Banking Union: what way out of the current deadlock?

Note written by Didier Cahen with Lucie Truchet

A paradox lies at the heart of the Maastricht Treaty: despite the introduction of a single monetary policy on 4 January 1999, responsibility for financial supervision remained national. Remarkably, in the 15 years following the creation of the euro, there was little concern about the need for a Banking Union. It was only in the wake of the EU sovereign debt crisis (2011-2012) that Member States reached a consensus to address this discrepancy.

The Banking Union aims to create a resilient banking sector in the EU by centralizing banking oversight, streamlining bank resolutions, and uniformly protecting depositors across Member States. The objective of the Banking Union, as stated in the Euro Area Summit Statement of 29 June 2012, which many regard as the 'birth certificate' of the Banking Union[1], was to "break the 'vicious circle between banks and sovereigns[2]', hence placing the banking sector on a more sound footing and restore confidence in the Euro as part of a longer term vision for economic and fiscal integration[3]."

Its architecture is still incomplete. The Banking Union is indeed built on three pillars to make the banking sector more stable and resilient: supervision, resolution, and the still-debated European Deposit Insurance Scheme (EDIS)[4]. The first pillar, the Single Supervisory Mechanism (SSM), created on November 4, 2014, has helped to promote a resilient banking sector, as demonstrated by the sector's resilience during the banking turmoil of spring 2023[5]. The second pillar, the Single Resolution Mechanism (SRM), created on January 1, 2016, aims to protect financial stability and taxpayers by planning for and managing bank failures. Yet, it requires improvements to make the European framework for Crisis Management and Deposit Insurance (CMDI EU resolution framework concretely applicable and less prone to deviations to the non-bail out principal.

Despite the creation of the SSM and the SRM, the distinction between home and host authorities and the 'national bias' still exists for banks operating across borders in the 'Banking Union' under the remit of the Single Supervisory Mechanism: transnational banking groups are unable to manage their capital, liquidity and MREL liabilities on a consolidated basis. The banking sector in Europe remains too fragmented and over-banked, and market concentration has progressed only at domestic level. As a result, the Banking Union project has been at a standstill for years.

The purpose of this paper is to suggest ways out of the political deadlock and to move forward with the completion of the Banking Union. The first part describes the benefits that a genuine Banking Union would bring to the competitiveness of the EU banking sector and the EU economies. The second part focuses on the existing shortcomings in the design of the Banking Union, which make it fragmented and sub-optimal. The third part assesses the ways forward that have been identified but have been hampered by the prevalence of national interests over European ones. Finally, the fourth part explores possible ways out of the impasse and guidelines for resuming meaningful progress on the Banking Union.

1. A genuine Banking Union would be beneficial for the competitiveness of the EU banking sector

A genuine Banking Union would bring several benefits to the EU banking sector, – and a fortiori to the EU financial sector as a whole – and to the EU economy. The first section shows that the completion the Banking Union would foster the

1. L. Mari Pastu Sortos, Vice-Governor of the *Banco de Portugal*, Opening remarks, June 2024.
2. European Council, Euro Area Summit Statement, 29 June 2012.
3. European Commission, "Single Market Act II – Together for new growth", 2012.
4. European Commission, "Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 806/2014 in order to establish a European Deposit Insurance Scheme", 2015; European Parliament, "Report on the proposal for a Regulation establishing the European Deposit Insurance Scheme (EDIS)", April 2024.
5. According to Claudia Buch (Speech on financial integration, 30 April 2024), "the CET1 ratio increased from 12.7% of risk-weighted assets in 2015 to 15.7% at the end of 2023. The leverage ratio, which is based on banks' total assets, has also increased, albeit more modestly – from 5.3% in 2016 to 5.8% at the end of 2023."

integration of banking markets and, as a result, make the allocation of resources in the EU economy more efficient. The second section focuses on the synergies existing between the Banking Union and the Capital Markets Union. Advancing both projects would strengthen the EU financial sector and financial sovereignty, provided that we improve the competitiveness of European banking and financial actors. The third section explains, however, that the benefits to the EU of a genuine Banking Union should not be overestimated.

1.1 A genuine Banking Union would accelerate the integration of banking markets, which is a prerequisite for a more effective allocation of resources across the EU economy

A proper Banking Union would promote a better integration of EU banking markets – *i.e.* banking markets in which banks operate in the Euro area as they would in their home country – which would in turn foster a more efficient allocation of resources across the Euro area (*e.g.* firms would be able to tap broader and cheaper sources of bank funding) and achieve a better diversification of risks. In such a context, Euro area cross-border banking groups would be considered as single entities from an operational, regulatory and supervisory perspective, rather than as the sum of separate subsidiaries with different capital, liquidity and recovery frameworks imposed at national level.

In other words, the EU regulatory framework would recognize cross-border banking groups at the consolidated level, making the Banking Union a 'single jurisdiction' based on the already largely single rulebook. In this single jurisdiction, the SSM and the SRB would be empowered to set appropriate levels of capital, liquidity and MREL at consolidated level for each cross-border banking group in Europe, to monitor the allocation of those financial resources across legal entities, and to ensure a fair allocation of losses in the event of resolution.

70% of the financing of the European economy is provided by banks, unlike the United States, which finances around 2/3 of its economic development through the markets. The solidity and competitiveness of banks in Europe and therefore the creation of a genuine Banking Union are key to ensuring the financing of economic activity and Europe's financial sovereignty.

But banks are becoming smaller compared with their global rivals and are not sized to face the economic challenges (energy and digital transitions, remilitarization). "While the balance sheets of the top five US banks are 2,8 times larger than those of the European peers, allowing for more diversification, larger exposures, and greater investment budgets with which to jump to the forefront of technological developments[6]." As a result, the large European banks are making much lower profits than their US rivals and have less capacity to provide new financing than their US counterparts (*see 2.3*)[7]. Banking fragmentation and the absence of large, globally competitive pan-European banks are also major obstacles to the emergence of a CMU.

As F. Villeroy de Galhau noted[8] "For banks, as we see this in the United States, scale is objectively a major determinant of competitiveness, particularly as it enables bank to amortize the cost of critical investments in digital technology and artificial intelligence."

An effective Banking Union would encourage this development of larger and more competitive transnational banking groups in the EU, helping to channel excess Euro area savings across borders to parts of Europe where the most attractive investment opportunities exist. Any firm in any Member State would be able to finance its investment projects through any subsidiary or branch located anywhere in the Banking Union.

Robust transnational banking groups would also improve private risk-sharing mechanisms. With transnational banks operating in different parts of the Union, they would be able to offset losses in one recession-hit region with profits in another, thereby continuing to lend to sound borrowers. Depositors would also contribute to the funding of a more diversified pool of assets, insuring them against shocks specific to their home country.

By facilitating the integration of European banking markets, the Banking Union should also lead to more efficient and safer institutions and better and cheaper banking services for customers.

Moreover, such an effective Banking Union is a step towards a genuine Economic and Monetary Union (EMU), as it will achieve a resilient and growth-friendly banking sector. It also improves the efficiency of the transmission of monetary policy, for which banking activities in the Euro area play an essential role, as the feedback loop between banks and sovereigns would have disappeared and funding costs between banks would converge.

