

The Next Goal:

euro area banking integration

A single jurisdiction for cross-border banks



EGOV
BANKING UNION

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Abstract

In its first ten years (2014-2023), the banking union was successful in its prudential agenda but failed spectacularly in its underlying objective: establishing a single banking market in the euro area. This goal is now more important than ever, and easier to attain than at any time in the last decade. To make progress, cross-border banks should receive a specific treatment within general banking union legislation. Suggestions are made on how to make such regulatory carve-out effective and legally sound.

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LIST OF ABBREVIATIONS

BRRD	Bank recovery and resolution directive
CEBS	Committee of European Banking Supervisors
CET1	Common equity tier 1
CMDI	Crisis management and deposit insurance
CRD	Capital requirements directive
CRR	Capital requirements regulation
DGS	Deposit guarantee scheme
DGSD	Deposit guarantee schemes directive
EBA	European Banking Authority
ECB	European Central Bank
ECBG	Eurozone cross-border group
EDIS	European deposit insurance scheme
EIM	Early intervention measures
EMU	European Monetary Union
EU	European Union
FOLTF	Failing or likely to fail
FSB	Financial Stability Board
HoldCo	Holding parent company
ICAAP	Internal capital adequacy assessment process
ILAAP	Internal liquidity adequacy assessment process
GFSA	Group financial support agreement
LAC	Loss-absorbing capacity
LCR	Liquidity cover ratio
MPE	Multiple point of entry
NCWO	No creditor worse off
NSFR	Net stable funding ratio
OpCo	Operational parent company
PIA	Public interest assessment
SPE	Single point of entry
SRB	Single Resolution Board
SREP	Supervisory review and evaluation process
SRM	Single Resolution Mechanism
SRMR	Single Resolution Mechanism regulation
SSM	Single Supervisory Mechanism
SSM	Single Supervisory Mechanism regulation
TLAC	Total loss-absorbing capacity

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EXECUTIVE SUMMARY

Ten years after its inception, the banking union remains incomplete; but not to the same extent in all respects. The single supervision at the ECB has broadly accomplished its immediate mission, defined in 2014 by its foundational chair, Danièle Nouy, as “... *to help rebuild confidence in the balance sheet of SSM area banks*”. Its responsibility now is to preserve and hone the progress achieved. The framework to deal with bank crises has not worked as expected; recognizing this fact, the European Commission has proposed in April 2023 a package of legislative amendments which are now being examined by the EU co-legislators.

What remains spectacularly underachieved and not properly addressed is the underlying objective of creating a true banking union: a single market for banking products and services commensurate to the economic and political dimension of Europe and to the global role she aspires to play.

The first part of this paper illustrates this fact and makes three points:

1. The lack of a single banking market is costly, always and especially today when Europe faces the historical challenge of enacting four economic and societal transformations: Green, Digital, Geo-Strategic and Structural.
2. Making progress towards an integrated banking union is easier now than it has ever been in the last decade; hence the time to act is now.
3. Cross-border banking pertains to a small group of banks, having the structure, the culture and the ambition to do so. Regulation should recognize this fact and design cross-border banking norms that fit those subjects specifically, within the general set of rules applying to banks in general.

The second part of the paper examines the legal obstacles to a genuine integrated banking union and sketches a set of legislative amendments that would remove those obstacles.

The overarching goal is to create a single jurisdiction for cross-border banks in the area covered by the banking union, “country blind” from the regulatory, supervisory and crisis management viewpoints.

The main elements of the proposal can be summarized as follows:

- Define a set of structural and prudential criteria that need to be satisfied by the euro area banking groups that conduct, or realistically aspire to conduct, substantial cross-border business;
- Repeal or waive the legal provisions that prohibit the free movement of capital, liquidity and other prudential resources within the banking groups belonging to this category;
- In parallel, strengthen the provisions that govern the internal support within those groups, making them mandatory and enforceable and prescribing that they should be activated, in case of distress, both before and after the entity reaches the point of non-viability;
- Establish that these groups and/or the entities thereof, if declared failing-or-likely-to-fail by the supervisor, would be resolved by the European resolution authority, not liquidated nationally;
- Prescribe that the deposit insurance function for these groups would be performed by a dedicated scheme, contributed by the groups themselves, whereas the existing deposit insurance schemes would retain their functions with regard to banks having a predominantly national business focus.

1. INTRODUCTION

The banking union was conceived in 2011 and launched in 2012 with a predominant prudential purpose in mind. Since the start of the Greek crisis (2009), the cohesion of the euro area had been in danger. Financial markets were betting on a euro breakup, and doubts about its cohesion mounted even within the euro area. 2011 was a turning point: previously confined in small countries with manageable problems, the crisis hit Spain and Italy. With financial contagion in motion,¹ the bank/sovereign “loop” seemed on the verge of bringing the whole single currency construction down.

The policy response focused on strengthening the banks, leaving momentarily other considerations aside. The legal basis chosen for the new ECB supervision emphasized prudential issues over single market considerations and legal harmonization.² The dominant prudential purpose was codified in the SSM regulation, which in article 1 assigns to the new supervisor the objective of “*contributing to the safety and soundness of credit institutions and the stability of the financial system*”.³ This objective was forcefully pursued by the foundational ECB Supervisory Board (2014-2019), along lines which Danièle Nouy, its chair, summarized in May 2014 as follows: “*Our first and more immediate challenge is to help rebuild confidence in the balance sheet of SSM area banks*”.⁴ A similar line, account taken of different economic conditions and communication styles, was pursued by the SSM during the banking union’s second quinquennium (2019-2023), under the chairmanship of Andrea Enria.

That said, the underlying objective of creating an integrated banking market as part of the EU Single Market was never far away, let alone abandoned. This objective underlay all reforms undertaken by the EU on banking matters, from the Banking Directives of the 1980s to the single rulebook, from the establishment of the Lamfalussy banking committee (CEBS) in 2004 to its subsequent transformation into the European Banking Authority (EBA) in 2011, ending with the SSM itself. Even the euro, which the banking union was created to defend, loses meaning if disjoint from the single market (EU Commission, 1990). The more strategic goal was momentarily postponed, waiting for more propitious times.

With hindsight, one must register the fact that while the immediate prudential purpose was attained beyond the rosier expectations, the underlying one of creating a single banking market in the euro area was spectacularly missed (evidence in section 2 below). According to some, the first objective worked against the second.⁵ Strengthening capital and reducing risks means, more often than not, shedding exposures that are harder to assess; foreign ones belong to this category. A prudence-minded authority wanting to stay safe is inclined to impose heavy prudential requirements on bank mergers, even domestic ones, thereby preventing banks from reaching the critical mass needed to

¹ The collapse of Spanish banks, exposed to an overpriced construction sector, endangered the country’s public finances; see Baudino et al. (2023). In short sequence, the crisis extended to Italy, a country made inherently unstable by its giant public debt and a banking sector which at the time was inefficient and ridden by non-performing loans.

² Barring a Treaty change, two alternatives were considered at the time. One was to attach the new supervisory function to art 114 TFEU, dealing with approximation of laws in the single market. The other was to use art 127(6), the so-called “enabling clause” allowing to “confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.” The second avenue was chosen because of the reference to the ECB, the institution where the new authority would be located, overcoming concerns by some that the expression “specific tasks” may be too narrow.

³ Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, available [here](#); henceforth SSM Regulation.

⁴ Danièle Nouy (2014).

⁵ Oliver Wyman and European Banking Federation (2023).

expand abroad. There is a grain of truth to the claim that the immediate and remote objectives conflicted, but this paper does not discuss this bygone issue. It rather concentrates on where we stand now and what can be expected and done in the future.

Starting with two premises. The first is that there are significant costs to the failure of establishing a single banking market, and that these costs are higher now, and going forward, than in the past. Section 3 revisits the arguments in favour of cross-border banking integration in light of recent developments and of the “Four Transformations” the European economy is facing: Green, Digital, Geo-strategic and Structural. An integrated banking system is a vital complement of the vibrant, competitive and self-sustained euro area economy that we need as we move deeper into the 21st century. The second premise, articulated in section 4, is that making progress towards banking integration is easier now than it ever was in recent years. The upturn of interest rates that occurred since 2022, likely to be persistent, allows banks to generate significant resources internally. The richer financial purse allows banks to expand. With financial constraints largely gone, it is up to regulation to create the conditions whereby that expansion favours area-wide integration, rather than the entrenchment of national champions.

In section 5 we argue that cross-border integration does not require changing the rules for all banks. World-over, banking across jurisdictional frontiers is for the few, not for the many. The US example, which many regard as a model of integration, teaches a lesson: the vast majority of banks neither expand across states, nor have any ambition to do so. By far most US banks operate within geographical areas that are much smaller than any of the 50 states. US regulation treats banks operating at local and national levels differently. The same should in Europe, without this implying any breach either of the letter or of the spirit of the banking union. An implication of this is that a regulatory framework conducive to euro area consolidation should target the conditions and needs of a small set of (probably large) banks that have cross border ambition and capability. A limited and specific focus would facilitate acceptance and implementation, making success more likely.⁶

In section 6 we enter the regulatory field, examining the legal obstacles preventing banking integration from happening. We identify two main roadblocks. The first consists of a small number of legal provisions, mainly in the Capital Requirements Regulation (CRR),⁷ that confine capital and liquidity requirements at the national level and prevent the single supervisor from waiving nationally based prudential requirements within cross-border banking groups. The second depends on the incompleteness of the bank crisis management framework, preventing effective cooperation across those groups’ entities. With regard to the latter, many specific issues must be addressed, distinguishing three phases: the one before resolution (early intervention), the moment of deciding whether to go for resolution or for national insolvency, and the resolution process itself.

We approach the regulatory agenda on two premises. The first is that progress toward cross-border integration must be possible without either creating a single all-encompassing EU-wide deposit insurance scheme, or changing the prudential treatment of sovereign exposures. These two issues have generated endless controversy in the last ten years, without material progress. On either of these

⁶ The idea of a regulatory framework specifically designed for European cross-border banks was first advanced, well before the banking union, in an IMF paper by Cihak and Decressin (2007). As a complement to the banking union, it was proposed by Angeloni (2020) and very recently by Cahen (2023). See also Muñoz et al, (2023).

⁷ From now on, references to CRR, CRD and BRRD are intended to comprise the original texts plus their successive modifications. At present, the texts in force are CRR3, CRD6, and BRRD2.

two fronts, changes are not more likely now than they were ten years ago. Making them a precondition for progress means ruling out any progress in the foreseeable future.

The second premise is that cross-border integration in the euro area⁸ should not, in the main, rely on the establishment of foreign branches, as a substitute for subsidiaries. Subsidiaries, separate legal entities with own structures and resources, are a more reliable and durable means of foreign establishment because they involve local investment in material, human and cultural capital. Recent research shows that branches, remote offices fully dependent on the mother company, are a more volatile and less reliable form of cross-border expansion.⁹ An additional and more pragmatic reason is that large European banking groups are already heavily invested in foreign subsidiaries. This creates a path-dependency in the integration process. A regulatory framework that facilitates foreign establishment taking place through branches would put European banks at a disadvantage relative to their non-European competitors, facilitating the latter's further penetration in the euro area.

Section 7 discusses, in a preliminary way, a combination of amendments and enhancements of the EU banking framework that would permit, and facilitate, the cross-border expansion of banks having continental ambition. Those amendments require no Treaty changes but do imply legislative action at EU level and national legislation for transposition of the directives involved. The legal material is complex. To facilitate the reading, section 7 is divided in two parts. The first uses a standard example to illustrate what happens to a cross-border group in distress, before and after it, or a subsidiary thereof, reaches the point of non-viability. Examining in detail this phase of the bank's life is crucial because much of the euro area's banking fragmentation today is due to the fact that there are no proper rules that ensure the cohesion of a cross-border group in distress. On this basis, the second part of section 7 includes a tentative list of legal amendments to ensure that cross-border banking groups are truly European, i.e. country-blind and cohesive both in health and when they are in trouble.

