Komparativna analiza tržišno-centričnih i banko-centričnih financijskih sustava

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A COMPARATIVE ANALYSIS OF MARKET-BASED AND BANK-BASED FINANCIAL SYSTEMS

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Declaration of Authenticity

I, Katarina Katušić, under full moral, civil and criminal liability, declare that I am the exclusive author of the master's thesis and that no unauthorised use of any part of other works (use without proper citation) was made and that I did not use any sources other than those listed herein.

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Summary

A financial system is an important part of a country's economy and while finance is partly dictated by market forces, regulation is still an important factor. These theories and their real-world application are mostly reviewed by economist but should be also examined more by legal professionals to ensure effective policy. After an introduction into what a financial system is, this paper will deal with the distinctions between two types of financial systems, bank-based and market-based. This will be followed by an overview of historical financial development of four countries deemed to be the principal examples of this distinction and a study on corporate governance. Finally, an analysis on the state of the financial system of the European Union and its efforts in building the Capital Markets Union.

Key works: financial system, bank-based, market-based, corporate governance, the European Union, Capital Markets Union

Sažetak

Financijski sistem je važan dio državne ekonomije i iako na financije dijelom utječu tržišne sile, regulacija je i dalje važan čimbenik. Ove teorije i njihova primjena u stvarnom svijetu su uglavnom provođene od strane ekonomista iako bi trebale biti istražene i od pravnih stručnjaka kako bi se osigurala učinkovita regulacija. Nakon uvoda u što je zapravo financijski sustav, ovaj rad će se baviti sa različitostima između dva moguća tipa financijskih sustava, bankocentričnih i tržišnocentričnih. Slijedit će pregled povijesnog financijskog razvoja četvero država koje su smatrane glavnim primjerima ove podijele i studija vezana za korporativno upravljanje. Naposljetku, analiza financijskog sistema Europske Unije i njenih napora u izgradnji uniji tržišta kapitala.

Ključne riječi: financijski sustav, bankocentričan, tržišnocentričan, korporativno upravljanje, Europska Unija, unija tržišta kapitala

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1. INTRODUCTION

1.1. The subject and goal

In this paper an analytical overview of market-based and bank-based financial systems will be presented. It reviews the historical development of four different countries to understand the factors that influence the formation of financial system in one direction or the other as well as what became the defining traits of each. This classification has been argued by some economic theorists not to be applicable anymore as globalization and organisation of countries on supranational levels urge consolidation on multiple fronts. This paper argues that this application is still relevant and that historical influences are deeply rooted and visible on multiple fronts impacting all areas. This will be demonstrated on the example of the European Union to show the difficulties and importance of establishing functional capital markets alongside a strong banking system.

1.2.The methodology and structure

This paper will take on a comparative overview of the financial systems and further inspect their influences. The second chapter will review what the financial system is and an outline of their evolution and role. This will be followed by an analysis of the four different approaches to their analysis and conclude the chapter with their typology. The third chapter serves as a comparative overview and is technically divided into two parts, market-based and bank-based. Each part will at first present a summary of their defining traits followed by examples of the historical development of two countries, respectively, the United Kingdom and the United States and as Germany and Japan. Since both systems have influence on the direction they take, later in the chapter the focus will be the corporate governance of companies and its specifics on systemically important financial institutions and the financial crisis of 2008 that brought them on. The fourth chapter will review the positives and negatives of a strong banking system of the European Union, followed and the legal aspects that have influenced the distinction. Afterwards, the paper will focus on the underdevelopment of the EUs capital markets and the efforts in building the Capital Markets Union. Finally, the conclusion will close out this paper with a short study on socio-political factors influencing the current active modelling of financial systems.

2. THE FINANCIAL SYSTEM

2.1. Description of a financial system

The financial system can be explained as a collection of financial institutions and markets which direct the transfer of payments and the flow of savings and investments or as institutions dealing with the ways financial decisions are made and financial relationships are designed. As a broad concept it possesses multiple functions as it deals with the transfer, pooling and management of risk, increases liquidity and dealing with the incentive problems that occur during transfers of information,[1] [2] as its design ends up influencing the decision-making process of individuals and companies and therefore also deals with the structure of corporate governance. Six different mechanisms can be named through which the financial systems can influence decision-making and how the financial sector is impacted – screening of activities of banks, credit rationing by banks, banks' role in liquidity creation and the impact of bank runs, bank loan commitments, debt restructuring and the feedback of the financial market.[3]

2.2. Evolution of financial systems

To understand today's financial systems which took their shape in the pre-World War I period[4] the historical analysis has to start with 19th century the industrialization period which timing in each country greatly influenced in which way its financial system will develop and explains the core differences between a bank-based and a market-based financial system. Another argument for the explanation of the typology that builds on the former one refers to the different ways countries have reacted to and dealt with instabilities on the financial market. Therefore, it has been argued that a helpful way to understanding the financial systems may be through the analysis of management of financial crisis which ultimately helped them take their shape. The most relevant countries to look towards in understanding these distinctions are the ones that fall further on the spectrum and which have been the most observed concerning this

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[1] De Haan, J.; Oosterloo, S.; Schoenmaker, D., *European Financial Markets and Institutions*, Cambridge University Press, New York, 2009, p. 3.
[2] Stiglitz, J., *The Role of the Financial System in Development*, World Bank, Global Development Finance 1998, Washington, D.C, 1998, p. 1, available at: https://www.kleinteilige-loesungen.de/globalisierte_finanzmaerkte/texte_abc/s/stiglitz_financial_system_in_development.pdf
[3] Thakor, A. V., *The design of financial systems: An overview*, Journal of Banking & Finance 20, 1996., p. 924.
[4] Fohlin, C., *Economic, Political, and Legal Factors in Financial System Development: International Patterns in Historical Perspective*, Social Science Working Paper No. 1089, 2000., p. 2, available at: https://ssrn.com/abstract=267674

topic. Those would be according to Allen and Gale, Germany for bank-based financial systems where banks are the dominating source for external financing of companies and the United States for market based where the financial markets and the banking system developed simultaneously, also including on either side, but not as contrasting, Japan and the United Kingdom, respectively.

The idea that the timing of the process of industrialization explains the key differences between the two types of financial systems comes down to the general hypothesis about the genesis of financial institutions. It is argued that countries where the industrialization process started early, like in the United Kingdom, capital was more abundant, securities were more finely refined and the financial markets were more developed, so funding through the market was a viable option. This propelled financial growth of companies, technological innovation and expansion of Britain's economy. On the contrary, 'moderately backward' economies of countries of northwestern Europe where industrialization started later, relied on the financing of banks as the primary source of financing for companies and the pushing force to help them to keep up as much as possible with the level of progress that the United Kingdom has managed to achieve. In countries like Germany at that time where financial capital was scarcer, to catch up with more developed countries, financing from banks was the only realistic way of acquiring funding for their business because of two main reasons which negate the feasibility of the modus operandi of financing in the United Kingdom being an actual possibility in Germany. Firstly, for new companies internally generated financing was practically non-existent and for a bit more developed ones quite a difficulty on account of having a large number of competing firms needing to obtain investments for newer (and therefore more expensive) technology and infrastructure to be able to reach the same level the companies from the United Kingdom already have. Thusly they needed to acquire the high volumes of required capital through external financing which was also problematic due to the second reason or that market financing was also proved nearly impossible due to the undeveloped securities markets and as a result investors weren't keen on investing on much other than on government bonds which were considered safe. With both of these avenues being closed, German firms turned to their universal banks which focused their finances on German based industrial investments, as the only viable source of financing because only banks were able to accumulate the required large sums of capital, take on the risks involved in such innovative projects, and properly monitor their investments. Banks had, and still have to a certain degree, a more restrictive view towards risk and choose where and how they are going to invest their funds carefully which in part leads to a more secure and stable financial system, instead of a one focused primarily on profit. However, once a bank has decided that a certain company is suitable and is meeting its requirements for funding, it nurtured its investment and formed a long-lasting relationship with its client. This way banks helped the firms continuously grow and simultaneously helping Germany catch up and expand.

"Nested within this traditional paradigm (and the Gerschenkron Hypnotises) is the idea that lack of economic development necessitated special characteristics and growth-promoting practices of banks: mobilizing capital through large networks of branches, screening potential entrepreneurs, providing long-term lending, deciding on investment and production strategies, monitoring the progress of clients' investments, promoting and re-organizing industries, arranging and enforcing industrial combinations, and diversifying away the inherent risk. Along similar lines, Allen (1992) and Allen and Gale (2000) argue, in part, that the historical experiences of Britain and the U.S. support the idea that markets are preferable in situations of complex decision processes and rapidly-advancing technology; whereas banks should dominate where optimal investments are agreed upon and primarily just need monitoring." [5]

2.2.1. Laissez-faire

Of course, the two types of financial systems weren't completely different from each other during their evolution (and they aren't now because it is a spectrum) and had some commonalities which developed during the attempt of regulation of both secondary markets and banking systems under a laissez-faire regime or in other words, there were little governmental regulations on their activities and many restrictions hindering their free operation have been lifted. Under such regime, banks expanded significantly in the beginning, at first in their number which was followed by consequently by a decrease and an increase in assets of banks concentrated in a country's financial centre which accounted for the majority of bank-system assets. Also, banks expanded the services they provide as the stocking market grew in importance. Now they included commercial and investments banking which were quite flexible in finance and proved very beneficial as such activities increased in their usage to the point, they basically dominated financial systems. Lastly, to continue on what was mentioned earlier, long lived banks tended to prefer financing established firms with a lower risk factor on a short-

[5] Fohlin, C., *Economic, Political, and Legal Factors in Financial System Development: International Patterns in Historical Perspective*, Social Science Working Paper No. 1089, 2000., pp. 6-7., available at SSRN: https://ssrn.com/abstract=267674

term basis and to direct them to the market for long term financing to additionally decrease risk for themselves.

