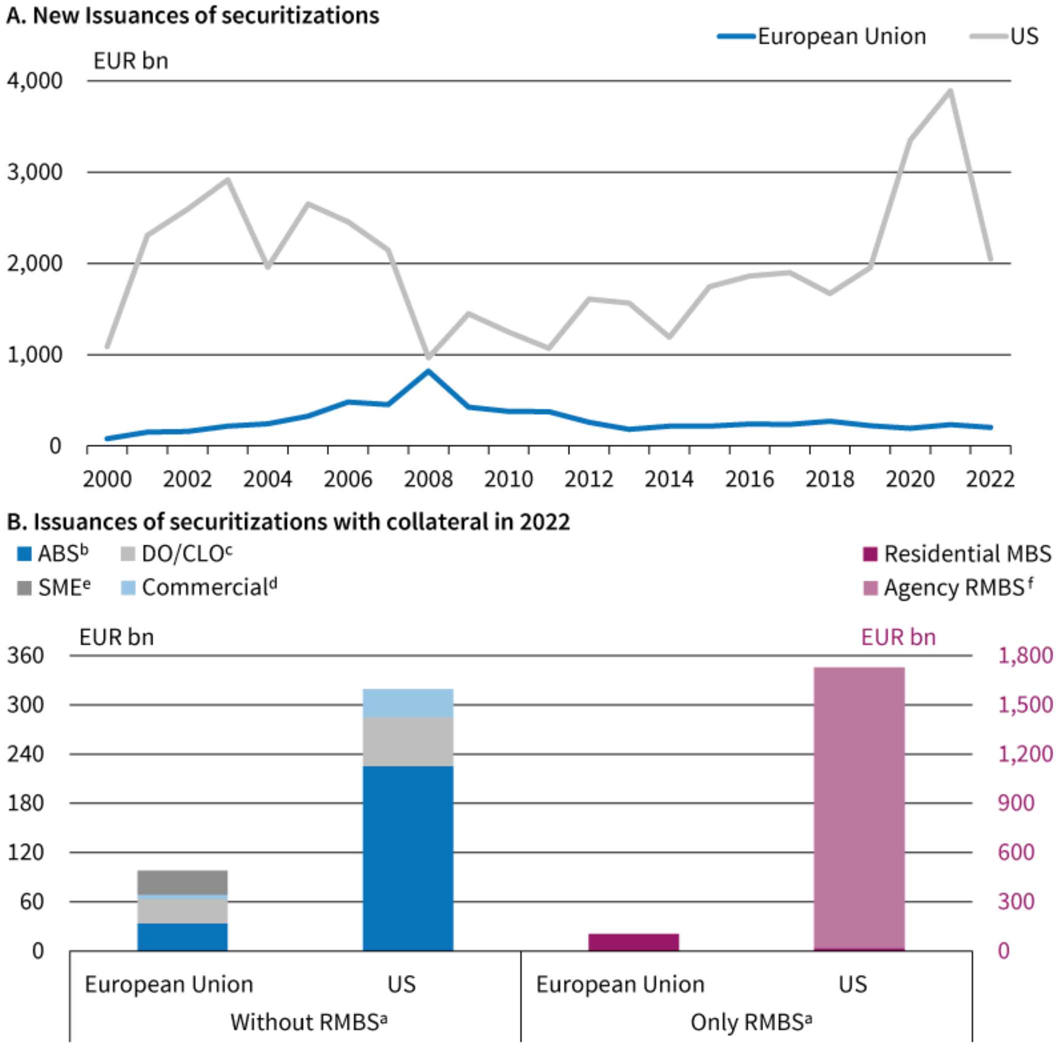
In addition to the economy, financial intermediaries could also benefit from a Capital Markets Union. One example of this is the securitization market. Historically, this has been less developed in Europe than in the US (see Figure 3). A transparent and high-quality securitization market allows banks to transfer risks in their loan portfolios to the capital market. This would increase their lending capacity and, in principle, increase their risk-bearing capacity. Other intermediaries may, for example, use the capital markets to better diversify the risks in their portfolios. Overall, a deep and liquid securitization market could contribute to a more efficient allocation of risk in Europe. However, given the experience of the global financial crisis of 2007/08, risk-sensitive regulation and Basel-compliant implementation are important in reviving the securitization market.

Figure 3

Securitization Market in the EU and the US



[a] Residential mortgage Backed securities (securitized housing loans). [b] Asset-backed securities (other asset-backed securities). [c] Collateralized Debt/loan obligations (securitizations of securities backed by loan receivables/securitized corporate loans). [d] Commercial mortgage-backed securities (securitized loans for commercial and multifamily real estate). [e] Small and medium-sized enterprises. [f] RMBS issued or guaranteed by one of the semi-state companies or a U.S. federal agency.

Source: German Council of Economic Experts. Data source: AFME.

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Greater integration of the capital markets also makes it possible to diversify risks more across countries and sectors. The costs of a shock in one Member State are spread over several shoulders and can therefore be better cushioned. As capital markets in Europe remain fragmented and financial investments within the Eurozone have a strong regional focus, this risk sharing has so far taken place only to a limited extent (ECB 2022).

In order to reap the benefits of a Capital Markets Union, the integration of capital markets in Europe must be deepened. This requires, amongst other things, the harmonization of legal regulations in the Member States. For example, insolvency and tax laws as well as accounting rules need to be harmonized. Due to the degree of intervention in national law, the political negotiations are complex and have not yet led to a comprehensive agreement.

Policy Conclusion

The European economy is facing major structural challenges. To address them, it would be desirable to complete the Banking Union and deepen the Capital Markets Union. In the case of the Banking Union, two of the three pillars have been implemented and have proven to be a success with regard to financial integration and stability. The 2023 banking turmoil has shown that it is important to reach an agreement on the third pillar, the European Deposit Insurance Scheme (EDIS), as it could reduce contagion between banks in the event of a crisis.

In our view, a hybrid model that ensures the autonomy of banking associations and provides support when national funds are exhausted is very promising. In any case, as a first step, we recommend strengthening the existing EU framework for bank crisis management and deposit insurance (CMDI).

The Capital Markets Union could support innovation and growth in the European economy, especially in terms of much-needed venture capital to boost the innovative capacity of European start-ups. It would also benefit financial intermediaries and Member States, as greater integration of capital markets would allow risks to be diversified across countries and sectors. Greater integration and resilience would thus go hand in hand, ensuring that the European financial system makes an important contribution to economic development.

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