Section 8 concludes.

This introduction and sections 6 and 7 are meant to be self-sufficient; the time-constrained reader may get the essence of the paper by reading only them. Sections 2, 3 and 4 argue that the EU banking market is fragmented, that this is a problem and that Europe should act now to address it. The reader already convinced of these points can easily skip them. Section 5 addresses the crucial issue of the legislative scope. It does so by presenting data from the US and Europe that show that banking across frontiers is conducted by few banks only, even in well-integrated banking markets. The scope of regulation should be set accordingly. As a rule, EU law submits all categories of banks to the same rules. This is understandable and desirable in other contexts, but is of hindrance from the viewpoint of cross-border integration.

⁸ From now on, we refer to "euro area" to mean the area covered by the banking union, where banks are supervised by the SSM. The difference between the two definitions today consists of Bulgaria, which is part of the SSM but not in the euro area. Bulgaria is an important country in many respects, but not for the issues discussed in this paper.

⁹ For empirical analyses of this issue see Aldasoro et al (2022), and the references therein.

2. BANKING UNION: WHERE IT SUCCEEDED AND WHERE IT FAILED

The actions taken by the ECB after 2012 to strengthen the euro area banking sector are well documented; only a brief summary is needed here.

From the outset, the SSM undertook prompt and forceful prudential actions.¹⁰ While it was still being set up, in 2013-14 the ECB conducted an in-depth analysis (the “comprehensive assessment”, effectively a due diligence), on all banks that it would supervise. That process set the tone for all subsequent work and led to the identification of 25 mid-size domestically-active banks having capital shortfalls that should be remedied as a matter of urgency.¹¹ The expectation of this exercise and of the fact that new and more stringent prudential standards would soon apply led to a quick recapitalization of a number of undercapitalized euro area banks, which took place even before the SSM was formally in charge, although they were indirectly caused by it.

After taking charge (November 2014), the SSM launched its Supervisory Review and Evaluation Process (SREP), an annual “health check” on each supervised bank based on a unified methodology. Henceforth, SREP and all other supervisory processes relied on a harmonized set of statistics constructed for the purpose, which for the first time allowed to benchmark European banks with a common yardstick. SREP looks at banks from four perspectives: business model and profitability; governance; risk to capital; risk to liquidity and funding. On that basis, scores are assigned measuring the safety and soundness of euro area banks on a methodologically consistent basis, under each of the four chapters and overall. Building on that, the ECB supervision sets additional (pillar 2) prudential requirements, on top of the legal ones. The combination of these steps jumpstarted much of the ensuing progress in euro area banksolvency standards.¹²

SREP, a holistic methodology, was complemented by sectoral analyses targeting specific banking activities and risk, the most important of which was the plan dealing with non-performing loans (NPLs). NPLs had increased massively during the financial crisis. Based on best practice analyses, the NPL Action Plan set standards and guidelines for banks to first improve their internal process to identify and monitor NPLs, then dispose them through sales and write-offs. Other areas of supervisory action involved vetting internal risk models and improving the methodologies that banks use to internally evaluate their capital and liquidity needs (so-called ICAAP and ILAAP).

¹⁰ The start of the banking union was not marked by a single event but by a protracted sequence of political and legal acts. The Eurogroup launched the project in June 2012. In December of the same year, the EU Council approved a first draft of what would become the Single Supervisory Mechanism Regulation (SSMR), after which the “trilogue” approval process began. The Capital requirements Regulation (CRR, the key legal text for the single supervision) is dated June 2013. The definitive text of the SSMR became law in October, after which the ECB started conducting its supervisory check (“comprehensive assessment”) on the banks that the SSM would start supervising a year later. The Bank Recovery and Resolution Directive (BRRD) and the Regulation of the Single Resolution Mechanism (SRMR), governing bank resolution at EU level, are dated June and October 2014, respectively. The SSM and the SRM assumed their full powers in November 2014 and January 2016, respectively. In the opinion of this author, the key dates marking the start of the banking union are the entry into force of the CRR and SSMR, respectively June and October 2013. This is because the comprehensive assessment, which was technically based on the CRR and to which both future chairs of the SSM and the SRM participated, is to be considered as an integral part of the upcoming single supervision.

¹¹ ECB (2014).

¹² SREP continues to be used and is occasionally updated and improved. Recently, an ECB independent external evaluation has suggested further refinements; see ECB (2023e).

This three-pronged strategy produced dramatic effects in a short period of time. As shown elsewhere,¹³ most balance sheet adjustment was frontloaded before 2017. Subsequently, pressure from the industry and new orientations in the EU itself softened the supervisory pressure somewhat. This mattered little, however, because in the meantime the benefit of sounder balance sheets for their business conduct had been appreciated by most of the banks themselves, making the process self-propelled and easier to manage from a supervisor's viewpoint. Therefore, progress continued in the following years, at a slower but steady pace.

Between 2012 and now (timing depending on the most recent data available), the average CET1 ratio (high-quality capital in percent of risk-weighted balance sheet assets) for ECB-supervised banks rose from just above 10% to nearly 18%. Other definitions of capital rose roughly in parallel. Bank liquidity, according to the Basel III definition of the liquidity coverage ratio (LCR; highly-liquid assets in percent of expected cash outflows over a 30-day period, in adverse conditions) rose from 75% in 2011 to over 200% now on average. The stability of funding, measured by the net stable funding ratio (NSFR: funding sources weighted by stability factors in percent of assets weighted by illiquidity factors) increased from below 96% in 2012 to over 130% today.¹⁴ An equally dramatic turnaround was achieved in asset quality. The average NPL ratio of SSM supervised banks declined, from 8% in 2014 to about 2% at end-2023.¹⁵

These numbers are remarkable by any geographical or historical standard. By comparison, the corresponding capital ratio for the 23 large US banks subject to the Federal Reserve stress-test increased in the same time period by just 2%, from about 10% to little over 12%. Today, LCR in the four largest US banks range between 112% and 123%.¹⁶ The headway made by euro area banks in the years after the financial crisis, in terms of their solvency, liquidity and asset quality standards, was much bigger than that of their competitors across the Atlantic. In other dimensions, though, euro area banks lagged behind. In terms of profitability and price-to-book ratios, in particular, US banks beat their euro area peers both in absolute levels and in terms of progress over time.¹⁷

The accomplishments on the prudential side stand in stark contrast with the absence of appreciable progress in the cross-border integration of the euro area banking system.

The ECB monitors financial integration using price and quantity-based information. Quantitative data inform on the size of banks' cross-border operations: direct lending, acquisitions, foreign establishments, etc. Price information measures the extent to which the prices of banking products and services converge across frontiers. The two measures are complementary and neither of them implies the other.

ECB analyses show that euro area financial integration has improved in certain respects after EMU but has collapsed during the financial and euro crisis (2008-2011), and has never recovered since.¹⁸ The pandemic period triggered another period of disintegration.¹⁹ In particular, banking sector integration,

¹³ See Angeloni (2021), chapter 2.

¹⁴ Data for LCR and NSFR are obtained combining the following sources: Angeloni (2021); EBA (2015); ECB (2024). In both cases, the minimum requirement is 100%.

¹⁵ See Fell et al (2021) and ECB (2024) for aggregate data; for further details see ECB (2023c).

¹⁶ Data on common equity ratios are from Federal Reserve Board (2023). LCR for the four largest US banks (JPMorgan, Bank of America, Wells Fargo and Citigroup), available from their quarterly disclosures, are comprised between 112% and 123%.

¹⁷ See Angeloni (2021) and De Vito et al. (2023).

¹⁸ A similar pattern was observed as regards global financial integration; see Claessens (2017).

¹⁹ ECB (2023f).

to the extent that it improved in the early years of the euro, and partly recovered after the financial and euro crisis, relied entirely on the convergence of money market interbank rates – a very partial and volatile integration channel, because it excludes retail banking and cross-border establishments (branches, subsidiaries, including mergers and acquisitions). These measures also show that the degree of integration is highly volatile and sensitive to market stress.²⁰

Direct information on cross-border mergers and acquisitions in banking confirms this picture.²¹ After a short-lived flurry after the start of the euro, mergers and acquisitions in the euro area banking sector petered out and never rose to significance again. A mild recovery of small domestic acquisitions was observed after the crisis, essentially reflecting officially-assisted solutions of banking crises. Cross-border operations remained insignificant ever since.

A holistic picture is obtained by looking at foreign claims by euro area banks vis-à-vis counterparties in other euro area countries, including all forms – direct lending and securities holding, indirect claims via branches and subsidiaries, etc. This aggregate can be calculated from the consolidated banking statistics compiled by the Bank for International Settlements (BIS).²² Figure 1 shows it for the period 2014-2022, together with a similar aggregate including all claims held by banks in non-euro area countries reporting to the BIS. This allows to compare the movements in intra-euro area foreign claims of euro area banks with those of the comparable aggregate referred to non-euro area banks²³.

The upper panel of the figure shows that since 2014 the bank foreign claims within the euro area have moved similarly to those held by non-euro area banks. The levels are different: the intra-area claims are larger. But the movements are similar, with a gradual increase in the post-crisis years and a decline after the pandemic.²⁴ From this one infers that the drivers are broadly the same, and the launch of the banking union has not impacted the two magnitudes differently.

The lower panel shows the same aggregates, but calculated as percent ratios of the total foreign claims of each of corresponding group of banks. What stands out here is the remarkable constancy of both ratios. The one referred to euro area banks moved up a bit, from 36.8% in 2014 to 38.4% in 202; the one referred to non-euro area banks declined a little (17.7% to 17.0%). These movements may be considered to be in the “right” direction, but over a horizon of ten years, and after a supposedly regime-changing reform, they are negligible.

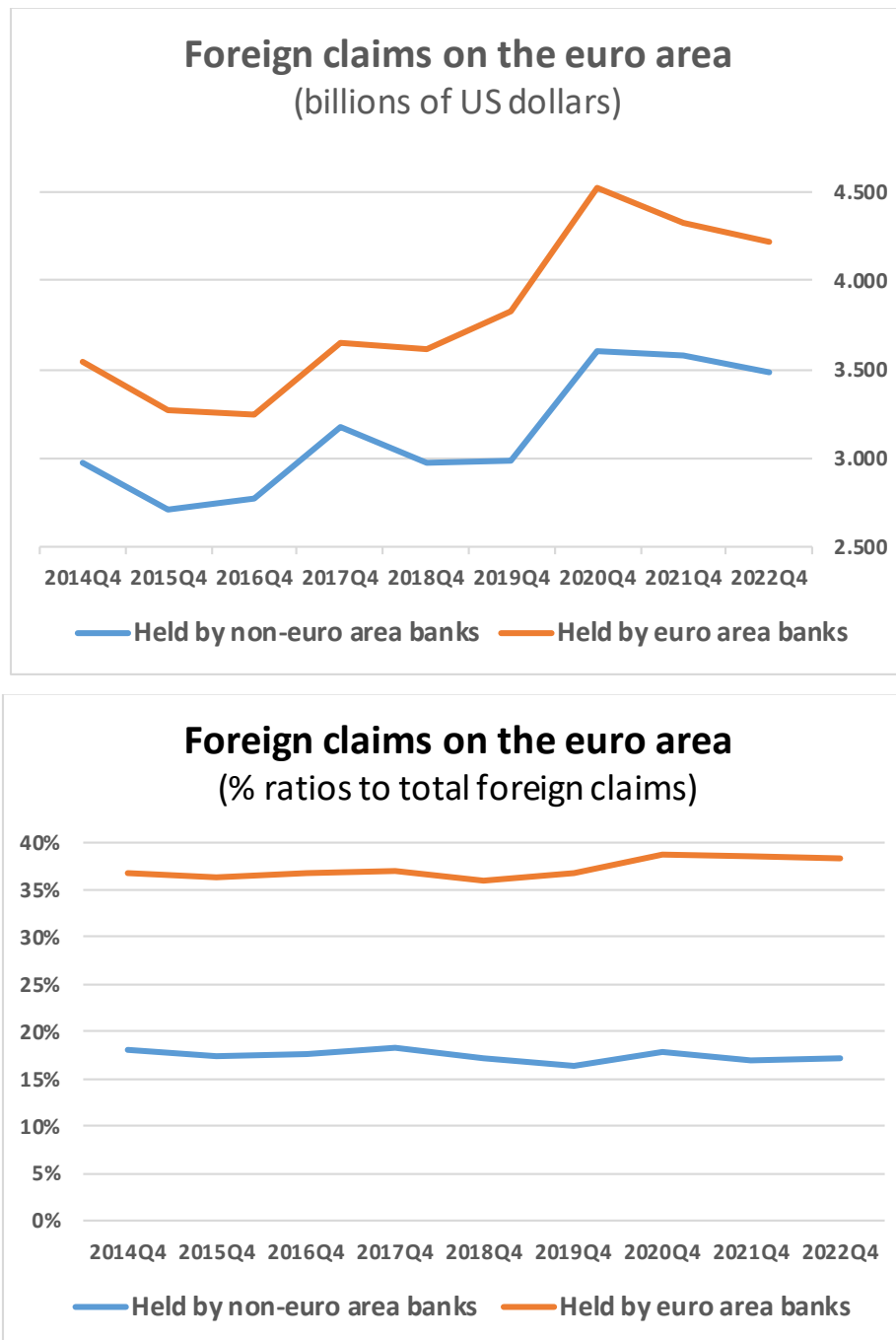
²⁰ Hoffmann et al., (2019a) and Hoffmann et al., (2019b).