Another important commonality of financial systems at the time was their increasing instability due to the laissez-faire regime. While bank-based financial systems are today considered more stable, back then the lack of institutional control and regulation of markets and banks on both a regional and a national level exposed the banking system to vulnerabilities and the possibility of financial systemic crisis significantly increased. To that instability contributed the improperly chosen and administered matching of short- and long-term financing and the newer sorts of securities markets. Such issues made bank runs more probable which could've had started with issues at one bank and spread rapidly and extensively. All these issues led to repeated financial crises which culminated in the 1929 with the Wall Street crash which led to the 1930s Great Depression in the United States which will be word on later.[6]

2.3. The role of a financial system

The existence of financial systems enables the existence and functioning of trade in any modern form as we know it today. To highlight its importance with its absence, trade would have to be executed at its oldest known form – bartering on spot markets. Bartering is the oldest form of commerce and represents the exchange of goods and services between two or more parties without the use of money (and consequently without a monetary medium) and instead the relative value is of each good and service is negotiated between the parties.[7] Spot markets (also known as physical markets and cash markets) are places where financial instruments (or in this case goods and services) are traded for immediate delivery and can take place on an exchange or over-the-counter.[8] Even though still useful for some everyday mundane interactions that don't require contracts or do simplistic ones or also in some more complex but quite specific situations, it would prove as quite complicated if tried to be applied in all forms of interactions with a financial benefit that may arise. The evaluation of goods and services would prove to be quite complex with more unique goods such as artwork or mechanical

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[6] Streeck, W.; Yamamura K., *The Origins of Nonliberal Capitalism: Germany and Japan in Comparison,* Cornell University Press, Ithaca, 2001, pp. 176-177.

[7] CFI Team, *Bartering*, Corporate Finance Institute, Vancouver, available at: https://corporatefinanceinstitute.com/resources/economics/bartering/ (14 October 2024)

[8] CFI Team, *Spot Market*, Corporate Finance Institute, Vancouver, available at: https://corporatefinanceinstitute.com/resources/career-map/sell-side/capital-markets/spot-market/ (14 October 2024)

inventions if one even had the ability to acquire enough financing for the development of some innovations because as a consequence of such a system internal financing would be essentially the only viable option. If this truly was still the only form of trade, our society would be much less developed and globalisation would still only be a theory.

As financial systems become more developed, more of the gains from trade can be captured, including the benefits from risk-sharing, diversification, insurance, intertemporal smoothing, "an efficient allocation of investment within and across industries, larger-scale investment opportunities, and regional and international trade"[9]. In practice, a well-functioning financial system is important for a country's welfare and growth[10] as it can efficiently select the most productive recipients for available resources (capital) from a large number of savers and ensure that they are allocated to be used in high return activities while also monitoring the process to confirm that the capital is being used in an efficient manner.

2.4.Approaches to analysis of a financial system

To analyse the financial systems of different countries four not mutually exclusive approaches were developed. Namely, institutional, intermediation, functional and systematic approach.[11] The first three are useful in comparative analysis for providing useful insights however they were proved insufficient.[12] The institutional approach focuses on which institutions do or don't exist in a country (banks, insurance companies, investment and pension funds, financial markets and the central bank system) thus the focus is narrow as it actually analyses only the financial sector not the system as a whole. The intermediation approach, as it names states, was developed to measure the role of intermediaries (and financial markets by proxy) and describes the financial sector as the part of the system which is composed financial intermediaries such as banks. While it does cover a financial system as a whole it does so in a simplistic manor. The functional approach analyses in a general way how different financial functions are fulfilled through various institutional arrangements however it doesn't understand the functions of a financial system and how it develops over time. The latest developed on, the

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[9] Allen, F; Gale, D., *Comparing financial systems*, The MIT Press, Cambridge, Massachusetts, 2001., p. 25.
[10] Schmidt, R. H.; Tyrell, M., *What Constitutes a Financial System in General and the German Financial System in Particular?*, Working Paper Series: Finance & Accounting, No. 111, 2003, Johann Wolfgang Goethe-Universität Frankfurt am Main, p. 5, available at: https://nbn-resolving.de/urn:nbn:de:hebis:30-17852
[11] Ibid.
[12] Schmidt, R. H.; Hryckiewicz, A., *Financial systems - importance, differences and convergence,* IMFS Working Paper Series, No. 4, 2006., Goethe University Frankfurt, Institute for Monetary and Financial Stability (IMFS), Frankfurt am Main, p. 6, available at: https://nbn-resolving.de/urn:nbn:de:hebis:30-70340

systematic approach, helps to further distinguish finance from finance systems in academic analysis and their development over time. It highlights the relations of several elements which compose a financial system by using concepts of complementarity and consistency. Complementarity an important part of corporate governance itself represents how well various elements of a financial systems fit together, be it how they complement each other or how they mitigate the negative effects. Simply put it can present how these parts can operate in an optimal state and when this potential isn't realized, the term consistency is used to describe the state in which the elements approach the potential. The systematic approach allows for "deeper understanding of how a given financial system functions, what its mechanisms are and on what its stability and efficiency depend. Moreover, it helps to see whether "essential" differences exist between two or more financial systems and whether a given financial system changes or has changed in a fundamental way"[13]. This approach though, even the most comprehensive one, can only be taken at a theoretical level since it cannot be examined at a practical level because it would require more information than it can be acquired.[14]

2.5. Typology of financial systems

Financial systems can be classified into two categories as of recent and this generalization is mostly ascribed to Alexander Gerschenkron's writings in 1962. Before the processes of privatization and liberalization existed a third category existed – the state-dominated financial systems of socialist countries in which the state played the dominant role in its financial system. Now this isn't really taken into account anymore and in financial science only the following two are considered relevant - bank-based (universal, relational) or market-based (specialized, arms-length). Very simply put, in a bank-based financial system banks play the dominant role and, in a market-based financial system the market plays the dominant role. Naturally due to complicacies of real-world economies, few financial systems can fit one of the extremes as to where it is dominated by banks or markets as the major providers of external financing for firms, so instead most fall somewhere on a spectrum. Both financial systems are in itself uniform ad a contrast to each other, which opens the questions in financial analysis the value of each type and the possibility of convergence from one to the other and if one is superior over the other. To even conceptualize a possible answer, one cannot take into account only a theoretical musing focused solely on such a narrow principle since it also didn't come in

[13] Ibid., p. 7.
[14] Ibid., pp. 7-8.

existence by itself but by the influence of different factors such as economic and political factors, legal regulation, governmental intervention, technological innovation etc. Nevertheless, these factors are difficult to separate from one another to be examined individually and we cannot understand system differences without first analysing their historical development.

3. COMPARATIVE OVERVIEW OF FINANCIAL SYSTEMS

3.1. Market-based financial systems

In this type of system, the main source of external financing for companies is acquired through capital markets via stock and bond issues and it is also where households also place a large part of their savings through non-bank financial intermediaries. Banks aren't really constructed as universal and are instead functionally specialized in either investment (specialised in forms of long-term company finance) or commercial (specialization in short-term commercial lending) banking activities. Furthermore, institution-client relationships are not as close and as such are better described as arm-length with the addition of being more short-term since direct transactions go through the market which dictates the prices of goods and services. Which means banks do not acquire as much information about firms and that information isn't of course then accumulated in one place but rather information is made public and collected through the market and consequently deals with a free-rider problem. All of which results in banks not playing an active role in corporate governance and lack of intervention in case of serious financial difficulties. Thus market-based financial systems are in turn shareholder-oriented which means the control is exerted by management through market forces and that investor protection is more important and better developed. Additionally, the market-based system is viewed as more 'profitable in the sense as the better cross-sectional risk sharing[15] enables higher returns because it allows for riskier investments, which can adversely make it more volatile for the economy if the risk-taking is taken to fair. It also allows for funds to be more quickly channelled towards companies since they don't have to go through the rigorous process of getting bank funding.

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[15] Thakor, A. V., *The design of financial systems: An overview*, Journal of Banking & Finance 20, 1996., p. 940.

3.1.1. The United Kingdom

Since financial markets and instruments were more refined in the UK than in other countries at that time, companies were able to attain financing by self-funding or from securities issued in financial markets which quality and success at the time was thanks to allowing non-wealthy talented individuals to become entrepreneurs[16]. Smaller companies were able to begin and grow their businesses by their own funds and those of friends and family (which can be referred to as an informal market) and larger companies of course outgrew this and stock exchanges became significant for their financing. Consequently, banks and companies didn't have a need for forming long-term relationship and in turn short-term lending was established as the preferred type of interaction. The Bank of England's (BoE) monopoly over limited liability banking was another contributing factor as it kept the British banks conservative.[17] This was solidified by the tries of banks during the 19th century to finance industry which led to failure of such companies during liquidity crisis which was also when the role of the Bank of England was established. It played an important role in providing stability of the banking system and after the Overend, Gurney and Company crisis of 1866 it was decided that it would be best for greater interventions of the Bank of England in the banking system to be mostly during times of crisis so it can provide necessary liquidity and help to deter from bank runs.

A bank run occurs when multiple bank clients withdraw their deposits simultaneously as a result of the uncertainty of a banks solvency. Simply put, bank runs happen because of panic. Multiple people act out of self-preservation and the mindset 'better safe than sorry' which sets out a chain reaction. Bank solvency issues are viewed as contagious so with the same mindset as the clients of the 'infected bank', bank runs start happening at other banks on account of the fear that that bank is the next to be infected. As more and more people start their withdrawals banks can start to find it harder to cover such loses and used up their cash reserves and end up at a default – the inability to cash-out further payments. Banks have a limit on how much they store in their vaults and typically have only a small amount of cash. When bank runs start, they have to sell their assets quickly to acquire cash and therefore have to sell them for a

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[16] Schmidt, R. H.; Hryckiewicz, A., *Financial systems - importance, differences and convergence,* IMFS Working Paper Series, No. 4, 2006., Goethe University Frankfurt, Institute for Monetary and Financial Stability (IMFS), Frankfurt am Main, p. 10, available at: https://nbn-resolving.de/urn:nbn:de:hebis:30-70340

[17] Fohlin, C., *Economic, Political, and Legal Factors in Financial System Development: International Patterns in Historical Perspective*, Social Science Working Paper No. 1089, 2000., p. 7, available at: https://ssrn.com/abstract=267674

lower price than normally and such losses causes concerns which triggers more withdrawals. Another option is the liquidation of loans, with which dangers exist like the costly liquidation of premature loans. All of which can really quickly lead to a full set on financial crisis and destabilization of the whole financial system. That being the case it important to rectify the situation as soon as possible and also ex ante precautions. For example, reserve requirements, regular inspections, deposit insurance, etc.

