Banking fragmentation issues in the EU

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Introduction

A paradox lay at the heart of the Treaty of Maastricht: while a single monetary policy was implemented on 4 January 1999, the responsibility for financial supervision remained national. it is strange that until 2014 *i.e.*, during 15 years following the creation of the euro, nobody has seemed to be concerned by banking union issues.

In the wake of the EU sovereign debt crisis (2011-2012), Member States of the EU found a consensus to respond to such a paradox.

While we have come a long way since the establishment of the Single Supervisory Mechanism (SSM), the banking union is far from complete. An efficient banking union would break the sovereign-bank vicious circle, foster a more effective allocation of resources across the Eurozone (*e.g.*, companies would be able to tap wider and cheaper sources of funding in all parts of the euro area), and help to achieve a better diversification of risks thus contributing to private risk sharing within the Union.

Despite the challenges faced in recent years, many European countries' banking systems remain overcrowded. Bank profitability continues to be hampered in Europe by overcapacity in several Member States and a highly competitive environment, with revenues under pressure not just from their peers but also from new entrants from outside the sector, such as fintech companies. In addition, international or cross-border consolidation processes have been few and far between, and this pattern has not changed since the launch of banking union. The limited strength of private risk-sharing channels in the euro area reflects both the underdevelopment of capital markets and a highly segmented banking system at the national level. There is little progress in cross-border lending, especially in the retail markets, or in other words, in lending to households and non-financial companies. Expanding this cross-border activity would be important for the sound working of the euro area.

Bank consolidation through mergers and acquisitions is one way of tackling structural problems, by helping to unlock economies of scale and diversify revenues. Little progress has been made on this front over the past few years within the EU, with only a small number of – mainly domestic – deals taking place. However, digitalization has started to create an upswing in consolidation: banks need to aggregate or enter partnership agreements with fintech start-ups, technology giants or smaller financial intermediaries in order to get the scale, expertise and resources needed, and stay competitive.

This paper shows how the banking union is failing to provide banking integration within the EU. Then it describes the resulting lack of profitability and competitiveness of EU banks compared to international peers. Finally, it assesses the possible solutions to move towards greater European banking consolidation.

1. The banking union is failing to provide the expected degree of financial integration

Despite the recent crises – namely the Covid-19 pandemic, the war in Ukraine and the turmoil caused by the failure of SVB and Credit Suisse – the European banking sector has shown remarkable resilience. This sheds light on the effectiveness of the enhanced regulatory and supervisory reforms conducted over the past 10 years. Yet, the EU should not be complacent about this resilience because a lot still has to be done in order to reduce banking fragmentation. Indeed, the banking union remains segmented along national lines because of ring-fencing practices implemented by Member States, the distrust among Member States that is enhanced by their divergent economic situations and the absence of fully integrated single market (*e.g.*, diversity of retail products and levels of consumer protection…), and this results in the continuation of the sovereign-bank loop and the Central Bank-sovereign nexus.

1.1 Ring-fencing practices continue to fragment the EU banking sector along national lines

The creation of the Single Supervisory Mechanism (SSM) and the Single Resolution Board (SRB) have not entirely had the expected impact on the banking integration in Europe. Domestic ring-fencing, and heterogeneities of the national retail markets due to the absence of harmonized legal, fiscal and consumer protection rules explain this fragmentation.

1.1.1 A low level of cross-border deposits and loans for a banking union

The cross-border integration of the sector 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%. Direct cross-border loans to non-financial firms reached 10% in May 2023, but this figure has evolved extremely slowly since the creation of the banking union (*see Chart 1*).

During the Eurofi Seminar of 2021, Andrea Enria[1] highlighted two additional indicators to illustrate the lack of integration: the total EU cross-border assets (branches and subsidiaries) in the euro area and the domestic and non-domestic claims in the euro area (*see Charts 2 and 3*).

Chart 2 highlights that "foreign" assets in the banks of the euro area have hardly changed since the creation of the banking union, suggesting that the integration of the banking sector in the area is still an "elusive target". In fact, the measures adopted by national governments in response to the Great Financial Crisis (GFC) led to the repatriation of many assets that were previously held in subsidiaries of cross-border groups located outside their home countries. The launch of the SSM has not reversed this trend. Overall, subsidiaries currently account for around two thirds of EU foreign assets in the euro area, while branches make up the remaining third. The total amount remains well below the early 2011 level.

Furthermore, no significant change in trend is to be noticed regarding the split between foreign assets and domestic assets held by euro area banks since the establishment of the European banking supervision (*see Chart 3*).

1.1.2 Subsidiaries of cross-border groups operating in the banking union are mainly governed by national rules

Ring-fencing is when host authorities take regulatory and supervisory action in order to secure resources within their own jurisdictions. There are no host supervisors anymore in the banking union, but the distinction between home and host authorities and the "national bias" still exist for banks operating across borders in the banking union under the remit of the SSM.

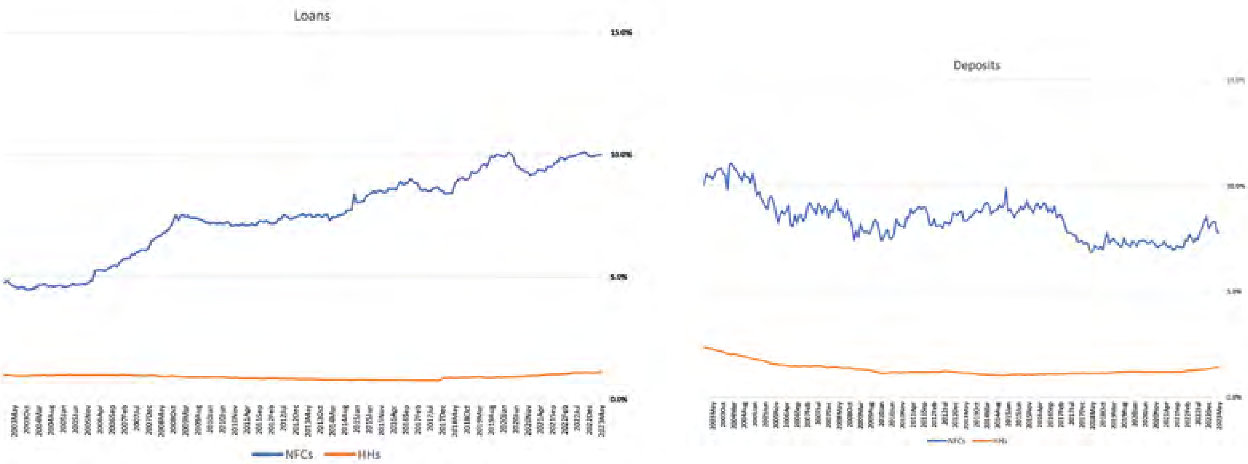
Indeed, national regulators still fear that capital and liquidity could be trapped in individual Member States or inadequately allocated from their own viewpoint if a pan-European banking group fails. This perception is particularly acute in countries that are strongly dependent on banks part of groups headquartered in other countries for the financing of their economies.

Ring-fencing policies are applied to capital, liquidity and MREL liabilities

The obstacles to the integrated management of bank capital and liquidity within cross-border groups operating in the banking union remain persistent and fragment banking markets. While recognized in 2013 by the fourth Capital Requirements Directive (CRD4), capital and liquidity waivers[2] remain at the discretion of the national supervisors, which are most often reluctant to use them. Consequently,

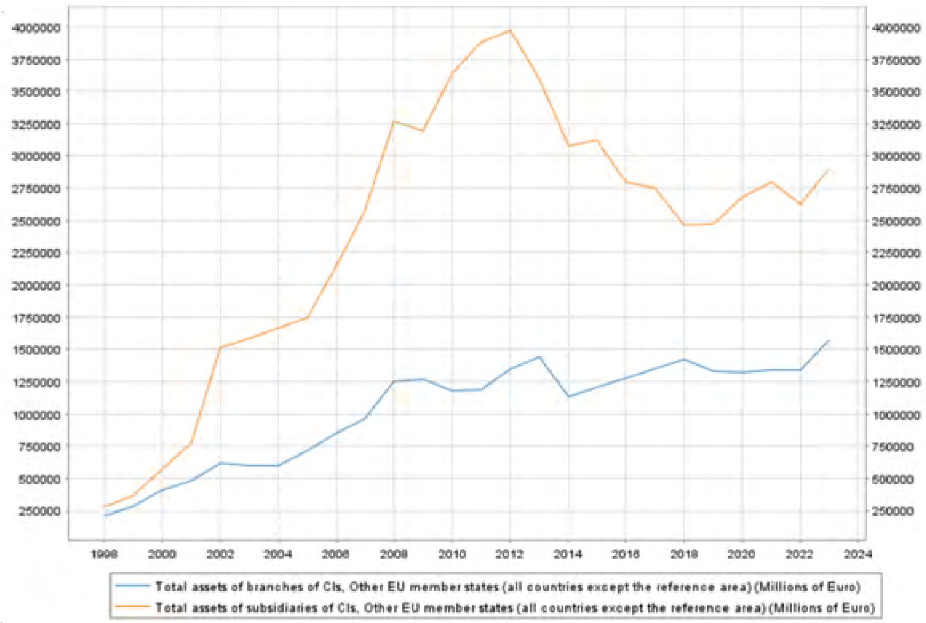
1. A. Enria, "How can we make the most of an incomplete banking union?", Ljubljana Eurofi seminar, September 2021.
2. The legislative framework does allow cross-border waivers of individual liquidity requirements, creating cross-border liquidity sub-groups. But some Member States, exercising an option that will remain in the legislation until 2028, have imposed limits on intragroup exemptions from the large exposure requirements which cannot be waived, cross-border, at the solo level. This restricts banks' freedom to move liquidity within their groups.

CHART 1.
Share of cross-border loans and deposits in the euro area for non-financial corporations (NFCs) and households (HHs)



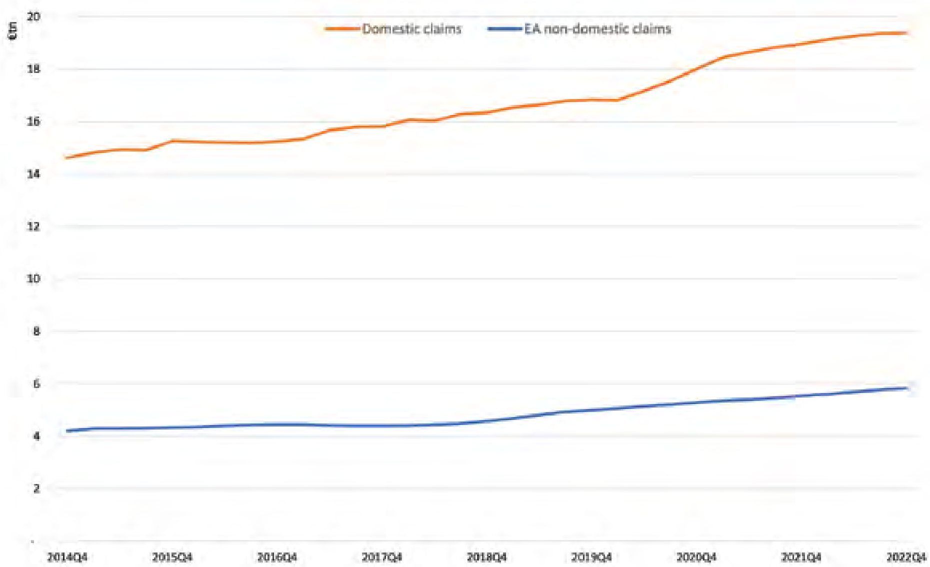
Source: ECB BSI statistics

CHART 2.
Total EU cross-border assets in the euro area



Source: ECB's Statistical Data Warehouse

CHART 3.
Domestic and non-domestic claims in the euro area



Source: Consolidated Banking Statistics and ECB calculations 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 often unable to manage their capital and liquidity on a consolidated basis. In practice, all capital and liquidity ratios are applied at both solo and (sub-) consolidated levels, notwithstanding the possibility of waivers allowed by the legislation.

Calculations by the ECB Banking Supervision show that, in the absence of cross-border liquidity waivers – as it is currently the case – the combination of the European and national provisions prevents around EUR 250 bn of High-Quality Liquid Assets from moving freely within the banking union[3].

One typical example in this respect is the application of the Output Floor (OF)[4], a central element in the Basel 3.1 standards, which remains at the discretion of national supervisors. The output floor has been designed by the Basel Committee on Banking Supervision (BCBS) to set a floor in capital requirements calculated under internal models at 72.5% of those required under standardized approaches for calculating capital requirements for all Pillar 1 risks.

This measure has been introduced to prevent Risk Weighted Assets (RWA) falling below what BCBS considers, rightfully or not, an inappropriately low level. Yet, the output floor is decided by national governments and is supposed to be calculated entity by entity. When national supervisors impose OF at sub-consolidated level, they impose that groups preposition sometimes very significant means at the level of local entities that do not specifically need them, encompassing all the sub-group including non-regulated activities. Those means often remains stuck in those entities and cannot easily be re-deployed within the rest of the group where they could be necessary[5].

Internal MREL and Daisy Chain

The “Daisy Chain” proposal has been adopted and imposes the deduction of own funds held by intermediate entities in their subsidiaries subject to internal MREL requirements instead of risk weighting them as it is currently done. This will lead to an increase of the level of internal MREL, and potentially also of own funds, required for these intermediate entities. As a result, and oddly enough, for intermediate entities, it will be less onerous to hold a participation in a foreign bank outside the EU for instance.

In addition, internal MREL will now be required for all institutions (*i.e.*, credit institutions and investment firms) and financial holding companies with a balance sheet exceeding EUR 5 bn, irrespectively to the size of the group.

All in all, ever more funds have to be pre-positioned at subsidiaries and thus are not available for re-allocation within groups if and when necessary. This could even get worse as the Commission proposal on Daisy Chain issued mid-April 2023 with the CMDI review package would allow resolution authorities to impose internal MREL on a sub-consolidated basis for intermediate entities. In some cases, this could very significantly increase the level of locally pre-positioned means that cannot re-deployed within groups.

Several host authorities tend to submit any dividend distribution to their approval

Several Member States 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 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.

Increased Pillar 2 Requirements (P2R) for subsidiaries of European transnational banking groups

P2R is a legally binding bank-specific capital requirement which applies in addition to the minimum capital requirement (known as Pillar 1) where where the latter underestimates or does not cover certain risks. The numerous instances where different P2R are applied by host supervisors to the same European banking group also illustrate the fragmentation of the EU banking union and the lack of harmonization within it. Indeed, even if the SSM is officially in charge of determining the level of P2R, including management buffers and Pillar 2 Guidance for subsidiaries, host countries can – most of the time successfully – submit their proposals to the SSM to increase such levels in order to protect their economy.

The same trend can also be observed on the resolution side in the SRM with internal MREL requirements.

1.1.3 The root causes of ring-fencing practices

The persistence of domestic ring-fencing practices in the Eurozone, despite a common supervision, mainly

3. Op. Cit. A. Enria.
4. The Output Floor, one of the central elements of the Basel III reform, sets a lower limit (“floor”) on the capital requirements (“output”) that banks calculate when using their internal models. The main aim is to address model risk, in particular the risk that a bank’s internal model incorrectly estimates the bank’s capital requirements.
5. The controversies initiated in July 2023 by a group of host countries around the final trilogue of the Basel III-package regarding the possibility to calculate the OF at the consolidated level in 2028 showed the fragility of the dead-locked discussion around capital waivers.

results from the solo approach of the EU banking regulatory framework and the existence of options and national discretions within the single rulebook.

1. **EU legislative framework does not recognize transnational banking groups at the consolidated level but only as a sum of separate subsidiaries and thereby maintain the "solo approach"**

Transnational banking groups of the euro area are not considered as unique entities from an operational, regulatory and supervisory point of view, but rather as a sum of separate subsidiaries. Subsequently, each subsidiary has to meet the liquidity, capital, MREL and output floor requirements on their own, leading the sum of the requirements of each subsidiary to be higher than what it would have been at the consolidated level.

This is called the "solo approach" and enables national authorities to contain the activity of their banking sector on their territory, with the idea that local resources are meant to finance locally booked business and to ensure national financial stability, and not flee elsewhere.

2. **Excessive flexibility in the EU macroprudential framework encourages ring fencing measures**

The legal framework for macroprudential tools grant flexibility to national designated authorities. The ECB can only intervene in the case of EU harmonized measures but many national macroprudential power are explicitly or *de facto* left at national level. Macroprudential decisions such as the level of certain capital buffers are still decided by national authorities. For instance, the level of countercyclical buffer, which is designed to counter procyclicality in the financial system, is as of July 2023 below 1% in France, Germany, the Netherlands, Italy, Spain whereas it is above 2% in Sweden, Denmark, Iceland, Czech Republic and Norway[6].