²¹ See ECB (2022), especially chart 7.

²² The data shown in the figures below are partly unpublished. I am grateful to Goetz von Peter and Swapan Pradhan, without involving them, for kindly providing these data and guiding me in their interpretation.

²³ UK data are left out because they are possibly spurious, the sample including years both before and after Brexit.

²⁴ A minor increase in within-euro area claims is visible in 2019-20. This is almost entirely attributable to French banks, a phenomenon noted also by ECB (2021).

Figure 1: Foreign claims on the euro area

Source: BIS banking statistics.

To sum up this section: while the banking union has decisively strengthened balance sheets of euro area banks, cross-border integration in the area during the period has either receded or not progressed, depending on the metric used. The small increase in cross-border claims measured in monetary units matches that of non-euro area banks, and cannot therefore signal an improvement in the euro area bank's ability to expand in other euro area countries.

3. WHY FAILURE MATTERS

Having established the facts, we should briefly visit the normative side: Is the lack of cross-border banking in the euro area a problem? Is it a problem especially now, in the very different world we live in, ten years after the banking union was conceived and launched?

The conclusion of this section is that not only it is a problem generally, but it is more of a problem now than it was 10 years ago.

This conclusion is not granted. Cross-border banking tends to come together with large bank size, a dubious side-effect. Banks that are too large to fail create moral hazard and enhance systemic risks. Moreover, banking away from one's roots may be inefficient: localism has many defenders, generally speaking and notably in banking.²⁵

A lucid and authoritative argument in support of banking integration in the euro area comes from the former ECB president Mario Draghi (2014) in a statement made, not by coincidence, a few days after the launch of ECB supervision. In a nutshell, his argument goes as follows. A monetary union, where countries forgo the benefit of exchange rate changes, needs compensating mechanisms to attenuate and redistribute country specific shocks. Absent those, the single currency union becomes a straightjacket and a burden for some members, and eventually breaks down. Well established monetary unions, e.g. the United States, provide such mechanism in the form of fiscal transfers at the federal level. The euro area does not (yet) have such mechanism. This shifts burden onto the private sector, chiefly to the financial markets. In Europe (again, unlike the US), financial intermediation is largely performed by banks. In Draghi's words: *"In this context, Banking Union represents a vital step forward in creating the conditions for a higher quality of financial integration. Single supervision and resolution should be catalytic in lowering the hurdles to cross-border activity and encouraging deeper retail banking integration. In the process, this will create more private risk-sharing within the sector."*

Data evidence in this respect is clear. Cimodomo et al (2018, charts 3 and 4), with data up to 2016, find that in the United States state-specific idiosyncratic shocks are smoothed out by about 60%: most of the smoothing comes from financial markets (30%), but a sizeable part comes from the fiscal side and also the credit channel (20%). By contrast, in the euro area country-specific shocks are almost entirely borne at the country level; no area-wide smoothing occurs. The credit channel even acts in a perverse way, exacerbating national shocks. The fiscal sector plays virtually no shock absorber role in the euro area; nor is there a ground to hope that progress was made after 2016.²⁶

An effective risk-sharing mechanism in the euro area is now as needed as ever, and absent a meaningful centralized fiscal capacity, such role can only be performed by the financial sector. Prospectively, the capital market union may be hoped to play a supporting role; but this will take a lot of time. Only an integrated euro-wide banking sector can be made available to potentially perform that role in the foreseeable future. Shortly before stepping down as ECB Supervisory Board chair at the end of 2023, Andrea Enria called the failure of the banking union to jumpstart euro area integration a "personal regret".²⁷

²⁵ For a general argument in favour of localism in an era of globalization, see Ferguson and Rajan (2023). Specifically on banking, Granja and Rajan (2018) find that "going the extra mile" – lending at great distance – increases bank risks and is procyclical, expanding credit in booms and contracting it in slumps.

²⁶ The Recovery and Resilience Facility, the program of investment and reforms launched and financed by the EU after the pandemic, remains a once-and-for-all.

²⁷ Enria (2023).

But there is more. Since 2020, priorities, requirements and constraints in the European continent have changed, in the face of new geo-strategic and economic realities. Briefly put, things are as follows. Continental Europe has lived through the post-war decades blessed by the comfort of four certainties: cheap energy from the East, free-of-charge defence from the West, absence of significant technological or environmental constraints, and an open and unfettered international trading system. The combination of these four pillars (pillows may be a more fitting image) allowed European countries, without relinquishing their own preferences, lifestyles, specialization, strong points and vulnerabilities, to prosper in a sort of middle ground in the global value chains; an intermediate position between, on the one hand, raw material inputs and basic manufactured goods cheaply supplied by less developed countries, and, on the other, advanced or luxury products high-up in the value added scale, largely exported to the rest of the world, developed as well as emerging.

The Covid pandemic, the Ukrainian and Middle-eastern crises and the associated cooling of international relations and disruptions of Europe's traditional trade and supply channels – the recent problems in transitivity of the Suez Canal is just an aspect of this process – have disrupted that comfort, maybe for good. How Europe will respond to those challenges, what new “model” will replace the old one is still unclear. All conceivable scenarios imply that continental Europe will need to become more self-sufficient in multiple respects: supply sources, outlet markets, defence, environmental and health sustainability. A historic turn that is hard to overestimate and that will have far reaching implications for the European Union, politically and economically.

The implications for finance and banking will not be of minor importance. Europe's upcoming “Four Transformations” – making the economy greener; providing for its own defence; moving up and staying close to the digital frontier; replacing an export-driven economy with one more reliant on domestic demand – will require massive investment in physical and human capital. In all likelihood those investments will be different from the past, *quantitatively* and *qualitatively*.²⁸

There are no reliable estimates available quantifying the investment requirements of the Four Transformations individually considered, let alone all of them together. In a recent opinion piece, the CEO of Amundi (Europe's largest asset manager) estimated the investment needed to achieve autonomy only in the semiconductor sector in “*hundreds of billions of euros*”.²⁹ Decarbonizing the European economy will require extra capital for an amount that has been estimated, *every year for the next three decades*, at 700 billions euros from the private financial sector alone (that is, excluding public budgets).³⁰ The digital transformation alone will cost, according to estimates, 4 trillion dollars globally as soon as 2027, of which 23% borne by Western Europe alone.³¹ The fourth transformation – unleashing domestic demand – would involve scaling-up the personal finance sector. And so on. If one puts all these numbers together, it is hard to come up with an estimate of additional investment requirement, for the aforementioned four chapters combined, of less than 5 trillion euros annually for the euro area as a whole, for decades, if the word “transformation” is to be taken seriously. As rough

²⁸ Lately, there are discussions in EU official circles about an “Open Strategic Autonomy”, or OSA. According to European Parliament (2022), OSA “refers to the capacity of the EU to act autonomously – that is, without being dependent on other countries – in strategically important policy areas.” OSA is a grand label, a broad concept that still needs to be filled with concrete content. It can cover many areas, from security and defence, to supply chain vulnerabilities, technology, up until broader concepts like democratic and social values. What matters here are only areas that require significant quantifiable investment.

²⁹ Baudson (2022).

³⁰ Gonzales Paramo (2021).

³¹ IDC (2023).

yardstick, this is about two times today's aggregate investment of the euro area excluding construction.³² External financing to euro area firms over the last five years amounted, on average, to about 0,8 trillion annually.³³ These tentative figures suggest that the financing need implied by the Four Transformations is of an order of magnitude higher than anything provided today by the euro area financial sector. At present, only two banks incorporated in the euro area feature among the 10 largest banks globally, in 9th and 10th places. Only one asset manager is in the corresponding list, in 10th place.³⁴ The euro area financial sector will hardly be able to shoulder that effort, without a radical change in its status quo.³⁵

The same conclusion comes from considering the *qualitative* angle. Investments to enhance the strategic autonomy of the continent will have an area-wide scope and include a significant component of European public goods. This will require area-wide ambition and vision on the part of the banking sector's leadership, to say nothing about public sector administrators and politicians. Such broad perspective cannot exist in a banking sector fragmented along national lines. Continental Europe must become the assumed playing ground of business plans for banks that have the will and capacity to act across borders. Another change of status quo – this time, in mentality, by bank managers and governing boards alike.

4. WHY NOW IS THE TIME

Cross-border banking integration may have been desirable already in past years, but in practice it was impossible because euro area banks did not have the resources to expand. By and large, over the whole decade after the crisis, their business plans were defensive, marked by a high degree of conservatism.

The financial crisis had led to a collapse of bank profitability, globally and in the euro area. Average returns on equity, previously oscillating in a range between 10 and 20%, collapsed around 2009 close to zero or just above.³⁶ Price-to-book ratios stayed at around 0.5 for over a decade. There were two concurrent factors behind this. One was the restriction of banking interest margins, driven by the low interest rate policy of the ECB. The second was the post-crisis clean-up of balance sheets, impacting bank accounts through provisions and capital write-offs. In practice, however, the most important factor was the impact of prolonged and very thin interest margins on the banks' revenues from traditional intermediation. Interest margins are still today the dominant source of profitability for most lenders, although euro area banks have attempted over time, to some extent successfully and in reaction to the adverse environment, to diversify their revenue channels.

This scenario changed drastically after mid-2021 when euro area inflation rose quickly and sharply above 2% (the ECB target), and even more a year later, when the ECB started raising its main policy rate, the remuneration paid by the central bank on the free deposits banks hold with the central bank, previously negative at -0.5%. Partly due to the ECB's belated response, in the following quarters the ECB deposit rate had to catch-up at unprecedented speed, up until today's level of 4%.

³² Data from the annual macro-economic database of the European Commission (AMECO).

³³ ECB (2023d).

³⁴ See Standard and Poor's (2023) and Pensions&Investments (2022).

³⁵ Similar conclusions are reached in a recent ECB Occasional paper (ECB, 2023a), where two additional considerations are made. First, "strategic autonomy" would imply reducing, or at least not increasing, the incoming flows of FDI. Second, an increasing and probably underestimated mass of incoming investment channels pertains to areas sensitive from a security perspective, such as China.