3.1.1.1.The South Sea Bubble

The South Sea Bubble regards to the burst of the financial bubble on the London market in 1720 and it focused on a large private company – the South Sea Company which held trade monopoly rights with the now United States and engaged in debt refinancing of the British government thanks to powerful political allies. These events are considered the first financial crisis in modern history and with them came the attributes we connect with crisis today - large and sudden price changes, panics in both equity and debt markets, the role of central banks, the danger of instability of large firms, state intervention (before, during, and after the crisis), public protests[18] etc. This is ascribed to have happened as a result of decades long financial transformation. New financial innovations in the form of new institutions, markets, and instruments began to democratize finance and socialize risk all as the result of globally expanding commerce which with financial expansion also brings volatility.[19] As the financial revolution happened rather quickly especially when compared with past progressions, the legal regulations weren't in place to properly cover them and neither could relevant customs be put in place at that pace and to cover the bigger territory. In a way, this instability was inevitable.

In 1720 the British debt was approximately 50 million pounds and of this, almost 40% was bought by the three largest corporations and of this the largest amount of roughly 12 million was held by the South Sea Company. The purchase was finalised with the help of bribing of state officials to approve the undertaking and is why this crisis is often associated with financial fraud and is mentioned alongside the repercussions of greed and corruption.[20] With this the asset price of the South Sea Company virtually grew but quickly that bubble of the value of their shares bursted. The consequently enacted, Bubble Act has to be specifically highlighted as these events are argued to have majorly influenced the United Kingdom's

[18] Bruner, R.F.; Miller, S.C., *The First Modern Financial Crises: The South Sea and Mississippi Bubbles in Historical Perspective,* Journal of applied corporate finance, Volume 32, Issue 4, 2020, p. 18.
[19] Ibid., p. 17.
[20] Garber, P.M., *Famous First Bubbles*, Journal of Economic Perspectives, Volume 4, Number 2, 1990, pp. 47-48.

economic growth and innovation and even delayed the timing of British industrialization. Initially designed as a short-term solution with the role of preventing a new wave of bubbles through diverting capital away from the bubble formed in South Sea Company shares; the Act introduced a prohibition on the creation of joint-stock companies unless the potential founders could secure a royal charter or an Act of Parliament and even those who could obtain such a charter, their company had to stay within the limits of the original charter.[21] Despite of that it is argued how much of an impact such a prohibition actually had on the cause that there are several ways of organizing a business and it was possible to choose another relatively similar form, regulation of that time wasn't as strict and some rules could be circumvented and joint-structure companies continued to finance Britain's intricate infrastructure through the use of markets.

The United Kingdom's economy recovered rather quickly from the financial crises in quite due to the ponderous help of the Bank of England, one of the predecessors of today's modern central banks, as it issued the currency, influenced the financial system and design of government policy. The Banks actions helped it secure its position as an important institution within the United Kingdom. Before a national bank structured as private-public partnership with a dual mandate focused of making profit[22], after these events "it had emerged as a lender of last resort and cornerstone of the British financial system[23] and became the global model of a central bank"[24]. "Over the next half-decade, the BoE financed British commercial expansion across the globe. It provided extensive credit to large firms like the London Assurance Company and the East India Company, in addition to maintaining liquid capital markets through its discounting operations."[25]

On a quick side note, the narrative that the South Sea Company has been the primary driving force for the bubble has been "challenged by Frehen et al., who argued that the debt-to-equity conversion scheme was the less significant of two factors driving the bubble. They instead emphasize the role of innovation in the insurance industry, arguing that investors were

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[21] Paul, H.; Di Liberto, N.; Coffman, D'M.; et al., *The Bubble Act: New Perspectives from Passage to Repeal and Beyond*, Palgrave Macmillan Cham, Cham, 2023, p. 245.
[22] Bruner, R.F.; Miller, S.C., *The First Modern Financial Crises: The South Sea and Mississippi Bubbles in Historical Perspective,* Journal of applied corporate finance, Volume 32, Issue 4, 2020., p. 28.
[23]Ibid.
[24]Ibid.
[25]Ibid.

responding to the uncertain potential of what was essentially a new financial technology"[26]. The London Assurance Company (and the Royal Exchange Assurance) as the name suggests is an insurance company which was incorporated in 1720 during the South Sea Bubble and experienced even more extreme price fluctuations than the South Sea Company.

After this set-back the United Kingdom's empire continued its growth with financing acquired partly from commercial banks and partly from stock markets where profits were acquired from smaller companies that couldn't afford the capital for commercial banks (which serves as a great demonstration of the accessibility of markets in the Anglo-American countries even back then). "The development of the financial sector played a role in this growth, mainly through the establishment of the BoE, which financed the government, provided a nationally accepted currency, monitored and disciplined the financial sector, and served as a lender of last resort. In concert with this establishment of a sound and widely respected financial system, the development of institutions and liberal values such as respect for rule of law, property rights, civil rights, and the growth of democracy through the broadening franchise created an atmosphere in which entrepreneurs, capital, and labour worked together to create the British economic juggernaut."[27]

3.1.2. The United States

The development of the United States's financial systems has to be excluded from the general discussion in differences of bank-based and market-based financial systems (in the part of this paper which explored the evolution of financial systems), because its development has been somewhat different than the development of other industrialized countries mostly due to political reasons.[28]

Originally the American banking system was organised similarly to the Bank of England ascribable to their shared history. So, a large federally chartered bank with an extensive branching network all through the country was founded – the First Bank of the United States (1791-1811) and later the Second Bank of the United States (1816-1836). However, there was, and still today is, strong mistrust towards such powerful institutions due to large concentrations of power and so there was an attempt to rechart the Second Bank in 1832 even

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[26] Acheson, G., Aldous, M. and Quinn, W., *The anatomy of a bubble company: The London Assurance in 1720*, Economic History Review, 77, 2024., pp. 161.
[27] Bruner, R.F.; Miller, S.C., *The First Modern Financial Crises: The South Sea and Mississippi Bubbles in Historical Perspective,* Journal of applied corporate finance, Volume 32, Issue 4, 2020., pp. 28-29.
[28] Allen, F; Gale, D., *Comparing financial systems*, The MIT Press, Cambridge, Massachusetts, 2001., p. 32.

though unsuccessful, that mistrust persevered and inclination towards the decentralization of the banking system grew. As a consequence of lack of a national system, multiple states introduced a ‘free banking’ system which allowed banks free entry and caused multiple banking panics. Even though the National Bank Acts 1863-1864 introduced a national banking system, the banking panics didn’t subside and the United States banking system was considered as malfunction and its economy known for disruptions and depressions.[29]

To try to remedy the situation of continuous occurrences of crisis and the mistrust towards concentration of power in the image of the British Bank, in the 1913 the federal reserve system was created which had a regional structure and allowed decision making at a decentralized level. Nonetheless, this didn’t stop the banking panics and still multiple banks were closed. To better illustrate the severity of the situation in the United States, during the pre-recession period 1921-1929 which was considered prosperous 5,411 banks were closed and during the first four year of the Great Depression 8,812 additional ones were closed. Conclusively, since the National Bank Acts approximately more than 17,000 banks closed.[30]

3.1.2.1.Banking Acts of 1933 and 1935

Such a devastating situation led to the creation of two important reforms which finally stopped the perpetually reoccurring banking panics and prevented the failure of many banks which encountered difficulties later on.

The first one was the Glass-Steagall Act of 1933 and with it the legal separation of commercial and investment banking, now one of the defining traits of market-based financial systems. The argument behind this regulation is based in the belief that lending and equity investing leads to conflict of interest as a bank with equity in another company cannot decide about its creditworthiness in an objective manor.[31] Additionally, it also introduced a function now used worldwide - deposit insurance which ensures protection of depositors in case of bank failure. The second Banking Acts augmented the operating system of the US central bank - the Federal Reserve and expanded its powers. These changes proved itself rather quickly as a significant improvement as within few years more than 90% of deposits in commercial banks and saving institutions were insured. The Federal Deposit Insurance Corporation (FDIC) was

[29] Allen, F; Gale, D., *Comparing financial systems*, The MIT Press, Cambridge, Massachusetts, 2001., p. 33.
[30] Ray, M., *deposit insurance,* in: The Editors of Encyclopaedia Britannica (ed.), Britannica Money, 11 October 2024, available at: https://www.britannica.com/money/deposit-insurance
[31] Frankel, A.B.; Montgomery, J.D.; Friedman, B.M.; Gertler, M., *Financial Structure: An International Perspective,* Brookings Papers on Economic Activity, Vol. 1991, No. 1, 1991., p. 258.,

created to regulate certain banking activities and to insure bank deposits in qualified banks up to $2,500 for each depositor which was continuously raised over the years.[32] The last change of the amount was in April 1, 2024 with currently the allowed maximum being $1,250,000.[33] According to the latest quarterly statistic trends posted on the official website of the FDIC, as of June 30, 2024 there are 4,539 FDIC-Insured institutions (of which 3,985 is commercial banks and 554 is saving institutions) and 2,896 FDIC-Supervised institutions (2,620 commercial banks and 276 saving institutions) and their combined assets amounts to $23,887 billion and 93.4% of them is considered profitable.[34]

3.2.Bank-based financial systems

This type of system is described as a concentrated, intermediary based financial system in which banks play the dominant role and therefore act as the main revenue for external financing for firms and are the most important revenue takers. The banks are structured as universal banks which is believed to help them form close long-lasting relationships with their clients and most companies have their "house bank"[35] and are therefore financed by only one or few banks which play an active role in the governance of a pluralistic and stakeholder-oriented system of corporate governance even in non-financial firms. Thus, they are able to accumulate a lot of information about their current and potential clients which gives them the ability to serve as an effective monitor of corporate activities and can intervene in case of serious financial difficulties helping firms not to go bankrupt and potentially, if it's a bigger company in question, bring on market collapse through chain reaction. This security blanket allows for a more long-term stable financial system and potentially hinders higher return on investments by not financing risky ventures. Naturally financing through the market plays a secondary role within such a system and "the possible fact that market capitalization and transaction volumes may be high and that secondary market trading may be very efficient does not imply that a given financial system is not bank-based"[36], simply liquidity creation is mainly directed through banks due to their risk sharing abilities. The bank-based system is deemed to

[32] Ray, M., *deposit insurance,* in: The Editors of Encyclopaedia Britannica (ed.), Britannica Money, , 11 October 2024, available at: https://www.britannica.com/money/deposit-insurance

[33] FDIC*, Deposit Insurance: Your Insured Deposits*, 14 May 2024, available at: https://www.fdic.gov/resources/deposit-insurance/brochures/insured-deposits

[34] FDIC, Quarterly Banking Profile: FDIC Statistics at a Glance, 13 June 2024, https://www.fdic.gov/system/files/2024-08/fdic-2q2024.pdf

[35] Schmidt, R. H.; Hryckiewicz, A., *Financial systems - importance, differences and convergence,* IMFS Working Paper Series, No. 4, 2006., Goethe University Frankfurt, Institute for Monetary and Financial Stability (IMFS), Frankfurt am Main, p. 8, available at: https://nbn-resolving.de/urn:nbn:de:hebis:30-70340

[36] Ibid.

be more stable as banks are risk-averse and mostly choose to invest in projects with high return, so intertemporal risk sharing is typically better in such economies.[37]

3.2.1. Germany

Britain's unprecedented growth has arguably spurred on the changes in the economies of many countries, including that of Germany which now serves as the most famous example of a bank-based financial system and that descriptor was gained during the latter half of the 19th century.