Similarly, the systemic risk buffer, which aims to address systemic risks that are not covered by the Capital Requirements Regulation or by the countercyclical buffer, can be at the discretion of the Member States, sectoral or general and varies from 0% in countries like France, Spain and Italy, to 3% for all exposures in Sweden and domestic exposure in Iceland, to 9% in retail exposures secured by residential property in Belgium as of May 2023[7]. This leads to discrepancies in the macroprudential requirements from one Member State to another, without necessarily having an adequate macroeconomic context to justify such differences.

3. **Host countries concerns are often dismissed, leading them to ring-fence in order to protect themselves**

Despite the implementation of the SSM and the SRM, national regulators still fear that capital and liquidity remain trapped in individual Member States or allocated in an unequitable way if a pan-European banking group fails. This is particularly the case for smaller members whose banking sector is mainly in the hands of foreign groups and would suffer dramatic consequences if a group failed and closed its subsidiary on their territory.

During several Eurofi sessions[8], experts and officials have lamented that the governance of the banking union does not sufficiently take into account the concerns of host countries regarding burden-sharing issues and the way cross-border banking groups' resolution may be handled in the EU. Host countries can indeed be particularly vulnerable to the current functioning of the resolution framework: when their banking system is mainly in the hands of groups, the possible failure of such groups or their local subsidiary could have a tremendous impact on their depositors and their economies, hence their tendency to ring fence.

Such concerns also shed light on the prominent role of the home authority in case of a resolution and on the absence of a single European authority entrusted with full powers to deal with pan-European banking groups. Moreover, this issue highlights the lack of trust between Member States and in the European authorities. This is one of the most damaging legacies of the GFC and the EU sovereign debt crisis. In an effective banking union, there should no longer be any distinction between home and host supervisors for banks operating across borders.

1.2 The lack of economic convergence at the EU level fosters distrust among Member States and hurdles the further integration of the EU banking market

1.2.1 The economic disparities between EU Member States partly explain the lack of progress towards a genuine banking union

The Eurofi Macroeconomic Scoreboard demonstrates that the Covid-19 pandemic and the war in Ukraine have exacerbated existing fiscal heterogeneities across EU Member States.

The intensity of fiscal and economic divergences between EU countries makes it more difficult to define in Europe a common interest, encourages a

6. ESRB, https://www.esrb.europa.eu/national_policy/ccb/html/index.en.html
7. ESRB, https://www.esrb.europa.eu/national_policy/systemic/html/index.en.html
8. Eurofi Seminar, Sessions from III. Banking and insurance policy priorities, p37-63, Paris, February 2022.

TABLE 1.
Public expenditure, current account balance, budgetary deficit/surplus and government debt, as % of GDP, 2019-2022

	2019			
	Public expenditure	Current Account Balance	Budgetary deficit/surplus	Government debt
Germany	46,9%	7,6%	1,5%	59,6%
The Netherlands	42,1%	6,9%	1,8%	48,6%
Italy	48,5%	3,3%	-1,5%	134,2%
France	55,4%	0,5%	-3,1%	97,4%
Belgium	51,9%	0,1%	-2,0%	97,6%
Spain	42,1%	2,1%	-3,1%	98,2%
Euro area	47,0%	2,2%	-0,6%	85,8%
	2022			
	Public expenditure	Current Account Balance	Budgetary deficit/surplus	Government debt
Germany	49,7%	4,2%	-2,6%	66,3%
The Netherlands	44,5%	4,4%	0,0%	54,3%
Italy	56,7%	-1,3%	-8,0%	144,4%
France	58,1%	-2,1%	-4,7%	111,6%
Belgium	53,5%	0,6%	-3,9%	105,1%
Spain	47,8%	-3,6%	-4,8%	113,2%
Euro area	50,8%	-0,7%	-3,6%	93,1%

Source: EU Commission spring forecast, May 2023

policy of "every man for himself", creates a climate of mistrust between Member States which hinders any progress in terms of public and private risk sharing and weakens the Eurozone. Additionally, these economic divergences give EU policy makers a hard time agreeing on a European safe asset as well on mutualized European Deposit Insurance Scheme (EDIS) and thus complete the banking union.

Various indicators shed light on the economic disparities that exist within the union: public expenditure, current account balance, budgetary deficit or surplus and government debt.

Table 1 shows that between 2019 and 2022, all countries have increased their public expenditure level to face the Covid-19 pandemic. France already had the highest level of public spending in the EU before the crisis, with 55,40% of its GDP in 2019. It remained in 2022 at the top of the Eurozone and the EU, with public spending equal to 58,1% of GDP, more than 7 pp above the Eurozone average of 50,8% of GDP. On the contrary, Germany, the Netherlands and Spain managed to keep their public expenditure below the Eurozone average in 2022. These divergent levels of public expenditure imply different tax pressures on firms, which explains their diverging level of competitiveness.

Additionally, Member States have different current account balance situations. Heterogeneities were already visible in 2019, with Germany and the Netherlands having current account balances culminating respectively at 7,6% and 6,9% of their GDP, while Italy, France[9], Belgium and Spain had more modest balances with respectively 3,3%, 0,5%, 0,1% and 2,3%. In 2022, the gap has been widened insofar as Germany and the Netherlands still had positive balances with respectively 4,2% and 4,4% of their GDP, while Italy, France and Spain had negative balances with respectively -1,3%, -2,1% and -3,6% of their GDP[10]. Belgium had a modest but still positive balance amounting at 0,6% of its GDP.

In theory, cyclical imbalances in a union are not in themselves a source of concern. But, as it is the case today, these figures are of a durable and structural nature

Since 2008, Member States with excess savings, such as Germany and the Netherlands, no longer finance investment projects in countries that have low GDP per capita, namely Spain, Italy, Portugal and Greece. This is notably due to the interest rate difference between the US and the EU. These limited cross-border capital flows in the euro area also reflect the persistent doubts of Northern investors towards other countries' companies and states solvency, as well as the lack of a complete banking union and integrated financial market.

Member States also display divergent behaviors regarding euro convergence criteria exposed in the Treaty of Maastricht and the Stability and Growth Pack (SGP), namely public deficit and government debt.

First, there are discrepancies regarding the budgetary discipline amongst Member States. In 2019, France and Spain already did not respect the 3% limit on budgetary deficit relative to GDP as both countries displayed a budgetary deficit amounting to 3,1% of their GDP, well above the 0,6% of the Eurozone. In the meantime, Germany and the Netherlands had budgetary surplus amounting respectively to 1,5% and 1,8% of their GDP. In 2022, only the Netherlands and Germany among the main Eurozone Member States have managed to keep

9. It should be underlined that the situation of France in 2019 is not representative as 2019 and 2021 are the only year since 2007 where France had a current account surplus. Between 2014 and 2019, France had an average deficit of 0.5% of its GDP per year while all its European neighbors had surplus. The deficit of the French current account balance reflects a competitivity issue which is rooted in a tax level too high compared to neighboring countries.

10. It should be underlined that 2022 was a year of energy crisis where euro area Member States (Italy, Spain) experienced negative current account balances due to the rising prices of energy, contrasting with non-crisis times.

their budgetary deficit below 3% of their GDP, with respectively 0% and 2,60%. In contrast, Italy, Spain, France and Belgium did not respect the Maastricht criterion with respectively 8%, 4,8%, 4,7% and 3,9% of budgetary deficit relative to their GDP.

There are also significant discrepancies in terms of government debt, about which the Stability and Growth Pack (SGP) implemented a limit of 60% of the GDP. In 2019, while Germany and the Netherlands managed to respect such a limit with respectively 59,6% and 48,6%, Italy, France, Belgium and Spain were all well above with respectively 134,2%, 97,4%, 97,6% and 98,2%. In the wake of the Covid-19 crisis, the trend is still the same, but the gap is even wider: while Germany and the Netherlands have government debt of respectively 66,3% and 54,3% of their GDP, Italy has exceeded double the limit with a government deficit amounting to 144,4% of its GDP, followed closely by Spain, France and Belgium with respectively 111,6%, 113,2% and 105,1%.

1.2.2 The lack of uniformity of standards at the European level is another barrier to an integrated European banking market

The single market is not yet a complete reality although banking regulation has become more uniform in the EU with the single rulebook and the ECB's clarification of the supervisory approach to consolidation[11]. Indeed, a number of traditional factors such as legal systems, languages and traditions remain and fragment banking markets. The EU Commission adds that "differences in taxation, borrower protection, or anti money laundering provisions at Member State level result in bank-specific entry and adjustment costs that discourage cross-border banking". For example, there is no single EU-wide loan registry, as it is the case in the US.

The European banking sector is therefore still characterized by the prevalence of national legislations, regulations, or enforcement practices. In addition, Member States understandably seek to ensure that national objectives are met in terms of, for instance, consumer protection, public health, and the environment. In doing so, they do not necessarily take due account of the impact of their actions on the EU banking sector.

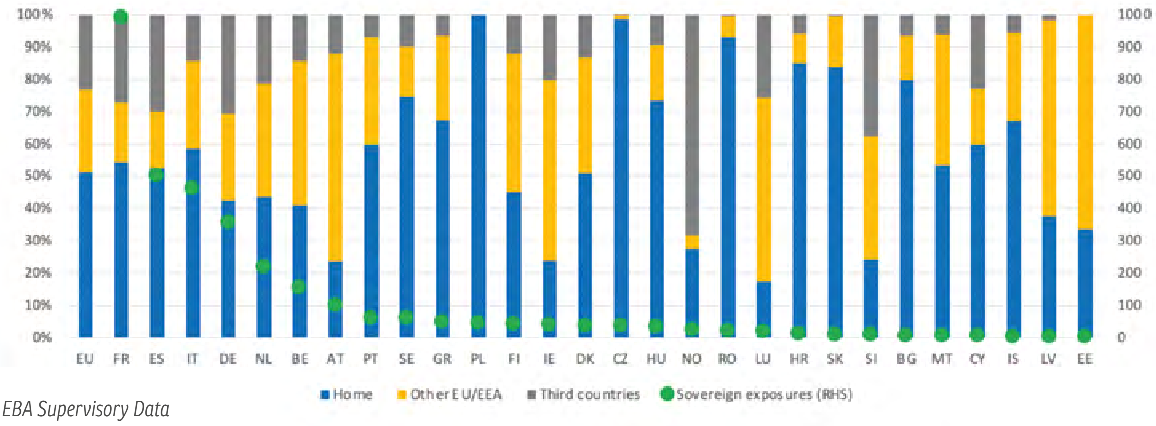
1.2.3 The absence of a single market for banking and financial services is synonym of fragmentation

Besides the supervisory fragmentation in the euro area (1.1.2), there is an important diversity in terms of banking products, especially regarding retail products leading to the fragmentation of the EU banking landscape.

For instance, households of some countries such as Spain, Italy, Germany are directly affected by the ECB's rising interest rates. A vivid example is real estate financing. European markets vary in consumers' preferences for mortgage types (fixed v. floating, amortizing v. bullet), legal requirements concerning consumer protection and collateral enforcement, national credit reference schemes (*e.g.*, Crédit Logement in France) and creditor selection criteria (LTV v. monthly incomes).

These cultural differences influence product design, distribution strategies and back-office operations in the EU. Moreover, they prevent banks from sharing processes and systems across European countries. Large banks consequently miss scale advantage when moving into new European markets. Since these domestic variations are greater in some lines of business than others – namely in retail more than in wholesale, the potential for Europeanisation also varies according to lines of business.

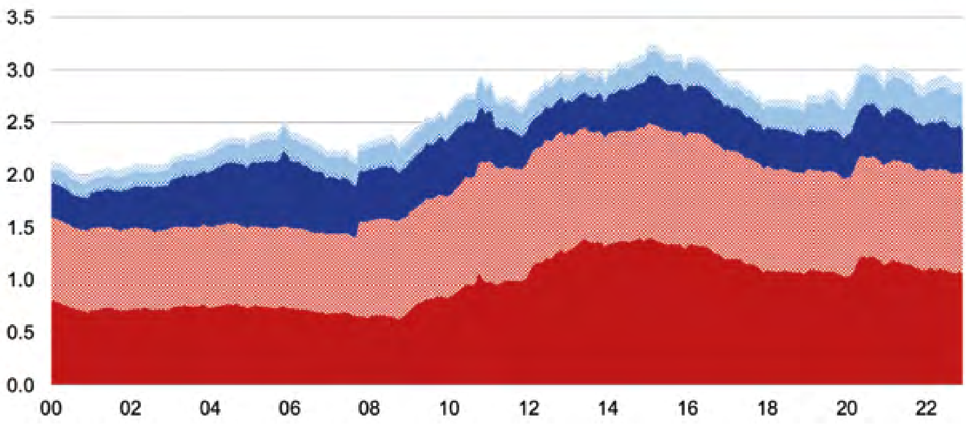
CHART 4.
Sovereign exposures [EUR bn] and country distribution by domicile (%) – December 2022



Source: EBA Supervisory Data

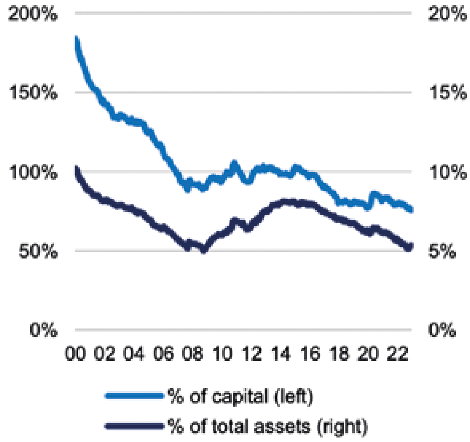
11. ECB Banking Supervision, Guide on the supervisory approach to consolidation in the banking sector, January 2021. This guide clarifies particularly three key prudential issues that are often discussed in this context: how the ECB sets Pillar 2 capital requirements for newly formed entities; how it treats badwill from a prudential perspective; and how it treats and assesses internal models.

CHART 5.
Exposure of euro area banks to general governments in EUR tr, until December 2022



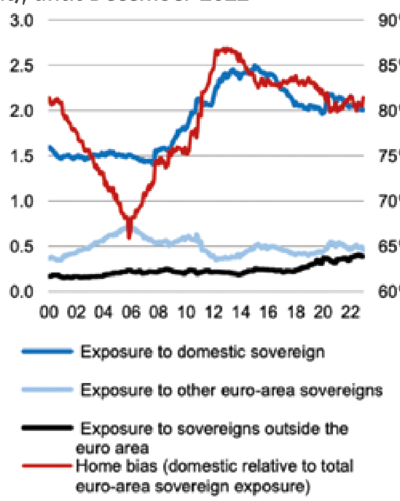
Source: ECB, Deutsche Bank Research

CHART 6.
Euro area banks' exposure to respective domestic government, until December 2022



Source: ECB, Deutsche Bank Research

CHART 7.
Euro area banks' exposure in EUR tn (left), home bias in % (right), until December 2022



Source: ECB, Deutsche Bank Research

1.3 Additionally, the sovereign-bank nexus and the Central Bank-sovereign nexus remain significant

The situation of European banks is certainly different from the one that prevailed between 2010 and 2012. European have indeed higher capital and liquidity ratios than at the time the banking union was created[12]. The European banking sector has shown remarkable resilience during the banking turmoil earlier this year. This highlights the effectiveness of the enhanced regulatory and supervisory reforms implemented in the last ten years.

Unfortunately, even if breaking the sovereign-bank doom loop was among the objectives of the banking union, it must be noted that this link remains an important issue, especially for financial stability.

According to EBA statistics, the domestic sovereign exposure of EU/EEA banks in December 2022 stood at 5,7% relative to their total assets, and at 101% compared to their capital, which means that the risk is still looming despite the downward trend. For instance, these figures are 9.9% and 160% for Italy, and 18.2% and 239.7% for Poland.

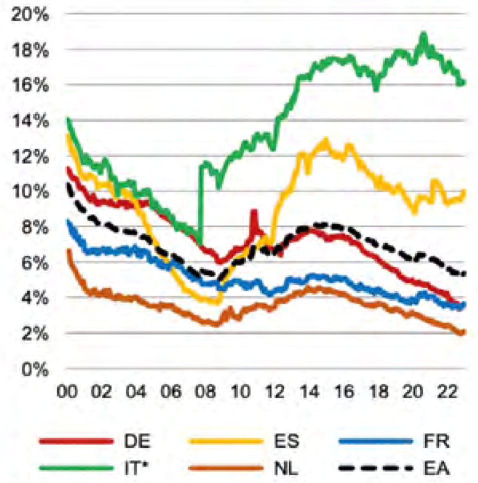
The total sovereign exposure of EU/EEA banks compared to total assets in December 2022 stood at 11.6%. Roughly 50% of banks' total sovereign exposures is to their home sovereign[13] (*see Chart 4*).