6. See C. Edelman, "why Pan-European banks are now a necessity", *Eurofi Magazine*, September 2024.
7. In 2023, the combined net income of six American GSIBs (JP Morgan Chase, Citigroup, Wells Fargo, Bank of New York Mellon, Goldman Sachs, and Morgan Stanley) totaled $113 billion, which is approximately 2.73 times higher than the combined net income of the six Euro area GSIBs (BNP Paribas, Crédit Agricole, BPCE, Santander, Société Générale, and Deutsche Bank), which amounted to €38.699 billion, or $41.408 billion.
8. F. Villeroy de Galhau, "Ten years of the Single Supervisory Mechanism: great achievements, and new journeys to complete", ACPR, 24 June 2024.

1.2 Apparent synergies exist between the Banking Union and Capital Markets Union

As V. Grilli points out[9], "A true Capital Market Union requires a Banking Union and an integrated and frictionless single market. Considering the amount of work that remains to be done in order to achieve the three, moving ahead simultaneously on all issues would be greatly beneficial to help grow the appeal of the EU's financial markets, as well as build trust and confidence in financial services from consumers across Member States. It would allow for the natural deepening of cross border integration across the Union."

1.2.1 The Banking Union supports the CMU, and the CMU supports the Banking Union

A fully-fledged Banking Union would contribute to the development of the Capital Markets Union (CMU), which would benefit investment and competitiveness in the EU.

Indeed, the Banking Union and the CMU are "mutually reinforcing initiatives that can take the single market for financial services to the next level", as banks and capital markets complement each other in financing the real economy. More specifically, V. Constâncio explains[10] that "a more resilient banking system supports the smooth functioning of capital markets. For example, resilient banks are more likely to act as market makers for certain capital market instruments and can ideally buffer extreme price movements in times of crisis. In addition, well-capitalized banks are less likely to be forced to sell certain asset classes. This leads to less market disruption in times of crisis.

In turn, the CMU supports the Banking Union: more integrated and jointly regulated capital markets would support cross-border activities and bank resilience." V. Constâncio underlines that "in a significantly more integrated capital market, banks would no longer need to develop local expertise for each national capital market. They could more easily exploit cross-border economies of scale by offering similar or even the same products and services in another Member State. By operating in a larger, integrated market, banks would be likely to increase their cross-border asset holdings and build larger and more diversified collateral pools for securitized products and covered bonds."

Securitization acts as a unique link between credit and capital markets. As V. Grilli notes in his interview for the *Eurofi Magazine* (September 2024), "Re-launching and scaling up securitization is an essential component of the CMU, a bridge between the Banking Union and the CMU, and can bring considerable benefits to the European financial system, including by reducing over-reliance on bank funding while encouraging cross border investments. When developed in such a way as to be responsible, prudentially sound and transparent, securitization is an important vehicle to increase the capacity of banks to lend and also for investors to have access to European credit products.

Another benefit of such reform would be the fact that it would significantly free up capital in bank's balance sheet. This increase in capital available could be deployed into corporates, making it easier for them to raise capital in the traditional banking system."

Ultimately, the Banking Union, together with the CMU, can play an important role in enhancing the EU's open strategic autonomy and strengthening confidence in the euro. Strategic autonomy requires, among other things, converging EU economies, a strong and widely used currency, and a resilient, competitive and thriving financial sector. These, in turn, would benefit greatly from, for example, a Euro area safe asset, deep capital markets and a single banking market.

Both larger and more numerous pan European banking groups and larger, deeper and more liquid capital markets are needed in Europe to respond to massive investment needs (digital and climate transitions…).

But to reap the benefits of the synergies between the Banking Union and the CMU, and to achieve effective financial strategic autonomy for the EU, European banks need to be competitive. Otherwise, the development of financial markets will mainly benefit non-EU banks.

1.2.2 The integration of banking and financial markets must be accompanied by an increase in the competitiveness of banking and financial operators

Industrial sovereignty in Europe is unattainable without financial sovereignty, which is the foundation of European sovereignty. To achieve financial sovereignty, it is essential to improve the competitiveness of EU financial institutions, such as banks and asset managers, which has declined significantly over the past 15 years.

Indeed, the EU's economic lag behind its main competitors (the US and Asia) has led to a decline in the competitiveness of European financial institutions.

9. V. Grilli, "The new political cycle brings an opportunity that cannot be missed if we want to achieve a true CMU", Interview for the *Eurofi Magazine*, September 2024.
10. V. Constâncio, "Synergies between banking union and capital markets union", Brussels, 19 May 2017.

The European financial sector has gradually lost market share to its US counterparts in both investment and corporate banking and asset management due to persistently low interest rates, the absence of a single market, and the high regulatory and supervisory burden in Europe.

Financial regulation should be predictable, legally precise, in line with best international practice, and rigorously implemented and enforced, without regulatory arbitrage. The fact that regulators have erred on the side of caution over the past decade is logical after the financial industry caused massive economic losses and chaos in the global financial crisis and in the EU economy. As a result, the EU has not seen the kind of bank failures over the past 13 years that the US has seen recently, with some of its regional banks betting on interest rate futures.

But European financial players complain that there are too many rules that are too detailed, too complex and too burdensome. They argue that the EU legislative process fails to assess the impact of these regulations on the competitiveness of market participants. They also stress that there are several cases of Level 1 texts being gold-plated by regulators or supervisors at Level 2 or 3, in a context where the European financial sector is gradually losing market share to its US counterparts, both in investment and corporate banking and in asset management.

To restore the competitiveness of European players, a fundamental shift in monetary, economic[16] and prudential paradigms in Europe is essential.

At the prudential level, a profound change in the way EU regulations are designed, is needed. We should avoid over-regulation and gold-plating of capital requirements.

Ideally, the official mandate of European regulators and supervisors should be revised to include

Table illustrating the decline in the global competitiveness of European financial players

Sector	Year	European Share (% of Relevant Parameter)	US Share (% of Relevant Parameter)	Notes
Banking[11] (Share of Global Market Capitalization of Banks)	2009	34	23	
	2022	17.5	34	Investor confidence has increasingly favored US banks due to their robust capital structures and profitability, further boosting their market capitalization
Global Capital Markets[12]	2006	18	43.6	
	2022	10	42.5	Decline in the EU due to more dynamic and better-integrated financial markets in the US and Asia
Asset management[13] (Global Funds Market Share)	2007	47	51	
	2022	22	70	Only two European asset managers (Amundi and Natixis) among the world's top 20
Insurance[14] (Share of the Global Insurance Market)	2010	37	32	
	2020	26	45	US's market share rose, showing stronger growth and resilience
Payments Market[15] (Share of the Total Payment Transaction Volumes in the Global Market)	2022	10	60	American players (Visa, Master Card, PayPal, Apple Pay, Google Pay) dominate in most European countries. Reflects technological superiority and lack of competitive European alternatives

11. SIFMA, Capital Markets Fact Book 2022.
12. SIFMA, Capital Markets Fact Book, 2023; McKinsey & Company, Mapping global capital markets: Fifth annual report, 2008.
13. EFAMA, Asset Management Report, 2022.
14. Global Insurance Market Report (GIMAR), 2020; Allianz, Selected Global Insurance Markets, 2020.
15. McKinsey & Company, The 2023 McKinsey Global Payments Report.
16. See Jacques de Larosière's interview in the Eurofi Magazine, September 2024.

objectives for competitiveness and long-term growth, similar to the approach in the US and, from 2023, in the UK[17].

Given the political complexity of changing these mandates, it is essential that any impact assessment of EU legislative proposals in the financial sector better considers the impact on the EU economy and the competitiveness of EU financial actors. This assessment should be carried out again during the trilogue, as the text will have been significantly modified.

