

European financial integration: the role of banks in capital markets - article by Rolf Strauch

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23/02/2022

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“European financial integration: the role of banks in capital markets”

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Published in *Eurofi Views Magazine*, February 2022

European capital markets are fragmented and small when compared with the US markets. The larger role of capital markets funding is one of the reasons usually mentioned to explain the faster US economic recovery after the global financial crisis of 2008. 2020 and 2021 will surely be remembered as the years of the pandemic. I would wish this and the coming years will also be recalled as a turning point for capital markets in Europe.

The crisis has induced extraordinary policy responses on all fronts. Support measures were successful in preserving financial stability by maintaining credit flows to the real economy. As we are gradually heading out of the pandemic, emergency crisis measures are being phased out and market financing of the recovery and the twin transition to a more digital and sustainable economy will be crucial. Europe should focus on two priorities that, although connected, are different in nature: first, Europe needs larger and deeper domestic capital markets to overturn the endemic capital markets underfunding; second, Europe needs further integration of its capital markets.

Advancing the capital markets union (CMU) initiative is key to succeed on these issues. Banks could promote progress on CMU and also benefit from it. There is consensus on the pivotal role of banks in CMU and in the European economy: banks are direct lenders to a significant proportion of the economy and are intermediaries in capital markets.¹ A single market for capital in Europe is, without a doubt, beneficial for the banking sector.

More integrated capital markets open the possibility for more cross-border activities. Banks' holdings of domestic assets could be better diversified. CMU would also expand banks' investor base for their equity and debt issuances, which are crucial in increasing their resilience. In addition, a harmonised securitisation framework would support banks' efforts to make further progress on risk reduction. Since the risk exposure of banks is an important political consideration for the completion of the banking union, progress on the CMU initiative could support removing some unresolved deadlocks. Several of the recent deliverables of the 2020 CMU Action Plan – such as the proposal to amend the Capital Requirements Regulation (CRR), European Single Access Point (ESAP), and Markets and Financial Instruments Regulation (MiFID) reviews – have a direct or indirect effect for enabling banks' activities in capital markets.

Banks are in the driver's seat to achieve better capital allocation in CMU

European banks are best placed to turn savers into market investors considering the size of savings sitting in bank deposits and the trusted relationship that clients have with their banks. For that to happen, banks need to provide more and better financial intermediation services including market making, both on a domestic and cross-border basis.

Banks constantly face the choice between intermediating between borrowers and depositors while retaining the credit risk on their balance sheets, or between issuers and investors where the credit risk is passed onto the investor. Unfortunately, there is not enough provision of investment banking services to SMEs, which complicates capital market access for these companies. Enhancing the capacity of European banks as intermediaries and market makers to support primary and secondary markets is key for financing SMEs during the recovery and the twin transition.

Banks' role in providing financial advice is of fundamental importance. Retail investors would benefit from access to independent advice, breaking possible

conflicts of interest across the distribution chain. The low level of financial literacy in Europe is a problem. Financial education is a long-term objective and one cannot expect tangible and swift results in shifting savers into investors without help from banks. Banks can also be useful in providing direct long-term equity financing, which is increasingly relevant as companies' capacity to absorb debt is reaching its peak.

The CMU project can clearly benefit from an enhanced role of banks in the financial services industry and, in turn, integrated capital markets will provide greater space for banks' business. Importantly, financial integration, via CMU and banking union, offers risk-sharing mechanisms that can mitigate the impact of global or country-specific shocks and, therefore, contribute to macroeconomic stability. More private risk-sharing remains crucial within the euro area, where policy's space to address asymmetric shocks is limited. These projects would also facilitate the implementation of the Recovery and Resilience Plans, particularly investments and reforms aiming to promote the green transition.

¹ Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Action Plan on Building a Capital Markets Union, European Commission, 2015, p. 21.

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