1.3.1 The evolution of sovereign exposure varies significantly among Member States

Though the levels of sovereign exposures, be they total or domestic, seem to be declining (*see Chart 5*), one must be careful with comparisons and implications, as the risk remains high.

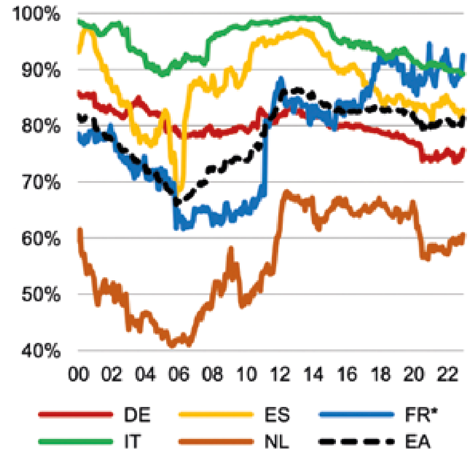
12. For instance, banks' Common Equity Tier 1 ratio stood above 15.5% in the first quarter of 2023, see A. Enria, Hearing of the Committee on Economic and Monetary Affairs of the European Parliament, June 2023.
13. Data from the EBA's Risk Dashboard.

CHART 8.
Domestic sovereign exposure in % of total assets, until December 2022



Source: ECB, Deutsche Bank Research

CHART 9.
Domestic relative to total euro area sovereign exposure, until December 2022



Source: ECB, Deutsche Bank Research
** Surge in 2011 due to a statistical reclassification of other euro area bonds*

The home bias remains important and the total sovereign exposure still presents risks for the banking union.

1. **The domestic sovereign exposure**

According to EBA statistics, in December 2022, the domestic sovereign exposure of EU/EEA banks relative to their total assets was 5,7%, and this ratio is down to 5% for euro area banks.

As shown in Chart 6, the level of home sovereign bonds and loans compared to total assets and capital have fallen to pre-crisis ratios of 2008. It is good news in terms of financial stability, but exposure remains considerable and a risk on bank balance sheets with 5% of total assets and 76% of capital for the euro area banks according to Deutsche Bank's research.

Yet, one must be careful when operating such comparisons over time, because differences in balance sheets and divergent national parameters prevent them from being entirely coherent.

Indeed, Chart 7 shows that the exposure to domestic sovereign in the euro area stood a little bit below EUR 1.5 tn in 2008, but above EUR 2 tn in 2022. The exposure has thus increased; if the ratio is the same, it means that banks have also increased their total assets, but that does not necessarily decrease the incurred risk.

And while euro area banking sector as a whole has reduced its domestic sovereign portfolio, there are considerable differences between countries. For instance, in December 2022, the domestic sovereign exposure equals 16% of Italian banks' balance sheet, while it is only 2% for Dutch banks. Additionally, some falling ratios are due to asset growth, as it is namely the case in France and Germany, where the domestic sovereign exposure compared to total assets is 4% (*see Chart 8*).

Another indicator of the disparities observable in the EU banking landscape is the domestic sovereign exposure compared to banks' capital. As one can see on Chart 9, Italian and Spanish banks have not joined the general downward trend: their holdings exceed capital which has declined over the past few years, while it has increased for banks in the other major markets[14].

As shown by Chart 9, the home bias remains significantly high, especially in countries with a high level of debts, 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.

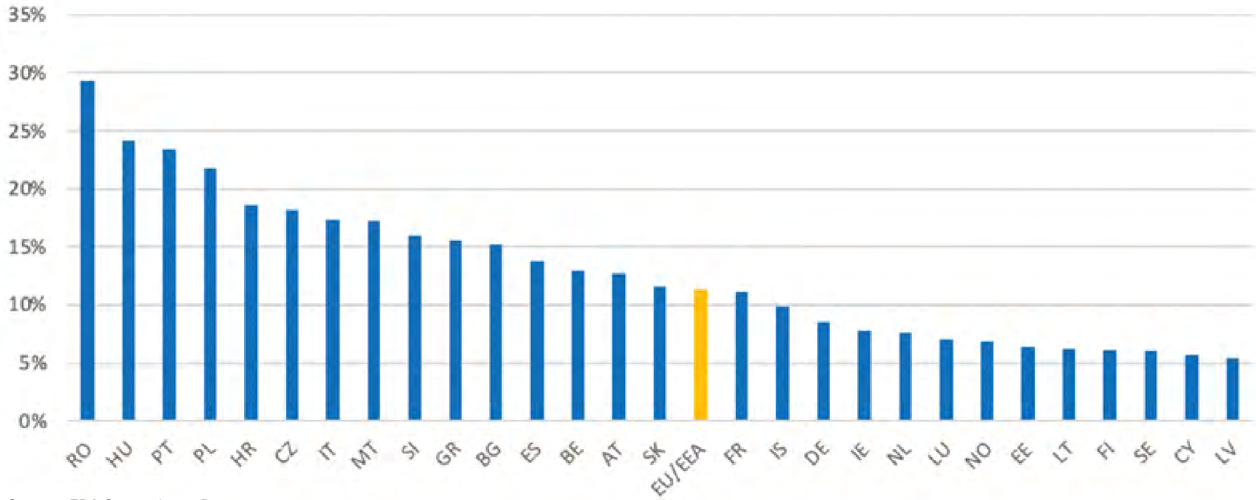
The first reason is that, as heavily indebted countries have higher risk profiles, their bonds are riskier and therefore not bought by countries with a safer risk profile. For instance, German banks will favor German bonds over Italian ones, because they know their home country's bonds to be less risky than Italian ones.

Moreover, loans are probably partly responsible for the home bias because bank loans account for almost 50% of domestic exposure, are mainly used by local and state authorities and granted by banks with a local presence.

Analysts also suggest that moral suasion and closer connections between the public and the financial sphere could foster this home bias.

14. Deutsche Bank Research, Sovereign exposures of European banks – revisited, May 12, 2023.

CHART 10.
Sovereign exposures as a percentage of total assets by country, December 2022



Source: EBA Supervisory Data
Note: the sample of banks has been adjusted to include only those entities that reported both domestic sovereign exposures and total assets

2. **The total sovereign exposure**

On top of being exposed to their home country's bonds and debts, EU banks are also exposed to governments located outside their territory, though in a less significant proportion (*see Chart 5*).

In the wake of the sovereign debt crisis, the total sovereign exposures of EU banks reached EUR 3.0 tn in December 2013 and increased to EUR 3.3 tn in 2015 according to EBA statistics.

Exposures to general governments have then slightly declined since June 2016, mainly due to the Quantitative Easing policies conducted by the ECB (*see 1.3.3*). Then, between 2016 and 2020, the sovereign exposures maintained a stabilized level in spite of the QE policies. Indeed, in the EU, unlike in the US, it is the banks that are the main sellers of sovereign bonds to the ECB; this phenomenon has been simultaneously accompanied by an increase in the balance sheets of central banks and an increase in the excess reserves of banks. Total sovereign exposure of the EU banking sector stood at EUR 2.7 trillion as of June 2018. As of June 2019, the total exposure to sovereign entities of EU banks stood at EUR 2.8 trillion, slightly up from June 2018.

European banks' ownership of sovereign debt has further increased in the course of the year 2020. Indeed, following the Covid-19 crisis, public debt across EU Member States exploded. Despite the unconventional monetary policy and the massive ECB's purchasing programs (Pandemic Emergency Purchase Program (PEPP), Asset Purchase Programs (APP)), the sovereign-bank loop rose again until the end of 2020 and in 2021, to decline somewhat towards the end of 2021, but remaining above pre-pandemic levels until now.

According to EBA's Risk Assessment, as of June 2022, EU banks reported around EUR 3.3 tn of total exposure towards sovereign counterparties. This is a volume increase of almost 5.4% from December 2021 (EUR 3.1 tn)[15]. In relative terms, the total sovereign exposure as a percentage of total assets in December 2022 stood at 11,6% in the EU/EEA. Yet again, significant disparities are observed: the ratio in Italy, Spain and Belgium remains significantly higher than in Germany and the Netherlands with respectively 17%, 14% and 13% against 8% and 6% (*see Chart 10*).

All in all, the sovereign-bank nexus is still an issue to the completion of the banking union. Even if the ratios of domestic exposures to total assets are back to pre-crisis levels, it must not be forgotten that part of the decrease is due to the asset growth fostered by Basel II, III and IV.

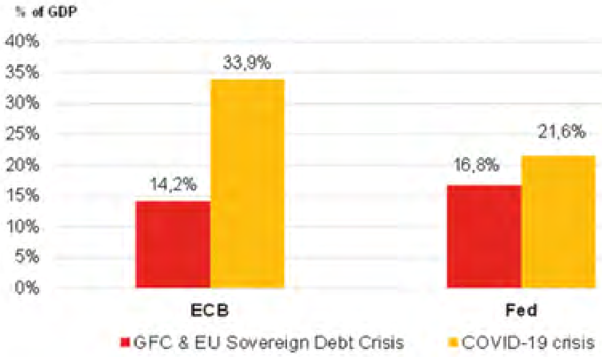
Furthermore, the divergent intensity of the sovereign-bank link prevents the creation of a European safe asset that would go along with the completion of the banking union. Indeed, from a political point of view, no country that is reasonably risky, fiscally disciplined and that has a relatively low sovereign-bank nexus will agree to buy a European asset that contains securities from countries that have a risky profile with a high sovereign exposure.

1.3.2 The sovereign-bank loop is fostered by the high level of public deficits and debts in some EU Member States, as well as by the prudential regulatory framework

Banks have responded to the issuance of bonds by the state: they have been encouraged to do so from a regulatory point of view for two reasons. One is to meet their regulatory short-term Liquidity Coverage

15. EBA, Risk assessment of the European banking system, December 2022.

CHART 11.
Expansion of Central Banks' balance sheet during the Global Financial Crisis and the Covid-19 crisis



Source: Federal Reserve
Notes: the period associated to the ECB's Balance sheets extended from 2008 to 2013; and from 2015 for the Fed; the Covid-19 period extends March 2020 to March 2022; data are calculated on the basis of the 2019 nominal GDP

Ratio[16] (LCR) and the second is the regulatory treatment of sovereign exposures.

Sovereign securities are considered liquid assets that help comply with the Basel LCR for banks.

The numerator of the LCR must be composed at least of 60% of Tier 1 assets (cash, Central Bank reserves, domestic sovereign debts or other 0% weighted assets). As L. Quignon explains[17], "the LCR creates an artificial demand for government bonds and incidentally tends to reinforce the link between banks and the government... The corollary of the improvement in bank liquidity is therefore the decrease in the credit multiplier for the fraction of High-Quality Liquid Assets constituted of government debt securities, a distortion of credit to the economy to the detriment of private sector financing".

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. These regulatory measures also contribute to the growing of the sovereign-bank loop in Europe.

The very high level of public debt in some Member States and the consequent financing requirements mainly explain the development of this sovereign-bank loop and the difference in intensity of such nexus across Member States. (*cf Table 1*)

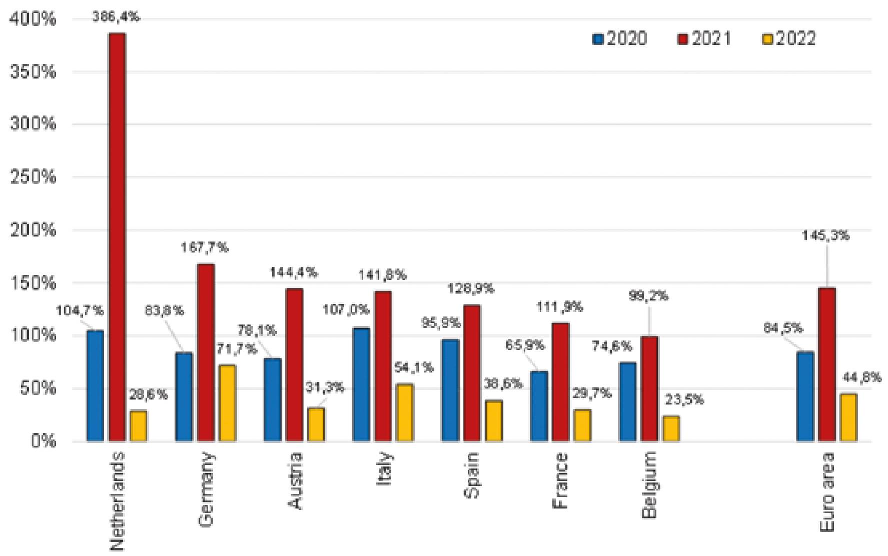
As long as the rules of the Stability and Growth Pact (SGP) are not applied across Europe, the sovereign-bank link cannot be reduced. An EU agreement on EDIS would not help to break this link.

In the meantime, some observers also point out that many Eurozone banks are controlled or influenced by national or local governments and or politics, which reinforces the bank-sovereign nexus.

1.3.3 The Central Bank-sovereign nexus rose significantly from 2015 to 2022 because of Quantitative Easing (QE) policies

The 2% inflation target pursued by central banks have pushed them to maintain very accommodative financing conditions, and asymmetric monetary policies over the past 20 years. Central Banks and the ECB in particular have not tightened monetary conditions when the crisis was over, between 2015 and 2022. The massive increase in central banks' total assets and the expansion of the monetary base in non-crisis times illustrates this asymmetry.

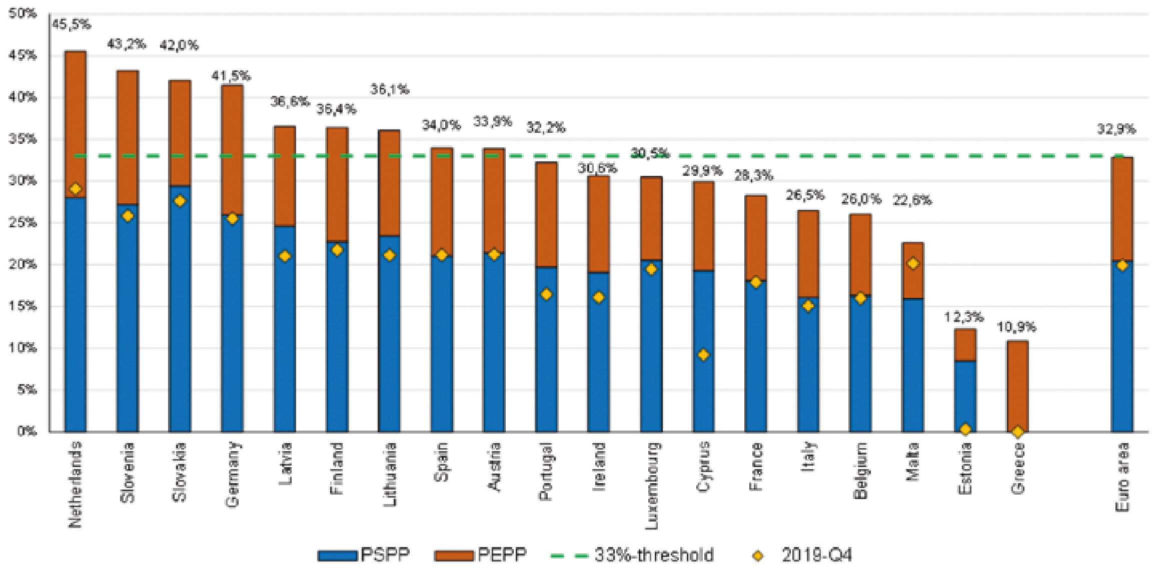
CHART 12.
Share of public debt purchased by the Eurosystem



Source: ECB, Eurostat, Eurofi calculations

16. The LCR is a ratio that calculates the minimum amount of High-Quality Liquid Assets (HQLA) that financial institutions are required to hold to ensure their ongoing ability to meet short-term obligations.
17. L. Quignon, "The LCR goes against the need to reduce the bank-sovereign link", Revue Banque, October 2013.

CHART 13.
Share of government debt held by the Eurosystem as of December 2022, %



Source: ECB, Eurostat, Eurofi calculations

We saw previously that the sovereign-bank nexus decreased between 2015 and 2019. The counterpart of such decrease has been an increase of the Eurosystem balance sheet due to the QE policy of the ECB. Thus, there is a stronger central bank-sovereign nexus.