Financial markets existed and were concentrated in Berlin and also Frankfurt but their use was severely limited to and used only for forms of governmental debt and loans to other states. There were tries of using markets to finance the industry, however nothing significant of mention came of that after successfully partly financing the railway system.[38]

The natural conclusion after that was to turn to banks for external financing and due to the lagging of financial markets, universal banks developed. The variety of services provided by such banks can be assigned as the reason for their formation of long-lasting relationships with their clients which in turn assisted with efficient resource allocation. To continuously facilitate this arrangement, through their collection of large amounts of information about their clients, banks intervened and helped their client-companies out of financially troubling times. Even though some companies in areas such as steel and coal turned away from close relationships with banks, most industry companies collaborated to such a degree that banks and companies were represented on each other's boards. This kind of close relationships led to the formation of the "Hausbank" system – forming of a close long-lasting relationship between a company and one or two banks as sources of external financing. Also, internal financing cannot be discounted as it served as the other main source for the reason that cartels, which were legal during that time, enhanced the lucrativeness of companies[39].

The banking system in that form proved itself to be efficient and quickly expanded and banks formed national networks but industry banks were not the only ones and two other types of banks were also formed around that time and became an important part of the system – "Landschaften" and cooperative banks. "Landschaften" banks were mortgage banks operated

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[37] Thakor, A. V., *The design of financial systems: An overview*, Journal of Banking & Finance 20, 1996., p. 940.
[38] Allen, F; Gale, D., *Comparing financial systems*, The MIT Press, Cambridge, Massachusetts, 2001., p. 37.
[39] Ibid.

in public interest by boards appointed by local governments and were not focused on achieving maximum profit and cooperative banks were focused on providing credit for smaller tradesman and workers.[40]

As perhaps the biggest disruptor to Germanys economic stability served the end of World War II when Allies forces attacked to bring down the Third Reich and during tried to break apart their banking system to accelerate the fall of the government. After the war ended, the banking networks relatively quickly reunited and continued their work and the financial centre became Frankfurt instead of Berlin[41]. Financial markets remained unimportant and few companies were publicly listed which didn't drastically change till today. One of the reasons for that is the belief since the markets were underdeveloped that there is simply no need when enough finances can be procured otherwise and this became a cycle that proved itself hard to break.

Two possible reasons for the formation of financial cycles were named earlier. The influence of the timing of industrialization is obvious but the management of financial crisis is not so clear. Germanys financial system was well established as bank-based, and without major crisis the sizes which occurred in the Anglo-American countries, before World War II and not much has changed afterwards. The second argument of formation influences could be viewed in this case in two ways – crisis management is not a significant contributor, however that can be disputed by the events in other countries or that in the case of Germany it served as a solidifier of what was showed to be a strong financial system.

3.2.2. Japan

Japan, the other famous example of bank-based financial systems, has two very important peculiarities. While financial systems in the other mentioned countries developed spontaneously, in Japan it was intentional. While in some countries it was financial crises that influenced their systems, here it was mostly several wars and the efforts during wartime and the rebuilding after instead. The government played a direct part and intervened much more than in any of the other three mentioned countries, in shaping the entire financial system.

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[40] Ibid., pp. 37-38.
[41] Ibid., p. 38.

The Meiji Restoration of 1868 ended the feudal system in Japan, restored the imperial system[42] and brought upon a period of major upheaval. The decision was made to integrate western types of financial institutions as a way to modernize the country after more than two hundred years of isolation. At first a liberal approach was taken and there wasn't much of governmental regulation, just like in the countries at the time the inspiration was taken from. However, just like in those countries, banking crises were repetitional and increasing in their intensity and after three major panics in 1920, 1923 and 1927, a new banking law was introduced and with it a prototype of a main bank system (equivalent to the German "Hausbank" system), where banks were given monopoly in a particular area. As the excessive number of banks was seen as the main contributor to the crises in the 1920s, with this system, the number of banks would be reduced through mergers and loans from the Bank of Japan could expedite the process. [43]

Governmental control was greatly expanded during the 1937-1945 Second Sino-Japanese War and didn't subside in the after-war period as there was a need for the reconstruction of the economy. First through the Reconstruction Financing Bank then in 1951 from the Japan Development Bank the government participated in the allocation of fund to industries deemed the most efficient in the rebuild of post-war Japan and during the 1950s and 1960s held the interest rates low which greatly contributed to Japan's stability. There was a try at another financial reconstruction right after World War II. The General Headquarters of the Allied Powers tried to introduce a United States style of securities markets that would serve as the source of long-term financing and banks would be mainly providing short-term loans. This proved to not be a real possibility as the banking system in place proved to be too deeply rooted, as strong long-term client-bank relationships have been established during wartime and with some post-war regulations, a main bank system was firmly in place.[44] [45]

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[42] Britannica, *Meiji Restoration,* in: The Editors of Encyclopaedia Britannica (ed.), Britannica, 28 October 2024, available at: https://www.britannica.com/event/Meiji-Restoration
[43] Allen, F; Gale, D., *Comparing financial systems*, The MIT Press, Cambridge, Massachusetts, 2001., p. 39.
[44] Ibid., p. 30-41.
[45] Britannica, *Second Sino-Japanese War,* in: The Editors of Encyclopaedia Britannica (ed.), Britannica, 01 August 2024, available at: https://www.britannica.com/event/Second-Sino-Japanese-War

3.3.Corporate governance

Corporate governance is a system of policies, rules and practices by which the company is directed and managed by primarily the board of directors.[46] How of an important notion it is can be seen by its consequences.

There are five universally accepted principles of what constitutes good corporate governance and should be taken in account – "responsibility, accountability, awareness, impartiality and transparency"[47]. If corporate governance is well planned out and administered it will manage in aligning the interest of the company itself, management, supervisory board, directors, employees, shareholders, and others – promoting the company's image and public reputation, attracting new investors, raising the price of shares, financial growth and stability etc. In case of bad corporate governance, the company's reputation diminishes which can be detrimental to its financial health and cause the fall of share prices, losing interest and confidence of investors etc. Corporate governance is a global occurrence and developed due to such problems, scandals and company bankruptcies. It varies from country to country, influenced by a lot of factors, like the ownership structure and legal regulation, including information exchange on the financial market.[48]

One of the functions of financial markets is determining the prices of financial instruments and it does so by exchanging information. So, if a company chooses to stay private and engage in bilateral financing (by a "Hausbank"/main bank) there is only need to share information with its banks (the bank does in turn accumulate a large amount of information thanks to their close collaboration) however, if the choice is to go public, the company must share information with the public and that starts with the initial public offering. In the European Union, in 2017 the Prospectus Regulation was introduced and with it a uniform regulation in all Member States and with it the obligation of publishing a prospectus when offering securities on the regulated market and within it disclose all vital information about itself in a

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[46] Conmy, S., *What is Corporate Governance*, Corporate Finance Institute, available at: https://www.thecorporategovernanceinstitute.com/insights/lexicon/what-is-corporate-governance/?srsltid=AfmBOoq51AO5q4XmT7MlfopuwHuQ4dhbRVKcnyJ9nrhRX56FBvEKqlJ6 (25 October 2024).
[47] Bryne, D., *What are the five principles of corporate governance?,* The Corporate Governance Institute, available at: https://www.thecorporategovernanceinstitute.com/insights/lexicon/what-are-the-five-principles-of-corporate-governance/ (25 October 2024).
[48] Conmy, S., *What is Corporate Governance?*, Corporate Finance Institute, available at: https://www.thecorporategovernanceinstitute.com/insights/lexicon/what-is-corporate-governance/?srsltid=AfmBOoq51AO5q4XmT7MlfopuwHuQ4dhbRVKcnyJ9nrhRX56FBvEKqlJ6 (25 October 2024).

comprehensible way. This is done to protect potential investors by removing information asymmetry between them and the company and is taken very seriously. Even though the prospectus was introduced in the United States back in 1933 with the Securities Act, it is not taken with the same seriousness and is only actionable in case of fraud and omission.[49] The information provided in the prospectus is not the only information that becomes public, just the one that must become public. To grow the company that is not enough, therefore the company must promote itself and it does that by publicizing more information. There is one big negative – the free-rider problem. The information is public, ergo, it is in public domain and their competitors are free to copy it and use it for themselves.

3.3.1. Anglo-American model

While banks are known for their ability to accumulate a lot of information, the feedback role of the financial market should not be dismissed. It has been argued that it has an invaluable role because it can present information that which can't be find on summary reports and may present one of the reasons it led to the adoption of market-based systems. The United States model for corporate governance follows the "Anglo-American" model[50] (applicable also to a such a close degree in the United Kingdom, therefore the naming "Anglo-American" and why there won't be special mention of the UK's corporate governance in this paper) and its shareholder theory, that the role of public companies is to maximise the profit of those who hold parts of it in the form of shares of stock – shareholders. "It is based on a single-tiered (one-tiered) Board of Directors which is primarily comprised of nonexecutive directors who have been elected by shareholders. Some single-tiered boards have both executive and non-executive directors, while others may have the CEO (Chief Executive Officer) serving as the Chairman of the Board, creating CEO/Chair duality, and then utilizing separate functional committees, for example, audit, nominating, and compensation committees."[51] Directors have a duty to protect the interests of the shareholders but can often end up pursuing their own at the expense of the others but since company's stock prices movement can also signal the effectiveness of managerial performance, in turn it affects decision making and holds managers

[49] Wex Definitions Team, *prospectus*, Legal Information Institute, Cornell Law School, Ithaca, March of 2022, available at: https://www.law.cornell.edu/wex/prospectus
[50] Meier, H.H.; Meier, N.C., *Corporate governance: An examination of U.S. and European models,* Corporate Ownership & Control, Volume 11, Issue 2, 2014, p. 348.
[51] Ibid.

accountable and thus serves as the main external governance system in Anglo-American countries.[52]

“In this framework, the financial market is viewed as a mechanism for aggregating many diverse opinions and hence providing information about optimal decision rules in corporations that is superior to that attainable through bank borrowing. The reason is that the bank provides a 'single check' as opposed to the 'multiple checks' of the financial market. Multiple checks are provided by the financial market through a variety of mechanisms - market prices, trading volume, takeover attempts, etc. It follows from this that capital will be allocated in the financial market when optimal decision rules are hard to formulate, and there is little consensus on how the firm should be run; for example, when information decays rapidly and new information arrives almost constantly. Allen cites biotechnology as an example of such an industry. In contrast, banks are desirable institutions for allocating resources in situations in which there is consensus on decision making, and the main problem is monitoring firms.”[53]

3.3.2. German model

Since Germany has been part of Europe based organisations since the formation of the European Coal and Steel Community in 1951 and the closer collaboration starting in 1992 with the European Union, the naming of this model may be seen as controversial. References to it can be found as the European or the Continental model[54] and even though there are many similarities in corporate governance systems of the Member States of the European Union, however they are not the same across all of Europe as it needs to be adjusted to conditions in each country.