³⁶ For this and other details that follow, see ECB 2023b, chapter 3.

The effect of the interest rate increase on bank margins and bank sheets more generally was massive. Average ROE at end-2023 is now estimated at around 10% for a sample of 19 large listed euro area banks. Notably, the margin effect explains over 100% of the increase in operating profits, which in turn explains more than 100% of the increase on ROE (data are from the ECB 2023b). The counterbalancing factors are revenue distribution, which picked up again, and impairment costs, which continue to be high although at a much lower scale than before. On balance, these elements suggest that the increase in bank profitability should be persistent in the coming years, though perhaps not permanent, thereby enhancing the banks' capital and reserve buffers. Impairments should hopefully remain low, because the post-crisis clean-up of balance sheets is now largely completed (a cautionary note comes, in some jurisdictions, from the possibility of residual NPLs from the pandemic period). The ECB interest rates may start declining at some stage, but a return to the abnormal zero or negative post-crisis levels is to be ruled out. Dividend distribution will probably rise further, but the moral suasion from the ECB supervision may contribute to moderate them. All in all, the belt-tightening years for the euro area banking sector are likely to be over.

Not only is bank profitability on the rise, and the same is happening to banks' share prices, but – also importantly from our viewpoint – this happens differently across banks. Intermediaries have different sensitivities to the main drivers of profitability, depending in their balance sheet configuration and business models. Therefore, wider gaps open-up among them in their net returns, operating profits and stock market valuations. The high tide raises all of them, but not to the same extent: there will be “winners” and “losers”, in relative terms. This increases the chances that the process may result in a new, perhaps unprecedented, wave of mergers and acquisitions. Not all “winners” may have sufficient share value for share-only mergers, but some of them may, and liquidity is ample too, and increasing.

The table below shows the changes in price-to book ratios for a sample of the 10 largest listed euro area banks, starting from mid-2021 (when inflation started rising) and mid-2022 (when policy rates started rising), up to today. It shows the simple average across the 10 banks and the dispersion, measured by the standard deviation and the min-max gap. The first column shows the (simple) mean increase in price-to-book ratios in the two periods. Especially from mid-2022 to today, the increase is remarkable, from 0.57 to 0.76, or 35%. The other two columns show the dispersion in terms of standard deviation and min-max gap. The dispersion increased for both definitions over the period by a sizeable amount. This gives a measure of the winner-loser effect that may create condition for capital operations.

Table 1: Price to book ratios

Average and dispersion across the ten largest euro area banks			
	MEAN	St.Dev	Max-Min
(a) Mid-2021	0,66	0,26	0,85
(b) Mid-2022	0,57	0,27	0,89
(c) 11/01/2024	0,76	0,33	1,12
(c) - (a) %	16	25	32
(c) - (b) %	35	22	26

Source: Author's calculation from online data. Banks included: Unicredit, BNP Paribas, Santander, Intesa, ING, Nordea, BBVA, Credit Agricole, KBC, SocGen.

For simplicity, the table includes only a small number of very large banks. However, acquisitions both domestic and across borders are probably going to involve to a greater extent medium-size banks, among which there are also winners and losers, and across which the dispersion may be even higher. The central point is that, if one looks at the prospects for cross border consolidation of the banking sector, now is the time: There was never a more favourable moment recently.

5. CROSS-BORDER BANKING IS FOR THE FEW

One must understand up front the characteristics of the banks inclined to conduct cross-border activities, because regulatory action that takes those characteristics into account is more likely to be successful. The main point in this section is that not all banks are good candidates for that activity: actually, they are quite few, and have certain characteristics in common.

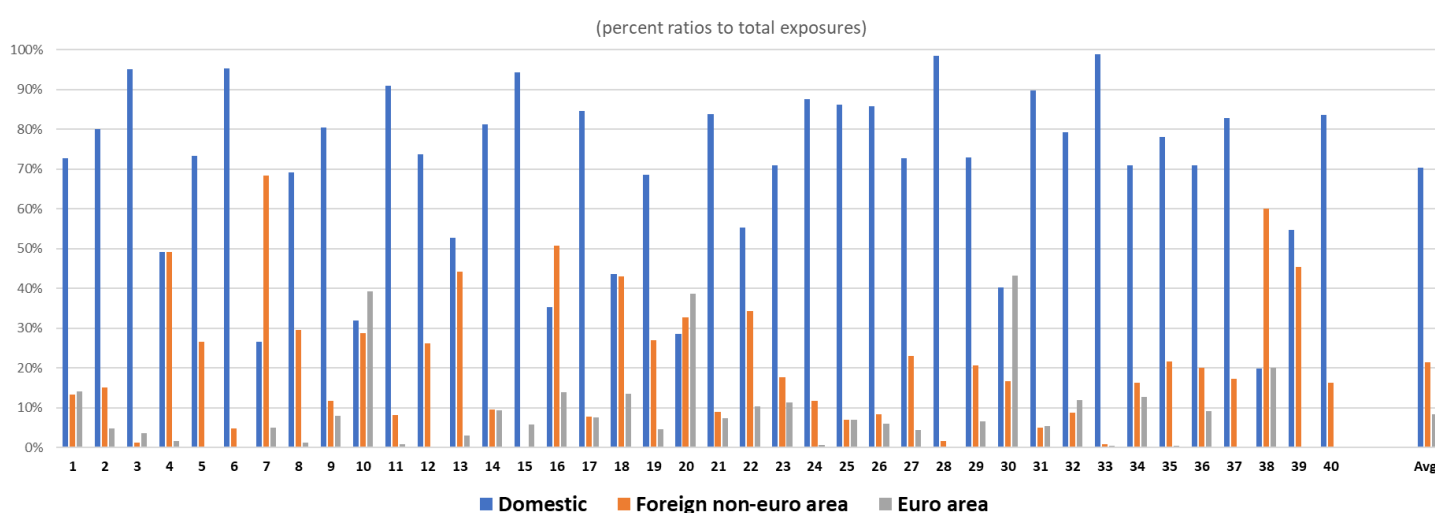
To make this exploration concrete, one must look at individual banks: country-wide aggregations are not suited. Here we are lucky to be able to use a very interesting public dataset compiled by two Dutch economists, Patty Duijm and Dirk Schoenmaker (2020). These authors collected from individual bank information (annual reports and other disclosures) annual data from 2010 to 2017 on total exposures, with counterparties broken down by country. The database covers 61 European banks, and the counterparties are classified by location in a detailed way – some 150 including individual countries and aggregating regions. For our purpose, the 61 banks were reduced to 40 after eliminating non-euro area banks (mainly UK and Switzerland), banks which no longer exist or are outside of the banking union's scope. The remaining banks are listed in Appendix 1.³⁷ The counterparties' locations were reduced to 22 (for cross-border exposures, the 20 euro area countries and the rest of the world, plus the domestic exposures). On this basis, it is possible to divide the exposures of each bank in three

³⁷ The list reflects the conditions prevailing at the end of the period in consideration. In particular, Landesbank Baden Württemberg (DE) and NRW Bank (DE, the regional bank of Nordrhein Westfalen) are included because they were still within SSM supervision at the time – they are no longer now. SNS Reaal (NL) was and still is in the SSM but has a new name, de Volksbank n.v. I am grateful to Nicolas Veron for spotting an earlier error in this classification.

categories: Domestic, Foreign non-euro area; and euro area (cross-border). One can also observe how the cross-border euro area exposures are distributed across euro area countries.

The chart below shows the three categories of exposures for each bank, and their unweighted average on the right-hand side, in the most recent year available (2017). The numbered list of banks in the appendix together with the numbers in the chart allow to connect data to each bank.

Figure 2: Domestic and cross-border exposures of the 40 largest euro area banks



Source: author's calculations based on Duijm and Schoenmaker (2020)

Three features stand out. First, as one would expect, for most banks, domestic exposures dwarf foreign ones. Most banks have a predominant national imprint. Not all of them, though. A minority is very active beyond their national frontiers, inside or outside of the euro area, or both. The second less obvious feature is that non-euro area cross-border exposures are much larger than euro area cross-border ones, for most banks and on average. The average cross-border euro area exposure, in percent of total exposures, is 8%, as against 21% for cross-border exposures outside of the euro area. Out of 40 banks, those for which the ratio of euro area cross-border to total exposures is larger than the one for non-euro area are only 7. This highlights that, on the one hand, banks are generally open to the option of operating beyond the national frontier, but, on the other, there is much room for progress in terms of translating this propensity into concrete progress of euro area consolidation.

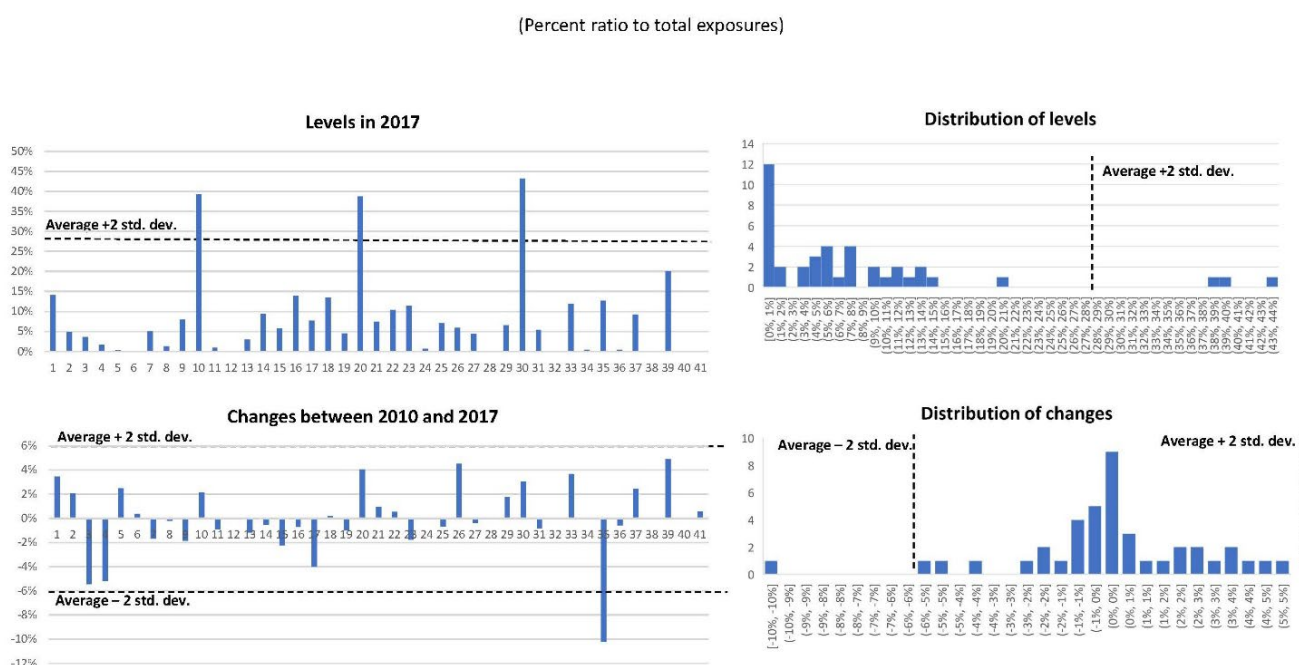
The third feature is that the banks with a significant cross-border presence, both in the euro area and outside, are generally among the large, but not necessarily the largest; conversely, some among the largest are not very active outside their national footprint. Appendix 1 reports the respective rankings among euro area banks, for the year 2018.³⁸ Broadly speaking, the banks for which the foreign presence is most significant occupy the following ranks: 1, 3, 4, 7, 8, 11, 14 and 28. The propensity to expand abroad is therefore a specific feature of the bank business model, likely linked, among other things, to its history and culture, but not intrinsically linked to its size.