1.3 Nonetheless, the benefits of the Banking Union should not be overestimated

Progress on the Banking Union requires, above all, economic convergence among the largest Member States (Germany, France, Italy, Spain) to restore trust among European leaders, without which cooperation is not possible. Economic convergence and sound public finances in all parts of the EU are essential to restore confidence among Member States, break the sovereign-bank doom loop, promote the creation of an EU safe asset and reach a European agreement on a European Deposit Insurance Scheme (EDIS).

Moreover, progress on the Banking Union and the CMU has been hampered by an adverse monetary and economic environment for more than a decade. Interest rates and returns on assets are systematically lower in Europe than in the US, leading Member States with excess savings, such as Germany and the Netherlands, to invest in the US rather than in countries with lower GDP per capita, such as Spain, Italy, Portugal and Greece.

Investment in the US is better remunerated in the US and economic growth is higher there than in the EU, because of economic disparities between large Member States and the lack of common policies in industry, energy, defense and other key sectors.

Differences in national approaches to state aid and bank taxes are additional obstacles to progress in the Banking Union. State aid creates competitive distortions across the EU due to its asymmetric distribution across Member States. Similarly, bank tax proposals in one country can cause turbulence across the EU, as illustrated by the reaction of EU bank share prices to the Italian bank tax proposal[18].

Beyond this adverse economic environment, the development of the CMU requires adjustments that are not linked to progress in the Banking Union:

- Similar returns on EU and US assets in order to avoid capital outflows,
- Long-term saving products[19] (*e.g.* pension funds),
- Stimulation of household investment in equity-like products (taking into account EU retail savers' aversion to risk); this links with the EU Retail Investment Strategy,
- An effective EU market for securitization,
- Rules that do not disincentivize equity financing (listed or not),
- Consolidation and centralized supervision of post-trade market infrastructure located on EU territory,
- (Progressive) harmonization of EU "securities, corporate and insolvency laws",
- A combination of a top-down approach – with a single rulebook regarding listing, market abuse, products, etc, and a bottom-up approach – where each Member State works on developing its capital market.

Moreover, a real Banking Union alone would not create a single market for retail banking services. This would require harmonization of legal, fiscal and consumer protection rules. Without such harmonization, cross-border banking groups would not benefit fully from economies of scale, and cross-border mergers in the retail area would continue to be hampered by this fragmentation.

In addition, the Basel regulatory framework, which increases capital requirements based on the size of the balance sheet, further complicates these mergers. Global systemically important banks (GSIBs) are classified by the Financial Stability Board into five "buckets" with increasing levels of systemic importance and corresponding additional capital requirements[20], although higher SIFI surcharge seems rather limited, according to policymakers, when considering the factors inhibiting the emergence of truly cross border banks in the EU.

Finally, it is important to keep in mind that a major challenge of the Banking Union is to achieve the objectives of an unrestricted single market while allowing for competitive national sub-systems. Steps towards further integration must take into

17. Since 2023, in the UK. Notably, the UK's Financial Conduct Authority now has a secondary objective focusing on international competitiveness and growth, as does its Prudential Regulation Authority. Their mandate includes "facilitating the international competitiveness of the UK economy, particularly the financial services sector, and its growth in the medium to long term."
18. "On August 7, 2023, Italy's vice-president M. Salvini unexpectedly announced a 40% tax on bank windfall profits (...) The markets responded spectacularly, send Italian bank shares plummeting on the Milan Stock Exchange" (Source: "Italy announces tax on bank windfall profits, causing stock to plummet, *Le Monde*, 9 August 2023).
19. Long-term saving products improve the financing of pension regimes (*e.g.* 401K in the US), improve the competitiveness of market activities in Europe and favor the development of EU asset managers.
20. See 2.1.

account the full spectrum of the EU's diversified banking sector. The success of the Banking Union should not be measured solely by the emergence of so-called 'European champions' in the banking sector. This is not a panacea for creating a more stable and efficient banking industry for Europe, its customers and the real economy.

2. Loopholes in the design of the Banking Union make it fragmented and suboptimal

Since the creation of the SSM and the SRM in 2014, significant progress has been made in the Banking Union. The European banking sector has shown remarkable resilience during the Covid-19 crisis, the war in Ukraine, and the banking turmoil of spring 2023. Nevertheless, loopholes exist that make the Banking Union fragmented and suboptimal. The first section explains the problem that persists around the resolution of some domestic Less Significant Institutions (LSIs). The second section examines other key issues such as economic divergence, the home-host dilemma, the sovereign-bank nexus, and ring-fencing practices that hinder the progress of the Banking Union. The third section shows that the existing fragmentation undermines the profitability and competitiveness of the EU banking sector and that, as a result, EU banks lag behind their international peers.

2.1 The SSM has strengthened the resilience of the EU banking system and the EU framework for bank resolution has progressed, although issues remain for the resolution of some domestic Less Significant Institutions (LSIs)

The first pillar of the Banking Union, the SSM, directly supervises the 115 most important Euro area banks (holding almost 82% of European assets). The enhanced regulatory and supervisory reforms implemented over the past 10 years have proven effective: the European banking sector showed remarkable resilience during the banking turmoil of the spring of 2023.

The second pillar, the SRM, needs to be improved, as national authorities continue to mistrust the European framework, especially with regard to crisis management and deposit insurance (CMDI).

European resolution rules have often been divisive, with past disagreements between the SRB and national resolution authorities over the definition of public interest (PI). However, the EU framework has been significantly strengthened over the past decade, particularly for large banks. According to the SRB[21], 97 out of 113 banking groups under the SRB's remit are prepared for resolution and have built up their capabilities to comply with the SRB's Expectations for Banks (EfB) and the steady state MREL[22] Target[23]. In addition, the Single Resolution Fund (SRF) reached 1% of covered deposits, marking the end of the SRF build-up phase and unlocking a significant normalization of earnings for banks, after years of massive contributions weighting on their Returns on Equity.

On April 18, 2023, the European Commission published its proposal to revise the BRRD, SRMR, DGSD and Daisy Chains Directive - the Crisis Management and Deposit Insurance Proposal (CMDI). In particular, the Commission proposed a new public interest test that would increase the number of banks that would be put into resolution (rather than liquidation) in the event of their failure. Of the approximately 2,000 Less Significant Institutions (LSIs) in the Banking Union, only 68 would be earmarked for resolution at the end of 2022. Out of these 68 banks, 25 still fell short of the final MREL target at the end of 2022.

The CMDI proposal is likely to bring additional banks within the scope of resolution, with the aim of strengthening financial stability and avoiding value destruction (where a transfer strategy is less costly than liquidation). It changes the criteria for determining which banks are subject to resolution (*i.e.* the so-called public interest test) but the decision on this matter remains at the discretion of the relevant resolution authorities.

The CMDI also seeks to enhance the funding options available to finance the market exit of these banks in resolution. The DGS bridge would absorb the bank's losses in lieu of deposits after MREL has been exhausted, up to the level of the 8% TOLF.

In effect, CMDI is proposing to make the possibility of using Deposit Guarantee Schemes (DGS) in resolution more practical. To achieve its objectives, the CMDI proposed to remove the DGS super-priority, to introduce a single tier depositor preference and some harmonization of the Least Cost Test (LCT). In other words, the CMDI proposed to change the position of the DGS in the creditor hierarchy by placing it on the same level as uninsured depositors. This change, which is necessary to increase resolution funding, has met with strong industry and some Member States' opposition which has lead to changes in the original Commission's proposal in the opposite direction.

