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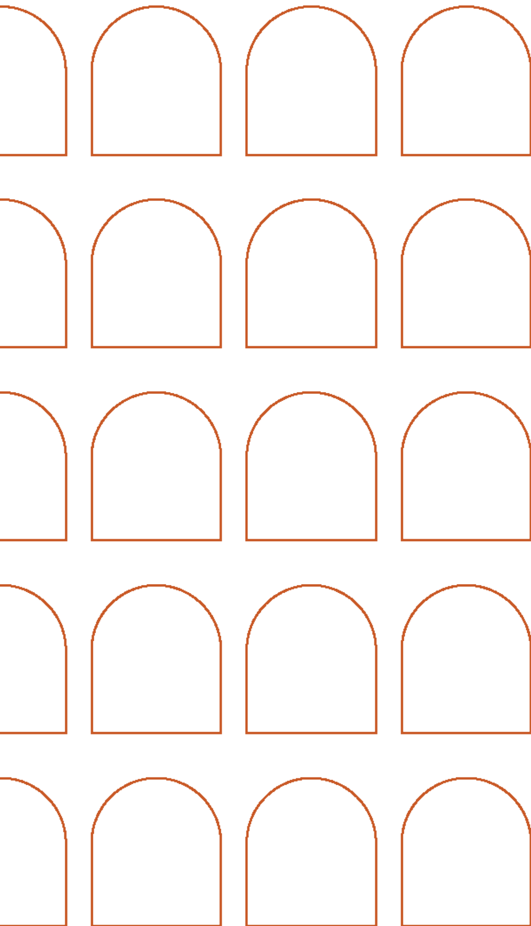

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Robert Schuman Centre for Advanced Studies
Florence School of Banking and Finance

Banking Supervision Policy Working Paper Series
In the context of the SSM-EUI partnership on SSM Banking Supervision Learning Services

WORKING PAPER

Banking Union: A Ten-Year Journey

Vítor Constâncio

Robert Schuman Centre for Advanced Studies
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Abstract

The Single Supervisory Mechanism of the European Banking Union (EBU) is a significant achievement in the long journey of European integration. However, challenges persist in the pillars of bank resolution and the absence of a common European Deposit Insurance Scheme (EDIS). This paper explores the theoretical underpinnings of the European banking integration, analyses the impact of the financial crises that spurred its development, and the historical reasons and shortcomings posed by the strict bail-in requirements stated in the Bank Recovery and Resolution Directive (BRRD). It also addresses concerns surrounding the full implementation of an EDIS, advocating for targeted reforms to overcome existing gaps and enhance European banking integration.

Keywords

European Banking Union, Bank Resolution, Single Supervisory Mechanism, European Deposit Insurance, Financial Stability

Banking Union: A Ten-Year Journey

I

Despite its significant incompleteness, what we call the European Banking Union represents the most important transfer of national competencies to the European level since the Monetary Union (MU). It started 10 years ago with European-level banking supervision, when the Single Supervisory Mechanism (SSM), as part of the European Central Bank, began its operations. This endeavour has been a success. Other components of what a fully-fledged Banking Union should include are either problematic (Bank Resolution) or non-existent (Deposit Insurance). Nevertheless, there are sufficient reasons for celebrating the success of what has been achieved.

The decision to introduce European banking supervision was triggered by a crisis, as has often been the case in the European project and was reflected in Jean Monnet's (1976) well-known saying. The Monnet method to build European unity, which starts with partial examples that gradually lead to wider and deeper cases of integration, was rationalised as the functionalist theory of international integration by Ernst Haas (1958).

The main mechanism behind the theory is that any partial integration generates spillovers that create problems in other spheres of activity, which then require new integration solutions. Attempts have been made to rationalise the whole European integration process in an apparently coherent narrative by using the functionalist approach. The theory can be complemented by the idea that any relevant integration decision has unintended consequences, a circumstance that can be used by the supranational institutions involved in the process to press for more reforms based on rational choices that lead to more integration (institutionalism theory).