More evidence comes in the second chart below, where the euro area cross-border exposures are charted alone, together with their distribution. In addition to the levels of these exposures for the year 2017, the chart reports also the change between two sub-periods: 2010-13 to 2014-17. The idea is to

³⁸ Standard and Poor's Global (2019). Not all our banks are included in the ranking contained in this source.

bring into this analysis not only the *recent levels* of these exposures, but also their *changes over time*. The obvious limit here is that the sample ends in 2017; it would be interesting to see what has changed in more recent times, especially in response to the pandemic, the recession and the more recent increase in geo-political risks. Unfortunately, the Duijm-Schoenmaker data are not available after 2017.³⁹

Figure 3: Within-euro area cross-border exposures



Source: author's calculations based on Duijm and Schoenmaker (2020)

This chart also reports the means of the levels and changes, and (two times) the standard deviation from that mean. The purpose here is to loosely identify a “normal pattern” of those figures as opposed to values that are somehow “anomalous”.⁴⁰

The distinction between the two types of observations emerges quite clearly. Regarding the levels, most observations except three are quite low, well below (only one at) 20%. The three “outliers” are quite important, at or above 40%. They correspond, respectively, to BNP Paribas (FR, ranked 1), ING (NL, rank 7), and Unicredit (IT, rank 8). The 20% value corresponds to Raiffeisen Zentralbank Österreich (AT, rank 28). The charts based on changes reveal that most banks have made no change at all, as regards the size of their euro area cross-border exposures, in the period under consideration. The mean of the changes is virtually equal to zero and all values except one lie within the informal confidence interval. The single outlier, Belfius Banque (BE, rank 35) is large and negative, meaning that the euro area exposure has dropped – an effect evidently linked to the dismantling of Dexia. Except for this very

³⁹ This is a pity. The European Parliament or other EU institutions may consider supporting an extension of this research.

⁴⁰ This calculation is indicative and not a rigorous analysis of outliers. Such analysis is complicated by the fact that the distribution of the levels is highly skewed, with many observations clustered at zero or near to it and few distant (presumable) outliers at the far right of the distribution. Outlier analyses relying on standard deviations or interquartile range distances apply to symmetric distributions and are particularly inappropriate for highly skewed ones; see for example Verardi and Vermandele (2018). In our case, informal observation of the charts suggests that the identification of the “anomalous values” is quite evident, so that using more sophisticated techniques does not seem necessary.

specific case, no significant changes have occurred across the system. On this point, specifically, it would be useful to be able to observe what changes have occurred more recently, especially after 2020.

It is interesting to relate the size of cross border euro area exposures with their changes, and also with the extent to which those exposures – especially the large ones – are geographically concentrated or else distributed across a large number of countries. If the large cross-border players are also those for which the exposures have increased (especially in the “hard times” following the financial and euro crisis), and also those which tend to distribute their presence over a large number of countries, then the indication is that cross-border business is a feature of a few banks, with several implications relevant from the viewpoint of euro area banking consolidation.

We show some evidence in the table below. The entries measure the number of banks out of 40 which share certain characteristics. The left side of the table indicates the cases in which the bank’s exposure surpasses 10% and 20% of the total exposures. The headings at the top display the size of the cross-border component; the fact that the bank is present in more than one country; and the fact that the total cross-border exposure has increased in the period under consideration. The first two criteria echo the benchmarks used by the ECB to measure the cross-border presence of the bank, which is one of the metrics used to determine the “significance” of the bank (as a result of which the bank is supervised directly by the ECB).⁴¹

The first column of entries shows that out of our 40 banks, 11 have an aggregate cross-border exposure higher than 10%, and 4 higher than 20%. Euro area cross-border banking is for the few: for the vast majority of banks, it is negligible. The second column tells that in all the cases just mentioned, the bank is present in more than one country. In fact, inspection of the data shows that in almost all cases, those banks are present in several countries, though the presence is typically more important in one foreign country. The third column shows that in most cases where the exposure surpasses 10% (8 out of 11), and in all cases where it surpasses 20% (4 out of 4), exposure has been growing, albeit modestly, in the period under consideration. Banks which were banking abroad have expanded that activity further, in spite of the difficulties of the post-crisis period.

Table 2: Banks with significant, diversified and growing cross-border business

Number of banks displaying significant, diversified and growing cross-border intra-euro area exposures in 2017 (1)			
	Total euro area exposures...	... and was present in at least 2 countries	... and exposure was growing
Above 10% of total exposures	11	11	8
Above 20% of total exposures	4	4	4
(1) Out of a total of 40 large euro area banks.			

Source: author’s calculations based on Duijm and Schoenmaker (2020)

⁴¹ The size of a bank’s cross-border exposure is one of the criteria for determining if a bank is supervised “directly” by the ECB, if the two size criteria are not satisfied. Specifically, a bank is classified as “significant” if its cross-border exposures are greater than 20% of its assets and are located in more than one country. See the ECB website [here](#).

Could the fact that just a few euro area banks engage in area-wide banking depend on European regulation not being cross-border friendly? The example of the US, where interstate banking was liberalized decades ago and within-state banking was free even earlier⁴² suggests that this is not the case, or at least not fully. Angeloni et al (2021) compiled a dataset of estimated banking characteristics in the US, disaggregated geographically by individual counties, from 1990 to 2020.⁴³ There are 4236 banks in the US,⁴⁴ unevenly distributed over 50 states (plus DC) and 3143 counties. Size and characteristics of US counties vary enormously, the smallest being in the East coast, the largest on the Western side of the nation – see map in Appendix 2.⁴⁵ The average county size is 1.173 sq. miles. By comparison, the smallest euro area state, Luxembourg, is 998 sq. miles; the largest one, Germany, is 138.063 sq. miles.

The graphs in Appendix 2 show that the vast majority of US banks are strictly local: three fourths of them serve between one and four counties only. Over half of them serve only one. On average, the number of counties served by a bank today is just five.

Importantly, territorial reach gets sharply higher for banks belonging to the fourth quartile: the top-sized banks typically operate in several hundred counties per bank, naturally including the most important ones demographically and economically. This is what helps making the US banking system integrated: not the myriad of local banks.

All in all, this evidence suggests that any regulatory changes having the purpose of helping banking consolidation in the euro area must pay special attention to the specific conditions and needs of the banks that are more likely to be prime actors of such consolidation. With two advantages. First, a properly tailored regulation is most likely to be effective. Second, if changes do not affect the generality of banks, even most of them at least immediately, there is going to be less resistance to change. As the banking union's short history shows, much of the reason why it remains incomplete is resistance to change especially among certain categories of small-medium sized banks and their constituencies. Future legislative initiatives need to pay more attention to that.

If legislative focus shifts, concentrating on the specific requirements of a restricted “club” of banks, an “open door principle” must apply. Club member banks exclusively enjoy certain benefits, subject to conditions, but at the same time, open and transparent access rules must be in place. Exclusivity and openness are not contradictory, if strict conditions apply to define the “club”. As recent behavioural research shows, exclusivity generates attraction.⁴⁶ If the new category is perceived as special, maybe privileged, more banks will want to be part of it. A dynamic that may become itself a factor of further consolidation.

⁴² For details see Angeloni, Kasinger and Tantasith (2023), section 5 and references therein.

⁴³ See Angeloni, Kasinger and Tantasith (2021). The data can be downloaded from the Harvard Dataverse [here](#).

⁴⁴ Only banks federally insured by the FDIC are considered. Credit Unions and other minor groups are excluded.

⁴⁵ County borders were set gradually over US history, starting shortly after the Mayflower anchored at Cape Cod (1620) and gradually moving West. Originally, their extension was determined by travel time, first by horse then by train; this explains why Western counties are larger than Eastern ones. The smallest county, Arlington (Virginia), best known for hosting the namesake cemetery where president John F. Kennedy is buried, is just 26 sq. miles. The largest one, San Bernardino (California), is 20.160 square miles.

⁴⁶ Exclusivity by itself generates demand for belonging to exclusive circles; see Imas and Madarasz (2023), who call this mechanism “superiority-seeking”. In their words: “‘Included’ members derive greater pleasure from consuming goods, possessing attributes, and belonging to organizations from which others are restricted”.

Let's be clear on one point, to avoid misunderstandings. In no case should the potential establishment of specific rules for cross-border banks require or be intended to allow a softening of ECB supervision on the remaining mainly domestic "significant" banks, let alone a repatriation of supervision on them to the member states. For at least two reasons: First, because the progress made in supervisory practices and prudential standards alluded to in section 2, made possible in large part by the actions of the SSM, should be preserved. Second, because otherwise the "open door principle" would not work. Different supervisory regimes would tend to entrench a semi-perpetual class of domestic banks, crippled in their ability to make the quantum leap to the cross-border category. This would weaken competition and result in a reversion, not an advancement, of the banking union.⁴⁷

Striking the delicate balance between regulating for the few and respecting the "open door principle" is a main concern of the following sections, where we sketch a set of regulatory changes aimed at jumpstarting bank consolidation in the euro area. We first identify a number of "legal roadblocks" (section 6), in general terms, then try to be a bit more specific on the legal amendments needed (section 7). Section 8 concludes.

6. LEGAL ROADBLOCKS

Making progress along the lines expounded in the previous sections is complicated by the extreme complexity of the EU banking legislation; a labyrinth where anybody, even the most seasoned professional jurists – and this author is not one of them – risk getting lost more often than not. Complexity derives in part from it being the result of stratified interconnected norms, injected at different times responding to different goals and constraints, sometimes transferring terms and concepts from one version to the next even when superseded. It also derives, evidently, from the European Union being a multinational entity. To the complex web of stakeholder interests that always characterizes the banking activity, EU law adds another dimension – the international one – which often ends up being the most important of all.

The treatment of cross-border banking groups is an eminent casualty of these difficulties. In essence, a legal environment facilitating the establishment and success of cross-border banking must satisfy two conditions. The first is *absence* of norms preventing the efficient – which must mean "country blind" – conduct of business in normal conditions, when economic and financial stability prevail and banks flourish and normally expand. The second is the *presence* of provisions that ensure internal support, so as to prevent the disintegration of the group in bad times, when banks are more sensitive to risk and tend to retrench. The two conditions are linked. It is impossible to guarantee the permanence of cross-border friendly conditions in good times if there is no solid trust that those conditions will continue to prevail in bad times, when there are likely winners and losers and each entity of the group, with the country it belongs to, may be left alone with its problems. This unresolved problem, the simultaneous *presence/absence* of those norms, is a main reason why cross-border integration has not proceeded in the last ten years, in spite of the existence of an otherwise successful "banking union".

To begin untying the knot, it helps to start in general terms. This is done in this section. The reader wanting more legal detail will find it in the next one.

To the first category (preventing group regulation from being "country blind") belong norms stipulating that the standard prudential requirements – minimum capital, liquidity and funding, large

⁴⁷ For similar reasons, in the United States the Federal Reserve, the Federal Deposits Insurance Corporation and the Office of the Comptroller of the Currency have competence on state-chartered banks as well.

exposures, leverage – need to be satisfied at the single legal entity level. These provisions are situated largely in the initial articles of the Capital Requirements Regulation (CRR),⁴⁸ and to a lesser extent in the Capital Requirement Directive (CRD).⁴⁹ It is worth noting that neither this legislation nor the SSM regulation (SSMR) usually refer to a legal entity concept when defining the objects of their requirements, but typically to “credit institutions”. This term is defined in CRR as “an undertaking (*our emphasis*) the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account” (art. 4). The meaning of undertaking is not uncontroversial,⁵⁰ but the term is normally used in a general sense, as whatever subject, individual or institutional, whose purpose is to do business, regardless of its specific legal nature. It seems therefore possible to adapt the concept of credit institution to accommodate the needs of cross-border banking groups, in particular considering the prudential requirements as applicable at group level only in absence of other explicit provisions stating the contrary.⁵¹ A proper technical-legal exploration of this possibility is not made in this paper.