21. "SRB Bi-annual reporting note to the Eurogroup", Single Resolution Board, November 2023.
22. Minimum requirement for own funds and eligible liabilities (MREL) is one of the key tools in resolvability, ensuring that banks maintain a minimum amount of equity and debt to support an effective resolution.
23. Therefore, as of December 2023, the 16 remaining groups under the remit of the SRB would go into liquidation.

Host supervisors fear that if a pan-European banking group fails, capital and liquidity will remain trapped in individual Member States or will be allocated inequitably (*see 2.2.3*). It might be hoped that the progress made on the EU bank resolution framework would at least partially address the concerns of host supervisors and encourage them to lift some ring-fencing practices[24], in particular with respect to liquidity management in cross-border banking groups. Such a decision could send a positive signal to authorities and banks to resume progress on the Banking Union. But this has not yet happened.

EDIS is the third pillar of the Banking Union. In November 2015, the EU Commission presented a proposal for EDIS. Since then, no political agreement has been reached. Support within the industry has also been limited. With EDIS, around 2,200 smaller and regional banks organized in networks fear losing the benefits of their Institutional Protection Schemes (IPS). Large banking groups also see the costs of implementing EDIS as outweighing the benefits.

2.2 The Banking Union faces a number of issues

Ten years after its creation, the Banking Union has not been completed as several key issues persist.

2.2.1 The EU banking sector is hampered by the significant economic divergences between Member States which fosters distrust among national authorities and the SSM and the SRB

The significant fiscal and economic disparities between EU countries, coupled with some Member States' fear of having limited influence over European decisions, make it difficult to define a common interest in Europe. This situation fosters an "every man for himself" mentality and creates a climate of mistrust between Member States. Moreover, these economic disparities make it difficult for EU policymakers to agree on a European safe asset and a mutualized EDIS, thus hindering the completion of the Banking Union.

The heterogeneous economic situations are particularly evident in the differences in public debt levels and current account balances from one Member State to another. For example, in 2023, Germany's public debt was about 63.6% of its GDP, while France's debt was between 110% and 115%, and Italy's debt exceeded 140% of its GDP. Moreover, in 2023, Germany had a substantial current account surplus of 6.9% of GDP, while France and Italy had current account deficits of -2.0% and -1.3% of GDP, respectively.

As long as Member States continue to diverge, significant progress towards the completion of the Banking Union, CMU and EMU will remain elusive. Member States are failing to cooperate due to persistent economic divergences and a lack of mutual trust, which is a prerequisite for a deeper Banking Union.

2.2.2 The sovereign-bank nexus persists not least because of endlessly too high fiscal deficits in certain Member States

Although EU banks now have higher capital and liquidity ratios than in 2012, and the EU banking sector proved resilient during the banking turmoil of the spring of 2023, the Banking Union has not achieved its objective of breaking the sovereign-bank nexus that threatens financial stability.

The persistence of the sovereign-bank loop is not the result of a dysfunction of the SSM or the SRB, but the consequence of fiscal slippages in some countries, exacerbated by the Covid-19 crisis (*i.e.*, the budgetary excesses encourage banks to contribute to the financing of these deficits).

It is also worth noting here that prudential regulations, in particular the Liquidity Covered Ratio (LCR)[25], encourage banks to buy sovereign securities on a massive scale, as they are considered more liquid. In addition, global and EU banking regulations treat sovereign debt as a risk-free investment for banks, allowing them to allocate no capital for such assets.

EU/EEA banks continue to increase their sovereign exposures

According to the EBA[26], the substantial increase in EU/EEA banks' debt securities holdings was mostly driven by sovereign exposures. EU/EEA banks exposures of around €3.4 tn towards sovereign counterparties increased in December 2023 by 8% compared with December 2022 (€3.1 tn). Almost half of these exposures were towards domestically domiciled counterparties, while 27% were towards other EU/EEA countries. Sovereign exposures towards non-EU/EEA domiciled counterparties were slightly above €810 bn, around €80 bn more than a year before.

EU/EEA banks' total exposure to sovereigns is more than twice their equity, while several banks have sovereign exposures that exceed several times their equity. As of December 2023, the reported sovereign exposure of EU/EEA banks was 203% of their CET1 equity. Banks in Central and Eastern as well as Southern Europe generally reported a higher ratio of sovereign exposures to capital.

24. See 2.2.
25. The LCR is a ratio that calculates the minimum amount of High- Quality Assets (HQLA) that financial institutions are required to hold in order to ensure their ongoing ability to meet short term obligations. The ne numerator of the LCR must be composed at least of 60% of Tier 1 assets (cash, central bank reserves, sovereign debts or other 0% weighted assets).
26. EBA – Risk assessment report – July 2024.

According to EBA statistics, the domestic sovereign exposure of EU/EEA banks in December 2023 stood at 6% relative to their total assets, and at 99% compared to their CET1 capital, which means that the risk concentrated on domestic sovereign is still looming.

These figures are 10% and 154% for Italy, 7% and 120% for France and 26% and 317% for Poland respectively.

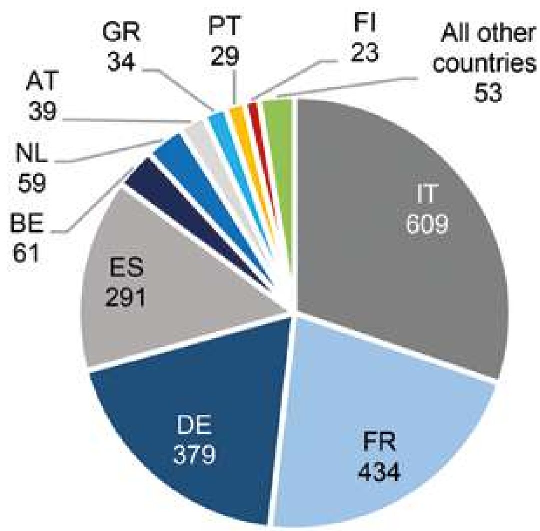
The evolution of sovereign exposure varies significantly among Member States

According to Deutsche Bank Research[27], "Aggregated Euro area banking sector figures mask significant national differences, though, within the monetary Union. Of particular importance are the five largest individual banking markets, which together account for 84% of total EMU bank assets: France, Germany, Italy, Spain, and the Netherlands. In absolute terms, Italian banks have invested the most in domestic sovereign debt, followed by France and Germany.

When considering the Eurozone, relative to total assets, Italian and Spanish banks remain the most exposed, while Dutch banks are the most restrained" (*see Chart 2*).

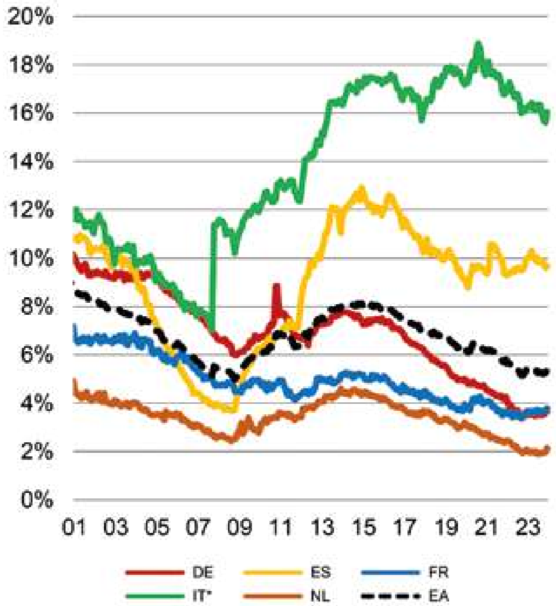
As the graph above shows, Italian banks' holdings of domestic bonds are almost twice as high as those of German banks in terms of value while, according to Eurostat data, the size of the Italian banking sector, in terms of assets held in 2020, is more than half that of the German banking sector (assets of €3,8 tn in Italy compared with 8,9 tn in Germany in 2020).