The German corporate governance model contrasts the Anglo-American on multiple fronts. Firstly, a free-rider problem is not as prevalent as information doesn’t need to be publicised to the same degree due to two reasons. The companies don’t have to work as hard to attract new investors since they typically have a bank as a long-term investor which can intervene in case of financial difficulties. The second reason lies with another major difference,

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[52] Thakor, A. V., *The design of financial systems: An overview*, Journal of Banking & Finance 20, 1996., p. 930-932.
[53] Ibid., p. 931-932.
[54] Bryne, D., *What is the continental governance model?,* Corporate Governance Institute, available at: https://www.thecorporategovernanceinstitute.com/insights/lexicon/what-is-the-continental-governance-model/ (25 October 2024).

the governing structure of companies - a two-tiered board model which includes a management board and a supervisory board with an emphasis on the stakeholder model.[55]

Stakeholders present a larger group that doesn't have to hold shares but is either way affected by the company's success and include shareholders, employees, partners, suppliers, customers, and local community.[56] Even though they all have an interest in the company's success, their personal motivations are different. Shareholders are interested in the financial growth of the company, in other words, they want for the company's stock to grow rapidly so that they can sell them for a higher price and get a return on their investment. However, what may be profitable on short term, may prove to be damaging to the company's long-term success. On the other hand, an employee's interest is for job security and a customer's interest for quality products or service. It can be said that a shareholder's interest is short term and of the other stakeholders is long term, so to bridge that gap, stakeholders' interest are translated to mean the company's interest as a legal person – what is best for the company is at the same time best for its stakeholders.

It seems that the managerial problem is an issue in all systems since there are reported problems of managers prioritizing their interest over the company's across the globe. To ensure that management's interest don't override the company's interest, in the German system as the main internal governance mechanism the supervisory board was established, composed of outsiders. Its size is established by law based on the company's size and cannot be changed and includes necessary representation of employees and can include the "Hausbank's" representative.[57] Even though this mechanism has come into question for the reason that on few occasions, managers were shown to be able to successfully exert their will over the supervisory board, it is still mostly effective in achieving its goal. It can be considered that this is the "Hausbank's" influence. Banks want to invest in safe long term successful companies as it benefits their reputation which in turn attracts them new clients, that is why they 'save' their client-companies if the need arises. If a company with bad business practices manages to lose

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[55] Meier, H.H.; Meier, N.C., *Corporate governance: An examination of U.S. and European models,* Corporate Ownership & Control, Volume 11, Issue 2, 2014, p. 349.
[56] Mallin, C. A., *Corporate Governance*, 5th edition, Oxford University Press, Oxford, 2016, p. 20.
[57] Bryne, D., *What is the continental governance model?*, Corporate Governance Institute, available at: https://www.thecorporategovernanceinstitute.com/insights/lexicon/what-is-the-continental-governance-model/ (25 October 2024).

the banks investment, just like in case of bankruptcy which will be later expanded on, it will become stigmatized and have a hard time acquiring funding from other banks.

3.3.3. Japan model

Japan's corporate governance model is very similar to the German model. Even though they are not so similar as the models in the United States and the United Kingdom that they warrant a combined name ("Anglo-American"), in economic research, when referencing bank-based specifics, often reference is made mainly on the German model. Both models are stakeholder oriented, based on a main bank with bank monitoring as the main external governance system etc. Still some differences specific to Japan are of note.

An important specific of Japanese companies is that they form "keiretsu" alliances - enterprise groups composed of companies in various industries where all have partial ownership in each other and all rely on the financing of a large main bank.[58] The idea behind these cross-shareholding arrangements is that in theory it provides additional support and monitoring, helping them maintain stable profit and with that interest of all their stakeholders (which additional to all named in the German model naturally include the members of their "keiretsu" grouping). Another significant difference, is the main internal governance system, the board of directors which in Japan is mostly composed of insiders namely executives and former employees. This structure leads to promoting employees' rights and interests in maintaining their stability of employment[59] and with that long-term health of the company, rather than maximizing profit.[60]

3.3.4. Systematically important financial institutions

An interesting case in corporate governance deals with the byproducts of globalisation - systematically important financial institutions, a term constructed after the 2008 global financial crisis.

Modern globalization is a process that started all the way back with the Industrial Revolution but globalisation then and globalization now doesn't have the same connotations. The current third era began round 1990 and is defined by rapid and extensive innovation and

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[58] Douthett, E.; Jung, K.; Kwak, W., *Japanese Corporate Groupings (Keiretsu) and the Characteristics of Analysts' Forecasts*, Review of Quantitative Finance and Accounting 23, 79-98, 2004, p. 80.
[59] Allen, F; Gale, D., *Comparing financial systems*, The MIT Press, Cambridge, Massachusetts, 2001., p. 80.
[60] Yoshikawa, T., McGuire, J., *Change and continuity in Japanese corporate governance*, Asia Pacific Journal of Management 25, 2008, p. 10.

global interconnectedness to the point it is hard to distinguish if a fourth era has or will soon begin.[61] New technologies became more easily accessible as companies expanded their reach, job opportunities became more easily as countries eased restrictions etc.

3.3.4.1.“The Great Recession”

The financial crisis of 2008 was preceded with an expansion of the housing market in the 1990s in the United States. Home ownership and residential investment significantly grew and house prices nearly doubled from then till 2006. Consequently, household mortgage borrowing also staggeringly expanded from 61 percent of GDP in 1998 to 97 percent in 2006.[62] Even though their relative importance to the crash of the housing market in the US is debated, there is an agreement to the factors that contributed to it.

Business practices preceding the burst of the Housing Market Bubble grew more hazardous, as the conviction, due to a prolonged period of global financial stability, that large financial crises of the past weren’t going to repeat. As a result of a recession in the United States in 2001, the Federal Open Market Committee reduced the federal funds rate several times in a period of almost two years from 6.5 percent to 1.75 percent and the plan was to slowly increase them after 2004. In turn, banks lowered their prime rates for consumer credit a.k.a. short- to intermediate- term loans with interest rates given to low-risk clients. In essence, the problem began when banks started to massively deal in subprime lending (extending loans to high-risk clients with higher interest rates)[63] since it proved quite profitable. Since high-risk clients obviously have a harder time paying off their mortgage, then banks are able to reposes their properties and sell them, which at that time meant at increasingly high prices as the house prices inflated. To continue on that, this practice led to prevalent use of securitization. Securitization is a practice of providing liquidity to lenders and involves the identification of illiquid assets (residential loans, auto leases, credit cards etc.), pooling them together, refinancing them by transforming them into tradeable securities and assigning them risk categories for various investors which by purchasing them can effectively diversify their

[61] Volle, A., *globalization,* in: The Editors of Encyclopaedia Britannica (ed.), Britannica Money, 22 October 2024, available at: https://www.britannica.com/money/globalization
[62] Weinberg, J., *The Great Recession and Its Aftermath*, Federal Reserve History, 22 November 2013, available at: https://www.federalreservehistory.org/essays/great-recession-and-its-aftermath
[63] Bondarenko, P., *subprime lending,* in: The Editors of Encyclopaedia Britannica (ed.), Britannica Money, 23 May 2023, available at: https://www.britannica.com/money/subprime-lending

portfolio.[64] [65] The use of securitization in 2008 left a bad connotation to this practice till today, even though it can be quite useful in diversifying banks portfolios and thus reduce risk overall in the financial system. Thousands subprime mortgages were bundled together into mortgage-backed securities which price grew alongside property prices.[66]

3.3.4.2.'Too big to fail'

Another significant contributing factor was the partial rescission of the legal separation of commercial and investment banking in 1999 which allowed banks to adopt business practices that were before divided between them and insurance and securities companies and merge with them. This led to formation of financial institutions that were deemed 'too big to fail', meaning that their size and interconnectedness is so great that in case of their insolvency, a threat to the stability of the whole financial system emerges.[67]

On account of such devastating consequences, the government will see it fit to intervene in case of financial difficulties of these institutions and prevent potential collapse. However, this creates a moral hazard[68] – if management trusts in government intervention and that the company will not be allowed to fail, they will engage in more high-risk project for the possibility of higher returns since they are protected from repercussions. That kind of risky behaviour requires additional regulation.

At this point of globalisation this type of threat is even greater since it is not localised. The Financial Stability Board in collaboration with other institutions has been following and identifying global systemically important financial institutions (now only banks and insurance companies 2013-2020) since 2011. To prevent a potential failure, factors for identification have to be constantly updated and refined to keep with market changes and financial innovations. As of 2023, 29 global systemically important banks have been identified. Furthermore, authorities enact stricter regulations, supervise their risk-taking activities and require of such

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[64] Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012, OJ L 347, 28.12.2017

[65] Bondarenko, P., *securitization,* in: The Editors of Encyclopaedia Britannica (ed.), Britannica Money, 23 March 2023, available at: https://www.britannica.com/money/securitization

[66] Duignan, B., *financial crisis of 2007-08,* in: The Editors of Encyclopaedia Britannica (ed.), Britannica Money, 2 July 2024, available at: https://www.britannica.com/money/financial-crisis-of-2007-2008#ref342321

[67] Ibid.