Clearly, if EU banking law is to allow for an efficient management of cross-border banking groups, those provisions need repealing for cross-border groups or sub-groups within the euro area; or at least the law must prescribe that they *should* be waived by the ECB supervisor under specific prudential conditions that must be satisfied by the group as a whole. As a matter of fact the SSM did attempt at an early stage to move in this direction, by agreeing on guidelines for the application of the so-called “national options and discretions” in EU law, a number of which concern solo requirements within cross-border groups.⁵² That attempt made little mileage, however, first because some of those waivers are explicitly not permitted by EU law, second because some national options and discretions are entrusted to member states hence cannot be waived by the supervisor, and finally because even those which can are not always granted.⁵³

It is equally clear that repealing those provisions is not sufficient; it actually risks being counterproductive in absence of other regulatory changes. As mentioned already, equilibrium in the functioning of a cross-border group relies on trust: trust that the confidence on whose basis certain entities transfer prudential resources to others in good times, are matched by an equally strong support among the various components of the group in bad times, when some of them are at risk and require funding from others. If that trust does not exist, opening the door to prudential waivers is not only prudentially unsound, but is likely to have the opposite effect, discouraging cross-border banking

⁴⁸ Regulation 575/2013 of the European Parliament and of the Council of 26 June 2013, including its successive revisions and the related implementing and delegated acts.

⁴⁹ Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013, including successive modifications and national implementing legislation.

⁵⁰ According to EBA (2020), “... elements of the definition – namely ‘the business of which’, ‘deposits’, ‘other repayable funds’ and ‘from the public’ – remain subject to different interpretations in the absence of EU-level definitions”.

⁵¹ For example, Jones (2012) argues in favour of using a broader range of definition of the term undertaking, including business groups, in the context of EU competition law.

⁵² See Angeloni and Beretti (2015). Those guidelines have been successively updated; the last version is ECB (2022).

⁵³ Members of the ECB Supervisory Board may coalesce to resist granting those waivers, either out of genuine prudential concerns or to protect national interests. The CRR opens this possibility because it states that competent authorities “may” grant them under certain conditions; it was never fully clear whether “may” means “must” if the conditions are fulfilled, or whether there are margins of discretion.

through the establishment of subsidiaries even further. One cannot count on intra-group support being maintained on a purely voluntary basis, without a proper legal framework underpinning it.⁵⁴

What is missing, therefore, are strong and transparent provisions establishing principles and practices of reciprocal support within euro area groups when safety and soundness of the group itself or of some of its entities are endangered. That support must operate both *pre-emptively*, before the resolution stage, and *ex-post*, in resolution. Let's consider the two separately.

EU law provides, in accordance with international standards, that when an institution either infringes, or is likely to infringe in the near future, the requirements of the CRR, a number of actions must be undertaken to avoid the further deterioration of the situation and the possible failure. Those actions are called "early intervention", or "recovery phase". Codified in a specific section of the Bank Recovery and Resolution Directive (BRRD),⁵⁵ such actions are triggered by the banking supervisor and undertaken in collaboration by the supervisor and the resolution authority. Without entering into unnecessary detail, what should be stressed here is that those ex-ante actions, which may help avert a full-blown crisis, must be strengthened by including support within the group in favour of the entity (or entities) in need.⁵⁶ The modalities of the ex-ante support must be consistent with the modalities of resolution (to be discussed next), to ensure time-consistency, because resolution is always the possible end-point of the process.

Already in its present form, the BRRD stipulates that in order to facilitate intra-group support under early intervention, groups "may" enter into agreements on the modalities in which that support is to be provided. Such "group financial support agreements" (GFSAs henceforth) are not an obligation for the group, nor is adherence mandatory by any of its members. If they exist, they are vetted and approved by the governing bodies of the bank and by the supervisor and transmitted to the resolution authority for information. The conditions under which support can be provided in the present law are strict and predominantly focused on the interest and stability of the entity providing support, not that of the group as a whole. The eventual decision to provide support is of the providing entity alone. All of this reduces the usefulness of GFSAs and is the reason why they were not widely adopted.

It is evident that in order to counterbalance the repeal or weakening of the solo requirements in CRR the provisions regarding GFSAs in BRRD must be significantly strengthened, making them mandatory, enforceable and consistent with the resolution plan of the group.

Let's move to the next stage now, when the bank reaches the point of non-viability and is declared "failing or likely to fail" (FOLTF) by the supervisor. What happens then is the subject of the central part of BRRD. The Directive deals with the matter in steps. First, it establishes general principles, objectives and conditions for resolution to be enacted. The most important condition is that a public interest must exist; if not, the entity is to be liquidated pursuant to normal civil code provisions. Then it establishes the modalities and tools to execute it, including crucially the potential use of bail-in to extract resources from shareholders and creditors. Then it establishes certain safeguards. Crucial among these safeguards is the so-called "no creditor worse off" principle, or NCWO, stating that in resolution no creditor should be made worse-off than she would be under normal liquidation; if this is the case, the creditor must be compensated.

⁵⁴ This point is articulated in detail by Dewatripont et al (2021).

⁵⁵ Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014, including successive modifications and national implementing legislation.

⁵⁶ On this point see Enria and Fernandez-Bollo (2020).

It helps to understand the origin, meaning and implications of NCWO. A basic common law principle introduced in the US bankruptcy code in the 1990s, NCWO has status of primary law in the United States pursuant to the Fifth Amendment of the Constitution, dated 1791, which among other things states: “... *no(r) shall private property be taken for public use, without just compensation.*” Part of the Bill of Rights, this norm protects citizen against the state, preventing individuals from being forced to bear costs incurred in the public interest. If that happens, they must be compensated.

After the financial crisis, NCWO has become one of the “key attributes” of bank resolution established at international level by the Financial Stability Board (FSB).⁵⁷ The “benchmark” to calculate the cost incurred by shareholders and creditors in resolution is that ensuing from ordinary liquidation, the fall-back procedure applied in absence of public intervention.⁵⁸

With due respect to NCWO, today a generally accepted principle incorporated in many banking jurisdictions worldwide,⁵⁹ two comments are in order.

First, NCWO fails to recognize that the collective interest pursued by resolution may also correspond to the particular interest of some individual creditors. Departing from the abstraction of atomistic agents, it may be that bank resolution indirectly benefits not only the community but also specific creditors of the bank who contribute to it. Typically, resolution allows for more efficient procedures to liquidate the bank’s estate, compared to standard insolvency, offering better prospects to maintain financial stability and ensuring that the resolved entity can continue to perform its critical functions throughout the resolution process. This may benefit shareholders and creditors through a variety of channels, including indirect ones not taken into account by the – necessarily simplified – valuation methodologies.⁶⁰ If some shareholders and creditors are made better off through these channels, optimality is not granted by NCWO, even theoretically.

The second comment is that in Europe, due to its particular institutional architecture, the NCWO principle operates differently from the US or any other legal context. Ordinary liquidation does not exist in EU legislation, hence standard insolvency means insolvency at national level. National liquidation regimes are different from one another and are not likely to be harmonized soon.⁶¹ Using national regimes as benchmarks to measure losses and determining on that basis the appropriateness of a resolution procedure conducted at European level amounts to injecting in the framework a powerful national fragmentation element, which retroacts back through the whole crisis management process.

⁵⁷ See Financial Stability Board (2014), chapter 5.

⁵⁸ As discussed by Kokorin (2021), NCWO applies the Pareto optimality concept familiar to economists. A Pareto optimal allocation is one where no individual can be made better off without another being worse off. A Pareto improvement occurs when an individual’s welfare increases without that of anyone else decreasing. A more general notion of optimal allocation is the so-called Kaldor-Hicks optimality, which occurs when the individuals who are made better off could in principle compensate those worse off. Compensation needs not occur; it must only be possible in principle. The Kaldor-Hicks criterion is less restrictive than the Pareto one because optimal allocations according to the latter are also optimal according to the former, while the reverse is not true.

⁵⁹ Except being contradicted in some circumstances. This happened when FINMA, the Swiss prudential authority, decided in the recent case of the demise of Credit Suisse that AT1 holders should be bailed in while UBS shareholders were not fully. After that episode, some investors in Switzerland have subscribed senior unsecured bonds explicitly forgoing NCWO protection; see IFR (2023).

⁶⁰ In the EU, the valuation for the purpose of assessing the NCWO principle (so-called “valuation 3”) is regulated by art 74 BRRD, EBA (2019) and the Commission delegated regulation 2018/344 of 14 November 2017.

⁶¹ Veron et al. (2020).

7. ESTABLISHING A SINGLE JURISDICTION FOR CROSS-BORDER BANKS

7.1. An illustrative example⁶²

To fix ideas, consider a situation quite typical for euro area cross-border banking groups: one in which there is an operational parent company (OpCo), with dominant business in the domestic economy, participating to the capital of subsidiaries (Subs) in other countries in the euro area and possibly elsewhere. The OpCo entertains multiple relations with the subsidiaries: credit/deposit relations, holding of senior and subordinated debt, and of course shareholding. The OpCo may be the single or dominant shareholder in some Subs (making a strategic investment implying a high degree of control), and a minority shareholder in others (a pure financial investment). Subs may in turn participate to the capital of other Subs. Subs typically entertain also relations with creditors/debtors in their own countries of establishment; there may be local shareholders, senior and junior debt holders, depositors as well as borrowers. Suppose also, which again is typical case for OpCos in the euro area, that the resolution authority (the Single Resolution Board, SRB) has approved a plan that envisages a single point of entry (SPE) strategy for resolution, according to which resolution occurs at a single point in the group structure, the OpCo itself.⁶³

When losses materialize in a Sub, whereby its viability may be imperilled but before it being declared FOLTF by the supervisor, consistently with the SPE concept intra-group support implies “upstreaming” losses from the Sub to the OpCo, and “downstreaming” capital along the group’s pyramid. If the Sub instead experiences a liquidity loss, liquidity must flow downstream from the OpCo to the Sub. Early actions (denominated in BRRD Early Intervention Measures, EIM) –undertaken before the entity is declared FOLTF and in fact intended to prevent that outcome – are an important element in the prudential framework. They will actually be strengthened once the package of legislative proposals advanced by the Commission in April 2023 (so-called “Crisis Management and Deposit Insurance”, or CMDI, reform package; see Box for details) will be adopted. Hence it is important to pay special attention to this phase.

Intra-group support is voluntary, though it may be encouraged by the supervisor. Many outcomes are possible. Focusing on capital losses (the liquidity case follows a similar logic), the Sub may raise capital from within the group and/or outside, through new share issuance, conversion of subordinated debt from inside or outside the group (internal or external MREL)⁶⁴ or extraordinary support from public sectors, for example the national deposit insurance scheme (DGS). The CMDI reform proposal enhances DGS “extraordinary” support among the prior actions (see Box) and envisages several modalities, with different implications for the cohesion of the group. Internal capital raising tends to strengthen it,

⁶² This simple example is paradigmatic of the obstacles to cross-border integration in the euro area and of the main points emerged in the debates about national “ringfencing”. More complex examples, for example considering multiple layers of subsidiaries or cases where losses originate in the parent company, do not modify the substance of the arguments nor the nature of the recommendations made.

⁶³ If the parent company is a pure holding (HoldCo), resolution processes are facilitated because HoldCo would have a much simpler balance sheet structure comprising essentially shareholdings, with no deposits, loans, etc.