From January 2015 to early March 2020, a total of EUR 2.66 tn of public and private securities were purchased by the Eurosystem, corresponding to nearly 20% of the 2019 Eurozone's GDP. This brought the value of the ECB's balance sheet to EUR 4.7 tn, *i.e.*, 39.1% of the 2019 GDP.

Between 2014 and mid-2022, the ECB's balance sheet increased from 21.2% of the Eurozone's GDP to 73.8% (*see Chart 15*). That is a EUR 6.8 tn rise towards the record of EUR 8.83 tn as of end-May 2022.

When the pandemic struck in March 2020, the key financing rate of the ECB could not be lowered further, leaving little room for maneuver. Substantial monetary policy accommodation was emphasized over the course of 2020 and 2021 to counter the negative impact of the pandemic on the inflation outlook. Thus, as one can see on Chart 11, the size of the Eurosystem's balance sheet as a share of the Eurozone's GDP more than doubled compared to its size after the GFC and the EU sovereign debt crisis.

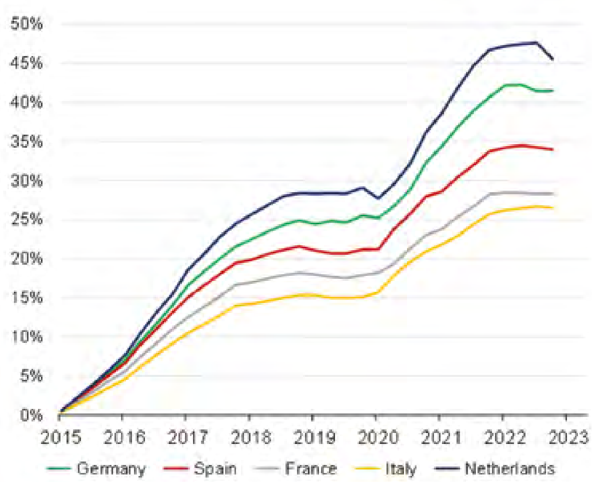
Considering the ECB's action, the Governing Council decided in March 2020 to launch the Pandemic Emergency Purchase Program (PEPP) of up to EUR 750 bn until the end of 2020, on top of the EUR 120 bn in extra purchases as part of the already existing APP.

Following the end of the net purchase under the PEPP in March 2022, the Eurosystem continued buying securities as part of the APP. The ECB started to slow down the pace of asset purchases in March 2022. Indeed, net purchases under the APP ceased on 1 July 2022.

The Eurosystem has then had a leading role in public debt monetization during the Covid-19 crisis, as its government securities purchases amounted to most of government debt issuance (*see Chart 12*).

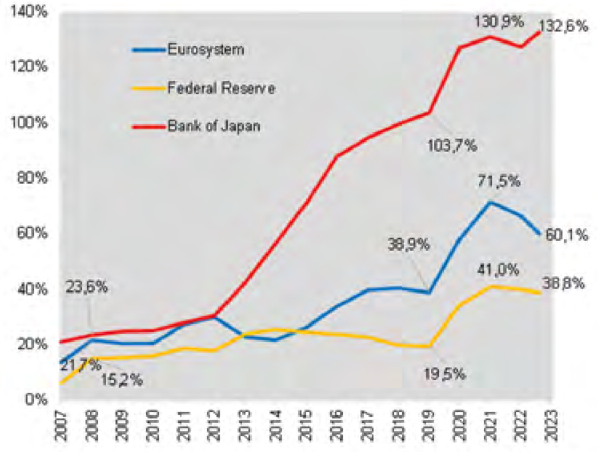
Charts 13 and 14 show the growing share of government debt held by National Central Banks (NCBs). The latter has been increasing continuously since 2015, when the ECB started its APP. Between January 2015 and December 2019, the share of public debt held by the Eurosystem grew from 4.4% to 19.5%.

CHART 14.
Share of public debt held by the Eurosystem



Source: ECB, Eurostat, Eurofi calculations
Note: Last observation 2022-Q4

CHART 15.
Central Banks' total assets relative to GDP



Source: Federal Reserve, Bank of Japan, ECB
Note: last data are from 30 June 2023; the ratio is calculated on the basis of the 2019 nominal GDP for all the data since 2019

The purchase of sovereign bonds since 2015 has led the Eurosystem to hold more than a third of the euro area's public debt outstanding in 2022.

These charts evidence the Central Bank-sovereign loop: in December 2022, the Eurosystem held 45.5% of the Dutch public debt, 41.5% of the German public debt, 34% of the Spanish public debt; all these figures are above the 33% threshold, initially set under the APP but suspended under the PEPP.

Most importantly, it highlights that the linkages between governments and banks are now extended to central banks. This sheds a special light on the independence of central banks, as NCBs own a growing and significant share of the national government debts and have *de facto* become the agents of fiscal policies.

1.3.4 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 of December 2022, the Eurosystem's balance sheet stood at EUR 7.9 tn, or 66.5% of the GDP of 2019.

The ECB started Quantitative Tightening (QT) on 1 March 2023. The decline in total assets since October 2022 as observed on Chart 15 is mainly due to the repayment by banks of Targeted Long-Term Refinancing Operation (TLTRO 3) launched in 2019 corresponding to EUR 1.5 tn of the EUR 2.2 tn program.

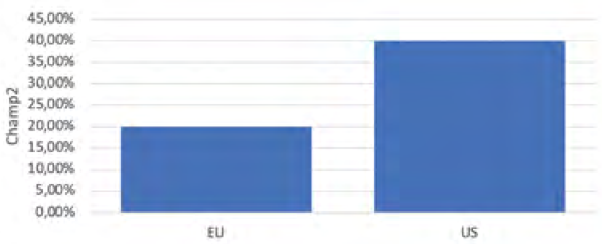
Another QT tool has been the non-reinvestment of all of the principal payments from maturing securities purchased under its APP averaging to € 15 bn per month between March and June 2023, and € 25 bn since July, has had a limited impact on the stock of securities and therefore on bank reserves so far[18]. Between March and June 2023, Eurosystem's securities holding dropped by € 42 bn to reach € 5.45 trn in June, from € 5.9 trn in March.

However, even if the ECB has started to reduce the size of its bonds holding, it continues to flexibly reinvest securities held under the PEPP, which could potentially reinforce the sovereign-central bank loop insofar as through such flexible reinvestments, the Eurosystem has been replacing maturing Dutch and German bonds with Italian or Spanish debt securities.

If the sovereign-bank loop has slightly decreased between 2015 and 2022, it is because it has been compensated by the central bank-sovereign nexus. With an effective normalization of monetary policy in Europe and the firm implementation of QT policies, one can fear that the sovereign-bank nexus be reinforced in the Member States which have high public deficit (above or eaqual to 3% of GDP), or high government debt (superior to 100% of GDP).

In this regard, the IMF stated in July 2023 that "euro area governments and bond markets will face lower ECB support in rolling-over maturing debt. The question arises as to which economic actors would step in and which spread levels would be required to attract demand. euro area banks seem to be the natural candidate given their historical appetite for sovereign bonds with current holdings standing below historical highs in most countries[19]".

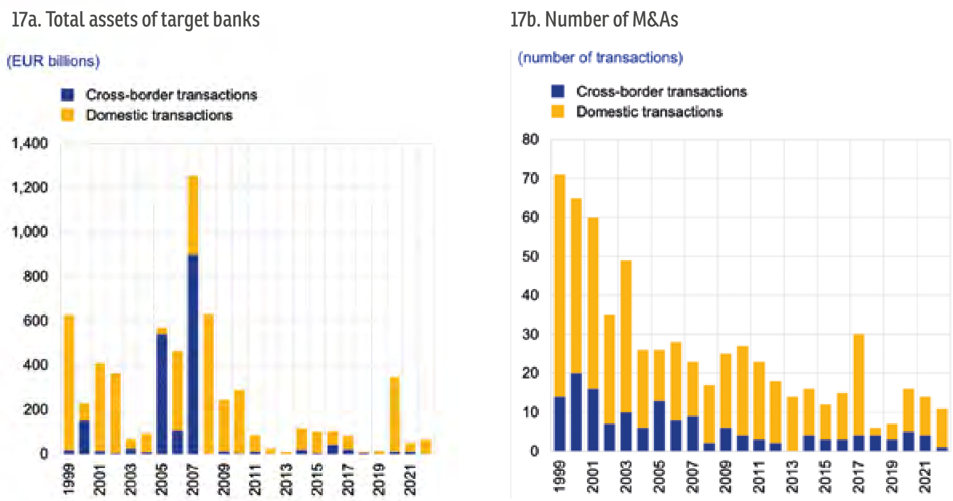
CHART 16.
Market shares of top 5 EU and US banks, January 2023



Source: Oliver Wyman, "The EU banking regulatory framework and its impact on banks and the economy", January 2023

18. By way of comparison, it should be remembered that the public sector purchase program (PSPP) started with purchases of €60 billion per month (from March 2015 to March 2016). After the Covid-19 crisis purchases rapidly increased throughout 2021 and continued at closed to an average of €90 billion per month (PSPP and PEPP together) at a time where inflation was already clearly above the target.
19. IMF, euro area Policies, Selected Issues, July 2023.

CHART 17.
Total assets of target banks and number of M&A deals in the euro area



Source: ECB calculations based on Dealogic and Orbis BankFocus
Notes: The sample includes M&A transactions involving Sis and LSIs in the euro area, excluding some private transactions and transactions between small banks not reported in Dealogic. Transactions associated with the resolution of banks or distressed mergers were removed from the sample. Transactions are reported on the basis of the year in which they were announced

As long as all EU Member States do not comply with budgetary 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. As a result, the EU banking sector is overcrowded, and EU banks are less competitive than international peers, especially US banks

The EU banking sector struggles with excess capacity, with too many undersized banks and a costly physical banking infrastructure. Too many banks still compete for the same customers.

Banks in Europe thus face a much more competitive environment than in the US and therefore much stronger pressure on their margins since the EU banking sector is not concentrated enough compared to the American one.

Other missing mechanisms such as private risk sharing hurt the competitivity of European banks and further hampers their profitability.

This section focuses on the overcapacity of the EU banking sector. It also aims at exposing and explaining the lagging profitability of EU banks compared to US ones. Finally, it outlines the differences that exist regarding private risk sharing mechanisms between the euro area and the US.

2.1 The lack of consolidation results in an overcapacity of the EU banking system

As shown by Chart 16, the market shares of the five US banks within the United States reached about 40% as of January 2023, while EU banks' market shares within the Eurozone were only 20%[20]. This indicates that the EU banking sector is much more crowded than the US one.

US banks that have a strong market share in their large domestic market have therefore an extra-ordinary competitive advantage and a greater capacity to develop internationally.

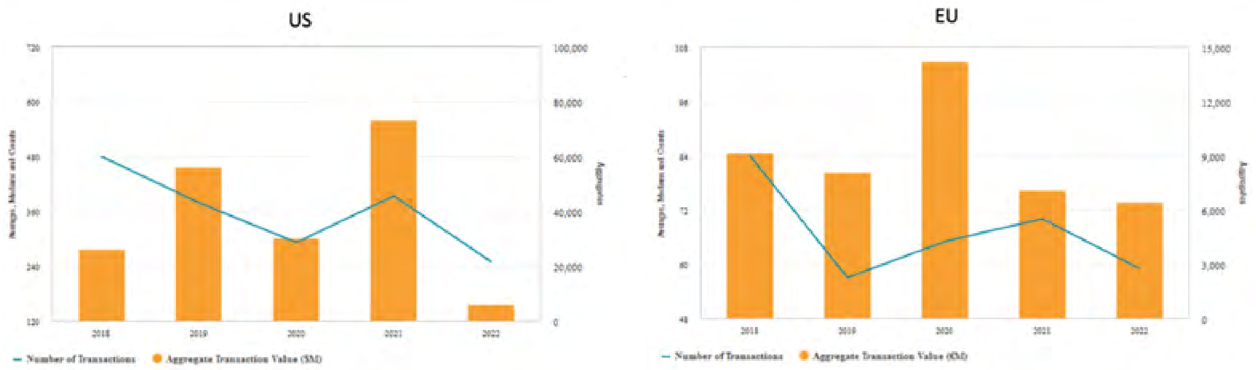
2.1.1 The downward trend in cross-border mergers since 2000 negatively impacts the level of concentration of the EU banking sector

Mergers and Acquisitions (M&A) are failing to accelerate the restructuring of the banking sector in Europe. Indeed, M&A represent an option for banks to streamline their operating structures to embark on consolidation. "Bank consolidation via M&A is frequently mentioned as a means of reducing overcapacities in banking as domestic-oriented M&A could allow the institutions involved to eliminate duplication in their branch networks and to release resources to speed up their restructuring. Domestic M&A deals can also help banks exploit potential cost synergies and economies of scale. M&A impact then the competitive landscape in the banking industry and can lead to higher market concentration[21]".

Yet, cross-border merger and acquisition activities among banks within Europe have drastically

20. Oliver Wyman, "The EU banking regulatory framework and its impact on banks and the economy" – January 2023.
21. Claudio Borio and Kostas Tsatsaronis (1999), Andrea R. Dombret (2018).

CHART 18.
Number of M&A transactions (left) and transaction values (right) for the EU and US banking sectors, 2018-2022



Source: EBA, S&P Market Intelligence Data

diminished since 2000 (*see Chart 17*), dropping from 70 major deals in 2000 to less than 10 in 2019 and 15 in 2021. This is notably due to the still predominant national bias, leading countries to use ring-fencing practices. As for remaining M&A deals, they are mainly domestic: on average, only one fifth of the number of transactions are cross-border M&A. This lack of M&A deals within Europe does not help improve the profitability of banks in Member States.

M&A deals, both in number and in valuation, are more important in the US than in the EU

Chart 18 shows that, even if the trends regarding M&A transactions are similar in the EU and in the US, the scales, on the other hand, are totally different.

While 2022 appears as a kind of exception, the M&A trend over the past 5 years clearly demonstrates the higher concentration of the US market.

In 2018, 479 M&A transactions took place in the US for a transaction value exceeding USD 25 bn (which equals a value over EUR 22.6 bn). In contrast, only 84 M&A deals were sealed in the EU during this same year, and the transaction value only amounted to EUR 9 bn. Such a difference in value can be explained by some of the deals that happened in 2018 in the EU for paltry sums, such as the Banco Popular-Santander takeover in Spain for a symbolic EUR 1 in June, or the Intesa Sanpaolo's acquisition of two failed domestic rivals in the Italian region of Veneto, also for a token price.

On the 2018-2021 period, Chart 18 shows that there are on average 5 times more transactions in the US than in the EU, and the transaction value is higher: it is twice in the US what it was in the EU in 2020, and ten times in 2021.

Yet, in 2022, even if the trend in the number of transactions is confirmed – 59 in the EU against 249 in the US, the transaction value is higher in the EU: EUR 6.4 bn against USD 6.2 bn (which equals EUR 5.6 bn). The number of transactions in 2022 in the US is the lowest of the period covered, and it is believed to be due to the current economic headwinds, geopolitical uncertainty, and a potential downturn, but not to be a lasting trend[22].

Some industry representatives have highlighted that consolidation in Europe exists in CIB, through the acquisition of teams and clients' portfolios because such activities happen on a global scale and are essentially submitted to international rules.

Five major reasons explain the decline in European M&A:

1. The single banking market is not yet a reality although banking regulation has become more uniform in the EU through the single rulebook and the ECB's clarified supervisory approach to consolidation. This fragmentation along national lines puts new cross-border market entrants at a disadvantage. In particular, banks that want to expand and diversify their activities throughout the EU have to create local service units in each Member State, which reduces economies of scale. Finally, improving the profitability of the EU banking sector is only possible on a country-by-country basis, through national mergers. New and innovative players have no choice but to develop a specific business case for each Member

22. McKinsey and Company, "Strategic M&A in US banking: creating value in uncertain times", November 2022.

State. The opportunities promised by the single market of (retail) financial services are thus not materializing.

2. The EU legislative prudential framework does not recognize trans-national groups at the consolidated level but as a sum of separate subsidiaries ("national or solo approach"), notably due to the insufficient trust of Member State with regard – among others – to national supervision. Moreover, ring-fencing policies (capital, liquidity, bail-in instruments, leverage ratios...) applied by host supervisors to subsidiaries of trans-national banking groups located on their territory enforce higher costs and discourage large EU banks to increase the number of their subsidiaries in the EU since scale effects through the centralization of capital and liquidity cannot be achieved.
3. Challenges linked to digitalization are prioritized over bank consolidation. In this case, M&A deals take place so that banks build capabilities accounts through the acquisition of fintech companies and expand their digital services[23].
4. Another obstacle to M&A activities is the structure of the banking industry: only 30% of the significant banks in the Eurozone (*i.e.*, directly supervised by the SSM) are publicly traded companies. Most of the non-listed banks in the Eurozone are (regional) state-owned saving banks, regional banks or cooperative banks.
5. In the current political context, no state would be keen to see the disappearance of one of its banks due to a takeover by a bank in another European country.