CHART 1.
EMU bank exposures to domestic sovereigns
(€ bn, December 2023)



Sources: ECB, Deutsche Bank Research

CHART 2.
Italian and Spanish banks remain the most exposed
(Domestic sovereign exposure in % of total assets, until December 2023)



** Surge in 2007 due to a statistical reclassification of loans*
Sources: ECB, Deutsche Bank Research

The home bias remains significantly high, especially in countries with a high level of public debt, such as France, Spain and Italy. On the contrary, countries with healthy fiscal situations tend to be below average; it is namely the case for Germany and the Netherlands. This home bias can find several explanations.

The main reason is that because highly indebted countries have a higher risk profile – This is illustrated by the ratings of Italian (BBB) and Spanish (A) debt, which differ from the AAA-rated German and Dutch debt (according to S&P), their bonds are riskier and therefore not bought by countries with a safer risk profile. For example, German banks will prefer German bonds to Italian bonds because they know that their own bonds are less risky than Italian bonds. Therefore, cross-border diversification by banks remains low, despite the same regulatory treatment for all Euro area sovereign debt[28].

Moreover, loans are also partly responsible for the home bias because bank loans. According to Deutsche Bank Research, "They are mostly taken out by lower levels of government which might explain why there are few cross-border loans. Also, there could be closer business ties between domestic banks and authorities. In addition, diversification has been particularly unattractive for banks in countries with higher sovereign yields, especially in the negative-rate environment."

27. Deutsche Bank Research, "European banks make some progress in diversifying their sovereign exposures", 26 March 2024.
28. Under current rules, there are no capital charges or concentration limits to mitigate sovereign risk on bank balance sheets, although such claims are in scope of the leverage ratio requirement.

Finally, it should be noted in this respect that, as a Eurofi note shows[29], the central bank-sovereign nexus has increased significantly from 2015 to 2022 because of Quantitative Easing (QE) policies. A genuine implementation of Quantitative Tightening (QT) by the ECB will mechanically reduce the central bank-sovereign nexus but should increase the sovereign-bank nexus, especially in highly indebted countries.

As long as all EU Member States do not comply with fiscal rules, the sovereign-bank loop is doomed to remain. Eradicating such a link requires that every Member States achieve fiscal consolidation. It is not the completion of the Banking Union that will resolve this issue, but sound budgetary policies.

2.2.3 The EU banking sector is fragmented along national lines

Despite the creation of the SSM and the SRM, the distinction between home and host authorities, coupled with a persistent 'national bias', still exists for banks operating across borders under the SSM, which contributes to weakening their competitiveness and hindering cross-border mergers.

There is no free flow of capital and liquidity within a banking group in EU countries. Ring-fencing refers to the regulatory and supervisory measures taken by host authorities to secure resources within their own jurisdictions. These measures apply to capital, including the output floor, liquidity, leverage ratio and MREL. In addition, banks must navigate a patchwork of national authorities with differing views on macroprudential rules and conduct. This, combined with tax differentiation, leads to fragmented banking markets.

Capital and liquidity Ratios

While recognized by the Capital Requirements Regulation (CRR), capital and liquidity waivers remain at the discretion of the national supervisors, who are reluctant to grant them[30]. Despite the progress made in terms of harmonization of banking law since the inception of the Banking Union in 2014, cross-border banking groups are unable to manage their capital and liquidity requirements on a consolidated basis. In practice, all capital and liquidity ratios (Liquidity Covered ratio, Net Stable Funding Ratio) are applied at both solo and (sub-) consolidated levels, notwithstanding the possibility of liquidity waivers allowed by the legislation (Article 8, CRR).

This situation will be further worsened with the application of the Output Floor (OF), which has been designed by the Basel Committee on Banking Supervision (BCBS) to set a floor in (consolidated) capital requirements calculated under internal models at 72.5% of those required under standardized approaches.

The transposition of this rule in Europe stipulates that this output floor will be calculated by default at the level of each subsidiary, while leaving open the possibility for a State (typically France or Germany) to authorize a calculation at the consolidated level of all the entities of the same group established on its own territory.

Likewise, the effective implementation of cross-border liquidity waivers, although prescribed by the European legislation, remains far too limited in practice.

The SSM has calculated that, without cross-border liquidity waivers, approximately €250 billion[31] of High-Quality Liquid Assets are prevented from moving freely within the Banking Union. This constraint significantly hampers the efficient allocation of liquidity across Member States and impacts the overall stability and flexibility of the European banking system.

Minimum Requirement for Own Funds and Eligible Liabilities (MREL)

The 'Daisy Chain' directive (2024) introduces significant changes to the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism Regulation (SRMR), particularly concerning the treatment of internal MREL within bank resolution groups.

The Daisy Chain amendments set out the concept and scope of liquidation entities and provides the conditions for the application of the consolidated treatment of 'internal MREL'. It includes targeted proportionality requirements to the treatment of 'internal MREL' in bank resolution groups.

Where an MREL instrument is issued by a subsidiary within a banking group and directly or indirectly subscribed by its parent group, it is referred to as 'internal MREL'. The intermediate subsidiary must deduct its holdings of internal MREL instruments in its own subsidiaries from its own MREL capacity to ensure the integrity and loss absorbency of the MREL instruments.

After analysis, the Commission found that the application of the deduction requirement on internal MREL could have a disproportionate detrimental impact for certain banking group structures, namely those operating under a parent holding company and certain operating company structures.

29. D. Cahen and A. Valroff, Banking fragmentation issues in the EU, Eurofi note, September 2023.
30. The CRR permits capital waivers for domestic subsidiaries only (Article 7).
31. Andrea Enria, "How can we make the most of an incomplete banking union?", Ljubljana Eurofi seminar, September 2021.

The new rules also give the resolution authorities the power of setting internal MREL on a sub- basis subject to certain conditions. Where the resolution authority requires an intermediate entity to apply such sub-consolidated treatment, it will not be obliged to deduct its individual holdings of internal MREL instruments in its own subsidiaries, thus logically preventing the detrimental effect identified by the Commission.

In addition, the new rules introduce a specific MREL treatment for 'liquidation entities'. Those are defined as entities within a banking group earmarked for winding-up in accordance with insolvency laws, which would, therefore, not be subject to resolution action (conversion or write-down of MREL instruments).

On this basis and as a rule, liquidation entities will not be obliged to comply with an MREL requirement, unless the resolution authority decides otherwise on a case-by-case basis for financial stability reasons. The own funds of liquidation entities without MREL requirement issued to the intermediate entities will not need to be deducted except when, in aggregate, they represent more than 7% of the own funds and eligible liabilities of the intermediate entity.

The objective is to prevent double-counting and ensure more accurate capital requirements at different levels of the banking group and to enhance the resolvability of banks by ensuring that sufficient resources are pre-positioned within entities that might face resolution.

However, this set of rules (deductions, option to set internal MREL on a sub-consolidated basis or to impose MREL higher than own funds for some liquidation entities) will lead to higher levels of internal MREL, in many cases without possibility to redeploy such means elsewhere in the Group, fueling further fragmentation and hindering free flow of funds within groups.