⁶⁴ MREL (minimum required eligible liabilities) are funding requirements in the form of subordinated debts, whose purpose is to facilitate recapitalization of banks in distress. MREL requirements introduce in European legislation the guidelines issued by the FSB regarding TLAC (total loss absorbing capacity), with reference to globally systemic banks (G-SIBs). See FSB (2014). “Internal” MREL are requirements to issue MREL assets within the group, prepositioned within the structure in order to create loss absorbing capacity (LAC) at appropriated points in the group structure.

whereas external capital injections (except when enacted by the OpCo in order to support the Subs) weaken it, especially if the participation in the Sub is strategic. Support by the national DGS tends to disaggregate the group because it dilutes intra-group share participation and usually reflects and promotes national interests, unlike other sources of private capital injections. In the entire process of dealing with a banking group distress, this is a **first point** where the solidity of the group comes under threat.

In the early stages of distress, preserving the group structure requires having in place clear and enforceable agreements guaranteeing reciprocal internal support, which, though not impeding external injections of capital, must prevent the disaggregation or material weakening of the group structure.⁶⁵ Group support can alleviate host member states' concerns that they may be left in the rain when a local subsidiary fails. Present provisions of BRRD are way too weak to guarantee solid group financial support agreements.

Moving to the next stage, capital and liquidity injections may not be successful in restoring the bank's soundness. In this case, the Sub is declared FOLTF by the SSM. From then on, the entity exits the realm of supervision and falls into that of the resolution authority. The SRB's first act is to determine whether the bank should be resolved. Legislation stipulates that this decision depends on a Public Interest Assessment (PIA), which determines if collective interests are better served by resolution (for example, by preserving certain critical functions of the banks), or are the objectives of resolution enumerated in art 31 BRRD, as opposed to adopting a normal insolvency procedure.⁶⁶ This is a **second point** in the process where the cohesion of group structure may be threatened. Even if resolution is chosen, NCWO must be respected. Since national insolvencies are not harmonized or consistent across the EU, if they are taken as benchmark NCWO may prevent desirable resolution strategies depending on how shareholders and creditors are treated.

The point to be made about this procedure, however, is that in the case of euro-wide cross border group which surpasses certain thresholds in terms of size and cross-border reach, national liquidation *cannot be regarded* as a plausible alternative. Those groups are not only significant according to the SSM definition, hence supervised by Europe, but have special characteristics that makes them area-wide systemic *by definition*. National insolvency should therefore be ruled out in this case, and resolution regarded as the rule, at most after a formal pass through the PIA. Adopting a prior judgement in favour of resolution also helps overcome the hurdle of NCWO because national liquidation would no longer be regarded as a valid benchmark to compare losses by shareholders and creditors.

Once the PIA is passed, the SRM would weigh alternative resolution strategies among those envisaged by BRRD. The subsidiary may be sold (transfer strategy), restructured after recapitalization and remain in business (possibly with bail-in and asset separation), or temporarily placed in a transitional entity (bridge bank). All this after considering the group's resolution plan (which may serve as a reference but is not binding) and any GFSA existing in the group. This is the **third critical point** where one must be attentive to ensure that incentives favour the group's cohesion.

⁶⁵ This point is stressed by Dewatripont et al. (2021).

⁶⁶ The CMDI reform proposal by the Commission now considered by the European legislators tries to tilt the balance toward resolution in several ways, first and foremost by prescribing for the PIA a change in the "burden of the proof": resolution would be preferred unless national insolvency fulfils the resolution objectives better than resolution (rather than, as in the current rules, also in cases where those objectives are attained to the same extent); see Box. The practical impact of this change remains to be seen, but surely is not sufficient to address the issues discussed here.

Under current law, national DGSs play as part of resolution the primary function of reimbursing covered deposits within a short time, without waiting for the end of the resolution process. A solid pay-off function is key to uphold depositor confidence and hence guarantee a well-functioning payment system based on bank money. Usually this is a low-risk function, because pay-outs occur rarely and DGSs rank very senior in the creditor hierarchies. Making the legal framework of euro cross-border groups (henceforth ECBG) country-blindness implies that this function should not be performed by national DGSs, lest injecting a national bias in burden sharing in the incentive structure. Consequently, ECBGs should preferably be allowed to spin-off from national DGSs to apply to a dedicated mutualized deposit insurance scheme.^{67 68}

The resolution action may have different effects on the group's cohesion, specific resolution strategy adopted. In absence of robust intra-group agreements, or if internal MREL is not sufficient or not appropriately positioned, bail-in or transfer strategies may contribute to dilute share participations within the group or the return of the resolved entities in the national sphere, unless, of course, the transfer is made to another ECBG. The uncertainty of the outcome of this phase highlights the importance of adopting, and enforcing, sufficiently robust internal support agreements, while prudential privileges to ECBGs are granted.

7.2. Sketching the legal agenda

An in-depth legal analysis of a framework addressing the issues just presented goes beyond the limits of this paper. A first choice to be made regards whether the formulation may take the form of detailed amendments – or additions – of the legal texts involved, which means at least the CRD, CRR, BRRD, SRMR and DGSD, or should it consist of a dedicated “single-text” regulation addressing the specific regime of ECBGs, derogating from existing laws. The second avenue would be preferable in terms of clarity.

In terms of content, the following six broad areas would need to be covered (under each, a tentative and possibly incomplete list of legislative texts involved is given).

- (1) The **first area** regards the characteristics a group must possess to be considered as part of the ECBG “club”, including the exit and entry rules. The group applying for that status should pass thresholds referred both to the overall size of its cross-border business and articulation by countries and possibly by technical instruments.⁶⁹ It is important that those thresholds and the related approval process be dynamic, facilitating entry of new members to the “club” rather than the entrenchment of the status quo. For this reason, applications should also be considered for groups that do not possess sufficient cross-border characteristics yet, but have approved a credible business plan according to which those thresholds are expected to be reached with a reasonable time frame. Applications for ECBG status should need to be approved by both the ECB Supervisory Board and the SRB, after hearing of or agreement by the national authorities and possibly the member states

⁶⁷ A DGS dedicated to few banks, though large, should be less complex to agree on and set up than the single scheme for all banks that the Commission has repeatedly and unsuccessfully tried to get approved with its EDIS (European deposit insurance scheme) proposals. An alternative in the same direction, proposed by Dewatripont et al (2021, section 3), is that burden sharing arrangements be made ex-ante by the national DGSs involved. This alternative is not preferable because it would give each national DGS a veto power and would complicate the addition of new entities to the group.

⁶⁸ Another function foreseen for DGSs in resolution, facilitated in the recent Commission proposal on CMDI (see Box), is to support certain resolution strategies, specifically transfer and bail-in. Such uses would also not be advisable for ECBGs, because they may in certain situations contribute to the “Balkanization” of the group.

⁶⁹ The 20% significance criterion already used by the SSM, applied to cross-border exposures, is a useful reference.

involved. Provisions in this area would be new and not related to any specific parts of the existing EU legislation.

- (2) The **second area** focuses on the prudential conditions a group must satisfy in order to qualify for the ESBG status. The group should be compliant with all prudential requirements (on capital, liquidity, large exposures, leverage, internal and external MREL amounts and positioning, macroprudential buffers, etc.), possibly for several years prior to the application and possibly with a safety margin, all on a fully-loaded basis. A key condition is a SPE resolution strategy for the group or the euro area sub-group, including a GFSA incorporating a full “internal support agreement” specifying the creditor hierarchy among internal shareholders and creditors, in particular the amount and position of internal MREL and other bail-inable senior unsecured instruments. The GFSA should be approved by the governance bodies of all entities in the group and should be legally enforceable at EU level, possibly (but not preferably) also by making recourse to extra-EU courts.⁷⁰ The financial and legal solidity of the GFSA would be a key element considered by the authorities before granting their approval. Provisions in this area would be largely new but would impinge on the parts of BRRD setting conditions and modalities for intra-group financial support – art. 19-26 thereof – and to a lesser extent SRMR – art. 11 on the assessment of resolvability.
- (3) The **third area** pertains to the chain of events that precede and follow the moment in which an institution – typically one of more subs, but not necessarily the group as a whole – is declared FOLTF by the SSM. In the early phase (before or after the formal activation of EIMs) intra group support would be activated according to the GFSA. National DGSS and Member States would remain out of this phase.⁷¹ In the eventuality that the institution is declared FOLTF, it is essential that the SRB undertakes resolution action by default, without considering national insolvency as an alternative. This would avoid that the group – or parts thereof – is subject to national liquidation, and implies – if not automatically at least by *lex ferenda* – that NCWO would not apply. To make this understanding explicit, GFSAs should specify that the entities of the group, including notably the shareholders and creditors of the OpCo, forgo the NCWO privilege. The SRB should conduct the resolution process directly, with its own structures in Brussels, and not, as presently foreseen, only by monitoring the execution conducted by the national resolution authorities. Provisions involved in this area are included in BRRD Title II (Preparation); Title III (Early intervention); and Title IV (Resolution), as well as the corresponding sections in SRMR Part 1 (in particular Chapter 1 on Resolution planning, Chapter 2 on Early intervention, Chapter 3 on Resolution) as well as art 28 (Monitoring by the SRB).
- (4) The **fourth area** concerns the prudential benefits that ECBGs may enjoy. Approval of the ECBG status would imply that the group is exempted from the capital, liquidity, large exposure and leverage limitations at solo level. Alternatively, the law would instruct the SSM to waive those requirements after checking that the related conditions are all met at group level. Macroprudential requirements included in EU law (systemic risk and counter-cyclical buffers, etc.) would be set by

⁷⁰ Ideally, one would want these judgements to be made by European courts. However, the ECJ's competence is on appeals of individuals against states, not with regard to civil law liabilities. On the other hand, if the SSM/SRB used intra-group commitments to allocate losses or to transfer assets between the entities in early intervention or resolution decisions, those actions would have to be challenged in the ECJ.

⁷¹ This would exclude also precautionary recapitalization ex art. 32 BRRD and the other support measures involving public funds envisaged in the same article. Emergency clauses may be considered in case of clear systemic risk.

the ECB.⁷² Provisions involved in this area are included in cover in particular art. 6, 7, 8 CRR and the articles referred to therein.⁷³ As regards macroprudential policies, the SSMR (art 5) would be involved, as well as the corresponding parts of the CRD.

- (5) A **fifth area** concerns DGS-related issues. ECBGs would be entitled – possibly gradually, see below point 5 – to transfer resources from the national DGSs to dedicated one constituted by the ECBGs. The dedicated DGS would be responsible for the pay-out function for all ECBGs. Any other uses of the dedicated DGS resources would either be excluded, or severely limited and made conditional to approval by the EU (Commission or Council). For the dedicated DGS, a backstop by the ESM could be considered.⁷⁴ For this part, amendments in the form of carve-outs would be needed particularly in the DGSD art. 4 (Official recognition, membership and supervision) and art. 11 (Use of funds). The sections regarding “extraordinary support” by public entities in BRRD and SRMR would also be involved.
- (6) Finally, a **sixth and last** area concerns any transitional issues that may be necessary to allow for a safe move to the new regime. The phase-in of the scheme would need to be gradual, to test its proper functioning and allow for adjustments based on experience, and to allow for phasing in of the DGS arrangements, which would need to proceed in parallel with the removal of the solo requirements. This means that the prudential carve-outs mentioned under point 3 above would enter into force gradually and in line with the DGS provisions under point 4.

⁷² At present, the ECB can only “top up” (i.e. increase) the buffers set by the national authorities. This would left open the issue of other macroprudential requirements set by member states’ authorities, such as the loan-to-value and loan-to-income ratio limits.

⁷³ Leverage requirements were not included in the original (2013) CRR version but were added subsequently; with the application of the CRR II package (<https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:02019R0876-20200627#M1-1>), the leverage ratio became a binding minimum requirement within the EU as of June 2021.

⁷⁴ If, instead of a dedicated scheme, the DGS function for the group was provided through a burden sharing agreement among the national DGSs involved, as proposed by Dewatripont et al. (2021), which is considered less robust as argued in an earlier note, the DGS function should be limited to pay-out.