An example of functionalism that has been used many times is the decision to create the MU, which also serves to illustrate the technocratic limitations of the theory. Having implemented in the first phase a free trade single market accompanied by freedom of capital movement and an agricultural policy that favoured fixed exchange rates, European integration fell into the Mundell-Fleming trilemma that it is impossible to have at the same time total freedom of capital movement, a fixed exchange rate and autonomous national monetary policies among countries (Obstfeld et al., 2005; Rey, 2015). Paddoa-Schioppa (1996, p.11) added free trade to the three points to create an "inconsistent quartet" that could only be solved by "suppressing the independence of national monetary policies" – the technically inevitable MU.

In reality, Monetary Union, contrary to the Monnet dictum, did not emerge as a result of a crisis, and although it was helped by the technocratic rationale of the "impossible trilemma" it was made possible as a way for the member nations to manage their self-interest in the context of German reunification. This perspective highlights that member nation-states are the real actors in integration according to their preferences when they conclude that deeper integration enhances their interests. This is the view of the intergovernmental theory of integration, the main authors of which are Alan Millward (1992) and Andrew Moravcsik (1998). Obviously, no single theory can encompass the multiple factors that are always present in complex historical turns of events.

Regarding Banking Union, it emerged in the context of a stressful crisis. Another impossible trilemma, that of financial stability, financial integration and national financial policies (mostly supervision), was proposed by Dirk Schoenmarker (2011) to justify the project. However, in this case the crisis was triggered by an outside cause, the big financial crisis that began in the US and spread to Europe through banks with significant American assets and with freezing liquidity in money and repurchase agreement (repo) markets. Intrinsic vulnerabilities in the minimal Monetary Union

design also powerfully contributed to the acute stressful situation. Monetary Union, initially reduced to a single currency and a fiscal brake (the Stability Pact), lacked three significant components: European banking supervision, a macro-stabilisation fund and an emergency liquidity assistance mechanism in the case of an acute liquidity crisis (Constâncio, 2018). The narrow concept was laid bare by the unprecedented speed of financial integration in the credit and capital markets. Even the Optimal Currency Area theory got it wrong, as Peter Kennen (1969) and James Ingram (1972) saw financial integration contributing to expanded access to financing as a positive aspect of MU.

In the European case, both credit and capital markets underwent meaningful market failures by wrongly assessing the credit risk of peripheral countries. Consequently, these countries were subject to huge inflows of capital funding macroeconomic imbalances, which led to explosions of their sovereign market yields. In the capital markets from 1999 to 2008, 10-year sovereign bond yields were practically equal for all MU members and then they exploded to a 2012 peak of almost 30% for Greece, 12% for Portugal and 11% for Spain and Italy. In the credit market, the exposures of banks in core countries to banks in the periphery quintupled between 1999 and the end of 2007. At the peak, these flows represented 50% of the GDP of the 5 peripheral countries. The result was overheating of their economies and their deficits, which meant sizeable increases in their indebtedness, especially private indebtedness (Constâncio, 2014).[1]

When the crisis started, the European banks were undercapitalised as they had gamed the regulatory asset risk weights, and there was no threshold regulatory leverage ratio. The IMF, and in particular American academics, exaggerated the recapitalisation needs of European Banks. In August 2011 the IMF recommended direct European recapitalisation of banks. Later in 2011 the focus was on the pressing need to restructure a relevant proportion of the Spanish banking sector. Several central European finance ministers publicly stated that any European assistance should be accompanied by European supervision of the banks involved in such specific programmes. The prevailing idea at the time was that other countries would need similar assistance, and the concept of a general European supervision mechanism gained traction in late 2011 and early 2012. Naturally, a European bank resolution mechanism had to accompany supervision. The whole project was born out of necessity and it was nurtured reluctantly by central European countries. To quote Dante's Inferno, "Necessitá c'induce e non dilletto" (Necessity and not delight compels us). The project aimed to overcome a crucial aspect of the crisis and create a risk-reduction framework for European banks, mainly by means of a resolution regime – the Bank Recovery and Resolution Directive (BRRD) published in 2014 – which was much more severe than the international FSB recommendations. Strangely, the idea of direct European recapitalisation of banks by the European Stability Mechanism (ESM) survived in the summit statement of June 2012. It would have been an unprecedented mutualisation of risk with public money, but naturally, it was never applied. When much later, the ESM approved a similar programme, its use became very unlikely as it could only be applied after a bail-in of 8% of banks' total liabilities and own funds (TLOF). The programme was then practically abolished in 2020, when the possibility of ESM loans to the Single Resolution Fund (SRF) was approved.