Some bankers also point out that the expansion of European banks is also penalized by the European regulation and supervision through:

- The non-recognition of the benefits of geographical diversification,
- The penalization of third country exposures in multiple ways,
- The penalization of the minority interest.

The post-GFC period (after 2008) is characterized by a predominant proportion of 'domestic' transactions

Compared with the pre-GFC period, the post-crisis period (after 2008) is characterized by a predominant proportion of 'domestic' transactions (around 80% of all transactions). Large transactions have also become scarce, and in recent years more euro area banks were acquired from outside the euro area than from within. Within the EU, cross-border M&A transactions have been clustered in neighboring countries and follow existing linkages, allowing to conclude on the fact that the single European market remains disjointed.

Indeed, one can observe on Chart 17 that in 2021, there were less than 5 cross-border transactions for a total amount of about EUR 10 bn.

No real progress has been observed since 2018 where two-thirds of European banking consolidation were also from domestic deals.

However, G. Siani[24] explains that "we have witnessed an upswing in consolidation mainly pushed by digitalization. Two channels emerge in this new context: aggregations based on traditional channels (M&A), and less traditional ones, seizing the opportunities provided by outsourcing key business functions".

2.1.2 Can the new rules decided by the global regulators on the calculation of extra-capital buffers with the EU help accelerate M&A deals?

In June 2022, the Basel Committee of Banking Supervision has completed its target to treating cross-border exposures within the European banking union on the methodology of G-SIBs. The Committee has recognized the improvement that has been made in the development of the banking union and this progress in the G-SIB framework through the existing methodology, which enables to make adjustments according to the supervisory judgement.

Under the agreement, a parallel set of G-SIB scores will be calculated for EBU-headquartered G-SIBs and used to adjust their bucket allocations. The parallel scores recognize 66% of the score reduction that would result from treating intra-EBU exposures as domestic exposures under the G-SIB scoring methodology. The Committee's agreement will not affect the classification of any banks as G-SIBs or the scores or bucket allocations of bank outside of the EBU.

The new rules agreed by the Bank for International Settlements (BIS) affect the calculation of extra-capital buffers for the eight Eurozone-based lenders included in the list of 30 Global Systemically Important Banks that are considered most likely to trigger a financial crisis if they were to go under.

In other words, only two-thirds of their pan-Eurozone exposures will be treated as domestic, instead of foreign – and therefore riskier.

With this, being able to consider their cross-border

23. McKinsey and Company, "Strategic M&A in US banking: creating value in uncertain times", November 2022.
24. G. Siani, "Bank diversity in Europe: what evolution?", Eurofi Magazine, September 2023.

exposures within the block more like domestic ones could reduce the amount of extra capital the banks need to cover because of their systemic importance. This reform is helping to remove one of the regulatory disincentives to developing pan-European activities.

According to the AGEFI[25], the French bank BNP Paribas, which is mainly implemented in Belgium and Italy, and which has the highest G-SIB buffer, could be the main beneficiary of this reform and see its systemic surcharge avoid an increase of 0.5 solvency ratio points.

This shift is a step in the right direction, towards a more integrated banking sector in Europe, the creation of a truly domestic market and a harmonization of regulations for the Eurozone banking sector. However, there are still too many obstacles to a real acceleration of banking consolidation. In addition to the regulatory burdens, the BCBS has decided, even for this reform, not to treat all, but only two-thirds of pan-European exposures as fully domestic because the banking union is still incomplete.

The lack of M&A deals hampers the profitability of the EU banking sector.

Both domestic and cross-border bank mergers have the potential to address excess capacities and cost inefficiencies, two of the factors behind structurally low profitability in Europe.

Nevertheless, domestic consolidation is growing at snail's pace and cross-border bank consolidation has practically disappeared (in terms of transaction value). It should thus be considered to remove remaining regulatory obstacles[26]. As pointed out by the ECB, such operations need to be supervised[27].

But as explained in the 1.42 subsection, the current EU legislative framework does not recognize transnational groups at the consolidated level (national approach). In addition, Member States have ring-fenced their banking sector. In such an environment, cost reduction through economies of scale becomes difficult, as scale effects of centralization of capital and liquidity cannot be achieved. This fragmentation along national lines means that banks that want to expand and diversify within the EU have to create local units in each Member State instead of focusing on M&A.

At this stage, profitability of the EU banking sector can then only be improved on a country-by-country basis, through national mergers.

Therefore, common EU practices and removing remaining obstacles to cross-border consolidation will allow more cross-border M&A deals and accelerate the restructuring of the EU banking sector into a more consolidated and profitable sector.

2.1.3 Can digitalization and innovation be a game-changer for the future of the banking union?

Many industry representatives highlight the fact that digitalization and innovation are starting to change the banking landscape. Achieving a seamless and quick digital transition would have a significant impact on the competitiveness of the banking union, but such a transition also brings about its share of operational, legal and reputational risks.

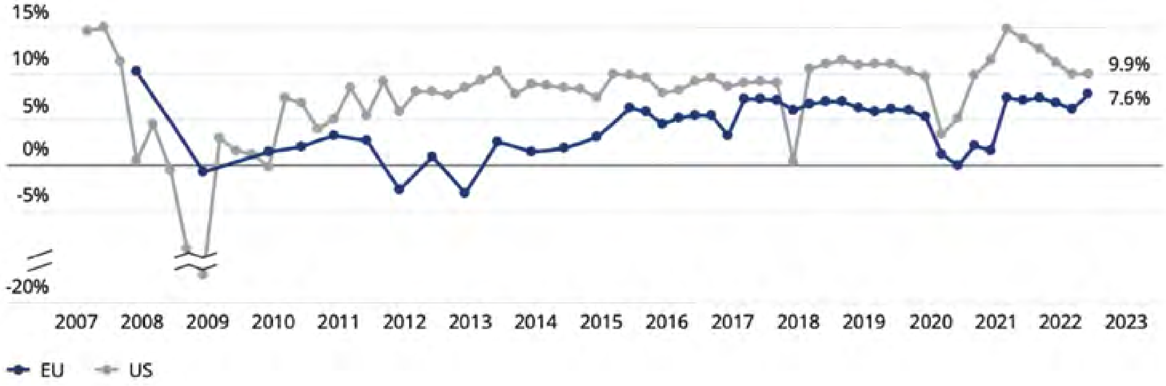
As explained by P. Padoan[28], "empirical analysis shows that in the longer run the EU banking industry can reduce the gap and improve its performance thanks to innovation and digitalization, provided the appropriate policies are adopted. What makes the current innovation episode unique is that, given the nature of the products of the financial industry, public institutions (central banks) react to innovation shocks. Such a mechanism of increased efficiency thanks to innovation could build momentum for making progress in banking union".

For instance, innovation such as the use of Artificial Intelligence (AI) in the banking industry can have an impact of business models in terms of data treatment. Other Information and Communication Technologies (ICTs) lead consumers' preferences and expectations to change; it is namely the case of Central Bank Digital Currencies (CBDCs) that are issued by central banks in reaction to private Big Tech companies issuing their own privately conceived payment systems. CBDCs are especially interesting for central banks in terms of strategic autonomy and sovereignty; but they are not without risks, especially in terms of financial stability, as they are substitutes for deposits and significantly increase the speed at which deposits may be withdrawn from banks, encouraging disintermediation.

Nevertheless, innovation alone will not be sufficient to improve the efficiency of the banking union: "innovation in banking has significant impacts on productivity. However, this is not uniform across sectors. Also, there is no strong evidence that digitalization improves the performance of firms that are already on the technological frontier,

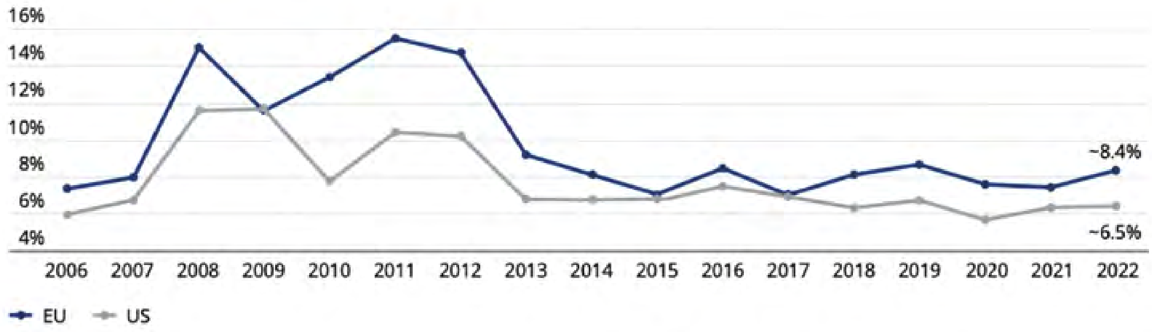
25. Franck Joselin, "Le Comité de Bâle lève un obstacle à la consolidation bancaire européenne", June 2022, AGEFI Quotidien & "La charge des banques systémiques s'allège en zone Euro", June 2022, AGEFI hebdo.
26. ECB – April 2022 – Financial Integration & Structure in the euro area, p15.
27. Gardó, S. and Klaus, B., "Overcapacities in banking: measurements, trends and determinants", Occasional Paper Series, N°236, ECB, November 2019.
28. P. Padoan, "Could the banking union be revamped by innovation?", the Eurofi magazine, September 2023.

CHART 19.
Comparison in return on equity between EU and US banks



Source: Oliver Wyman, "The EU banking regulatory framework and its impact on banks and the economy", January 2023

CHART 20.
Comparison in cost of equity between EU and US banks



Source: Oliver Wyman, "The EU banking regulatory framework and its impact on banks and the economy", January 2023

neither that it affects the capacity of laggard firms to move to the frontier. It also suggests that investment in digital must be complemented by other variables to produce productivity gains. Most notably intangible and human capital, R&D and supportive regulation aimed at increasing competition and efficiency, notably regulation to support venture capital[29]".

2.2 The profitability of EU banks remains behind international competitors and hampers the effort of the Eurozone towards strategic autonomy

The overall profitability of the EU banks – except during the Covid-19 crisis – has improved, but remains behind the profitability level of US peers.

Banks in the EU plays a crucial role in the funding of the economy as they provide about 70% of corporate borrowing. In contrast, capital markets provide 77% of corporate funding. Thus, the profitability of banks in the EU is all the more important as it being persistently weak can pose a risk to financial stability and to the EU strategic autonomy.

2.2.1 The structural lack of profitability of European banking sector is largely reflected in the low Return on Equity (RoE) and the balance sheets of EU banks

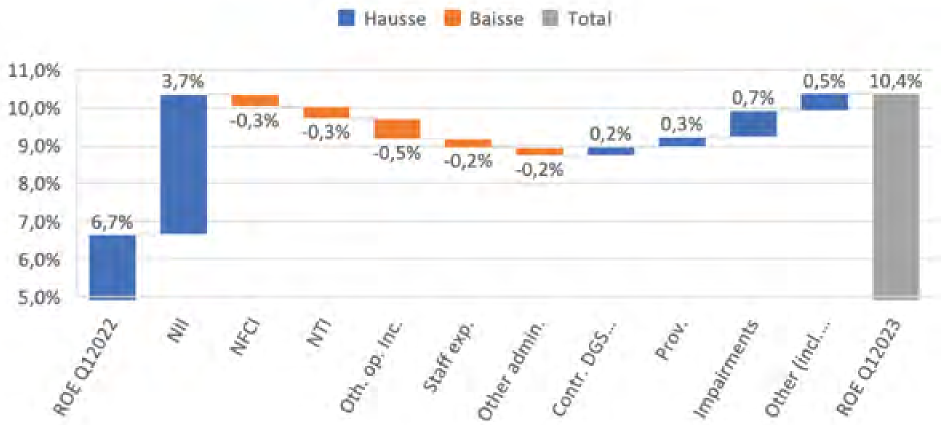
"Even before the Covid-19 outbreak, the European banking system suffered from a number of known structural weaknesses, such as a low profitability, as reflected in high-cost income ratios implying little capacity to invest in new technologies. This persistently low level of profitability is linked to an overcapacity in the European banking sector30".

Before the GFC, both the EU and the US banks had similar RoEs, above 10%. However, unlike their US peers, EU banks have failed to recover their pre-GFC profitability margins until 2023.

Chart 19 highlights that US banks continuously

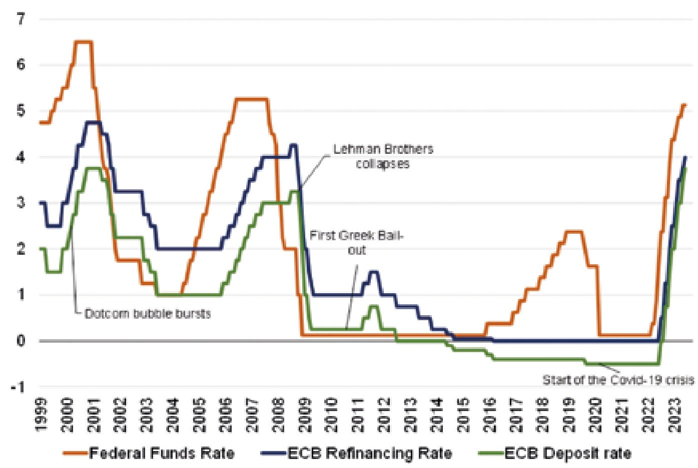
29. Op. Cit. P. Padoan.
30. E. Fernandez-Bollo, Does the Covid-19 crisis reinforce the case for banking union?, Views, The Eurofi Magazine, September 2022.

CHART 21.
Return on equity – year on year (2022-2023)



Source: EBA

CHART 22.
Key nominal short-term interest rates for the US and the euro area



Source: EBA
Note: latest data from June 2023

exceed EU banks in terms of RoE since the GFC, with for instance a 9.9% RoE in Q2-2022, while the RoE of EU banks lagged behind at 7.6%.

Moreover, Chart 20 shows that EU banks have not only a higher Cost of Equity (CoE) compared to US peers, but also compared to their own RoE. There is no doubt that the Covid-19 shock has further damaged the profitability of the European banking sector, especially that of banks that were already struggling before the pandemic. It must be noted that even if lagging behind, the EU banks have managed to reduce the gap with their American peers between 2021 and 2022.

Nevertheless, the RoE of EU banks was back to pre-pandemic levels in 2021. In spite of a slight drop in Q1 2022 to 6.7%, the Q1 2023 RoE of EU banks was 10.4%. This is mainly due to an increase in Net-Interest Income (3.7%) and to a lesser extent to a decrease in impairments (0.7%). Other non-recurrent items such as profit from from negative goodwill or from non-current assets (included under 'Other (incl.tax)' in Chart 21) played a limited role (0.5%) (see Chart 21).

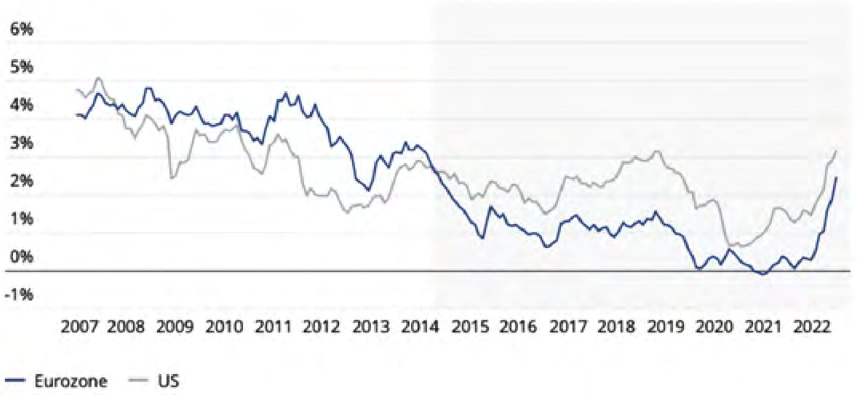
Although they reached pre-GFC level of profitability in 2023, European banks' RoE remains below their CoE, which approximates 17% on average in 2023. If profitability is higher than the cost of capital, then value is created. Otherwise, value is destroyed. And this has been the case for European banks since 2008 as evidenced by Charts 19 and 20 when comparing their levels of CoE and RoE.

Low profitability implies a double risk. Firstly, since profits are the first line of defense against losses, banks with low operating profits might be in a worse position to withstand a shock. Secondly, should a capital increase be necessary, this would be very expensive in terms of shareholder dilution for banks with poor market valuations.