Leverage Ratio

In the EU, the leverage-based capital requirements are defined as a ratio relative to T1 capital. The stack consists of a minimum requirement of 3%, a potential Pillar 2 Requirement for the Leverage Ratio (P2R LR), an add-on for Global Systemically Important Institutions (LR G-SII buffer) calibrated to 50% of the G-SII buffer requirement in the solvency framework, as well as a Pillar 2 Guidance for the Leverage Ratio (P2G LR).

Macroprudential framework

The European macroprudential framework operates under a regime of minimum harmonization. Most macroprudential requirements are part of the Capital Requirements Directive (CRD), while the main macroprudential measures remain optional for Member States. The ECB's intervention is limited to EU-harmonized measures[32], while many macro-prudential powers reside at the national level.

Andrea Enria, highlighted this issue during a speech in Ljubljana. He noted, "The current framework for macroprudential policy is characterized by minimum harmonization, which allows for significant national discretion. This has led to a diverse and sometimes fragmented landscape of macroprudential measures within the Banking Union."

National authorities determine the levels of three capital buffers: the Countercyclical Capital Buffer (CCyB)[33], the Systemic Risk Buffer (SyRB)[34], and the Other Systemically Important Institutions (O-SII) buffer[35].

These three buffers vary widely across the EU, creating an uneven macroprudential landscape. This could be justified as financial cycles differ across EA countries, but the problem is the way these buffers are calibrated and activated which may create inconsistencies.

For instance, as of July 2024, the CCyB, which is designed to counter procyclicality in the financial system, stands at 1% or less in Italy, Spain, France and Germany, whereas it is equal to or greater than 2% in the Netherlands, Sweden, Denmark, Iceland, and Norway.

Similarly, the SyRB varies widely. It ranges from 0%

32. While the macroprudential framework is not centralised by design, the ECB has contributed to the harmonised use of such measures by national authorities, for instance through its floor methodology for the setting of O-SII buffers.
33. The Countercyclical Capital Buffer (CCyB) is a capital buffer which is designed to counter procyclicality in the financial system. When cyclical systemic risk is judged to be increasing, institutions should accumulate capital to create buffers that strengthen the resilience of the banking sector during periods of stress when losses materialise. This will help maintain the supply of credit to the economy and dampen the downswing of the financial cycle. The CCyB can also help dampen excessive credit growth during the upswing of the financial cycle. The CCyB is set for each Member State. The CCyB applicable to each bank is calculated as the sum of each credit exposure weighted by the CCyB rate defined by the Member State where the exposures are located. It generally ranges from 0% to 2.5% of TREA but can exceed 2.5% in some circumstances.
34. The Systemic Risk Buffer (SyRB) addresses systemic risks not covered by the CRR, CCyB, or G-SII/O-SII buffers. The level of the SyRB's can vary across institutions and exposures. The level of the SyRB may vary across institutions or sets of institutions as well as across subsets of exposures. It is cumulative to the O-SII and G-SII buffers. If the SyRB is above 3% (up to 5%) an opinion from the Commission needs to be considered and if the combined O-SII (or G-SII) and SyRB is above 5% then the European Commission needs to provide an authorisation. Since the advent of CRR2/ CRD5, the SyRB can be implemented on a sectoral basis, such as for example targeting only exposures secured by residential real estate in a country.
35. The Other Systemically Important Institutions (O-SII) buffer is assigned to a specific subset of banks that is deemed to be of systemic importance to a specific jurisdiction. The framework supplements the buffers applied to Global Systemically Important Banks (G-SIBs). For an individual bank that is also a G-SII, the level of the O-SII buffer may exceed the level of the G-SII buffer. National authorities identify O-SIIs in their jurisdiction and determine the level of the buffer. The maximum level is 3%, but can be set higher if an NCA receives authorisation from the European Commission.

in France, Spain and Italy, to 3% for all exposures in Sweden and domestic exposure in Iceland, and to 9% for retail exposures secured by residential property in Belgium as of May 2023. Such discrepancies can lead to ring-fencing and undermine the stability and coherence of the European financial system.

Lastly, whilst the EBA has adopted a methodology to identify which banks should be classified as O-SIIs based on their local systemic importance[36], there are wide divergences between the O-SII buffer levels of banks with similar scores in different countries. This is because national authorities have wide discretion deciding on the level of the requirement, and there is no binding link between the level of the buffer and the O-SII score.

According to industry players, no authority currently reviews the aggregate capital requirements for a bank against its actual risk profile, leading to excessive capital requirements for even low-risk banks. While public decision makers recognize the complexity of the institutional framework involving European and national micro and macroprudential authorities, they underline that ECB has a mandate for both micro- and macroprudential supervision and looks holistically at the capital requirements of its supervised banks. In addition, they often state that they have no evidence that capital requirements are excessive in the EU.

Intra-group Dividend Distribution Approval

Several national supervisors tend to submit dividend distribution from subsidiaries to parent entities within cross-border banking groups to their approval, even if these distributions are organized at group level and thus should be supervised by the group supervisor (Joint Supervisory Team, JST) in line with the different macroprudential measures taken, as well as with views to make the group more resilient and agile at the consolidated level.

Pillar 2 Requirements (P2R)

Eventually, subsidiaries of European transnational groups can be required to have increased Pillar 2 Requirements (P2R). Pillar 2 Requirement (P2R) is a mandatory capital requirement that can be set by competent authorities on top of the Pilar1 minimum capital requirement, and below the CBR. P2R serves the purpose of capturing risks, besides the risk of excessive leverage, that are insufficiently or not captured in the Pillar 1 capital requirements. Total P2R has been subject to public disclosure since CRR2/ CRD5.

According to industry players, while the Single Supervisory Mechanism (SSM) is responsible for setting P2R levels, including Pillar 2 Guidance (P2G) for subsidiaries, host countries can – most of the time successfully – submit their proposals to the SSM to increase such levels in order to shield their economy, further contributing to inconsistencies across the Union.

Public decision-makers respond to this argument by pointing out that SREP decisions, both at consolidated level and at subsidiary level (for domestic and non-domestic subsidiaries alike), are taken by the Supervisory Board, based on proposals by the relevant JSTs which include both ECB and NCA staff. There are no separate NCA proposals for individual subsidiaries.

2.2.4 Root causes of ring-fencing practices have been identified but continue to exist

First, ring-fencing is deeply rooted in a general lack of trust, mainly due to the economic and fiscal divergences between the largest Member States described above.

Second, national supervisors still fear that if a pan-European banking group were to fail, capital and liquidity might be trapped in other individual Member States or might be inadequately allocated from their point of view. This perception is particularly acute in countries that rely heavily on banks belonging to groups headquartered in other Member States for the financing of their economies.

In addition, the bad memories of the EU sovereign debt crisis (2011-2012) in some Member States, such as Luxembourg or Belgium, where some foreign banks took over leading national banks, are a fundamental root for ring-fencing measures.

Developing a pan-European financing offer in these host countries to develop investment and the competitiveness of their economies is not an argument shared by these countries, for two reasons:

- Local banks respond well to local financing needs and public demands (national debt financing).
- In these host countries, there are few large companies – they have no financing difficulties – and a very large majority of very small companies that are satisfied with local financing.

In these countries, therefore, there is no apparent need for additional financing. On the contrary, these host countries are afraid of being enslaved and losing control over the financing of their economies by opening up to the offers of non-local banks.