Neither the June summit statement nor the detailed roadmap of all the necessary implementation tasks, which was approved by the Council in December 2012, mentioned the expression 'banking union'. As then EU President Van Rompuy wrote in 2014, "I remember vividly […] how careful we were not to employ the term 'banking union,' out of a concern that this was politically sensitive and people would go up the barricades." (Van Rompuy, 2014, p. 6). The reason was the so-called third pillar of a genuine European Banking Union: the European Deposit Insurance Scheme (EDIS). The roadmap only referred to a revised Directive on National Deposit Guarantee Schemes, which was eventually published in 2014. Only in November 2015 did the Commission put forward a proposal for the gradual implementation of EDIS, which has not come to fruition to this day.

1 Between 1999 and 2007 public debt increased by 13% in Greece to 107% of GDP, by 33% in Portugal to 68.4% of GDP, by 8.6% in Italy to 103% of GDP by 42 % in Spain to 36% of GDP and by 46.8% in Ireland to 26% of GDP. The huge increase in indebtedness was in the private sector: Greece (217%), Ireland (101%), Spain (75.2%), Italy (71%) and Portugal (49%).

Nevertheless, none of this diminishes the historical relevance of introducing supervision and resolution of European banks. They go beyond a simple case of negative integration as their objective is not just to create a free market for banking services, as in the earlier 1999 Financial Services Action Plan, but instead to centralise decision-making on supervision and resolution of credit institutions in supranational bodies.

Considering the entire project, European supervision by the ECB/SSM has been a great success. However, resolution has been hampered by the non-credible maximalist approach of the BRRD. The absence of EDIS is a critical loss as it would increase confidence in our currency and improve trust in all cross-border banking initiatives.

Many specialists criticise the low number of banks exiting the market and the very few examples of resolutions that have been made. However, these views are shaped by the overly ambitious and even unrealistic objective to use resolution as a significant instrument to change the banking sector structure. We do not see a queue of banks about to fail. There is also some contradiction between the consensual lavish praise of bank supervision and that type of complaint.

Beyond the three Banking Union components, there was always a fourth implicit aim to promote full integration of banking activities. This would allow centralised management of pan-European bank groups in all dimensions: capital, liquidity and collateral. A European banking market free of obstacles to banking services and mergers and acquisitions could deliver welfare gains stemming from a lower cost of financial intermediation, if we ignore the possibility of this being eroded by oligopolistic behaviour.

Unfortunately, in a time of heightened national interests, the prospect of overcoming the Banking Union's shortcomings any time soon seems rather dim. Right now, we are waiting for the final stages of the Crisis Management and Deposit Insurance (CMDI) package proposed by the Commission, a positive but insufficient reform which, given a few controversial points, may end up being watered down.