Furthermore, "research suggests the stronger the return profile of a bank, the more likely it will make use of its buffers when allowed and encouraged to do so by supervisors, making policy tools more effective[31]".

31. Oliver Wyman – "The EU banking regulatory framework and its impact on banks and the economy" – January 2023, p. 8.

CHART 23.
Comparison of long-term interest rates in the eurozone versus the US, 2007-June 2022



Source: Oliver Wyman, "The EU banking regulatory framework and its impact on banks and the economy" – January 2023
Note: long-term interest rates refer to government bonds maturing in ten years

2.2.2 Both cyclical and structural reasons explain why profitability of major European banks has lagged behind international peers

As demonstrated above, in the wake of the GFC, despite a significant increase in EU banks' resilience, their profitability has lagged behind international competitors. Both cyclical and structural reasons explain the gap in profitability and valuation between the major European banks and their international peers.

Cyclical reasons

- **The US's more favorable macroeconomic environment**

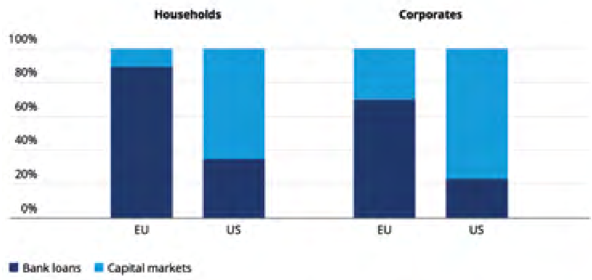
EU growth has been slower than the US over the past decades: US GDP in volume grew by 61% from the beginning of 1998 to the third quarter of 2022 and by only 36% in the euro area[32]. Slow growth equalled fewer lending opportunities, lower valuations, less profit for banks, and smaller RoE.

- **The yield curve and interest rate differential between the US and the Eurozone**

The US more favourable economic environment was also reflected in monetary policy since 2015, with the ECB that kept short-term rates down longer than the US Federal Reserve, putting pressures on banks' interest margins (*see Chart 22*).

Diverging monetary policy stances between the two regions have pushed euro area long-term bond yields to remain well below those of the US since 2014. Lasting low interest rates, as can be seen on Chart 23, have had negative consequences on EU banks profitability: it compresses net interest margins – which penalizes them *vis-à-vis* their American counterparts. Indeed, net interest income represents 50% of EU banks' net operating income, and Profit and Loss (P&L) is made of more than 50% of credit and loan related activities. The interest rate level matters.

CHART 24.
Comparison of ultimate sources of funding in Eurozone versus US



Source: Oliver Wyman, "The EU banking regulatory framework and its impact on banks and the economy", January 2023
Note: 2021 Q4 for EU, 2022 Q2 for US

- **The corporate taxation rate**

In the US in 2018, a reduction of the corporate taxation rate brought it to 21% which is much lower than what the top 10 SSM banks are required to pay.

Structural reasons

1. **The European financial market remains small and most of the financing in Europe is provided by the banking sector as shown by Chart 24.** Almost 90% of households in the EU are funded through bank loans against less than 40% in the US. Regarding corporate funding, a whopping 80% come from capital markets, against less than 40% in the EU (*see Chart 24*).
2. **There is an absence of a securitization and a single capital market in Europe.** Indeed, there are banks that have large balance sheets in Europe, but unlike those in the US, they are not able to originate and (mainly) distribute as much as they should, due to regulatory constraints. Therefore, a euro of capital is, by definition, not as productive depending on the side of the Atlantic where the bank is located.

32. Eurofi, Macroeconomic Scoreboard, September 2023.

Recent research conducted by Oliver Wyman[33] found that the European securitization market (including the UK) is about 6% the size of its counterpart in the US, representing about 1% of GDP compared to 18% in the US (*see Chart 25*).

Thanks to active securitization as well as federal agencies, US banks can reduce their balance sheets and have greater capital efficiency.

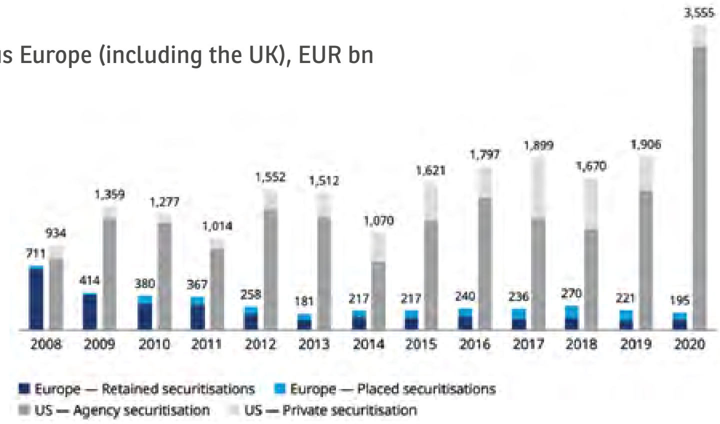
In contrast, integration in EU capital markets is only at an early stage and the euro area still lacks a common risk-free asset. It is an impediment, in particular in the light of the Basel IV framework, where holding a loan in the balance sheet will be even more expensive than it currently is. Moreover, the fact that the EU does not have public agencies like the American Freddie Mac and Fannie Mae – which act as giant vacuum cleaners of major amounts of mortgage loans that EU banks have to keep on their balance sheets – reinforces the gap between the EU and the US.

Additionally, "in a hypothetical scenario where EU banks could transfer half of their current mortgage portfolio to non-bank investors, banks' CET1 ratio would increase by around 0.9 percentage points, and banks' lending potential could increase by about EUR 0.9 tn[34]".

3. **The underlying risk requirements can be very different depending on the US or the EU market.** For instance, in the French banking system, there is a long historical period of lower and less volatile cost of risk. Such conditions, year after year, reflect a low risk profile on the domestic market, and especially on residential real estate. With lower risk, there are lower interest margins, as there is less risk that needs to be covered. This can partly explain the EU-US difference in terms of profitability.

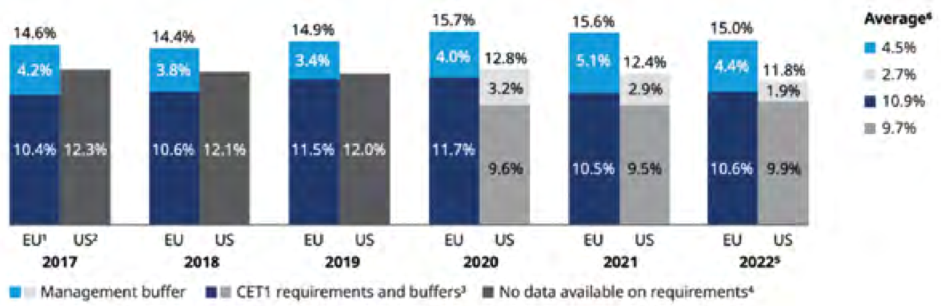
4. **The competitive structure differs between the euro area and the US banking system because many Eurozone banks are controlled or influenced by national or local governments, leading the euro area banking landscape to remain fragmented.** There is a much more diverse nature to national markets in Europe, and that is due to different attitudes towards credit, to the different legal frameworks, to the different structures and the need to satisfy different types of customers' needs. The most pertinent goal for euro area banks is to generate healthy levels of

CHART 25.
Comparison of securitization volumes, US versus Europe (including the UK), EUR bn



Source: Oliver Wyman, "The EU banking regulatory framework and its impact on banks and the economy", January 2023

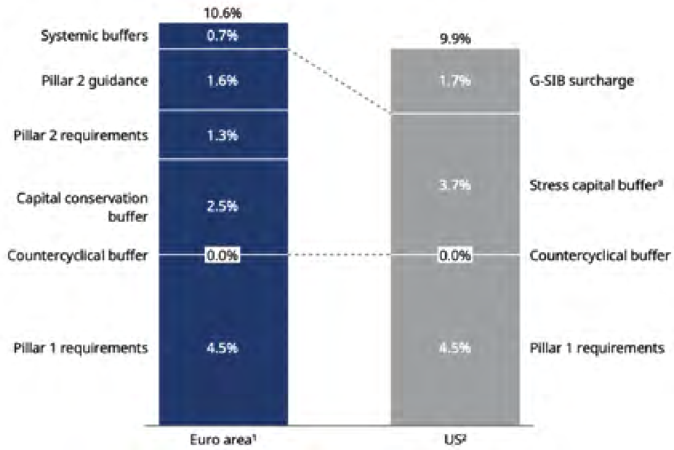
CHART 26.
Evolution of CET1 ratio in the EU and US



Source: Oliver Wyman, "The EU banking regulatory framework and its impact on banks and the economy", January 2023
1. Based on sample of banks participating in SREP; 2. Based on sample of US large banks participating in Dodd Frank Act Stress Test; 3. EU capital requirements reported as simple average; 4. Capital requirements and buffers only available for the US from 2020 onwards; 5. Latest (2022-Q1); all other data points are respective to the Q4 of that year; 6. Average over the period 2020-2022 where all data points are available for comparison

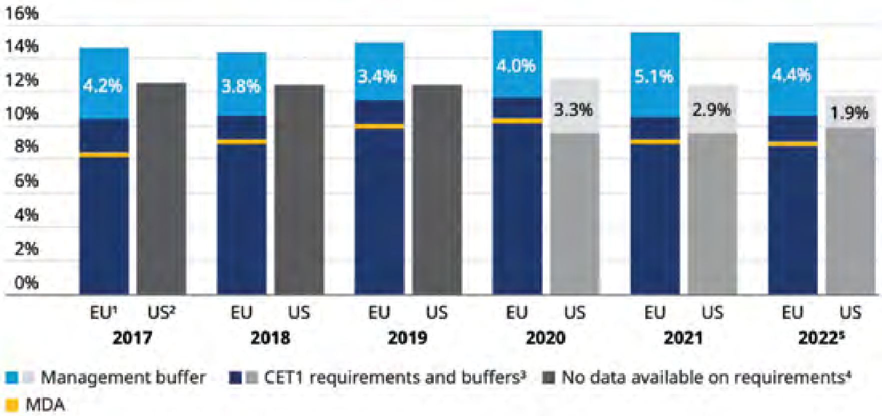
33. Oliver Wyman – "The EU banking regulatory framework and its impact on banks and the economy" – January 2023.
34. Oliver Wyman, Op. Cit., p. 14.

CHART 27.
Breakdown of CET1 capital requirements of Europe versus US in 2022



Source: Oliver Wyman, "The EU banking regulatory framework and its impact on banks and the economy", January 2023
1. Based on sample of 108 banks participating in 2021 SREP determining 2022 capital levels; 2. Based on sample of 34 US large banks participating in 2022 Dodd Frank Act Stress Test; 3. US' entity-specific Stress capital buffer (determined annually based on DFAST results) includes the Capital conservation buffer, Projected Stress Test Losses, and Q4-Q7 Dividend prefunding; 2. Capital requirements and buffers have been re-ordered to facilitate comparability with the US

CHART 28.
Evolution of CET1 management buffers held by banks in the EU and the US



Source: Oliver Wyman, "The EU banking regulatory framework and its impact on banks and the economy", January 2023
1. Based on sample of banks participating in SREP; 2. Based on sample of US large banks participating in Dodd Frank Act Stress Test; 3. EU capital requirements reported as simple average; 4. Capital requirements and buffers only available for the US from 2020 onwards; 5. Latest (2022-Q1); all other data points are respective to the Q4 of that year

profitability, which functions as a buffer against losses. The goal is not for EA banks to be compared directly to US banks but to look at how to address the profitability questions. The fragmentation and the different regimes in Europe are then reasons for the cost income ratio of European banks being so high.

5. **Regulatory-induced costs are potentially higher for EU banks than for their US counterparts. Research conducted by Oliver Wyman[35] emphasizes that both risk-based and non-risk-based requirements as well as management buffers are heavier in the EU than in the US.**

Regarding capital constraints between 2020 and 2022, EU banks hold on average 3.1 pp more CET 1 capital compared to Risk-Weighted Assets (RWAs) than US banks, as observable on Chart 26. 1.3 pp are explained by the higher requirements and buffers imposed by the EU regulator, and the remaining 1.8 pp correspond to higher management buffers held by entities due to ring-fencing practices (*see 1.1*).

Risk-based capital requirements

The current EU framework for capital buffers is complex, while the US have tried to simplify theirs in 2020 by introducing a single Stress Capital Buffer (SCB), leading to differences evidenced by Chart 27. While the US has only four components to their risk-based capital requirements, the euro area has 6, leading the latter to have higher CET1 ratio and putting pressure on its banks' margins.

Non-risk-based capital requirements (leverage ratio)

Besides the P1R generic 4.5%, both the EU and US apply a minimum leverage ratio of 3%[36]. However, given the structure and density of risks of balance sheets and the impact of accounting considerations, the comparison is not fully meaningful.

35. Oliver Wyman, Op. Cit, p. 20.
36. Yet, in 2021, additional own funds requirements for the leverage ratio were introduced in the revised Capital Requirements Directive and Regulation in the EU. It enables competent authorities to impose P2R-LR and P2G- LR limits if the risk of excessive leverage is perceived not to be covered by P1R-LR. The rationale differs in the US: the leverage is said not to be risk-sensitive by design, and thus there are no additional leverage requirement driven by differences in the risk profile.

Management buffers

In addition to capital requirements, EU banks hold a management buffer which is on average 1.8% higher than in the US (*see Chart 28*). The higher capital buffer in the EU is mainly explained by the supervisory pressure, which materializes both through formal restrictions and informal requirements. Supervisor discretion and uncertainty regarding capital requirements also prompt EU banks to have high levels of capital. But due to depressed market valuations and limited investor appetite, raising additional capital is expensive and difficult for EU banks, further weighing on their profitability.

Nonetheless, A. Enria argued in an interview for the Eurofi Magazine of September 2023[37] that "comparing capital requirements across jurisdictions is never a trivial exercise, as several factors can blur the picture. The European legislator has chosen to apply the Basel standards to all banks, including small and mid-sized banks, whereas in the United States rule apply differently depending on banks' size. As a result, smaller banks probably face, on average, more stringent prudential framework in the EU". He also explains that regarding G-SIBs, "the average supervisory add-on is probably a bit more conservative in the EU, while being more diverse in the US, where significantly higher capital charges are applied to specialized investment banks."

All in all, the comparison operated above is likely to change over the coming months. Indeed, following the US banking turmoil of early 2023, the Vice-Chair for supervision of the Fed Michael S. Barr has initiated a holistic review of capital requirements for large banks with more than USD 100 bn in total assets to better reflect credit, trading and operational risks. In a speech delivered on 10 July 2023[38], he declared that "the proposal's more accurate risk measures as equivalent to requiring the largest banks fold an additional 2 percentage points of capital, or an additional $2 of capital for every $100 of RWAs".

6. **Safety net architectures also differ on both side of the Atlantic, and this is visible in the public resolution funds and deposit guarantee schemes as well as in the loss-absorbing capacity requirements.**

Firstly, "the target size of bank-funded deposit insurance or resolution structures in the EU stands at approximately 2.4% of covered deposits, compared to 1.35% in the US[39]". While US banks are only required to contribute to a single fund (the Financial Deposit Insurance Corporation (FDIC)), EU banks have to contribute at the EU level to the Single Resolution Fund (SRF), and at the national level to the Deposit Guarantee Schemes (DGS).

Secondly, there are also differences regarding loss-absorbing capacity requirements. While there is a Total Loss Absorbing Capacity (TLAC) requirement of 18% for both EU and US banks, the EU has introduced a Minimum Requirement for own funds and Eligible Liabilities (MREL) to further enhance loss-absorbing capacity, which is wider in scope and represents an additional burden to EU banks. Furthermore, the BIS found that building loss-absorbing capacity is more costly for EU banks, with average senior bail-in bond risk premiums estimated to be twice as high for EU banks than for US ones.

7. **New rivals have entered the competition, especially fintech.** This new paradigm between banking activities and new actors is a challenge in terms of profitability for banks, which are obliged to invest large amounts to be able to compete with these new actors and properly address consumers' expectations.

8. **The low level of concentration and the higher fragmentation of the EU banking sector is a source of inefficiencies and vulnerabilities.** This situation leads to insufficient risk sharing at the EU level, since in case of difficulties, safety nets remain largely national. Fragmentation also entails "overbanking", which in the end affects banks' profitability in the system – as shown by the higher cost to income ratio, notably linked to the relatively high number of branches within the EU.