[68] Kidwell, D.S.; Blackwell, D.W.; Whidbee, D.A., *Financial Institutions, Markets and Money*, 12th edition, John Wiley & Sons, Hoboken, 2016, p. 33.

banks better risk management and internal control. There is a need to periodically carry out stress tests to ensure their resistance and in case difficulties do happen, to prepare and submit a liquidation plan. However, this kind of extensive regulations has also come into question, as it can impair economic growth and competitiveness thus this question is also an ongoing process.[69]

4. THE EUROPEAN UNION

Each of the analysed historical periods was mostly confined to the country in question as back then globalization mostly just lessened communication and transportation issues that incur with distance. Today that kind of seclusion is almost impossible. Free market competition, transnational companies etc., countries come closer together through numerous reasons and also via joining organisations which grew in itself via a growing number of Member States and their supranational abilities that countries grant them. As an example, the European Union (EU) started at first as the Community for Steal and Coal with the simple goal of stopping major conflict by the way of combining resources in rebuilding Europe after World War II and over time became the European union growing into a political and an economic and monetary union. One of factors motivating the establishment of the monetary union is in fact globalization. With the introduction of the coordination of economic and fiscal policies, common monetary policy and the adoption of a single currency helped Member States to become more competitive in global markets as the euro also helped to lower economic inefficiency caused by currency exchange rates. Europe's banking system grew rapidly since the 1992 Maastricht Treaty and the EUs financial system quickly defined itself as strongly bank-based.[70] Europe is home to the world's largest banking system which proves to show the degree to which the EU has defined itself as bank-based as no advanced economy in the world comes close it.[71] This is not surprising since even before integration most of today's Member States were defined as bank-based and, the now former member, the United Kingdom clearly being the biggest exception.

4.1.Positives of the European integration

The European Union stands to show how much countries can benefit from joining together, opening their markets to other Member States and establishing a strong coordinated

[69] Ibid.
[70] Langfield, S.; Pagano, M., *Bank bias in Europe: effects on systemic risk and growth*, ECB Working Paper 1797, May 2015, p. 2, available at: https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1797.en.pdf
[71] Ibid., p. 3.

banking system. Not only has this level of integration allowed now 27 countries to improve their economy, but with it came a large spectrum of other benefits such as improved medical help, socio-political liberalization, implementation of environmentally-conscious procedures etc.

"The total assets of banks in the EU amounted to €42tn (334% of EU GDP) in 2013. By contrast, Japanese banks' assets added up to €8tn (196% of Japan's GDP), while US banks' assets were worth €11tn (88% of US GDP). Converting the US figure to international accounting standards would add €3.5tn,1 bringing the US banking system to 115% of US GDP – still just over a third of the size of Europe's banking system."[72] The European single market is the world's biggest barrier-free, economic area. This area includes almost 450 million people with a gross domestic product of about €14.5 trillion in 2021 and it is estimated that it has created 2.8 million jobs. Now the European union as a result is one of the largest players in international trade due to its numerous trade agreements it became a leading trading partner for 80 countries. It is the world's second largest exporter of goods after China and the third largest importer after the US and China. In addition, the EU is the number one trader of services. In 2019, more than 38 million jobs (one in five) in the EU were supported by exports to countries outside the EU and most of those export-related jobs are well paid, on average 12% better paid than other jobs. Consumers are also greatly profiting from various trade agreements as lower duties for importers mean lower prices for goods and services and also more variety. These benefits attribute to the increase of the level of wealth and comfort and improvement of standards of living.[73]

4.2.Negatives of the EU's bank-based financial system

However, with all the benefits, one large negative also comes with it, lower economic growth[74] than theoretically possible, when compared with other advanced economies. Even though many positive results have been noted due to its bank-based financial system and successfully placed it as an important player in the world's economy, when compared to, let's say the United States, it can be noted that its bank-market ratio is significantly tilted towards

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[72] Ibid., p. 4.
[73] European Parliament, *Benefits of economic globalisation in EU: facts and figures*, Strasbourg, 17 July 2023, available at: https://www.europarl.europa.eu/topics/en/article/20190603STO53520/benefits-of-economic-globalisation-in-eu-facts-and-figures
[74] Langfield, S.; Pagano, M., *Bank bias in Europe: effects on systemic risk and growth*, ECB Working Paper 1797, May 2015, p. 3, available at: https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1797.en.pdf

the banking system. It can be argued that this is to be expected since the US is market-based but that stays the case even when compared with the other famous example of bank-based financial systems, Japan.[75] Banks are historically conservative in choosing which projects and companies to fund and that is why they ex ante acquire large amounts of information of about their possible clients. Granting, information collecting activities of banks eliminate some problems of market-based systems, namely information asymmetry and free-riding; however, this creates a problem of its own – this kind of advantage allows banks to lay claims to a substantial part of their client-company's profits which in turn hinders their motivation to perform.[76] Rajan (1992) has addressed this and explained that if the client can partly fund themselves through the market, that creates external competition and mitigates the banks bargaining power. The problem is, capital markets in the European Union are underdeveloped; which brings the EU to a similar position like Germany was in during the 19th century – since capital markets are underdeveloped and there is a need to keep up with other developed economies, external financing must be done through the banking system. Europe's heavy reliance and deep trust in banks can be seen in its legal systems and so can the distrust in the Anglo-American.

4.3.Legal aspects of the financial systems

All the various influences are interconnected so it's hard to separate them neatly from each other, which can be clearly seen during the analysis of the historical development in this paper. Even though the focus was mainly on the economic influences, mention of legal regulations and political narrative is inevitable which shows that to understand and differentiate financial systems it is necessary to explore all of these factors since they still have very much so great influence today. Political circumstances and the ideas relevant at that time often end up being part of legislation in one way or another so they can be efficiently explored by reviewing the legal systems they are part of.

That idea can be traced to Dietl's work in 1998 where he presents, similarly to the financial systems spectrum, highly stylized poles - neoclassical and relational regulation which respectively connect to common law and civil law legal systems. Regulation systems viewed in this way represent opposites and extremes and no country will fall completely on one side irrelevant of its legal system. Nonetheless, this kind of distinction can aid in understanding of

[75] Ibid., p. 5.
[76] Ibid., p. 6.

these workings and show the ramifications if political influence should ever try to sway regulation too heavily in one direction in hope for achieving the benefits it offers. It is of note that this may have already happened and that varying national governmental regulations in the past have possibly hindered the evolution of both financial markets and the banking system. “Some have argued, for example, that government regulation in Germany simultaneously promoted the large, universal banks and hampered operation of securities markets. Similarly, limitations on bank operations may have spurred financial market development in the U.S., especially during the twentieth century. Regulation of non-bank institutions – such as securities markets, corporate chartering[77], limited liability, and bankruptcy – may have further altered the shape of financial systems. For example, laws that protect investors, contracts, and property rights might be argued to encourage the development of all kinds of financial institutions, and particularly atomistic market arrangements[78].”[79]

Neoclassical systems as the regulation system associated with market-based financial systems have as its goal of obtaining profit and therefore it aims to eliminate capital market imperfections and perfect the allocation system and consequently have quite strict accounting regulations and prohibitions on insider trading, market manipulations, anti-competitive behaviour, and on true universal banking[80]. As a result of a such legal environment it has been noted that attaining large profits through short-term investment[81] is considered easier but the system ends up being more vulnerable to shocks and financial crisis in number and severity. On the other end, associated with bank-based financial systems, lies relational regulation systems which have the objective of perfecting as much as possible, corporate governance,

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[77] “A corporate charter is a flexible document that an incorporator is required to prepare and file with the Secretary of State in the state of incorporation. The corporate charter must name the original incorporations, the corporation’s name and its business, and its original capital structure (for instance, the number and classes of shares). Corporate charters also include information about the corporation’s purpose, any voting rights attached to these shares, and sometimes the size of the Board of Directors along with their terms and the process for removing a member of the Board of Directors.” (V.) Wex Definitions Team, *corporate charter*, Cornel Law School, Legal Information Institute, Ithaca, January of 2022, available at: https://www.law.cornell.edu/wex/corporate_charter

[78] “When the number of sellers is quite large, and each seller’s share of the market is so small that in practice he cannot, by changing his selling price or output, perceptibly influence the market share or income of any competing seller, economists speak of atomistic competition.” (Amplius) Bain, J.S., *monopoly and competition*, in: The Editors of Encyclopaedia Britannica (ed.), Britannica Money, 28 September 2024, available at: https://www.britannica.com/money/monopoly-economics#ref920520

[79] Fohlin, C., *Economic, Political, and Legal Factors in Financial System Development: International Patterns in Historical Perspective*, Social Science Working Paper No. 1089, 2000., p. 7., available at: https://ssrn.com/abstract=267674

[80] Ibid., p. 8.

[81] Ibid.

reduction of occurrences of financial crises and the costs of financial distress in general and also aiming to improve coordinative efficiency. On the grounds of focusing more on the banking system instead of markets the outcome is vague laws on accounting, market manipulations, and the extent of banking functions. The result is understandably opposite of its counterpart – a system with a better resistance to systematic financial shocks and an emphasis on acquiring profit through long-term investments which amount though ends up being not as large.

4.3.1. Bankruptcy regulation

As an example of the opposing legal aspects and perhaps an overlooked argument in the comparison that uniquely highlights the differences of financial systems are the bankruptcy procedures which include formal arrangements imposed by the legal system (reorganization and liquidation) and informal workout arrangement, and their consequences. Bankruptcy rules greatly differ between the Anglo-American countries (neoclassical regulation system) and those in Germany and Japan (relational regulation system).

Before it was mentioned that banks didn't form close relationships with clients in the United States and the United Kingdom and the reason lies with the fact that their courts have generally penalized banks which have engaged in that practice and have due to that avoided them. In Germany and Japan not only have the courts protected banks, but have even do so at the expense of other creditors and to build on that informal workout arrangement dominate over formal ones.[82] Banks help their client companies recover from financial troubles they encounter to further elevate their own reputation as being capable in devising successful arrangements for leading companies and attract promising new clients that way. Such a reputational factor does not exist in the United States. External financing through numerous small investors, doesn't create such an incentive to protect a company. This is probably done purposively, as from the owners side it can more effectively negate the possibility of hostile takeovers which are way more common than in Germany, and from the investors side to diversify risk as to not invest to many funds in just one company but to invest smaller amounts in a larger number of companies. Another reason for banks in bank-based systems to intervene in debt restructuring is the risk factor. As mentioned, banks are averse to risk and are more likely to choose to invest in projects they have deemed as more likely to succeed than to fail.

[82] Frankel, A.B.; Montgomery, J.D.; Friedman, B.M.; Gertler, M., *Financial Structure: An International Perspective,* Brookings Papers on Economic Activity, Vol. 1991, No. 1, 1991., pp. 288-291.