In the June 2022 Eurogroup statement on the future of the Banking Union, the CMDI reform was the focus, while the remaining components were only mentioned half-heartedly, reflecting a manifest lack of enthusiasm:

“ - create a more robust common protection for depositors,
- facilitate a more integrated single market for banking services, and
- encourage greater diversification of banks' sovereign bond holdings in the EU. ”

The 2012 summit statement and the Council roadmap did not explicitly mention the three Banking Union pillars. The aim most mentioned was to use the new institutional framework “to break the vicious circle between banks and sovereigns” (Euro Summit statement, 2012, p.1). For this purpose, the summit charged the ESM with creating a programme to assume direct participation in banks' capital to alleviate the potential burden on national sovereigns with capitalisation of failing banks. However, the primary tool to sever this link was a new regulation to incentivise or force banks to diversify their holdings of domestic sovereign bonds. The 2015 Commission proposal associated creating EDIS with approval of the new Regulatory Treatment of Sovereign Exposures (RTSE), thus creating a dialectic between risk sharing and risk reduction, which for a few years animated European debates. Neither objective has been achieved, as I will develop later in this paper.

In what follows, I will not dwell too much on the successful first pillar of supervision because it is clear to everyone that it steered the implementation of the Basel Accords, the smooth but firm reduction of non-performing loans and the complex navigation of the effects of the pandemic, culminating in a non-existence of bank turbulence in spring last year, which was endangered by the American and Swiss banking tremors.

II

The European bank resolution process has been more problematic because the measures outlined in the BRRD exceeded the severity of the international standard approved by the Financial Stability Board (FSB). The new approach represented a change from a culture in which banks were bailed out with public funds in times of stress to a strategy focusing on bailing in shareholders and creditors to resolve distressed banks. However, international norms and their use in other jurisdictions did not establish a specific minimum threshold for bailing in, below which using resources from resolution funds or public money would be prohibited. In contrast, the BRRD mandates that a minimum of 8% of a bank's total liabilities and own capital must be used for bail-in purposes before any other funds can be utilised in the resolution process. This significant proportion of the entire balance sheet increased the likelihood of triggering a bail-in of some types of deposits, which is the primary risk to financial stability that authorities typically strive to prevent.

The problem was made worse by using the demanding resolution tool for all banks regardless of their size. Smaller banks, less significant institutions (LSIs), have more difficulty issuing debt securities and, therefore, are more dependent on deposits, raising the risk of some having to be bailed in to reach the 8% threshold. As foreseen by many, the BRRD bail-in tool was never applied, a sad example of self-defeating maximalism.

The creation of Total-Loss Absorbing Capacity (TLAC) for global systemically important banks (G-SIBs) and the MREL for all European banks improved the realism of the BRRD. However, it naturally took years for significant banks with market access to build up a sufficient stock of eligible subordinated liabilities, and the 8% bail-in limit was to be applied from the start. We can speculate that this was one of the reasons behind the Single Resolution Board (SRB) declaration that resolution of two Italian banks in the Veneto region was not in the "public interest", avoiding using the BRRD bail-in tool despite their status as significant banks. This much-discussed case generated indignation in some circles, but I submit that the outcome, which included the banks exiting the market, was preferable for European stability to a blind use of the European resolution rules, with its aftermath of instability and some social unrest, possible in this specific case. Common sense should have led to the use of the 8% bail-in tool only after the significant institutions had completed their MREL stock.

What could be the rationale for the 8% threshold and its impervious immovability, which no other jurisdiction adopted? It could not be just a justified reaction to the political and social backlash against bailing out banks to avoid a financial system collapse. This backlash was at least as intense in other parts of the world but without the same effect. It is, therefore, possible that a role was played by concern about the possibility of some future mutualisation of risks involving either public or even private transfers from the Single Resolution Fund.

The ECOFIN was made aware of the ECB's calculation that in the big financial crisis only one bank's losses came close to 8%, and the average loss of all banks from 2008 to 2010 was slightly below 3% (ECB, n.d.). Similar information came from the Nordic countries after their own banking crisis in the early 1990s, in which average losses stayed well below 4%. Curiously, for this reason, in the decisive ECOFIN meeting, the Nordic countries managed to obtain an alternative quantification of the minimum bail-in threshold of 20% of risk-weighted assets (RWA) instead of 8% of the balance sheet. At that time, however, the ratio of RWA to total assets in the Nordic countries was only slightly above 20%, which meant that their use of the 20% threshold was equivalent to a level of around 4% of the total balance sheet instead of the 8% for other countries which had an average risk density of 45%.