8. CONCLUSION

The legal amendments sketched in the previous section are neither easy nor innocuous: they encroach deeply into multiple parts of today's EU banking law. But they are doable. They have the advantage of a clear underlying concept-goal: that of making the rules for cross-border euro area banks "country blind" and really European. They also have a good chance of being effective, because they attack head-on the obstacles that, ten years into the so-called banking union, prevent the rise of a real union in the banking field.

Banks are crucial, not only to support the European economy while it faces historical transformations, but also for the birth of the "capital markets union" that the EU is planning. Creating a strong community of continent-wide European banks would help in that direction, too. The courage it requires is worth it.

Box 1: The 2023 Crisis Management and Deposit Insurance (CMDI) reform proposal

On 18 April 2023, the EU Commission put forth a reform proposal of the EU crisis management and deposit insurance framework (CMDI), containing detailed amendments of the three main EU legislative acts involved in bank crisis management: the BRRD, DGSD, and SRMR.¹ The proposal is now considered by the EU co-legislator; the approval process is expected to last no less than two years].

After the previous round of amendments of EU banking law dated 2019, aimed at “derisking” the system essentially by transposing in EU law the Basel III provisions, the present proposal’s main aim is to facilitate the management of banking crises, particularly with reference to small and medium-size banks, by strengthening early actions before resolution, encouraging the SRB to choose resolution in lieu of national liquidation more often, providing more resources to resolution notably by involving DGSs, and by promoting more effective cooperation among the authorities involved at all stages in the process.

This Box does not contain a comprehensive description of the reform proposal;¹ It only aims at identifying possible implications for the activity of euro area cross-border banks.

Leaving minor aspects aside, the main elements of the proposal can be subsumed in four points.

1. Extending the scope of resolution actions, as opposed to national liquidation. The Commission recognizes that the banking union’s framework has not functioned as intended, because authorities are hesitant to use resolution according to EU law to treat banks in distress. After the bank is declared FOLTF by the supervisor, the SRB uses the PIA to determine if the conditions for resolution are met. The Commission proposes that under the PIA resolution be chosen every time its objectives would be met by national insolvency procedures *worse* (or more costly) than they are under resolution, rather than only when resolution fulfils these objectives *better* than national insolvency. The difference resides in situations where those objectives are deemed to be met *equally well* by the two procedures; in that case resolution would be chosen according to the proposal, rather than national insolvency under current rules. The practical impact of this change is uncertain and would need to be seen in practice, especially considering that the valuation processes involved in the PIA are subject to some uncertainty and approximation. Be that as it may, this proposal would be largely neutral from the viewpoint of cross-border integration, and in any case does not address the need to avoid national liquidation altogether in the case of ECBGs.
2. Enhancing the role of national DGSs, by facilitating and codifying the use of their resources both before and under resolution. Current rules foresee two functions for national DGSs: a pay-out function, reimbursing covered depositors, and a “support function”, intervening in support of banks in distress before they reach the point of non-viability. The proposal recognizes that in many cases, especially regarding small and medium-size banks, the cost of the first function may prove to be higher than the cost of providing ex-ante support. It hence introduces more detailed provisions to codify and extend the second function. As in the previous case, the impact and effectiveness of those provisions remain to be seen. National DGSs committing resources ex-ante may end-up having less resources for pay-out (the law itself stipulates that resources must be used “primarily to repay depositors”)¹, and may become underfunded. On the one hand, being these amendments conceived primarily with small and medium-size banks needs in mind, they should be neutral with respect to large cross-border groups. On the other, as argued in the text, for those groups any alternative uses of DGS funds should be severely controlled or outright excluded, to avoid weakening the pay-out function.
3. Modify the creditor hierarchy, by granting a “depositor preference” *pari-passu* to all depositors. Under current rules, covered depositors, and the DGS which replaces them, are treated as super-senior in their claims on the bank’s estate in resolution. This raises the bar for the choice made by the SRB for resolution, as opposed national insolvency, due to the NCWO principle, because it raises the standing of the DGS as a creditor. The proposal replaces this with a generalizes preference to all depositors, including the DGS, whose claims on would then go *pari-passu* with those of other depositors. This proposal, like the preceding ones, goes in the direction of weakening the financial standing of DGSs, though the extent cannot easily be judged ex-ante.
4. Bolstering the early intervention phase, with a number of provisions that ensure that early actions are undertaken as early as possible and that the relevant authorities (SSM and SRB primarily) cooperate closely and effectively, especially by exchanging information at an early stage.

The amendments comprised in the CMDI reform package are designed with the needs of small and medium sized banks in mind and are broadly neutral with regard to large cross-border banks. The one caveat that we already mentioned regards the more extensive use of DGS resources for “extraordinary” ex-ante interventions. The expression “extraordinary” lacks precise meaning and may allow, ex-post, more flexibility than originally intended. As a result, the resources available for pay-outs may be reduced. This strengthens the case for a dedicated DGS for ECBGs, where ex-ante extraordinary operations should probably be very limited or excluded altogether.

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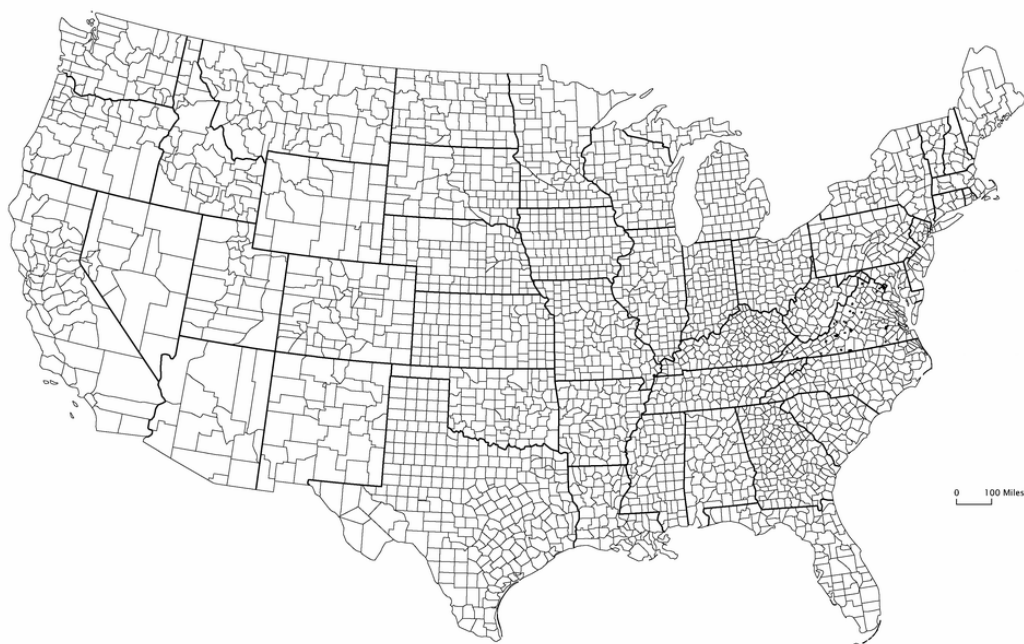
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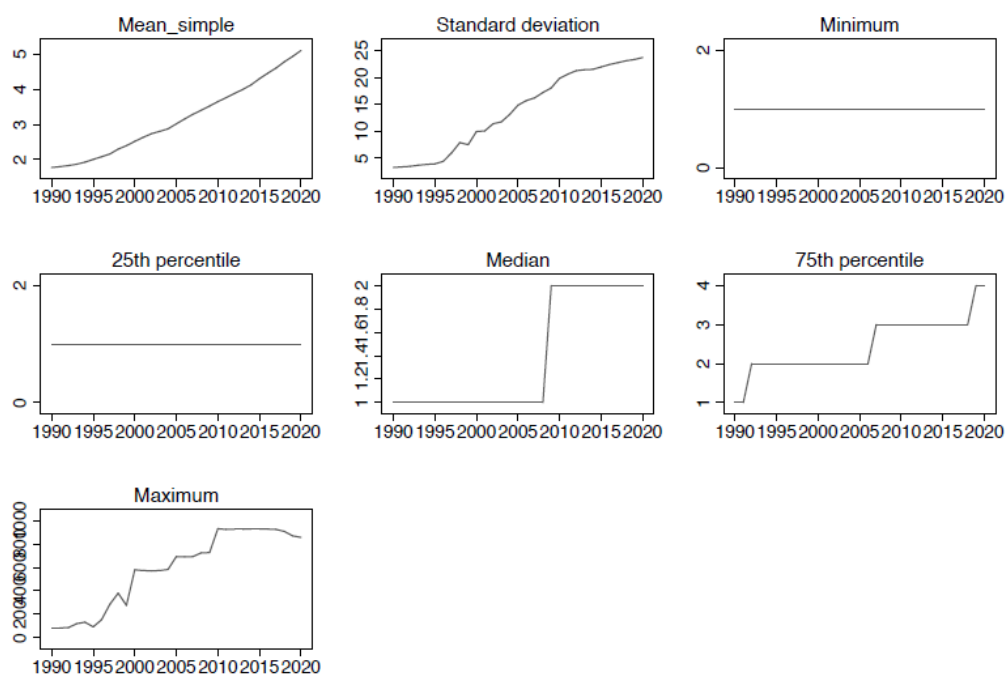
APPENDIX 1: EURO AREA BANKS ANALYSED IN SECTION 5

n.	name	country	rank
1	ABN Amro	NL	(16)
2	Allied Irish Bank	IE	(n.a.)
3	Banca Monte dei Paschi di Siena	IT	(29)
4	BBVA	ES	(11)
5	Banco de Sabadell	ES	(21)
6	Banco Popolare Società Coop.	IT	(25)
7	Banco Santander	ES	(3)
8	Bank of Ireland	IE	(n.a.)
9	Bayerische Landesbank	DE	(22)
10	BNP Paribas	FR	(1)
11	Groupe BPCE	FR	(6)
12	Caixa Geral de Depósitos	PT	(n.a.)
13	Commerzbank	DE	(14)
14	Crédit Agricole Group	FR	(2)
15	DekaBank Deutsche Girozentrale	DE	(n.a.)
16	Deutsche Bank	DE	(4)
17	Deutsche Zentral-Genossenschaftsbank	DE	(13)
18	Erste Group Bank	AT	(20)
19	HSH Nordbank	DE	(n.a.)
20	ING Bank NV	NL	(7)
21	Intesa Sanpaolo	IT	(10)
22	KBC Group	BE	(17)
23	Landesbank Baden-Württemberg	DE	(19)
24	National Bank of Greece	GR	(n.a.)
25	Norddeutsche Landesbank	DE	(26)
26	OP Financial Group	FI	(27)
27	Coöperatieve Rabobank	NL	(12)
28	SNS Reaal	NL	(n.a.)
29	Société Générale	FR	(5)
30	UniCredit	IT	(8)
31	Crédit Mutuel Group	FR	(9)
32	CaixaBank	ES	(15)
33	La Banque Postale	FR	(18)
34	Belfius Banque	BE	(24)
35	Landesbank Hessen-Thüringen	DE	(23)
36	NRW Bank	DE	(n.a.)
37	NV Bank Nederlandse Gemeenten	NL	(n.a.)
38	Raiffeisen Zentralbank Österreich	AT	(28)
39	Volkswagen Financial Services	DE	(n.a.)
40	Landesbank Berlin Services	DE	(n.a.)

APPENDIX 2: COUNTY-LEVEL COVERAGE OF US BANKS



Number of counties a bank operates in



The charts above are reproduced from Angeloni et al (2021 and 2022).

In its first ten years (2014-2023), the banking union was successful in its prudential agenda but failed spectacularly in its underlying objective: establishing a single banking market in the euro area. This goal is now more important than ever, and easier to attain than at any time in the last decade. To make progress, cross-border banks should receive a specific treatment within general banking union legislation. Suggestions are made on how to make such regulatory carve-out effective and legally sound.