After lending, banks are able to attain more information about their client-company which serves as an incentive to restructure.[83] To put it in simple terms, let's say a bank has a choice between lending to a new company and acquire it as a new client and partaking in debt restructuring of a long-term client-company, it is more likely the second option will be chosen because they will be perceived as safer thanks to the already accumulated information. In Anglo-American countries it is by law forbidden for banks to intervene in an insider role during times of turmoil for companies and the United States go even a step further in penalizing informal workout agreements.[84] Another contributing factor for the lack of a closer bank-client relationships and interventions is the relatively low bankruptcy costs and the social perception. While in Germany if a company does go bankrupt the owners will be stigmatized by such an event and have a lot of difficulties going forward in attaining new bank loans for business ventures, in the United States going bankrupt multiple times and starting over is seen as a normal occurrence.

4.3.2. Banking system

One of the main differences between the two types of financial systems are their banking systems. Like mentioned before, in the United States as a result of the Glass-Steagall Act of 1933, banking activities are usually performed separately in two types of specialist banks, commercial and investment, despite the fact that the legal separation was partially rescinded in 1999 with the Gramm-Leach-Bliley Act in an effort to modernize financial services[85]. Meanwhile, this kind of Act never existed in Germany, so the functions performed separately in the US, are united and provided in just one type of bank– the universal bank. This structure was deemed to be more fitting at the time to properly handle the needs of the "Hausbank" system.

Commercial and investment banks clearly differ in the type of products and services they offer and also in regulations they must adhere to, type of clients and processed amount of money. Commercial banks cater to the general public – households, small and medium sized business etc. providing lending and payment services, accepting deposits, safeguard assets, account services, online banking and limited investment opportunities. Investment banks, on

[83]Frankel, A.B.; Montgomery, J.D.; Friedman, B.M.; Gertler, M., *Financial Structure: An International Perspective,* Brookings Papers on Economic Activity, Vol. 1991, No. 1, 1991., p. 286.
[84] Ibid., pp. 288-291.
[85] Mahon, J., *Financial Services Modernization Act of 1999 (Gramm-Leach-Bliley),* Federal Reserve History, 22 November 2013, available at: https://www.federalreservehistory.org/essays/gramm-leach-bliley-act

the other hand, work with institutional investors, wealthy individuals, large corporations and governments on financing expensive projects, merger and acquisition transactions, wealth and asset management, security underwriting, assisting clients by financial advising and auditing, securitization etc.[86] Universal banks are financial institutions that combine the differences of the specialised banks and serve a wide range of clientele and perform a diverse range of financial services, including commercial and institutional banking services. A very important function of universal banks are their extensive monitoring activities.

4.3.3. Financial markets

Financial markets, like banks, promote the stability and expansion of a countries economy by supplying the financial system with liquidity, capital and ensures efficient allocation of resources. They function by performing the following functions – exchange of information, determining the prices, presenting a platform for financial instruments to be traded on and managing risk. The umbrella term financial market encompasses any marketplace (stock, bond, money, equity, derivatives, etc.) that enables trading in any of the types of financial instruments.[87] Multiple types of markets exist and are based on the financial instruments traded on them since different instruments cannot be traded in the same way. For example, company shares can be traded between multiple consequent shareholders (and there is usually no intervention of the company after the initial public offering of its shares) and their price depends on the condition of the stock market, while national saving cannot be freely distributed but have to be sold back to the state and government bonds are issued at a fixed rate for the entire time of their existence.[88]

The United States as the prime example of market-based financial systems, has far more publicly listed firms than any country and for that reason, there is considerably more information about them that is available in the public domain than in most other countries. In general, the American financial markets are more highly developed than those in other countries and as such, instigate financial innovation and multiple avenues for increasing

[86] Liaw, K.T., *The Business of Investment Banking: A Comprehensive Overview*, 3rd edition, John Wiley & Sons, Hoboken, 2012, pp. 2-3.
[87] CFI Team, *Financial Markets*, Corporate Finance Institute, Vancouver, available at: https://corporatefinanceinstitute.com/resources/career-map/sell-side/capital-markets/financial-markets/ (24 October 2024)
[88] Howells, P.; Bain, K., *Financial Markets and Institutions*, 5th edition, Pearson Education Limited, Essex, 2007, p. 18.

financial gain.[89] Factors like the distrust towards powerful institutions, the effects of the Glass-Steagall Act etc., marked the financial markets, instead of banks like in the Continental Europe, as the primary source of external financing. As a result, they grew in importance even after the legal separation of commercial and investment banking activities was partially rescinded. On the other hand, the markets of Continental Europe are underdeveloped simply due to the historically imbedded dependence on banks as the main source of external financing which was reviewed during the historical overview of the economic development of Germany. Once formed, this dependence was perpetuated by the European Union's strict banking regulations. The effects of these regulations aren't isolated to the banking system itself and can spill over to the financial markets and affect their development[90] and thus keep them from significant development.

4.4.The financial markets of the European Union

As mentioned, the European Union's bank-market ration is significantly swayed onto the side of bank domination. A clear consequence of this kind of system is the underdevelopment of capital markets which makes banks virtually the only source of funding and the approach of its banks further perpetuates the cycle.

Banks are generally deemed as conservative in their business activities, as they are seemed to be risk-averse. As a result, they are more likely to extend financing to clients they evaluate to be "high return" and for that reason will engage in extensive monitoring. Not only will they ex ante screen the potential client itself and the presented project but also continue the monitoring during their involvement for two reasons. The first reason is to avoid moral hazard, in other words to prevent opportunistic behaviour, most often from the management and the second to help the solvency of their client-company if such need arises. The second reason acts like a large incentive for the client to convey large amount of information and to prevent miscellaneous behaviour, making monitoring relatively easy.[91] That isn't to mean that only "perfect" clients can get access to bank funding. Banks seek to protect themselves, so when they lend to, what they evaluate to be "high-risk" clients, they will seek collateral and, for example include high interest rates which can be so high that they act to potential clients as an additional deterrent to the already long and complicated process. This would not present

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[89] Thakor, A. V., *The design of financial systems: An overview*, Journal of Banking & Finance 20, 1996., p. 931.
[90] Ibid., p. 940.
[91] Berger, A.N.; Molyneux, P.; Wilson, J.O.S., The Oxford Handbook of Banking, 2nd edition, Oxford University Press, Oxford, 2015., pp. 247-248.

such a substantial problem if other avenues of financing would be more accessible. However, market funding remains unattainable for most companies especially small and medium.[92]

With this setup it serves as a no wonder why: 1) none of the BigTech companies are based in the EU[93], 2) London, the capital city of the United Kingdom, a market-based system, is home to one of the seven most powerful global FinTech centres[94], 3) the same city was the centre for the international use of the euro[95] and 4) was chosen to be the centre of the EU Capital Markets Union while it was still its Member State.[96] Brexit was certainly a significant issue for the further development of EUs capital markets since the financial centres in London played a significant role within the EU financial system as the London-based capital markets and financial institutions account also for a notable part in the global finances. Financial centres, like the London one, are a result of its historical development which helped it gain its todays comparative advantage and economic clusters. Whilst this is naturally harder to replicate, factors like the taxing system and regulatory requirements are incredibly important factors[97] and offer insight to the changes needed to be implemented to develop weaker financial markets.

4.4.1. Capital Markets Union

With time it became clear that market forces alone would not be enough and that it would take coordinated planning by the EU and collaborative administration of Member States to shift the EUs bank-market ratio. So, the EU turned special attention towards building the Capital Markets Union.

The Capital Markets Union (CMU) is envisioned as part of the Economic and Monetary Union (EMU) which also includes the Monetary union, Banking Union, coordination of

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92 Langfield, S.; Pagano, M., *Bank bias in Europe: effects on systemic risk and growth*, ECB Working Paper 1797, May 2015, p. 2, available at: https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1797.en.pdf
92 Ibid., p. 5.
93 Bajakić, I., Razvoj financijske regulacije i supervizije u Europskoj Uniji – Integracijski procesi europskih financijskih sustava, Faculty of law University of Zagreb, Zagreb, 2021., p. 186.
94 Ibid.
95 European Central Bank, *Review of the international role of the euro*, Frankfurt am Main, December 2003, p. 38, available at: https://www.ecb.europa.eu/pub/pdf/ire/eurointernationalrole2003en.pdf
96 Enria, A., *Brexit and the EU banking sector: from the fundamental freedoms of the Internal Market to third country status*, European Central Bank / Banking Supervision, Frankfurt am Main, 26 January 2023, available at: https://www.bankingsupervision.europa.eu/press/interviews/date/2023/html/ssm.in230130~cd7de9ce0c.en.html
97 Enoch, C.; Everaert, L.; Tressel, T.; Zhou, J., *From Fragmentation to Financial Integration in Europe*; Laeven, L., Tressel, T., Chapter 3. European Union Financial Integration before the Crisis, International Monetary Fund, Washington D.C., 2023, pp. 60-62.

economic and fiscal policies and strategy of strengthening institution and democratic values.[98] After the Banking Union became operational in 2014[99] with the implementation of the Single Supervisory Mechanism[100] - the banking supervision system through the collaboration of the European Central Bank and the national supervisory bodies of the Member States [101], the Five Presidents' Report of 22 June 2015 presented the plan for the deeper integration of the EMU. Four goals were highlighted: a genuine Economic Union, a Financial Union, a Fiscal Union and a Political Union.[102] As means to achieve the Financial Union, the completion of the Banking Union and the CMU were named as a priority[103] as both banks and capital markets are complementing vital parts of the financial system.[104] The Banking Union, while open to all Member States, was designed for implementation in the euro area. In turn the CMU, while especially relevant to the euro area, was designed from the start to include all Member States in the Single Market.[105] [106] The CMU is envisioned in a three-pillar form: 1) EU Single Market, 2) clear and simple rules and 3) effective supervision.[107]

4.4.2. Benefits of establishing the CMU

Strong capital markets would act as a complementary to the already strong banking system of the EU and would thus diversify the available sources of external funding. This would act as a turning point and allow small and medium enterprises (SMEs) to get easier access to financing and mitigate the aforementioned problem of the bargaining power of banks.