Mention of the Nordic example evokes the successful use of public interventions in distressed banks to ensure financial stability in cases of a systemic crisis. In their 1990s banking crisis, public intervention in banks and their subsequent sale mitigated financial losses, whereas penalisation of

shareholders and top management avoided moral hazard, making the case a paradigmatic example. There are other historically successful public interventions, but they should not become the regular method for dealing with bank distress due to the negative cumulative spread of moral hazard it would generate.

The BRRD does not entirely exclude public interventions. Articles 56 to 58 admit in the resolution phase the use of government stabilisation tools conditioned to significant financial stability concerns as a measure of last resort when all other tools have been exhausted, including an 8% bail-in, or to address a general systemic crisis. This is contemplated in Article 37(10), which states: "In the extraordinary situation of a systemic crisis, the resolution authority may seek funding from alternative financing sources through government stabilisation tools provided for in Articles 56 to 58."

However, the official interpretation of these articles is that the SRB cannot use them for resolutions at the European level; they are just national-level options. Perhaps this is because Articles 56 to 58 start by saying "Member States may …". For instance, Article 56(1) states: "Member States may provide extraordinary public financial support through additional financial stabilisation tools in accordance with paragraph 3 of this Article, Article 37(10) and with Union State aid framework, for the purpose of participating in the resolution of an institution."

According to the official interpretation, these tools can only be used in national resolutions, meaning on smaller banks that are not under the SRB's remit. However, this ignores the possibility that the SRB, as a resolution authority, could discuss with national governments the use of public intervention tools to resolve significant banks or systemic crises. The extraordinary consequence of this is that in the case of a "systemic crisis," as foreseen in Article 37 and for resolutions of significant banks that the SRB decides to conduct, government stabilisation tools cannot be used. If the official interpretation I describe is juridically correct, then the legislation should be changed.

Before the resolution stage, Article 32(4.d) admits three types of precautionary government interventions, from guarantees to capital injections, subject to strict conditions. The bank must be solvent; the intervention must be temporary; it must not be used to offset incurred or expected losses; and finally, the amount involved must be limited by shortfalls identified in stress tests. Unfortunately, the new CMDI proposal adds that the bank's solvency condition must be ensured not only at the moment of the intervention but also in the following 12 months without any additional support, making the availability of the tool even more difficult.

The instances in which the BRRD admits the use of public money in Articles 32, 37 and 56 are practically nullified. This should not come as a surprise because there are many texts, both official and ancillary ones, in which the overriding aim of resolutions, above continuity of service or financial stability, appears to be just to avoid using public money. This approach seems to consider that the public good of financial stability should never deserve a cent of public funds, in contrast with accepting all the aims underlying many other government expenditures. As one of the objectives of resolving banks, we should take minimisation of using public money seriously, but this differs from overall prohibition of it.

Last year, the Commission made a legislative proposal on crisis management and deposit insurance (CMDI). It was an ingenious and positive attempt by the Commission to expand the possibility of applying the framework to resolutions of less significant banks (LSI) accompanied by market-exiting transfer strategies and the help of the Single Resolution Fund, which would be achieved by changing the regime of super-preference for covered deposits and national DGS claims.

In the present regime, non-covered deposits are separated from covered deposits in the loss-absorbing hierarchy, thus enlarging the amount of liabilities that can be bailed in before reaching the super-protected covered deposits. Some types of uncovered deposits are also conflated with certain kinds of other securitised liabilities. In this situation, the super-preference for covered deposits, and crucially, for corresponding national DGS claims, means that the test of least cost to which the

use of DGS resources is subject always leads to preferring a payout of covered deposits. This conclusion excludes the possible use of DGS funds, either for preventive measures or to help with a bank resolution. This results from the fact that the super-preference for covered deposits and DGS claims maximises the mass of 'bail-inable' claims, thus reducing the risk of DGS payouts being fully necessary.