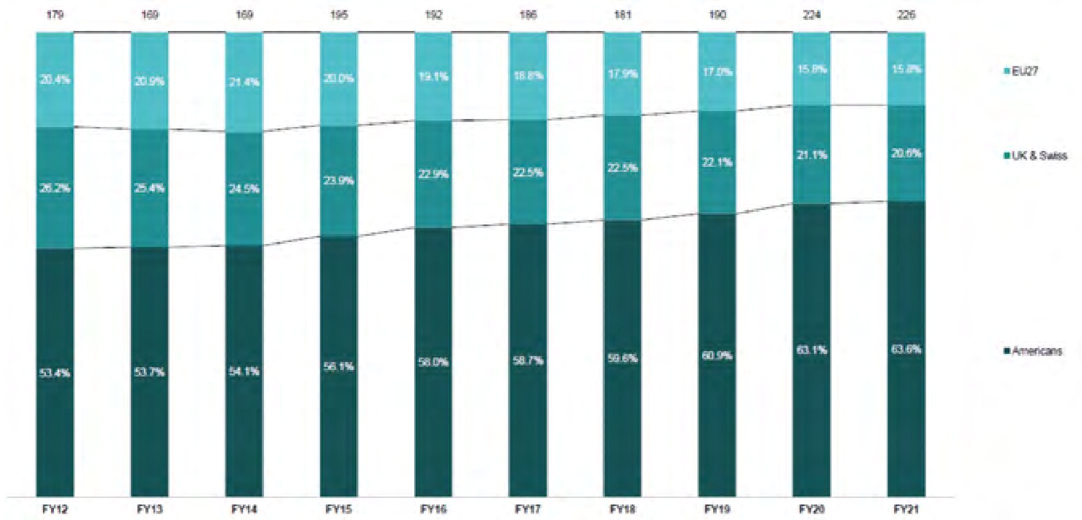
9. **There is also the issue of the treatment of Non-Performing Loans (NPLs).**

In that regard, in a speech given in June 2023[40], A. Enria highlighted that the divisive issue of NPLs from the GFC was resolved, because "the volume of NPLs held by significant banks dropped from around EUR 1 tn to under EUR 340 bn by the end of December 2022, the lowest level since supervisory data on the banks under ECB supervision were first published in 2015". The dropping level of NPLs in the EU is a positive thing, but in case of a new crisis (*e.g.*, in case of stagflation), it will remain a problem as there is no active market for NPLs in Europe.

10. **The high share of personnel costs in total costs of European banks compared to US and even more to Asian ones does not also hurt their profitability and denotes a relative inefficiency.**

37. A. Enria, "The integration of the EU banking sector and the challenges of global competition", Views, The Eurofi Magazine, September 2023.
38. M. S. Barr, "Holistic Capital Review", 10 July 2023.
39. Op. Cit. Oliver Wyman, p. 35.
40. A. Enria – "Well-run banks don't fail – why governance is an enduring theme in banking crises" – 1 June 2023.

CHART 29.
The market share evolution of EU banks in the global CIB market vs US banks (%)



Source: EBF

The structural lack of profitability in the European banking union is a problem both for the financing of the recovery, the green and digital transition and for financial stability, as it means that European banks would take longer to build the necessary capital levels to meet the financing needs, and to rebuild them if buffers were consumed in a crisis. Achieving higher profitability is therefore important for strengthening resilience, engaging the transformation towards more sustainable business models, and unlocking sufficient investment in digitization and consolidation in order to remain competitive.

2.2.3 Foreign investment banks acquire a rising number of market share in European markets, which contradicts the European will to reach strategic autonomy

Foreign investment banks are increasingly present into European markets, threatening EU financial sovereignty. Moreover, the framework implemented by Basel III still presents many obstacles to banking consolidation.

Non-EU investment banks are gaining market share in Europe, putting pressure on profitability and strategic autonomy of the EU economies.

The EU has long been attractive to banks which are headquartered outside the EU. US banks which have a strong market share in their large domestic market have an extraordinary advantage and a greater capacity to develop internationally (*e.g.*, the US still represent 50% of the global financial market, with the capitalization of a company like Apple being USD 3 trillions – the equivalent of the CAC 40). They are active in Europe and take market shares from local competitors.

At this stage on retail, it may be seen by authorities as a remote issue, but we should not underestimate their competition in the future. They might try to take part in the most attractive part of the retail and wealth management business in Europe.

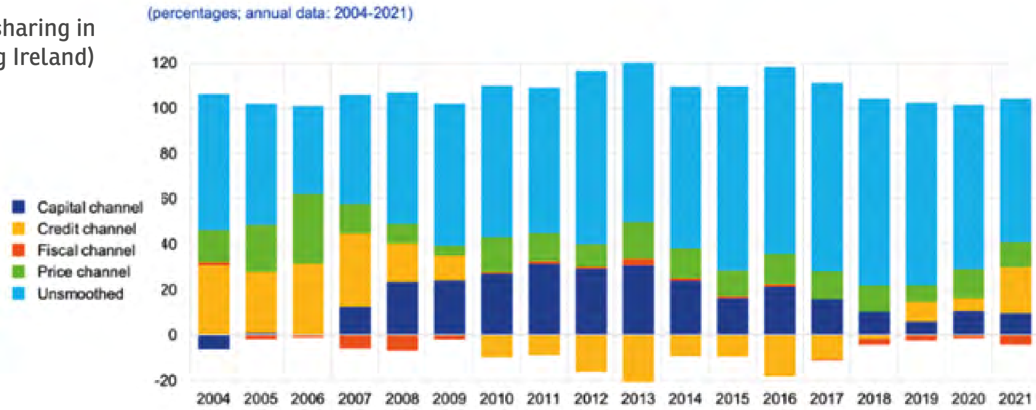
In addition, European banks have more of a compliance mindset while American ones have a growth mindset. In such a context, looking at the role of Global Systemically Important Institutions (G-SII) in the European Union, American banks are 2.5 times more active than European banks in fixed income; in equities it is 3 times and 4 times in Investment Banking Department. That gap has been growing every year.

Chart 29 displays historical data on the market share evolution of EU banks in the global CIB market vs. US banks, with a particular focus on the US and European regions. As expected, the main takeaway is that in 10 years, US banks gradually took 10% of market share away from European banks (5% away from EU27 banks, 5% away from UK/Swiss banks) – this is true both in North America and in Europe as regions as well.

Thus, an additional source of concern affecting EU banks' profitability is the overtaking of EU banks by their US counterparts in their own market as the largest US banks have accounted for more than half of total investment banking revenues in the EMEA region since 2016.

This latest development sharply raises the stakes for further financial integration in the EU, as not only is the EU banks' profitability at stake, but also EU sovereignty. Indeed, the increasing market share of non-EU investment banks could expose the EU economy to a risk of investment outflows in times of stress. As such, the coming years will be crucial to

CHART 30.
Consumption risk sharing in the EA12 (excluding Ireland) and its channels



Source: ECB calculations
Notes: the charts diplays, by year, the contribution to the smoothing of country-specific shocks to real GDP growth from capital markets (via cross-border ownership of productive assets), credit markets (via cross-border borrowing and lending), fiscal tools (via public cross-border transfers), and relative prices (via changes in the domestic consumer price index relative to the euro area average index). The respective contributions are calculated using a vector-autoregression (VAR) model whose parameters are estimated over an eleven-year rolling window of annual data, applying the Asdrubali and Kim (2004) approach enhanced for relative price adjusments. The bars display the share of a one-standard-deviation shock to domestic GDP growth that is absorbed by each risk sharing channel. The shares are computed on the basis of the cumulative impact of the shock on the variables capturing each risk sharing channel over a five-year horizon. Year-to-year variations in shares reflect changes in the re-estimated model parameters. The remaining portion represents the portion of the shock to country-specific real GDP growth that remains unsmoothed and is fully reflected in country-specific consumption growth. The individual bars may fall below 0% if one or more of the channels involved has a dis-smoothing effect on country-specific consumption growth. All bars together total 100%. Ireland is excluded due to the major change in its GDP reporting in 2015

address any systemic risks stemming from excessive reliance on non-EU entities.

2.3 Private risk sharing differs on both sides of the Atlantic and further widens the gap between EU and US banks

Risk sharing in the euro area is the sum of mechanisms through which a shock – positive or negative – to a country's economy is transmitted in other economies. Risk sharing takes place through two main channels: one is public (or fiscal) and the other is private (credit or market).

Private 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.

Yet, private risk sharing has been impaired in the EU area, and *a fortiori* in the EU, due to the absence of an efficient banking union and a genuine capital markets union. This should be a concern, as it is through risk sharing channels that the overall system becomes simultaneously more resilient and productive.

As explained by M. Draghi[41], private risk-sharing has a double key role which contributes to stabilizing the local economies.

- The first one happens through integrated capital markets as it allows the de-linkage of consumption and income at the local level. For instance, if during a recession people see their labor income shrunk, they can use the financial returns received on assets located in areas that know growth to smooth their consumption.
- The second one happens through banking integration and allows the de-linkage of the capital of local banks from the volume of local credit supply. In that regard, cross-border banks are able to compensate a loss in a recession-hit region with gains they made in another. Subsequently, there is no, or very little, cut lending and sound borrowers still have access to credit supply.

Once again, 2018 figures about private risk-sharing are unmistakable: in the US, financial markets smooth around 70% of local shocks – 45% absorbed by capital markets and 25% by credit markets, whereas in the EU the total figure was only 25%.

Private risk-sharing in the US is fostered by their single integrated financial market. Since the integration that happened in the early 1990s with the number of multistate banks growing from 100 to more than 700, the volatility of business cycle has been reduced, as well as the link between local capital and local credit supply.

Furthermore, the US benefits from a single and unified legal framework and a resolution authority –

41. M. Draghi, President of the ECB, "Risk-reducing and risk-sharing in our Monetary Union", speech at the European University Institute, Florence, 11 May 2018.

namely the Federal Deposit Insurance Corporation – that is backstopped by the US Treasury, aiming at reassuring the markets in case of deep crises, and at strengthening confidence in the financial institutions.

In the EU, there is a clear lack of confidence between Member States, and thus private risk-sharing mechanisms are difficult to implement: weaker Member States have the potential to become trapped in bad equilibria, and stronger ones refuse to endorse the risk for them. Thus, risk-sharing should go along with risk-reducing and economic convergence: the smaller the risk, the easier it is for Member States to accept to share it.

Moreover, the EU lacks deep financial integration and a pool of cross-border banks and investors. This missing consolidation that we studied previously is also an important hurdle to private risk-sharing insofar as the EU lacks the actors that would enable private risk-sharing.

Additionally, there is no single set of insolvency rules as there should be in a single market. According to an ECB analysis, regions with efficient insolvency and judicial framework have higher risk-sharing through both capital and credit markets. The EU is not quite there yet as can be seen on Chart 30.

As A. Enria already stated in 2018[42], since 2007 in the euro area, the credit channel has acted more as a shock amplifier than a shock absorber. Indeed, Chart 29 shows the negative contribution to risk-sharing via the credit channel between 2010 and 2018, implying borrowing abroad in economic good times and repayment of the loans in economic bad times. However, The contribution of the fiscal channel was also negative until 2021, but NGEU is expected to stimulate fiscal risk sharing, which has been muted to date, and further boost the credit channel, at least for the duration of the program[43]. Overall, risk sharing via the capital channel remains rather modest (below 10%) despite an improvement after the GFC[44].

Overall in 2021, about 60% of local shocks remained unsmoothed, indicating fragmentation in the region. In 2019 and 2020, *i.e.*, during the Covid-19 crisis, this percentage exceeded 70% and there was a clear decline in private risk-sharing since 2016.

The finding suggests that a complete banking union is a fundamental prerequisite to allow the credit channel to contribute positively to private risk sharing (as it is the case in the US).

This fragmentation reduces "the potential for private risk sharing in the European banking market". A. Enria explains in the Eurofi Magazine[45] that this "increases risks to local financial stability rather than reducing them. In fact, the integration of the banking sector plays a significant role in smoothing local shocks".

3. The EU needs to implement ambitious and effective solutions at a swifter pace

The EU created the banking union in 2012 as a response to the sovereign debt crisis. The goal was to safeguard financial stability (*i.e.*, to reduce financial fragmentation and to break the link between banks and their national sovereigns), to deliver a safer banking sector and protect the taxpayers from the cost of bank failures.

Having a fully integrated and complete banking union would have several benefits and allow to achieve the targets mentioned above, on top of contributing to a strong and better functioning Economic and Monetary Union (EMU):

- A safer and more integrated banking system would better support the currency union by efficiently transmitting the monetary policy.
- A genuine banking union would foster a more effective allocation of resources across the Eurozone (*e.g.*, companies would be able to tap wider and cheaper sources of funding), help to achieve a better diversification of risks and thus contribute to private risk sharing in the union. Depositors would also contribute to the financing of a more diversified pool of assets which would insure them against shocks specific to their home country. Such a risk diversification achieved under the surveillance of the EU would also help to reduce the sovereign-bank nexus.
- An integrated banking system would restore and improve saving allocation mechanisms to address productive investment opportunities more efficiently across Europe and in particular the Eurozone. Indeed, even if Eurozone members share a single currency, there has never been optimal financial flows between them, while the fundamental goal of a currency area is that savings may flow to finance the most productive investments throughout the currency area.
- A fully integrated banking union would enable the emergence of transnational banking groups,

42. A. Enria, Fragmentation in banking markets: crisis legacy and the challenge of Brexit, EBA, 17 September 2018.
43. https://www.ecb.europa.eu/pub/pdf/fie/ecb.fie202204~4c4f5f572f.en.pdf
44. Op. Cit. ECB.
45. A. Enria, "the integration…", the Eurofi Magazine, September 2023.

which would help Eurozone excess savings to circulate across borders to parts of Europe where most attractive investment opportunities exist, and to increase private risk sharing. Genuine transnational banking groups could also help the Eurozone undertake its digital and environmental transitions quicker and more effectively. Lastly, the EU needs transnational EU banking groups to rely on EU sufficient sources of financing and avoid being dependent on international US or Chinese groups.

As enhanced in the two first parts of this paper, several essential building blocks are missing in order to progress towards a fully integrated EU banking system and make effective that corporates and individuals wherever they are located in the EU can be financed by depositors of a given transnational EU banking group.

This section exposes different solutions that tackle the different barriers towards the completion of the EU banking union. Firstly, it is urgent that transnational groups be recognized at the consolidated level and that cross-border banking groups opt for branchification over subsidiarization. Secondly, there is still room for improvement regarding the CMDI framework.

3.1 Recognizing transnational groups at the consolidated level and promoting branchification is the way forward

Creating new rules for cross-border lenders is essential for EU consumers and businesses to reap the benefits of the single market.

3.1.1 The EU prudential and crisis management frameworks should recognize trans-national groups at the consolidated level

It is important to consider capital, liquidity and MREL requirements at the consolidated level rather than fragmenting these assessments and considering each legal entity in a cross-border banking group individually. The EU prudential and crisis management frameworks (CRD, CRR, BRRD) should adopt a consolidated approach for the definition of capital and liquidity requirements (LCR, NSFR, MREL, leverage ratio…).

As suggested by A. Enria[46], Member States should entrust the authorities of the banking union, the ECB[47] and the SRB with powers to define adequate levels of capital, liquidity and MREL of transnational banking groups in order to guarantee that the group and each of its subsidiaries with the single prudential jurisdiction are resilient and capable of supporting their customers, including in distressed situations.

“To this end, EU legislation should directly empower European authorities to require banks to maintain an appropriate level of capital, eligible loss-absorbing liabilities, and liquidity also at the level of each subsidiary and rely on recovery and resolution plans to make sure that losses can be properly distributed across the group and liquidity can flow where needed at times of stress. We, as prudential and resolution authorities for the whole area, will then tailor the requirements to the specific business model of each bank and enable a greater pooling of resources were arrangements for group support in case of stress are more robust and reliable”.

In parallel, it is essential to entrust the authorities of the banking union (ECB and SRB) with effective powers to ensure their prudential supervisory tools are calibrated in the most appropriate way to balance group-wide interests with legitimate concerns at the national level of each legal entity. This approach would be a real step forward compared with a rigid, one-size-fits-all, legislative regime, and could also be implemented in the absence of EDIS.

In an article issued in the Financial Times in July 2020[48], A. Weber advocates for a “regulatory Big Bang”: a EU single set of rules for cross-border banks would be designed, and the SSM would be fully in charge of supervising EU-wide lenders. In this perspective, there would also be a single license for cross-border groups willing to operate in the union. This would lift existing barriers to economies of scale and would also reduce costs. Indeed, he explains that “Europe needs to have a single European banking license. A pan-European bank needed 27 national licenses in Europe, 27 platforms and 27 management teams. If it could run its entire European business out of Frankfurt or Paris centrally with a single banking license, supervised by a single supervisor, subject to a single resolution regime, subject to a single deposit insurance scheme, it would have been a profitable market”.

