The Financial Inclusion Centre

Financial markets that work for society

JOINT ECB/ EC CONFERENCE ON FINANCIAL INTEGRATION IN EUROPE

PANEL SESSION: MISSION COMPLETED? ACHIEVEMENTS AND FURTHER STEPS FOR THE BANKING UNION

Introduction

Panellists were asked to provide opinions on two questions:

1. What have been the main achievements so far; how far have we travelled towards a banking union and integrated financial markets – is the 'glass half full, or half empty?'
2. What are the challenges – what needs to be done?

Response

The first point to make is that we are not trying to promote banking and capital markets union for the sake of it. A reform programme has to be judged against whether it produces tangible benefits for households and the real economy. Nor can it be assumed that reforms which suit banks and other financial institutions will result in benefits for households and the real economy (especially SMEs).

1. Is the 'glass half full or half empty'?

So, what progress have we made? If effective integration was judged by the amount of policy activity (for example, SRM, single rule book, harmonising deposit guarantee schemes, CMU, retail market green paper, regulatory call for evidence, and now the EDIS) then we would conclude we have made much progress. Policymakers must be congratulated on their efforts to develop and steer through a great deal of reform. But, of course, policy activity is not the same as actual progress.

The question that matters is: is the 'glass half full or half empty' from the perspective of households and real economy? To think of this logically, it is better to think of four glasses, not just one glass. The four glasses represent the four primary functions of financial markets. Financial markets are huge and complex but they are supposed to undertake four interconnected primary functions:

- Transaction banking and payments systems
- Ensuring capital and resource gets from where it is, to where it is needed, in the most economically and socially productive way (this is the asset gathering, allocation, and management function)
- Financial intermediation, maturity transformation, and credit creation (particularly relevant for the banking system)
- Insurance and risk management

If these functions are working properly (and if the single market is working well), then the following benefits should be evident across the EU:

- Consumers and businesses are able to transact safely, efficiently and at low cost;
- Consumers and investors have a choice of financial instruments which provide a reasonable return on their investments/ deposits (at lowest cost possible) and real economy firms (and governments) have access to sustainable, long term capital for investment;
- Households and real economy firms have access to short and long term credit that meets their needs and preferences (on fair terms and at a reasonable cost);
- Households and real economy firms can insure themselves or their business activities against risk (on fair terms and at a reasonable cost); and
- Financial markets should also contribute to, not threaten, wider financial and economic resilience.

But, it is only on the first of those – transaction banking and payments - where we can say there is some evidence of meaningful progress *from the user perspective.*

There has been serious market failure in the other three areas – asset management, lending and credit creation, and insurance/ risk management. Moreover, the impact of financial market behaviours on the real economy and society is well known – as evidenced by the economic and now social crises evident in the EU.

Of course, we support the various attempts at reforms. But, it is too early to say whether the reforms will have any real impact. We do have concerns that these reforms do not go far enough from the user/ real economy perspective. Moreover, we will not know whether the financial stability and micro-prudential reforms have made markets more stable and resilient unless tested by a new crisis

2. What challenges remain, what needs to be done?

So, what needs to be done to create an effective integrated banking and capital market from the user/ real economy perspective?

As mentioned, we support the Commission's reform programme – especially CMU, retail market integration, and call for evidence on regulation (these need to be taken together to address the transmission problems between capital markets and 'retail' markets).

But robust interventions (horizontally at EU level and vertically at Member State level) are needed to tackle the root causes of so much market failure. These interventions should be based around the following themes:

- **Structural and institutional reform**: financial markets are still too focused on financial activities which are not economically or socially useful or non-productive assets such as property. This will not change unless financial markets and institutions are restructured and incentives are reformed so that financial markets are compelled to deploy more resource to activities which serve the needs of the real economy.
- Tackling the '4Cs' – market conduct, culture, competition, and confidence primarily through supply side interventions.

- **Supply side interventions:** in addition to structural and institutional reform, a new *ex-ante* approach (as opposed to *ex-post*) to regulating behaviours in financial markets is needed. We do not need more choice, we need better quality, better value choices and more efficient markets. But history tells us that the evolution of effective markets is rarely consumer demand led. Policymakers have to deploy robust supply side interventions to make markets work.
- Tough regulation on conduct and culture is important. Conduct failures and aggressive cultures don't just harm consumers, they distort market behaviours. Activities which have illusory value are preferred over more productive activities, externality costs are not priced in – as has been often said, the rewards are privatised, the risks and costs socialised. This undermines real competition and economic utility of markets.
- Tough interventions are also needed to clear space (or at least level the playing field) for better value providers – whether this is alternative providers trying to compete with the established banks, or new providers trying to break into local markets. One of the main barriers to effective competition and integration we found is the effect of dominant local providers and established distribution practices. Unless national supervisors enforce conduct of business regulations to tackle distribution distortions, local dominant providers will keep out better value providers so undermining a true single market.
- **Confidence raising measures**: a series of confidence raising measures is also needed to encourage consumers and, of course, suppliers to trust the single market. This includes: harmonised, consistent, tough regulation and consumer protection including redress (tough regulation doesn't stifle, it promotes, true innovation).

The conclusion is that, of course, policymakers should be congratulated on their efforts to develop policy. But, there is no guarantee that these policy measures will create effective, integrated financial markets. It is not enough to create the conditions for effective markets and step back and hope that market forces will work. Financial markets have to be made to work. This is just the end of the beginning – the hard work comes now.

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