Therefore, the preferred option in the Commission's CMDI package is to abolish super protection of covered deposits and DGS claims and include them with all the other types of deposits – the single-tier depositor preference. Therefore, the DGS least cost test would, in this case, allow the use of DGS funds to help the resolution by providing money that can be counted to reach the 8% bail-in threshold and consequently permit the use of the SRF to help the transfer strategy at stake. Overcoming the least cost test results from the fact that, if everything goes well, the DGS funds used to help the resolution with transfer tools reduce the possibility of full payouts compared to the insolvency case in which they would be necessary.

Naturally, the loss of the super-preference for DGSs causes concerns, which were already reflected in the negotiating position approved by the European Parliament plenary on the 24th of April, which contains many amendments, including one favouring a two-tier deposit preference. The Commission's impact assessment clarifies that a two-tier regime drastically reduces the usefulness of the package. In a sample of 368 banks, in the case of the single-tier deposit preference, 31 banks, or 8.4% of the 368, could benefit from DGS funds sufficiently to reach 8% of their TLOF. In the case of the two-tier preference, only 13 banks or 3.5% could obtain the same outcome. Under the present regime, only two banks in the whole sample would benefit (European Commission, 2023). A word of warning: the 368 sample is less than 10% of the total and is chosen not randomly but according to data availability, which means we cannot generalise these percentages because we can surmise that the sample is not fully representative of the structure of bank sizes.

Finally, the choice to use resolution or liquidation under national laws naturally rests in the hands of national resolution authorities, and it is uncertain what they will prefer, smoother liquidation under national laws or the riskier revised CMDI European resolution, which also means banks exiting the market. Therefore, my preferred institutional framework would consist of the following points: 1) transformation of the SRB into a European Federal Insurance Corporation (FDIC) managing the SFR and EDIS, as I proposed in 2011 (Constâncio, 2011); 2) admitting the impossibility of changing the 8% minimum bail-in while introducing a second-tier resolution regime for LSIs, with a lower minimum bail-in percentage of TLOF and consequently a lower MREL; 3) creating an administrative bank liquidation procedure, inspired by the US, which could be harmonised for use at the national level or centralised at the SRB; 4) revising the BRRD to make possible effective use at the European level of BRRD Articles 32(4.d), 37(10), 56, 57 and 58, concerned with precautionary and public resolution interventions.

III

Regarding the third pillar of the Banking Union, European deposit insurance, a feature that was never fully assumed at the Council or summit levels and whose discussion was suspended a while ago, I previously mentioned the advantage of its existence for financial stability and the currency union. I also mentioned the initial rejection of the concept by some central European countries, particularly Germany. The reasons were again related to non-acceptance of any transfer system, even if it only involves private funds. Perhaps even more importantly, there was the political difficulty of extensive institutional protection schemes (IPSs), which are a cheap type of deposit insurance for German saving and cooperative banks. I recall that in 2017, Chancellor Merkel assured her Party

Congress that the IPSs would never be changed. A way of granting the IPSs in the EDIS project an exemption or exceptional treatment was never really discussed, given their weight in the overall German banking sector. This has been a significant obstacle to completion of the Banking Union.

The work we did at the ECB, which involved quantitative simulations of different scenarios in which the EDIS is used to pay out actual deposits lost in banking crises, should have dispelled concerns about the EDIS provoking significant transfers among countries. The ECB published an occasional paper reporting these simulations just before my departure in 2018 (Carmassi et al., 2018). The scenarios were based on the following assumptions:

1. First, a fully-funded deposit insurance fund with ex-ante contributions of 0.8% of the covered deposits would be sufficient to cover payouts even in the case of hypothetical losses much higher than those experienced during the 2007/9 crisis.

2. The contributions to the EDIS fund would increase progressively according to the degree of riskiness of each bank determined by the SSM.