36. https://www.eba.europa.eu/documents/10180/930752/964fa8c7-6f7c-431a-8c34-82d42d112d91/EBA-GL-2014-10%20(Guidelines%20on%20O-SIIs%20Assessment).pdf

2.2.5 The market for retail banking services progresses too slowly: the lack of uniform standards, products and protection rules at the EU level is a barrier to an integrated European banking market which discourages cross-border banking

Despite the EU's single rulebook and the ECB's clarification of the supervisory approach to consolidation, a number of traditional factors such as legal systems, languages and customs remain and fragment banking markets.

In addition, differences in taxation, borrower protection or anti-money laundering rules at Member State level create bank-specific entry and adaptation costs that discourage cross-border banking.
For example, there is no single EU-wide credit registry, as there is in the United States. Moreover, the Rome I Convention stipulates that the consumer protection rules of the consumer's country must be applied. As these rules vary widely from country to country, cross-border retail banking is not possible, except for very simple products such as payments.

Finally, there is a significant diversity of banking products, leading to fragmentation of the EU banking landscape. For example, banks in countries such as Spain, Italy and Germany offer variable interest rates and are therefore directly affected by the ECB's interest rate hikes, while French banks mostly offer fixed interest rates.

2.2.6 The Banking Union is hampered by the lack of cooperation among Member States

Overall, progress on the Banking Union is hampered by the lack of cooperation. One example of that is the outcome of the proposals of the Eurogroup of December 2021 in order to complete the Banking Union. The Eurogroup proposed 4 areas to explore:

- To strengthen the framework for the management of failing banks in the EU,
- To create a more robust common protection scheme for depositors,
- To facilitate a more integrated single banking market for banking service,
- To encourage greater diversification of banks' sovereign bond holding in the EU.

After six months of discussions, the Eurogroup decided in June 2022 to only focus on strengthening the Crisis Management and Deposit Insurance (CMDI) framework. In the meantime, no further concrete steps are contemplated to improve the single banking market or to tackle the sovereign-bank nexus.

2.2.7 Banking integration in Europe remains limited and the EU lacks private risk sharing mechanisms

Private risk sharing mechanisms work through the credit channel (cross-border lending and borrowing) and the capital market channel (diversified private investment portfolios across Euro area countries). The more risk is shared through banks and markets, the fewer fiscal mechanisms are needed on the public side to address failures. Banking integration through private risk sharing mechanisms is essential to strengthen the EMU but the EU currently lacks such mechanisms.

CHART 3.
10-year sovereign bond yields (%) in the United States and Germany

Source: OECD
Note: Note: the German government bond is considered as a benchmark for a EU safe asset and thus can be compared to the US government bond

As A. Enria already stated in 2018[37], since 2007 in the Euro area, the credit channel has acted more as a shock amplifier than a shock absorber.

Cross-border assets held by banks in the Euro area have hardly changed since the launch of the Banking Union project. Furthermore, the cross-border integration of the sector in the retail area has progressed at a snail's pace in recent years, including after the establishment of the single European banking supervision in 2014. Indeed, the share of cross-border loans to households and cross-border deposits from households in the Euro area remain negligible, a little above 1%.

There is relatively little cross-border retail banking activity, with slow movement towards further integration. Cross-border merger and acquisition activity in banking has been weak. Most lending takes place within national markets. According to the SSM, cross-border lending within the Euro area accounts for 7% of total retail lending, while lending to borrowers outside of the Euro area accounts for 11%[38].

2.3 Fragmentation undermines the profitability and competitiveness of the EU banking sector and as a result, EU banks lag behind their international competitors

Fragmentation has left the European banking sector struggling with overcapacity, as cross-border merger and acquisition (M&A) activity among banks in Europe has declined dramatically since 2000.

As a result, the EU banking sector is overcrowded, putting pressure on banks' margins. Overcapacity is also associated with cost inefficiencies, which are two of the factors behind the structurally low profitability of EU banks. This is a real concern, given that around 70% of economic activity in the EU is financed by bank loans: the profitability of EU banks is all the more important as it can pose a risk to financial stability and the strategic autonomy of the EU if it remains weak.

Moreover, the ECB's Financial Stability Review of November 2023 highlights that the low valuations of bank shares – driven by political and regulatory uncertainty in addition to economic expectations – can also pose a risk to financial stability. In contrast, the profitability of American banks is fostered by several elements. First, growth in the US is stronger than in the EU: Since 1995, real US gross domestic product has increased more than 90 per cent, against the Euro area's more than 50 per cent.

Interest rates are also structurally higher in the US than in the EU as evidenced by Chart 3. The prolonged period of low interest rates has had a negative impact on the profitability of EU banks up to 2022: it has compressed net interest margins – putting them at a disadvantage compared to their US counterparts. In fact, net interest income represented 50% of EU banks' net operating income, and more than 50% of their profit and loss (P&L) was derived from lending and borrowing activities.

Furthermore, U.S. banks benefit from a consolidated single market for banking services, which means there is less competition than in Europe and U.S. banks therefore have greater pricing power, which increases their revenues. Unlike the EU, which has 27 Member States, the US is a single country with a deep and liquid Treasury market, a consolidated post-trade infrastructure (DTCC) and a single set of securities, corporate and insolvency laws.

In addition, the US has a true securitization market[39] with government-sponsored enterprises (GSEs) such as Freddie Mac and Fanny Mae, and benefits from a strong equity financing ecosystem, including long-term savings products (*e.g.*, 401K). Finally, US retail savers tend to be more risk-averse than European savers, possibly due to a more developed financial market that encourages risk-taking behavior.

The overall profitability of EU banks has improved, except during the Covid-19 pandemic, but still lags behind that of US banks.

At the beginning of 2008, the market capitalization of the top Eurozone bank was very similar to that of the top US bank. At the beginning of this year, JPMorgan Chase was worth more than the top 10 Eurozone banks combined. The profitability of the European banking sector has eroded to a level much lower than that of other international players. Since 2008, EU banks have been weakened by weak growth, prolonged negative interest rates, market fragmentation and lack of scale.

European banks are losing ground to competitors, especially US banks, which have a market share four times higher than EU banks. EU banks also have a lower CIB market share than UK and Swiss banks. Thus, European banks remain smaller and less competitive on a global scale than their US counterparts. In 2023, the domestic market share of the top five US banks was 42%, while the top five European banks had only about 28%.

37. A. Enria, Fragmentation in banking markets: crisis legacy and the challenge of Brexit, EBA, 17 September 2018.
38. Speech by Claudia Buch, Chair of the Supervisory Board of the ECB, April 2024.
39. As V. Grilli notes in his interview for the *Eurofi Magazine* (September 2024), "securitization represents 12.5% of GDP in the US (excluding GSEs) and 12% in the UK *vs*. 3% in the EU-27. We can therefore see the potential that securitization has in the EU to advance capital markets union and green finance, although it does not mean that the same levels should be replicated in the EU."

Moreover, the most active European bank in investment banking ranks only ninth globally, well behind the top five, all of which are American. As a result of this size disparity, European banks will capture only 29% of the investment banking fees generated by the top 10 players in Europe in 2023, down from 34% a year earlier[40].

3. Ways forward have been identified but are hampered by the prevalence of national interests over European interests

During the Eurofi Financial Forum of September 2023, officials and industrial representatives have emphasized the need for a mindset shift regarding the completion of the Banking Union and the integration of banking markets. Several ways forward have been identified, but their implementation requires significant will and effort. The first section outlines the main advantages and drawbacks of branchification as well as the reason why banks are reluctant to branchify retail activities. The second section explains that credible support provided by parent companies to Euro area subsidiaries based on European law and European authorities is another way forward to solve the home-host dilemma.