“This would allow EU banks to exploit significant economies of scale and operate much more efficiently using a single platform… This pan-European bank would be able to provide a full suite of banking services across all 27 using a single International Bank Account Number (IBAN) code… Only a regulatory Big Bang would provide the nucleus of a proper single European market in financial services, decisive advantage for consumers, banks and the economy as a whole[49]”.

46. A. Enria, “Of temples and trees: on the road to completing the European banking union”, May 2022.
47. The SSM is not a home supervisor. It is both the home and the host supervisor, also responsible for subsidiaries.
48. A. Weber, “European banking needs a Big Bang”, The Financial Times, 28 July 2020 & “European banking union needs a Big Bang”, Eurofi Magazine, April 2023.
49. A. Weber, “European banking union needs a Big Bang”, Eurofi Magazine, April 2023.

3.1.2 Branchification can also be an effective way to have strong cross-border banking groups

Another solution would be for banks to review their cross-border organizational structure more actively and rely more on branches and the free provision of services, rather than subsidiaries, to develop cross-border business within the banking union and the single market.

A. Enria argued in an interview for the Eurofi Magazine[50] that "branchification", the process of merging all existing subsidiaries into the parent company and operating through branches of a single, unified legal entity, could enable banks to use the freedom of establishment enshrined in the Treaty to the maximum extent possible. [He] suggested this option in [his] speech at Eurofi in September 2021, taking inspiration from the widespread use of this model by third country banking groups relocating business to the euro area as a consequence of Brexit. So far only a few European cross-border banking groups have explored this avenue and only some groups in Nordic and Baltic countries decided to implement it.

"This is a missed opportunity because it is a solution readily available and completely consistent with the current legislative and regulatory frameworks. If you are a single legal entity structured in this way across different Member States, you no longer have to abide by the capital and liquidity requirements in the various countries where you operate. You can allocate your financial resources however you like. Therefore, there is no issue of trapped capital and liquidity resources and no obstacle concerning the distribution on capital, liquidity and MREL with cross-border banking groups. The constraints to transferring contributions into deposit guarantee schemes (DGSs) across systems could be the only regulatory hurdle standing in the way of such transformation: this is the reason why the ECB advised the co-legislators to slightly amend the framework. But even in the absence of this, legislative change agreements can be found, and have been found, between home and host DGSs to support branchification".

Banking groups that use branchification reported significant efficiency gains in terms of simplified legal structures and corporate governance, savings related to annual accounts and internal audit and lower overall regulatory requirements, among many others.

However, there are obstacles to branchify subsidiaries with significant retail activities such as legal obstacles and a pressure from host jurisdictions. For instance, some governments have made clear that business would not be available to banks if they set a branch framework instead of a subsidiary framework. In addition, the differences in retail market practices may lead a branch model to be inappropriate for that type of business.

This is the reason why Eurofi has underlined in different papers[51] that such a solution – to be acceptable for host countries – requires that the national supervisors and Parliaments should receive the necessary information to understand the risks national depositors are exposed to from these branches and the possible impacts on the financing of their economies. This may require developing specific reporting instruments and processes for the local authorities to continue to be able to appropriately supervise local activities and thus contribute to supervisory decisions taken at the SSM level that may impact their jurisdiction.

3.1.3 Credible support provided by parent companies to euro area subsidiaries based on European law and enforced by European authorities is a 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 need 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 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.

The SSM recognized that such a solution already

50. A. Enria, "The integration of the EU banking sector and the challenges of global competition", The Eurofi Magazine, September 2023.
51. https://www.eurofi.net/current-topics/banking-union/

A note from Eurofi written in 2022 has made comments and proposals on these subjects[54]:

According to many representatives of the banking industry, allowing mid-sized banks under the remit of the SSM not to have MREL above minimum capital requirements would raise level playing field issues and hinder wind-ups across the Banking Union. Losses need to be allocated; there is no cost-free solution.

If creditors and depositors of banks with a negative PIA are totally exempted from the constraints stemming from the resolution framework but can still benefit from State aid or "aid-free" mutualized resources at a lower cost than in resolution, this would contradict the principles of BRRD. Taxpayers and the DGS (*i.e.*, essentially healthy and relatively large banks within the sector) might be subsidizing ailing banks that do not issue sufficient MREL. Therefore, it appears mandatory to avoid the moral hazard issue caused by "free-riders" sailing between the two positions, claiming not to have the means to raise MREL, but claiming to be too important locally or nationally to go into insolvency.

Furthermore, it can be argued that such "free-riders", sometimes smaller banks or banks with one-sided business models attracting depositors with off-market deposit interest rates, affect the profitability of the entire EU banking system: not only can they sell their financial products and services at a lower price because they do not currently have to charge for the cost of MREL, but they can also force other banks to contribute more to the SRF or DGS to pay for their potential failure. These banks must exit the market in an orderly fashion in the event of failure. It is in everybody's interest.

In such a context, this note proposed that MREL requirements must be specified for medium-sized banks even with a credible sale of business as preferred resolution strategy. Until recently, the MREL market – also due to the low interest rate environment that fuels a search for yield – was wide open for small medium-sized banks. In such a context, this note proposed that:

Access to the Single Resolution Fund would also remain subject to prior bail-in of at least 8% of total liabilities and own funds (TLOF): taxpayers and DGSs should not subsidize banks that do not have sufficient MREL, and the moral hazard issue caused by "free riders" must be avoided.

Small banks – *e.g.*, with a balance sheet of less than 5 billion euros – do not have to go into resolution if they are in difficulty: they must be liquidated and exit the market (they are not by definition of public interest).

proposed in a Eurofi 2018 paper, would, at least foster a more positive attitude from national authorities, creating the conditions for legislative change to happen sooner.

3.2 The EU needs to address the issues raised by bank resolution and liquidation

Having an effective and integrated framework for managing crises is essential for preserving trust in the financial system, fighting against further fragmentation and safeguarding financial stability.

The EU framework has been seriously reinforced over the last decade, in particular for large banks, but there remains room for improvement and harmonization to achieve a crisis management framework effective for all types of banks, including small and medium-sized ones. The variety of approaches followed by national authorities notably in the management of failing mid-sized banks in recent years generated obvious mistrust between Member States, which is one of the obstacles to completing the banking union.

The recent collapse of regional US banks reminds us that medium-sized banks can be systemic. This banking turmoil as well as the merger of Credit Suisse and UBS have also demonstrated the growing influence of digitalisation (mobile apps) and social media in triggering sudden financial outflows – we have seen bank runs that were unprecedented in volumes and speed – and the need for effective and agile crisis management framework that rapidly reassure depositors and minimize disruption.

52. Eurofi, "Improving the EU bank crisis management framework for small and medium-sized banks and D-SIBs", February 2022.

On 18 April 2023, the European Commission published its proposal concerning the review of the BRDD, SRMR, DGSD and Daisy Chain Directive.

3.2.1 Should the EU allow Deposit Guarantee Schemes to address the funding gap in resolution for small and medium-sized banks?

The EU is more constrained in its ability to deploy the resources of the Single Resolution Fund (SRF) and Deposit Guarantee Schemes (DGS)[53] on a least cost basis than the United States. Funding from the Single Resolution Fund (SRF) can be disbursed only after at least 8% of own funds and liabilities have been bailed in, which for many mid-sized banks, unlike for large cross-border groups, would imply digging deep into the uninsured depositors' base[54].

National Deposit Guarantee Schemes can not only be used to repay depositors, but also to support sales of business or other crisis management tools, when this implies lower disbursement of resources than compensating depositors in liquidation. However, 15 Member States across the banking union do not make use of this possibility. In the remaining six Member States, where national deposit guarantee schemes could perform a wider range of functions, national discretion on how to carry out the least-cost test has further contributed to a fragmentation of the Single Market.

The European Commission has proposed in April 2023 to use the Deposit Guarantee Schemes (DGSs) more proactively. To accommodate that more proactive use, the creditor hierarchy must be changed, creating a single tier preference for deposits and the super-priority of DGSs must be removed. This proactive use of DGSs would be governed by a harmonized least-cost test. All the elements in the CMDI proposal are interdependent. If the creditor hierarchy and super-preference of DGSs cannot be changed, the DGSs cannot be used proactively either.

A. Enria believes these reforms would improve the functioning of the EU crisis management framework, even in the absence of a fully-fledged EDIS. By building trust in the functioning of our crisis management tools, this could also allay some Member States' concerns on possible mutualization of bank losses in a crisis scenario, thus helping the transition to a complete banking union.

Yet, many industry experts disagree with such views and rather advocates for the establishment of safeguards regarding DGS and IPS proactive intervention, as well as for the remaining of creditor hierarchy.

Deposit Guarantee Schemes (DGS)/ institutional Protection Schemes (IPS) funds could support early or alternative intervention but within strict pre-established safeguards in order to limit moral hazard:

- DGS/IPS must be systemically subject to state-aid rules when they are mobilized to carry out preventive and alternative measures, in the same way as Fund Aid through Article 19 SRMR. This is all the more important now that some of these DGS can escape state-aid control (thanks to the Banca Tercas ruling of the ECJ) and therefore disrupt the level playing field between national banking markets.
- DGSs/IPS should have reached the target of 0.8% (or 0.5% in concentrated markets) of covered deposits and that the amount available for use in such circumstances be capped at a certain level (*e.g.*, 0.2% of covered deposits).
- Increasing the capacity of DGS/IPS to fund alternative tools must not come at the cost of deteriorating a DGS's general position. This is why such an approach must strictly respect the 'least-cost-test' principle.
- The statement of the Eurogroup from June with regard to "preserving a functioning framework for institutional protection schemes to implement preventive measures" [Eurogroup Statement dd 16 June 2022] has to be respected.
- This least cost test (LCT) should be harmonised at the EU level to allow for consistent application to banks under the remit of the SRB (or the SSM for early intervention measures) and across the whole banking union.
- Harmonization of LCT implies that it must be approved at EU level, not at national one.
- The LCT should be subject to three conditions that must be fulfilled for the DGS to provide funding for alternative measures:

1. The gross cost of alternative measures does not exceed the gross cost of pay-out for covered deposits. As for the cash flow analysis, it disregards reimbursements and recoveries and limits the gross amount used for alternative measures.

53. The SRF will amount to an estimated €80 billion (1% of all covered deposits of authorized banks in all the participating Member States) by the end of 2023. The latest available data indicate that at the end of 2020, national deposit guarantee schemes collectively totaled some €37 billion, and should reach 0.8% of covered deposits by the end of 2023. All in all, the amount of total resources is in the same ballpark as in the United States, where the FDIC has an objective of a 2% reserve ratio, but which at the end of 2021 stood at 1.27%, or USD 123 billion.
54. "The SRB recently announced[26] that the SRF will amount to an estimated €80 billion (1% of all covered deposits of authorised banks in all the participating Member States) by the end of 2023. The latest available data[27] indicate that at the end of 2020, national deposit guarantee schemes collectively totalled some € 37 billion, and should reach 0.8% of covered deposits by the end of 2023. All in all, the amount of total resources is in the same ballpark as in the United States, where the FDIC has an objective of a 2% reserve ratio, but which at the end of 2021 stood at 1.27%, or USD 123 billion", quote from A. Enria, "Of temples and trees: on the road to completing the European banking union", Paris, 17 May 2022.

2. The hypothetical loss resulting from the alternative measures (cost of alternative measures, including indirect costs, net of funds that would be subsequently recovered, *i.e.*, reimbursement of loans, reimbursement or sale of an equity stake in a bridge bank) does not exceed the hypothetical ultimate loss borne by the DGS in case of pay-out after deducting funds recovered in the insolvency proceeding and adding indirect costs. As reminder, alternative measures should anyway lead to market exit.
3. The indirect cost assumed in case of a pay-out does not exceed a cap determined in terms of the covered deposits.
4. No alternative or preventive measure should be considered for banks with negative Public Interest Assessment (PIA) as determined at EU level, unless to ensure smooth and swift liquidation.

In addition, any early intervention that aim at preventing failure and at keeping a bank alive should also be subject to SSM (or SRB) approval, which should only be a one-time intervention granted to viable banks with a credible and sustainable business plan and a positive PIA as determined at EU level.

There should be no change in the creditor hierarchy, as it would lead to a wider use of preventive interventions and would cost more, according to several industry leaders.

Change of the creditor hierarchy by establishing a general preference for all deposits (instead of the current super preference for covered deposits and preference limited to retail and small enterprises' deposits over senior creditors that include corporate and institutional deposits today) or a removal of the DGS super preference (as they are substituted to the covered deposits) in insolvency would increase the final net cost for the DGS of compensating creditors and, hence, make the LCT easier to pass. In fact that would facilitate the bail-out of ailing banks by the sound part of the banking sector.

Furthermore, reviewing the deposits or the DGS positioning in creditor hierarchies present additional significant drawbacks: bank liquidity issues, increased of volatility of bank deposit financing, potentially weakened depositors' confidence and this would inevitably introduce moral hazard. Indeed, raising all deposits to the same level in creditor hierarchies would *de facto* reduce the bail-in-able instrument base. This would force healthy banks to "bail out", *i.e.*, replenish, DGSs much more often.

Corporate behaviour would change to the detriment of bond liabilities and to the benefit of bank deposits. Such an approach would relieve corporate treasurers of their risk analysis duties who would seek then the best possible return for their deposits, which is often offered by the weakest banks (which need these deposits).

3.2.2 This change would therefore be ineffective in stabilizing corporate deposits, which would remain less sticky than retail

The EU needs a harmonized bank liquidation regime for small and medium banks that cannot be placed in resolution to make them effectively exit the market.

There is currently a European resolution framework which is matched by 19 different liquidation regimes. Liquidation is still managed at the national level (entity by entity), and this can require public money of the Member State where the distressed bank is located.

National insolvency frameworks should be harmonized, allowing those non-viable small and medium-sized banks that cannot be placed in resolution to be safely and effectively removed from the market. The variety of approaches followed by national authorities for small and mid-sized banks in recent years crystallized a lack of trust amongst Member States. This is one of the obstacles on the road to completing the banking union. The new rules should ensure an equal treatment of creditors of the same rank.

Deciding the Public Interest Assessment at the EU level, including for the small and mid-sized banks, and making it more transparent and predictable could help to increase the trust in the framework, avoid limbo situations and ensure that banks that could not be resolved today without state aid or DGS alternative measures correctly pay ex-ante the cost of their true (locally) systemic nature.

In an interim stage, Eurofi proposed in 2018 one solution that would be to extend to subsidiaries the liquidation approach currently used for branches, This would allow all the subsidiaries of the Group to be treated under the same liquidation regime.

Conclusion

When the more fiscal and structural convergences (such as a reasonable level of public debt in all Eurozone countries…) are achieved, the more positive integration trends will creep into the Union and reduce the incentives for national authorities to "ring fence" transnational banks in terms of capital and liquidity, thus strengthening banks in their capacity to become pan-European players. In other words, a monetary union and all the more so a banking (or capital) union are not workable without economic convergence and fiscal discipline.

Despite remarkable achievements in terms of balance sheets cleaning, regulatory harmonization, and deepening institutional integration within the banking union, where the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) are up and running, financial integration is lagging. The banking union is failing to provide the degree of financial integration that we would have expected. Rather than smoothing idiosyncratic shocks to individual Member States, the current, fragmented, structure of the EU banking sector entails that it tends to amplify shocks.

If the EU wants to keep up with the US and China economically as well as politically, it must break out this downward spiral and strengthen its banking industry. Only competitive and profitable banks can take on the risks necessary to finance sustainable growth. This is why a financial integration agenda for the banking union should rank high among the priorities of legislators and authorities for the coming semesters. It is essential to give to the markets the message that the path to further integration is still there to ensure that the banking system will be in the future able to finance the necessary transformation of the economy, to address the challenges and opportunities of both digitalization and climate change.

Furthermore, EU legislators should make sure that the implementation of Basel III does not affect the financing capacity of EU banks. There is indeed a serious gap between the impact recently measured by EBA and G20 statement that the reform should not lead to a significant increase of capital requirements.

Finally, this integration movement must preserve the diversity of banking business models in Europe. Such a diversity is a European asset: it increases the resilience and the financing potential of the financial system and satisfies different types of customers and stakeholder needs. Sufficient profitability is essential to all banks, but profitability should not be the sole compass for the supervisors. Proportionality in regulation and supervision is of the essence.

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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.