3. Two banking crisis scenarios were considered: either the riskiest 3% or 10% of euro area banks would fail simultaneously and only MREL-eligible liabilities would be bailed in up to 8% of TLOF.

4. Losses in resolution would equal 5%, 10% and 15% of total assets, assumptions that would be higher than historical losses in Europe and the United States.

The simulations showed that the EDIS fund would not have to be used in crises with these assumptions. Only with losses above 20% of total assets would the EDIS fund be necessary, and in this case the fund would not be depleted. Another crucial result was that there would not be significant amounts of cross-subsidisation among countries and none systematic, in the sense that no national banking system would systematically contribute less than it would get from the deposit insurance fund. This result would also hold when considering country-specific shocks.

In its initial 2015 EDIS proposal, the Commission had the idea of obtaining the approval of central European countries by including norms to reduce banks' holdings of domestic sovereign bonds, thus mitigating one of the feedback loops between sovereigns and banks. This particular feedback involves the effects of weak sovereign debt on sizeable bank portfolios of these bonds and the losses they would undergo if public debt required restructuring with haircuts. When in the Deauville bilateral Summit in 2010, Germany and France agreed on the need for a Greek debt default – which after lengthy discussions was approved in early 2012 – one of the considerable difficulties was the impact that the default would have on Greek banks. In fact, in successive adjustment programmes for Greece a significant part had to be dedicated to supporting the banks. The expectations and fear that other countries would probably have to follow the Greek example explain the high priority given to the RTSE in the December 2012 Council roadmap for the Banking Union, which underlined that "It is imperative to break the vicious circle between banks and sovereigns."

The debates on reforming the regulatory treatment of sovereign exposures were heated, gave rise to many working groups, reports and papers, and involved several institutions, culminating in the BIS. The 2015 Five Presidents' Report on 'Completing Europe's Economic and Monetary Union' correctly stated that a change in the regulation "should only be considered as part of a coordinated effort at the global level." After another report by a working group, there was no agreement in the Basel Committee on changing the privileged treatment of zero-risk weights for sovereign bonds or any other restrictive method. The big countries did not have a problem, and the smaller ones, usually with shallow bond markets, were afraid they would not find sufficient foreign buyers to buy domestic bonds.

It is worth noting that the literature provides some good explanations of an empirically well-documented degree of home bias. The reasons are related to information advantages, hedging

against real exchange moves or redenomination risk, the cost of foreign asset trading and behaviour biases (Coeurdacier & Rey, 2013). On the other hand, if we consider the issue from the perspective of the overall risk of European bank portfolios, the conclusion of analytical papers by the ECB and the ERSB is that “a diversification requirement such as the ones proposed can actually increase the risk of the resultant portfolios while having little effect on the tail-risk or contagion risk” (Giuzio, Craig & Paterlini, 2019, p. 4). Another paper shows that only a European safe bond, another shelved project, would allow portfolio diversification that would reduce the risk in the portfolios of all banks (Alogoskoufis & Langfield, 2019). The whole RTSE subject, which seemed so serious and urgent in 2011/2012 but only materialised in the case of Greece, lost traction with the subsequent development of the overall euro area economic and banking situation.

The other type of feedback, from collapsing banks to sovereign bonds, which was the Irish case, was less prominent in the discussion and was expected to be dealt with in the future through European supervision and resolution helped by the direct European recapitalisation tool, which was then reaffirmed but soon forgotten. The future did not confirm the more gloomy expectations of the time: neither was ESM recapitalisation of banks necessary, nor did more cases of debt default occur, nor did programmes dedicated exclusively to helping banks had to be repeated.

Recently, on 18 April, the Committee on Economic and Monetary Affairs (ECON) of the European Parliament proposed as a draft parliament legislative resolution its own 2016 Report on EDIS, trying to resuscitate the issue. This is very positive, but my description of the whole background should be enough to show how difficult it will be to reach a serious agreement on the third pillar of the Banking Union.