3.1 Branchification offers real benefits for wholesale banking, but branchifying retail activities is impeded by Member States

Branchification is the process of merging all existing subsidiaries into the parent company and only operating through the branches of a single, unified legal entity.

Benefits from branchification include "clearer governance and accountabilities, simpler and more effective balance sheet and liquidity management, avoidance of many duplicated requirements on subsidiaries (capital, liquidity, MREL...), ability to cater for large financing needs (scale benefits from a large balance sheet), one prudential supervisor, improved resolvability, and reduced reporting burden", explains J. Vesala[41], Head of Group Credit at Nordea.

However, many obstacles remain and prevent banks from undergoing this transformation. Indeed, branchification is very difficult to implement in banks that offer retail services as host jurisdictions are often opposed to such a legal structure. It is extremely burdensome and complicated for banks to do business in a country on a daily basis against the directives of the country's government, so it is easier for banks to keep their subsidiaries and avoid possible retaliation. Furthermore, even with a branch structure, national conduct rules need to be followed, and complex and varying macro-prudential rules create unnecessary uncertainty that discourages banks from branchifying.

Additionally, technical obstacles to branchification exist and include legal hurdles and a pressure from host jurisdictions. Though Nordea chose this structure, J. Vesala acknowledges that "the process of branchification remains complex and cumbersome, even in the Nordic region. The challenges include transition uncertainties and the operational burden taking the focus away from regular banking business". For instance, banks aiming to convert a subsidiary into a branch may face problems for the treatment of the contributions to the local Deposit Guarantee Schemes (DGSs). There is no, or at best very limited "portability" of contributions between DGSs. This may represent a technical roadblock to convert a subsidiary in a branch, but it is a technical issue that could be addressed.

3.2 Credible support provided by parent companies to Euro area subsidiaries based on European law and enforced by European authorities is another way forward to solve the home-host dilemma

Authorities in the host Member States may be concerned that, in the event of a crisis, the parent entity might refuse to support local subsidiaries. To address these concerns, European transnational banking groups that wish to operate in an integrated way could decide to commit to providing credible guarantees to each subsidiary located in the Euro area in case of difficulty and before a possible resolution situation ("the outright group support").

This "outright group support" would consist of mobilizing the own funds of the Group to support any difficulties of a subsidiary located in the Euro area. Since the level of own funds and the creation of MRELs have considerably increased the solvency of EU banking groups, they should be able to face up to any difficulty of their subsidiary located in the Euro area.

This group support should be based on EU law and enforced by EU authorities. It could be enshrined in

40. See F. Villeroy de Galhau, "Ten years of SSM: great achievements, and new journeys to complete", ACPR, June 2024.
41. J. Vesala, "Why there is little cross-border branching in the EU", Views, the *Eurofi Magazine*, September 2023.

groups' recovery plans and approved by the supervisory authority – the ECB – which would be neutral, pursuing neither a home nor a host agenda. This would also ensure that the parent company has the necessary own funds to face the possible needs of their subsidiaries.

This commitment is the key condition for these banking groups to define prudential requirements at the consolidated level.

Some believe that a European fund financed by Member States should even be created to be deployed to assist a host country in difficulty due to the failure of a subsidiary of a pan European banking group and thus provide a complete insurance system.

The SSM recognized that such a solution already proposed in a 2018 Eurofi paper, would, at least foster a more positive attitude from national authorities, creating the conditions for legislative change to happen sooner. Yet, due to the lack of confidence among Member States, it is not possible to implement it yet.

4. What to do?

70% of the financing of the European economy is provided by banks, unlike the United States, which finances around 2/3 of its economic development through the markets. The absence of a genuine banking union in such a context has very negative and worrying consequences for the financing of the European economy, the global competitiveness of European banks, the momentum in favour of CMU, and Europe's financial sovereignty: competition for savings remains largely national, the opportunities to deploy capital where it can create the most growth are limited, and the lack of scale means that European banks cannot compete in all aspects of global finance.

However, economic and fiscal fragmentation in Europe is an obstacle to the development of common projects such as the Banking Union because it creates a climate of mistrust between Member States (between indebted and less indebted countries, in particular). Fragmentation also constitutes a risk for the future of the banking sector because it perpetuates the sovereign doom loop in countries with high budget deficits, making the banking sector more fragile in these Member States, less profitable and therefore more vulnerable to shocks.

For several years, the Banking Union has been characterized by the absence of solutions to the 'home-host' dilemma and is currently at an impasse. Paradoxically, all stakeholders seem to be satisfied with the situation: some host countries benefit from the capital of the subsidiaries of large groups to help finance their public debt and national fiscal needs, favoring their interests to the detriment of European ones.

In addition, European G-SIBs are reluctant to grow too much in order not to cross the threshold that requires larger buckets and are satisfied with not having to pay additional financial contributions that would further reduce their profitability (*e.g.* for EDIS).

The projects of making the Banking Union a single jurisdiction and a single European banking license remain out of reach today, especially given the strong economic divergences between major countries and the rise of nationalism in many Member States.

According to many banking players, there is a misunderstanding between them and public decision-makers about the ambitions of the Banking Union. For public authorities, the Banking Union is a temple with three pillars: SSM, SRM and EDIS. Their objective is to put in place the third pillar, which they believe would complete the Banking Union.

For these industry players, this is not the case at all. SSM, SRM and EDIS are administrative items that do not in themselves ensure the emergence of a European banking market with free movement of capital and liquidity within European banking groups. In fact, every year they see the emergence of additional obstacles, such as the principle of applying the output floor at solo level in the banking package, with only the possibility of a derogation at the national level. In reality, they explain that we are moving further away from the 'Banking Union' every year, with the 'improvements' in the administrative columns in no way compensating for the worsening economic and financial fragmentation in Europe.

In the short term, only the creation of a European securitisation market seems feasible and useful for the competitiveness of banks and contributing to the revival of the CMU.

We do not live in an ideal European community: national interests prevail over European goals and benefits. In fact, the proposed solutions are not supported by European political leaders. Moreover, the strengthening and rise of extremism and anti-European nationalism exacerbate this tendency to refuse to move forward in European construction and to leave European projects in a kind of paralysis.

This is not doomed to be the case forever, but without a strong awareness and willingness to act together as a European community, nothing will change, and the EU will remain in the deadlock it has been in for years. This passivity and inaction are accompanied by the return of nationalism, which takes precedence over the common European interest.

For real integration to take place, fiscal discipline must first be restored to the public finances of countries with excessive debt (France, Italy, Belgium...). In the current tense global context, fiscally virtuous countries are facing a series of difficulties and will not take the additional risk of paying for the budgetary slippage of these countries.

Once all Member States have made sustainable adjustments, it will be easier to move towards the Banking Union and the CMU. Only with strong political will and cooperative determination can the EU overcome the current impasse and realize the full potential of a full Banking Union.

Baron Louis, Minister of Finance in France said to his government around 1820: "Faites-moi de la bonne politique et je vous ferai de la bonne finance", which can be translated as "Make good policies, and I will bring you good finance."

We could say under his tutelage and inspiration: "Do the structural reforms, eliminate excessive disequilibria, converge our economies symmetrically, show a little more kindness on risk sharing and I will bring you a Banking Union". In other words, it is not only the Union that makes the Force, but also the Force that makes the Union: only strong Member States – which have corrected their fiscal imbalances and are effectively converging economically among themselves – will make Europe stronger.