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[98] Bajakić, I., Razvoj financijske regulacije i supervizije u Europskoj Uniji – Integracijski procesi europskih financijskih sustava, Faculty of law University of Zagreb, Zagreb, 2021., p. 123.
[99] Enria, A., *Brexit and the EU banking sector: from the fundamental freedoms of the Internal Market to third country status*, European Central Bank / Banking Supervision, 26 January 2023, available at: https://www.bankingsupervision.europa.eu/press/interviews/date/2023/html/ssm.in230130~cd7de9ce0c.en.html
[100] Bajakić, I., Razvoj financijske regulacije i supervizije u Europskoj Uniji – Integracijski procesi europskih financijskih sustava, Faculty of law University of Zagreb, Zagreb, 2021., p. 125.
[101] Ibid., p. 129.
[102] Juncker, J.-C.; Tusk, D.; Dijsselbloem, J.; Draghi, M.; Schulz, M., *Completing Europe's Economic and Monetary Union*, The European Commission, Brussels, 22 June 2015, pp. 4-5, available at: https://commission.europa.eu/publications/five-presidents-report-completing-europes-economic-and-monetary-union_en
[103] Ibid., pp. 11-12.
[104] European Commission, Mid-Term Review of the Capital Markets Union Action Plan, Brussels, 8 June 2017, COM(2017) 292 final, available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52017DC0292
[105] Ibid., p. 12.
[106] Enria, A., *Brexit and the EU banking sector: from the fundamental freedoms of the Internal Market to third country status*, European Central Bank / Banking Supervision, Frankfurt am Main, 26 January 2023, available at: https://www.bankingsupervision.europa.eu/press/interviews/date/2023/html/ssm.in230130~cd7de9ce0c.en.html
[107] European Commission, Capital Markets Union: progress on building a Single Market for capital for a strong Economic and Monetary Union, Brussels, 15 March 2019, COM(2019) 136 final, p. 3, available at: https://ec.europa.eu/finance/docs/policy/190315-cmu-communication_en.pdf

Consequently, it would help SMEs to expand and to create new job opportunities[108] whilst providing households with better opportunities regarding their saving and investments allowing their decisions to the result of a competitive choice.[109] Also, it would redirect financing to investment projects across EU allowing Member States with small markets to realize their high growth potential and Member States with developed markets to benefit from saving opportunities and greater cross-border investment. By integrating into a single capital market across the EU and removing all implicit and explicit borders and developing equity markets, risk sharing will improve allowing Member States to share the impacts of financial shocks.[110] With these conditions' competitiveness will increase and with it financial innovations which lead to the emergence of new markets[111] further diversifying sources of funding, which in turn deepens the financial integration, lowers costs and elevates the position of the EU on the global market.[112]

4.4.3. The fist CMU action plan

The European Commission published a progress report March 15 2019 in preparation for the new action plan, which included legislative measures dealing with the (a) CMU, (b) sustainable finance and (c) proposal of relevance to the CMU, taken since the five-year 2015 CMU action plan and the mid-term review of June 2017. In that time, two important plans have been made as part of building the CMU: the action plan on sustainable finance and the FinTech action plan; three regulations have been adopted on the topics of securitisation, the prospectus and European venture capital funds (a); the European Parliament and the Council of the EU have reached political agreements on subjects regarding (a) the Pan-European personal pension product, covered bonds, cross-border distribution of collective investment funds, investment firms review, preventive restructuring, second chance and efficiency of procedures, promotion of small and medium enterprises growth markets, European market infrastructure regulation

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[108] European Commission, Action Plan on Building a Capital Markets Union, Brussels, 30 September 2015, COM(2015) 468 final, available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52015DC0468

[109] European Commission, A Capital Markets Union for people and businesses-new action plan, Brussels, 24 September 2020, COM(2020) 590 final, available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM:2020:590:FIN

[110] European Commission, Action Plan on Building a Capital Markets Union, Brussels, 30 September 2015, COM(2015) 468 final, available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52015DC0468

[111] Thakor, A. V., *The design of financial systems: An overview*, Journal of Banking & Finance 20, 1996., p. 941.

[112] European Commission, Action Plan on Building a Capital Markets Union, Brussels, 30 September 2015, COM(2015) 468 final, available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52015DC0468

(supervision), (b) on disclosure rules and establishment of benchmarks on low-carbon, and (c) European market infrastructure regulation; mandate is being negotiated or no agreement has been reached on (a) crowdfunding, applicable law to third-party effects of assignment of claims, European Supervisory Authorities review, including reinforced anti-money laundering rules, (b) taxonomy[113], (c) common consolidated corporate tax base and recovery and resolution of central counterparties.

While market capitalization of listed companies is above pre-crisis level, initial public offerings have not significantly changed, listed equity of non-financial firms has from 2014 to 2018 increased by 5%, debt securities by 2% and the cross-border distribution of investment funds has shown steady growth. Member States and stakeholders could be involved to a higher degree and national measures need to be refined. All of the above serves to show that while progress was made, the CMU is still far from functioning at a satisfying level.

4.4.4. The 2020 CMU action plan

To continue the work on building the CMU with the additional task of supporting market recovery after the COVID-19 crisis, the European Commission adopted on 24 September 2020 a new action plan, based on three main objectives and their 16 legislative and non-legislative actions: (1) making financing more accessible for EU-based companies and with that support a green, digital, inclusive and resilient economic recovery (making companies more visible to cross-border investors, supporting access to public markets and vehicles for long-term investment, encouraging more long-term and equity financing from institutional investors, directing SMEs to alternative providers of funding, helping banks to lend more to the real economy), (2) working on ensuring that the EU stays a safe place for savings and long-term investments of individuals (empowering citizens through improving their financial literacy, building retail investors' trust in capital markets, supporting people in their retirement) and (3) integrating national capital markets and thus establishing the EU single market (alleviation of the tax associated burden in cross-border investment, securing the predictability of cross-border investment as regards insolvency proceedings, facilitating shareholder

[113] Taxonomy is a classification system which acts as an important market transparency tool to ensure investments are being directed towards activities most needed for ensuring environmental sustainability. (Amplius) European Commission, *The EU Taxonomy's uptake on the ground*, Brussels, 6 June 2024, available at: https://finance.ec.europa.eu/sustainable-finance/tools-and-standards/eu-taxonomy-sustainable-activities/eu-taxonomys-uptake-ground_en

engagement, developing cross-border settlement services, consolidated tape[114], investment protection and facilitation and supervision).

The reports in anticipation of the 2020 action plan as well as European Court of Auditors and the Council of the EU have noted that a need exists to establish clearly defined and propriate indicators to monitor the progress of accomplishing the objectives of the CMU. In line with that, the European Commission has on 9 June 2021 (corrected version of 14 July 2021 currently published) drafted up a Commission Staff Working Document which introduced and explained the indicators it has adopted. The effects of individual measures are now also tracked and considered under the overall CMU plans. The indicators serve three purposes: 1) monitoring the progress made towards the CMU objectives, 2) providing a framework and an empirical basis for the analysis of capital market development and of the overall impact of past CMU measures and 3) pointing out areas that need to be newly regulated or existing policies need to be adjusted. Just like in the 2020 action plan, the indicators are set out to regulate the three main objectives.[115] With the list of indicators, the Commission published an overview of CMU indicators which it updates each year with the latest being published 19 July 2024. In the 2024 update, most indicators show that although there has been steady growth in some areas, in others a decline has been noted and there is a large disparity across the Member States. The current state of development of the CMU is far from ideal.

5. CONCLUSION

Throughout this paper the historical development has been explored and the factors argued to be most influential in the formation of either bank-based or market-based financial systems and their aspects. In his work in 1996 Thakor has argued that, in the future, the differences between financial institutions and markets will blur together and that there will be progressively less need for national regulation. To a certain point, he was right. As it was conveyed earlier the rapid pace and intensity of the third era of globalization has indeed induced

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[114] Consolidated tape or consolidated data (CT data) refers to the various data feeds collecting data from various sources about trading activity across a financial market and its dissemination through a single, market data feed in a “standardised” format. (Amplius) European Commission: Directorate-General for Financial Stability, Financial Services and Capital Markets Union, The study on the creation of an EU consolidated tape – Final report, Brussels, September 2020, p. 13, available at: https://data.europa.eu/doi/10.2874/434465

[115] European Commission, Commission Staff Working Document: Monitoring progress towards a Capital Markets Union: a toolkit of indicators, SWD(2021) 544 final/2, Brussels, 14 June 2021, pp. 4-6, available at: https://finance.ec.europa.eu/publications/list-indicators-monitor-progress-towards-cmu-objectives_en#ecl-file-726631775

integration of different functions but that doesn't mean regulation has necessarily decreased. Maybe we aren't at that point yet, but throughout this paper it has been noted that for years there were attempts, owing to believes such as Smith's "invisible hand", at laissez-faire type of regulation. Sadly, such efforts still haven't proved successful for too long as financial crisis ensued and that is when regulation typically increases. Nonetheless, there are repeated attempts at deregulation. That proves to show that countries continuously strive towards improving their economy, regardless of the difficulty. To plan out a new direction it is needed to properly asses what is already in place and not just senselessly implement something just because it works in one country, because what may work in one system may not work in another. It has been noted that many traits of the financial systems exist due to influences surrounding the time of their establishment. Let's take the United States for example. Their strong market-based financial system can be attributed to their mistrust towards strong financial institutions as a consequence of their history with the United Kingdom; and even though, their financial markets can be considered volatile and the effects of financial crises will be not only felt domestically, but also globally since many companies with global reach are based there, not much is changing. There is still strong distrust from individuals toward financial institutions and lack of strong bank-client relationships, even after almost two hundred years, and attempts to modernize their banking system in order to incorporate them to a higher degree in their financial system. Similar can be said for the European Union. While some progress has been made in the creation of the Capital Markets Union, no immense change has been noted. Banks are still considered as a "safer" source since capital markets are not developed enough to serve as proper alternative choice which will be hard to establish without them being made use of. The EU will have to continue to its work, monitor the progress and adapt accordingly. Maybe the most difficult task will be changing the mentality. In the United States many individuals are willing to take multiple risks in the hope of one day achieving success like Steve Jobs and Mark Zuckerberg. A significant contributor may be their approach to bankruptcy, as there isn't that much of a stigma. There is a need to further augment the regulation in the EU around that area which will make the consequences that come with it less severe and continued focus on increasing the financial literacy. What is important to remember when trying to implement traits from one system is, that the financial system already in place has to be well understood so appropriate steps can be taken. However, just like financial systems haven't formed overnight, real change cannot be as quick either. At last, it stands to show that the distinction between bank-based and market-based financial systems remains relevant and that significant change cannot be implemented without understanding the system already in place.

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