IV

A relevant shortcoming of the present situation of the Banking Union project is the failure to achieve what I initially designated as the implicit fourth objective of the whole endeavour. I am referring to a real and full integration of banking activities in the entire European space. This would involve an absence of obstacles to cross-border offerings of all banking services, which has more or less already been achieved, and the full possibility of pan-European banking groups using centralised management of liquidity, capital, and collateral. Naturally, a straightforward implementation of cross-border mergers and acquisitions would be included, an activity that peaked in 2007 and has waned ever since. The expectation was that the fully integrated banking space would lead to cross-border bank consolidation, which would eliminate excess capacity in the regions where it exists. This change of banking structure in the Euro Area would increase efficiency and reduce intermediation costs if we discount or exclude the possible collusion practices in oligopolies.

This vision has not materialised for two reasons. The first is that smaller countries fear that in times of crises and possible resolutions cross-border banks would leave their markets, which would hamper the provision of vital banking services. Therefore, these countries prefer to exert their legal options and discretion to ring-fence liquidity, capital and collateral in their local markets. Normally, they also use persuasive ways to pressure pan-European banks to use subsidiaries and not branches.

The second reason is that even if all these impediments were removed, the conditions surrounding banking activity have not been attractive enough for cross-border mergers and acquisitions since the big financial crisis, and the recent rebound may not be sustainable. There is a long list of facts contributing to these adverse conditions: a) profitability has been low during much of the period; b) regulation has been strictly tightened, as was necessary; c) the unsolved ‘boundary problem’ allowed less regulated financial institutions to competitively enter the payments and credit markets; d) the ‘open banking’ regulatory movement (Payment Services Directive 1 and 2) to facilitate access

by fintech firms to elements in the databases of banks, the core of their franchise; and finally e) the growing size of big American banks that have taken the European market for investment banking. All these and other developments have kept banks under siege with low profitability and less attractive activity than before the financial crisis. We should not extrapolate the high ROEs in 2023, which will already decline this year, and which will presumably continue to be below the cost of capital because equity markets systematically consider only earnings not adjusted to risk as the metric for their valuations of bank shares and demand unattainable returns.

To address the issue of incentives for cross-border consolidation, in a very recent report to the European Parliament, Ignazio Angeloni (2024) proposed the creation of a separate jurisdiction for sizeable banks already with a European cross-border presence or the conditions to develop it. For these banks, new legislation would be passed to "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" (Angeloni, 2024, p. 8). The new conditions would hopefully incentivise more banks to become agents of cross-border consolidation in Europe. The recent Basel decision to exclude cross-border activity within the EU from the criteria defining the GSIBs surcharge will also help. To reassure smaller countries, the proposal, among other things, would make Group Financial Support Agreements (GFSAs) mandatory and enforceable in the BRRD and would impose that banks in this category would only be obliged to apply a European resolution conducted by the SRB with a single point of entry. It is uncertain whether these proposals alone would spur a new wave of M&A in the EU. Nevertheless, I support them and hope that the two reassurance measures will be enough to get the approval of the countries that fear being left behind in a crisis without an appropriate banking sector.

V

Despite all the misgivings and shortcomings, the partial Banking Union we now have is a significant achievement in the long European integration journey. The only improvement now being considered is the positive but limited CMDI package in the pipeline, provided it survives the final stages of approval without being watered down. Naturally, it is understandable that the EU now faces different priorities that may divert attention from banking union reform. The challenges of defence, climate change, energy security, industrial and technological policies, and the capital markets union deserve to be the main focuses. However, to achieve all these aims, very sizeable public and private additional expenditures would be required, which in the present European political environment will be hard to finance. The hope of using the European budget to take on the bulk of additional funding now seems an illusion (except perhaps for defence) and the recent agreement on the Stability Pact will lead to a quite restrictive fiscal policy in member states in the next five years. Europe is at a critical crossroads in a delicate political moment. Uncertainty remains as to whether it can steadily progress to ambitious objectives or will continue to lag behind in meeting its vital needs.

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